



INFRASTRUCTURE, GOVERNMENT AND HEALTHCARE

NHS Health Scotland

Annual audit report for 2004-05 to NHS Health Scotland
and the Auditor General for Scotland

28 July 2005

AUDIT

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Notice: About this report

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This report is for the benefit of only NHS Health Scotland and is made available to Audit Scotland (together the beneficiaries), and has been released to the beneficiaries on the basis that it shall not be copied, referred to or disclosed, in whole or in part, without our prior written consent.

Nothing in this report constitutes a valuation or legal advice.

We have not verified the reliability or accuracy of any information obtained in the course of our work, other than in the limited circumstances set out in the scope and objectives section of this report.

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1. Executive summary

Corporate governance

- A saving in the year of £447,000 against the Board's revenue resource limit was largely a result of a 55% increase in funding from 2003-04 and a failure to defray expenditure throughout the year as originally budgeted. The Scottish Executive gave the Board dispensation to carry forward up to £450,000 to fund health improvement initiatives in 2005-06.
- The Board, then Health Education Board for Scotland, came together with PHIS on 1 April 2003. Since then, the Board has implemented a staff restructuring exercise, establishing a number of new posts and management positions. A number of posts were not filled until late 2004-05, resulting in an increased reliance on agency staff in the year.
- The Board received income in the year of £1,552,000 to fund the *Scotland Against Drugs* campaign. These funds were not received until relatively late in the financial year and the Board has therefore deferred income of £412,000 to fund various initiatives in 2005-06.
- In June 2005, the Board received notification from the Scottish Ministers that it would relocate to east Glasgow by May 2007 from its present sites in central Edinburgh and Glasgow. The Board has made reference to this event in the directors' report to the 2004-05 financial statements.
- As part of our 2004-05 annual audit plan, we completed a review of the priorities and risks facing the Board and the plans in place to meet identified factors. Our report concluded that the Board faced a number of significant risks in relation to corporate and financial governance. Whilst plans are in place to tackle these risk areas, these may take some time to implement.
- During 2004-05 we also reviewed the systems and controls over a number of financial systems. A number of performance improvement observations were identified which, when implemented, will enhance the internal control environment at the Board. These have been summarised in the action plan to this report.

Corporate governance (continued)

- On 31 March 2005 we issued a progress implementation review assessing the level of implementation of previous external audit recommendations. Management have made limited progress in implementing these recommendations due to resources being prioritised on the restructuring exercise.
- The Board's internal audit service is provided by Scott-Moncrieff. The internal auditors' annual audit report concludes that the Board has adequate and effective systems of internal controls in place. This is consistent with the directors' statement of internal controls included in the 2004-05 financial statements.

Financial statements

- On 28 July 2005 we issued an audit report expressing an unqualified opinion on the financial statements of the Board for the year ended 31 March 2005 and on the regularity of the financial transactions reflected in those financial statements.
- During the audit process we identified two insignificant financial statement errors in the first draft of financial statements. These unadjusted errors were reported to the Board and it was agreed that they did not represent material misstatements and no adjustment was required.
- A number of other presentational and disclosure issues were identified within the first draft of the financial statements which were subsequently resolved by management.

Performance audit

- During the year we completed a review of staff governance arrangements. Our report concluded that the self-assessment process undertaken by the Board appears to have been robust.

2. Introduction

Background

2004-05 was the fourth year of our five year appointment as external auditors of NHS Health Scotland ("the Board"). This report summarises our opinion and conclusions and highlights significant issues arising from our work.

The framework under which we operate under appointment by Audit Scotland is as outlined in our *strategic (long-term) planning memorandum* issued on 3 February 2005. The scope of the audit was to:

- provide an opinion on, to the extent required by the relevant authorities, the Board's financial statements and the regularity of transactions in accordance with the standards and guidance issued by the Auditing Practices Board;
- review and report on, to the extent required by relevant legislation and the requirements of the *Code*, the Board's corporate governance arrangements in relation to systems of internal control, the prevention and detection of fraud and irregularity, standards of conduct, and prevention and detection of corruption; and the Board's financial position; and
- review and report on, to the extent required by relevant legislation and the requirements of the *Code*, aspects of the Board's arrangements to manage its performance, as they relate to the economy, efficiency and effectiveness in the use of resources.

