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Foreign and Commonwealth Office

Spending reduction in the Foreign and Commonwealth Office

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.

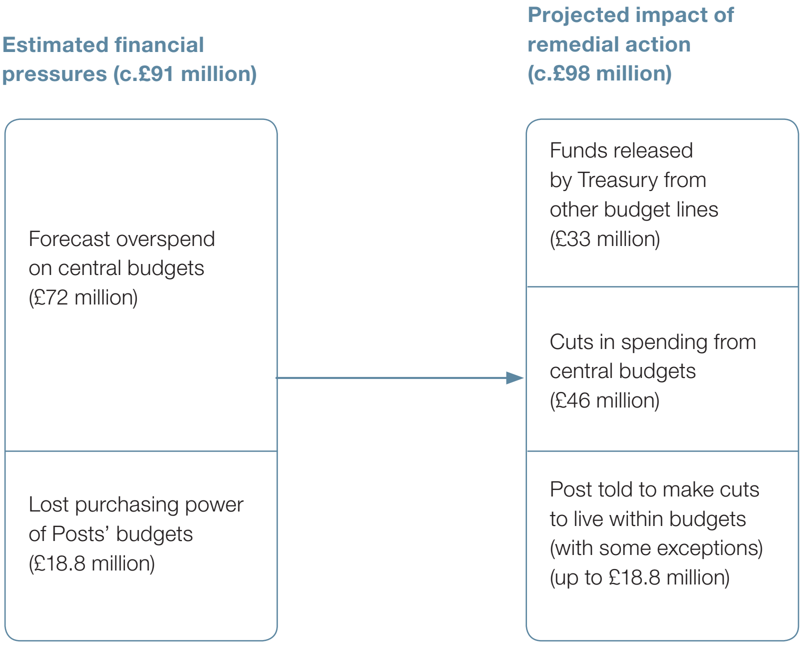
6 The gap had arisen mainly as a result of exchange rate movements. Before 2008 the Treasury largely protected the Department from such movements, but from April 2008, as part of the 2007 Comprehensive Spending Review, the Treasury removed this protection. This was shortly followed by a weakening in 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.