National Audit Office

Report
by the Comptroller
and Auditor General

Ministry of Defence

Strategic financial management in the Ministry of Defence

HC 268 SESSION 2015-16 17 JULY 2015

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Ministry of Defence

Strategic financial management in the Ministry of Defence

Report by the Comptroller and Auditor General

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Sir Amyas Morse KCB
Comptroller and Auditor General
National Audit Office

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This report examines the Ministry of Defence's progress improving its financial management since our last report on this subject in 2010.

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Contents

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Key facts

£35.8bn	£9.7bn	£6bn
departmental spending in 2014-15	costs the Department committed to avoiding or saving as a result of spending reviews since 2010 and which it reports it has largely met	anticipated savings that the Department has removed from its budget for equipment and support in future years

£38 billion	the size of the gap between its estimated funding and the forecast cost of defence over the next ten years before the Spending Review 2010.
May 2012	the date that the Department announced it had brought its budget into balance.
April 2014	the date that the Department introduced its new operating model.
61,460	the Department’s workforce reduction between 2010 and 2015: made up of 33,770 military personnel and 27,690 civilian staff.
220,425	the average number of military (162,800) and civilian (57,625) full-time equivalent staff employed by the Department during 2014-15.
£162.9 billion	the amount that the Department plans to spend on equipment and support over the period 2014–2024.
50%	the percentage of the Commands’ estate ambitions that the Department can afford to fund.

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.

Part One

The Department's financial position

Introduction

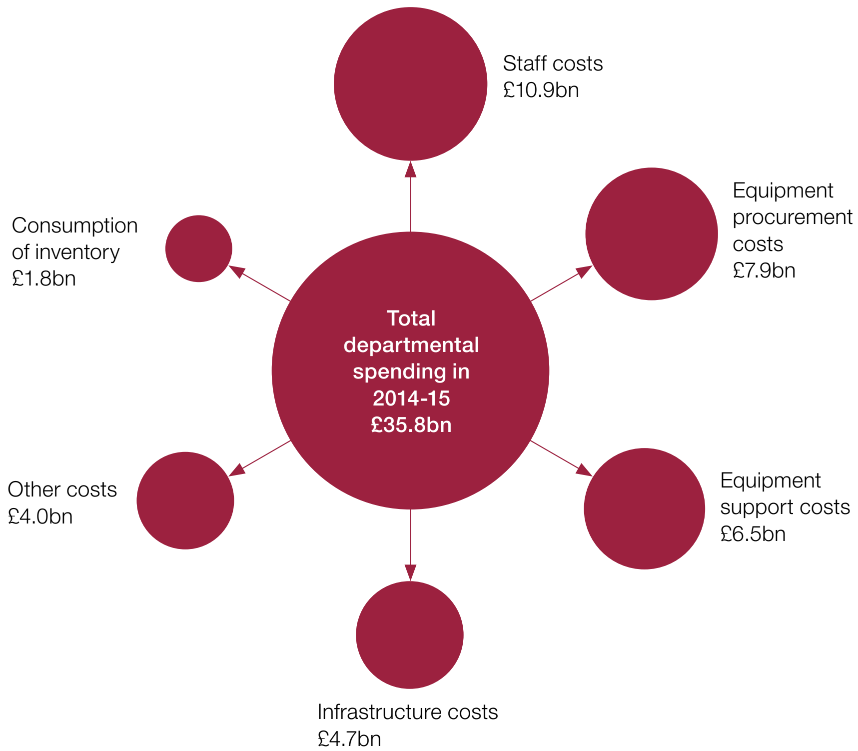
1.1 This is our second stocktake of the Ministry of Defence's (The Department's) financial management. Our 2010 report found that the Department needed to make improvements. It had overcommitted against its budget, which was resulting in short-term cuts and the deliberate slowing down of equipment delivery. This was creating instability and resulting in poor value for money.[1]

1.2 Financial management in the Department is complicated by the size and nature of its responsibilities. It has the third largest departmental budget (£35.8 billion in 2014-15) and has approximately 220,425 members of staff (162,800 military personnel and 57,625 civilian staff) located across approximately 440,000 hectares of estate in the UK and overseas.[2]

1.3 The Department spends the majority of its resources in four broad areas: equipment procurement and support (approximately 40%); military personnel and civilian staff (approximately 31%); infrastructure (approximately 13%); and inventory (approximately 5%) (**Figure 1** overleaf).[3] The Department's capital investment programme is the largest in government. It manages around a quarter of the government's balance sheet and one fifth of the major projects in the government's Major Projects Portfolio.

1 Comptroller and Auditor General, *Strategic Financial Management of the Defence Budget*, Session 2010-11, HC 290, National Audit Office, July 2010.
2 Total departmental spending.
3 The spend on equipment procurement and support as a percentage of the Department's total budget differs from that reported in the Equipment Plan 2014–2024 because we are basing our analysis on cash spending on equipment and support in-year.

Figure 1
The Department's major areas of spending



Notes

1 This chart shows the major areas of Departmental spending. It does not include depreciation and will therefore not agree in total to the outturn reported by the Department in its Annual Report and Accounts.

2 Staff costs include both civilian and service personnel and contributions to the civil service and the Armed Forces pension schemes.

3 Spending within the Department's Equipment Plan is not directly identifiable from within the published accounts; the figures shown here for 'equipment procurement costs' and 'equipment support costs' are therefore estimates of these components of the Equipment Plan.

4 The Department accounts for the cost of inventory when it is used, not purchased.

5 Significant items of expenditure within 'other costs' include research and development, and war pensions benefits.

Source: All data, unless otherwise stated, are taken from the Department's *Annual Report and Accounts 2014-15*

1.4 Since 2010, the Department has adopted a two-pronged approach to improving its financial management. In this report we examine whether this strategy has:

- addressed the funding gap in the Department's equipment programme that was having a destabilising effect on the defence budget, and reduced costs and delivered efficiencies in all areas of the defence budget to meet the Spending Review 2010 settlement (Part One);
- secured improvements to the Department's management structure, which, it assessed, had contributed to that funding gap emerging, by:
  - creating a more controlled and financially responsible 'demand' for procuring equipment, equipment support and infrastructure. Greater responsibilities were delegated to the Armed Forces (the Commands), giving them the ability to decide how to use their resources to best effect within their own budgets (Part Two); and
  - securing better management of financial risk and a more predictable good quality 'supply' of equipment procurement, equipment support and infrastructure to the Commands through reforms to the Department's Head Office, Defence Equipment and Support (DE&S) and Defence Infrastructure Organisation (DIO) (Part Three).

1.5 Our audit approach and evidence base are set out in Appendices One and Two.

Addressing the funding gap

1.6 Between 2010 and 2012, the Department focused its efforts on bringing the defence budget under greater control, committing to reducing costs and delivering savings totalling £9.7 billion by April 2015 (**Figure 2** overleaf). This included launching a programme to deliver efficiencies from procurement, workforce, construction and IT costs and reducing its equipment programme by withdrawing or cancelling some capabilities, reducing order sizes for some equipment and renegotiating some contracts with industry.

1.7 The Department has stayed within reduced budgets, reporting that it is on track to deliver most of the cost reductions and savings to which it has committed. There are some areas in which it has not met its goals, in particular in relation to civilian staff costs. However, it has not tracked savings in a way that has enabled them to be audited or for it to fully demonstrate whether it has met its budget through efficiency measures; moving costs into future years; stopping projects; or transferring costs.

1.8 In May 2012 the Department announced that the defence budget was in balance.[4] It instituted a new approach to preventing it from overheating again. This included setting out a rolling ten-year Plan of equipment to which it is committed (known as the Equipment Plan) and an annual statement on the affordability of that Plan.

4 Resources expected over the following ten years are sufficient to cover its estimate of the cost of the defence programme.

Figure 2

Cost savings and efficiencies reported by the Department as a result of the 2010 reviews

Area	Cost saving or efficiency target (£bn)	The Department's progress against target (2011-12 to 2013-14) (£bn)	Expected savings (2014-15) (£bn)	Projected performance (2011-12 to 2014-15) (£bn)
Strategic Defence and Security Review 2010				
Reducing or delaying some capabilities and renegotiating contracts	5.4	5.3 of future costs avoided[1]		5.3
Spending Review 2010				
Military personnel	1.6	0.9	0.75	1.65
Civilian staff	1.4	0.6	0.5	1.1
Equipment	0.1	0.1	0.04	0.14
Property management	0.6	0.28	0.29	0.57
Information technology and communication	0.15	0.065	0.074	0.14
Other savings[2]	0.45	0.0	0.0	0.0
Total	**9.7**	**7.2**	**1.7**	**8.9**

Notes

1 These include future costs avoided and will be fully realised beyond 2014-15. The Treasury provided the Department with funding of £1.3 billion to realise these savings.

2 The Department has lived within reduced budgets that reflect these savings. However, it has not tracked where or how they have been achieved in a way that has enabled them to be audited or to fully demonstrate whether it has met its budget through efficiency measures, moving costs into future years, stopping projects or transferring costs.

3 As part of Spending Round 2013, the Department committed to delivering an additional £1.08 billion of savings in 2015-16.

Source: Departmental data

1.9 We report to Parliament annually on the assumptions underpinning the Department's affordability statement. The Department has significantly revised the way it compiles and manages the Plan, and has taken positive steps to deal with the accumulated affordability gap and lay the foundations for future stability.[5] However, there are several risks associated with the assumptions underpinning the affordability of the Plan. We explore some of these in further detail in paragraphs 1.14 to 1.19. HM Treasury has also recognised improvements in the Department's approach by increasing its financial delegation limit for projects and contracts from £100 million to £600 million.

