

INFRASTRUCTURE, GOVERNMENT AND HEALTHCARE

Lothian NHS Board

Annual audit report for 2005-06 to members of Lothian NHS Board and the Auditor General for Scotland

30 June 2006

AUDIT

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Notice: About this report

This report has been prepared in accordance with the responsibilities set out within Audit Scotland's *Code of Audit Practice* ('the Code') and *Statement of Responsibilities of Auditors and Audited Bodies*.

This report is for the benefit of only Lothian NHS Board and is made available to Audit Scotland (together the beneficiaries), and has been released to the beneficiaries on the basis that wider disclosure is permitted for information purposes but that we have not taken account of the requirements or circumstances of anyone other than the beneficiaries.

Nothing in this report constitutes a valuation or legal advice.

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Executive summary

Financial position

While the Board met all three of its financial targets, this represented a significant challenge. The financial outturn for 2005-06 included the planned use of £25.6 million non-recurring funding, reflecting a non-recurring increase to the revenue resource limit of £13.6 million, consisting of the £19.6 million carry forward from 2004-05 less £6 million repayment of brokerage. On 21 June 2006 the Board received an additional revenue resource allocation of £5.7 million to reflect the impact of changes in accounting treatment of certain fixed assets. This is repayable at a future date from asset sales, giving a balance of £19.7 million brokerage outstanding.

While the Board is reporting achievement of its CRES target of £24 million, £9.5 million (39%) is on a non-recurring basis and includes support of £4 million from asset sales in earlier years.

The Board's 2006-07 financial plan is projecting a breakeven position, with a number of high risk factors identified. Any arising financial pressures will have to be managed through an increase in the 2006-07 cash releasing efficiency savings target. In our view, achievement of a balanced financial position in 2006-07 will require tight management control and staff engagement at all levels of the organisation. The underlying assumptions on which financial balance is predicated will also present significant challenges for management. As such, there remains a substantial risk that the outturn projected in the financial plan will not be achieved.

The Board's total savings target for 2006-07 is £31.1 million (including a cash releasing efficiency savings target of £24.7 million), which in our view is likely to be extremely demanding for management. We note that at the time of finalising this report, just over half of the savings projects had still to be identified.

Corporate governance

Management has made significant progress in actioning key governance recommendations reported in 2004-05, with the approval of its revised corporate governance structure in March 2005. On 1 April 2005 the Board implemented the second phase of its restructuring, creating the operating division, the primary care organisation, four community health partnerships and one community healthcare partnership. The implementation of robust and consistent risk management arrangements remains a significant element of the system of internal control requiring action.

The Board continues to demonstrate partnership working at all levels, including in respect of both internal and external partners.

Reflecting the complexity of the organisation, progress towards a single-system framework, including aspects of finance structures, has been lengthy.

Our systems and controls work found important areas where basic controls were not operating as intended. Despite being reported by us previously as significant issues, weaknesses relating to access to the financial ledgers remained. We also found a number of other problems stemming, in our view, from the failure of management to implement appropriately recommendations agreed in previous years to address limitations in the operation of systems.

The Board's internal auditors have noted that the proportion of 'satisfactory' ratings applied during 2005-06 has declined significantly, compared with 2004-05. In part, management believe this to be as a consequence of a greater focus on higher risk areas identified through the risk management process.

Executive summary (continued)

Financial statements

On 30 June 2006 we issued an audit report expressing an unqualified opinion on the financial statements of the Board for the year ended 31 March 2006 and on the regularity of the financial transactions reflected in those financial statements. The change in the reporting deadline to 30 June 2006 presented particular challenges for management in view of the maintenance of divisional financial recording and reporting arrangements.

During the 2005-06 audit a number of technical accounting issues arose. Some of these were in respect of management's accounting for capital transactions. In the majority of cases the issues were resolved, or with audit differences noted for discussion with management and reporting to the audit committee.

Performance management

2005-06 priorities and risks framework

Management has made progress in addressing recommendations reported as part of our 2004-05 audit. But we also found that there are a number of important recommendations remained outstanding, including in relation to business continuity arrangements.

Our review of management's arrangements over regional planning identified some areas of good practice. In respect of the Board's efficient government arrangements we made a number of recommendations for improvement, but none of these recommendations were considered by us to be significant. Specifically, we found that management required to ensure policies and procedures under development or review were finalised and approved in a timely manner. In addition, action requires to be implemented to improve the accuracy and availability of measurement data.

Best value

Our baseline review of the Board's arrangements to secure best value and continuous improvement identified that the Board was 'well developed' in seven of the 10 areas under review and 'under development' in the remaining three areas.

Performance audit

During 2005-06 Audit Scotland published a number of reports from national studies. The Board's audit committee routinely considers these, along with papers setting out the implications for NHS Lothian from the findings.

Audit Scotland did not determine any centrally directed studies during 2005-06 for completion by us.

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Introduction

Audit framework

2005-06 was the final 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. While a requirement of Audit Scotland's *Code of Audit Practice*, this report, having been discussed in draft with the audit committee, also discharges our obligations under International Auditing Standard 260: *Communication of audit matters to those charged with governance*.

The framework under which we operate under appointment by Audit Scotland was outlined in the audit plan for the year discussed with the Board's audit committee.

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.

Priorities and risks

In September 2005, Audit Scotland published the *Priorities and Risks Framework: A National Planning Tool for 2005/06 NHSScotland Audits* ("PRF") setting out nine areas for consideration during the audit. We built on and updated our understanding of the Board's processes and management arrangements in these areas in focusing our audit effort. In addition, our own planning process identified a number of other areas for specific attention:

- achievement of financial targets;
- accuracy and timeliness of information received from NHS National Services Scotland in relation to family health services income and expenditure;
- accuracy of adjustments relating to the 2004-05 estates revaluation processed in the financial ledger; and
- compliance with legislation and financial regulations.

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 2005-06 we issued two reports accompanied by an action plan, including management responses and dates for implementation of agreed recommendations. This report summarises the main points arising from that work, but we have not repeated those 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 continued to bring us into 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. It is our intention to minimise the disruption to the Board from a change in auditor through briefing and liaison on unresolved issues with the incoming auditor's staff.

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Financial position

Financial targets

The Scottish Executive Health Department sets financial targets on an annual basis. The Board met all three of its financial targets in 2005-06.

In July 2005 we reported¹ that the Board's five-year financial plan forecast a break-even position for the year ending 31 March 2006. During 2005-06 management consistently reported their expectation of break-even at 31 March 2006 to the board and finance and performance review committee and to the Scottish Executive through the submission of monthly monitoring returns.

The outturn position for 2005-06 was reported to the finance and performance review committee as, subject to audit, all targets having been met. Appendix 1 summarises the movements in the reported financial position during the Board's completion processes and the subsequent audit, including:

- the operating division's financial controller prepared a reconciliation of balances due to one of the Board's primary pharmaceutical suppliers and identified an under accrual of £1 million, which was subsequently adjusted. In addition, differences in the pharmacy stock system following the stock count gave rise to an adjustment of £800,000;
- review of VAT recovery within the primary care organisation identified £620,000 of previously under-recovered VAT. Management had initially deferred recognition of this income but adjusted this to support the 2005-06 financial outturn;
- the process of agreeing balances with other NHS bodies identified a number of material under and over accruals with other NHS bodies which required investigation and correction prior to finalisation of the financial statements.

The nature and values of the changes between reported positions and final financial statements this year and previous years in aggregate, introduces a level of unnecessary volatility and risk into the Board's overall financial position. This requires management to review the financial recording processes – principally at the operating division – to ensure that arrangements are effective.

¹ Annual audit report (27 July 2005)

Non-recurring funding

The financial outturn for 2005-06 included the planned use of £25.6 million non-recurring funding, reflecting a non-recurring increase to the revenue resource limit of £13.6 million, consisting of the £19.6 million carry forward from 2004-05 less £6 million repayment of brokerage.

On 21 June 2006 the Board received an additional revenue resource allocation of £5.7 million to reflect the impact of changes in accounting treatment of certain fixed assets. This is repayable at a future date from asset sales, giving a balance of £19.7 million brokerage outstanding.

Non-recurring funding was deployed in support of the operating division (£8.4 million), primary care organisation (£700,000), pan-Lothian review projects (£7.9 million), pay modernisation (£8.1 million) and the additional costs of teaching (£500,000).

Total capital to revenue transfers during 2005-06 were £19.6 million (2004-05: £38.2 million), with £10 million (2004-05: £15.8 million) used to support recurring operations (see above) and £9.6 million (2004-05: £22.4 million) to fund capital expenditure that did not add value in terms of the accounting framework.