Our audit approach focused on the identification of strategic business risks and operational and financial risks impacting the Board:

- compliance with legislation, financial regulations and financial reporting standards;
- financial strategy, budget setting and monitoring processes;

Background (continued)

- relocation of the Board's activities; and
- the legal relationship between the Board and Scotland Against Drugs ("SAD").

Basis of information

External auditors do not act as a substitute for the Board's own responsibility for putting in place proper arrangements to ensure that public business is conducted in accordance with the law and proper standards, and that public money is safeguarded and properly accounted for, and used economically, efficiently and effectively.

During the year, we completed a 'priorities and risks framework' assessment and a review of progress in implementation of prior year recommendations. Reports from both were accompanied by an action plan, including management responses and dates for implementation of agreed recommendations. This report covers the main points arising from our work.

To a certain extent the content of this report comprises general information that has been provided by, or is based on discussions with, management and staff of the Board. Except to the extent necessary for the purposes of the audit, this information has not been independently verified. The contents of this report should not be taken as reflecting the views of KPMG LLP except where explicitly stated as being so.

Acknowledgement

Our audit has brought us in contact with a range of Board staff. We wish to place on record our appreciation of the co-operation and assistance extended to us by staff in the discharge of our responsibilities.

3. Corporate governance

Financial position

It is the responsibility of the audited body to conduct its affairs and put in place proper arrangements to ensure that its financial position is soundly based. We are required to consider whether the Board has established adequate arrangements in this regard. The Scottish Executive Health Department set three budget limits for the Board in 2004-05. The Board's performance against these targets is set out in table 1.

Table 1: Performance against financial targets

Source: audited financial statements 2004-05	Target £'000	Actual outturn £'000	Variance £'000
Revenue resource limit ("RRL")	17,148	16,701	447
Capital resource limit ("CRL")	65	32	33
Cash requirement	16,000	16,000	Nil

The main reason behind the significant saving against the Board's RRL is the increase in the RRL in the year (55%) and lack of identification of a significant projected underspend until late in the year. This underspend arose due to a number of factors, including double budgeting of some staff costs in the Glasgow office, the failure to profile the budget throughout the year and some weaknesses in communications between the finance team and budget holders. Management have since established plans to prevent a recurrence of this underspend.

The Board has received dispensation from the Scottish Executive to carry forward this saving, which is more than the 1% ordinarily permitted.

The saving against the CRL represents a decision by management to defer capital expenditure until the future location of the Board was clear. This policy will therefore continue until the relocation of the Board is complete to prevent unnecessary capital expenditure on the existing Board estate.

Scotland Against Drugs

At the time of issuing this report, the Board was still awaiting a decision by the Scottish Ministers on the legal position of SAD in relation to the Board. It is expected that a decision will be made by 31 March 2006.

In accordance with prior years, the Board has therefore consolidated the financial performance of SAD into the Board financial statements for 2004-05. In the year, the Board drew down £1,552,000 of SAD funding. However, due to this funding being allocated late in 2004-05, £412,000 remained unspent as at 31 March 2005. This balance has therefore been deferred to fund SAD initiatives in 2005-06.

Proposed relocation

During 2004-05 the Board awaited a decision by the Scottish Ministers in relation to possible relocation, in line with the Scottish Executive relocation policy. We considered the affect of this uncertainty during the course of our audit, but found no evidence that the operation of internal controls had been affected.

In June 2005, the Board was informed that it would be relocated to the east side of Glasgow by May 2007. Details of this decision has been included in the 2004-05 directors' report and no further financial statement disclosures have been made.

3. Corporate governance (cont'd)

Systems of internal control

Priorities and risks framework

As part of our 2004-05 audit, we completed a review of the Board's corporate and financial governance arrangements against Audit Scotland's 'priorities and risks framework'. As part of this work, we identified the following risk areas:

- the creation of NHS Health Scotland involved the establishment of a new organisational structure, strategy and associated governance framework. The integration gave rise to a number of corporate governance and risk management implications for the Board; and
- a significant number of cost pressures are building within the NHS with the impact of pay modernisation, through the three different strands of *Agenda for Change*, consultants' contracts and GMS contract. The one relevant to the Board is *Agenda for Change* ("AfC"). In addition, if the Board does not set an appropriate budget, it may not be able to meet its objectives.

