



National Audit Office

Report

by the Comptroller
and Auditor General

Ministry of Defence

Strategic financial management in the Ministry of Defence

Summary

1 The government sees strengthening departments' financial discipline as an important part of reducing the deficit, achieving value for money and delivering high quality public services. With the third-largest budget in government and a quarter of the government's balance sheet, improving financial management in the Ministry of Defence (the Department) is essential. In 2014-15 the Department spent the majority of its £35.8 billion funding in four broad areas: equipment procurement and support; military personnel and civilian staff; infrastructure; and inventory.

2 This is our second stocktake of the Department's progress in this area. Our 2010 report found that improvements were needed and the Department had overcommitted against its budget, which was resulting in short-term cuts and the deliberate slowing down of equipment delivery. This was creating instability and resulting in poor value for money. Since our report in 2010, the Department has adopted a two-pronged approach to improving its financial management. It has sought to:

- Address the funding gap in its equipment programme, which was having a destabilising effect on the defence budget, and to reduce costs and deliver efficiencies in all areas of the defence budget to meet the Spending Review 2010 settlement.
- Improve its management structure by:
 - delegating greater responsibilities to the Armed Forces (the Commands), giving them the ability to decide how to use their resources to best effect within their own budgets, thereby creating a more controlled and financially responsible 'demand' for procuring equipment, equipment support and infrastructure; and
 - reforms to the Department's Head Office, and to Defence Equipment and Support and Defence Infrastructure Organisation (known as the 'enablers') to secure better management of financial risk and a more predictable good quality 'supply' of equipment procurement, equipment support and infrastructure to the Commands.

3 This new management structure addressed the recommendations of the 2011 *Independent report into the structure and management of the Ministry of Defence*, led by Lord Levene.

4 Measuring the Department's performance is complicated by the fact that there are no clear defence 'outcomes' that can easily or meaningfully be measured to assess how efficiently the Department is using its resources. The criterion we have therefore used to judge the Department's success is whether it is in a good position to manage its future spending plans effectively, including whether it has delivered the reduction in 'inputs' to which it committed to balance its budget.

Key findings on addressing the funding gap

5 **The Department has brought its costs under greater control, focusing on ensuring that the defence budget is affordable.** The Department cancelled some projects and took other equipment out of service earlier than planned, reporting that it avoided some £5.4 billion of future costs. It has taken a positive step by putting in place an affordability regime for equipment over the next ten years, laying the foundations for future stability. In addition, the Department has put in place plans to deliver £4.3 billion of savings to staff, military personnel and other administrative costs it needed to balance the defence budget over the period 2010 to 2015. Greater confidence in its future costs has enabled the Department to focus on improving the management of its equipment programme, rather than continual reprogramming of activities in-year so that it lives within its budget (paragraphs 1.6 to 1.12).

6 **The defence estate is larger than needed, under-utilised, too expensive to maintain and fails to support the Department's longer term strategy for the Armed Forces.** The Department recognises that the defence estate is unsustainable at its current size and condition and that it can only afford to fund 50% of the estate infrastructure programme the Commands believe they need to deliver the Department's strategic objectives. However, it has made slow progress addressing the Committee of Public Accounts' 2010 recommendations that it should make more efficient and effective use of the estate. In September 2014, it brought in a private sector business partner to help improve its management of the estate (paragraphs 1.24 and 1.25).

7 **The Department has lived within reduced budgets as set through the Spending Review 2010 and subsequent spending reviews.** While it knows the broad areas in which it has achieved savings, it has not tracked the success of individual savings initiatives. It therefore does not have a full assessment of the extent to which savings have been made through genuine efficiency measures, or the potential impact on future costs or savings measures (paragraph 1.7 and Figure 2).

8 Risks remain to the continued balance of the defence budget, including both improving the Department's performance to deliver the additional savings already assumed in future budget allocations, and future possible budgetary pressures. The Department has reduced budgets on the basis of significant expected savings in equipment, infrastructure and inventory costs. Delivering these savings will depend on the success of the Department's efforts to improve how it operates. There are also a number of forthcoming budgetary pressures that the Department will need to manage, including: the increasing dominance within the Equipment Plan of a small number of large, complex, and politically important programmes; aligning the size of the defence estate with its budget; and managing potential increases in staffing and military personnel costs (paragraphs 1.13 to 1.28).

