National Audit Office

REPORT BY THE
COMPTROLLER AND
AUDITOR GENERAL

HC 290
SESSION 2010–2011

21 JULY 2010

Ministry of Defence

Strategic Financial Management of the Defence Budget

Our vision is to help the nation spend wisely.

We apply the unique perspective of public audit to help Parliament and government drive lasting improvement in public services.

The National Audit Office scrutinises public spending on behalf of Parliament. The Comptroller and Auditor General, Amyas Morse, is an Officer of the House of Commons. He is the head of the National Audit Office which employs some 900 staff. He and the National Audit Office are totally independent of Government. He certifies the accounts of all Government departments and a wide range of other public sector bodies; and he has statutory authority to report to Parliament on the economy, efficiency and effectiveness with which departments and other bodies have used their resources. Our work leads to savings and other efficiency gains worth many millions of pounds: £890 million in 2009-10.

National Audit Office

Ministry of Defence

Strategic Financial Management of the Defence Budget

Ordered by the House of Commons
to be printed on 19 July 2010

Report by the Comptroller and Auditor General
HC 290 Session 2010–2011
21 July 2010

London: The Stationery Office
£14.75

This report has been prepared under Section 6 of the National Audit Act 1983 for presentation to the House of Commons in accordance with Section 9 of the Act.

Amyas Morse
Comptroller and
Auditor General

National Audit Office

16 July 2010

The Ministry of Defence is one of the largest spending departments, responsible for over £42 billion of expenditure. Defence needs effective financial management to direct and control its resources to deliver its aims and objectives within its budget.

Printed in the UK for the Stationery Office Limited
on behalf of the Controller of Her Majesty's Stationery Office
2378665 07/10 STG

Contents

The National Audit Office study team consisted of:

Ross Campbell, Toby Fenwick, Chris Lambert, Andrew Makin, Mary Scott and Cat York.

This report can be found on the National Audit Office website at www.nao.org.uk/MOD-financial-management-2010

For further information about the National Audit Office please contact:

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

Tel: 020 7798 7400

Email: enquiries@nao.gsi.gov.uk

Website: www.nao.org.uk

Twitter:@NAOorguk

Summary

Scope of the NAO examination

1 The Ministry of Defence (the Department) is one of the largest spending departments, responsible for over £42 billion of expenditure. Defence needs effective financial management to direct and control its resources to deliver its aims and objectives within its budget. While the size of the future deficit is highly sensitive to the budget growth assumptions, in December 2009 we reported a shortfall between the estimated budget and the cost of the forward defence spending programme that ranges from £6 billion to £36 billion over the next ten years.

2 In May 2010, the Government announced a Strategic Defence and Security Review to be completed by the end of the year. Central to this review is the issue of reducing the shortfall and restoring balance to future defence spending. Of equal importance is ensuring that the Department is able to maintain this balance in the future and prevent a recurrence of the present situation. This report will consider whether the Department's approach to financial management will be sufficient to achieve this objective.

3 The Defence environment is complex and presents the Department with a range of challenges to its financial management from both external and internal factors. The main emphasis of this report will be to focus on internal factors which are more amenable to management by the Department. If the Department manages its finances well, it should be better positioned to respond to external challenges.

4 The Department's Resource Accounts 2008-09 were qualified on several bases, which included errors in military specialist pay and allowances, the income recovered from military personnel for certain accommodation and food, and the existence and valuation of some stock and fixed assets. Our work in 2009-10 indicates the Department has made improvements, but that some of the issues remain. This report presents the findings and recommendations from our examination of the Department's strategic financial management of the defence budget in three parts:

- Part One: the role of the Department and its impact on financial management;
- Part Two: defence spending and cost drivers; and
- Part Three: the strategic planning processes.

Key findings

The Department faces a number of challenges due to the nature of the defence environment

5 **The Department has been operating above the level of activity for which it is routinely resourced and will have additional funding for Iraq and Afghanistan withdrawn when these operations end.** The last exercise wholly to reset the policy baseline for defence was the 1998 Strategic Defence Review. This exercise was updated in 2002 and 2004. Since 1998 the Department has responded to tensions that have arisen between the spending plans set by these assumptions, the changing priorities and the available funding, by continuously reprioritising planned expenditure. When current operations end, if the Department wishes to retain any of the additional equipment acquired for operations, it will have to fund the costs of repair and support from within its core budget.

6 **The growth in the input costs of defence has been more than general inflation.** Inflation in defence costs is estimated by the Department to have averaged 3.8 per cent over the last four years[1], which is 1.2 percentage points higher than the GDP deflator[2], HM Treasury's measure of general inflation in the domestic economy and between 0.4 – 1.1 percentage points higher than a range of general inflation indices.

7 **The Defence plans require a longer horizon than Government spending plans and are relatively inflexible.** Long timescales are required to develop and field modern military capabilities with defence plans extending up to 20 years when compared against typical spending reviews at two to three year intervals. Decisions taken at any given point in time create long term commitments and liabilities, with up to 75 per cent of the budget committed in the next financial year to long term capabilities and people, reducing gradually thereafter.

8 **There are a number of other influences in the Defence environment which have affected the Department's plans over time.** The last full Strategic Defence Review was in 1998 and some of the issues we refer to in this report have built up over the following years. The Department considers that, in the absence of a Defence Review, although its financial planning rounds had identified shortfalls between forecast expenditure and budgeted provision, some of the measures that could have reduced costs, but would have had an adverse impact on longer term Defence capability, could not be agreed within Government. The Department's ability to react has also been constrained by industrial policy and commitments arising from international alliances.

The Department could use financial management more effectively to address those factors that are within its control

9 The outcome of the Department's annual planning rounds contributed to significant in-year budgetary pressure. By the end of July 2009, the budget for the Department was exceeded by its forecast for the rest of that year by £700 million (around two per cent of the total defence budget). At the end of the 2010 planning round, the Department forecast a shortfall of £185 million between planned expenditure and budget for 2010-11. When the operational budget holders reassessed the assumptions underlying the plan, they forecast the deficit as more than £500 million.

10 Although the Department uses the planning round to set strategic priorities, it has not routinely prioritised individual elements of its spending programme. As a consequence, it does not have a straightforward basis to determine which areas of expenditure should receive priority when budgets are insufficient to fund all previously planned activities.

11 The Department would find it easier to prioritise and find efficiencies if it had better visibility of its costs. Each year the Department carries out work to analyse its overall cost base. It has an understanding of the component parts, such as fuel costs and salaries, although it needs to develop this further, particularly for cross-cutting activities, outputs, and the total cost of capabilities.

12 The Department could place greater focus on the extent to which its assets are used efficiently. To date, the Department's financial plans have been based only on the control total funding regime set by HM Treasury which does not place a focus on the size of asset holdings, for example stock levels. Consequently, there may be scope to realise savings from efficiencies in relation to asset holdings.

13 The Department has some of the financial management capabilities it needs but could use them more effectively. The Department now has a professionally qualified Finance Director, who is a member of the Defence Board. However, the Director General for Strategy leads on strategic aspects of financial planning, while the Director General for Finance provides advice on the financial coherence of the emerging plans, risk and contingency. We understand that the Department's rationale for this arrangement included workload, particularly during a Strategic Defence and Security Review, but we take the view, in line with HM Treasury guidance, that this is undesirable as it reduces the authority of the Finance Director.

Over-committed plans have significant consequences

14 At the end of the last two spending rounds, the Department's over-committed plans have led to budgetary pressure in the new financial year. This has led to additional savings being necessary. During 2009-10 the Department had to find additional savings of £800 million in year to bring its planned expenditure back into line with its budgets. Finding further savings mid-year is a time-consuming and de-stabilising exercise. Many areas have to revisit or adjust their plans leading to delays, material changes to project specifications, and costly renegotiation of contracts with industry.

