



National Audit Office

Report

by the Comptroller
and Auditor General

Cross-government

Government's spending with small and medium-sized enterprises

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Report by the Comptroller and Auditor General

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Comptroller and Auditor General
National Audit Office

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This report examines what the government is doing to make the public sector marketplace more accessible for small and medium-sized enterprises.

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Key facts

27%

proportion of the government's reported procurement spending that reached small and medium-sized enterprises (SMEs) in 2014-15 (Cabinet Office estimate)

£4.9bn

government's reported procurement spending directly with SMEs in 2014-15

Unknown

number of SMEs working on government contracts

25% aspiration for government's level of procurement spending to reach SMEs by 2015

8 of 17 number of central government departments that reported exceeding the government's aspiration in 2014-15

19% proportion of the Ministry of Defence's procurement spending that reached SMEs in 2014-15 (the Ministry of Defence is currently responsible for 44% of government's procurement spending)

33% government's target for the level of procurement spending to reach SMEs by 2020

4 the number of different methods government has used to estimate its spending with SMEs in the last five years

60% proportion of government's spending with SMEs that was via another, larger, contractor to SMEs in their supply chains (indirect spending)

Summary

1 Each year, the government spends around £45 billion on goods and services supplied by non-public sector organisations. Increasing the proportion of this spending that reaches small and medium-sized enterprises (SMEs) was a key priority within government's procurement policy over the past five years. In 2010, the government announced an aspiration for 25% of the spending to go to SMEs by 2015. In August 2015, the government announced that it would extend this target to 33% by 2020. The target covers both direct contracts with SMEs and spending that reaches SMEs indirectly (where the government's contract is with a larger provider that subcontracts SMEs as part of its supply chain).

2 The Department for Business, Innovation & Skills (BIS) estimates that there are currently 5.4 million SMEs operating in the UK. Most are private sector businesses, but the definition includes many voluntary, community and social enterprise (VCSE) organisations. Government uses the European Commission's definition of an SME, which defines it as an entity engaged in economic activity that:

- employs fewer than 250 people; and
- has annual turnover less than or equal to 50 million euros (£39 million); or
- has a balance sheet total of less than or equal to 43 million euros (£33 million).

3 The Cabinet Office's Crown Commercial Service (CCS) is responsible for the government's commercial policies. This includes leading on government's SME procurement policy. By increasing government's use of SMEs, the CCS aims to increase competition and innovation for public sector contracts. It intends to do this by:

- monitoring government's spending with SMEs, against its target; and
- identifying and removing barriers that SMEs face when bidding for government contracts.

4 Individual contract awards are decided by the government department awarding the contract. By identifying and removing the barriers faced by SMEs across government, the CCS aims to make it easier for SMEs to do business with government. As this becomes easier, the CCS expects more SMEs to bid for government contracts, increasing competition for work and leading to better value for the public sector.

Scope of this report

5 This report looks at what government is doing to make the public sector marketplace more accessible to SMEs. It focuses particularly on the action government took to achieve its aspiration of 25% by 2015 and early plans to achieve the 2020 target. The report sets out:

- central government's progress in increasing the government's use of SMEs;
- efforts to remove the barriers that SMEs face when bidding for government contracts; and
- the challenges for government of realising the benefits of using SMEs.

6 We did not audit the value for money offered by SMEs compared with other providers for individual contracts. Appendix One explains our methodology.

Key findings

The government's use of SMEs

7 **For many years, government has sought to harness the potential benefits of involving SMEs in the public sector marketplace.** The departments we met agreed that SMEs can offer a number of benefits to the public sector, compared with other providers. For example, offering more flexibility, innovative approaches and better value for money due to lower overhead costs. The Cabinet Office told us that SMEs, particularly VCSEs, can offer value in terms of local investment and improved social outcomes. Although government set its first target for spending with SMEs in 2010, the underlying policy is not new. Government has sought to increase its work with SMEs for similar reasons since the 1990s (paragraphs 1.5 to 1.9 and Figure 1).

8 **In order to track performance, the CCS has made improvements to the understanding government has about its spending with SMEs.** The number of bodies involved and different data systems have made it difficult to develop reliable estimates of government's spending with SMEs in the past. The CCS has worked with departments to improve the quality of government's information about SME spending. For example, it introduced a survey of large suppliers in 2011-12, in order to develop an indicative estimate of the amount government spends with SMEs through the supply chain. It has continued to refine the methodology each year up to 2015 (paragraphs 1.18 to 1.20).

9 **In February 2015, government reported that it had met its 2010 SME spending target a year early.** The Cabinet Office estimated that 26% of government spending reached SMEs in 2013-14, surpassing its 2010 aspiration of 25%. It estimates that government further increased its spending with SMEs the next year, to 27% of total procurement spending. The CCS reported that departments spent £4.9 billion directly with SMEs in 2014-15 and that a further £7.3 billion reached SMEs through supply chains (paragraphs 1.10 to 1.15 and Figure 2).

10 However, we cannot be certain that the amount government spends with SMEs has increased over the last Parliament. The reported annual increases in spending with SMEs happened in parallel with the CCS' work to improve government's understanding of its spending with SMEs. As a result, we do not know how much of the reported increase is due to the changes in approach and how much is an actual increase in SME activity. For indirect spending, the Cabinet Office has surveyed a larger group of providers each year since 2011-12 so annual figures are not comparable. The CCS' methodology for direct spending has not changed since 2011-12, but we cannot be certain that numbers are directly comparable due to the structure of the underlying data (paragraphs 1.6, 1.16 and Figure 3).

11 Increasing SME spending further by 2020 will be challenging. The government has set a new target for 33% of spending to reach SMEs by 2020. Whether it reaches this will depend heavily on the Ministry of Defence (MoD), which is currently responsible for 44% of central government procurement. In 2014-15, 19% of the MoD's procurement spend reached SMEs. The other 16 departments collectively reported 33% of spending reaching SMEs. The MoD told us it will be challenging to increase its SME spending further by 2020. It has already committed large proportions of its annual spending and is unlikely to be letting many further large contracts during the current parliament (paragraphs 1.21, 1.22 and Figures 2 and 4).

Progress in removing barriers SMEs face when bidding for contracts

12 The government has introduced initiatives to reduce the barriers faced by SMEs when bidding for public sector work. In 2011, the Cabinet Office launched a package of measures aiming to make sure that SMEs were better able to compete for government contracts. The Cabinet Office identified barriers such as the poor visibility of opportunities and burdensome pre-qualification requirements. It has launched initiatives aimed at reducing these barriers. For example, government has abolished pre-qualification questionnaires for low-value contracts and departments are now required to use Contracts Finder (a portal for advertising government tenders, first launched in 2011). Furthermore, the Social Value Act 2012 requires commissioners to consider wider social, economic and environmental benefits in procurement processes, which is often thought to benefit VCSEs in particular (paragraphs 2.2 to 2.21 and Appendix Three).

13 But SMEs still face barriers. SMEs told us the government initiatives had resulted in positive changes but, in practice, are still not sufficient to ensure that more work flows to SMEs. For example, the centrally-led initiatives depend on individual commissioning teams in departments choosing to implement them. The barriers most commonly cited by SMEs – and echoed by government departments – have not significantly changed. They include:

- **Transparency of information:** SMEs struggle to find contracting opportunities and have difficulty identifying where to go to for support.
- **Departmental appetite for risk:** Commissioners may be wary of using SMEs that have no financial track record or parent company guarantee.
- **Disproportionate bidding requirements:** SMEs often do not have the resources to complete lengthy tender documentation.
- **Capability of commissioners:** Commissioners who lack commercial expertise can be more risk averse. They are less likely to seek out innovative approaches or take social value into account.
- **Delays in payments:** SMEs are less likely to have the financial capacity to absorb delays in payment and may struggle to manage their cash flow (paragraphs 2.26, 2.27, Figure 6 and Appendix Three).

Achieving the benefits of using SMEs in delivery

14 Commissioners must balance the government's aspirations for using SMEs with other conflicting priorities. Most contracting decisions are made by commissioners across government, rather than by the CCS. The SME agenda is only one part of significant ongoing changes in the way the government does business with its providers. Some of these trends may make it harder for SMEs to win contracts as commissioners seek to balance different government priorities in decisions about contracts, including:

- **Reductions in commissioner capacity**

Our recent reports have highlighted gaps in government's commercial capability. Most government departments plan to make further cuts by 2020, which is likely to affect capacity in commercial teams. Departments' efforts to improve the way they manage contracts has focused on larger contractors. Government has not yet set out how it will manage smaller contractors. Departments may rely on larger contractors (prime contractors) to manage supply chains on their behalf so commissioners only have one contract to manage rather than many. In recent years, government has extended this model to new areas of spending, such as estates management and learning and development. This trend is likely to continue if spending cuts reduce the capacity of commissioning teams to manage a larger number of contracts (paragraphs 3.4 to 3.8).

- **Greater use of government's collective buying power**

In many areas of government, particularly for common goods and services (such as office supplies and training), government is increasingly merging the spending of different departments and using its collective buying power to simplify procurement and cut costs. This allows it to standardise products and services so providers compete on the basis of price rather than quality. Providers of these products and services can no longer rely on their pre-existing relationships or specialised nature of their product or service to win contracts. This can limit opportunities for SMEs that rely on their specialist services to secure business. While the CCS has shown that SMEs can win contracts even when government merges its spending, the move towards greater price competition and standardisation changes the type of SME that is likely to win these contracts. This reduces the likelihood that SMEs will bring innovation or niche expertise (paragraphs 3.9 to 3.12 and Figure 8).

- **Pressure on departments to make savings**

Government's austerity policy means departments will need to achieve further cost savings by 2020. With reduced budgets, departments are less able to absorb the cost of projects overrunning or exceeding budgets. When delivery is outsourced, commissioners can seek to transfer most of the financial risks of delivering the contract to the provider, by agreeing a fixed price at the start of the project. However, it means providers must be willing and able to take on financial risk. SMEs often do not have the resources or financial support (eg from a parent company) to be able to do this so commissioners may perceive them as more risky than larger providers (paragraphs 3.13 to 3.15).

15 Consequently, most SMEs working on government contracts are part of the supply chain and it is not clear that this will lead to increased competition and innovation.

These SMEs make up 60% of government's annual £12 billion estimated spending with SMEs. They work for larger prime contractors and may not compete directly for government contracts. In most areas, government has limited knowledge of these supply chains, as prime providers appoint, set contract terms for, and manage the supply chain directly. These SMEs can bring other benefits and subcontractor roles can help them increase their capacity and experience, to be better able to compete for future work. However, the Cabinet Office has no way of knowing whether it is making progress towards its overall aim of increased competition and innovation. Prime providers will also take a management fee, which either reduces the income received by subcontractors or increases the cost to government of delivering services (paragraphs 1.7, 1.15 and 3.26 to 3.28).

16 Some parts of government have identified categories of spending where SMEs can have the most impact on delivery.

The CCS expects all departments to try and increase their use of SMEs. We found some examples of commissioners identifying areas where they could make greater use of SMEs. For example, sectors where SMEs are already thriving (eg digital services) or where government is keen to support SMEs to grow (eg construction). Commissioners have developed plans to reduce barriers to bidding in these areas, and make contracting arrangements more SME friendly. For example, Highways England has reduced the lot size for some construction contracts to make them accessible to SMEs (paragraphs 3.16 to 3.25 and 3.29).

