

Scottish Rail Holdings Limited

2022/23 Annual Audit Report



 AUDIT SCOTLAND

Prepared for Scottish Rail Holdings Limited and the Auditor General for Scotland

15 December 2023

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Key messages

2022/23 annual report and accounts

- 1 Audit opinions on the annual report and accounts are unmodified.
- 2 Finance staff worked well with the audit team to ensure the layout and contents of the organisation's first Annual Report and Accounts complied with the requirements of the 2022/23 FReM and the Accounts Direction issued by Scottish Ministers.

Financial management and sustainability

- 3 Scottish Rail Holdings Limited (SRH) has appropriate budget monitoring and reporting arrangements.
- 4 The majority of SRH expenditure was on payments to SRT for the delivery of ScotRail train services: £699 million of SRH's total expenditure of £701 million. SRH reported an underspend of £21 million against its resource budget allocation, substantially due to savings in demand led activities and the positive net impact of contractual Network Rail compensation paid during industrial action.
- 5 Management is still to determine what internal audit coverage is required for the SRH single entity functions.
- 6 Medium-term / long-term financial planning has not yet been developed.

Vision, leadership, governance and use of resources

- 7 SRH and Transport Scotland oversaw the successful mobilisation of the public sector operators of the ScotRail train services and Caledonian Sleeper service.
- 8 Greater clarity is needed over the role of SRH in setting strategic policy for Scotland's rail services. This requires all parties to work together to progress this as a matter of priority.
- 9 SRH is still to fully develop its oversight arrangements of SRT and CSL and it continues to develop its governance arrangements.
- 10 SRH has still to develop a Best Value framework.

Introduction

1. This report summarises the findings from the 2022/23 annual audit of Scottish Rail Holdings Limited (SRH) 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 May meeting of the Audit and Risk Committee. This annual audit report comprises significant matters arising from the audit of the Scottish Rail Holdings Limited annual report and accounts and conclusions on the wider scope areas, as set out in the [Code of Audit Practice 2021](#).
3. We would like to thank directors and staff, particularly those in finance, for their cooperation and assistance and we look forward to continuing to work together constructively over the course of the five-year appointment.

Responsibilities and reporting

4. SRH 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. SRH 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 and the [Code of Audit Practice 2021](#) and supplementary guidance and International Standards on Auditing in the UK.
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 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 and that we have not undertaken any non-audit related services. We are not aware of any relationships that could compromise our objectivity or our independence.

1. 2022/23 annual report and accounts

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

Audit opinions on the annual report and accounts are unmodified.

Finance staff worked well with the audit team to ensure the layout and contents of the organisation's first Annual Report and Accounts complied with the requirements of the 2022/23 FReM and the Accounts Direction issued by Scottish Ministers.

Audit opinions on the annual report and accounts are unmodified

8. The Board approved the annual report and accounts for SRH and its group for the 17-month period from 1 November 2021 to 31 March 2023, on 14 December 2023. The independent auditor's report included the following 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
- expenditure and income were in accordance with applicable enactments and guidance
- 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.

The 2022/23 annual report and accounts were certified on 15 December 2023

9. We received the unaudited single entity annual report and accounts and working papers on 10 October 2023, and the consolidated group statements and working papers on 2 November 2023.

10. A number of revisions were required to the layout and contents of the annual report and accounts presented for audit to ensure they complied with the requirements of the 2022/23 FReM. However, as this was the first set of annual accounts produced by SRH, it was anticipated that these types of revisions would be required, and finance staff worked well with the audit team to agree

these presentational and disclosure changes. This helped ensure that the final accounts audit was completed in time for the 2022/23 annual report and accounts to be certified on 15 December 2023, and laid at the Scottish Parliament prior to the 31 December deadline.

Our audit approach and testing was informed by the overall materiality level of £19.5 million

11. 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.

12. Our initial assessment of materiality was carried out during the planning phase of the audit and was based on the projected group and single entity expenditure for the year ended 31 March 2023. These materiality levels were reported in our annual audit plan to the May 2023 meeting of the Audit and Risk Committee.

13. On receipt of the unaudited 2022/23 annual report and accounts we reconsidered our materiality levels based on the actual financial results for the year ended 31 March 2023, and decided to amend our materiality levels to reflect the lower than projected group expenditure, and higher than projected single entity expenditure. The revised materiality levels are detailed in [Exhibit 1](#).

Exhibit 1 Materiality levels for the 2022/23 audit

Materiality level	Amount
SRH group materiality levels	
Overall materiality	£19.5 million
Performance materiality	£10.7 million
Reporting threshold	£0.25 million
SRH single entity materiality levels	
Overall materiality	£35,000
Performance materiality	£26,000
Reporting threshold	£5,000

14. Performance materiality is used by auditors when undertaking work on individual areas of the financial statements. It is a lower materiality threshold, set to reduce the probability of aggregated misstatements exceeding overall materiality. Performance materiality was set at 55 per cent of overall materiality, reflecting that this was the first set of accounts prepared by SRH, the extent of estimation in the accounts, and the planned testing in proportion to the scale of the organisation.