15 Delaying projects leads to significant increases in costs. In December 2009 two-thirds of the gross cost increases reported in the Major Projects Report reflected deliberate decisions to slip projects, in particular the new aircraft carriers. The decisions were taken corporately by the Department as part of a wider package designed to address a gap between estimated funding and the cost of the Defence budget over the next ten years.[3]

The Department has started to take action to improve financial planning

16 The Strategy for Defence published in October 2009 helped to set out key priorities by identifying success in Afghanistan as the main effort. In support of this aim, additional funding equivalent to approximately one per cent of the annual defence budget has been found from within the existing defence budget for each of the next three years. To make these additional funds available, in addition to finding efficiencies, the Department chose to delay some spending on new capabilities, to close bases early, and to accept some short-term restrictions on its ability to conduct contingent operations.

17 The Department is introducing new governance arrangements, planning tools and systems to improve strategic financial management. In November 2009 it introduced a new sub-committee of the Board looking at the overall planned expenditure on the equipment plan and the relative priorities between the programmes and projects. Other initiatives include work to improve forecasting, to introduce a new strategic planning tool, to hold an external audit of the affordability of the defence equipment plan, and to improve performance monitoring. These initiatives, if implemented rigorously, should assist the Department in having a more realistic set of financial data on which to make better informed decisions.

Conclusion on value for money

18 There have been improvements in financial management in the Department; however we consider that it still does not place financial management at the heart of its decision making. While the Department operates in a constrained and complex environment and there are factors which are not of its own making that have led to its plans being over-committed, in our view the Department has given insufficient weight to sound financial management practices in setting its budgets and priorities. The Department's finance function does not have as central a role in strategic planning as it should, and financial management does not have a high enough priority to counter the tendency to make over-commitments in its strategic planning.

19 The Strategic Defence and Security Review will provide an opportunity for the Department to rebalance its future spending plans in the short term. Over the longer term, however, the challenge for the Department will be to ensure that these plans remain in balance. Perpetuating the cycle of over-committed plans, short term cuts and re-profiling of expenditure, would mean the continuation of poor value for money for the taxpayer on the projects affected and a reduction in the funds available to support front line activities.

20 Value for money will be improved in the long term principally by making future plans deliverable and through strong governance of the planning process. The Department can show it is determined to achieve this outcome by making maintenance of a balanced forward programme a primary objective of its plans. The most effective tool at its disposal to do this is its finance function, which should be supported by active sponsorship from the Defence Board. The Department has work under way that should make financial planning more effective, but it also needs to demonstrate that it has the will to use the tools it already possesses.

Recommendations

21 The National Audit Office makes the following recommendations:

a **The Department should use the Strategic Defence and Security Review to rebalance its programme and take action to keep it in balance for the future. The Department should:**

- underpin the Strategic Defence and Security Review with an explicit financial strategy;
- set out the relative priorities of expenditure;
- regularly review performance against financial plans; and
- reprioritise funds to keep the programme in balance without using delays and de-scoping projects as the default approach to reducing expenditure.

b **The financial strategy should be reflected in financial plans prepared by the Department. The Department should make sure that the plans:**

- articulate and review spending priorities annually;
- revisit at least annually the assumptions that underpin the financial plans;
- contain adequate financial provision for risk and to counter optimism bias; and
- consider changes to the assets held and not just the HM Treasury control regime.

c **The Department should use the financial capability it has to best effect and enhance its capability further. The Department should:**

- use professionally skilled finance staff to develop the long term financial strategy and associated risk management strategy;
- drive out the culture of optimism bias that fails to recognise the full cost of projects; and
- enhance visibility and understanding of the cost of delivering outputs and cross-cutting activities.

Part One

Role of the Department and the impact on strategic financial management

1.1 The Ministry of Defence comprises a department of state, a military headquarters, and the armed forces. In 2009-10 it spent over £42 billion and was one of the largest areas of UK government spending. It employed over 76,000 civilian staff and 195,000 in the armed forces. There are a further 90,000 reserve staff. Within the first part of this report we will examine:

- the role and aim of the Department;
- how the Department determines the resources it needs; and
- how the Department is funded.

Role and aim

1.2 The Department has the aim:

- **To deliver security for the people of the United Kingdom and the Overseas Territories by defending them, including against terrorism; and to act as a force for good by strengthening international peace and stability.**[4]

1.3 The Department has three strategic objectives:[5]

- achieve success in the military tasks that it undertakes at home and abroad;
- be ready to respond to the tasks that might arise; and
- build for the future.

1.4 The Department presents a complex financial management challenge, with personnel and assets deployed in a considerable number of locations across the globe. It has responsibility for a range of different bodies, including agencies, Trading Funds, museums, and a large and varied estate. It also controls a huge range of different types of assets, including land, equipment and buildings valued at approximately £89.7 billion, and stocks valued at approximately £7.2 billion.

1.5 The Department's Resource Accounts 2008-09 were qualified on several bases which included errors in military specialist pay and allowances, the income recovered from military personnel for certain accommodation and food, and the existence and valuation of some stock and fixed assets. Our work in 2009-10 indicates the Department has made improvements, but that some of the issues remain.

1.6 The Department is responsible both for Defence strategy that comprises the definition of the military capability and other objectives to meet the Government's overall policy aims within planned resources; and for providing the military capability to deliver policy on defence and support wider policy. It provides essential support to the Government's foreign policy and security objectives, and also contributes forces to NATO as required by Treaty. In addition, it provides support to other public bodies, for example helping the emergency services within the UK when there is severe flooding.

1.7 The Department's decisions can also have an effect on the wider economy of the UK. Around 300,000 jobs in the UK are supported by defence expenditure or exports.[6] In many cases, the Department opens up the procurement process to build and supply equipment and other assets to international competition as a way of increasing the value for money obtained in the procurement. An example is the Military Afloat Reach and Support project to replace the existing Royal Fleet Auxiliary flotilla. There are, however, some items of equipment where it is Government policy to place contracts on a single-source basis to either support retention of industrial capability to manufacture equipment in the UK, or for security reasons, or where due to the nature of the technology there may be only one manufacturer able to produce the equipment. The most recent Defence Industrial Strategy[7] was published by the then Government in December 2005.

Determining the size of defence capability

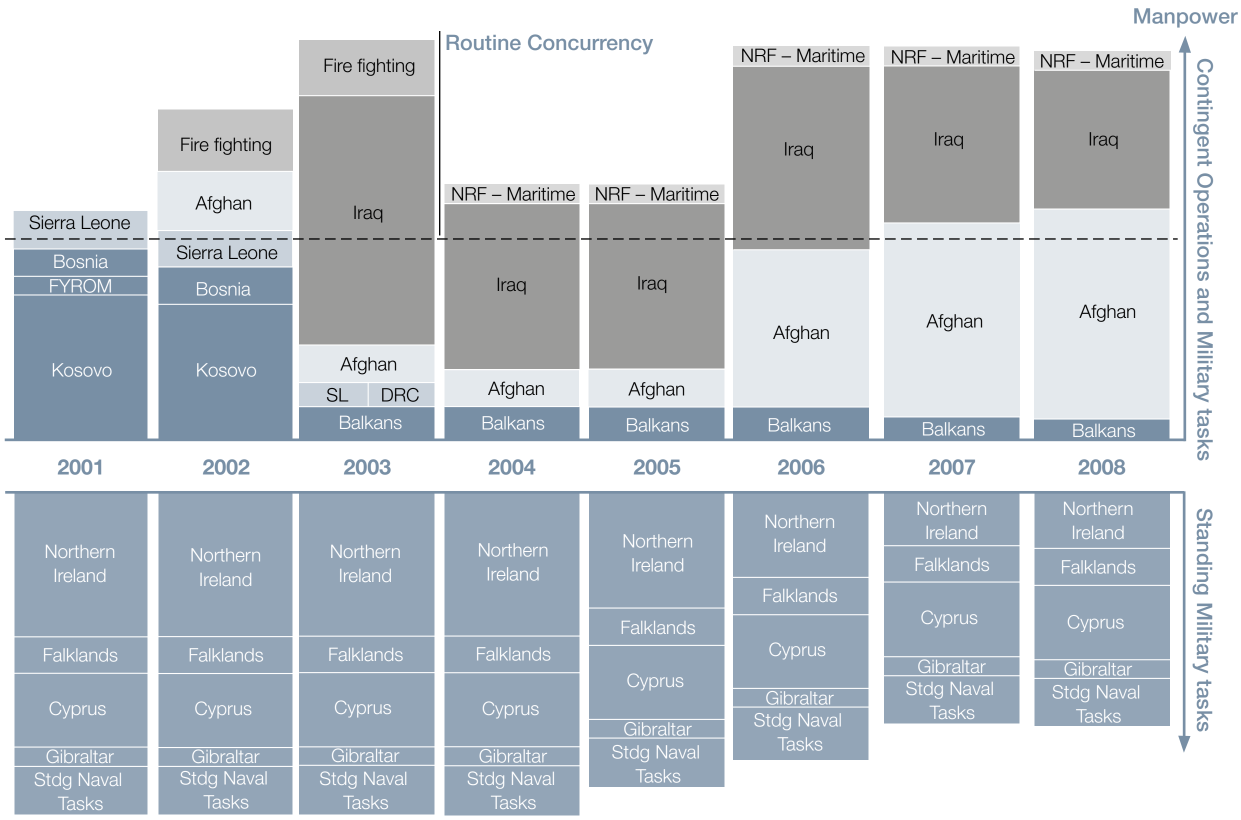
1.8 To deliver against its objectives, the Department needs appropriately sized and trained armed forces, together with the necessary equipment and concepts for its effective employment to generate military capabilities. The Department carries out periodic reviews of the strategy for defence and determines the capability requirements and the structure of the armed forces needed to deliver across a range of military tasks. The overall size of forces and numbers of equipment are set by the scale, concurrency, and readiness levels in the defence planning assumptions. In 1998 the Strategic Defence Review[8] set out the number and type of simultaneous military tasks the armed forces would be funded to achieve. The review planned a reduction, in real terms, of £500 million for 1999-2000, rising to £700 million by 2001-02.