17 The fractured nature of government procurement systems makes it harder for the CCS to pursue a more targeted approach for government as a whole.

An underlying theme of this report is that government lacks an integrated digital platform for procurement. We reported in 2014 that individual departments do not have systems that integrate information on contracts, payments, and contractor performance. In areas not covered by CCS frameworks, this makes it harder for CCS to assemble information on cross-government spending or contracts and identify areas in which SMEs are making significant contributions to the delivery of government services or have the potential to have a greater impact. Contracts Finder holds information on some of government's contracts, but it depends on public bodies uploading information to it that is currently held in over 200 different procurement portals and the CCS has limited oversight of this data. Since July 2015, the CCS has begun to carry out a small number of spot checks to confirm that public bodies are using Contracts Finder to publicise their contract opportunities.

Conclusion

18 Over the last five years, the Government has had a clear and sustained focus on the involvement of SMEs in government contracts. Government reported that over 25% of its spending reached SMEs in 2014-15. It now aims to increase this to 33% by 2020. However, we cannot be certain that the amount government spends with SMEs has increased since it set its original target in 2010. As it seeks to increase it further, government needs to think carefully about the full range of risks and opportunities that contracting with SMEs presents, compared to working with larger providers.

19 Government will be more likely to harness the potential benefits of using SMEs if it takes a more focused approach. It currently bases its approach on the assumption that more SMEs will win government work if there are fewer barriers to SMEs being able to bid. However, wider trends in government contracting mean that, although SMEs can bid for work, they are often not suitable to deliver it. If the government is serious about increasing its use of SMEs, it will need to focus on those areas where SMEs can deliver real benefits. This will take a more concerted effort not only to remove barriers to bidding, but to ensure that what and how government procures achieves the desired benefits of using SMEs.

Recommendations

20 To support the CCS in developing its strategy to meet government's 2020 target, we make the following recommendations to the CCS:

a **Taking a more focused approach to achieving the benefits of using SMEs**

The CCS needs to move from a generic approach of lifting barriers to SMEs bidding for contracts to an approach that involves working with departments to identify areas where different types of SME can bring the most benefit. It should:

- **Stop changing its basis for estimating SME spending**

The CCS should settle on a methodology for 2015-16 and ensure that any subsequent years' data can be compared with this 2015-16 baseline.

- **Identify those areas of government where different providers can bring the most benefits**

The CCS should ensure that, as departments develop plans to meet the 2020 target, they are identifying areas of spending where SMEs can have the most impact and the types of providers they would like to encourage in those areas (such as innovative businesses or VCSEs).

- **Use best practice to inform future decisions**

The CCS should identify where departments are effectively harnessing the benefits of using SMEs and VCSEs. It should disseminate these across government to help departments to shape their procurement and contracts to maximise the benefits from using these providers.

The CCS should also use this evidence to review the impact of SMEs on the public sector marketplace, to inform its own decisions about the quantitative target and central initiatives.

- **Identify where government needs to have oversight of the relationship between prime contractors and their subcontractors**

Government should identify areas where the majority of SMEs will continue to operate within a supply chain. In these areas, it should ensure prime contractors' behaviour does not prevent subcontractors delivering benefits for the public sector. For example, by introducing codes of conduct for prime contractors, or project bank accounts to ensure prompt payments.

21 In addition, there is a need for greater visibility and transparency of government's procurement, so the CCS should work with the Cabinet Office and the Government Digital Service to:

- **Assess the feasibility of an integrated cross-government procurement platform to support its commercial strategy**

This might be built of many systems with compatible data or a single system.

This will require leadership from the centre of government now if it is to be achieved during this Parliament.

- **As a first step, improve the quality of data in Contracts Finder**

The CCS should ensure there are clear lines of governance and accountability for the use of Contracts Finder, particularly enforcing the requirement for public bodies to use it to advertise opportunities.

Part One

Central government's use of small and medium-sized enterprises

1.1 This part sets out the scale of the government's procurement spending with small and medium-sized enterprises (SMEs) and its objectives to make more use of SMEs in public sector contracts.

The SME landscape

1.2 At the start of 2015, there were 5.4 million businesses in the UK. Over 99% of these were SMEs. Of these, most were micro-businesses, employing fewer than ten people.¹ The Office for National Statistics estimates that SMEs create around £35 of gross value added to the UK economy for every £100 of turnover, while larger companies create around £24.²

1.3 Central government spends nearly £45 billion each year on goods and services provided by non-public sector organisations. It estimates that over £12.1 billion of this reaches SMEs. The government defines an SME as an entity engaged in economic activity that:

- employs fewer than 250 people; and
- has annual turnover less than or equal to 50 million euros (£39 million); or
- has a balance sheet total of less than or equal to 43 million euros (£33 million).³

The government's definition includes most voluntary, community and social enterprise (VCSE) organisations.

1.4 The government does not know how many SMEs were awarded government contracts directly in 2014-15. The Cabinet Office's Crown Commercial Service (CCS) collected data from larger providers about spending with SMEs within their supply chains. However, there are gaps in these data so it is not possible to be sure of the actual number of SMEs working for the government, nor the types of SMEs involved.

¹ Department for Business, Innovation & Skills, *Business Population Estimates for UK and the Regions*, 2015.

² Office for National Statistics, *Annual Business Survey*, 2013.

³ European Commission definition, available at: http://ec.europa.eu/growth/smes/business-friendly-environment/sme-definition/index_en.htm

Government's objectives

1.5 In November 2010, the government announced an aspiration for 25% of government procurement to reach SMEs by 2015.⁴ This was part of a group of measures intended to help SMEs in the UK grow and to boost enterprise across Britain. In February 2011, at a strategic supplier summit for SMEs, the Prime Minister reinforced this commitment, saying:

“We need to make the [procurement] system more open to new providers, more competitive between suppliers ... helping us tackle waste, control public spending and boost enterprise and growth. It will also help us modernise our public services, opening them up to the forces of competition and innovation, and give our great charities and social enterprises the opportunity to deliver services too.”⁵

1.6 Government set a target for SME spending for the first time in 2010, but the objective to increase the government's use of SMEs is not new. Over recent decades, government has repeatedly expressed similar intentions to improve access to public sector procurement for SMEs. It anticipates their involvement will lead to greater value for money through increased competition and innovation. Government had also tried to track spending with SMEs before 2010. In 2005, the government conducted a survey of a sample of public bodies. It used data collected from this sample to estimate that, as a percentage of total contract value, it awarded 22% of its business to SMEs in 2004-05. This estimate excluded spending by the National Health Service and the Ministry of Defence (MoD).⁶

1.7 The CCS leads the government's policy on using SMEs. Over the last five years, government has set a clear policy objective to increase its spending with SMEs. This has been a priority objective for CCS and remains a priority for the next five years. It aims to develop a broader provider market for government contracts to get best value for the public purse through increased choice and competition. Its approach to increasing central government's use of SMEs is to:

- monitor government's spending with SMEs, against its target; and
- identify and remove barriers that SMEs face when bidding for government contracts.

4 Minister for the Cabinet Office, *Summit for small business speech*, November 2010, available at: www.gov.uk/government/news/plans-to-open-up-government-to-small-businesses

5 Prime Minister, PM's speech at the Strategic Supplier Summit, February 2011, available at: www.gov.uk/government/speeches/pms-speech-at-the-strategic-supplier-summit

6 Small Business Service, *Access to public procurement for small and medium enterprises: progress report – December 2005*, available at: www.bipsolutions.com/docstore/pdf/12111.pdf

Benefits for the public sector

1.8 Government did not assess the costs and benefits of this policy in detail before implementing it. However, we found a broad consensus among the departments and providers we met during our fieldwork on the benefits that can be achieved by using SMEs. The most commonly cited were innovation, flexibility and better value for money (**Figure 1**).

1.9 We were also told VCSEs can offer additional benefits where their social or charitable objectives align with government's objectives. For example, VCSEs are more likely to employ disadvantaged people. A recent report found that 59% of social enterprises employ at least one person who is considered disadvantaged in the labour market, such as the long-term unemployed or ex-offenders.⁷

Figure 1

Benefits for the public sector of working with SMEs

Benefits

Innovation – fresh thinking compared with established larger providers.

Flexibility – providers can be more agile and responsive to client needs as they have a direct relationship with commissioners.

Better value for money – fewer corporate overheads and senior staff.

Expertise – specialist skills and knowledge in a particular field can lead to better outcomes.

Local focus/knowledge – closer to the community and service users, hence better able to engage them and address needs.

Economic growth – by growing the supplier base and creating jobs.

Illustrative examples

An SME was awarded a contract to provide the Driver and Vehicle Standards Agency's Hazard Perception Test. By **using digitally generated people rather than real people** in the video tests, they could use a far wider range of scenarios as there was no risk, therefore improving the quality of the test.

Home Office awarded a hosting contract for the Disclosure and Barring Service to an SME that **charges on an hourly basis allowing information services to be switched on and off freely depending on demand**.

MoD contracted an SME to use cloud hosting to deliver an information management system for a staff suggestion scheme for simplifying activities and reducing costs. The contract was **delivered significantly faster and cheaper** than other approaches.

Department for Culture, Media & Sport's galleries procure **fine art print from specialist SMEs** as the usual central government printing providers do not have the requisite skills.

Nuclear Decommissioning Authority recognises that many SMEs operating in the nuclear decommissioning supply chain are part of local communities so **may be better placed to build relationships with the local community** than larger multinational providers.

Research shows that for every £1 spent with an SME there was an additional 63p benefit for the local economy compared with 40p in every £1 spent with a larger business.¹

Note

¹ Federation of Small Businesses, *Local Procurement: Making the most of small business, one year on*, June 2013.

Source: Case study departments and provider meetings

Measuring government's performance

Government targets

1.10 In 2010, the government announced an aspiration for 25% of central government's contracts to be awarded to SMEs. In February 2015, it announced that 26% of central government spending reached SMEs in 2013-14, achieving the aspiration a year early.

1.11 In August 2015, the government announced a revised target for 33% of government spending to be with SMEs by 2020. Based on current spending, this would represent a further £2.7 billion.

1.12 Both targets:

- are measured by the value of contracts and not by volume or number of contracts;
- include departments' supply chains ('indirect' spending); and
- include centrally managed procurement, central government departments, their agencies and their arm's-length bodies.

