MBA (Health Executive) Programme 2001

Accounting and Financial Management

Assignment:

Auditing is becoming an increasingly expensive part of the management of health care. Discuss the role it plays in the financial management of a hospital, and comment on the value this adds.

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Report to: Education and Training Development Group of a NHS Trust

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Subject: A review of the present system of, and the future for, financial audit within the overall audit framework of the National Health Service.

1. Introduction to paper

This paper aims to define audit within the context of the National Health Service (NHS) with a particular focus on the financial auditing of NHS Trusts. The paper will provide an introduction to public sector and NHS audit, discuss the uncertainty concerning audit and identify key implications for the future.

2. Introduction to Audit

The Collins Concise English Dictionary defines audit as "an inspection, correction and verification of business accounts by a qualified accountant" and "any thoroughgoing examination or check." Within the NHS the term audit refers to both the financial aspects of the business and the quality of services through clinical audit.

The key purpose of financial audit is to ensure the appropriate use of resources, within the public sector this primarily relates to the use of tax payers money. Therefore, the Government must ensure audit is an essential part of Parliamentary and public sector bodies processes. The National Audit Office (NAO) (2001) stated "accountability for the use of public funds is a cornerstone of democratic government." The demonstration of this accountability is through the process of audit which provides an independent and skilled assessment that the financial accounts accurately reflect the financial position of the organisation and that resources have been utilised effectively. In carrying out this duty all public sector organisations are responsible for "putting in place proper arrangements for the governance of their affairs and the stewardship of the resources at their disposal" Audit Commission (2002c).

The Audit Commission (2002c) states that public sector organisations, including NHS Trusts, have a duty to ensure that public money is "properly accounted for and used economically, efficiently and effectively." Therefore, audit must not be limited to financial regimes, but must also evaluate clinical practice and other processes. Moreover, the documenting of audit processes and results are essential.

The Cadbury Committee in 1992 (cited in HFMA and the NHS Executive - 2001) identified three key fundamental requirements for good corporate governance in organisations, these being:

* Internal financial controls
* Efficient and effective operations and
* Compliance with applicable laws and regulations

Within the financial professions audit can be defined as "the process of validation of the accuracy, completeness, adequacy of disclosure of financial records" (HFMA and the NHS Executive - 2001).

There is a legal framework which governs how audit is carried out and by whom. In the past 10 years the legal framework within the United Kingdom (UK) has become more complex and comprehensive as a result of strengthening the audit requirements because of a number of financial scandals during the late 1980's.

3. A Two-Tiered Audit System

A key element of the audit process is the legal segregation of internal and external audit.

The two separate systems are linked and often there is collaboration between the two.
However, the separation is to ensure appropriate relationships are maintained and to demonstrate accountability for resources, through an additional system of checks.

Internal audit is defined as "an independent and objective appraisal service within an organisation" (HM Treasury Governmental 2001). Within the same document "independent" is defined as being "separate from the process or activity being audited", therefore "impartial and effective professional judgements and recommendations" can be implemented. Internal audit must be an ongoing, independent process of management, to ensure general management and financial management systems are robust and not open to abuse.

To implement this process within NHS Trusts a lead officer for internal audit, often referred to as the "Head of Internal Audit", must be appointed. Their independence is vital, however, they will work closely with the accountable officer (normally the Director of Finance), moreover, they must have direct access to the organisation's audit committee.
They will monitor the financial systems and assess the budgets in order to discharge the requirements of internal audit.

The second level of audit is external audit, the Audit Commission (2002c) notes external audit provides "an essential element in the process of accountability for public money and makes an important contribution to the stewardship of public resources and the corporate governance of public services." Within the public sector one role of external audit is to provide an independent opinion on the financial statements of the public bodies. Moreover, the external auditors review and report on financial systems and arrangements in managing the resources of an organisation. In recent years, the external auditors have considered wider issues on the effective use of resources in terms of management, systems and processes.

As the name suggests external auditors are brought in from other organisations, normally commercial audit companies, to carry out a risk assessment of the organisation and its systems against specific standards and potential risks. Within the NHS, the Audit Commission appoints external auditors, from a "long list" of companies. The long list is includes companies who are able to demonstrate they satisfy the standards laid down by the Audit Commission.

However, it should be noted that each NHS trust agrees a three year rolling audit plan which identifies the work to be carried out across nine standards. The agreement is reached by the Accountable Officer and the external auditors. The decision on the audit priorities will be based on the results of a risk-assessment process.

4. Audit Committees

Audit Committees were established as a result of the Cadbury report into business conduct. It was recognised that senior executives within organisations needed to be monitored to ensure the appropriate use of resources. Within the NHS the membership is drawn from non-executive directors, this is to “reflect the need for independence and objectivity” (Department of Health 2002).

