Corporate

National report

July 2005

Stewardship and governance 2004

A review of the work of the Audit Commission's appointed auditors in 2004

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First published in July 2005 by the Audit Commission for local authorities and the National Health Service in England, 1st Floor, Millbank Tower, Millbank, London SW1P 4HQ

Summary

This report summarises the key findings of the Commission's auditors' work on the 2003/04 accounts. It identifies a number of important policy issues that need to be addressed in order to improve financial performance, financial reporting and corporate governance arrangements in both health and local government bodies.

Issue	The Commission's response
Financial performance	
The financial standing of individual NHS bodies and local health economies remains a primary concern for the Commission and its appointed auditors.	Increasingly, appointed auditors will use their formal reporting powers to highlight concerns regarding financial performance. The Commission's joint report with the NAO makes a number of specific recommendations to improve financial management in the NHS.
Financial reporting	
A quarter of local authorities were required to resubmit their accounts for approval because of significant errors identified at audit. This represents a deterioration on last year's already poor performance, when one in five had to be resubmitted. Although there was an improvement on 2002/03, auditors expressed concerns regarding the quality of accounts at one in five primary care trusts (PCTs).	The poor culture of financial reporting in local government needs to be addressed as a matter of urgency. Local authorities' financial reporting performance will be a key factor in auditors' use of resources judgements for comprehensive performance assessment (CPA) 2005. The Commission will work with the Chartered Institute of Public Finance and Accountancy (CIPFA) to help it develop practical guidance for public sector bodies on re-engineering the annual accounts preparation process by improving arrangements during the year for monitoring, forecasting and reporting income and expenditure.

Issue	The Commission's response
Financial reporting continued	
Many health and local government bodies regard the annual accounts as a year-end exercise rather than incorporating them with ongoing financial management processes. The accounting frameworks in the public sector need to be aligned more closely with best professional practice.	The Commission will continue to lobby the Department of Health (DH) and CIPFA/LASAAC (Local Authority (Scotland) Accounts Advisory Committee) to ensure that accounting frameworks in health and local government are closely aligned with 'generally accepted accounting practices' in the UK (UKGAAP).
Corporate governance arrangements	
Only half of local authorities have a formally constituted audit committee. There remains significant scope to improve the quality of statements on internal control in both health and local government. The lack of formal governance arrangements for partnerships may inhibit the achievement of their objectives and increase the potential for breakdown in governance arrangements and controls.	The Commission will continue to advocate the setting up of audit committees in local government. The existence and effectiveness of audit committees will be a key factor in auditors' use of resources judgements for CPA 2005. The Commission and its auditors will focus increasing attention on statements on internal control over the coming year. Auditors will continue to monitor the performance of partnership arrangements and help bodies to ensure that these are supported by formal, robust partnership agreements. The Commission will publish a report on the governance of partnerships during 2005.

1

Overview of key findings and issues

1 Public audit is an essential element in the process of accountability for the stewardship and use of public money and the conduct of public business.

2 The day-to-day, often invisible and unsung, work of the Commission's local appointed auditors – whether from the Commission's own staff or the private sector – is the bedrock of the Commission's regulatory regime and underpins all the work of the Commission nationally.

3 The key findings and messages arising from local appointed auditors' work in 2004 at NHS and local government bodies are discussed in detail in Sections 2 and 3 of this report. This section summarises the key findings and draws out a number of important policy issues that need to be considered in order to improve financial performance, financial reporting and corporate governance arrangements.

Financial performance

4 The Commission's primary concern in respect of financial performance remains the financial standing of individual NHS bodies and local health economies. This concern is shared by our appointed auditors.

5 During the year, we developed, consulted on and issued revised guidance to auditors – which is published on our website – about how they should report their concerns about financial standing, initially to the boards of NHS bodies, but ultimately escalating to use of their special powers to report in public and refer bodies to the Secretary of State. During the year two public interest reports were issued on issues of financial standing. However, given the increasing concerns about financial management and the financial standing issues at NHS bodies reported to the Commission by auditors, it is expected that the number of public interest reports relating to these issues will increase over the coming year.

6 Following our publication *Achieving First Class Financial Management in the NHS* in April 2004 we carried out a study, jointly with the National Audit Office (NAO), on financial management in the NHS now and in the future. This included an overview of the effects of these issues at a national level and the consequences for the national health economy. The joint report was published in June 2005.

7 The report makes a number of specific recommendations for improvement:

- to help boards (which have a key role in improving financial management) understand and challenge the financial information presented to them and drive improvements in financial management;
- to increase the level of challenge to financial 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 monthly management accounting processes, preparing for the production of the annual accounts and liaising with the external auditors to facilitate faster closing of the accounts; and
- to increase the disclosure of financial support received by organisations in the annual accounts to improve transparency.

8 In both health and local government, auditors will continue to monitor how well authorities manage their expenditure against budget. They will assess the effectiveness of financial management arrangements in giving their use of resources judgements for use in the Healthcare Commission's assessment model and CPA 2005 respectively.

Financial reporting

9 The principal means by which local government and NHS bodies discharge their accountability for the stewardship and use of public money is through the production of timely, audited accounts and the associated narratives and disclosures.

10 Last year, we expressed concern about the standard of financial reporting in both local government and the NHS.

11 In particular, we commented on what we defined as a poor culture of financial reporting in local government – simply, local government as a whole does not take the process of preparing and publishing accounts seriously enough. Auditors' experience in 2004 reinforces these concerns. Although 95 per cent of local authorities achieved the earlier statutory deadline for approving their accounts (indeed 45 per cent achieved the even earlier deadline that will come into effect from 2005/06), this seems to have been at the expense of quality. Some 26 per cent of authorities' accounts had to be re-submitted to members for approval because of significant errors identified by auditors during the audit process – that is one in four of all local authorities' accounts (which compares with 19 per cent, one in five, last year).

12 This level of performance reflects badly on local government and must be improved, even taking account of the advanced closure timetable and the accounting complexities introduced by FRS17 with respect to pensions. Leaders and chief executives in local government need to take responsibility for securing improvements in this area. A local authority's accounts are precisely that, the accounts of the authority as a whole – they are not the sole responsibility of the director of finance and local authorities' performance in this area will be a key factor in auditors' use of resources judgements for CPA 2005.

13 Generally, the boards of NHS bodies do take their financial reporting responsibilities seriously. Again, however, we expressed concerns last year about the promptness and quality of NHS accounts, particularly at PCTs. We are pleased to report that in 2004 we saw some significant improvement. Nevertheless, auditors still had concerns about the quality of accounts presented for audit at 18 per cent of PCTs – one in five (although this compares with approximately half last year) – and about the quality of supporting working papers – one in four (an improvement on the two-thirds reported last year). However, there remains significant scope for further improvement.

14 Generally, the inability to produce good-quality accounts promptly at the end of the financial year reflects badly on local government and NHS bodies' financial monitoring, reporting and forecasting arrangements. Too often the preparation of the final accounts is seen as an end-of-year exercise only and it may well be the first time that income and expenditure are properly accrued and a balance sheet is drawn up. Good financial reporting is a key element of good financial management. The final accounts should be derived from routine management accounting information and their production should be a natural extension of normal monthly management reporting.

15 This is an area in which both local government and NHS bodies need to improve their performance. This requires better planning, the allocation of appropriate resources and in local government, a change in attitudes. Both local government and NHS bodies need to re-engineer the annual accounts preparation process. To a significant extent this could be achieved by putting in place better arrangements for monitoring, forecasting and reporting income and expenditure, cash flow and working capital during the year. The DH is aware of the potential advantages of re-engineering of the annual accounts process and has commissioned the Health Financial Management Association (HFMA) to produce a best practice guide for the NHS on interim accounts. The guide will help to improve in-year performance and potentially shorten the finalisation of annual accounts. Over the coming year, we will work with CIPFA to help it develop practical guidance for public service bodies in this area.

16 A precondition of proper accountability for the stewardship and use of public money is proper accounting, in compliance with best professional practice, defined as UK generally accepted accounting practice (UKGAAP). The accounting framework in health is closely aligned to UKGAAP through compliance with HM Treasury's Resource Accounting manual and the DH is making improvements to the form of accounts to improve the transparency of reporting of financial performance. The Commission was concerned however, that the DH's guidance in 2004 to NHS bodies encouraging the capitalisation of some categories of low value items of equipment, led to some inconsistency in accounting treatment. In local government, the departures from UKGAAP are more significant, including the disposal and depreciation of fixed assets and accounting for pension liabilities. We are concerned at the delay in making the necessary changes to bring the accounting framework in line with UKGAAP. We will continue to lobby the DH and the CIPFA/LASAAC Joint Committee – which has been recognised by the independent Accounting Standards Board as the body responsible for developing accounting standards for local government in the UK – to ensure that the accounting frameworks in health and local government remain, or are brought in line with UKGAAP.

17 In a discussion paper on *A New Framework of Financial Reporting and Accountability in Local Government*, issued in 2001, the Commission proposed changes to the accountability framework for local government bodies. In particular, we called for there to be a requirement for them to produce an annual report. We continue to believe that an annual report to local taxpayers and other stakeholders, including service users, that provides an objective, balanced and understandable account and assessment of the authority's activities and achievements, and of its financial position and performance, is a key vehicle through which local government bodies can discharge their accountability for the stewardship and use of public money and the proper conduct of public business. Local authorities are unique in being the only economically significant entities that are not required to produce such an annual report and the Commission considers the lack of such requirement a significant weakness in the accountability framework for local authorities. In the coming year we will develop proposals for rationalising the accountability framework for local authorities, linking them to developments in the private sector, where there is now a mandatory requirement for public interest entities to produce an operating and financial review.