1.13 Government measures its target using two types of data on spending, which are reported by the CCS on behalf of central government:

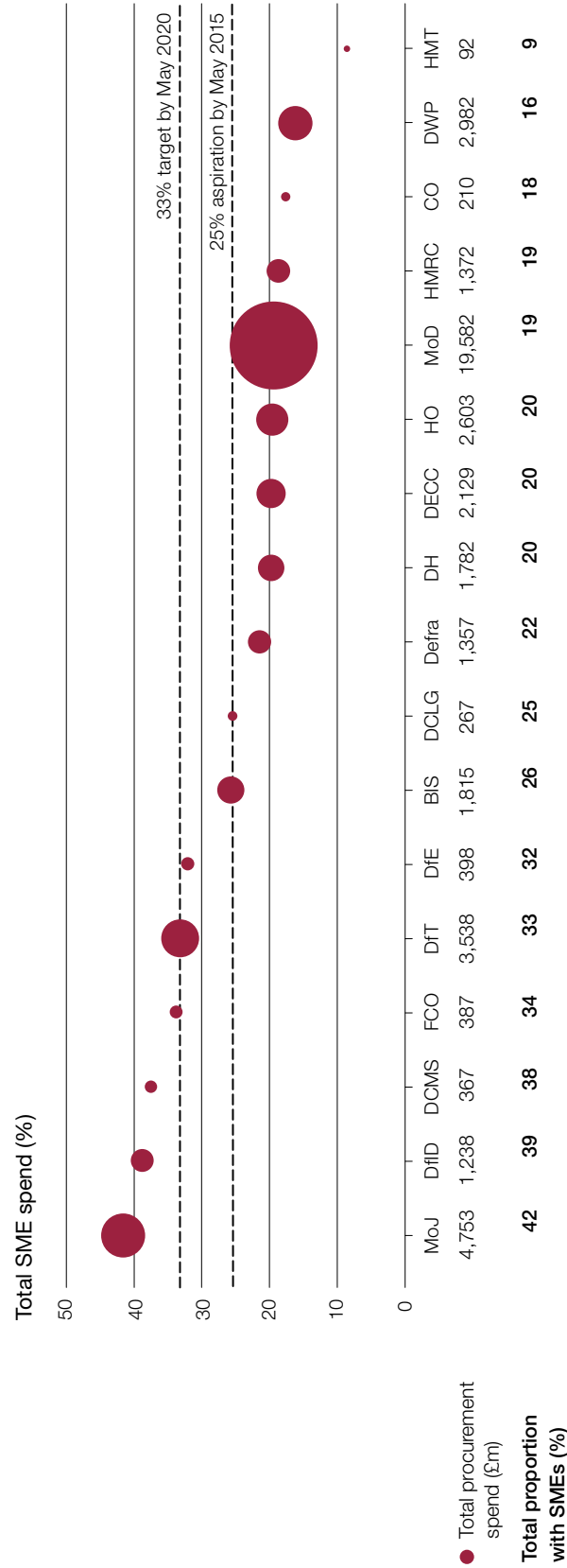
- **direct:** the public sector awards a contract directly to an SME; and
- **indirect:** the public sector contracts with a larger provider and SMEs are appointed as subcontractors in the supply chain.

1.14 The CCS first reported direct spending with SMEs in 2010-11 as 6.8% (£3.2 billion). It first reported indirect spending a year later in 2011-12, at 6.5% of spending. Government reported year-on-year increases in these estimates. In 2013-14, it reported that it had met the 25% target for the first time.

1.15 The latest figures, for 2014-15, show 10.9% direct spending (£4.9 billion) and 16.2% indirect spending (£7.3 billion), making a total of 27.1%. Most of the increase is in indirect spending, which now accounts for 60% of reported SME spending. Across government, departments reported significant variation in performance, ranging from 8.6% (HM Treasury) to 41.6% (Ministry of Justice) (**Figure 2**).

Figure 2
Departments' spending with SMEs in 2014-15

Government surpassed its 25% aspiration in 2014-15; MoD spent more than any other department



Notes

- 1 Total government procurement spending: £45 billion (27.1%, £12.1 billion with SMEs).
- 2 Departments take different approaches to collating spending figures, for example MoD only includes spending from the core department whereas other departments include some agencies and arm's-length bodies.
- 3 In addition, suppliers reported indirect spending of £1,490 million for central government with no departmental association. The value of this spend accounts for 12% of total SME spending and 3% of total procurement spending.
- 4 MoJ = Ministry of Justice; DfID = Department for International Development; DCMS = Department for Culture, Media & Sport; FCO = Foreign & Commonwealth Office; DfT = Department for Transport; DfE = Department for Education; BIS = Department for Business, Innovation & Skills; DCLG = Department for Communities and Local Government; Defra = Department for Environment, Food & Rural Affairs; DH = Department of Health; DECC = Department of Energy & Climate Change; HO = Home Office; MoD = Ministry of Defence; HMRC = HM Revenue & Customs; CO = Cabinet Office; DWP = Department for Work & Pensions; HMT = HM Treasury.

Source: National Audit Office analysis of Crown Commercial Service data. Available at: www.gov.uk/government/uploads/system/uploads/attachment_data/file/482638/Publication_of_1415SpendUpdate_1_1_14_15.pdf

Government's developing approach

1.16 We cannot be certain that the amount of spending going to SMEs has increased since 2010 as the annually-reported numbers are not directly comparable. Since 2010-11, the Cabinet Office has changed its approach to measuring performance every year except 2014-15 (**Figure 3** on pages 19 and 20).

1.17 The CCS's approach for estimating direct spending changed from using departments' quarterly data summaries in 2010-11 to using its tool for analysing spending (Bravo) in 2011-12. Data in Bravo are taken directly from departments' accounting systems. Bravo uses the Dun and Bradstreet database to identify SMEs within the data.⁸ The data in Bravo are known to be incomplete but this is gradually improving as more central government bodies are added to it and inconsistencies resolved. Since the CCS started using Bravo the estimate of direct spending with SMEs has been between 10% and 11%.

1.18 The CCS has improved the way it estimates indirect spending several times. It did not report indirect spending at all before 2011-12. Between 2012-13 and 2013-14, it increased the sample size for its survey of government's suppliers from 120 to 500, capturing a wider pool of expenditure. In 2013-14, it started to use a separate methodology for MoD, extrapolating findings from a survey of 60 MoD suppliers. This added a further 2% of SME spending, allowing government to report that it had met its target.

1.19 The CCS relies on departments to validate figures on direct spending. This validation process has led to the figures being revised both upwards and downwards over time. The Foreign & Commonwealth Office and the Ministry of Justice have reported large increases in direct SME spending performance following changes in approach to data validation. Across government in 2014-15, departmental validation resulted in an overall addition of £61 million of spending that Bravo had not classified as spending with SMEs.

1.20 Overall, the CCS now has a better understanding of government's spending with SMEs. The latest estimate is more reliable than the 2010-11 estimate of 6.8% or the 2005 estimate of 22% (see paragraph 1.6). However, the government's understanding of its indirect spending with SMEs remains incomplete. Departments told us that they rely on the goodwill of large suppliers to report spending accurately to the CCS as departments usually have no way to verify the accuracy of the figures. Suppliers may only have data on their spending with the next tier of their supply chain, so may not report spending with SMEs in lower tiers. Furthermore, suppliers may have different approaches to collecting and validating data and identifying SMEs, leading to inconsistent measurement.

⁸ Dun and Bradstreet provides the SME classifications used in the matching process to identify new SMEs and monitor classifications of SMEs.

Figure 3
 Government's approach to report SME spending, 2010 to 2015
 Government has changed its approach to reporting SME spending in four of the last five years

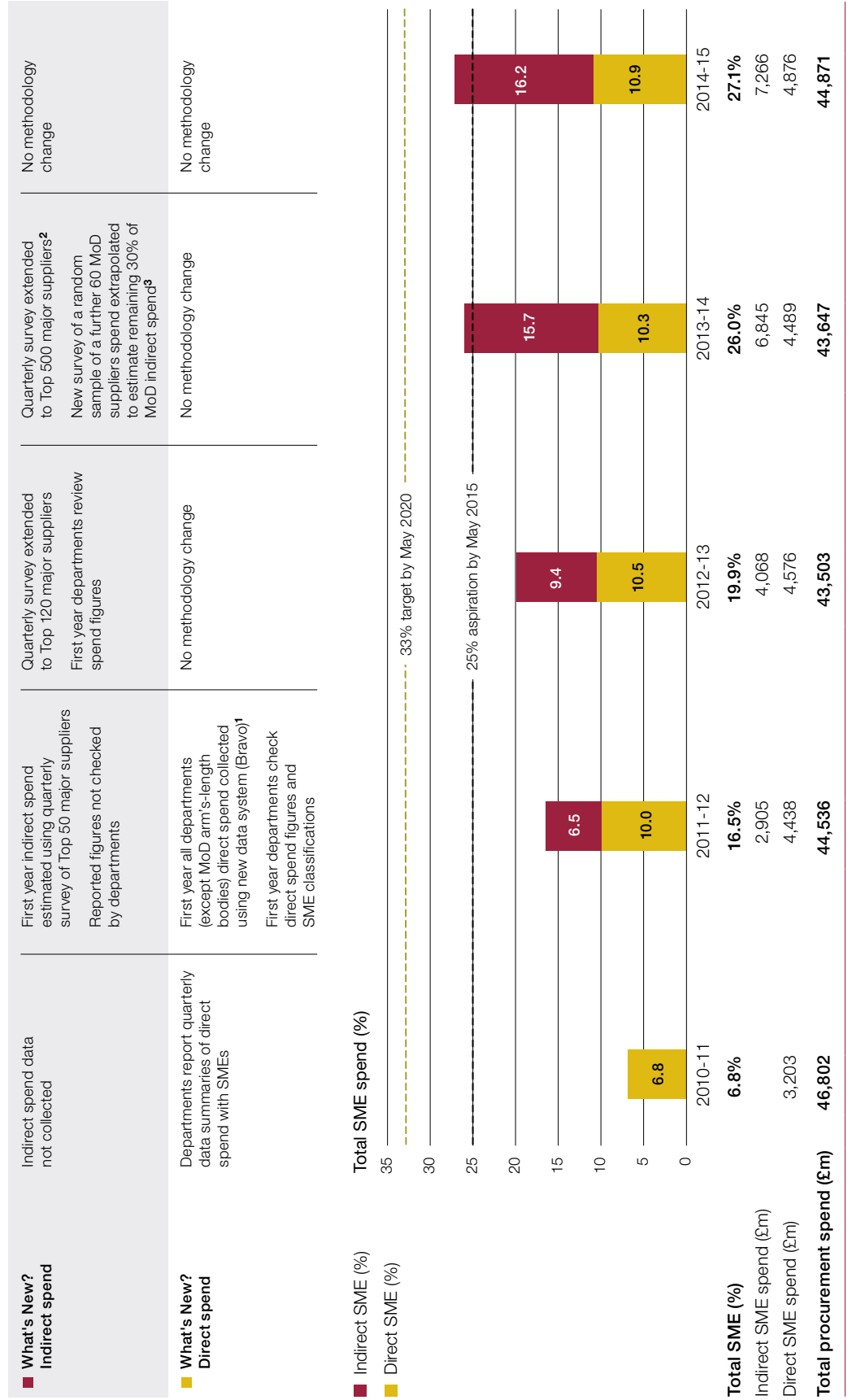


Figure 3 *continued*

Government's approach to report SME spending, 2010 to 2015

Notes

- 1 CCS collects data on procurement spending using a third party system called Bravo. Bravo collects data from departments' invoices, identifies SMEs within the data using Dun and Bradstreet classifications and provides monthly data reports on SME spending by department.
- 2 In 2013-14, to estimate indirect spend, the Cabinet Office asked a stratified random sample of central government's 500 largest suppliers to report their spending with SMEs.
- 3 Of the MoD spend, 30% is not included in the indirect spending sample. The CCS introduced a further survey of 60 MoD suppliers to gather data on spending with SMEs through the MoD supply chain. It conducted this survey in January 2015 and used the data as the basis for estimating indirect spending in 2013-14 and 2014-15.
- 4 In 2011-12, 27 of the 50 suppliers surveyed responded. In 2012-13, 87 of the 120 suppliers surveyed responded and in 2013-14 350 of the 500 suppliers responded.
- 5 The figures for SME spend and total procurement spend have not been adjusted for inflation.

