

Water Industry Commission for Scotland

Report on the 2007/08 Audit



November 2008



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Contents

Executive Summary	1	Governance	7
Introduction	2	Looking Forward	9
Financial Statements	3		

Executive Summary

Introduction

Our audit was based on understanding the key strategic and financial risks being faced by the Water Industry Commission for Scotland (WICS). We audited the financial statements and we also reviewed relevant aspects of governance and performance. This report sets out our key findings.

Financial Statements

We have given an unqualified audit opinion on the financial statements of WICS for 2007/08. We have also concluded that in all material respects, the expenditure and receipts shown in the financial statements were incurred or applied in accordance with applicable enactments and relevant guidance.

Financial Position

WICS's Operating Cost Statement records overall net expenditure for the year of £2.77 million (2006/07: £0.64 million net expenditure). The grant-in-aid credited to reserves for the year was £1.91 million (2006/07: £1.71 million). The main reason for fluctuation in net expenditure between years is that the statutory income contribution from Scottish Water relating to the establishment of the Central Marketing Agency was received in 2006/07, but the related expenditure was spread across both years. Income and expenditure relating to the Central Marketing Agency is reflected in WICS's accounts up to the time of its incorporation in September 2007.

The budget for 2008/09 is £4.382 million (2007/08: £5.558 million). The 2007/08 budget included £0.766 million funding in respect of Waterwatch Scotland which, from 2008/09, is no longer funded through WICS.

Governance

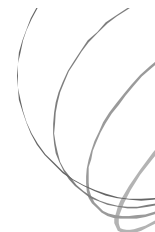
We concluded that the overall governance arrangements within WICS were satisfactory. In 2006/07 the disclosures in the Statement on Internal Control relating to Waterwatch Scotland were considered carefully. The Statement on Internal Control for 2007/08 provides an update on the position on Waterwatch Scotland and we consider that these and other disclosures in the Statement are appropriate.

Looking forward

The final part of our report notes some risk areas for WICS going forward. In particular, the proposed activity across the range of business objectives and the plans to further develop the control environment could put a strain on staff and resources and it will be important to monitor the position carefully during the year. Also, the implementation of International Financial Reporting Standards (IFRS), starting with 'shadow accounts' for 2008/09, may present some challenges.

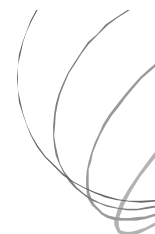
The assistance and co-operation given to us during our audit is gratefully acknowledged.

Audit Scotland
November 2008



Introduction

1. This report summarises the findings from our 2007/08 audit of the Water Industry Commission for Scotland (WICS). The scope of the audit was set out in our Audit Plan following discussions with the Commission staff over the Spring of 2008. The Audit Plan described the work we planned to carry out, the primary focus being an audit of the financial statements and a review of WICS's arrangements for governance and internal control.
2. The contents of this report have been agreed with relevant officers to confirm factual accuracy. We would like to take this opportunity to express our appreciation for the assistance and co-operation provided by officers and members of WICS during the course of our audit. This report will be submitted to the Auditor General for Scotland and will be published on our website, www.audit-scotland.gov.uk.



Financial Statements

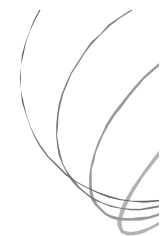
3. In this section, we summarise key outcomes from our audit of WICS's financial statements for 2007/08, and comment on the key financial management and accounting issues arising. The financial statements are an essential means by which the organisation accounts for its stewardship of the resources available and its financial performance in the use of those resources.

Our responsibilities

4. Our audit plan sets out our responsibilities in detail. In summary, we audit the financial statements and give an opinion on:
 - whether they give a true and fair view of the financial position of WICS and its expenditure and income for the period in question;
 - whether they and the Remuneration Report were prepared properly in accordance with relevant legislation, applicable accounting standards and other reporting requirements;
 - the consistency of the Directors' Report and Management Commentary with the financial statements; and
 - whether, in all material respects, the expenditure and receipts are regular (comply with statutes and guidance).
5. We also review the statement on internal control by:
 - considering the adequacy of the process put in place by the Chief Executive, in his role as Accountable Officer, to obtain assurances on systems of internal control;
 - assessing whether disclosures in the statement are consistent with our knowledge of WICS.

Overall conclusion

6. We have concluded that the financial statements give a true and fair view of the state of affairs of WICS as at 31 March 2008.

