National Audit Office

REPORT BY THE
COMPTROLLER AND
AUDITOR GENERAL

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Foreign and Commonwealth Office

Spending reduction in the Foreign and Commonwealth Office

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Foreign and Commonwealth Office

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Amyas Morse
Comptroller and
Auditor General

National Audit Office

24 March 2011

In 2009-10, the Foreign and Commonwealth Office made cuts in planned spending to deal with an immediate problem. This report examines the Department's experience in making these cuts and draws out lessons for the Foreign and Commonwealth Office and other departments.

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Contents

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Summary

1 During the second half of 2009-10, the Foreign and Commonwealth Office (the Department) made cuts in planned spending of more than £60 million – around 4 per cent of its annual budget – in response to financial pressures caused mainly by a decline in the exchange rate between sterling and key overseas currencies. This report examines the Department's experience in making these reductions, and draws out lessons for the Department and other departments as they set about the cost reductions required by the 2010 Spending Review.

Introduction

2 Departments are under increasing pressure to reduce costs. The scale of cost reduction required means that they need to take a structured approach to cost reduction, in which they look beyond immediate short-term measures and think more radically about making efficiencies by taking cost out of the business and sustaining this in the longer term.

3 The Department's cuts in 2009-10 were made to deal with an immediate problem, but provide early experience of the challenges that the Department will face in making the 10 per cent real term cost reductions to core Departmental expenditure required by the 2010 Spending Review. This report therefore evaluates the Department's action in 2009-10 to assess what can be learnt from:

a The reasons why the Department needed to act.

b How the Department made short term spending reductions.

c How the Department managed the spending reduction exercise.

Key findings

The Department's action was part of a response to financial pressures arising mainly from exchange rate movements

4 The Department directly managed a budget of some £1.6 billion in 2009-10. During the first half of the financial year it identified financial pressures facing the Department which by August 2009 it estimated to be around £91 million, over 5 per cent of its £1.6 billion budget, made up of two elements:

- The Department estimated that there was a gap of some £72 million between its forecast expenditure and the funds it expected to be available, mainly as a result of a decline in the exchange rate between sterling and key overseas currencies.

- Posts[1] overseas faced pressures within their budgets equivalent to a budget cut of £18.8 million, as a result of the decline in exchange rates.

5 The Department took action to deal with the gap in three ways (**Figure 1** overleaf). In September 2009, it made cuts of £46 million in centrally managed budgets and it instructed most Posts to cut spending locally so that they could manage within their existing budgets – therefore making total cuts of more than £60 million. It also sought permission from the Treasury to transfer additional funds totalling £33 million from other categories of spend, such as capital expenditure and contingency budgets, to increase the funds available to cover the forecast spending. The value of the actions taken did not precisely match the value of the financial pressures, because both were subject to forecasting uncertainty and the Department needed to have some margin between funds available and the final spending total. In the event, the Department's action closed the gap between spending and funds available, and the Department ended the year within its budget by a margin of £3.8 million, 0.2 per cent of its budget.

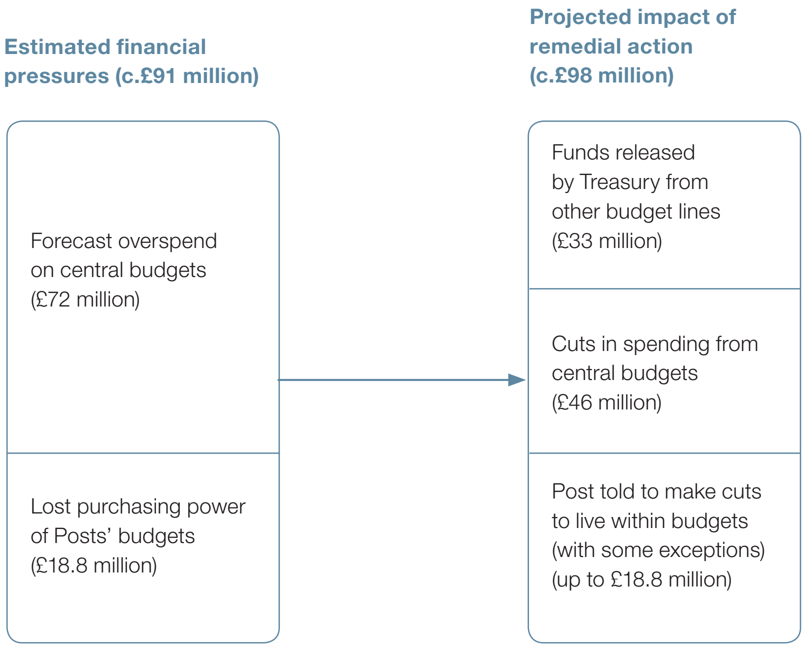
6 The gap had arisen mainly as a result of exchange rate movements. Before 2008 the Treasury largely protected the Department from such movements, but from April 2008, as part of the 2007 Comprehensive Spending Review, the Treasury removed this protection. This was shortly followed by a weakening in the value of sterling against other major currencies. In 2008 the Department began to forward purchase foreign currency to reduce its exchange rate risk, and this had helped the Department avoid serious pressures in 2008-09. However, forward purchasing had not eliminated all risk, and to some degree only deferred the impact of sterling weakening. Pressures were more severe therefore in 2009-10. The Treasury restored exchange rate protection in the 2010 Spending Review.

The Department's spending reductions were mainly short term measures

7 Cutting spending effectively requires departments to take a strategic overview to avoid an erosion of service quality in priority delivery areas. Departments should clearly prioritise what matters most, based on an accurate, realistic assessment of the costs, benefits and risks of the options. Implementation will be through a combination of tactical, strategic and sustainable measures, with the former generally practical within shorter timescales than the latter. An important consideration is to avoid damaging value for money through over-simplistic cuts.

1 Posts are the Department's presence overseas and consist of Embassies, High Commissions or Consular Offices. There are currently some 260 Posts.

Figure 1
How the Department planned to tackle the financial pressure



NOTE
1 These are the financial pressures estimated as of the end of August 2009. Both figures were subject to continued fluctuations, for example as exchange rates continued to change.

Source: National Audit Office

8 In the case of the Foreign and Commonwealth Office, the time available to make cuts was very limited and the Department's objective was to reduce in-year expenditure, rather than make long term efficiencies. The Department first identified a gap of around £70 million during the first half of 2009-10, but because it had a record of significantly underspending its budgets in previous years it first investigated the causes of the gap before taking action. However, by the end of August 2009 the forecast gap had grown to £72 million and the Department decided that urgent action was needed to close it.