Our audit identified and addressed the risks of material misstatement

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

Exhibit 2

Significant and non-significant risks of material misstatement

Nature of risk	Audit response	Conclusion
Significant risks of material misstatement		
<p>1. First time production of Scottish Rail Holdings Limited annual report and accounts</p> <p>Scottish Rail Holdings Limited (SRH) was established on 1 November 2021 to oversee the operation of ScotRail services by its subsidiary: ScotRail Trains Limited (SRT).</p> <p>SRH has been established with the expectation that the Office for National Statistics (ONS) will confirm its status as a Non-Departmental Public Body (NDPB), and we expect the Accounts Direction will reflect this classification. This will determine the accounting framework to be applied to SRH.</p> <p>As an NDPB, SRH will be required to produce accounts in accordance with the Government Financial Reporting Manual: 2022-23 (FReM) for the period ended 31 March 2023</p>	<ul style="list-style-type: none"> Review of ONS classification and Accounts Directions. Reviewed accounts presented for audit against the requirements of the 2022/23 FReM to identify any material areas of non-compliance. Confirmed that Performance Report, Governance Statement, and audited part of the Remuneration and Staff Report, have been compiled in accordance with the appropriate regulations and frameworks, and are consistent with the financial statements. 	<ul style="list-style-type: none"> The ONS classification of SRH as a non-departmental public body was confirmed during 2022/23, and the SRH Accounts Direction was issued on 31 August 2023. Both were reviewed to understand the applicable accounting framework and reporting requirements for the 2022/23 Annual Report and Accounts. The ONS classification of SRT as a non-departmental public body was also confirmed during 2022/23. However, there was no retrospective change to the SRT Accounts Direction for the period ended 31 March 2023, and therefore it required to produce accounts in accordance with FRS101. The Performance Report, Governance Statement and Remuneration and Staff

Nature of risk	Audit response	Conclusion
<p>and follow the “NDPB Green illustrative statements”.</p> <p>This will include group statements that consolidate the financial results of SRT. SRT intends to produce 2022/23 accounts which will be prepared in accordance with the requirements of FRS101 – Reduced Disclosure Framework.</p> <p>The classification of SRT has not yet been confirmed by ONS but, we understand the Accounts Direction will confirm that FRS101 is the appropriate framework for 2022/23.</p> <p>SRH will need to make a number of consolidation adjustments to the SRT FRS101 disclosures to present the SRH group statements in compliance with the 2022/23 FReM requirements.</p> <p>There is a risk that the information required to prepare FReM compliant accounts may be incomplete, unavailable or require additional processes to ensure FReM compliance.</p> <p>There is also a risk that the ONS classification will change for SRT, based on the assessment of dependence on government funding.</p>	<ul style="list-style-type: none"> • Considered expected key accounting adjustments on consolidation including government income, IFRS 16 leasing, pensions, and treatment of grants. • Reviewed key judgements by management and their disclosure in the accounts. 	<p>Report presented for audit were generally in accordance with the appropriate regulations and frameworks, and consistent with the financial statements, but we identified some revisions to ensure full compliance and improve the quality and clarity of the disclosures.</p> <ul style="list-style-type: none"> • The consolidation adjustments were complete and included adjustments to recognise grant income deferred by SRT that the FReM required SRH to recognise fully in the year of receipt, and adjustments to remove intercompany transactions between SRH and SRT. • Key judgements on the applicable grant agreement term, grant agreement term accounting exemption and IFRS 16 accounting, were appropriately disclosed and reflected in the accounting treatment in the financial statements.
<p>2. Application of grant agreement term accounting exemption</p> <p>A key judgement for the preparation of SRH’s 2022/23 financial statements is whether SRT as the train operating company and SRH as the rail holding company, are permitted to limit their recognition of certain assets and liabilities to the grant agreement term. This issue is particularly relevant to the valuation of the IAS19 pension liability / asset</p>	<ul style="list-style-type: none"> • Reviewed SRH management’s assessment of this key judgement and estimate over the use of a rail grant agreement exemption and the length of time that the agreement is expected to operate. • Discussed this issue with the external 	<p>We accept that:</p> <ul style="list-style-type: none"> • The Final Expiry Date of 31 March 2032 is adopted as the grant agreement term for the SRT 2022/23 accounts, after consultation with the auditors of SRT. • A grant agreement term accounting exemption could be applied by SRT to limit its recognition of assets and liabilities (including IAS19 pension liabilities and