1.9 In 2002 the then Government published "The Strategic Defence Review: A New Chapter"[9] after it looked again at its concepts, forces and capabilities to meet the threat of international terrorism following the terrorist attacks of 11 September 2001. In 2004 "Delivering security in a changing world: future capabilities"[10] set out the conclusions of a further review to adapt to the threats presented by international terrorism, and the lessons learnt from recent operations. Neither of these reviews was a full review of defence strategy. In May 2010, the Government announced a Strategic Defence and Security Review to deliver by the end of the year.

1.10 Since 1990 the Department and armed forces have been involved in an increasing level of military operations, which have generally been of a higher level of intensity and concurrency than those experienced in the previous decade. **Figure 1** demonstrates that since 2001 the armed forces have consistently been operating above their routine concurrency assumptions (the level for which Defence is resourced and structured to routinely sustain). Over the course of 2003 to 2009 an average of 8,000 military personnel were deployed to Iraq and an average of approximately 8,900 military personnel since 2008 have been deployed in Afghanistan.

Figure 1

Armed Forces Level of Operational Commitments against Defence Planning Assumptions since 2001



NOTES

FYROM: Former Yugoslav Republic of Macedonia

DRC: Democratic Republic of Congo

SL: Sierra Leone

NRF: NATO Reaction Force

The dotted line across the chart indicates the level of routine concurrency (the level for which the Ministry of Defence is resourced and structured to routinely sustain) assumed.

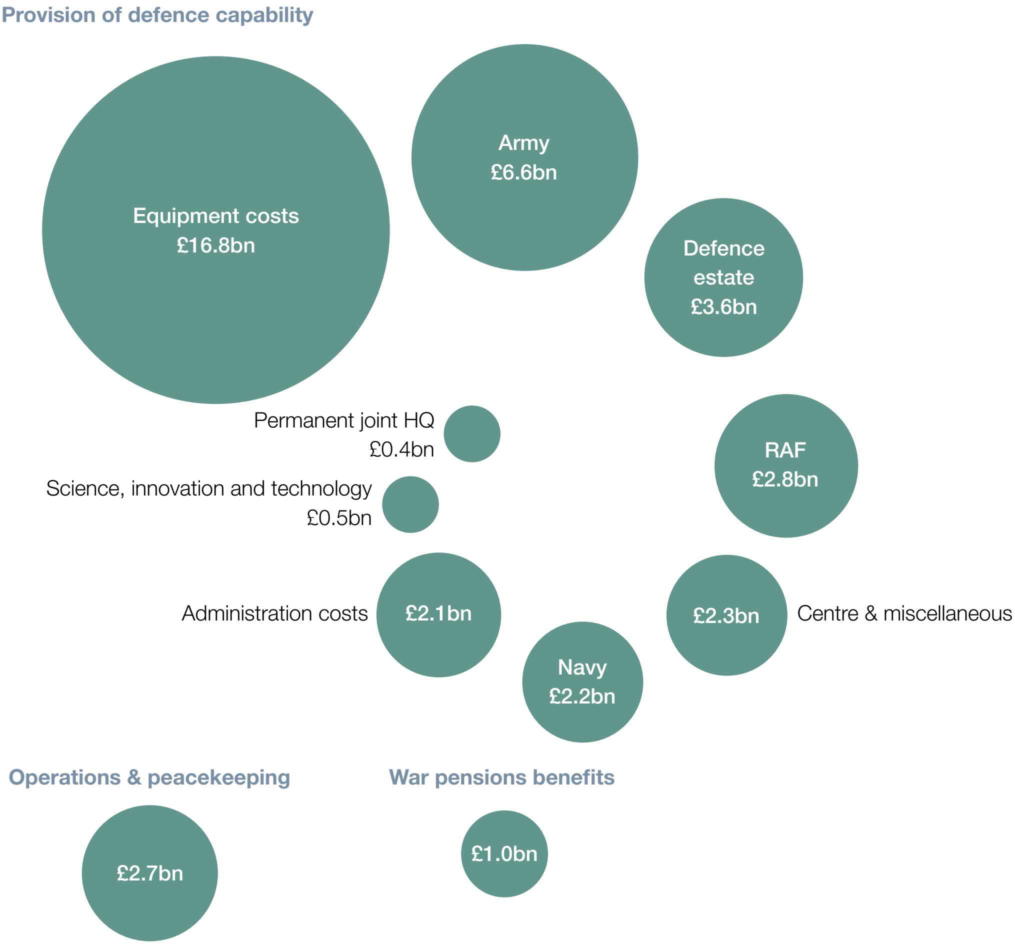
Source: Ministry of Defence Annual Report and Accounts, 2008-09. The Department has not been able to provide the data for 2009.

Funding defence

1.11 In 2009-10 the Department spent over £42 billion and managed its activities through eight operational budget holders (**Figure 2**).

1.12 The Department is predominately funded by the Government though the Parliamentary Supply Estimates. The Department receives funds for the provision of defence capability sufficient to maintain forces at peacetime activity levels and for war pensions and allowances. In addition, it also accounts separately for the additional cost of operations which are funded from the HM Treasury Reserve. These costs include the cost of modifying existing equipment or procuring new equipment to meet specific operational needs, known as Urgent Operational Requirements.

Figure 2
Spending by area on activity and administration



NOTE
1 The size of the circle is proportionate to the amount of spend by each area. Equipment costs include purchasing, upgrading and maintaining defence equipment. The Science Innovation and Technology Budget closed and its responsibilities moved to the Defence Science and Technology Laboratory at the beginning of April 2010. The figures are shown net of income (£1.4 billion). Administration is not a separate budget holder but is managed by the Central and Miscellaneous budget holder.

Source: National Audit Office analysis of unaudited departmental expenditure data 2009-10

Part Two

Defence spending and cost drivers

2.1 In this part of the report we examine past defence spending; the forecast spending commitments; the impact of operations on future spending; the level of flexibility in the defence budget; the cost drivers of defence; and the impact of inflation.

