SUMMARY

Joint report by the National Audit Office and the Audit Commission

This report was prepared jointly by the National Audit Office and the Audit Commission. It incorporates the findings of:

- **the National Audit Office from their audit work on the NHS summarised accounts, the Department of Health's resource account, other statutory health organisations with a national remit, and their value-for-money reports into the health sector;**
- **the Audit Commission's appointed auditors' work on the 2003-04 accounts of individual NHS organisations.**

Through this joint perspective, the report outlines the financial issues facing individual NHS organisations now and in the future, together with an overview of the effects of these issues at a national level and the consequences for the national health economy.

1 *Financial management in the NHS* is a report prepared jointly by the National Audit Office and the Audit Commission. It sets out the state of NHS finances in England in 2003-04, looks at current financial management and reporting issues, and briefly considers the most significant financial issues facing the NHS beyond 2003-04.

2 In 2003-04 the NHS spent a total of £63 billion. Over the period of the five year settlement announced in the 2002 Budget (2002-03 to 2007-08), expenditure in the NHS is rising at an average of 7.3 per cent each year in real terms, bringing total annual expenditure to £76 billion in 2005-06 and reaching £93 billion by 2007-08, making healthcare the fastest growing area of public expenditure. At the same time, the Government has set out an ambitious reform programme, devolving responsibility with the establishment of NHS Foundation Trusts, introducing new contracts for nearly all NHS staff, developing the information technology infrastructure and changing the funding system for hospitals. Taken together, these issues place an unprecedented level of pressure on the NHS financial regime from 2004-05.

Summary of financial performance in 2003-04

3 The Department of Health achieved financial balance across the 600 local bodies of the NHS in 2003-04. However, compared to 2002-03 the number of bodies failing to achieve financial balance increased and there was also an increase in the number of bodies incurring significant deficits.

In summary:

- the aggregate underspend for all NHS bodies was £72 million (0.11 per cent of total expenditure) compared with an underspend of £96 million (0.18 per cent) in 2002-03 **(Annex 1)**;
- 106 NHS bodies (18 per cent) failed to achieve in-year financial balance, compared with 71 (12 per cent) in 2002-03. 24 per cent of NHS Trusts did not achieve break-even and 14 per cent of Primary Care Trusts failed to keep expenditure within their revenue resource limit **(Figure 1)**. In most cases the deficits were small both in absolute terms and in proportion to turnover;
- a small number of NHS bodies are struggling to manage large deficits. The number of significant deficits (of over 0.5 per cent of income or available revenue resources) increased, to 13 per cent from eight per cent in 2002-03. 12 NHS Trusts reported a deficit of over £5 million in 2003-04, compared to seven in 2002-03. Four Primary Care Trusts had revenue resource limit overspends of over £5 million compared to three in 2002-03. The number of bodies with significant deficits and the size of those deficits would have been greater without specific financial support either from Strategic Health Authorities or centrally; and
- No Strategic Health Authorities reported revenue overspends in 2003-04. However, Strategic Health Authorities have a target of delivering financial balance in aggregate across the NHS bodies within their area. Seven Strategic Health Authority areas reported an aggregate overspend in 2003-04 compared with six in 2002-03 **(Figure 2)**.

4 All NHS bodies with deficits not only need to take steps to achieve recurrent financial balance, but also have to recover deficits from previous years. Although a number of bodies may have a deficit in any one year, the hardest problems arise when the deficit which has been created is very significant or where there is a history of year on year or gradually increasing overspends. The first type is randomly distributed across the country, but there is some evidence of the latter being concentrated in a relatively few geographical areas (Figure 2). A measure of financial management success in the future will be the extent to which the number of areas with long standing problems grow or reduce. Those NHS bodies with the most severe financial problems may have to re-organise their services to achieve this.

Audit of the 2003-04 Accounts

5 As in 2002-03, the appointed auditors of individual NHS bodies did not qualify their opinion on the truth and fairness of the accounts of any Strategic Health Authority, Primary Care Trust, or NHS Trust. The Comptroller and Auditor General was therefore able to give an unqualified opinion on the truth and fairness of the summarised accounts for these bodies.

6 The appointed auditors gave unqualified opinions on the regularity of expenditure on all of the Strategic Health Authority and Primary Care Trusts accounts, except for 53 Primary Care Trusts. These qualifications arose because of 42 breaches of resource limits and 13 instances of other irregular expenditure (two of these accounts were qualified both for resource limit breaches and for incurring other irregular expenditure). However, the Comptroller and Auditor General did not qualify his opinion on the summarised account of Primary Care Trusts since there are no overall resource limits for the aggregate expenditure of these organisations. He also gave an unqualified regularity opinion on the summarised account of Strategic Health Authorities.

