The Explanatory Report of the Comptroller and Auditor General to the House of Commons

Introduction

1. The Department of Health (the Department) leads the health and care system to ensure people experience a service that protects and promotes health and provides safe, effective and compassionate care. In December 2015, I reported on the 'Sustainability and financial performance of acute hospital trusts', which highlighted the severe, and worse than expected, decline in the financial position in hospital trust finances. I concluded that this trend was not sustainable particularly in the context of increasing demand and user expectations. It was and remains my view that the Department and its partners needed to create and implement a plan to put the NHS' finances in England on a sustainable footing. The Department's 2015-16 accounts show that action is some way from being delivered.

2. I have now completed my audit of the Department of Health's accounts, incorporating the financial results of NHS organisations in England. Given the scale of the financial and performance challenges facing the Department I have concluded that it is appropriate to use my powers to report on the accounts for 2015-16. I am also reporting on the accounts of NHS England (which is responsible for the Five Year Forward View which informs its commissioning of healthcare services) and the Consolidated Foundation Trust account (which reflects the financial results for that sector). England's non Foundation Trust organisations have their financial results directly consolidated into the Department's accounts and are therefore dealt within this report.

Structure of this report

3. Drawing on the findings of my audit of the Department's 2015-16 accounts and my recent programme of value for money reports on the health sector, the purpose of this report is to:

    - Describe the system of budgetary control which provides the context for the annual accounts.
    - Set out the final position of the Department against the budgetary control totals for 2015-16 and explain how key parts of the Departmental group contributed to the Department's 2015-16 financial outturn.
    - Explain how the Department achieved its final 2015-16 outturn and the implications of this.
    - Detail the prospects for 2016-17 and my planned work examining the financial sustainability of the NHS in England.

The budgetary control regime

4. The budgetary control regime under which the Department works includes control totals for revenue and capital spending. These are authorised by Parliament through an annual vote (main estimate) and updated towards the end of each year through another vote (supplementary estimate), In addition to these Parliamentary controls HM Treasury also sets a budgetary control total in respect of total departmental spending. The difference between the two controls is funding from the National Insurance Fund, which is not voted on by Parliament. A breach of either the revenue or capital voted totals results in an 'Excess Vote' through which Parliament authorises the additional spend. A breach of the non-voted Treasury limit does not require Parliamentary authorisation but does have implications for how the Government overall is managing its budgets.

5. The Department has not breached its Parliamentary control totals but it has exceeded the non-voted revenue limit. I set out in this report how this happened. In practical terms however the Department got the benefit of additional non-voted funds which enabled it to avoid breaching its revenue budget set by Parliament.

Financial performance in 2015-16

6. The Department delivers its areas of responsibility through a complex network of component bodies, details of which are disclosed on pages 6 to 11 of the Annual Report. **Figure 1** on page 2 of the Annual Report shows how the funds voted by Parliament flow through the Departmental group.

7. The Department's spend against its total 2015-16 Resource Departmental Expenditure Limit (RDEL) was £114.7 billion and its Capital Departmental Expenditure Limit (CDEL) spend was £3.6 billion. The Statement of Parliamentary Supply on pages 99 to 104 of the Department's Annual Report shows that the Department has remained within the voted spending limits set by Parliament for 2015-16. Accordingly, I have not qualified my opinion on regularity in this regard.

8. **Figure 1** below summarises the Department's financial outturn against the voted, non-voted and total RDEL and CDEL for both the 2015-16 and 2014-15 reporting periods. The Department's voted RDEL underspend for 2015-16 was £210 million (0.220 per cent of the Parliamentary spending limit) (2014-15: 0.002 per cent). The Department's CDEL underspend for 2015-16 was £58 million (1.57 per cent of the Parliamentary spending limit) (2014-15: 1.57 per cent).

Figure 1

	2015-16 (£ million)			2014-15 (£ million)		
Spending Control	**Spending Limit**	**Outturn**	**Variance**	**Spending Limit**	**Outturn**	**Variance**
Voted Resource Departmental Expenditure Limit	95,625	95,414	210	91,867	91,865	2
Non-Voted Resource Departmental Expenditure Limit	18,899	19,316	(417)	18,689	18,689	0
Total Resource Departmental Expenditure Limit	**114,523**	**114,730**	**(207)**	**110,556**	**110,554**	**2**
Capital Departmental Expenditure Limit	**3,690**	**3,631**	**58**	**4,014**	**3,951**	**63**

Figure 2 below analyses the contribution key parts of the Departmental group made to the Department's 2015-16 financial outturn. For the purpose of this analysis, we have identified the following key components or sectors:

- The Core Department.
- The Commissioners, including NHS England as parent entity for the 209 CCGs.
- The NHS Providers, comprising 90 NHS Trusts and 153 NHS Foundation Trusts.
- Other components of the Departmental group, including ALBs and companies.

