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Executive Commentary

Introduction - Section 1
Our overall responsibility as external auditor of NHS Health Scotland ("the Board") is to undertake our audit in accordance with the principles contained in the Audit Scotland Code of Audit Practice ("the Code"), revised and published in March 2007. We have a dual reporting responsibility for the audit: to the Board Members of NHS Health Scotland and to the Auditor General for Scotland.

Financial Statements and Audit Opinion - Section 2
The financial statements of the Board for the year ended 31 March 2011 have been prepared to comply with accounting requirements contained in the NHS Board Accounts Manual for Directors' Report and Accounts of NHS Boards and for Scottish Financial Returns, and supplementary guidance, as issued by the Scottish Government Health Directorates (SGHD) and approved by the Scottish Ministers. We are pleased to report that our opinion on the financial statements for the year ended 31 March 2011 is unqualified.

The financial statements and supporting schedules were presented to us for audit within the agreed timetable and the quality of working papers provided by management was of a high standard. Overall an efficient audit process was achieved through an effective working relationship with your staff.

As a result of our work, we proposed a number of audit adjustments, predominantly disclosure in nature. All adjustments have been accepted by management and were processed within the 2010/11 financial statements.

2010/11 Financial Performance - Section 3
Through a concerted cost management focus, the achievement of efficiency savings in excess of those budgeted, an inability to fully utilise anticipated project budgets, as well as the reduction in the level of senior management, the Board under-spent against budget, resulting in a total Revenue Resource Limit (RRL) surplus of £1.1m.

The most significant capital project undertaken in the period was the improvement of the Board’s IT infrastructure which was part of an overall Capital Resource Limit (CRL) and outturn of £0.2m.

Looking Forward - 2011/12 - Section 4
The year ahead is expected to bring further challenges to all NHS Bodies. The public sector must respond to a deep and protracted funding squeeze as public finances are rebalanced. While the Health sector in Scotland has been protected from the vast majority of these budget reductions, the achievement of financial balance will continue to be a significant challenge for management.

The Board has identified cost pressures resulting from a number of factors including: the rate of inflation; a reduction in the Board’s core allocation; to manage risk, a decision to fund all staff costs from the Board’s core allocation and therefore to accept less non core funding from the Scottish Government; and, following production of a balanced business plan, recognition that in-year bids for additional or new project funding would be made, and that appropriate resources would need to be found from efficiencies and other measures such as budget surrenders.

Capital funding from the Scottish Government has been reduced for 2011/12 however this has been compensated by a £0.4 million transfer from revenue to capital as a result of a carried forward surplus from 2010/11. The Board plan to deploy this expenditure on actions, in accordance with the Strategic Accommodation Review, to commence consolidation of the Board’s office premises to two sites, from the existing five.
Governance and Control - Section 5

We have assessed the Board’s overall governance arrangements including a review of Board and key Committee structures and minutes, financial reporting to the Board, and risk management. We consider that appropriate structural and reporting arrangements are in place.

The Code of Audit Practice requires us to review and report on the Board’s Statement on Internal Control. The Board has used the correct format for its Statement and has outlined the processes it had employed to identify and evaluate risks. In addition, key elements of the Board’s control framework have been highlighted. Based on our normal audit procedures, we do not disagree with the disclosures contained in the Statement.
Section 1: Introduction

Our Annual Audit Report which follows is designed to set out the scope, nature and extent of our audit, and to summarise our opinion and conclusions on issues arising. Specifically this will direct your attention to matters of significance that have arisen out of the 2010/11 audit process and to confirm what action is planned by management to address the more significant matters identified.

Our overall responsibility as external auditor of NHS Health Scotland (“the Board”) is to undertake our audit in accordance with the principles contained in the Audit Scotland Code of Audit Practice published in March 2007 (“the code”). In this regard, the Code sets out the need for public sector audits to be planned and undertaken from a wider perspective than in the private sector involving not only assurance on the financial statements but also consideration of areas such as regularity, propriety, performance and the use of resources.

It also sets out the need to recognise that the overall audit process is a co-ordinated approach involving the “appointed auditor”, the Auditor General for Scotland and other auditors such as Audit Scotland’s Health Performance and Public Reporting Group. Our audit has been planned and conducted to take account of these wider perspectives.

