

**Report of the Comptroller and Auditor General on  
the Department for Environment, Food and Rural  
Affairs 2009-2010 resource accounts**

## Department for Environment, Food and Rural Affairs

### Report of the Comptroller and Auditor General to the House of Commons

#### Introduction

1. The Department for Environment, Food and Rural Affairs develops and implements policy relating to the environment, food and rural issues. It is also responsible for negotiating EU agricultural and rural funding on behalf of the UK. The Department receives funding from the European Commission to deliver the Common Agricultural Policy and other initiatives.
2. I have reported previously on the difficulties experienced by the Rural Payments Agency, an executive agency of the Department, in implementing the Single Payment Scheme. The Single Payment Scheme was introduced by the European Union as part of the 2003 Common Agricultural Policy reforms which replaced 11 separate crop and livestock based production subsidies with a single payment based on land area.
3. The Rural Payments Agency's difficulties have resulted in the European Commission proposing financial penalties. Where the European Commission takes the view that the detailed European Regulations have not been applied correctly in processing European Union Scheme transactions there is a risk of financial penalties (referred to as disallowance) of expenditure under the Scheme. These penalties are payable by the Department for Environment, Food and Rural Affairs as a deduction from future Commission funding. In anticipation of these financial penalties the Department retains a provision in its resource accounts for disallowance penalties arising in respect of the Single Payment Scheme, for a number of smaller on-going schemes and for Single Payment Scheme predecessor schemes. The total provision for penalties held at 31 March 2010 by Defra is £220 million. In addition, penalties totalling £160 million were confirmed during 2009/2010.

## Purpose of Report

4. The financial statements on the following pages represent the results of the Department for Environment, Food and Rural Affairs for the period from 1 April 2009 to 31 March 2010. I have qualified my opinion on the 2009-2010 resource accounts on the grounds of regularity. The requirement to pay material disallowance penalties results in a loss to the UK exchequer which is outside Parliament's intentions in relation to the proper administration of European funding. In 2009-2010 the European Commission has confirmed penalties totalling £160 million.
5. In addition, I have limited the scope of my audit opinion as I was unable to obtain sufficient audit assurance to support the balances relating to Single Payment Scheme trade receivables of £17.2 million and Single Payment Scheme trade payables of £30.9 million which are recorded in the Department's resource accounts.
6. The purpose of this Report is to explain the background to the qualifications of my audit opinion. The report also provides an overview of progress made by the Department in addressing the prior year qualifications and the issues identified in the Rural Payment Agency as highlighted in my previous reports<sup>1</sup>, the most recent of which was issued in October 2009.

## My obligations as Auditor

7. Under the Government Resources and Accounts Act 2000, I am required to examine, certify and report on the financial statements that I receive. I am required, under International Standards on Auditing (UK and Ireland), to obtain evidence to give reasonable assurance that the Department for Environment, Food and Rural Affairs financial statements are free from material misstatement. In forming my opinion I examine, on a test basis, evidence supporting the disclosures in the financial statements and assess the significant estimates and judgements made in preparing them. I also consider whether the accounting policies are appropriate, consistently applied and adequately disclosed. I am also required to satisfy myself

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<sup>1</sup> *The delays in Administering the 2005 Single Payment Scheme in England, HC 1631 Session 2005-06, 18 October 2006.*  
*Progress update in resolving the difficulties in administering the Single Payment Scheme in England, HC 10 Session 2007-08, 12 December 2007.*  
*A second progress update on the Administration of the Single payment Scheme by the Rural Payments Agency, HC880 Session 2008-2009, 15 October 2009*

that, in all material respects, the expenditure and income of the Department for Environment, Food and Rural Affairs have been applied to the purposes intended by Parliament and conform to the authorities that govern them.

### **Progress since my report on the 2008-2009 financial statements**

8. In 2008-2009 I qualified my audit opinion on the Department's resource accounts on two bases.
  - The Department's resource accounts consolidate the results of its Agencies, the most significant being the Rural Payments Agency. The Department and its agencies are required to produce financial statements in accordance with HM Treasury's 'Financial Reporting Manual'. I did not consider that the Department's or the Rural Payments Agency's 2008-09 financial statements complied with Financial Reporting Standard 23 'The effects of changes in foreign exchange rates'. The Department and the Agency had significant exposure to exchange rate risk as the Agency paid out European scheme funds (the most significant of which is the Single Payment Scheme) to English farmers in sterling – but the cash was reimbursed in euro. I therefore qualified my opinion on the basis of a disagreement on the application of this standard in the financial statements. The Agency has worked closely with the Department to resolve this issue and the Department has appropriately reflected the effects of foreign exchange transactions in its 2009-2010 financial statements. In addition, the Department has restated its prior year balances to reflect the correction needed to last year's financial statements. I have therefore removed my qualification in this respect.
  - In addition, I qualified my regularity opinion due to the payment of material disallowance penalties being imposed by the European Commission. I have also qualified my audit opinion on the 2009-2010 financial statements due to further material disallowance arising from the Rural Payments Agency's administration of European Commission agricultural subsidy schemes. Further details are provided in paragraph 12 to 16.