Key findings on creating a more controlled and financially responsible 'demand'

9 The Commands are taking greater ownership of their significant budgets and continue to build their capabilities at varying paces. The Commands are now responsible for determining what equipment they need to meet their strategic objectives, and for managing those equipment programmes and budgets. Although the Commands are building up their capabilities to take on their enhanced role, there remain significant gaps in their skills and expertise in this respect. They continue to develop their understanding of equipment costs, their project, programme and financial management skills, and the service level agreements against which they intend to track the performance of Defence Equipment and Support (DE&S) (paragraphs 2.4, and 2.6 to 2.13).

10 Over the longer term the Department expects its new operating model to encourage the Commands to make better use of their resources but it could do more to ensure this happens. The Department anticipates that giving the Commands responsibility for managing the majority of the defence budget will lead to greater stability and improved value for money. However, there are differing views within the Department on how to give the Commands incentives to improve value for money over the longer term. For example, the Commands do not know whether they will be able to retain savings they identify from improving project performance over the forthcoming ten-year Equipment Plan period, or how they will be held to account for securing better value for money (paragraphs 2.16 to 2.18).

Key findings on ensuring better management of financial risk and a more controlled and financially responsible 'supply'

11 The Department has strengthened its corporate governance in recent years, increasing independent scrutiny. The Defence Board now acts as the main decision-maker for non-operational matters, addressing a key recommendation from the Levene Review. The quality of financial reporting to the Defence Board has also improved, enabling it to take a stronger role in overseeing improvements to financial management (paragraphs 3.2 and 3.3).

12 The affordability of the Equipment Plan critically relies on improvements in the performance of DE&S. The Department has a plan in place to deliver these improvements. To deliver the defence capabilities the Department assesses it requires, DE&S must work with contractors to deliver the equipment and support in the Equipment Plan to time, cost and quality, and achieve over £6 billion of savings built into the Plan, which primarily relate to equipment support. While DE&S has improved its understanding of equipment procurement costs, its understanding of its equipment support costs is less well- developed and achieving these savings will require a step-change in its performance. After a delayed organisational change programme, in April 2014 the Department: secured new pay freedoms to retain and enhance the skills of its workforce; introduced new governance arrangements; and contracted with the private sector for business support. The Department expects that its programme to improve DE&S's capabilities will span the next three years (paragraphs 1.17, and 3.20 to 3.22).

13 The Department has a four-year plan to transform the provision, and use of, information technology across Defence. It recognises that, at present, a proliferation of bespoke systems, weak contracting procedures and inconsistent management are not delivering the management information the Department needs to manage its business and operations efficiently, or to achieve value for money from its IT spend (paragraphs 3.16 and 3.17).

14 Given its size and complexity, the Department recognises that improving its financial management is a long-term endeavour, with sustained effort across the Department needed to ensure that momentum is maintained and the full benefits realised. Many of the recent changes to its structure and capabilities are not yet embedded and initiatives to streamline and standardise financial processes, improve financial skills, and change behaviours are ongoing. Finance staff currently spend too much of their time repackaging financial information, rather than using their skills to add value. Better financial management has resulted in some improvements in how it produces its financial accounts. However, our audit of the Department's accounts continues to identify major issues which may cause significant misstatement of the accounts and weaknesses in internal controls in a wide range of areas. Development of an integrated risk, control and assurance framework is under way to provide the Accounting Officer with assurance on the operation of internal controls (paragraphs 2.18, 3.5, and 3.10 to 3.14).

Conclusion

15 The Department's strategy for improving its financial management makes sense to us and is delivering results with considerable challenges still ahead. The Department has brought its costs under greater control and is in a better position than it was in 2010 to manage its future spending plans effectively. It has taken substantial steps through its affordability regime for equipment over the next ten years, laying the foundations for future stability. There are, however, some significant risks to the continued balance of the defence budget that the Department must manage, including delivering savings already removed from budget allocations.