The audit committee will oversee the governance agenda, including clinical governance systems to ensure “the delivery of patient centred, safe, high quality care, within a reporting and learning culture” (Department of Health 2002). A key role for the audit committees is to ensure the organisation responds effectively and quickly to weaknesses identified by the internal or external auditors.

5. Strengthening the Audit Framework

Following the scandals involving Robert Maxwell, Polypeck and the BICC bank there has been an increased regulatory framework governing the financial performance and reporting of organisations. The reviews and reports, such as Cadbury, Greenbury, Hempel and Turnbull are now familiar to companies quoted on the stock exchange and increasingly other organisations, including the public sector. Her Majesty’s (HM) Treasury have used the good practice identified in these reports to improve the public sector audit processes.

The process of audit has become part of the corporate governance agenda for organisations which incorporates financial management and control and risk management. The term governance, within the business context, describes a company’s systems and processes used to maintain internal management control. Within the NHS this has been developed under the Controls Assurance initiative, which now has 21 areas of governance control (Controls Assurance Support Unit - 2001).

The Institute of Chartered Accountants in England and Wales (1999) state that the Turnbull report highlighted the importance of reviewing an organisation's systems of internal control through a risk assessment and management approach. The aim is to minimise the possibility of errors or malpractice and to develop effective contingency plans should problems arise.

A key element of such a review is to report to shareholders the findings of the review. For public sector organisations Parliament and the general public can be viewed as the shareholders.

6. Audit Organisations and Framework

There is a legal framework which governs the conduct of audits, however, during the process of researching this report a range of organisations and documents were identified as involved in shaping the audit process. The table below provides a summary of the information:

Table 1 Organisations and Documents relating to Audit

Organisation	example document
HM Treasury	Government Internal Audit Standards 2001
Accounting Standards Board	Statement of Standard Accounting Practice (SSAP) Financial Reporting Standards (FRS)
National Audit Office	A Good Practice Guide for co-operation between internal and external auditors
The Audit Commission	Code of Audit Practice (2002).
Department of Health	Internal Audit Manual
Controls Assurance Support Unit	21 governance controls, of which financial controls is one, within which there are 12 standards.

In order to comply with HM Treasury regulations the accountable officer within all NHS trusts must submit a Statement of Internal Control (SIC) to the Department of Health. The scope of the SIC includes organisational and clinical controls, as well as financial controls.

Moreover, the Accounting Standards Board (ASB) which was established, in 1990, to establish rules for reporting on accounts, requires companies to state that their accounts have been prepared in accordance with the relevant accounting standards and detail any variations from the standards. The ASB have published 16 FRS that companies must follow, although not all are applicable to NHS organisations. One of the roles for external auditors is to confirm, whether, in their opinion the "financial statements present a true and fair view of the body's financial position and its expenditure and income for the financial year" Audit Commission (2002a).

The Audit Commission has a statutory responsibility to appoint external auditors to local government, as well as NHS organisations. However, Trusts can become involved in the tendering process to select external auditors. The external auditors are normally appointed for five years, however, this does not prevent contracts being extended. There are advantages in developing a long term relationship as the auditors gain greater insight into the specific risks within each organisation.

The Audit Commission (2002a) states "it is clearly important to guard against too close a relationship developing between auditors and the body they audit" due to the risk of the relationship "being perceived as cosy." To overcome this risk there are a number of steps the Audit Commission take to avoid a potential loss of objectivity of the auditors, including rotation of individual audit staff and companies.

At this time approximately "70 per cent of audits are carried out by District Audit, the Commission's own arm's length audit agency." Audit Commission (2002b).

7. Output from Audit

Within financial audit there are a number of obligations that organisations, and individual officers are responsible for producing, assessing and thereby signing to confirm appropriate action. The Audit Commission (2002a) have identified four main areas for audit:

* "The legality of financial transactions
* The financial standing of the audited body, (in terms of Income and Expenditure, the balance sheet and cash flow statements)
* Systems of internal financial control (such as Standing Financial Instructions)

* Standards of financial conduct, and the prevention and detection of fraud and corruption."

The information below sets out a number of key responsibilities for the financial aspects of audit, it is not intended to be an exhaustive list, but provides an indication of the work involved.

The annual accounts have to be sign by the accountable officer, and external auditors, to demonstrate that they are satisfied that the accounts reflect the actual financial position, that they comply with statutory requirements and that proper practices have been observed in compiling the accounts. The account standards are laid out in the FRS and SSAP (taken from xrefer website).

NHS Trusts "submit a Statement of Internal Control (SIC) as part of the audited annual financial statements" (Department of Health 2002). This process is repeated at the higher levels of the NHS hierarchy and ultimately the Chief Executive of the NHS has to sign a SIC on behalf of the whole service and must answer to Parliament through the Public Accounts Committee (PAC).