Support to the operating division shown above excludes a further £4 million support provided to meet slippage in the implementation of CRES schemes, resulting in total non-recurring support provided to the operating division in 2005-06 of £12.4 million (2004-05: £16.5 million).

Ring-fenced funding

The Scottish Executive Health Department allocated £4.4 million of ring-fenced funding to the Board during 2005-06 for coronary heart disease and stroke strategy, and blood borne virus prevention. Financial monitoring procedures include consideration of the use of this funding to ensure it is used for the purposes identified.

Financial position (continued)

Cash releasing efficiency savings ("CRES")

For 2004-05 we reported² that the 2005-06 cash releasing efficiency savings target of £20.4 million was, in our view, extremely demanding. In addition, management set a £3.7 million target for corporate savings. Figure 1 summarises the cumulative CRES position at 31 March 2006.

Figure 1: 2005-06 CRES status at 31 March 2006

£'000	Recurring	Non-recurring	Total
Target per strategic financial plan	18,722	5,378	24,100
<i>Achieved:</i>			
Operating division	8,135	4,954	13,089
Primary care organisation and CHPs	2,815	551	3,366
Non-Lothian service level agreements	1,500	-	1,500
Pan-Lothian review projects	500	-	500
Non-recurring support for the operating division	-	4,000	4,000
CRES on prescribing	1,836	-	1,836
Total	14,786	9,505	24,291

Source: Lothian NHS Board (March 2006)

The operating division was allocated £4 million funding on a non-recurring basis to reduce its original cash releasing efficiency savings target of £17 million. This is consistent with the £6 million allocated for similar reasons in 2004-05. While the Board is reporting achievement of its target, £9.5 million (39%) is on a non-recurring basis and includes support of £4 million from asset sales in earlier years. In addition, the savings include some items of one-off additional income.

² Annual audit report (27 July 2005)

The 2006-07 pan-Lothian cash releasing efficiency savings target is £20 million. However, this is in addition to identifying recurring savings of up to £4.7 million to make up the 2005-06 recurring shortfall. On 14 June 2006 management provided an update to the finance and performance review committee on its cash releasing efficiency savings requirements (Figure 2).

Figure 2: CRES and other savings targets 2006-07

£'000	2005-06 CRES balance	2006-07 CRES target	2006-07 other targets	2006-07 total targets	To be identified
Operating division	4,000	11,000	5,200	20,200	11,600
Single system	700	2,500	500	3,700	3,700
PCO and CHPs/CHCP	-	4,500	700	5,200	700
Prescribing	-	2,000	-	2,000	-
Total	4,700	20,000	6,400	31,100	16,000

Source: Lothian NHS Board (June 2006)

Achievement of the £31.1 million total savings target for 2006-07 is, in our view, likely to be extremely demanding. The focus will therefore require to be on securing the benefits of the identified pan-Lothian review and service re-design projects. With the introduction of the efficient government agenda, and the moves towards single-system working and shared services, management is under pressure to continue to identify significant savings. We note that at the time of finalising this report, just over half of the savings projects had still to be identified.

At the time of finalising this report, management information on the financial position of the Board to 31 May 2006 was unavailable. It is likely that, given the absence of a number of identified cash releasing efficiency savings (discussed below), that an overspend position exists.

Financial position (continued)

Financial planning

A key requirement of Audit Scotland's *Code of Audit Practice*³ is to understand and report on the Board's financial position and we have considered and reported on the financial position and financial plans during each year of our appointment. We have consistently reported that, in our view, ongoing achievement of financial targets and recurring financial stability would be challenging. As noted above, the 2005-06 financial outturn has been achieved through the use of a variety of sources of non-recurring funding, primarily capital to revenue transfers and, in previous years, financial brokerage from the Scottish Executive Health Department.

Management reports that planned, non-recurring funding utilised for recurring purposes has totalled £109 million in 2003-06 (£44 million 2003-04, £39 million 2004-05 and £26 million 2005-06).

The continued use of non-recurring funding during the past five years indicates a significant, recurring shortfall and underlying, but reducing, funding gap. The Board's 2006-07 financial plan risk assessment (below) highlights that the withdrawal of capital to revenue transfers presents a significant risk to the achievement of financial balance. This has already been recognised by management.

2006-07 financial plan

On 22 March 2006 management presented the 2006-07 draft financial plan to the board. The plan indicated a deficit of £2.1 million, but suggested that a number of options were being considered to manage this position. The plan clearly states that any arising financial pressures will have to be managed through an increase in the planned cash releasing efficiency savings target of £20 million. The 2006-07 financial plan was subsequently submitted to and approved by the finance and performance review committee on 12 April 2006 (the anticipated deficit had been addressed through accounting for lifecycle costs payable to the Royal Infirmary of Edinburgh's PFI contractor as a capital grant (see the section on 'financial statements')).

³ Revised strategic planning memorandum: 2005-06 annual plan

The director of finance re-emphasised the significant financial pressures inherent in the financial plan, both for 2006-07 and future years, including the reduction in reliance on non-recurring support and achievement of cash releasing efficiency savings targets and delivery of pan-Lothian review targets and securing the benefit of pay modernisation. Reliance on non-recurring funding is forecast at £8.5 million during 2006-07 (Figure 3).

Figure 3: non-recurring funding 2006-07

	£'000
Anticipated carry forward from 2005-06	2,000
Capital receipts and capital reserve	2,500
Capital grants	2,000
Review of new allocations / mid-year review process	2,000
Total	8,500

Source: Lothian NHS Board (April 2006)

Since approval of this plan, management has reviewed the underlying assumptions in the light of the 2005-06 outturn.

The financial plan is based on a number of assumptions, which were assessed by management in terms of the risk of non-achievement. There are 12 keys risks, five of which are assessed as "high", six "medium" and one as "low" risk. The "high" risk assumptions are:

- failure to deliver cash releasing efficiency savings and efficiency targets;
- withdrawal of capital to revenue transfers;
- management of pressures not in line with agreements;
- general medical services allocation;
- fuel costs.

Financial position (continued)

While KPMG LLP has not, in the context of our audit responsibilities, considered the assumptions underlying the projections in detail or their components, in our view effective mitigation of the potential impact of these risks – and achievement of a balanced financial position in 2006-07 – will require tight management control and engagement of staff at all levels of the organisation. The underlying assumptions on which financial balance is predicated will also present significant challenges for management. As such, there remains a substantial risk that the outturn projected in the financial plan will not be achieved.

The five-year financial plan to 31 March 2011 forecasts breakeven position each year. Management plans to rely on non-recurring funding of £8.5 million each year to support the financial position from 2007-08 onwards.

NHS tariff scheme

Management have confirmed that there was no significant impact from the shadow implementation of phase one of the tariff scheme. The under-recovery of £1.2 million on orthopaedic activity was met by an increase in income from the treatment of cardiac and thoracic patients. Phase two of the scheme will add an additional five specialities in 2006-07. Management is currently forecasting a neutral impact in 2006-07, primarily consisting of a decrease in neuroscience income, partially met by increases in ear, nose and throat and urology. The impact of the tariff scheme is included as a medium risk in the 2006-07 financial plan.

Pay modernisation

In response to guidance⁴ the Board approved its pay modernisation benefits delivery plan in September 2005, against which progress is monitored monthly. The March 2006 progress report links plans to demonstrate productivity gains to the ongoing requirements to meet cash releasing efficiency savings and efficiency targets, but highlights that the benefit from *Agenda for Change* will not be measurable until 2007-08 following delay in full implementation to December 2006.

⁴ HDL (2005)28: delivering the benefits of pay modernisation in NHSScotland

Figure 4 summarises the Board's cumulative pay modernisation investment for the three years to 31 March 2007. These total £61 million, representing a 12% increase in staff costs.

Figure 4: pay modernisation cost pressures (cumulative)

£'000	2004-05	2005-06	2006-07
Consultants' contract	11,300	13,000	14,000
GMS contract (including out-of hours)	10,100	15,000	17,000
Agenda for Change	5,900	21,000	30,000
Total	27,300	49,000	61,000

Source: Lothian NHS Board (June 2006)

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Corporate governance

Introduction

Corporate governance is concerned with structures and processes for decision-making, control and behaviour at the upper levels of the Board in accordance with the fundamental principles of openness, integrity and accountability. Management is responsible for establishing arrangements for the conduct of its affairs, including compliance with applicable guidance, ensure the legality of activities and transactions and to monitor the adequacy and effectiveness of these arrangements in practice. The *Code* requires auditors to review aspects of the corporate governance arrangements as they relate to:

- the Board's review of its systems of internal control;
- the prevention and detection of fraud and irregularity;
- standards of conduct, and the prevention and detection of corruption; and
- its financial position.

