



INFRASTRUCTURE, GOVERNMENT &
HEALTHCARE

The State Hospitals Board for Scotland

Annual audit report to The
State Hospitals Board for
Scotland and the Auditor
General for Scotland 2006-07

25 June 2007

AUDIT

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Executive summary

Scope of report

This report summarises our work for the 2006-07 year and our findings in relation to our audit of the financial statements, corporate governance arrangements, and performance management arrangements.

Financial statements

On 25 June 2007 we issued an audit report expressing an unqualified opinion on the financial statements of the Board for the year ended 31 March 2007 and on the regularity of transactions reflected in those financial statements.

The Board achieved all three of its financial targets for 2006-07. The 2006-07 financial plan forecast a cumulative surplus in the current year of £0.74 million. The actual outturn was a cumulative surplus of £0.9 million, reflecting additional allocations from the Scottish Executive Health Department and savings against budget.

Corporate governance

The statement on internal control for 2006-07 provides details of processes, controls and the roles and membership of the corporate governance committees.

In May 2007 internal audit issued their statement of internal control readiness report which reported positively on the results of a high level assessment of the systems to ensure that there is sufficient evidence available to the chief executive to produce the statement on internal control.

During the year the Board participated in the National Fraud Initiative for the first time. The finance and performance management director has taken the lead role in the process and has reported the results of the data matching exercise to the audit committee and board. Management have accessed the NFI web application regularly since the results were released and have updated the results with comments as appropriate. All data matches are either resolved or under investigation.

Our testing of the design and operation of controls over entity level controls and significant risk points in key financial processes confirms that, subject to the minor weaknesses reported, controls are designed appropriately and operating effectively.

Performance management

The Board has weekly senior management team meetings where operational, regulatory, planning and performance issues are discussed. A finance report is prepared for each board meeting. This details the position to date and the expected year end outturn. Progress against capital budgets is also reported to the board.

The board has recognised the resource pressures that the hospital redevelopment project will have from quarter three 2007-08 and beyond.

Introduction

Audit framework

2006-07 was the first year of our five-year appointment as external auditors of The State Hospitals Board for Scotland ("the Board"). This report outlines our opinion and conclusions and highlights significant issues arising from our work.

In accordance with Audit Scotland's *Code of Audit Practice* ("the Code"), the scope of the audit was to:

- provide an opinion on the Board's financial statements and, as required by relevant authorities, the regularity of transactions;
- review and report on (as required by relevant legislation, the Code and any guidance issued by Audit Scotland):
 - the Board's corporate governance arrangements as they relate to: its review of systems of internal control; the prevention and detection of fraud and irregularity; standards of conduct, and prevention and detection of corruption; and its financial position;
 - the Board's arrangements to achieve Best Value; and
 - other aspects of the Board's arrangements to manage its performance, as they relate to economy, efficiency and effectiveness in the use of resources.

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.

Priorities and risks

To assist in the development of a consistent approach to the audit across bodies, Audit Scotland published a *Priorities and Risks Framework* setting out seven areas for consideration. We built on this and the Board's processes and management arrangements in these areas in focusing our audit effort. In addition, we identified a number of other areas for specific attention.

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 its 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 accountable officers, to make arrangements to secure Best Value.

Acknowledgement

We wish to place on record our appreciation of the co-operation and assistance extended to us by staff during the first year of our work in the discharge of our responsibilities.

Financial statements audit

Audit opinion

On 25 June 2007 we issued an audit report expressing an unqualified opinion on the financial statements of the Board for the year ended 31 March 2007 and on the regularity of transactions reflected in those financial statements. We wish to bring the following issues to the Board's attention.

Hospital redevelopment

During 2006-07 the Board progressed plans for the re-development of the hospital. This included submission of addenda and sign-offs against the outline business case submitted previously. Final approval of the business case by the Scottish Ministers is expected in autumn 2007. Guidance on the expectations of the forensic service configuration that is required within Scotland to provide a full range of forensic inpatient services and the level at which those services should be commissioned was also received. This guidance clearly identified that there would no longer be a requirement for provision of high security women's services, therefore triggering the requirement for alternative provision other than that provided by the Board.