Under the requirements of International Standard on Auditing (UK and Ireland) (‘ISA’) 260: “Communication of audit matters to those charged with governance”, we are required to communicate audit matters arising from the audit of financial statements to those charged with governance, in NHS Health Scotland’s case this is the Board. This Annual Audit Report to Members, together with previous reports to the Audit Committee throughout the year, discharges our responsibilities under ISA 260.

We would like to formally extend our thanks to the Board’s managers and staff for the assistance they have given us during the current year’s audit process and throughout our tenure as appointed auditors, which now ceases.

PricewaterhouseCoopers LLP
Appointed Auditor
Glasgow
28 June 2011
Section 2: Financial Statements and Audit Opinion

Financial Reporting
The financial statements for NHS Health Scotland for the year ended 31 March 2011 have been prepared to comply with the UK HM Treasury Reporting Manual (FREM) and International Financial Reporting Standards (IFRS).

Accounts have been produced using the template and supplementary guidance, as issued by the Scottish Government Health Directorates (SGHD) during 2010/11 and approved by Scottish Ministers.

Audit Process
The draft financial statements and supporting schedules were made available to us at the start of our audit allowing us to progress and complete the audit within the agreed timescales.

The quality of the financial statements and working papers produced by management was of a good standard. Overall, we believe an effective working relationship exists between ourselves and your managers and staff and an efficient audit process was achieved, as has been the case in prior years.

Approval
The Financial Statements will be submitted to the Audit Committee on the 28 June 2011 and are to be approved and adopted at the Board meeting on 28 June 2011.

Unadjusted Misstatements
Under ISA 260 - “Communication of audit matters to those charged with governance”, we are required to report to members of the Board all unadjusted misstatements which we have identified during the course of our audit, other than those which we deem to be of a trivial nature.

As a result of our work, we proposed a number of audit adjustments, predominately disclosure in nature. All of these adjustments have been accepted by Management and were processed within the 2010/11 financial statements.

Audit Opinion
Our audit opinion concerns the true and fair statement of the Board’s financial results for the year ended 31 March 2011 and the regularity of its income and expenditure for the year.

We are pleased to report that our opinion on the true and fair view on the financial statements and on the regularity of income and expenditure is unqualified.

We also provide a view as to whether those parts of the Remuneration Report subject to audit have been properly prepared. Our opinion on the Remuneration Report is unqualified. Our audit opinion does not extend to any other part of the Directors’ Report.

Accounting Issues
We did not identify any significant accounting issues during the course of our audit.
Section 3: 2010/11 Financial Performance

Performance against Key Financial Targets

The Board’s financial performance has been presented in respect of 3 key statutory metrics: Income, Revenue expenditure and Capital expenditure, as set out below:

<table>
<thead>
<tr>
<th></th>
<th>2010/11 Actual £million</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income</td>
<td>25.371</td>
</tr>
<tr>
<td>Expenditure</td>
<td>24.284</td>
</tr>
<tr>
<td><strong>2010/11 Surplus/(Deficit)</strong></td>
<td><strong>1.087</strong></td>
</tr>
<tr>
<td>Capital Expenditure</td>
<td>0.192</td>
</tr>
</tbody>
</table>

A final outturn surplus of £1.087 million was recorded in respect of the Board’s revenue allocation, while a balanced position was reached on the Board’s 2010/11 capital budget.

During the year, Management faced a number of challenges in achieving the budgeted financial outturn, as reflected in the summary analysis below.

Expenditure

Expenditure in the period totalled £24.284 million, £1.087 million less than budget. There were a number of factors which impacted this under-spend, including £0.276 million carry forward from 2009/10 and a combination of £0.639 million of efficiency savings and slippage in relation to project budgets. The most significant elements of the efficiency savings are explained below:

- £0.344 million was saved in relation to payroll costs due to measures such as internal restructuring as an alternative to external recruitment;
- Approximately £0.052 million reduction in costs was realised from moving to electronic order processing; and
- £0.029 million was saved in relation to lower warehouse costs achieved from moving the storage location of inventory.

The project slippage occurred due to an inability to spend allocated project budgets, which resulted mainly from a combination of the efficiency savings above, a more conservative approach to budget accountability, and some delays experienced in working with partners.