Source: National Audit Office analysis of Crown Commercial Service data

Achieving the 2020 target

1.21 In working towards the new target of 33%, the CCS is negotiating individual targets with departments. Departments have committed to helping the government meet its target by including relevant objectives in their single departmental plans.⁹

1.22 If it is to meet the 2020 target, the government will rely heavily on the MoD increasing its level of SME spending. The rest of central government has already collectively achieved the 2020 target, reporting SME spending of 33% in 2014-15 (see Figure 2 on page 19). In contrast, only 19.4% of the MoD's 2014-15 expenditure was with SMEs. Based on CCS estimates of 2020 spending, if MoD increases its SME spending to 25%, the rest of government collectively will need to increase their SME spending to at least 37% of their total procurement spending. The MoD told us it is limited in its ability to increase its spending with SMEs due to the complexity of defence procurement (**Figure 4**).

Figure 4

MoD faces a number of challenges in increasing its use of SMEs

Significant proportions of MoD's procurement spending up to 2020 is already committed, with limited opportunities to renegotiate contracts. Furthermore, the nature of its work means it can be difficult to identify opportunities that are appropriate for SMEs. For example:

- Most of MoD's procurement relates to high-value defence equipment, such as submarines or warships, which are usually delivered by larger prime suppliers. The supplier is then responsible for appointing a supply chain. SMEs will not have the capacity or experience to compete for these contracts so – for much of MoD's spending – can only access opportunities further down the supply chain.
- MoD requires all its providers to meet security requirements, which may deter some SMEs from pursuing MoD opportunities.
- MoD tends to work with a small number of existing suppliers. In the past it has used single-source approaches for more than half of its procurement, although this is reducing. This makes it harder for new entrants to access the market.
- In its procurement, MoD is aware that it uses language that may be unfamiliar to those not already working with it and aware of its approach. Similarly, the size of the MoD (1,600 commercial staff) can mean SMEs struggle to find out who to contact for information.

Source: Interviews with senior Ministry of Defence commercial staff

9 These were published on 19 February 2016 and are available at: www.gov.uk/government/collections/single-departmental-plans-for-2015-to-2020

Part Two

Increasing participation of small and medium-sized enterprises

2.1 This part sets out the government's progress in identifying and reducing barriers that small and medium-sized enterprises (SMEs) face when bidding for government contracts, including reasons why government may be reluctant to contract with them directly.

Removing the barriers

2.2 In 2011, the government set out three areas of concern for SMEs that it was aiming to tackle. These were:

- the lack of visibility of contract opportunities;
- overly burdensome pre-qualification requirements; and
- access to government to pitch ideas and promote innovation.¹⁰

2.3 The Crown Commercial Service (CCS) has introduced several initiatives aimed at making it easier for SMEs to compete for government contracts, by reducing the barriers SMEs face. These initiatives are expected to improve the way government does business with all its providers, although some are targeted specifically at SMEs or VCSEs. We set out the full list in Appendix Three and summarise the main themes overleaf.

¹⁰ Cabinet Office, *Making government business more accessible to SMEs – one year on*, March 2012. Available at: www.gov.uk/government/publications/making-government-business-more-accessible-to-smes-one-year-on

Reform of the public procurement regulations

2.4 The government's approach included reforming the regulations governing public sector contracts. These reforms are reflected in the Public Contract Regulations 2015, which became effective in February 2015 for public sector procurements. The new regulations include:

- removing pre-qualification questionnaires for contracts below a certain value and introducing a standardised questionnaire for higher-value contracts;
- requiring contracts to stipulate payment of invoices within 30 days throughout the supply chain;
- advertising all contracts above a certain value and publishing all award notices and framework call-offs; and
- introducing a 'comply or explain' requirement for commissioners to break contracts into different lots.

2.5 The CCS told us it was able to introduce some elements of these reforms early in central government, for example central government has used a core set of pre-qualification questions since 2011. It expects the legislation to ensure greater consistency across the wider public sector.

Improving transparency of information

Contracts Finder

2.6 Contracts Finder is an online portal that brings most of government's published contracting opportunities together in one place. The government has committed to making its data more transparent and sees Contracts Finder as a way of meeting this commitment. Contracts Finder shows:

- contract opportunities above £10,000 that are open for tenders;
- planned work that will lead to contract opportunities in the future; and
- previous tenders and awarded contracts (including a copy of the contract).

2.7 Contracts Finder was re-built in 2015, to improve its search function and ensure the design could be updated more easily in the future. For most contracts, public bodies are now required to use it under public procurement regulations.¹¹

¹¹ The Public Contracts Regulations 2015: Section 110, February 2015 does not require all contracts to be advertised on Contracts Finder, for example single tender actions. Some public bodies are exempt from the requirements, such as academies, maintained schools and NHS bodies.

2.8 Contracts Finder brings together data from over 200 procurement portals. Some data are automatically uploaded into the system, but most portals require public bodies to manually add it to Contracts Finder. We found gaps in the data it holds. For example:

- **contract opportunities:** the Cabinet Office identified 56 central government open contract opportunities on the European Union's contracting portal that it would have expected to find on Contracts Finder. It was only possible to find 45 (80%) of these on Contracts Finder.
- **published awards:** of 3,474 contract award notices on Contracts Finder as of July 2015, only 1,523 of these notices (44%) included links to published documents. We were not able to link published award notices to previously-advertised contract opportunities.

2.9 Contracts Finder provides some transparency over public procurement, but is limited in its scope. The CCS issued guidance in July 2015 relating to the transparency of government contract information, such as pricing and incentives, performance metrics and governance arrangements.¹² Contracts Finder is not currently set up to hold this sort of information and it is not yet clear where contracting authorities are expected to publish it.

Improving skills

The Commissioning Academy

2.10 In 2012, the Cabinet Office launched the Commissioning Academy, as a development programme for public sector commissioners. The Academy, delivered by the CCS, aims to help commissioners deliver more efficient and effective public services. The core Academy comprises a six-day programme, including a 'provider perspective' day at which participants meet a range of service providers, including SMEs and VCSEs. By February 2016, 1,049 representatives from around 120 public sector bodies had attended the Academy. Most attendees were local commissioners, with central government making up a third of attendees. The CCS has also supported some local commissioners to run Academy programmes focused in a particular geographic area.

2.11 The Commissioning Academy has a wide-ranging syllabus and is supported by a range of SME and VCSE delivery partners. However, beyond the provider perspective day, the focus on SME or VCSE-specific issues is limited. In June 2015, the Office for Civil Society (OCS) piloted a Commissioning Academy Civil Society Programme, which focused on contracting with VCSEs. Like the core Commissioning Academy, this was mainly attended by local commissioners so it is not clear how the OCS intends to disseminate the messages to central government commissioners.

¹² Crown Commercial Service, Procurement Policy Note – Increasing the Transparency of Contract Information to the Public Action Note 13/15 31 July 2015. Available at: www.gov.uk/government/publications/procurement-policy-note-1315-increasing-the-transparency-of-contract-information

2.12 The CCS told us it is currently working with its delivery partners to determine the future shape of the Academy programme. It expects the Academy to be run by its partners in the future, with government providing support and guidance on programme content. The OCS will take over responsibility for the Commissioning Academy at the end of 2015-16.

Masterclasses for VCSEs

2.13 The Cabinet Office has also undertaken work developing the capability of VCSEs in particular. In 2012, the OCS introduced masterclasses to build VCSEs' commercial skills and help them 'up their game' when bidding for public service contracts. Programme funding ended in May 2015. Also in 2012, the OCS launched a £13 million investment and contract readiness fund providing grants to social ventures to help them grow and equip themselves to win government contracts. In total, £154 million in contracts were won by over half (46 out of 86) of the organisations seeking contracts. The fund closed in March 2015.

Delays in payment

2.14 Our January 2015 report on paying government suppliers on time found that almost all departments have publicly reported good performance against government's prompt payment commitments.¹³ However, we found little evidence that the commitments were having the intended effect of helping SMEs. This resulted in the risk that the main impact was to boost the working capital of prime contractors rather than benefiting other businesses in the rest of the supply chain. Delaying payments to subcontractors is an easy way for prime providers to manage their cash flow.

2.15 Departments and providers told us that prompt payment remains a significant issue for SMEs within supply chains. SME representatives we interviewed told us they understood larger providers sometimes delayed payments for over 60 days, severely affecting the sustainability of government work for SMEs. Highways England told us that subcontractors may charge a premium to manage their own financial risk, because they anticipate late payments. This cost is incurred by the prime contractor but reflected in the price it charges to government.

2.16 In most cases, departments rely on prime providers to manage their own supply chains. This includes appointing subcontractors and setting their terms and conditions. Prime providers usually expect to charge a fee for these services, which will either increase the charge to government or reduce payments to subcontractors. We heard anecdotal evidence that some prime providers require subcontractors to waive prompt payment targets as part of these terms and conditions. Government has limited information about its subcontractors and their terms and conditions. This means it is unable to ensure that changes to its own approach are benefiting all SMEs involved in government contracts. The experiences of SMEs within the supply chain are discussed further in Part Three.

¹³ Comptroller and Auditor General, *Paying government suppliers on time*, Session 2014-15, HC 906, National Audit Office, January 2015.

Improving procurement processes

Abolishing pre-qualification questionnaires

2.17 Following complaints about the length and complexity of pre-procurement qualification questionnaires, the CCS abolished questionnaires for contracts below £100,000. For larger contracts, it has standardised the questionnaire for contracting authorities to use. The CCS told us that complaints have reduced since then. However, sector representatives told us the contracting authorities may include similar requirements with their invitations to tender or within their criteria for reviewing bids. This can mean SMEs proceed further through the procurement process before discovering they do not meet departments' requirements.

Other central initiatives

Crown Representatives

2.18 The Cabinet Office has introduced separate Crown Representatives for SMEs and VCSEs. The roles were intended to promote better communication between government and these organisations, to help government's efforts to open up the public sector marketplace for them. The VCSE's Crown Representative was in post from June 2012 until October 2014. The SME's Crown Representative was in post from February 2011 until July 2015. Both posts are currently vacant. The CCS has advertised the SME role and expects a replacement to be in post by March 2016. The VCSE role has not yet been re-advertised.

The CCS SME panel

2.19 In June 2011, the Cabinet Office formed the SME panel "to hold our [government's] feet to the fire" and advise it on work to help SMEs.¹⁴ The panel consists of 24 SMEs. Most panel members are from small IT or consultancy businesses, based in London and the South East. Between 2011 and 2015, the panel met around 14 times. It set up subgroups on pre-market engagement, late payments and consortiums to help the government better understand the barriers that prevent SMEs bidding for government contracts.

2.20 The panel has not met since January 2015. In September 2015, the CCS reviewed the structure and focus of the SME panel. It intends to broaden the representation on the panel, to include a wider range of sectors and a broader geographical area.

