Water Industry Commission for Scotland

2023/24 Annual Audit Report

AUDIT SCOTLAND

Prepared for the Water Industry Commission for Scotland and the Auditor General for Scotland

10 December 2024

Contents

Key messages

2023/24 annual report and accounts

1 The regularity opinion on the accounts was qualified as our audit identified material expenditure for the year ended 31 March 2024 that was not incurred in accordance with applicable enactments and guidance issued by Scottish Ministers. All other audit opinions are unmodified.

Financial settlement paid to former Chief Executive

2 The Commission's use of a settlement agreement for the financial settlement paid to the former Chief Executive did not follow the process set out in the Scottish Public Finance Manual. We would have expected the Commission's sponsor division to have provided clearer guidance and support to the former Chair and the Board in relation to this matter.

3 As the Director General Net Zero at the Scottish Government provided approval for the settlement payment, it is not considered irregular expenditure and does not impact on our audit opinion.

4 We believe that further consideration should have been given to the enforceability of the notice terms within the former Chief Executive's 2007 contract as part of the VFM assessment in support of the settlement agreement business case.

5 The use of a settlement agreement to secure the departure of the former Chief Executive, removed the possibility for disciplinary procedures to be taken against him in relation to the issues identified during our 2022/23 and 2023/24 audits.

6 The financial settlement paid to the former Chief Executive reflected his contractual entitlement for payment in lieu of notice and untaken leave. The total cost, including legal fees, to the Commission of the former Chief Executive's departure was £105,488.

Financial management and sustainability

7 The Commission reported an operating surplus of £1.1 million for 2023/24. This resulted in cash reserves increasing to £4.9 million at 31 March 2024. Management is reviewing this to identify what level of funds need to be retained to cover future costs and what can be returned to Scottish Water and Licensed Providers. We do not currently have any concerns about the financial sustainability of the organisation.

8 Expenditure totalling £74,832 was incurred during 2023/24 which did not comply with the Commission's Financial Policies and Guidelines or the requirements of the Expenditure and Payments section of the SPFM. Internal audit testing confirmed that compliance levels improved for the last 3 months of the year, following action taken by management to address the financial management weaknesses reported in our 2022/23 Annual Audit Report. Our testing did not identify any instances of non-compliant expenditure between January and March 2024.

9 Internal audit's work identified that financial controls did not operate effectively between April and December 2023. Therefore, they concluded that no assurance could be provided on the effectiveness of the systems of control during 2023/24.

10 Due to the weaknesses in the operation of the system of internal control, and the instances of expenditure that was not supported by appropriate receipts or other proof of purchase, we have concluded that adequate arrangements were not in place to prevent and detect fraud during the year. This is not a judgement on whether any fraudulent activity actually occurred.

Vision, leadership, and governance

11 The Board and senior management team will need to work together, and with the Scottish Government sponsor division, to deliver the changes required to ensure the Commission operates to the high standards expected of a public body. The Commission is implementing an organisational change programme to address the issues reported in the Section 22 report on the 2022/23 audit, and deal with wider issues across the organisation.

12 Management has taken action to send a clear message that bullying and harassment will not be tolerated and any instances reported will be dealt with appropriately.

13 The Corporate Plan provides a clear vision and strategic direction for the Commission over the 2021-27 regulatory period, highlighting the important role the organisation has in regulating the domestic and retail water market in Scotland. However, management should review the KPIs used to measure and report performance against the plan.

14 Governance arrangements did not operate effectively during 2023/24 but improvements have been made in the level of reporting and scrutiny at the Board and Audit and Risk Committee since January 2024.

Use of resources to improve outcomes

15 Management has taken action to address the financial management and governance issues identified during 2022/23 and 2023/24. However, it is too early for us to conclude whether this will be successful in promoting a culture of Best Value across the organisation.

16 It is important to the Commission's regulatory role that it is able to engage external experts when required, but it must be able to demonstrate that these appointments are supported by a robust VFM assessment. Management should therefore identify which staff will be required to engage external consultants as part of their role, and ensure that they have adequate training and support to undertake a robust VFM assessment prior to appointments being made.

Introduction

1. This report summarises the findings from the 2023/24 audit of the Water Industry Commission for Scotland (the Commission) and will be published on Audit Scotland's website: www.audit-scotland.gov.uk.

2. The scope of the audit was set out in our annual audit plan presented to the June meeting of the Audit and Risk Committee. This annual audit report comprises the significant matters arising from the audit of the Commission's annual report and accounts, conclusions on the wider scope areas set out in the Code of Audit Practice, consideration of Best Value arrangements, and our follow-up of the issues reported within the Auditor General for Scotland's Section 22 Report on the 2022/23 audit. It also details the findings and conclusions from our review of the process followed to agree the former Chief Executive's departure and the financial settlement payment.

3. We would like to thank Commission members and officers, particularly those in finance, for their cooperation and assistance during the course of the audit.

Responsibilities and reporting

4. The Commission has responsibility for ensuring the proper financial stewardship of public funds. This includes preparing an annual report and accounts that are in accordance with the accounts direction from Scottish Ministers. The Commission is also responsible for establishing appropriate and effective arrangements for governance, propriety, and regularity.

5. The responsibilities of the independent auditor are established by the Public Finance and Accountability (Scotland) Act 2000, the Code of Audit Practice, and supplementary guidance, and International Standards on Auditing in the UK (ISAs).

6. This report contains an agreed action plan at Appendix 1 setting out specific recommendations, responsible officers and dates for implementation. Weaknesses or risks identified in this report are only those which have come to our attention during our audit work and may not be all that exist. Communicating these does not absolve management of its responsibility to address the issues we raise and from maintaining adequate systems of control.

Auditor Independence

7. We can confirm that we comply with the Financial Reporting Council's Ethical Standard. We can also confirm that we have not undertaken any non-audit related services and therefore the 2023/24 audit fee of £22,460, as set out in our 2023/24 Annual Audit Plan, remains unchanged. We are not aware of any relationships that could compromise our objectivity or our independence.

1. 2023/24 annual report and accounts

Public bodies are required to prepare an annual report and accounts comprising financial statements and other related reports. These are the principal means of accounting for the stewardship public funds.

The regularity opinion on the accounts was qualified as our audit identified material expenditure for the year ended 31 March 2024 that was not incurred in accordance with applicable enactments and guidance issued by Scottish Ministers. All other audit opinions are unmodified.

The regularity opinion on the accounts was qualified as our audit identified material expenditure for the year ended 31 March 2024 that was not incurred in accordance with applicable enactments and guidance issued by Scottish Ministers. All other audit opinions are unmodified.

8. The Board approved the annual report and accounts for the Water Industry Commission for Scotland for the year ended 31 March 2024 on 21 November 2024. The independent auditor's report included the following unmodified audit opinions on the annual report and accounts:

- the financial statements give a true and fair view and were properly prepared in accordance with the financial reporting framework
- the audited part of the remuneration and staff report was prepared in accordance with the financial reporting framework
- the performance report and governance statement were consistent with the financial statements and properly prepared in accordance with the relevant legislation and directions made by Scottish Ministers.

9. The independent auditor's report included a qualified opinion on regularity as our audit identified expenditure for the year ended 31 March 2024 included in the Statement of Comprehensive Net Expenditure of £74,832 which was not in accordance with guidance from the Scottish Ministers. This expenditure included:

- £43,604 which did not meet the requirements of the Scottish Public Finance Manual on delegated authority limits (Issue 3 in Exhibit 3)
- £23,774 incurred on travel and subsistence expenses which were not incurred in accordance with the requirements set out in Commission's Financial Policies and Guidelines, and did not meet the requirements for authorisation of expenditure set out in

the expenditure and payments section of the Scottish Public Finance Manual (Issue 2 in Exhibit 3)

- £7,454 of staff expenses for which no itemised receipts or other proof of purchase were provided, which did not meet the requirements for proof of payment requirements set out in the expenditure and payments section of the Scottish Public Finance Manual (Issue 2 in Exhibit 3).

The 2023/24 annual report and accounts were certified on 21 November 2024, in line with the agreed audit timetable

10. We received the unaudited annual report and accounts on 4 September 2024, in line with the agreed audit timetable. These were substantially complete but management advised that some pension information required from the actuary for the remuneration report was still outstanding and would be provided as soon as it was available. This was provided on 8 October.

11. The accounts and working papers presented for audit were of a reasonable standard and management and finance staff provided good support to the team during the audit process. This helped ensure that the final accounts audit was completed in line with the agreed audit timetable, with the 2023/24 annual report and accounts certified on 21 November 2024.

Our audit approach and testing was informed by the overall materiality level of £34,000

12. The concept of materiality is applied by auditors to determine whether misstatements identified during the audit could reasonably be expected to influence the economic decisions of users of the financial statements, and impact the opinion set out in the independent auditor's report. Auditors set a monetary threshold when considering materiality, although some issues may be considered material by their nature and it is ultimately a matter of the auditor's professional judgement.

13. Our initial assessment of materiality was carried out during the planning phase of the audit and was based on the financial results reported in the audited 2022/23 annual report and accounts. These materiality levels were reported in our annual audit plan to the June meeting of the Audit and Risk Committee.

14. On receipt of the unaudited 2023/24 annual report and accounts we revised our materiality levels to reflect the financial results for the year ended 31 March 2024. These are detailed in Exhibit 1.

Exhibit 1
Materiality levels for the 2023/24 audit

Materiality level	Amount
Overall materiality: This is the figure we calculate to assess the overall impact of audit adjustments on the financial statements and is set based on our assessment of the needs of the users of the financial statements and the nature of the Commission's operations. Due to the issues identified during our financial statements audit last year, the overall materiality level was set at 1 per cent of gross expenditure. This was lower than the 2 per cent level set in the prior year.	£34,000
Performance materiality: This acts as a trigger point. If the aggregate of errors identified during the financial statements audit exceeds performance materiality, this could indicate that further audit procedures are required. Using our professional judgement, we set performance materiality at 50 per cent of planning materiality.	£17,000
Reporting threshold: We are required to report to those charged with governance on all unadjusted misstatements more than the 'reporting threshold' amount.	£2,000

Source: Audit Scotland

Our audit work responded to the risks of material misstatement we identified for the annual report and accounts

15. Exhibit 2 sets out the significant and non-significant risks of material misstatement to the financial statements. It also summarises the audit procedures we performed during the year to obtain assurances over these risks and the conclusions from the work completed.

Exhibit 2
Significant and other risks of material misstatement

Nature of risk	Audit response	Conclusion
Significant risks of material misstatement		
1. Risk of material misstatement due to fraud caused by management override of controls As stated in International Standard on Auditing (UK) 240, management is in a unique position to perpetrate fraud because of management's ability to override controls that otherwise appear to be operating effectively.	• Detailed testing of transactions and journals with a focus on significant risk areas, including year-end and post-close down entries. • Focussed testing of accruals and prepayments. • Substantive testing of income and expenditure transactions around the	**Satisfactory** These audit procedures did not identify any evidence of management override of controls to manipulate the financial position reported in the annual report and accounts. We are satisfied that there is no material

Nature of risk	Audit response	Conclusion
	year-end to confirm they are accounted for in the correct financial year. • Review of significant accounting estimates. • Evaluation of significant transactions outside the normal course of business.	misstatement arising from this risk.
Other non-significant risks of material misstatement		
2. Risk of fraud in expenditure Practice Note 10 extends the requirements of ISA 240 to include consideration of fraud in expenditure for public bodies. Due to the extent of the expenditure issues identified as part of our 2022/23 audit, we believe there is an increased risk that expenditure could be misstated in the 2023/24 financial statements. There is also a risk that expenditure has not been incurred in accordance with applicable enactments and guidance issued by the Scottish Ministers.	• Substantive testing of expenditure transactions across the full financial year, including targeted testing of items that did not appear to comply with the Commission's Financial Policies and Guidelines or the requirements of the Expenditure and Payments section of the Scottish Public Finance Manual • Focussed testing of travel and subsistence expenditure. • Targeted substantive testing of expenditure transactions around the year-end to confirm they are accounted for in the correct financial year. • Substantive testing of accruals and prepayments. • We reviewed the results of the above testing alongside the findings from the Commission's internal review of transactions for the first 9 months of the financial year 2023/24, and internal audit's review of expenditure.	**Unsatisfactory** These audit procedures did not identify any issues that impacted upon our 'true and fair' opinion on the financial statements. However, they did identify material expenditure for the year ended 31 March 2024 that was not incurred in accordance with applicable enactments and guidance issued by Scottish Ministers – see issues 2 and 3 in Exhibit 3.