Capital Expenditure

The main focus of capital work during 2010/11 was the improvements to IT infrastructure (£0.146 million). Capital expenditure was as forecast and in line with available capital funding.

Severance costs

Included within the financial statements this year is an analysis of severance costs. During 2010/11 NHS Health Scotland paid £0.583 million in redundancy costs and £0.066 million in early retirement costs. None of the payments made was as a result of compulsory redundancies.
Section 4: Financial outlook for 2011/12

The year ahead is expected to bring further challenges to all NHS Bodies. The public sector must respond to a deep and protracted funding squeeze as public finances are rebalanced. In particular, the Scottish budget has been reduced by £1.3 billion in 2011/12. While the Health sector in Scotland has been protected from the vast majority of these budget reductions, the achievement of financial balance will continue to be a significant challenge for management.

The Board has agreed the following budget for 2011/12, in respect of Income, Expenditure and Capital spend:

<table>
<thead>
<tr>
<th>2011/12 Budget (£million)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income 22.429</td>
</tr>
<tr>
<td>Expenditure 22.205</td>
</tr>
<tr>
<td>2011/12 Surplus/(Deficit) 0.224</td>
</tr>
<tr>
<td>Capital Expenditure 0.550</td>
</tr>
</tbody>
</table>

The financial plan was agreed by the Board on 25 March 2011.

2011/12 Cost Pressures

The start of 2011/12 has seen a number of internal bids for additional funding which is an indication that cost pressures may replace under-spend as a primary risk for the year ahead.

The Board has highlighted several cost pressures in its 2011/12 financial plan that may impact on its ability to achieve its agreed budget. The more significant and challenging of these are: the rate of inflation; a reduction in the Board’s core allocation; to manage risk, a decision to fund all staff costs from the Board’s core allocation and therefore to accept less non core funding from the Scottish Government; and, following production of a balanced business plan, recognition that in-year bids for additional or new project funding would be made, and that appropriate resources would need to be found from efficiencies and other measures such as budget surrenders. There is already some evidence of this, referred to in the paragraph above.

Savings Plans

The Board continues to approach the delivery of required savings through an efficiency savings programme. NHS Health Scotland’s core budget allocation from SGHD has been uplifted by 1% in 2011/12. However, this has been offset by the reduction of a 5% efficiency savings target.

The Board expects to achieve this through a number of measures including a target of no growth within payroll expenditure. Internal restructuring will be utilised where possible as an alternative to external recruitment. This will result in savings from the cost of advertising and filling vacancies as well as payroll costs. A Workforce Review Group has been established to consider whether empty posts require to be filled and senior management reduction plans have been put in place.

The Strategic Accommodation Review and the Property Asset Management Strategy have been put in place to drive forward the plans to consolidate the current five office locations into two sites, one in Glasgow and one in...
Edinburgh. This is expected to achieve significant efficiency savings in the form of reduced travelling expenses, the introduction of more efficient working practices, and the utilisation of shared services.

**Capital Plan**

The Scottish Government has confirmed the Board’s capital allocation of £0.150 million for 2011/12. In addition to this it has been agreed with SGHD that £0.868 million of the surplus from 2010/11 will be carried forward to 2011/12. NHS Health Scotland has taken the decision to transfer £0.400 million of this from revenue to capital to commence consolidation of office accommodation.

Additional capital spend is planned for the rolling Information Management and Technology programme (£0.075 million) and the property programme (£0.075 million).

**2012/13 and Beyond**

Despite receiving confirmation of only a 1 year funding allocation from SGHD, the Board has prepared outline financial plans for 2012/13 and 2013/14. However, given the level of uncertainty in the economic environment, these plans contain a series of assumptions in respect of both funding and likely expenditure growth.
Section 5: Governance and Internal Control Arrangements

Overall Governance Arrangements

The established Committee framework at the Board remains in place, incorporating Audit, Staff Governance, Health Governance and Remuneration Committees. Governance arrangements are also supported by the Corporate Management Team and the Partnership Forum. Each of these Committees meets on a regular basis and is chaired by a non-executive member.