Figure 2 (per figure 10 in the Departmental Accounts)

2015-16 Total Revenue DEL - Sector breakdown	**Variance (£ billion)**
Core Department	1.5
Commissioners	0.7
NHS Providers	(2.5)
Other components	0.1
Total RDEL overspend	**(0.2)**

9. Financial sustainability in the provider sector has been the focus for the budgetary challenges faced by the NHS. As set out in **Figure 2** the NHS Providers overspent by some £2.5 billion in 2015-16 (£0.9 billion in 2014-15). Savings both centrally and on the Commissioners' side have offset the increased provider deficit together with other measures which I describe below.

Financial performance of NHS Foundation Trusts, NHS Trusts and Commissioners in 2015-16

10. I am also reporting on the Consolidated Foundation Trust account and NHS England account for 2015-16. These reports can be found beneath my audit certificate in the Annual Report and Accounts of the Consolidated Foundation Trust and NHS England. Key issues from these reports are summarised below:

    - **Consolidated Foundation Trust:** In 2015-16, the number of foundation trusts reporting a deficit increased again to 101, compared to 78 in the previous year. 23 foundation trusts (14%) received emphasis of matter paragraphs in their audit reports relating the going concern assumption or financial performance (2013-14: 21 of 153, 14%). The rise in deficit is driven by the increase in operational costs, mainly caused by underlying increases in demand. Staff costs, particularly agency costs, have continued to increase.

    - **NHS Trusts:** In 2015-16 these Trusts reported a total deficit of £1,351 million (£473 million in 2014-15). Cost drivers in this sector are identical to those described above for the Foundation Trust sector.

    - **NHS England**: Is responsible for spending some £100 billion annually. In 2015-16 £73 billion was spent through the 209 Clinical Commissioning Groups which locally commission healthcare services. The rest of the annual budget represents specialist commissioning and other activities delivered directly by NHS England. It is responsible for the Five Year Forward View which sets out the strategic direction of the NHS in England. This set the £22 billion efficiency challenge which provides the context for the overall financial sustainability of the NHS in England. The £700 million of savings achieved in 2015-16 are not the result of any overarching plan but are rather non-recurrent and therefore unavailable in 2016-17 onwards.

11. The accounts of local NHS organisations are audited by local auditors under the Code of Audit Practice that I issue in accordance with the Local Audit and Accountability Act. The majority of the Arm's-Length Bodies of the Department are audited by the National Audit Office. I issue instructions to all component auditors under the International Standard on Auditing (ISA) 600. This year I directed their attention to the implications of the Department's proximity to its budgetary control totals and asked them to confirm to me their findings in a range of related areas. I therefore consider the outcomes of their work in framing my own audit.

How the Department achieved its final 2015-16 outturn

12. The Department took a range of actions (described on pages 33 to 47 of its accounts) to manage its 2015-16 outturn, ranging from those which aim to deliver savings in areas of significant pressure, such as the well-publicised cap on agency staff costs, together with short-term, non-recurring savings, including those arising from revisiting historical technical budgeting and accounting treatments. In addition to these actions the Department also benefited from additional receipts which it was able to retain this year.

13. Notable examples of these short-term or non-recurring savings or benefits observed through my financial audit work are set out in more detail below to help the reader understand the scale of the actions taken by the Department. None of the transactions described would be at the core of a comprehensive plan to secure the financial sustainability of the NHS in England. The capital to revenue transfer may in the longer term mean that planned service improvements can not happen or will not happen in a timely way. In other reports I have made the point that deferring capital investment has significant consequences for both service users and taxpayers. Meeting the annual budgetary controls through mechanisms like these

is understandable in the absence of the plan both I and the Committee of Public Accounts have recommended but they are unsustainable. The availability of these areas to create favourable budgetary control impacts necessarily reduces through time. And they are unlikely, in my view, to be able to continue to answer in 2016-17.

14. I have not identified any issues of non-compliance with the Government Financial Reporting Manual, Consolidated Budgeting Guidance or Managing Public Money arising from the actions taken by the Department or the instructions given to bodies within the Departmental group. I do, however, note that the impact of the majority of these actions and instructions was to improve the Department's financial outturn against the control totals voted by Parliament.

