National Audit Office

REPORT BY THE
COMPTROLLER AND
AUDITOR GENERAL

HC 1593
SESSION 2010–2012

25 NOVEMBER 2011

Department for Environment, Food and Rural Affairs

Financial Management Report 2011

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National Audit Office

Department for Environment, Food and Rural Affairs

Financial Management Report 2011

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Amyas Morse
Comptroller and
Auditor General

National Audit Office

21 November 2011

This report provides an overview of the Department's financial management against a model developed by the National Audit Office. Our work focuses on the financial management of the Department. This includes how it manages its own finances and how it manages its arm's-length bodies to ensure their sound financial management.

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Contents

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This report can be found on the National Audit Office website at www.nao.org.uk/defra-financial-management-2011

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Key facts

£5.14bn

the Department's budget in 2010-11

40 per cent	the amount of this budget reimbursed by the European Union (EU) to support England to deliver the Common Agricultural Policy
£4 billion	or 80 per cent – the amount of the Department's budget spent by its arm's-length bodies in 2010-11
29 per cent	the real terms funding cut the Department will undergo by 2014-15

Summary

1 The Department for Environment, Food and Rural Affairs (the Department) develops and delivers policy on the environment; sustainable development and the green economy; food, farming and fisheries; animal health and welfare; environmental protection; and rural communities. The Department is also responsible for preparing for, and managing risk from, animal and plant diseases, flooding, and other environmental emergencies. It devolves delivery of most of its aims to arm's-length bodies, the largest of which are the Rural Payments Agency, the Environment Agency, Natural England and the Animal Health and Veterinary Laboratories Agency.

2 In 2010-11, the Department had a budget of £5.14 billion, the second smallest departmental budget across Government.[1] The 2010 spending review requires the Department to reduce its resource budget by 29 per cent between 2011 and 2015.

3 This report provides an overview of the Department's financial management against a model developed by the National Audit Office.[2] Our work focuses on the financial management of the Department. This includes how it manages its own finances and how it manages its arm's-length bodies to ensure their sound financial management. Our methodology is outlined in Appendix One and in more detail on our website.

4 Good financial management supports sound decision-making and accountability, improves planning and revision of plans, and helps an organisation to devise its strategy and manage risks to delivery. Failures in financial management can increase costs, reduce value for money and put service delivery at risk. Effective financial management has never been more important, with the Government requiring departments to achieve significant cost reductions.[3]

Key findings

The Department's financial governance and leadership

5 **The Department's new Accounting Officer has implemented a transformational change programme, which will look at the Department's operating model.** The principles of sound financial management should be embedded within the aims of the change programme so that progress made to date is not lost.

1 The smallest departmental budget is that of the Foreign and Commonwealth Office.
2 More information on the financial management maturity model is available at www.nao.org.uk/help_for_public_services/financial_management/fmmm.aspx
3 Comptroller and Auditor General, *HM Treasury: Progress in improving financial management in government*, Session 2010-11, HC 487, National Audit Office, March 2011.

6 The Department has taken steps to improve its financial management since we reported in 2008, and its Accounting Officer understands the importance of good financial management. However, the Department has not measured the benefits of its finance improvement projects, so it does not know the extent of the improvements made. The Department has undertaken a number of finance improvement projects designed to strengthen its financial management. These projects have resulted in some positive outcomes such as revised management reporting and greater finance involvement in approval panel processes for allocating and reallocating funds. Whilst the Department has taken some steps to monitor and evaluate these projects, it has not measured the benefits, so it does not know to what extent improvements have been made, or how effective these projects have been.

7 A recent Cabinet Office benchmarking exercise highlighted that the Department has a higher than average ratio of finance staff, and a higher than average percentage of qualified staff when compared with similar organisations. Given this level of finance resource, the Department should aim to achieve a more developed set of skills, and expertise in financial management.

8 The Department has improved its financial capacity and capability, though weaknesses remain. Financial skills could be better integrated across the Department to embed a culture of strong financial management. The non-executive directors bring extensive knowledge of major public and private sector bodies. The Department has increased the number of permanent qualified finance staff and also offers financial skills training courses for non-financial staff. Senior staff appraisals include an assessment of financial skills, and a consideration as to whether budget holders have contributed towards value for money. For these improvements to be sustained, the Department should ensure that non-finance staff who manage budgets are financially literate. In addition, the Department should focus on improving its commercial skills, such as contract management.

9 The Department's internal control and risk management have improved, both across the Department and its arm's-length bodies. It should now focus on building its oversight of these bodies. To continue to improve, the Department should focus on strengthening its understanding of risk across its arm's-length bodies. The 2009 capability review identified that the Department's management committee needed to better oversee strategic risks. The Department understands that it has weaknesses in this area and is taking steps to address them.

Planning, monitoring and performance reporting

10 In 2010-11, the Department has reduced its underspend against its departmental expenditure limit to £34 million, or 1 per cent. However, since 2002, the Department has consistently reported a significant underspend against its total Parliamentary estimate. In 2010-11, this underspend was £530 million, or 10.3 per cent. The details of the Department's underspends are explained in more detail in paragraphs 3.10 to 3.13. Managing expenditure against estimate is an indicator of how well departments are managing use of public funds. Budgets will be aligned to estimates in 2011-12 and the Department considers that this will lead to a significant reduction in underspend against estimate going forward. The Department needs to continue to challenge forecasts to ensure it can have greater confidence in their accuracy and reduce underspend against the estimate.

11 The Department has improved its processes for reallocating resources in-year. However, there remains, in some areas, a culture of budget holders keeping back surpluses. The Department has put in place local approval panels, which examine the portfolio of activities for each of the Department's Groups. It also has a central approval panel that makes budget allocation decisions, which are escalated to them from the local approval panels, and for budget allocation issues relating to programmes. These panels should assist the Department to overcome cultural barriers to reallocating funds.

12 The spending review has spurred the Department to work more closely with its arm's-length bodies. However, this collaboration and engagement needs to be more proactive, and integrated into 'business as usual'. The Department has improved how it engages with arm's-length bodies, for example, by establishing a minimum reporting requirement. However, there is no clear strategic model of engagement with arm's-length bodies. Without such a model, the Department cannot clearly understand both the risks and opportunities for it and its arm's-length bodies. The Department is developing a set of 'accountability systems statements' with its arm's-length bodies, which should help to build appropriate oversight.

13 Under the spending review, the Department has cut its spending in a targeted way and has challenged and altered its models for delivery. It instructed its arm's-length bodies to assess value for money of spending on activities and cost benefit analysis of different options was carried out. The Department should continue to focus on value for money going forward so its ability to make evidence-based strategic decisions is not hampered.

14 The Department faces a challenge in delivering the HM Treasury alignment project. The project aims to simplify financial reporting to Parliament. This means that, in 2011-12, departments will need to produce consolidated accounts that include departments' and arm's-length bodies' income, spending, assets and liabilities. The Department has established a project team, and has developed a project plan to deliver pre-recess consolidated accounts. It plans to review progress after a dry run exercise, and to monitor delivery against the project plan throughout 2011-12. The Department should ensure that plans are realistic, based on the timing of necessary information from its arm's-length bodies. The alignment project will also reinforce the need for the Department to work closely with its arm's-length bodies to achieve common objectives.

15 The Department has improved the quality of reports to the management committee, though not all relevant financial information is reported. The information reported to the committee is clearer and more consistent than when we reported in 2008. However, there are aspects that could be improved, for example, better links between performance and financial information.

16 The Department needs to better understand its own costs and cost drivers, and those of its arm's-length bodies, rather than just monitoring spending. The Department does not have an overview of cost drivers for the key work of its arm's-length bodies, or understand the costs of its policies or objectives. Some of these bodies themselves demonstrate progressively improving understanding of their own cost structures. The Department has started to collect better management information from its arm's-length bodies, but performance and cost information is not generally integrated. Without this information, the Department cannot make fully informed decisions on how best to manage its resources, or accurately assess the effectiveness of its activities.