Framework

Following a period of extensive consultation and consideration, the Board approved its revised corporate governance structure on 23 March 2005, which was subsequently updated on 22 March 2006. The revised corporate governance structures establish formal lines of reporting and accountability and a committee structure, supported by formal procedures. On 1 April 2005 the Board implemented the second phase of its restructuring, creating the operating division, responsible for the provision of acute health services, the primary care organisation, four community health partnerships and one community healthcare partnership (known collectively as "the CHPs"), responsible for the provision of primary care and community services. Progress towards a single-system framework has been extended, both operationally and in terms of the approval and communication of pan-Lothian documents and strategies, reflecting organisational complexity.

The Board continues to demonstrate partnership working at all levels, including in respect of both internal and external partners.

Risk management

The implementation of robust and consistent risk management arrangements remains a significant element of the system of internal control requiring action. In this respect, management has identified that the harmonisation of risk recording, monitoring and reporting at an operational level remains ongoing. An internal deadline of October 2006 has been set to review progress made in embedding a consistent process.

Risk management arrangements within the CHPs are informal and have not yet been embedded in the operational structure.

Systems and controls

In preparation for our audit of the financial statements, we reviewed the design and operating effectiveness of controls over a number of systems to assess if they were operating effectively to prevent or detect a material misstatement in the financial statements. We found important areas where basic controls were either absent or were not operating as intended. Significant issues relating to access to the financial ledgers – reported as weaknesses by us in previous years – were identified, posing an increased risk of fraud and error and subsequent misstatement:

- insufficient differentiating access controls limiting the ability of staff to post journals to restricted or controlled ledger codes;
- financial operating procedures do not require journal entry documentation to be independently authorised at the primary care organisation or headquarters prior to input to the general ledger, although management believe that alternative control mechanisms are in place;
- while the operating division's financial procedures require authorisation of journal entries, testing confirmed that weaknesses continue to exist and that journal entries are not consistently evidenced as independently reviewed, nor routinely filed with adequate supporting documentation; and
- continued processing of large volumes of journal entries, particularly within the operating division, disproportionate to the requirements of the computerised financial ledger, associated sub-ledgers and payroll systems.

Corporate governance (continued)

During the course of our audit work on the financial statements we identified a number of problems stemming, in our view, from the failure of management to implement appropriately recommendations agreed in previous years to address limitations in the operation of systems. This is despite the existence of a system of implementation follow-up. Figure 5 highlights those recommendations and the impact of non-implementation on the 2005-06 financial statements processes.

Figure 5: impact of unaddressed weaknesses in financial control

Suspense accounts

- Absence of controls over authorisation of postings into ledger suspense accounts and review of transactions to identify any mispostings.
- Cash received is not consistently allocated against relevant debtor balances in a timely manner, undermining the effectiveness of debt collection procedures.

Impact: The draft financial statements presented for audit required to be adjusted to post unallocated cash of £2.4 million and clear other suspense account entries totalling £500,000. The existence of unallocated cash was one of the primary reasons for difficulties in the agreement of balances with other health bodies as at the year end.

SFR 30s – agreement of balances with other NHS boards

- Income and expenditure agreements with other NHS boards were not signed in a timely manner, incomplete in relation to the range of services provided and / or received and out of date in relation to the activity and cost data on which agreements are based.
- There were a number of delays in agreeing outstanding balances at 31 March 2005 and final agreement on a number of balances was not received until July 2005.

Impact: By 5 June 2006 cumulative balances as at 31 March 2006 totalling £1.7 million had not been formally agreed. The NHS manual for accounts requires that all NHS Scotland organisations agree debtor and creditor balances outstanding at 31 March by 30 April 2006. Key factors contributing to the delay in fully agreeing balances included:

- formal agreements were not agreed prior to or during the financial year;
- reflecting the decision to wait until the outcome of price tariff discussions were known, the operating division did not issue service level agreement invoices totalling £55 million until March 2006;
- the unallocated cash account was not cleared in a timely manner – £1 million received from NHS Grampian in October 2005 and February 2006 was not recognised as having been received until June 2006; and

- inadequate communication between finance staff based in the operating division and in headquarters, who were responsible for coordinating the agreement of balances.

Supplier statement reconciliations

- An absence of formal controls in relation to the preparation of effective supplier statement reconciliations which included the resolution and clearing of reconciling items in a timely manner. This included a decrease in the number of supplier statement reconciliations performed for significant suppliers.

Impact: While management implemented a process of reconciling balances for significant suppliers, based on an analysis of risk, volume and value of transactions, at 31 March 2006, the approach adopted did not mitigate the risk of error. Completed reconciliations included a significant volume and value of reconciling items.

Creditor payments

- The NHS manual for accounts requires that NHS boards disclose performance against the CBI Prompt Payment Code. The code recommends that all invoices are paid within 30 days of receipt; regulations allow creditors to charge interest on overdue payments. Disclosures in previous years have highlighted that the code is not being adhered to.

Impact: During audit testing of invoices processed around the end of the financial year and during April to June 2006 we identified weaknesses in management's control over the recording of expenditure. In addition, we found some invoices received by one unit in the operating division up to 12 months ago had not been processed onto its ledger until March and April 2006. This lack of control and efficiency is a key reason for the continued deterioration in performance.

Bad debts

- Lack of evidence of the processes followed to monitor aged debts and the requirement for improved and consistent credit control procedures.
- Absence of consistency in the calculation of bad debt provisions across NHS Lothian.

Impact: There was £1.8 million of debt outstanding at 31 March 2006 greater than 12 months, of which £800,000 has been outstanding for more than two years, indicating scope for continued focus in this area.

Corporate governance (continued)

Internal audit

In completing our audit, we sought, where appropriate, to rely on the work carried out by the Board's internal auditors⁵. The relevance of internal audit reports and changes to the internal audit plan were subject to continual review throughout our audit to maximise the reliance placed on their work.

The Board's internal auditors have noted that the proportion of 'satisfactory' ratings applied during 2005-06 has declined significantly, compared to the previous year. In 2005-06 'satisfactory' ratings were applied to 15% of reviews (2004-05: 43%), with no 'satisfactory' ratings applied for reviews completed at the operating division. The proportion of 'satisfactory' ratings arising from the primary care organisation and CHP, pan-Lothian and headquarter reviews has also fallen. 'Requires improvement / partial progress' ratings have been applied to 75% of audits in 2005-06 (2004-05: 52%). In addition, "a general poor standard of internal control and / or identification of critical issues, requiring immediate attention" have been identified by internal audit in respect of 9% of audits (2004-05: 3%). These relate to the following reviews:

- fleet and transport training requirements;
- clinical policies and procedures;
- locum doctors – financial control (2004-05 project);
- capital accounting; and
- credit control procedures.

Management believe this to be as a consequence of a greater focus on areas of higher risk identified through the risk management process.

In conclusion, the Board's internal auditors have noted that "processes reviewed have not contained fundamental weaknesses other than those highlighted for consideration by management for inclusion in the statement on internal control".

⁵ Strategic planning memorandum: 2005-06 annual plan (23 November 2005)

Primary care systems

The Board is dependent on the work of NHS National Services Scotland ("NSS") 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 2005-06 the NSS' service auditor reported that the downward trend in the number of points commenced in earlier years had continued, but with a slight increase in the number and proportion of "high priority" points identified. Of the numerous points identified by the service auditor, none were considered to be a significant weakness which compromises internal control and/or operational efficiency and which should be addressed immediately.

The service auditor concluded that, except for the matters set out in the report, the controls implemented by NSS management were suitably designed to achieve the specified control objectives and the 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 auditor's report

The external auditors of NSS issued a letter summarising the relevant information from their review. The external auditors concluded that NSS continues to perform its role in managing payments to NHS practitioners, but drew attention to the matters raised in the service auditor's report.

Family health services

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

- NSS's service auditor and external auditor reports;
- management's processes for evaluating and reporting the results arising from payment verification; and

Corporate governance (continued)

- 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, our 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 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.

