



INFRASTRUCTURE, GOVERNMENT AND HEALTHCARE

## Lothian NHS Board

Annual audit report for 2004-05 to members of Lothian NHS Board  
and the Auditor General for Scotland

27 July 2005

AUDIT

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## Notice: About this report

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# 1. Executive summary

## Corporate governance

Following a period of extensive consultation and consideration, the Board approved its new corporate governance structure on 23 March 2005; 2004-05 has therefore been a transitional year.

The key findings in relation to Quality Improvement Scotland's work on the Board's governance and risk management arrangements, particularly in relation to single system working, are consistent with our planning approach and findings reported to management in respect of 2004-05.

There is evidence of single system working at a strategic level, particularly within Board headquarters and the structure of the executive management team. There is also evidence of plans to promote significant progress during 2005-06 following the second phase of restructuring from 1 April 2005, creating a single operating division and a primary care organisation supporting the introduction of five community health partnerships ("CHPs").

Despite the delay in the distribution of formal guidance, the Board submitted its CHP schemes of establishment by the deadline of 24 December 2004. Following a number of questions, the Scottish Executive formally gave consent to the Board, as one of six of the 15 NHS boards, to go ahead on 1 April 2005.

The executive management team approved the final draft of the risk management strategy on 16 March 2005, and the audit committee considered the strategy on 23 May 2005. The strategy has also now been approved by both the clinical governance committee and the Board.

The Board demonstrates partnership working at all levels, including both internal and external partners and the majority of directors and other management staff consider these representatives to be a valued addition to these groups, rather than simply a 'token gesture' invitation.

The Board's internal auditors have concluded that *"processes reviewed did not contain fundamental control weaknesses."*

## Financial statements

On 27 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.

The Board achieved all three financial targets set by the Scottish Executive Health Department, reporting a surplus of £19.6 million. The Board projected a break-even position in the five year financial plan prepared in July 2004.

The Board's reported surplus at 31 March 2005 was underpinned by the use of £39.2 million (2003-04: £44.4 million) of non-recurring funding. The Board has recognised that the reduction in non-recurring support from £39.2 million to £26.4 million in 2005-06 is a key priority in achieving financial balance on an ongoing basis, which is also dependent on the operational delivery against CRES and pan-Lothian project targets being met.

In 2004-05 the Board achieved £6.55 million of CRES against a target of £7.35 million. The CRES target secured demonstrated an increased focus on service redesign and increased efficiency. Achievement of the £20.6 million operational CRES target in 2005-06, is, in our view, extremely demanding. The university hospitals division reported non-achievement of £1.8 million of CRES, against an annual target of £17 million, to its management team for the two months ended 31 May 2005.

The Board received £6.2 million in Scottish Executive financial brokerage in 2004-05, taking the total brokerage received to date to £20 million. The five year financial plan assumes that repayment of brokerage will commence in 2007-08.

The Board's underlying recurring expenditure position remains significantly in deficit against recurring income.

Cost pressures in respect of the pay modernisation agenda for 2004-05 were £27.3 million rising to £49 million in 2005-06.

# 1. Executive summary (continued)

## **Performance management**

### *Performance management arrangements*

The Board bases performance management and assessment on the performance assessment framework. The targets highlighted in the 2004-05 local health plan confirm the Board's intention to meet the national targets and, in some cases, bring forward the Scottish Executive Health Department's deadlines.

The finance and performance review committee oversees the monitoring of performance at Board level, although this committee is not required under statutory guidance. Use of a traffic light system in performance management reports provides an indication of performance change, particularly when comparing previous and current periods. The inclusion of the responsible officers promotes ownership and accountability for performance management and improvement.

We identified a number of obstacles to the timely availability of accurate performance data and a number of departments continue to use manual systems to record activity. The coding systems used have been in place for a number of years and do not fully meet the Board's current activity monitoring requirements.

A variety of divisional business continuity plans exist but these are inconsistent and, overall, may be inadequate to protect the interests of the Board and its patients.

### *Service sustainability*

At April 2005 the Board reported that it exceeded its annual target of 257 delayed discharges by 27 patients. The Board received specific allocations from the Scottish Executive and local authorities in addition to the use of internal funding.

The Board's outturn of 339 people waiting more than six months for inpatient treatment is a 22% improvement against the target. At 31 March 2005, 5,153 outpatients were waiting more than six months, a 21% improvement over the target set. This was supported internally and by allocations from the Scottish Executive national waiting time unit.

### *Workforce management*

During 2004-05 the Board developed a pan-Lothian workforce planning team and work has been ongoing throughout the year in the development of a workforce management database. The Board is currently in the process of developing key human resource strategies, including a recruitment strategy, flexible working policies and a redeployment policy.

### *Joint future*

The timescale established for full implementation of joint management arrangements was challenging, especially when combined with the introduction of CHPs. Financial processes established at the time of our review were not considered sufficiently robust to demonstrate the effective management of funds and the delivery of improved outcomes.

### *Information management*

The Board is reviewing the local eHealth strategy for 2005-08. Formal approval was deferred by the Board to take into account the impact of the national eHealth strategy changes and the Kerr report. The Board should review the level of recurring revenue resources to support the level of IM&T capital investment. This is a significant cost pressure and potential barrier to effective implementation of the strategy.

### *Staff governance*

On the basis of the evidence provided we concluded that the self-assessment process undertaken appeared to have been robust and review of the evidence provided by the Board supported the responses within the self-assessment audit tool. Review of the action plan suggested that while it appeared credible it was ambitious given the change and organisational development agenda facing the Board.

## 2. Introduction

### Background

2004-05 was the fourth year of our five year appointment as external auditors of Lothian NHS Board ("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*. The scope of the audit was to:

- provide an opinion on, to the extent required by the relevant authorities, the financial statements and the regularity of transactions in accordance with the standards and guidance issued by the Auditing Practices Board;
- review and report on 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 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, including:

- a failure to meet its financial targets;
- assets, income and expenditure for private finance initiative contracts may be inaccurate or incomplete;
- the financial plan may not be achieved;
- the risk management framework may not be robust;

- the estimate financial impact of pay modernisation may not be accurate;
- the outcome of the revaluation at 31 March 2005 may not be appropriately disclosed or accounted for; and
- changes required by legislation on joint future and community health partnerships may not be appropriately managed.

### 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.

We have issued a number of reports accompanied by an action plan, including management responses and dates for implementation of agreed recommendations in respect of 2004-05. This report summarises the main points arising from our work, but, we have not repeated the action plans.

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 wide range of Board staff. We wish to place on record our appreciation of the continued co-operation and assistance extended to us by staff in the discharge of our responsibilities.

### 3. Corporate governance

#### Financial position

##### Financial targets

The Scottish Executive Health Department sets three financial targets at NHS board level on an annual basis. These, together with actual performance, are summarised in figure 3.1.

**Figure 3.1: 2004-05 outturn against financial targets**

Target	Achieved	Result £'000
Revenue resource limit ("RRL") – expenditure should not exceed the RRL	☑	Target: £956,609 Actual: £937,043 Variance: £19,566
Capital resource limit ("CRL") – capital expenditure should not exceed the CRL	☑	Target: £7,663 Actual: £7,577 Variance: £86
To remain within the cash limit	☑	Target: £924,272 Actual: £914,256 Variance: £10,016

During 2004-05 management consistently reported their expectation of break-even at 31 March 2005 to the Board and finance and performance review committee. In February 2005 both meetings were informed that a surplus of 1%, or around £9 million, was predicted. This position was again reported to the finance and performance review committee on 13 April 2005, with the director of finance predicting of a surplus of £9.5 million. This was also consistent with the March 2005 monitoring return submitted to the Scottish Executive.