¹⁴ Cabinet Office, *Annex A SME Progress Report: Making government procurement more accessible to SMEs*, March 2012.

Departmental initiatives

2.21 Most initiatives are developed and led centrally by the CCS or the OCS on behalf of government as a whole. We spoke to a few departments and identified further initiatives they had introduced to reduce barriers for the SMEs they work with. Each department has an SME champion and these champions meet with the CCS quarterly. All the departments we met agreed that these meetings would be a good opportunity to share ideas for what works well, but this has not always happened regularly. The CCS told us it has sought to increase opportunities for sharing best practice over the last year, both from departments and those within CCS responsible for cross-government spending.

Highways England and Project Bank Accounts

2.22 Highways England (a government-owned company within the DfT group) now uses project bank accounts as standard for supply chain payment. These are ring-fenced bank accounts from which payments can be made to all members of the supply chain, rather than relying on prime contractors to pass payments on to subcontractors. Highways England told us it introduced these accounts to ensure that prime contractors were not delaying payments to subcontractors, although it recognised that setting them up can be costly. It reported benefits for SMEs in particular as they have reduced capital costs and are better protected if the prime contractor goes into liquidation. Project bank accounts are not widely used elsewhere in government.

Nuclear Decommissioning Authority and supplier engagement

2.23 Many departments have been seeking to improve the transparency of contract opportunities for example by using Contracts Finder or doing more pre-market engagement supplier roadshows. The Nuclear Decommissioning Authority, part of the Department of Energy & Climate Change (DECC), uses a range of initiatives including:

- simplifying and standardising procurement requirements;
- holding regional and national supplier events to help providers link up; and
- running an SME mentoring scheme.

This has corresponded with an increase in indirect SME spending across the DECC group from 13.5% in 2011-12 to 17.8% in 2014-15.

Feedback from providers

2.24 The Cabinet Office told us that it uses a 'mystery shopper' scheme to monitor its progress in removing barriers affecting SMEs. It launched this scheme in February 2011. Any government provider, including SMEs, can raise concerns about public procurement practice directly with the CCS. This enables the CCS to investigate and take action to address concerns.

2.25 However, our previous report found limited but indicative evidence that subcontractors were not aware of the service, and those who had heard of it feared that making a report would result in a loss of business.¹⁵ A 2014 survey of 216 specialist subcontractors in the construction industry found that 72% had not heard of the service and a further 15% had heard of it but did not know what it does. These concerns were echoed by sector representatives we spoke to during fieldwork for this report.

2.26 Since it launched in 2011, the CCS told us its Mystery Shopper team has received over 1000 complaints. The CCS does not publish details of on-going investigations, but once it has concluded its work it publishes short case summaries on its website, with details of any actions taken. Between February 2011 and January 2016, it has published details of around 600 cases. Overall, the total number of complaints published each year has increased since 2011 but remains low relative to the number of government contracts (86 complaints in 2015).¹⁶

2.27 However, not all of these complaints relate to SMEs and the CCS has only partial data on the size of the organisation affected. To identify the complaints most likely to come from SMEs, we compared the case summaries for January to September 2015 to a list of issues commonly identified as barriers by SMEs (see paragraphs 2.28 to 2.30). This identified 38 complaints about these barriers. The two most commonly raised issues were insufficient capacity (9 complaints) and late or no payment (7 complaints). We also looked at complaints raised over a similar period in 2011 (**Figure 5** overleaf). The number and type of concerns had increased between the two years but numbers are too low to draw meaningful comparisons. It is therefore not possible for us or the CCS to use these numbers to conclude on progress with addressing barriers facing SMEs.

Barriers to SMEs winning government contracts

2.28 Sector experts continue to raise concerns about the barriers to winning government contracts faced by SMEs. In February 2015, the Prime Minister's Enterprise Adviser, Lord Young, highlighted some of the barriers faced by small businesses, including:

- a lack of SMEs with the digital capability to make use of opportunities;
- a lack of accountability if contracts fail; and
- fragmented support to SMEs.¹⁷

¹⁵ Comptroller and Auditor General, *Paying government suppliers on time*, Session 2014-15, HC 906, National Audit Office, January 2015.

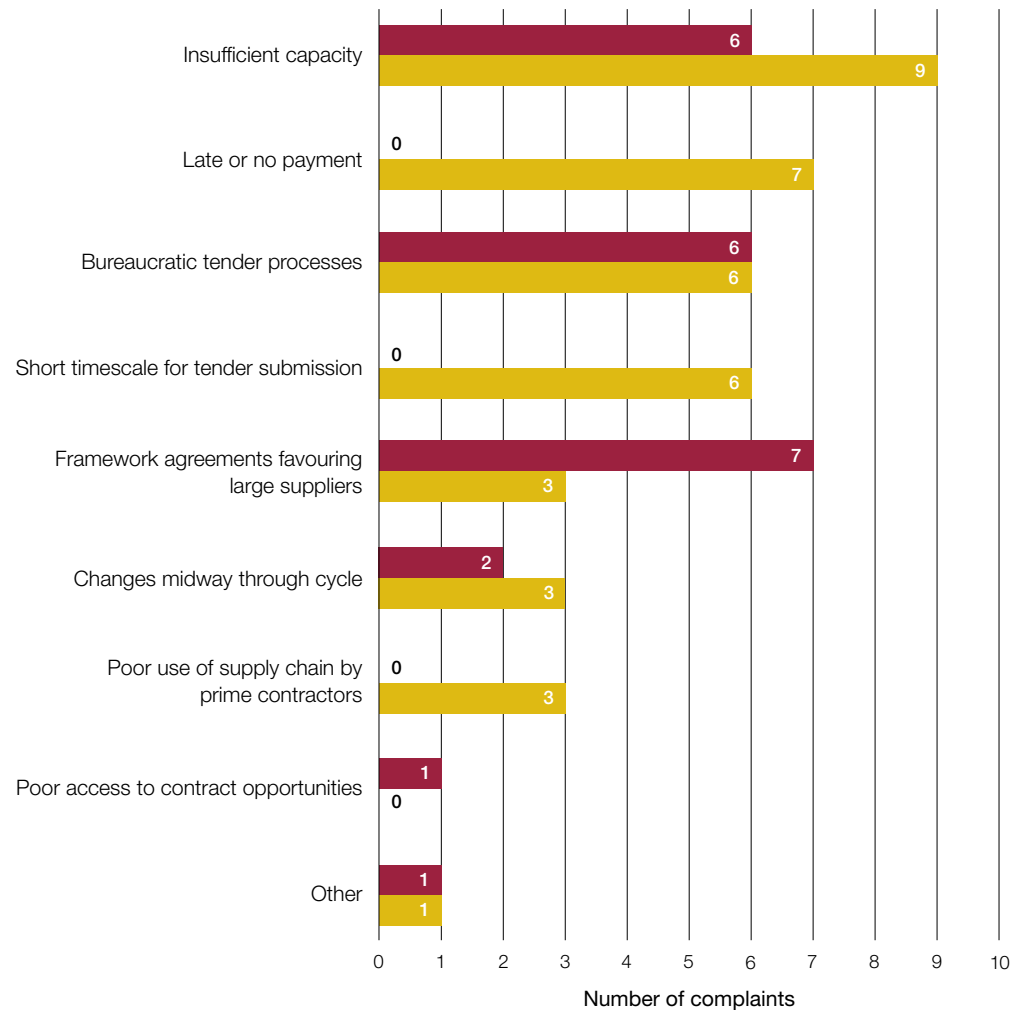
¹⁶ Case summaries are available at: www.gov.uk/government/collections/mystery-shopper-results

¹⁷ Lord Young, *The Report On Small Firms 2010–2015*, February 2015.

Figure 5

Complaints to 'mystery shopper' about issues commonly identified as barriers by SMEs

Complaint type



■ 2011
■ 2015

Notes

- 1 It was not possible to identify from the mystery shopper data if the complaint was made by an SME. To identify which complaints were most likely to relate to the SMEs, we compared a list of issues commonly identified as barriers by SMEs contracting with the public sector with complaints reported by mystery shopper.
- 2 In complaints where more than one barrier to an SME was identified, only the barrier connected to the main focus of the complaint was selected.
- 3 The figures are based on our analysis of mystery shopper complaints from February to October 2011 and January to September 2015.

Source: National Audit Office analysis of Cabinet Office data

2.29 We spoke to sector representatives and SMEs about their experiences of finding and bidding for public sector contracts. We also asked departments about barriers SMEs may face. Overall, the feedback we received suggests that the government's initiatives are directed at key issues facing SMEs, but that the initiatives are not being consistently implemented across the public sector.

2.30 We collected this feedback in 2015, after some of these initiatives had been running for some time. However, it is possible that the impact of the various initiatives may take time to be felt by the sector. Nonetheless, we noted that the challenges SMEs think they face remain the same as those recorded for many years (**Figure 6**).

Figure 6

Barriers to contracting between government and SMEs

Issue	Government-side barriers	Provider-side barriers
Transparency of information	Do not fully understand their providers or market capacity.	Cannot identify suitable contracting opportunities or who to approach for help.
Departmental risk aversion	Stick to providers they already know or seek to outsource their risk management, perceiving larger suppliers as less risky.	Cannot meet requirements set by government, for example providing parent company guarantees or demonstrating a track record of delivery for government.
Capability	Lack of commercial skills can increase risk aversion and reduce ability to seek out innovative approaches or consider social value.	Tend to have a more specialist range of products or services and so may only be capable of delivering a small proportion or certain parts of contracts.
Capacity	Limited capacity means commissioners are more likely to outsource their supply chain management to prime contractors.	Do not have the resources to invest in developing relationships, prepare lengthy bids or deliver large contracts.
Delays in payment	Limited oversight means that government cannot ensure that prompt payment targets are passed on by prime contractors.	Less likely to have the financial capacity to absorb payment delays, creating cash flow and workflow issues.

Source: Discussions with departments and sector stakeholders

Barriers for VCSEs

2.31 Most VCSEs meet the government's definition of an SME and so face many of the barriers discussed above. However, the structure and purpose of these organisations creates unique challenges, particularly for charities (**Figure 7**). A recent survey by the Lloyds Bank Foundation found that 49% of small and medium-sized charities that bid for public sector contracts described the process as 'difficult' or 'impossible'.¹⁸

2.32 As well as the barriers facing SMEs, the VCSE sector has had to adapt to an evolving government funding environment. A decade ago, much of the sector's funding from government was in the form of grants, but this has changed significantly. A recent report found that commissioning contracts for charities have grown by £6.5 billion in over a decade, while grant funding has shrunk by £2.2 billion.¹⁹ As a result, VCSEs may find themselves competing with other organisations to win a contract for a service they previously received a direct grant to run. They may lack the skills, capacity or experience to submit a competitive bid.

2.33 Our VCSE focus group expressed frustration at the impact that increased contracting has had on government's approach to commissioning services. They told us commissioners develop contract specifications that do not fully understand or reflect users' needs and may restrict providers' ability to engage the hardest to help. VCSEs were particularly concerned about short-term contracts, which fail to recognise the length of time required to achieve complex outcomes. They also believed the contribution of the voluntary sector in some areas can be taken for granted, with the government assuming that charitable organisations will step in, even if not funded to do so.