Nature of risk	Audit response	Conclusion
Other opinion risks		
3. Financial settlement paid to former Chief Executive The former Chief Executive and Accountable Officer tendered his resignation with effect from 31 December 2023. As part of the terms of his departure he received a financial settlement from the Commission as payment in lieu of notice. There is a risk to our regularity opinion that the financial settlement paid did not reflect the former Chief Executive's contractual entitlements or comply with the requirements set out in the Scottish Public Finance Manual.	• We reviewed the financial settlement paid to the former Chief Executive to ensure the value of the payment reflected his contractual entitlements and was correctly disclosed in the remuneration report in the 2023/24 annual report and accounts. • We reviewed the process followed to agree the former Chief Executive's departure to ensure this complied with the requirements of the Scottish Public Finance Manual in place at the time.	**Satisfactory** Our testing confirmed that the financial settlement paid to the former Chief Executive reflected his contractual entitlement for payment in lieu of notice and untaken leave. Although the Commission's use of a settlement agreement for the financial settlement paid to the former Chief Executive did not follow the process set out in the Scottish Public Finance Manual, this did not impact on the audit opinion as approval was provided by the Director General Net Zero at the Scottish Government for this payment - see issue 1 in Exhibit 3.
4. Governance Statement The Scottish Public Finance Manual requires that the preparation of the Governance Statement should be informed by assurances from senior staff through a certificate of assurance from each Director. These were not completed by Commission staff last year and there was no formal process for the Accountable Officer to obtain assurances from the senior management team to inform the disclosures within the Governance Statement. There is a risk that appropriate arrangements are not in place to support the preparation of the Governance Statement in accordance with	• We reviewed the assurance arrangements in place to inform the disclosures within the Governance Statement and considered the accuracy and completeness of these based on our knowledge of the Commission.	**Satisfactory** We concluded that appropriate arrangements were in place to support the preparation of the Governance Statement in accordance with relevant legislation and directions made by Scottish Ministers. We are also content that the disclosures included in the Governance Statement are accurate and complete.

Nature of risk	Audit response	Conclusion
relevant legislation and directions made by Scottish Ministers.		

We reported the significant findings from the audit to those charged with governance prior to the annual report and accounts being approved and certified

16. International Standard on Auditing (UK) 260 requires us to communicate significant findings from the audit to those charged with governance, including our view about the qualitative aspects of the Commission's accounting practices.

17. The significant findings are summarised in Exhibit 3. Our audit also identified a number of other presentational and disclosure issues which were discussed with management. These were all adjusted in the audited annual report and accounts and were not considered significant enough to be separately reported under ISA260.

Exhibit 3
Significant findings and key matters from the audit of the annual report and accounts

Issue	Resolution
1. Use of settlement agreement for the financial settlement paid to the former Chief Executive The former Chief Executive and Accountable Officer tendered his resignation with effect from 31 December 2023. As part of the terms of his departure he received a financial settlement from the Commission as payment in lieu of notice. Our audit identified that the Commission's use of a settlement agreement for the financial settlement paid to the former Chief Executive did not follow the process set out in the Scottish Public Finance Manual. This was due to the agreement being signed, and a legal binding obligation created, prior to a supporting business case being prepared and submitted to the Scottish Government Sponsor Team for their consideration. Given the settlement agreement related to the former Chief Executive, and Accountable Officer, we also believe this was a 'high profile case' and therefore Ministerial views should have been obtained before entering into the agreement. **(See paragraphs 21. to 27. for further details)**	As shown in Exhibit 4 on pages 16-18, the settlement agreement business case for the financial settlement paid to the former Chief Executive was submitted to the Scottish Government by the Commission's Director of Strategy and Governance (now interim Chief Executive) on 23 January 2024, and the supporting value for money assessment was submitted on 4 March 2024. The settlement payment was approved by the Director General Net Zero on 11 March 2024 and the payment was made on 27 March 2024. As the Director General Net Zero at the Scottish Government provided approval for the settlement payment, it is not considered irregular expenditure and does not impact on our audit opinion.

Issue	Resolution
2. Expenditure not incurred in accordance with applicable enactments and guidance issued by Scottish Ministers Expenditure totalling £74,832 was incurred during 2023/24 which did not comply with the requirements of the Expenditure and Payments section of the SPFM. This expenditure included: • £43,604 which did not meet the requirements of the Scottish Public Finance Manual on delegated authority limits (see item 3 below for details) • £23,774 incurred on travel and subsistence expenses which were not incurred in accordance with the requirements set out in Commission's Financial Policies and Guidelines, and did not meet the requirements for authorisation of expenditure set out in the expenditure and payments section of the Scottish Public Finance Manual. • £7,454 of staff expenses for which no itemised receipts or other proof of purchase were provided, which did not meet the requirements for proof of payment requirements set out in the expenditure and payments section of the Scottish Public Finance Manual. **(See paragraphs 65. to 82. for further details)**	As detailed at paragraph 9. , this non-compliance with the requirements of the SPFM has been reflected in a qualified opinion on regularity in our independent auditor's report on the Commission's 2023/24 Annual Report and Accounts.
3. Expenditure that required Scottish Government pre-approval which had not been obtained Management's review of financial transactions for 2023/24 identified three items of expenditure totalling £43,604 which did not meet the requirements of the Scottish Public Finance Manual on delegated authority limits. • Expenditure of £19,484 with a recruitment consultancy. This required Scottish Government approval as the expected costs of £28,000 exceeded £20,000 and the contract was not awarded via a competitive tender exercise. • A gift bought for a visiting international delegation which cost £120 which exceeded the Commission's delegated limit of £75 for gifts. • £24,000 paid as a retainer for the use of a King's Counsel for "advanced reservation and commitment of	As detailed at paragraph 9. , these three items of expenditure totalling £43,604 which did not meet the requirements of the Scottish Public Finance Manual on delegated authority limits have been reflected in the qualified opinion on regularity in our independent auditor's report on the Commission's 2023/24 Annual Report and Accounts.

Issue	Resolution
diary time each quarter". The value and unusual nature of this expenditure means that this should have been approved by the Scottish Government in advance, but no approval was obtained. **(See paragraphs 67. to 72. for further details)**	
4. Overstatement of year end receivables and payables balances Our audit testing of year-end receivables and payables balances identified that an invoice for the lease payment due to Stirling Council for Moray House for March to May 2024 had been incorrectly accounted for in the unaudited accounts. This resulted in the prepayments (included within other receivables) balance and the trade payables and other current liabilities balance both being overstated by £16,669 in the Statement of Financial Position.	Management has corrected this misstatement in the audited financial statements. This reduced the other receivables balance and the trade payables and other current liabilities balance by £16,669 in the Statement of Financial Position. The net impact of this adjustment on the net assets figure in the Statement of Financial Position in nil.

Source: Audit Scotland

All misstatements identified during the 2023/24 audit were corrected in the audited annual report and accounts

18. It is our responsibility to request that all misstatements, other than those below our reporting threshold, are corrected, although the final decision on making the correction lies with those charged with governance.

19. Only one misstatement was identified during the audit which exceeded our reporting threshold (issue 4 in Exhibit 3). This was corrected in the audited accounts. We considered whether further audit procedures were required and reviewed the nature and cause of this misstatement, which related to the accounting treatment of an invoice for the lease payment due to Stirling Council for Moray House for March to May 2024. We concluded that this was an isolated error that had been identified in its entirety and did not indicate further systemic error.

Progress has been made against all our prior year recommendations

20. Our 2022/23 annual audit report included five recommendations for improvement. The Commission has taken action in response to all of these as detailed in Appendix 1.

2. Financial settlement paid to former Chief Executive

This section of the report details the findings and conclusions from our review of the process followed to agree the departure of the former Chief Executive and the financial settlement payment made.

The Commission's use of a settlement agreement for the financial settlement paid to the former Chief Executive did not follow the process set out in the Scottish Public Finance Manual. We would have expected the Commission's sponsor division to have provided clearer guidance and support to the former Chair and the Board in relation to this matter.

As the Director General Net Zero at the Scottish Government provided approval for the settlement payment, it is not considered irregular expenditure and does not impact on our audit opinion.

We believe that further consideration should have been given to the enforceability of the notice terms within the former Chief Executive's 2007 contract as part of the VFM assessment in support of the settlement agreement business case.

The use of a settlement agreement to secure the departure of the former Chief Executive, removed the possibility for disciplinary procedures to be taken against him in relation to the issues identified during our 2022/23 and 2023/24 audits.

The financial settlement paid to the former Chief Executive reflected his contractual entitlement for payment in lieu of notice and untaken leave. The total cost, including legal fees, to the Commission of the former Chief Executive's departure was £105,488.

The Commission's use of a settlement agreement for the financial settlement paid to the former Chief Executive did not follow the process set out in the Scottish Public Finance Manual

21. The former Chief Executive and Accountable Officer tendered his resignation with effect from 31 December 2023. As part of the terms of his departure he received a financial settlement from the Commission as payment in lieu of notice.

22. Exhibit 4 sets out the timeline for the financial settlement paid to the former Chief Executive, including the process relating to the use of a settlement agreement (i.e. a legally binding contract between an employer and an employee whereby the employee agrees to waive their rights to bring any claims against the employer, and vice versa, often in exchange for compensation).

Exhibit 4

Timeline for the financial settlement paid to the former Chief Executive

Date	Event
6 November 2023	Draft 2022/23 Annual Audit Report issued by appointed auditor to the former Chief Executive.
21 November 2023	Appointed auditor presented 2022/23 Annual Audit Report to the Audit and Risk Committee and notified them that the Auditor General for Scotland would be preparing a Section 22 Report on the Commission's 2022/23 audit. This was confirmed via e-mail on 22 November 2023 which provided the Section 22 report timetable and requested that this information was shared with the Commission's sponsor division.
6 December 2023	Appointed auditor issued draft Section 22 report to the former Chief Executive, former Chair of the Board and Chair of the ARC. The covering e-mail requested that the report was also shared with the sponsor division to ensure they were aware of the issues being reported by the Auditor General for Scotland within the report.
7 December 2023	The Commission's Senior Management Team presented a draft action plan to the Board setting out actions to address the points being reported in the Section 22 report on the 2022/23 audit.
10 December 2023	The former Chair of the Board received a letter from the former Chief Executive setting out his intention to retire in October 2024.
12 December 2023	The Board discussed the former Chief Executive's letter and agreed as a Board that they would accept his resignation but wished for him to leave the organisation as soon as possible.