Patient exemption checking

During 2005-06 the Board introduced a series of anti-fraud workshops for family health practitioners to raise awareness of fraudulent exemption claims made by patients and to introduce them to relevant checks and balances, with an emphasis on the prevention of patient fraud. These workshops are being developed in conjunction with internal audit and the NHS Counter Fraud Service ("CFS") and aim to generate a long-term reduction in the level of fraud and error, demonstrating management's commitment in this area.

In accordance with the protocol on patient fraud, CFS provided an annual estimate of the level of fraud/error in respect of the Board's FHS income. Consistent with prior years, management has extrapolated the level of fraud/error based on the sample tested by CFS. Using the latest available data, suggests an estimated fraud/error for the 12 months to 31 December 2005 of £1.45 million (2004: £1.7 million). In our opinion, this is not significant enough to indicate there is a material level of irregularity in respect of FHS income.

Payment verification

The Board's payment verification processes involve receipt of NSS practitioner services division ("PSD") generated reports, meetings to review reports, decisions on follow up actions and reporting of summary results to the primary care partnership committee. In line with guidance, Board officers meet with representatives of PSD on a quarterly basis to discuss emerging issues within each of the contractor groups. Quarterly reports on payment verification and patient exemption checking are prepared for the primary care organisation audit committee. A summary report was issued to the board's audit committee on 26 June 2006.

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 for 2005-06 provides details of the processes and controls highlighted by management where processes and strategies will be developed and actions implemented in 2006-07, including implementation of:

- a single financial system and completion of outstanding financial operating procedures and a programme of procurement improvement, in conjunction with the national procurement exercise, and completion of a risk assessment exercise around the move to single-system working;
- systems to provide reliable access to patient case notes and finalisation of the development of a records management strategy;
- a Board-wide human resource system, processes to monitor compliance with the European Working Time Directive and controls to ensure the reliability of payments made to junior doctors; and
- introduction of comprehensive emergency plans.

Corporate governance (continued)

External reviews

During 2005-06 the Board was subject to a number of reviews by NHS Quality Improvement Scotland ("NHS QIS"), focussing on performance against standards in respect of maternity services, learning disabilities, food, fluid and nutritional care and the provision of safe and effective primary medical services out of hours. Management has confirmed that the results of these reviews have been considered by the board's clinical governance committee and action plans developed to address any issues identified.

The Health and Safety Executive undertook a number of visits during 2005-06, but not all have resulted in formal communications from HSE.

Early retirements and redundancies

The ongoing restructuring and move to single-system working required the Board to reduce its workforce. This was achieved through voluntary redundancy and early retirement of staff. The human resources department established a number of specific criteria to be met before staff requests were approved. All applications were formally reviewed prior to approval being given to 30 members of staff, at a total cost of £2 million. Within this total, early retirement costs were £1.6 million, with redundancy costs being £400,000. During the approval process, management and partnership representatives considered the 'payback period' i.e. relationship between the ongoing salary cost (had the employee remained in post) and the cost of redundancy and early retirement prior to awarding early retirement and redundancies and considered these acceptable.

Single system financial ledger

Following creation of the unified Board on 1 April 2004, management has been working towards implementation of a single financial ledger from 1 April 2006. Best practice suggests that an organisation should complete a robust testing operation prior to implementation or continue double-running for a short period to minimise the risk of an operational impact, however, management opted for a direct changeover on 1 April 2006. The significant matters recorded in the project log, include:

- delays in the transfer of codes and associated structure to the new financial ledger and errors in VAT default coding; and
- payments made to suppliers without an invoice number, manual adjustment of supplier bank details and missing and duplicate suppliers.

Our observations during the audit process confirm the ongoing impact of implementation issues and significant resources being required to analyse raw data from the ledger during the preparation of May 2006 management accounts.

The financial services structure is also under ongoing review, pending the outcome of the national shared services review, with the majority of staff expected to remain in temporary positions until at least August 2006. This potentially increases uncertainty and could lead to a lack of staff morale. This may lead to a risk that key controls are not performed in a robust and timely manner.

Fraud and irregularity, standards of conduct, integrity and openness

Work in these areas has been addressed over the duration of our appointment. In relation to fraud, we have had regard to relevant auditing standards when completing our work. Work in relation to standards of conduct etc has included monitoring of the Board's arrangements for adopting and reviewing standing orders and financial instructions, schemes of delegation and compliance with applicable codes of conduct. We have not identified any significant weaknesses in these areas.

Audit committee

Oversight of the Board's internal control and reporting arrangements is provided through its audit committee. This operates on pan-Lothian basis dealing with significant control, performance and external audit matters. The committee's work is supported by sub-committees for the operating division and the primary care organisation / CHPs. The audit committee includes two members with formal accountancy qualifications, including the committee chair.

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Financial statements

Audit opinion

On 30 June 2006 we issued an audit report expressing an unqualified opinion on the financial statements of the Board for the year ended 31 March 2006 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. The change in the reporting deadline to 30 June 2006 presented particular challenges for management in view of the maintenance of a divisional financial recording and reporting arrangements. Figure 6 summarises the key elements of the audit process with which we require management to engage.

Figure 6: key elements of the audit process

Completeness of draft financial statements
Draft financial statements were received from the Board's divisions on 15 May 2006, in line with the agreed timetable. Draft financial statements for the Board as a whole were not received until 23 June 2006, prior to the audit committee on 26 June 2006.
Quality of supporting working papers
We spent significant time discussing documentation requirements with the Board's financial controllers prior to March 2006 to reach understanding on the nature and level of audit evidence sought. Despite this, the schedules provided by the operating division were below expectations and were not provided in accordance with the agreed timetable. Finance staff were consequently working to complete the remaining schedules at the same time as answering audit queries and performing their daily tasks. Staff were also unable to provide sufficient explanations for, and documentation to support, some variances between actual and budget expenditure and some balance sheet movements.
Some schedules had not been reviewed by a senior member of the department prior to audit submission. In contrast, 'prepared by client' schedules and documentation, internal and external, to support capital transactions and accounting treatment were subject, in our view, to excessive review and delays prior to being made available for audit.
Response to audit queries
The majority of routine audit queries were dealt with in a timely manner.

Financial adjustments and confirmations

In Figure 7 we draw attention to adjustments to the financial statements made by management as a result of the audit process.

Figure 7: financial statement adjustments

	Operating cost statement £'000	Balance sheet £'000
Reversal of capital grant to University	(3,250)	-
Reversal of capitalisation of calibrated equipment	(2,471)	(2,471)
Overstatement of debtors from other NHS boards	(432)	(432)
Understatement of provisions	(200)	(200)
Adjustment to assets under construction	105	105
Net adjustment	(6,248)	(2,998)

In addition, over £33 million of balances were reclassified between notes within the balance sheet and operating cost statement with no financial statement impact.

Confirmations and representations

We confirm that as of 26 June 2006, 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. This has been confirmed separately in writing to the audit committee.

In accordance with auditing standards, we obtained representations from the Board's directors on material issues prior to signing our opinion. Management have not adjusted a number of audit differences which they believe to be immaterial, both individually and in the aggregate, to the financial statements taken as a whole. The summary of unadjusted audit differences was attached to the management representation letter.

Financial statements (continued)

Significant accounting issues

Independent confirmation of significant amounts owing to and by the Board

During the audit planning process we discussed our requirement for management to obtain formal confirmation of significant third party balances due to and from the operating division as at 31 March 2006. While management issued the necessary letters to the identified parties, this was not done on a timely basis. Replies received identified material differences between the balances requested for confirmation by the operating division and those recorded by the third parties. Subsequent work identified that elements of the division's dealings with those third parties had been omitted through difficulties in extracting complete and accurate information from the financial ledger.

Circularisation of the balance due from the Board's Endowment Funds identified a number of aged balances under dispute. Management has subsequently provided against the disputed invoices.

Opening balances

Our 2005-06 audit plan identified a risk over the accuracy of adjustments relating to the 2004-05 estates revaluation processed in the financial ledger. We considered the opening balances during our interim audit visit in February 2006, but were unable to complete this work as the fixed asset entries had not been processed. These were processed and presented for audit on 16 June 2006.

An error was identified in the opening general fund during audit of the consolidation process. This arose within the operating division due to poor version control of internal documentation. This was rectified and the opening balances adjusted on 22 June 2006.

Fixed assets and capital accounting

During the audit planning process management processed a number of technical accounting adjustments in relation to capital transactions. The following section reports management's proposed accounting treatment and our assessment of this treatment in line with the NHSScotland capital accounting manual ("CAM") and financial reporting standards ("FRS").