9 The Department developed options for cuts during September 2009 and made decisions towards the end of that month. By this time the spending reductions needed to take effect very quickly, since the aim was to reduce total spending during the 2009-10 financial year.

10 The cuts were driven by a need to cut in-year spending and therefore almost all were tactical and short term in nature. Nonetheless, we found clear evidence of prioritisation and the Department seeking to protect its frontline activities. The Department did not classify all cuts according to the area of spend affected, but among the £47 million proposals for cuts in centrally managed spending, we estimated that approximately 37 per cent were from back office functions; around 38 per cent came in roughly equal proportions from subscriptions to international organisations, human resources, travel and hospitality, and the budget devolved to Posts for priority projects; and some 25 per cent related to front line activity. Forty six per cent of the £47 million were intended to be permanent reductions in spend but the Department did not set up a process to ensure that the spending that was cut was not resumed subsequently.

11 A majority of the spending reduction resulted from doing less – either slimming down budgets, or stopping activities altogether. We also estimated that about 10 per cent were from simple deferral – postponing activities such as non-essential maintenance to be done in a later year.

12 The Department was also making efficiencies in response to the 2007 Comprehensive Spending Review during this period. These were run as a centrally managed programme of projects that were measured, monitored and evaluated to ensure savings were sustainable and cash-releasing. The Department also took advantage of other long-standing initiatives to reduce the running costs of maintaining existing levels of activity. These initiatives included a programme with projects to restructure and re-engineer its corporate services activities (for example, finance and human resources) and to replace some UK-based staff at Posts overseas with locally employed staff. While neither of these programmes had been initiated in response to the Department's 2009-10 budgetary problems, both delivered savings in 2009-10, and the pace of the initiatives was increased to provide additional savings in the year.

13 Additional tactical spending reduction activities were initiated at Posts to deal with pressures on their budgets caused by foreign exchange rate movements. In our survey of a selection of Posts we found that the measures taken included:

- temporarily reducing travel and hospitality budgets;
- deferring non-essential health and safety expenditure;
- recruitment freezes;
- temporarily freezing training; and
- enforcing a week of unpaid leave for local staff and making 35 people redundant.

14 We also found some long-term efficiency savings, for example, Posts improving the use of their estates to reduce spending on rents. The Department monitors how Posts spend their budgets albeit at a regional level. It did not monitor centrally the detailed action taken by Posts to reduce expenditure in 2009-10.

The Department needs to extend financial management to measurement and evaluation

15 We assessed the Department's approach to spending reductions against a number of key principles for successful management. An important factor in the Department's approach was a programme it has been working on since 2007 to improve its financial management through better processes, IT systems, the collection of monthly management information and the financial skills of its staff. We found that while the Department had effectively utilised its improved management information in the strategy, planning and implementation phases of the exercise, it could have made more use of this information for measurement and evaluation.

Strategy, Planning and Implementation

16 As part of its programme to enhance financial management, management information improved over the period, providing good financial information upon which the Board could rely to give a reliable picture of the state of the finances in August 2009. When the Board recognised the extent of the problem, it acted quickly and demonstrated strong leadership in guiding the whole organisation to contribute to its objectives of living within its budget. The Department established three clear, albeit high level, principles to guide spending reduction which were endorsed by its Ministers. These were that spending related to staff safety was not to be reduced; Departmental Strategic Objective priorities should guide resource decisions; and closure of Posts should be avoided where possible. The Board agreed the cuts based on these principles.

17 The Department identified cuts within a month, and by the end of the financial year succeeded in closing the gap between forecast expenditure and the funds available. This was achieved with a positive culture across the organisation of acting corporately and offering up activities to cut, reduce or defer largely in line with the Department's three principles. The Department helped implement cuts by making all budget holders more accountable for their expenditure and reporting, and incentivising them to remain within their budgets, thus closing the gap down to targets levels. Implementation was assisted by the Department's programme to improve its financial management including the presence on the Board of a financially qualified Director General Finance, and challenge and support from its Non-Executive Directors.

Measurement, evaluation and feedback

18 The Department closely measured and monitored the gap between its forecast spend and budget each month between August 2009 and March 2010 in performance reports to the Board. Every business area reported to the Board the progress of spending reductions on their budgets and the central finance team assessed the realism of their projections. However, we would expect the Department to have validated that the cuts made in centrally managed spending were those which had been planned and agreed. We would also expect a level of central oversight of cuts made at Posts. These limitations prevented the Department from assessing whether its three principles had been upheld once the cuts were actually made, and knowing which spending reductions were most effective at cutting costs with least impact on the achievement of the Department's objectives.

19 Although the Department had assessed the risks of spending cuts, it did not have measures in place to assess the impact on the achievement of the Department's objectives at the time cuts were made. This is due in part to the inherent difficulty in measuring the Department's performance against its policy objectives and the speed with which the Department needed to act. However, as part of its standard end of year review process, the Department considered the impact of the cuts on achieving its plans, although the level of detail provided varied by area.

20 The Department did not conduct a formal evaluation of the spending reduction activities in 2009-10 and therefore missed a valuable opportunity to learn and feed back from this exercise. It did, however, in 2010-11, start to set Posts' budgets in the local currency thus providing them with budgetary certainty. In February 2010 the Department also started to develop contingency plans in case further cuts were required in 2010-11. In addition, all the staff we spoke to were clear on the lessons they had learnt from the experience. These include taking ownership of the spending reduction activity early on and ensuring management information for the Board is simple and effective.

Conclusion on value for money

21 The Department rose to the challenge of bringing expenditure down quickly to within its budget. Its achievements built on the effort it has put into improving its financial management over recent years, which helped it manage and direct spending reductions in line with corporate priorities; and on a culture which responded to the clear lead provided by the Board. It had sought to manage its exchange rate risk through forward purchases of foreign currency but the scale of movement in rates was even greater than it had foreseen. In the circumstances its action was value for money.

22 There are, however, important learning points for the Department. Limited measurement and evaluation means that the Department cannot be confident that all spending reductions were implemented as intended and that the cuts have had the minimum possible impact on the Department's business. To achieve value for money as it responds to the challenges set by the 2010 Spending Review, the Department now needs to put in place and deliver a plan for a fully strategic and sustainable approach to cost reduction, soundly based on a thorough understanding of its costs and the value added by its activities.