Conclusion on value for money

17 The Department has taken a number of steps to address weaknesses in financial management since we reported in 2008. We cannot yet conclude that the Department is achieving value for money in its financial management activity, because we would have reasonably expected faster progress in improving performance and a higher level of financial management maturity today, given the focus and resources applied.

18 It is clear, nevertheless, that improvements have been made, and the Department understands that it needs to maintain momentum to further develop its financial management. Its recently launched change programme provides an opportunity to embed the principles of good financial management throughout the Department.

Recommendations

Financial governance and leadership

a The Department does not have a fully embedded culture of sound financial management across the Department and its arm's-length bodies. To achieve this it should:

- ensure that the aims of the change programme reflect the principles of good financial management;
- improve the financial management skills of non-financial staff by requiring budget managers to undertake financial training on forecasting and budgeting that it already offers on a voluntary basis; and
- make sure that business managers who deal with contracts undertake training in commercial skills, such as contract management, to support the Department to get the best value out of its contracts.

With its arm's-length bodies, the Department should, when developing accountability systems statements:

- establish an engagement model with each of its arm's-length bodies based on relative risk;
- ensure proportionate flows of information are in place between it and its arm's-length bodies that reflect the needs of the business; and
- build on its engagement with arm's-length bodies to develop realistic and achievable plans for the alignment project, which take into account relative size and track record in producing timely and accurate accounting information.

Planning, monitoring and performance reporting

b The Department's monitoring and forecasting is not always accurate or robust. To improve, it should:

- build on the accuracy and realism of its forecasts and budgets, by targeting those areas that consistently underspend and providing appropriate support and training in forecasting and budgeting;
- enhance its monitoring of forecasts and budgets, with appropriate triggers to give 'early warning' of potential problems; and
- increase the level of challenge from central finance and investment approval panels on all bids for funding and on in-year forecasts.

c The Department does not fully understand the costs of its activities or plan and monitor robustly. It should:

- develop a 'systems view' of its cost reductions, which clearly assesses how cuts in one area will impact other areas, to better understand costs and cost drivers within its delivery network;
- undertake more robust planning, for example, focus on costs rather than just spending, and embed this in 'business as usual' processes;
- implement a monitoring regime, which would build on the monthly reporting information already collected from arm's-length bodies. This would allow the Department to assess how well value for money is being preserved, in the light of spending reductions; and
- enhance monthly reporting to the committee to include relevant financial information, as well as robust data on performance against budgets and forecasts.

Part One

Operating environment

Responsibilities

1.1 The Department for Environment, Food and Rural Affairs (the Department) develops and delivers policy on the environment; sustainable development and the green economy; food, farming and fisheries; animal health and welfare; environmental protection; and rural communities. In its latest business plan, the Department states its objectives as:

- supporting and developing British farming and encouraging sustainable food production; and
- helping to enhance the environment and biodiversity; and to support a strong and sustainable green economy.

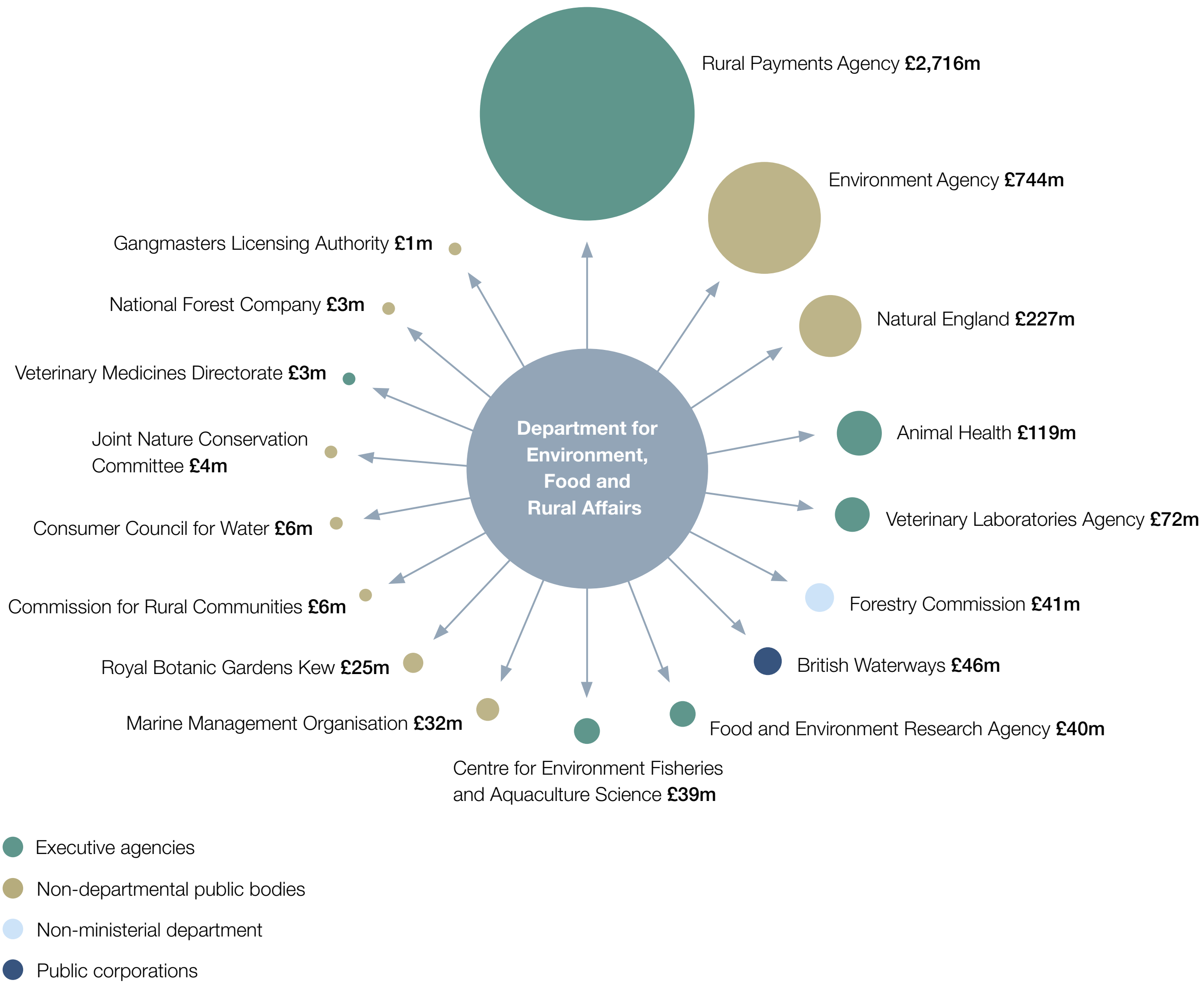
The Department is also responsible for preparing for, and managing risk from, animal and plant disease, flooding, and other environmental emergencies. It devolves delivery of most of its aims to arm's-length bodies.

Funding and delivery landscape

1.2 In 2010-11, the Department had a budget of £5.14 billion. Some 40 per cent of this is to support England to deliver the Common Agricultural Policy and is reimbursed by the European Union (EU). The Department delivers the majority of its work through arm's-length bodies to which, in 2010-11, it provided around £4 billion, or 80 per cent of total spending. The most significant of these bodies are the Rural Payments Agency, the Environment Agency, Natural England and the Animal Health and Veterinary Laboratories Agency. **Figure 1** overleaf shows the Department's funding to its arm's-length bodies.

Figure 1

The Department's funding to arm's-length bodies, 2010-11



NOTE

1 The Figure includes those bodies that received funding from the Department of £1 million or over. The Animal Health Agency and the Veterinary Laboratories Agency merged in April 2011 to become the Animal Health and Veterinary Laboratories Agency. The bulk of expenditure by the Rural Payments Agency represents grants to farmers and landowners under the Single Payment Scheme, within the European Union Common Agricultural Policy.