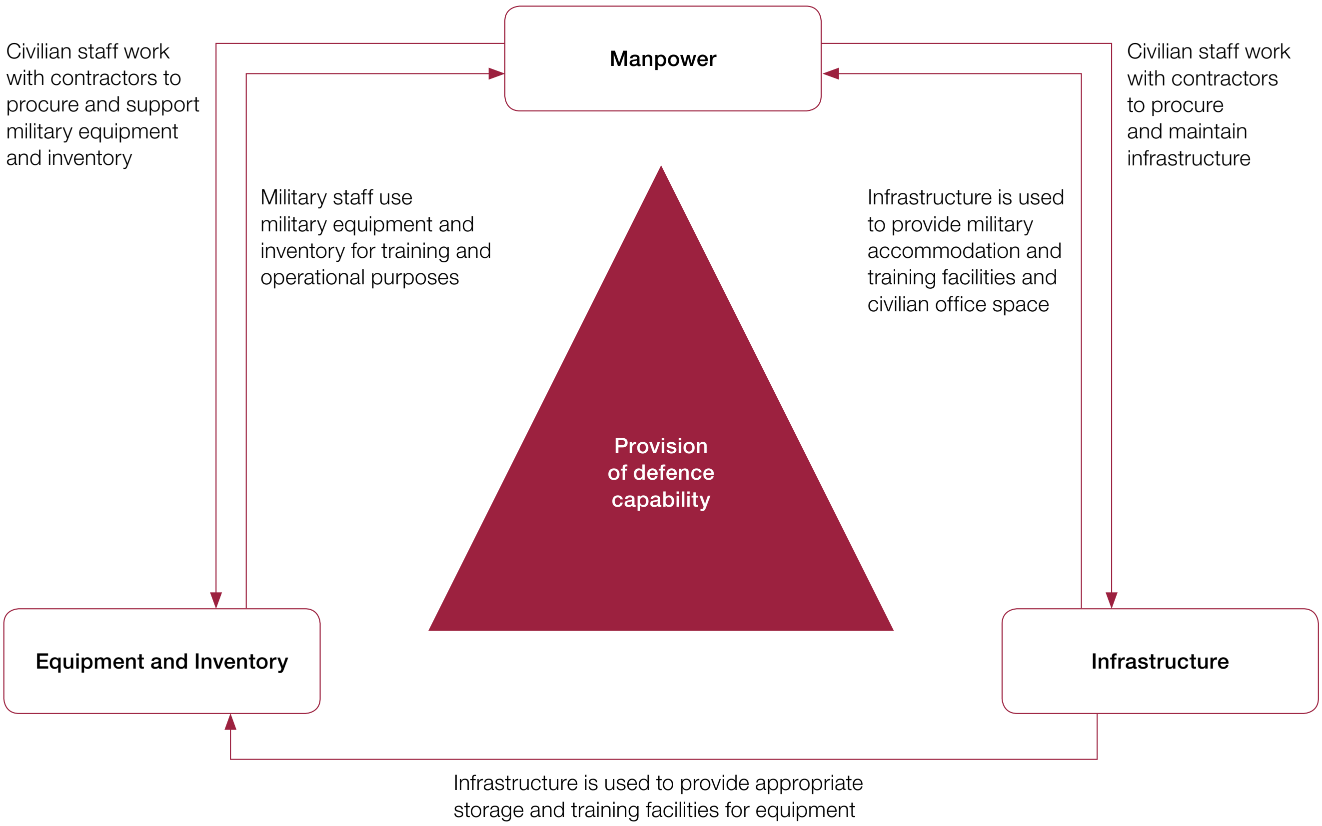
5 Comptroller and Auditor General, *Equipment Plan 2012 to 2022*, Session 2012-13, HC 886, National Audit Office, January 2013.

Management of the defence budget

1.10 Maximising value from the defence budget requires the Department to understand the benefits and risks of its decisions across all categories of spend. **Figure 3** shows that all categories relate to each other and that spending decisions on one category can have implications for other categories. Where the Department does not sufficiently understand the interdependencies this can undermine its ability to manage risks. For example, our report, *Army 2020*, identified that the Department had not sufficiently considered the interdependencies between its programme to restructure and resize the Army (Army 2020) and its programme to accommodate UK troops returning from Germany.[6]

Figure 3

The relationship between manpower, infrastructure, and equipment and inventory



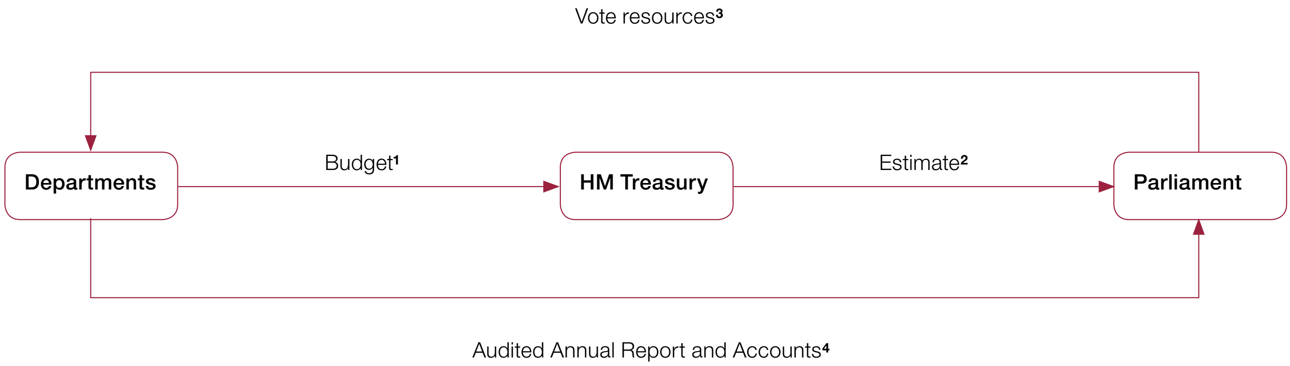
Source: National Audit Office analysis

6 Comptroller and Auditor General, *Army 2020*, Session 2014-15, HC 263, National Audit Office, June 2014.

1.11 The Department must operate within the government's annual funding and accountability cycle (**Figure 4**). Budget holders are responsible for ensuring that they live within their in-year budget. These budgets are made up of both capital and revenue elements.[7] If the Department does not spend the capital budget it has forecast on individual equipment projects in the year it is allocated then the budget is often lost for future years. Since 2010 the Department has frequently underspent its capital budget but had to seek parliamentary approval to increase its resource budget. For example in 2012-13 the Department underspent against the forecast cost of the Equipment Plan by £1.2 billion.

1.12 The Department uses a range of approaches to minimise the impact of poor equipment cost forecasting on its budgetary position. These include, where possible, transferring budget into future years; using budget to buy equipment outside its 'core' programme; and bringing forward equipment projects from future years. For example, the Department used the £1.2 billion underspend in 2012-13 to purchase additional capabilities not included within the 'core' Equipment Plan. The Department's approach is sensible in the context of the issues it faces with regard to accurate forecasting. However, it creates a risk that the Department is not spending all of its funds on the equipment that is core to it achieving its strategic priorities.

Figure 4
Departmental funding and accountability cycle



Notes

1 The cycle starts with departments preparing their annual budgets and submitting them to HM Treasury.

2 HM Treasury reviews and challenges these, before presenting them to Parliament in the form of the Estimates for each department.

3 Parliament then authorises this expenditure by voting on it. The details of the authorised amounts are set out in a Supply and Appropriation Act.

4 The cycle is completed after the end of the year when departments report back to Parliament, in their audited Annual Report and Accounts, their actual outturn for the year compared with their authorised amounts. A fundamental element of the parliamentary accountability cycle is the presentation of each department's Annual Report and Accounts which have been audited by the Comptroller and Auditor General. It is through this mechanism that each department demonstrates how much of its voted resources it has used, shows what it has used its resources for, and explains the outcomes it has achieved with them.