Past Defence spending

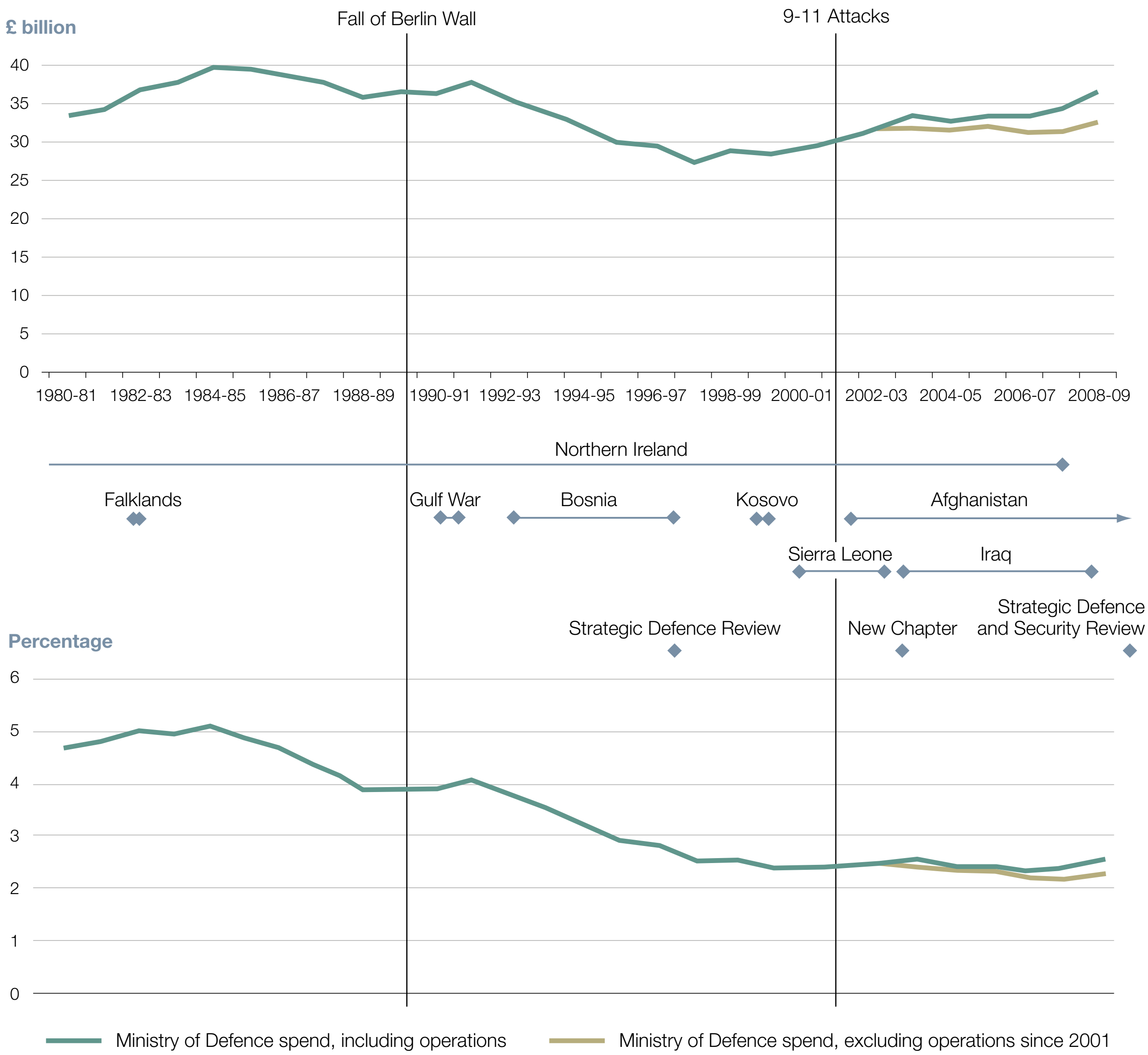
2.2 Defence spending as a proportion of GDP reduced gradually after the end of the cold war down to approximately two-thirds of its 1984-85 levels by 1997-98. At the time of the fall of the Berlin Wall, defence spending, including the additional cost of operations, was £36.4 billion (3.9 per cent of GDP) per annum. **Figure 3** overleaf illustrates that both real terms spending and spending as a proportion of GDP, both including the additional cost of operations, fell overall to £27.3 billion (2.5 per cent of GDP) until 1997-98. At this time, spending as a proportion of GDP stabilised and, in real terms, it began to rise.

2.3 The attacks of 11 September four years later and subsequent medium scale operations in both Iraq and Afghanistan did not result in an immediate change to this trend. It is only in the last couple of years that spending began increasing as a consequence of greater use of HM Treasury Reserve funding for the additional costs of operations.

Current Defence plans are likely to exceed the Defence budget

2.4 The Department faces a number of significant challenges in the strategic management of its budget. The most significant among these is the extent to which the forward programme of forecast Defence spending is likely to exceed the Defence Budget. **Figure 4** on page 15 illustrates that the size of the future deficit is highly sensitive to the budget growth assumptions used. The Major Projects Report 2009[11] stated a range between £6 billion (assuming a 2.7 per cent increase per annum over ten years) and £36 billion (assuming a flat cash scenario over the same period).

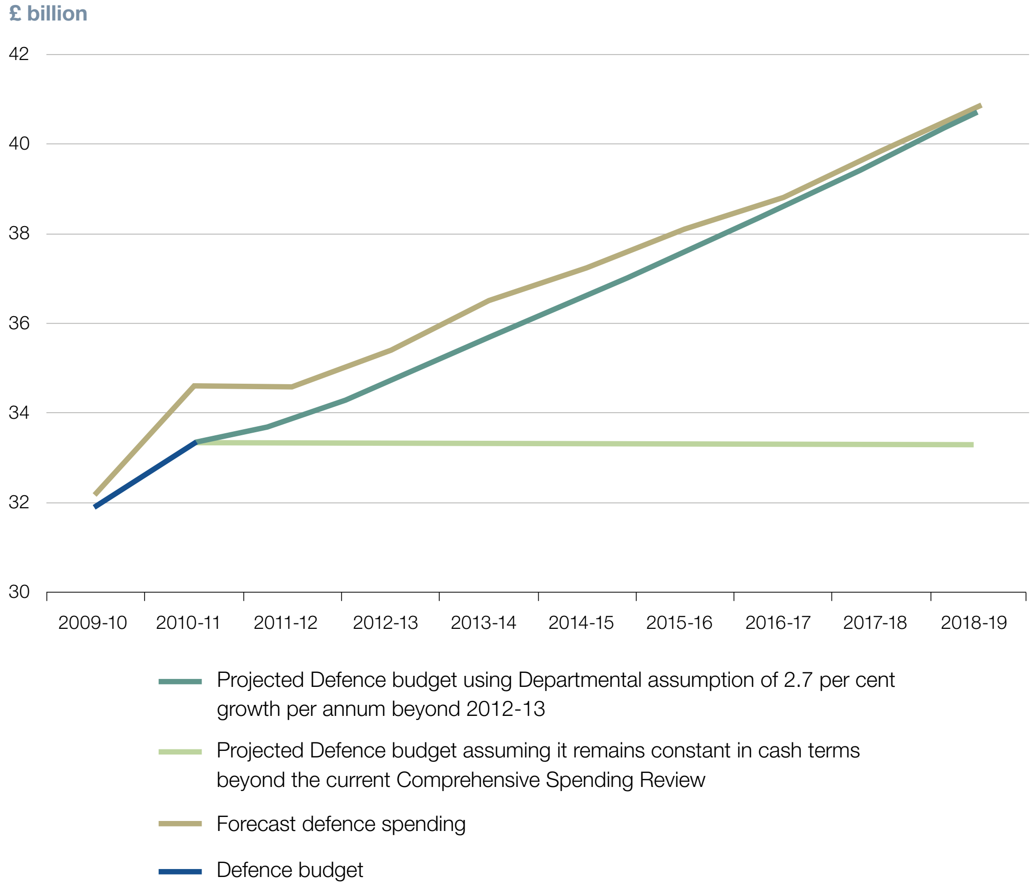
Figure 3
Defence spend in real terms and as a proportion of GDP



NOTES
1 Spending figures for the additional costs of operations include funding from HM Treasury Reserve.
2 Defence Spending in real terms is shown in 2008-09 prices.