Nature of risk	Audit response	Conclusion
<p>and the liability for leased rolling stock.</p> <p>There are a number of factors here, that might be considered relevant:</p> <ul style="list-style-type: none"> the extent to which SRH exists as only a holding company and is an organisation aligned with the franchise operator appointment period of SRT, the existing practices in DfT OLR Holdings Limited and any differences or similarity with SRH. <p>If a grant agreement term accounting exemption can be applied then SRT and SRH will also need to make a further judgement as to the appropriate period to use as the grant agreement term.</p> <p>These issues also highlight the need for a wider review of the accounting for the IAS19 and rolling stock liabilities within Scotland. With franchise operations now being delivered by the public sector, it seems appropriate that these long-term liabilities are recognised for the first time within the Scottish public sector accounts of either SRH, Transport Scotland or the Scottish Government.</p>	<p>auditors of Transport Scotland and SRT.</p> <ul style="list-style-type: none"> Consulted our technical services team on the appropriate accounting treatment. Reviewed and tested the accuracy and completeness of any disclosures and amounts in the accounts. 	<p>IFRS16 leases assets and liabilities) to the grant agreement term.</p> <ul style="list-style-type: none"> SRH reflects the same grant agreement term as SRT and should also apply a similar grant agreement term accounting exemption to limit its recognition of assets and liabilities. <p>The 'Critical accounting judgement' is disclosed in <i>Note 1. Statement of Accounting Policies</i> in the SRH 2022/23 Annual Report and Accounts.</p>
<p>3. Risk of material misstatement due to fraud caused by management override of controls</p> <p>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. As a result, we are required to design audit procedures to specifically address this risk for all of our financial statements audits.</p>	<ul style="list-style-type: none"> Detailed testing of SRH consolidation adjustments, transactions and journals. Review of significant accounting estimates. Focussed testing of accruals and prepayments. 	<ul style="list-style-type: none"> The consolidation adjustments were complete and included adjustments to recognise grant income deferred by SRT that the FReM required SRH to recognise fully in the year of receipt, and adjustments to remove intercompany transactions between SRH and SRT. The main accounting estimates related to SRT

Nature of risk	Audit response	Conclusion
	<ul style="list-style-type: none"> • Evaluation of significant transactions outside the normal course of business. • Group auditor assurances obtained from PwC, based on the outcome of the audit procedures designed to address the risk of management override of controls for the SRT external audit. 	<p>balances. We consulted with the auditors of SRT on the appropriateness of these and obtained sufficient assurances over them.</p> <ul style="list-style-type: none"> • Our testing of accruals and prepayments identified two issues (detailed in Exhibit 3). We concluded that these were isolated errors that had been identified in their entirety and did not indicate further systemic error. • Our audit did not identify any significant transactions outside the normal course of business. • Group auditor assurances received from PwC confirmed that they were satisfied that there was no material misstatement arising from this risk for the SRT audit. <p>Based on the results of the audit procedures undertaken, we are satisfied that there is no material misstatement arising from this risk.</p>
<p>4. Introduction of IFRS 16 – lease accounting</p> <p>International Financial Reporting Standard 16 - Leases is effective for accounting periods starting from 1 April 2022.</p> <p>Under IFRS 16, lessees are required to recognise assets and liabilities for leases with a term of more than 12 months, unless the underlying asset is of low value.</p> <p>As noted above, there is a key judgement to be made on the use of any grant agreement term</p>	<ul style="list-style-type: none"> • Examined and tested any consolidation adjustments by SRH. • Obtained assurances from the external auditor of SRT. • Reviewed list of leases to assess for completeness. 	<p>As IFRS16 was fully adopted by SRT for the year ended 31 March 2023, the accounts of the subsidiary were largely aligned with the accounting policy of SRH and there were a limited number of IFRS16 consolidation adjustments required in SRH's 2022/23 Annual Report and Accounts.</p> <p>PwC provided component auditor assurances in respect of SRT's IFRS 16 accounting arrangements.</p>

Nature of risk	Audit response	Conclusion
<p>accounting exemption for SRT and SRH and consideration of whether the full IFRS 16 liability / asset will be accounted for in Scottish public sector accounts.</p> <p>There is a risk that SRH's group statements do not accurately reflect the impact of the new IFRS 16 accounting arrangements.</p>		<p>Our review of the list of SRT leases did not identify any material omissions. However, officers identified that a consolidation adjustment to recognise right of use assets for three peppercorn leases held by SRT had been omitted in error – see issue 3 in Exhibit 3 for details.</p>
<p>5. Significant risks of material misstatement in component bodies</p> <p>PwC, as the appointed external auditors of SRT, has identified the following significant risks of material misstatement for SRT's 2022/23 financial statements:</p> <ul style="list-style-type: none"> • Management override of controls • Revenue recognition • Pension assumptions • Service agreement length assumption • Going concern <p>As SRT is the major component of the SRH group these also represent significant risks of material misstatement for the SRH 2022/23 group financial statements.</p>	<ul style="list-style-type: none"> • Group auditor assurances obtained from PwC in accordance with the requirements of International Standard on Auditing (UK) 600 - Special considerations: audits of group financial statements (including the work of component auditors). 	<p>PwC provided component auditor assurances in respect of the significant risks of material misstatement for SRT's 2022/23 financial statements.</p>
Other non-significant risks of material misstatement		
<p>6. Estimation in the valuation of pension assets and liabilities</p> <p>Actuarial estimates are a complex combination of liabilities over significant future periods based on life expectancy, CPI growth and discounting (based on corporate bond rates).</p> <p>As noted above, there is a key judgement to be made on the use of any grant agreement term</p>	<ul style="list-style-type: none"> • Reviewed SRH management's assessment of this key judgement and estimate over the use of a rail franchise exemption and the length of time that the franchise is expected to operate. • Obtained assurances from 	<p>As detailed at point 2 above, we accepted that:</p> <ul style="list-style-type: none"> • SRT limited its recognition of assets and liabilities (including IAS19 pension liabilities) to the grant agreement term. • SRH reflected the same grant agreement term as SRT to limit its recognition of assets and liabilities.