Source: National Audit Office guide, *Understanding central government's accounts*, March 2014

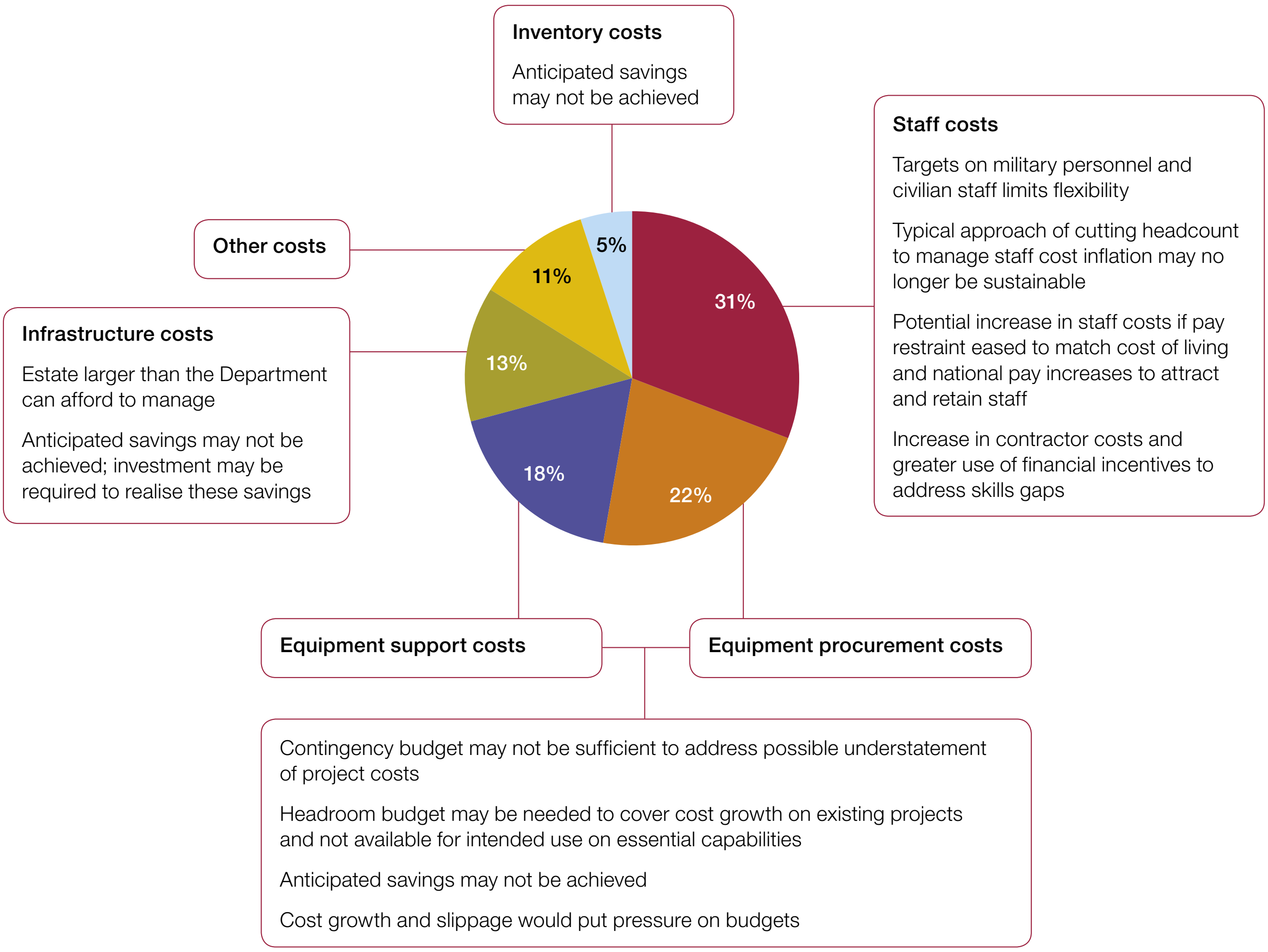
7 Revenue spending is money that is spent on day-to-day resources and administration costs. Capital spending is money that is spent on investment and things that will create growth in the future.

Stability of the defence budget

1.13 The Department faces a number of existing and potential challenges to the continued stability of the defence budget (**Figure 5**).[8]

Figure 5
Challenges to the stability of the defence budget

The defence budget



Note
1 Significant items of expenditure with 'other costs' include research and development, and war pensions benefits.

Source: National Audit Office analysis

8 The Department's current spending plans are based on the Strategic Defence and Security Review 2010 and the Spending Review 2010, and on subsequent revisions to its budget through the Autumn Statement 2012 and the Spending Round 2013.

Managing pressures on equipment budgets

1.14 The Equipment Plan sets out the Department's ten-year £162.9 billion[9] rolling plan for procuring and supporting the equipment the Armed Forces need to meet the objectives of the *National Security Strategy*[10] and the *Strategic Defence and Security Review*.[11] The Plan is based on the Department's assumption that it will receive 1% annual above-inflation increases in funding for equipment. The 2014–24 Equipment Plan was made up of: the forecast cost of equipment procurement (£69 billion – 42%) and support (£81 billion – 50%); with £4.6 billion (2.8%) set aside as contingency; and £9.2 billion (5.6%) for emerging requirements. It is the only example of such a long-term plan being used in government to improve control of a portfolio of investment projects.

1.15 The Equipment Plan is made up of hundreds of individual costs relating to specific projects. Most consist of thousands of assumptions based on technical and specialist knowledge. By their nature these forecasts are uncertain. The Department forecasts its costs at the 50th percentile, meaning that they are as likely to be an overestimate as an underestimate.

1.16 Since 2010 the Department has aimed to improve its forecasting of equipment costs. DE&S has instituted quarterly reviews of project costs to challenge their realism. In addition, the Department's Cost Assurance and Analysis Service (CAAS) has produced its own forecast of the cost of the largest projects within the Equipment Plan. At the Department's request it initially focused its efforts on better understanding procurement costs and has therefore covered more procurement than support costs.

1.17 Based on reviews to date, project costs may be understated by £5.2 billion. The Department considers that the contingency provision of £4.6 billion is sufficient to cover possible understatement. However, as CAAS reviews more support costs there is a risk that the level of understatement might grow. The Department has recognised its weaknesses in its forecasting skills. It is running a training programme to address these, although it is too soon to conclude on its success.

9 Forecast cost of the Equipment Plan between 2014 and 2024.
10 HM Government, *A Strong Britain in an Age of Uncertainty: The National Security Strategy*, Cm 7953, October 2010.
11 HM Government, *Securing Britain in an Age of Uncertainty: The Strategic Defence and Security Review*, Cm 7948, October 2010.

1.18 As well as managing the risk that project costs are understated, the Department will need to make anticipated savings of over £6 billion that have already been removed from the budget for the Equipment Plan in future years.[12] The Department is confident that it can make £3.3 billion of these savings, of which £2.5 billion relates to equipment support, and has agreed savings plans to do so. In addition to these savings the Department reports that it has avoided £750 million of future equipment support costs by identifying opportunities to reduce its future costs to bring them in line with budget. These reductions do not count against the overall savings target. The Department is planning how to deliver the remaining £3 billion removed from the budget for the Equipment Plan in future years.[13] If the Department fails to make these savings it may need to draw on its £9.2 billion unallocated budget which it views as essential to achieving its ambitions for transforming defence.

1.19 The Equipment Plan will become increasingly dominated by a small number of large, complex, politically important programmes for which Head Office has retained responsibility. Managing these projects will require the Department to improve its performance and transparency so that the full impact on the remaining defence budget is clearly understood. In December 2014, the team managing these programmes assessed itself as being the least mature part of the Department for managing the Equipment Plan. However, these projects are the most closely supervised by Head Office.

Pressures on staff cost budgets

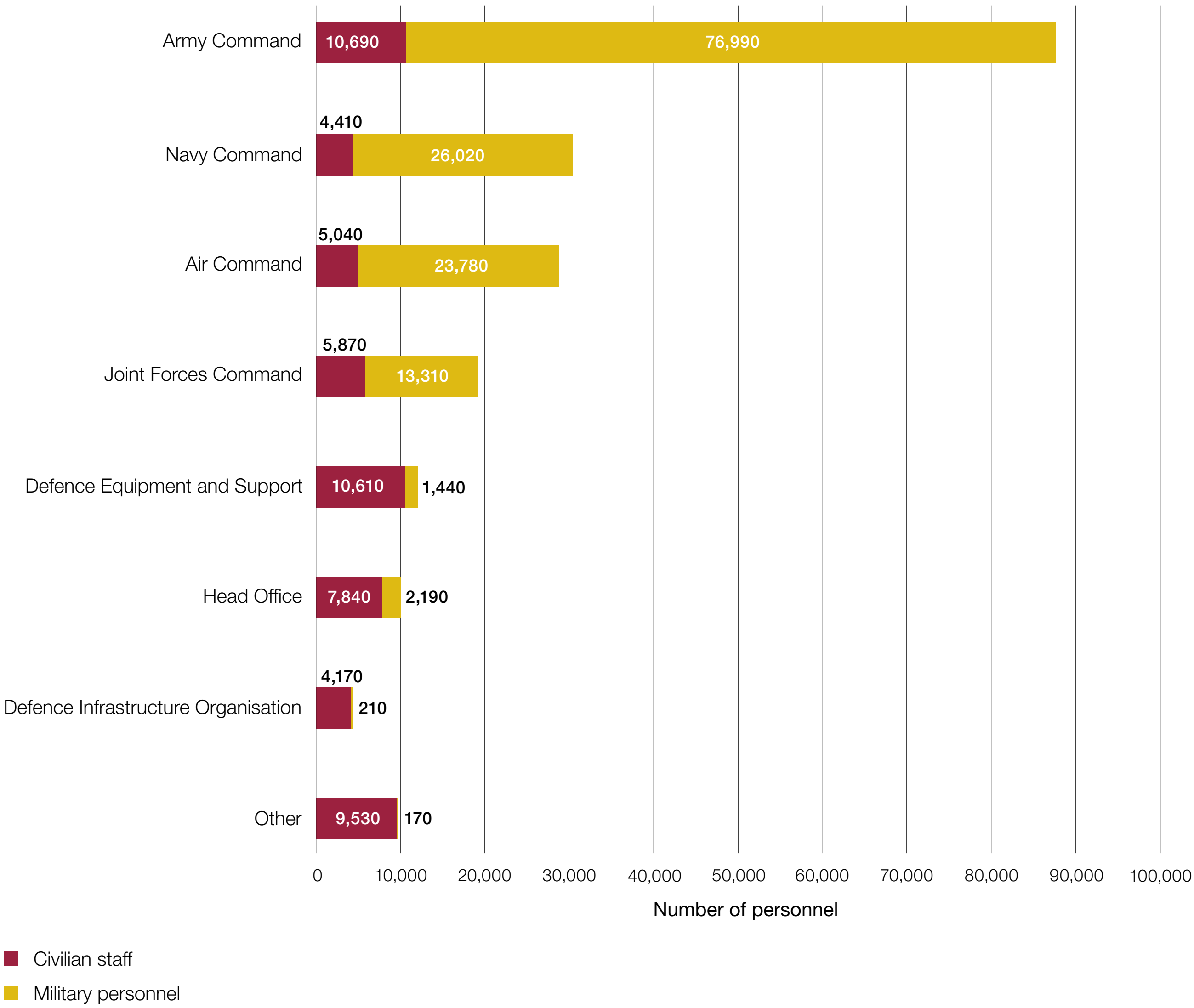
1.20 In 2014-15, the Department employed on average 162,800 military personnel and 57,625 civil servants (**Figure 6** overleaf) at a cost of £10.9 billion.[14]