16 The Commands are paying greater attention to financial management and taking greater ownership of their budgets, creating more controlled and responsible 'demand' on the enablers – Defence Equipment and Support (DE&S) and Defence Infrastructure Organisation (DIO). However, the Commands continue to build their capabilities to manage their significant budgets at varying paces. Improving their financial, commercial and project management capabilities, and management information remains important for the Commands to effectively hold the 'enablers' to account to drive up performance.

17 Good financial management alone will not achieve all of the change that the Department requires. This will also be dependent on changing the behaviours necessary for the system to work, and improving the skills within DE&S and DIO. The Department has programmes in place to improve DE&S and DIO over the next few years. It is too soon to gauge whether these programmes will enhance their performance to provide the Commands with a predictable good quality 'supply' that meets the Commands' equipment and infrastructure requirements. As with any long-term strategy, it is inevitable that the Department will face some challenges sustaining progress. We will continue to monitor the success with which it implements its strategy and overcomes these challenges in the future.

Recommendations

18 Our recommendations are designed to help the Department further strengthen its financial management and ensure it has robust governance arrangements in place to monitor the impact of, and risks arising from, new ways of working.

19 To improve its strategic overview and strengthen its governance arrangements, the Department should:

- a** **Ensure it has a strong understanding of the relationship between any changes to its forecast funding and the defence capability that it is able to provide.** It should be able to demonstrate the consequences of any changes to its finances and use this information to avoid a situation where its future funding and the defence objectives it is required to deliver are not aligned. It should also have a good understanding of the relationship between its different areas of spend and the optimal balance between them.
- b** **Put effective arrangements in place to capture how it is delivering savings from recent and forthcoming spending reviews, including where these are being delivered by the Commands.** While the Department has lived within its budget in recent years it does not have a strong understanding of how it has met savings targets. This needs to improve if the Department is to make informed decisions about the impact of possible future cuts and how these might be achieved.
- c** **Put in place strong governance arrangements to monitor the impact of its new ways of working and resulting risks.** Transformation of the Department will result in new risks. The Department should have strong processes in place for monitoring these so it is able to respond quickly to any potential new destabilisers to its budget or activities.

20 To ensure that its reforms are creating a more financially responsible, and cost-effective, demand for equipment, infrastructure and resources from the Commands, the Department should:

- d Create greater clarity regarding the incentives in place for the Commands to use their resources efficiently and effectively and hold them to account for this.** The Department anticipates that the implementation of the new operating model will improve long-term value for money but it has yet to set out clear incentives to support the Commands delivering cost-effectively, nor a mechanism to assess how efficiently the Commands are operating.
- e Ensure that relevant knowledge is shared across the Commands.** The Commands are separately setting up processes to support their financial management capability, including establishing investment committees, and finance and business management specialisms. We support the Department's efforts to set up specific centres of expertise, but believe more can be done to share knowledge and good practice across the Commands.

21 To ensure that its reforms are creating a more predictable and better quality supply of equipment and infrastructure, the Department should:

- f Further develop its understanding of the likely cost of equipment support and the impact of changes in the level of support it provides.** The Department needs to better understand: the realism of its current forecast; the impact of any changes in the level of support it provides in-year; and the potential for further efficiency savings.
- g Put in place strong governance arrangements in key areas to monitor the performance of contractors and their internal management controls.** The Department is relying on contractors to improve its performance and to help it deliver savings already removed from budgets. The Department needs to monitor the performance of these contractors effectively so that it can take swift action where there is a risk that they will not deliver.
- h Ensure that it has robust measures in place to monitor the performance of its private sector business partner in improving its management of the defence estate.** The defence estate is unsustainable in its current size and condition and the Department can currently only afford to fund half of the infrastructure programme the Commands believe they need to deliver the Department's strategic objectives. It has brought in a business partner to help it address this issue and Head Office has strengthened its role in regard to monitoring Defence Infrastructure Organisation's performance. The Department should be ready to react quickly if the performance improvements required fail to materialise and risk destabilising the defence budget.