Figure 7 Barriers specifically facing VCSEs

Barrier	Impact
Disproportionate loss of funding as government reduces use of grants.	Need to find other sources of funding to preserve service continuity and invest in developing expertise needed to find, bid for and win contracts.
Lack of familiarity with procurement processes.	May mean VCSEs are unable to secure government contracts, even where they have relevant skills and experience.
Poor alignment between government's aims and VCSEs' charitable or social objectives.	VCSEs must comply with objectives set out in their governance documents so may not be able to deliver certain government requirements if these are seen to create a conflict.
Prime providers use VCSEs as 'bid candy' – highlighting their involvement in bid documents but failing to pass on work from the contract.	Difficult for VCSEs to plan and allocate resources if work (and income) is not guaranteed by the prime provider.
Perception from VCSEs that government does not respect intellectual property.	Creates a culture of distrust and uncertainty, reducing opportunities for collaboration between VCSEs and the public sector.

Source: National Audit Office

¹⁸ Lloyds Bank Foundation, *Expert Yet Undervalued and on the Front Line*, July 2015.

¹⁹ New Philanthropy Capital, *Times of Change*, April 2015.

Part Three

Achieving the benefits for specific contracts

3.1 This part of the report looks at:

- the trends in government contracting that constrain the use of small and medium-sized enterprises (SMEs);
- the challenge of gaining the benefits from SMEs in the supply chain; and
- some of the innovative approaches being used across government to achieve the benefits of using SMEs.

Constraints in the use of SMEs

3.2 Commissioners cannot award a contract to an SME instead of a larger provider simply because they would like to use an SME. They must be able to demonstrate decisions represent value for money and comply with procurement regulations. However, commissioners can choose what to procure and how to structure their procurements and contracts. This can affect whether SMEs are suitable for a contract, likely to win that contract and able to provide the intended benefits of using an SME.

3.3 However, in making these decisions, commissioners have other factors to consider, which could potentially make it harder for them to develop SME-friendly approaches. We observed three significant developments in government's commercial agenda that may indirectly constrain the use of SMEs:

- reductions in commissioner capacity;
- greater use of the government's collective buying power; and
- pressure on departments to cut costs and make savings.

We describe these further overleaf.

Reductions in commissioner capacity

3.4 Recent reports from both the National Audit Office and the Committee of Public Accounts have identified a lack of commercial and project management skills and systemic weaknesses in contract management across government.²⁰ This has led to the Cabinet Office setting up a commercial capability programme and the larger departments undertaking significant efforts to reform the way they manage contracts.

3.5 So far, departments have mainly focused on improving their approach to their larger, more strategically important contracts, which tend to be with larger providers. We estimate that 25% of central government's spending is with a small group of only ten providers. Yet government has records for over 100,000 government contractors. Most departments are yet to decide how to improve their management of government's large group of smaller contractors.

3.6 The 2015 Spending Review has led to further budget cuts for most departments. At the same time, the Cabinet Office and HM Treasury's commercial capability reviews of 11 departments have recommended they increase the seniority, experience and skills of their commercial teams but reduce the number of staff. The aim is for commercial teams to focus on providing more valuable expertise in commercial strategy, market engagement and then operational contract management rather than the procurement process. However, this will also mean reducing the number of administrative staff available to manage contracts. We have yet to see a clear strategy from central government about how it will manage its smaller contracts in this context.

3.7 One option might be greater automation of procurement and management of smaller contracts, using a digital platform to enable policy teams to procure without the support of commercial teams. An alternative is consolidating supply chains through the use of 'prime contractors'. Faced with capacity constraints, government has for many years relied on large prime contractors to manage its more complex supply chains on its behalf. These prime contractors assemble the supply chain, often including SMEs before they bid for the contract. They then manage the supply chain during the contract's operation. Prime contracting also means that subcontractor appointments within the chain normally fall outside public procurement regulations. This makes it potentially quicker and more flexible than direct contracting by a government body.

3.8 Although the new Public Contract Regulations 2015 (paragraph 2.4) requires commissioners to consider breaking contracts into smaller lots, government has extended the use of prime contracting to new areas of spending over the last five years. These included MoD estates, civil service learning, civil service pensions and contingent labour.

²⁰ Comptroller and Auditor General, *Transforming government's contract management*, Session 2014-15, HC 269, National Audit Office, September 2014 and HC Committee of Public Accounts, *The Centre of government*, Nineteenth Report of Session 2014-15, HC107, October 2014

The greater use of government's collective buying power

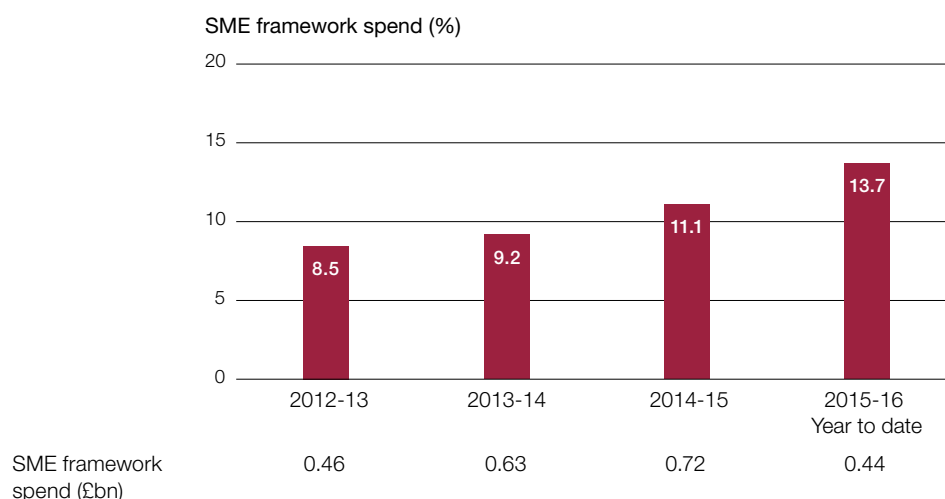
3.9 The government is increasingly using its collective buying power to drive down the costs of what it buys. This strategy has three parts: increasing government's leverage when negotiating with strategic providers; looking for economies of scale; and using standardisation to promote price competition. The latter two affect SMEs.

3.10 For common goods and services (such as office supplies, energy and travel), departments have transferred responsibility for procurement to the CCS, which acts on behalf of government as a whole.²¹ Collective procurement can make it harder for SMEs to compete, as they may not have the capacity to deliver bulk contracts or meet the criteria to qualify for a national framework. The CCS has taken steps to ensure SMEs are represented on its framework agreements. In 2014-15, 62% of the 7,000 providers on the CCS's 178 framework agreements were classified as SMEs. Of the £3.2 billion spent through CCS frameworks between April 2015 and January 2016, 14% was spent with SMEs (**Figure 8**). Even though overall spending through these frameworks has decreased in 2015-16, the proportion of spending with SMEs has increased steadily since 2012-13.

Figure 8

Crown Commercial Service framework spend with SMEs

The proportion of spend through CCS frameworks going to SMEs has increased



Notes

- 1 Frameworks data includes spend by departments using CCS frameworks.
- 2 Year to date 2015-16 figure based on data as at 11 January 2016.

Source: National Audit Office analysis of Crown Commercial Service data

21 As at January 2016, seven departments have transferred responsibilities to the Crown Commercial Service.

3.11 Government has also sought to encourage price competition, by standardising products and services. Providers compete on the basis of price, rather than their distinguishing features. This is sometimes associated with an attempt to consolidate the market and number of providers. It means providers of these products and services can no longer rely on pre-existing relationships or the specialised nature of their product to secure business. For example, providers delivering training courses under the Civil Service Learning contract are not allowed to offer training courses directly to departments that compete with common cross-government courses. Therefore, any training provider building their business around strong relationships with particular public bodies or by differentiating their training for a particular subject, may find the new arrangements a direct threat to their business model.²²

3.12 Promoting price competition benefits some types of SMEs and not others. It also affects the likelihood of SMEs delivering benefits for the public sector, as procurement based on standard products and services is less likely to lead to economic growth or encourage innovation (paragraph 3.19). Some SMEs are able to flourish as providers of standard products and services. For example, government's G-Cloud provides a web platform for advertising a catalogue of IT-related products and services, mostly provided by SMEs, that departments can use (paragraph 3.24).

Pressure on departments to cut costs and make savings

3.13 Most departments will need to achieve further cost savings by 2020. This may result in departments using more fixed-price contracts. Fixing the price at the start of the contract allows commissioners to transfer some financial risk to the provider. This is attractive for departments that have to achieve challenging budget cuts, as it means they can, in effect, 'bank' the saving from the procurement. However, providers must be willing and able to take on this risk. SMEs may not have the resources or financial support (eg from a parent company) to be able to do this so commissioners can perceive them as more risky than larger providers.

3.14 SMEs may be excluded from bidding or winning contracts by requirements intended to reduce a department's risk. Some requirements are difficult for SMEs to fulfil. For example, bidders for one of 40 prime contracts for the Work Programme had to demonstrate annual turnover of at least £20 million.²³ This is because it was a payment by results contract with payment not made for at least the first six months. Our focus group told us that for the Transforming Rehabilitation programme, bidding requirements were refined at the last minute to include a parent company guarantee for all bidders – a requirement that VCSEs were unable to meet. Many bidders had spent significant amounts on tendering before being told they were no longer eligible.

3.15 Our recent principles paper on provider failure set out our view, based on our experience of auditing government, that government could improve the way it considers and manages failure of providers.²⁴ Departments often believe that in contracting out services they have transferred the risks to the provider. But when a contract fails the provider can walk away from delivering a service, government cannot. Overly rigid controls to ensure an SME is not a credit risk, such as a requirement to have a financial history or parent guarantee, do not always protect a department from failure.

Ensuring SMEs deliver benefits for the public sector

3.16 In part one, we set out the benefits government told us it could gain from the greater involvement of SMEs in government contracts. At a government-wide level, the CCS's aim was to make it easier for SMEs to compete with larger providers for government contracts. But it cannot demonstrate that the initiatives set out in part two have had this impact overall. For example, it has no data on whether the number of SMEs bidding for government contracts has changed.

3.17 At a departmental level, SMEs can deliver benefits for particular areas of spending or individual contracts (see Figure 1 on page 15). In late 2015, the CCS began work to identify areas of cross-government spending where there was the potential for greater use of SMEs. It analysed different departments' spending with SMEs through its frameworks, in order to identify similar departments with different levels of SME spending. It told us it intends to use this analysis to demonstrate to departments areas in which they could make greater use of SMEs. However, government has not yet sought to identify areas where SMEs are thriving in the private sector and so are better placed to compete with larger providers for government contracts. For example, in the information and communication sector, SMEs have increased their market share since 2010, accounting for 45% of the sector's total turnover in 2015.

²³ House of Commons Library, *Work Programme: background and statistics*, Number 6340, 26 June 2015.

²⁴ Comptroller and Auditor General, *Principles Paper: Managing provider failure*, Session 2015-16, HC 89, National Audit Office, July 2015.

3.18 We found some examples of areas of government developing strategies to increase their use of SMEs. In these cases, commissioners identified:

- benefits to their business of increasing their use of SMEs;
- the type of SME that could best deliver those benefits; and
- specific strategies to make it easier for those SMEs to compete for contracts.