1.21 To deliver £3 billion of savings in staff costs announced in the 2010 Strategic Defence and Security Review (SDSR) between 2010 and 2015, the Department committed to reducing staff numbers by 42,000 to 222,600 and restructuring its staffing to better integrate regular and reserve military personnel, civilian staff and contractors.[15] The SDSR envisages that by 2020 the full-time trained strength of the Armed Forces would be 154,500.[16] This target was then further reduced to 142,500.[17] Combined with further planned reductions to civilian staff, the Department is working towards reducing staff numbers to an overall figure of 196,350 by 2020.[18]

12 Savings removed from equipment plan budgets: £4.1 billion from equipment support, £1.05 billion from submarine programmes, and £1.2 billion from complex weapons programmes.
13 HC Committee of Public Accounts, *Major Projects Report 2014* and *the Equipment Plan 2014 to 2024*, and *Reforming Defence Acquisition*, Forty-seventh Report of Session 2014-15, HC 1045, March 2015.
14 Full-time equivalent.
15 Known as a 'whole force approach' concept.
16 Royal Navy: 29,000, Royal Air Force: 31,500 and Army: 94,000.
17 The target for the Army was reduced to 82,000 following the three month exercise.
18 Made up of 142,500 full-time trained members of the Armed Forces 53,850 full-time equivalent civilian staff.

Figure 6
The split between military personnel and civilian staff across the Department

Military and civilian staff are employed across the Department



Notes

1 As at 1 April 2015.

2 Civilian staff numbers are on a full-time equivalent basis.

3 Military personnel numbers are 'UK Armed Forces full-time trained strength' and include all trained Regular Forces, Gurkhas and the element of full-time Reserve that count against the Armed Forces requirement. Figures have been rounded.

4 Navy Command includes Royal Fleet Auxiliary staff.

5 Other includes those civilian staff and military personnel without a specific allocation, trading fund staff and locally engaged civilians.

Source: National Audit Office analysis of Departmental data

1.22 The Department is on course to meet its staff reduction target, but faces staff cost pressures in the longer term. Due to higher than expected outflow, the Department had reduced its headcount to 202,280 as at 1 April 2015, exceeding the target to reduce headcount by 2015 and on its way to meeting the extended 2020 target.[19] It has estimated that if the current public sector pay assumptions change, workforce cost inflation may outstrip its planning assumptions by £6.5 billion over ten years. The Department is developing measures to manage this risk including:

- reviewing the terms and conditions of employment and introducing a new military pay system in 2016; and
- considering greater flexibility in the targets its uses to manage the split between military personnel and civilian numbers. For example, the Department estimates that changing 1% of the regular army to civilian staff could yield savings of £40 million per year.

Pressures on infrastructure and inventory budgets

1.23 The Department manages a diverse and geographically dispersed estate, covering approximately 240,000 hectares in the UK, with a further 200,000 hectares managed overseas. The estate includes airfields, living accommodation, naval bases and training ranges and is valued at around £31 billion. In 2014-15, the Department spent £4.7 billion on infrastructure, mostly on maintenance, new build and 'invest to save' initiatives to reduce utility costs.

1.24 The Department has made slow progress improving how efficiently it uses its estate. It has made limited progress in addressing recommendations from the Committee of Public Accounts that it improve its management information on the state of the estate and set out a robust mechanism for determining the estate that it needs.[20]

1.25 The Department will need to manage a number of risks to infrastructure costs exceeding anticipated future budgets. The current estate is larger than needed, underutilised, too expensive to maintain and fails to support the Department's longer-term strategy for the Armed Forces. In particular, there is a shortfall of £8.5 billion in the estate maintenance and change budget over the next ten years. To inform future decisions about how to reduce, and make better use of, the estate, the Department undertook an exercise to determine and prioritise the estate requirements of the Commands. This identified that the Department can only afford to fund 50% of the value of the Commands' ambition for the estate infrastructure programme they believe they need to deliver the Department's longer-term strategy. Future costs may also rise if the Department fails to achieve the £5 billion of savings assumed in future budgets. These savings are expected to be delivered by DIO's private sector business support partner (paragraph 3.19), and by disposing of estate and reducing utility costs. However, achieving these savings may require further investment by the Department.

19 Full-time trained strength of 144,120 and 58,160 full-time equivalent civil servants, as at 1 April 2015.
20 HC Committee of Public Accounts, *Managing the defence budget and estate*, Tenth Report of Session 2010-11, HC 503, December 2010.

1.26 Our 2012 report on the Department's management of its supplies and spares (known as inventory) found that the Department was buying more inventory than it was using and not consistently disposing of stock it no longer needed. Money spent on unnecessary levels of stock could be made available to be spent elsewhere. The Department had weaknesses in its inventory records that were resulting in its financial accounts receiving a qualified audit opinion for a number of years.[21]

1.27 Since we reported, the Department has made some progress reducing its holdings to lower costs.[22] There has also been sustained improvement in accounting for assets held on inventory systems, with the last long-standing accounts qualifications in this area being removed in 2013-14. However, the Department continues to face significant challenges in using and accounting for its inventory. This is partly because of the number and complexity of the inventory systems it maintains.

1.28 The Department has contracted out its Logistics and Commodities Service to improve its management and make additional savings of £0.5 billion over the next 13 years.[23] It has removed these assumed savings from future budgets and forecast costs may rise if its contractor fails to deliver these savings.

Preparation for the Strategic Defence and Security Review and Spending Review

1.29 If the Department does not undertake sufficient preparatory work to understand the flexibility in its budget there is a risk that its efforts to ensure its programme is affordable could be undermined by the forthcoming Strategic Defence and Security Review and Comprehensive Spending Review. The Department was ill-prepared for the 2010 reviews. This meant that it had to carry out an additional exercise to better balance resources with defence objectives.[24]

1.30 The Department is starting from a better position than in 2010, and has a better understanding of the drivers of its costs. It is undertaking work to prepare for the forthcoming reviews, including considering opportunities to innovate to reduce costs, increase productivity, increase international collaboration and better capture the value of defence to the economy as a whole. The Department has not been able to share full details of its work as it is ongoing.

1.31 Any misalignment between the government's defence aspirations and budget might lead to the Department resorting to past ways of working, where the focus was on the short term at the expense of longer-term affordability, eroding the progress achieved so far. The Department maintains that it will not be able to retain all of its planned capabilities if it receives any significant further cuts to its budget and that, if that happens, it will renegotiate its strategic objectives with the government.

21 Comptroller and Auditor General, *Managing the defence inventory*, Session 2012-13, HC 190, National Audit Office, June 2012.
22 In 2013-14, the Department spent £1 billion on new inventory, compared with £1.65 billion in 2011-12. Total inventory holdings had also reduced, down from £40.3 billion in 2011-12 to £34.4 billion in 2013-14.
23 Press release: www.gov.uk/government/news/mod-announces-preferred-bidder-to-run-military-logistics-programme
24 Referred to as the 'three month exercise'.

Part Two

Creating a more controlled and financially responsible ‘demand’ within the new operating model

The new defence operating model

2.1 To deal with the weaknesses that led to it having a £38 billion funding gap, the Ministry of Defence (the Department) has implemented a new operating model to increase the focus on, and responsibility for, financial management throughout defence. The new model was based on findings from an independent review (known as the Levene Review) and aimed to create simpler structures, be more cost-effective, and allocate responsibilities, authority and accountability more clearly.[25] **Figure 7** on pages 24 and 25 shows that, under the new model Head Office has delegated most of its responsibilities for financial management.