Corporate governance arrangements

18 Because of the special accountabilities that are attached to the conduct of public business, it is incumbent on public services to put in place corporate governance arrangements that reflect current best practice as defined by the *Combined Code* as adapted for each sector.

Audit committees

19 An essential element of good corporate governance is an effective audit committee. In the Commission's and its appointed auditors' experience, audit committees play a vital role in raising the profile of financial reporting and internal control issues. They also provide an important forum for considering the work of both internal and external auditors.

20 For that reason, the Commission remains concerned that still barely half of local authorities have a formally constituted audit committee. The absence of an audit committee contributes in part to the poor culture associated with financial reporting in local authorities. It may also account for the fact that some 29 per cent of local authorities still do not have a risk register that identifies their key business risks (although this is down from 50 per cent last year).

21 The Commission will continue to work in partnership with other national stakeholders to advocate the setting up of audit committees in local government. The existence and effectiveness of these committees will be a key factor in auditors' use of resources judgements for CPA 2005.

Statement on internal control

22 The principal annual statement on corporate governance arrangements is the statement on internal control (SIC). NHS bodies have been required to produce SICs for a number of years. In 2004 all bodies prepared a SIC in line with DH guidance. However, only 11 per cent had the required system of internal control in place throughout the entire financial year, although 96 per cent were able to provide evidence that risk management processes were embedded by 31 March 2004.

23 In local government, 2003/04 was the first year in which local authorities have been required to prepare a SIC. Guidance on the form and content of SICs was issued by CIPFA relatively late. However, nearly all authorities (98 per cent) were able to produce a

SIC that complied with proper practices, although in the first year authorities had the option of producing an interim statement under transitional arrangements. This represents a significant achievement, although only 59 per cent were able to produce a full SIC. There remains significant scope to improve the quality of SICs in both health and local government and the Commission and its auditors will focus increasing attention on these statements over the coming year.

Partnerships

24 Increasingly, modern public services are delivered through a range of formal and informal partnerships and other forms of joint working. It is essential that formal governance arrangements are put in place for such partnership arrangements.

25 Auditors reported that in 2004, 20 per cent of partnerships entered into by NHS bodies were not supported by a formal agreement between the partner bodies – a reduction from 30 per cent the previous year. Nevertheless, auditors reported problems with governance arrangements in 31 per cent of partnerships, including 22 per cent where there was a formal partnership arrangement in place.

26 In local government, auditors reported that 42 per cent of authorities' corporate governance arrangements had not been reviewed to ensure that appropriate control could be exercised within their partnership arrangements. Of even greater concern is the fact that 61 per cent of authorities had no comprehensive partnership arrangements in place for any of their partnerships, with only 9 per cent having such agreements in place for all their partnerships.

27 The lack of formal governance arrangements for partnerships may inhibit the achievement of the partnerships' objectives and increase the potential for breakdown in governance arrangements and controls. The Commission will publish a report on the governance of partnerships during 2005 and auditors will continue to monitor the performance of partnership arrangements and help bodies to ensure that these are supported by formal partnership agreements that promote sound governance arrangements.

Promoting better financial management

28 Good financial management is an essential element of good governance. It underpins effective service delivery and improvement. Improvements in performance are still required in some areas if the challenging reform agenda is to be delivered. What was good – or good enough – in the past will not be good enough in the future.

29 The key lever available to the Commission to bring about improvements in financial management are the new use of resources judgements – qualitative assessments of the effectiveness of different aspects of audited bodies' financial management arrangements. Auditors will be required to deliver these for both CPA 2005 and the Healthcare Commission's assessment model. In developing the key lines of enquiry and related criteria for judgement that underpin these judgements, we have been able to reflect our expectations about the minimum level of performance to be expected in different aspects of financial management, while at the same time raising the standard in terms of the level of performance required if an audited body is to be judged good or excellent. Therefore, there is an incentive for audited bodies that aspire to being assessed as good or excellent to improve their financial management arrangements and to address the specific concerns set out in this report.

30 So far as the NHS is concerned, we have also established the NHS Financial Management Advisory Group. The Group has representatives from the DH, Monitor, the NAO, CIPFA and the HfMA and seeks to coordinate our respective work programmes and to develop a shared understanding of the key financial management challenges facing the NHS. It also assesses what these challenges mean in terms of the skills and competencies that will be required by financial managers in a modern NHS.

31 Finally, later this year we will publish a discussion paper on what constitutes world class financial management, drawing on case studies from PricewaterhouseCoopers' global best practices database. Our aim in preparing the discussion paper is to:

- stimulate debate about what standards of financial management the public sector should aspire to over the longer term;
- exemplify 'best in class' standards that world class organisations are able to achieve; and
- establish a framework for our future work on financial management.

2

Health

Financial performance

32 The financial standing of individual NHS bodies and local health economies continues to be a key concern for the Commission and its appointed auditors. Good financial management is an essential element of good governance and some NHS bodies still need to make significant improvements in this area in order to meet the government's challenging reform agenda. The Commission will continue to comment on the quality of financial management in the NHS and develop practical guidance to help bodies improve.

33 The requirement for NHS bodies to meet their statutory financial duties each year can influence the preparation of year-end accounts. The restrictions of the NHS finance regime place pressure on NHS bodies to report financial balance (defined as break-even for NHS trusts and keeping within specified resource limits for PCTs), and some of those struggling to achieve financial balance may try to adjust year-end balances inappropriately. Auditors reported an increase in 2003/04 in the number of bodies attempting to adjust cash or balances inappropriately **(Figure 1, overleaf)**. This focus on the break-even duty can be at the expense of good financial management throughout the year. Auditors will continue to challenge NHS bodies that seek to adjust their year-end financial position inappropriately by, for example, misstating year-end balances and provisions.

34 Following our publication, *Achieving First Class Financial Management in the NHS*, in April 2004, we carried out a study with the NAO on the financial issues facing individual NHS organisations now and in the future. This included an overview of the effects of these issues at a national level and the consequences for the national health economy.

35 The key findings were that:

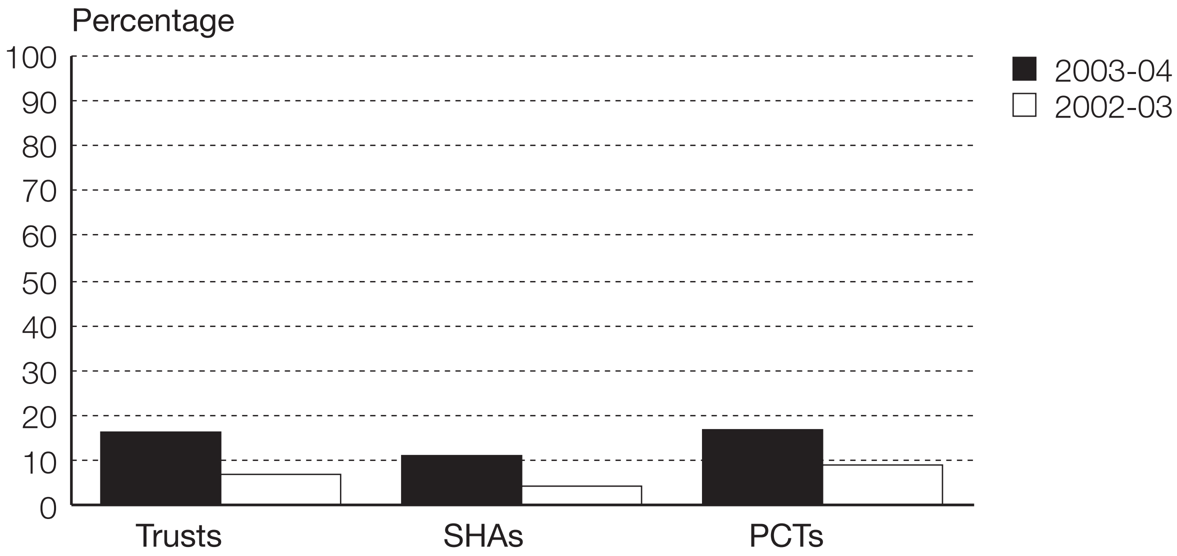
- 106 NHS bodies (18 per cent) failed to achieve in-year financial balance in 2003/04, compared with 71 (12 per cent) in 2002/03. Among NHS trusts, 24 per cent did not achieve in-year break-even and 14 per cent of PCTs failed to keep expenditure within their revenue resource limit. In most cases the deficits were small both in absolute terms and in proportion to turnover; however,
- 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 8 per cent in 2002/03. Twelve NHS trusts reported a deficit of over £5 million in 2003/04, compared to seven in 2002/03. Four PCTs 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 (SHAs) or centrally; and

- seven SHA areas reported an aggregate overspend in 2003/04 across the NHS bodies within their area compared with six in 2002/03.

Figure 1
Percentage of bodies where auditors reported concerns over the inappropriate adjustment of cash or balances

Auditors reported an increase in 2003/04 in the number of bodies attempting to adjust cash or balances inappropriately.

