



10 DOWNING STREET

*From the Principal Private Secretary*

cc: HMT  
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DOT  
CSO, HMT  
21 September 1981

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Sir J. Rayner's office, Co

FINANCIAL MANAGEMENT IN THE MINISTRY OF DEFENCE

The Prime Minister was grateful for your Secretary of State's minute of 14 September and for a sight of the draft document for publication which Nick Evans sent with his letter of 17 September to Tim Lankester.

The Prime Minister is very pleased that Mr. Nott has found the report of the study of financial control procedures thorough and constructive and looks forward to being informed in due course of the findings of the study of financial responsibilities and accountability. She attaches particular importance to clarifying responsibilities for control and management and to making cash the medium of control at all levels.

The Prime Minister welcomes your Secretary of State's intention to publish the document but would like him to consider the following two points before the text is finalised.

First, she agrees that the candour of the analysis should not be regarded as an obstacle to publication. But she thinks that as the report may arouse Parliamentary and other interest, it is worth including in the last few paragraphs of the text a reasonably firm indication of when Ministers expect to take decisions on the more detailed recommendations of the study. The Prime Minister thinks that it is particularly important to get working relationships with contractors (paragraph 43) onto a footing which is fair to the Ministry, suppliers and the taxpayer.

Second, the Prime Minister does not understand why Mr. Nott has not enthusiastically adopted the report's recommendation that formal responsibility for observing the cash limit on the Defence Procurement Vote (Vote 2) should be placed on the Systems Controllers (paragraphs 26 and 40 of the draft). The report suggests that one of the main weaknesses of the arrangements examined was that responsibility for avoiding overspending rested on the shoulders of too few senior officers, including the Chief of Defence Procurement. It appears vital to the Prime Minister that in such a large system of financial management a delegation should be made to the next tier in the way recommended by the report. This would be consistent with and assist the intended wider devolution of responsibility lower down (paragraph 40). Yet at present the draft document for publication rejects this key recommendation with virtually no explanation.

~~CONFIDENTIAL~~

/ Finally,

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Finally, the Prime Minister sympathises with your Secretary of State's references to annuality. She would welcome progress towards greater flexibility between years, provided that it did not substitute for other measures to increase further the efficacy of procurement processes and that it was consistent with the wider objectives of public expenditure control.

On a point of detail, Mr. Nott may like to know that the Prime Minister commented in passing:

"Can we not find a better word than 'controllerates'.  
Where does it come from? It is awful."

I am sending copies of this letter to John Kerr (HM Treasury), David Heyhoe (Lord President's Office), David Edmonds (Department of the Environment), Ian Ellison (Department of Industry), John Rhodes (Department of Trade), Terry Mathews (Chief Secretary's Office, HM Treasury), Jim Buckley (Civil Service Department), David Wright (Cabinet Office) and Clive Priestley (Sir Derek Rayner's Office).

CAW

David Omand, Esq.,  
Ministry of Defence.

CONFIDENTIAL

Mr WHITMORE

*HWJ*  
*22/9*



*Govt*  
*Mad*

FINANCIAL MANAGEMENT IN MOD

*May B attached*

Sir Derek Rayner has seen my minute to you of 18 September. He wishes you to know that he very strongly agrees with the reference to making the Systems Controllers responsible for observing the Cash Limit and has drawn my attention to the treatment of a related point of principle in his 1971 report. Government Organisation for Defence Procurement and Civil Aerospace (Cmd. 4641). I am sure that he will welcome the vigour of your letter to MOD of yesterday.

2. The point of principle on which Sir DR rested many of his proposals for the Procurement Executive and which, initially at least, was adopted in his organisation was that of "fully accountable units of management".
3. With that in view, authority and responsibility were concentrated at the Controller level for all activities in such a particular area as the development and production of land, sea or air systems - and the process was to be continued down each controllerate. The Systems Controllers would be accounting officers for their own Vote and the Chief Executive the accounting officer for the Vote covering HQ administration, R&D and research.
4. After Sir DR ceased to be the Chief Executive, I understand that the Systems Controllers ceased to be accounting officers. Thus it is that the Reeves report on financial control procedures describes a situation which, in some respects at least, has reverted to what it was before the Rayner report of 1971.
5. "Controllerates", unhappily, stem from the 1971 White Paper.

*C*

C PRIESTLEY

22 September 1981



STATE DEPARTMENT  
OFFICE OF THE SECRETARY

1961 P

RECEIVED  
APR 12 11 21 AM '61  
L 869

The Secretary has received from the Director of the Office of Management and Organization a report dated April 11, 1961, regarding the proposed reorganization of the Office of Management and Organization. The report states that the proposed reorganization is necessary in order to improve the efficiency of the Office and to better coordinate the activities of the various offices within the Office. The Secretary is requested to approve the proposed reorganization.

The proposed reorganization of the Office of Management and Organization is being considered by the Secretary. The proposed reorganization is necessary in order to improve the efficiency of the Office and to better coordinate the activities of the various offices within the Office. The Secretary is requested to approve the proposed reorganization.

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B

Mr WHITMORE



FINANCIAL MANAGEMENT IN MOD

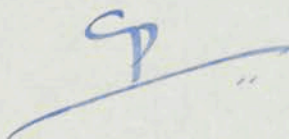
1. I have now read the draft document for publication promised in Mr Nott's minute to the Prime Minister of 14 September. I attach a possible letter for you to send to his office on her behalf. It is largely self-explanatory, but see below. I have restricted it to points which it is reasonable to suppose that the Prime Minister would have picked up.
  
2. The minute and draft together indicate broadly satisfactory responses to the Reeves study of expenditure control, which resulted in a masterly report. I have already sent you a copy of Sir Derek Rayner's comments on it. But it is clear that MOD have specifically if inexplicably rejected one of the two central recommendations made by the team, namely that  

"responsibility for observing the cash limit, and if necessary controlling spending within it, should in the systems area be placed squarely on the Systems Controllers and should be written into their charters where these exist" (Report, para. 709; draft paras. 26 and 40).
  
3. The reasons for the recommendation are given in para. 503 while possible counter-arguments are dealt with in paras. 710-715, attached. The reasons for the rejection are not stated, but I guess that it has to do with the fact that the Systems Controllers, as senior Service officers, have a dual allegiance, as immediate deputies of the Chief of Defence Procurement within the Procurement Executive and as members of the single Service Boards where they have close professional and personal links with Service colleagues who are their main customers.
  
4. Rejection does not offer a robust solution to the defects identified by the Reeves team. It is also somewhat paradoxical.

It will leave the CDP with an absurdly heavy personal responsibility and the Systems Controllers in a curious limbo between the CDP with his Accounting Officer responsibilities on the one side and subordinate managers with their clarified responsibilities on the other (draft para. 40). This should not go without challenge - but if you think it is not a "Prime Minister-like" point we will do our best with it here.

*! agree.*  
*I think it is.*  
*I have suggested a slightly different way of dealing with the point in the draft letter itself.*

5. The team's other central recommendation is that all finance staff should monitor and control spending during the year in terms of cash. I think that this is sufficiently secured by the Secretary of State's response to the report and, indeed, I understand that a good many changes have been made since the report was submitted.



C PRIESTLEY  
18 September 1981

CONFIDENTIAL

*12 type*

*Onward.*

LETTER FROM MR WHITMORE TO THE PRIVATE SECRETARY TO THE SECRETARY OF STATE FOR DEFENCE

FINANCIAL MANAGEMENT IN THE MINISTRY OF DEFENCE

1. The Prime Minister was grateful for your Secretary of State's minute of 14 September and for a sight of the draft document for publication which <sup>Nick Evans</sup> was later sent to her. *with his letter of 12<sup>th</sup> Sept to Tim Barker.*

2. The Prime Minister ~~welcomes the fact that the study of financial control procedures was commissioned, is very~~ <sup>is</sup> pleased that <sup>Mr NOK</sup> your Secretary of State has found ~~it~~ thorough and constructive and looks forward to being informed in due course of the findings of the ~~second~~ <sup>and subsequent</sup> study of financial responsibilities. She attaches particular importance to clarifying responsibilities for control and management and to making cash the medium of control at all levels.