Source: National Audit Office

Financial management

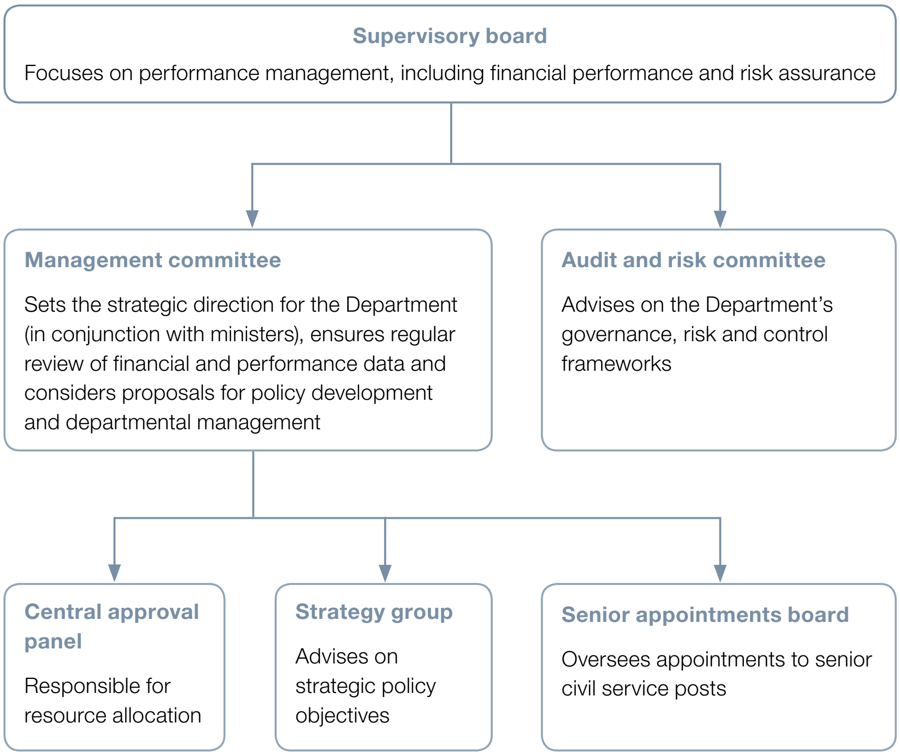
1.3 The Department's Permanent Secretary, in her role as Accounting Officer, is responsible for the Department's organisation, governance and performance, and ensuring that HM Treasury requirements of financial management are achieved. The current Accounting Officer took up her post on 28 March 2011. The Department's management committee supports the Accounting Officer in providing strategic and operational leadership.

1.4 The Department revised its governance structure in 2010 after the Cabinet Office and HM Treasury's revised corporate governance code was published.[4] In line with the code, the Department established a supervisory board, chaired by the Secretary of State, which meets regularly and monitors performance and delivery, including that of its arm's-length bodies. The Department's management committee is the main sub-committee of the supervisory board and is supported by three committees. **Figure 2** overleaf outlines the Department's governance structure in more detail. We have not examined the function of the supervisory board in this report because, as of September 2011, it had only met twice. One of the aims of the boards, as set out in the corporate governance code, is to reinforce the importance of governance in helping to achieve good financial management.[5]

1.5 In July 2011, the Department appointed a new Finance Director and the remit of the role has been revised to include performance monitoring and strategic financial planning. The aim of this change in role is to more clearly join up finance, performance and strategy. In addition, procurement and commercial activities have been transferred to corporate services to link the commercial function with the divisions responsible for procurement, such as estates. The Department has around 150 finance staff, working within financial control and the organisation's four directorates. **Figure 3** on pages 16 and 17 shows how finance integrates with the rest of the Department.

4 HM Treasury and Cabinet Office, *Corporate governance in central government departments: Code of good practice 2011*, 2011.
5 ibid.

Figure 2
Governance structure



NOTE

1 This reflects the Department's governance structure since December 2010.

Source: National Audit Office analysis of information from the Department

Scope of the examination

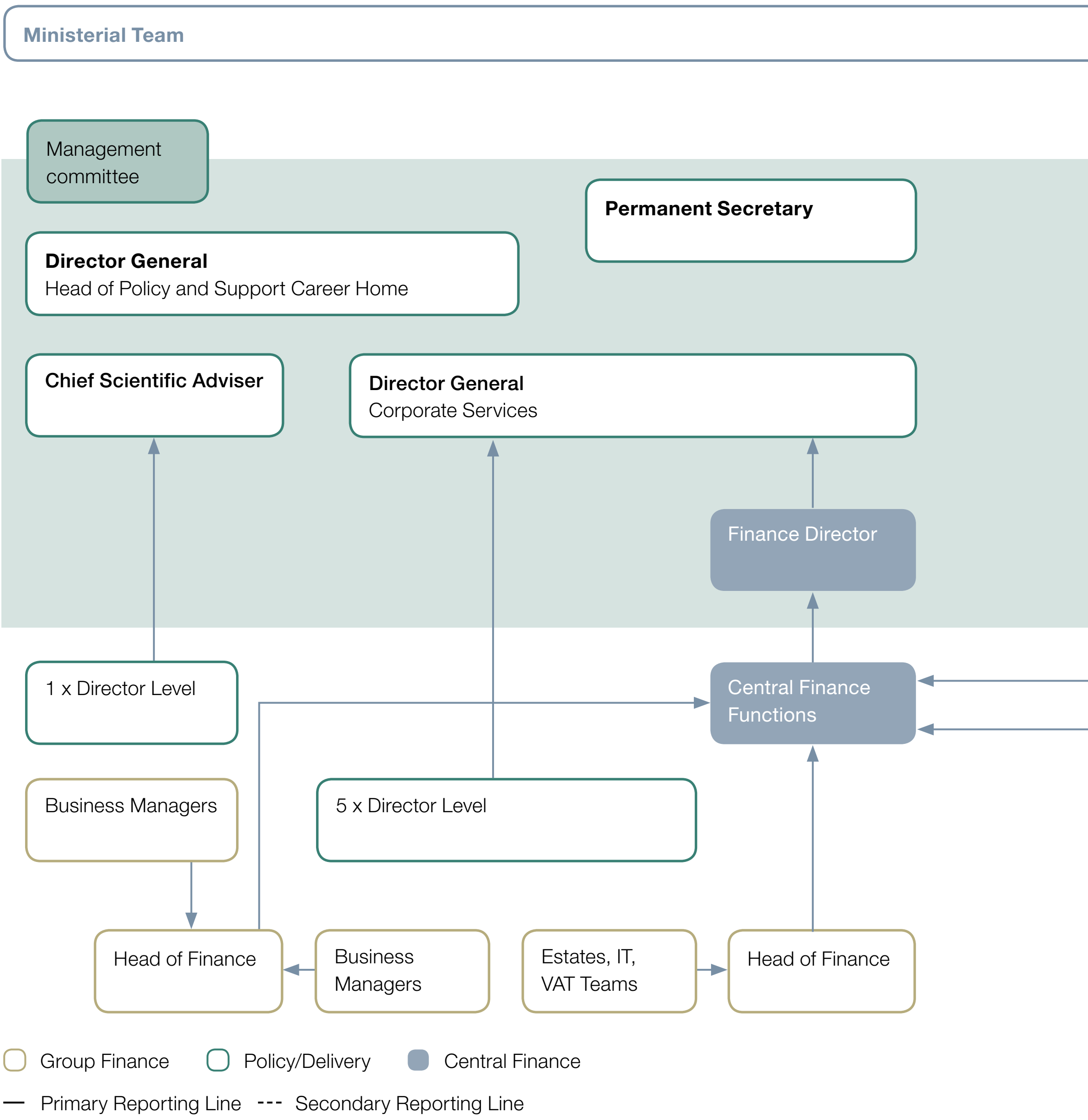
1.6 This report provides an overview of the Department's financial management against a financial management maturity model developed by the National Audit Office, drawn from best practice and applied elsewhere in central government.[6] The main areas the model focuses on are:

- financial governance and leadership;
- financial planning;
- finance for decision-making;
- financial monitoring and forecasting; and
- financial and performance reporting.