University of Edinburgh – Centre for Reproductive Biology

In the draft financial statements, management proposed, following discussions with the Scottish Executive Health Department, to treat the cash settlement of a liability inherited from the former Lothian University Hospitals NHS Trust relating to the disposal of interests of the University in the Lauriston site as an accounting transaction in 2005-06. Because of a change in the NHS reporting framework, management sought to utilise the ability to record the transaction as a capital grant which would have been advantageous to the Board's revenue resource outturn. While management initiated discussions with us over this transaction at an early stage, we were unable to accept the justifications offered for the proposed accounting treatment and the treatment was subsequently reversed.

Calibrated instrumentation

During 2005-06, management amended the Board's accounting policy to capitalise calibrated instrumentation such as digital hearing aids, implantable defibrillators and pacemakers on the basis that these items remain the property of the Board and are recalled, tested and re-programmed as necessary.

This amendment was discussed extensively with management, but we were unable to accept that the instrumentation concerned met an acceptable interpretation of the definitions of an asset within financial reporting standards. This led to a reversal of the accounting treatment, although we understand that management will request the NHS Technical Accounting Group to consider the matter.

Financial statements (continued)

Information technology

During 2005-06 the Scottish Executive Health Department revised guidance on the capitalisation of 'grouped assets', conditional on meeting specified criteria. The Board identified £2 million of items of IT equipment which, in previous years, would have been charged as revenue expenditure and funded by way of a capital to revenue transfer. The benefit gained in 2005-06 from adoption of this guidance will reduce in future years until the annual depreciation charge equals the annual expenditure. Accounting for these items as fixed assets will result in increased capital charges.

Capital grants

The Scottish Executive Health Department introduced the ability to pay capital grants to other NHS boards during 2003-04. Since then, the guidance has been revised to include all public sector organisations and subsequently third parties. The ability to make capital grants is dependent on demonstrating that the expenditure meets a specified definition. The draft financial statements presented for audit disclosed capital grants to primary care practitioners (£2.4 million), local authorities (£0.5 million) and the PFI contractor (£3.1 million).

Grants paid to primary care practitioners are a combination of cash payments and instances where the primary care organisation purchased equipment that was subsequently given to practitioners. The Scottish Executive Health Department allocated £1.9 million during 2005-06 for the purposes of funding these payments; the remaining £0.5 million was to be funded from recurring revenue sources. As a result of the 2005-06 reporting framework, management reviewed the nature of the transaction and concluded that treating it as a capital payment was appropriate. This resulted in an in-year benefit for performance against the revenue resource limit of £1.9 million.

We confirmed that, overall, the grants met the definition stated in relevant guidance. However, we highlight that, despite meeting the definition of a capital grant, the specific items do not consistently meet the definition of an asset stated in CAM and FRS 15, including painting, plumbing and small items of medical equipment below the capitalisation threshold.

The PFI contract for the Royal Infirmary of Edinburgh requires payments to fund 'lifecycle' costs. These are in addition to those payments made to cover ongoing maintenance of the building. A schedule of planned expenditure was included in the original PFI contract and the Board is making payments throughout the term of the contract (25 years), which are understood to be held in a capital reserve by the PFI provider. In previous years, the Board made these payments from revenue expenditure, funded by capital to revenue transfers. In 2005-06, management took the decision to benefit from the revised capital grant guidance and 'score' the payments against the capital resource limit rather than the revenue resource limit.

Valuation of tangible fixed assets

FRS 15 requires that land and buildings are fully revalued every five years, with asset values adjusted in the intervening period. Following cancellation of the national valuation contract, in place for the year ended 31 March 2005, NHS boards are required to obtain professional valuations for its property on a rolling basis. The Board formally commissioned James Barr & Company ("Barr") in January 2006 and requested valuations for three properties as at 1 April 2005 and indices for the financial year to 31 March 2006. The request was subsequently amended to include a fourth property. Barr issued the final report to the Board on 8 May 2006 and this was presented for audit on 7 June 2006.

Capital charges for 2005-06 were calculated taking into account the valuation adjustments as at 1 April 2005. The Financial Reporting Manual ("FReM") 5.2.6 requires that "*all tangible fixed assets shall be carried at valuation at the balance sheet date*", which is consistent with the requirements of FRS 15. Although not specifically stated, it is implicit within the FReM and reporting standards that assets are revalued at the financial reporting date.

Management's decision to request the valuation at 1 April 2005 is linked to the decision to adopt an alternative method of calculating capital charges. This was permitted in the previous year and management's interpretation was that this was acceptable in 2005-06 and future years. Adjusting for the revaluation as at 1 April 2005 has resulted in a financial benefit of £1.6 million.

Financial statements (continued)

Surplus assets – disposal costs

The Board is progressing the sale of a number of surplus sites, including Bangour Village Hospital, Eastern General Hospital and the Hopetoun Unit. The Board does not charge costs associated with the preparation of the sites for disposal or, for example, ongoing security costs, to revenue as incurred. These costs are held as prepayments to be matched against future disposal proceeds, albeit that this will inevitably reduce the value of any future gains and is not the typical treatment of such costs. At 31 March 2006 the prepaid disposal costs amounted to £1.3 million. Management has provided evidence that the estimated disposal proceeds from each of these three sites is greater than the current carrying value of the assets and the prepaid disposal costs combined.

Impairment

FRS 11 'impairment of fixed assets and goodwill' requires that "*a review for impairment of a fixed asset or goodwill should be carried out if events or changes in circumstances indicate that the carrying amount of the fixed asset or goodwill may not be recoverable*". The standard goes on to provide examples of 'events and changes in circumstances' and includes "*a commitment by management to undertake a significant reorganisation*". The Board's key strategy for healthcare in Lothian is improving care, investing in change ("ICIC"). ICIC proposals include the redesign of services currently provided on three major sites (Royal Victoria, Royal Edinburgh and Edinburgh Sick Children's Hospitals). Despite the status of these proposals and Ministerial approval, management had not formally assessed any impairment implications, as they believed there would be no impact.

At our request, management has undertaken a review and confirmed that their current understanding of the redesign proposals does not lead to any impairment. If circumstances change from management's current assumptions, and as redesign options are determined, this area has potential to have a material impact on the Board's financial position and requires careful monitoring.

Capital charges and fixed asset transactions for 2005-06 and 2006-07

The Scottish Executive Health Department issued a dear colleague letter on 2 February 2006 in relation to 'capital charges and fixed asset transactions for 2005-06 and 2006-07' and requested submission of information, including any additional funding requests, by 14 April 2006. We understand that management did not comply with this request. Despite numerous discussions and inclusion in formal communication of audit evidence outstanding, it was brought to our attention at a late stage that management had not calculated indexation on fixed assets, using indices provided by Barr on 8 May 2006. This was subsequently corrected.

Car parking income

Under the terms of the Board's PFI agreements, the management of the car parks provided at the Royal Infirmary of Edinburgh is the responsibility of the PFI provider. The Board is entitled to receive 50% of any net surplus from this service calculated in accordance with the existing contract. This calculation excludes certain costs, for example, estates management and rates. No income had been recognised prior to 2005-06 due to the absence of robust information. £350,000 of income relating to the period from 1 April 2003 to 31 March 2005, and a further £200,000 in respect of the year ended 31 March 2006, has been recognised in 2005-06. Management have confirmed their compliance with circular HDL (2004) 19 'guidance on hospital car park charging', noting that when costs outwith the agreement are reflected, there is a "loss" recorded by the Board on these activities.

PFI

The Board continues to progress discussions with its PFI operator with a view to reaching conclusions on areas of disputed interpretation of the operating contract and on the prospect of participating in the gains from refinancing of debt by the operator. Management has sought legal and financial input to its deliberations in these areas.

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Performance management

Priorities and risks framework

Audit Scotland's 2005-06 *Priorities and Risks Framework: A National Planning Tool* ("PRF") set out nine areas for consideration during the audit. We built on and updated our understanding of the Board's processes and management arrangements in each of the PRF areas considered in prior years.

Figure 8 summarises management's progress during 2005-06, while Figure 9 highlights significant areas still requiring ongoing attention.