*The report of the study of financial control procedures*

3. The Prime Minister <sup>welcomes the study of which's minutes to publish</sup> is content for <sup>him</sup> the document to be published, but would like your Secretary of State to consider the following two points before the text is finalised.

4. First, <sup>the</sup> ~~the~~ Prime Minister agrees that the candour of the analysis should not be regarded as an obstacle to publication. But she thinks that, as the report may arouse Parliamentary and other interest, it is worth including in the last few paragraphs of the text a reasonably firm indication of when Ministers expect to take decisions on the more detailed ~~the~~ recommendations of the study. The Prime Minister

thinks that it is particularly important to get working relationships with contractors (para. 43) onto a footing which is fair to the Ministry, suppliers and the taxpayer.

Prime Minister  
I doubt whether it would be credible to offer this comment in this form in your name. Instead I suggest that we say that you have noted that this key recommendation is rejected in the document to be published and that you think it might be wise for more explanation to be set out in the document than is the case now. Agree?

~~Simply does not~~

5. Secondly, the Prime Minister ~~thinks that there might be substantial advantage in adopting~~ <sup>understand why ~~the~~ ~~has~~ ~~not~~ ~~enthusiastically~~ ~~accepted~~</sup> the report's recommendation that formal responsibility for observing the cash limit on the Defence Procurement Vote (Vote 2) should be placed on the Systems Controllers (paras. 26 and 40 of the draft). The report suggests that one of the main weaknesses of the arrangements examined was that responsibility for avoiding overspending rested on the shoulders of too few senior officers, including the Chief of Defence Procurement. It appears <sup>vital</sup> to the Prime Minister that ~~it would be prudent~~ <sup>is vital</sup> in such a large system of financial management ~~to make~~ <sup>should be made</sup> a delegation to the next tier in the way recommended by the report. This would be consistent with and assist the intended wider devolution of responsibility lower down (para. 40). Yet ~~at present the key document for~~ <sup>published in reports this key recommendation with virtually no explanation.</sup>

6. Finally, the Prime Minister sympathises with your Secretary of State's references to annuality. She would welcome progress towards greater flexibility between years, provided that it did not substitute for other measures to increase further the efficacy of procurement processes and that it was consistent with the wider objectives of public expenditure control.

On a point of detail, I think you will be aware that the P.M. commented in passing:-  
7. "Can we not find a better word than 'controllers'. Where does it come from? It is awful."  
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7. I am sending copies of this letter to John Kerr (Treasury),  
David Heyhoe (Lord President's Office), David Edmonds (DOE),  
Ian Ellison (DOI), John Rhodes (Department of Trade),  
Terry Matthews (Treasury), Jim Buckley (CSD), David Wright  
and Clive Priestley (Cabinet Office).

C A WHITMORE

502. We asked those we spoke to to tell us what they believed they were controlling once 1980-81 had begun. The finance staffs at Assistant Secretary and Principal level were clear that they and the project managers with whom they worked had authority to spend up to their share of the programme, ie A in the diagram - which in practice would be enhanced by the actual rate of inflation, resulting in the figure at D. There were differences of emphasis. Some felt no responsibility to contain expenditure even within the programme figure; they should of course report any excesses as soon as foreseen, but would wait to be told what action if any to take. Others felt they had this responsibility; one, the Director General Weapons (Naval), wrote to his major contractors in July asking them to ensure that they did not spend more than the programme. Others were uneasy about the looseness of the system, and in one or two cases were applying cash limit controls informally on their own initiative.

503. We asked the Controllers and their AUSs where if anywhere responsibility lay for ensuring during the year that the block-adjusted Estimate - the figure at B - was not exceeded, and from five out of six received the answer that it did not lie with them but was a matter for central MOD decision. The exception was a Controller who said he accepted responsibility for keeping within the block-adjusted Estimate provided the cash limit enhancement was adequate. Among the majority there were again differences of emphasis. Some made the point that to curtail spending during the year meant making choices involving Service priorities, on which the Service customer must have the determining voice; this ruled out unilateral action by Controllers. One Controller told us that he would have welcomed a clear mandate to take action in face of the emerging overspend. But the five were agreed that, as a question of fact, they were not responsible for conforming to the block-adjusted Estimate; as one AUS put it, his Controller was not obliged to consume his own smoke.

504. There remains the third figure, the cash limit itself - C in the diagram. The fact that it is a block cash limit means that MOD remains free to vary its priorities during the year, as long as the overall cash limit is not exceeded, and that the cash limit enhancement is regarded as a central pool of cash to be allocated wherever it is most needed. Thus a sector of the programme experiencing higher inflation than expected, or overspending in volume, can be given a large allocation, while a sector with lower inflation and/or a volume underspend may need none at all. Allocation of the cash limit enhancement rests with the centre of MOD: initially the PFO and his staff, ultimately the FPMG.

505. Written internal guidance on these matters is sparse, but what material does exist makes it clear that SFOs are meant to control volume while cash is monitored and controlled by the centre. DUS(FB) re-affirmed this in relation to 1980-81 in a minute written in January 1980. What is not clear from the written record is whether the majority of Controllers and AUSs are correct in believing that they are not responsible for living within the block-adjusted Estimate. The truth is probably that in the years of underspending either it did not matter, or action to boost spending was initiated by the centre; once MOD began to overspend the tendency to look to the centre for the broader view persisted, and was encouraged by the arrival of cash limits, which came under central control both in theory and in practice.

706. Those conditions have now gone and we are in a new era. Volume underspending has gone dramatically into reverse, at least for the time being, in all three Controllerates at once. Cash control has eclipsed volume control in Ministers' economic policy. Since 1979-80 cash limits have been subsumed in the Estimates voted by Parliament; the printed page shows how much cash Parliament believes is being devoted to each item. Rapid and efficient procurement of defence equipment remains an important objective, as does minimising project costs; but keeping within the annual cash limit has assumed overriding importance.

→ 707. Viewed against this new background the defects of the present system of control are plain to see. Responsibility for taking action to avoid overspending rests on a very few pairs of senior shoulders: those of DUS(FB) and above him, PUS, CDP, the Chiefs of Staff and the Secretary of State. Project and finance staffs in the PE dealing with the various types of equipment are working to programme totals which are at two removes from the published Estimates themselves and on a different price base. Not all of them feel obliged to act on their own initiative to keep within even these figures. Because the figures are at Survey prices they tend to regard subsequent inflation as an allowable extra, even though it may be greater than allowed for in the cash limit. The Controllers and their AUSs who decide on the level of block adjustment have no responsibility to act if it proves to be unjustified. The whole emphasis is on monitoring and reporting - from the finance branches to the systems AUSs and from them to the centre - rather than on action. The strain is taken by the topmost level of management rather than by the system as a whole.

✓ 708. In our view this structure of responsibilities is not only vague and confusing in itself but also inadequate for the task. The timescale for cash control is short; with over 90% of the year's procurement programme committed before 1 April it is impossible to counter a major trend towards overspending unless it is identified quickly and decisions on offsetting measures are taken quickly. A fully co-ordinated response is unavailing if it comes too late.

✓ 709. Our two central recommendations are designed to bring greater clarity and effectiveness to the control task. The first is that responsibility for observing the cash limit, and if necessary controlling spending to keep within it, should in the systems area be placed squarely on the Systems Controllers and should be written into their charters where these exist. The second is that, irrespective of whether this responsibility is delegated further, all finance staffs should monitor and control spending during the year in terms of cash, -ie at outturn instead of Survey prices.

710. These changes would bring substantial benefits. The attention of all concerned with spending would be focussed on cash, rather than on volume which is of only secondary relevance to in-year spend; it would no longer be open to PE staff at all levels, as it is at present, to regard any inadequacy in the cash limit enhancement as someone else's problem. Action to counter overspending would be taken more quickly and effectively by the Controllers acting on their own initiative than it can be by the FPMG who are some distance further up the reporting chain and must in any case achieve a consensus before acting. The Controllers' accountability for the accuracy of their block adjustment judgements

would be sharpened; although they are already responsible for this, under our proposal the onus would be on them to make good the consequences of any mistake. By the same token they and their AUSs would have a sharper incentive than at present to insist on accurate forecasts of outturn in their areas.