2.2 The Department anticipates that implementing the new operating model will improve the value for money with which it uses its resources over the longer term. It has not set out to measure the financial benefits of the new model, but it has developed a range of areas in which it expects to realise benefits, including:

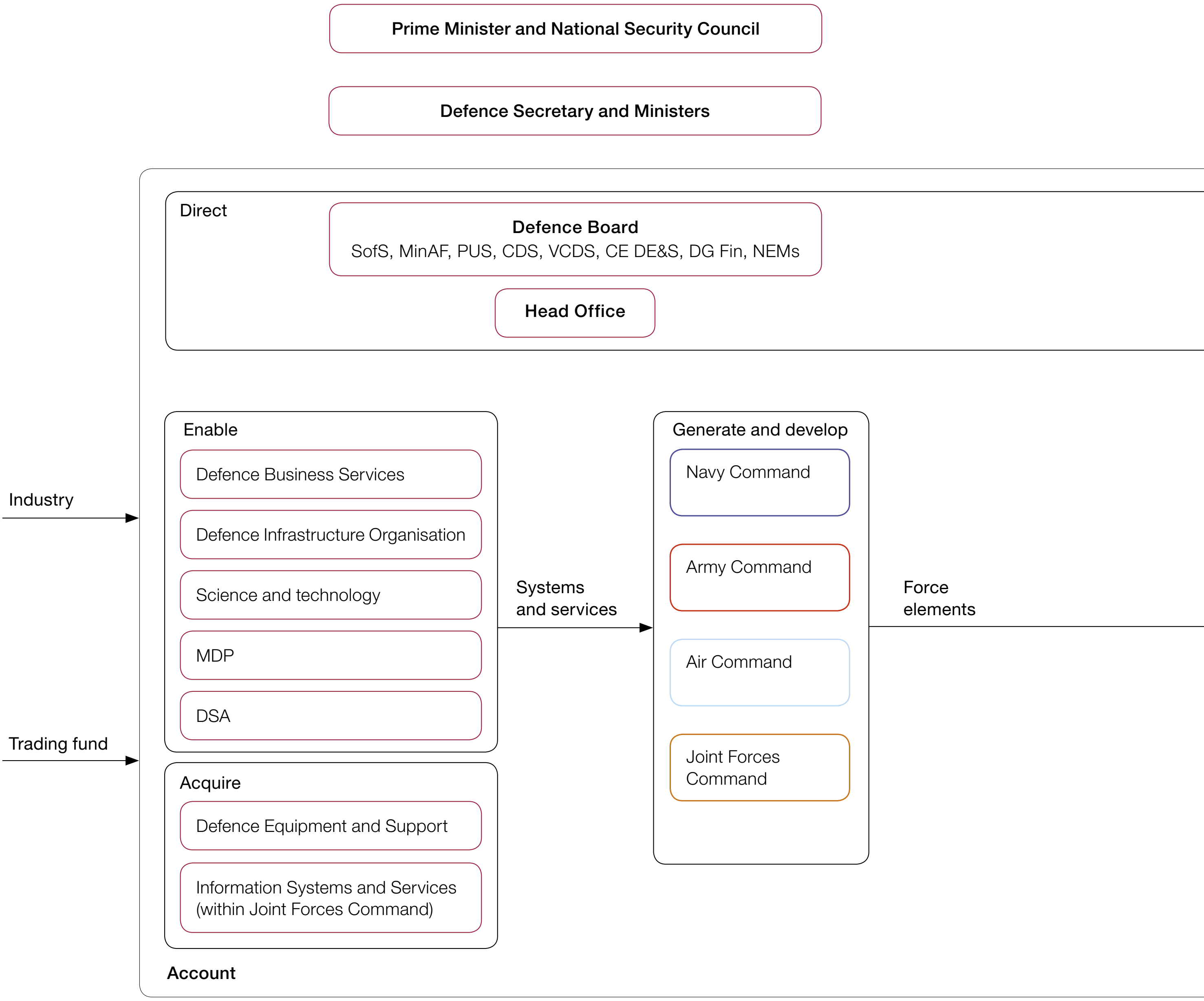
- reducing the risk of not having the right military capability;
- increasing the efficient and effective delivery of operational outputs;
- reducing non-front-line costs as a proportion of overall defence expenditure; and
- a better skilled, motivated and engaged workforce.

2.3 It will take many years for the potential benefits of the new operating model to be realised. Successful implementation requires the Department to change its organisational structures, restructure its governance arrangements, and introduce new ways of working, as well as changing the culture and behaviours within defence. A recent survey of Departmental staff found that many respondents felt that the changes from the new model were still bedding in and the effects may not be observed for years.

25 Lord Levene of Portsoken, *Defence reform: an independent report into the structure and management of the Ministry of Defence*, June 2011.

Figure 7

How the Department is organised



Notes

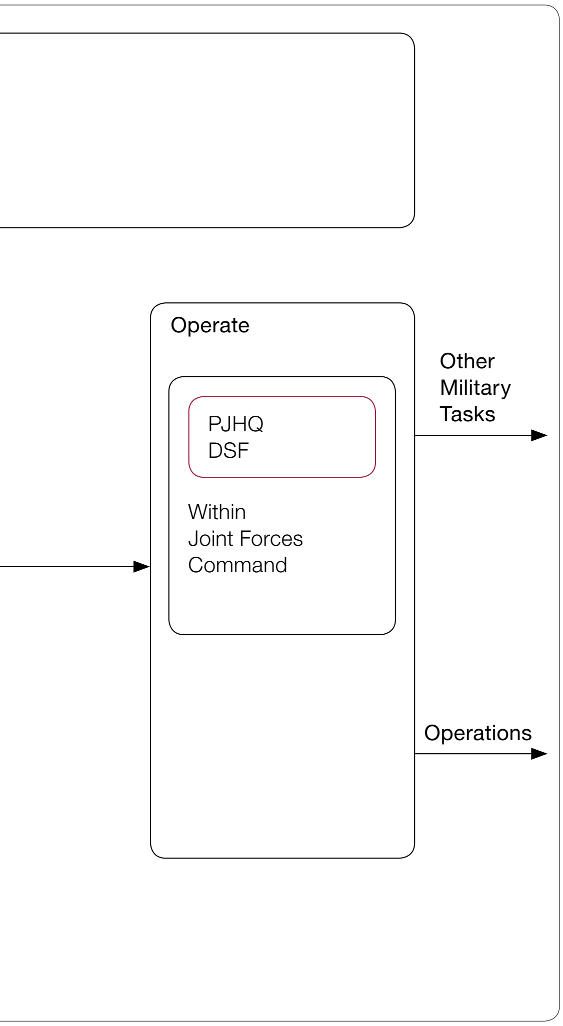
1 SofS = Secretary of State; MinAF = Minister for the Armed Forces; PUS = Permanent Under Secretary; CDS = Chief of Defence Staff; VCDS = Vice Chief of the Defence Staff; CE DE&S = Chief Executive of Defence Equipment and Support and Chief of Defence Materiel; DG Fin = Director-General Finance; NEMs = Non-Executive Members; MDP = MoD Police; DSA = Defence Safety Authority; PJHQ = Permanent Joint Headquarters; DSF = Directorate of Special Forces.

2 The National Security Council (NSC) is the main forum for setting national security strategy across Departments of State (including MoD) and other parts of the government. The NSC meets every week, is chaired by the Prime Minister and attended by the Defence Secretary and, if necessary, the CDS.

3 On 1 April 2014 following DE&S becoming a Bespoke Training Entity, the position of Chief of Defence Materiel (CDM) became the Chief Executive of DE&S (CE DE&S).

4 Trading Funds are organisations owned by a government department that mainly finance new operations from income generated through trading activity.

Source: Ministry of Defence, *How Defence Works*, September 2014



Enable and allow defence to work properly by providing supporting services.

Acquire the equipment, systems and other items our armed forces need.

Generate and develop our armed forces so that they are ready for operations.

Operate our armed forces at home and overseas.

Direct policy, military operations and our contribution to national security at the strategic level, as well as direct rules and standards applying to the whole organisation.

Account for and report on defence activity and spending to Parliament and the public.

Force elements – units and formations that are held ready for use on operations.

Defence Business Services – provides services including civilian HR, service personnel and veterans, finance, security vetting, and knowledge and information.

Defence Infrastructure Organisation – provides infrastructure support for the armed forces by building, maintaining and servicing what the men and women who serve our country need to live, work, train and deploy on operations.

Ministry of Defence Police (MDP) – civilian police force operating within defence.

Defence Safety Authority (DSA) – responsible for the regulation of defence health, safety and environmental protection.

Permanent Joint Headquarters (PJHQ) – responsible for the planning and execution of UK-led joint, potentially joint and multinational operations, and for exercising operational command of UK Forces assigned to multinational operations led by others.

Directorate of Special Forces (DSF) – provides a joint special operations task force headquarters and is headed by the Director of Special Forces.

Joint Forces Command – ensures joint capabilities, such as medical services, training and education, intelligence, and cyber-operations, are efficiently managed and supported.

Financial management in the new operating model

2.4 Responsibilities for financial management in the Department are delegated. The Permanent Under-Secretary of State (PUS) is accountable to Parliament for the propriety and regularity of departmental expenditure, for keeping proper records and for safeguarding departmental assets. The majority of the defence budget is allocated to six 'top level budget' (TLB) holders. These must deliver agreed outcomes as effectively, efficiently, safely, sustainably and economically as possible and are held to account by the PUS for their performance. The four Commands – Army, Navy, Air and Joint Forces – are each TLBs, as well as Head Office and Defence Infrastructure Organisation.[26] From 1 April 2015, the Commands were responsible for managing around 70% of the defence budget, **Figure 8**.

Figure 8

The characteristics of the Commands

Military personnel: 23,780

Civilian staff: 5,040

HQ: High Wycombe

Budget in 2015-16: £6.2 billion

Major Projects: Manages a number of large, often collaborative programmes with other nations, to procure fast jets (Lightning II, Typhoon); and support aircraft (A400M, Voyager).

Military Staff: 13,310

Civilian Staff: 5,870

HQ: Northwood

Budget in 2015-16: £4.3 billion

Major Projects: Manages a number of programmes for all Commands, including: information technology; intelligence; and cyber.

Military Staff: 76,990

Civilian Staff: 10,690

HQ: Andover

Budget in 2015-16: £8.8 billion

Major Projects: Equipment dominated by project to procure armoured vehicles (Scout SPV). Also manages hundreds of smaller projects providing equipment to the Army, including tactical communications (Morpheus).