Nature of risk	Audit response	Conclusion
<p>accounting exemption for SRT and SRH and consideration of whether the full IAS19 liability / asset will be accounted for in Scottish public sector accounts. This might require a separate IAS 19 actuarial report.</p> <p>It is also possible that any valuation might result in a net pensions asset and further consideration may need to be given to obtaining an actuary's report on the extent that any pensions assets should be limited by IFRIC 14.</p>	<p>PWC, as the appointed external auditors of SRT.</p>	<p>In line with the above, <i>Note 14. Retirement benefit obligations</i> in the SRH Annual Report and Accounts identifies an 'operator adjustment' to reduce the defined benefit obligation at 31 March 2023 to zero, which accurately reflects that a pension liability is not attributable to SRH or its group. This is consistent with the IAS19 accounting treatment adopted by SRT in its 2022/23 annual accounts and reflects the fact that any liability arising from the pension scheme would fall on Transport Scotland rather than SRT or SRH.</p>

We reported significant findings from the audit 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 board's accounting practices.

17. The significant findings are summarised in [Exhibit 3](#) on page [13](#). Our audit also identified other presentation and disclosure issues which were discussed with management. These were all adjusted in the audited annual report and accounts and none were significant enough to require to be separately reported under ISA 260.

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

Issue	Resolution
<p>1. SRT funding prepayment</p> <p>Transport Scotland pay over SRT's 4-weekly funding to SRH in advance so that SRH can pass it to SRT on the day before each new 4-weekly period commences.</p> <p>The 2022/23 financial statements presented for audit included both the £51.7 million funding received from Transport Scotland in March 2023, and the corresponding payment made to SRT on 31 March 2023, for period 1 of 2023/24.</p> <p>However, both of these payments at the end of the year relate to services that will be delivered as part of 2023/24 and should both have been treated as pre-payments (income and expenditure) in the 2022/23 accounts.</p>	<p>Management has corrected this misstatement in the audited financial statements. This resulted in:</p> <ul style="list-style-type: none"> • A receivables balance (for the prepayment of funding to SRT) of £51.7 million being recognised for SRH in the <i>Group and Company Statements of Financial Position</i>. • A payables balance (for the prepayment of funding from Transport Scotland) of £51.7 million being recognised for SRH in the <i>Group and Company Statements of Financial Position</i>. <p>As this adjustment resulted in the 'Trade and Other Receivables' and 'Trade and Other Payables' balances both increasing by £51.7 million, it had a nil impact upon the 'Total assets less total liabilities' figure for SRH in the <i>Group and Company Statements of Financial Position</i>.</p>
<p>2. Grant-in-aid accrual</p> <p>The 2022/23 financial statements presented for audit included accruals totalling £0.3 million for SRH and £6.4 million for the Group, for grant-in-aid funding due in respect of services delivered during 2022/23 but that were not paid for until after 31 March 2023, when the cash funding was drawn down. As grant-in-aid funding for the year requires to be shown in the <i>Group and Company Statements of Changes in Taxpayers' Equity</i> on a cash basis, it cannot be accrued for. Therefore, an adjustment was required to correct this.</p> <p>The funding shown in the <i>Group and Company Statements of Changes in Taxpayers' Equity</i> in the unaudited financial statements also included the Group's non-cash grant-in-aid funding figure of £4.1 million which should not be included.</p>	<p>Management has corrected this misstatement in the audited financial statements. This resulted in the 'Grant-in-aid from Scottish Government' shown in the <i>Group and Company Statements of Changes in Taxpayers' Equity</i> reducing by £0.3 million for SRH and £6.4 million for the Group, and the receivables balances in the <i>Group and Company Statements of Financial Position</i> reducing by the same values.</p> <p>The <i>Group and Company Statements of Changes in Taxpayers' Equity</i> was also updated to remove the £4.1 million shown for the Group for non-cash funding, so that the funding figure shown reflected the actual cash draw down by SRH and its Group between 1 November 2021 and 31 March 2023.</p>

3. Peppercorn leases right-of-use assets

Peppercorn leases are leases where the lease payments are of nil or nominal value.

SRT held three such leases during 2022/23: for offices within Edinburgh Waverley Station and Glasgow Central Station, and for Class 153 rolling stock. These leases were excluded from SRT's accounts on the grounds of materiality, and no right of use assets were recognised, in line with the FRS101 interpretation of IFRS 16 – Leases.

The FReM interpretation of IFRS 16 for the public sector sets out different recognition criteria for right of use assets under peppercorn leases. This requires right of use assets for peppercorn leases to be valued at either current value in existing use or fair value. Therefore, a consolidation adjustment should have been made in the SRH group statements to recognise the value of the right of use assets for the three assets leased by SRT through peppercorn leases.