711. In testing out these ideas on senior staff and discussing them among ourselves we encountered a number of objections. The first is that to sub-divide the cash limit in this way would be to sacrifice the flexibility bestowed by the block cash limit concept, and thus make underspend more likely. This is the issue raised in paragraph 2 of our terms of reference. It seems to us that the advantage of the block cash limit lies solely in this flexibility. It is a major advantage, but we do not see why acceptance of our proposals should mean sacrificing it. MOD would remain free to offset underspending on one Vote against overspending on another. In practical terms it would still be open to a Controller faced with a developing overspend to ask his Service Board colleagues whether they could help him out by making economies in, say, Service manpower or logistics support. It would still be possible for one Controller to help bail out another; the FPMG could still review the outturn on a defence-wide basis. The crucial difference from the present position is that the Controllers would be self-starting instead of awaiting instructions. While hoping for and seeking outside relief they could not assume it, and the onus would be on them to keep within their cash limit even if no help were forthcoming.

712. A second objection is that the Controller as supplier cannot decide where cuts should fall since this is the prerogative of the Service customer. This argument seems to us to discount too much of the standing and experience of the Controllers themselves, who are officers of 3- or 4-star rank in their own Services and colleagues of their respective Chiefs and Vice-Chiefs of Staff on the Service Board concerned. We take it for granted that in cutting back spending to keep within his cash limit a Controller would take Staff and secretariat advice at whatever level was appropriate. In cases of difficulty we consider the guiding rule should be that the Controller should have the right and duty to specify the level of savings required and satisfy himself that the measures proposed would achieve that level; the Chief or Vice-Chief of Staff should state the military priorities governing the choice of savings; and in a last resort, failing such guidance within a reasonable timescale, the Controller should have the right and duty to make his own choice of measures in order to ensure that the required savings are realised during the year.

713. A third objection is the operational difficulty discussed in Chapter 3 of translating the equipment programme from Survey into cash limits prices when the cash limit enhancement is settled so late in the day (November or December). This is no doubt one reason why the cash limit is regarded as primarily the PFO's affair. The fact that the cash limit enhancement arrives late on the scene is not in our view a good reason for Vote 2 managers to ignore its existence during the year; the problems it brings have to be faced some time, and the sooner they are faced the better. But in any case the changes in PESC procedures announced in the Chancellor's recent Budget statement largely remove this objection. If expenditure plans for 1982-83 are to be discussed from the outset in terms of the cash available for that year, it seems to us that Vote managers not only can but must take account of the cash limits dimension through-out the scrutiny

of Estimates. Although there will no doubt be a difficult learning process, once it has been completed in-year control should be simpler because all financial managers will be working to cash figures which are familiar to them.

714. There remains the question whether, if the Controllers are made responsible for living within the cash limit, they should sub-delegate this responsibility down their chain of command and if so how far. The case for sub-delegation rests on effectiveness; the case against rests on flexibility. Unless the Controller sub-delegates he may be faced with a situation in which his immediate subordinates the Directors General, and all their subordinates down to project manager level, are collectively planning to overspend to the extent of the block adjustment. By sub-delegating he would ensure from the outset that those below him were working to the same end and thus reduce the risk of an overspend too big to eliminate. In doing so however he might run into the opposite danger of overkill. By constraining all his subordinates to keep within cash sub-limits he should logically provoke an underspend, since overshooting would be forbidden but some would undershoot. This would argue for a looser regime under which Directors-General would be free to overspend against their cash allocation unless the Controller told them not to.

715. When we put this point to the Controllers their reactions were different. One said that he would sub-delegate the cash limit down to Project Director level; another said that he would not sub-delegate at all; the third had not at that time reached a final view but has since introduced arrangements for sub-allocation to Directors General. We think that if block adjustments were to remain at their present level Controllers would certainly need to sub-delegate to some degree in order to be sure of keeping within their cash limits. This however raises the wider question of the size of and justification for block adjustments.

#### Block adjustments

716. The present rationale for block adjustments is basically that the project manager who prepares the Estimates line item sees only his own project and cannot allow for wider influences on spending - the industrial environment, the level of civilian demand which may compete with his project, administrative bottlenecks and so forth. His view of his own project may be distorted by optimism; he may ask for more cash than he needs. The Controller and his AUS can take the wider view. By applying a discount on a block basis they reduce the Estimates bid to a realistic level while leaving each project manager free to do his best.

✓ 717. Self-evidently this rationale contains some truth; but the high level of  
✓ block adjustments in recent years is in our view a symptom of weakness. The task  
✓ of preparing Estimates is supposed to be the same at all levels, from Controller  
✓ to the lowliest project manager: to estimate cash flow in the year ahead.  
✓ Controllers should not have to compensate for unrealism or tactical bidding on  
✓ the part of their own staff. If Controllers have so little faith in the project  
✓ estimates that they have to discount them by 10-30%, something is amiss. The  
✓ fact that block adjustments of that size have proved to be justified, until this  
✓ year, makes the situation worse because it suggests that the process feeds on  
itself. As long as high block adjustments are tolerated project managers have

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MINISTRY OF DEFENCE  
MAIN BUILDING WHITEHALL LONDON SW1  
Telephone 01-~~938 702X~~ 218 2111/3

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17th September 1981

*Dear Tim,*

FINANCIAL MANAGEMENT IN THE MINISTRY OF DEFENCE

In his minute to the Prime Minister of 14th September on this subject my Secretary of State mentioned that a copy of the open government document which the MOD intended to issue would be sent to your office. It is now attached. Copies also go to the Private Secretaries of the Ministers who received Mr Nott's minute, *+ Sir R. Armstrong + Sir D. Rayner.*

*Yours sincerely  
Nick Evans*

(N H R EVANS)

T P Lankester Esq

MINISTRY OF DEFENCE  
MAJORITY BUILDING WHITEHALL LONDON SW1



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STUDY OF THE CONTROL OF EXPENDITUREI INTRODUCTION

1. A study of control of expenditure in the Ministry was set in hand in December 1980, with the approval of the then Secretary of State for Defence, because of serious concern about the substantial overspend against the 1980/81 defence budget and cash limit which at that time appeared in prospect. Its object was to review arrangements for monitoring expenditure and forecasting its outturn, for providing explanations of variations from estimates and cash limits and for controlling expenditure against cash limits. It was undertaken by two officials of the Ministry of Defence, Mr W D Reeves and Mr B P Shillito, and two qualified chartered accountants from the firm of Arthur Anderson & Co, Mr V C Watts and Mr E R Dolby. The full terms of reference of the study are at Annex A.
  
2. The study concentrated mainly on the sea, land and air systems areas of Defence Vote 2. The study team consulted widely within MOD, and held discussions or corresponded with officials of the Treasury, the Civil Service Department, the Department of Industry and Department of the Environment. They also received guidance from Sir Derek Rayner. Their report was submitted on 31 March 1981.
  
3. Part II of this document contains a summary by Mr Reeves of his group's report. Part III sets out the Ministry's views on the report's recommendations and describes the action being taken on them.

II SUMMARY OF THE REPORT ON THE CONTROL OF EXPENDITURE

4. The combined total of the four cash-limited Defence Votes originally submitted to Parliament in March 1980 was £10125M; a year later it stood at £10755M, an increase of £630M. About one-third of the increase (£218M) was for forces and civilian pay awards in 1980 which could not be quantified when the original Estimates were presented. A further net £150M represented a deliberate increase in the cash limit in August 1980 made in the light of international circumstances and in recognition of the priority given by the Government to defence. The balance of some £260M represented estimated overspending against the revised cash limit, which in Parliamentary terms had been legitimised by the voting of a Spring Supplementary Estimate.<sup>(1)</sup>

(1) Notwithstanding the increase in the cash limit and the measures, including the moratorium, on uncommitted expenditure taken to restrain spending, the Ministry could not rule out a further overspend against the revised cash limit and accordingly took a Spring Supplementary Estimate. They did so in the knowledge that it would not be until well after the end of the financial year that their success in restraining spending could be measured. This was the position reached when the Report was submitted in March 1981. In fact by August 1981 it was established that the overspending against the reused cash limit was £64M. Part II of this document makes no further mention of this late development; see however Part III, paragraph 38.