7 The findings of the appointed auditors are reported in more detail in **Part 2** and the financial performance of NHS organisations is reported in more detail in **Part 3**.

1 Performance and aggregate outturn of NHS bodies in 2003-04

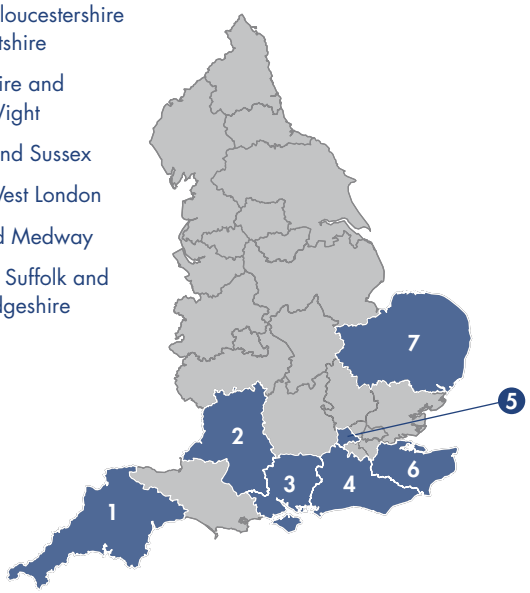
Type of NHS body	Number of bodies	Number breaking even in 2003-04	Number failing to break even in 2003-04	Aggregate surplus/ underspend £million	Aggregate Deficit/overspend £million	Net total £million
Strategic Health Authorities	28	28	0	206	0	206
Primary Care Trusts	303	262	41	95	(91)	4
NHS Trusts	269	204	65	37	(175)	(138)
Total	**600**	**494**	**106**	**338**	**(266)**	**72**

Source: Audited accounts of individual NHS bodies

2 Strategic Health Authority areas with an aggregate overspend

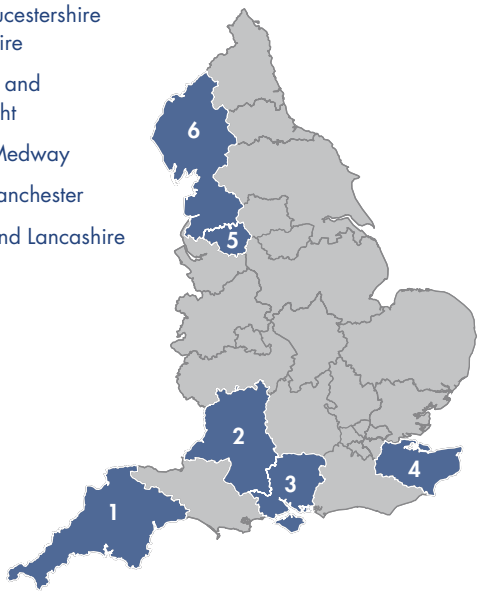
2003-04

1 South West Peninsula
2 Avon, Gloucestershire and Wiltshire
3 Hampshire and Isle of Wight
4 Surrey and Sussex
5 North West London
6 Kent and Medway
7 Norfolk, Suffolk and Cambridgeshire



2002-03

1 South West Peninsula
2 Avon, Gloucestershire and Wiltshire
3 Hampshire and Isle of Wight
4 Kent and Medway
5 Greater Manchester
6 Cumbria and Lancashire



Source: Audited accounts of individual NHS bodies

Key themes for improved financial management

8 Our report looks at four key financial management themes and makes specific recommendations aimed at both the Department and individual NHS bodies to aid improvement. The key themes, considered in more detail in **Part 4**, are:

- **The role of the Board**. The Board has a key role in improving financial management. Several recent examples of bodies incurring significant deficits illustrate the consequences of ineffective oversight or lack of financial acumen at Board level. Non-executives have an important part to play here. It is important that they include individuals with financial knowledge who could, for example, take a lead role on finance both in the Board and on the Audit Committee. We make recommendations to help Boards understand and challenge the financial information presented to them, and drive improvements in financial management.

To increase the effectiveness of Board oversight, we recommend that:

- The NHS Appointments Commission should appoint individuals so that all Boards include non-executives with the appropriate financial management skills and experience.
- Board members need to take collective responsibility for financial matters and be able to understand, effectively challenge, and act on the financial information presented to them.
- Finance Directors and Chief Executives should present the Board with focused and timely financial information, clearly showing the overall financial position and highlighting the important issues that require action at Board level.
- Where a body incurs a deficit, the Board should satisfy itself that the reasons for the financial difficulties are understood and that a realistic recovery plan is in place which tackles the difficulties, and should monitor progress against the recovery plan.