Audit work undertaken in response to these risk areas resulted in a number of matters being raised with management:

- In 2004-05 the Board's budgetary control procedures did not detect a projected £1 million expenditure underspend until December 2004. Management have since identified appropriate improvements to the budgetary control environment which will be implemented during 2005-06.
- The national approach to calibration of public health employees has limited the Board's progress in implementing the AfC initiative. Management estimates that AfC will not be fully implemented during 2005-06 and a project manager has been appointed to progress this.
- Some progress has been made in establishing strong corporate governance arrangements since the coming together of PHIS and HEBS. However, we found that the Board has been heavily involved in operational issues and there is an absence of formal performance measurement arrangements.

Control environment

During 2004-05 we reviewed the systems and controls over a number of financial and non-financial systems. We identified a number of performance improvement opportunities arising from this work and these have been included within appendix 1 of this report.

We also completed a progress implementation review, the results from which were reported on 31 March 2005. Management has made limited progress in implementing previous external audit recommendations due to the focussing of resources on the staff restructuring exercise. In total, 19% of recommendations had been fully implemented, with 81% remaining outstanding at the time of our review. Management have since employed a new finance manager, who will focus on the implementation of these outstanding recommendations in 2005-06.

Internal audit

In completing our audit, we sought, where appropriate to rely on the work carried out by the Board's internal auditors. During 2004-05 we placed reliance on internal audit in respect of their work on:

- general ledger maintenance;
- expenditure;
- budgeting and monitoring;
- property management;
- risk management; and
- IT strategic developments.

The Board's internal auditors have concluded in their annual internal audit report that the Board is operating an adequate and effective system of internal control.

3. Corporate governance (cont'd)

Statement on internal control

As part of the development of corporate governance, public sector bodies are required to make a statement of how they have applied the principles of corporate governance. We are required to review this to assess whether the description of the process adopted in reviewing the effectiveness of the system of internal control appropriately reflects the process. We are not required to provide an opinion on the Board's systems of internal controls.

The 2004-05 statement on the systems of internal control prepared by the Board does not disclose any major weaknesses. The processes described within the statement on internal control are consistent with our understanding of the Board's corporate governance arrangements.

Fraud and irregularity

During 2004-05 we followed up recommendations made in previous reports in respect of preventing and detecting fraud and irregularity. We had regard to Statement of Auditing Standards 110: *Fraud and Error* and International Standards on Auditing 240: *The Auditor's Responsibility to Consider Fraud in the Audit of Financial Statements* when completing our work in this area.

There are a number of outstanding recommendations from previous reports having a bearing on the Board's responsibilities in relation to preventing and detecting fraud and irregularity, which are included in our implementation progress review.

Standards of conduct and prevention and detection of corruption

Public business should always be conducted with fairness and integrity including matters such as the avoidance of personal gain from such business, even handedness in the appointment of staff, open competition in the letting of contracts and the avoidance of waste and extravagance. We are required to consider whether the Board has put in place adequate arrangements to maintain and promote proper standards of financial conduct and detect corruption. Our work over the five year period of our appointment in relation to this element of the Code was reflected within our long term plan.

Performance audit

The terms of appointment from Audit Scotland include a requirement for a proportion of our audit time to be spent on performance audit work. Performance audit work covers a variety of areas, both financial and non-financial, including both Audit Scotland centrally directed studies and locally determined studies based on agreement between each organisation and their auditors.

During the year we completed a performance audit review of staff governance arrangements. Our report concluded that the required self-assessment process undertaken by the Board appears to have been robust.

Review of the action plan suggested that it is ambitious given the limited resources available within the Board's human resource department.

We also considered the progress made by the Board in implementing previously agreed staff governance arrangements. Management have taken action against 15 of the 19 agreed recommendations.

