Public Interest Report

November 2005

audit commission

Public Interest Report

Scarborough and North East Yorkshire NHS Trust

Audit 2004/2005

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Introduction

1 I am the external auditor appointed by the Audit Commission to audit the accounts of Scarborough and NE Yorkshire NHS Trust ('the Trust').

2 This report is issued under section 8 of the Audit Commission Act 1998. This section of the Act requires me to consider whether, in the public interest, I should make a report on any significant matter coming to my notice during the course of the audit. The purpose of this report is to bring to the attention of the public, and seek the Trust's response to my concerns over the Trust's financial position and the shortcomings in the action taken to address the position.

3 Following a report published in the Scarborough Evening News in July 2005 there is also a need for me to report the facts concerning the adjustments made to the Trusts accounts. The report refers to 'some flexible accounting techniques' employed by the Trust and the Director of Finance is quoted as describing the methods as 'legitimate accounting treatments'. This report sets out the accurate position for the benefit of the public.

Background

4 Hospital trusts are required to operate within certain prescribed financial limits, one of which is to breakeven year-on-year. This statutory duty is set by the National Health Service and Community Care Act 1990. If this statutory duty is breached, the Trust has three years to move back into balance and repay the deficit. This period can be extended to five years with the agreement of the Strategic Health Authority.

5 The Trust has been in a difficult financial position for a number of years and 2004/05 was year three of a recovery plan agreed with the Trust's main commissioner Scarborough, Whitby and Ryedale PCT ('the PCT') and the North and East Yorkshire and North Lincolnshire Strategic Health Authority ('the SHA'). Over the last four years the Trust received additional financial support from the SHA totalling £10 million which the Trust repays year on year as part of its recovery plans:

- 2001/02 £1.3 million;
- 2002/03 £3.4 million;
- 2003/04 £3.5 million; and
- 2004/05 £1.8 million.

6 With this support the Trust met its key NHS plan waiting time targets for each year and its financial breakeven target until 2004/05. In 2004/05, the Trust failed to meet its breakeven target and, after misstatements in the accounts were corrected at audit, reported a deficit of £4.5 million. I reported my proposed audit opinion to the Audit Committee on 13 July 2005. In the light of the Trust's financial position and the misstatements in the draft accounts (and the Trust's balanced Financial Information Monitoring System (FIMS) return submitted to the SHA), I informed the Committee that there was a need for me to consider my other reporting responsibilities and whether a report in the public interest was necessary.

Previous audit action

7 In my 2003/04 Annual Audit Letter to the Board, which was issued in December 2004 after discussions with officers in November, I set out my concerns over the Trust's financial position at the time. I stressed the major challenges that the Trust faced in 2004/05, both in meeting local patients' needs and national targets while facing significant financial pressures. I referred in my Letter to the need for the Trust to work closely with the PCT to take account of new pressures and share financial risks and to re-double efforts to generate efficiency gains to address its financial difficulties.

8 In commenting in the Annual Audit Letter on the financial recovery plan, I highlighted the large degree of risk over the main element of the plan at the time, which involved a proposed profit on the sale of assets. I stated that the assets should be re-valued before sale to comply with the required accounting standards within the NHS. This approach was not followed by the Trust in preparing the 2004/05 accounts.

9 Following audit work in 2004 on the management of the community hospitals in the area, I recommended that the Trust and the PCT urgently needed to agree a common long-term vision for healthcare and how the community hospitals were to be run. Progress has been made in clarifying the management arrangements for the hospitals but there is currently no agreement on required funding levels and this is a major factor underpinning the financial difficulties of the Trust.

The Trust's financial position in 2004/05

10 In 2004/05, there was an early realisation of difficulties in achieving financial balance following difficult negotiations with the Trust's main commissioning body, the PCT. In common with other NHS Trusts throughout the country, the costs of national initiatives such as consultant contracts and reducing waiting time targets created significant financial pressure, and this became more apparent to the Trust as the year progressed.

11 Table 1 summarises the financial position reported by the Director of Finance to the Board.

Table 1 Financial Position 2004/05

	31 July 2004 £m	30 September 2004 £m	30 November 2004 £m	28 February 2005 £m
Budget - variance to-date				
Additional income	0.5	0.9	1.2	1.7
Total divisional overspends	(2.1)	(3.3)	(4.6)	(6.8)
Financing/other operating expenses (over)/underspend	0.6	(0.6)	0.0	1.1
Total net overspend to-date	(1.0)	(3.0)	(3.4)	(4.0)
Forecast year-end				
Additional income	1.0	1.0	1.5	1.5
Divisional overspend	(4.0)	(4.5)	(6.8)	(6.8)
Financing/other operating expenses underspend	3.0	3.5	5.3	5.3
Final position	Break-even	Break-even	Break-even	Break-even

Source: Summarised from Financial Reports to the Trust Board by the Director of Finance

12 Deterioration of the financial position during the year is not unusual at the Trust. In 2002/03, £3.4 million additional support was needed from the SHA late in the financial year.