- **Forecasting**. The annual pattern both for individual bodies and the NHS as a whole is for a significant overspend to be forecast in the autumn and early new year but for break even to be achieved at the year end. The fact that NHS bodies are not always able to accurately forecast their year end financial position during the course of the year, makes it difficult for them to take timely and appropriate action to achieve financial balance. The reasons for inaccurate forecasting are considered in detail in **Part 4**.

  The introduction of Payment by Results and the use of independent healthcare providers will mean that for NHS Trusts the receipt of income will be less certain and therefore producing accurate forecasts more difficult. For Primary Care Trusts, Payment by Results will mean that expenditure is more volatile. Greater uncertainty will need to be matched by better risk management and better forecasting. All NHS bodies need to improve their performance in this area of financial management.

  We examine the causes of inaccurate forecasting and make recommendations to increase the level of challenge to forecasts; to enhance budgeting procedures and the treatment of cost savings targets; and to agree funding earlier. Improvements within each of these areas would bring better financial management.

To improve forecasting we recommend that:

- NHS bodies should continually test whether cost savings programmes are realistic. They should monitor progress against these programmes and include the most up to date position in their budgets and forecasts.
- NHS bodies should take full account of likely mitigating action when risks are reflected in forecasts. When reviewing the financial information presented to them by other NHS bodies, Strategic Health Authorities and the Department of Health should more robustly challenge the impact of the risks factored into forecasts.
- Boards should set realistic budgets at the start of the financial year, and understand and challenge the assumptions underpinning the budgets. NHS bodies should regularly review the budgets and profile them to reflect patterns of expenditure and income. Performance against budgets should be regularly monitored and variances explained and acted upon.

- **Earlier preparation of accounts**. The Department and all NHS bodies are working towards producing their annual accounts sooner after the year end. In 2003-04 there was a significant improvement in the quality and timeliness of the NHS bodies' annual accounts, but improvements in financial management, particularly in management accounting processes, are key to achieving the earlier production and audit of the annual accounts. Many commercial organisations produce monthly or even weekly accounts including balance sheet information, so as to keep a clear and current view of their overall financial position. NHS bodies may also find such an approach useful. We make recommendations on improving monthly management accounting processes, preparing for the production of the annual accounts, and liaising with the external auditors.

To facilitate the production of annual accounts sooner after the year end, we recommend that:

- The financial information produced throughout the year should closely reflect the standard and range of information required in the annual accounts and be produced shortly after the period end to which it relates. Such improved financial reporting procedures will also be required for NHS Trusts to apply successfully for NHS Foundation Trust status.
- Boards, Finance Directors, and budget holders should review the financial information presented to them and assess whether the picture presented is consistent with their knowledge of events.

- **Transparency**. Boards, managers and stakeholders would be helped by greater transparency of reporting, including in the annual accounts. In 2003-04, there was an improvement in the transparency of NHS Trust accounts, with the financial support received and its effect on the reported surplus or deficit more clearly shown. However, the effects of giving and receiving support were not as clearly reported in the accounts of Primary Care Trusts and Strategic Health Authorities.

To make clear the extent of non-recurrent support, we recommend that:

- In line with the Department's instructions for 2004-05 onwards, the amount of financial support received, and its nature, should be disclosed in the annual accounts of all NHS bodies.
- Internal financial reporting should highlight the use of non-recurrent funding and cost savings programmes and ensure the implications for the future financial position are made clear.

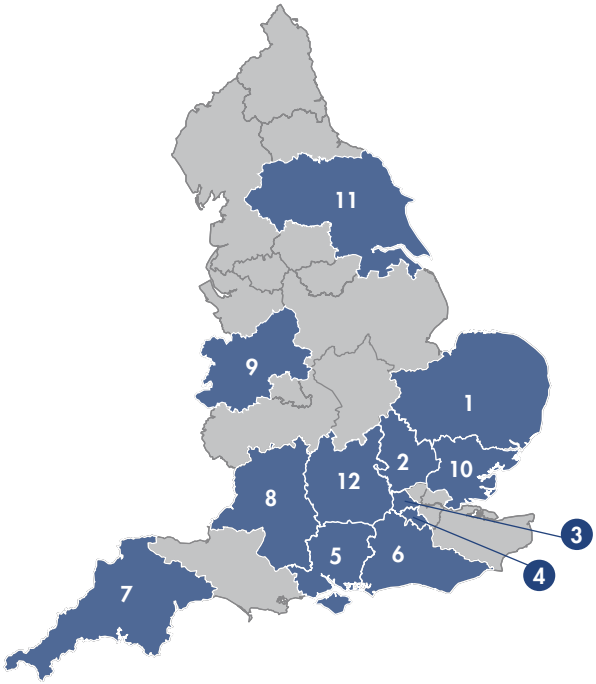
More detailed recommendations under each of these key themes are included in **Part 4**.