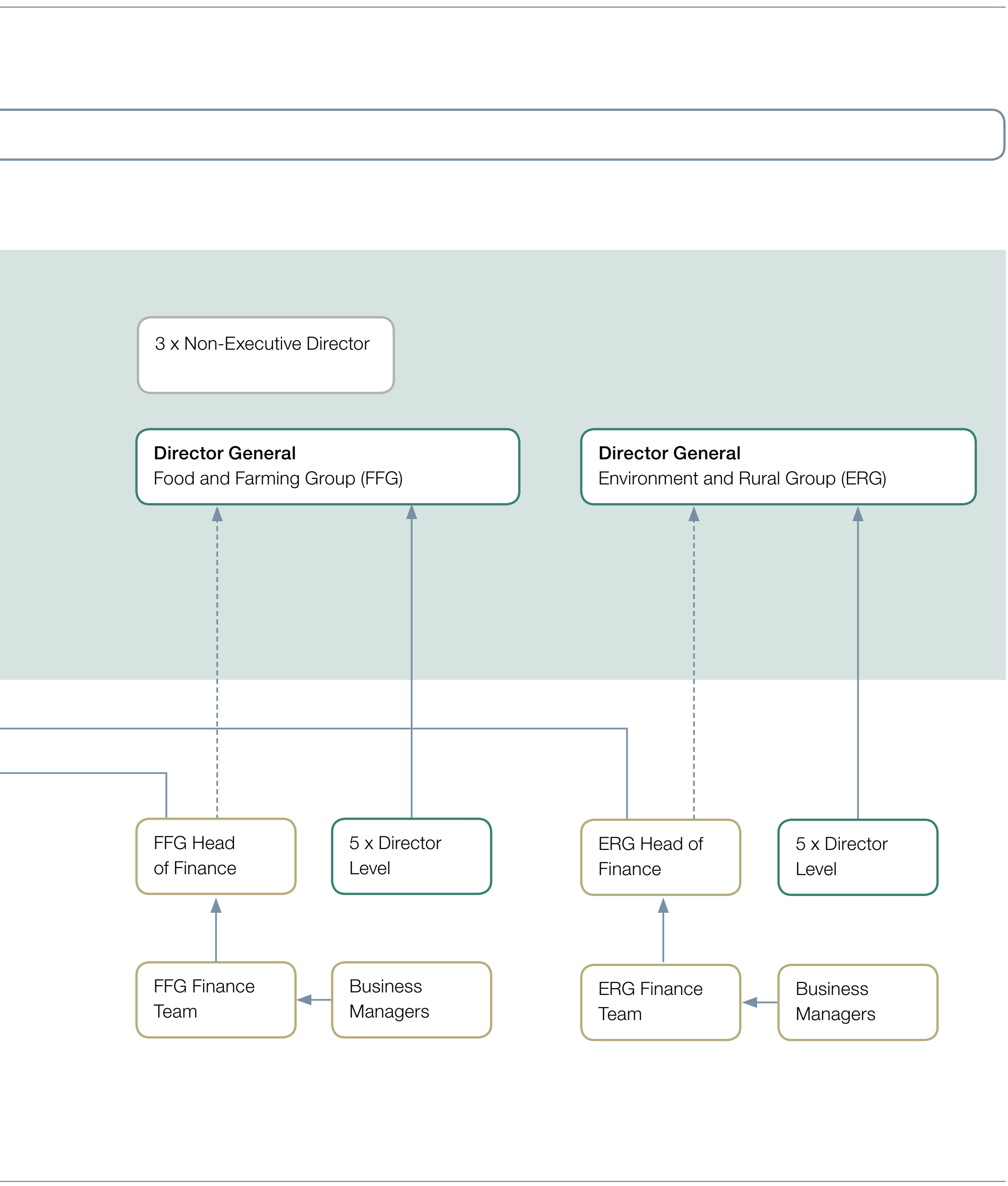
1.7 Our work focuses on how the Department manages its finances, both for itself and its arm's-length bodies, to ensure sound financial management. We refer to individual arm's-length bodies to illustrate our findings on the Department itself. We produce separate reports on significant issues in arm's-length bodies, including the Rural Payments Agency. Our methodology is outlined in Appendix One and a more detailed methodology can be found on our website.

6 More information on the financial management maturity model can be found at www.nao.org.uk/help_for_public_services/financial_management/fmmm.aspx.

Figure 3
Finance structure



Source: National Audit Office analysis of information from the Department


3 x Non-Executive Director
Director General
Food and Farming Group (FFG)
Director General
Environment and Rural Group (ERG)
FFG Head of Finance
5 x Director Level
ERG Head of Finance
5 x Director Level
FFG Finance Team
Business Managers
ERG Finance Team
Business Managers

Part Two

Financial governance and leadership

2.1 This Part examines financial governance and leadership, including:

- financial skills;
- internal controls and risk management; and
- how the Department oversees its arm's-length bodies.

The Department values financial management, but benefits since 2008 have not been measured

2.2 The Department has responded positively to our report on the management of expenditure in 2008 and the subsequent hearing by the Committee of Public Accounts.[7] In 2009, it launched its 'finance counts' programme. It had three workstreams covering people, systems and money. Programme outputs included:

- revised management reporting;
- greater finance content in approval panel processes; and
- revising year-end processes.

In 2010, the programme was incorporated into one of the work streams of a new finance transformation programme.

2.3 The finance transformation programme had a number of aims, including reviewing and restructuring the finance function, reducing staff numbers, supporting staff in career development and promoting greater cross-group working.[8] As of July 2011, the programme was in transition between completing phase one and starting phase two.[9] Some specific outcomes of this programme include:

- changing the reporting lines of finance, so they report primarily to the Finance Director (previously the primary reporting line was to the Director General of each Group), to help the Finance Director to better oversee finance and improve the accountability of finance staff; and

7 Comptroller and Auditor General, *Department for Environment, Food and Rural Affairs: Management of Expenditure*, Session 2007-08, HC 309, National Audit Office, March 2008.
8 The Programme originally had six work streams – financial control group, business improvement, arm's-length bodies, group finance, support function and people management.
9 The second phase has four work streams – the support team project, arm's-length bodies, business improvement, and people and communications.

- a drive to get all finance staff qualified, for example, several members of staff took their Chartered Institute of Management Accountants (CIMA) qualifications.

2.4 Whilst the Department has taken steps to monitor and evaluate these projects, it has not fully measured the benefits, so it cannot say to what extent improvements have been made, or demonstrate how effective these projects have been.

2.5 The 2009 Cabinet Office capability review also reported that the Department had made progress since it last reported in 2007.[10] In 2008-09, the Department was one of only nine departments to receive a rating of 'well placed' or above in terms of its strategy and delivery functions.[11] The review found that while the Department had made significant improvements, it needed 'to place a greater focus on building the capability, and managing the performance, of the wider delivery network'.

2.6 In summer 2011, the new Accounting Officer initiated a change programme, the main focus of which is to examine the Department's operating model. As elements of its finance transformation programme are still ongoing, the Department will want to ensure that the principles of sound financial management are embedded within the aims of the change programme, so that improvements made to date are not lost.

2.7 The Department sometimes focuses more strongly on policy than finance. It should make sure it consistently places an emphasis on finance, given that the current cost reduction agenda requires delivering more for less. The Department should aim to fully integrate policymaking with financial decision-making, which would allow it to assess the value for money of policy initiatives up front and on a continuing basis.

