

Audit Commission review of the NHS financial management and accounting regime

Questions and answers for NHS bodies

Why was the review undertaken?

The Secretary of State asked the Commission to undertake the review as a result of the current financial position of the NHS as a whole and, in particular, the number of NHS bodies with deficits. The objectives of the review were to consider and comment on the current regime and recommend changes that:

- enable and encourage the NHS and individual bodies within it to operate on a sound and sustainable financial footing;
- support the identification of financial problems and facilitate recovery;
- promote clear and transparent accountability; and
- support individual organisations to develop the necessary financial management capacity and capability to operate effectively.

How did the Commission go about undertaking the review?

The review is based on a substantial body of previous Audit Commission work and published reports; the report contains a bibliography of material which provided an evidence base for the review.

The Commission has also drawn on the experience and knowledge of NHS managers, finance staff and auditors in the field; on evidence from Monitor; on the work of the Healthcare Financial Management Association; and on the input of senior executives and non-executives within the NHS. PricewaterhouseCoopers undertook research on our behalf and commented from their own knowledge and expertise. We have also been advised in the course of the review by the Commission's own NHS Financial Management Advisory Group.

What are the main areas covered?

The report covers a number of different areas within the NHS financial management and accounting regime. These include:

- the primary care trust (PCT) and NHS trust financial regimes;
- the application of resource accounting and budgeting (RAB) to the NHS;
- financing, financial support and failure regimes;

- external and internal financial reporting;
- departmental and strategic health authority (SHA) oversight and management;
- recruiting and developing the staff with the right skills; and
- strengthening financial governance.

What are the report's main recommendations?

The main recommendations included within the report are:

- RAB is incompatible with the NHS trusts' financial regime and should not be applied to those organisations. The Department should instead establish a national buffer so that it can meet its obligations but trusts can then operate as intended. Such a buffer will, in any event, be needed as the number of NHS foundation trusts grows as the Department must cover any aggregate deficit which they incur. Individual trusts that have suffered RAB adjustments without any compensating financial support should have the funds returned to them.
- NHS trusts should move onto a financial regime that gives greater emphasis to cash and liquidity and has transparent arrangements for borrowing for both investment and working capital purposes. This will help in the preparation for foundation trust status and give greater financial clarity for individual organisations.
- Support for organisations' capital development and other working capital needs should be provided. This should be arranged via a separately identifiable, professionally staffed banking arrangement within the NHS. This would also provide loans for capital developments and all other working capital needs as well as receive cash and pay interest on cash deposits from NHS bodies. This should build on the Trust Financing Facility for foundation trusts.
- There should be a more effective and swifter mechanism for identifying and dealing with financial distress, with clear trigger points and matched intervention strategies.
- The NHS Manuals for Accounts should be reviewed, made less prescriptive and more principle-based and brought more closely in line with UK Generally Accepted Accounting Practice (GAAP). This would also have the benefit of making NHS finance staff less reliant on specific Department of Health instructions and more reliant on their own professionalism.
- The Department of Health and SHA oversight and management could be improved by addressing the way in which policy initiatives are costed, the payment by results tariff

is developed and given greater certainty over the medium term, and relevant guidance is issued promptly to the service. There should also be reductions in the quantity of data required while at the same time improvements are made to its quality.

- Specific steps should also be taken to improve the skills of finance staff and the capacity and capability of boards.

We have made detailed recommendations on each of these issues in the report as well as proposed a number of other changes.

What would the overall effect of implementing all the recommendations be?

We believe that implementing the recommendations set out in the report will result in a fairer, more transparent regime, with NHS bodies better able to manage their affairs. NHS bodies would also be less affected by failures elsewhere in the system and will therefore become more accountable for their own performance. The overall effect of implementing the recommendations would be that the NHS and individual bodies within it would operate on a sound and sustainable financial footing. They would:

- ensure that the Department of Health meets its commitments to HM Treasury and the taxpayer while enabling trusts to operate in a more business-like way;
- bring greater clarity to the financing system both for individual organisations and for the NHS as a whole;
- further improve the professionalism of NHS finance staff; and
- increase the capacity and capability of individual bodies to manage their affairs and, at the same time, increase their accountability for doing so.

What will the review mean for my organisation and when will the recommendations come into force?

The Secretary of State and the Department of Health are currently considering the Commission's recommendations and we expect them to issue a response in the autumn. We are in broad agreement about the issues raised in the report, however, the Department may decide to take a different approach to solving some of the issues covered. At this stage the Department has made no commitment to implement the recommendations, therefore NHS bodies should not take any actions in anticipation of changes being made to the regime.