5. The 1980-81 position contrasted with a long and fairly consistent history of underspending against volume on the defence budget. ("Against volume" means in terms of Survey prices, ie those prevailing in the September before the beginning of the financial year). Since 1964-65 there have been volume underspends in all but two years, 1970-71 and 1971-72, prior to 1980-81 itself. Since 1976-77 however, volume controls have been supplemented by cash limits. For the first two years the defence cash limit was underspent; in the two following years it was overspent by £74M and £62M respectively. (A cash limit overspend can co-exist with a volume underspend because the allowance for inflation included in the former is insufficient and/or because the cash limit is net of a reduction to compensate for past overspending).

6. In their report the study team noted that the previous Government had placed the defence budget on a rising trend in response to the NATO target of 3% annual real growth in defence spending for members of the Alliance. At the same time MOD was engaged in trying to restore momentum to a programme which had stagnated during the Defence Review of 1974 and subsequent cuts in the defence budget. All three Services were encouraged to build up their programmes. However, when the 1979 Long Term Costing (LTC 79) was completed early in that year, MOD's forecast of total spending in 1980-81 was found to exceed the financial target by no more than 1.25%. All recent experience suggested that with the passage of time this excess would be eroded and eventually turn into an underspend. Nevertheless in 1980-81 itself successive forecasts of outturn, at monthly or bi-monthly intervals, showed a rising trend of overspend, with a slight decline at end-August and end-September, but reaching a peak at end-December and falling back to the end-November level at end-January. In its analysis of the end-November forecast on which the Spring Supplementary Estimate was based the report noted that:

a. Of the forecast overspend of £630M against the original cash limit, some £480M was for pay and price increases. Of this some £370M had been regularised by an increase in the cash limit, leaving about £110M of pay and price increases uncovered.

b. On Defence Votes other than Vote 2 (Defence Procurement - ie equipment) the outturn in volume terms would have been close to the Estimate had it not been deliberately cut by £225M as a result of measures described in the next paragraph.

c. The problem lay on Vote 2. Despite cuts assessed at nearly £150M during the year the forecast outturn exceeded the original estimate by £380M in volume terms.

7. Once the forecast overspend was diagnosed vigorous measures were taken to reduce it. Two tranches of saving measures, totalling £160M and £100M in cash terms, were approved in July and a third (eventually totalling £90M) the following month. A moratorium on uncommitted expenditure was announced in August; any exceptions required Ministerial approval. This was succeeded in November by a regime of stringent discipline limiting the undertaking of new commitments until the end of the financial year. In March 1981 the total effect of all these savings measures was assessed at £400M in cash terms. But for these measures the overspend would have been higher.

8. The report concluded that the main causes of the 1980-81 overspend were a substantial build-up of MOD's contractual commitments over previous years; insufficient pruning of the programme at the stage of Estimates preparation; the recession, which released industrial capacity and thus both enabled and encouraged contractors to put more effort into defence work; and the fact that the defence programme was too inflexible to counteract fully an overspend on this scale once it was forecast. Secondary causes may have included some increase in the capacity of the defence industries in recent years and prompter presentation of bills by defence contractors, spurred on by high interest rates.

#### MOD's System of Estimating, Monitoring and Forecasting

9. The report commented that in-year monitoring, forecasting and control cannot be divorced from the prior activities of financial planning and preparing Estimates; and went on to describe the main features of MOD's organisation and systems for these operations.

10. The defence budget consists of the five Defence Votes (plus some minor additions), of which Votes 1, 2, 4 and 5 are cash-limited. In practice these are managed as a single cash limit; an overspend on one or more Votes is permissible as long as the aggregate total is not exceeded. The four Votes have different Accounting Officers (AOs). The two biggest Votes in money terms are Vote 1 (forces and civilian pay, stores, supplies etc), for which the Permanent Under-Secretary (PUS) is AO, and Vote 2, for which the Chief of Defence Procurement (CDP) is AO. AOs are responsible through their Minister (in this case the Secretary of State for Defence) to Parliament for the proper management of their Votes, including conforming to the Vote totals.

Where there is more than one AO in a Department the PUS is responsible for financial procedures across the Department; thus in MOD the PUS has concurrent responsibility for Vote 2. All AOs are advised by the Principal Finance Officer (PFO), who in MOD is a Deputy Secretary.

11. Commitment of resources rests with the three Service Boards - Admiralty, Army and Air Force - in conformity with broad defence policy laid down centrally. The military members of each Board include not only the Chief of Staff of the Service concerned but also a Systems Controller, for sea, land and air systems respectively. These senior officers are members of the Procurement Executive (PE), which is an integral part of MOD, and are accountable to its head, CDP; they head organisations known as the Systems Controllerates. Together the three Systems Controllers disposed of £3.37 billion in 1980-81 original Estimates, representing 84% of Vote 2. Each Systems Controller receives financial and administrative advice from an Under-Secretary. The latter also owe allegiance, in their capacity of Senior Finance Officers, to the PFO, who in addition has his own direct staff responsible for co-ordination of Estimates and in-year forecasts of outturn, as well as accounting and the payment of bills.

12. MOD's basic planning document is the annual Long Term Costing (LTC), with a 10-year coverage of which the first year is the Estimates year immediately ahead. Preparation of Estimates moves in step with the Public Expenditure Survey (PESC), which is orchestrated by the Treasury. Estimates are originally prepared at Survey prices (see paragraph 5 above) and can only be translated into cash limits at a comparatively late stage (December and January) when the conversion factors from Survey to forecast outturn prices have been decided by Ministers and circulated by the Treasury.

13. An important feature of MOD's preparation of Estimates is the "block adjustment". This is a discount applied to the aggregate cost of programmes in the expectation, based on past experience that problems as yet unforeseen will prevent the estimate from being spent in full. In 1980-81 Estimates block adjustments in the systems areas (ie the budgets of the Systems Controllers) averaged 19.4%.

14. The report commented that these procedures resulted in the existence of three money figures for any given expenditure which were of interest to different people:

- a. The cost of the programme at Survey prices. Project managers were authorised to spend up to this level during the year.
- b. The Estimate at Survey prices after block adjustment. This was less than a. by the amount of the block adjustment (the 19.4% just mentioned).
- c. The cash limit. This was b. increased by the cash limit enhancement factors received from the Treasury, and formed part of published Estimates.

15. The report noted that in-year forecasts of outturn are of two main kinds. Firstly there are the monthly or bi-monthly "departmental forecasts" (see paragraph 6 above) which are prepared by the finance officers supporting project, commodity and personnel managers. Secondly there are the monthly analyses of payments from the Paymaster General's Office (the Financial Information System, or FIS), which by extrapolation are used to project outturn. There are also various supplementary projections.

Performance of the Forecasting System 1980-81

16. The report concluded that, while MOD expected from the beginning that there would be an overspend against the cash limit, its scale was not appreciated for some time - though the inflation component of the overspend on Vote 2 was assessed with fair accuracy from the beginning. The FIS projections were unfortunately distorted by the effects of the Civil Service strike in April-June 1979, which had slowed down bill-paying and made extrapolations based on that year's experience unreliable. However a different form of analysis, based on cumulative monthly expenditure expressed as a proportion of final outturn (for past years) or the cash limit (for 1980-81) indicated by the end of May that spending had moved into a higher gear. An alternative presentation, based on three-monthly averages and thus avoiding the distortion caused by the 1979 strike, would have told a similar story. In both cases the sharp acceleration of spending would have been noticeable by end-April 1980 and unmistakable by end-May. Analysis of the number and value of bills paid by MOD's office at Liverpool, as described in detail in the report, would have provided confirmation. The report concluded that, while the sea-change in the pattern of defence equipment production and spending which occurred in 1980-81 was perhaps unforeseeable, once it did occur MOD might have appreciated its scale more quickly if the analyses of FIS and bill-paying data just described had been prepared.

