INFRASTRUCTURE, GOVERNMENT AND HEALTHCARE

Orkney NHS Board

Annual audit report to Orkney NHS Board and the Auditor General for Scotland

Year ended 31 March 2010

30 June 2010

AUDIT

AUDIT ▪ TAX ▪ ADVISORY

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The contacts at KPMG in connection with this report are:

Stephen Reid
Director
Tel: 0131 527 6795
Fax: 0131 527 6666
stephen.reid@kpmg.co.uk

Ally Taylor
Senior Manager
Tel: 0131 527 6813
Fax: 0131 527 6666
ally.talyor@kpmg.co.uk

Eve Gizzie
Audit In-charge
Tel: 0131 527 6673
Fax: 0131 527 6666
eve.gizzie@kpmg.co.uk

About this report

This report has been prepared in accordance with the responsibilities set out within the Audit Scotland's *Code of Audit Practice* ("the Code").

This report is for the benefit of Orkney 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 wider requirements or circumstances of anyone other than the beneficiaries.

Nothing in this report constitutes an opinion on a valuation or legal advice.

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

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Executive summary

The service design programme is fundamental to delivering the five year clinical strategy *Our Orkney, Our Health* and the five year financial plan. With an executive management team, in which all substantive posts are filled on a permanent basis, there is increased commitment and capacity to deliver long-term plans. Service redesign programmes have delivered efficiency savings in acute services, but this was not replicated in primary care medical staffing costs or prescribing activities. Audit Scotland's report *Using locum doctors in hospitals* (June 2010) highlights the Board's reliance on locums, but acknowledges that rural and islands boards have historically incurred higher expenditure in this area. 11.4% of Board medical staffing expenditure in 2008-09 was in respect of locums, in comparison to the Scottish average of around 6%. Management's internal review of controls over the approval of locum doctor payments has identified weaknesses and inconsistencies that require immediate attention. The combined impact of not delivering efficiency savings and recurring overspends was a key cost pressure in 2009-10 and is likely to continue to present significant challenges.

Orkney Health and Care was formally created on 1 April 2010; its fundamental objective is to deliver improved services for the local population. The development of *Orkney Health and Care* aims to enhance current local arrangements by formalising links and aligning structures and processes within the context of national guidance and regulations, alongside ongoing public engagement.

Management and board consideration of medium term service redesign focuses on redevelopment of the Balfour hospital, for which a draft outline business case was prepared and considered during the year. Articulating the clinical case for change and associated risks, rather than upgrading or constructing new facilities, will be key to achieve service sustainability, and, consequently, financial sustainability.

The Board met its financial targets, but both the revenue and capital outturns were subject to a number of audit adjustments. Maintaining financial balance, and securing recurring financial balance within the next three years, continues to present significant challenges. Improved financial reporting and monitoring processes increases the timeliness and appropriateness of remedial action during each financial year. The underlying assumptions on which financial balance is predicated will continue to present significant challenges for management. As such, there remains a substantial risk that the outturn projected in the financial plan will not be achieved. Ongoing risk management and quantification of risks and assumptions will be key to minimising fluctuations in financial outturn and 'late surprises'.

Financial plans are also dependent on delivery of £2.3 million of efficiency savings, over half of which are considered to be 'high' risk, in addition to maintaining £4.5 million of savings delivered previously. Management continues to make progress in developing more robust budget-setting and financial monitoring arrangements, but continued achievement of recurring efficiency savings is, in our view, likely to be extremely demanding, particularly without routine monitoring and reporting of savings achieved in specific areas.

Significant progress has been made in 2009-10 towards developing over-arching arrangements that are appropriate to support the board in its ambitious, but vital, service modernisation programme, which ultimately aims to deliver financial and service sustainability. Efforts are now targeted at embedding these arrangements in routine activities with a focus on being proactive, rather than reactive. Arrangements around information governance, risk management, clinical governance and patient safety remain high on management's agenda. Use of enhanced and more frequent reporting mechanisms, combined with system improvements, such as the DATIX risk management system, increases the robustness of information and subsequent decision making. Data validation exercises, including, for example, to identify and investigate trends, and moving away from a reactive approach towards a proactive approach are key elements of future plans.

Scope

Our audit work is undertaken in accordance with Audit Scotland's *Code of Audit Practice* ("The *Code*"). This specifies a number of objectives for our audit.

Audit framework

This year was the fourth of our five-year appointment by the Auditor General for Scotland as external auditors of Orkney NHS Board ("the Board"). This report to the Board and Auditor General provides our opinion and conclusions and highlights significant issues arising from our work. We outlined the framework under which we operate, under appointment by Audit Scotland, in the audit plan overview discussed with the audit committee earlier in the year.

The purpose of this report is to report our findings as they relate to:

- the **financial statements** and our audit opinions on net operating costs and the regularity of transactions;
- **use of resources**, including financial outturn for the year ended 31 March 2010 and financial plans for 2010-11 and beyond;
- arrangements around **governance and accountability**, including risk management, patient safety, partnership working and our consideration of the work of internal audit; and
- **performance management** and the Board's arrangements to achieve efficiency savings.

Best Value

Audit Scotland and the Scottish Government have been committed to extending the Best Value audit regime across the whole public sector for some time now, with significant amounts of development work having taken place during the last year. Using the Scottish Executive's nine best value principles as the basis for audit activity, Audit Scotland selected five areas as priority development areas (use of resources, governance and risk management, accountability, review and option appraisal, and joint working). In 2009-10 we completed work on arrangements to achieve Best Value through performance management and procurement.

International financial reporting standards

The 2007 Budget had announced that central government and health bodies would report under international financial reporting standards ("IFRS"), as adapted by HM Treasury through the financial reporting manual ("IFReM"). The financial statements for the year ended 31 March 2010, including comparative figures for 2008-09, were prepared on the basis of the IFReM.

Responsibilities of the Board and its auditors

External auditors do not act as a substitute for the Board's own responsibilities for putting in place proper arrangements to account for the stewardship of resources made available to it and its financial performance in the use of those resources, to ensure the proper conduct of its affairs, including compliance with relevant guidance, the legality of activities and transactions, and for monitoring the effectiveness of those arrangements and, through the accountable officer, to make arrangements to secure Best Value.