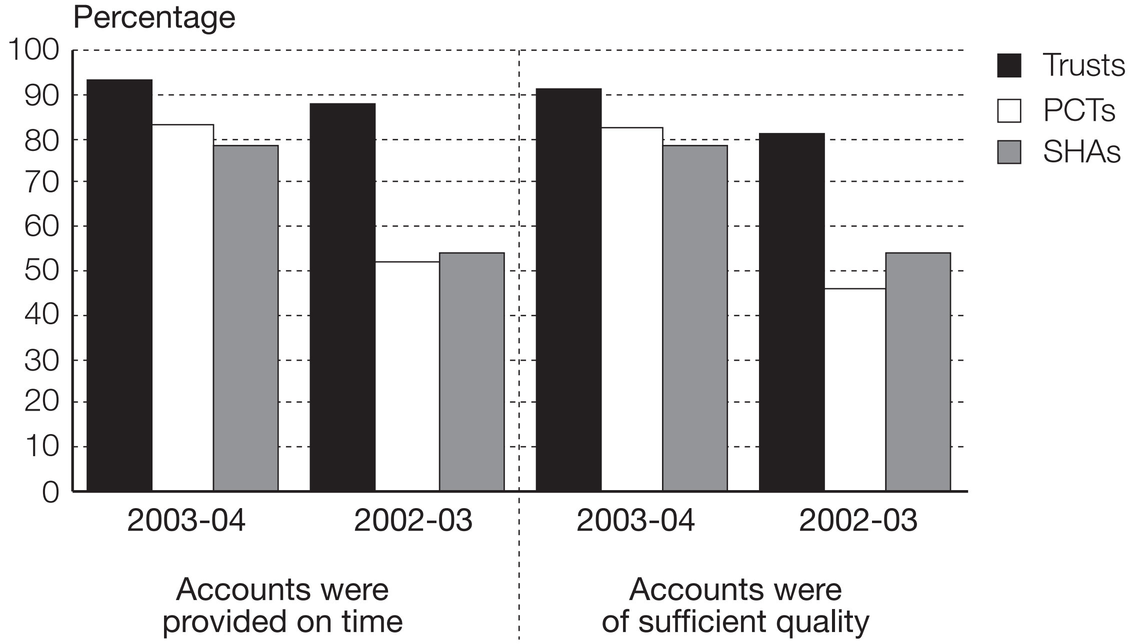


Source: *Audit Commission*

Promptness and quality of accounts

36 In 2003, the Commission expressed concerns about the promptness and quality of NHS accounts, particularly at PCTs. It is pleasing to report that in 2004 auditors saw significant improvements in both the timeliness and quality of the accounts and working papers **(Figure 2)**. These improvements reflect the increased experience of finance staff working in PCTs, in particular, but they are also the result of initiatives introduced by the DH, following the concerns expressed in 2003. The initiatives included the introduction of exemplar working papers and a reconciliation exercise at month nine in which all NHS bodies within a SHA area were required to agree the amounts owed to and due from each other. However, auditors still had concerns about the quality of accounts presented for audit at 13 per cent of NHS bodies.

Figure 2
Timeliness and quality of accounts
In 2004 auditors saw significant improvements in both the timeliness and quality of the accounts and working papers.

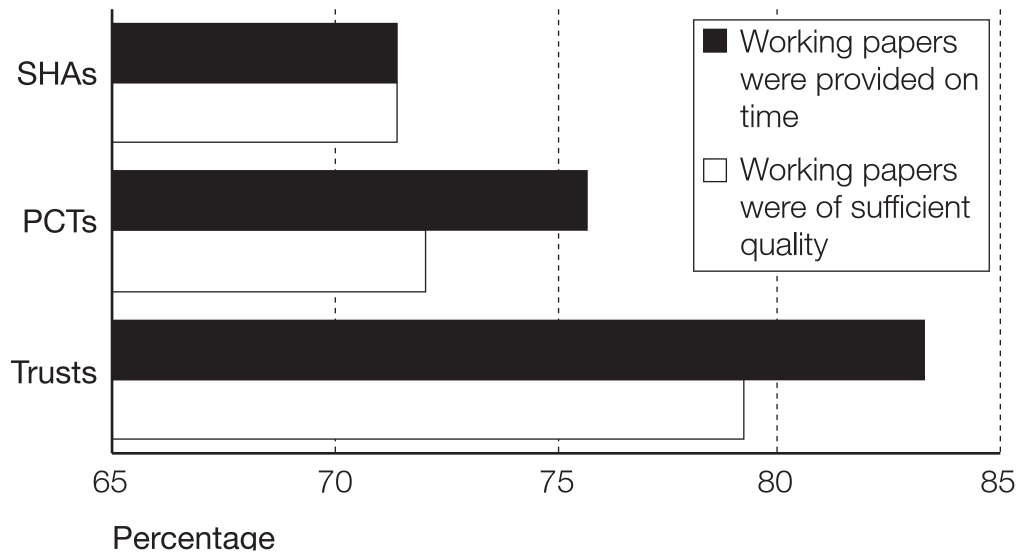


Source: *Audit Commission*

37 Auditors also reported concerns about the quality of supporting working papers at 25 per cent of NHS bodies and timeliness at 21 per cent of bodies **(Figure 3)**. While this represents a significant improvement compared to 2003, there remains a need for further improvement.

Figure 3
Timeliness and quality of working papers

While there has been significant improvement compared to 2003, there remains a need for further improvement.



Source: *Audit Commission*

38 Inability to produce good-quality accounts and working papers by the established deadlines reflects badly on an NHS body's financial management arrangements, as much of the information that needs to be produced for final accounts purposes is also required for good financial management during the year. Furthermore, the importance of having in place proper financial monitoring and reporting arrangements in-year is increasing, as the DH continues to seek to bring forward the accounts deadlines still further in response to HM Treasury deadlines. The Commission continues to work closely with the DH to identify how the production of the accounts can be re-engineered, with processes such as the reconciliation of control accounts and the updating of asset registers being undertaken during the year, rather than at year end. Changes such as this will enable the earlier timetable to be achieved. For 2004/05 the agreement of the amounts owed to and due

from NHS bodies within SHA areas, which was first undertaken in 2003/04, has been extended to become a full national reconciliation exercise. It will also include the reconciliation of income and expenditure. NHS bodies are also required, for the first time, to submit a full set of unaudited accounts to the DH at the same time as these are presented for audit. This is primarily to enable earlier consolidation, but also to enable the DH to form a view on the accounts. In response, the Commission will work with its auditors to identify how the audit process can also be re-engineered, enabling the audit of the accounts to be moved forward.

Qualified audit opinions on the annual accounts

39 Where auditors decide that a body's annual accounts do not provide a true and fair view of its financial performance, they give a qualified opinion on those accounts. In 2003/04, there were no qualifications on the accounts of NHS bodies. At PCTs and SHAs, auditors also give a 'regularity opinion', which confirms that money has been spent in accordance with the intentions of Parliament. In 2003/04, auditors qualified 53 regularity opinions at PCTs. Of these, 40 qualifications related to breaches of resource limits, 11 related to pooled budgets where the governance arrangements had not been formally established and 2 related to both **(Figure 4, overleaf)**. This is a significant increase on the number of qualifications in 2002/03 (a total of 16, of which 11 related to breaches of resource limits, although in 2002/03 not all of the 30 PCTs breaching resource limits resulted in automatic qualification) and is indicative of the increasing number of bodies experiencing difficulty in achieving financial balance. This is due, in part, to the DH's tougher stance on providing support. Where regularity opinions are qualified, auditors make recommendations to NHS bodies to improve their financial management arrangements going forward.

Public reporting

40 The Audit Commission Act 1998 provides auditors with the power to report should they have specific concerns arising from their audits:

- section 8 requires auditors to consider whether, in the public interest, they should report on any matter coming to their notice; and
- section 19 requires the auditor to refer matters to the Secretary of State if he or she has reason to believe that an NHS organisation has made a decision that involves, or may involve, unlawful expenditure.

Figure 4
Qualified regularity opinions given to PCTs

In 2003/04, auditors qualified 53 regularity opinions at PCTs.

Cause of qualification	Number of PCT regularity qualifications (2002/03 in brackets)
Resource limit breaches	40 (11)
Irregular expenditure (pooled budgets)	11 (5)
Resource limit breach and irregular expenditure through pooled budgets	2 (0)
Total qualifications	53 (16)

Source: Audit Commission

41 In 2004, auditors issued three reports using these powers **(Figure 5)**.

Figure 5
Auditors' powers to report

Auditors issued three reports using their formal reporting powers.

Public interest reports	S19 referrals
The auditor of Hammersmith and Fulham PCT drew attention to his concerns regarding the PCT's financial standing. The PCT had deficits in 2002/03 and 2003/04 and the auditor raised concerns about whether financial balance could be achieved in 2004/05 and the longer term. The cumulative deficit at the end of 2003/04 was £10.2 million.	The auditor of a mental health partnership referred to the Secretary of State his concerns about a minor element of the severance arrangements for the former Chief Executive.
The auditor of Mid Yorkshire Hospitals NHS Trust drew attention to his concerns regarding the Trust's financial standing. In 2003/04, the Trust had a deficit of £18.6	

Public interest reports	S19 referrals
million. The auditor raised concerns about the ability of the Trust to achieve financial balance in future periods.	