Constraints on the Control of Expenditure

17. The report identified three constraints which limit MOD's discretion to vary its rate of spending in order to keep within cash limits. The first is the annual



character of the cash limits themselves, which are tied strictly to financial years with no provision for overspends or underspends to be carried forward. Since 1979-80 cash limits have been absorbed into Parliamentary Estimates, thus in effect giving their annuality statutory force. The second constraint lies in the statutory rules, going back to the Exchequer Audit Department Act 1866, which require that liabilities which have matured and whose payment has been authorised before the end of the year must be paid immediately and charged against the Votes of that year, and that payments may be neither postponed nor advanced. Taking these constraints together, and given the margin of error which unavoidably exists in forecasting equipment and stores expenditure between 4 and 16 months ahead (ie at the time Estimates are beginning to take final shape), it must follow logically that, to be certain of conforming to the cash limit, MOD must aim to undershoot it to the extent of margin of error. In other words MOD must plan for an underspend. This conclusion is obviously unwelcome to MOD since it conflicts with the objective of using to the full the money voted by Parliament for defence. Although the concept of cash limits as originally published envisaged the need to allow limited flexibility between successive financial years in cases where the timing of expenditure could not be controlled with precision, the operational rules made no provision for this. The problem was examined by the Public Accounts Committee in 1980, but so far the conventions remain unchanged.

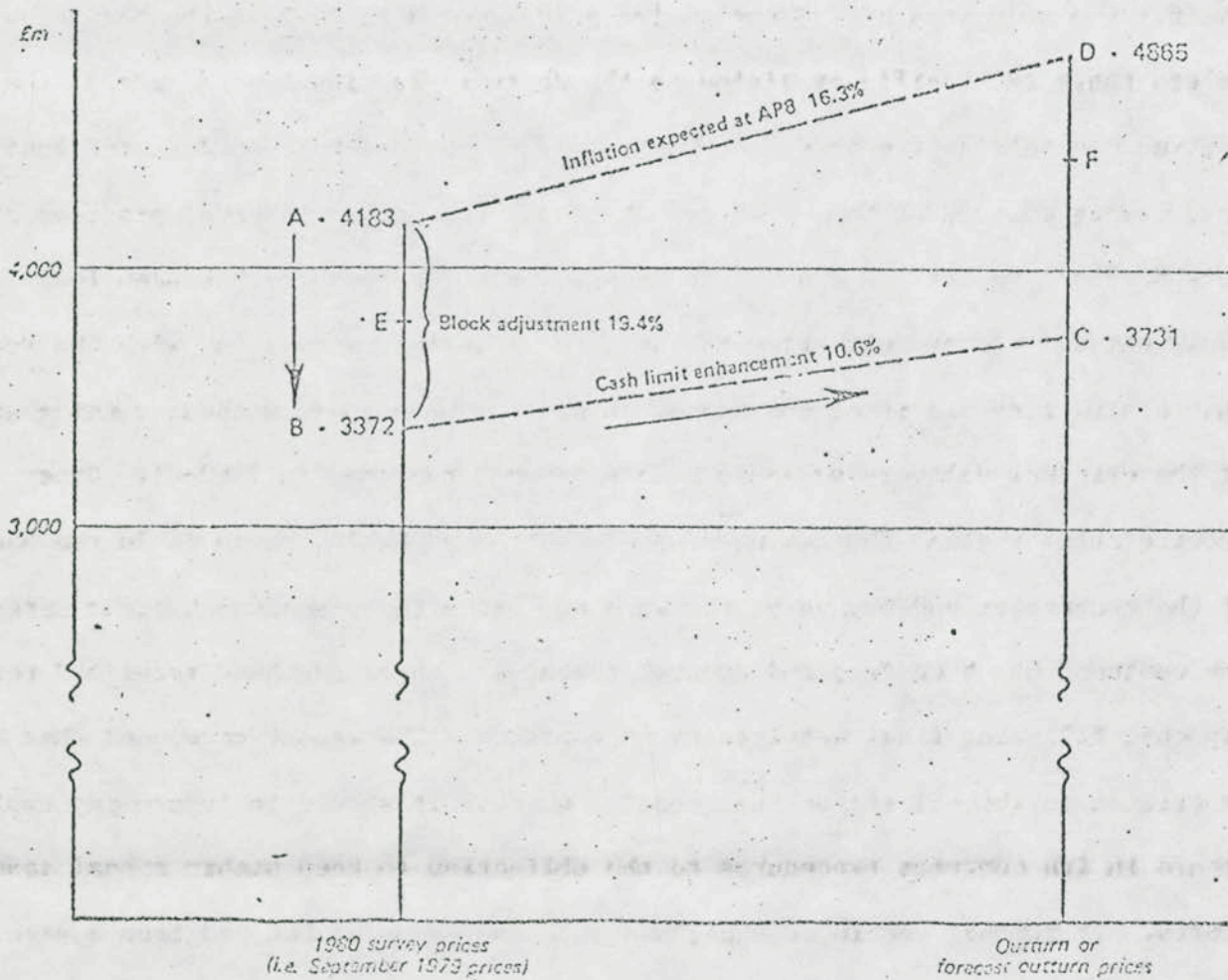
18. The third constraint lies in the contractual commitments entered into by MOD itself. During the late 1970s these increased considerably; over the three systems areas outstanding contractual liability (OCL) rose from £2.85 billion in March 1977 to £6.5 billion in March 1980, a 51% increase at constant prices. MOD's contracts staff are charged with obtaining the best value for money. They have no responsibility for deciding what should be purchased or when, nor are

they responsible for aligning contractual liability with annual budgets. The terms of contract which MOD negotiates with its suppliers do not directly govern MOD's cash flow, though they influence it indirectly; for example, a production contract will specify a delivery date or dates, which if adhered to will give rise to a bill soon afterwards, and for bigger projects a sequence of stage payments or progress payments along the way. The report noted, however, that this was of limited value for predicting cash flow, and even less for controlling it, for two main reasons. Firstly, incentive contracts work on the basis that, unless there is specific provision to the contrary (a minority of cases), the contractor is left free to deploy his resources in what he considers the best way, taking account of his other commitments. This makes physical progress of work hard to predict. Secondly, in recent years the tendency has been for equipment and stores deliveries to run late, sometimes very late, with the result that contractors can if circumstances change put on a spurt without running ahead of the original delivery schedule. This is what happened in 1980-81. Other uncertainties include the timing of presentation of bills, which is in the hands of the contractor and may vary; the wage and price increases which occur after the contract has been let; and special features such as overhead rates and terminal payments following final settlements on contracts. The report concluded that MOD's experience in 1980-81 raised the question whether it should in future pay explicit regard in its contract procedures to the obligation to keep within annual cash limits. It further concluded that, since the build-up of OCL had been a significant factor in creating the risk of a sudden upsurge of work and billing demands which had in fact materialised in 1980-81, the size and composition of OCL should be monitored and analysed more systematically than at present.

Control of Expenditure - Objectives and Performance

19. The report expressed the estimating process diagrammatically as follows.  
 (AP8 = end-November).

ORIGINAL DEFENCE VOTE 2 1980 - 81 - Sea, land and air systems



- A = programme
- B = block-adjusted estimate
- C = cash limit
- D = 'A' enhanced by inflation which has actually occurred
- E = AP8 forecast at 1980 Survey prices - £3796m
- F = AP8 forecast at forecast outturn prices - £4403m

The sequence of preparing Estimates is from A to B to C (see paragraph 14 above).

20. The study team attempted to establish how staff at various levels perceived their responsibilities for controlling spending during the year. The general picture which emerged was that project managers and the finance staff working with them mostly believed that they had authority to spend up to their share of the programme (A in the diagram), which would in practice be enhanced by the actual rate of inflation (D in the diagram). There was a widespread view that responsibility for observing the cash limit (C in the diagram) rested with the centre of MOD: initially the PFO and his staff, ultimately the AOs in consultation with the Chiefs of Staff. This was justified on the argument that central management of the cash limit enabled the cash limit enhancement (the difference between B and C in the diagram) to be treated as a central pool of cash to be allocated wherever it was most needed; this could most conveniently be done from the centre. The report noted that it was not clear who was responsible for adhering to the block adjusted estimate at Survey prices (B in the diagram): in other words for ensuring that the block adjustment assessed during the preparation of Estimates was in fact achieved. In general the Systems Controllerates tended to look to the centre of MOD for this.

21. The study team concluded that MOD's achievement in securing savings of some £400M during 1980-81 through deliberate measures to limit the overspend was impressive by any standards. Nevertheless the cash control system had been ineffective in relation to Vote 2. The Treasury told the study team that the overspend had conflicted with the Government's economic objectives. From the Armed Forces' point of view, while the high level of spending on Vote 2 had brought some benefits in terms of increased production, these gains were offset by the cuts measures in terms of delayed orders, reduced activity levels, cuts in stocks

of fuel, stores and supplies, delays in the works programme and so forth. The savings measures had also had an adverse effect on the defence industries. The report concluded that more effective controls on in-year spending were needed to safeguard against a repetition of an overspend on the 1980-81 scale and the inconveniences which it brought in its train.