4. Financial statements

Audit opinion

On 28 July 2005 we issued an audit report expressing an unqualified opinion on the financial statements of the Board for the year ended 31 March 2005 and on the regularity of the financial transactions reflected in those financial statements.

Audit completion

An important measure of proper financial control and accountability is the timely closure and publication of audited financial statements. We have summarised in figure 4.1 the three key elements of the audit process with which we require the Board to engage,

Figure 4.1: key elements of the audit process

Completeness of draft financial statements

A fully completed set of draft financial statements were received at the beginning of the audit on 20 June 2005.

Quality of supporting working papers

In accordance with our normal practice, we issued a 'prepared by client' request that set out a number of documents required for our audit of the financial statements. Documentation provided was again to a good standard and enabled our audit to be conducted efficiently.

Response to audit queries

All audit queries were dealt with in a timely manner.

Source: KPMG LLP (June 2005)

Audit adjustments

In figure 4.2 we draw attention to adjustments to the financial statements made by management following the audit process.

Figure 4.2: audit adjustments

There were no significant audit adjustments required for the 2004-05 financial statements. A number of minor misstatements were identified from the draft financial statements. We have agreed with the Board that these misstatements were not material to the financial statements and no adjustments were therefore made.

In addition, a number of presentational and disclosure issues were identified on review of the draft financial statements against the *NHS Unified Board Accounts Manual* and general good practice. Management has since processed all these changes.

Source: KPMG LLP (June 2005)

Confirmations and representations

We confirm that as of 13 July 2005, in our professional judgement, KPMG LLP is independent within the meaning of regulatory and professional requirements and the objectivity of audit staff is not impaired. Appendix two provides a copy of a statement to this effect.

In accordance with auditing standards, we have obtained representations from directors on material issues prior to signing our opinion.

As noted in figure 4.2, management have not adjusted a number of non-trifling errors which they do not believe to be material, both individually and in the aggregate to the financial statements taken as a whole. The summary of unadjusted differences was attached to the management representation letter.

4. Financial statements (cont'd)

Significant accounting issues

Summarised in figure 4.3 are the significant accounting matters impacting the 2004-05 financial statements.

Figure 4.3: accounting issues

Issue	Commentary
Saving against RRL	<p>As noted, the Board has reported a saving against its RRL of £447,000. We have confirmed that the Scottish Ministers have given the Board special dispensation to carry forward up to £450,000. However, we have made a number of recommendations to management in relation to the budgetary control environment to ensure that in future years the Board remains within its 1% permitted variance against its RRL.</p> <p>The Board experienced an in-year increase of 55% in its RRL and this contributed to difficulties in managing its overall position. The Board is to discuss further with the Scottish Executive the operational difficulties caused by in-year adjustments of this magnitude.</p>
Deferred income	<p>During 2004-05 the Board initially believed that the SAD campaign would not continue to be funded by the Scottish Executive. However, the Scottish Executive informed the Board during 2004-05 that funding would be made available and that all available funds should be drawn down. In total, £1,552,000 of SAD funding was drawn down by the Board in 2004-05. As a result of this delay in notification, the Board was unable to defray all this funding and £412,000 has been deferred to fund various SAD initiatives in 2005-06.</p>
Fixed asset revaluation	<p>In 2003-04, the NHSScotland estate was revalued according to directions from the Scottish Executive. Following this revaluation, the Board's land and buildings increased in value to £960,000. From 1 April 2004 it is the policy of the Scottish Executive that the whole NHSScotland estate should be revalued on a 20% rolling basis over a five year period.</p> <p>The Board's estate was selected for revaluation in 2004-05 resulting in an increase in the balance sheet value by a further £30,000 as at 31 March 2005. In the remaining four years until the next revaluation, the Board will apply indexation to its land and buildings, as well as its other tangible fixed assets, in line with the <i>NHS Unified Board Accounts Manual</i>.</p>
Fixed assets depreciation	<p>In our review of the first draft of financial statements, we found that the in year depreciation charge for land and buildings had been overstated by £8,000. The net book value of fixed assets had not been overstated due to the subsequent revaluation of the Board's land and buildings as noted above. This misstatement is not material and so no adjustments have been made to correct this error. However, we have recommended that the controls operating over the fixed asset register be enhanced, as outlined in our action plan in appendix 1.</p>