Source: *Audit Commission*

42 The two public interest reports were published in accordance with Commission guidance issued to auditors on a revised approach to reporting concerns about financial standing at NHS bodies. This revised approach encourages auditors to report their concerns promptly, in a short, succinct paper, enabling prompt discussion of the issues and the development of appropriate recovery action. In the light of this revised guidance, and the increasing concerns about financial management, it is expected that auditors will issue an increasing number of public interest reports relating to financial management issues in the future.

43 In addition to the three formal reports discussed above, the Commission agreed with the DH that, for the purposes of S19 of the Audit Commission Act 1998, the 42 PCT regularity qualifications arising from breaches of resource limits also constituted referrals to the Secretary of State.

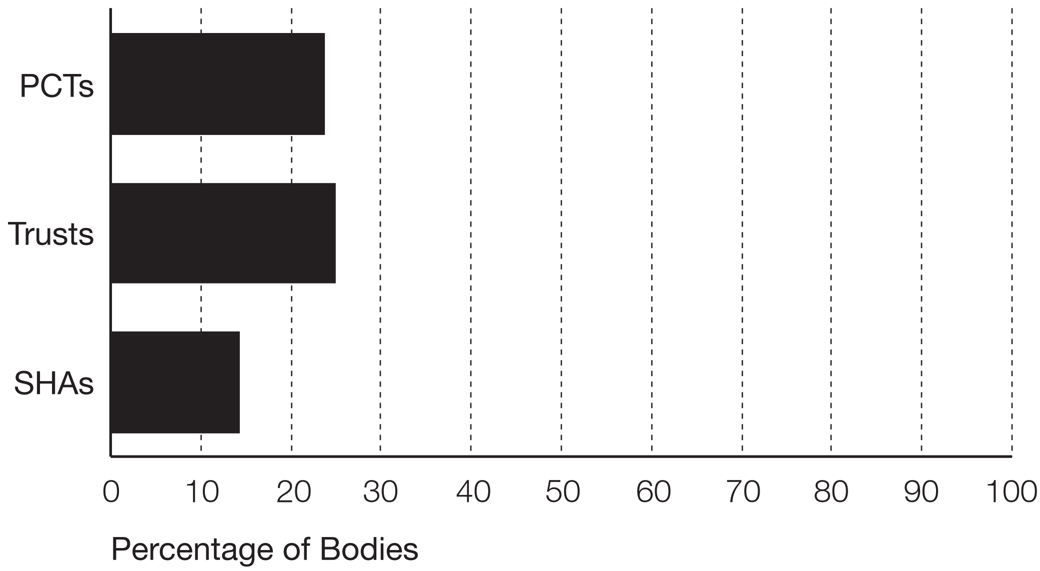
Governance

44 As part of the annual accounts, every NHS body is required to provide a SIC. This sets out the arrangements for identifying, evaluating and managing the risks that could prevent the body from achieving its business objectives and confirms that the arrangements have been reviewed for effectiveness. In order to comply with HM Treasury requirements, NHS bodies had, by 1 April 2004, to be able to demonstrate that the system of internal control had been in place for the whole of the previous financial year. However, in recognition of structural changes in the NHS, HM Treasury conceded that NHS bodies could report full compliance if the required risk management and review processes were in place by 31 March 2004.

45 NHS bodies performed well against this requirement – all prepared a SIC in line with DH guidance. However, only 11 per cent had the required system of internal control in place throughout the entire financial year, although 96 per cent were able to provide evidence that risk management processes were embedded by 31 March 2004.

46 A number of bodies reported 'significant internal control issues' in their SIC. These issues covered a range of matters **(Figure 6)**; the most commonly reported relating to the financial standing and management of the organisation and the further work required to fully embed the assurance framework. Auditors will continue to review the SICs produced by audited bodies to ensure compliance with HM Treasury and DH reporting requirements and will also assess the actions that bodies are taking to address any internal control issues they have identified.

Figure 6
A number of bodies reported 'significant internal control issues' in their SIC

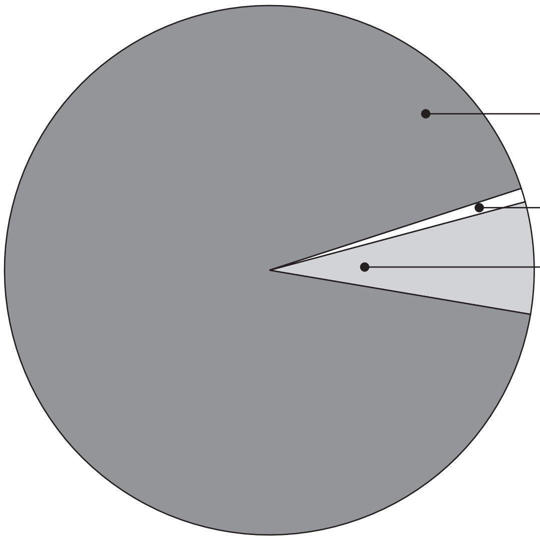


Source: *Audit Commission*

Risk management

47 The NHS continues to face a wide range of risks that can impact on its ability to deliver high-quality health services. We reported in 2003 that only 50 per cent of NHS bodies had identified their principal risks, as required by the NHS's approach to risk management. In 2004, this increased to 93 per cent, with the majority of these bodies (92 per cent) also having established arrangements to enable them to address these major risks **(Figure 7)**.

Figure 7
Risks to the delivery of high-quality health services
The majority of NHS bodies have established arrangements to enable them to address their principal risks.



Source: *Audit Commission*

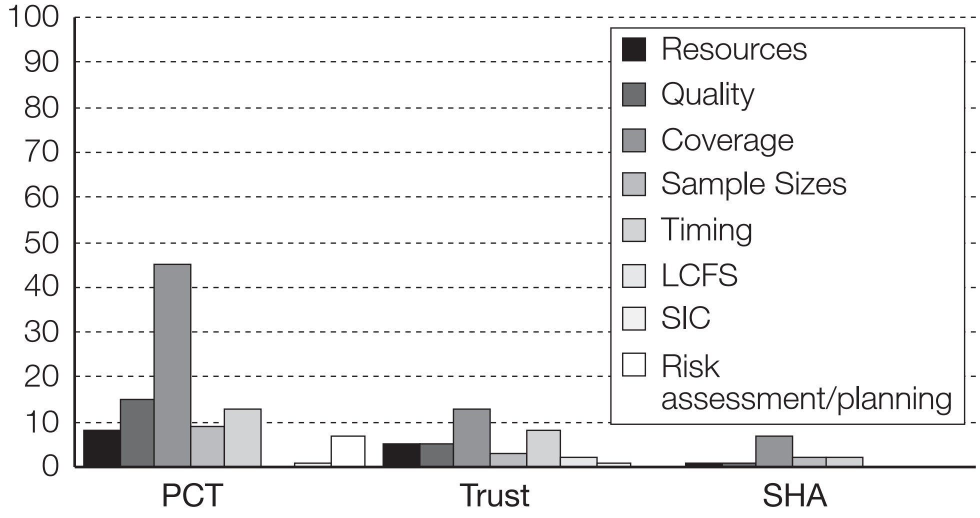
48 Auditors have continued to help NHS bodies to address their identified business risks by applying audit tools developed by the Commission. The key strategic themes covered by these tools were financial management, workforce issues and information management and technology. In 2004, auditors carried out work looking at key issues, such as preparing for new funding flows, implementing the new Agenda for Change pay deal, out-of-hours services and reviewing the implementation of the new consultant contract.

Internal audit

49 An effective internal audit function makes a significant contribution to good governance and is key to enabling NHS bodies to issue their annual SIC. In 2004, auditors reported that they had no significant concerns about the coverage, scope or quality of internal audit work at 81 per cent of NHS bodies. Where auditors have reported concerns, these are centred mainly around the timing of internal audit work and inadequate coverage of core financial systems **(Figure 8, overleaf)**.

Figure 8
Auditors' concerns

Auditors' concerns are centred mainly around the timing of internal audit work and inadequate coverage of core financial systems.