## **Limitation of scope on Single Payment Scheme trade receivables and Single Payment Scheme trade payables**

9. I limited the scope of my audit opinion on the Rural Payments Agency's 2008-09 financial statements as I was unable to obtain sufficient audit assurance to support the trade receivables balance arising from Single Payment Scheme overpayments. This balance was not material to the consolidated Defra resource account in 2008-09 and therefore I did not qualify my opinion on the Defra resource accounts in this respect.
10. The 2009-2010 financial statements for both the Department and the Agency record Single Payment Scheme trade receivables after providing for doubtful debt of £17.2 million and trade payables in respect of underpayments made to farmers of £30.9 million. There was insufficient evidence to support that these balances are reflected in the financial statements at the appropriate amount and represent the total value of Single Payment Scheme trade receivable and Single Payment Scheme trade payables owing to or from the Rural Payments Agency. I consider that the total value of these balances in 2009-2010 is material to the Department for Environment, Food and Rural Affairs and I have therefore limited the scope of my audit opinion on both the Department and the Rural Payments Agency in respect of the valuation, existence and completeness of these balances.
11. I have reported separately on this issue in my report accompanying the Rural Payments Agency 2009-2010 financial statements (HC 141).

## **Disallowance penalties**

12. I qualified my audit opinion on the Department's resource accounts in 2008-09 on the grounds of regularity due to confirmed disallowance penalties totalling £92.25 million. These penalties included £55 million in respect of Arable Area Payments Scheme (AAPS), the largest of the SPS predecessor schemes in England; £15 million relating to export refunds, cross compliance, exceptional measures and meat premiums; and £22 million in respect of fruit and vegetable operational funds and product groups for 2006 which impacted on the Rural Payments Agency financial statements.

13. Prior to my certification of this account the European Commission confirmed disallowance penalties of £160 million. This includes penalties of £132 million in respect of the administration of the Single Payment Scheme in England in 2005, 2006 and 2007. The residual penalties confirmed relate to cross compliance penalties (£14 million) and the administration of the Rural Development Programme for England in 2006 (£3 million). In addition, the European Commission has confirmed a disallowance of £11 million in respect of the administration of the Single Payment Scheme in Northern Ireland. In the future disallowance incurred by the devolved administrations will be met by the relevant administration. I have qualified my audit opinion on the Department's resource accounts in 2009-10 on the grounds of regularity due to confirmed disallowance penalties totalling £160 million.
14. The Department's 2009-2010 resource accounts include provision for a further £220 million in respect of disallowance penalties. This sum includes a total of £171 million in respect of the Single Payment Scheme in England for 2007, 2008 and 2009. The European Commission has made observations on the operation of the Scheme in 2007 and 2008 which are similar in nature to those identified in the 2005 and 2006. The Department does not consider that significant progress in Scheme administration will be identified in respect of the 2009 scheme year, and my financial audit continues to identify significant issues in respect of data quality and IT systems within the Agency, including under and over payments, control failings and IT systems which are out of support or due to fall out of support.
15. The remaining disallowance provision reflected in the 2009-2010 resource accounts includes £22 million in respect of fruit and vegetable operational funds and product groups for 2007 and £7 million in respect of the Rural Development Programme for England in 2007 and 2008.
16. The Department for Environment, Food and Rural Affairs continues to contest the amounts of disallowance that will be applied and will seek arbitration on the amounts prior to accepting the settlement.

## **Progress made by the Department in resolving the Rural Payments Agency's difficulties in administering European Funds**

17. Disallowance penalties have been incurred as a direct result of weaknesses in the management and administration of the Rural Payments Agency. The difficulties experienced by the Rural Payments Agency have led to three value for money reports<sup>2</sup> by the National Audit Office. Following the publication of the second report the Department and the Agency made a number of assurances to the Committee of Public Accounts that the problems of the original implementation were largely addressed and that progress was well underway to rectify mistakes and recover overpayments. However my last report in October 2009<sup>3</sup> demonstrated that there was still a long way to go and that progress has been slow and costly. In particular, my report highlighted that IT systems were expensive and cumbersome, the administrative cost per claim was high, there are unquantified under and over payments, and management and governance issues.

18. I have reported separately in my report accompanying the Rural Payments Agency 2009-2010 financial statements on the extent of the progress made by the Agency since October 2009 (HC 141).