Date	Event
19 December 2023	The former Chair of the Board and another board member met with the former Chief Executive to discuss the timing of his departure. The Board also held separate discussions with its legal advisers and the former Deputy Director of the Scottish Government Water Policy Division during the day. Later that day the former Chief Executive advised the former Chair that he would resign and confirmed via e-mail that evening that he was giving six months' notice, from 31 December 2023, as required under his contract. Following further consideration, the Board agreed that it would accept the former Chief Executive's resignation but would require him to step down with effect from the end of December rather than working his notice period. The Board instructed its legal advisers to prepare a settlement agreement to cover the payment the Commission were required to make for the period of his notice and for any accrued leave up to and including the 31 December 2023.
20 December 2023	Section 22 report on the 2022/23 audit published and the Scottish Government released a media statement stating that: "*The Water Industry Commission for Scotland's Chief Executive is stepping down with immediate effect and has tendered his resignation.*"
22 December 2023	The former Chair of the Board contacted the former Deputy Director of the Scottish Government Water Policy Division to formally notify him of the Board's decision regarding the departure of the former Chief Executive. This e-mail made reference to the previous discussions held between him and the Board and also stated that: "*Under his contract he had to provide six months notice and as confirmed by the Scottish Government Public Pay Policy Unit to you he is entitled to his salary for the period of his notice; in paying this WICS is meeting it's contractual obligation and not making any change to his contract. WICS had received legal advice confirming our contractual obligation in respect to Alan's notice period.*" However, the e-mail made no reference to the use of a settlement agreement in relation to the former Chief Executive's departure.
4 and 5 January 2024	A settlement agreement confirming the terms and date of the former Chief Executive's departure was signed by the former Chief Executive (4 January 2024) and the former Chair of the Board (5 January 2024).
12 January 2024	The Commission's finance team e-mailed the former Deputy Director of the Scottish Government Water Policy Division to inform him of the value of the payment due to the former Chief Executive and to seek confirmation they could make the payment. This e-mail also noted that the Commission held a copy of the related settlement agreement.
15 January 2024	The Water Policy Division e-mailed the Commission's finance team to advise that the settlement payment could not be approved until the Commission completed a business case for the settlement agreement in accordance with the requirements set out in the Scottish Public Finance Manual.

Date	Event
19 January 2024	The Commission's Director of Strategy and Governance (now interim Chief Executive) submitted a voluntary severance business case to the Water Policy Division in relation to the former Chief Executive's financial settlement on the basis that the payment made was a contractual entitlement (i.e. payment in lieu of notice). The Water Policy Division advised that a settlement agreement business case would be required as the Commission had used a settlement agreement for the financial settlement.
23 January 2024	The Commission's Director of Strategy and Governance (now interim Chief Executive) submitted a settlement agreement business case to the Water Policy Division.
29 February 2024	The Water Policy Division requested additional documentation, including a copy of the settlement agreement value for money assessment, to be submitted in support of the settlement agreement business case.
4 March 2024	The Commission's Director of Strategy and Governance (now interim Chief Executive) resubmitted the business case for the settlement agreement, along with the related value for money assessment and employee information schedule, to the Water Policy Division.
11 March 2024	Financial settlement to be paid to the former Chief Executive approved by Director General Net Zero.
15 March 2024	Letter sent by Cabinet Secretary for Wellbeing Economy, Net Zero and Energy to the former Chair of the Board noting: "*that the manner in which the removal [of the Chief Executive] was achieved was not in accordance with Scottish Government requirements as set out in the Scottish Public Finance Manual*". The letter also stated that: "*I note that in choosing a Settlement Agreement to conclude the departure of the former CEO, the Board failed to follow due process. This is extremely concerning given the nature of the failings identified by the Auditor General. Furthermore, it did not offer an opportunity to the SG to offer a wider steer on the use of Settlement Agreements and in particular the concerns that the PAC has expressed in respect of the use of such agreements. While I am advised that the payment reflects contractual terms this recurrent breach of process is unacceptable.*"
27 March 2024	Payment to former Chief Executive made in accordance with the settlement agreement and business case.

Source: Documents provided by the Water Industry Commission for Scotland

23. As shown in Exhibit 4, the settlement agreement confirming the terms and date of the former Chief Executive's departure was signed by the former Chief Executive on 4 January 2024 and the former Chair of the Board on 5 January 2024. At this point a legal binding obligation was created between the Commission and the former Chief Executive to pay him a financial settlement in accordance with the terms of the settlement agreement, see paragraphs 46. to 50. for details of the financial settlement.

24. At January 2024, when the settlement agreement was signed, the *Settlement agreements, severance, early retirement and redundancy terms* section of the Scottish Public Finance Manual (SPFM) set out the following key points for the use of settlement agreements:

- *The final decision as to whether to enter into a Settlement Agreement will rest with **the Accountable Officer** for the public body. Information on Settlement Agreements where SG has provided comments indicating that the agreement should not be entered into will form part of the information that may be made available to the Scottish Parliament.*
- *These arrangements will not affect the requirements for related disclosures in **annual accounts**: individual bodies will follow the requirements of the Financial Reporting Manual (FReM) for the financial year in question.*
- *SG will collate and provide information to the **Scottish Parliament** on the number of Settlement Agreements and the costs involved in reaching those agreements across the Scottish Administration. SG sponsored bodies should ensure that all Settlement Agreements follow the reporting process.*
- *The Public Audit Committee has expressed concern about **the use of excessive discretionary (non-contractual) payments** in Settlement Agreements. Accountable Officers must ensure that where discretionary payments used, they are necessary, justifiable and demonstrate value for money.*
- *The Public Audit Committee has also expressed concern about **the use of confidentiality clauses** in Settlement Agreements. These clauses may still be used but only where there is explicit agreement between both the employer and employee that this is required and there will be a general presumption against their use. While there is a general presumption against their use, we have developed, in consultation with public bodies, a draft confidentiality clause.*
- *Payment to individuals will be **capped** at £95,000.*
- *Where an organisation considers that there are compelling reasons that the cap cannot be applied, a full business case must be submitted outlining the reasons for this. **Ministerial views** must be obtained if this situation arises.*

- ***Ministerial views** must be obtained as and when appropriate, including in relation to any potentially high profile cases or where there is a strong, compelling business case that the cap cannot be applied.*

25. The *Settlement agreements, severance, early retirement and redundancy terms* section also set out the 'Settlement agreement - Business case submission process' which included the following:

- *With the approval of their Accountable Officer, the public body prepares a business case using the attached guidance and templates.*

- *Prior to offering or entering into any Settlement Agreement, the public body will consult Scottish Government by submitting a copy of the business case to the relevant SG Sponsor Team or SG lead contact who will send to the SG Sponsor Director, People Directorate, Severance Policy Team and Finance Business Partner.*

- *Ministerial views must be obtained as and when appropriate, including in relation to any potentially high profile cases or where there is a strong, compelling business case that the cap cannot be applied.*

- *If the Scottish Government is not satisfied with either the need for such an agreement, or the terms of the proposed agreement, or its value for money, this will be highlighted in the response.*

- *The final decision as to whether to enter into a Settlement Agreement will rest with the Accountable Officer for the public body. Information on Settlement Agreements where SG has provided comments indicating that the agreement should not be entered into may form part of the information that may be made available to the Scottish Parliament.*

26. Annex A to the *Settlement agreements, severance, early retirement and redundancy terms* section of the SPFM, as shown in Exhibit 5 on page 21, then provided a settlement agreement flowchart setting out the steps to be followed and the reporting process, which reflected the requirements detailed at paragraphs 24. and 25. above.

27. From our review of the process followed by the Commission to use a settlement agreement for the financial settlement paid to the former Chief Executive, as set out in Exhibit 4 on pages 16-18, we have concluded that it did not follow the process set out in the Scottish Public Finance Manual. This is due to the agreement being signed, and a legal binding obligation created, prior to a supporting business case being prepared and submitted to the Scottish Government Sponsor Team for their consideration. Given the settlement agreement related to the former Chief Executive, and Accountable Officer, we also believe this was a 'high profile case' and therefore Ministerial views should have been obtained before entering into the agreement.

Exhibit 5

Extract from the *Settlement agreements, severance, early retirement and redundancy terms* section of the Scottish Public Finance Manual at January 2024 showing 'Annex A: Settlement agreement flowchart and reporting process'

Stage	Requirement
Step 1	Public Body prepares Settlement Business Case with approval of Accountable Officer and seeks advice/clearance as required from SG Sponsor Team / Lead Contact.
Step 2	Business Case submitted to SG Sponsor Team / Lead Contact.
Step 3	SG Sponsor Team / Lead Contact send to Sponsor Director, People Directorate (PD), Finance Business Partner (FBP) and Severance Policy Team (FPP) for advice.
Step 4	People Directorate, FBP and FPP consider settlement case, seeking input from their Deputy Director as appropriate and recommending independent expert advice / referral to Ministers as required. Note: If more information is required, the SG Sponsor Team / SG Lead contact seek the required information from the public body.
Step 5	Sponsor Team / SG Lead Contact liaise with public body on any cases that breach severance policy and with Portfolio Cabinet Secretary for comments / views. Cabinet Secretary for Finance included in all Ministerial submissions for information.
Step 6	SG Sponsor Team / SG Lead Contact collate responses and provide feedback to public body (including Ministerial comments where appropriate).
Step 7	Accountable Officer makes final decision on whether to proceed with settlement agreement.
Step 8	Public Body to notify Sponsor Team / Lead Contact, copying SG Sponsor Director and SG People Directorate if and when Settlement Agreement is finalised providing details of final agreement.
Step 9	SG People Directorate reports annually to Public Audit Committee on Settlement Agreements.

Source: Scottish Public Finance Manual (January 2024)

As the Director General Net Zero at the Scottish Government provided approval for the settlement payment, it is not considered irregular expenditure and does not impact on our audit opinion

28. As shown in Exhibit 4 on pages 16-18, the settlement agreement business case for the financial settlement paid to the former Chief Executive was submitted to the Scottish Government by the Commission's Director of Strategy and Governance (now interim Chief Executive) on 23 January 2024, and the supporting value for money assessment was submitted on 4 March 2024. The settlement payment was approved by the Director General Net Zero on 11 March 2024 and the payment was made on 27 March 2024.

29. As the Director General Net Zero at the Scottish Government provided approval for the settlement payment, it is not considered irregular expenditure and does not impact on our audit opinion.

We believe that further consideration should have been given to the enforceability of the notice terms within the former Chief Executive's 2007 contract as part of the VFM assessment in support of the settlement agreement business case

30. During our review of the process for the financial settlement paid to the former Chief Executive we obtained a copy of the business case and supporting documents submitted to the Scottish Government on 4 March 2024. This included the value for money (VFM) assessment which set out 5 options considered by the Commission:

- **(1)** Accept the first offer from the CEO to work until November 2024,
- **(2)** Suspend the CEO to allow an investigation/ hearing,
- **(3)** Dismiss the CEO (and incur 12 months contractual severance),
- **(4a)** Allow the CEO to work 6 months' notice period, and
- **(4b)** Make a payment in lieu of 6 months' contractual notice.

31. The VFM assessment set out the financial costs, non-financial costs, and non-financial benefits of each option. It noted that options 4a and 4b were the lowest financial cost options, but option 4b was considered to offer the optimal combination of the lowest financial and non-financial costs and the greatest non-financial benefits. Therefore, it was concluded that option 4b maximised value for money.

32. Our review of the VFM assessment document confirmed that the conclusion reached that option 4b maximised value for money was accurate based on the information detailed for each option in the form. We also confirmed that the options included in the assessment were consistent with the meeting notes we had been provided with in relation to the options considered by the Board during their discussions in December 2023. However, our review of the underlying documents identified that the 'Notice' section of the former Chief Executive's most recent contract of employment (dated February 2007) stated:

> *"The length of notice, which you are entitled to receive from the Commission to terminate your employment is 6 months however if you have been employed for over 2 years this will change to 3 months. The length of notice that you are required to give the Commission to terminate your employment is 6 months. In each case, notice must be in writing"*

33. Based on this the former Chief Executive would only have been entitled to 3 months contractual severance if the Commission terminated his employment rather than 12 months as used in the VFM assessment document. Had the financial costs of dismissing the former Chief Executive been assessed based on 3 months contractual severance, rather than 12 months, then this would have been the lowest financial cost option.