4. Financial statements (cont'd)

Issue	Commentary
Leased accommodation	<p>During 2004-05 the Board received notification that the lease on its Priory building would expire in 2005-06. Management have reviewed the condition of the building and confirmed that there is no requirement to provide for potential costs arising from the completion of this repairing lease.</p> <p>In order to ensure that there is sufficient accommodation for Board staff, management have secured the lease of Rosebery House from the Scottish Executive as short term accommodation until the relocation takes place. A number of fixed assets have been purchased to furnish this new building.</p>
<i>Agenda for Change</i> accrual	<p>We noted in our 2004-05 'priorities and risks framework' report that the national approach to calibration of public health employees has limited the Board's progress in implementing the AfC initiative. The Board has therefore followed Scottish Executive guidance and has made a £20,000 accrual in the financial statements to reflect these AfC costs.</p>
Early retirement enhanced pension costs	<p>In 2003-04, the Board accrued £230,000 of costs relating to an early retirement award to a former employee. The Board initially planned to repay this amount in full in 2004-05 but were prevented from doing so by delays in advice from SPPA. This accrual has therefore also been included as at 31 March 2005.</p> <p>We have confirmed that the Board has since paid £190,000 to SPPA with the remaining £40,000 to be paid later in 2005-06.</p>

Appendix 1 – Action plan

This appendix summarises the performance improvement observations we have identified from the work performed to prepare this audit highlights memorandum. Each of our observations has been allocated a risk rating (as explained below)

Priority rating for performance improvement observations raised

	<p>Grade one (significant) observations are those relating to business issues, high level or other important internal controls. These are significant matters relating to factors critical to the success of the Board or systems under consideration. The weakness may therefore give rise to loss or error.</p>		<p>Grade two (material) observations are those on less important control systems, one-off items subsequently corrected, improvements to the efficiency and effectiveness of controls and items which may be significant in the future. The weakness is not necessarily great, but the risk of error would be significantly reduced if it were rectified.</p>		<p>Grade three (minor) observations are those recommendations to improve the efficiency and effectiveness of controls and recommendations which would assist us as auditors. The weakness does not appear to affect the availability of the controls to meet their objectives in any significant way. These are less significant observations than grades one and two, but we still consider they merit attention.</p>
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No	Grade	Observation	Recommendation	Management response	Responsible officer / completion date
1	2	<p>Management review of control procedures</p> <p>As a result of increased pressures on senior management in 2004-05 arising from the staff restructuring exercise, senior management have not completed their quarterly review of the operation of the key internal controls. Whilst senior management have performed a year end review and confirmed that all controls were operating as intended, a risk exists that failures in the internal control environment are not identified and rectified on a timely basis.</p>	<p>Management should ensure that all internal controls are reviewed as a matter of routine. This will ensure that controls are operating as designed and that any control failures are promptly identified and rectified.</p>	<p>Agreed.</p> <p>Reviews will be carried out on a quarterly basis commencing July 2005.</p>	<p>Director of resource management</p> <p>July 2005</p>
2	2	<p>Authorised signatory list</p> <p>As part of our controls testing in 2004-05, we noted that a number of authorised officers had not provided sample signatures for the authorised signatory list. A risk therefore exists that purchase invoices are processed without having been appropriately authorised in line with the Board's standing orders.</p>	<p>All authorised signatories should be required to provide sample signatures for the authorised signatory list to enable effective checking of authorisations by processing staff. This will ensure that only appropriately authorised invoices are passed for payment.</p>	<p>Agreed.</p>	<p>Finance manager / resources manager</p> <p>31 July 2005</p>