The Trust's response to its financial problems

13 The Trust's initial response to the projected overspend, identified in the July Board report as £3.0 million, was to use a range of options to meet its statutory financial and waiting list targets. The options initially included:

- selling property, mainly doctors' accommodation, to make a profit; and subsequently; and
- making accounting adjustments by adopting a different approach to the recording of expenditure on medical instruments bought in previous years, treating them as stock or fixed assets and in so doing, reducing costs in the 2004/05 accounts.

14 Senior finance officers spent a significant amount of time considering these options and other accounting measures aimed at trying to balance the financial position.

15 In the past the Trust has needed to make significant savings to balance its financial position and meet its statutory duty to breakeven, taking one year with another. It has not always achieved its cost reduction targets, however, and this has led to the need for the continuing financial support from the SHA. A financial review process was set up in 2003/04, in which achievement of budget and savings targets were reviewed monthly by the Chief Executive, Director of Finance, Divisional Directors and Management Accountant. This helped the Trust to meet its targets in 2003/04, but no such reviews took place in 2004/05 as corporate procurement and staffing initiatives to reduce costs were pursued.

16 In November 2004 the Director of Finance reported to the Board that whilst the forecast year end position was breakeven, divisional overspends were expected to total £6.8 million by the end of the year. This was an increase of £1.8 million compared with the previous month. The value of any 'accounting adjustments' or other measures needed to balance the financial position increased accordingly and stricter spending controls were introduced in January 2005, including:

- strengthening establishment controls, delaying the replacement of non-key staff; and
- reviewing orders within the finance department to stop non-essential purchases.

17 The controls introduced did not have a significant impact, but action taken at an earlier stage might have reduced the overspend and the overall deficit of the Trust.

18 Despite the reference in my draft Annual Audit Letter (which was discussed with the Chief Executive and the Director of Finance in November 2004) to risks, in my view the Board remained focused on the 'accounting adjustments' as a solution to deal with emerging deficit.

19 My Audit Manager met the Director of Finance and senior finance staff in March 2005 and discussed the proposed accounting adjustments. One week before that meeting my Audit Manager, sent a copy of the technical advice we had obtained to the Director of Finance. During the meeting my Audit Manager once again made the Director of Finance aware of the appropriate accounting definitions for fixed assets and stock, and also confirmed with him the materiality threshold for errors and misstatements. This is important as uncorrected items in the accounts above this threshold would mean we would need to issue a qualified audit opinion.

20 The Director of Finance chose to disregard our view that the ‘accounting adjustments’ proposed would be contrary to accounting standards and reported a balanced financial position to the Board and in the draft accounts submitted for audit in May 2005 and in the FIMS return sent to the SHA. The Trust’s accounts were subsequently found to be inaccurate. The Director of Finance has informed me he did not carry out any detailed work to justify the proposed accounting treatments or seek any second opinion on the relevant accounting standards that apply to the specific circumstances of the Trust. It seems to me that the Trust’s annual accounts and FIMS return were therefore produced in the Director of Finance’s full knowledge that they would not be acceptable for audit, as the reclassifications proposed would be in excess of our materiality threshold.

Annual accounts

21 The form of accounts and accounting standards relevant to NHS Trusts are set out in the NHS Trust Manual for Accounts. Directions issued by the Secretary of State require strict compliance with the Manual which largely follows accounting standards and generally accepted accounting practice applicable to all public and private bodies in the UK and is intended to allow accounts from different organisations to be comparable. Within these rules there are accepted principles to match income received to expenditure for the same accounting period. The Trust’s draft accounts did not properly reflect these accounting principles. The inappropriate ‘accounting adjustments’ and errors made by the Trust in the draft accounts are listed in Appendix 1.

Accounting adjustments

22 In my view a key element of the Trust’s response to its poor financial position was to change the accounting policy for medical instruments such as scalpels, forceps, theatre trays etc. Normal accounting practice in the NHS is for this expenditure to be charged to the income and expenditure account in the year the spending takes place. This is in accordance with the accounting treatment of revenue expenditure set out in the Manual, and is how the Trust has accounted for these items previously. In 2004 the Trust assessed the insurance value of these items, and created a detailed list of instruments purchased over the preceding 15 years which had a total value of over £4 million. The Trust hoped it could reduce in-year spending by re-classifying these previously purchased items as stock (£1.6 million) and fixed assets (£1.2 million).