Management identified very late in the audit process that this adjustment had not been made in the financial statements. The value of these three right of use assets at 31 March 2023 would be £1.6 million (£2.1 million for the value of assets initially recognised less £0.5 million for accumulated depreciation on these assets).

This remains as an unadjusted error in the audited financial statements.

Had an adjustment been made for this error it would have increased the SRH Group 'Right of use assets' in the *Group and Company Statements of Financial Position* by £1.6 million, and also increased the SRH Group 'Taxpayers Equity' in the *Group and Company Statements of Changes in Taxpayers' Equity* by the same value.

The financial statements include one unadjusted misstatement of £1.6 million

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. Three misstatements were identified during the audit which exceeded our reporting threshold. Two of these were corrected in the audited accounts (issues 1 and 2 in [Exhibit 3](#)) and one is reported as an unadjusted error of £1.6 million (issue 3 in [Exhibit 3](#)). We reviewed the nature and causes of these misstatements and considered whether further audit procedures were required in response. We concluded that these were isolated errors that had been identified in their entirety and did not indicate further systemic error.

2. 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 is being able to meet the needs of the present without compromising the ability of future generations to meet their own needs.

SRH has appropriate budget monitoring and reporting arrangements.

£699 million of SRH's 2022/23 expenditure of £701 million was on payments to SRT for the delivery of ScotRail train services.

SRH reported an underspend of £21 million against its resource budget allocation, substantially due to savings in demand led activities and the positive net impact of contractual Network Rail compensation paid during industrial action.

Management is still to determine what internal audit coverage is required for the SRH single entity functions.

Medium-term / long-term financial planning has not yet been developed.

SRH had appropriate budget monitoring and reporting arrangements in place during 2022/23

20. SRH's finance team produced regular budget monitoring packs during 2022/23 that detailed the single entity and group position for the year to date, and the projected year-end outturn. These reports were considered by the Senior Management Team during 2022/23 to enable them to respond to any emerging issues and take corrective action. A summary of this information was also included within the Finance Update papers to each meeting of the SRH Board. This also included an update on any budget discussions or financial management and governance issues.

£699 million of SRH's 2022/23 expenditure of £701 million was on payments to SRT for the delivery of ScotRail train services

21. SRH is the vehicle through which the Scottish Government, via Transport Scotland, provides funding for Scottish rail passenger operations. During 2022/23 this covered only the funding of ScotRail train services provided by SRT, but from 2023/24 will also include the funding of the Caledonian Sleeper

train services provided by Caledonian Sleeper Limited (CSL). Sleeper train services were brought into public ownership on 25 June 2023.

22. During 2022/23, SRH drew down grant-in-aid funding from the Scottish Government of £700.9 million, with £691.9 million (99 per cent) paid across to SRT to fund the costs of delivering ScotRail train services during the year. A further £7.5 million was paid to SRT, as an intercompany loan, to provide them with a working capital balance for cash management purposes.

23. The remaining £1.5 million was used to fund SRH's costs for 2022/23, with £1.4 million used for staff costs. SRH's staff costs will increase in 2023/24 as the majority of current staff did not take up their posts until part way through 2022/23, and additional staff capacity will be required to support its role in overseeing the Caledonian Sleeper train services.

SRH reported an underspend of £21 million against its resource budget allocation, substantially due to savings in demand led activities and the positive net impact of contractual Network Rail compensation paid during industrial action

24. As explained at paragraphs [21.](#) to [23.](#), almost all of SRH's 2022/23 expenditure consisted of payments to SRT for the delivery of ScotRail train services. [Exhibit 4](#) shows how this expenditure was split across the body's Scottish Government budget allocations, and the final outturn against the non-cash and annually managed expenditure budget allocations for the year.

25. As can be seen from [Exhibit 4](#), SRH reported an underspend for the year of £72.5 million against its Scottish Government budget allocation, prior to HMT adjustments, which included a £21 million underspend against its RDEL budget and an overspend of £1.3 million against its CDEL budget. The positive resource outturn position reported is substantially due to savings in demand led activities and the positive net impact of contractual Network Rail compensation paid during industrial action, which reduced the level of SRH funding that was required for the delivery of ScotRail train services.

Exhibit 4**Performance against Scottish Government budget allocations in 2022/23**

Scottish Government budget allocation category	Budget allocation £m	Outturn £m	Over/(under) spend £m
Resource departmental expenditure limit (RDEL)	398.5	377.1	(21.4)
Capital departmental expenditure limit (CDEL)	328.9	330.2	1.3
Non-cash limit	1.5	2.6	1.1
Annually managed expenditure *	56.9	3.4	(53.5)
Outturn prior to HMT adjustments	785.8	713.3	(72.5)
His Majesty's Treasury adjustments **	722.8	599.3	(123.4)
Outturn after HMT adjustments	1,508.6	1,312.6	(195.9)

* The annually managed expenditure budget allocation related entirely to the expected impact of IAS19 pension accounting. The large underspend against this budget reflects the application of a grant agreement term accounting exemption by SRT and SRH to limit the recognition of assets and liabilities (including IAS19 pension liabilities) to those arising over, relating to, the period of the current Scotrail Grant agreement, as explained at point 6 in [Exhibit 2](#).