The draft financial statements presented for audit on 7 July 2005 disclosed a surplus of £13.8 million, which was adjusted prior to the final financial statements being approved by the Board on 27 July 2005. A reconciliation of the movement in the surplus was provided by management is shown in figure 3.2.

**Figure 3.2: reconciliation of financial statement outturn**

	£'000
<b>Financial outturn per month 12 (13 April 2005)</b>	<b>9,500</b>
Elimination of the 2003-04 cost of capital charge	3,150
Recognition of the public health medical trainees allocation	180
Increase in allocation to WLHD	(210)
Increase in debtor for reimbursement of clinical/medical negligence provision	350
Reduction in provisions for enhanced pensions and injury benefits	400
Increase in income following agreement of inter-NHS balances	390
Other	47
<b>Financial outturn in draft financial statements (7 July 2005)</b>	<b>13,807</b>
Financial statement adjustments (figure 4.2)	(1,259)
Accounting adjustments	7,018
<b>Financial outturn in the final financial statements (27 July 2005)</b>	<b>19,566</b>

*Source: Lothian NHS Board (July 2005)*

The Board's financial plan for 2004-05 was based on achieving a break-even position for 2004-05. Figure 3.1 confirms that the Board achieved a surplus of £19.6 million, a significant improvement on the planned outturn. The accounting adjustments in figure 3.2 primarily relate to the financial impact of the revaluation, including capital charges for 2004-05. The key elements contributing to the surplus are shown in figure 3.3.

**Figure 3.3: key factors in the financial outturn 2004-05**

	£'000
Prescribing adjustment	8,297
Revised cost assessment for Agenda for Change	2,700
Divisional income adjustment	3,000
<b>Financial outturn in draft financial statements</b>	<b>13,807</b>

*Source: Lothian NHS Board (July 2005)*



### 3. Corporate governance (continued)

The Board's final outturn was also dependent on the achievement of financial targets at divisional level. Divisions reported a break-even position in April 2005, with the exception of LUHD which disclosed a small surplus. Reconciliations prepared by divisional finance staff between April 2005 finance reports and the financial statements highlight adjustments prior to the completion of draft financial statements, as shown in figure 3.4.

**Figure 3.4: reconciliations of month 12 divisional finance reports and the draft financial statements**

	£'000
<b>LUHD divisional management team report (April 2005)</b>	<b>21</b>
Reversal of consultants' contract accrual	250
Increase in provision for bad debts	(466)
Increase in accrual (performance related pay, standard accruals and other)	(540)
Additional accrual for PFI ancillary expenditure	(525)
Adjustments to capital expenditure	137
Reverse capitalisation of ward stock and other stock adjustments	(394)
Adjustment to income from other NHS boards	(150)
Reclassification of capital grant awarded to the University of Edinburgh	(304)
Additional RRL allocation	2,000
<b>LUHD outturn draft reporting pack</b>	<b>29</b>

Source: Lothian NHS Board (July 2005)

	£,000
<b>LPCD divisional management team report (April 2005)</b>	<b>-</b>
Increase in provision for enhanced pensions	(181)
Increase in accruals	(71)
Additional RRL allocation	181
Movement in deferred income	46
Other	25
<b>LPCD outturn in draft reporting pack</b>	<b>-</b>

Source: Lothian NHS Board (July 2005)

	£,000
<b>WLHD divisional management team report (April 2005)</b>	<b>-</b>
Increase in enhanced pension / injury benefit provision	(425)
Additional charges	(159)
Increase in income	154
Additional RRL allocation	430
<b>WLHD outturn in the draft reporting pack</b>	<b>-</b>

Source: Lothian NHS Board (July 2005)

#### Non-recurring funding

The use of £39.2 million of non-recurring funding was reported to the finance and performance review committee, summarised in figure 3.5.

**Figure 3.5: sources and application of non-recurring funding in 2004-05**

	£'000	£'000
<b>Source of non-recurring funding</b>		
Capital to revenue transfers	15,800	
Scottish Executive financial support <sup>1</sup>	15,400	
2003-04 carry forward flexibility	8,000	
<b>Total</b>		<b>39,200</b>
<b>Application of non-recurring funding to support recurring activities</b>		
Non-recurring support		
- LUHD	16,500	
- LPCD	1,000	
- WLHD	3,100	
Pan-Lothian review base	11,100	
National initiatives (including pay modernisation)	7,500	
<b>Total</b>		<b>39,200</b>

Source: Lothian NHS Board (July 2005)

<sup>1</sup> Including £6.2 million brokerage and £9.2 million additional allocation.

### 3. Corporate governance (continued)

Authorised capital to revenue transfers during 2004-05 totalled £38.2 million, of which £15.8 million was used to support recurring operations and £22.4 million to fund capital expenditure that does not add value in terms of the accounting framework. The Board also received £3 million of capital receipts.

There procedures in place to monitor the use of non-recurring funding. Monthly financial reports identify categories of recurring and non-recurring funding and clearly report the use of non-recurring funding to meet recurring costs. Nonetheless, divisions continue to fund ongoing operational requirements on a non-recurring basis, resulting in the continuation of an underlying financial deficit, albeit at a planned, reducing level. Reports to the finance and performance review committee during 2004-05 identified that slippage in year had been accommodated through the use of non-recurring funding, as shown in figure 3.5, on the assumption that savings would be recognised in future years based on implementation plans currently in place.

The Board has successfully reduced its reliance on non-recurring funding to £39.2 million (2003-04: £44.4 million). In 2005-06 the Board plans to further reduce its use of non-recurring funding to £26.4 million, reflecting the anticipated restrictions on virement of capital funding to revenue in future years.

#### *Pan-Lothian review*

During the year there was £11.1 million slippage on pan-Lothian review projects. This is higher than the projected shortfall reported to the finance and performance review committee in February 2003, which estimated slippage of £7.4 million, on which we commented in our *Annual audit report for the year ended 31 March 2003* to the Board and the Auditor General. The difference is accounted for by inflationary pressures, together with additional slippage on the Board's care of the elderly and laboratory projects.

#### *Ring fenced funding*

The Scottish Executive Health Department allocated £5.695 million of ring fenced to the Board during 2004-05 for cancer services, coronary heart disease and stroke strategy, and blood borne virus prevention. The Board's financial monitoring procedures include consideration of the use of this funding to ensure it is used for the purposes identified.

#### *Cash releasing efficiency savings ("CRES")*

In 2004-05, the Board achieved £6.55 million of CRES, against a target of £7.35 million. Figure 3.6 analyses CRES targets for 2004-05, highlighting a carry forward of £6.3 million, in addition to a 2005-06 in year target of £8.3 million and £6 million of additional cost pressures resulting from unachieved CRES at LUHD. An additional savings target of £3.4 million has been identified at Board level against which savings from key areas of service redesign will be monitored.

**Figure 3.6: cumulative CRES targets**

£'000	brought forward	2004-05 target	2004-05 total	2004-05 actual	carry forward	2005-06 target	2005-06 total
LUHD	5,400	4,000	9,400	3,100 <sup>2</sup>	6,300	4,700	17,000 <sup>3</sup>
LPCD	900	2,600	2,600 <sup>1</sup>	2,700	0	3,600	3,600
WLHD	200	750	750 <sup>1</sup>	750	0	*	*
Total	6,500	7,350	12,750	6,550	6,300	8,300	20,600

Source: KPMG LLP (July 2004) and Lothian NHS Board (July 2005)

1 LPCD and WLHD are required to achieve financial balance each year. On the basis that financial balance is achieved, unachieved CRES targets are not carried into subsequent years.