## **Financial management within the Department for Environment, Food and Rural Affairs**

19. The Department's resource accounts for 2009-2010 show that the Department has under spent against its Resource Estimate of £6 billion by £938 million (15.7 per cent). The Department has historically under spent by significant amounts: 12 per cent in 2006-2007, 12.5 per cent in 2007-2008 and 7 per cent in 2008-2009. The NAO highlighted the Department's difficulties in accurately budgeting and forecasting expenditure in a value for money report issued in March 2008<sup>4</sup>. This emphasised that in order to secure long term improvements in financial management the Department had to ensure that senior management in

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<sup>2</sup> *The delays in Administering the 2005 Single Payment Scheme in England, HC 1631 Session 2005-06, 18 October 2006. Progress update in resolving the difficulties in administering the Single Payment Scheme in England, HC 10 Session 2007-08, 12 December 2007. A second progress update on the Administration of the Single payment Scheme by the Rural Payments Agency, HC880 Session 2008-2009, 15 October 2009*

<sup>3</sup> *A second progress update on the Administration of the Single payment Scheme by the Rural Payments Agency, HC880 Session 2008-2009, 15 October 2009*

<sup>4</sup> Department of Environment, Food and Rural Affairs Management of Expenditure, HC 309 Session 2007-2008, 6 March 2008

the Department and the Agencies fully supported the financial management improvement plans and that management throughout the organisation had the skills and information to produce reliable cost estimates of activities and objectives to justify resource bids and to evaluate the cost- effectiveness of work done.

20. The Department's plans that fed into the 2009-2010 Estimates were shown to be significantly overstated. This was primarily due to the inaccurate estimation of the impact of a change of accounting policy on the prior year in respect of Single Payment Scheme income and expenditure which accounts for £496 million of the under spend. The work underpinning this complex change in accounting policy was not complete at the time the Estimate was agreed and the Department considers that this represented the best estimate at this time. This leaves an underlying under spend of £442 million of which £231 million is due to expenditure being less than forecast on European Funded schemes. The Department explains this in detail in its Management Commentary (Page 5) and in the Statement on Internal Control.
21. The Department for Environment, Food and Rural Affairs recognised that the Rural Payments Agency did not have sufficient capacity and capability within the finance function and bought in significant resources to improve financial management within Rural Payments Agency. This investment has resulted in additional costs of £1.4 million during 2009-2010.
22. The additional support to the Rural Payments Agency finance function has allowed progress to be made in the current year and this has resulted in improvements in key financial controls and reconciliations. It has also allowed the Agency to implement a number of significant and complex accounting adjustments relating to foreign exchange transactions and to reduce the Agency's exposure to volatility arising from these transactions. There is a risk however that the underlying capacity and capability of the Agency remains unaddressed as the level of investment in temporary support is not sustainable and their skills and knowledge is not yet embedded within the Agency's own staff.
23. The Department relies on a significant number of agency or temporary staff. During 2009-2010 the core Department spent £23.4 million on contractor and temporary staff. The length of time which contractors



operate with the Department can be substantial and whilst they have often built up extensive knowledge of the business, the approach is not sustainable and is not leading to enhancements in the capacity and capability of permanent staff.

### **Further actions taken or proposed to be taken by the Department for Environment Food and Rural Affairs**

24. As a result of my audit qualifications on the 2008-09 financial statements and the findings in my Value for Money report, the Department for Environment, Food and Rural Affairs commissioned an external review of the Rural Payments Agency. The findings of this review were published on 20 July 2010. This review commenced in August 2009 and cost a total of £1.9 million .

25. The review's recommendations included:

- improvements to the Agency's operations in order to reduce duplication and to bring down the cost of administering a claim;
- the use of a specialist team to improve the quality of the information on which claims are processed;
- changes to the Agency's responsibilities and operating model;
- improvement to the Agency's financial controls;
- reducing the Agency's reliance on temporary staff; and
- improvements to the governance arrangements exercised over the Rural Payments Agency by the Department for Environment, Food and Rural Affairs.

26. I have reported previously on the problems with the Department's oversight of the Rural Payments Agency and my concerns remain extant. Progress in remedying the situation is slow and until the Department put in place a management team with the skills and experience necessary to address the challenges little progress is likely to be made. The Department for Environment, Food and Rural Affairs should:

- recruit, appoint or assign staff from its better performing agencies and non departmental public bodies to the Agency so that it has the management capability and culture to address the on-going issues highlighted in this report and in my previous value for money reports;
- set targets to accurately measure the Agency's performance against which it can challenge and monitor progress; and
- prepare a robust action plan to tackle the major challenges it faces in improving data quality, ensure that IT systems work effectively and reducing the costs of administering the Single Payments Scheme.

27. I have also reported previously on the financial management in the Department. The Department must ensure that it can accurately forecast expenditure and improve the Estimate process to avoid requesting for resources that are not utilised. In order to achieve this Department and its Agencies must be able to produce reliable cost estimates of activities and objectives to support resource bids. This information is also fundamental to allow the Department to accurately assess the cost effectiveness of work completed. The reduction in public sector spending means that Department must be able to clearly prioritise what matters most, based on an accurate and realistic assessment of the costs and benefits.

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