Source: *Audit Commission*

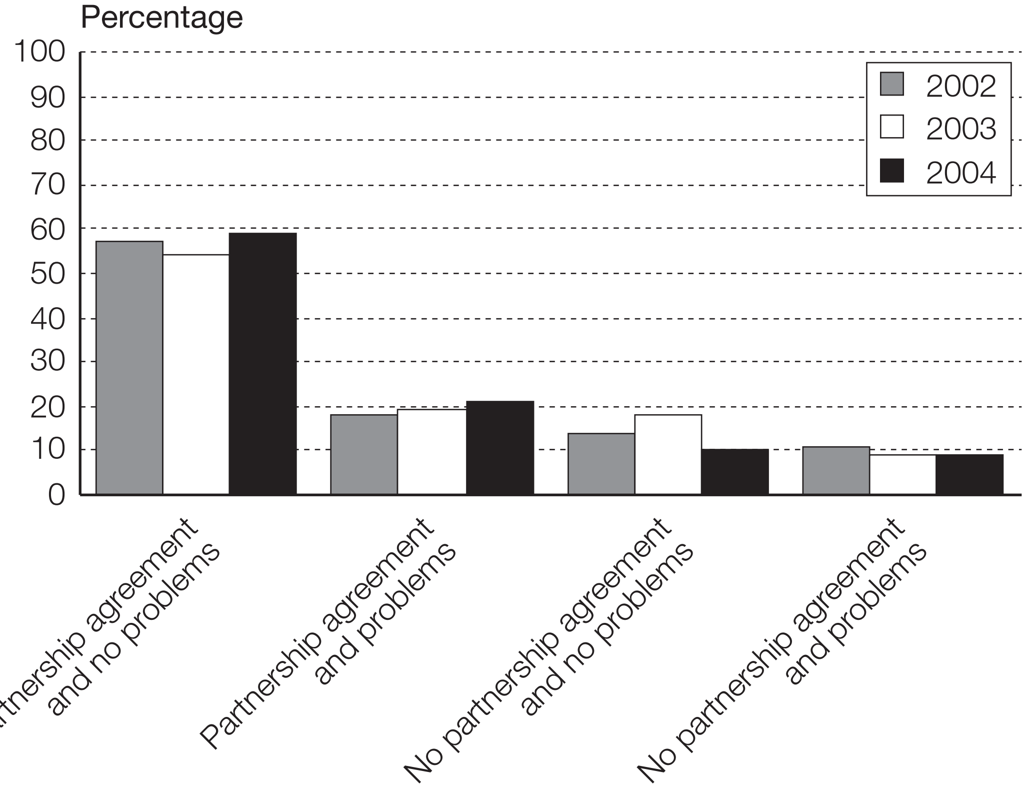
50 In many instances, these concerns reflect a change in the focus of the work undertaken by internal audit. The requirement on internal auditors to provide a head of internal audit opinion on the effectiveness of the system of internal control creates an additional pressure on internal audit resources. Consequently, unless additional resources are commissioned by NHS bodies, less work may be done by internal audit on financial systems on which external auditors can place reliance for audit opinion purposes. This could lead to additional work being undertaken by external auditors to enable unqualified audit opinions to be issued. The Commission is working with the DH to follow up these concerns and assess whether the overall level of resources allocated to internal audit services is adequate. Auditors will also continue to work with individual NHS bodies to address local concerns regarding the quality, scope and timeliness of internal audit work.

Partnerships

51 NHS bodies are increasingly using partnership arrangements to deliver modern, integrated healthcare services. In 2003, we reported that 30 per cent of the partnerships entered into by NHS bodies were not supported by a formal agreement between the partner bodies. We are pleased to note that in 2004, the number without formal agreement has fallen to 20 per cent **(Figure 9)**. However, it remains a concern that auditors are reporting problems with the governance arrangements in 31 per cent of partnerships, including 22 per cent where there is a formal partnership agreement in place. Auditors will continue to monitor the performance of partnership arrangements and help bodies to ensure that these are supported by formal partnership agreements that promote sound governance arrangements.

Figure 9
Partnership arrangements

The number of partnerships without formal agreements has fallen.



Source: *Audit Commission*

3

Local government, police and fire authorities and probation boards

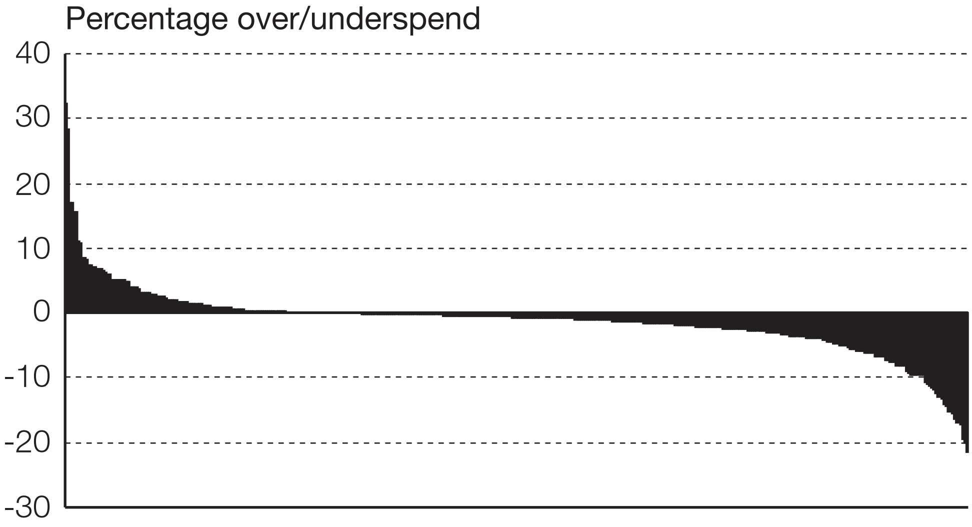
Financial performance

52 Some 20 per cent of local authorities overspent their budgets in 2004, a marked improvement compared to the 30 per cent reported in 2003. Of these, 2 per cent overspent by more than 10 per cent of their revenue budget (1.5 per cent in 2003) **(Figure10)**.

Figure 10

Local authorities' financial performance

Councils' financial performance against their revenue budgets, from (left to right) overspenders to underspenders.



Source: *Audit Commission*

53 Significant variations from budgets, whether deficits or surpluses, are often an indication of poor financial management. CIPFA's financial management self-assessment tool has now been published and we encourage all local authorities to use it to assess their financial management performance. Auditors will assess the effectiveness of authorities' financial management arrangements in their use of resources judgements under CPA 2005.

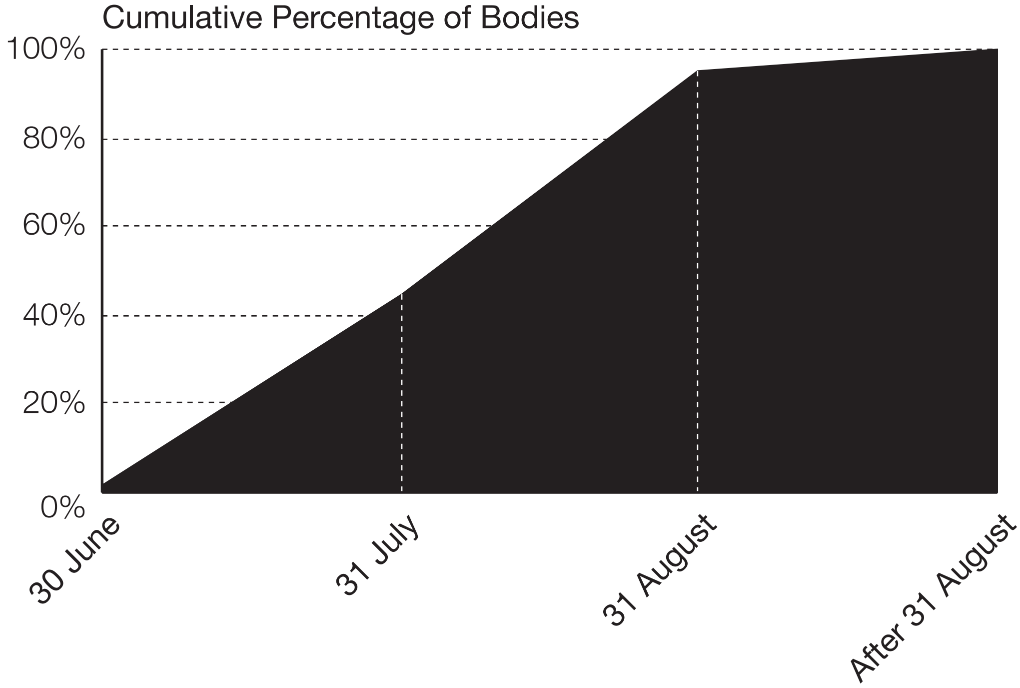
Financial reporting

54 Auditors' experience in 2004 reinforces the concerns raised in 2002/03 regarding the poor quality of financial reporting in local government.

55 Overall, 95 per cent of local authorities achieved the earlier statutory deadline of 31 August 2004 for approving their accounts (indeed 45 per cent achieved the even earlier deadline of 31 July, which will come into effect from 2005/06) **(Figure 11)**.

Figure 11
When councils approve their accounts

Overall, 95 per cent of local authorities achieved the earlier statutory deadline of 31 August 2004 for approving their accounts.

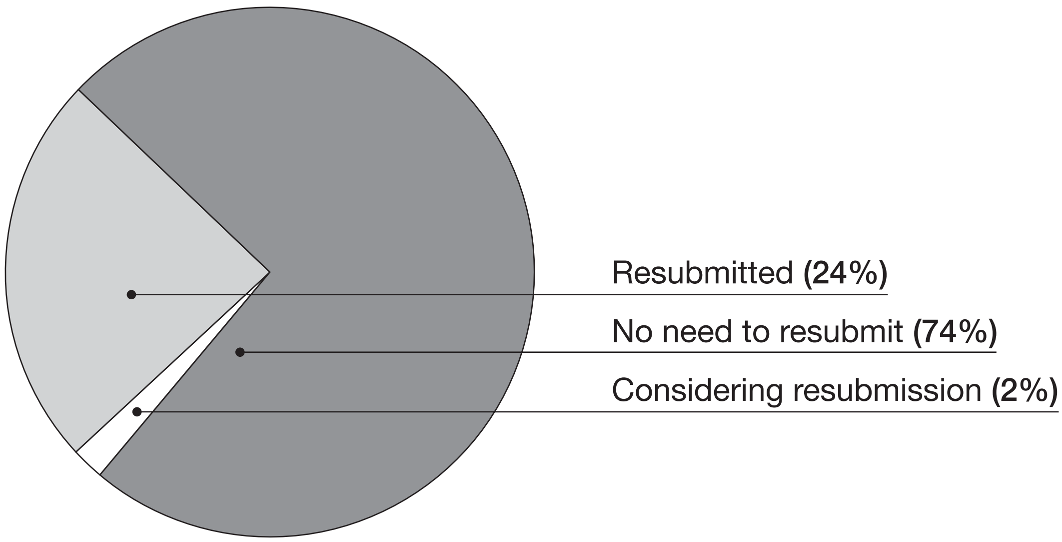


Source: *Audit Commission*

56 Auditors reported that 89 per cent of authorities also published their accounts by the 30 November 2004 statutory deadline, although this represents a deterioration compared to 2003, when only 6 per cent of failed to meet the then December deadline. These figures suggest that the earlier deadlines in future years will present an increasing challenge to the arrangements that many local authorities have in place for closing their accounts.