    - **National Insurance contributions (£417 million) –** Each year the Department is allocated a share of National Insurance contributions. The value of the receipts are scored against the Department's non-voted expenditure limit and are spent in full each year. These receipts are used for the provision of healthcare, but the expenditure isn't voted on by Parliament and spend in excess of the non-voted limit does not result in an Excess Vote.

      The Department is notified of the amount of National Insurance receipts it will receive in advance each quarter from Her Majesty's Revenue and Customs (HMRC). In normal circumstances when the Department receives notification of the Quarter 4 receipt amount from HMRC it will notify HM Treasury of this amount through the Supplementary Estimate process. This allows HM Treasury to factor the level of receipts into the overall health budget for the rest of the year. In previous years HM Treasury has either increased or decreased the Department's voted RDEL limit by the equal and opposite value of the change in National Insurance receipts the Department is notified that it will receive. Receipts can be higher or lower than anticipated.

      In quarter 4 in 2015-16 the Department received an extra £417 million from National Insurance contributions than was anticipated in its original Annual Estimate which was then authorised by Parliament. In 2015-16 the Department did not follow the process adopted in previous years and HM Treasury wasn't notified of the extra receipts which the Department were due to receive from HMRC. This meant that the Estimate figures weren't updated as part of the Supplementary Estimate process. As a result of this the Department received £417 million of additional receipts from HMRC and neither HM Treasury nor Parliament has had the opportunity to consider whether to reduce the voted funding by an equal and opposite amount.

      Without these extra receipts the Department would have exceeded its Voted RDEL by £207 million. If the receipts had actually been less than originally forecast this position would clearly have been worse. The failure to follow well-established past practice in relation to these National Insurance receipts has been ascribed by the Department to an administrative error. Through my audit work on this area to date I have not seen any evidence that suggests this was done intentionally.

      The extra receipts mean that the Department overspent against its total RDEL limits.

    - **Super Dividend from the Medical and Healthcare Products Authority (MHRA) - £100 million** – In March 2016, MHRA agreed to pay a 'super dividend' of £100 million to the Department. This was recorded as a receivable and payable in the accounts of the core Department and MHRA respectively. This transaction has a favourable impact on CDEL outturn, as MHRA is a trading fund which sits outside of the Departmental accounting boundary. In accordance with the requirements of Managing Public Money, approval from HM Treasury was sought and granted for the Department's right to retain the cash arising from it. The Department have benefited from MHRA sitting on a large cash balance and being able to take this one-off dividend of £100m as a CDEL benefit. Without this the Department would have breached its voted CDEL limit.

- **Central adjustments posted by the Department –** The Department has posted a number of central adjustments which are as a result of the work it has done reviewing the underlying accounts of their component bodies. In the majority of instances these adjustments are appropriate and improve the quality of the financial statements. However, over the course of the audit a number of more speculative adjustments which improved the outturn position were considered by the Department. These were not subsequently processed but their active consideration further demonstrates the pressures under which the Department is operating. We have found instances where the Department has made central adjustments to audited underlying accounts when consolidating the figures into their account and we have reported some of these back to the Department as errors. The value of these adjustments is immaterial and we have not identified any issues of non-compliance with the Government Financial Reporting Manual, Consolidated Budgeting Guidance or Managing Public Money. The majority of adjustments have had a positive impact on the Department's position against its control totals.

- **Capital to revenue transfers - £950 million** – The Department secured approval through the Supplementary Estimate for the transfer of £950 million of budget cover from CDEL to RDEL. As part of this transfer, the Department introduced local capital to revenue transfers for NHS providers totalling £331 million which, in practice, involved certain NHS providers surrendering capital budget in return for revenue funding which was scored as income in their accounts.

  Most, but not all, NHS providers in receipt of this income were required to remit the cash back to the Department in return for a reduction in outstanding Public Dividend Capital balances due from them. The impact at Departmental group level was neutral in terms of the impact on RDEL and CDEL outturn, but did result in a reduction in the deficit reported by those NHS providers (or an increase in their surplus). In March 2016, the Department and Monitor issued guidance as an 'FAQ' to the Manual for Accounts and Foundation Trusts Reporting Manual prescribing the treatment of this income as revenue in the accounts of NHS providers.

- **Guidance to NHS providers by Monitor and the NHS Trust Development Authority** – In January 2016, Monitor and the NHS Trust Development Authority (TDA) wrote to all NHS providers instructing them to consider a number of areas in preparing their annual accounts, with a view to improving financial outturn. While some of this focused on identifying genuine savings, much of it focused on looking for one-off accounting adjustments which could improve the bottom line in 2015-16. While these adjustments are in line with accounting standards, the guidance was focused on finding adjustments with a positive impact, rather than a full review of all areas which could result in adjustments which have both a positive and negative impact on their final outturn position.