2 The division achieved £4.1 million CRES in 2004-05, however, the full year recurring effect of these savings is £3.1 million.

3 The initial 2005-06 total is £11 million, based on the carry forward and in year target. However, the total includes £6 million additional pressures, based on previous unachievement of CRES, for which the Board funded LUHD on a non-recurring basis in 2004-05.

\* Following restructuring on 1 April 2005, the targets for WLHD have been appropriately aggregated into the targets for the acute division and PCO / CHPs.

During 2004-05 there has been a visible change in attitude and increased clinical and operational consultation in preparing CRES plans for 2004-05 and 2005-06. The CRES targets secured in 2004-05 demonstrated an increased focus on service redesign and increasing efficiency.



### 3. Corporate governance (continued)

Achievement of the £20.6 million operational CRES target for 2005-06 is, in our view, extremely demanding. The financial position reported to the operating division's (formerly LUHD and WLHD) management team on 30 June 2005 is a cumulative overspend to 31 May 2005 of £2.3 million, of which £1.8 million is non-achievement of CRES during the first two months.

#### *Financial recovery plan*

The Board continues to formally update its five year plan on an annual basis to reflect the actual outturn for 2004-05 and changes in future assumptions. The five year plan reports reliance on £54.6 million non-recurring funding, in addition to the £13.2 million surplus carried forward from 2003-04. This is £25.6 million higher than the £39.2 million reported in figure 3.3 and relates to the use of non-recurring funding against non-recurring expenditure.

Figure 3.7 compares the 2004-05 planned and actual outturns and the 2005-06 planned outturn. This highlights an increase in the funding gap from £30.9 million to £51.3 million i.e. the difference between recurring funding and recurring expenditure. This increase in the funding gap is primarily the result of a change in Scottish Executive guidance restricting capital to revenue transfers.

The five year plan is based on a number of key assumptions, including:

- from 2006-07 full funding of pay and prices uplifts, and a differential uplift in prescribing and hospital drugs;
- identified additional funds being sufficient the incremental cost increases associated with the new GMS contract, the consultants' contract and Agenda for Change; and
- repayment of Scottish Executive brokerage is phased in from 2007-08 onwards.

*Source: Lothian NHS Board (July 2005)*

The Board received £6.2 million in financial brokerage in 2004-05, taking the total brokerage received to date of £20 million.

The Board has recognised that the reduction in non-recurring support from £39.2 million to £26.4 million in 2005-06 is a key priority in achieving financial balance on an ongoing basis, which is also dependent on the operational delivery against CRES and pan-Lothian project targets being met. Key cost pressures in 2005-06 are primarily based on the pay modernisation agenda. An analysis of the resulting cumulative cost pressures for 2004-05 and 2005-06 is shown in figure 3.8.

Figure 3.7 highlights a significant variance between the five year financial plans issued in July 2004 and July 2005 in relation to the comparison between the planned and actual results for 2004-05. Details of the key contributors to the variance in the final outturn is provided in figure 3.3. The reductions in gross income and expenditure are the result of a change in accounting treatment of income from other NHS boards. The variances identified above are not unreasonable based on audit work performed during the year.

The Board's underlying recurring expenditure position remains significantly in deficit against anticipated recurring income. Despite these significant cost pressures, increasing CRES and efficiency savings targets the Board has reaffirmed its commitment to achieving financial balance on a recurring basis.

KPMG LLP has not, in the context of our audit responsibilities, considered the assumptions underlying the projections or their detailed components. However, we consider that, on the basis of the financial information available to us in discharging our responsibilities as auditors of the Board, there are components of the balanced financial plan which present a significant challenge to Board management in their implementation and, as such, there remains a substantial risk that the outturn projected in the financial plan will not be achieved.

### 3. Corporate governance (continued)

**Figure 3.7: extract from the five year financial plans**

	2004-05 plan (as at July 2004)		2004-05 actual (as at July 2005)			2005-06 plan (as at July 2005)	
	Recurring £'000	Non-recurring £'000	Recurring £'000	Non-recurring £'000	Variance £'000	Recurring £'000	Non-recurring £'000
Net resource outturn	969,287	75,557	919,677	23,125	102,042	957,842	24,196
Revenue resource limit (excluding brought forward surplus)	939,236	105,608	888,777	54,625	101,442	937,431	30,800
Brought forward balance	-	-	-	13,207	13,207	(30,900)	44,707
<b>Saving / (excess) against revenue resource limit</b>	<b>(30,051)</b>	<b>30,051</b>	<b>(30,900)</b>	<b>44,707</b>	<b>13,807</b>	<b>(51,311)</b>	<b>51,311</b>

Source: Lothian NHS Board (July 2004 and 2005)

There has been a significant level of additional investment in NHSScotland in recent years, continuing with indicative increases of 7%, 6.75% and 6% for the 2005-06, 2006-7 and 2007-08 allocations respectively, as announced in the Scottish Executive Health Department's letter dated 4 February 2005. The pay modernisation agenda is currently one of the largest cost pressures and drivers of change within NHSScotland. The Scottish Executive allocated additional funding of £9.2 million in 2004-05, which has been used by the Board to fund elements of the cost pressures of pay modernisation, however, there is an element to be funded by the Board from its recurring allocation.

#### *Pay modernisation*

The Board is monitoring the financial impact of pay modernisation on a pan-Lothian basis. A pay modernisation board has been established to oversee and ensure appropriate linkage between pay modernisation initiatives, including agenda for change, the consultants' contract and the contract for general medical services.

**Figure 3.8: pay modernisation cost pressures (cumulative)**

	2004-05 £'000	2005-06 £'000
Consultants' contract	11,300	13,000
GMS contract (including out-of-hours)	10,100	15,000
Agenda for change	5,900	21,000
<b>Total</b>	<b>27,300</b>	<b>49,000</b>

Source: Lothian NHS Board (July 2005)

#### Consultants' contract

The financial cost pressure resulting from the implementation of the consultants contract has been quantified by the Board, as shown in figure 3.8. The Board has accrued £1.3 million at 31 March 2005 to account for a combination of back-pay for elements of the contract not yet agreed, extra programmed activities above expectations and additional consultant fees.

#### GMS contract

Implementation was a key financial risk area for the Board, particularly in 2004-05 due to the large unknown element. The Board quantified the actual quality payments for 2004-05 in June 2005, requiring an accrual of £6.4 million at 31 March 2005. A £15 million cost pressure has been recognised in the 2005-06 financial plan. This relates in part to the continued increase in the level of quality payments payable to general practitioners on achievement of established targets.

#### Agenda for change ("Afc")

The Board currently employs over 27,000 staff, over 90% of whom are included within the remit of AfC. An accrual of £5.6 million, in addition to £0.3 million of implementation costs, is included in the 2004-05 financial statements to account for the implementation of AfC, backdated to 1 October 2004.

### 3. Corporate governance (continued)

#### *Financial control framework*

Formal agreement between headquarters and the divisions of additional funds is a lengthy process, often resulting in late confirmation of amounts available. In respect of the process of notification of the baseline RRL to divisions, formal letters were not issued to divisions until October 2004 and a number of assumptions were not confirmed until later in the year.

The Board supplements monthly finance reports with a full mid-year financial review covering the first six months of the financial year. This is an example of good practice allowing the Board the opportunity to identify and resolve significant issues in a timely manner.

Since April 2004, all divisions and headquarters use Cedar's e-financials integrated ledger system. However, a lack of integrated information technology and system support continues to result in an inability to integrate the systems. The Board plans to introduce a standard reporting template during 2005-06, based on the monthly Scottish Executive Health Department returns, and align the financial ledger codes from April 2006.