57 Of greater concern is the fact that the earlier deadlines in 2004 appear to have had a detrimental impact on the quality of accounts. Some 26 per cent of authorities' accounts had to be resubmitted for approval because of material errors identified by auditors during the audit process. This compares to 19 per cent in 2003 **(Figure 12)**.

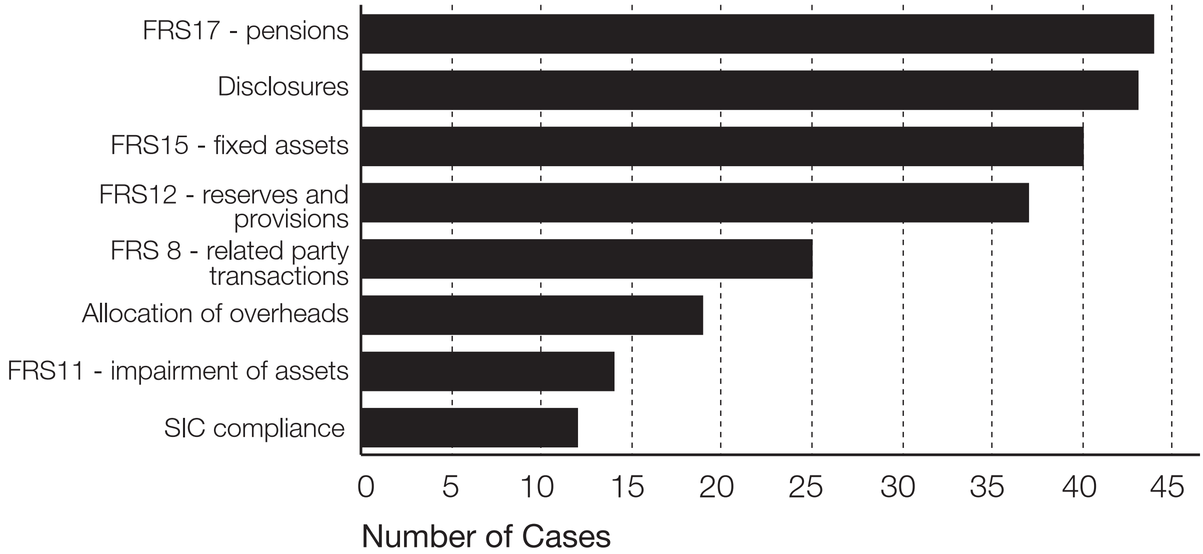
Figure12
One in four local authorities were required to resubmit their accounts



Source: *Audit Commission*

58 In many cases, auditors have required resubmission of accounts because local authorities failed to comply with relevant professional standards such as the *Code of Practice on Local Authority Accounting – Statement of Recommended Practice [SORP]*. Auditors continue to identify authorities that are failing to comply with accounting requirements, many of which have been in place for a number of years, such as the valuation of fixed assets and disclosure requirements. However, the new FRS17 requirements for accounting for pension costs presented authorities with new challenges **(Figure 13)**.

Figure 13
Problems in councils' compliance with the SORP

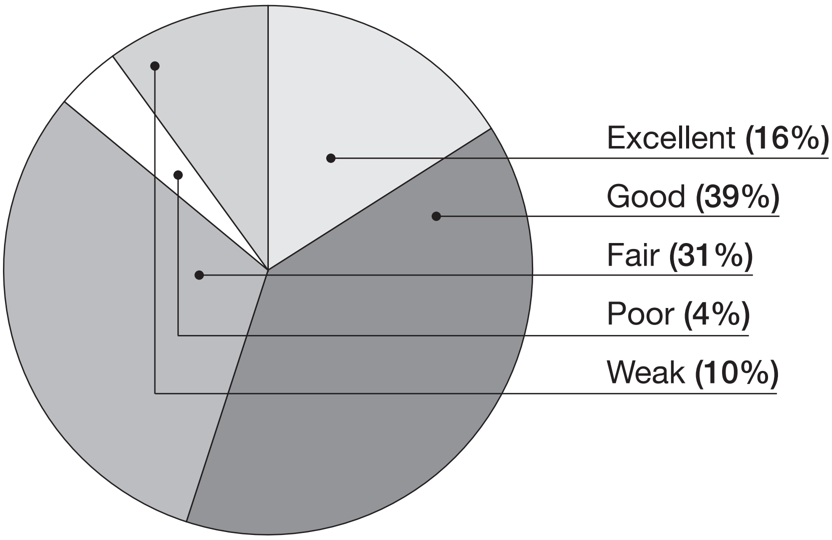


Source: *Audit Commission*

59 The majority of the issues identified in figure 13 relate to information that authorities will need to take into account when making decisions about future service provision and financial performance. Auditors will continue to work with authorities to help them improve the quality of information contained within the statements of accounts. The Commission will also work with other agencies, such as CIPFA and the ODPM, to consider what further guidance can be made available to authorities to help them respond to the earlier accounts and audit deadlines imposed by the Accounts and Audit Regulations 2003, under which authorities will, by 2006, be required to have their accounts approved by 30 June.

60 Local authorities' performance in the preparation of their accounts will be a key factor in auditors' use of resources judgements for CPA 2005. This will be particularly important for those authorities assessed as excellent or good under the current assessment arrangements, which account for 55 per cent of all resubmissions **(Figure 14, overleaf)**. Under the more challenging criteria being established for CPA 2005, this performance, if repeated, would mean that such councils would be unlikely to retain their excellent or good status.

Figure 14
Resubmission of accounts shown by CPA categorisation of authority



Source: *Audit Commission*

Qualified audit opinions on the annual accounts

61 One outcome of authorities' difficulties in getting to grips with financial reporting is that the number of qualifications doubled to 11 in 2003/04, from 6 in 2002/03. Nonetheless, the large majority (97 per cent) had no audit qualification given or under consideration.

Public reporting

62 Where auditors take the view that issues need to be made public and dealt with immediately rather than waiting for them to be included in the annual audit and inspection letter, they can issue a public interest report under section 8 of the Audit Commission Act 1998. They can also make recommendations under section 11 of the Act, which requires a public response from the audited body. In 2004, auditors issued seven public interest reports and made recommendations requiring a public response to eight councils **(Figure 15)**.

Figure 15
Public interest reports and recommendations requiring a public response (2002/03 figures in brackets)

	Public interest reports	Recommendations requiring a public response
Number	7 (5)	8 (4)
Issues	Staff remuneration (Corby BC)	Financial management [2] (Croydon LBC and Oxford DC)
	Service charges (Camden LBC)	Publicity costs (Nottingham City Council)
	Financial standing (Croydon LBC)	Disposal of property (Great Yarmouth DC)
	Planning (Southwark LBC)	Project management (Stafford BC)
	Procurement (Scarborough BC)	Accounts production [2] (Bedfordshire CC and Hackney LBC)
	Disposal of public land (Hastings BC)	Governance arrangements (Copeland BC)
	Unlawful expenditure (Lincolnshire CC)	