23 Accounting rules could allow the classification of medical instruments as stock in certain circumstances, such as disposable instruments with a short life of less than one year. NHS rules similarly allow single items valued over £5,000 or dependent grouped assets with an individual value above £250 to be classified as fixed assets. Instead of identifying medical instruments which met these criteria, the Trust calculated the total it needed to change the initial deficit of £2.8 million to a small surplus of £20,000. It therefore reduced 2004/05 spending by £2.8 million through increasing stock on the balance sheet by £1.6 million and fixed assets by £1.2 million using the insurance list of assets; this reduction in revenue expenditure was in effect a balancing figure. In my view the accounting adjustment employed for these items was a device to achieve financial balance, rather than improve the accuracy of the accounts, and did not comply with accounting standards.

24 The rules for large adjustments related to purchases made in previous years are also clear, stating that current year income and expenditure should not be adjusted for such transactions to avoid distorting the financial statements. So even if the adjustment for medical instruments complied with the stock or fixed asset criteria, the adjustment could not be made to create a financial benefit in the 2004/05 accounts because such a change in accounting policy would require a prior period adjustment.

25 The following further examples of incorrect accounting treatment resulted in misstatements to the value of over £900,000:

- overstatement of profit arising from asset sales (£270,000);
- inappropriate capitalisation of salaries (£290,000); and
- revenue costs inappropriately classed as prepayments (£380,000).

Errors in the draft accounts

26 In addition, to this failure to properly apply the Manual, checking procedures adopted by the Trust were inadequate and the draft statements included errors to the net value of £789,000 which I have set out in Appendix 1.

Final position

27 Following completion of the audit the Trust agreed to amend the accounts to ensure the correct position was reported. The income and expenditure statement which initially reported a surplus of £20,000 was corrected to show a deficit of £4.5 million. In my experience misstatements of this scale in NHS Trust accounts are highly unusual. In my opinion the desire to present a small surplus at the year end has compromised the integrity of the production of accurate annual accounts.

Reporting the financial position

28 Reporting to the Board and the SHA takes place on a monthly basis. The Trust's reports forecast a final breakeven position and highlighted the extent of the overspends in divisional budgets and hence the value of the cost improvement measures that the Trust needed to identify.

29 Whilst the Trust Board was apprised of the risk of budget overspends, in my view the risk of reporting a deficit was significantly under-estimated. Following my Annual Audit Letter and by March 2005, after further discussions with my Audit Manager, it is unclear why the Director of Finance did not amend the reports to the Board.

30 The December 2004 report to the Board by the Director of Finance showing the position to the end of November highlighted divisional overspends to the value of £6.8 million. The report suggested a number of possible actions to address this position, but did not provide any information about the potential value of the accounting adjustments. The report described the adjustments as 'not a change in accounting policy, but rather more accurate compliance'. In my view the adjustments did involve a material change to accounting policy and did not comply with proper accounting practice. As such the adjustments misrepresented the true financial position of the Trust.

31 The proposed adjustments were described in the December report as requiring 'consultation with the auditors'. There was no information provided of the level of risk and even after the meeting between my Audit Manager and the Director of Finance in March, the April report still forecast breakeven but with 'further clarification still required' from the auditor.

32 Financial reports to the SHA were submitted on the same basis. The Director of Finance has informed me that the planned revenue support of £1.8 millionm from the SHA was conditional on reporting a balanced position in the monthly reports received from the Trust. If the Trust had correctly reported the likely deficit it could have lost this planned support.

33 In July 2005 I reported to the Trust's Audit Committee the corrections needed, and explained that the effect of the 'accounting adjustments' had been to misstate the Trust's financial position in the accounts prepared for audit and in reports to the Board and the SHA. Later in July 2005, however, the Chief Executive and Director of Finance issued a press release expressing the view that 'adjustments to the annual accounts put the Trust into deficit to the tune of £4.5 million for 2004/05'. Following the press release the Scarborough Evening News reported that 'auditors added to the Trust's woes'. The Director of Finance is quoted in that report as saying the methods used by the Trust were legitimate. The corrections made to the annual accounts, however, were required to set out the true financial position of the Trust, and to allow the Director of Finance to present a compliant set of accounts for Board approval, and for submission to the Department of Health.

Planned action by the Trust for 2005/06 onwards

34 Detailed work started with the PCT in April 2005 to update the local health economy recovery plan and agree funding for 2005/06 patient care activity. Agreement was reached with the PCT on funding levels on 6 June 2005. The Trust reported its three year financial plan to the Board on 21 June 2005 and the PCT to its board on 29 June 2005. The Trust updated its recovery plan to take account of the deficit on 26 July 2005.

35 While there has been a joint approach in identifying recovery action, each organisation is required to produce its own separate plan to fulfil the requirements of the SHA's monitoring process. There are some differences between the plans as can be seen from Table 2.