Management concluded, in the light of the progress on the hospital re-development business case and guidance on women's services, that the carrying value of the existing hospital was impaired as at 31 March 2007. Accordingly, accelerated depreciation of £63,000 was recognised in 2006-07. Given the complex nature of the hospital development and the intended phased approach for implementation, management will need to keep under review the remaining useful life of the hospital as the work progresses.

Agenda for Change

Implementation of the pay modernisation agenda, specifically *Agenda for Change*, has progressed during 2006-07. Management confirmed that at 31 March 2007 38% or 155 staff had yet to be assimilated to the new pay and grading structure. The *Agenda for Change* accrual included within the financial statements is £2.9 million, an increase from 2005-06 of £1.8 million. Management have confirmed that the large increase in the estimated costs is due to a refinement in the measurement of the costs as more information is now available, the assimilation exercise being incomplete and no arrears of salary having been paid. During 2007-08 effectively implementing *Agenda for Change* will remain a priority for management, particularly the need to demonstrate benefit realisation from this and the other additional investment associated with the wider pay modernisation agenda.

Equal pay

Article 141 of the Treaty of Rome requires member states to ensure and maintain "the application of the principle that men and women should receive equal pay for equal work". This was expanded on in the Equal Pay Directive which made it clear that all such discrimination should be eliminated from all aspects of remuneration. The National Health Service in Scotland has received a number of claims for backdated pay increases arising from this requirement.



As at 31 March 2007 the Board had received 29 claims and these had been referred for attention to the Central Legal Office, the Board's legal advisers. Even taking account of the work which has been undertaken in relation to *Agenda for Change*, it is still possible that these claims represent a current liability for the Board; although it is worth noting that we have not been able to obtain from the Central Legal Office any estimate of the potential liability being faced by the Board.

For 2006-07 we have accepted this position because of its stage of development and as a result of the Board including within its annual accounts a contingent liability note setting out relevant details on the matter. Nevertheless, we would have expected further details to have been available to management beyond those currently received from the Central Legal Office, including a reasonable estimate of the Board's liabilities determined in accordance with financial reporting standards. While the factors impacting resolution of this matter are currently outwith the Board's direct control, we would strongly encourage Board management, working with the Scottish Executive Health Department and other stakeholders, to resolve this matter in advance of compilation of next year's financial statements.

Corporate governance

Introduction

Corporate governance is concerned with structures and processes for decision-making, accountability, control and behaviour at the upper levels of organisations. The public sector is complex, but regardless of size and operating framework, 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 the Board's 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;
- standards of conduct and arrangements for the prevention and detection of corruption; and
- its financial position.

Systems of internal control

Statement on internal control ("SIC")

The SIC for 2006-07 provides details of the processes and controls and highlights that the organisation is committed to a process of continuous development and improvement: developing systems in response to any relevant reviews and developments in best practice. Specifically, the SIC notes the continued development in respect of standing documentation, risk management strategy and supporting strategic documentation.

In May 2007 internal audit published their statement of internal control readiness report which reported the results of a high level assessment of the systems to ensure that there was sufficient evidence available to the chief executive to produce the statement on internal control. Annually a report is also produced collating the various sources of evidence available to the chief executive and audit committee to allow the Board's system of internal control to be assessed and the results of the evaluation reported to the board. While this report concluded that that the system of internal control is in place and being complied with, some areas for development were noted. During 2007-08 it is important that management continue to ensure that key governance documentation is in place and up to date to support the Board's governance framework.

Governance arrangements and risk management

The Board is subject to the requirements of the Scottish Public Finance Manual and accordingly operates under a risk management strategy in accordance with relevant guidance. The current risk management strategy was approved in July 2006 and it, along with the corporate risk register, has been reviewed to confirm that their contents are appropriate. During 2006-07 responsibility for the management of operational risk passed to the hospital management team. This work is overseen by the

risk and governance committee. In addition, this committee keeps under review the strategic risk management issues and risk management policy, strengthening the Board's arrangements.

In May 2007 NHS Quality Improvement Scotland ("NHS QIS") performed a local peer review 'clinical governance and risk management: achieving safe, effective, patient-focused care and services'. NHS QIS reported that the Board *"is implementing its policies, strategies systems and processes to control risk, continually monitor care and services and work in partnership with staff, patients and members of the public; take into account individual needs, preferences and choices; and promote public confidence about the safety and quality of the care and services it provides"*.