Action plan

This report includes an action plan containing areas for development or improvement identified during our financial statements audit fieldwork. We have not repeated recommendations raised in reports issued during our earlier work in respect of our 2009-10 audit. Responsibility for taking action and monitoring progress in response to all our recommendations lies with management.

Acknowledgement

We wish to record our appreciation of the continued co-operation and assistance extended to us by your staff during our work.

Service overview

The Board's vision of the future involves organisation-wide change such as the redesign programmes and individual service reviews, which are currently being agreed. This future vision has contributed to an integrated approach to planning. With an executive management team, in which all substantive posts are filled on a permanent basis, there is increased commitment and capacity to deliver long-term plans. Board staff recognise that the new additions to the executive management team have already provided further stability and direction, in particular linking financial and service redesign plans.

The service design programme is fundamental to delivering the five year clinical strategy *Our Orkney, Our Health* and the five year financial plan. The programme will be replaced by an efficiency and productivity plan that aligns clinical practice and service delivery with an overarching service modernisation programme, workforce plan and financial recovery plan.

Achievements in acute service redesign during 2009-10 include closure of one ward, delivering savings of £104,000 in long-stay and rehabilitation. Other savings to be made include the impact of the new hospital nursing staff model, which will reduce expenditure by around eight whole time equivalents and, in management's view, without impacting patient care. Ongoing acute services redesign includes consideration of nursing and junior doctor models and the potential savings that will arise from the review of community nursing initiated during the year. Primary care redesign proposals focus on delivery of in hours and out of hours clinical services through integrated multidisciplinary teams.

Following establishment of a shadow community health and social care partnership in 2008-09, 'Orkney Health and Care' was formally created on 1 April 2010. The fundamental objective of Orkney Health and Care is to deliver improved services for the local population and a scheme of delegated responsibility will be approved to provide a framework for the full range of social service functions, a range of health services and aligned planning arrangements. The development of Orkney Health and Care aims to enhance current local arrangements by formalising links and aligning structures and processes within the context of national guidance and regulations, alongside full public engagement. Good working relationships have already been developed with several jointly planned, funded, and executed community developments underway, including plans for new joint health and social care facilities in Kirkwall and St Margaret's Hope.

Management and board consideration of medium term service redesign focuses on redevelopment of the Balfour hospital, for which a draft outline business case was prepared during the year. Following initial consideration by the finance and performance committee, and subsequently the board, the outline business case is being enhanced to increase the focus on the clinical benefits of proposals, rather than the construction aspects. Redesigning the way in which services are delivered, rather than upgrading or constructing new facilities, will be key to achieving service sustainability, and, consequently, financial sustainability.

Achieving financial balance continues to present significant challenges, but improved financial reporting and monitoring processes increases the timeliness and appropriateness of remedial action. Financial management arrangements continue to improve and regular financial updates are presented for review and scrutiny by senior management to the finance and performance committee. In addition, increasing awareness and responsibility for financial management across the Board has included sessions with middle managers, with a particular focus on the financial recovery plan, the role of managers in terms of accountability and performance management arrangements to record progress and appropriately taken action.

Service overview (continued)

Audit Scotland's reports on national studies aim to assess and share best practice, while acting as a trigger for development. Since January 2010, the director of finance has allocated responsibility for action to named lead managers, which will be monitored by one of the board's sub-committees. Reports on financial management and waiting list management have been subject to particular consideration and recommendations reflected in local practices.

The Board continues to work on its governance structure, including delegation to committees. Scrutiny of performance and achievement of targets has increased during 2009-10, with the new director of finance having responsibility for performance management. Discussions continue to take place in relation to the possible adoption of a corporate scorecard.

Action has been taken to respond to concerns regarding information governance and the medical director continues to consider roles and responsibilities in this respect. Responsibility for information assurance legislation has now been designated and, from April 2010, an updated information governance action plan has been led by the information governance team.

NHS Quality Improvement Scotland published a detailed review of clinical governance and risk management arrangements at the Board in February 2010. The Board was commended on demonstrating a commitment to partnership working, particularly within business continuity planning, but it was recommended that management review risk management arrangements; the risk management policy is being revised.

The main forum for the championing of patient safety continues to be the quality and improvement committee. A clinical safety and quality strategy for 2008-10 was approved by this committee in July 2008. Following significant weaknesses in clinical incident reporting in 2008-09, steps have been taken to enhance arrangements, including upgrading the DATIX risk management system, giving feedback to staff and refining data. The clinical safety and quality team provide weekly reports for ward noticeboards, which include performance in key areas of patient safety, such as compliance with hand hygiene requirements. Plans are being progressed to develop a matrix to identify where weaknesses exist and, with more data now available, the next step is to consider the validation of data, including, for example, to locate and investigate trends. The medical director recognises that there is still progress to be made in patient safety, in particular, to move away from a reactive approach towards a proactive approach.

Management of risks around workforce planning and capacity to deliver will be key in delivering service redesign proposals. In recognition of these risks, on 17 March 2010, the finance and performance committee received an action plan to strengthen workforce controls, such as through the vacancy control committee, and this will be integrated into the 2010-11 human resources development plan. Sickness absence continues to be actively monitored; the monthly rate for March 2010 was 3.7%. Audit Scotland's report *Using locum doctors in hospitals* (June 2010) highlights the Board's reliance on locums, but acknowledges that rural and islands boards have historically incurred higher expenditure in this area. 11.4% of total medical staffing expenditure in 2008-09 was in respect of locums in comparison to the Scottish average of around 6%. Management's internal review of controls over approval of locum doctor payments has identified weaknesses and inconsistencies that require immediate attention.