Appendix 1 – Action plan

No	Grade	Observation	Recommendation	Management response	Responsible officer / completion date
3	2	<p>Progress of previous recommendations</p> <p>We reported in our 2004-05 progress implementation review that the Board has made limited progress in implementing previous external audit recommendations. We also noted that the Board's register of audit recommendations was not being maintained or used to drive the implementation process.</p> <p>The failure to implement audit recommendations may lead to significant control weaknesses not being addressed in a timely manner.</p>	<p>The Board should ensure that all outstanding audit recommendations are implemented as a matter of priority and that the register of recommendations is used to facilitate this process.</p> <p>This will ensure that all control weaknesses are suitably addressed.</p>	<p>Agreed.</p> <p>Database to be updated by 31 July 2005 and action on an ongoing basis thereafter.</p>	<p>Finance manager</p> <p>31 July 2005</p>
4	2	<p>Stocktakes</p> <p>We were unable to obtain evidence to support management assertions that sample stocktakes are undertaken on a monthly basis.</p> <p>Whilst we have obtained evidence that the year end 100% stocktake has been performed satisfactorily, the lack of evidence over the monthly stocktakes results in a poor audit trail and a lack of assurance that this control is operating as designed.</p>	<p>Management should ensure that all monthly stocktakes are formally evidenced and reviewed by a senior officer with results reported to senior management. This will ensure that the control is operating as designed and that any unusual variances are appropriately followed up.</p>	<p>Agreed.</p>	<p>Finance manager / head of marketing</p> <p>31 July 2005</p>
5	2	<p>Fixed asset register</p> <p>The Board is not including its land and building tangible fixed assets in the electronic fixed asset register. This increases the risk of misstatement and error as manifested by the error in calculating the depreciation charge for these assets.</p>	<p>All fixed assets should be monitored using an electronic fixed asset register, which is capable of recording cost, revaluations and depreciation. This will minimise the risk of human error and will improve the efficiency of the control process.</p>	<p>Agreed.</p>	<p>Finance manager</p> <p>31 July 2005</p>

Appendix 1 – Action plan

No	Grade	Observation	Recommendation	Management response	Responsible officer / completion date
6	3	Budget holder meetings During our review of the budgetary control procedures, we noted that there is no evidence retained of meetings between budget holders and finance staff. This reduces the effectiveness of the audit trail and may result in reasons for budget variances not being properly documented and reports to senior management.	All meetings with budget holders should be properly documented by finance staff to ensure that a strong audit trail exists and that senior management are appropriately informed of budget variances and discussions with budget holders. This should form part of the overall improvement in the budgetary control environment as agreed with management in our 'priorities and risks framework' report.	Agreed. Recording system to be implemented by 31 August 2005	Finance manager 31 August 2005

Appendix 2 – Confirmation of independence

To: The NHS Health Scotland Board and the Auditor General for Scotland

Effective for periods commencing after 15 December 2004 professional ethical standards require us to communicate to you in writing at least annually all significant facts and matters, including those related to the provision of non-audit services and the safeguards put in place that, in our professional judgement, may reasonably be thought to bear on KPMG LLP's independence and the objectivity of the audit team. This statement is intended to comply with this obligation earlier than required.

We have considered the fees paid to us by Audit Scotland and NHS Health Scotland for professional services provided by us during the reporting period.

We are satisfied that our general procedures support our independence and objectivity.

General procedures to safeguard independence and objectivity

KPMG LLP is committed to being and being seen to be independent. As part of our ethics and independence policies, all KPMG LLP staff annually confirm their compliance with our Ethics and Independence Manual including in particular that they have no prohibited shareholdings or interests. Our Ethics and Independence Manual is fully consistent with the requirements of the Ethical Standards issued by the UK Auditing Practices Board. As a result we have underlying safeguards in place to maintain independence through:

- instilling professional values;
- communications;
- internal accountability;
- risk management; and
- independent reviews.

Please inform us if you would like to discuss any of these aspects of our procedures in more detail.

There are no other matters that, in our professional judgement, bear on our independence which need to be disclosed to the Board.

Confirmation of audit independence

We confirm that as of 13 July 2005, in our professional judgment, KPMG LLP is independent within the meaning of regulatory and professional requirements and the objectivity of the audit director and audit staff is not impaired.

This report is intended solely for the information of the Board and the Auditor General and should not be used for any other purposes.

Yours faithfully

KPMG LLP