Military Staff: 26,020

Civilian Staff: 4,410

HQ: Portsmouth

Budget in 2015-16: £5.7 billion

Major Projects: Manages large combat (Type 23 frigates, Type 45 destroyers) and support ships (tankers).
Note: Aircraft carriers and submarines are managed by Head Office due to their strategic importance.

Notes

1 Civilian staff and military personnel numbers are shown as at 1 April 2015.

2 Civilian staff are on a full-time equivalent basis.

3 Miliary personnel numbers are 'UK Armed Forces full-time trained strength' and include all trained Regular Forces, Gurkhas and the element of full-time Reserve that count against the Armed Forces requirement.

4 Military personnel numbers are those currently working for that Command.

5 The full-time trained strength of the Armed Forces at 1 April 2015: Royal Air Force – 31,830; Army – 82,230; and Royal Navy – 30,060. Ministry of Defence, *UK Armed Forces Quarterly Personnel Report*, 1 April 2015.

Source: National Audit Office analysis of Departmental data

26 Defence Equipment and Support became a bespoke trading entity on 1 April 2014.

2.5 In this Part we assess whether the new operating model has created a more controlled and financially responsible 'demand' for equipment procurement, equipment support and infrastructure 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. In Part Three we assess whether the new operating model has secured better management of financial risk and a more predictable good quality 'supply' of equipment procurement, equipment support and infrastructure to the Commands through reforms to the Department's Head Office, Defence Equipment and Support (DE&S) and Defence Infrastructure Organisation (DIO).

Financial management capability

2.6 The Commands are developing their financial management capabilities at varying paces. A recent assessment by the Chartered Institute of Public Finance and Accountancy (CIPFA) of the Department's financial management found a range of capabilities were evident (Appendix Three). Overall, CIPFA found the Department scored within the third quartile of public bodies it had reviewed. However, CIPFA recognised the complexity of both the Department and its operating environment and noted that the assessment made no allowance for this complexity.

2.7 There is some evidence that military chiefs are providing greater financial management leadership in line with the principles behind the delegated model.[27] In his third review of the Department's progress against his recommendations Lord Levene found that the Commands, on the whole, "own their plans, take more responsibility for delivery, and are much more active in determining their own priorities". However, there was limited delegation of responsibilities down through their organisational structure, limiting the benefits to defence from the delegated model.

Challenges for the Commands

2.8 To build on recent enhancements to their financial management capability, the Commands must focus on improving:

- financial skills;
- how they manage their budgets; and
- value for money.

27 The third annual review of progress addressing the Levene Review recommendations noted "most of the military chiefs … now felt personally empowered … clearly depicting themselves as Chief Executives actively running their service": Letter from Lord Levene to the Secretary of State for Defence, 5 December 2014.

Improving financial skills

2.9 The Commands face a number of challenges professionalising their finance teams. Military staff are often posted to roles on rotations of between two and three years. This erodes the accumulated knowledge of finance teams. Few have formal financial qualifications and the percentage of finance staff who are qualified varies significantly across the Department (**Figure 9**). A departmental target on the number of civil servants to be employed within the Department can restrict the Commands' ability to recruit financial staff and professionalise their teams.

Improving how the Commands manage their budgets

Equipment

2.10 The success of the new operating model rests on the maturity of the relationship between Defence Equipment and Support (DE&S) and the Commands. The Commands are now responsible for determining what equipment they need to meet their strategic objectives, and for managing those equipment programmes and budgets. DE&S is now focused on delivering to the Commands' specification, acting as the Commands' agent and engaging with industry. The success of these arrangements will depend on the Commands' ability to manage major capital programmes; to act as 'intelligent customers' of DE&S; and to hold DE&S to account for delivery. To do this, the Commands need to have good management information about the projects DE&S is delivering and the ability to interrogate and interpret that data.

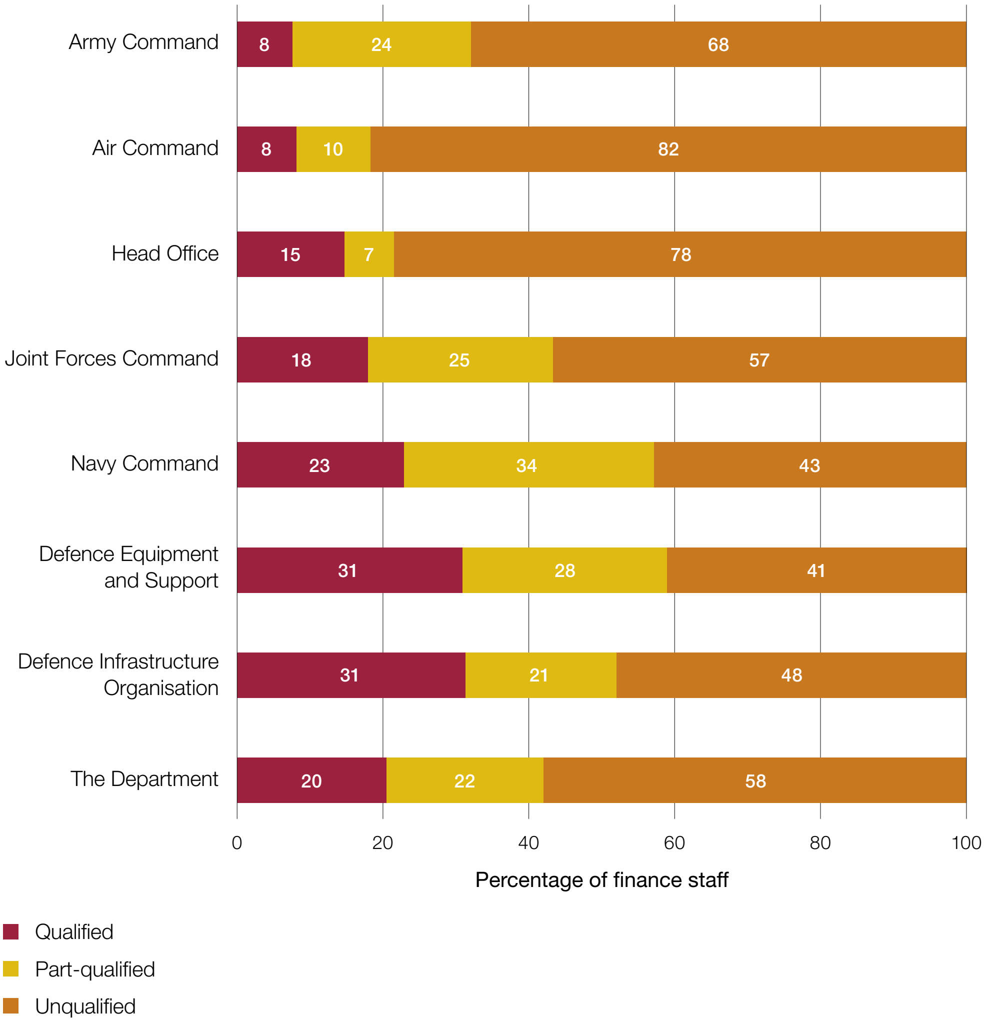
2.11 The quality and timeliness of management information remains a systemic weakness within the Department. The Commands told us that existing systems often record the data they require, but extracting it can take significant time and effort. However, all of the Commands are working on systems to extract the information they need from DE&S. The Commands told us that the quality of management information from DE&S was improving.

2.12 Although the Commands are building their capability to take on their enhanced role, there remain significant gaps in their skills and expertise in this respect. In December 2014 the Commands assessed their capabilities and found that these were below the level expected to manage their equipment programmes effectively. Particular areas of weakness were assessed in management information and having appropriately skilled staff in place. The Commands continue to develop their own project management offices to improve project and programme management throughout their Command. They are beginning to take ownership of their projects at a portfolio level.

Figure 9

The percentage of finance staff who hold, or are working towards, a professional accountancy qualification

The percentage of qualified and part-qualified finance staff varies across the Department



Notes

1 As at 1 September 2014.

2 Civilian staff only.

3 Qualified means those staff with a qualification from a member of the Consultative Committee of Accountancy Bodies (CCAB) or Chartered Institute of Management Accountants (CIMA).

4 Part-qualified means those staff working towards a qualification from either a CCAB member or CIMA.

5 Part-qualified includes Associate Accounting Technicians.

Source: Departmental data reported to HM Treasury

2.13 To support effective performance management, the Commands and DE&S are developing service level agreements. Known as Command Acquisition and Support Plans (CASPs), these set out the Commands' equipment and support requirements over the following decade. The Department expects that these will be the primary mechanism used by the Commands to hold DE&S to account on project performance. It also expects that CASPs will support effective change control procedures for projects, preventing equipment specification changes from unbalancing the Equipment Plan. It is too soon to conclude on whether CASPs are supporting improved project performance. Although these were expected to be in place by 1 April 2015, not all CASPs are fully developed or agreed.

Military personnel and civilian staff

2.14 Responsibilities for managing their civilian staff, as well as military personnel, transferred to the Commands on 1 April 2013. The Commands are beginning to develop integrated workforce plans (across civilian, military and contractors) in line with the Department's aspiration of a 'whole force approach' being adopted. However, the Department's targets to reduce staff numbers to control costs are limiting the flexibility the Commands have to fully deliver that aspiration, as is a lack of reliable management information on staff skills.