Statement on Internal Control

The Code of Audit Practice requires us to review and report on the Board’s Statement on Internal Control. The Board has used the correct format for its Statement and has outlined the processes it has employed to identify and evaluate risks. In addition, key elements of the Board’s control framework have been highlighted and details have been provided of the approach to compliance with Best Value guidance outlined by SGHD in March 2011. Based on our normal audit procedures, we do not disagree with the disclosures contained in the Statement.

Systems of Internal Control

Over the term of our external audit appointment we review those key financial processes and controls which could have a direct impact on the fair statement of balances within the financial statements. Our audit testing included individual walkthroughs of the specific financial processes in place and more detailed testing of certain key financial controls to ensure that these controls are operating as expected. For 2010/11 this detailed work included:

- Sales and Receivables;
- Purchasing and Payables;
- Cash Management; and
- Payroll.

In addition, we reviewed NHS Health Scotland’s IT general control environment, as it relates to the core financial systems.

The results of our work on systems of internal control were communicated to the Audit Committee in our Interim Management Letter in April 2011. The report contained nine recommendations to improve controls, with one recommendation graded as high risk, in respect of the Board’s Information Governance arrangements.

Management has completed an action plan detailing those individuals responsible for implementing our recommendations and the timetable for completion.

While performing our detailed year-end audit testing over the existence of fixed assets we identified £0.023 million of fully depreciated IT equipment that had been disposed of prior to the year end. This was communicated to management and has subsequently been removed from the financial statements. From review of the fixed asset register for IT equipment it can be seen that a number of aged items have been fully depreciated and so it is recommended that management conduct a full physical verification exercise to confirm the existence of these assets.

Action 1
Follow up of outstanding recommendations

In addition to our work on internal controls we followed up the Board’s progress in implementing external audit recommendations made in the prior year. We identified 16 recommendations of which 10 have either been fully or partially implemented and a further 2 were considered no longer applicable. Our Follow up of Prior Year Recommendations Report was considered at the Audit Committee meeting on 6 May 2011.

National Fraud Initiative

The National Fraud Initiative (NFI) brings together data from health bodies, councils, police and fire rescue bodies and other agencies, to help identify and prevent a wide range of frauds against the public sector. These include housing benefit fraud, occupational pension fraud and payroll fraud.

The 2010/11 NFI project is a two year programme. The Board has run both payroll and creditors data sets and were notified of 289 recommended matches requiring further investigation.

At the time of our review, investigation of these matches had not begun. Due to the volume and potential significance of these matches, we recommend that a plan is put in place to ensure the investigative work is completed in a timely manner.

Action 2

Improving Public Sector Purchasing

At the request of Audit Scotland, we were required to perform targeted follow up work on one of their National Performance Reports: Improving public sector purchasing (published July 2009) during the year.

As per our review we can confirm that ongoing progress is being made by the Board to further refine and strengthen procurement arrangements.

The Performance Capability Assessments (PCA) results have shown an improvement, from 28% 'conformance' in 2009/10, to 55% 'improved performance' in 2010/11. This was predominately achieved by raising the profile of the Procurement function within the Board, providing quality training and improving the use of technology such as the intranet.

Despite the improved procurement performance, the following areas have been identified by the Board as being the main areas where development could be achieved:

• Performance measurement and benefits tracker;
• Supplier management; and
• A procurement journey update.
Appendices
Appendix 1: Action Plan

To assist management in assessing each audit finding and recommendation, we have assessed the risk to the organisation of each of the recommendations which has not yet been implemented fully and have categorised each recommendation according to the criteria shown below:

<table>
<thead>
<tr>
<th>Risk Rating</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>High</td>
<td>Significant control weakness requiring immediate attention by management</td>
</tr>
<tr>
<td></td>
<td>Control weakness identified which needs to be rectified but where there is no material impact on the achievement of the control objectives</td>
</tr>
<tr>
<td>Low</td>
<td>Minor control weakness identified</td>
</tr>
</tbody>
</table>

The following recommendations have been raised within the body of this report:

