



Prime Minister.

There is no need for you to read the document for publication at Stage 'A'.

Advice from Mr. Presley is at Stage 'B'.

Consider what I should write on the basis of the report at Stage 'C'?

Yes - I inspected on

The initial report - see draft note.

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PRIME MINISTER

FINANCIAL MANAGEMENT IN THE MINISTRY OF DEFENCE

My predecessor informed you on 31st December last year of two studies of financial management in the Ministry of Defence.

2. The second study, on financial responsibilities and accountability is well advanced and will be completed this autumn. The first study concerning financial control procedures, was completed at the end of March. The Department was greatly helped by the participation of accountants (from Arthur Andersen) and also by the advice of Sir Derek Rayner, who took a close interest.

3. I have studied the report and found its analysis most thorough and constructive. My officials have consulted the Treasury and other Departments. The report has already led to some important changes in our procedures.

4. The report detected four main areas of weakness: in the reliability of the Department's forecasts of cash flow: in the use of secondary but significant indicators of expenditure trends: in the relationship between the Department's contractual commitments and available financial resources: and, most importantly, in the definition of responsibilities within the Department for controlling annual spending. I attach an Annex listing the conclusions and recommendations which the team drew from their diagnosis.



5. I fully support the general thrust of these conclusions and recommendations. I endorse the need for clearer definition of responsibilities within the Department for control of expenditure within the cash limit and for much greater emphasis on the monitoring and control of expenditure in terms of cash.

6. I agree too with the objective of improving our estimating and forecasting sufficiently to allow the Department to manage the programmes with much smaller discounts for realism (the block adjustments referred to in recommendation 3) than have been used in the past. The nature of the defence programme does not make this easy to achieve. But discounts are smaller this year than last and we have set ourselves the aim of a further reduction in 1982/83.

7. We are evaluating the more detailed recommendations, and have reservations about some of them. Our reducing staff numbers are an important constraint and we may have to be severely selective in the changes we introduce. But I am determined that our study should be pressed forward positively and that it will result in real improvements. None of this is helped by the inflexibility of our annual accounting conventions.

8. I have considered the question of publication. I am greatly in favour of publication and would not regard the candour of the report's analysis as an obstacle. The best way of achieving this would, I believe, be an open government document which would explain the reason for the report, summarise its contents and state our



'action plan'. I have had such a document prepared and a copy ^{- flag 'A'} is being sent to your office, and to those of other recipients of this minute. I have decided, subject to any contrary views, that the date of publication should be in mid-October, probably the week after the Party Conference.

9. There is one final point I should make. The report (Conclusion 1) correctly, and consistently with Government policy, makes avoidance of overspending cash limits the first priority objective of financial control. But we must recognise the implication of this, that, because of the inevitable margin of uncertainty in forecasting expenditure, particularly on our complex equipment programme, we must plan for underspend and run the risk of wasting resources allocated to defence, unless new and much more effective methods of fine tuning can be developed. Fine tuning within the year is part and parcel of good management, and as the report recommends, we must seek to improve our performance in this respect. But I believe that there are practical limits to what can be achieved by these means, and that much greater flexibility between years is a necessity. The report discussed this question of annuality (Conclusion 8) and reference is made to it in the open government document (paragraphs 36, 42 and 44). The topic has been well aired before Select Committees and discussions between my Department and the Treasury continue though little progress has been made. I am looking for a positive and constructive conclusion and I shall return to this subject at a later date.



10. I am sending copies of this minute to Geoffrey Howe, Keith Joseph, Christopher Soames, John Biffen and Leon Brittan, who saw Francis Pym's minute of 31st December, and also to Michael Heseltine, who has an interest because of the involvement of the Property Services Agency, and to Francis Pym, who initiated the study. Copies also go to Sir Derek Rayner and Sir Robert Armstrong.

FW .

Ministry of Defence
14th September 1981

SUMMARY OF CONCLUSIONS AND RECOMMENDATIONSConclusions

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 [?] controllérates 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 controllérates, 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 addback 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.