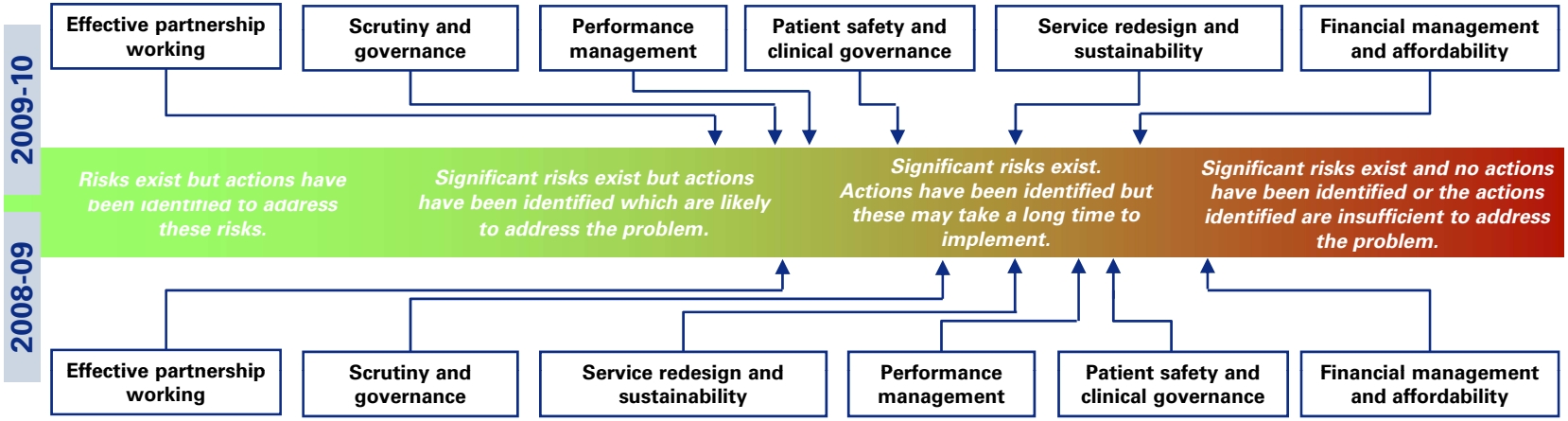
In April 2010 management completed two of Audit Scotland's toolkits for monitoring arrangements to achieve Best Value through performance management and procurement. The topics were agreed with management to reflect the developing status of arrangements in both areas. While the 'scores' in the toolkit confirmed that arrangements in a number of areas did not exist or were 'basic', our validation of management's self-assessment concluded that progress was being made in both areas and that developments are likely to enhance processes and controls in the short term.

Service overview (continued)

A formal performance management framework now exists, but is subject to further development and testing, including increased alignment with the governance framework. The performance reporting framework was subject to detailed challenge and scrutiny by the finance and performance committee in early December 2009. A number of training sessions have been held with target responsibility leads to discuss the HEAT targets for which they are responsible and the availability of data and information. Similar to other arrangements, embedding performance management across all activities and promoting collective responsibility at all staff levels will be key to successful implementation of a robust performance management framework.

A joint procurement role was established with Orkney Islands Council ("the Council"). A single member of staff, employed by the Council, is developing the Board's procurement strategy, under the director of finance's leadership. The draft strategy makes reference to procurement objectives being compatible with corporate values, plans and priorities. Underlying principles also include consideration of continuous improvement and national procurement strategies. There are limited formal procurement arrangements and heads of department are responsible for their own spending in line with annually agreed budgets, albeit in line with standing financial instructions. These instructions set out procedures and appropriate values for procurement activities, such as obtaining quotations and the requirement for formal tenders, but are in the process of being updated and need to reflect changes to advertising and public contract policies to ensure compliance with the Scottish Government's mandatory requirements to advertise public contracts. Consideration is being given to implementing an electronic procurement system (PECOS), which will strengthen controls and processes.

Arrangements to achieve national priorities and mitigate against key risks in 2008-09 and 2009-10 are characterised by us as follows:



Progress has been made in 2009-10 to continue development of over-arching governance and management arrangements that are necessary to support the board in its ambitious, but vital, service modernisation programme. Recent formal approval of the programme ultimately aims to deliver financial sustainability as well as an efficient and appropriate health service for the local population. Efforts are now targeted at embedding these arrangements at an operational level and ensuring that tasks such as risk management, information management, performance management and reporting, and workforce management are performed as part of routine activities on a proactive and timely basis, rather than in a reactive and *ad hoc* manner.

Financial statements

We have issued unqualified opinions on the financial statements and the regularity of transactions reflected in those financial statements.

Management successfully advanced the financial statement preparation timetable for the second year, but financial reporting arrangements could be enhanced by reducing reliance on resource intensive, and inherently higher risk, manual processes and reconciliations.

Capital grants of £1.25 million were approved and paid to the Council in line with plans, but expenditure disbursed by the Council had slipped during the year. It is important that management continues to monitor construction progress prior to making payments.

Errors in accounting for invoices received after the year end were adjusted in the outturn against revenue and capital resource limits.

Reporting arrangements and timetable

The draft financial statements were available, as agreed, for audit on 20 May 2010. The standard of documentation provided at the start of our audit fieldwork was good; the quality and quantity of information provided on the first day demonstrated improvement compared to previous years. This allowed for timely completion of the audit and the board considered and approved the financial statements at the board meeting as planned. A new financial ledger was introduced in 2008-09 when the Board joined a consortium led by NHS Ayrshire and Arran, but it appears that the full benefits and functionality of the new ledger are not being used. In addition, extensive manual processes and reconciliations continue to be performed, which are time and resource intensive.

Audit opinion

Following board approval we issued an audit report expressing unqualified opinions on the financial statements for the year ended 31 March 2010 and on the regularity of transactions reflected in those financial statements.

Key issues arising during our audit of the financial statements

Our audit plan overview and interim management report narrated potential key risk areas and we identified additional risk areas during our audit of the financial statements.

The Scottish Government announced on 25 April 2008 that all Scottish Government departments, executive agencies, non-departmental public bodies and health boards would report under IFRS, as interpreted by the financial reporting manual issued by HM Treasury, from 2009-10, necessitating the restatement of comparative information under new accounting policies. As part of the process of transition to IFRS, the Board prepared 'shadow financial statements' which we reviewed and reported on in Autumn 2009. Our review identified a number of issues which required further consideration by management. Each of these has subsequently been actioned.

The transition to reporting under IFRS has resulted in the following key changes in the financial statements:

- an accrual has been made for untaken holiday pay at the balance sheet dates; and
- accounting policies have been updated in line with the IFReM.

There have also been significant changes to the overall presentation of the financial statements.

