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The principal objective of our audit procedures is to enable us to express our opinion, in line with the requirements of the Audit Scotland Code of Audit Practice, on the financial statements as a whole. Our audit opinion does not guarantee that the financial statements are free from misstatement. Our audit responsibilities and their limitations are explained in our letter of appointment.

Any oral comments made in discussions with you relating to this report are not intended to have any greater significance than explanations of matters contained in the report. Any oral comments that we make do not constitute oral advice unless we confirm any such advice formally in writing.

The matters raised in this and other reports that will flow from the audit are only those which have come to our attention arising from or relevant to our audit that we believe need to be brought to your attention. They are not a comprehensive record of all the matters arising, and in particular we cannot be held responsible for reporting all risks at the Board or all internal control weaknesses. This report has been prepared solely for your use and should not be quoted in whole or in part without our prior written consent. No responsibility to any third party is accepted as the report has not been prepared for, and is not intended for, any other purpose.

# 1. Executive Commentary

## Introduction – Section 2

Our overall responsibility as external auditor of NHS Shetland ('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 Shetland and to the Auditor General for Scotland.

## Financial Statements and Audit Opinions – Section 3

The financial statements of NHS Shetland for the year ended 31 March 2010 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 2010 is **unqualified**.

In order to prepare financial statements which are IFRS compliant, the Board has been required to change the format of its financial statements and include a considerable number of additional disclosures. Significant work has been undertaken (in consultation with the PricewaterhouseCoopers' technical support team) to achieve this objective.

Over the last 18 months this has required a significant time commitment by the Finance team and it is to their credit that this first full audit under IFRS has been completed smoothly.

No unadjusted misstatements or significant financial issues were identified during the audit, with targeted audit work around the revaluation reserve balance and NDC Control account not giving rise to any such matters. We have, however, raised action points relating to the timely review of the National Distribution Centre ("NDC") control account and the implementation of recommendations arising from the review of the 2008/09 IFRS shadow accounts.

## Recommendations 1 and 2

## 2009/10 Performance – Section 4

The Board budgeted to break even for the year ended 31 March 2010 and achieved this with a final outturn surplus of £0.004 million. However, this outturn position was reliant on the abatement of £1.050 million of the total Revenue Resource Transfer to Shetland Islands Council of £1.200 million. Indeed the Board carried an underlying recurring deficit of £1.364 million at the end of 2009/10 (£1.850 million 2008/09), demonstrating that a significant challenge still lies ahead in

widening existing savings and efficiency plans.

We have also considered the Board's performance and people management arrangements. We found appropriate arrangements and reporting mechanisms in respect of performance management. However, the Board has also acknowledged challenges regarding levels of reported sickness absence and recruitment of adequate levels of qualified dentists. Furthermore, management face a challenge in ensuring that 80% of staff have their annual Knowledge and Skills Framework development reviews completed and recorded on eKSF by March 2011.

**Recommendation 3**

## **Governance and Control – Section 5**

We have reviewed 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. Appropriate arrangements and reporting were found to be in place.

We have also considered other aspects of the internal control environment, including partnership working, fraud and the Board's response to outstanding audit recommendations. Appropriate arrangements and reporting were noted.

Additionally, we have reported on the Best Value self-assessment exercise undertaken by the Board in the period and subsequently validated by PwC. From a selection of 18 Best Value toolkits, management agreed that 'People Management' would be a useful area in which to carry out a Best Value assessment. The outcome of the Board's self-assessment noted arrangements in respect of 'effective people management' and 'engagement and performance of staff' as indicative of 'better practices', with 'workforce, strategic and financial planning' and 'achievement of organisational goals' representing basic practices. We validated these self-assessment findings and concurred with Board's conclusions. The full report will be taken to the Staff Governance Committee on 20 July.

## **Managing in Uncertain Times – Section 6**

Despite entering the downturn from a relatively strong financial position, the NHS in Scotland currently faces a period of uncertainty. Impending tightening of public expenditure will impact the sector at a time when the cost base of many NHS bodies will rise.

In response, Audit Scotland developed a good practice checklist following the issue of its report: Improving Public Sector Efficiencies, in February 2010. The checklist is intended to promote detailed review and reflection and, if necessary, a basis for improvement. We recommend that those responsible for leading efficiency and improvement work at the Board should formally assess themselves against each question.

**Recommendation 5**

While some NHS bodies will be more vulnerable than others, all NHS bodies, including NHS Shetland, will be impacted. Regardless of whether an NHS body is in a relatively stronger or weaker financial position, difficult decisions are going to have to be made. We recommend looking at six key areas that our experience in other sectors has shown may be relevant to addressing the challenges ahead:

- Honesty and awareness of the size of the challenge
- Strong leadership
- Need to engage with the whole organisation and external stakeholders
- Realistic and detailed plans to resolve the situation
- Rigorous implementation (programme management arrangements)
- Financial control and discipline

#### **Recommendation 6**

Careful consideration and achievement in respect of each of these areas will go a considerable way to ensuring that NHS Shetland will emerge from this unprecedented period of financial challenge on a strong and stable footing.

## 2. Introduction

### **Purpose of this report**

The 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 from the 2009/10 audit process and to confirm what action is planned by management to address the more significant matters identified for improvement.

### **Scope, nature and extent of our audit**

Our overall responsibility as external auditor of NHS Shetland ('the Board') is to undertake our audit in accordance with the principles contained in the Code of Audit Practice issued by Audit Scotland in March 2007. 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 of an entity. This Annual Audit Report to Members, together with previous reports to the Audit Committee throughout the year, discharges the requirements of ISA 260.

### **Acknowledgment**

We would like to formally extend our thanks to all Board managers and staff for the assistance they have given us during the audit process.