Source: National Audit Office analysis of data from Defence Analytical Services and Advice and HM Treasury GDP data, http://www.hm-treasury.gov.uk/d/gdp_deflators.xls

Figure 4
Defence plans are unaffordable



NOTE
1 Data refers to the core Defence budget and does not include the additional costs of operations.

Source: National Audit Office analysis of Departmental data

2.5 The new coalition government has recently outlined its programme for government, including an intention to make a 25 per cent reduction in the running costs of Defence. The extent that this intention is realised will affect these projections. However, addressing the excess of plans over budgets is the most important financial issue facing the Department at the present time.

Keeping equipment purchased from the reserve for operations may affect future spending plans

2.6 Additional costs of operations are paid for from the HM Treasury Reserve. If the Department chooses to retain any Urgent Operational Requirements (equipment procurement and modifications for operations paid for from HM Treasury Reserve) after the withdrawal from operations, then it must pay for support and maintenance through its future funding. The Department spent over £1 billion on Urgent Operation Requirements in 2008-09.

2.7 There is therefore a risk that the over-commitment will worsen in the short term as the withdrawal from Iraq and, in the future, Afghanistan takes place. Funding already committed elsewhere is then needed to pay to support Urgent Operational Requirements retained for future use. This constraint may be partially offset by a reduced need to procure new equipment, the requirements for which are already being fulfilled by those Urgent Operational Requirements retained for future use. The Department is unable to quantify this at present.

The defence budget is relatively inflexible

2.8 The Defence Budget has a relatively high level of commitment. Over the next few years, 75 per cent of spend is already committed, either to personnel costs or through procurement contracts which are the main cost-drivers. To procure modern military equipment, train personnel and generate effective military capabilities requires long lead times. In practice, this means the Department must plan expenditure and enter into significant financial commitments for many years in advance of being able to field a military capability. When a capability is created, further financial commitments are needed to ensure it is maintained and kept up to date.

2.9 In recent years, the Department has also entered into many long term contracts for equipment, principally as a means of securing value for money, but also in some cases as a means of supporting the retention of essential industrial capabilities. The consequence is that a significant amount of procurement and support expenditure is committed for years in advance. An example of the need for such long term contracts is the Merlin Mk 3 helicopter. The initial procurement contract was signed in 1995 and Initial Operating Capability was achieved eight years later in April 2003. To support the aircraft throughout its expected service life, a 25-year support contract was then agreed in 2006.

2.10 A significant proportion of the Department's budget is also represented by the cost of personnel, both military and civilian. In practice, personnel costs often offer little scope for financial flexibility in the short to medium term. The armed forces have been operating at a level above their routine concurrency assumptions, which may militate against significant reductions. In the case of both military and civilian personnel, employment terms and conditions require periods for consultation and to explore redeployment of staff. Furthermore, in the event of redundancies on any scale there would be a significant upfront cost.

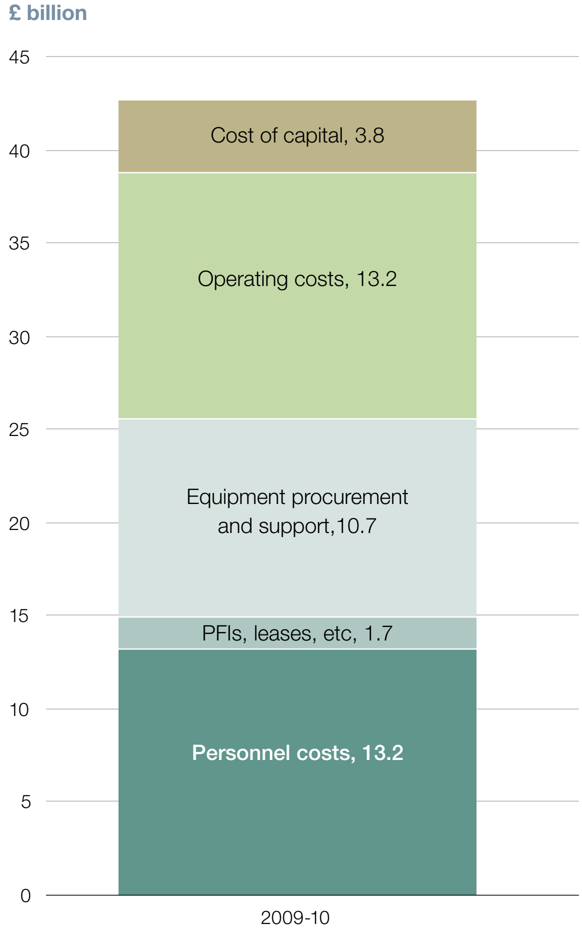
2.11 There are other costs, including fuel prices and foreign exchange, over which the Department has no effective control. As a consequence it can only mitigate fluctuations in the cost of these items by maintaining a sufficient reserve or through hedging. While the latter are managed through purchases of forward contracts, during periods of sustained changes any adverse movements must be absorbed within the Defence budget.

2.12 A breakdown of the Department's expenditure is provided in **Figure 5**. Our analysis of the Department's expenditure data indicates that the Department has a £13.2 billion annual personnel cost, combined with a further known £1.7 billion of PFI and lease commitments per annum. There is also an additional £23 billion of contractual capital commitments spread over the next ten years or more. With approximately 75 per cent of budget allocated in advance, the ability of the Defence budget to respond to unexpected events in the short term is limited.

Cost drivers are understood at a high level, but spending is not routinely linked to outputs

2.13 As indicated below, the two key cost drivers in defence are personnel and equipment (including procurement and support). IT and communications, logistics, stock, property management, research and development, and PFI commitments are also significant spending areas. The Department has a fair understanding of costs within each major component of its budget, however, it does not routinely analyse the cost of cross-cutting activities across all of the elements required to generate military capabilities. Consequently, even at a high level the Department is not able to make informed, evidence based choices between them. The Department is undertaking a project looking at the costs of defence to assess how to develop its understanding of these costs.

Figure 5
Analysis of Defence expenditure



NOTE

1 Cost of capital is a notional charge imposed as part of the HM Treasury control regime to reflect the cost of holding assets.

Source: National Audit Office analysis of unaudited departmental expenditure data 2009-10

Inflation and cost growth increase pressure on budgets

2.14 The Department has also faced considerable pressure on its budgets due to growth in many of the costs of its inputs in excess of inflation in the general economy. Between 2005-06 and 2008-09 the Department's own estimate of defence inflation has been an average of 3.8 per cent;[12] this is 1.2 percentage points higher than the GDP deflator[13] over the same period, and between 0.4 – 1.1 percentage points higher than other, wider measures of inflation.[14]

2.15 Unlike the other measures of inflation outlined above, the Department's measure of defence inflation only takes account of inputs and does not reflect that the same inputs one year produce slightly more outputs the next. Such productivity improvements would be expected to decrease the rate of defence inflation. The measure of defence inflation also excludes factors that remain within the Department's control such as the cost of moving to more capable equipment, and the risks associated with using cutting-edge technology.