Recommendations

23 While these recommendations are focused on the Foreign and Commonwealth Office, they could apply equally to other departments who need to make cost reductions as part of the 2010 Spending Review.

a **The Department's actions in 2009 were an urgent response to a gap between expenditure and budget and did not demonstrate all the necessary features of a strategic and structured approach to cost reduction.** If the Department is to deal effectively with the Spending Review, it will need to embed further within the organisational culture, and sustain over a period of years, an emphasis on seeking efficiencies and continuous improvement so that to do so becomes regarded by managers as part of business as usual.

b **The Department could do more to verify spending cuts and develop measures that would enable it to assess the impact on its objectives.** It needs to extend its efforts on performance measurement to:

- Assess the realisation of savings and cost reduction measures. This will enable the Department to ensure that cost reduction measures stay within established principles, and assess whether some measures are more effective than others at generating savings while preserving public value.
- Monitor the impact of cost reduction measures to ensure that the Department is aware of both anticipated and unexpected consequences of cutting costs.

c **Individual Directorates tracked spending cuts at Post; but for this exercise there was no central point of oversight to shape, coordinate and ensure that actions taken by Posts were in-line with the Department's corporate policies and strategic direction.** The Department should have better central awareness of spending reduction activity at Posts to allow such oversight and spread good practice.

d **Currently there is strong financial representation on the Board but this has not always been the case.** The Department should ensure that the Board maintains this level of professional representation, and commitment to improving financial management, to ensure strong financial management remains a priority for staff throughout the Department.

Part One

The reasons why the Department needed to act

1.1 In 2009-10 the Department faced a gap of some £72 million between its forecast expenditure and budget. This gap was caused by several factors but primarily by a weakening in the value of sterling against other major foreign currencies. In addition, Posts[2] overseas faced pressures in their budget equivalent to a cut of £18.8 million. This was due to the reduced purchasing power of their budgets, caused by the weakened value of sterling and increases in local inflation.

1.2 This part examines:

- the scale of the pressures faced by the Department; and
- the contribution made by spending reductions to closing the gap.

The Department faced financial pressures totalling approximately £91 million

1.3 The majority of the £72 million gap between forecast expenditure and budget was related to the weakening in the value of sterling against major foreign currencies, which reduced the Department's purchasing power abroad and increased the sterling cost of commitments fixed in overseas currencies.[3] Other contributing factors included a reduction in the income expected from other government departments for using the Department's property and services overseas, and concerns that savings forecasted from procurement efficiencies would not in fact be cashable that year.

1.4 In addition to the £72 million, Posts faced pressures in their budgets equivalent to £18.8 million. This pressure was also caused by a weakening in the value of sterling, and increases in local inflation, which had reduced the purchasing power of the budgets of overseas Posts. As of the end of August 2009, the Department faced financial pressures totalling approximately £91 million, 5 per cent of its £1.6 billion[4] budget.

2 Posts are the Department's presence overseas and consist of Embassies, High Commissions or Consular Offices.
3 The £72 million takes into account anticipated gains and losses for the rest of the financial year.
4 Total net spending by the Department in 2009-10 was £2.3 billion but UK contributions to international peacekeeping operations are not counted within the budget the Department manages and bodies receiving grants from the Department (principally the British Council and the BBC World Service) are responsible for their own internal budgetary management.

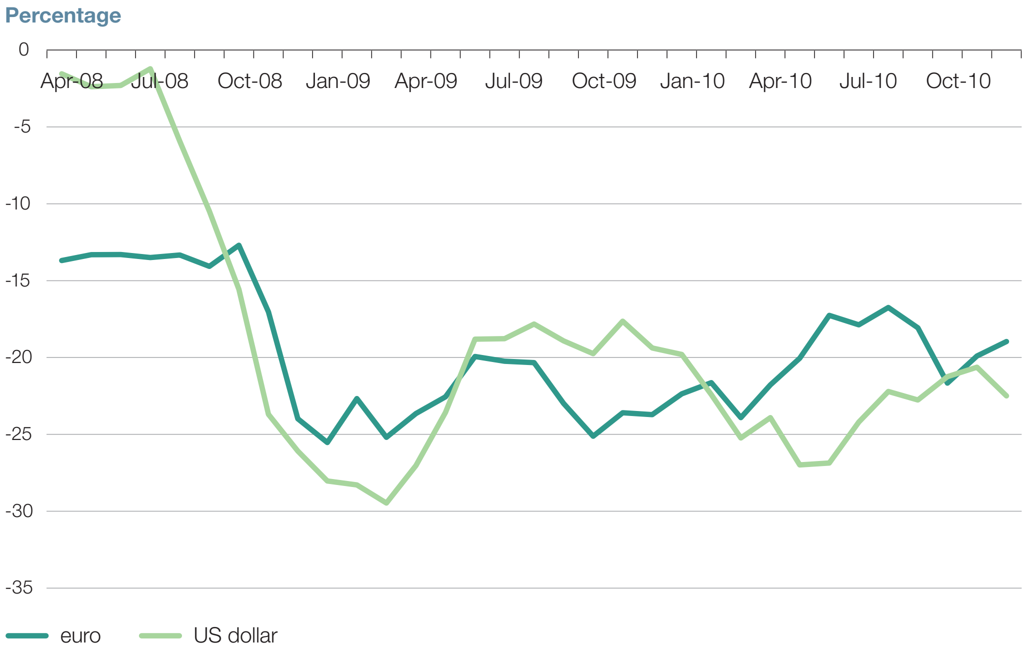
1.5 The Department is affected by currency movements because approximately half of its budget is spent in foreign currencies. The Department has a global network of some 260 overseas Posts. Posts' budgets are spent in the local currency and are affected by both local inflation and currency fluctuations, impacting on their in-year purchasing power. In addition, other elements of the Department's budget, including subscriptions for international organisations such as the United Nations, are also spent in foreign currency and often fixed in those currencies.

The Department in part dealt with exchange rate risk

1.6 Before 2008 the Treasury largely protected the Department from changes in local price and exchange rate movements, but from April 2008, as part of the 2007 Comprehensive Spending Review, the Treasury removed this protection[5], leaving the Department's budget exposed to the effects of these changes. This was shortly followed by a weakening in the value of sterling against other major currencies (**Figure 2**).

Figure 2

Percentage change in sterling against the euro and US dollar from the rates set at the 2007 Comprehensive Spending Review



NOTES

1 The 2007 Comprehensive Spending Review rates were set at \$2.01 and €1.46.

2 A declining line represents the depreciation, or weakening of the sterling against the euro or US dollar. A rising line represents an appreciation, or strengthening of the sterling against the euro or US dollar.

Source: Oanda.com; Foreign and Commonwealth Office Resource Accounts 2009-10

5 National Audit Office briefing for the Foreign Affairs Committee, *Management of exchange rate risk by the Foreign and Commonwealth Office*, December 2009.