PricewaterhouseCoopers LLP  
Glasgow

25 June 2010

## 3. Financial Statements and Audit Opinion

### Audit opinion

Our audit opinion concerns the true and fair statement of the Board's financial results for the year ended 31 March 2010 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.

### Audit Process

NHS Shetland agreed at the end of the 2008/09 audit process to put in place more effective arrangements for its accounts closure and preparation process for 2009/10. We agreed to assist by delaying the start of the 2009/10 audit fieldwork by one week and also giving guidance to the finance team on how to improve the quality of working papers.

Although the financial statements were not presented to us for audit at the start of our fieldwork as agreed, we can report that the working papers were of a higher quality than in the prior year and that we were able to agree the figures in the financial statements to the underlying accounting records. We will continue to work with the Finance team to improve the referencing between the financial statements and underlying working papers.

Overall, a relatively efficient audit process was achieved through an effective working relationship with your staff.

### Basis of Preparation

The financial statements were prepared in accordance with the 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.

Government bodies, including NHS Boards, have been required to adopt International Financial Reporting Standards (IFRS) from 2009/10 onwards. This included a restatement of 2008/09 comparatives. The objective is to bring the public sector into line with the private sector and to introduce greater comparability and consistency across public sector accounting.

In order to prepare financial statements which are IFRS compliant, the Board has been required to change the format of its financial statements and to include a considerable number of additional disclosures. Significant work has been undertaken (in consultation with the PricewaterhouseCoopers' technical support team) to achieve this objective.

Over the last 18 months, this has required a significant time commitment by the Board's Finance team and it is to their credit that this first full audit under IFRS has been completed smoothly.

## Approval

The Financial Statements were submitted to the Board's Audit Committee on 25 June 2010 and are to be approved and adopted at the Board meeting on 25 June 2010.

## Unadjusted misstatements

Under ISA 260 - "Communication of audit matters to those charged with governance", we are required to report to you 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 and all of these have been processed by management in the finalised version of the 2009/10 financial statements. We therefore have no unadjusted misstatements to report.

## Accounting Issues

A number of accounting issues were discussed with management during the audit. The most significant of these are set out below:

### Revaluation Reserve

On the basis of our work on the IFRS shadow accounts, we recommended that the Board should analyse the Revaluation Reserve to individual asset level. This is to ensure that the Board can account for impairments to and disposals of fixed assets correctly, with amounts written off against the Revaluation Reserve being limited to the balance held in the Revaluation Reserve for that particular asset.

The Board carried out a significant exercise during the year to tie balances in the Revaluation Reserve back to individual assets in line with our recommendation. This exercise highlighted the need for a transfer between the Revaluation Reserve and General Fund Reserve in respect of the depreciation charge on the revalued portion of asset values. The inter-reserve transfer was not made between 2003 and 2009 and has now been processed through a prior year adjustment



to the 2009/10 financial statements. This has had no impact on the Board's net asset position. Now that the Board has completed a full analysis of the Revaluation Reserve, it will be possible to account for the depreciation on individual revalued assets through an annual inter-reserve transfer.

#### Inventories – NDC control account

We noted during our testing of the inventory balance in the financial statements that the National Distribution Centre (“NDC”) control account of £0.200 million had been included in error. NDC makes payments on behalf of NHS Shetland for inventory ordered and these payments are recorded within the NDC control account. The payments should be allocated and cleared from the NDC control account once invoices are received and processed by NHS Shetland. However, the invoices for the 5 months prior to year end had not been processed in the purchase ledger, meaning that a balance remained in the NDC control account at year end.

#### Recommendation 1

The NDC control account is cleared against a trade payables control account once invoices are received. The fact that this had not happened by year end meant that both the Inventory and Trade Payables balances were overstated. The subsequent financial adjustment to correct the overstatement resulted in a reduction of both the Inventory and Trade Payables balances of £0.200 million which had no effect on the Board's net assets or surplus positions.

#### Asset Useful Lives and Residual Values

As part of our work on the IFRS shadow accounts, it was noted that NHS Shetland was not routinely reviewing the useful lives of assets at the end of each year or taking residual values into account when depreciating assets. We recommended that the Board should undertake an evaluation of useful lives and residual values in order to ensure the depreciation charge is as accurate as possible. However, we note that this evaluation was not undertaken at the 2009/10 year end.

If residual values are not taken into account, the annual depreciation charge may be incorrectly stated. While we recognise that almost all of the Board's assets are specialised in nature and may not have any residual value, management should nevertheless consider the possibility for assets to have a residual life. The in-year depreciation charge may be overstated or understated if useful lives of assets are not re-evaluated at each year end.

#### Recommendation 2

#### Equal Pay

The National Health Service in Scotland has received a number of claims for equal pay including related back pay. By the end of May 2010 there were two grievance and employment tribunal claims registered against the Board, with over 11,000 registered across the country. The NHS Central Legal Office (CLO) has been instructed by the Management Steering Group of NHS Scotland in this regard and is co-ordinating the legal response of NHS Scotland to this issue.

The CLO has co-ordinated the legal response to all claims and has attended tribunal hearings at which discussion about procedural matters has taken place. The CLO has confirmed that the cases in Scotland are at too early a stage to allow any assessment of the potential financial exposure to be included in the financial statements. The Board has included a Contingent Liability Note in its financial statements, setting out this matter. The wording used within this note reflects guidance issued by Audit Scotland.