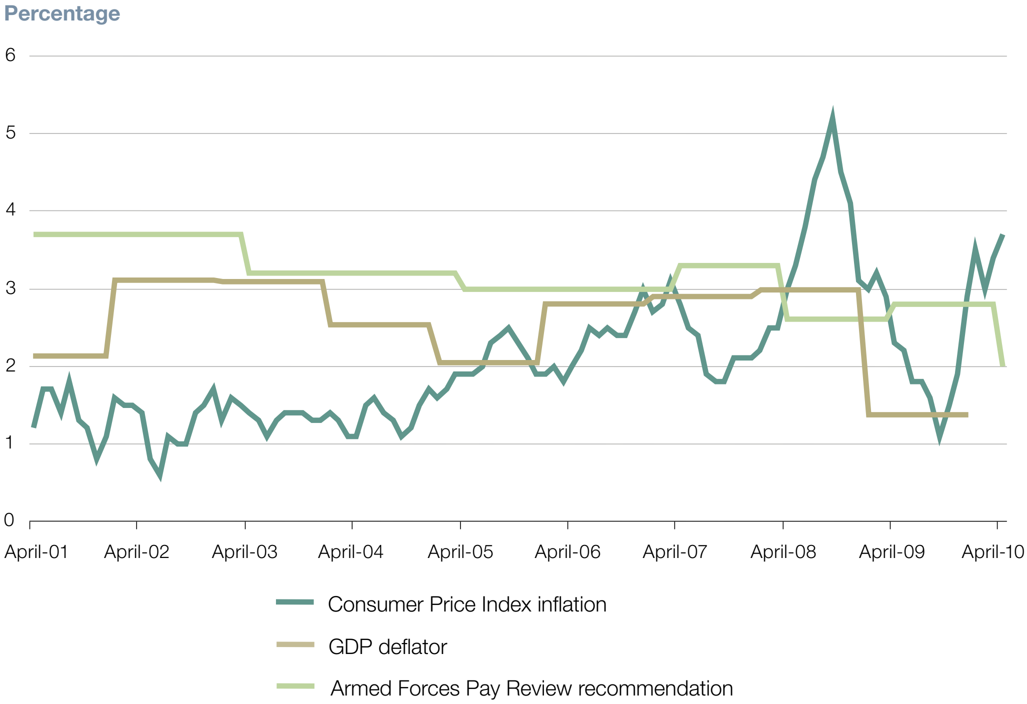
2.16 The Government has consistently accepted the recommendations of the independent Armed Forces Pay Review Body to award service personnel real terms pay rises. **Figure 6** shows that the pay of the armed forces has moved ahead of inflation for much of the past ten years, which has placed further pressure on the Defence budget.

2.17 Whether or not the concept of inflation specific to defence is accepted, it is a fact that the Department has experienced growth in its costs above the level of inflation in the general economy or the level assumed in public expenditure plans. Some of this inflation, such as the cost of underlying materials, has not been within the Department's control. It has, however, had some control over decisions made in other areas, including matters such as pay and the specification of equipment. The Department has not routinely made sufficient provision in its financial plans to accommodate the levels of cost growth it has experienced in practice.

The consequences of cost growth are significant

2.18 The combined impact of the above factors results in a continual round of cost-cutting and re-planning as plans are found to be undeliverable in practice. Where a high level of uncertainty about plans is usual, greater use should be made of forecasting methodologies that take account of past experiences, flexible contracts, making conservative adjustments for optimism bias and setting aside a reserve of unallocated funding to be able to respond to changes.

Figure 6
Armed forces pay and inflation



Source: National Audit Office analysis of Armed Forces Pay Review reports and National Statistics data

2.19 In practice, the high degree of forward commitment and allocation of funds means that very little funding is left unallocated – with the following consequences:

- Defence outputs are often affected by the need to make cost savings. For example, in 2009 when the Department chose to allocate £300 million per annum for three years to support operations in Afghanistan, there was no contingency funding for this. Instead, the Department chose to delay new capabilities and to close bases early in order to release the necessary resources.

- Contracts with industry need to be renegotiated in order to reduce costs in the short term. This is often done at the expense of value for money. The NAO Major Projects Report 2009 highlighted the Department's decision to delay the introduction into service of the Queen Elizabeth Class aircraft carriers by up to two years. This saved the Department £450 million over the first four years, but subsequently added £1,124 million (a net increase of £674 million). A similar decision was made to delay the Astute Class submarines by an average of nine months. This saved the Department £139 million in the short term, but subsequently added £539 million (a net increase of £400 million).

Part Three

Strategic planning

3.1 The overarching strategic plans of an organisation should link the financial strategy to the business strategy, and reflect the organisation's key strategic priorities. Within the longer term financial strategy should be integrated investment and expenditure plans. There should also be an assessment of the financial risk within the plans and the cashflow required.[15] For a strategy to be credible, it needs to be affordable given the organisation's projected income. If this is not the case, then it would need to include plans to increase income or reduce the cost base so as to become affordable.

3.2 The Department has several strategies and plans that it needs to co-ordinate at any one time:

- a long term assessment of the strategy for defence that is derived from the National Security Strategy;
- the Government expenditure plans for funding defence spending;
- the Department's own forward plans which are medium term strategies looking at operating costs and capital investment strategies; and
- the annually approved planning round budgets for the year ahead that are published in the Defence Plan.

The Strategic Defence and Security Review provides an opportunity to create a sustainable, balanced budget

3.3 The Department carries out periodic reviews of the strategy for defence and sets out the assessment of trends and potential future threats. It assesses the capability required to address those potential threats and the different types of engagement that the armed forces may be required to undertake simultaneously. It then assesses the type of equipment and the structure of the armed forces needed to deliver those capabilities. The cost of the defence spending to produce capabilities is then projected forward using assumptions about the level of inflation.

3.4 The ability of the Department to spend on future capabilities to meet its objectives is constrained by the Government's plans to spend on defence compared with other priorities. If the cost of providing the planned capability is more than the planned funding then the Department needs to deliver its outputs more efficiently or make savings. The 1998 Defence Review and the successive reviews of capability in 2002[16] and 2004[17] did not set out the relative priorities of the different capabilities. Consequently, there is not a clear policy-based assessment of relative priorities against which cost reductions can be made. Although the Department uses the planning round to set strategic priorities, it has not routinely prioritised individual elements of its spending programme. What happens in practice is that individual items of planned expenditure are assessed to determine what can be reduced or deferred with the least risk to the delivery of military tasks that year. This approach has resulted in incremental cuts in funding across the whole programme rather than a priority-led approach.

3.5 In February 2010 the then Government announced its intention for a Strategic Defence Review in the summer[18] and the Defence Strategy for Acquisition Reform[19]. The Acquisition Reform Strategy contained proposals to improve the planning processes including:

- legislating to ensure that reviews of defence strategy are conducted in every parliament and that the plans are kept under close scrutiny between reviews to ensure they fully reflect emerging operational needs;
- publishing an assessment to Parliament each year of the costs and affordability of the equipment and support programmes against a ten-year planning horizon agreed with HM Treasury. The NAO will independently audit the process used to produce the assessment;
- strengthening top-level oversight of the equipment and support programme by an equipment sub-committee of the Defence Board which looks at the strategic direction and affordability of the programme. The committee met for the first time in November 2009;
- introducing contingency allowances to deal with cost growth in projects where it would not be sensible to cancel or de-scope the projects; and
- establishing a strategic partner relationship with the private sector to improve cost estimation and forecasting.

3.6 There has not been an explicit financial strategy underlying the past reviews of defence strategy to set out the overall principles to keep the programme in balance with potential funding. Consequently the Department has not been able to refer back to those principles and use them as a mechanism to challenge changes to the programme or rising costs. The Department is considering whether a financial strategy should be part of the Strategic Defence and Security Review in 2010, which the Department has told us that it intends to create a legacy of affordability. We consider that creating the strategy will be an essential first step to keeping the Department's planned expenditure in line with its funding.

3.7 In May 2010, the Government announced a Strategic Defence and Security Review to deliver by the end of the year. It would involve working with other departments including the Foreign Office, the Department for International Development and the Home Office as part of the new National Security Council. One aim is to ensure that Britain's defence is based on a clear definition of the strategic interests; the role in NATO and other partnerships; the threats faced; the military capabilities needed; and the programmes to deliver those capabilities.

3.8 As the Department has already acknowledged, until major decisions on the size and shape of Defence in the UK are taken in the Strategic Defence and Security Review, there is little scope to reduce the size of the Defence budget to make it affordable or create headroom.