Financial skills are improved but not yet fully integrated

2.8 The Department has a relatively high ratio of finance staff. Our analysis of Cabinet Office data indicates that, in 2009-10, the Department had one member of finance staff for every 15.5 full-time-equivalent staff, compared with an average of one for approximately 56 staff in comparable organisations. Around a third of its finance staff are qualified, placing it in the top quartile of large organisations. Finance costs represent 1.7 per cent of the Department's overall running costs, against an average of 1.1 per cent.[12] This translates to a higher annual cost of finance per full-time equivalent member of staff; £5,360, compared to an average of £2,450 in comparable organisations. The Department's staffing levels and skills set mean it should be aiming to achieve a higher level of skills and expertise in relation to its financial management that reflects its business needs.

10 http://www.civilservice.gov.uk/about/improving/capability/reports.

11 The Cabinet Office defines 'well placed' as well placed to address any gaps in capability for future delivery through practical actions that are planned or already under way, or is making improvements in capability and is expected to improve further in the medium term.

12 http://www.cabinetoffice.gov.uk/resource-library/back-office-benchmark-information-200910. Ratio calculated using the figures from the second annual Back Office Benchmarking Survey. The figures are for the core Department. Whilst we consider that this gives a useful indication of the strength of the Department's finance function, any cross-government comparison will be affected by the different roles and responsibilities of each department.

2.9 Our 2008 report on managing expenditure[13] recommended that 'the Department's Management Board incorporate the performance of budget holders in managing their resources into each staff appraisal and associated personal development plan, determining any skills gaps amongst budget holders so that suitable training courses can be developed'. The Department has implemented this recommendation; its appraisals process now includes an assessment of financial skills, and a consideration as to whether budget holders have contributed towards value for money.

2.10 In line with its increased focus on financial management, the Department has made efforts to improve financial capability. The previous and new non-executive directors bring extensive knowledge of major public and private sector bodies. One of the non-executive directors is also a chartered accountant and should be well placed to support the further development of financial management. The Department has increased the number of permanent qualified finance staff and gives finance training courses for non-finance staff. In addition, as of July 2011, the Finance Director is a member of the supervisory board and management committee, which should further enhance financial capability.

2.11 The Department needs to manage the risk that finance and the finance function are seen as back-office support rather than being integral to business management. There is evidence that finance skills are not yet fully embedded across the Department. For example, some budget holders retain budgets rather than freeing them to be reallocated. These findings are similar to those from the Department's own commissioned review of its financial management. The review, which used a model developed by the Chartered Institute of Public Finance and Accountancy (CIPFA), highlighted the variable levels of financial management competence for operational staff.

The Department should improve its commercial skills

2.12 Commercial skills are needed for departments to gain value for money from the contracts that they manage. In our 2009-10 financial audit, we recommended that the Department should improve how it manages some of its significant commercial contracts. This would include a full stakeholder consultation, complete agreement of contractual terms before the contract begins, and identifying appropriate performance indicators.

2.13 The Department has begun to improve its contract management, including beginning a renegotiation of its facilities management contract, increased challenge of its IT contract and strengthening controls around management information. In June 2011, it introduced a service to support its staff with contract management advice. The newly-appointed Director General of corporate services has submitted a paper to the management committee, which outlines how to strengthen the Department's commercial function.

13 Comptroller and Auditor General, *Department for Environment, Food and Rural Affairs: Management of Expenditure*, Session 2007-08, HC 309, National Audit Office, March 2008.

The Department needs to manage the balance between permanent and temporary staff

2.14 The Department needs to carefully manage the risks arising from reducing contract and interim staff, in response to its reduced funding. The Department's strategy is to reduce the number of temporary staff employed – the total number fell by 63 per cent in 2010-11.[14] However, in March 2011, the Department's internal audit function identified that it was unclear how temporary staff will be used or how their numbers will be reduced.

2.15 In addition, the Department has not identified the skills gaps that temporary staff fill, or how to capture the knowledge that they have attained. In our 2010-11 financial audit, we stated that reducing temporary staff could affect how the Department delivers against its objectives. We also noted that there could be a gap in expertise and in continuity left by these outgoing staff. The Department reports that for the last 18 months, every interim contract has required a business case submission to the Accounting Officer, identifying the skills gap that the temporary worker will fill.

The Department should improve its internal control and risk management, particularly of its arm's-length bodies

2.16 The Department's internal control and risk management activities have evolved since 2008. The management committee manages its own portfolio of risk using a strategic risk register, with risks classified by severity, likelihood and timescale; in the short, medium or long term. The committee has sought to embed risk management within normal business activities. Arm's-length bodies are responsible for identifying and managing their own risks and the Department discusses these with the bodies as part of day-to-day business.

2.17 The Department needs to improve its oversight of risks, particularly those within its arm's-length bodies. For example, we reported in 2009 that the Department did not receive adequate information on the seriousness of internal control, operational and management problems within the Rural Payments Agency, so it could not act in a timely and effective manner.[15] This example highlights the importance of timely escalation of risk, and full consideration of the potential implications to the Department and its arm's-length bodies. This issue is not particular to the Department. Our cross-government report on managing risks in Government found that 'there is often a lack of clarity over the ownership of, and accountability for risks, particularly with respect to devolved delivery bodies. In all types of arrangements, there is a need to improve and clarify risk escalation processes by clearly communicating to staff when risks should be escalated.'[16]

14 The 63 per cent reduction is across the Department and its Executive agencies.

15 The Department has taken a number of steps to address the issues at the Rural Payments Agency, including the Lane Review, which considered the current state of the Agency as well as its readiness for a changed Common Agricultural Policy after 2013. http://www.defra.gov.uk/news/2010/07/20/rpa-news/

16 National Audit Office, *Managing risks in government*, June 2011.

2.18 The Department knows it needs to improve its risk approach, and has taken steps to ensure it has a greater understanding of internal and external risks to arm's-length bodies that may impact upon the Department or other bodies. In 2010-11, the Department's audit and risk committee reported that the Department needed to improve risk escalation processes, as well as relationships between the Department and its arm's-length bodies. The previous Chair of the committee established processes to increase contact with these bodies and enhance consideration of their risks. The newly appointed Chair intends to hold regular meetings to bring together the chairs of audit and risk committees across arm's-length bodies. While it is important that the committee gives sufficient assurance to the management committee on managing risk and control, the Department should own, drive, and lead on risk issues.

2.19 The Department recognises that there are still weaknesses in its risk management, especially around the integrated reporting of financial and risk information, and is taking steps to address them. For example, since May 2011, the Department has required arm's-length bodies to routinely report financial and other risks alongside financial management information. In addition, it has partnered with the Risk Centre at Cranfield University to better understand external environmental risks. The lack of integration between financial and risk information is a common area of weakness across departments. Our report on managing risk in Government found that 'risk information reported to the board is not fully integrated with performance and financial information. While risk registers are an effective way of capturing risks and mitigations, they may not drive the right type or level of discussion which allows either management to make informed decisions, or the board to challenge and scrutinise, based on a proper assessment and evaluation of the key risks.'[17]

The Department faces a challenge in overseeing arm's-length bodies

2.20 The Department sponsors a large number of arm's-length bodies, which differ substantially in size, influence and risk. The Department's Permanent Secretary, in her role as Accounting Officer, is responsible for ensuring that the Department, and any arm's-length bodies it sponsors, operate effectively. This includes delivering the standards of governance, decision-making and financial management outlined by HM Treasury in *Managing Public Money*.[18] If there is a serious failure at an arm's-length body, the Accounting Officer of the Department can arrange for the governance of that body to be adjusted, or replaced, if that is necessary to bring about required improvements. Assessing and then maintaining appropriate oversight of arm's-length bodies is a challenge faced across government departments.

17 National Audit Office, *Managing risks in government*, June 2011.
18 HM Treasury, *Managing Public Money*, 2011.

2.21 The public bodies review[19] has driven the Department to reduce the number of arm's-length bodies it funds from 92 to 36, with a further two bodies under review. However, these reforms were not primarily intended to deliver cost reductions. The majority of the changes were to bodies that received only small amounts of funding: around £78 million, or 3.5 per cent of the Department's budget for 2011-12. The arm's-length bodies affected by the review are listed in Appendix Two.