## 4. 2009/10 Performance

### Financial Results 2009/10

|   | £m       | £m             |
|---|----------|----------------|
| Recurring income  | 35.889   |                |
| Recurring expenditure (before savings)                                    | (38.092) |                |
| Recurring savings   | 0.839    |                |
| <b>Underlying recurring surplus/(deficit)</b>                             |          | <b>(1.364)</b> |
| Non-recurring income  | 9.881    |                |
| Non-recurring expenditure (before savings)                                | (9.202)  |                |
| Non-recurring savings   | 0.689    |                |
| <b>Non-recurring surplus/(deficit)</b>                                    |          | <b>1.368</b>   |
| <b>Financial surplus/(deficit) for the year</b>                           |          | <b>0.004</b>   |
| <b>Underlying recurring (deficit) as a percentage of recurring income</b> |          | <b>3.80%</b>   |

Figures confirmed by NHS Shetland Director of Finance, Nick Kenton.

The Board budgeted to break even for the year ending 31 March 2010 and has achieved this with a surplus of £0.004 million. Similar to 2008/09, the most significant factor contributing to this breakeven position was the

agreement with Shetland Islands Council (SIC) not to pay the full Revenue Resource Transfer (RRT) of around £1.200 million, although the Board did pay £0.150 million of the total due. Abatement of the RRT has been successfully negotiated with SIC each year since 2005/06. The RRT abatement supported an underlying recurring deficit of £1.364 million, although this represents an improvement from the 2008/09 position of £1.850 million. The Board will have to widen existing efficiency and savings plans significantly to return to a recurring surplus position. In achieving breakeven, the Board encountered a number of variations from budget, as detailed below.

#### Efficiency Savings

The Board achieved total efficiency savings of £1.528 million which is in excess of the internal target set by the Board in March 2009 of £1.479 million. The most significant savings were achieved through the reduction in primary care prescribing costs (£0.270 million), staff vacancies during quarter 1 of 2009/10 (£0.275 million) and the deferral of the National Tariff by NHS Grampian (£0.350 million). This compares to total prior year savings of £0.874 million.

#### Clinical Services

The most significant underspend in 2009/10 was achieved in the Clinical Services Directorate and amounted to £0.460 million below budget. This resulted chiefly from an underspend in Dental Services due to vacancies that amounted to £0.252 million. Nursing also contributed to the underspend for the Directorate. Fewer level 5 nurses were employed than had been budgeted, with the resource gap being filled by higher numbers of level 3 nurses and by training of level 2 nurses to operate at level 3.

## Income

From our review of Board minutes, we understand that SGHD decided to claw back £0.450m of the Board's 2009/10 Revenue Resource Limit in year after the Board notified SGHD of its anticipated surplus of £0.450 million during December 2009. This put the Board on course for a year end breakeven position. We understand that the Board will receive this funding back in 2010/11.

## Estates and Facilities

Estates and Facilities had a total overspend of £0.790 million. This arose mainly because of catch-up maintenance work during the year which was not initially budgeted. However, this work was offset by the underspend within Clinical Services (see above) which was utilised to fund the maintenance work. A corporate reserve of £0.250 million was also utilised to part-fund the overspend.

## Information Management & Technology

The budget for IM&T was overspent by £0.219 million, caused chiefly by unbudgeted improvements that were made to IT security and IT infrastructure. For example, the Board purchased a new server array which aligns primary care IT functions more closely with the IT functions used to maintain the secondary care environment. Automatic software patching and security updates are now also deployed by IM&T to every NHS Shetland IT asset to provide better performance and security of IT hardware and data.

## Overall Position

In spite of the significant impact of unbudgeted cost pressures encountered in the period, arising principally in the form of catch-up maintenance work and IM&T, the Board did manage to achieve breakeven. We note that this was chiefly due to agreeing with SIC that £1.050 million of the total RRT due of £1.200 million could be waived.

## Performance against Key Financial Targets

The Board is required to meet three targets each year as set by the SGHD. The performance of the Board against these targets is as follows:

|                        | Limit set by<br>SGHD<br>£m | Actual<br>Outturn<br>£m | Variance<br>(over)/under<br>£m |
|------------------------|----------------------------|-------------------------|--------------------------------|
| Revenue Resource Limit | 45.771                     | 45.767                  | 0.004                          |
| Capital Resource Limit | 4.927                      | 4.777                   | 0.150                          |
| Cash Requirement       | 52.800                     | 52.591                  | 0.209                          |

The Board has achieved all three of its financial targets in the year.

The Board also achieved efficiency savings in the year above the 2% Scottish Government target. Cash-releasing revenue efficiencies of £1.528 million were generated in the year, against the Scottish Government recurring savings target of £0.720 million.

## Managing Financial Performance

Management receives detailed financial information to help manage performance against budgets and control expenditure. Detailed management accounts are prepared on a monthly basis, while management accountants liaise with directors and senior management to analyse the management reports and understand key variances against budgets. Directors receive responses from budget-holders within their directorates regarding variances, which they feed through to management accountants. The outcomes of the monthly reviews are consolidated into financial monitoring reports for consideration by the Board and senior management. The information produced and frequency of reporting ensures decision makers have appropriate information on which to base decisions. The reporting arrangements were considered during the year and summarised in the Interim Management Letter, as reported to the Audit Committee on 7

May 2010. We note that management has made some progress towards implementing our recommendations since.

The NHS Ayrshire & Arran Consortium (of which the Board is part) is currently in the process of providing training and user acceptance testing for a system called BOXi. This enables users, including budgetholders, to access their own budget statements. The BOXi rollout to budgetholders is currently being piloted and, if favourable, will lead to implementation for all Boards. Management anticipates that the roll-out will occur during 2010/11, thereby ensuring that budgetholders have improved access to financial monitoring information.

### Managing Performance and Non-Financial Performance Targets

An assessment of the Board's performance management arrangements is detailed in full within the Interim Management Letter. However, the key points and a year-end update are summarised below:

- Performance is reported to the Board on a monthly basis. The reports expand on issues that are highlighted by the performance measures.
- The information reported and monitored focuses on the achievement of Local Delivery Plan (LDP) national HEAT targets and local KPIs, as well as a range of other measures including Community, Health & Care Partnership (CHCP) performance.
- Performance measures are refreshed annually, following the publication of the LDP.