** HMT adjustments totalling £599.3 million were required during 2022/23 for IFRS16 lease accounting adjustments. The underspend reported against this budget reflects the actual accounting impact of the implementation of IFRS16 on the SRH group being £123.4 million less than estimated.

Source: Scottish Rail Holdings Limited 2022/23 Annual Report and Accounts

Management is taking action to strengthen the controls to check the operation of the automatic bank feeder

26. As noted in the Statement of Accountable Officer's Responsibility, the Accountable Officer is responsible for putting in place the internal controls they determine are necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

27. As we adopted a fully substantive approach for the SRH 2022/23 audit, we did not require to undertake any testing of the systems of internal control to confirm that the controls were operating as expected. However, as part of the accounts preparation process management identified that there had been a

failure of the automatic bank feeder during period five, which had not been identified at the time.

28. This resulted in a funding payment made to SRT being omitted from the SRH ledger and a year-end journal was required to correct this. As part of our financial statements audit we reviewed the significant transactions through SRH's bank account and confirmed that no other material payments or receipts had been omitted from the SRH ledger. SRH management is taking action to strengthen the controls to ensure that any failure of the automatic bank feeder is detected earlier.

Management is still to determine what internal audit coverage is required for the SRH single entity functions

29. Management is still considering what internal audit coverage is required to cover SRH single-entity functions. Given that almost all of the single-entity expenditure relates to payments to SRT for the delivery of ScotRail train services, the majority of the financial control risks are borne by SRT. However, the financial controls over SRH staff costs expenditure or budgeting monitoring and reporting arrangements, or the wider governance arrangements, including the operation of performance monitoring of SRT delivery, may be areas where internal audit input could be beneficial.

30. SRT's internal audit function is delivered by its in-house internal audit team and the findings from their work is reported by the Audit, Risk and Compliance Manager to the SRT Audit and Risk Committee.

Recommendation 1

Management should determine what internal audit coverage and assurance is required for SRH single-entity functions, based on the review and development of SRH responsibilities.

Standards of conduct and arrangements for the prevention and detection of fraud and error are appropriate

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

32. SRH's [Code of Governance \(December 2021\)](#) includes the body's code of conduct. This is based around the requirements of the Ethical Standards in Public Life (Scotland) Act 2000 and sets out guidance on expected conduct at meetings and principles to be followed. It also details requirements for registering interests and avoiding conflicts of interest.

33. SRH also has a separate fraud strategy which is based around the requirements set out within the Scottish Public Finance Manual and is aligned with the Transport Scotland fraud strategy. The document also sets out that

Transport Scotland's Audit and Risk Committee has a general responsibility for monitoring the operation and effectiveness of anti-fraud arrangements and the committee require regular reports on fraud activity from SRH. Management advised that any fraud risks identified would be reported to the Transport Scotland ARC and would also be included in the SRH ARC Chair's report to the quarterly meetings of the Strategic Rail Board. These arrangements would ensure that any fraud risks identified are discussed with SRH's sponsor body.

34. We noted that the fraud strategy has a section on whistleblowing and refers to a SRH Whistleblowing Policy, but this is not yet in place. Management are considering if a separate whistle blowing policy is actually required for SRH or whether it could adopt the Scottish Government or Transport Scotland whistleblowing policy and reporting arrangements.

Medium-term / long-term financial planning has not yet been developed

35. A medium or long-term financial strategy has not yet been developed by SRH for the funding of its two train services operated by its subsidiaries, or for its corporate role. There are core overall strategies that need to be developed still as part of SRH's role, which will underpin any financial strategy. This includes strategies covering the train fleet and rolling stock investment over future decades and consideration of the environmental impact and timing of any changes and the development of a 5-year strategic plan, as discussed at paragraphs [40.](#) to [43.](#) .

3. Vision, leadership, governance and use of resources

Public sector bodies must have a clear vision and strategy and set priorities for improvement. Public sector bodies also 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.

SRH and Transport Scotland oversaw the successful mobilisation of the public sector operators of the ScotRail train services and Caledonian Sleeper service.

Greater clarity is needed over the role of SRH in setting strategic policy for Scotland's rail services. This requires all parties to work together to progress this as a matter of priority.

SRH is still to fully develop its oversight arrangements of SRT and CSL and it continues to develop its governance arrangements.

SRH has still to develop a Best Value framework.

SRH and Transport Scotland oversaw the successful mobilisation of the public sector operators of the ScotRail train services and Caledonian Sleeper service

36. SRH's initial focus when it was established in November 2021 was to ensure that the necessary arrangements were put in place to mobilise a wholly-owned company, SRT, to operate ScotRail train services from 1 April 2022, when the franchise operated by Abellio ended and the service was taken in to public ownership.