2.22 The Department will, however, have to oversee and manage a small number of significant changes as a result of the review. This includes closing the Commission for Rural Communities. In addition, the Department is overseeing the merger of the Veterinary Laboratories Agency and the Animal Health Agency, which was announced prior to the public bodies review. Its intention was to provide a broader science base and was not, therefore, primarily intended to result in cost savings.

2.23 Our 2008 report on managing expenditure recommended that 'the Department's Management Board from 2008-09, specifies the timing and information required in the monthly progress reports, to include integrated performance and finance data, from each delivery body to enable the sponsoring Directors General to engage more effectively with the delivery bodies and to respond to challenges at the Department's Management Board meetings.'[20] Largely driven by the spending review, the Department has started to work more closely with its arm's-length bodies and established a minimum reporting standard, which has improved oversight and reporting.

2.24 Finance directors from the Department's arm's-length bodies are working together to improve financial management. The finance directors from key arm's-length bodies are using the National Audit Office's financial maturity model for self-assessment to identify areas for improvement across the Department's network. These activities include collecting information on staff finance skills and the costs of the finance function. The Department is engaged in the initiative, although it is being driven by the arm's-length bodies themselves. As the Department and its arm's-length bodies all have different skills and are at different levels of maturity, it is important that they work together to share best practice. This exercise is still ongoing and it is too early to assess its effectiveness.

19 The public bodies review, which was launched in October 2010, aimed to substantially reform a large number of public bodies across government. It covered all of Government's non-departmental public bodies, as well as other bodies, such as some non-ministerial departments and public corporations.

20 Comptroller and Auditor General, *Department for Environment, Food and Rural Affairs: Management of Expenditure.* Session 2007-08, HC 309, National Audit Office, March 2008.

2.25 Whilst the Department is working with its arm's-length bodies to improve financial management, it lacks a clear and proportionate model of engagement with them. The Department is working on a set of accountability systems statements, which will establish arrangements for accountability across the network. In doing this, the Department should ensure that it does not adopt a 'one size fits all' approach to managing its arm's-length bodies. It should engage with its arm's-length bodies at a sufficient level of seniority. The management committee should take direct ownership of these relationships to make sure they are properly managed. The HM Treasury alignment project will also reinforce the need for the Department to work closely with its arm's-length bodies to achieve common objectives.[21]

21 The HM Treasury alignment project aims to simplify financial reporting to Parliament. This means that, in 2011-12, departments will need to produce consolidated accounts that include departments' and arm's-length bodies' income, spending, assets and liabilities.

Part Three

Planning, monitoring and performance reporting

3.1 This Part examines:

- planning and decision-making;
- financial monitoring and forecasting; and
- financial and performance reporting.

The Department will need to improve and integrate financial and performance planning to meet spending review commitments

3.2 Following the spending review, the Department was required to make significant reductions to its UK funded resource spending. It has committed to reduce this spend from £2.3 billion in 2010-11 to £1.8 billion in 2014-15. Taking account of inflation, this means that the Department's UK funded budget will reduce by 29 per cent by 2014-15. **Figure 4** overleaf shows the reduction in the Department's overall budget over this period. **Figure 5** on page 27 gives illustrative examples of the reductions in budgets that will also be required over the spending review period.

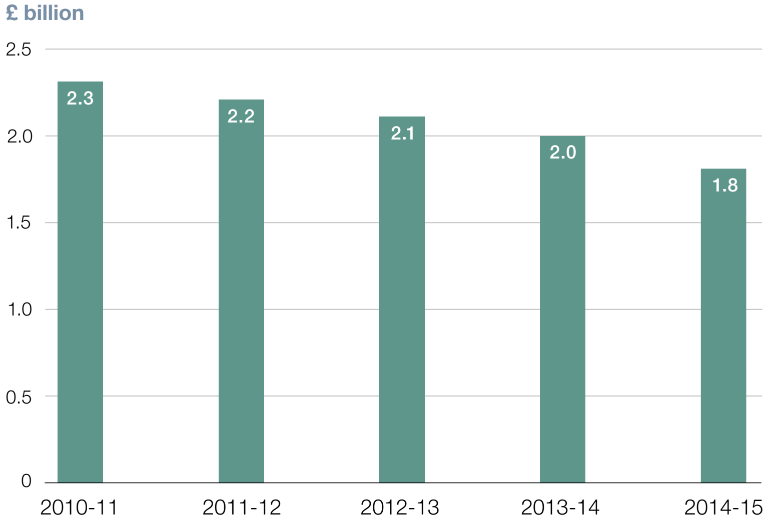
3.3 The Department has aimed to cut its spending in a targeted way and has challenged and altered its models for delivery, in line with our good practice guide on structured cost reduction.[22] In order to consider where best to target its cost reduction activities, the Department instructed its arm's-length bodies to assess value for money of its spending on activities and cost benefit analysis of different options was carried out. The Department also introduced blanket cuts of 33 per cent in administrative spend, as set out by HM Treasury as part of the spending review. Going forward, the Department will benefit from retaining its ability to evaluate the cost effectiveness of its strategy and to make evidence-based strategic decisions.

3.4 In our 2008 report on managing expenditure, we identified that the Department needed to improve how it allocated funds, according to the strategic objectives of the organisation.[23] Overall, we found that because of the planning needed for the spending review, the Department has taken steps to integrate its financial planning along with its strategic planning. However, this integration between financial and strategic planning needs to be embedded into normal business processes.

22 National Audit Office, *A short guide to structured cost reduction*, June 2010.
23 Comptroller and Auditor General, *Department for Environment, Food and Rural Affairs: Management of Expenditure,* Session 2007-08, HC 309, National Audit Office, March 2008.

Figure 4

Department resource budget, 2010-11 to 2014-15



NOTE

1 EU funding spent by the Department is not included in the Department's UK budget. The Department is forecast to receive £2.3bn of EU funding in 2011-12 (www.hm-treasury.gov.uk/d/defra_main_supply_estimates_april11.pdf).

Source: Spending Review 2010 http://cdn.hm-treasury.gov.uk/sr2010_completereport.pdf

The Department has improved its in-year financial planning

3.5 In our 2008 managing expenditure report[24] we recommended that 'the Department's Management Board develops a range of measures to benchmark forecast spending each year across its different activities, to enable senior officials to probe the rigour of the budgets set and to determine more methodically whether there are any resources that could be reallocated to support the Department's strategic objectives'. We also recommended that the Department improve holding managers to account for the management of their resources.

3.6 In 2008, the Department set up two investment approval panels to begin to improve its processes for in-year reallocation of resources. The local approval panels examine the portfolio of activities for each Group. The local panels are responsible for in-year reallocations and reprioritising budgets between programmes. The Department has also set up a central approval panel, which is responsible for cross-cutting elements of budgets and for allocating resources where funds are not available within Groups. The central approval panel is developing its role so it continually reviews financial performance, and is presented with summaries of work undertaken by local approval panels. We have not reviewed actions taken by these panels, as their remit is undergoing considerable change, so they can support the Department to implement the spending review cuts.

24 ibid.

Figure 5

Illustrative examples of decreases in budget allocations over the spending review period

	2010-11 Total budget (£m)	2014-15 Total budget[1] (£m)	Decrease (%)
Keep Britain Tidy	4.8	0.5	90
Waste and Resources Action Programme	48.1	30.1	37
Royal Botanic Gardens Kew	24.6	17.3	30
Forestry Commission	44.8	33.4	25
Environment Agency (Flood Management)	629.0	485.2	23
Marine Management Organisation	30.9	24.4	21
Natural England	197.1	155.1	21
Joint Nature Conservation Committee	4.6	3.7	20
Rural Payments Agency	159.0	127.0	20
British Waterways	48.0	39.0	19
National Forest Company	3.3	2.7	18
Environment Agency (non-flood)	199.9	167.0	16
National Parks and Broads Authorities	53.6	46.6	13
Gangmasters Licensing Authority	4.2	3.9	7
Total allocations	**1,451.9**	**1,135.9**	**22**

NOTES

1 The figure includes reductions in budgets for a selection of programmes and arm's-length bodies. It is not intended as an exhaustive list.