Figure 8: action taken on significant recommendations from 2004-05

- A regular programme of meetings was established during 2005-06 at financial controller and associate director of finance level, with formal 'single system' budgets created and responsibility allocated to specific individuals.
- A process of programme budgeting has commenced, beginning with a zero-based budgeting approach to delayed discharges. This is being performed on a pan-Lothian level involving the operating division, primary care organisation and CHPs. The use of zero-based budgeting had also increased for the 2006-07 budget setting process.
- The Board met the February 2006 deadline for submission of the completed local delivery plan, including the five-year financial plan. The process of agreeing localised action plans with clinical management teams and CHPs has included a large element of clinical and operational consultation, demonstrating the Board's commitment to continuous improvement and collaborative working.
- Significant progress has been achieved in implementing pan-Lothian human resources policies, including the race equality scheme, human resources strategy, freedom of speech, redeployment and promoting attendance policies. Quarterly workforce management reports are now formally produced, reporting statistics such as sickness absence, staff turnover, agency utilisation and staffing costs.
- In response to SEHD guidance, the Board approved its pay modernisation benefits delivery plan in September 2005, against which progress is monitored on a monthly basis. Board reporting now also links plans to demonstrate productivity gains to the ongoing requirements to meet cash releasing and efficiency targets.

- CHPs were formally created during public vesting days in September 2005. Ongoing monitoring of implementation plans is performed through the executive management team and primary care partnership committee. Performance management arrangements will support CHPs' progress in service implementation and improvement.
- The Board and CHPs have formally documented governance arrangements, including specific devolved responsibilities, terms of reference and reporting arrangements. Progress in finalising revised policies, such as complaints reporting and monitoring is continuing.
- The Board's commitment to performance measurement and management is reflected in the processes being implemented at CHP level. The existence of the performance assessment framework, local delivery plan, local improvement targets and the joint performance improvement assessment framework provide CHPs with a number of SMART (specific, measurable, achievable, realistic and timely) targets. The CHPs can demonstrate progress in aligning local targets with pan-Lothian and national targets, including a proposed system of regular reporting.
- The appointment of joint directors of health and social care in both Edinburgh and West Lothian has strengthened existing links between the Board and the City of Edinburgh and West Lothian Councils. In addition, joint community planning groups continue to exist in both Edinburgh and Midlothian. West Lothian CHCP is currently the only CHP with aligned budgets.

Figure 9: significant areas requiring ongoing attention

- There are inconsistencies in the documentation and formality of ownership of individual budget areas on a pan-Lothian basis, although management has assured us that accountable individuals within clinical management teams and CHPs have been required to formally 'sign up' to their 2006-07 expenditure budgets.
- The Board continues to work with local authorities, police, fire and ambulance services in developing comprehensive business continuity plans. There remains no formal business continuity plan, but the Board aims to approve a formal pan-Lothian plan by 31 December 2006.
- A full business case for the new human resources system was considered by the executive management team in April 2006. Management should ensure that adequate financial and staff resources are available to support timely implementation of the new system.

Performance management (continued)

- The Board has established a working group, chaired by the director of finance, to progress plans to implement a pan-Lothian performance management information system. Management has confirmed that an enhanced performance management information system will be implemented during 2006-07, but full benefits will not be evident until 2007-08, resulting in the continuing risk presented by some inconsistencies in data and activity monitoring.
- The Board successfully appointed staff to augment the existing Agenda for Change implementation team, with progress in the implementation process continuing. Full implementation has, however, been delayed until 2006-07, primarily due to the volume of work required to implement the change for 90% of the Board's 28,500 staff.
- Management anticipates that the revised IM&T structure will be fully operational in its current form within the first quarter of 2006-07.
- The eHealth strategy was finalised and approved during 2005-06, but a change of direction at a national level has resulted in the need to revisit this document; a revised eHealth strategy will be developed following publication of the Scottish eHealth strategy. Ongoing delays will continue to impact agreement of funding allocations and staff resources.
- Management has commenced the process of designing a pan-Lothian asset management tool, including remote management processes and a standard desktop solution. Management information will be derived automatically as a by product of the software. However, further work is required to complete the process and introduce the final product across Lothian. During this time, the risk of incomplete records and unlicensed assets and software remains.

Two new PRF areas – regional planning and efficient government – were specifically considered during 2005-06.

Regional planning

The South East and Tayside planning group ("SEAT") is one of three Scottish regional planning groups. SEAT's role is to plan services for the region in accordance with the principles of subsidiarity and to work on shared problems to reach a shared solution within delegated authority limits as agreed with individual 'sovereign' bodies.

Following stakeholder discussions in autumn 2005, SEAT is developing its framework for governance to provide a structure for accountability and decision-making, including a scheme of delegation. SEAT's acting director of regional planning is developing and formalising the regional planning cycle, focusing on aligning the identification and prioritisation of issues with national and local timetables. The 2005-06 annual regional workplan, outlining SEAT's plans to respond to national priorities outlined in *delivering for health*, was ratified at the November 2005 stakeholder day. Borders NHS Board's director of performance management is developing SEAT's framework for priorities and investment, which aims to complete the link with the framework for governance and the rolling annual work plan.

During 2005-06 the Board and SEAT have discussed the NHS tariff scheme and its impact on service agreements and funding levels. In preparation for full implementation of the scheme in 2006-07, SEAT is considering the benefits to be gained from a simulation exercise to forecast the impact of the scheme on regional planning.

Following approval of SEAT strategies, policy documents and frameworks, ratification is required by all member NHS boards. There are risks through timing issues where local, regional and national planning cycles are not aligned. In addition, the level of partnership participation in SEAT activities was unclear.

SEAT's annual report specifically focuses on patient benefit in relation to work performed during the year. Management anticipate that evidence and reporting in this area will increase in the 2005-06 report following completion of significant areas of work in progress at the end of 2004-05.

Efficient government

In line with Audit Scotland requirements, we completed the *efficient government – management arrangements diagnostic*, although there were some difficulties in obtaining supporting documentation within the required timescale.

In response to the efficient government agenda, management has amalgamated the processes for monitoring pan-Lothian savings, CRES and efficient government

Performance management (continued)

targets to ensure a clear and consistent message is provided across the organisation in relation to the value of savings and timetable for achievement.

Figure 10 summarises the savings achieved and future annual targets solely resulting from efficient government initiatives, while Figure 11 highlights the key issues reported in this diagnostic.

Figure 10: efficient government savings and targets

£'000	2005-06	2006-07	2007-08
Asset management	*	*	*
Managing absence	1,200	3,900	1,400
Procurement	2,500	2,200	1,200
Shared support services	*	*	*
Streamlining bureaucracy	1,640	1,022	-
Other	2,789	1,555	6,598
Total	8,129	8,677	9,198

Source: Lothian NHS Board (April 2006)

* This information was unavailable at the time of compilation of the return and submission to Audit Scotland.

To date, there is no evidence that the requirement for significant savings and efficiencies has had a detrimental impact on the Board's ability to deliver against its policies and meet activity targets. However, following the introduction of the efficient government agenda, and the moves towards single system working and shared services, management is clearly under pressure to continue to identify significant savings.

Figure 11: efficient government arrangements

Key arrangements

- The property and infrastructure strategy has recently been updated and is currently going through the approval process.
- During 2005-06 management implemented a comprehensive sickness absence policy

and reporting framework, including sickness absence rates.

- As part of the move towards single system working, the pan-Lothian procurement function and strategy has been in operation from 1 April 2006.

We identified that management required to ensure policies and procedures under development or review to be finalised and approved in a timely manner. In addition, action should be taken to improve the:

- accuracy and availability of measurement data, e.g. accurate sickness absence rates, and
- quantification of savings in discrete areas, including asset management and shared support services.

We reported⁶ a number of recommendations for improvement based on our work. None of these recommendations are considered to be significant.

Best value

We performed a baseline review of the Board's arrangements to secure best value and continuous improvement and reported the results to Audit Scotland in May 2006. While a comparative analysis of the Board's position will be provided later in the year, the Board's arrangements were found to be well developed in seven of the 10 areas under review. Figure 12 provides our assessment and summarises the current position and areas for development.

Figure 12: best value arrangements

Arrangements for securing best value (well developed)

The Board's key strategy for healthcare in Lothian is *Improving Care, Investing in Change* ("ICIC"). During 2004-05, the ICIC service redesign proposals were subject to an extensive public and staff consultation and ICIC continues to drive the Board's service redesign process. The Board defines continuous improvement on an ongoing basis both internally, through strategies, policies and action plans, and externally in published plans and external assessments, including the local delivery plan and five year financial plan, action plans to identify and record benefits from pay modernisation, and published strategies on areas for improvement e.g. sexual health strategies.