37. At the start of March 2023, the Transport Minister for Scotland announced that the Caledonian Sleeper rail service would also be nationalised and would come into public ownership on 25 June 2023. Transport Scotland was tasked with supporting the train operator, CSL, in putting in place appropriate arrangements for the services to transfer over to public ownership.

38. In both cases the train services transferred from the private train operators to the new public sector train operators on the agreed dates, with minimum disruption to passengers.

SRH's ongoing role is to provide oversight of, and strategic direction for, train operators in Scotland

39. As defined on the [What we do page of the website](#), SRH's ongoing role is to provide oversight of, and strategic direction for, the train operators delivering rail services in Scotland, ensuring that the organisations deliver on all aspects of the Framework Agreement and Grant Agreement. This is intended to ensure good governance of the railways in Scotland and support train operators to:

- offer a world-class railway service
- deliver value to passengers
- drive socio-economic benefit across the wider Scottish economy
- provide excellent customer service
- remain financially and environmentally sustainable.

Greater clarity is needed over the role of SRH in setting strategic policy for Scotland's rail services. This requires all parties to work together to progress this as a matter of priority.

40. SRH's framework agreement with Scottish Ministers, acting through Transport Scotland, requires it to prepare a 5-year strategic plan setting out strategic objectives, expenditure plans, performance indicators, and other key information to support it in exercising its role in overseeing the delivery of rail services in Scotland.

41. Management has advised that the strategic plan is still in development and is the subject of ongoing discussions with Transport Scotland, as the sponsor body, to agree its final contents.

42. We understand that a government gateway review was undertaken on behalf of Transport Scotland in response to the requirement to review the framework agreement within 12 months of its commencement to ensure it is fit for purpose and is delivering everything it is designed to. However, SRH has not yet seen the full results of this process.

43. We believe that greater clarity is required over the role of SRH in setting strategic policy for Scotland's rail services, and for the roles of Transport Scotland and Scottish Ministers to be better defined. This requires all parties to work together to progress this as a matter of priority. The gateway review and the finalisation of a strategic plan would help SRH develop its role and governance arrangements.

Recommendation 2

SRH should seek to obtain a copy of the gateway review and assess whether this includes any additional context or findings which could help inform the development of SRH.

Recommendation 3

Management should work with Transport Scotland to finalise SRH's 5-year strategic plan for overseeing the delivery of rail services in Scotland.

SRH is still to fully develop its oversight arrangements of SRT and CSL

44. We believe that SRH is expected to provide oversight of SRT and CSL's delivery of rail services and to report periodically on performance, including its financial performance.

45. The tripartite ScotRail grant agreement between Scottish Ministers, SRH and SRT and the Caledonian Sleeper service tripartite grant agreement between Scottish Ministers, SRH and CSL, sets out the conditions of the new train operator arrangements. These agreements were largely based on the previous franchise agreements, but also include a range of strategies and policies that the train operators are expected to submit to SRH for approval by key dates. Management has advised that some of these strategies and policies have not been developed and agreed between the train operators, Transport Scotland and SRH by the dates set out in the agreements.

46. A full review of the CSL grant agreement is being undertaken, as required by the parties signing the grant agreement at mobilisation. The SRT grant agreement stipulates the requirement for an annual review, which is currently in progress and is due to be completed early in 2024. This review will also consider future monitoring and reporting requirements to ensure the efficient and effective oversight of the operations.

47. In December 2021, SRH appointed a Finance Director who was responsible for overseeing all aspects of the finances of SRH and the financial aspects of SRH's oversight of SRT. In December 2022, the Finance Director was appointed as interim Chief Executive of SRH following the resignation of the previous incumbent, but a new Finance Director has not been appointed.

48. No additional resources have been provided to SRH to enable it to undertake some of this review work or to expand its finance and monitoring capacity.

Recommendation 4

Management should engage with Transport Scotland to agree what additional resource SRH requires to expand its capacity to enable it to review performance arrangements and to provide effective financial and performance oversight of the delivery of rail services provided by SRT and CSL.

SRH is continuing to develop its governance arrangements

49. During 2022/23 management put governance arrangements in place to support SRH in undertaking its core duties, including the establishment of a Board and Audit and Risk Committee.

50. The Audit and Risk Committee only met three times during the 2023 calendar year and further arrangements to support good governance have also still to be established, including the development of a risk management framework.

51. Management advised that the Audit and Risk Committee are considering what further arrangements require to be developed during 2023/24 to support good governance.

Recommendation 5

The Audit and Risk Committee should continue to develop governance arrangements.

The SRH group is taking action to reduce the environmental impact of its operations

52. The SRH group has a major role in Scottish Government plans for sustainable inclusive growth and the delivery of net zero emissions by 2045. Transport Scotland has a “Mission Zero” to reduce emissions by 75% by 2030.

53. SRH has committed to continually improving environmental and energy performance, whilst minimising pollution and recognising its role in supporting the delivery of the Scottish Government’s emission reduction targets.

54. During 2022/23, the group continued to take action to reduce the environmental impact of its operations in the short and medium-term while progressing the long-term goal to deliver net zero passenger rail services for Scotland.