1.7 The Department in part dealt with the risk created by the withdrawal of its exchange rate protection. In 2008 it began to forward purchase foreign currency, which helped the Department avoid serious pressures in 2008-09. Forward purchasing provided the Department with a degree of certainty of its costs, but did not eliminate all risk, and to some degree only deferred the impact of sterling weakening. Pressures were more severe therefore in 2009-10, resulting in the need to make cuts. At the start of 2009-10, business areas were asked to identify three activities they could cut if needed, but these did not constitute detailed contingency plans which could be used in the event of additional or delayed impacts.

The Department took timely action based on good data

1.8 The Department first identified a gap of around £70 million during the first half of 2009-10. The Department had a record of significantly underspending its budgets in previous years and so it first investigated the causes of the gap before taking action. By the end of August 2009 the forecast gap had grown to £72 million – some 4 per cent of budget for the financial year. As it was half way through the financial year, and these figures were based on firmer expenditure forecasts than earlier in the year, the Department concluded that urgent action was needed to close the gap.

1.9 The Department recognised pressures were felt more keenly by Posts whose local currencies appreciated the most against sterling; therefore it tracked and reported on these currencies. By July 2009 it was clear that if Posts did not receive additional funding they would face significant real cuts in purchasing power, with the worst hit (Tehran and Addis Ababa) facing cuts of 24 per cent (**Figure 3** overleaf), and over 30 Posts facing cuts of over 10 per cent. The average cut across Posts was 5 per cent in 2009-10.

The pressure mainly affected 2009-10

1.10 The pressure from exchange rate movements was a particular problem in 2009-10, and similar gaps did not materialise in 2008-09 or 2010-11 even though the value of sterling was weak during these years. For 2008-09, the Department made greater gains in forward purchases of foreign currency and had an underspend on its budget. In 2010-11, the Department received some £50 million from the Treasury to help it manage the pressures caused by exchange rate fluctuations and secured Treasury agreement to recycle £25 million from asset sales back into its budget. For 2011-12, the Treasury agreed to replace the Overseas Prices Movement Mechanism with a new arrangement – the Foreign Currency Mechanism – that provides greater certainty over purchasing power from April 2011.[6] As of the end of January 2011, the Department was forecasting an underspend of around £13 million against its budget for the year, although the final outturn may be affected by the cost of responding to subsequent events in the Middle East and the Japanese earthquake.

6 The new Foreign Currency Mechanism only gives protection against foreign currency movements, not local inflation.

Figure 3
The ten Posts with most exchange rate pressure in July 2009

Post	Total Budget (£)	Exchange rate and local inflation impact (£)	Pressure as percentage of Budget (%)
Tehran	3,220,033	773,075	24
Addis Ababa	1,155,485	277,355	24
Honiara	134,194	31,485	23
Windhoek	258,962	59,107	23
Cape Town	670,919	146,339	22
Johannesburg	895,019	195,219	22
Pretoria	3,758,165	819,721	22
Caracas	1,725,581	346,519	20
Gaborone	277,035	47,608	17
Doha	1,790,739	298,456	17

Source: The Foreign and Commonwealth Office

About two-thirds of the Department's response consisted of spending reductions

1.11 The Department recognised the size of the potential gap between its forecast spend and budget at the end of August 2009 and began action with the aim of reducing the gap to £25 million. The Department asked all business areas to propose spending reductions that would total between £40 million and £50 million, deciding to reduce the balance of the gap over the remainder of the financial year. In response, all business areas proposed reductions, amounting to between 1 and 5 per cent of their budgets. The Board and Ministers agreed almost all the proposals in September 2009, which had the effect of reducing planned spending by £46 million – 2.9 per cent of its £1.6 billion budget. In addition, Posts were instructed to cut spending locally so that they could manage within their existing budgets, but some limited additional support was provided in special cases. Given the disaggregated nature of the financial data we have not been able to calculate the extent of the additional funds which were made available to Posts.

1.12 The Department also sought permission from the Treasury to transfer additional funds totalling £33 million from other categories of spend, such as capital expenditure and contingency budgets, to increase the funds available to cover the forecast spending. The Department also received £8 million from the Treasury to fund restructuring, including headcount reductions.

1.13 The value of the actions taken did not precisely match the value of the financial pressures, because both were subject to forecasting uncertainty and the Department needed to have some margin between funds available and the final spending total. In the event, the Department's action closed the gap between spending and funds available, and the Department ended the year within its budget, by a margin of £3.8 million, 0.2 per cent of its budget.

Part Two

Spending reduction activity

2.1 This part examines:

- the short-term measures taken to reduce spending in 2009-10; and
- the extent to which the Department's actions showed elements of good practice in achieving long-term efficiencies.

Structured cost reduction

2.2 The National Audit Office's published guidance[7] on taking a structured approach to cost reduction summarises good practice on how to implement a structured programme of long term cost management. Cutting spending effectively requires departments to take a strategic overview to avoid an erosion of service quality in priority delivery areas. Departments should clearly prioritise what matters most, based on an accurate, realistic assessment of the costs, benefits and risks of the options. An important consideration is to avoid damaging value for money through over-simplistic cuts. Departments will also need to need to embed a culture of ongoing cost management and continuous improvement if they are to ensure long-term efficiencies are achieved and sustained in the future.

2.3 The time available to the Department was very limited. The Department's actions were not aligned to what we would expect in a long-term efficiency programme as this was not the Department's objective. In fact, they differed from it in a number of ways:

- the objective was to reduce in-year expenditure;
- there was little planning time as cuts were required immediately; and
- there was uncertainty in the level of cuts required at the outset given constantly fluctuating exchange rates and the identification and re-calculation of other risks.

Nevertheless, assessing this activity against good practice for both short term cost reduction and longer term efficiencies, helped us to identify the Department's capability and assess what the Department needs to put in place for a successful long term efficiency programme in the future.

7 National Audit Office: *A short guide to structured cost reduction, June 2010.*

Short-term spending reduction

Spending reduction centrally

2.4 The majority of the Department's spending reduction activity can be described as short term in that it focused on 'quick wins' such as spending cuts, deferring activity and therefore spending, and small scale saving initiatives. Short-term spending reduction is a legitimate response to an immediate budgetary problem and, as in this case, can be implemented quickly to help respond to an external shock.

2.5 The cost reduction exercise which resulted in £46 million of cuts (paragraph 1.11) was a direct and immediate reaction to the £72 million pressure. Proposals were targeted at the Department's administrative budget where two-thirds of the proposals focused on activities such as training and procurement. This was in-line with an ongoing drive within the Department to reduce the ratio of back office to front line expenditure. This helped to protect the delivery of the Department's main activities such as diplomacy which are delivered largely through its programmes. Cost reduction proposals within the programme budget accounted for the remaining third and included withdrawing from capacity building projects overseas and cancelling research projects.