Table 2 Comparison of Trust and PCT recovery plans 2005/06

	Savings in Trust recovery plan £000	PCT additional Cost £000	Comments
Community Hospitals - reduction in subsidy by the Trust	850	800	The Trust recovery plan is based on the draft agreement the final saving was £800,000.
Service Level Agreements - services provided by the Trust to the PCT	750	250	The Trust provides a number of services such as IT support to the PCT. Difference represents disagreements over costs. Internal Audit currently looking into the difference.

Source: Year 1 of the Three Year Financial Recovery Plan Reports for the Trust and PCT.

36 A significant area of disagreement with the PCT is the financial responsibility for elderly medical patients at the Community Hospitals. According to the Trust the impact for a full year is that its costs exceed funding received from the PCT by £4.5 million although this is disputed by the PCT. The finance directors of both the Trust and the PCT have agreed that Internal Audit will provide an independent assessment of the costing and recharging arrangements and further work is needed to finalise the agreement on how the costs can be fairly distributed. The proposed re-organisation of provided services, including those at the Community Hospitals, is due in October 2006 and could provide an opportunity to deal with the funding issues in the medium-term.

37 The deficit reported in 2004/05 exacerbates the Trust's underlying cash flow difficulties, which have arisen from previous brokerage arrangements. This deficit will need to be repaid over three years and the Trust is currently predicting serious cash flow problems. The latest predictions are that this cash shortfall will be £4.3 million by the end of 2005/06 although this assumes property sale receipts of £3.5 million which remain uncertain.

38 The revenue savings target in the first year of the new three-year recovery plan for the Trust totals £6.3 million for 2005/06, even after taking into account the planned support from the SHA of £4.2 million. Stronger controls are planned that include re-introducing meetings with budget holders by the Chief Executive and Director of Finance and more realistic budget and savings targets for services. The October Trust Finance Report refers to a £1 million budget overspend by operational divisions against their 2005/06 budget allocations by the end of September. New plans need to be developed to deal with this overspend and I note:

- there remains a £0.5 million difference between the Trust and PCT recovery plans;
- the anticipated surplus on the sale of properties of £1.3 million may not be realistic; and
- £0.6 million savings have yet to be identified.

Audit recommendations for action

39 It is the Board's responsibility to ensure that the Trust meets its statutory financial responsibilities. It is essential that recovery action is pursued vigorously and progress is closely monitored. The Board will need to provide strong leadership for the recovery process, and carry out a robust scrutiny and challenge of overall financial performance.

40 The Board needs to ensure that:

- the financial recovery plan is agreed with the SHA and the PCT and action is taken to agree a solution for resolving the accountability issues that surround the community hospitals;
- recovery proposals are supported by detailed action plans in the areas where savings are required, including the 2005/06 overspend;
- effective budgetary control is maintained, so that planned savings are delivered;
- the monthly and year end reported financial position is free from errors and misstatements. Any further accounting adjustments considered by the Trust should be set out in detail and scrutinised, to ensure they are justifiable and in accordance with accepted accounting practice; and
- the draft accounts are approved at a meeting of the Board, and detailed checking procedures introduced, so the accounts in future are free from material error.

41 The Board needs to consider the issues raised and recommendations made in the report and specify the actions needed in response.

42 I will continue to monitor the Trust's financial position and financial recovery action, and consider whether I need to take further action in respect of the exercise of my formal powers under the Audit Commission Act 1998.

Mark Kirkham

District Auditor

11 November 2005

Appendix 1 – Significant audit amendments

	Detail	Incorrect accounting treatment £000	Errors £000	Errors prior year £000	Total £000
Fixed assets	Medical instruments assets do not meet NHS Capital Accounting Manual criteria and in year adjustment for prior year. This item was a balancing figure to increase in-year capital spending to meet the capital resource limit target.	-1,190			**-1,190**
Profit on sale of assets	Profit overstated taken as difference between sale proceeds and book value rather than re-valued amount and not in accordance with the NHS Capital Accounting manual.	-266			**-266**
Capitalisation of salaries	Inappropriate reduction in revenue costs and charge to capital not in accordance with the NHS Capital Accounting manual.	-286			**-286**
Stocks	Medical instruments treated as stock contrary to Accounting Standards and an in-year adjustment for the prior year. This item was a balancing figure used to transfer £1.6 million expenditure to the balance sheet.	-1,616			**-1,616**
Debtors	Overstatement of debtors and income mainly arising from double counting one significant debtor.		-894	377	**-517**
	Debtors understated in the first draft of the accounts.		175		**175**
Pre-payments	Revenue costs such as training shown as a pre-payment charged to the balance sheet and not in accordance with Accounting Standards.	-379			**-379**
Creditor accruals	Payments in 2005/06 but related to 2004/05 not charged back to 2004/05 in accordance with accounting standards for overtime, agency staff utility invoices due to an error by accountancy staff.		-447		**-447**
Total		**-3,737**	**-1,166**	**377**	**-4,526**