The Board continues to actively manage the challenges in relation to cancer targets and is working closely with colleagues in NHS Grampian in order to reduce delays and improve access to diagnostic and treatment services for patients with cancer.

### People Management - Sickness Absence

NHS Shetland's sickness absence rate for the year-ended 31 March 2010 was 4.79%, an increase of 0.34% from the previous year. This annual

position places NHS Shetland 12th out of 22 Boards. There were signs of improvement towards the end of the financial year as the monthly figure for March 2010 was 3.48%, compared with 4.13% in March 2009. Going forward into 2010/11, each Head of Department has been allocated a specific objective around sickness absence management, demonstrating that the Board is taking proactive steps to reverse the recent trend.

### People Management – Pay Modernisation and Workforce

The three main strands of pay modernisation in the NHS are: Consultant Contract, General Medical Services Contract and Agenda for Change. In addition to these three programmes, NHS Shetland is implementing the Scottish Community Pharmacy Contract and the General Dental Services Contract.

Despite creativity in modifying and developing new dentist roles, the Board has experienced difficulty recruiting dentists to the service in NHS Shetland and there has been considerable reliance on locums, particularly in the North Mainland and North Isles. Scottish Government initiatives have included golden hello packages, remote areas allowances and on-call payments dependent on intensity. Despite these efforts, management believes that NHS Shetland still requires an additional 6.5 full time dentists.

NHS Boards are to ensure at least 80% of staff covered by Agenda for Change have their annual Knowledge and Skills Framework development reviews completed and recorded on eKSF by March 2011. To date, 13.1% of reviews have been completed, suggesting that it will be challenging for management to meet the target by the March 2011.

### Recommendation 3

## 5. Governance, Control and BV toolkits

### Overall Governance Arrangements

The established Committee framework at the Board remains in place, incorporating Audit, Clinical Governance, Staff Governance, Remuneration, Service Redesign and Community Health Partnership (CHP) Committees. Each of the Committees meets regularly and has at least one non-executive director present. The Board also has a Controls Assurance Group (chaired by the Director of Human Resources and Support Services) which has overall responsibility for risk management and for reporting any risk issues to the Board. The only significant change in senior positions at the Board occurred when the Chairman's tenure came to an end on 31 July 2009. The position was subsequently filled by the Vice Chairman.

The NHS Quality Improvement Scotland (QIS) Standards for Clinical Governance, Patient Safety and Risk Management cover all aspects of clinical governance and risk management from the perspective of patient outcomes. A QIS Clinical Governance and Risk Management monitoring visit was carried out at the Board in April 2010. At the time of this report, the outcome has yet to be finalised.

### Partnership Working and Shared Services

The Board's partnership working arrangements are characterised by SLAs with other NHS bodies, membership of the NHS Tayside Consortium for shared payroll services, membership of the NHS Ayrshire & Arran Consortium for shared Cedar e-financials systems and the CHCP with SIC.

We note that the Board is behind schedule with the implementation of the SSTS payroll system. However, assistance has been offered by NHS Ayrshire & Arran and the Board aims to have 50% rolled out by September 2010. The ongoing objective of implementing the Cedar Fixed Asset Module (once it is ready to go live) is being monitored by the Finance team. We understand that the Board intends to implement the module as soon as it has been demonstrated to be fit for purpose.

A number of performance measures have been created to monitor the CHCP's performance against its objectives. The performance measures and targets apply to a single financial year and are monitored by the CHP Committee quarterly. This Committee's minutes are, in turn, approved by the Board, providing it with direct oversight of the activities of the CHCP. The CHP action plan includes referenced links to both the Board's LDP and to the Council's Service Plan. A small number of Single Outcome Agreement performance measures have been included in NHS Shetland's Performance Measurement framework including, for example, health improvement, efficiency and access to treatment.

## Best Value

Best Value audits are being carried out across the public sector to help protect taxpayers' interests by examining the use of resources and to report on the delivery of outcomes for people who use services. The Best Value audits are being carried out in a cycle, focusing on distinct areas each year. In 2008/09, the Use of Resources Best Value audit focused on Information Management. In 2009/10, Audit Scotland issued 18 toolkits with instructions that one was to be performed and validated by the auditors of each NHS Board.

In order to add value and address one of the key risk areas identified by management, we agreed with the Board that the 'People Management' toolkit would be undertaken. The evaluation for each module is classified in one of four categories: **does not meet basic requirements; basic practices; better practices; and advanced practices.**

A summary of the Board's assessment against the key areas of the toolkit is detailed below:

| Planning and Resource Alignment Toolkit Module | Evaluation       |
|--|------------------|
| Effective People Management                    | Better Practices |
| Workforce, Strategic and Financial Planning    | Basic Practices  |
| Achievement of Organisational Goals            | Basic Practices  |
| Engagement and Performance of Staff            | Better Practices |

Our detailed findings and assessment of the Board's self-evaluation ratings will be reported to the next meeting of the Staff Governance Committee on 20 July.

## Systems of Internal Control

The results of our work on systems of internal control were communicated to the Audit Committee in our Interim Management Letter on 7 May 2010. The report contained 8 recommendations to improve controls, none of which was graded as higher risk. There were also no risks identified that could be considered business critical in nature. Management has completed an action plan detailing those individuals responsible for implementing our recommendations and providing a timetable for completion. We will follow up this action plan during the 2010/11 audit process.