Financial statements

Capital grants

The Board is intending to provide capital grant funding to the Council totalling £3.25 million over three years as a contribution to new integrated facilities in St Margaret's Hope and Kirkwall. Senior management are represented on the project board, which meets every six weeks. The total cost of the facilities will be £10.4 million, to which the Board will contribution £3.25 million (35%). The Council originally intended to incur expenditure of £3.9 million in 2009-10, with the Board's contribution of £1.6 million (41%) being slightly higher than the overall funding proportion. During 2009-10 the planning and construction timetable slipped and the legal agreement was not signed until December 2009. Expenditure incurred by the Council in the period to November 2009 was £0.4 million and it was apparent that total spend for the year would be significantly below the planned £3.9 million, but, due to timing, management was unable to revise capital spend forecasts agreed with the Scottish Government Health Directorate. In February 2010 management reported to the finance and performance committee that the Board's contribution in 2009-10 would far exceed its percentage contribution, but that it would not contribute more cash than had been disbursed by the Council. The spend profile and Board contributions are as follows:

Financial year	Council capital expenditure (£'000)	Board capital grants (£'000)	Annual board contribution (%)	Cumulative board contribution (%)
2009-10	1,780	1,600	90	90
2010-11	5,245	750	14	33
2011-12	3,000	1,250	42	36
2012-13	400	-	-	35

Council spend, at the date of this report, in 2010-11 is £8,000 and is likely that total annual spend will fall short of the planned £5.2 million; resulting in the Board's contribution remaining at a higher proportion of total spend. It is important monitoring of project spend and progress continues in 2010-11 and future years to ensure that NHS contributions remain timely and regular, i.e. that the Board is not providing cash to the Council in excess of that disbursed in any one financial year. Ongoing liaison with the Scottish Government Health Directorate will reduce the likelihood of potential 'late surprises' in outturn should the profile of capital grants change during the project.

Recommendation one

Accounting for transactions in the correct accounting period

We identified a number of errors in accounting for income and expenditure in the correct accounting period. The proximity of the draft outturn against revenue and capital targets to zero meant that our testing had to consider the potential for errors to change surpluses into deficits. None of the errors, individually or in total, were considered material in relation to total expenditure. Following extended audit testing and management review, net operating costs were increased by £74,000 and capital expenditure was increased by £13,000. The impact of achievement of financial targets is considered later in this report. It is important that management rectifies these weaknesses in June 2010 to mitigate the risk that decisions taken on the basis of monthly management accounts during 2010-11 are robust and based on complete and accurate information.

Recommendation two

Financial statements

Equal pay

The National Health Service in Scotland has received in excess of 11,000 claims for equal pay and the Board has received one claim. These have been referred for the attention of the NHSScotland Central Legal Office ("CLO") to co-ordinate the legal response to this issue.

Developments over the past year have slowed the progress of claims and led to a reduction in the number of claims going forward. The CLO has stated that claims still do not provide sufficient detail about the comparator jobs to allow an estimate to be made of the likelihood of the success of the claims or of any financial impact that they may have. The CLO and Equal Pay Unit are monitoring the progress of claims as well as developments relating to NHS equal pay claims elsewhere that may further inform the position.

Discussions have been held between Audit Scotland, their partner firms, the Scottish Government, the CLO and board representatives to ascertain the appropriate accounting treatment of equal pay claims in 2009-10. Given the CLO's advice, it is not possible to estimate the impact of the claims and it has been agreed that disclosure as an unquantified contingent liability remains appropriate for the 2009-10 financial statements.

We continue to strongly encourage management, working with the Scottish Government Health Directorate, the CLO and other NHS boards to progress resolution of equal pay so that there is clarity over the Board's financial position.

Recommendation three

Regularity

Regularity of transactions

Management has processes to receive Scottish Government Health Directorate circulars, register, allocate and distribute responsibility for action points and monitor and follow up these action points.

Family health services

NHS National Services Scotland ("NHS NSS") processes family health services ("FHS") income and payments on the Board's behalf. Transactions are completed on the basis of self-certification by FHS contractors. Payment verification processes operate on a quarterly basis and management provided a summary of activity to the audit committee at the end of the year. The Board complied with the requirements of the qualities and outcomes framework.

Patient exemption checking

The patient fraud protocol requires NHS Counter Fraud Services to provide an annual estimated level of fraud and error to each NHS board for the 12 months to December. Total estimated fraud represents income lost through patients fraudulently or mistakenly claiming exemptions against dental, pharmaceutical and ophthalmic treatment charges. Total estimated fraud within Orkney in 2009 was £14,594 (2008: £13,866). The estimated level of fraud is based on the extrapolation of findings from a small sample and does not necessarily represent the actual level of lost income. We concur with management's view that the potential fraud / error is not significant and has not been reflected in the financial statements.

Service organisations

NHS NSS operates a number of systems and initiatives on behalf of NHS organisations in Scotland. Service auditors are appointed to provide assurance over control objectives agreed between NHS NSS and NHS boards in relation to the operation of these national systems. Service audits were conducted in accordance with Statement on Auditing Standard 70 ("SAS 70"), issued by the American Institute of Certified Public Accountants, in order to provide positive assurance over controls and to identify areas of control weakness.

Audit Scotland, as external auditor of NHS NSS, reviews the work of service auditors on behalf of auditors of other NHS bodies. This has enabled us to place reliance upon the work of service auditors of the practitioner services division of NHS NSS, the national logistics programme, national information and management technology systems. The Board entered into agreement with NHS Ayrshire and Arran for the provision of managed technical services and application support services, which took effect from 1 April 2008. The Board received a SAS 70 service auditor report in respect of the financial ledger shared service, which did not identify any significant weaknesses. We have placed reliance on these findings for our own responsibilities.

Locum medical staffing

Internal audit was invited by the chief executive and director of finance to evaluate the adequacy of risk management and control arrangements around payments to locum medical staff during 2009-10. The draft report, presented to the audit committee in early May 2010, highlighted a number of significant weaknesses, including a lack of signed contracts, evaluation forms and timesheets, an inconsistent ordering, checking and approval of locum work. Significant spend on locum costs in 2009-10 totalled £0.7 million and resulted in a number of budget overspends. Consequently, management completed an internal review of locum spend and reported to the audit committee in June 2010, that despite significant and widespread process weaknesses that require immediate attention, no material errors were identified in payments made.

Recommendation four

Use of resources

The Board met its financial targets – revenue resource limit, capital resource limit and cash requirement. The outturn against revenue and capital resource limits was subject to change as a result of the audit process and achievement of the latter target was dependent on a late additional allocation from the Scottish Government Health Directorate.