34. We discussed this issue with the former Chair who advised that, based on the legal advice received, the Board was uncertain about the Commission's ability to enforce the terms of the former Chief Executive's 2007 contract as he had not signed it. Therefore, the terms of notice in his previous contract of employment (dated June 2005) were used for the VFM assessment which stated:

> *"The length of notice which you are entitled to receive from the Commission to terminate your employment is 12 months. The length of notice which you are required to give the Commission to terminate your employment is 6 months. In each case, notice must be in writing"*

35. The former Chair also advised that the Board did not believe that they had grounds to dismiss the former Chief Executive, discussed further at paragraphs 38. to 40. , and therefore this option would not have been pursued even if it had been assessed as the cheapest option in the VFM assessment.

36. Given the significant difference in the potential costs to the Commission of terminating the former Chief Executive's contract under the terms in his 2005 or 2007 contracts, and the fact that the former Chief Executive had worked under his 2007 contract for 16 years, we would have expected further consideration to have been given to the enforceability of the terms of the 2007 contract as part of the VFM assessment process. We noted that the legal advice provided to the Board by its legal advisers did not give any clear view on the enforceability of the 2007 contract.

37. As the notice period that the former Chief Executive had to provide the Commission to terminate his employment was 6 months in both the 2005 and 2007 contracts, the financial cost of options '(4a) Allow the CEO to work 6 months' notice period', and '(4b) Make a payment in lieu of 6 months' contractual notice' was consistent regardless of which contract was used for the VFM assessment. This also reflected the payment in lieu of notice made to the former Chief Executive as part of his financial settlement, paragraph 46. .

The use of a settlement agreement to secure the departure of the former Chief Executive, removed the possibility for disciplinary procedures to be taken against him in relation to the issues identified during our 2022/23 and 2023/24 audits

38. The documentation provided to us in support of the process followed to agree the former Chief Executive's departure, included a file note from the Board's legal advisers detailing their discussions with the Board in relation to the options available to the Board. This included consideration of whether the Commission could look to commence a disciplinary investigation against the former Chief Executive to establish if there were grounds to dismiss him for gross misconduct.

39. The file note highlighted the potential financial risk to the Commission of commencing a disciplinary process as the former Chief Executive would need to have been suspended on full pay for the duration of the investigation, which may be lengthy. Also, if at the end of the disciplinary process, the Board could not demonstrate sufficient grounds to justify a gross misconduct dismissal, then the Commission would need to terminate on due notice which could result in a payment of 12 months notice to the former Chief Executive (based on the former Chief Executive's 2005 contract discussed at paragraphs 32. to 34.). The file note states that: "*…the risk of spending time and money investigating a case against the CEO, only to find that WICS had to pay him in lieu of 12 months notice and carry exposure to a potential unfair dismissal claim was a reasonable risk for the Board to have cognisance of when negotiating an exit for the CEO.*". Based on these considerations, and the financial risks identified, the Board concluded that it would not pursue a disciplinary process against the former Chief Executive.

40. Given the issues identified during our 2022/23 audit, and the subsequent issues identified by management's review of transactions between April to December 2023 (paragraphs 65. to 72.), internal audit's review of expenditure during 2023/24 (paragraphs 73. to 76.) and our expenditure testing as part of our 2023/24 audit (paragraphs 77. to 79.), it is clear there were repeated and deliberate breaches of the Commission's Financial Policies and Guidelines by the former Chief Executive. The use of a settlement agreement has removed the possibility for any disciplinary procedures to be taken against the former Chief Executive in relation to these matters.

We would have expected the Commission's sponsor division to have provided clearer guidance and support to the former Chair and the Board in relation to the former Chief Executive's departure

41. As set out at paragraphs 24. to 27. and Exhibit 5, the *Settlement agreements, severance, early retirement and redundancy terms* section of the SPFM at January 2024 was written based on the final decision to enter into a settlement agreement resting with the Accountable Officer for the public body.

42. As this settlement agreement related to the Accountable Officer of the Commission he clearly could not be involved in the decision in this case. Therefore, as detailed in Exhibit 4, the former Chair and the other board members had to reach a decision on the terms of the former Chief Executive's departure based on legal advice from its legal advisers and discussions with the former Deputy Director of the Scottish Government Water Policy Division.

43. Based on our discussions with the former Chair and other board members involved in the decision regarding the departure of the former Chief Executive, including the use of a settlement agreement to secure this, we are content that they did not knowingly disregard the requirements of the SPFM and were under the impression at the time that they were following the required process. It was also clear that the Board felt there was an expectation from the sponsor division that it should agree a speedy resolution to the situation.

44. Given that the former Chair and Board were dealing with a situation that would usually be dealt with by an Accountable Officer, and the high profile nature of this case, we would have expected the Commission's sponsor division to have provided clearer guidance and support to ensure that the process complied with the requirements of the SPFM.

45. We note that the *Settlement agreements, severance, early retirement and redundancy terms* section of the SPFM was revised in March 2024 and now includes an additional clause in the 'Key Points' section stating that: "*Where the Accountable Officer is the subject of the Settlement Agreement, advice about the appropriate approval process should be sought from the SG Sponsor Team, SG lead contact (or equivalent for NHS and Educational bodies).*"

The financial settlement paid to the former Chief Executive reflected his contractual entitlement for payment in lieu of notice and untaken leave. The total cost, including legal fees, to the Commission of the former Chief Executive's departure was £105,488.

46. The terms of the financial settlement to be paid to the former Chief Executive, as set out in the settlement agreement, were for the Commission to pay him:

- £84,800 as payment of salary in lieu of the 6 months' notice period (less deductions for income tax and employees' national insurance contributions) (the "PILON"); and
- £1,468 in lieu of 2.25 days of accrued but untaken holiday (less deductions for tax and employees' national insurance contributions).

47. As discussed at paragraphs 32. to 35. , the notice period that the former Chief Executive had to provide the Commission to terminate his employment was 6 months in both his 2005 and 2007 contracts. Therefore, the payment of salary in lieu of the 6 months' notice period included in the settlement agreement reflects his contractual entitlement upon resigning. Similarly, the payment in lieu of accrued but untaken leave was a contractual entitlement due to the former Chief Executive.

48. The agreement also set out that the Commission would pay legal costs up to a maximum of £700 plus VAT (£840), incurred by the former Chief Executive for advice wholly in connection with the termination of the employment and entering into the settlement agreement, and this was to be paid directly to his legal representative's firm within 28 days of receipt by the Commission of an invoice for these costs.

49. As part of our audit we reviewed the payments made in respect of the settlement agreement, and the related costs incurred by the Commission. This identified that the payment to the former Chief Executive was made on 27 March 2024 and totalled £86,268 (less income tax and national insurance contributions) as set out in the settlement agreement, paragraph 46. . These payments have been correctly disclosed in the 'Directors' Salary and Pension Entitlements' section of the remuneration report in the Commission's 2023/24 Annual Report and Accounts.

50. We also identified that the Commission paid £840 to the former Chief Executive's legal representatives, in line with the contribution to legal costs figure set out in the settlement agreement, paragraph 48. . In addition, the Commission paid £11,800 to HMRC for the employer national insurance contributions due on the payment in lieu of notice, and incurred costs of £6,580 for legal advice and services relating the former Chief Executive's departure and the preparation and signing of the settlement agreement. Therefore, the total cost to the Commission of the former Chief Executive's departure was £105,488.

3. Financial management and sustainability

Financial management means having sound budgetary processes, and the ability to understand the financial environment and whether internal controls are operating effectively. Financial sustainability means being able to meet the needs of the present without compromising the ability of future generations to meet their own needs.

The Commission reported an operating surplus of £1.1 million for 2023/24. This resulted in cash reserves increasing to £4.9 million at 31 March 2024. Management is reviewing this to identify what level of funds need to be retained to cover future costs and what can be returned to Scottish Water and Licensed Providers. We do not currently have any concerns about the financial sustainability of the organisation.

Expenditure totalling £74,832 was incurred during 2023/24 which did not comply with the Commission's Financial Policies and Guidelines or the requirements of the Expenditure and Payments section of the SPFM. Internal audit testing confirmed that compliance levels improved for the last 3 months of the year, following action taken by management to address the financial management weaknesses reported in our 2022/23 Annual Audit Report. Our testing did not identify any instances of non-compliant expenditure between January and March 2024.

Internal audit's work identified that financial controls did not operate effectively between April and December 2023. Therefore, they concluded that no assurance could be provided on the effectiveness of the systems of control during 2023/24.

Due to the weaknesses in the operation of the system of internal control, and the instances of expenditure that was not supported by appropriate receipts or other proof of purchase, we have concluded that adequate arrangements were not in place to prevent and detect fraud during the year. This is not a judgement on whether any fraudulent activity actually occurred.

The Commission reported an operating surplus of £1.1 million for 2023/24

51. The Commission is funded by a levy paid by Scottish Water and the Licensed Providers of retail services in the non-household market. For 2021-2027 the Scottish Government approved levies totalling £24.67 million, Exhibit 6, to fund the Commission's activities over the six-year regulatory control period.

Exhibit 6
Levy income set for 2021-2027 regulatory control period

	21/22 £m	22/23 £m	23/24 £m	24/25 £m	25/26 £m	26/27 £m	Total £m
Scottish Water levy	2.26	2.28	2.30	2.32	2.35	2.37	**13.88**
Licensed Provider's levy	1.67	1.72	1.77	1.82	1.88	1.93	**10.79**
Total levy income	**3.93**	**4.00**	**4.07**	**4.14**	**4.23**	**4.30**	**24.67**

Source: Water Industry Commission for Scotland Corporate Plan 2021-2027

52. For 2023/24 the Commission reported an operating surplus of £1.142 million (£1.251 million in 2022/23), as shown in Exhibit 7. This reflected annual income of £4.519 million (including actual levy income of £4.020 million) and expenditure of £3.378 million (with 70 per cent relating to staff costs). The slightly reduced surplus reported for the year was attributable to a decrease of £0.806 million (68 per cent) in Hydro Nation income from £1.185 million in 2022/23 to £0.379 million in 2023/24, largely offset by a corresponding reduction in costs due to the completion of the Commission's international work in New Zealand.

Exhibit 7
Operating surpluses reported over the 2021-2027 control period

	2021/22 £m	2022/23 £m	2023/24 £m	Cumulative position for 2021-2027 control period £m
Income	4.481	5.288	4.519	14.288
Expenditure	(3.871)	(4.037)	(3.378)	(11.285)
Operating surplus / (deficit)	**0.610**	**1.251**	**1.142**	**3.003**

Source: Water Industry Commission for Scotland 2023/24 Annual Report and Accounts

Cash reserves increased to £4.9 million at 31 March 2024. Management plans to review this to identify what level of funds need to be retained to cover future costs, and what can be returned to Scottish Water and Licensed Providers.

53. At the end of the previous six-year regulatory period the Commission held a cash and cash equivalents balance of £2.452 million. This has now increased to £4.938 million at 31 March 2024 as a result of the operating surpluses achieved in the first three years of the 2021-2027 regulatory period, Exhibit 7.

54. The level of the cash reserves held at 31 March 2024 represented 146 per cent of the Commission's 2023/24 expenditure, and current liabilities at the year-end totalled only £0.441 million.