3.19 This focused approach recognises the diversity of SMEs. While SMEs are commonly seen as distinct from government's main (large) suppliers because of their size, they are not a homogenous group. A small business will differ from a VCSE and a fast-growing start-up will have different concerns to an established, niche provider. For instance, we have identified three broad categories of SMEs:

- **Niche providers** – such as those in the heritage sector or VCSEs supporting specific groups, can provide highly-specialised services, products and expertise that no-one else can. But such providers are unlikely to contribute significantly to economic growth.
- **Innovative start-ups** – technology start-ups and new companies can give the government access to new ways of doing things and act as a driver of economic growth. But such providers can be inflexible as they seek to grow their business and require ownership of their intellectual property.
- **Commodity providers** – small providers operating in highly competitive markets (eg IT hardware, recruitment agencies) can offer value for money and flexibility, but may not provide economic growth or specific expertise.

3.20 Identifying the potential benefits of using SMEs and the types of SMEs that can have most impact can help departments develop strategies to ensure SMEs thrive within a particular sector. This part looks at three examples of where government has done this:

- Highways England and the construction sector
- G-Cloud, led jointly by the Government's Digital Service and the CCS
- Supply chain oversight

Highways England

3.21 The largest area of spending within the Department for Transport group is construction. Highways England (which is responsible for 71% of DfT's 2014-15 procurement spending) also recognised the value of supporting SMEs within the construction sector. It told us that most SMEs operate locally, so a government contract with an SME would create jobs locally and improve links with local communities. However, both DfT and Highways England told us that construction is a difficult area for SMEs to win contracts, due to the size and complexity of projects. Most of Highways England's construction contracts are worth over £200 million.

3.22 To address this, Highways England took SMEs into account when launching its Collaborative Delivery Framework in 2014. For one framework lot, the contract value is initially limited to £25 million, ensuring that contracts are accessible to smaller businesses. Highways England told us it intends these smaller contracts to allow SMEs to build up a track record of delivery so that they can secure future business and grow.

G-Cloud

3.23 For ICT spending, the Cabinet Office's Government Digital Services (GDS), working with the CCS, identified specific benefits to be gained by working with SMEs and developed an approach to make it easier for SMEs involved in technology to do business with government. Its 2011 ICT strategy committed to spending more with SMEs to benefit from the innovative approaches they could offer.²⁵

3.24 A key change in the government's approach to ICT procurement was the introduction of G-Cloud in 2012, a digital purchasing platform through which the public sector can procure cloud-based services. G-Cloud is intended to make it easier for SMEs to work with the government, by allowing departments to purchase from any G-Cloud provider rather than tying them into long-term contracts with single suppliers. In December 2015, GDS estimated that 51% of the government's spending through G-Cloud, since its launch, was with SMEs. It estimates that over 80% of suppliers on the framework are SMEs.

²⁵ Cabinet Office, *Government ICT Strategy*, March 2011.

3.25 The GDS's strategy also requires departments to:

- stop using contracts worth over £100 million for IT programmes and reduce the length and size of contracts to make them more accessible for SMEs; and
- consider cloud options first in any IT procurement, encouraging the use of G-Cloud and the government's Digital Marketplace, both of which include SMEs.²⁶

In reporting progress against the 25% aspiration in 2013, ICT was the category of spending mentioned most frequently by departments, reflecting the government's strategic focus in this area.²⁷

Supply chain oversight

3.26 The two examples above illustrate how government can adapt its procurement approach to ensure that SMEs have opportunities to compete for work directly. However, most SMEs working on government contracts do so as subcontractors and this is unlikely to change significantly in the future.

3.27 SMEs we spoke to raised concerns about the sustainability of working within a public sector supply chain. The main concerns raised were:

- difficulties identifying subcontractor opportunities;
- prompt payments not passed on;
- onerous commercial terms reflecting unfair distribution of risk;
- volume of work far lower than expected, so income reduced; and
- limited independent contact with the contracting authority so dependent on the success of the prime contractor.

3.28 In most cases, departments appoint a single prime contractor, who they rely on to appoint subcontractors. This means government rarely knows who makes up its supply chain or the terms and conditions of their contracts. With this lack of oversight, it is difficult for commissioners to ensure that SMEs are able to thrive and deliver benefits for the public sector. Departments also told us they were concerned about the dependency it created between government and prime contractors. For example, a department usually has no way to remove a prime contractor without losing the attached subcontractors as well. This has a detrimental effect on service continuity as the department must identify and appoint a new supply chain.

²⁶ The Digital Marketplace is an online catalogue of ICT services for the UK public sector, available at: www.digitalmarketplace.service.gov.uk.

²⁷ Cabinet Office, *Making Government business more accessible to SMEs Two Years On*, August 2013.

3.29 Some departments are introducing initiatives to help SMEs thrive within the supply chain and to influence how prime contractors treat their subcontractors:

- The Department for Culture, Media & Sport (DCMS) told us that it is developing a new approach where it identifies and appoints subcontractors, before transferring the contracts to a prime provider to manage. DCMS told us this is to ensure it has a better understanding of the subcontractors involved in the work and control over their terms and conditions. This approach is only used where the project is of sufficient size to require a prime contractor to manage the works or services. DCMS told us it also recently changed its procedure to require prime providers to list any subcontractors they intend to use when they bid for work.
- The Department for Work & Pensions (DWP) has developed the Merlin Standard, a code of conduct for prime providers of the Work Programme. In a recent review, 48% of subcontractors felt Merlin had improved supply chain management, suggesting it is having some impact although the review also noted that subcontractors did not generally agree that Merlin ensured subcontractors were protected and treated fairly. Despite this, 74% of subcontractors felt Merlin should be used more widely by other commissioners.²⁸
- Highways England has introduced Project Bank Accounts for many of its large contracts to ensure that subcontractors are paid on time (see paragraph 2.22).

²⁸ Centre for Economic & Social Inclusion, *Review of the Merlin Standard*, October 2015, available at: www.gov.uk/government/uploads/system/uploads/attachment_data/file/468202/rr907-review-of-merlin-standard-full-report.pdf

Appendix One

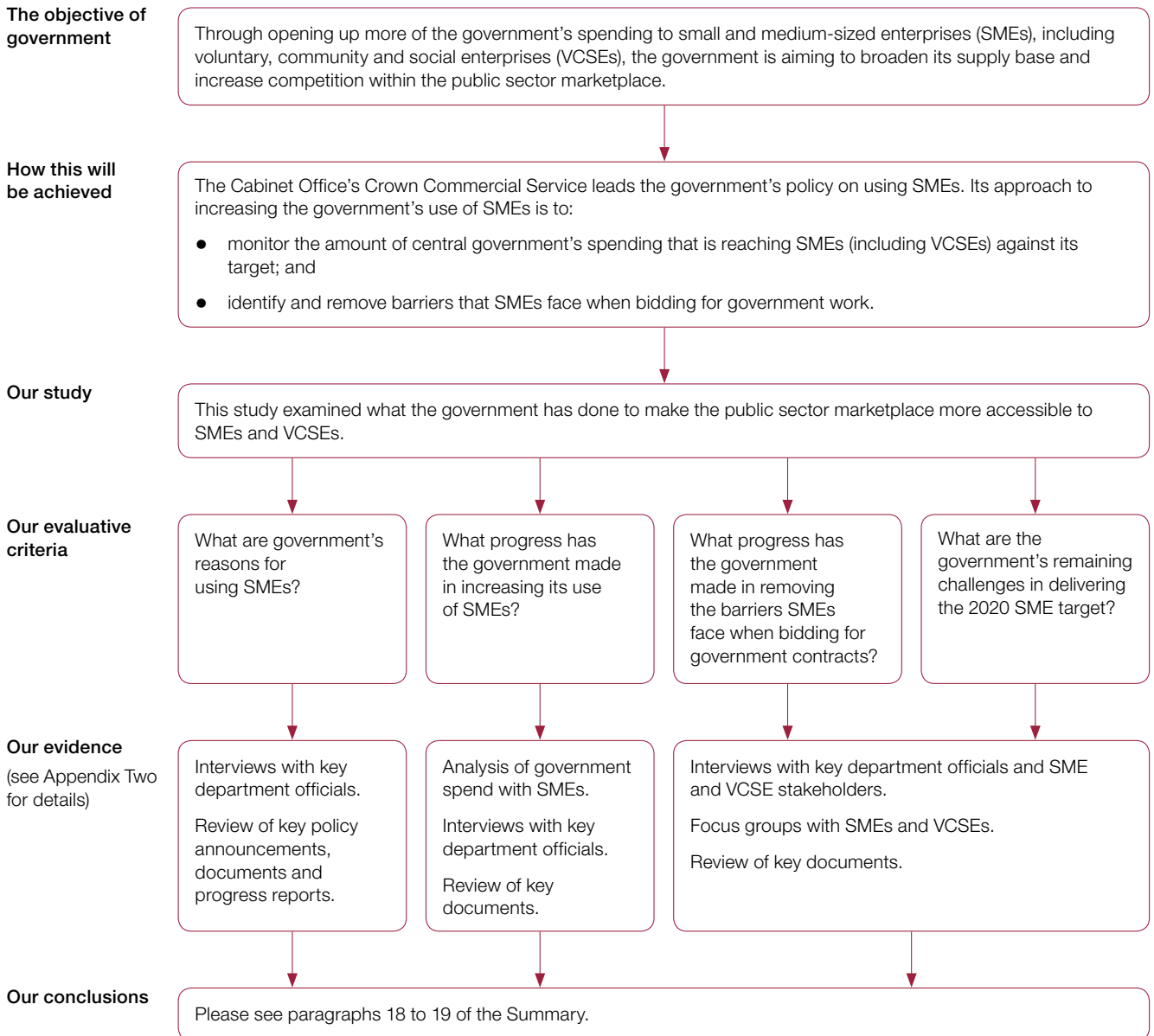
Our audit approach

1 This study looked at what the government has done to make the public sector marketplace more accessible to small and medium-sized enterprises (SMEs) and voluntary, community and social enterprises (VCSEs). We examined:

- the government's reasons for using SMEs;
- progress in increasing the government's use of SMEs;
- progress in addressing barriers SMEs face when bidding for government contracts; and
- the government's remaining challenges in delivering the 2020 SME target.

2 We did not audit the value for money offered by SMEs compared with other providers for individual contracts.

3 Our audit approach is summarised in **Figure 9**. Our evidence base is described in Appendix Two.

Figure 9**Our audit approach**

Appendix Two

Our evidence base

1 We carried out fieldwork for our independent review of the actions taken by the government to make the public sector marketplace more accessible to SMEs between August 2015 and October 2015. Our audit approach is outlined in Appendix One.