<table>
<thead>
<tr>
<th>Ref</th>
<th>Recommendation and Risk Rating</th>
<th>Management Response, Responsible Officer and Implementation Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td><strong>Action 1</strong></td>
<td><strong>Management Response:</strong> Recommendation accepted.</td>
</tr>
<tr>
<td></td>
<td>We identified £23,000 of fully depreciated IT equipment on the fixed asset register at 31 March 2011 that had been disposed of prior to the year end. From review of the fixed asset register for IT equipment it can be seen that a number of aged items have been fully depreciated and so it is recommended that management conduct a full physical verification exercise to confirm the existence of these assets.</td>
<td><strong>Responsible Officer:</strong> Head of Finance/Head of IT <strong>Implementation Date:</strong> 31 July 2011</td>
</tr>
<tr>
<td></td>
<td><strong>Risk Rating - Medium</strong></td>
<td></td>
</tr>
<tr>
<td>2</td>
<td><strong>Action 2</strong></td>
<td><strong>Management Response:</strong> Recommendation accepted.</td>
</tr>
<tr>
<td></td>
<td>Due to the volume and potential significance of the matches within the National Fraud Initiative output, we recommend that a plan is put in place to ensure the investigative work is completed in a timely manner.</td>
<td><strong>Responsible Officer:</strong> Head of Finance <strong>Implementation Date:</strong> 31 October 2011</td>
</tr>
<tr>
<td></td>
<td><strong>Risk Rating - High</strong></td>
<td></td>
</tr>
</tbody>
</table>
### Appendix 2: Communication to Management

International Standards on Auditing ("ISA") (UK&I) 260 – Reporting to those charged with Governance, requires that the External Auditor communicates certain matters to those charged with governance. Those charged with Governance is taken to be the Members of the Audit Committee with responsibility discharged through the regular meetings of the Audit Committee during the year. Summarised below are the requirements set out within ISA 260 together with reference to the relevant communication with you during 2010/11 or comments as appropriate.

<table>
<thead>
<tr>
<th>Communication Required under ISA 260</th>
<th>Reference/Comment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Engagement Letters</td>
<td>Signed Engagements Letter with Audit Scotland at the start of our 5 year appointment and updated annually.</td>
</tr>
<tr>
<td>Independence</td>
<td>Audit Planning document reported to 29 October 2010 Audit Committee and confirmed no member of audit team has any direct interest, financial or otherwise, in NHS Health Scotland.</td>
</tr>
<tr>
<td>Audit Approach and Scope</td>
<td>Audit Planning document (reported to Audit Committee 29 October 2010). During the year there were no changes to our plan or risk assessment that we are required to communicate with you.</td>
</tr>
<tr>
<td>Materiality</td>
<td>Audit Planning document (reported to Audit Committee 29 October 2010)</td>
</tr>
<tr>
<td>Form and Timing of Communications</td>
<td>Audit Planning document (reported to Audit Committee 29 October 2010)</td>
</tr>
<tr>
<td>Accounting Policies/Estimates/Disclosures</td>
<td>Section 2 of our Annual Report to Board Members and the Auditor General for Scotland.</td>
</tr>
<tr>
<td>Correspondence with management on significant matters</td>
<td>Discussed and resolved matters arising with management throughout audit process.</td>
</tr>
<tr>
<td>Letter of Representation</td>
<td>Signed by the Chief Executive on 28 June 2011.</td>
</tr>
<tr>
<td>Other matters significant to the oversight of financial reporting process</td>
<td>None identified.</td>
</tr>
<tr>
<td>Material Uncertainties relating to Going Concern</td>
<td>None identified.</td>
</tr>
<tr>
<td>Related Parties</td>
<td>Other than those transactions disclosed in the financial statements we have not identified any further transactions requiring disclosure.</td>
</tr>
<tr>
<td>Fraud</td>
<td>Discussed fraud arrangements with the Chair of the Audit Committee 29 October 2010 and management throughout audit process and separately within our Annual Report.</td>
</tr>
<tr>
<td>Material Weaknesses in Internal Controls</td>
<td>Internal Controls findings reported separately in our Interim Management Letter 30 April 2011</td>
</tr>
<tr>
<td>Improving Public Sector Purchasing: Follow-up</td>
<td>Separate report issued June 2011 as requested by Audit Scotland</td>
</tr>
<tr>
<td>Letter to the Chair of NHS Health Scotland following our review of high earners, as requested by the Cabinet Secretary for Health and Wellbeing</td>
<td>Letter issued end of March 2011.</td>
</tr>
</tbody>
</table>