During the audit of the debtors balance, we identified a significant increase in the VAT debtor compared to the prior year. The VAT refund due from HMRC at 31 March 2010 was £0.306 million compared to £0.137 million at 31 March 2009. On further investigation, we found that of this total balance, £0.146 million related to a claim for VAT that had been under-recovered during the year. The amount was identified through a detailed review carried out by VAT Liaison. This suggests there is scope for the Board to tighten up the process for identifying VAT that can be reclaimed.

### Recommendation 4

## 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. Based on our normal audit procedures, we do not disagree with the disclosures contained in the Statement.

## Follow up of outstanding recommendations

We followed up on the Board's progress in implementing recommendations made in the prior year, with our Follow Up Report being considered at the Audit Committee meeting on 7 May 2010. At the time of reporting, of the 17 agreed actions, progress was as follows:

| Status                | Interim Management Letter<br>2008/09 | Annual Report to Board Members<br>2008/09 | 2008/09 Results of Further<br>Follow up of 2007/08 Audit<br>Recommendations | Total     |
|-----------------------|--------------------------------------|---|---|-----------|
| Action Implemented    | 5                                    | 0   | 1   | 6         |
| Action in Progress    | 0                                    | 3   | 4   | 7         |
| Little Action to Date | 1                                    | 0   | 1   | 2         |
| Not Yet Due           | 0                                    | 0   | 1   | 1         |
| No Longer Applicable  | 0                                    | 0   | 1   | 1         |
| <b>Total</b>          | <b>6</b>                             | <b>3</b>                                  | <b>8</b>  | <b>17</b> |

## Information Technology General Controls

ISA (UK&I) 315.93 requires auditors to "... obtain an understanding of how the entity has responded to risks arising from IT". IT General Controls (ITGCs) are controls put in place by management to mitigate those risks. ITGCs help ensure the continued proper operation of information systems to maintain the integrity of information and security of data.

Several of the Board's IT operations are outsourced to service organisations such as National Services Scotland, NHS Ayrshire & Arran Consortium and the Tayside Consortium. As a result, we are able to gain assurance over the Family Health Service, Payroll and General Ledger systems through the receipt and review of service organisation auditor reports, such as a SAS 70. Our review of these reports did not uncover any instances whereby we were unable to place reliance upon the outsourced key financial systems. In other areas, we perform our own ITGC procedures.

From our own ITGC work, five control weaknesses were noted in respect of the Board's IT control environment. All of these issues were reported in the Interim Management Letter and none was noted as high risk or as having an impact on the level of reliance that could be placed on the key financial system outputs.

### Internal audit

The role of internal audit is determined by management and therefore its objectives differ from ours. Part of our overall audit approach involves gaining an understanding of the internal audit function to determine if it would be effective and efficient to use their work.

During 2009/10, the Board continued to outsource its internal audit function to Deloitte. We have reviewed the work of internal audit and have, where appropriate, placed reliance on their work.

### 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 2008/09 NFI project is a two year initiative which has just been completed, with the report being issued by Audit Scotland in May 2010. The Board met its mandatory requirements in 2008/09 with regard to the submission of payroll data sets and subsequent investigation of matches. As reported in our Interim Management Letter, no exceptions were noted in our review of this area. The report issued by Audit Scotland (National Fraud Initiative in Scotland – Making an Impact), detailing the results of the 2008/09 NFI exercise, made no specific reference to NHS Shetland.



## 6. Managing in Uncertain Times

The UK economy went into recession in mid-2008 for the first time since 1991. By summer 2009, UK economic output had fallen for five consecutive quarters. Significant financial pressures remain and the future economic position is uncertain and difficult to predict.

In response to the recession, the UK Government almost doubled its level of borrowing to £175 billion in 2009/10 to allow it to increase public spending to support the economy. This level of borrowing means that the UK Government will need to pay higher debt interest payments, which in turn reduces the amount left for spending on the public sector. The recent Westminster General Election has resulted in a change of Government and this has led to a change in the plans for repaying the national debt with the new coalition government planning to halve the debt by 2013/14. In order to achieve this ambitious target, significant reductions in public sector spending will be required. A recent paper by the Scottish Government Chief Economist predicts that public sector spending in Scotland may fall in real terms by 3% every year to 2014/15 and will take a total of 12 to 15 years to get back to 2009/10 levels.

Further details of this challenge may become clearer with the June 2010 UK emergency budget, although the impact this will have on the NHS in Scotland may take some time to become apparent.

In April 2009, the UK Government also announced that public sector **capital budgets would fall**.

Taken together, these factors will have **serious consequences** for the Scottish budget. As a result of the current financial position, Audit Scotland

has issued a number of reports on the matter. Key reporting themes from two of these reports are highlighted below.

### **Audit Scotland - Scotland's Public Finances: Preparing for the Future**

In November 2009, Audit Scotland published its report: 'Scotland's Public Finances: Preparing for the Future'. This report highlighted the fact that the Scottish Government budget is likely to have peaked in 2009/10 for the foreseeable future. This means that individual public bodies will have **smaller budgets** in future years. It highlighted that in addition, **other public sector income is likely to be less than previously forecast** – in particular, NHS capital funding, which may affect the Board's ability to deliver its capital programme.

The report concluded that we are at a real **historical breakpoint** in public finances.

### **Audit Scotland - Improving Public Sector Efficiencies**

Following on from the Scotland's Public Finances report, Audit Scotland published a further report in February 2010: 'Improving public sector efficiency'. It provided a position statement on the first year (2008/09) of the Efficient Government Programme (the Programme), which aims to deliver £1.6 billion efficiency savings over the three years to 2010/11. It also gave an update on how the Scottish Government and public bodies have addressed the recommendations made in a 2006 Audit Scotland report about the previous efficiency programme.

The report noted that Scottish public bodies had reported more efficiency savings than the Government's two per cent target. However, there were serious financial challenges ahead – the biggest since devolution – and making the required savings simply through efficiency will become increasingly difficult.