3.9 The new Strategic Defence and Security Review is an opportunity to review the types of threat the UK is likely to face in the coming years. It also provides the chance to determine which activities and programmes will need to be reduced to achieve a sustainable and balanced budget. Bernard Gray's Review of Acquisition[20] in defence recognised that there are potentially infinite demands competing with each other for a share of finite resources. It will therefore be important that the Government sets clear priorities for expenditure in future defence policy to provide a basis to make defence plans affordable.

Government spending plans have been shorter term than Defence planning horizons

3.10 Since 1998 HM Treasury has led a cycle of spending reviews at two or three year intervals which produce expenditure plans across government. The reviews set out the expenditure for the three years ahead. Usually, year three is then re-examined as the first year of the next spending review. The spending reviews fix the level of funding that the Department can expect to receive over that period. The Department projects likely spending review settlements beyond the expenditure plan period on the basis of past experience and GDP growth expectations.

3.11 The Department has separate plans for:

- The operational budget holder's short term plans, which cover operating costs including spending on personnel, fuel utilities, and support for equipment already in service. The plans looked ahead for four years, and in the future the Department intends the plans to look 10 years ahead.
- The Equipment Programme, which looks at the plans for the acquisition and development of military equipment in detail for 10 years ahead (and for some projects unto 20 years ahead) to ensure that plans to purchase and support equipment are coherent and affordable. The Department does not, however, build an overall contingency allowance into the Equipment Programme so that when individual projects increase in cost, the programme as a whole becomes unaffordable.

- The Equipment Support Plan, which covers the support for the military equipment beyond the operational budget holders' four year plans for up to 10 years ahead.
- The Defence Non-Equipment Investment Plan typically covers estates and IT investments. In 2007 the Department started to plan for ten years ahead rather than four years so as to make the plans consistent with those for equipment and equipment support.

3.12 The separate plans together form an assessment of the future spending profile for the Department. Taken together the Department can extrapolate spending forward for ten years. However, as funding is uncertain beyond at most three years ahead, the Department faces the risk that the assumptions and commitments it makes as a basis for procurement activity are not matched by funding.

The way the Department presents incremental changes affecting the whole plan is complex

3.13 In years between spending reviews the plan is managed on the basis of changes to the baseline. In January 2010 the paper to the Board on the proposed Defence Plan for 2010-11 onwards set out all the potential adjustments and the implications on expenditure for the next ten years.

3.14 The size and extent of detail about the changes examined in each review imposes a significant burden on senior decision-makers who have to absorb the implications of the proposals. It is difficult to form a clear and holistic understanding of how the overall position has changed rather than just the consequences for individual programmes. As an example of the size and level of detail that the Departmental Board has to absorb, the 26-page summary in the January 2010 paper was supported by 158 pages of annexes of proposed changes.

The planning process is long but the treatment of financial risk is starting to improve

3.15 Since 2007 the Department has carried out an annual planning round that culminates in a published Defence Plan, which sets out the short and medium term objectives for the four years ahead. The planning round also sets targets and budgets for business units.

3.16 The way in which the Department conducts the planning processes now takes so long that it occupies finance staff for most of the year. They must also plan the successive year at the same time as trying to balance the books for the current year. The planning round for 2010-11 started at the end of March 2009, with a discussion of the planned approach by the Departmental Board, and only concluded in March 2010 when the plan was approved by the Board.

3.17 The Department has started to introduce more formal financial risk management processes into the strategic planning. The planning round in 2009-10 considered in more detail the level of risk associated with funding, prices for foreign exchange and fuel, and over programming. The changes are a significant step forward to improving the Department's management of financial risk. Further understanding of the financial risk in the planning processes, will help the Department better manage and mitigate risks.

Over-committed annual plans have led to significant cuts

3.18 In the previous two planning rounds the Department has made over-committed assumptions about the year ahead. By the end of July 2009, the forecasts made by operational budget holders of their own spending for the year were already £700 million (about two per cent) in excess of the budget set for the year at the end of the planning round. In autumn 2009 the Department had to examine options for reductions and saved approximately £800 million against the planned budget for 2009-10. The planning round for 2010-11 ended with a forecast deficit between planned expenditure and budget of £185 million and the expectation that further cuts would be necessary. When the operational budget holders reassessed the assumptions underlying the plan, they forecast the deficit as more than £500 million.

3.19 The planning round seeks to balance the planned expenditure with the funding both for the year ahead and for future years. In December 2009, Ministers announced that £900 million over the next three years would be reprioritised from the Department's core funding to support the operation in Afghanistan. This required the Department to make changes elsewhere to match the available funding. Ministers announced measures[21] including a reduction in the size of the Harrier fast jet force by one squadron, the closure of RAF Cottesmore, the consolidation of the Harrier force at RAF Wittering, a reduction in Army training not required for current operations, taking one survey ship and one minehunter out of service early, cancelling the current procurement competition for unprotected utility vehicles, and spending less than previously planned on the wider defence estate. In February 2010, however, the financial plan for 2010-11 onwards, recommended by the Board to Ministers, had insufficient funds projected to meet planned expenditure despite incorporating the changes to expenditure plans announced in December and the knock-on impacts of the savings made in autumn 2009.

3.20 The Department, against the background that this report has described, has reached the situation where it is constantly planning in a manner that makes insufficient allowance for the potential financial risks. Each year the finance function has to try to identify savings in year, whilst trying to plan the budgets for the following year. The impact of changes made to planned spending during the year must then be carried forward into the plans for the future years. This makes each year progressively harder.

3.21 To address some of these issues the Department plans to introduce new planning tools and systems. There are a range of initiatives under way which include work to improve forecasting, to introduce a new strategic planning tool, to hold an external audit of the affordability of the defence equipment plan, and to improve performance monitoring. The new strategic planning tool should enable the Department to begin modelling the costs of different combinations of defence outputs.

3.22 The Department has also formed a new steering committee for equipment comprising the Permanent Under Secretary, Second Permanent Under Secretary, Chief of the Defence Staff, Vice Chief of the Defence Staff, and Director General Finance. The intention of the Department is that this committee will examine plans for equipment procurement from a holistic perspective and be in a better position to make decisions about priorities.

Updating several plans at once will be a challenging exercise

3.23 During 2010-11 the Department expects to carry out:

- the Strategic Defence and Security Review;
- the Comprehensive Spending Review for 2011-12 to 2014-15; and
- the annual planning round for 2011-12.

3.24 The timetables for the reviews require the three separate planning processes to be linked so that they do not contain different assumptions. Maintaining these distinct sets of plans will pose a significant challenge for the finance staff in the operational units, who are also likely to be looking for cuts to in-year spending.

The Department does not consider measures of the efficient use of assets in its financial plans

3.25 All the financial plans will be produced using the HM Treasury Control Total regime which looks at planned spending. The regime requires departments to plan for current expenditure, split by costs and non-cash treatments, and capital investment. The Department does not produce plans on the basis of forecast operating cost statements nor balance sheets as it would do if it was in the private sector. Consequently, it does not recognise the full costs of the assets used within its future plans.

3.26 The Department holds significant levels of fixed assets that exist to enable the armed forces to deliver operational capability. Our report on the Department's estate management[22] concludes that while it has strengthened its estate planning structures and achieved significant disposal receipts, the changes made to date are not sufficient to rigorously drive value for money. The lack of clear rationalisation objectives, inadequate mechanisms and insufficient central data, means that the Department is not well placed to systematically align its estate to changing operational requirements in combination with structured cost reduction.

Responsibility for financial planning is split

3.27 Undertaking planning at a strategic level in the Department is a significant exercise, particularly when simultaneously carrying out a Strategic Defence and Security Review and the planning work required for a comprehensive spending review. The Department created the role of Director General for Strategy to bring together responsibility for high level defence planning and business strategy. The Director General for Strategy reports directly to the Permanent Secretary, but is not a member of the Board. The Director General for Finance, who is a member of the Departmental Board, provides advice on the financial coherence of the emerging plans, risk and contingency. We understand that the Department's rationale for this arrangement included workload, particularly during a Strategic Defence and Security Review, but we take the view, in line with HM Treasury guidance, that this is undesirable as it reduces the authority of the Finance Director.