2.6 A majority of proposals for spending reduction resulted from doing less – either slimming down budgets, or stopping activities altogether. The budgets for climate change projects and travel were reduced, whereas some regional conferences were stopped altogether. Forty six per cent of the cuts were intended to be permanent reductions in spend. As part of the Department's standard resource allocation practice, cuts identified as permanent are challenged but the Department did not set up a separate process to report whether the spending that had been cut in this exercise was not resumed subsequently.

2.7 The proposals also included a small proportion of 'quick wins' such as surrendering contingency budgets for legal claims and consular crises, some of which risk a future requirement for funding. In addition, there were a small number of proposals to defer expenditure until 2010-11, for example, by delaying opening an embassy or starting new projects – which we estimated were worth about 10 per cent of the total. Although deferring spending helped the Department to close the £72 million gap, it may not be value for money as it can lead to additional spending needed in the following year.

2.8 The Department did not classify the cuts in relation to the type of activity affected, but we estimate that approximately:

- 37 per cent were from back office functions;
- 25 per cent related to frontline activities;
- 12 per cent were Human Resources related;
- 10 per cent were from a budget devolved to Posts for priority projects;
- 9 per cent related to subscriptions to organisations; and
- 7 per cent were in travel and hospitality.

This split is largely in-line with the Department's corporate priority to protect frontline activities.

Spending reduction at Posts

2.9 In general, Posts were expected to cut spending to remain within their budgets despite their shrinking purchasing power. We surveyed 19 Posts (see Methodology for selection criteria) requesting details of any spending reduction activity in 2009-10. We interviewed representatives of nine of those for further information. Posts responded to the budget squeeze with a number of short term measures to reduce expenditure. These included stopping spending on training and working overtime and reducing the level of spending on travel and hospitality.

2.10 Again some of these spending cuts were in fact deferring expenditure, such as non-essential maintenance which was cut in five of the nine Posts to which we spoke. In 2009-10, the Department estimated that underinvestment in maintenance and health and safety meant approximately 40 per cent of the estate no longer complied with legal and Departmental standards, although this may not have always resulted from lack of funds[8] due to exchange rate pressure. This underinvestment may well require further spending later in order to get properties back up to standard.

2.11 The Department allowed Posts to manage their own spending reduction activities as they were best placed to know which areas to cut to minimise impact on performance. The Department monitors how Posts spend their budgets albeit at a regional level. It did not monitor centrally the detailed action taken by Posts to reduce expenditure in 2009-10. The Department communicated high level principles (paragraph 3.4) to Posts, but it did not provide detailed guidance or give direction on areas not to cut. **Figure 4** and **Figure 5** show in more detail the actions taken by the Posts interviewed.

8 Comptroller and Auditor General, *Adapting the Foreign and Commonwealth Office's global estate to the modern world*, Session 2009-10, HC 295, National Audit Office: February 2010.

Figure 4
Case example: the United States network of Posts

At the start of 2009-10, the United States network of 11 Posts received a budget allocation of US$40.3 million. In June 2009, it agreed to deliver 5 per cent efficiency savings, mainly through the reduction of discretionary spending, such as travel and official hospitality. However, by September 2009 it was clear this would not be enough to cover the budget deficit caused by exchange rate movements. A further US$3.3 million saving (8.2 per cent of the original allocation) over the second half of the year was required in order to stay within budget. As such, the network undertook a number of spending reduction measures, including: reducing programme spending, instigating a recruitment freeze, reducing maintenance spending, temporarily freezing training and employer matched pension contributions for local staff, further reducing travel and official hospitality spend, enforcing a week of unpaid leave for local staff and making 35 people redundant. Total realised savings from these actions were US$3 million. These savings were boosted by additional funding totalling US$425,000 from the Department centrally later in the year, following requests from the Embassy in Washington for financial help. This allowed the network to stay in budget and also ease or reverse some of the temporary spending reduction measures, such as paying back pension contributions.

Source: National Audit Office interview

Figure 5
Case example: Berlin

Berlin was hit worst by currency pressures in 2008-09 with the exchange rate falling from £1 to €1.27 in April 2008 to £1 to €1.08 in March 2009. In April 2009, the Post faced an estimated additional pressure, due to exchange rate fluctuations, of up to £2.45 million needed to pay the annual charge for the embassy built under the Private Finance Initiative, as this was a fixed commitment in euros that was funded from the local budget. As a result, the Post put in place a number of spending reduction measures. These measures continued into 2009-10. These included: renegotiating vehicle leases and security contracts, cutting back on office stocks, cutting maintenance and furniture budgets, and reducing discretionary budgets such as travel (by 33 per cent), training (by 25 per cent) and official hospitality (by 50 per cent). The Post acknowledged that most of these were unsustainable deferrals of spending rather than long term spending cuts. Berlin received additional funding in 2009, but this was only enough to cover 25 per cent of the budget pressure reported. The payments for its embassy have now been transferred to the central Estates and Security Directorate budget, which has removed this pressure from the local budget.

Source: National Audit Office interview

Longer-term efficiencies

2.12 Despite the short timescales, the Department's actions indicated it has the capacity to drive long term efficiencies in the future. Evidence of the implementation of longer term efficiencies include:

- Posts' spending reductions included a number of longer term efficiency savings in line with reducing overhead costs. For example, Paris renegotiated telephone contracts, while New Delhi invested to utilise their estate more efficiently and accommodated more families on its compound.
- The Department increased the contribution to 2009-10 savings from ongoing initiatives to reduce the running costs of maintaining existing levels of activity. Its corporate services programme included projects to restructure and re-engineer its corporate services activities (for example finance and human resources) and also to replace UK-based staff in Posts overseas with locally employed staff. While these projects had not been initiated to respond to the Department's 2009-10 budgetary problems, both delivered savings in 2009-10, and the pace of the initiatives was increased to provide additional savings in the year.
- The Department was also making efficiencies in response to the 2007 Comprehensive Spending Review during this period, which helped the Department deal with its budgetary problems in 2009-10. These were run as a centrally managed programme of projects that were measured, monitored and evaluated to ensure savings were cash-releasing, sustainable and reported net of costs.

Part Three

The Department's management of the spending reduction process

3.1 To assess how the Department managed its spending reduction in 2009-10, we used the core management cycle as a guide to good practice. The cycle consists of six stages for successful management: strategy, planning, implementation, measurement, evaluation and feedback (**Figure 6**).