### Outside Practice

22. The study team examined whether organisations outside central government faced problems comparable with those of MOD in running a large procurement programme, within an inflexible annual budget. (Within central government the scale of MOD's problem is unique, since defence accounts for about 80% of central government purchasing but only 17% of expenditure). For private sector companies, while the need to live at all times within the finance available to them is a matter of life or death, the precise amount of annual cash flow is seldom critical. Unspent balances and borrowings are carried forward from year to year as a matter of routine. Although their forecasting is liable to be upset by business uncertainties they can respond more flexibly: by obtaining additional finance within prudent limits, by delaying payment of debts or by offering customers cash inducements to settle their bills quickly. Nationalised industries are cash-limited only as regards their external finance. Although they are ultimately underwritten by central government, the fact that they operate commercially gives them various forms of flexibility not available to MOD, in particular an independent source of finance, freedom to carry forward cash balances from year to year and freedom to time payments according to commercial criteria. In addition, since April 1981 they have been given a facility to carry forward cash limit overspends, but not under-spends; from year to year subject to a limit of 1% of the sum of turnover and fixed capital expenditure. Local authorities work on the basis of accrual accounting,

which reduces uncertainty about the timing of recording revenue and expenditure; they have independent sources of revenue in the form of rates, rents and charges; they may carry forward cash balances from year to year; they may borrow short-term for limited purposes, with repayment not required until 3 months into the following year; and for capital expenditure they have the ability to defer borrowing until the money is needed, and as a result of recent legislation the right to transfer up to 10% of their capital budget from the current year to the next year or vice versa. Regional Health Authorities may carry forward to the next year under-spending of up to 1% of their revenue allocations and up to 10% of their capital allocations. Overseas, within their different constitutional and financial frameworks the Defence Departments of our NATO Allies seem in general to be less rigidly confined to annual budgets than the UK; this applies to the USA, France, the Federal Republic of Germany, the Netherlands, Belgium, Norway and Italy.

23. The Arthur Andersen & Co members of the study team compared financial control practice in MOD with that of large commercial organisations in the private and public sectors. As a broad generalisation they found that the high priority given by business organisations to responding successfully to changing requirements was less evident in MOD, which in their view may have gone a little too far in insulating its managers from financial uncertainty. Symptoms of this were an elaborate reporting chain and the use of Survey prices as the basis of control even though these were out of date by the time the financial year began. They were struck by the long administrative lead times for stores procurement in MOD, and by an absence of emphasis on keeping the programme flexible and responsive to emerging trends of over- or under-spending. From their limited conversations they were also struck by MOD project managers' tolerant attitude towards substantial slippage in delivery dates.

The Study Team's Proposals

24. The study team diagnosed four shortcomings requiring solution: unreliability of the departmental forecast of outturn, mainly because it was based on inadequate information; neglect of certain secondary but significant indicators of spending trends; looseness in the relationship between MOD's contractual commitments and the financial resources available to it year by year; and above all an unsatisfactory definition of responsibilities within MOD for controlling annual spending, resulting in inconsistency and uncertainty in the perceptions of staff at various levels and in different parts of the organisation.

25. These shortcomings required a range of remedies. The first was a clear definition of what MOD's in-year control of expenditure should be trying to achieve. The report noted the incompatibility between the Treasury's view that MOD must if necessary aim to underspend in order to avoid overspending, and MOD's commitment to taut estimating and maximum efficiency of spending and its strong motivation to make full use of the resources for defence approved by Ministers and Parliament in order to strengthen the forces and improve their equipment. However, experience in 1980-81 had shown that the margin of uncertainty in predicting expenditure was greater than had previously been supposed. The study team were not convinced that this was a temporary aberration from a normal pattern of underspending which would soon reassert itself. They accordingly attempted their own definition of the objectives of financial control in MOD in order of priority. The first priority objective should be to ensure that the defence block cash limit is not overspent in any year. The second priority objective should be to achieve the first objective in a way which maximises the defence capability and value for money obtained and, consistent with this, minimises underspending.

26. The study team concluded that it was a basic weakness that, although the defence cash limit is a control total, relatively few finance staffs in MOD focus on it. This might have been justified in the early experimental years of cash limits, which were also years of underspending; but the situation had now changed, and the defects of the system were apparent. Responsibility for taking action to avoid overspending rested on a very few pairs of senior shoulders: those of the PFO and above him PUS, CDP, the Chiefs of Staff and the Secretary of State. Project and finance staffs in the PE were working to programme totals which were at two removes from the published Estimates themselves and on a different price base. The study team accordingly recommended that responsibility for observing the cash limit, and if necessary controlling spending to keep within it, should in the systems areas be placed on the Systems Controllers; and that all finance staffs should monitor and control spending during the year in terms of cash, ie at outturn instead of Survey prices. The study team were unconvinced by the objections that to sub-divide the cash limit in this way would be to sacrifice the flexibility bestowed by the block cash limit concept, thus making underspending more likely; or that to give the Controllers this responsibility would usurp the prerogative of the Service customer to decide where cuts should fall. They noted that their recommendations would be operationally easier to implement under the revised PESC procedures announced in the Chancellor of the Exchequer's March 1981 Budget statement, whereby in future the Government's expenditure plans would be discussed from the outset in terms of cash available for the coming year.

27. The study team also concluded that the high level of block adjustments in recent years had weakened financial control by encouraging lax estimating and, more important, concealing from programme managers the significance of the acceleration of payments in 1980-81. Because the block adjustment was so large most project managers perceived themselves as underspending against their programmes at a time



when the central management of MOD was grappling with a major overspend against the cash limit. The study team noted that block adjustments would be much reduced in 1981-82, but concluded that for later years it was necessary to go further. They accordingly recommended that it should be established as a ground rule of MOD estimating that no Systems Controller's programme should be block adjusted by more than 2.5% for the Estimates year. They judged this figure to be broadly in line with the flexibility available to reduce spending on Vote 2 during the year, short of emergency measures such as a moratorium. The size of the block adjustment would thus be commensurate with the flexibility available to reduce spending in-year, instead of greatly exceeding it. The study team rejected the objections raised that project managers would inevitably over-estimate and that an arbitrary limit on block adjustments would guarantee underspending. They recognised that there was some force in the objection that project managers at present lacked the necessary basis of knowledge for discounting their estimates to allow for future uncertainties, but considered that this difficulty could be substantially reduced by providing them with better information.

28. The study team noted that, in theory at least, in-year flexibility to curb or boost spending ought to provide the perfect reconciliation between the Treasury's insistence on observance of the cash limit and MOD's reluctance to underspend. They recognised that flexibility was necessarily limited by the high degree of commitment of funds before the financial year begins, but considered that MOD could almost certainly achieve substantial increases in flexibility by deliberately setting out to create it through advance planning by project managers and commodity managers. They accordingly recommended that a system should be devised to identify savings and addback opportunities before the start of the year and to monitor and control their use during the year. Some of these measures should be controlled centrally, others at project manager level.

29. The report contained a number of recommendations designed to improve the accuracy of outturn forecasts. The study team noted that, at the time Sketch Estimates (in effect the first departmental forecast of outturn) were prepared, staff were required to forecast outturn between 6 and 18 months ahead and before they could predict with any accuracy the outturn for the current year. The study team concluded that forecasting could be improved by breaking the estimate into smaller time-slices, as is normal practice in the private sector. Profiling should be done on a quarterly basis, looking six or seven quarters ahead; thus the current year's outturn and Sketch Estimates for the following year could be surveyed as a continuum. Outturn in past quarters should be compared with the profile, and the comparison used to throw light on the profiles for the coming quarters. The value of profiling would be enhanced by sub-dividing the quarterly figures into a monthly profile at the beginning of the financial year. MOD's requirements for financial information from contractors should be reviewed with profiling in mind; the report recommended a further study to define MOD's needs in this regard. Profiling should be introduced in 1981-82 using simplified procedures which could be expanded in 1982-83 into a formal unified system.