The report recommends that to deal with reduced future funding, public bodies need to consider fresh approaches to improving efficiency and productivity. They must take a more fundamental approach to identifying priorities, improving the productivity of public services, and to improving collaboration and joint working.

To support these high-level recommendations, Audit Scotland, the Northern Ireland Audit Office and the Wales Audit Office have drawn on their combined experience to develop a detailed good practice checklist. The checklist is intended to promote detailed review and reflection and, if necessary, a basis for improvement. We recommend that those responsible for leading efficiency and improvement work at the Board should formally assess themselves against each question.

We note that the Board has an established process for originating, reviewing and monitoring efficiency savings proposals which draws in the Senior Management Team, Local Partnership Forum and the Board. In order to enhance the existing process, we recommend that those responsible for leading efficiency and improvement work at the Board should formally assess themselves against each question of the 'Improving Public Sector Efficiencies' good practice checklist.

#### **Recommendation 5**

#### **NHS Shetland's Perspective**

Despite entering the downturn from a relatively strong financial position, the NHS in Scotland currently faces a period of uncertainty. Impending tightening of public expenditure will impact the sector at a time when the cost base of many NHS bodies will rise.

The Board is already considering how best to respond to the existing drive for efficiencies. While we acknowledge that the Board has exceeded Scottish Government efficiency targets for 2009/10, it is likely that much of the easier savings will already have been achieved so that the ability of the Board to respond to a prolonged wave of revenue reduction arising from the re-assessment of public spending levels and priorities is likely to be more difficult. Forecasts for the next four years should include "downside" scenarios and challenge from zero and priority-based budgeting. In addition, there are lessons to be learned from other organisations that have already weathered financial challenge and crisis.

While some NHS bodies will be more vulnerable than others, all NHS bodies, including NHS Shetland, will be impacted. Regardless of whether an NHS body is in a relatively stronger or weaker financial position, difficult decisions are going to have to be made. We recommend looking at six key areas that our experience in other sectors has shown may be relevant to addressing the challenges ahead:

- Honesty and awareness of the size of the challenge
- Strong leadership
- Need to engage with the whole organisation and external stakeholders
- Realistic and detailed plans to resolve the situation
- Rigorous implementation (programme management arrangements)
- Financial control and discipline

#### **Recommendation 6**

The 2010/11 budget was set against the backdrop of significant economic uncertainty. 2010/11 was within the current three year spending review period with allocations from the Scottish Government linked to the corresponding three year pay award. The severity of the economic conditions has already impacted on future resource availability however with a revised allocation being given by the Scottish Government in 2010/11. This actual allocation to be received represents an uplift of 2.15%, against a pay award for employees covered by the Agenda for Change agreement, of 2.25%. The effect of the pay award will be compounded by the impact of incremental drift, which management has estimated at a further 1%.

The Board is required to achieve efficiency savings of 2%, as outlined in the NHS Scotland Efficiency and Productivity Programme: Delivery Framework, published in June 2009. Cash and productivity efficiency savings are required to enable the Board to produce a break-even budget. The Board has identified the savings for 2010/11 to achieve and exceed the targeted 2%, generating £1.4 million towards the annual budget.

### Projected Outturn 2010/11

|   | £m         | £m                  |
|---|------------|---------------------|
| Recurring income  | 34.4       |                     |
| Recurring expenditure (before savings)                                    | (37.0)     |                     |
| Recurring savings   | <u>1.2</u> |                     |
| <b>Underlying recurring surplus/(deficit)</b>                             |            | <b><u>(1.4)</u></b> |
| Non-recurring income  | 9.7        |                     |
| Non-recurring expenditure (before savings)                                | (8.5)      |                     |
| Non-recurring savings   | <u>0.2</u> |                     |
| <b>Non-recurring surplus/(deficit)</b>                                    |            | <b><u>1.4</u></b>   |
| <b>Financial surplus/(deficit) for the year</b>                           |            | <b><u>0.0</u></b>   |
| <b>Underlying recurring (deficit) as a percentage of recurring income</b> |            | <b><u>3.5%</u></b>  |

Figures confirmed by NHS Shetland Director of Finance, Nick Kenton

Some of the key cost pressures which will impact the achievability of the budgeted savings are detailed in the analysis below. Management has undertaken an exercise whereby all cost pressures were identified, with funding allocated to those pressures deemed to be the most significant:

### CNORIS

Whilst participating in the CNORIS scheme transfers and mitigates significant financial risk, the continued volume increase in claims against NHS Scotland bodies is expected to lead to an increase in the cost of this risk transfer. This is expected to crystallise in the form of an upward revision to the Board's maximum liability in respect of each claim, as well as increase in the volume of claims made.

### SLA with NHS Grampian

There is a very significant cost pressure resulting from the Service Level Agreement (SLA) with NHS Grampian which is estimated at £0.353 million. SLA activity has shown a continuous upward trend over the last 3 years. An agreement was reached with NHS Grampian to phase-in the impact of the increase in 2008/09 over two years, with the full impact first being recognised in 2010/11. In addition, the national policy is to move towards a national tariff for healthcare (whereby the same price for treatment is paid everywhere in NHSScotland). Since NHS Grampian is a relatively low-cost provider, this will lead to an increase in the price charged to NHS Shetland. This effect of this movement towards a national tariff price will be felt in 2010/11.

### Information Technology

The Board approved an eHealth Plan in May 2009 which recognises that additional investment is required to support the desired growth and resilience. Specifically, the Plan aims to move the Board's IT architecture towards a more efficient and patient-centred environment, utilising new products and technologies. The impact of the investment set out in this Plan for 2010/11 is expected to be £0.101 million of which £0.044 million is non-recurring. In addition, a non-recurring reserve of £0.250 million has been established to facilitate a step-change in the IT infrastructure.