The underlying recurring deficit has reduced from £3.6 million to £2.7 million and is forecast to be eliminated by 31 March 2012. Efficiency savings of £2.3 million were reported by management.

Financial plans are based on a number of high risk over-arching assumptions around cost pressures, recurring overspends and service development, together with individual risk assessments in respect of efficiency savings plans; over half of which are considered to be 'high' risk.

Management continues to make progress in developing more robust arrangements in respect of budget-setting and financial monitoring and there is evidence of good practice in risk assessment of savings plans and financial planning assumptions. However, continued achievement of efficiency savings, particularly on a recurring basis, is unlikely under current arrangements, which require to include robust and routine monitoring of savings achieved in specific areas.

Financial position

This table summarises the outturn against the three financial targets set by the Scottish Government Health Directorate for 2009-10.

£'000	Allocation	Outturn	Variance
Revenue resource limit	42,550	42,542	**8**
Capital resource limit	3,279	3,275	**4**
Cash requirement	47,100	47,075	**25**

The final outturn for the year is consistent with the 2009-10 financial plan and the majority of financial reports to the board and Scottish Government Health Directorate during the year. The outturns against the revenue and capital resource limits were subject to a number of audit adjustments in June 2010 and achievement of the capital resource limit was therefore subject to a late increased funding allocation. The table below summarises the recurring and non-recurring elements of financial performance during the year, as reported by management.

£'000	Recurring	Non-recurring	Total
Income	**41,392**	3,085	44,477
Expenditure	**(45,544)**	(1,158)	(46,702)
Savings	**1,483**	750	2,233
Underlying surplus (deficit)	**(2,669)**	**2,677**	**8**
Forecast underlying position	(2,495)	2,495	-

Financial management

The table below summarises key movements during the year, after the year end, and during the preparation of the financial statements.

Movement	£'000	Movement	£'000
2009-10 forecast outturn against the revenue resource limit	-	**31 March 2010 SGHD return**	**6**
Overspends		Minor post year-end adjustments	12
Prescribing and hospital medicines	(503)	**Draft financial statements**	**18**
General medical services	(453)	Understatement of accruals	(11)
Human resources, pension enhancements and related costs	(69)	Understatement of prescribing accruals	(63)
Underspends		Overstatement of lease costs	6
Externally commissioned services	399	Overstatement of annual leave accrual	22
Reduction in capital expenditure charged as revenue	120	Overstatement of cash limited dental expenditure	36
Miscellaneous income	132		-
Operational services	380		-
31 March 2010 SGHD return	**6**	**Outturn in the financial statements**	**8**

Similar to previous years, the financial position fluctuated throughout the year. However, there is greater understanding, and therefore transparency, in the underlying reasons for variances against budget. This is due, in part, to the more detailed way in which budgets were set for 2009-10; a process that has continued to improve in respect of 2010-11. Errors in accounting for invoices received after the financial year end and understatement of prescribing accruals were identified during the audit process. Achievement of the revenue resource limit was subsequently achieved through reductions in lease costs, annual leave accruals and dental expenditure.

Achievement of financial balance in 2009-10 was continually subject to significant challenges in delivering savings targets and managing recurring overspends in operational departments. Planned recurring efficiency savings in prescribing (£250,000) and primary care services (£150,000) were not realised during the year and are not expected to be realised, in their planned form, in future years. Closure of the piper ward delivered cost savings of £104,000 in long-stay and rehabilitation and service redesign plans in estates delivered savings in domestic (£75,000) and laundry (£36,000) expenditure, principally due to revisions to shift patterns and rotas. Recurring overspends in prescribing, similar to those experienced across Scotland, and locum medical staff costs continue to arise, increasing pressure on future financial plans.

The 2009-10 financial plan assumed £0.5 million of resource transfer abatement from the Council. During the year, management doubled this request, but the Council only agreed to increase the abatement to £0.75 million. The level of abatement is significantly lower than 2008-09 (£1.8 million). The Board and Council have agreed that there will be no resource transfer abatement in 2010-11 or future years, which requires the Board to identify and deliver £0.75 million additional savings, or reduce recurring expenditure by the same amount.

Management and the finance and performance review committee recognise that achievement of the outturn against the revenue resource limit was very challenging. There is a keen awareness that achievement of a small surplus does not mask the underlying financial position and that recurring overspends in key service areas are not sustainable in 2010-11.

Financial management

Our 2008-09 annual audit report included management's risk assessment of assumptions underpinning the 2009-10 financial plan. The table below summarises the impact of these risks on the 2009-10 financial year.

Identified risks	£'000	Risk rating	Comments	2009-10 impact
Brokerage assumptions	1,608	Medium	The financial plan assumed £1.6 million brokerage would be received in 2009-10 and a further £1.2 million in 2010-11. Following discussion with the Scottish Government Health Directorate, brokerage of £0.86 million and £0.76 million was approved respectively. Brokerage in 2009-10 increased to £1.1 million following a partially unsuccessful request for additional resource transfer abatement from the Council.	498
Uplift assumptions	1,064	High	The uplift in revenue resource limit was received.	-
Cash-releasing efficiency targets	550	Medium	The 2009-10 financial plan did not identify specific areas where these savings would be achieved. Management has reported achievement of these savings on a recurring basis. However, there is a lack of detail available to demonstrate how these savings were achieved and therefore consider whether they will recur in future years. It is important that management's understanding and reporting of efficiency savings improves during 2010-11 to mitigate the risk that savings are non-recurring and have a detrimental impact on achievement of financial plans in future years.	-
Resource transfer abatement	500	Medium	The original resource transfer request was approved by the Council. £0.25 million of a subsequent request for an additional £0.5 million was also approved. This is the last year that the Council will authorise resource transfer abatement.	250
Prescribing savings	250	Medium	Savings were not achieved and are unlikely to be achieved in 2010-11 as further consideration of the nature of individual schemes is required before achievement is considered realistic.	(250)
Service redesign savings	400	High	These savings were achieved and management is confident that they will recur in future years.	-