- **'Transaction review' commissioned by the Department** – The Department engaged two accountancy firms to undertake a review of certain accounting policies and practices adopted by a sample of 21 organisations within the Departmental group. This sample included ten NHS providers, ten Clinical Commissioning Groups and one Arm's-Length body.

  The findings of these reviews were used to identify adjustments which were processed by local bodies or at group level by the Department. While the actions taken as a result of the review met the requirements of the relevant financial reporting standards the point of the exercise, demonstrated both through the terms of reference for it and its actual outcomes focus overwhelmingly on looking for areas which would improve the financial outturn of the Department.

- **Accounting treatment of European Economic Area liabilities** – The Department's accounts include liabilities in respect of amounts due to other EU countries for healthcare received by UK citizens. In accordance with *International Accounting Standard 37 – Provisions, Contingent Liabilities and Contingent Assets*, these are split between provisions (reported as Resource Annually Managed Expenditure (RAME) for budgeting purposes) and accruals (reported as RDEL), based on judgements around the certainty of the timing and amount of the liability. In 2015-16, the Department scored a one-off, favourable RDEL impact in the region of £150 million based on elements of the liability becoming less certain. While we agree with the reclassification of the accrual to a provision, this is a one-off non-recurring benefit to RDEL which has no impact on the total amount spent by the Department in year, but improves its position against the voted expenditure limit by the £150 million.

The system of budgetary control and its implications for financial management and audit

15. As already described the Department prepares Annual and Supplementary Estimates of its net expenditure. Authorisation to incur this expenditure is then authorised through Parliamentary votes. These votes set a series of annual limits on net expenditure which the Department may not exceed and on the total cash that it may use. Where these voted limits are breached, I qualify my opinion on regularity since this would mean that the Department had incurred expenditure that was not in line with Parliament's intentions. Parliament authorises such excess spending through a subsequent Excess Vote. The Department therefore has to manage its annual capital and revenue spending to an absolute limit to ensure that they avoid a qualified opinion.

16. The requirement for the Department to achieve a specific and absolute budgetary control figure creates significant additional pressure on its financial management. This pressure is compounded by the lack of an overall plan. Together these issues create a focus on the short-term (meeting the annual budget control) rather than the long term (putting the NHS in England on a more financially sustainable footing). Considerable effort has been expended by the available financial capacity within the system on the problem of meeting this year's budget. More effort is needed on creating the conditions for achieving the Five Year Forward View.

Prospects for 2016-17 and my planned work on the financial sustainability of the NHS in England

17. The Spending Review published in November 2015 announced that an extra £5.4 billion will be available for NHS providers in 2016-17. Of this £5.4 billion:

    - £1.8 billion comprises the Transformation and Sustainability Fund, £1.6 billion of which will be passed to NHS providers who conduct emergency care, and is conditional on those providers agreeing and achieving their control totals for capital and resource expenditure in 2016-17. This funding is subject to approval from both the Department and HM Treasury before being passed to providers.

    - £3.6 billion will be distributed through commissioning allocations and related budgets, meaning it is reflected in an overall uplift in tariff prices which will result in higher income for NHS providers.

18. This will relieve some of the pressures on NHS providers, subject to the financial impact of any new activity such as seven day working practices, and the consequences of higher than planned deficits having been reported for 2015-16.

19. Sustainability and Transformation Plans are now being developed on 44 local footprints in England bringing together both commissioners and providers to reach agreement on how they will provide services within a shared budgetary control total in each area. The governance arrangements around these Plans remains unclear. As does the governance and assurance mechanisms around the 5 Year Forward View.

20. I will return to the issue of financial sustainability in the NHS in England in a report this autumn. Given where the NHS in England starts, the scale of the 2016-17 challenge remains considerable particularly

given the weaknesses in the arrangements of local NHS organisations to secure value for money reported of local auditors under my Code of Audit Practice. The challenge will not be met by further ad hoc measures of the type I have observed in 2015-16.

21. Where the Department chooses to engage in short-term, non-recurring activity to manage outturn in 2016-17, I will consider the implications for the scope and timing of my 2016-17 audit. I will continue to give careful consideration of the measures taken by the Department to manage its position against the Parliamentary controls when framing my opinion on its accounts.

Sir Amyas C E Morse **12 July 2016**

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