Source: Audit Commission

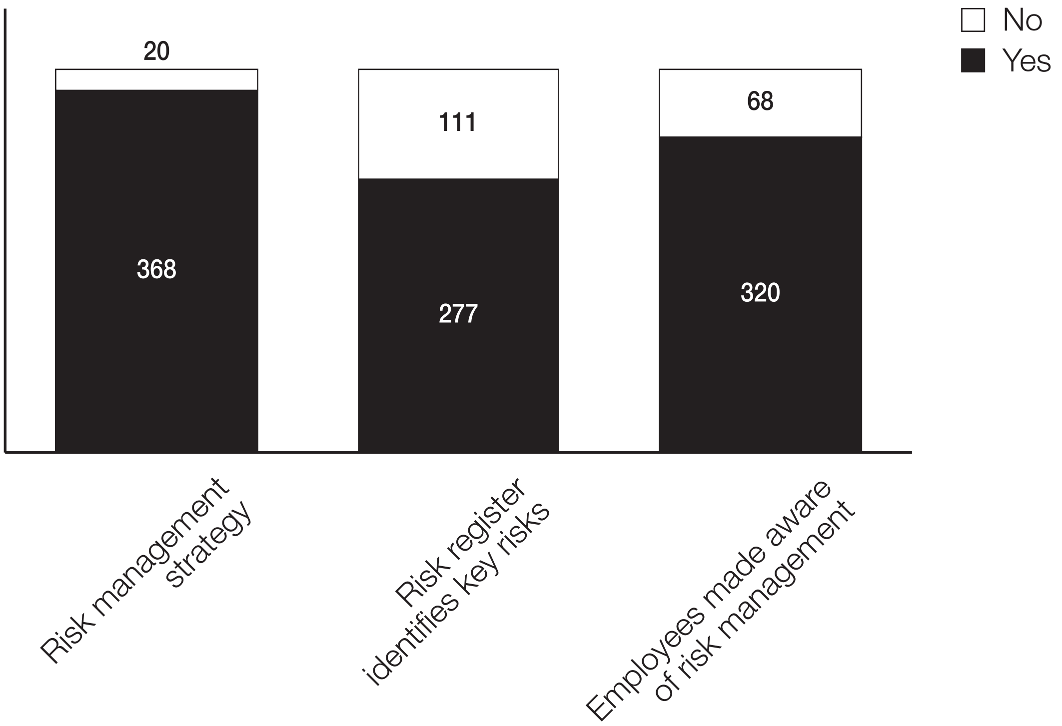
Governance

63 The Commission remains concerned that only 47 per cent of local authorities have a formally constituted audit committee. The absence of effective audit committees is a fundamental weakness in local government bodies' governance arrangements. Addressing this weakness could help to improve the poor culture of financial reporting and weaknesses in risk management.

64 However, analysis of those authorities required to resubmit their accounts shows an equal split between those with audit committees and those without, and the level of resubmission of accounts required at those bodies where audit committees do exist raises questions about their effectiveness.

65 Auditors also report that 29 per cent of authorities still lack a risk register that identifies their key business risks, although this is down from 50 per cent in 2002/03 **(Figure 16)**. Again, an analysis of those bodies without a risk register shows an equal split between those with a formal audit committee and those without.

Figure 16
Councils' risk management arrangements



Source: *Audit Commission*

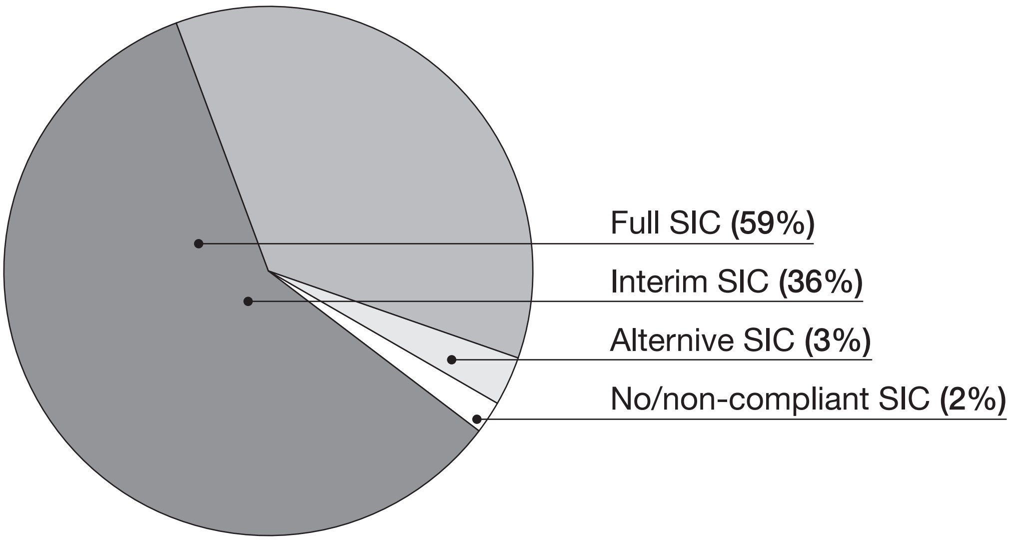
66 The Commission, working in partnership with CIPFA, will continue to advocate the setting up of audit committees in local government. Their existence and effectiveness will be a key factor in auditors' use of resources judgements for CPA 2005.

67 Where authorities had identified their business risks, these remain focused on issues of service delivery, such as staffing, funding and IT issues as well as significant local issues.

68 Auditors will continue to use their risk-based audit planning to focus on the significant risks facing local authorities and make practical recommendations to address them.

69 In accordance with the Accounts and Audit Regulations 2003, local authorities were required to prepare a SIC in 2003/04 for the first time. Guidance on the form and content of the SIC was not issued by CIPFA in final form until 3 April 2004. Almost all authorities (98 per cent) produced a SIC in the first year that complied with proper practices as defined by CIPFA, although in the first year authorities had the option of producing an interim statement under transitional arrangements. While this represents a significant achievement, only 59 per cent of authorities were able to produce a full SIC, which was supported by the necessary assurances and including all required disclosures **(Figure 17)**.

Figure 17
Proportion of different types of SIC produced by local authorities



Source: *Audit Commission*

70 Auditors also report that 78 per cent of those authorities that did not produce a full SIC have an action plan in place to achieve full disclosure in 2004/05. Auditors will continue to work with authorities to improve the quality of reporting through the SIC. They will challenge those authorities whose SICs do not, in the auditors' view, appropriately report significant internal control issues.

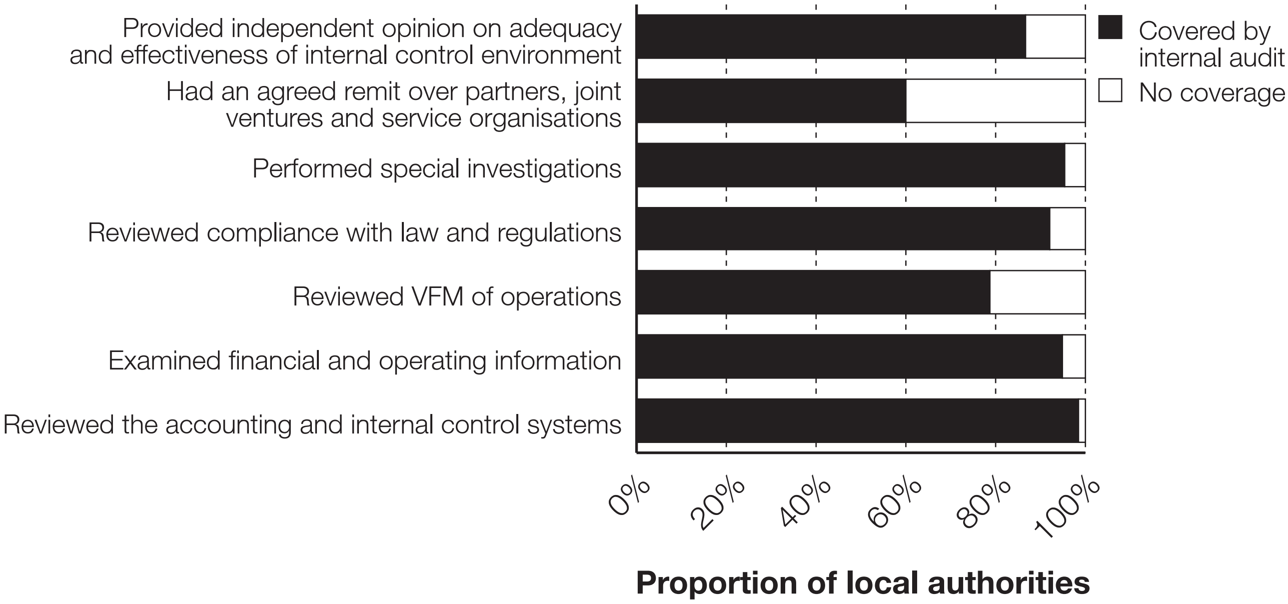
Internal audit

71 An effective internal audit function is an essential element of good governance. As local authorities implement their arrangements to produce a full SIC, internal audit will have a key role to play in commenting on the effectiveness of risk management and internal control systems. For 2004, auditors reported no significant concerns regarding the work of internal audit at 79 per cent of authorities (70 per cent in 2003) **(Figure 18)**. Where concerns exist, these often relate to resourcing and coverage issues. However, auditors reported that at 40 per cent of authorities' internal audit had no remit over partners, joint ventures and service organisations and that 60 per cent of internal audit functions did not review partnerships on a systematic basis. This represents a deterioration compared to 2002/03, when auditors reported that 30 per cent of authorities' internal auditors had no remit over partnerships. Given the growth in partnership working arrangements to deliver services it is important that internal audit covers and provides assurance on these arrangements in a systematic way.