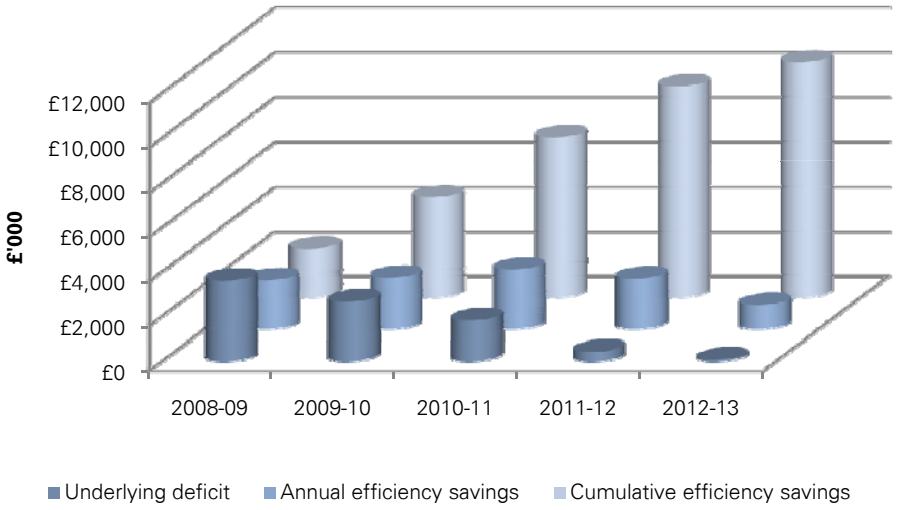
The impact of risks that materialised was just over 10% of the total potential impact of assumptions included in the 2009-10 financial plan (£4.4 million) considered to be medium or high risk. However, these risks are not unique and will continue to present challenges to management going forward, which are reflected in the 2010-11 financial plan.

Financial management (continued)

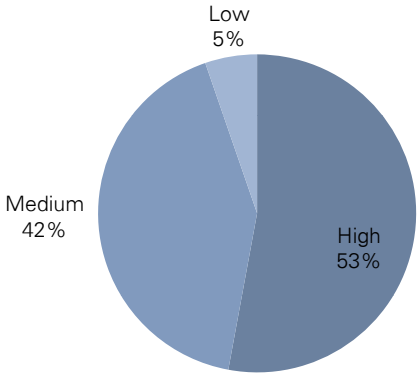
Financial planning

The 2010-11 local delivery plan, incorporating the financial plan, was approved by the Scottish Government Health Directorate in April 2010, which demonstrates a significant improvement in the timeliness of financial planning compared to the previous year when amendments were not finalised until August 2009. The forecast outturn against revenue resource limits for the period from 2008-09 to 2012-13 continues to be a breakeven position, but management recognises the inherent, and significant, uncertainty around financial planning from 1 April 2011 onwards as a result of economic pressures.

This graph summarises the planned decreasing underlying deficit, from £3.6 million in 2008-09, and the levels of efficiency savings, totalling £10.5 million, required to achieve this goal. Management expects around 80% (£8.4 million) of planned cumulative efficiency savings to be recurring savings. Similar to 2009-10, one element of efficiency plans is required to be delivered through cash releasing efficiency savings. The 2010-11 target for non-specific schemes if £0.7 million (2009-10: £0.5 million). While there has been an improvement in identifying specific schemes at an early stage in the process, gaps remained at the beginning of the financial year.



Management continues to demonstrate best practice in performing a risk assessment in respect of annual efficiency savings categories. The diagram below highlights that the majority of saving schemes continue to be considered 'high' risk.



'High' risk savings:

- Prescribing savings (£250,000) were originally planned, but not delivered in 2009-10. Despite management's doubts over the feasibility of savings in this area, this target is required to maintain financial balance 2010-11. In recognition of the level of risk attached to this savings target, management is pursuing alternative plans to minimise the risk to achievement of these savings.
- Primary care and acute services (£750,000) savings are dependent on managing continuing unplanned medical locum staff costs and successful implementation of the network of care programme, together with an ongoing focus on recruitment and workforce planning.

In addition to those savings quantified above, £0.9 million of non-recurring savings will also be required during 2010-11, none of which were identified at the time of approval of the financial plan.

Financial management (continued)

The 2010-11 financial plan is based, inevitably, on a number of significant assumptions and continues to link closely to service redesign proposals and new ways of working approved in 2008-09 and 2009-10. The table below summarises the significant elements of the annual financial plan.

Financial planning area	Comments
Efficiency savings	The Scottish Government target for efficiency savings continues to be set at 2%, but the Board, like many boards, is required to deliver efficiencies significantly in excess of this target to achieve financial balance, albeit non-recurringly. Efficiency savings required in 2010-11 represent 6.8% of the revenue resource limit, reducing to 2.8% in 2012-13. The full impact of efficiency savings delivered in 2009-10 has not yet been quantified. Management estimates that at least £400,000 of savings were achieved on a non-recurring basis , but this does not include the likelihood that a proportion of cash releasing efficiency savings were also achieved on a non-recurring basis. This gap will need to be rectified in 2010-11, increasing the requirement for savings above the 6.8% required in-year.
Funding uplifts	The Scottish Government Health Directorate confirmed that the funding uplift on the base allocation for 2010-11 would be 2.15%, which is 1% higher than forecast in financial plans. This equates to £350,000 additional funding, but is offset by a reduction in specific funding of £116,000.
Cost pressures	Current estimates indicate that inflationary cost pressures on pay and non-pay budgets are £300,000 higher than the funding uplift received. These pressures are reflected in the financial plan and contribute to the need for efficiency savings.
Recurring overspends	The financial plan makes no allowance for recurring overspends, such as prescribing and medical locum costs that arose in 2009-10. In addition, the financial plan highlights that funding in respect of non-discretionary charges, such as those relating to the clinical and medical negligence indemnity scheme and capital charges, have not been subject to annual uplift from the Scottish Government Health Directorate for a number of years. Unallocated reserves of £450,000 are being held centrally to meet some of these overspends and the cost pressures mentioned above, but this is unlikely to mitigate all risks.
Service development	A number of service developments have been identified and require £271,000 of funding to be released through planned efficiency savings.
Scottish Government brokerage	Brokerage in 2010-11 of £0.7 million was agreed by the Scottish Government Health Directorate in August 2009. Approval was provided on the basis of an agreed repayment profile, which starts in 2012-13. The Board's ability to meet this repayment profile is solely dependent on achieving recurring balance in 2011-12 and recurring surpluses thereafter.