#### **Systems of internal control**

##### *Corporate governance framework*

Following a period of extensive consultation and consideration, the Board approved its new corporate governance structure on 23 March 2005; 2004-05 has therefore, been a year of transitional corporate governance arrangements. Progress towards a single system framework has been lengthy both operationally and in terms of the approval and communication of pan-Lothian documents and strategies.

There is evidence of single system working at a strategic level, particularly within Board headquarters and the structure of the executive management team. There is also evidence of plans to promote significant progress during 2005-06 following the second phase of restructuring from 1 April 2005, creating a single operating division and a primary care organisation supporting the introduction of five community health partnerships ("CHPs").

2004-05 was also a transitional year for staff in executive and management positions. A new structure was in effect from 1 April 2005 with a due process being effected to recruit people into that structure. Until that structure or any changes implemented, people continue in their existing roles. Appointments into the new structure have already commenced.

The Board has invested significant effort and resources in recent months to consider and establish a management framework for the new structure. This included significant input from the human resources department, in terms of redeployment protocols and ensuring fair and equal treatment of all staff involved. The delay in formal approval from the Scottish Executive for the creation of CHPs resulted in delays in finalising the structure.

##### *Risk management*

In respect of risk management, the executive management team approved the final draft of the risk management strategy on 16 March 2005, and the audit committee considered the strategy on 23 May 2005. The strategy has also now been approved by both the clinical governance committee and the Board.

We note that the Board recognises the time taken to introduce a pan-Lothian risk management strategy, however, it believed that the existing arrangements, based on the previous trust structure, provided adequate guidance in the interim period. There is a variation of practice in terms of risk management roles, responsibilities and reporting arrangements, which the Board has responded to with the formation of a pan-Lothian risk management steering group. Previously the three NHS trusts were individually accountable organisations, all of which successfully achieved level one accreditation under the clinical negligence and other risks indemnity scheme ("CNORIS"). At the time, the scheme required compliance with a number of established CNORIS standards, and did not focus on consistency or parity across NHS trusts.

### 3. Corporate governance (continued)

#### *Partnership working*

The Board demonstrates partnership working at all levels, including both internal and external partners and the majority of directors and other management staff consider these representatives to be a valued addition to these groups, rather than simply a 'token gesture' invitation. The Board's communication team has operated on a pan-Lothian basis since September 2004. The move to a single team and the introduction of a consistent approach has brought a number of benefits in terms of internal and external communication.

#### *Community health partnerships*

In respect of CHPs, the process for implementation commenced in June 2003 when the Board began a review of the existing local healthcare co-operatives ("LHCCs"). Despite the delay in the distribution of formal guidance, the Board followed the spirit of this timetable, resulting in the successful submission of the scheme of establishment by the deadline of 24 December 2004 required by the Scottish Executive Health Department. Timely preparation and submission to the Scottish Executive of the scheme of establishment demonstrated the Board's commitment to the development of CHPs and was the result of dedication and input of significant resources. Following a number of questions, the Scottish Executive formally gave consent to the Board, as one of six of the 15 NHS Boards, to go ahead on 1 April 2005.

The Board has established the CHP development implementation groups, and latterly the PCO implementation group, to manage the implementation process. The membership of both groups is all encompassing and the direct link between the Board, executive management team and the CHP implementation group is through one of the non-executive directors, who is a member of all three and who has chaired the CHP implementation group. The leadership and delegated authority of this director ensured that the group was acting in the interests of the Board throughout the process. However, the involvement of a non-executive director, albeit elected as the stakeholder member representing the former local healthcare co-operatives, in operational duties may be seen, externally, as beyond the role of a non-executive and as becoming involved in operational decisions.

From 1 April 2005, the Board delegated the necessary authority to the primary care partnership committee to oversee the implementation, development and ongoing operation of CHPs, including the work of the PCO and the primary care contractors organisation. The Board approved this structure in March 2005, subject to refinement in 2005-06. The five CHPs have prepared implementation plans to cover the implementation process. However, only the West Lothian CHP had submitted their plan to the executive management team and the Board for approval. In West Lothian arrangements are in place for enhanced joint working during a pilot over the next two years. As a result, the community health care partnership (CHCP) in West Lothian has made more progress in a number of areas. However, this may result in some inconsistency and inadequacy of operational governance arrangements at a pan-Lothian level for the Board to retain adequate control over the healthcare services and the related expenditure.

Our review also found that the Board has transferred all budgets previously managed by the eight local healthcare co-operatives to the five CHPs, which was done without a formal review of the ongoing accuracy and suitability of these budgets within the context of CHPs, albeit that budget processes followed have been in place since 1999 and have found to be sustainable over that period.

#### *Systems and controls*

During 2004-05 we reviewed the systems and controls over a number of financial and non-financial systems. The key findings of these are summarised below.

- *Payroll and staff expenses (18 April 2005)* – the majority of controls over payroll and staff expenses were found to be operating satisfactorily. However, we identified weaknesses relating to controls over recruitment authorisation, and reconciliations between the financial ledger, payroll and human resources systems and the process for removing leavers from the payroll system and inconsistencies relating to payroll and staff expenses procedures. Overpayments of £258,591 made to staff who have left the employment of the Board from 1 April 2004 to 31 January 2005 were identified during the review. Action was taken subsequent to this and over £200,000 recovered.

### 3. Corporate governance (continued)

- *High level financial controls (13 May 2005)* – a number of priority one recommendations were made including the need to introduce a consistent process to ensure that all invoices are captured and appropriately recorded in the Board's accounting records and the introduction of a policy requiring the independent authorisation of journal vouchers.

#### *Internal audit*

In completing our audit, we sought, where appropriate to rely on the work carried out by the Board's internal auditors. Our *revised strategic planning memorandum: 2004-05 annual audit plan*, issued on 11 January 2005, highlighted the areas on which we intended to place reliance. The relevance of internal audit reports and changes to the internal audit plan have been subject to continual review throughout our audit to maximise the reliance placed on their work.

The Board's internal auditors have concluded that "*processes reviewed did not contain fundamental control weaknesses.*"

#### *Primary care systems*

The Board is dependent on the work of NHS National Services Scotland ("NSS") (formerly known as the Common Services Agency) in relation to the processing of information and transactions relating to family health services ("FHS") and require to obtain evidence from third party sources to provide assurance over those transactions.

#### *Service auditor's report*

In 2004-05 the NSS' service auditor reported only the significant control weaknesses and not the status of each control as had been done in previous years. The service auditor has concluded that, overall, except for specific matters identified, the controls implemented by management were suitably designed to achieve the specified control objectives, and these controls were operating with sufficient effectiveness to provide reasonable, but not absolute, assurance that the related control objectives were achieved during the period of review.

#### *NSS external auditors' report*

The external auditors of NSS issued a letter summarising the relevant information from their review. The external auditors concluded that NHSS continues to perform its role in managing payments to NHS practitioners.

#### *Family health services*

In relation to the regularity of FHS expenditure and income, we considered the:

- NSS' service auditor and external auditor reports;
- Board's internal auditors' review of payment verification arrangements (where appropriate);
- Board's processes for evaluating and reporting the results arising from payment verification; and
- substantive information received by the Board in respect of the payment verification work completed.

In the case of the various income and payment streams for general medical, dental, ophthalmic and pharmaceutical services, the regularity objective includes, for example, consideration of how only genuine prescriptions are charged to the NHS and that free prescriptions are only given to those entitled to them. In terms of FHS payments, a key consideration is that the prescription was dispensed to a valid patient and/or for a valid reason. FHS income and payments are processed on behalf of the Board by NSS and therefore issues of systems of control and the regularity of transactions are outwith the immediate, direct control of the Board. Transactions are completed on the basis of self-certification by the patient. Consideration in terms of payment verification therefore needs to be given, not only to the question of practice visits in relation to FHS payments, but also in relation to related charges to patients, e.g. prescription charges.