Financial issues arising in 2004-05 and beyond

9 There are a significant number of financial management issues that NHS bodies are facing for the first time in 2004-05.

10 Some NHS bodies have experienced increased financial pressures in 2004-05, with auditors currently reporting concerns about financial standing at 32 per cent of NHS bodies and the NHS as a whole forecasting a financial deficit. However, the NHS has a history of forecasting significant deficits which do not materialise at the year end. In 2003-04, this pattern was followed and indeed the final aggregate position was a small underspend. It is therefore difficult to say with any certainty even at this late stage what the audited year-end financial position will be, although the Department is currently expecting a small deficit across the NHS as a whole, with an increase in 2004-05 in the number of individual bodies failing to achieve in-year financial balance. The Department is also estimating that at least 12 Strategic Health Authority areas will report an aggregate overspend in 2004-05 **(Figure 3)**, compared with seven Strategic Health Authority areas in 2003-04 and six Strategic Health Authority areas in 2002-03 (Figure 2).

3 Strategic Health Authority areas currently predicted to overspend in 2004-05



2004-05

1 Norfolk, Suffolk and Cambridgeshire
2 Bedfordshire and Hertfordshire
3 North West London
4 South West London
5 Hampshire and Isle of Wight
6 Surrey and Sussex
7 South West Peninsula
8 Avon, Gloucestershire and Wiltshire
9 Shropshire and Staffordshire
10 Essex
11 North and East Yorkshire and North Lincolnshire
12 Thames Valley

Source: Department of Health

11 Key developments that will introduce new risks to financial balance in 2004-05 and beyond include the introduction of new contracts of employment for most NHS staff, the National Programme for IT and the implementation of Payment by Results.

12 The first NHS Foundation Trusts were created on 1 April 2004. There are now 31 NHS Foundation Trusts some of which have been early implementers of Payment by Results in 2004-05, the new system of funding under which NHS Trusts will be paid a set tariff for each treatment they deliver. Only the NHS Trusts judged to be the best managed and most financially stable are licensed to become NHS Foundation Trusts, and even they are finding the going tough. NHS Foundation Trusts have had to change their approach to financial management significantly to cope with both Payment by Results and the more commercial financial regime under which they operate.

13 When Payment by Results is implemented across the NHS from 2005-06, all NHS bodies will face the new financial risks that this system brings. In January the Department recognised the pressure placed on NHS financial management and the risk of financial instability by delaying the introduction of a key element of this new funding regime. From 1 April 2005, only elective admissions (around 30 per cent of a Trust's income) are covered by Payment by Results; emergency and out patient activity will now not be included until April 2006. Whilst we welcome this move in order to reduce the financial risks of introducing the system, it has meant that NHS bodies have had to revise their financial and operational plans for 2005-06 close to the start of the financial year, and will face further uncertainty if more changes are made to the implementation of Payment by Results.

14 To minimise the risks arising from the forthcoming changes to the NHS financial regime, we recommend that the Department introduces a change management programme to support NHS bodies, similar to that accompanying other major changes such as the introduction of National Service Frameworks.

15 The financial issues arising in 2004-05 and beyond are considered in more detail in **Part 5**.

Conclusion

16 Many NHS bodies need to improve their financial systems and financial management skills to meet the challenges of faster closing and improve their forecasting even under the existing financial regime. 2003-04 was a relatively stable year in terms of challenges facing NHS financial management but, despite this, a number of bodies found it difficult to manage resources effectively. Subsequent developments in 2004-05 and beyond mean that there will be increasing financial challenges which bodies will be expected to manage.

17 Both Primary Care Trusts and NHS Trusts will need to further improve their skills around the strategic aspects of financial management to cope with financial forecasting and modelling under Payment by Results, in particular the identification and management of the new risks that the system will bring. Increased use of independent healthcare providers will further intensify the uncertainty about income levels and highlight the need for better financial management. NHS Trusts will also need to develop appropriate commercial finance skills, to be in a sound position to apply for Foundation Trust status.

18 The National Audit Office and the Audit Commission are committed to working with the Department, Monitor (the Independent Regulator for Foundation Trusts), and NHS bodies to support the NHS in the considerable task of improving its financial management arrangements.