3.2 This part assesses:

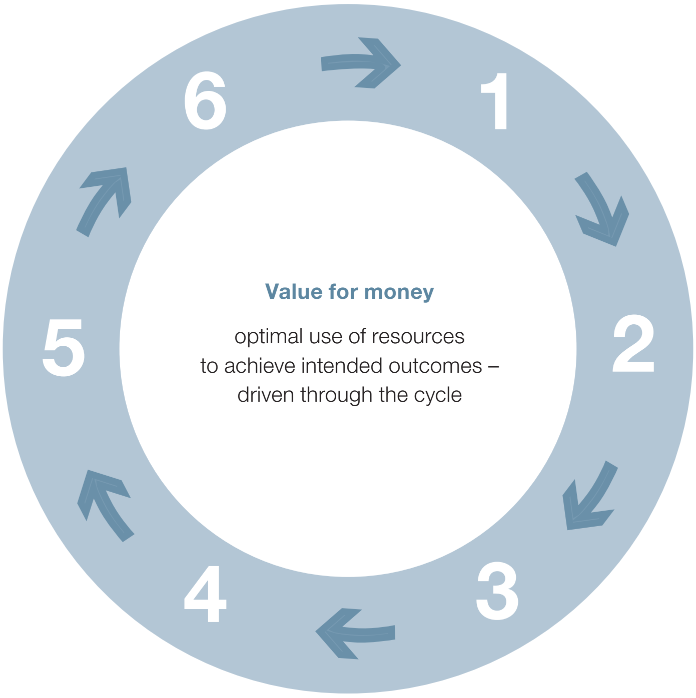
- the Department's management of its spending reduction activity in 2009-10, using the management cycle; and
- the Department's performance within each stage of the cycle and identifies strengths and weaknesses to be addressed for future cost reduction activity.

Figure 6
The core management cycle

6 Feedback
amends priorities and informs future strategy and planning

5 Evaluation
of implementation against strategic goals

4 Measurement
of quality, delivery, costs and user experience against benchmarks and targets



1 Strategy
based on evidence with clear policy goals

2 Planning
with agreed priorities, resources, management information and programme management in place

3 Implementation
with good financial management, risk management, governance and controls in place

Source: National Audit Office: A short guide to structured cost reduction, June 2010

The Department's performance in managing the spending reduction process was mixed

3.3 An important factor to the Department's approach was a programme it had been working on since 2007 to improve its financial management through better processes, IT systems, the collection of monthly management information and the financial skills of its staff. We reported on progress of this change programme in summer 2009 and found that the Department had made significant progress in developing its financial management capability.[9] Many of the improvements we reported on were key factors in its approach to reducing the £72 million gap.

Strategy

3.4 The Department had an obvious objective for the spending reduction activity: to manage in-year expenditure to meet budgetary targets. As we would expect, it established three clear, albeit high level, principles to guide spending reduction activities across the Department. These were communicated across the Department and were that:

- spending related to staff safety and security was not to be reduced;
- Departmental Strategic Objective priorities should guide resource decisions; and
- Post closures should be avoided where possible.

Planning

3.5 From its decision to act, the Department had only six months in which to produce plans to identify and deliver savings to close the £72 million gap. Nonetheless, the Department showed elements of good practice, some of which resulted from the Department's programme to improve financial management. The Board understood the importance of accurate and timely data on which to make decisions, and Board members and other key stakeholders told us that financial information in the Key Performance Reports improved over the period, as did the understanding and ownership of them (**Figure 7**).

3.6 Improved financial information was critical to the Department's efforts to plan and manage its spending reduction activities. Our report on financial management in the Department noted the development of Key Performance Reports, which report key financial data to the Board on a monthly basis, as a positive step in providing better commentary to the Board and also that financial information had improved at this time.[9]

9 Comptroller and Auditor General, *Financial Management in the Foreign and Commonwealth Office*, Session 2008-09 HC 289; National Audit Office: June 2009.

Figure 7
Improving financial management

"Managing down the spend and coming in on-budget both years in this period could not have been done five years ago …now …we have seen a real improvement in the management accounts, including the ability to do this".

Source: Non Executive Director

Implementation

3.7 As discussed in Part Two, the Department reduced the £72 million gap by the end of the financial year. This was achieved in part by a cultural change with business areas across the organisation acting corporately and offering up expenditure to cut, reduce or defer. While the Department sought to protect its frontline activities, it did not strategically prioritise cuts as it did not seek to prioritise one area of the Department over another. Business areas were expected to offer up whatever spending reductions they could make in line with the Department's three principles. However, the Department did control spending reductions as the Board assessed and agreed the cuts offered up by business areas.

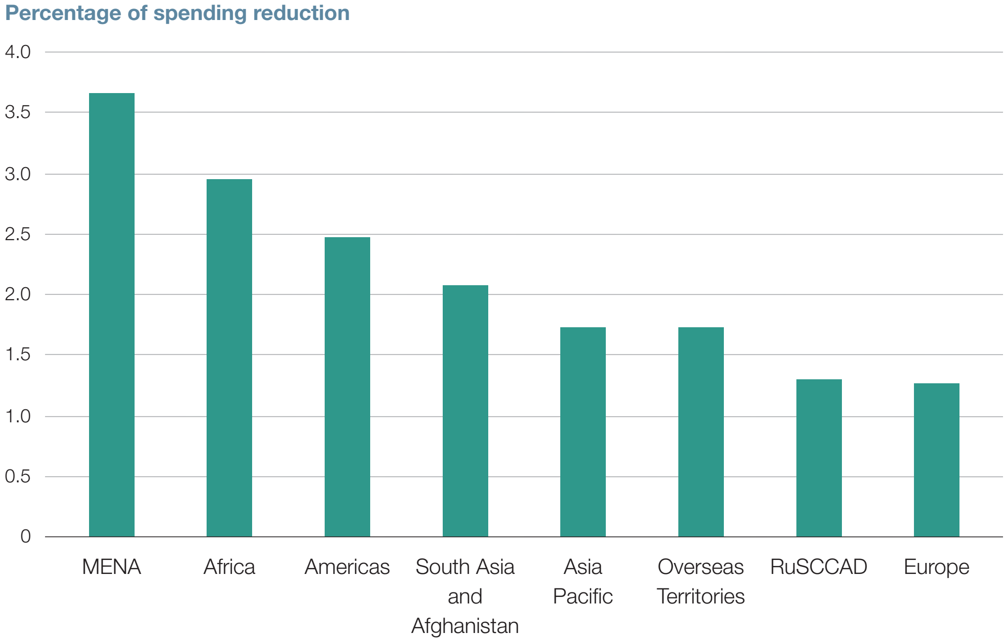
3.8 It was not the case that every budget was reduced by a set percentage (**Figure 8** overleaf). For example, the business areas of the Middle East and North Africa Geographical Directorate proposed cuts of 3.7 per cent of its budget, whereas Europe proposed 1.3 per cent. In absolute terms, proposed cuts for these two Directorates were £2.7 million and £2 million respectively; the largest in the Department.