For NHS Trusts the Head of Internal Audit must produce an annual report for the Audit Committee to consider and accept, or amend, as appropriate. There is an annual audit report from Audit Committee that demonstrates its internal control work.

External auditors have a duty, for NHS bodies to inform the Secretary of State (or the National Assembly for Wales) when they believe NHS Trusts have made, or will make decisions that are potentially illegal, or will result in misappropriation of resources.

8. Added value of Audit

NHS Trusts are under constant pressure to manage, and reduce costs, any increase, particularly for an indirect patient care service will raise concerns with the Trust Board.
Therefore, it is important to consider what added value audit brings to the organisation beyond confirming internal control systems.

The findings of the external auditors will be reported within the annual financial statements, therefore it is important for the accountable officer and the organisation, as a whole, to demonstrate proper control systems and the appropriate use of resources.

An integrated model of audit can add benefit to organisations by responding to the complexity of services and performance management requirements. An example where the integrated models adds benefit is in considering all the aspects of “delayed discharges” across the whole health and social care sectors.

Audit develops and strengthens internal systems of control as part of an ongoing process. In taking a risk assessment approach it allows the organisation to objectively consider the various risks that could occur and assessment them against levels of probability and likelihood.

A matrix for risk assessment can be developed to indicate which areas require more immediate action, and which require less vigorous monitoring. The framework can be set out as follows in diagram one.

Diagram 1 Risk Assessment Framework

Decreasing Likelihood
Low impact
High likelihood
3
Medium impact
High likelihood
2
High impact
High likelihood
1
Low impact
Medium likelihood
4
Medium impact
Medium likelihood
3
High impact
Medium likelihood
2
Low impact
Low likelihood
4
Medium impact
Low likelihood
4
High impact
Low likelihood
3
Increasing impact

Box 1 represents the areas that will need immediate action to rectify the risks,

Box 2 represent the second level of risk, that do not require urgent action, however, action is necessary.
Box 3 represent areas of work once levels 1 and 2 have been resolved.
Box 4 represent areas for monitoring, although immediate action is not required. The position needs to be monitored to ensure the risk remains, relatively low.

The value of external audit is to ensure all areas are monitored and that the risk assessment is validated through a separate process. Another advantage in using external auditors is that they gain expertise and experience through working with other organisations and they become familiar with risk assessments from various organisations. This allows external auditors to, in effect, benchmark different organisations to ensure there is a level of consistency in the risk assessment, whist maintaining client confidentiality.

9. Increasing costs of audit

One of the reasons for the increasing costs of audit is the use of an integrated audit model which attempts to deliver corporate governance through a common approach to auditing the accounts, the financial aspects of the corporate governance and the use of performance management information (Audit Commission 2002a). It is now recognised that there is a need to monitor more than financial systems and transactions. However, in order to carry out the integrated approach there are two possible reasons for costs having to increase, these are:

1. the need for more detailed audits and therefore more working days of audit to complete the work and
2. the need for the auditors to have more skills to understand the nature of the business, or additional staff, with specialist skills.

When appointing an external auditor the skills of the specific auditors must be considered. There is increasing scope to employ people from other professional backgrounds to carry out elements of the audit, in order to provide different views points and add further value to the process. This may increase costs of carrying out an audit, another factor in the cost of audit is the increasing complexity of the legal framework within which auditors have to operate and therefore must understand.

The above reasons may lead to a decrease in the number of organisations who can demonstrate they have the capacity and capability to meet the Audit Commissions standards for audit. In terms of supply and demand, there appears to be an ever increasing demand for audit time, due to the complexity and broader range of issues being covered. However, this may have the effect of reducing the number of suppliers of skilled audit. Following the basic economic principles of demand and supply this may increase the costs to the organisation being audited.

10. Problems with Audit

Corzine (2002) notes that "America has witnesses a wave of revelations about corporations defrauding investors, employees and the public trust." through "shady accounting practices that created the appearance of earning where none actually existed." The American situation has impacted across the world, due to the global markets and the fact that many companies are directly, or indirectly linked to American companies and markets.

Enron and Worldcom used their balance sheets to indicate increased profits. The companies' auditors had failed to identify the problem, and in the case of Enron the auditors, Andersen, appeared to destroy documents, thereby helping the company hide the fraud.

This has lead to many people questioning the role of auditors, Skapinker and Parker (2002) note that companies "appoint the auditors, pay them and often ask them to provide additional services such as management consulting."

The Institute of Chartered Accountants have claimed that because of the impact of Maxwell, Polypeck and BICC in the late 1980's the UK has responded to the risks and thereby fraud on this scale is not possible. They are clearly creating a distance between themselves and the USA model, however, similarities remain, such as commercial audit companies also providing additional management consultancy services.