30. The study team noted that many staff engaged in financial forecasting found the volume of data too great to handle by manual means. A number of them had developed or were developing ideas for computer assistance. The report recommended that this work should be co-ordinated and expedited through the commissioning of a study to design and outline the main components of a scheme for computer support for finance staff in the PE and to recommend priorities for its orderly development.

31. The report recommended that statistics of FIS data and the value of bills paid, which might have given earlier warning of the emerging overspend in 1980-81 (see paragraph 16 above), should be prepared on a regular basis and made available to those

concerned with the departmental forecast. Some technical adjustments would be necessary. In addition, in view of the link between the state of the economy and the rate of defence spending which was once again demonstrated by 1980-81 experience, assessments of economic prospects should be regularly prepared and circulated as background to this preparation of estimates.

32. The report recommended that MOD's outstanding contractual liability (OCL) should be regularly monitored and its size and composition analysed, the results being brought to the attention of all levels of management. In particular, efforts should be devoted to translating MOD's total OCL at any given time into a pattern of annual cash flow for the future.

33. The study team identified a number of tasks which in their view should be carried out to improve the quality of MOD's forecasting and monitoring of expenditure. Apart from the analysis of FIS and bill-paying data and the analysis and monitoring of OCL these included economic advice and a study of material emanating from the PE's Accountancy Services division, who are in close touch with the costs of industry. In addition, under an agreement reached earlier this year, MOD's major contractors have undertaken to submit quarterly profiles of the amounts for which they intend to bill MOD in the future; analysis of these would be valuable. The report recommended that a new unit should be set up in the PE to undertake all these analytical tasks and provide a common source of advice to finance staffs in the Controllerates. The unit could be very small, but it should if possible combine statistical, economic, administrative and operational research skills, together with contracts expertise.

34. Commenting on MOD's contract procedures, the study team observed that many of MOD's forecasting difficulties stemmed from slippage of delivery dates which could increase or decrease substantially and unpredictably without ever disappearing. While the ideal remedy was for contractors to deliver on time, some degree of slippage unfortunately had to be accepted as a fact of life. This being so, MOD's aim should be to try to narrow the time-frame within which it could be called upon to make payments. From this point of view different types of contract presented different problems. The report recommended that, where a contract called for payment on delivery, MOD should specify a starting date (or "not before" date) for delivery and should establish clearly in the contract its own right to refuse acceptance or payment any earlier than this. The contract should contain provision for a new "not earlier" date to be specified, to protect MOD against sudden acceleration of demands for payment, in the event of major slippage occurring. In the case of contracts eligible for stage payments (ie due at pre-determined stages of the work) or progress payments (ie due at regular intervals of time, usually monthly) the objective should be essentially the same, namely to relate MOD's payment obligations more closely to its ability to pay within annual cash limits. The study team attempted to define the ideal characteristics of a contract which would secure this objective. It should enable MOD to specify, before or during each year, the maximum amount it could afford to pay on that contract in that year. A generous ceiling could be set in time of underspend and a tight ceiling only when there was a danger of overspend. In this way MOD would be assured that the contractor's calls for cash would not exceed the funds available, but the contractor would be free to make more rapid progress if a general underspending made additional funds available. However, various constraints necessitated a selective approach and the report suggested alternatives for these cases where such a scheme was impracticable. For contracts

involving stage payments they recommended a "stage payments time schedule", whereby the contract document would contain a schedule of "not earlier" dates for payments for each stage of work. The schedules should be revised in the event of significant slippage on projects. In the case of contracts calling for progress payments a "progress payments profile" should be introduced. This would involve writing into the contract the total anticipated payment in each year of the contract, together with a condition giving MOD the right to withhold payment for expenditure at a faster rate than that specified. It would be implicit in both the schemes just described that the controller concerned should relate the schedule or profile to the availability of annual funds. The team recognised that staffing constraints in MOD might make it necessary to confine these arrangements to contracts above a certain level of value.

#### Wider Implications of the Study Team's Proposals

35. The study team recognised that their proposals would inevitably mean more work in MOD, thus conflicting with the current drive to cut civilian staff and aggravating the overstretch which, as was evident during the team's visits and discussions, was already being suffered by finance staffs. This indicated a need to reduce the finance workload elsewhere if at all possible.

36. The report noted that, if its recommendations were accepted and proved effective, MOD's former propensity to underspend could return. This in the study team's view presented a challenge to both the Treasury and to Parliament, since it could not be part of the intention of either that a substantial slice of the funds approved by Ministers and the House of Commons for defence should be returned to the Exchequer at the end of the year as a matter of routine. The study team suggested that new

ways should be explored of ensuring that voted funds were spent in the year in which they were granted by Parliament, not only through undertaking new purchases but also by accelerating the rate of payment for existing commitments and possibly also the timing of bringing existing payments to account. To be of any value such changes would need to be genuinely flexible according to circumstances; a new set of inflexible rules would merely replace one rigidity with another. The study team envisaged an arrangement whereby, where commitments are prefunded, MOD could in a year of underspend apply to the Treasury and Parliament to charge to Vote some part of the advances already made, explicitly for the purpose of reducing underspend. PESC provision would be unaffected because MOD would merely be spending more of its approved budget; the PSBR would be unaffected because the money would have been paid anyway. While amendment of the 1866 Act might be necessary, Parliamentary control would not suffer if the proposals were presented squarely to Parliament. The study team suggested that this idea deserved serious examination, together with other proposals with the same object.

37. Finally, the report recognised that its proposals for better forecasting and changes in the terms of contracts would affect the defence industries. The study team did not however consider that they would lay unreasonable demands or constraints upon them, and expressed the view that MOD was entitled to expect the co-operation of its suppliers in helping to manage its cash flow, bearing in mind the benefits which industry was obtaining from defence work in hard times.

#### SUMMARY OF THE REPORT'S CONCLUSIONS AND RECOMMENDATIONS

##### Conclusions

1. The first priority objective of financial control in MOD is to ensure that the defence block cash limit is not overspent in any year. The second

priority objective is to achieve the first objective in a way which maximises the defence capability and value for money obtained and, consistent with this, minimises underspending.

2. There is confusion in the systems controllerates as to the control total for expenditure in the financial year. This is due in the main to the imposition of large block adjustments, coupled with instructions to project managers to work to their programmes expressed at Survey prices before block adjustment. It is a widely held view in the systems controllerates, supported by formal instructions, that they are not responsible for the control of expenditure within cash limits.
3. Departmental forecasts of outturn in 1980-81 have been inadequate.
4. Information was available in MOD which was not used by those preparing forecasts and which would have given earlier warning of the size of the impending overspend in 1980-81.
5. Insufficient attention is paid within MOD to the search for items which can be procured in greater or lesser quantity with an early effect on cash flow and can therefore be used to give a degree of in-year flexibility. This is in marked contrast to outside practice where managers respond quickly to changed circumstances. Administrative lead times on stores procurement in MOD compare unfavourably with practice in industry.
6. Present contractual procedures do not give MOD control over the timing of delivery of goods or the rate of billing. There is inadequate information from contractors of their billing intentions.

7. Outstanding contractual liability, which can be a useful indicator of future expenditure levels, had been rising steadily over the last few years up to the beginning of 1980-81.
8. Annuality restrictions bear more severely on UK central government, and on defence in particular, than on local government, nationalised industries, regional health authorities and the majority of NATO governments.

#### Recommendations

1. Responsibility for observing the cash limit, and controlling expenditure to achieve this, should be placed on Systems Controllers.
2. All monitoring and control of expenditure should be against cash (ie forecast outturn prices) rather than against Survey prices.
3. Systems controllerates' block adjustments should be limited to a maximum of 2.5% in the Estimates year.
4. A system should be devised to identify savings and adback opportunities before the start of the year and to monitor and control their use during the year. Some of these should be controlled centrally, others at project manager level.
5. In order to improve forecasting, quarterly profiles of expected expenditure should be prepared. This should be done initially in 1981-82 using simplified procedures which can be expanded in 1982-83 into a formal unified system.