55. Management had previously advised that due to the nature of the Commission's work, the annual expenditure during a regulatory period can vary significantly. To allow Scottish Water and Licensed Providers a predictable payment schedule, the income is agreed at a set rate for each year at the outset of the regulatory period, as shown in Exhibit 6. The impact of this is that the Commission can have unusually high cash balances at certain points in the regulatory cycle. At the end of a regulatory period, if there are excess funds, they are returned to Scottish Water and the Licensed Providers, as appropriate.

56. The Commission accept that the cash balance now exceeds what will be required to supplement the levy income to fund the Commission's work over the remainder of the regulatory period, due to the additional income earned through the Commission's international work during the first three years of the 2021-2027 regulatory period. Management has therefore advised that it plans to review this balance to identify what level of funds needs to be retained to cover the Commission's future costs, so that any excess funds can be returned to Scottish Water and Licensed Providers.

Recommendation 1

The Commission should review what level of cash reserves needs to be retained to cover the Commission's future costs, so that any excess funds can be returned to Scottish Water and Licensed Providers.

We do not currently have any concerns about the financial sustainability of the Commission

57. As shown in Exhibit 7, the Commission has reported an operating surplus in each of the first three years of the current regulatory control period and has achieved a cumulative surplus of £3.003 million over that period.

58. In 2023/24, the Commission's expenditure totalled £3.378 million which was £0.642 million less than the levy income of £4.020 million received during the year, and it held cash reserves of £4.938 million at 31 March 2024.

59. International activity as part of the Hydro Nation initiative is currently paused so this income stream is expected to reduce in future years. However, based on the financial position at 31 March 2024 we do not currently have any concerns about the financial sustainability of the Commission.

Management has concluded its workplan to address the financial management weaknesses reported in our 2022/23 Annual Audit Report. We will monitor the impact of these actions during 2024/25 and make further recommendations for improvement as required.

60. Following the publication of the Auditor General for Scotland's Section 22 report on the 2022/23 audit in December 2023, management agreed a 21 point workplan to respond to the issues reported in our 2022/23 Annual Audit Report.

61. The range of actions agreed to address the financial management weaknesses reported in our 2022/23 Annual Audit Report included an overhaul of the Commissions governance and controls, including revising the expenses policy, reinstating an approval panel to scrutinise expenditure, and strengthening the internal reporting processes. It also included training to ensure all staff are aware of the requirements of the Commission's Finance Policies and Guidelines and the SPFM, and their role in ensuring that all expenditure is incurred in compliance with these, and specific VFM training.

62. The initial actions within the workplan were taken between January and March 2024 and placed a significant additional burden on the finance team. These demands have reduced during 2024 but the finance team is still providing support to officers to ensure they are complying with the requirements of the Commission's Financial Policies and Guidelines, and approving invoices for payment timeously. We would expect these demands to reduce further as the new financial management arrangements bed in and officers across the Commission take responsibility for ensuring compliance with the revised Financial Policies and Guidelines. However, management should monitor the finance capacity of the organisation to deal with these additional demands to ensure they are not impacting on the wellbeing of finance staff, or their ability to perform their core roles.

63. We also noted during the audit that the extent of time required to deal with the ongoing scrutiny activity and public interest in the Commission, and the increased reporting to the Board and the audit and risk committee, has placed additional pressure on finance and other support staff which, again, may impact on their wellbeing or capacity to perform the other duties required of their role.

Recommendation 2

Management should view the Commission's capacity within finance, and other support services, to ensure it has sufficient staff resources to enforce and report on compliance with the revised Financial Policies and Guidelines, and to deal with the other additional resource pressures that the organisation is currently facing.

64. The actions in the workplan have now been completed. We will monitor the impact of these actions on the financial management of the organisation during 2024/25 and make further recommendations for improvement as necessary.

Management reviewed expenditure during the first 9 months of 2023/24 and identified non-compliant expenditure totalling £51,068

65. As part of the Commission's response to the issues reported in the Section 22 report on the 2022/23 audit, management conducted a review of financial transactions to proactively identify areas of similar non-compliance during the first 9 months of 2023/24. This review considered all transactions, receipts and invoices submitted, along with purchase orders for transactions over £1,000, up to the end of December 2023.

66. The Commission's review identified expenditure totalling £51,068 which was non-compliant with its Financial Policies and Guidelines or the requirements of the SPFM. It also identified other items that complied with the Commission's policies but may not have represented value for money. The items identified by management's review were:

- £24,000 spent on the payment of a retainer for the use of a King's Counsel for "advanced reservation and commitment of diary time each quarter" (at £6,000 per quarter).
  (See paragraph 71. for further details)
- £19,484 paid to a recruitment consultancy under a contract that required Scottish Government approval which had not been obtained.
  (See paragraph 68. for further details)
- £7,314 of expenditure that was not supported by appropriate receipts or other proof of purchase.
- £840 for benefits in kind paid to staff that had not been treated as taxable benefits (£690 for reimbursement of eyecare costs, in line with the financial policies and procedures that were in place at the time, and £150 relating to 3 gifts to staff members).
- £120 for a gift bought for a visiting international delegation from Barbados that required Scottish Government approval which had not been obtained (See paragraph 69. for further details).
- £17,686 for business class flights. This expenditure was in line with the Commission's Financial Policies and Guidelines at the time but we noted that these did not set clear criteria for when business class flights could be used, stating: "*When air travel is required, the best value fare available should be obtained, having consideration for any business requirement for flexibility within the class of ticket, personal security and personal welfare (e.g. length of the working day on the day of travel) and operator selected.*"

- £2,669 on meals which exceeded £50 per head. This expenditure was in line with the Commission's Financial Policies and Guidelines that were in place at the time as the limit per head for meals was removed from the policy in January 2023.
  (Discussed further at paragraphs 91. to 96.)

The non-compliant expenditure identified by the Commission's review included three items of expenditure totalling £43,604 that required Scottish Government pre-approval which had not been obtained

67. As detailed at paragraph 66. above, management's review of financial transactions for 2023/24 identified two items of expenditure that required Scottish Government pre-approval which had not been obtained.

68. The first item related to the use of a recruitment consultancy to assist the Commission in a recruitment search for suitable candidates for the role of 'Senior Operations Director'. The purchase order raised for contract was for £28,000 based on the expected costs of this work. The recruitment search was ultimately unsuccessful and so only £19,484 was incurred against this contract. However, as the expected costs exceeded £20,000 and the contract was not awarded via a competitive tender exercise, it required to be approved by the Scottish Government in advance, but no approval was obtained.

69. The second item was a gift bought for a visiting international delegation from Barbados which cost £120. As this exceeded the Commission's delegated limit of £75 for gifts, it required to be approved by the Scottish Government in advance, but no approval was obtained.

70. The Commission contacted its Scottish Government sponsor division to request retrospective approval for these two items of expenditure but were informed that this would not be provided.

71. In addition to these two items, the value and unusual nature of the £24,000 paid as a retainer for the use of a King's Counsel for "advanced reservation and commitment of diary time each quarter", flagged by management's review of transactions, should also have been approved by the Scottish Government in advance, but no approval was obtained. Our audit identified that the Commission also paid directly for costs totalling £1,441 for travel and accommodation costs for the KC traveling to Edinburgh for a meeting with the former Chief Executive, detailed at paragraph 79. , and incurred fees of £9,240 for services provided by the KC to the Commission during 2023/24. Therefore, the total costs incurred by the Commission during the year in relation to the KC totalled £34,681, with £24,000 being the KC retainer payments.

72. As detailed at paragraph 9. , these three instances of expenditure which did not meet the requirements of the Scottish Public Finance Manual on delegated authority limits have been reflected in the qualified opinion on regularity in our independent auditor's report on the Commission's 2023/24 Annual Report and Accounts.

Internal audit’s review of expenditure during 2023/24 identified additional items of non-compliant expenditure, although compliance levels improved for the last 3 months of the year

73. In addition to the Commission’s own review of financial transactions, management also asked its internal auditors, Grant Thornton, to conduct a review of expenditure for the full year to identify any further instances of non-compliant expenditure not identified for the first 9 months of 2023/24, and any non-compliant expenditure for the last 3 months of the year.

74. Grant Thornton reported the findings from this work to the June meeting of the Audit and Risk Committee. These highlighted that the internal audit team had sampled a total of 68 items from the first 9 months of 2023/24, of which 36 were in line with policy following the appropriate procedures and 32 items were non-compliant, representing a 53 per cent compliance rate. The report also noted that the sampled items included spending on business entertaining, which was out with the expectations of a public sector entity.

75. From review of the internal audit report it is clear that many of the 32 non-compliant items identified for the first 9 months of the year had already been identified by the Commission’s own review of financial transactions between April and December 2023. However, it is not possible for us to quantify the volume and value of additional items identified by internal audit’s review due to the way the information is collated and presented in the report.

76. Internal audit’s review of expenditure for the final 3 months of 2023/24 involved the selection of a sample of 25 items for testing, of which 19 items of expenditure were confirmed to be in line with the Commission’s financial policies and guidelines, which represented a 76 per cent compliance rate. This represented an improved level of compliance from the first 9 months of the year, but shows that there are still areas to be addressed to ensure that all expenditure is incurred in compliance with the Commission’s Financial Policies and Guidelines and the requirements of the SPFM.

Our targeted regularity testing identified 18 additional items of non-compliant expenditure, totalling £23,764, between April and December 2023

77. As part of our 2023/24 audit we conducted expenditure testing across the full financial year. This included routine expenditure testing to support our “true and fair opinion” on the financial statements, and targeted testing of potentially contentious expenditure to support our regularity opinion.

78. Our targeted regularity testing involved interrogating the full listing of non-staff costs expenditure for 2023/24 to identify any items requiring further investigation based on our professional judgement. This identified 57 items of expenditure that it appeared may not comply with the Commission’s Financial Policies and Guidelines or the requirements of the Expenditure and Payments section of the SPFM.

79. Following discussion of the 57 items selected for targeted regularity testing with management and review of each item of expenditure against the Commission's Financial Policies and Guidelines and the requirements of the Expenditure and Payments section of the SPFM, we concluded that 23 of these items, totalling £25,558, represented non-compliant expenditure. All the non-compliant items of expenditure we identified related to the first 9 months of 2023/24, and these included 5 items, totalling £1,794, that had already been identified by management's own review of expenditure. Therefore, our testing identified 18 additional items of non-compliant expenditure, totalling £23,764, during 2023/24. These were:

- Travel and accommodation costs of £1,441 for the KC traveling to Edinburgh for a meeting with the former Chief Executive which were paid directly by the Commission rather than being invoiced as part of the KC's fees.
  (The total costs incurred by the Commission during the year in relation to the KC are detailed at paragraph 71.)

- The cost of flights, accommodation and subsistence totalling £21,905 for a visiting delegation from Barbados that were paid for by the Commission as part of its Hydro Nation business development activity.
  (Expenditure on Hydro Nation business development activity is discussed further at paragraphs 91. to 96.)

- A petty cash write-off of £140 for cash withdrawn from an ATM using a corporate credit card for which no receipt had been provided to evidence what this money had been spent on.

- 6 gifts purchased using the Commission's funds for items such as leaving gifts and wedding presents for staff, which cost £278 in total (these were all below £75 so did not require Scottish Government approval).

80. Our testing also identified two further instances of meals, totalling £590.23, where the cost per head exceeded £50 per head and included external guests. One of these was a meal at the Road Hole Restaurant in St Andrews costing £370 that was attended by a visiting water services regulator and his wife. This expenditure was in line with the Commission's Financial Policies and Guidelines that were in place at the time as the limit per head for meals was removed from the policy in January 2023. This is discussed further at paragraphs 91. to 95. .