The inherent uncertainty and potential impact has been highlighted to both the finance and performance committee and the board. The local delivery plan highlights 'high' risks of £750,000 around general practitioner and community nursing costs and prescribing savings, together with £512,000 of 'medium' risk assumptions in respect of non-pay inflation, prescribing costs, inflationary pressures associated with externally commissioned services and unplanned activity. Similar to previous years, ongoing monitoring of these areas will be key to minimising fluctuations and uncertainty in financial results.

Financial management (continued)

2009-10 capital expenditure and 2010-11 capital plans

Expenditure of £3.265 million was incurred in 2009-10 in line with capital plans, including £1.25 million of capital grants paid to the Council. Individually significant projects include Balfour hospital ward reconfiguration (£202,000), Kirkwall health centre refurbishment (£227,000) and information technology projects (£622,000). A reconciliation of the outturn against the capital resource limit is shown below.

Movement	£'000	£'000
2009-10 forecast capital outturn	-	
Expenditure capitalised during the year	(3,265)	
Capital resource limit	3,269	
Draft outturn against the capital resource limit		**4**
Financial statement preparation adjustments		3
Outturn in the draft financial statements		**7**
Understatement of capital accruals	(13)	
Revision to capital resource limit in June 2010	10	(3)
Final outturn against the capital resource limit		**4**

Audit work on invoices received after 31 March 2010 identified two invoices that related to capital spend incurred during 2009-10. In response, management successfully obtained an increase in the capital resource limit, which resulted in a breakeven position against this financial target.

It is important that estates staff fully understand the requirement to account for capital expenditure in the correct accounting period, which is based on the year in which items are received or capital works are performed, rather than when the invoice is received or paid.

The draft capital plan for 2010-11 anticipates expenditure of £3 million and a breakeven position against the capital resource limit. Uncommitted capital resources total £659,000. Total spend includes £750,000 in capital grants payable to the Council in line with the agreed contribution to integrated care facilities in St Margaret's Hope and Kirkwall.

Corporate governance arrangements

We considered the corporate governance arrangements and have concluded that the framework has been designed and implemented appropriately. Progress continues to be made in developing appropriate arrangements to support the board in ensuring long term financial and service sustainability, but it is important that all committees retain their roles of scrutiny and challenge. It is also important that high level arrangements are cascaded throughout the Board to ensure effective governance and controls at all levels.

Our testing of the design and operation of controls over significant risk points confirms that, with the exception of some weaknesses noted, controls are designed appropriately and operating effectively.

The statement on internal control provides details of the purpose of the system of internal control, the risk and control framework and the effectiveness of this framework. The statement complies with the Scottish Government Health Directorate's guidance.

Introduction

Corporate governance is concerned with structures and processes for decision-making, accountability, control and behaviour. The three fundamental principles of corporate governance – openness, integrity and accountability – apply to all bodies.

Through its chief executive, the Board is responsible for establishing arrangements for ensuring the proper conduct of its affairs, including compliance with relevant guidance, the legality of activities and transactions, and for monitoring the adequacy and effectiveness of these arrangements. The *Code* requires auditors to review and report on corporate governance arrangements as they relate to:

- the Board's reviews of its systems of internal control, including its reporting arrangements;
- the prevention and detection of fraud and irregularity; and
- standards of conduct and arrangements for the prevention and detection of corruption.

Governance framework

The governance framework includes four governance sub-committees of the board: audit, staff governance, quality and improvement committee, and finance and performance committee. The terms of reference for each committee are up to date and detail decision-making powers and delegated responsibility.

Progress continues to be made in developing the role and operation of board committees. The code of corporate governance received formal board approval in April 2009 and an updated version was approved on 29 June 2009. That code defines the framework of committees and demonstrates an effective committee structure with increased clarity over reporting lines and the remit of each committee. The level of challenge from sub-committees, such as the remuneration committee, has also improved with responsibilities and roles clarified and more pertinent questions being asked of management.

Progress has also been made in developing the finance and performance committee and the quality and improvement committee. Plans to split the latter are being considered with a view to reducing the workload of individual committees. The remuneration committee also continues to develop and, in 2009-10, has made significant progress in approving executive director objectives. A 2010 corporate governance work plan was submitted to the audit committee on 26 January 2010; demonstrating future corporate governance monitoring arrangements including the Board's committee structure and performance management capacity.

Corporate governance arrangements (internal audit)

The four sub-committees met on 22 occasions during the year, with individual committees meeting between four and seven times. In addition, the remuneration committee met nine times. The level of detail and frequency in which the governance committees are considering information prepared by management is more than our experience across the sector. It is perhaps not unreasonable given weaknesses in approval and decision-making processes in previous years, but it is important that all committees retain their roles of scrutiny and challenge. The table below summarises key areas of the annual reports prepared by the board's committees.

Committee	Highlights of committee annual report to the board
Audit	An annual development day was held in May 2010, during which members of the committee identified actions required to further strengthen its ability to effectively challenge. These actions include reviewing the committee's terms of reference, refining its business cycle, clarifying reporting to the board, and implementing a structured development programme. Each member of the committee completed a self-assessment of the committee's effectiveness. This highlighted gaps in understanding the risk and control framework and how this is monitored, monitoring the effectiveness of internal audit, and audit committee reporting to the board.
Finance and performance	At the end of its first full year of operation, the committee's annual development session concluded that the integrated approach, frequency of meetings, breadth of business undertaken and range of meeting attendees had allowed the committee to fulfil its remit. Areas for improvement, identified through member self-assessment, include considering efficiency and value for money, providing assurance to the board on performance management issues, and reviewing the skills, knowledge and experience required from committee members.
Quality and improvement	A key element of the committee's work during 2009-10 was review of the action plan prepared in response to the report issued by NHS Quality Improvement Scotland on the board's clinical governance and risk management arrangements. Updates on progress against the action plan will feature as a standing item on future committee agendas. The committee recognises the increasing complexity and volume of matters to be considered and continues to monitor its performance against agreed indicators, which are both qualitative and quantitative in nature. Committee members completed a self-assessment of the committee's performance during the annual development session in May 2010 and identified areas for continued development and improvement, including considering the degree of cross-committee assurance, developing a co-ordinated clinical audit system, clarifying operational, committee and board reporting systems, and using the Board's risk and control assurance framework to produce a clinical strategy.
Staff governance	The committee self-assessed its performance during an annual development session in May 2010 and recognised that the committee had refocused its role during the year to adapt to organisational change and legislative requirements. The committee considered the work of the remuneration committee, which had prepared a separate report to the board on its activities. For the first time, the remuneration committee has worked to an agreed business cycle, focussing primarily, in 2009-10, on the objectives of executive directors, recruitment of interim and permanent positions in the executive management team and associated remuneration.