6. A study should be commissioned to devise a scheme for computer support for systems controllerates.
7. Outstanding contractual liability should be monitored and analysed.
8. A new unit should be set up in the PE to give a common service to all controllerates covering analysis of FIS data, bill payments, cash profiles from contractors, OCL, material from PDAS, risk, and economic relationships affecting procurement.
9. Future contracts should where possible specify earliest delivery dates. Delivery schedules and the timing of stage payments should be revised if slippage occurs. There should also be constraints on stage and progress payments. These changes should be applied to existing contracts so far as this is sensible and attainable.
10. All the above recommendations should be implemented immediately with the exception of recommendation 3 which should be implemented for 1982-83 Estimates.

### III THE MINISTRY'S VIEWS AND ACTION BEING TAKEN

38. The analysis on which the Report was based covered the period up to end January 1981 when, as indicated in the Spring Supplementary Estimates, an overspend of about £260M against the revised cash limit was being forecast. In the event the actual overspend of £64M is nearly £200M less, perhaps a fitting commentary on a year in which accurate forecasting was very difficult, partly because of circumstances outside the control of the MOD and partly because the incidence of measures

taken to restrain expenditure was not easy to predict. From the outset a large overspend, exceeding £500M, against the original cash limit was predicted. Early analysis of cash flow figures conducted by the established method of comparison with expenditure profiles of a number of previous years, rather than a three term average, suggested the possibility of a somewhat larger overspend. But there were other factors at work eg a measure of catching up after the engineering and steel strikes which might have been expected to produce an initial surge in expenditure falling away later. In short the judgements facing those producing forecasts were somewhat more difficult than the analysis in the Report might suggest. Some further glosses on the Report would also be justified in the light of the actual out-turn.

39. Nevertheless the general thrust of the Study's conclusions and recommendations remains valid and is accepted by the Ministry. In particular the Ministry supports the conclusions that the responsibility of managers to control expenditure within the cash limit has required clearer definition and emphasis and that much greater stress should be placed on monitoring and control of expenditure in terms of current cash. It accepts the objective of improving estimating and forecasting to a point which will allow a move to much smaller block adjustments than have been used in the past and it endorses the study's view of the way in which the present annuality restrictions bear upon defence expenditure.

40. A number of changes have been made in these directions. Managers have been notified of their cash allocations in 1981/82 and told of their responsibility to monitor and control cash against them. Although central management of the defence budget will still allow one area to help out another in the event of difficulty, the onus is now more clearly on managers to keep their expenditure within allocations without assuming relief from elsewhere. The Department does not consider,

however, that formal responsibility for observing the cash limit on Vote 2 should be placed on Systems Controllers. Cash allocations have been made in Vote 2 as in other Votes, and here as elsewhere managers at all levels must accept responsibility for keeping expenditure within allocations and initiating corrective action when this is necessary. Nevertheless the Chief of Defence Procurement as Accounting Officer for Vote 2 will continue to look to the Systems Controllers for authoritative advice on the forecasting and control of expenditure in their areas of responsibility; and arrangements for more formal consultations with Controllers on each forecast of outturn have been instituted by the Chief of Defence Procurement for 1981/82. Throughout the defence budget it is intended to consolidate and develop the devolution to managers of responsibility to control expenditure within cash allocations. At present responsibility rests at different levels in the Department. The plan will be to devolve it as far as practicable. Experience in the current year will help to show how far the process can sensibly be carried.

41. The recommendation that Systems' controllerate block adjustments should be limited to a maximum of 2.5% in the Estimates year presents a stiff challenge to the Department. Block adjustments are a method of adjusting the programme for realism and have been applied at various levels. Up to 1979/80 the actual outturn of expenditure each year has shown large block adjustments to have been broadly justified. In 1980/81 the block adjustments were found to be too great in prevailing economic circumstances. The aim must be to make estimates of expenditure on individual projects and services as realistic as possible, and to improve estimating and forecasting techniques with this object in view. But some adjustment to take account of factors not evident to individual managers will continue to be necessary particularly in areas of expenditure on large numbers of relatively small projects. For 1982/83 an upper limit of 2.5% on the central element of block adjustments has nevertheless been set as an aim.

42. The more detailed recommendations of the study (4-8) relate to the means of achieving these broader objectives. They are being evaluated in detail. The Department has reservations about the scope for identifying and activating savings and addback opportunities within the financial year. (Recommendation 4). It is clearly part of good management to identify and exploit this kind of flexibility as much as possible. But there are problems about the lead time before new commitments produce new expenditure and about knock-on effects in later years; and addback exercises by their nature are not conducive to tight control and discipline. There is a point beyond which flexibility between years in cash rather than purchase of commodities makes better sense. A study is being made of computer support for systems controllerates (Recommendation 6) and of the profiling of expenditure (Recommendation 5). A study is also being carried out of the best means of providing to managers the range of information referred to in Recommendation 8, including a more detailed analysis of outstanding contract liability (Recommendation 7). On its completion a decision will be taken on the setting up of a new unit in the Procurement Executive. Meanwhile more use is being made of statistical assistance in analysing expenditure trends and guidance on industrial performance and capacity and on current and forecast economic activity will be circulated as a background to the preparation of Estimates. Work flowing from these recommendations, notably the profiling of expenditure could call for much increased staff effort. The limit of what can be done within available staff resources is likely to make choice between priorities unavoidable. Some existing activities may have to be given up if we are to move quickly in the directions recommended by the report.

43. The report proposes one set of additional instruments of direct control of expenditure (as opposed to improvements in arrangements for estimating and monitoring). This is the new contractual conditions summarised in Recommendation

9. Consideration is being given to the case for specifying earliest delivery in contracts, where possible, and to introducing contractual procedures which will give the department tighter control over the timing of delivery of goods and the rate of contractors' billing. No decisions have yet been taken. Controlling cash flow within strict cash limits in a way which will not inhibit the search for maximum value for money is a difficult challenge, and the Department will continue to search for new methods of control which will serve both these objectives.

44. The same challenge is posed by the study's first conclusion that avoidance of overspending cash limits should be treated as the first priority objective of financial control. This conclusion is consistent with Government policy but its implications for efficient management and value for money in a programme as large and complex for defence are clearly brought out in paragraph 36 of the summary of the study. Improvement of estimating performance and procedures for control of cash flow must be the Department's first objective. But we agree with the view of the study about the contribution to efficient management of voted expenditure which would be made by some relaxation of annuality rules and greater end year flexibility. Consideration of this will continue.

ANNEX A

The Terms of reference for the study were as follows:

"1. The object of the study will be:-

a. to review the present arrangements for monitoring expenditure, for forecasting the outturn, and for providing explanations of variations, both in volume and cash, from estimates and cash limits during the course of the financial year;

b. to review the present arrangements for controlling expenditure against cash limits and the efficacy of available control measures;

c. to propose improvements.

2. At 1b the study should take full account of the advantages of the block cash limit concept from which are derived the present arrangements for central monitoring and control of cash flow and which allows maximum flexibility for adjustments to be made on a defence basis during the financial year. But the case for applying the cash limit discipline to particular vote or management areas should also be considered.

3. Particular attention should be given to expenditure on goods and services supplied by industry, and to the problems of forecasting and control in changing economic circumstances, which may affect industry's performance of defence work. The present policy and practice of block adjustment should be reviewed, and account taken of the examination being given within the Department to the introduction of cash limits for firms as a means of controlling industrial capacity paid for by the defence budget and any scheme that may emerge.

4. The study should seek to establish to what extent the objective of value for money and the control of cash flow against an annual limit may necessarily be in conflict in the procurement area. It should consider whether there are trade-offs between these objectives and whether there is scope and need for change to align ordering and contracts policy and the system of annual control of cash flow more closely. Account should be taken of the present arrangements for project management in the Procurement Executive, of the way in which the Department's procurement and contract procedures contribute to the objective of securing maximum value for money and of the effect of drastic programme cuts and/or continuing uncertainty about the future programme.

5. Continuation of the PES, supply and cash limits systems and of the present rules for government accounting should be assumed but changes in these areas may be recommended. In particular account should be taken of the consideration which has already been given, within the Department and elsewhere to flexibility between financial years and of the extent to which innovations in this area might permit improved effective control over expenditure.

6. Account should be taken of the work so far done to analyse and quantify the reasons for the forecast overspend against the defence cash limit in 1980/81.
  
7. The study is to be completed by 31 March 1981".