Infrastructure

2.15 The Commands do not manage their infrastructure budgets. They believe this limits both their flexibility and their incentives to use their estate efficiently. The Commands told us that they have limited influence on prioritising estate investment and no ability to hold DIO to account for delivery. However, if the infrastructure budget is delegated to the Commands they will need strong incentives to maintain investment. When estates budgets were previously within the Commands' control (before 2011) they were failing to invest in maintaining infrastructure, which was falling into disrepair.

Improving value for money

2.16 The Department anticipates that implementing the new operating model will improve value for money in the longer term by giving the Commands the ability to decide how best to use their resources, and holding them to account for those decisions. It also anticipates that Commands will be incentivised to use their delegated resources more efficiently and to live within their allocated budget. However, this will require a change of behaviour from the Commands who have historically competed for resources.

2.17 The Department has not yet set out clear incentives for the Commands to use their resources cost-effectively; neither has it set out a mechanism to assess how efficiently the Commands are operating. For example, there is uncertainty amongst the Commands about whether they will be allowed to keep any efficiency savings they make, or how they will be held to account for becoming more efficient. Consequently, there is a risk of unintended behaviours emerging that are not in line with the defence operating model. The Commands may deliberately over-programme so as to minimise risk if budget is taken away from them. In its review, CIPFA found that imprecise budget setting may make it difficult to accurately assess the savings the Commands achieve.

2.18 The Department has made limited progress in delivering on its objective of changing behaviours to instil a culture of efficiency in all areas of defence spending. Progress has been made in some areas. For example, increased scrutiny, through the Department's Investment Approvals Committee, has focused project teams within the Commands on demonstrating value for money from investments. However, the Commands told us that the Department's 'Be, Think, Do' programme has stalled. This was established to try and change behaviours across the Department and encourage the more efficient use of resources. The Department is now working on a programme to identify the behavioural issues preventing its acquisition model from operating effectively, and set out a range of incentives and sanctions to overcome these issues.

Part Three

Ensuring better management of financial risk and a more predictable good quality ‘supply’ within the new operating model

Head Office’s responsibilities for financial management

3.1 The strategic centre of the Ministry of Defence (the Department) is known as Head Office. It supports ministers, the Permanent Under-Secretary of State and the Chief of Defence Staff in leading the Department. Head Office has overall responsibility for financial management and undertakes a number of financial management roles including:

- planning and allocating resources and managing the overall defence budget;
- corporate financial reporting and accountancy support to budget holders;
- internal audit and management of a system of internal controls; and
- continuous improvement of financial processes and skills.

3.2 Greater delegation of responsibilities within the Department has enabled Head Office to take a more strategic role in managing the defence budget. As part of the delegated model the Department has established 18 defence authorities responsible for its approach to thematic issues such as people and commercial. The Department intends that they will be responsible for managing corporate level risks and ensuring that key activities are carried out on a coherent and consistent basis across the Department, balancing corporate needs and Command freedoms. The Department intends that defence authorities will be a key element of its ongoing improvements to its management of risk (paragraph 3.11).

3.3 The Department has strengthened its corporate governance in recent years in line with the recommendations in the Levene Review.[28] The Defence Board is now the main decision maker for non-operational matters and has been strengthened by the appointment of non-executive members.[29] In his third report on progress in implementing his recommendations, Lord Levene concluded positively on the maturity and leadership of the Defence Board and its similarity in its operation to a commercial board. The quality of reporting to the board has also improved and contains greater analysis and commentary relating to performance and risk across the Department's activities.

Financial management capability

3.4 Since we last reported in 2010, Head Office has improved its financial management capability. The Chartered Institute of Public Finance and Accountancy's (CIPFA's) recent review of the Department identified strengths in Head Office's approach to financial management, including a more strategic approach to its finance role and experienced staff with strong corporate knowledge. Weaknesses identified included weak performance management and accountability, and poor resilience due to reliance on a limited number of key staff. The Department is addressing CIPFA's findings as part of a wider programme to improve financial management in the Department (paragraphs 3.13 and 3.14).

3.5 Integrating finance and military capability teams has encouraged Head Office to give greater consideration of the affordability of military capabilities as they are developed. Head Office has also developed software to assess the impact on capability of budgetary changes, improving the Department's ability to make informed decisions in the forthcoming Strategic Defence and Security and Spending Reviews. The Department has also sought to better integrate its strategic and financial planning rounds to ensure that the defence programme is affordable within anticipated resources.[30,31]

28 Lord Levene of Portsoken, *Defence reform: an independent report into the structure and management of the Ministry of Defence*, June 2011.

29 The Department, *How Defence Works*, September 2014. Membership of the Defence Board: Secretary of State for Defence (Chair), Minister for the Armed Forces, Permanent Under-Secretary of State, Chief of Defence Staff, Vice-Chief of Defence Staff, Chief Executive DE&S, Director General Finance and four non-executives. It meets every month. Its role is to oversee how the Department is managed, including strategy, performance, risk and plans.

30 Annual strategic planning round that culminates in a published defence plan, setting out the short- and medium-term objectives for the next four years.

31 Its annual budgeting cycle sets targets and budgets over the forthcoming ten years to deliver the objectives set out in the defence plan.

3.6 While the Department has made improvements to its planning processes, some weaknesses remain. Its financial planning process is largely incremental, building on the rolling forward of costed plans and a refresh of existing corporate planning assumptions.[32] However, constructing individual budgets is largely based on a 'top-down' assessment of requirements and available budget. This can create a gap between forecast costs and budget for individual projects. Where this is the case, the Department expects Commands to reduce costs to fit the budget, but does not currently have a good understanding of the actions the Commands take to do this. For example, the Commands sometimes delay expenditure on projects to live within their annual budget, rather than seeking efficiencies. In the context of the forthcoming Strategic Defence and Security Review this creates a risk that the Department does not fully understand how far the budget can be cut while continuing to deliver its current plans.

Challenges for Head Office

3.7 There are a number of issues that Head Office must address to sustain improvements to management of financial risk:

- balancing spending in-year across defence;
- improving internal controls, financial accounting and reporting; and
- achieving benefits from its Financial Management Transformation Programme.

Balancing spending in-year across defence

3.8 Head Office is required to ensure that overall defence spending stays within Parliament-approved totals. This process occupies a significant amount of Departmental effort as there continues to be significant variances in spending compared to budget at the top level budget holder level.

3.9 From 1 April 2015, the Armed Forces (the Commands) assumed additional responsibilities for managing equipment programme budgets in-year. Previously, Head Office directed Defence Equipment and Support (DE&S) to take actions to balance the equipment programme. Now, in the event of significant over or underspending on individual equipment programmes, Head Office may be required to work with the Commands to balance budgets across the Department. Senior managers across the Department had different views on how this may be managed. The Department will monitor whether adverse behaviours arise as a result.

32 On pay, foreign exchange rates, fuel cost and asset revaluation indices.

Improving internal controls, financial accounting and reporting

3.10 Each year the Department must publish a set of resource accounts which are audited by the Comptroller and Auditor General (C&AG). The results of the C&AG's audit demonstrate that the Department is making some progress in improving its finance systems and financial reporting. However, his opinion on the accounts have been qualified for the last six years due to material misstatement. In 2013-14 two qualifications were lifted from the accounts and they were only qualified due to weaknesses in accounting for leases.[33,34] In 2014-15 the qualification on accounting for leases remained in place and the C&AG also qualified the accounts in respect of the comparative figures for the inventory impairment charge in the 2013-14 accounts. This qualification has no impact on the opinion given in respect of the charges made in the 2014-15 accounts. However, the audit continues to identify major issues that may cause significant misstatement of the accounts and significant weaknesses in internal control in a wide range of areas.[35]

3.11 Defence Internal Audit's annual review of internal controls regularly identifies significant weaknesses in financial processes. To improve its approach to internal controls, the Department is developing an integrated risk, control and assurance framework. It expects this to take between three and five years to complete. The Department has identified there are around 40 key finance processes and is prioritising its work in this area.

3.12 A lack of in-year scrutiny of the balance sheet as part of the Department's monthly management accounting process increases the risk that its financial accounts are materially misstated. Also, accountability for managing equipment and inventory assets rests with DE&S and infrastructure assets rests with DIO which means the Commands do not yet have full visibility of the assets being managed on their behalf. In early 2014, as part of our audit of the Department's 2013-14 accounts, we raised concerns regarding the substantiation of a £2.7 billion balance previously disclosed as infrastructure assets under construction. The Department delayed publication of its 2013-14 Annual Report and Accounts to undertake further work to substantiate the balance, eventually writing off £267 million of costs previously recorded as assets. In 2014-15 a continuation of work reviewing remaining assets under construction balances led to a further write off of £127 million in 2014-15.

33 Concerning the valuation of non-current assets and inventory and the impairment in the value of the Germany estate.
34 In the 2013-14 Accounts the 2012-13 comparative figures corresponding to the valuation of non-current assets and inventory and the impairment in the value of the Germany estate were qualified.
35 Non-current assets, inventory, liabilities, provisions and contingent liabilities, and cash.

Achieving benefits from its Financial Management Transformation Programme

3.13 In response to the government's Financial Management Review, and the findings from the CIPFA report on financial management, in July 2014 the Department launched a Financial Management Transformation Programme. The Department intends that the programme will help it to build an effective and efficient finance support function to support the new operating model. The programme is made up of several projects including cost communication; improvements to in-year management; mapping of financial processes; and the definition of a skills strategy.