⁶ Overall arrangements 2005-06: priorities and risks framework (31 May 2006)

Performance management (continued)

Figure 12: best value arrangements (continued)

<p>Commitment and leadership (well developed)</p> <p>The ICIC process is the current primary driver of service change and redesign and outlines the three key strategies for the future:</p> <ul style="list-style-type: none"> • Better Acute Care in Lothian – aiming to build “a fast and seamless service that gives guaranteed standards and greater choice for all”; • review of services for older people – highlights that “providing the best care for older people is a high priority for NHS Lothian”; and • joint mental health and well-being strategy – provides detail of the joint management arrangements with the four local authorities which have been involved in communicating the message that “promoting good mental health and well-being is everyone’s business”. <p>The Board’s commitment to continuous improvement is demonstrated in the local delivery plan with the intention to set targets in excess of national targets where those have already been achieved within Lothian.</p>
<p>Sound governance at strategic and operational levels (well developed)</p> <p>The Board’s commitment to continuous improvement is evident in published strategies, the focus provided by key committees (including finance and performance review, service redesign and clinical governance) and the overall internal control framework.</p> <p>Management has established an annual key project programme, under which six key sub-groups monitor, report and prioritise key issues on a project basis. The creation of these groups and the formal allocation of responsibilities for individual key project programmes play a key role in a positive and proactive approach to service improvement and efficiencies.</p>
<p>Accountability (well developed)</p> <p>The Board’s commitment to partnership working and stakeholder involvement is demonstrated both formally and informally, including publication of the annual report, local delivery plan, and ICIC implementation updates. In addition, management has established pan-Lothian communications function, and a formal process for monitoring complaints and identifying learning points.</p>

Sound management of resources / contractual arrangements (under development)

The Board’s commitment to performance management and the ongoing requirement to meet substantial cash releasing efficiency savings targets provides a framework for making best use of resources. This includes ongoing consideration of the benefits of activity based costing, progression of plans to implement a pan-Lothian performance management information system to ensure robust activity data can be collected and reported to assist decision making and demonstrate improvement and preparation and monitoring of progress against action plans to demonstrate benefits realised from financial investment in pay modernisation.

The Board has commenced implementation of a single structure for procurement, with a target completion date of 30 June 2006. The single finance system, implemented from 1 April 2006, should allow for increased cooperation and collaboration prior to full implementation of the new structure. A pan-Lothian procurement strategy and action plan is being developed and will be completed in line with new structure. e-procurement (PECOS) has been implemented, but NHS Lothian, along with other NHS boards and public sector bodies, is experiencing certain operational problems which is delaying full implementation.

At the beginning of 2005-06 the Board finalised its corporate governance structure, including establishing formal lines of reporting and accountability and the committee structure, which are supported by formal procedures. Following further restructuring later in the year – including the creation of community health partnerships – the scheme of delegation and standing financial instructions were further revised on 22 March 2006.

Responsiveness and consultation (well developed)

The Board’s key strategy for healthcare in Lothian is ICIC. During the initial stages of the ICIC consultation, the Board considered specific areas for which detailed papers are available on the Board’s internet site, including public consultation and responses to public consultation, strategic service proposals, and next steps in informing, involving and engaging. We understand that a similar process will be followed during the redesign of childrens’ services later 2006.

In terms of responsiveness and consultation, there are also a number of specific initiatives, including regular complaints monitoring and identifying learning points, and patient surveys and ward observation audits.

Regular progress updates on the results of consultation are provided to the board and other committees, including the service redesign committee, strategic change group, primary care partnership committee, and operating division’s management team.

Performance management (continued)

Figure 12: best value arrangements (continued)

<p>Use of review and options appraisal (under development)</p> <p>The Board's commitment to, and focus on, performance management and measurement provides a sound framework for consideration of effectiveness. The achievement of targets and the setting and monitoring of action plans for improvement ensure continuous improvement e.g. the local delivery plan and pay modernisation benefits plans. ICIC is the key driver of change and increased efficiency and the future options, and associated service impacts, under each of the three strands of ICIC are clearly highlighted. The ICIC project manager is developing guidance material for operational managers, which includes a service redesign process flow and key performance indicators to be addressed during reviews of service provision.</p>
<p>A contribution to sustainable development (under development)</p> <p>The Board approved its health inequalities plan in January 2006, based on a broad programme of activities to improve health and address health inequalities, including action on determinants of health, prevention of disease and health services to reduce the burden of disease and disability. The Board's healthcare academy helps train unemployed people with the skills to get them back into the workplace and offers training and support that is directly linked to real jobs in healthcare.</p> <p>The Board's property and infrastructure strategy is currently being revised with a view to implementing a pan-Lothian strategy during 2006-07, which includes sustainable development factors as key outcomes.</p> <p>An equality and diversity impact assessment is part of the development of all strategies and policies.</p>
<p>Equal opportunities (well developed)</p> <p>The Board's code of working is published on the internet and intranet, detailing values and behaviours. The two key documents promoting equal opportunities – which meet the requirements of all key guidance and legislation – are the equal opportunities policy, and race equality policy, including an action plan addressing the Scottish Executive's 'fair for all' initiative. Awareness training in equality and diversity is part of the induction process and the Board's framework for ongoing training and development. Mainstreaming equalities is also integral to the role of the ethnicity and diversity managers.</p> <p>There are a number of methods of reflecting the needs of all groups in its strategic planning. Initial statistics on the ethnic minority profile of the workforce have already been presented to the NHS Lothian minority ethnic health forum and will be added to existing data monitoring, reported through the quarterly workforce reports. Focus groups are used to provide input from disadvantaged and minority groups into key strategic decisions, including the current review of childrens' services.</p>

Joint working (well developed)

Partnership working is evident at all levels of the Board. The membership of committees, implementation groups, project groups, and discussion fora extends to include representatives from the partnership forum, staff-side and the voluntary sector. Management has also indicated that these representatives are considered a valued addition.

Frameworks over governance arrangements, accountability and performance management require to be formalised in the majority of cases, but there is evidence of significant progress with regard to relationships with local authorities following the creation of CHPs. Joint directors of health and social care were appointed during 2005-06 with City of Edinburgh and West Lothian Councils.

There is some evidence that issues identified in previous years on the IT aspects of single shared assessments remain to be fully resolved.

Following recent reviews of child protection arrangements, the Board has strengthened working relationships with the police and criminal justice system.

Other value for money arrangements

As a public sector organisation the Board is required to ensure appropriate arrangements are established to manage its performance as it relate to the economy, efficiency and effectiveness in the use of resources. During 2005-06 Audit Scotland published a number of reports from national studies. The Board's audit committee routinely considers these, along with papers setting out the implications for NHS Lothian from the findings.

Audit Scotland did not determine any centrally directed studies during 2005-06 for completion by us.

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Appendix I – reconciliation of financial statement outturn

	£'000	£'000
Finance and performance review committee (12 April 2006)		62
Operating division		
Correction of accruals and stock errors	(1,800)	
Additional income and release of deferred income	663	
Increase in pension costs	(151)	
Capitalisation of assets	150	
Decrease in capital charges	145	
Net decrease in accruals	(126)	
Amendments to agreements with other NHS boards	119	
Release of bad debt provision	100	(900)
Primary care organisation		
Release of deferred income (VAT)	620	
Increase in prescribing accrual	(527)	
Net decrease in accruals	234	
Decrease in capital charges	38	365
Headquarters		
Adjustments to agreements with other NHS boards	(893)	
Additional income	770	
Decrease in <i>Agenda for Change</i> accrual	586	
Decrease in pension liability	212	
Clinical and medical negligence adjustment	165	
Net increase in accruals	(128)	712
Draft financial statements (15 May 2006)		239

	£'000	£'000
Draft financial statements (15 May 2006)		239
RRL allocation (20 June 2006)		5,721
Reduction in depreciation and capital charges		243
Increase in pension / injury benefit provisions		(256)
Decrease in <i>Agenda for Change</i> accrual		480
Audit adjustments (Figure 7)		(6,248)
Final financial statements (27 June 2006)		179

Source: Lothian NHS Board (April, May and June 2006)

Appendix II – action plan

This appendix summarises the performance improvement observations we have identified during the financial statements audit. Each of our observations has been allocated a risk rating, which is explained below.