55. SRT is also a key stakeholder in Scotland’s Railway Sustainability Strategy including the governance and delivery of planned outcomes. It continued to maintain externally certified environmental and energy management systems.

SRH has still to develop a Best Value framework

56. [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.

57. Given SRH's unique role in overseeing the delivery of rail services in Scotland, the Chief Executive, as Accountable Officer, should establish how it can demonstrate that it is securing best value in the delivery of these services.

Recommendation 6

The Chief Executive should develop an appropriate Best Value framework for SRH, that reflects its developing role.

Appendix 1. Action plan

2022/23 recommendations

Issue/risk	Recommendation	Agreed management action/timing
<p>1. Internal audit provision</p> <p>Management is still to determine what internal audit coverage is required for the SRH single entity functions.</p> <p>Risk: SRH single entity functions are not subject to appropriate review by internal audit.</p>	<p>Management should determine what internal audit coverage and assurance is required for SRH single-entity functions, based on the review and development of SRH responsibilities.</p> <p>Paragraphs 29. and 30.</p>	<p>As part of refining its structure and people plans, SRH will be determining how to resource its internal audit requirements.</p> <p>Responsible officer: General Counsel</p> <p>Agreed date: 30 June 2024</p>
<p>2. Gateway review</p> <p>A government gateway review was undertaken on behalf of Transport Scotland in response to the requirement to review the framework agreement within 12 months of its commencement to ensure it is fit for purpose and is delivering everything it is designed to. However, SRH has not yet seen the full results of this process.</p> <p>Risk: Management are unaware of context or findings from the gateway review which could help inform the development of SRH.</p>	<p>SRH should seek to obtain a copy of the gateway review and assess whether this has any additional context or findings which could help inform the development of SRH.</p> <p>Paragraphs 40. to 43.</p>	<p>SRH will request the gateway review to assess whether this has any important recommendations or findings which could inform the development of SRH.</p> <p>Responsible officer: General Counsel</p> <p>Agreed date: 31 March 2024</p>

Issue/risk	Recommendation	Agreed management action/timing
<p>3. Strategic Plan</p> <p>SRH's 5-year strategic plan has still to be finalised.</p> <p>Risk: SRH does not have a clear strategy for overseeing the delivery of rail services in Scotland.</p>	<p>Management should work with Transport Scotland to finalise SRH's 5-year strategic plan for overseeing the delivery of rail services in Scotland.</p> <p>Paragraphs 40. to 43.</p>	<p>SRH is working with a variety of stakeholders, including Transport Scotland, to agree the SRH group strategy following the mobilisation of CSL and SRT.</p> <p>This strategy will be presented to Transport Scotland for approval in 2024.</p> <p>Responsible officer: Rail Business Director</p> <p>Agreed date: 30 September 2024</p>
<p>4. Staff capacity</p> <p>Since June 2023 SRH has been required to provide oversight of CSL's delivery of the sleeper service, while still providing similar oversight of the SRT rail services.</p> <p>Risk: SRH may not have sufficient finance and monitoring capacity.</p>	<p>Management should engage with Transport Scotland to agree what additional resource SRH requires to expand its capacity to enable it to review performance arrangements and to provide effective financial and performance oversight of the delivery of rail services provided by SRT and CSL.</p> <p>Paragraphs 44. to 48.</p>	<p>SRH is in the process of refining its structure and people plan. It anticipates commencing the recruitment of additional permanent resources in 2024 once approval is obtained from Transport Scotland.</p> <p>As an interim measure, the SRH Board has authorised the recruitment of interim resources to improve its short term capacity.</p> <p>Responsible officer: Chief Executive Officer</p> <p>Agreed date: 31 March 2025</p>

Issue/risk	Recommendation	Agreed management action/timing
<p>5. Governance arrangements</p> <p>Arrangements to support good governance have still to be fully established.</p> <p>Risk: SRH does not have appropriate arrangements in place to support good governance.</p>	<p>The Audit and Risk Committee should continue to develop governance arrangements.</p> <p>Paragraphs 49. to 51.</p>	<p>The SRH Audit and Risk Committee (ARC) will determine appropriate developments for the governance arrangements.</p> <p>Resourcing these arrangements will form part of the refinement of SRH's structure and people plans.</p> <p>Responsible officer: General Counsel</p> <p>Agreed date: 30 June 2024</p>
<p>6. Best Value framework</p> <p>SRH has still to develop a Best Value framework.</p> <p>Risk: SRH is unable to demonstrate that it is securing best value in the delivery of rail services in Scotland.</p>	<p>The Chief Executive should develop an appropriate Best Value framework for SRH, that reflects its developing role.</p> <p>Paragraphs 56. and 57.</p>	<p>The SRH strategic plan that is being developed will include measures to demonstrate the value being delivered by the group and its constituent parts.</p> <p>Responsible officer: Chief Executive</p> <p>Agreed date: 30 September 2024</p>

Scottish Rail Holdings Limited

2022/23 Annual Audit Report

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