### 3. Corporate governance (continued)

The control environment with respect to FHS expenditure is improving, with a comprehensive framework of payment verification. A new partnership agreement has been established by NHS Scotland Counter Fraud Services ("CFS") and health boards, which sets out their roles in respect of identifying and investigating alleged fraud and corruption. An outline of the revised procedures contained within the agreement was provided to the service by Health Department Letter (2005)5.

#### Patient exemption checking

In accordance with the draft protocol on patient fraud the CFS of NSS provided an annual estimate of the level of fraud/error in respect of FHS income for the primary care divisions of the Board. Consistent with prior years, management has extrapolated on a stratified basis the level of fraud/error for the Board based on the sample tested by CFS. Using this approach across the population provided a level of fraud/error for the Board for 2004-05 is £1.8 million (2003-04: £1.7) and, in our opinion, is not significant enough to indicate there is a material level of irregularity in respect of FHS income. We have therefore been able to issue an unqualified opinion in respect of the regularity of FHS income streams.

#### Payment verification process at the Board

As a result of the new GMS contract, the medical payment verification process was changed with the introduction of a new protocol. The payment verification arrangements for the other streams – dental, ophthalmic and pharmacy – remain unchanged. The payment verification process involves receipt of PSD generated reports, meetings to review reports, decisions of follow up actions and reporting of summary results to the divisional management team at LPCD and audit committee at WLHD.

In line with guidance, the Board's officers meet with representatives of PSD on a quarterly basis to discuss payment verification issues within each of the contractor groups. During 2004-05 we identified that management had not submitted pan-Lothian reports on payment verification and patient exemption checking to the Board's audit committee. As a result of the audit process a summary report was issued to the audit committee on 25 July 2005.

#### National IT services

NSS manages a range of information technology dependent services used throughout NHS Scotland which are central to the activities of NHS Scotland organisations. As external auditors of NSS, Audit Scotland considers the arrangements over these IT systems. During 2004-05, Audit Scotland concluded that NHSS continues to perform its role in managing some core aspects of the NHS Scotland IT infrastructure.

#### 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 statement provides details of the processes and controls highlighted by the Board in its annual statement at 31 March where processes and strategies will be developed in 2005-06.

#### NHS Quality Improvement Scotland ("QIS")

QIS issued their *NHS Lothian local interim report* on clinical governance and risk management arrangements in June 2005. Figure 3.9 is an extract from this report, highlighting their findings on the Board's strengths and challenges. This report was issued to management in draft form and subsequently approved for final issue.

The key findings in relation to QIS' work on the Board's governance and risk management arrangements, particularly in relation to single system working, are consistent with our planning approach and findings reported to management in respect of 2004-05.



### 3. Corporate governance (continued)

**Figure 3.9: the Board's strengths and challenges**

#### **Strengths**

- NHS Lothian documents progress against the PAF using a traffic-light system;
- the finance and performance review committee focuses on service delivery; and
- the clinical guidelines steering group co-ordinates implementation of national advice.

#### **Challenges**

- maintaining clear documentary evidence of decision-making processes and subsequent actions, monitoring and feedback;
- developing draft strategies into comprehensive and substantive documents; and
- clearly define the roles and remits for implementing the clinical governance and risk management strategies and to integrate these with single-system working.

*Source: Quality Improvement Scotland (June 2005)*

Our report, *systems and controls: fraud and irregularity*, issued on 27 April 2005, highlighted that, while the Board has made progress in updating strategies and policies at a pan-Lothian level, documents were either approved towards the end of the 2004-05 financial year, or remain in draft form awaiting approval early in 2005-06, including the NHS Lothian freedom of speech policy, code of conduct for staff, revised partnership agreement. An updated scheme of delegation, standing orders and standing financial instructions were approved on 23 March 2005, however, financial operating procedures still require to be updated to reflect recent organisational and system changes.

#### **Fraud and irregularity, standards of conduct and prevention and detection of fraud and irregularity**

Our work over the five-year period of our appointment was outlined in our strategic (long-term) planning memorandum. During 2004-05 we completed a review of the high level arrangements in respect of the prevention and detection of 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.

## 4. Financial statements

### Audit opinion

On 27 July 2005 we issued our 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 number of delays were encountered during the audit in relation to the provision of draft financial statements. We received a completed draft of presentation financial statements for the Board on 22 July 2005, prior to the audit committee on 25 July 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. In future years we would encourage management at Board headquarters to cross reference working papers to the 'prepared by client' list issued in advance of the audit. This should be completed following a detailed quality check of all working papers to identify and resolve arithmetical and formulae errors prior to presentation for audit.

#### Response to audit queries

The majority of audit queries were dealt with in a timely manner with staff at all levels responsive to the audit process.

*Source: KPMG LLP (July 2005)*

The Scottish Executive Health Department is currently considering changing the date by which NHS financial statements should be submitted to 30 June. This is a key issue for consideration by the Board prior to the audit of the 2005-06 financial statements.

### Financial statement adjustments and confirmations

In figure 4.2 we draw attention to adjustments to the financial statements made by management during the course of the audit.

**Figure 4.2: financial statement adjustments**

	Operating cost statement £'000	Balance sheet £'000
Provision for clinical and medical negligence claims	(5,500)	(5,500)
Debtor for reimbursement of clinical and medical negligence claims	3,548	3,548
Divisional creditors	998	998
Accruals	(813)	(813)
Provisions for enhanced pensions and injury benefits	508	509
<b>Net adjustment</b>	<b>(1,259)</b>	<b>(1,259)</b>

*Source: KPMG LLP (July 2005)*

#### Confirmations and representations

We confirm that as of 25 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 the letter issued to the audit committee on 25 July 2005.

In accordance with auditing standards, we will provide separately text for the representations to be obtained from directors on material issues prior to signing our opinion. Management have not adjusted a number of audit differences 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 audit differences is attached to the management representation letter.

## 4. Financial statements (continued)

### 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
<p>Tangible fixed assets:</p> <ul style="list-style-type: none"> <li>• revaluation; and</li> <li>• capital receipt.</li> </ul>	<p><i>Revaluation</i></p> <p>The revaluation of the NHSScotland estate as at 31 March 2004 resulted in a significant overall increase in value for both land and buildings across NHS Lothian. In our 2003-04 <i>annual audit report</i>, issued on 28 July 2004, we noted that while the valuations were reflected in the 2003-04 financial statements Board management indicated that there were aspects of the valuation data which required to be considered further during the early part of 2004-05. At the time, the Board acknowledged that this may result in adjustments to the carrying values of certain assets in the financial statements for the year ended 31 March 2005.</p> <p>A number of meetings were held with management during 2004-05 to establish the audit approach of the revaluation processes and the extent of third party advice required. Following on from the valuation of land and buildings incorporated in the financial statements as at 31 March 2004, the Board initiated detailed consideration of the methodology underpinning the valuation approach, including discussions with the Scottish Executive. While matters raised by the Board, and other NHS boards resulted in some adjustments to the way in which valuations were executed as at 31 March 2005, the Board determined to proceed with a valuation of land computed on a depreciated replacement cost basis by reference to extended notional locality rather than prevailing use. The impact of this change, together with changes in the approach to the valuation of land and buildings on an existing use basis has reduced the carrying values of the Board's land at 31 March 2005 by £109 million.</p> <p>On 22 July 2005 the Scottish Executive notified the Board that capital charges for 2004-05 should be calculated by reference to balances as at 1 April 2004, rather than 31 March 2005, these balances to reflect the appropriate impact of the valuation changes effected as at 31 March 2005. The impact of this was to reduce capital charges for the year by £3.9 million.</p> <p>The revaluation at 31 March 2004 resulted in £2.3 million being charged to the operating cost statement due to a diminution in value of a building at the Western General Hospital. This was because it was believed at the time that the diminution was permanent. In the course of the revaluations undertaken as at 31 March 2005, external advice is that the building value has risen and accordingly the entry in 2003-04 has been reversed.</p> <p><i>Capital receipt</i></p> <p>We have examined the capital receipt disclosed in relation to the disposal of the old Royal Infirmary of Edinburgh. This identified an absence of joint working between finance and estates staff, resulting in a lack of clarity in the justification for the accounting treatment adopted. We were able to confirm that income in respect of this capital receipt is not materially misstated.</p>