It is worth noting that the public sector should be more protected from the risks of a close relationship forming between external auditors and the audited body because of the regulations and monitoring role of the Audit Commission.

Although not a direct problem with audit there are wider implications caused by the auditing scandals. Corzine (2002) identifies the loss of confidence in the financial markets and national economies as having a real impact, particularly in raising the cost of capital and damping investment and although the NHS does not play a role in the stock market, the scope of the Private Finance Initiative (PFI) may be influenced by the cost of borrowing and the willingness of companies to invest. Therefore the cost of PFI borrowing may increase, however, the uncertainty over the global stock markets may make PFI, as a government backed initiative, a more attractive investment proposition. The position is likely to remain fluid for sometime.

11. Drivers For Change

Parker et al (25/7/2002) reported that Patricia Hewitt, Trade and Industry Secretary in announcing an "immediate review of accountancy profession's regulation" had "warned that accountants might face sweeping reforms because of the lack of confidence in audited accounts." A number of reforms have been mentioned such as the "mandatory rotation of audit firms around companies as well as possible restrictions on the ability of audit firms also to offer non-audit services to clients." It is not clear whether this will include the Audit Commission and its arm's length audit agency, District Audit. A final report will be published later this year.

There is likely to be a strengthening of the role of the Financial Reporting Review Panel (who investigate complaints regarding the reporting of company accounts) and changes to Audit Committees of companies. Although the review will focus on the private sector there will be an impact on the public sector, through the possible adoption of the new private sector rules by the Government and through the availability of firms who are able and willing to provide audit services.

It will be interesting to see if changes in the accountancy profession regulation mirror those of healthcare professions, where the government's response to various scandals has been to increase the role of the public in the processes of regulation.

The announcement by the Secretary of State for Health (2002) of a new Commission for Health Audit and Inspection (CHAI) will "bring together the health value-for-money work of the Audit Commission, the work of the Commission for Health Improvement and the private healthcare role of the National Care Standards Commission." The new body is intended to be more independent than the Audit Commission with a different appointments process for key posts. There is more detail required on this initiative before the full impact on audit can be assessed.

A problem facing the Audit Commission and individual organisations appointing external auditors is the number of organisations now requiring auditing. Following the publication of "Shifting the Balance of Power" (Department of Health 2001) Primary Care Trusts have been established with their own financial budgets to commission and deliver services. Due to the dual commissioning and provider roles Primary Care Trusts may require more detailed audits to ensure the internal control systems are in place.

This is also linked to the drive for integrated audit model which may introduce more organisations to the system who need to be assessed within the scope of an audit.

A future trend is likely to see external auditors requiring additional time to ensure that an organisation has safe systems and has used the resources appropriately. The BBC on 21st July reported that "KPMG (one of the "top-4" auditing companies) is already reviewing is auditing procedures to become more comprehensive in examining management systems."

12. Future of Audit

The immediate future of audit is uncertain due to the US and UK governments reviews of auditors and auditing scandals which are presently receiving significant media attention. However, the results of the reviews are likely to result in a greater demand for auditors time and skills. One outcome may see other skilled people being required to become involved in audit, as the function broadens out more from the financial systems of the organisation.

The drivers for change within audit are likely to put pressure on increasing the cost of conducting an audit. This is primarily due to the integrated audit approach, increasing the regulation of auditors (and the associated costs of regulation), the possible restriction on company activities beyond audit and the increasing numbers of organisations requiring an audit process.

A general management trend, which increases the need for audit, is the devolution of managerial and budgetary responsibility to service managers, this makes systems of internal financial control more complex and therefore the associated risks for internal control are increased.

The use of Information and Communication Technology (ICT) can reduce the complexity of work, however, it increases the need for control in terms of security systems and monitoring transactions.

There are a number of initiatives to reduce the burden and impact of audit, these include collaboration between internal and external auditors, as set out in the NAO good practice guide on the subject. The role of the new CHAI may also reduce the time spent on separate audits. There will be a need to share the findings and reports by the different auditing bodies, in order to minimise duplication of work.

The development of the pilot for shared services for the high volume transactional financial processes may negate some of the complexity of audit, however, the trail for audit to follow may not necessarily become simplified. The pilots for shared services commenced in 2002 and the evaluation process includes “governance arrangements” (National Shared Services Initiative 2002).

13. Conclusions

The impact of US scandals have made auditing a high profile subject. The primary purpose of audit within the public sector remains to demonstrate the appropriate use of resources. It is important that the perception of the public and Parliament, through the PAC, are satisfied.

In specific terms the future of audit is uncertain, however, given the facts identified in this report the demand for and the costs of auditing public sector organisations are likely to become more difficult to control.

A key element in delivering effective audit will be the supply of a skilled audit workforce.
There may be scope and a need for recruiting people from different professional backgrounds in order to support audit processes.

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