3.9 Implementation was helped by a number of factors. The Department increasingly held senior managers to account for their financial management. Budget holders signed to confirm the accuracy of their monthly submissions to the Board, highlighting any questionable numbers. Spending cuts were incentivised by holding budget holders to account for targets and accurate reporting, and linking pay and career progression to budgetary management. Our report on financial management[10] in the Department noted that managers were increasingly held more accountable for their own financial management performance in performance appraisals and consideration of career moves.

10 Comptroller and Auditor General, *Financial Management in the Foreign and Commonwealth Office*, Session 2008-09 HC 289; National Audit Office: June 2009.

Figure 8

Spending reductions by Geographical Directorates as a percentage of budget



NOTES

1 MENA is Middle East and North Africa.

2 RuSCAD is Russia, South Caucasus and Central Asia.

3 Budget figures are from September 2009.

Source: National Audit Office analysis of the Department's data

3.10 A strong financial management culture at the top of the Department contributed to the handling of the financial difficulties caused by the gap. When the Board recognised the extent of the problem, it demonstrated strong leadership in guiding the whole organisation to contribute to its objectives of living within its budget. The Board and Permanent Under-Secretary communicated a strong message across the Department on the seriousness of the gap, and that all staff had a role to play in reducing it. Our 2009 report on the Department's programme to improve financial management noted this financial management culture.[11]

3.11 The Department also benefited from a financially capable Board, which at the time included a professionally qualified Director General Finance, and input from Non-Executive Directors with relevant skills and experience, who provided strong and effective challenge. Other Board members also received financial training.

11 Comptroller and Auditor General, *Financial Management in the Foreign and Commonwealth Office*, Session 2008-09 HC 289; National Audit Office: June 2009.

Measurement

3.12 The improvements in financial information allowed the Department to monitor and measure the evolving financial situation on a monthly basis. It can be seen how the forecast was managed down from its peak in August 2009 of £72 million to an underspend of £3.8 million (**Figure 9**). In particular, the contribution of the £46 million of spending cuts can be seen in the decline in the potential gap in September. The inclusion of human resources data, including the headcount, from September 2009 helped the Board manage and measure staff costs; the Department's biggest single cost driver at 20 per cent of total budget.

Figure 9

The Department's monthly monitoring of the gap between forecast expenditure and budget in 2009-10

Source: The Foreign and Commonwealth Office

3.13 The Board had sight of the proposed £47 million cuts. It agreed proposals to, for example, reduce expenditure on the campaign to promote attendance at the Olympics and reduce royal visits. It accepted the associated risks, such as the reduced ability to meet objectives and networking opportunities overseas. Every business area reported to the Board the progress of their spending reductions on their budgets and the central finance team assessed the realism of their projections. However, we would expect the Department to have validated that the cuts made in centrally managed spending were those which had been planned and agreed. These limitations prevented the Department from assessing whether its three principles had been upheld once the cuts were actually made, and knowing which spending reductions were most effective at cutting costs with least impact on the achievement of the Department's objectives. While the Department showed good practice in setting key principles to guide the cuts, limited validation and oversight means that the Department cannot be confident that these principles were upheld.

3.14 While individual Directorates tracked spending reductions at Posts there was no central point of oversight to shape, coordinate and ensure that actions taken by Posts were in line with the Department's corporate policies and strategic direction. This makes it difficult to get a consolidated picture of spending cuts across all Posts and prevents a thorough assessment of what worked well and dissemination of lessons across Posts.

Evaluation

3.15 The Department was alert to the risks that its spending cuts generated as a risk assessment was done for each spending reduction proposal. However, we could not find evidence to show that these risks were then logged, monitored or mitigated as the cuts were implemented.

3.16 The Department did not have measures in place to evaluate the impact on the achievement of the Department's objectives at the time the cuts were made. This is due in part to the speed with which the Department needed to act and the inherent difficulty in measuring the Department's performance against its objectives. It is difficult to quantify outcomes fully as there are no robust measures for all areas of its work. Some impacts, such as the effects of overseas diplomacy, are not easily measurable and may take time to materialise. However, as part of its standard end-of-year review process, the Department considered the impact of cuts on achieving its plans, although the level of detail provided varied by area. The Department has not consolidated this information to learn lessons.

3.17 In 2009, the Department had an overall objective to 'reduce the impact of conflicts globally through enhanced UK and international efforts'. This was underpinned by eight Departmental Strategic Objectives which were the Department's key aims (**Figure 10**). Although the Departmental Strategic Objectives are being replaced by the new government, they were a key set of performance measures under the previous government.

Figure 10
Departmental Strategic Objectives

Objective	
1	A flexible global network serving the whole of the British Government
2	Supporting the British Economy
3	Supporting British Nationals Abroad
4	Supporting Managed Migration for Britain
5	Countering Terrorism, Weapons Proliferation and their causes
6	Preventing and Resolving Conflict
7	Promoting a low carbon high growth global economy
8	Developing effective international institutions above all the United Nations and European Union

Source: The Foreign and Commonwealth Office

3.18 Many of the Department's goals related to long-term objectives, for example, 'Increased international commitment for an open and equitable low carbon global economy', a goal under Objective seven (Figure 10). This makes it difficult to assess outcomes of a spending reduction programme within a year of its completion.

3.19 Performance against the eight Departmental Objectives was not publicly reported in a consistent format in spring and autumn 2010 because of the change of government. The Department reported activity and outturns against each objective, but did not rate its performance as it had done in previous years. This makes it difficult to identify any impact of the spending reductions. In the 2008 and 2009 departmental performance reports there is no evidence of a substantial drop in performance in achieving its objectives.[12] Where targets have not been reached this has not been directly linked to costs or constrained budgets. In 2009[13] the Department reported that three of the eight targets showed strong progress, with the remaining five showing some progress. For the Department's overall objective to 'reduce the impact of conflicts globally through enhanced UK and international efforts', it reported no progress against two targets and some progress against two. As with business areas, the Department internally reported impacts on Departmental Strategic Objectives of some cuts although the level of detail varied. The Department has not consolidated this information to learn lessons.

12 Foreign and Commonwealth Office, *Autumn Performance Report 2009*; and Foreign and Commonwealth Office, *Autumn Performance Report 2008*.
13 Foreign and Commonwealth Office, *Autumn Performance Report 2009*.