Partnerships

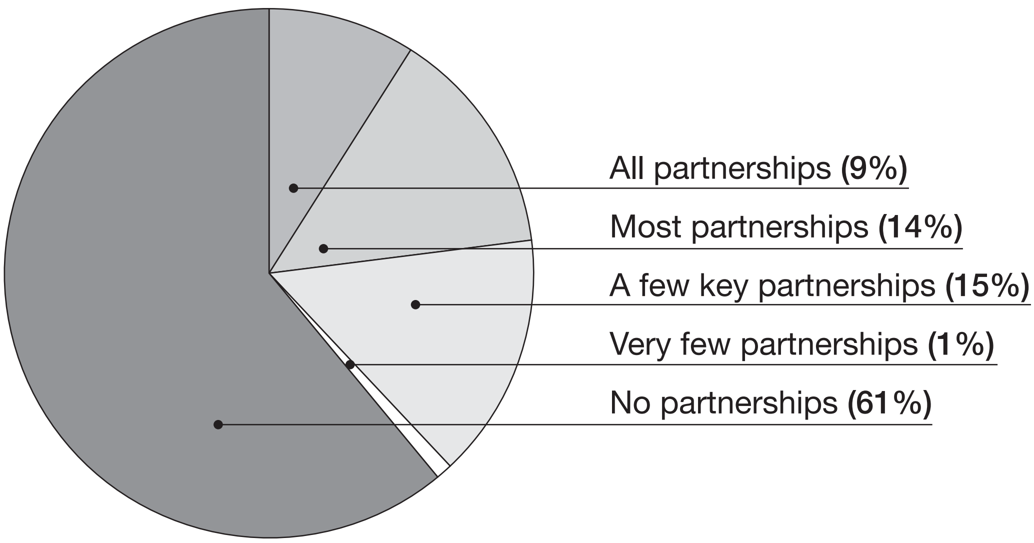
72 Over 90 per cent of local authorities are involved in some form of partnership working with a wide range of partner bodies. However, for 2004, auditors report that at 42 per cent of authorities' corporate governance arrangements have not been reviewed to ensure that the authority can exercise appropriate control over partnership activity. Of further concern is the fact that 61 per cent of authorities have no comprehensive partnership agreements in place for any of their partnerships. Such agreements should specify the aims and objectives of the partnership but just 9 per cent of authorities apply them to all their partnerships **(Figure 19)**. The absence of formal governance arrangements, coupled with the lack of internal audit coverage highlighted above, may inhibit the achievement of the partnerships' objectives and increase the potential for a breakdown in governance arrangements and controls.

Figure 18
Internal audit coverage



Source: *Audit Commission*

Figure 19
Few authorities have model comprehensive partnership agreements for all their partnerships



Source: *Audit Commission*

73 Auditors will continue to review the arrangements that authorities have in place to enter into and manage partnership arrangements. They will work with authorities to help them strengthen their governance arrangements in this increasingly important area.

Grants

74 Councils receive significant sums of money each year in the form of grants and subsidies from central government departments. Each year, auditors certify grant claims and returns to provide assurance that the amounts are being claimed in accordance with grant conditions and accurate information about how money has been spent.

75 On 1 April 2004, the Commission implemented new arrangements for certifying claims and returns as part of our commitment to Strategic Regulation. This new risk-based, proportionate approach is already successfully reducing the burden of grant certification work through a combination of reductions in:

- the number of claims and returns where the Commission has agreed to make certification arrangements;
- the amount of work being undertaken by auditors on claims and returns below established de minimis thresholds; and
- a reduction in required certification for high-performing authorities in respect of certain schemes.

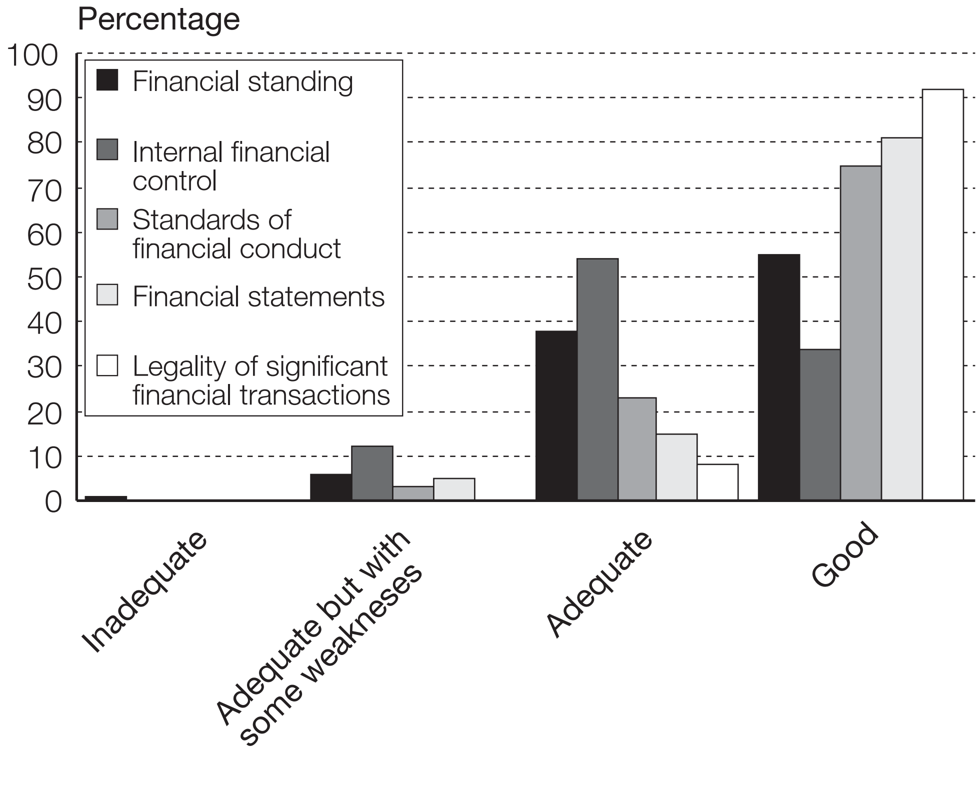
76 Where auditors are not satisfied that claims or returns are fairly stated and/or grant conditions have been met, they agree adjustments to the claim with the authority. Where this is not possible, they issue a qualification. Qualifications made by auditors in 2003/04 and amendments to claims agreed at audit are summarised below:

Number of claims	9,782
Value of claims	c£54 billion
Number of claims qualified	2,934
Increases made to claims	£29.2 million
Decreases made to claims	£96 million.

CPA

77 In 2004, for the third and final year, auditors scored their assessment of single tier authorities' and county councils' financial management arrangements for input into the CPA process under the 'auditor scored judgements' framework. Auditors reported that the majority of authorities' arrangements were adequate or better, with only one authority receiving an inadequate rating for a specific aspect of their financial management arrangements **(Figure 20)**. These scores are an improvement compared to those awarded by auditors in 2003.

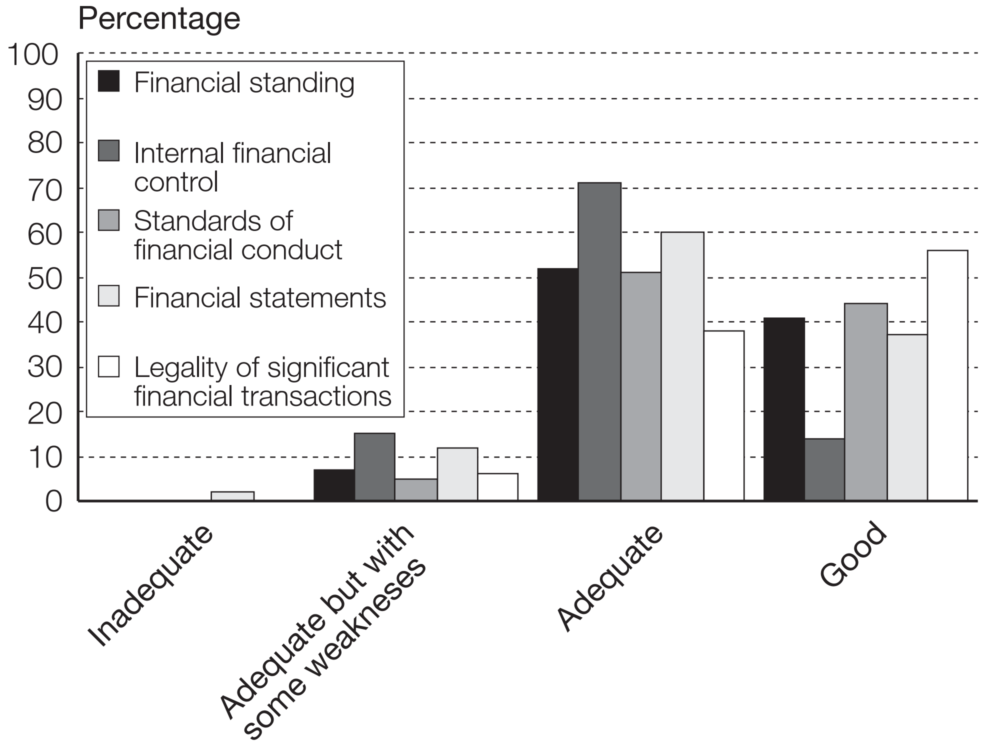
Figure 20
Upper tier authorities CPA ratings



Source: *Audit Commission*

78 In 2004,auditors also completed their scored assessments of financial management across all district councils. The majority of councils were assessed as either adequate or good **(Figure 21)**.

Figure 21
District council CPA ratings: auditors' judgements



Source: *Audit Commission*

79 As part of the development for CPA for 2005, the Commission has updated the criteria for auditor judgements, putting more emphasis on the achievement of value for money. Those criteria will also be more challenging, so that authorities will need to improve performance to maintain their current scores. By raising the bar in this way, the Commission expects auditors' new use of resources judgements to be a key driver in improving financial management across local authorities.

This report is available on our website at **www.audit-commission.gov.uk**. Our website also contains a searchable version of this report.

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