## Balanced Budget

In addition to the pressures noted above, it is important to note that the Board's breakeven position for 2010/11 is dependent on two large non-recurring items:

- The abatement of the RRT to SIC of £1.200 million; and
- Income allocations from 2009/10 of £0.450 million being restored in 2010/11.

The position regarding the agreement of the abatement of the RRT will have to be closely monitored by the Board during 2010/11 as this is fundamental to the Board achieving a breakeven position at the end of the year.

## Service Sustainability

The annual service redesign planning cycle is overseen by the Director of Human Resources and Support Services, who reports to the Senior Management Team and the Board on the progress of the activities involved. The Director of Public Health and the Chief Executive attend the NHS North of Scotland Planning Group and report on these meetings to the Board, feeding back national and regional priorities. Plans for service redesign come under scrutiny of the Service Redesign Committee (a formal Board Committee) and minutes of this Committee are then taken to the Board for additional scrutiny. Almost all redesign proposals were self-funded, although SGHD has met the cost of LEAN Phase 1.

The Board made progress with a number of redesign proposals during the year. In particular, the Estates Improvement Action Plan was progressed from the previous year and a new Head of Estates was appointed during July 2009. Emphasis was placed on updating and increasing skills within the Estates team which resulted in significant time and resources being dedicated both to the preparation of an Estates training plan and to training for individual Estates staff.

The Board has taken steps to redesign Maternity Services, with the aim being to develop safe and sustainable services for Shetland. An Outline Business Case identified 3 options to be taken forward in preparation for the next stages in developing the business case. The Board's preferred option required training for midwives to become Assisted Birth Practitioners (ABP). It was also planned that two members of staff would undertake ABP training in 2010 and another in 2011 and thus completion of ABP training would be spread over 3-4 years.

The Board has an updated Financial Plan covering the period to 2012/13. This is included within the Local Delivery Plan 2010/11 to 2012/13 which has been approved by the Board. The Financial Plan shows that the Board will continue to rely on the full abatement of the RRT to achieve breakeven.

As part of wider efficiency drives, LEAN processes have been embraced by the Board. Although the Board intends the LEAN programme to deliver cash-releasing efficiencies, the precise amount that LEAN projects will contribute to 2010/11 targets has not yet been defined.

# Appendices

# Appendix A – Action Plan

| Ref | Issue and Recommendation  | Management Response  |
|-----|---|--|
| 1   | <p>The Finance team should ensure that invoices related to inventory orders placed by National Distribution Centre (NDC) are processed on a monthly basis.</p> <p>Payments made by NDC on behalf of NHS Shetland should then be allocated to the Purchase Ledger to allow the NDC control account to be cleared in a timely manner. Management should review the process on a monthly basis.</p>  | <p><b>Management Response:</b></p> <p>We are now up to date with these NDC invoices and will request that the purchase ledger is kept open for an extra few days at year end 2010/11 so we can ensure that there is no control account balance at year end.</p> <p><b>Responsible Officer:</b><br/>Head of Finance &amp; Procurement</p> <p><b>Due Date:</b><br/>31/03/2011.</p> |
| 2   | <p>While we recognise that almost all of the Board's assets are specialised in nature and may not have any residual value, management should nevertheless consider the possibility for assets to have a residual life. If appropriate, residual values should be built into depreciation calculations to ensure an accurate in-year charge and accumulated depreciation balance.</p> <p>In addition, management should re-evaluate the useful lives of assets at each year end and should adjust depreciation charges in the event that useful lives require amendment.</p> | <p><b>Management Response:</b></p> <p>We have brought the fixed asset register up to date and will continue to maintain this throughout the year. We will build in this useful lives / residual values exercise for 2010/11.</p> <p><b>Responsible Officer:</b><br/>Head of Finance &amp; Procurement</p> <p><b>Due Date:</b><br/>31/03/2011</p>                                 |
| 3   | <p>NHS Boards are to ensure at least 80% of staff covered by Agenda for Change have their annual Knowledge and Skills Framework development reviews completed and</p>   | <p><b>Management Response:</b></p> <p>We have a dedicated member of staff to assist with this issue</p>  |

| Ref | Issue and Recommendation  | Management Response  |
|-----|---|--|
|     | <p>recorded on eKSF by March 2011. To date, 13.1% of reviews have been completed, suggesting that there it will be challenging for management to meet the target by the March 2011.</p> <p>Management should therefore put in place an Action Plan to ensure that the rate of completion will be sufficient to meet the March 2011 deadline.</p>  | <p>and 'champions' supporting various departments. The use of eKSF is in every manager's objectives. The Board is kept aware of our performance via the Performance Monitoring Report (which goes to every Board meeting). It is also a standing item at every meeting of the Area Partnership Forum and the Staff Governance Committee - corrective actions may be agreed at these meetings as required.</p> <p><b>Responsible Officer:</b><br/>Director of Human Resources &amp; Support Services</p> <p><b>Due Date:</b><br/>Ongoing with 31/03/2011 as the completion date</p> |
| 4   | <p>The Finance team should investigate training opportunities to address the technical aspects of VAT that led to the under recovery of amounts due to the Board in 2009/10.</p> <p>While we note that the Board has ultimately claimed amounts due as a result of a review by VAT Liaison, a greater level of technical expertise within the team should help ensure that amounts due to the Board are claimed promptly. This will lead to a more positive cash flow position during the year.</p> | <p><b>Management Response:</b><br/>We have spoken to VAT Liaison about training and they will contact us soon about the possibility of joining a course through videoconference. Bringing them up to Shetland is not cost effective but they are scheduled to return in Spring 2011 when training will be given to all relevant staff.</p> <p><b>Responsible Officer:</b><br/>Head of Finance &amp; Procurement</p> <p><b>Due Date:</b><br/>31/03/2011</p>   |
| 5   | <p>Following the publication by Audit Scotland in February 2010 of their report: <i>Improving Public Sector Efficiencies</i>, a detailed good practice checklist was developed. The checklist is intended to promote detailed review and reflection and, if necessary, a basis for improvement.</p> <p>Those responsible for leading efficiency and improvement work at the Board should formally assess themselves against each question and report the outcomes to the</p>                        | <p><b>Management Response:</b><br/>The checklist has been reviewed briefly at the Senior Management Team. However, it is accepted that a more detailed / formal review might be useful. We will consider bringing this to a future Board Information Session.</p>  |