3.20 As a consequence of its devolved budget structure there was also little central oversight of the impact of reducing spending at overseas Posts. In autumn 2009 the Department conducted an exercise to assess the impact of exchange rate related losses at Posts. This was not a comprehensive or quantified exercise but gave an indication of impacts overseas. One Post, for example, reported that reduced travel weakened its ability to tap into a wide range of political, public and media opinion and a reduction in security personnel heightened perceived vulnerability amongst staff.

3.21 The majority of respondents to our survey reported that the spending cuts described in Part Two had no negative impact on their operations and front line delivery. **Figure 11** and **Figure 12** below detail the impact in the United States and Berlin. Of the nine Posts interviewed, five stated that overall they did not think there were any negative impacts resulting from efficiency measures and spending cuts.

Figure 11
Case example: the United States network of Posts

Many of the cuts in 2009-10 were temporary and aimed at staying within budget that year rather than looking for long-term improvements. However, staff did get used to doing more with less and levels of expenditure have not increased to previous levels. Consequently the network now considers itself a more efficient operation. It believes that future cuts may be more difficult since most of the easier cuts have already been made. There are also continuing financial pressures that erode some of the efficiency gains made, such as the increasing and unpredictable costs associated with health care in the United States.

Although staff state that the lasting effect is hard to quantify, intangibles were impacted by the cuts, including morale and staff time. Staffing redundancies were a shock to some staff on the front line. However, in general the network feels that operations were not badly impacted. The cuts of 40 to 50 per cent in discretionary budgets such as travel and official hospitality were partly restored in 2010-11.

Source: National Audit Office interview

Figure 12
Case example: Berlin

Staff in Berlin found it difficult to assess the long-term impact of reduced official hospitality and travel budgets. There were concerns that it may reduce the list of contacts and networking opportunities with effects in future years. The cuts in training budgets had the most effect, reducing the morale of staff. Staff felt that cutting training budgets temporarily, for one year was not too problematic, but cutting them for a number of years would erode the skills and quality of staff. Staff were concerned that being unable to offer official hospitality could impact negatively on the Department's reputation.

Source: National Audit Office interview

3.22 The Department was better at measuring the ongoing impact of spending reductions on the corporate services programme with performance measures in place for some of the affected activities. A key performance measure of the finance function is its ability to pay suppliers promptly. In 2009-10 payment within 10 days was achieved in 91.9 per cent of cases, higher than the 84.8 per cent of cases in March 2009. The Department did not set out to measure the impact of spending reductions on staff. However, increasing numbers of internal applicants for 'hard-to-recruit' overseas positions suggests that the spending cuts had not unduly affected staff morale, and the 2010 staff survey only reported a 1 per cent decline in morale.

Feedback

3.23 The Department did not conduct a formal evaluation of the spending reduction activities in 2009-10 and therefore missed a valuable opportunity to learn and feed back from this exercise. Effective feedback is hampered by the Department's limited measurement and evaluation. Nonetheless some lessons were learnt and acted on. As a consequence of this exercise, for 2010-11, Posts' budgets were set in the local currency thus providing them with budgetary certainty while allowing the Department to manage the foreign exchange rate risk centrally by holding a reserve fund. In February 2010 the Department also started to develop contingency plans in case further cuts were required in 2010-11. There were also other valuable learning points, as all the staff we spoke to were clear on the lessons they had learnt from the experience. **Figure 13** summarises the common themes.

Figure 13
Lessons learnt by the Department

- Ownership early on is crucial
- Ensure management information for the Board is simple and effective
- Set out transparent budgets for the whole saving period to encourage long-term thinking
- Be clear about priorities, what is going to be cut, by how much, and do it quickly
- Look at new ways of delivering things
- Co-ordinate activities for a system-wide view
- Assign personal responsibility for cuts and incentivise delivery
- Make campaigns positive to gain staff buy-in and prevent morale dropping
- Collaborate with other government departments and partners
- Evaluate outcomes and impacts

Source: National Audit Office interviews

3.24 The Department must continue to make efficiencies and cut spending. The 2010 Spending Review imposed cuts of approximately 10 per cent to core departmental expenditure over the course of the four-year Spending Review.[14] The Department is currently making plans to find efficiencies to meet this target.

14 House of Commons Foreign Affairs Committee, *Foreign and Commonwealth Office Performance and Finances, Third report of the session 2010-11*, 2 February 2011. These savings exclude the BBC World Service and the British Council.

Appendix One

Methodology

The main elements of our fieldwork took place between November 2010 and January 2011.

Method	Purpose
Financial analysis of the Department's budget, expenditure and forecasting data for the financial year 2009-10.	To ascertain the potential impact of exchange rate fluctuations on the Department's budget, spending reductions realised in 2009-10.
Document review of Board papers, meeting minutes, internal communications, planning papers, performance reports, risk registers and published reports and briefings.	To ascertain how information was used to make decisions and put plans into action to control the Department's budget in 2009-10.
Survey of 19 overseas Posts **1** The eight Posts that experienced more than 20 per cent financial pressure from exchange rate fluctuations: Tehran, Addis Ababa, Honiara, Windhoek, Cape Town, Pretoria, Johannesburg, and Caracas. **2** All other Posts that experienced more than £450,000 pressure: Washington D.C., Tokyo, Islamabad, New Delhi, Riyadh, Brussels, Berlin and Rome. **3** Three strategically important Posts (not covered by 1 or 2): Paris, Beijing and New York. We received responses covering all 19 Posts. Of these, one did not cut spending as a result of exchange rate pressures, and two had no staff available to answer our questions. We developed case examples on Berlin and the United States network of Posts as these large operations provided a robust evidence base and enabled us to track progress along the core management cycle.	To ascertain the impact of exchange rate fluctuations on overseas Posts, guidance received from the Department, spending cuts and the subsequent impact on activity.

Method	Purpose
Interviews with nine overseas Posts	
Posts were selected from the geographical spread: Tehran, Windhoek, Johannesburg, Washington D.C., Islamabad, New Delhi, Brussels, Berlin and Paris.	To gain a more in-depth understanding of the spending cuts at Posts and the impact on outputs and outcomes.
Interviews with London-based staff: Board members, functional and geographical Directors, finance, strategy and change unit teams.	To ascertain the approach taken to expenditure reduction at the centre, identify good practice and lessons learnt for the future.
Analysis of the Department's approach to expenditure reduction.	To ascertain what worked well in contributing to the Department's budgetary control in 2009-10, and what the Department will need to build on and develop to enable a more structured approach in the future.

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