2 The 2010-11 budgets differ from those outlined in Figure 1 as they exclude one-off and time limited expenditure.

Source: National Audit Office analysis of information from the Department

The Department must improve its understanding of costs and cost drivers across its arm's-length bodies

3.7 The Department does not have an overview of the cost drivers for key work undertaken by its arm's-length bodies, or an understanding of the full costs of its policies or objectives. It cannot easily identify the full cost of work, or whether spending is reasonable, to inform its decision-making. Nor can it easily measure the cost of achieving an objective when more than one arm's-length body undertakes the work. We highlighted this issue in October 2010 in relation to the Department's work in the area of animal health.[25]

25 National Audit Office, *Commentary on cost data provided by the Department for Environment, Food and Rural Affairs to the Advisory Group on Responsibility and Cost Sharing*, October 2010. One of the aims of the merger was to address the issues raised in our report, though it is too early to judge its effectiveness.

3.8 The Department has started to collect better management information from its arm's-length bodies but performance and cost information is not generally integrated. Without this information, the Department cannot make fully informed decisions to best manage its resources, assess the effectiveness of its activities, design realistic budgets and forecasts, or effectively use its cash allocation.

3.9 In our report on managing front line delivery costs we found that the Department had few indicators to assess whether the costs of activities in arm's-length bodies were high or low. We found that the Department used some external benchmarking of costs against commercial markets where appropriate, but had no formal indicators to routinely assess value for money.[26] Neither does the Department have a good grasp of the cost drivers for programmes of work of arm's-length bodies and has not yet undertaken analysis to improve its understanding. We did conclude, however, that some of these bodies themselves demonstrated progressively improving understanding of their own cost structures, and were taking steps where necessary to improve the data available to them. As of April 2011, as part of its structural reform commitments, the Department publishes a quarterly data summary which reports on its budget, spend and performance and financial indicators.

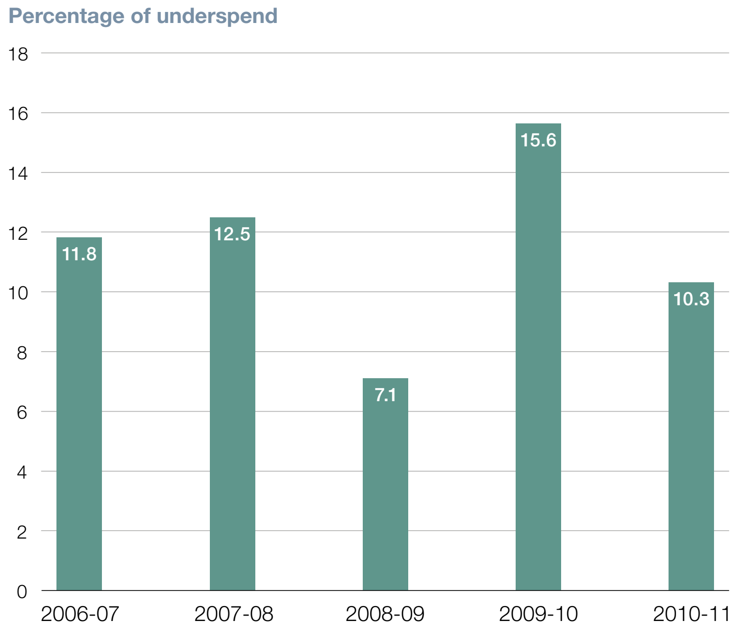
The Department's monitoring and forecasting require further improvement

3.10 The Department has consistently overestimated the total resources it requires and has reported underspending resources granted by Parliament each year since 2002. **Figure 6** shows the percentage underspend against net resource requirement for the years 2006-07 to 2010-11. In 2010-11, the total underspend against resources granted by Parliament was £530 million, against an estimate of £5.14 billion. Some £220 million of this underspend was due to a ministerial decision to increase checks to ensure the accuracy of European Agricultural Fund payments, which slowed the rate of payment. A further £136 million related to pension scheme accounting provisions and should not recur in future years.

3.11 However, there were some elements of the underspend within the Department's influence. Some £44 million relates to delayed payments by the Environment Agency. A further £44 million relates to an estimated provision for staff exit costs, which did not materialise during 2010-11. From 2011-12, there will only be one opportunity each year to adjust departmental estimates, so it will be important that the Department can forecast accurately and monitor in-year variations closely.

26 Comptroller and Auditor General, *Managing Front Line Delivery Costs*, Session 2010-11, HC 1279, National Audit Office, July 2011.

Figure 6
The Department's underspend, 2006-07 to 2010-11



	2006-07	2007-08	2008-09	2009-10	2010-11
Net resources used by the Department (£m)	5,604	5,150	4,873	4,957	4,610
Net resources granted for the Department's use by Parliament (£m)	6,356	5,885	5,245	5,876	5,140
Underpend (£m)	751	735	373	918	530
Underspend (%)	11.8	12.5	7.1	15.6	10.3

NOTE
1 Numbers may not total due to rounding.

Source: Department Resource Accounts, 2006-07 to 2010-11

The Department has improved its management of expenditure against its departmental expenditure limit

3.12 The resources provided by Parliament are subject to several subsidiary 'control totals' against which departments must also report performance. These include outturn against net resource requirement, departmental expenditure limit and net cash requirement, as indicators of how well departments are managing their use of public funds. The Department has significantly improved management against its departmental expenditure limit, and has reported reduced underspends against this limit since 2008.

3.13 In 2010-11, the Department initially forecast an overspend of approximately £100 million against this limit. A team within finance was tasked with identifying underspends, using trend analysis to examine spending profiles and to compare forecasts to prior year spending. The team was then able to use that information to identify savings of £162 million to meet the in-year reduction in funding imposed by the Emergency Budget in June 2010. The approach allowed the Department to move from its forecast overspend for 2010-11 to an eventual underspend against the departmental expenditure limit of £34 million, around 1 per cent. This is a significant reduction from the £72 million underspend in 2008-09. The Department recognises the benefits of this approach and is looking to embed this into 'business as usual' activities.

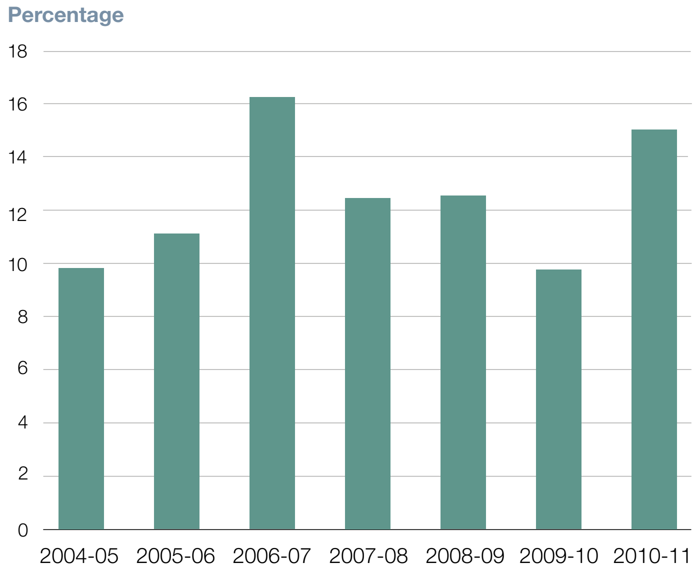
3.14 The Department's in-year budgeting has begun to improve, but it needs to challenge forecasts far more robustly so it can have greater confidence in their accuracy. It should overcome cultural barriers to reallocating funds, such as those responsible for budgets holding on to resources. In 2010-11, the Department took action to restrict the circumstances in which budgets could be adjusted. Before this, it allowed regular amendments to budgets rather than requiring budget holders to explain and justify differences. Our 2010-11 financial audit noted that there was insufficient challenge at committee level of the explanations of differences, though it did acknowledge that improvements had been made in the challenge process. Given the future spending constraints from the spending review, the Department should monitor spend more closely to maximise outcomes.