## 4. Financial statements (continued)

Issue	Commentary
<p>Tangible fixed assets:</p> <ul style="list-style-type: none"> <li>leases.</li> </ul>	<p>As part of the 2004-05 audit we considered the Board's accounting treatment of a new total bed management service. The nature and quality of evidence provided was sufficient in view of the relative materiality of the value of the contract. We concluded that we would not be minded to challenge the Board's accounting treatment, but, noted that in certain respects it may be considered aggressive under the requirements of financial reporting standard 5, <i>reporting the substance of transactions</i>.</p>
<p>Private finance initiative:</p> <ul style="list-style-type: none"> <li>IT lease; and</li> <li>recognition of liabilities.</li> </ul>	<p><i>IT lease</i></p> <p>During 2004-05 we considered the proposed accounting treatment for the Board's contract with a private finance initiative contractor for the provision of a range of IM&amp;T services. On the basis of the information provided to us, we concluded that we were not minded to challenge the Board's view that an off balance sheet accounting treatment is appropriate to this transaction.</p> <p><i>Recognition of liabilities</i></p> <p>During 2004-05 we considered the basis of recognising expenditure in relation to ancillary services provided by the Board's private finance initiative contractor at the Royal Infirmary of Edinburgh. At 31 March 2005, the Board did not recognise the full amount outstanding. The remaining balance has been noted on our schedule of unadjusted audit differences to recognise the Board's total liability at 31 March 2005.</p>
Provisions for injury benefits and enhanced pensions	<p>The Board disclosed a total provision for unfunded pension liabilities and injury benefits of £2.4 million at 31 March 2005. There is a requirement to re-perform actuarial calculations on an annual basis. At 31 March 2005 LUHD and WLHD management used a discount rate of 2.8%. During the audit, we highlighted that the discount factor at 31 March 2005 was 3.5%, and that the decrease to 2.8% does not take effect until 2005-06. Management re-calculated the provision, quantifying the errors of £503,000, which was subsequently adjusted in the financial statements.</p> <p>The Board has previously agreed to allocate additional funding to divisions to cover the cost of provisions required, resulting in debtors at divisional level and a corresponding creditor in the Board headquarters' accounting records. We identified a discrepancy of £998,000 between LUHD's debtor and the corresponding creditor at Board headquarters. The reduction in the Board's creditors was also adjusted by management in the financial statements.</p>
Bad debt provision	<p>Prior to restructuring on 1 April, the former NHS Lothian trusts did not apply a consistent policy in relation to the calculation of their provisions for bad debts. The Board recognised the need for consistency at a pan-Lothian level and made the decision to provide for all external debts outstanding for greater than 90 days. Given the increase in credit control, highlighted in our report <i>high level financial controls</i>, issued on 13 May 2005, there is a potential for some overstatement of the provision for bad debts. Management has considered our view but are of the opinion that the provision continues to be relevant until the Board has gained assurance over the existence and operation of adequate credit control procedures.</p>

## 4. Financial statements (continued)

Issue	Commentary
Clinical / medical negligence	<p>The Board has provided £27 million for future liabilities in relation to the payment of clinical and medical negligence claims. The Scottish Executive Health Department issued guidance on 9 October 2002 highlighting the recommended practice for calculating debtors for the reimbursement of clinical and medical negligence claims. The Board has complied with this circular in its calculation of provisions and contingent liabilities. This circular provides three thresholds above which the Board is entitled to claim reimbursement for their provisions. The threshold used in each individual calculation is based on the level of the claim and the estimated future timing of settlement. The use of threshold level three allows boards to calculate their maximum liability, and therefore the related debtor, in any one year. Calculation of this liability is based on information available on estimated settlement dates available at 31 March each year. Prior to 1 April 2004, the calculation of reimbursement against threshold level 3 was not performed on a consistent basis, and LUHD was the only division (and former trust) to adopt a policy of calculating a debtor based on settlement dates.</p> <p>The Board recognised the requirement for consistency at a pan-Lothian level from 1 April 2004, resulting in the decision to maintain the approach previously adopted by LPCD, WLHD and Board headquarters. This decision was based on the Board's opinion that the information available on estimated settlement dates is not sufficiently robust as a base for the calculation of a material debtor. This change resulted in a £1.6 million reduction in the debtor previously recognised by LUHD.</p>
VAT on transactions with universities	<p>A recent VAT tribunal decision impacts the VAT treatment of university employees working within NHS boards (and board employees working within universities) and the arrangements that exist between academics, universities and NHS boards. In particular whether the supply of these employees is taxable as a supply of staff or exempt as a supply of medical services by qualified consultants. HM Revenue and Customs indicated their view that the supply by the universities was exempt.</p> <p>In order to gauge the impact of this tribunal case for the Board, it will be necessary to establish the nature of cross supplies of staff, establish the formality of such arrangements and examine any contracts between the Board and its university partners. Additionally, where there are supplies from the Board, it should consider the beneficial impact on future VAT recovery and the scope to make a retrospective claim. In addition, the Board should consider whether it will be able to reclaim any VAT chargeable by universities. In relation to supplies from universities which have already taken place, it should be borne in mind that there may be limited scope for the Board to reclaim any VAT, due to the annual deadlines for recovering VAT under the contracted out service rules. The uncertainty surrounding the potential impact of these transactions has been disclosed as a contingent liability.</p>

## 5. Performance management

As part of our 2004-05 audit, we have considered a number of risk areas facing the Board. This review was based on the Audit Scotland publication *Priorities and Risk Framework: A National Planning Tool for 2004/05 NHSScotland Audits*. Key findings arising from this work have been incorporated within this report, but we have not been repeated the action plan.

### Performance management arrangements

The Board bases performance management and assessment on the performance assessment framework ("PAF"), which is assessed by the Scottish Executive Health Department as part of the annual accountability review. The local health plan is the forum for disseminating information and targets from the local performance management framework. The local targets highlighted in the 2004-05 local health plan confirm the Board's intention to meet the national targets and, in some cases, bring forward the Scottish Executive Health Department's deadlines.

#### *Performance monitoring*

The finance and performance review committee oversees the monitoring of performance, although this committee is not required under statutory guidance. The continued commitment to performance management demonstrated by this committee has received positive comments in the past as part of the annual accountability review process.

The structure and format of the reports prepared for the finance and performance review committee provide information about the Board's performance, including details of agreed action plans to support continued performance improvement. Use of a traffic light system provides an indication of performance change, particularly when comparing previous and current periods. The inclusion of the responsible officers, at an appropriately strategic level within the Board, promotes ownership and accountability for performance management and improvement.

Director responsibility rests with the director of finance for the completion of the PAF, with other staff responsible for co-ordinating the information collected and reported at divisional level.