How much will it cost the Department of Health to implement the recommendations?

Given the time available to the Commission it has not been possible to cost all the recommendations. The recommendations that are likely to have significant cost implications are: the creation of the buffer; providing additional income to NHS trusts that had income reductions under RAB without compensating financial support; and the creation of the NHS banking function (if loans are in excess of deposits). We recommended that further work be undertaken on the costings before final conclusions are drawn on their implementation.

Do any issues covered in the review require further work?

Given the short time available to the Commission to undertake the review, it has not been possible to be definitive in all the areas covered in the report and we believe that there are some issues that would merit further investigation. These are:

- the size of the buffer required to provide the Department with some protection against the aggregate performance of NHS bodies (including foundation trusts) and to eliminate the impact that RAB has had on the NHS trusts it has been applied to;
- a more detailed review of the financial information currently collected and used by SHAs and the Department in order to monitor financial performance;
- the financial regime for PCTs, specifically the incentives and levers available to PCTs and the need for a failure regime for PCTs;
- the practical considerations in the establishment of the banking function recommended in the report; and
- data quality in the NHS.

The Department is considering how these issues can be taken forward alongside the recommendations.

Why didn't the Audit Commission recommend that trusts' cumulative deficits should be written off?

The Commission did consider in some depth the advantages and disadvantages of restructuring the balance sheets of those NHS trusts that have accumulated significant deficits. We decided against this because writing off the deficits would have a real cost to the NHS and would have to be funded from current resources. It could also be seen as letting trusts off the hook and condoning failure. Furthermore, in the past we have seen organisations having their cumulative deficits eliminated, only for the trust to continue to incur significant deficits.

Instead the Commission has recommended that the focus should be on dealing with the consequences of having cumulative deficits and ensuring that the trust's most recent financial performance is satisfactory and is sustainable over the medium term. Having a deficit can have serious consequences for both the immediate and longer-term financial viability of the trust. A trust with a significant cumulative deficit is likely to be short of cash. We have recommended that the Department needs to deal with these consequences, concentrating first on each trust's cash position and their future financial robustness as opposed to their past weaknesses.

Does this mean that trusts' statutory duty to break-even is no longer important?

Absolutely not. Our recommendations do not in any way undermine the importance of trusts' statutory duty to break-even taking one year with another. NHS trusts need to have robust plans in place to return to recurrent financial balance and generate the necessary surpluses to meet that statutory duty.

How will the income reductions made under RAB be made good?

The Department has not yet agreed that NHS trusts should have this funding returned to them. If this approach was to be taken each trust would have to be considered on a case-by-case basis as not all trusts have had RAB applied to them and of those that did, some received compensating financial support. All of this would need to be unpicked and verified.

What are the main functions of the banking arrangement proposed?

The Commission believes that a more transparent approach to providing finance and financial support is required to support the other proposals in the report and to improve individual organisational accountability. There are a number of functions to be undertaken including the provision of funds for capital investment, providing cash for working capital purposes, the provision of grants to organisations requiring financial support and the receipt of cash deposits.

How will the banking arrangement proposed operate?

We recommend that it should build on and incorporate the Trust Financing Facility for NHS foundation trusts. It is important to recognise that the institution would not be like a commercial bank. It would, for example, be inappropriate to charge interest according to risk or to foreclose on loans to organisations because of the possible effects these would have on service provision. The institution may also itself be unable to generate funds in order to provide loans as cash deposits from organisations in surplus may well not meet the requirements for loans.

In the Commission's view, the banking function should operate as a proper institution within the NHS. It need not be established as a separate authority and it could operate either at national or at regional (SHA) level. The important points are that it should be identifiable; staffed by experienced personnel, including some with relevant commercial banking expertise; and have defined functions and rules of operation. It should aim to provide a more clearly separate, objective and rigorous assessment of ongoing financial performance. In the report we have set out the areas that need to be considered further. The creation and operation of the banking system were identified in the report as areas for further, more detailed work.

Are there any recommendations for changes to the PCT financial regime?

Yes. We make a number of recommendations to improve financial planning over the short and medium term, building on the fitness for purpose assessments currently being undertaken. We also recommend that the Department should:

- set the allocations and agree three-year funding objectives with SHAs and, through them, PCTs during which time the basic financial regime should remain the same;
- consider allowing resource limits to be flexed over the three-year allocation period; and
- encourage PCTs to develop modest reserves by underspending against their resource limits in order to offset possible overspends later (under RAB underspending against resource limits result in an increase of the same amount the following year).