Internal audit

Internal audit's overall assessment based on the audit work carried out for 2006-07 is that the Board's established internal control procedures were adequate to meet the control objectives agreed with management for each system reviewed. This opinion included the results of the financial controls self-assessment review. The assessment reported an overall improvement in financial controls, but two medium / high risk recommendations were made in relation to a need to enhance business continuity planning arrangements and back-up procedures over IT systems.

Internal controls

Drawing on the work of internal audit, in accordance with our plan we undertook detailed testing in relation to both entity-level and key financial controls. This identified that some governance documentation requires enhancing and updating. In terms of the work over significant risk points in major financial systems, our work confirmed that, subject to minor weaknesses reported, controls are designed appropriately and operating effectively.

Prevention and detection of fraud and irregularity

Fraud policy

The Board has a fraud, theft and corruption policy and response plan, as well as controls and procedures in its standing financial instructions ("SFIs") for the prevention and detection of fraud and other irregularities. The SFIs are reviewed and updated on an annual basis. While the Board's fraud policy was revised in April 2006 to take account of the establishment of NHS Counter Fraud Services ("CFS") and the requirements of the partnership agreement with CFS, the policy has not been fully updated for some time. Management has now commenced a full review, with the status of the work reported periodically to meetings of both the audit committee and the board. The policy review is expected to be completed around mid-2007-08 after full internal consultation and review.

National Fraud Initiative

In 2006-07 the Board took part in the National Fraud Initiative ("NFI") in Scotland. The Scottish Executive Health Department and NHS Counter Fraud Services have strongly supported the involvement of health bodies in the exercise, which is undertaken as part of the audits of the participating bodies. NFI brings together data from health bodies, councils, police and fire and rescue boards, 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. Health bodies provided payroll data for the exercise. The NFI has generated significant savings for Scottish public bodies (£27 million to

2005), but if fraud or overpayments are not identified, assurances may be taken about internal arrangements for preventing and detecting fraud.

The NFI 2006-07 results (data matches) were made available to health bodies on 29 January 2007 via a new secure web-based application. Participating bodies follow-up the matches, as appropriate, and record the outcomes of their investigations in the application. We monitored the Board's involvement in NFI 2006-07 during the course of the audit.

The finance and performance management director has taken the lead role in the process and has reported the results of the data matching exercise to the audit committee and board. Management have accessed the NFI web application regularly since the results were released and have updated the results with comments as appropriate. The audit committee received a paper in February 2007 highlighting the initiative, the nature of the data matching exercise and the results of the data matching for the Board. At the time of this report, all data matches were either under investigation or resolved.

Standards of conduct

The Ethical Standards in Public Life etc. (Scotland) Act 2000 requires NHS organisations to implement a code of conduct for board members. Best practice also requires that a similar code is made available to all employees, thereby promoting a culture of honest and ethical behaviour. The code of conduct for board members and staff is incorporated and set out within the Board's standing orders and standing financial instructions and is applicable to all board members and members of staff.

Financial position

The Board achieved all three of its financial targets for 2006-07.

The 2006-07 financial plan forecast a cumulative surplus in the current year of £0.74 million. The actual outturn was a cumulative surplus of £0.9 million, reflecting additional allocations from the Scottish Executive Health Department and savings against budget. The Board expects to carry forward the full saving against the revenue resource limit into 2007-08. This will be utilised in the proposed hospital redevelopment and the continued forensic care network.

In 2006-07 the board approved a detailed two year financial plan which included a full five years at a summarised level. Senior management and budget managers have considered proposals for savings through the joint board and hospital management team workshops. The need to set aside funding for revenue costs, including double running costs, as a result of the planned hospital redevelopment programme has been incorporated into the Board's financial plan. The redevelopment programme shows that these costs will begin to have a significant effect from quarter three of 2007-08.

The financial position is currently that of an underlying recurring deficit. The underlying financial position in 2006-07 and the forecast position in 2007-08 are shown below.