There is a need for the Board to ensure that objectives and performance measures are cascaded from a strategic level to individual members of staff across the organisation. This will assist the Board in holding individuals to account for performance. We also identified inconsistencies in the reporting processes at divisional level, presenting a risk that some areas of weakness are not identified in a timely manner. This may have a detrimental impact on the options and timescale available to improve performance.

### Service sustainability

#### *Waiting times*

In respect of waiting times, the number of people waiting more than six months for inpatient treatment decreased by over 70% during 2004-05. The Board's outturn of 339 represents a 22% improvement against the target of 433. The Board has been successful in meeting the locally agreed target, and is making significant progress towards achieving the national target by 31 December 2005. The Board's target for 2004-05 was to reduce the number of outpatients waiting for treatment longer than six months to 6,551 patients. At 31 March 2005, 5,153 patients were waiting more than six months, a 21% improvement over the target set. The Scottish Executive national waiting time unit allocated £2.7 million during 2004-05, in addition to the £12 million allocated internally by the Board.

#### *Delayed discharge*

The Board and local authorities have jointly agreed a delayed discharge action plan. The January 2005 quarterly actual results were in excess of the quarterly targets, primarily due to the increase in patients during the winter season. However, at April 2005 the Board reported that it exceeded its annual target of 257 by 27 patients, with an outturn of 230 delayed discharges.

The Board received a specific allocation of £3.986 million following agreement of the action plan with the Scottish Executive. In addition, the Board internally allocated £6 million from NHS modernisation funds and NHS strategy funding and £5.5 million was allocated by the four local authorities.



## 5. Performance management (continued)

### *Regional planning*

The Board's director of planning holds the position of regional planning director of the South East and Tayside planning group ("SEAT"), of which the Board's chief executive has been the chair since January 2003. The executive directors from the five NHS boards represented on SEAT also meet in single discipline groups on a regular basis.

### *Business continuity*

A variety of divisional business continuity plans exist, primarily based on the structure of the former trusts, but these are inconsistent and, overall, are inadequate to protect the interests of the Board and its patients. The absence of appropriate plans presents a risk of unsustainable patient services with a detrimental impact on patient care should an incident occur.

### **Workforce management**

#### *Pan-Lothian arrangements*

Prior to the re-structuring on 1 April 2004 there were no formal centralised workforce management arrangements. During 2004-05 the Board developed a pan-Lothian workforce planning team and appointed staff to two senior posts. Similarly, there was no formal and consistent workforce reporting prior to 2004-05, primarily due to the lack of a common or unified workforce information database. Work has been ongoing throughout 2004-05 in the development of a database and is establishing the source of the information and implementing formal mechanisms for reporting workforce management statistics.

#### *Human resource strategies and life-long learning*

The Board is currently in the process of developing key human resource strategies, including a recruitment strategy, flexible working policies and a redeployment policy. During 2004-05, there has also been progress in the development of local i.e. Board level, and regional workforce planning structures.

In support of the Board's lifelong learning aims there are a number of local initiatives, including accreditation by the Institute of Leadership and Management, the introduction of practice education facilitators to support nursing staff, the continuation of the learning academy with learning centres now accessible to all staff.

### **Joint future**

Our report *performance audit - joint future progress evaluation (December 2004)* was issued on 16 May 2005. We summarise the key issues highlighted in this report.

The timescale established for full implementation of joint management arrangements was challenging, especially when combined with the forthcoming introduction of CHPs, for which the schemes of establishment were submitted to the Scottish Executive on 24 December 2004.

While progress had been made, none of the partnerships had successfully implemented robust management arrangements. Informal consideration of known risks does take place, but, by virtue of its informality, partnerships cannot gain any assurance that all risks are adequately identified and monitored, and subsequently no assurance can be gained that controls, or systems of control, are established to mitigate identified risks. The implementation of a formal scheme of delegation will strengthen partnership systems of control and accountability arrangements. A number of areas of good practice were identified during our review of resource transfer, the predecessor to joint financial resources. However, the requirement for full implementation for joint financial resourcing was tight.

The Board's contribution to the joint strategic baseline was £180 million during 2003-04. While this is clearly significant, the processes established at the time of our review are not considered sufficiently robust to either adequately manage these funds, nor identify whether the resources identified for joint working are sufficient to deliver the services and improve outcomes for people using services.

## 5. Performance management (continued)

### Information management

#### *eHealth strategy*

At the time of our review, the Board was considering its local eHealth strategy for 2005-08. Formal approval had been deferred to take into account the impact of the national eHealth strategy changes and the Kerr report. We understand that for the first time in Scotland, clinicians have provided significant input in drafting the local eHealth strategy. Our review also identified that the Board should review the level of recurring revenue resources to support the level of IM&T capital investment. This has been identified as a significant cost pressure and a potential barrier to effective implementation of the strategy.

#### *IM&T support*

In respect of IM&T support, management primarily focuses resources on providing on-going support for critical systems, however, remaining IM&T services also require reviewed focus. There are no agreed service level agreements with internal users of its services, or agreed service performance and quality targets. Once finalised, the draft service level agreement with GPs refers to agreed working practices and available services, which, if utilised, should reduce the risk of security and irrecoverability of data.

#### *IT security*

Due to the historic, divisional approach to IT security, a variety of security solutions are used across the Board, with differing levels of protection and maintenance at a higher combined cost. There are also a number of policies relating to asset management. Standard procedures require to be implemented for all tagged assets and software licences, ensuring that each item has a complete and separate entry on the register.

#### *IM&T organisational structure*

The current organisational structure of IM&T is still largely aligned to the structure of the former trusts. A revised structure has been proposed which includes separate roles for an associate director of clinical information and an associate director of eHealth, however, this has not yet been approved. Similarly, reporting lines from the divisional security officers to the security manager at headquarters continues on an informal basis.

#### *Business continuity*

In respect of business continuity, management has addressed some aspects of plan preparation, but some issues remain outstanding, including inconsistencies in documentation format and content; a lack of integration between the IT disaster recovery and business continuity plans; and the lack of a comprehensive contingency plan.

#### *Data Protection Act and Freedom of Information (Scotland) Act*

These acts have had, and will continue to have, a significant impact on the Board in respect of record retention and ensuring policies and procedures are fully compliant. There is currently no pan-Lothian data retention policy. Prior to progressing this matter, the Board is awaiting updated official guidance from the Scottish Executive in respect of a data retention policy.

### Staff governance

In 2004-05 there was one centrally directed study on staff governance. In accordance with our plan we reported the results of our work to management on 30 March 2005.

The Board's local partnership forum and staff governance committee formally approved the self-assessment audit tool output and resulting action plan.

Although the Board met the 2004-05 staff governance deadline, considerable effort was required to meet the target due to the internal process only being completed in March 2005. We also noted that for 2005-06 a revised timetable needs to be developed allowing work to be completed earlier in the financial year.

## 5. Performance management (continued)

On the basis of the evidence provided, we concluded that the self-assessment process undertaken appeared to have been robust and review of the evidence provided by the Board supported the responses within the self-assessment audit tool. Review of the action plan suggested that while it appeared credible it was ambitious given the change and organisational development agenda facing the Board.

Consideration of the progress made by the Board in implementing previously agreed staff governance recommendations for the period 2003-04 found that management had taken action against five (71%) of the seven recommendations that were previously agreed. Discussions with management identified that progress against many of the recommendations was incomplete due to management's focus on restructuring, in line with the move towards single system working. We noted that, while that was understandably a key focus, it was important that management ensures that sufficient progress is made in delivering previously agreed staff governance actions to meet the requirement of sufficient progress year on year.