Expenditure totalling £74,832 was incurred during 2023/24 which did not comply with the Commission's Financial Policies and Guidelines or the requirements of the Expenditure and Payments section of the SPFM

81. Taken together, the non-compliant expenditure identified during 2023/24 through our testing and the review conducted by management totalled £74,832. This figure does not include the items of non-compliant expenditure identified by internal audit for the first 9 months of the year, as detailed in paragraphs 74. and 75. . This is due to the fact that it was not possible for us to determine with any certainty which of these items had also been identified by our testing, or management's review of expenditure, and would therefore be double counted if added to this total. We also haven't included any amount for the 6 items of non-compliant expenditure identified by internal audit for the final 3 months of the year, discussed at paragraph 76. , as these were not clearly quantified within their report.

82. As detailed at paragraph 9. , as material expenditure was identified during the year that did not comply with the Commission's Financial Policies and Guidelines or the requirements of the SPFM, this has been reflected in a qualified opinion on regularity in our independent auditor's report on the Commission's 2023/24 Annual Report and Accounts.

Our testing did not identify any instances of non-compliant expenditure during January to March 2024

83. As detailed at paragraph 79. , our targeted regularity testing identified 18 additional items, totalling £23,764, of non-compliant expenditure. However, these all related to the first 9 months of 2023/24 (i.e. prior to the conclusion of our 2022/23 audit and the issue of the Section 22), and we did not identify any instances of non-compliant expenditure during the final 3 months of the year through this testing, our routine expenditure testing, or the other audit procedures conducted as part of our 2023/24 audit.

84. The fact that our testing did not identify any non-compliant expenditure between January and March 2024, and the improved level of compliance identified by internal audit for the final 3 months of the year (paragraph 76.), suggests that the immediate action taken by management to address the financial management weaknesses reported in our 2022/23 Annual Audit Report has had an impact. However, management should continue to focus on embedding financial management, and a focus on value for money, across the organisation so that it becomes business as usual and all expenditure incurred by the Commission complies with its Financial Policies and Guidelines and the requirements of the SPFM.

Recommendation 3

Management should continue to focus on embedding financial management, and a focus on value for money, across the organisation to ensure all staff are aware of the requirements of the Commission's Finance Policies and Guidelines and the SPFM, and their role in ensuring that expenditure is incurred in compliance with these.

Internal audit's work identified that financial controls did not operate effectively between April and December 2023. Therefore, they concluded that no assurance could be provided on the effectiveness of the systems of control during 2023/24.

85. The Head of Internal Audit is required by the Public Sector Internal Audit Standards to provide the Commission with an annual opinion on the overall adequacy and effectiveness of the risk management, control and governance processes (known as the system of internal control). The purpose of the Head of Internal Audit's Opinion is to contribute to the assurances available to the Accountable Officer and the Board, for their assessment of the effectiveness of internal control.

86. Grant Thornton's 2023/24 Internal Audit Annual Report and Opinion was issued in August 2024. This noted that: "*Our opinion for the period 1 April 2023 to 31 December 2023 is that based on the scope of reviews undertaken and the sample tests completed during the period, that no assurance can be given on the overall adequacy and effectiveness of the organisation's framework of governance, risk management and control*".

87. For the final 3 months of 2023/24 the report noted that: "*…we can give reasonable assurance over the adequacy of the design of controls as they relate to the framework of governance, risk management and control, alongside limited assurance on operation of control, in part due to the need for controls to be further embedded.*"

88. The report concluded that: "W*e are required to give an overall opinion for the year. Therefore, whilst noting the positive developments and improvements in the last quarter, the opinion for the year is no assurance. Overall, we have therefore concluded that, in the areas examined, the risk management activities and controls are not suitably designed to achieve the risk management objectives required by management. Those activities and controls that we examined were not operating with sufficient effectiveness to provide reasonable assurance that the related risk management objectives were achieved during the period under review*".

89. The opinion provided by the Head of Internal Audit is included in the Governance Statement in the Commission's 2023/24 Annual Report and Accounts and also reflected in the Accountable Officer's overall conclusion on the effectiveness of the systems of control during 2023/24.

90. Management has taken action to address the financial management weaknesses reported by internal audit during 2023/24, to ensure that systems of internal control will operate effectively going forward. We will review the impact of these actions as part of our 2024/25 audit.

The Commission's Financial Policies and Guidelines did not adequately cover Hydro Nation business development activity, provide limits on expenditure on meals or prohibit the purchase of alcohol

91. During both our 2022/23 and 2023/24 audits we identified expenditure that did not comply with the Commission's Financial Policies and Guidelines. Many of these instances, including the £23,028 spent on flights, accommodation and subsistence for a visiting delegation from Barbados in 2023/24, related to what the Commission term Hydro Nation "business development activity".

92. From our discussions with management it is clear that there was a view amongst the Commission's staff that expenditure could be incurred in relation to Hydro Nation business development activity that would not be permissible for its core regulatory work. This view was informed by the Commission's Corporate Plan 2021-27 ring fencing £0.6 million of its budget over the regulatory period for Hydro Nation network building, and a further £0.3 million for Hydro Nation research projects. The corporate plan also sets out that it was expected that the Commission would generate a net contribution from international activities of £1.3 million over the regulatory period. This work therefore had a commercial focus on identifying opportunities to take on income generating consultancy contracts with water authorities in other countries.

93. The type of expenditure we identified is unusual for a public sector body and the financial policies did not adequately cover what was permissible activity and expenditure as part of this Hydro Nation business development work.

94. A key feature of the Hydro Nation business development activity that we identified was expenditure on meals paid for by Commission staff and attended by external guests. As detailed at paragraph 66. and 80. , the costs of these meals often exceeded £50 per head, included the costs of non-Commission staff, and included the purchase of alcohol. We noted that the limits for meal costs were removed from the Commission's Financial Policies and Guidelines in January 2023, and at the time the policy also did not prohibit the purchase of alcohol. Both of these are highly unusual for a public sector body.

95. The Commission's Financial Policies and Guidelines document was updated during 2023/24 with subsistence rates re-established and the purchase of alcohol no longer permitted.

96. As detailed at paragraph 124. , the Commission's international work has been put on hold since January 2024. Prior to this recommencing, management should engage with the Scottish Government to discuss the expectations of activity in this area in the future. This would include the governance arrangements and financial policies that would require to be put in place to provide clarity on what is permissible activity and expenditure as part of this work.

Due to the weaknesses in the operation of the system of internal control, and the instances of expenditure that was not supported by appropriate receipts or other proof of purchase, we have concluded that adequate arrangements were not in place to prevent and detect fraud during the year. This is not a judgement on whether any fraudulent activity actually occurred.

97. Public sector bodies are responsible for implementing effective systems of internal control, including internal audit, which safeguard public assets and prevent and detect fraud, error and irregularities, bribery and corruption.

98. From review of the Commission's Code of Conduct for Board Members and the fraud and whistleblowing policies outlined in the Employee Handbook, we are content that they adequately cover the arrangements in place to prevent and detect fraud.

99. As detailed at paragraphs 85. to 89. , Internal audit's work identified that financial controls did not operate effectively between April and December 2023. Therefore, they concluded that no assurance could be provided on the effectiveness of the systems of control during 2023/24. In addition, multiple instances have been identified of expenditure that was not supported by appropriate receipts or other proof of purchase during the year, paragraphs 65. to 81. . We have therefore concluded that adequate arrangements were not in place to prevent and detect fraud during 2023/24. This is not a judgement on whether any fraudulent activity actually occurred.

4. Vision, leadership and governance

Public sector bodies must have a clear vision and strategy and set priorities for improvement within this vision and strategy. They work together with partners and communities to improve outcomes and foster a culture of innovation.

The Board and senior management team will need to work together, and with the Scottish Government sponsor division, to deliver the changes required to ensure the Commission operates to the high standards expected of a public body. The Commission is implementing an organisational change programme to address the issues reported in the Section 22 report on the 2022/23 audit, and deal with wider issues across the organisation.

Management has taken action to send a clear message that bullying and harassment will not be tolerated and any instances reported will be dealt with appropriately.

The Corporate Plan provides a clear vision and strategic direction for the Commission over the 2021-27 regulatory period, highlighting the important role the organisation has in regulating the domestic and retail water market in Scotland. However, management should review the KPIs used to measure and report performance against the plan.

Governance arrangements did not operate effectively during 2023/24 but improvements have been made in the level of reporting and scrutiny at the Board and Audit and Risk Committee since January 2024.

The Board and senior management team will need to work together, and with the Scottish Government sponsor division, to deliver the changes required to ensure the Commission operates to the high standards expected of a public body

100. Following the publication of the Section 22 Report, the former Chief Executive and Accountable Officer tendered his resignation with effect from 31 December 2023. From 1 January 2024, until the Director of Strategy and Governance was appointed interim Chief Executive and Accountable Officer on 20 March 2024, the Commission operated without a Chief Executive or Accountable Officer. The Director of Strategy and Governance remains in post as the interim Chief Executive and Accountable Officer and his substantive post has not been back filled. The Commission plan to commence the recruitment of a permanent Chief Executive early in 2025.

101. Donald MacRae resigned as Chair of the Board with effect from 21 October 2024. On 14 October 2024 the Cabinet Secretary for Net Zero and Energy wrote to the Public Audit Committee to advise that Ronnie Hinds had been appointed as interim Chair while a permanent Chair is recruited. In the letter she stated that: "*I have been clear with the interim Chair and the Board that they need to continue to work hard to deliver the changes required to reset the organisation so it delivers to the high standards I expect of a public body*" and also noted that: "*I welcome the opportunity this provides to continue to reset WICS in light of the unacceptable financial and governance issues that have arisen in the organisation.*"

102. The Board and senior management team will need to work together, and with the Scottish Government sponsor division, to deliver the changes required to ensure the Commission operates to the high standards expected of a public body.

The report from the independent review of governance at the Commission was published on 7 November 2024. This identified the need for cultural and structural changes at the Commission, and highlighted further historical instances of inappropriate use of public funds. We will consider management's response to this as part of our 2024/25 audit.

103. The Director General Net Zero informed the Public Audit Committee on 21 March 2024 that there would be an independent review of governance at the Commission. The Cabinet Secretary Net Zero and Energy subsequently confirmed that the review would also include consideration of the Commission's culture.

104. This review was undertaken by the Scottish Government's Internal Audit and Assurance team, with support from EY, and the resultant report was published on 7 November 2024. This noted that the Commission remains in a state of reset. It also noted that refreshing policies and procedures will not be sufficient to move the Commission forward and that resetting the 'tone from the top' and getting the basics right is critical. This includes ensuring the Commission has the appropriate structure, capability and capacity to deliver its statutory functions, and that roles and responsibilities are understood, and policies are complied with.

105. The report also highlighted that it is vital that the Commission fosters a culture where it is safe to challenge, staff views are heard, and issues of non-compliance are identified and acted upon. It also noted that there needs to be effective challenge and scrutiny in the right places and follow through of actions from the Board, Audit and Risk Committee and other governance structures. High quality information is also needed to support management and key governance groups in discharging their duties effectively. Alongside this, strong leadership and support from the Scottish Government sponsor function is necessary to ensure the Commission can re-build.

106. EY's review of historical financial transactions looked at expenditure prior to 2022/23, dating back to the 2017/18 financial year. This testing did not identify any risks or themes not already highlighted by previous reviews, but did highlight further instances of inappropriate use of public funds which demonstrated weaknesses in governance and control which pointed to the patterns of behaviour identified by previous reviews.

107. As the independent review was backward looking, we would expect the issues identified to be addressed by the workplan to tackle the financial management weaknesses reported in our 2022/23 Annual Audit Report (discussed at paragraphs 60. to 64.), the actions in response to internal audit's recommendations to strengthen the governance and financial control system (discussed at paragraphs 130. and 131.), or the organisational change programme to address the issues reported in the Section 22 report on the 2022/23 audit and deal with wider issues across the organisation (discussed at paragraphs 108. to 112.). However, we will consider management's response to the findings of this review, and any additional action required, as part of our 2024/25 audit.