	<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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Issue, risk and priority	Recommendation and benefit	Management response	Responsible officer and implementation timetable	
1	<p>The nature and values of the changes between reported positions and final financial statements this year and previous years in aggregate, introduces a level of unnecessary volatility and risk into the Board's overall financial position.</p>	<p>Management should review the financial recording and reporting processes – principally at the operating division – to ensure that arrangements are effective.</p>	<p>A review has already commenced emphasising recording in the financial ledger and will give specific focus to issues highlighted by internal and external audit.</p>	<p>Associate Director of Finance – UHD 30 September 2006</p>
2	<p>We note that at the time of finalising this report, just over half of the CRES savings projects for 2005-06 had still to be identified. With the introduction of the efficient government agenda, and the moves towards single-system working and shared services, management is under pressure to continue to identify significant savings.</p>	<p>Management should consider the current timetable for identification of CRES projects to ensure that:</p> <ul style="list-style-type: none"> • appropriate projects are identified to meet the current £16.1 million shortfall for 2006-07; and • projects are identified and implemented in a timely manner in future years to maximise the in-year recurring benefit. 	<p>An initial report was taken to the June 2006 finance and performance review committee. Managers have committed to complete the identification of CRES projects to allow a finalised position to be taken to the next meeting.</p>	<p>Director of Finance and lead directors 31 August 2006</p>

Appendix II – action plan (continued)

Issue, risk and priority	Recommendation and benefit	Management response	Responsible officer and implementation timetable
<p>3</p> <p>During the course of our audit work on the financial statements we identified a number of problems stemming, in our view, from the failure of management to implement appropriately recommendations agreed in previous years to address limitations in the operation of systems. This is despite the existence of a system of implementation follow-up.</p> <p>In addition, the Board's internal auditors have noted that the proportion of 'satisfactory' ratings applied during 2005-06 has declined significantly from 43% of reviews in the previous year to 15% in 2005-06, with no 'satisfactory' ratings applied for reviews completed at the operating division.</p> <p>The risks associated with previous recommendations have materialised during 2005-06, resulting in a number of errors identified during the audit process.</p>	<p>Management should ensure that responses to audit recommendations are actioned within the agreed timescales.</p> <p>In addition, management should consider implementing a process of internal follow-up where implementation is tested to confirm the appropriateness of both the design of the control and operating effectiveness.</p>	<p>The post of corporate governance and VFM manager has been created to support the timely and comprehensive delivery of internal audit, external audit and Audit Scotland recommendations.</p>	<p>Associate Director of Finance – PCO Ongoing</p>
<p>4</p> <p>The financial services structure is under ongoing review, with the majority of staff expected to remain in temporary positions until at least August 2006.</p> <p>This potentially increases uncertainty and could lead to a lack of morale among staff, which may lead to a risk that key controls are not performed in a robust and timely manner.</p>	<p>Management should ensure that appropriate responsibility and accountability arrangements exist during the ongoing transitional period, particularly during the continued implementation of the new single financial ledger.</p> <p>This should provide assurance that key controls are performed in a robust and timely manner.</p>	<p>The remaining restructuring only refers to the financial services section and will facilitate a smooth transfer to the national shared services project. The maintenance of key controls during this period has been included in the transitional arrangements.</p>	<p>Associate Directors of Finance 30 October 2006</p>

Appendix II – action plan (continued)

Issue, risk and priority	Recommendation and benefit	Management response	Responsible officer and implementation timetable
<p>5</p> <p>The statement on internal control provides details of the processes and controls highlighted by management where processes and strategies will be developed and actions implemented in 2006-07.</p> <p>Guidance on preparation of the statement requires that the system of internal control should be in place for the whole year. Given the weaknesses identified, the accountable officer may be unable to sign a fully compliant statement for the year ending 31 March 2007.</p>	<p>Management should continue to progress action to rectify significant weaknesses in internal control to ensure that a full compliant statement can be signed for the year ending 31 March 2008.</p>	<p>Significant progress has been made in actioning previously identified issues. A similar focus will be given to those issues highlighted in 2005-06.</p>	<p>Corporate Governance and VFM Manager 31 March 2007</p>

Appendix II – action plan (continued)

Issue, risk and priority	Recommendation and benefit	Management response	Responsible officer and implementation timetable
<p>6 Following creation of the unified Board on 1 April 2004, management has been working towards implementation of a single financial ledger from 1 April 2006. Best practice suggests that an organisation should complete a robust testing operation prior to implementation or continue double-running for a short period to minimise the risk of an operational impact, however, management opted for a direct changeover on 1 April 2006.</p>	<p>Appropriate focus and resources should be given to resolving all implementation issues to minimise the risk of error.</p>	<p>The system was fully tested before being put into production on 8 April 2006 and the system has been in production since then for all financial accounting, procurement (except stock as below) and management accounting transactions. The issues arose from the loading of transaction data from the previous systems and the new operating procedures required by the single ledger. The data load had also been tested, but the sheer volume of transaction data to be loaded caused some problems which were managed by putting the old system back into production for the stock system at UHD only. This worked successfully and transactions generated by this have since been moved onto the new system. A full stock take was undertaken to check for any errors.</p>	<p>Head of Finance – PCO 30 September 2006</p>

Appendix II – action plan (continued)

Issue, risk and priority	Recommendation and benefit	Management response	Responsible officer and implementation timetable
<p>7</p> <p>The change in the reporting deadline to 30 June 2006 presented particular challenges for management in view of the maintenance of a divisional financial recording and reporting arrangements.</p> <p>Despite significant investment of time by us and the Board's financial controllers during the planning process, there remain a number of process areas where improvements can continue to be secured.</p>	<p>Management should ensure that appropriate resources and focus is given to the preparation of schedules in advance of the audit fieldwork. In addition, consideration should be given to the details requested in the 'prepared by client' list and subsequent discussions with the financial controllers.</p> <p>All schedules should be subject to quality checking and review by a suitable qualified and senior member of the finance department, which should be built into the internal timetable.</p> <p>This should ensure that schedules of the expected quality are provided at the start of the audit fieldwork, which should reduce the ongoing time required by members of the finance department during the audit process.</p>	<p>The move to a single database and single ledger will assist in meeting the timetable in future years. A review meeting will take place internally by the end of August 2006 to resolve specific issues and link with the new external auditors, building on the practice adopted for 2005-06.</p>	<p>Associate Directors of Finance 31 March 2007</p>
<p>8</p> <p>We identified a number of weaknesses in the operating division's process of obtaining formal confirmation of balances due to and from third parties at 31 March 2006.</p> <p>There is a risk of incomplete financial reporting and errors in debtors and creditors. In addition, there is a risk of poor credit control and that the Board may not receive all income due.</p>	<p>Management should implement a process to review month end balances with all key third parties, including the University of Edinburgh, pharmacy suppliers and the Board's Endowment Funds.</p> <p>In addition, sales invoices to third parties should be raised in a timely manner to avoid the requirement for significant balances of accrued income, which has a significant inherent risk of non-receipt.</p> <p>This should provide assurance over the accuracy of monthly financial reporting and reduce the risk of unexpected liabilities and non-recovery of income.</p>	<p>Action has already commenced on a number of the issues raised.</p>	<p>Associate Director of Finance – UHD 31 March 2007</p>

Appendix II – action plan (continued)

Issue, risk and priority	Recommendation and benefit	Management response	Responsible officer and implementation timetable
<p>9</p> <p>We considered the opening balances during our interim audit visit in February 2006, but were unable to complete this work as the fixed asset entries had not been processed. These were processed and presented for audit on 16 June 2006. An error was identified in the opening general fund during audit of the consolidation process. This arose within the operating division due to poor version control of internal documentation.</p> <p>There is a risk of inaccurate financial reporting during the year, together with a risk of incomplete financial statements.</p>	<p>Management should ensure that transactions are processed in the financial ledger in a timely manner. Significant adjustments, including those to opening balances, should be subject to review by a senior member of the finance department.</p> <p>In addition, consideration should be given to the pan-Lothian position to provide assurance over the risk of duplication and omission.</p>	<p>2005-06 included the added complexity of moving towards a single ledger. This issue will be addressed as part of strengthening financial procedures across NHS Lothian.</p>	<p>Associate Director of Finance – UHD 31 March 2007</p>
<p>10</p> <p>Despite the status of ICIC proposals and Ministerial approval, management had not assessed any impairment implications under the requirements of FRS 11. This was completed during the audit process at our request, presenting the risk that fixed assets were materially misstated.</p>	<p>Management should continue to consider changes in circumstances management's assumptions. As redesign options are determined, this area has potential to have a material impact on the Board's financial position and requires careful monitoring on an ongoing basis to ensure the accuracy of fixed assets.</p>	<p>Due to the lack of imminent impact in 2005-06, no formal assessment was undertaken in year. In line with previous practice within NHS Lothian, review of the impact under FRS11 will be carried out in future years.</p>	<p>Associate Director of Finance – UHD Ongoing</p>