	2006-07	2007-08
	£'000	£'000
Recurring income	32,150	33,684
Recurring expenditure	32,692	31,334
Underlying recurring (deficit) / surplus	(542)	2,350
Non-recurring income	3,088	9,722
Non-recurring expenditure	2,050	12,305
<i>Balance of non-recurring</i>	1,038	(2,583)
Difference	496	(233)
Other income sources	396	235
Non-recurring SEHD income/year-end support	-	-
Corporate savings programme	7	-
<i>Total other income</i>	403	235
Financial surplus	899	2

Source: State Hospitals Board for Scotland minimum dataset (June 2007)

Performance management

Priorities and risks

Audit Scotland's priorities and risks framework sets out seven areas for consideration during the audit, building on the work undertaken in each of these in earlier years. Consideration of these areas identified the need to:

- consider the impact, and subsequent accounting treatment, of the Board's decisions surrounding service redesign during the financial statements audit, particularly in relation to ensuring that the Board complies with the requirements of FRS 11 impairment of fixed assets and goodwill;
- perform a detailed review of the financial management controls, including budgeting processes, to assess the robustness of the system of control and reporting;
- assessment of the design and implementation of entity level controls;
- review the directors' report with the annual report for the year ending 31 March 2007 for consistency with our expectations and available evidence during the financial statements audit and comment on achievement of key national targets;
- review the system of controls over full implementation of *Agenda for Change*, including the requirement to backdate pay to October 2004; and
- evaluate the IT general controls.

We have considered these issues and commented throughout our report on any significant matters arising.

Action taken during 2006-07

The previous external auditors made a number of recommendations arising from their work on the priorities and risks facing the Board, particularly in relation to governance arrangements. During 2006-07 these arrangements have been progressed, including the creation of the directorate structure and development of risk management processes.

At each meeting of the audit committee a status implementation report is presented which provides details of the implementation status of previously made recommendations. In addition, on an annual basis, internal audit complete a follow-up review to provide independent assurance to the audit committee over the status of recommendations.

Significant areas requiring ongoing attention

The Board has complied with the Scottish Executive Health Department's requirements to report performance against its agreed variations to the 'HEAT' targets: modernising service delivery; health improvement; efficiency and governance improvements; access to services; and treatment appropriate to individuals through its annual local delivery plan which was approved in June 2006 for the years 2006-08.

While performance management reporting is currently taking place the framework is undergoing further development with full implementation incomplete. The finance and performance management director

is developing the full reporting process to include appropriate indicators, a dashboard system to show progress, trend analysis with prior years and the planned actions by the responsible officers to meet the objectives. The senior management team recognises that this framework has taken longer than anticipated to fully implement, but once in place, there should be a simple corporate level reporting system that includes progress reports on each objective.

Review of the information management arrangements identified staff continuity difficulties in the IT department. In the past five years the IT infrastructure manager has changed eight times. This has led to difficulties in the delivery of some projects and increased pressure on the remaining members of the department. In addition, the board recognises that the overall approach to information management still requires improvement and has planned an in-depth review of the information security policy in 2007-08. This will include reconsidering the approach to mobile working and remote access to internal systems.

Managing full implementation of the pay modernisation agenda, particularly *Agenda for Change* and the knowledge and skills framework, is a priority in 2007-08 to maintain staff morale and demonstrate benefit realisation from significant, and continued, additional investment.

Best Value

The Board participated in Audit Scotland's 2005-06 baseline review of Best Value arrangements in the NHS. Management's approach to progressing Best Value was reported to the October 2006 audit committee before being approved by the board. This report noted that since the completion of the Best Value template in May 2006 significant progress was made with the finalisation of the local delivery plan and its associated elements and in respect of organisational development.

Efficient government

The efficient government initiative is a five-year programme with the aim of tackling waste, bureaucracy and duplication in Scotland's public sector. NHS boards need to embrace the efficient government agenda and establish a clear programme for delivering efficiency savings.

During 2006-07 the joint negotiating committee agreed to delivering savings of £300,000 by 2007-08. By 31 March 2007, they delivered £23,000 (full year effect £77,000). The remaining savings are to be delivered through other projects in 2007-08.

By 31 March 2007 the Board met its overall savings target delivering £321,000 of savings, of which £260,000 relate to efficient government.