The Commission is implementing an organisational change programme to address the issues reported in the Section 22 report on the 2022/23 audit, and deal with wider issues across the organisation

108. One of the first actions of the interim Chief Executive following his appointment was to undertake a review, with support from the Board, to identify the strategic and cultural change required within the organisation to establish the Commission as a more efficient and effective organisation, delivering its core duties and demonstrating value for money. This included consideration of how the Commission could improve service delivery, and ensure that its activities align with the expectations of public sector efficiency and accountability.

109. Following the completion of the review the Board approved an organisational change programme at its June 2024 meeting, while acknowledging that this was part of a broader reform journey, paving the way for wider organisational change within the Commission.

110. The organisational change programme is intended to address the issues reported in the Section 22 report on the 2022/23 audit, alongside wider issues across the Commission, including a lack of clear lines of responsibility and accountability within the current organisational structure. The programme is centred on clarifying roles and responsibilities, aligning budgets effectively, and strengthening the Commission's risk and assurance functions, communication strategies, and hybrid working practices. It also reflects the need to strengthen key functional areas such as human resources, risk, assurance and communications. The activity in the programme includes 28 actions split across 9 key themes:

(1) Clarify roles within the Commission

(2) Establish directorate budget centres

(3) Revise hybrid working arrangements

(4) Strengthen risk and assurance functions

(5) Communication strategy

(6) Update financial policies and guidelines

(7) Revise Approval Panel terms of reference

(8) Revise the Governance Framework document

(9) Revise compliance reporting

111. The actions in the organisational change programme commenced in 2024/25 but are expected to continue into 2025/26. Managing and delivering the organisational change programme alongside the Commission's core regulatory activity is likely to place significant pressure on the interim Chief Executive and other key staff. The actions to deliver certain key themes will also need legal and HR input to ensure that the Commission is complying with legal requirements when implementing changes to the organisational structure and staff roles.

Recommendation 4

The Board should ensure that adequate resource is allocated to manage the delivery of the organisational change programme and realistic timescales are set for the delivery of each action. Professional advice and support should also be obtained at key stages in the programme to ensure that the Commission is complying with legal requirements when implementing changes to the organisational structure and staff roles.

112. We will monitor the progress made in implementing the organisational change programme and report on this in our 2024/25 Annual Audit Report.

The Commission is re-establishing a physical office presence and adopting a hybrid working model to foster better collaboration and cohesiveness within and between teams

113. Prior to the Covid-19 pandemic the Commission was based at offices at Moray House in Stirling, which it leased from Stirling Council. However, following the pandemic the former Chief Executive decided that the Commission did not need a physical office as all staff could work from home. The Commission therefore entered into an agreement to sub-lease Moray House to Zero Waste Scotland from 1 July 2021.

114. While the decision to vacate Moray House has saved the Commission around £0.2 million a year, management believe it had a detrimental impact on the organisation in terms of collaboration and cohesiveness within and between teams, and communication across the organisation.

115. A key theme of the organisational change programme is to revise hybrid working arrangements and an essential aspect of this is re-establishing a physical office presence. This will provide staff with greater opportunities for in-person interaction with colleagues while retaining the flexibility of remote work.

116. Management are currently exploring options for a physical office which includes the potential to use Moray House as Zero Waste Scotland has indicated that they may no longer require this office space beyond the end of 2024.

Management has taken action to send a clear message that bullying and harassment will not be tolerated and any instances reported will be dealt with appropriately

117. In February 2024 staff at the Commission were asked to complete a Health and Safety Executive (HSE) Stress Survey. This survey was designed by HSE to help organisations identify and manage work-related stress among employees and includes questions across six key areas: Demands, Control, Support, Relationships, Role and Change.

118. The results of the survey were reported in March 2024 and highlighted that:

- 32 per cent of respondents reported that they have experienced bullying in the workplace, and
- 37 per cent reported that they have experienced harassment in the workplace.

119. HSE are clear that management should take urgent action to address any occurrence of bullying or harassment and provide guidance on the steps to be followed:

- Send a statement of commitment from senior management emphasising that bullying and harassment will not be tolerated.
- Establish a formal system for reporting and tackling inappropriate behaviour - keep it simple and include staff (and their representatives) when developing it.
- Provide examples of the different types of behaviour that is unacceptable so that everyone is reminded of their responsibility to one another.

- Remind employees what they should do if they believe they are subject to bullying or harassment.
- Explain the types of support available to them, e.g. company intranet, Employee Assistance Programmes, other helplines or websites, members of staff they can talk to in confidence etc.
- Reassure employees that they will be dealt with fairly and confidentially if they come forward to report an incident of bullying or harassment.

120. To address these requirements management engaged AAB HR consultants to provide Bullying and Harassment training and a Diversity, Equality, and Inclusion workshop for staff in June 2024.

121. Management has advised that staff will be given the opportunity to complete the HSE Stress Survey again during 2025 to enable the Commission to assess the extent to which issues with bullying and harassment still exist within the organisation. In addition, the Commission also plans to conduct its own staff survey and pulse surveys to monitor the wellbeing of staff on an ongoing basis.

The Corporate Plan provides a clear vision and strategic direction for the Commission over the 2021-27 regulatory period, highlighting the important role the organisation has in regulating the domestic and retail water market in Scotland

122. The Commission's Corporate Plan 2021-27, published in December 2020, sets out its three strategic objectives for the current regulatory period which are each underpinned by three outcomes, as shown in Exhibit 8.

Exhibit 8

Commission's strategic objectives and outcomes for 2021-2027 control period

Source: Water Industry Commission for Scotland Corporate Plan 2021-27

123. The Corporate Plan provides a clear vision and strategic direction for the Commission over the 2021-27 regulatory period which largely reflects its regulatory role over the domestic and retail water market in Scotland, with the main focus currently being the Strategic Review of Charges ahead of the 2027-33 regulatory period. However, a key aspect of the Commission's activity in relation to *Strategic Objective 3: To become an international leader in the field of economic regulation* has been its international project work as part of the Hydro Nation initiative, which has included significant income generating projects in Romania and New Zealand.

124. The Commission's international work has been put on hold since January 2024, and we noted that a number of the instances of non-compliant expenditure during 2023/24, detailed in section 3 of this report, related to Hydro Nation business development activity relating to the Hydro Nation initiative. However, given that this remains one of the Commission's strategic objectives for the current control period, management should engage with the Scottish Government to discuss the expectations of activity in this area in the future. This would include the governance arrangements and financial policies that would require to be put in place to provide clarity on what is permissible activity and expenditure as part of this work, discussed at paragraphs 91. to 96. .

Management should review the KPIs used to measure and report performance against the Corporate Plan 2021-27

125. Within the Corporate Plan 2021-27, the Commission identified a suite of 11 Key Performance Indicators (KPIs) to be used in measuring performance against the 9 outcomes supporting the 3 Strategic Objectives, shown in Exhibit 8.

126. The Performance Analysis section of the Performance Report in the 2023/24 Annual Audit Report detailed the Commission's progress against these 9 outcomes for the 2021-27 regulatory period. This showed that progress had been made against each of the 9 outcomes but as there are no numeric performance measures it is difficult to ascertain whether the KPIs have or haven't been achieved for the year.

Recommendation 5

Management should review the KPIs used to measure performance against the Corporate Plan 2021-27 to ensure these provide a clear and objective framework to measure progress against the 9 outcomes identified to deliver the 3 strategic objectives.

Governance arrangements did not operate effectively during 2023/24 but improvements have been made in the level of reporting and scrutiny at the Board and Audit and Risk Committee since January 2024

127. The issues identified as part of our 2022/23 audit highlighted a lack of oversight and scrutiny by the Board, and the Audit and Risk Committee (ARC), of the wider activity of the Commission and the related expenditure. A key factor contributing to this was a lack of appropriate information being shared with the Board and the ARC by officers, and a lack of transparency over the operations of the Commission. This was also the case during 2023/24 up to the publication of the Section 22 report in December 2023.

128. During the 2023/24 audit we monitored the completeness and transparency of reporting to the Board and ARC, and the level of scrutiny and challenge of officers by non-executive members, since January 2024. As part of this work we also met separately with each of the Board members to get their views on the openness and transparency of reporting to the Board and ARC, and their other engagement with officers.

129. Based on our observation of Board and ARC meetings, review of the committee papers, and discussions with Board members we are satisfied that improvements have been made in the level of reporting and scrutiny at the Board and ARC since January 2024.

Management is implementing an action plan to address internal audit's recommendations to strengthen the governance and financial control system at the Commission

130. In response to the findings reported in the Auditor General's Section 22 Report on the 2022/23 audit, the Board asked its internal auditors, Grant Thornton, to undertake a detailed review of governance and financial management arrangements. This review included a review of expenditure for the full 2023/24 financial year to identify any instances of non-compliant expenditure, discussed at paragraphs 73. to 76. .

131. The report on internal audit's review was considered at the June meeting of the Audit and Risk Committee and included a range of recommendations to deliver a stronger governance and financial control system at the Commission. Management agreed an action plan to address these recommendations with all actions due to be implemented by the end of the 2024/25 financial year. We will assess the impact of these actions on the governance and financial management of the Commission as part of our 2024/25 audit.

The Commission has appointed Azets as its internal auditors for 2024-27

132. The 2023/24 financial year was the final year of Grant Thornton's appointment as the Commission's internal auditors and the organisation operated without internal auditors for the first half of the 2024/25 financial year.

133. A competitive procurement process to appoint new internal auditors was undertaken during Autumn 2024 with a deadline of 16 September 2024 set for the submission of bids. Seven bids were received and Azets were appointed as the Commission's new internal auditors for the period 2024-27 in October 2024, following an evaluation process undertaken by the interim Chief Executive, Chair of the Audit and Risk Committee and another board member.

5. Use of resources to improve outcomes

Public sector bodies need to make best use of their resources to meet stated outcomes and improvement objectives, through effective planning and working with strategic partners and communities.

Management has taken action to address the financial management and governance issues identified during 2022/23 and 2023/24. However, it is too early for us to conclude whether this will be successful in promoting a culture of Best Value across the organisation.

It is important to the Commission's regulatory role that it is able to engage external experts when required, but it must be able to demonstrate that these appointments are supported by a robust VFM assessment. Management should therefore identify which staff will be required to engage external consultants as part of their role, and ensure that they have adequate training and support to undertake a robust VFM assessment prior to appointments being made.

Management has taken action to address the financial management and governance issues identified during 2022/23 and 2023/24. However, it is too early for us to conclude whether this will be successful in promoting a culture of Best Value across the organisation.

134. Ministerial guidance to Accountable Officers for public bodies and the Scottish Public Finance Manual (SPFM) sets out the accountable officer's duty to ensure that arrangements are in place to secure best value. The guidance sets out the key characteristics of best value and states that compliance with the duty of best value requires public bodies to take a systematic approach to self-evaluation and continuous improvement.

135. The Auditor General for Scotland issued a Section 22 Report on the 2022/23 audit of the Water Industry Commission for Scotland in December 2023. This highlighted that: "*The financial management and governance issues found at the Commission fall far short of what is expected of a public body. Immediate action is required to address the issues and promote a culture of Best Value across the organisation.*"

136. As detailed in the Financial management and sustainability section of this report, similar financial management and governance issues have been identified during 2023/24. As detailed at paragraphs 60. to 64. , management completed a 21 point workplan during 2024 to address the financial management weaknesses reported in our 2022/23 Annual Audit Report. The

Commission is also implementing an organisational change programme to address the issues reported in the Section 22 report on the 2022/23 audit and deal with a range of other wider issues across the organisation, discussed at paragraphs 108. to 112. . However, it is too early for us to conclude whether these will be successful in promoting a culture of Best Value across the organisation.