2 We examined the government's reasons for using SMEs:

- We conducted **semi-structured interviews** with officials in the Cabinet Office's Crown Commercial Service (CCS) and Office for Civil Society (OCS) to understand the government's objectives for making greater use of SMEs and how it monitors whether the benefits of this are realised.
- We conducted **semi-structured interviews** with officials responsible for compiling data on spending with SMEs for the Cabinet Office at six departments/arm's-length bodies. We asked them about their views on the benefits of procuring from SMEs. We selected departments/arm's-length bodies to provide a range of different sizes of contracting authority, proportions of direct SME business and the progress made against the SME spending target. The departments/arm's-length bodies selected were the Ministry of Defence, the Department for Transport (DfT) and Highways England (a government-owned company within the DfT group), the Nuclear Decommissioning Authority (part of the Department of Energy & Climate Change), the Department for Culture, Media & Sport, and the Home Office.
- We completed a **document review** of key Cabinet Office SME policy announcements and documents and progress reports on spending with SMEs to understand the government's objectives for making greater use of SMEs (including VCSEs). We also reviewed departmental SME action plans on gov.uk to understand the benefits departments aim to achieve by spending more with SMEs.

3 We analysed the progress in increasing the government's use of SMEs:

- We **analysed data** on direct and indirect SME spend since reporting began in 2010 to understand: how much the government is spending with SMEs; which areas of government spend the most with SMEs; progress against the government's aspiration to spend more with SMEs; and the impact of known errors or inconsistencies in the data.

- We conducted **semi-structured interviews** with officials at the CCS to understand the method for measuring and reporting progress against the government's aspiration and target to spend more with SMEs and to understand the definitions of direct and indirect spend used in the methodology.
- We completed a **document review** of CCS guidance for departments to measure SME spend.

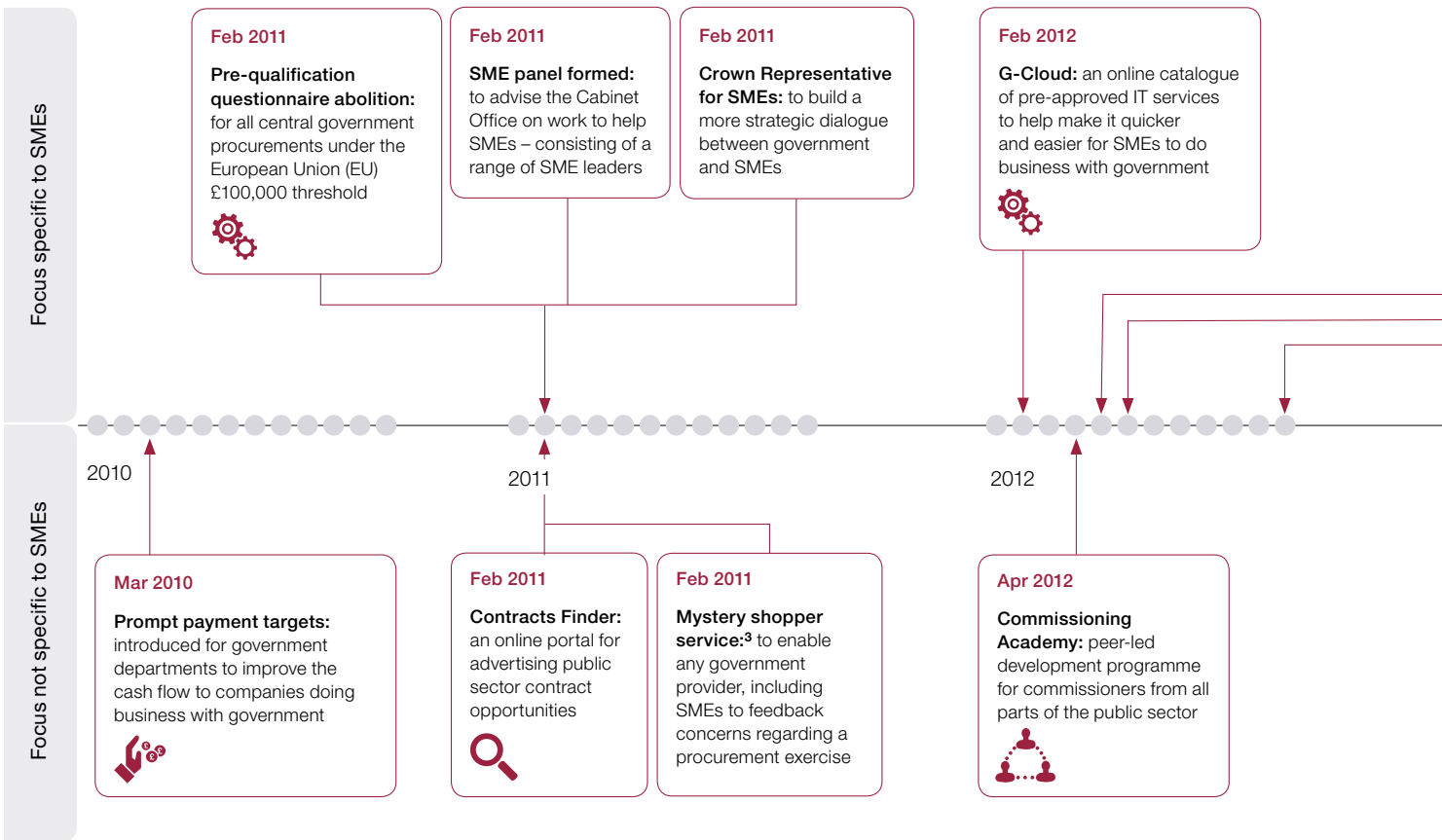
4 We assessed the progress in addressing the barriers SMEs face when bidding for government contracts. We also examined the government's remaining challenges in delivering the 2020 SME target:

- We conducted **semi-structured interviews** with CCS and OCS officials to understand the barriers the government has identified to SMEs bidding for and winning public sector work. We also sought to understand the Cabinet Office's strategy, initiatives and reforms to remove these barriers and its views on meeting the 2020 SME spend target. We sought to understand the level of support that the CCS gives to departments. We also met key officials in the Department for Business, Innovation & Skills to understand its role in supporting the overall policy aim for government to make greater use of SMEs.
- We conducted **semi-structured interviews** with SME champions and key procurement officials at six departments/arm's-length bodies (see Appendix Two, paragraph 2) to understand: the barriers to SMEs accessing the public sector marketplace; their plans and initiatives to remove these barriers; and the challenges of meeting the government's 2020 SME spend target.
- We conducted **semi-structured interviews** with SME and VCSE stakeholders including the Federation of Small Businesses (FSB), representatives of the Cabinet Office's SME panel, and the National Council for Voluntary Organisations (NCVO). This was to get providers' perspectives on the challenges of accessing government contracts and their awareness of and views on the effectiveness of government initiatives to remove the challenges.
- Working with the FSB and NCVO, we held two **focus groups** with senior representatives from SMEs – one with private sector SMEs and one with VCSEs – to understand in greater depth the barriers these organisations face when bidding for government work and their views on what the government is doing to remove these barriers.
- We completed a **document review** of published reports and relevant government initiative/reform documents to understand the barriers, and the extent and effectiveness of government initiatives since 2010.
- We **analysed complaints data** in the Cabinet Office's mystery shopper service reports for 2011 and 2015 to identify the number of complaints commonly raised by SMEs. We analysed data on the Contracts Finder online portal to understand the number of SME contract opportunities and the level of information on contract award notices. We analysed data on CCS frameworks spend to understand the proportion of spend going to SMEs.

Appendix Three

Full list of government's procurement initiatives

Government's procurement initiatives, 2010 to 2015

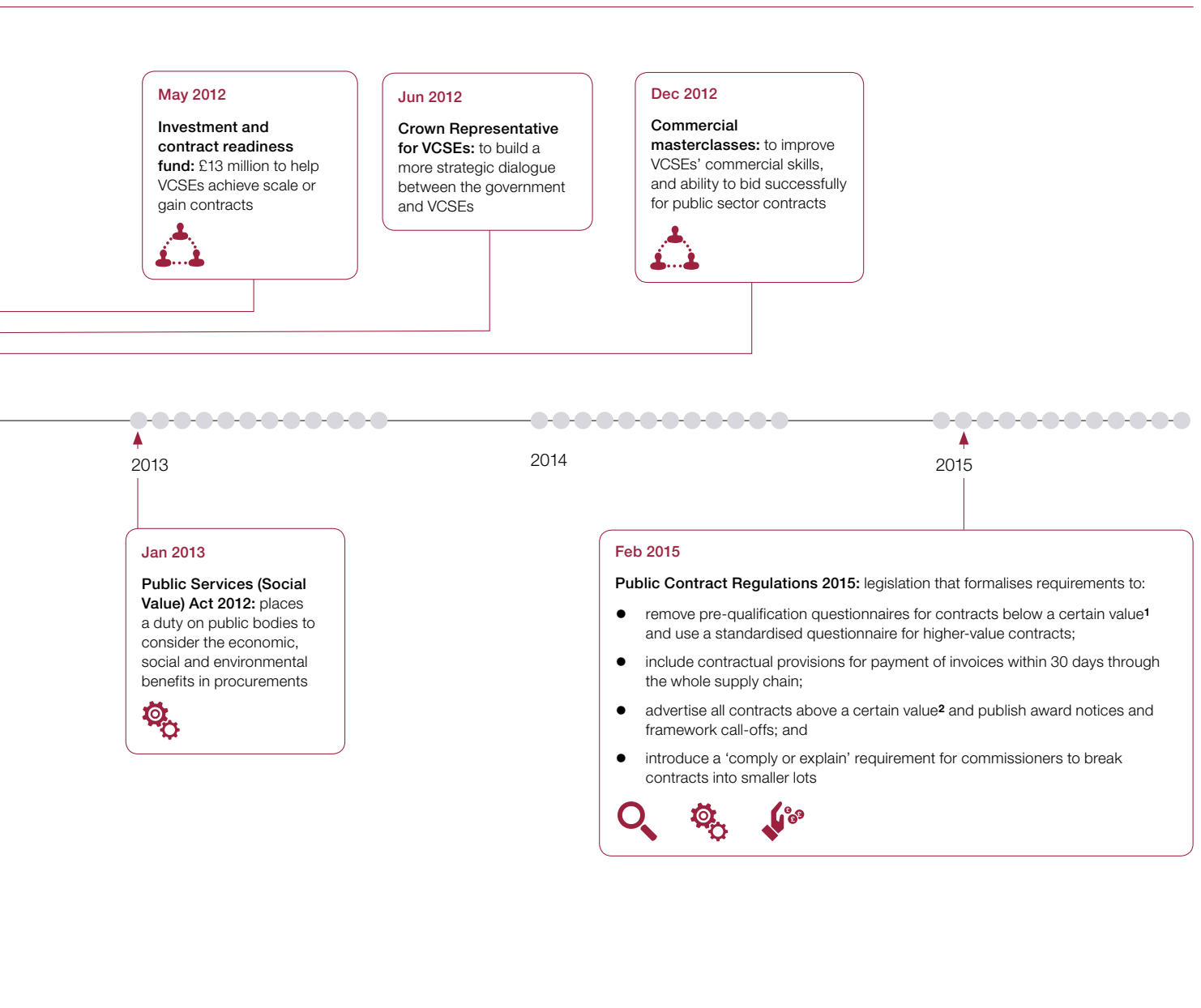


Transparency
 Skills
 Processes
 Delays in payment

Notes

- 1 Currently £111,676 in central government and £172,514 outside central government.
- 2 £10,000 for central government and £25,000 for other public bodies.
- 3 The mystery shopper service is available to any government provider and therefore provides partial SME focus.

Source: Meetings with the Crown Commercial Service and the Office for Civil Society



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