We also suggest that further thought should be given to what should happen when PCTs incur significant overspends against their resource limits. In our view, in some cases where there is a significant overspend, the reduction in income the following year under RAB may require smoothing over a period of years.

There seems to be more emphasis in the report on trusts rather than PCTs – why is this?

There was much less consensus in the course of our review on whether, and how, the PCT regime should be developed. This is in part a reflection of the relative newness of PCTs but it also, in our view, stems from a comparative lack of certainty as to how PCTs will develop as the new structures are introduced. Fitness for purpose assessments, practice based commissioning and other developments will also have an impact. We think this is an area for further work.

We have also made specific recommendations about the PCT financial regime and many of the proposals in the report apply to both PCTs and NHS trusts, these include: the banking arrangements; the improvement of internal and external reporting; recruiting and developing staff with the right skills; and strengthening financial governance arrangements.

Why do you recommend that RAB should be applied to PCTs but not trusts?

NHS trusts and PCTs operate under very different financial regimes. PCTs are statutorily required to achieve financial balance each year (by keeping expenditure within resource limits) and NHS trusts are required to achieve financial balance over a rolling 3- to 5-year period (breaking-even taking one year with another). RAB is consistent with the PCT financial regime but not the NHS trust regime, because of the requirement to achieve financial balance over different time periods.

What size will the Department of Health's buffer be?

The size of the buffer is a matter of judgement. It can be changed year on year in the light of experience. If, in the light of experience, the buffer has, for example, been overestimated, the excess funds it contains can be released in the following year when the money is returned to the Department under the RAB rules. The report sets out the factors that we believe should be considered when setting the buffer.

How would individual NHS bodies access the buffer?

Individual NHS bodies will not have access to the Department's buffer. The buffer is intended to ensure that the Department achieves its financial duties, regardless of the financial performance of NHS trusts and foundation trusts. It would never be allocated to NHS organisations.

What changes are you proposing to improve external financial reporting?

We recommend that the Manuals for Accounts governing SHAs, PCTs and NHS trusts should be brought fully in line with UK GAAP, made less prescriptive and more principles-based. We believe that the elimination of variances from UK GAAP where there is no obvious justification for them, is not just a matter of good housekeeping. It also conveys an important message about the financial culture of the NHS – that the NHS is subject to the same sort of financial disciplines as other organisations.

Why are improvements required to internal financial reporting?

In the Commission's opinion the financial reporting that is undertaken in some NHS organisations at present is not fit for purpose and does not support good decision making. Contributory factors to this are varied and include the poor quality of underlying data, the inability of IT systems to produce the information that is needed, under-skilled finance staff and a lack of challenge from senior managers and boards.

The report makes recommendations to improve internal financial reporting.

How can the Department help NHS bodies to improve their financial management arrangements?

In the report we set out a few areas where the Department could assist NHS bodies with their financial planning. These include a more transparent process for the costing of national initiatives and the production of the tariff, and earlier publication of the necessary guidance.

Why has the Commission recommended that redeployment of NHS directors should be used much more sparingly?

In our view there is a need for a more consistent approach to the treatment of poorly performing executive directors. Currently, it is common for an executive who is removed from his or her post on performance grounds to either be seconded or re-employed by another NHS organisation (or the Department itself) or alternatively be given consultancy work within the NHS. In our opinion this sends the wrong message. The high penalty of removal from a post creates an incentive for covering up poor performance and the routine use of redeployment blurs the distinction between weak performers and those individuals who could perform effectively under different circumstances. Furthermore, without adequate performance assessments, training and support there is a substantial risk that poor performance will simply be repeated in a new setting.

Why do the arrangements for the removal of non-executives need to be looked at?

The removal of non-executive directors on the grounds of individual poor performance can be a lengthy legal process. In circumstances of poor performance, non-executive directors are often encouraged to resign, to avoid formal action having to be taken against them. We recommend that the legal basis for appointments be reviewed to see if there is scope for removing non-executives on the grounds of corporate as well as individual failure.

Are there any actions NHS bodies can take now to implement the recommendations?

There are some recommendations made in the report that individual NHS bodies can consider now. These include:

- undertaking a review of the content of their monthly board reports and ensuring that a monthly balance sheet is prepared and reported to the board;
- considering differences between services as part of the annual planning cycle and taking explicit decisions that take full account of the financial viability of services based on robust costing information;
- ensuring that the information reported within the organisation to the board is consistent with information reported to the SHA and Department; and
- ensuring that internal audit programmes are driven by a proper process of risk assessment, that projects are scoped to cover all key issues in an area, and that the effectiveness of internal audit is reviewed regularly.

📄 Copies of the full report are available at: www.audit-commission.gov.uk
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