Cashflow forecasting

3.15 The Department needs to improve its cashflow forecasting. In 2010-11, HM Treasury ranked the Department bottom across all departments on its ability to accurately forecast its monthly cash requirements. It was the only department to receive a 'red' rating. A main driver of cashflow forecast uncertainty comes from volatility in the timing of payments by the Rural Payments Agency, which are made on a five-day cycle. **Figure 7** shows the difference between the Department's cash forecast and its spend.

3.16 In addition, the difference between the cash allocated to the Department by Parliament and the cash spent in 2010-11 was 15 per cent (the 'net cash requirement'). This is three times higher than the 5 per cent target set by HM Treasury. Only three departments had a variance of over 10 per cent and the Treasury has said it will meet with these departments to help them improve their performance.

Figure 7
Monthly percentage difference of cash forecast to cash spent, 2004–2011



	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11
Average monthly percentage difference of cash forecasting figures	9.8	11.1	16.2	12.4	12.5	9.68	15.01

Source: National Audit Office analysis of information from the Department

3.17 The Department should also manage its forecasts of total cash expenditure more effectively. The committee receives data on arm's-length bodies' cash position, but the Department rates its position as 'green' if an underspend is predicted, even if the underspend is large. The Department has significantly underspent against its estimated net cash requirement, some £474 million in 2010-11. The Department's underspend is affected by payments made by arm's-length bodies, particularly the Rural Payments Agency. The changes to year-end flexibility will help the Department to manage its cash requirement. Also, improved oversight would allow the Department to give more accurate forecasts to HM Treasury, and will better support timely in-year reallocation of unspent funds to take forward delivery.

The Department should better integrate performance and financial reporting

3.18 We previously reported on the Department's financial management in 2008. Our report identified that the Department needed to raise the profile of financial management through rigorous scrutiny and debate at management board meetings, so early corrective action could address emerging risks. Since 2008, the quality of the Department's reporting to the management committee has improved, both in clarity and quality of content. The business analysis team generates the finance and performance reports for the committee and we found it provides financial information in a consistent format. The reports provide suitable types of information, for example, a narrative of financial issues, outturn against control totals such as delegated spending limits and resource estimates, and variances against budgets.

3.19 There is scope, however, for the committee to receive more complete information, which would strengthen oversight of the Department's finances further. For example, working capital and other assets and liability information is not included in information presented to the management committee. This implies that, in some cases, not all relevant financial information is routinely included. In addition, the performance and finance documents submitted to the management committee are standalone documents, which indicate that there is inadequate linkage between these areas.

3.20 Our report on performance and board reporting found that this was a common weakness across departments. We reported that 'in all but two organisations we examined, the performance and financial reports are separate reports. In all other organisations reviewed there was either no mention of costs in the performance reports, or there was only very limited reference to costs. Previous National Audit Office work has found that Public Service Agreements and Departmental Strategic Objectives rarely contained any links to finance. We found that "financial information has been poorly linked with the Public Service Agreement indicators. Annual departmental expenditure has been apportioned by Departmental Strategic Objective, but this apportionment is not broken down by the indicators used to report progress, and so is not readily usable for deeper analysis of the cost of progress."'[27] As of July 2011, however, the Department has brought both its finance and performance function under one Director.

3.21 The Department produces month-end management information in good time, though there are issues with quality. The Department has a reporting cycle time of five working days, among the quickest reporting cycle times reported to the Cabinet Office by large organisations. However, further improvements are required in this area. For example, the Department does not always accurately record its estimated spending and has to re-open the books after month end to correct the errors. If data entered into the ledger is not accurate, then this will hamper the Department's ability to monitor and control spending.

27 National Audit Office, *Performance Frameworks and Board Reporting II*, May 2011.

3.22 The Department's financial reporting meets the standards set by HM Treasury. During our 2010-11 financial audit, however, we did find that the accounts production process could be improved. The Department produced the accounts very late, which placed the timetable to lay the accounts before Parliament at risk. The process was delayed due to late submissions from some arm's-length bodies and the time required to process their information centrally. Because of these issues, the Department faces a challenge in meeting the deadlines set out in HM Treasury's alignment project.

The Department faces a challenge in complying with the alignment project

3.23 The alignment project, or 'clear line of sight', led by HM Treasury, is a project to simplify financial reporting to Parliament. This means that in 2011-12, for the first time, departments will need to produce consolidated accounts that include departments' and arm's-length bodies' income, spending, assets and liabilities. The Treasury has set the target delivery date as 30 June 2012, around three weeks earlier than the previous year.

3.24 The Department and a number of its largest arm's-length bodies have a consistent record of only just meeting the current deadline for reporting to Parliament. The shortening of the timetable is the biggest challenge facing the Department, although there are also some challenges in consolidating additional arm's-length bodies. The Department has established a project team, and has developed a project plan to deliver pre-recess consolidated accounts. It plans to review progress after a dry run exercise, and to monitor delivery against the project plan throughout 2011-12. The Department should ensure that plans are realistic, based on the timing of necessary information from its arm's-length bodies.

3.25 Under the alignment project the Department will no longer receive cash from the UK Exchequer to pay European Union funded grants. Before the alignment project the UK Exchequer provided cash to pay grants initially and then received reimbursement from the European Union. As a result, the Department's total cash allocation from Parliament will fall by £2.71 billion in 2011-12. This is a significant challenge for the Department's cash management, especially given the weaknesses identified in its cash forecasting.

Appendix One

Methodology

1 The National Audit Office has developed a model of financial management maturity, which was used in this examination. The model identifies good financial management under five main criteria: financial governance and leadership; financial planning; financial decision-making; financial monitoring and forecasting; and financial and operational reporting.

2 In making our assessment, we used the methods set out below. A fuller methodology is provided on our website.

Methods	Purpose
Semi-structured interviews	
We carried out 20 interviews across the Department including: • senior management; • finance staff; and • operational staff. We interviewed nine board members, including five non-executive directors.	To understand the condition of the Department's financial management and progress made since 2008.
Analysis of Departmental papers	
We reviewed key documents including: • board finance reports; • board minutes; • budgeting and forecasting working papers; • finance improvement projects; • internal audit reports; and • strategic planning documents.	To understand the condition of the Department's financial management and progress made since 2008. To triangulate and fully evidence findings from our interviews.
Analysis of financial data	
We reviewed financial data published by the Department and HM Treasury to analyse the Department's spending over the years 2006-07 to 2010-11. This included examining capital and revenue budgets, parliamentary supply estimates and spending. We reviewed internal financial data used in decision-making, such as management accounts.	To assess how the Department performed in terms of budgeting and forecasting, in-year budget setting, and providing financial and performance information.

Source: National Audit Office

Appendix Two

Reforms of the Department's delivery network announced in the public bodies review, October 2010

Abolished or reclassified and functions transferred within Government

Agricultural Wages Board for England and Wales

Commission for Rural Communities

Spongiform Encephalopathy Advisory Committee

Abolished and reconstituted as a committee of experts

Advisory Committee on Hazardous Substances

Advisory Committee on Packaging

Advisory Committee on Pesticides

Air Quality Expert Group

Darwin Advisory Committee

Farm Animal Welfare Council

National Standing Committee on Farm Animal Genetic Resources

Pesticide Residues Committee

Veterinary Residues Committee

Zoos Forum

Abolished and functions ceased

Advisory Committee on Organic Standards

Agricultural Dwelling House Advisory Committees (x16)

Agricultural Wages Committees (x15)

Animal Health and Welfare Strategy England Implementation Group

Committee on Agricultural Valuation

Commons Commissioners

Expert Panel on Air Quality Standards

Food from Britain

Inland Waterways Advisory Council

Royal Commission on Environmental Pollution

To be transferred out of Government

British Waterways

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