| Ref | Issue and Recommendation  | Management Response  |
|-----|---|--|
|     | Board.  | <p><b>Responsible Officer:</b><br/>Director of Finance</p> <p><b>Due Date:</b><br/>30/09/2011</p>  |
| 6   | <p>As part of initiatives to generate efficiency savings, management should consider six key areas that our experience in other sectors has shown may be relevant in addressing the financial challenges ahead:</p> <ul style="list-style-type: none"> <li>• Honesty and awareness of the size of the challenge</li> <li>• Strong leadership</li> <li>• Need to engage with the whole organisation and external stakeholders</li> <li>• Realistic and detailed plans to resolve the situation</li> <li>• Rigorous implementation (programme management arrangements)</li> <li>• Financial control and discipline</li> </ul> | <p><b>Management Response:</b><br/>We are in support of these principles and we feel that these are reflected in our approach to the financial challenges that we have experienced and will continue to experience.</p> <p><b>Responsible Officer:</b><br/>Chief Executive</p> <p><b>Due Date:</b><br/>Ongoing</p> |



# Appendix B – Communications 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 2009/10 or comments as appropriate.

| Communication Required under ISA 260   | Reference/Comment   |
|--|---|
| Engagement letters   | Signed Engagement Letter with Audit Scotland at the start of our 5 year appointment and updated annually.   |
| Independence   | Audit Planning document report to Audit Committee on 7 May 2010, confirming no member of audit team has any direct interest, financial or otherwise, in the Board.                  |
| Audit Approach and Scope   | Audit Planning document (reported to Audit Committee on 7 May 2010).  |
| Accounting Policies/Practices with a Material Effect on the Financial Statements                 | Sections 3 and 4 of our Annual Report to Board Members and the Auditor General for Scotland.  |
| Potential Effects of Material Risks and Exposures  | Identified in our Audit Planning document (7 May 2010) and addressed satisfactorily through our audit approach over the course of the year.   |
| Audit Adjustments  | Section 3 of our Annual Report to Board Members and the Auditor General for Scotland.   |
| Material Uncertainties relating to Going Concern   | None identified.  |
| Disagreement with Management about Matters that could be Significant to the Financial Statements | Not applicable.   |
| Expected Modifications to the Auditor’s Report   | No modifications identified. A true and fair opinion provided.  |
| Letter of Representation   | Signed by Management 25 June 2010.  |
| Material Weaknesses in Internal Control  | Internal Controls findings reported separately in our Interim Management Letter (7 May 2010), Section 5 of our Annual Report to Board Members and the Auditor General for Scotland. |

| Communication Required under ISA 260  | Reference/Comment   |
|---------------------------------------|---|
| Fraud                                 | Discussed fraud arrangements with the Chair of the Audit Committee (7 May 2010) and Management throughout the audit process.              |
| Laws and Regulations                  | We have not identified any material breaches of laws and regulations in the period which impact on the 2009/10 Financial Statements.      |
| Audit Materiality                     | Audit Planning document – presented to Audit Committee on 7 May 2010.   |
| Fair Value Measurement and Disclosure | Included in representation letter signed by Management, dated 25 June 2010.   |
| Related Parties                       | Other than those transactions disclosed in the financial statements we have not identified any further transactions requiring disclosure. |

### Formal Reporting to Management during 2009/10

During the year we have presented a number of formal reports to Management and the Audit Committee and produced certain outputs. Our principal outputs during 2009/10 are summarised below:

| Formal Output  | Timing   |
|--|--|
| Letter outlining work undertaken in relation to our review of the Board's 2008/09 shadow IFRS based financial statements                                   | 3 November 2009  |
| Audit Planning document  | 7 May 2010   |
| Detailed Timetable for 2009/10 Financial Audit   | 7 May 2010   |
| Follow-up of 2008/09 Recommendations   | 7 May 2010   |
| Interim Management Letter  | 7 May 2010   |
| Annual Report to Board Members and the Auditor General for Scotland  | 25 June 2010   |
| Audit Opinions<br>1. True and fair value on the financial statements ✓<br>2. Regularity of income and expenditure ✓<br>3. Remuneration Report (sections) ✓ | } Unqualified<br>} Audit<br>} Opinions<br>25 June 2010 |

### **Freedom of Information Act (Scotland) 2002**

In the event that, pursuant to a request which the institution has received under the Freedom of Information Act (Scotland) 2002 or the Environmental Information Regulations 2004 (as the same may be amended or re-enacted from time to time) or any subordinate legislation made there under (collectively, the "Legislation"), the Board is required to disclose any information contained in this report, it will notify PwC promptly and will consult with PwC prior to disclosing such report. The Board agrees to pay due regard to any representations which PwC may make in connection with such disclosure and to apply any relevant exemptions which may exist under the Legislation to such report. If, following consultation with PwC, the Board discloses any of this report or any part thereof; it shall ensure that any disclaimer which PwC has included or may subsequently wish to include in the information is reproduced in full in any copies disclosed.

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