3.14 The Department does not use the skills of its finance staff to best effect. The Department has a large finance function of some 2,500 people including over 1,000 qualified or part-qualified accountants. However, in its report CIPFA found that a significant volume of these qualified staff are not required to fully use their professional skills and training and are consequently not adding value. To improve its knowledge of the skills of its finance staff, and to address gaps, the Department conducted a survey of its finance staff. This survey found that staff report that they have gaps in the basic accountancy and analytical skills they need for their roles. The Department intends to address this gap through its emerging skills and training strategy.

Information technology and the supply of equipment and infrastructure to the Commands

3.15 It is important for the Department to focus on achieving a more predictable and good quality supply to the Commands in the following areas:

- information technology;
- infrastructure; and
- equipment and support.

Information technology

3.16 The Department has undertaken a review of information technology (IT) across Defence which has identified a number of issues. For example, there has been a proliferation of hardware, computer servers and bespoke software, and the Department lacks suitably qualified and experienced staff to manage these. In addition, contracting procedures for new systems, designed for military equipment, often deliver systems that are already out of date. As a result, management information needed by the Department to make decisions often has gaps, and is inconsistent across systems.

3.17 The Department is implementing a four-year plan to transform current systems. This includes baselining all IT projects and systems within the Department; establishing new governance arrangements to take greater ownership of the specification and design of systems; changing internal contracting procedures to make them more timely and in line with best practice in industry; and developing a single portfolio of IT projects to be managed by an improved project management office. The Department recognises that securing change in the way that IT is designed, built and operated will require significant cultural change and suitably qualified and experienced staff to deliver that change.

Infrastructure

3.18 The Department has been slow to improve its management of its estate and this remains a key risk to financial stability. In 2011, the Department established the Defence Infrastructure Organisation (DIO) to bring together responsibilities for the defence estate into a single organisation. To meet challenging budgets, DIO significantly reduced its staffing and developed a new operating model.

3.19 In 2012 DIO set out to contract with the private sector to improve its business. In 2014, a year behind schedule, DIO signed a contract with Capita, with URS in support. Head Office now plays a stronger role in scrutinising DIO's performance. It has also established a Joint Infrastructure Committee to scrutinise investment and disposal decisions bringing together representatives from across the Department. However, improvements in DIO's performance are not yet evident.

Equipment and support

3.20 In 2011, the Department launched an organisational change programme to improve skills and capabilities within DE&S and to give it the management freedoms it needed to deliver equipment projects to performance, cost and time. After the Department's preferred option for change – a government-owned, contractor-operated organisation – proved undeliverable, DE&S became a bespoke trading entity in April 2014.

3.21 DE&S remains in the public sector but has freedoms from certain civil service pay rules. Departmental and DE&S governance structures have also been enhanced. DE&S has let contracts worth £250 million over three-and-a half years to private sector companies for business support and to help improve its skills.

3.22 The Department expects that it will take a further three years to improve the performance of DE&S. Being able to track benefits will be essential both to establish whether the bespoke trading entity is delivering acquisition reform at DE&S, and to allow the Department to take any additional measures to improve performance should it be necessary. Furthermore, unless the Commands can gain assurance that DE&S's performance is improving there is a risk that they will pursue alternative procurement routes, including going direct to industry. This risks reducing value for money for defence overall.[36]

36 Comptroller and Auditor General, *Reforming defence acquisition*, Session 2014-15, HC 946, National Audit Office, February 2015.

Appendix One

Our audit approach

1 This report examined the Ministry of Defence's (the Department's) progress in improving its financial management since our last report on this subject in 2010. We assessed whether:

- the Department had tackled the funding gap in its budget and is addressing the challenges to the stability of its financial position;
- changes to financial management arrangements had created more controlled and financially responsible demand for procurement of equipment, equipment support and infrastructure from the Armed Forces (the Commands); and
- better management of financial risk and a more predictable good quality 'supply' of equipment procurement, equipment support and infrastructure to the Commands has been secured from reforms to Head Office, Defence Equipment and Support (DE&S), and Defence Infrastructure Organisation (DIO).

2 We applied an analytical framework to assess the Department's performance. Measuring the Department's performance is complicated by the fact that there are no clear defence 'outcomes' that can be easily or meaningfully measured to assess how efficiently the Department is using its resources. The framework that we used therefore considered whether the Department is in a good position to manage its future spending plans effectively.

3 Our audit approach is summarised in **Figure 10** and our evidence base is outlined in Appendix Two.

Figure 10
Our audit approach

The Department's objective	To improve its financial management so that it can effectively and efficiently deliver all elements of defence capability, contributing to national security.
How this will be achieved	By eliminating its funding gap; implementing a new affordability regime for its Equipment Plan; and improving its management structure.
Our study	We examined whether the Department's strategy for improving its financial management has secured results including whether the Department is in a good position to manage its future spending plans effectively within known future funding.

Our key questions

Has the Department tackled the funding gap in its budget and is it addressing the challenges to the stability of its financial position?	Have changes to financial management arrangements created a more controlled and financially responsible 'demand' for procurement of equipment, equipment support and infrastructure from the Commands?	Has better management of financial risk and a more predictable good quality 'supply' of equipment procurement, equipment support and infrastructure to the Commands been secured from reforms to the Department's Head Office, DE&S and DIO?

Our evidence

(see Appendix Two for details)

We assessed progress by:

- **Reviewing and analysing official documents** including: financial planning documentation and Defence Board papers; the Department's assessment of benefits from the new operating model for defence; and documents relating to improvement programmes.
- **Interviewing key staff** including senior finance staff across the Department, and members of the Defence Board.

Our conclusions

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.

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 and Defence Infrastructure Organisation. 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.

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 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.

Appendix Two

Our evidence base

1 We reached our independent conclusions on the Department's progress in improving its financial management after analysing evidence that we collected between February and June 2015. Our audit approach is outlined in Appendix One.

2 We assessed whether the Department tackled the funding gap in its budget and is addressing the challenges to the stability of its financial position.

3 We **reviewed the Department's financial accounts** since 2010, analysing its management of resources against budgets set by Parliament. We considered issues raised in our reports to management as part of our statutory audit of these accounts, identifying issues concerning internal controls and governance.

4 We **reviewed official documents** concerning financial and strategic planning and how the Department expected to achieve financial savings and reduce costs. We reviewed the Department's management accounts, Defence Board papers and other documentation to understand how the Department reports and challenges its progress against budgets in-year.

5 We analysed our work undertaken over the last three years on the affordability of the Department's plans for how it will buy and support the military equipment the Armed Forces (the Commands) require over the next ten years.

6 We conducted **semi-structured interviews** with senior officials to understand the Department's strategy for improving its financial management. We also explored the Department's assessment of the challenges it faces in balancing its budget over the next ten years. We met with members of the Defence Board, including the lead non-executive member, to understand the role it plays in scrutinising the Department's financial position.

7 We assessed whether changes to financial management arrangements created a more controlled and financially responsible 'demand' for procurement of equipment, equipment support and infrastructure from the Commands.

8 **We reviewed and analysed official documents**, including reports on the benefits from the new operating model for defence. We also reviewed both HM Treasury's and the Chartered Institute of Public Finance and Accountancy's (CIPFA's) assessments of financial management in the Department. We analysed the findings on internal controls within the reports of the Department's internal audit team.

9 We visited and held **semi-structured interviews** with senior finance staff within Air, Army, Navy and Joint Forces Commands to understand how they are improving their financial management and dealing with the issues they face.

10 We assessed whether better management of financial risk and a more predictable good quality ‘supply’ of equipment procurement, equipment support and infrastructure to the Commands has been secured from reforms to the Department’s Head Office, Defence Equipment and Support (DE&S) and Defence Infrastructure Organisation (DIO).

11 We conducted **semi-structured interviews and reviewed key documentation** to understand the Department’s Financial Management Transformation Programme and how the Department is improving the performance of DE&S and DIO. We also reviewed documentation concerning the Department’s behavioural change programme called ‘Be, Think, Do’. We reviewed the key service level agreements between DE&S and the Commands and minutes of key meetings to review equipment project progress.

12 We **interviewed key financial staff** in DE&S and DIO to understand the challenges they face improving their financial management, how the new operating model is embedding and how they manage financial risk.

Appendix Three

CIPFA assessment of financial management in the Department

CIPFA's assessment of the Department's financial management capability (scored 0 to 4)

Management dimensions	Department	Head Office	Navy Command	Air Command	Army Command	Joint Forces Command	DIO	DE&S
Leadership	2.5	2.5	2.5	2.5	2.5	2.5	2.0	3.0
People	1.5	2.0	2.0	1.5	1.5	1.5	1.5	2.0
Processes	2.5	2.5	2.0	2.5	2.0	2.0	1.5	2.0
Stakeholders	2.5	2.5					2.0	2.0

Notes

1 'Leadership' focused upon strategic direction and business management, and the impact on financial management of the vision and involvement of the organisation's board members and senior managers.

2 'People' included both the competencies and the engagement of staff. This aspect generally faces inward to the organisation.

3 'Processes' examines the organisation's ability to design, manage, control and improve its financial processes to support its policy and strategy.

4 'Stakeholders' deals with the relationships between the organisation and those with an interest in its financial health, whether Treasury, inspectors, auditors, taxpayers, suppliers, customers or partners. It also deals with customer relationships within the organisation, between finance services and its internal users.

5 Scored from 0 to 4, with 0 indicating no evidence of best practice being followed and 4 indicating full evidence of best practice.

6 The review did not score the Commands under the 'stakeholders' management dimension.

Source: Chartered Institute of Public Finance and Accountancy, *Review of financial management using the CIPFA Financial Management Model*, December 2014

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