It is important to the Commission's regulatory role that it is able to engage external experts when required, but it must be able to demonstrate that these appointments are supported by a robust VFM assessment

137. In addition to the non-compliant expenditure identified by our testing, detailed at paragraphs 77. to 79. , we also identified expenditure during the year which complied with the Commission's Financial Policies and Guidelines but which may not have represented the best value for money for the public purse. This included £5,848 spent on taxi journeys during 2023/24 which included 16 journeys costing over £100 and the purchase of home office working equipment which was reclaimed via staff expenses.

138. Our audit also identified significant expenditure on consultancy and legal advice during 2023/24. Given the nature of the Commission's regulatory role, and the size of the organisation, it is unavoidable that it will require to engage external experts as it is not practical for it to have, for example, its own legal team or to employ a specialist engineer on a permanent basis. Therefore, it is vital that staff across the organisation understand the importance of demonstrating value for money when engaging external experts and are confident in assessing the value for money of different options.

139. It is important to stress that demonstrating value for money does not mean that the Commission should always engage the cheapest option. However, it should be able to demonstrate that the option selected represents the best value option based on its assessment of financial and non-financial factors. Non-financial factors would include the Commission's assessment of whether the external expert can deliver the required work or advice to the quality standard and timescale required.

Recommendation 6

Management should identify which staff will be required to engage external consultants as part of their role, and ensure that they have adequate training and support to undertake a robust VFM assessment prior to appointments being made.

Appendix 1. Action plan

2023/24 recommendations

Issue/risk	Recommendation	Agreed management action/timing
1. Cash reserves balance The level of the cash reserves held at 31 March 2024 represented 146 per cent of the Commission's 2023/24 expenditure, and current liabilities at the year-end totalled only £0.441 million. **Risk:** Money is being held in the Commission's bank account that could be released back to Scottish Water and Licensed Providers.	The Commission should review what level of cash reserves needs to be retained to cover the Commission's future costs, so that any excess funds can be returned to Scottish Water and Licensed Providers. Paragraphs 53. to 56.	The Commission has committed to a financial sustainability review (scope agreed in organisational change programme) and an action on a cash reserves policy (action 8 in Board action tracker). Completing both of these actions will bring a conclusion to the position on cash reserves going forward. **Responsible officer:** Interim Chief Executive Officer **Agreed date:** 30 June 2025
2. Finance and support services capacity Finance and support services staff have faced an increased workload during 2024. **Risk:** The additional demands on finance and other support services staff may impact on their wellbeing or capacity to perform the other duties required of their role.	Management should view the Commission's capacity within finance, and other support services, to ensure it has sufficient staff resources to enforce and report on compliance with the revised Financial Policies, and Guidelines and to deal with the other additional resource pressures that the organisation is currently facing. Paragraphs 60. to 64.	The Commission has committed to reviewing roles within directorates as part of phase two of its role review (action 3 of the organisational change programme). This will include finance and other support services staff on a temporary and permanent basis. **Responsible officer:** Interim Chief Executive Officer **Agreed date:** 31 March 2025

Issue/risk	Recommendation	Agreed management action/timing
3. Need to embed financial management across the organisation Management took a range of actions to address the financial management weaknesses reported in our 2022/23 Annual Audit Report which included revising the Commission's expenses policy, reinstating an approval panel to scrutinise expenditure, and strengthened the internal reporting processes. It now needs to ensure that these are embedded across the organisation and staff are committed to adhering to the Commission's Finance Policies and Guidelines and the SPFM. **Risk:** Staff are still not fully aware of the requirements of the Commission's Finance Policies and Guidelines and the SPFM, and their role in ensuring that expenditure is incurred in compliance with these.	Management should continue to focus on embedding financial management, and a focus on value for money, across the organisation to ensure all staff are aware of the requirements of the Commission's Finance Policies and Guidelines and the SPFM, and their role in ensuring that expenditure is incurred in compliance with these. Paragraphs 60. to 64. , and paragraphs 83. and 84.	The Commission has committed to reviewing its training policy (action 33 of the organisational change programme). This will include mandatory training on a periodic basis for managers which finance policies will be an element of. The Commission has also committed to a staff training session on changes to policies and processes (action 49 of the organisational change programme). This training policy will be completed in 2024 with periodic training in 2025 and beyond. **Responsible officer:** Interim Chief Executive Officer **Agreed date:** 31 March 2025

Issue/risk	Recommendation	Agreed management action/timing
4. Delivery of organisational change programme Managing and delivering the organisational change programme alongside the Commission's core regulatory activity is likely to place significant pressure on the interim Chief Executive and other key staff. The actions to deliver certain key themes will also need legal and HR input to ensure that the Commission is complying with legal requirements when implementing changes to the organisational structure and staff roles. **Risk:** There is a risk that the Commission does not have sufficient resource or professional expertise to deliver the organisational change programme.	The Board should ensure that adequate resource is allocated to manage the delivery of the organisational change programme and realistic timescales are set for the delivery of each action. Professional advice and support should also be obtained at key stages in the programme to ensure that the Commission is complying with legal requirements when implementing changes to the organisational structure and staff roles. Paragraphs 108. to 111.	The Commission acknowledges this risk. Management has an action plan in place (organisational change programme) and are working through the actions. The Board and management team are also in the process of establishing a sub-committee to focus on these initiatives and to ensure timescales are achievable and resources / expertise is in place to deliver this change programme. **Responsible officer:** Interim Chief Executive Officer **Agreed date:** 31 December 2024 to establish sub-committee
5. Performance reporting The KPIs used for reporting performance against the Corporate Plan do not include any numeric performance measures. **Risk:** Performance against the 9 outcomes for the 2021-2027 regulatory period is not clearly reported.	Management should review the KPIs used to measure performance against the Corporate Plan 2021-27 to ensure these provide a clear and objective framework to measure progress against the 9 outcomes identified to deliver the 3 strategic objectives. Paragraphs 125. and 126.	The Commission has committed to a review of the Corporate Plan (action 2 of the organisational change programme). **Responsible officer:** Interim Chief Executive **Agreed date:** 30 June 2025

Issue/risk	Recommendation	Agreed management action/timing
6. Demonstrating value for money in the use of consultants It is important to the Commission's regulatory role that it is able to engage external experts when required, but it must be able to demonstrate that these appointments are supported by a robust VFM assessment. **Risk:** There is a risk that the Commission can not demonstrate the value for money of expenditure on consultants and legal advice.	Management should identify which staff will be required to engage external consultants as part of their role, and ensure that they have adequate training and support to undertake a robust VFM assessment prior to appointments being made. Paragraphs 137. to 139.	The Commission has committed to including budget responsibilities into roles. This action will include making clear who is responsible for requesting and managing the use of consultants (action 32 of the organisational change programme). We have also committed to an action to review the use of hiring staff versus procuring consultants to support any VFM assessment (action 35 of organisational change programme). **Responsible officer:** Interim Chief Executive **Agreed date:** 30 September 2025

Follow-up of prior year recommendations

Issue/risk	Recommendation and Agreed Action	Progress
PY1. Dilapidation provision for Moray House The provision calculation is based on the dilapidation costs that the Commission had to pay when it vacated a former office in April 2011. **Risk:** The value of the provision does not represent a reliable estimate of the dilapidation charge that the Commission will incur at the end of the current lease agreement.	Management should engage with the Estates Team from Stirling Council during 2023/24 to obtain a realistic estimate of what dilapidation payment they anticipate will be sought when the Commission vacate Moray House at the end of the lease in March 2026. **Responsible officer:** Director of Corporate and International Affairs **Agreed date:** December 2023	**Complete** Management have engaged with a property management company to obtain a more accurate estimate of the dilapidation costs expected at the end of the lease term. This has been correctly reflected in the dilapidation provision in the accounts.
PY2. Scottish Government approval of expenditure Our audit identified two items of expenditure incurred during 2022/23 that required Scottish Government approval which had not been obtained. **Risk:** The Commission incurs expenditure that is not in accordance with applicable enactments and guidance issued by Scottish Ministers.	Management should ensure that all expenditure incurred is in accordance with the requirements of the Commission's Finance Policies and Guidelines, and the rules and guidance set out in the Scottish Public Finance Manual (SPFM). Where there is any dubiety as to whether this is the case, approval should be sought from the sponsor division prior to the expenditure being incurred. **Responsible officer:** Chief Executive **Agreed date:** Immediate	**Complete** Three items of expenditure totalling £43,604 which did not meet the requirements of the Scottish Public Finance Manual on delegated authority limits were identified during 2023/24. Paragraphs 67. to 72. These items all occurred during the first 9 months of 2023/24, prior to the issue of our Annual Audit Report in December 2023. Since then, management has concluded its workplan to address the financial management weaknesses reported in our 2022/23 Annual Audit Report. We will monitor the impact of these actions during 2024/25 and make further recommendations for improvement as required.

Issue/risk	Recommendation and Agreed Action	Progress
PY3. Expense claim issues We identified widespread issues with staff submitting expense claims that significantly exceed the approved subsistence rates and were not supported by itemised receipts. **Risk:** The Commission incurs expenditure that is not in accordance with applicable enactments and guidance issued by Scottish Ministers.	Management should ensure that all expense claims are supported by itemised receipts and staff are only reimbursed at the approved subsistence rates set out in the Commission's Finance Policies and Guidelines. **Responsible officer:** Director of Strategy and Governance **Agreed date:** Training to be completed by 30 January 2024.	**Complete** £7,454 of staff expenses for which no itemised receipts or other proof of purchase were provided were identified during 2023/24. Paragraphs 65. to 81. These items all occurred during the first 9 months of 2023/24, prior to the issue of our Annual Audit Report in December 2023. Since then, management has concluded its workplan to address the financial management weaknesses reported in our 2022/23 Annual Audit Report. We will monitor the impact of these actions during 2024/25 and make further recommendations for improvement as required.
PY4. Identification of taxable benefits to staff The Commission identified an obligation of £8,818 in respect of the UK tax and national insurance contributions due on previous payments, dating back as far as 2018/19, that should have been treated as taxable benefits. **Risk:** The Commission incurs additional costs that should be met by the individual employees receiving the taxable benefit.	Management should ensure that adequate arrangements are in place to attribute taxable benefits to relevant staff so that they incur the related income tax and national insurance contributions. **Responsible officer:** Chief Executive **Agreed date:** 30 January 2024 for the advice and March 2024 for its implementation.	**Ongoing** £840 for benefits in kind paid to staff that had not been treated as taxable benefits were identified during 2023/24. Paragraphs 65. and 66. These items all occurred during the first 9 months of 2023/24, prior to the issue of our Annual Audit Report in December 2023. Since then, management has concluded its workplan to address the financial management weaknesses reported in our 2022/23 Annual Audit Report. We will monitor the impact of these actions during 2024/25 and make further recommendations for improvement as required.

Issue/risk	Recommendation and Agreed Action	Progress
PY5. Sub-lease agreement The current sub-lease agreement with Zero Waste Scotland does not include any requirement for it to contribute to dilapidations costs at the end of the Commission's lease with Stirling Council. **Risk:** The Commission will be unable to obtain a payment from Zero Waste Scotland towards the dilapidation charge from Stirling Council.	Management should ensure that any future sub-lease agreement with Zero Waste Scotland accurately reflects the obligations and liabilities of both parties for Moray House. **Responsible officer:** Chief Executive **Agreed date:** Contract renewal September 2024.	**Complete** Management advised that there is no opportunity for the Commission to renegotiate the terms of the sub-lease agreement with Zero Waste Scotland.

Water Industry Commission for Scotland

2023/24 Annual Audit Report

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