National shared support services

During the period to January 2007 NHS Scotland has been developing proposals for shared support services in financial and related services in the form of a "hub and spoke" model. The response to the proposals, including that from the Board, was characterised by reservations over the risks inherent in the proposed scheme, the impact on staff and the deliverability of savings. The project has recently been re-launched as the shared support services programme, involving a two-tier approach which seeks to build confidence in new ways of working, using common processes and systems, leading to a single services model based on a common finance system. The approach involves a "foundation" level of involvement around common ledger arrangements, or a "pathfinder" approach which seeks to develop more advanced elements. It is envisaged that a national business case for the revised approach will not be available until mid to late 2008.



The Board is interested in participating in the pathfinder activities with a longer-term view of becoming a partner board in a finance consortium. Management recognise that the finance function is currently vulnerable due to system inadequacies and potential loss or unavailability of key staff. Through shared services these risks could be mitigated as well as achieving savings.

Appendix – action plan

Priority rating for performance improvement observations raised		
<p>Grade one (significant) observations are those relating to business issues, high level or other important internal controls. These are significant matters relating to factors critical to the success of the Board or systems under consideration. The weakness may therefore give rise to loss or error.</p>	<p>Grade two (material) observations are those on less important control systems, one-off items subsequently corrected, improvements to the efficiency and effectiveness of controls and items which may be significant in the future. The weakness is not necessarily great, but the risk of error would be significantly reduced if it were rectified.</p>	<p>Grade three (minor) observations are those recommendations to improve the efficiency and effectiveness of controls and recommendations which would assist us as auditors. The weakness does not appear to affect the availability of the controls to meet their objectives in any significant way. These are less significant observations than grades one and two, but we still consider they merit attention.</p>

No.	Issue and performance improvement observation	Management response	Officer and due date
1	<p>During 2006-07 the Board progressed plans for the re-development of the hospital. Approval of the final business case by the Scottish Ministers is expected in autumn 2007.</p> <p>Given the complex nature of the hospital development and the intended phased approach for implementation, management will need to keep under review the remaining useful life of the hospital as the work progresses.</p> <p><i>Grade one</i></p>	<p>Agreed. This is a complex matter and requires ongoing review and consideration. The next significant milestone is the appointment of a preferred contractor at which time this will be reviewed in detail.</p>	<p>Finance and Performance Management Director</p> <p>31 August 2007 and ongoing</p>
2	<p>During 2007-08 effectively implementing Agenda for Change will remain a priority for management, particularly the need to demonstrate benefit realisation from this and the other additional investment associated with the wider pay modernisation agenda.</p> <p><i>Grade one</i></p>	<p>Agreed. The Board has an approved Pay Modernisation Benefits Realisation Plan which is regularly reviewed.</p>	<p>Learning and Development Director</p> <p>Quarterly reviews to be scheduled – ongoing</p>

No.	Issue and performance improvement observation	Management response	Officer and due date
3	<p>Despite the existence of claims in relation to equal pay, management has not yet been able to quantify the extent of the potential liability it may face.</p> <p>While currently the factors impacting resolution of this matter are outwith the Board's direct control, we strongly encourage management, working with the Scottish Executive Health Department and other stakeholders, to resolve this matter in advance of compilation of next year's financial statements.</p> <p><i>Grade one</i></p>	<p>Agreed. This will be progressed in conjunction with the Scottish Executive Health Department and other stakeholders.</p>	<p>Learning and Development Director</p> <p>31 March 2008</p>
4	<p>Our review of key governance documentation found that some of this documentation required updating and / or enhancement. In addition, management have identified that while the system of internal control is in place and being complied with, some areas exist for development.</p> <p>During 2007-08 it is important that management continue to ensure that key governance documentation is in place and up to date to support the Board's governance framework. Specifically, the development and implementation of a comprehensive set of core plans, including loss of accommodation, loss of the control room, loss of staff and IT failure. to support the Board's business continuity plan. In addition a number of other documents require to be revised / updated, including the:</p> <ul style="list-style-type: none"> • financial operating procedures; • employee conduct policy, including disciplinary procedures; • IM&T strategy, linking to the national ehealth strategy; and • fraud, theft and corruption policy and response plan. <p><i>Grade two</i></p>	<p>Agreed. The control environment is reviewed at least annually to ensure continuous improvement. Action plans are in place for all the areas identified.</p>	<p>Finance and Performance Management Director</p> <p>31 October 2007 and 31 March 2008</p>