# 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><b>Grade one (significant) observations are those relating to business issues, high level or other important internal controls.</b> 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><b>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.</b> The weakness is not necessarily great, but the risk of error would be significantly reduced if it were rectified.</p>		<p><b>Grade three (minor) observations are those recommendations to improve the efficiency and effectiveness of controls and recommendations which would assist us as auditors.</b> 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>Individual reports on payment verification and patient exemption were submitted to the LPCD and WLHD divisional management teams during 2004-05 and separate annual reports were considered by divisional audit committees following the 31 March 2005 year end.</p> <p>However, we identified that management had not submitted pan-Lothian reports on payment verification and patient exemption checking to the Board's audit committee.</p> <p>There is a risk that the Board and the audit committee do not have access to appropriate consolidated information. Individual reporting also presents the risk that the Board does not identify and resolve pan-Lothian issues in a timely manner.</p>	<p>Management should prepare formal pan-Lothian payment verification and patient exemption reports for the PCO management team on a quarterly basis with an annual summary presented to the audit committee.</p> <p>The Board would benefit from the timely availability of appropriate and consistent information on which to base key decisions for the Board as a whole. It should also provide the Board with a mechanism for identifying and initiating appropriate action in relation to common issues.</p>	<p>The issue is primarily one of operational control, which is why it was reported through the divisional audit committees. The minutes of which are brought to the NHS Lothian audit committee.</p> <p>It is, however, accepted that an annual summary report will be brought to the NHS Lothian audit committee to ensure that the strategic dimension is reflected.</p>	<p>Associate director of finance – primary care organisation</p> <p>31 March 2006</p>

## Appendix 1 – Action plan (continued)

No	Grade	Observation	Recommendation	Management response	Responsible officer / completion date
2	1	<p>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 for inclusion with the financial statements. Significant restructuring on 1 April 2004 was a key factor in the transitional governance arrangements in place during 2004-05, although the Board has made progress in finalising the structure during the last quarter of the financial year.</p> <p>The 2004-05 statement on internal control highlighted a number of areas where governance arrangements had not been in place for the twelve months commencing 1 April 2004, or where further work is required in 2005-06 to complete formalisation of arrangements and Board strategies.</p> <p>There is a risk that the Board is not in a position to sign a fully compliant statement of internal control at 31 March 2006, i.e. that relevant arrangements and processes have not been in place for the year from 1 April 2005.</p>	<p>Management should ensure that a comprehensive action plan is prepared, including named responsible officers and implementation timescales, against which implementation progress can be monitored during 2005-06.</p> <p>This should benefit the Board in demonstrating the emphasis placed on transparent governance arrangements and in ensuring that key processes, policies and procedures are updated on a pan-Lothian basis and implemented in a timely manner.</p>	<p>Agreed. Many issues are either resolved or at an advanced stage. An action plan will be produced.</p>	<p>Associate director of finance</p> <p>31 August 2005</p>
3	2	<p>Despite a number of meetings with management during the year the working papers provided did not include key documents requested. In addition, the analysis and calculations did not meet the quality standards expected. Due to delays in the finalisation and receipt of valuation reports from third parties and staff holidays, and KPMG staff illness we were unable to audit the revaluation adjustments within the agreed timescale.</p> <p>There is a risk of significant misstatement of the financial statements and non compliance with accounting standards and Scottish Executive guidance.</p>	<p>Management should consider the impact on the finance department's resources in future years to ensure that sufficient and appropriate resources are provided in respect of key risk areas.</p> <p>The Board should benefit from the assurance that significant annual adjustments to the financial statements, based on the annual rolling programme, are processed consistently, accurately and in a timely manner.</p>	<p>The key adjustment required in respect of asset revaluation required extensive discussions with the Scottish Executive before it was actioned. Further discussions with the Scottish Executive only resulted in final clarification on 19 July 2005. An internal debrief, together with one with KPMG will assist in the effective delivery of the 2005-06 plan.</p>	<p>Director of finance</p> <p>30 September 2005</p>

## Appendix 1 – Action plan (continued)

No	Grade	Observation	Recommendation	Management response	Responsible officer / completion date
4	2	We have examined the capital receipt disclosed in relation to the disposal of the old Royal Infirmary of Edinburgh. This identified an absence of joint working between finance and estates staff, resulting in a lack of clarity in the justification for the accounting treatment adopted. We were able to confirm that income in respect of this capital receipt is not materially misstated.	<p>The Board should consider the current processes and links between finance and operational departments, including support facilities such as estates, to emphasise the importance of consideration of the timing of correspondence and key decisions, in addition to the actual receipt and payment of cash.</p> <p>Management would benefit from the assurance that the accounting records reflect the substance of operational activities in line with Scottish Executive guidance and accounting standards. The availability of timely and accurate financial information should also benefit management in their financial planning and budget management processes.</p>	<p>Scottish Executive guidance has been requested.</p> <p>Internal linkage will be reviewed and strengthened as required.</p>	<p>Associate director of finance</p> <p>Immediate</p>
5	2	<p>During 2004-05 the Board commenced a number of key projects in the move towards single system working. We identified a number of areas where finance initiatives are now co-ordinated at a pan-Lothian level. However, we also identified areas where a co-ordinated approach on a pan-Lothian basis would be beneficial, including:</p> <ul style="list-style-type: none"> <li>provisions for clinical and medical negligence claims, and the related reimbursement debtors;</li> <li>provisions for injury benefits and enhanced pensions; and</li> <li>road traffic accident income.</li> </ul> <p>There is a risk of inconsistent accounting treatment at a pan-Lothian level. There is also the risk of unnecessarily complex and high value adjustments required to account for inter-divisional balances and funding agreements between divisions and Board headquarters.</p>	<p>Management should consider allocating responsibility for specific tasks and accounting areas at a pan-Lothian level.</p> <p>Management would benefit from assurance over the consistency, at a pan-Lothian level and on a year by year basis, of accounting treatment in key areas. It would also represent a move towards single system working and shared services.</p>	<p>Agreed.</p> <p>This is part of the move towards a single finance structure across NHS Lothian.</p>	<p>Associate director of finance – strategy</p> <p>30 September 2005</p>



## Appendix 1 – Action plan (continued)

No	Grade	Observation	Recommendation	Management response	Responsible officer / completion date
6	2	<p>A recent VAT tribunal decision impacts the VAT treatment of university employees working within NHS boards (and board employees working within universities) and the arrangements that exist between academics, universities and the NHS boards. In particular whether the supply of these employees is taxable as a supply of staff or exempt as a supply of medical services by qualified consultants. HM Revenue and Customs ("HMRC") indicated their view that the supply by the universities was exempt.</p> <p>In relation to supplies from universities which have already taken place, it should be borne in mind that there may be limited scope for the Board to reclaim any VAT, due to the annual deadlines for recovering VAT under the contracted out service rules.</p> <p>We brought this issue to the attention of management during the audit and, as a result, the Board has disclosed its potential exposure to additional expenditure as a contingent liability.</p>	<p>The Board should liaise closely with its university partners, VAT advisors and, where necessary, HMRC to ensure:</p> <ul style="list-style-type: none"> <li>• appropriate treatment of VAT from 2005-06 onwards; and</li> <li>• that all issues relating to previous accounting periods are resolved and that any liabilities due are settled in a timely manner.</li> </ul>	Discussions took place with our VAT advisors on being informed of this issue.	<p>Associate director of finance</p> <p>31 August 2005</p>

## Appendix 2 – Confirmation of independence

### **To: Lothian NHS 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 Lothian NHS Board 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 / audit committee.

### **Confirmation of audit independence**

We confirm that as of 25 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 audit committee of Lothian NHS Board and should not be used for any other purposes.

Yours faithfully

**KPMG LLP**