Corporate governance arrangements (internal audit)

Internal audit

The board tendered its internal audit service during the year and re-appointed the existing service provider.

Internal audit completed their plan for the year and presented their internal audit draft annual report to the audit committee on 15 June. That report concluded that *"based on the work undertaken in 2009-10, significant assurance can be given that there is a generally sound system of internal control, designed to meet the organisation's objectives, and that controls are generally being applied consistently. However, some weaknesses in the design and inconsistent application of controls put the achievement of particular objectives at risk".* The areas of 'higher risk' highlighted by internal audit are health and safety and delivery of HEAT financial targets.

Internal controls

Since our appointment as the Board's external auditors in 2006 we have reported opportunities for improvement in the operation of some key financial controls. Some of these have been reported in more than one year, but all recommendations have been accepted by management. Recurring weaknesses include a lack of evidence of preparation and review of financial control recommendations and controls over stock, including pharmacy stock.

Our testing, combined with that of internal audit, of the design and operation of controls over significant risk points confirms that, with the exception of some weaknesses noted, controls are designed appropriately and operating effectively.

The statement on internal control provides details of the purpose of the system of internal control, the risk and control framework and the effectiveness of this framework. The statement complies with the Scottish Government Health Directorate's guidance.

Prevention and detection of fraud and irregularity;

The Board has a formal fraud policy and a confidential contacts network facilitates fraud reporting by staff. The director of finance is the fraud champion and recognises the need to increase awareness of NHS Counter Fraud Services and the role of the fraud liaison officer. This should include promoting completion of fraud training by all staff.

Recommendation five

National Fraud Initiative ("NFI")

Health bodies took part in the NFI exercise for the second time. We tested a sample of resolved matches and concluded that satisfactory evidence was available to support all matches noted as resolved on the NFI system. A summary of the Board's activity is shown below.

	Total matches	Number investigated	Volume of fraud identified	Value of fraud identified
2007	54	54	-	-
2009	62	60	-	-

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Audit Scotland national reports

Audit Scotland national reports

Audit Scotland periodically undertakes national studies on topics relevant to the performance of NHS Scotland. While the recommendations from some of the studies may have a national application, elements of the recommendations are also capable of implementation at board level, as appropriate.

Management has established procedures to consider individual reports. As self-assessment is completed for all reports relevant to the Board. The reports are then assigned responsibility and are forwarded to the appropriate person or committee where an action plan is prepared and progress against these plan is monitored.

In 2009-10 we have reported action taken by management in response to a number of reports and those not previously reported on are summarised below. We will report the Board's response to Audit Scotland in respect of these reports in July 2010.

Report topic (issue date)	**Discussed by a committee**	**Noted by a committee**	**Self-assessment performed**	**Local action plan prepared**	**Plans to feed back to a committee**	**Frequency of feedback**
Scotland's public finances	×	✓	×	×	×	n/a
Overview of NHS in Scotland performance 2008-09	×	✓	×	×	×	n/a
Improving public sector efficiency	×	✓	×	×	×	n/a
Managing NHS waiting lists	×	✓	✓	×	×	n/a
Review of orthopaedic services	×	✓	×	×	×	n/a

Appendix one – action plan

Priority rating for recommendations		
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.	**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.	**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.

No.	Issue and recommendation	Management response	Officer and due date
1	The Board's capital grant to the Council in 2009-10 exceeded the Board's percentage contribution to the integrated care facilities project. It is likely that this position will continue throughout 2010-11. It is important monitoring of project spend and progress continues in 2010-11 and future years to ensure that NHS contributions remain timely and regular, i.e. that the Board is not providing cash to the Council in excess of that disbursed on the project in any one financial year. Ongoing liaison with the Scottish Government Health Directorate will reduce the likelihood of potential 'late surprises' in outturn should the profile of capital grants change during the project. (*Grade one*)	The Board will monitor the expenditure position closely during the year and will liaise with the Scottish Government Health Directorate if expenditure projections are significantly lower than anticipated.	Director of finance. Ongoing during the year via the project board
2	We identified a number of errors in accounting for income and expenditure in the correct accounting period and adjustments were made to the financial statements to increase net operating costs and capital expenditure. It is important that management rectifies these weaknesses in June 2010 to mitigate the risk that decisions taken on the basis of monthly management accounts during 2010-11 are robust and based on complete and accurate information. (*Grade one*)	The accounting errors arose from weaknesses in the systems and processes around ordering and receipting of goods. A revised methodology is currently being put in place to address the identified weaknesses.	Director of finance 30 June 2010

Appendix one – action plan

No.	Issue and recommendation	Management response	Officer and due date
3	We strongly encourage management, working with the Scottish Government Health Directorate and other NHS boards, to progress resolution of equal pay so that there is clarity over the Board's financial position. *(Grade two)*	NHS Orkney will continue to liaise closely with Scottish Government Health Directorate and Central Legal Office colleagues to ensure that the most up to date information is available and utilised in financial planning.	Director of finance Director of human resources Ongoing
4	Internal audit and management review of processes and controls around approval and use of medical identified significant weaknesses and inconsistencies in arrangements. Significant spend on locum costs in 2009-10 totalled £700,000 and resulted in a number of budget overspends. Management should identify and implement consistent practice across all areas, ensuring that processes are both effective and efficient. (*Grade one*)	A revised ordering, receipting and payment process will be developed specifically for locums. A follow up visit by internal audit has already been arranged for December 2010.	Director of finance 31 August 2010
5	The director of finance is the fraud champion and recognises the need to increase awareness of NHS Counter Fraud Services and the role of the fraud liaison officer. This should include promoting completion of fraud training by all staff. (*Grade two*)	The director of finance will be meeting with Counter Fraud Services to understand what assistance can be made available to support fraud awareness and training for all staff.	Director of finance 31 December 2010