3.28 The formal split of responsibilities was introduced prior to the Cabinet Office Capability Review[23] of the Department published in March 2009. The Capability Review referred to the challenge to balance the long-term programme with the likely available budget. It considered that the Department needed a departmental strategy that aligned priorities with resources and spanned all of its operational and non-operational activities for the medium to long term. The report acknowledged that the Department understood the need and considered that the creation of and appointment to the new Strategy Director General post would help. To meet its commitment to produce a departmental strategy, in October 2009, the Department published the Strategy for Defence[24] ahead of the strategic defence review, that was supported by a detailed technical instruction for defence staff. The Strategy will be revised to take account of the outcome of the Strategic Defence and Security Review.

3.29 The 2004 Spending Review required all departments to have professional Finance Directors reporting to the Permanent Secretary with a seat on the departmental board, at a level equivalent to other board members, by December 2006.[25] The Department now has a professionally qualified Finance Director who took up post in January 2009. Amongst the public sector finance profession, one of the core responsibilities of the Finance Director or Chief Financial Officer role is leading the development of the medium term financial strategy and the annual budgeting process to ensure financial balance and a monitoring process to ensure its delivery.[26] The role of the Finance Director and his responsibilities in government departments is set out as an essential minimum in Managing Public Money.[27] One of the roles is to co-ordinate the planning and budgeting processes. The guidance states that the Finance Director should exercise leadership for financial management including:

- maintaining a long term financial strategy to underpin the organisation's financial viability within the agreed framework; and
- developing and maintaining an effective resource allocation model to optimise outputs.

3.30 By introducing the arrangements described in paragraph 3.27, in our view, the Department is running the risk that the next planning round will not have a sufficiently well articulated financial strategy underpinning it.

Appendix One

Methodology

1 The National Audit Office developed its own toolkit for reviewing financial management from published methodologies, and this was used when undertaking the 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 HM Treasury and other commentators. The toolkit identified a series of key statements on good financial management under the five main criteria of financial governance and leadership; financial planning; financial decision making; financial monitoring and forecasting; and financial and operational reporting.

2 In making our assessment, guided by the toolkit, we used the following methods:

- semi-structured interviews with senior officials of the Department and senior military personnel;
- analysis of data published by HM Treasury on the Ministry of Defence's Estimates; its annual budgets and expenditure since 2004-05, and an analysis of high level indicators of the Ministry of Defence's management of financial performance; and
- an analysis of departmental reports; Board meeting papers and minutes; guidance and reviews by external bodies and individuals; and previous National Audit Office research.

More detail is provided below.

Semi-structured interviews

3 Interviews were conducted with several members of the senior management, both civilian and military, within the Ministry of Defence. The interviews included all of the executive and non-executive Defence Board members. An interview also took place with the head of the HM Treasury spending team. Similar themes were addressed in all interviews, with individual questions tailored to the role of the individual member. The interviews took place in April and May 2010.

Analysis of the HM Treasury data on Ministry of Defence budgets and outturn

4 We analysed data published by HM Treasury regarding the Ministry of Defence's Estimates; its budgets and expenditure. The main sources were Supply Estimates and Resource Accounts for the years 2004-05 to 2008-09 inclusive. We also drew on analyses of Defence Analytical Services and Advice which provides professional analytical, economic and statistical services and advice to the Department, and defence-related statistics to Parliament, other Government Departments and the public. The Defence Statistics are produced in accordance with the professional standards of the Office for National Statistics.

An analysis of Departmental papers

5 We examined a selection of Departmental papers, Board meeting papers and minutes, guidance and reviews by both internal parties and external bodies and individuals, and previous National Audit Office research relating to the Ministry of Defence to identify best practice, future plans, and strategies.

Endnotes

1 Defence Analytical Services and Advice, Defence Inflation Estimates 2005-06 to 2008-09, Ministry of Defence, March 2010.

2 http://www.hm-treasury.gov.uk/data_gdp_index.htm

3 The Major Projects Report 2009, NAO, HC 85-I session 2009-10, December 2009, paragraph 2.

4 How Defence works: Defence Framework, July 2009, page 4.

5 How Defence works: Defence Framework, July 2009, page 5.

6 Defence Analytical Services and Advice Estimate. Defence Statistics 2009, chapter 1 table 1.10.

7 Defence Industrial Strategy, Defence White Paper, Cm 6697, December 2005.

8 The Strategic Defence Review, Cm 3999, 1998.

9 The Strategic Defence Review: A New Chapter, Cm 5566, July 2002.

10 Delivering security in a changing world: future capabilities, Cm 6269, July 2004.

11 The Major Projects Report 2009, NAO, HC 85-I session 2009-10, December 2009.

12 Defence Analytical Services and Advice, Defence Inflation Estimates 2005-06 to 2008-09, Ministry of Defence, March 2010.

13 The GDP deflator is a measure of changes in the overall level of prices for the goods and services that make up GDP.

14 The estimate of defence inflation is 0.4 per cent higher than the Retail Price Index (the most familiar domestic measure of inflation in the UK, which includes housing related costs). It is 1.1 per cent higher than the Consumer Price Index (the main UK measure of inflation for macroeconomic purposes and forms the basis for the Government's inflation target, which excludes housing related costs).

15 World Class Financial Management: A discussion paper, Audit Commission, November 2005, Paragraph 11.

16 The Strategic Defence Review: A New Chapter, Cm 5566, July 2002.

17 Delivering Security in a Changing World – Future Capabilities, Cm 6269, July 2004.

18 Adaptability and Partnership: issues for the Strategic Defence Review, Cm 7794, February 2010.

19 The Defence Strategy for Acquisition Reform, Cm 7796, February 2010.

20 Bernard Gray, Review of Acquisition for the Secretary of State for Defence, Ministry of Defence, October 2009.

21 Hansard Debates, The future Defence programme, c801, 15 December 2009.

22 A Defence estate of the right size to meet operational needs NAO, HC 70, July 2010.

23 Civil Service Capability reviews, Ministry of Defence progress and next steps, March 2009, page 10.

24 http://www.mod.uk/NR/rdonlyres/32421DC3-CA13-49BC-88F4-2F77E973CB67/0/strategystatement.pdf

25 Spending Review 2004, HM Treasury, Cm 6237, July 2004, Paragraph 2.25.

26 The role of the Chief Financial Officer in public service organisations, CIPFA, June 2009, page 10.

27 http://www.hm-treasury.gov.uk/d/mpm_annex4.1.pdf

FSC
Mixed Sources
Product group from well-managed forests and other controlled sources
Cert no. TT-COC-002825
www.fsc.org

Design and Production by
NAO Communications
DP Ref: 009316-001

This report has been printed on Consort 155 and contains material sourced from responsibly managed and sustainable forests certified in accordance with FSC (Forest Stewardship Council).

The wood pulp is totally recyclable and acid-free. Our printers also have full ISO 14001 environmental accreditation which ensures that they have effective procedures in place to manage waste and practices that may affect the environment.

Published by TSO (The Stationery Office) and available from:

Online
www.tsoshop.co.uk

Mail, Telephone, Fax & Email
TSO
PO Box 29, Norwich, NR3 1GN
Telephone orders/General enquiries: 0870 600 5522
Order through the Parliamentary Hotline
Lo-Call 0845 7 023474
Fax orders: 0870 600 5533
Email: customer.services@tso.co.uk
Textphone: 0870 240 3701

The Parliamentary Bookshop
12 Bridge Street, Parliament Square,
London SW1A 2JX
Telephone orders/General enquiries 020 7219 3890
Fax orders: 020 7219 3866
Email: bookshop@parliament.uk
Internet: http//www.bookshop.parliament.uk

TSO@Blackwell and other Accredited Agents
Customers can also order publications from:

TSO Ireland
16 Arthur Street, Belfast BT1 4GD
028 9023 8451 Fax 028 9023 5401

£14.75

ISBN 978-0-10-296537-7

9 780102 965377