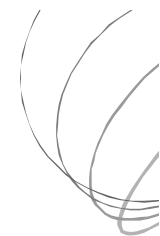


7. We have also concluded that:
 - the financial statements and the part of the Remuneration Report to be audited have been properly prepared in accordance with the Local Government etc. (Scotland) Act 1994, as amended by the Water Industry Act 1999 and the Water Industry Act 2002, and directions made thereunder by the Scottish Ministers;
 - the Directors' Report and Management Commentary is consistent with the financial statements; and
 - in all material respects the expenditure and receipts shown in the financial statements were incurred or applied in accordance with any applicable enactments and guidance issued by the Scottish Ministers.
8. We liaised with WICS and Scott-Moncrieff post year end on the presentation and disclosures in the draft account and recognise the good work done in resolving any issues arising in the presentation of information therein. As a result the accounts were updated and there are no known unadjusted errors in the financial statements. The accounts were signed by the Accountable Officer on 28 October 2008, with the audit opinion signed on 31 October 2008.

Financial Position

Outturn 2007/08

9. The income and expenditure for 2006/07 and 2007/08 have been analysed out to show the contribution from continuing and discontinuing activities, reflecting the Central Marketing Agency becoming established as a separate legal entity during 2007/08 (see paragraph 16). Overall the net expenditure for the year was £2.77 million (2006/07: £0.64 million net expenditure). The grant-in-aid credited to reserves for the year was £1.91 million (2006/07: £1.71 million).
10. WICS received operating income of £3.58 million during 2006/07 (2006/07: £4.90 million). The majority of income arises from a contribution from Scottish Water of £3.55 million (2006/07: £4.88 million). This contribution includes £nil (2006/07: £1.48 million) in relation to the establishment of a Central Market Agency and £0.73 million (2006/07: £0.65 million) for the activities of Waterwatch Scotland.
11. Total operating costs of £6.39 million (2006/07: £5.56 million) show an increase of £0.83 million compared to the previous year. This movement is mainly attributable to the escalation and completion



of WICS's CMA activities during 2007/08, and the increase in the number of staff employed by WICS during the year.

12. WICS's balance sheet at 31 March 2008 showed net assets of £0.41 million (2006/07: £0.95 million). This net reduction of approximately £0.5 million is mainly attributable to the decrease in the year-end bank balance that had been in place to cover the establishment of the Central Market Agency (£1.2 million reduction), offset by an improvement in the net position on pension asset and liabilities (£0.3 million increase – see paragraph 17), creditors (£0.3 million reduction) and fixed assets (£0.1 million increase).

2008/09 Budget

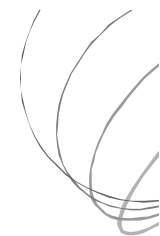
13. The budget for 2008/09 is £4.382 million. This is less than the budget of £5.558 million in 2007/08, including £0.766 million in relation to the funding of Waterwatch Scotland. The main reason for the reduction is that, from 2008/09, Waterwatch Scotland is no longer funded through WICS.

Issues arising from the audit of the financial statements

14. International Standard on Auditing (ISA) 260 requires auditors to report certain matters arising from the audit of the financial statements to 'those charged with governance' prior to the accounts being signed. We reported in the terms of ISA 260 in draft to the Commission's audit Committee in late September 2008, with an update before the accounts were signed by the Accountable Officer. We are pleased to confirm that there were no significant issues or concerns that merit inclusion in this report.
15. There were no matters of accounting practice or financial reporting that required to be drawn to attention in the audit opinion. However, there are two qualitative aspects that merit comment: an update on the un-audited position recorded in the annual report, including the treatment of the Central Marketing Agency; and movements on pension assets and liabilities.

Commission's annual report

16. The un-audited summary financial statements for 2007/08 included in the Commission's annual report recorded income of £3.6 million and expenditure of £5.3 million; this created a net deficit of £1.7 million which was financed by Scottish Government Grant of £1.9 million, as reflected in the General Reserve. The statutory accounts reflect further final adjustments to the position in June as recorded in the annual report, but overall are consistent with the summary statements. One important difference relates to the activity of the Central Marketing Agency, which was excluded from the annual report figures. In accordance with accounting requirements, the statutory accounts reflect the activity

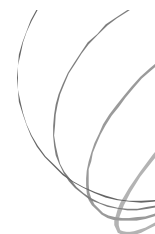


of the Central Marketing Agency, which is disclosed as a discontinued activity, with appropriate comparative figures and other disclosures.

17. A further qualitative aspect of the financial reporting I would also like to draw to attention is the accounting for pensions, much of which flows through the Statement of Recognised Gains and Losses rather than the Income and Expenditure Account. Last year we reported that over 2006/07 there was a change from a position in which pension assets were approximately equal to pension liabilities at the start of the year to a year-end position in which the liabilities exceeded assets by approximately £0.2 million. Over 2007/08 the position has improved by £0.3 million, to leave net assets of £0.1 million at the year end. The most important factor in these changes has been the discount rate used by the actuary in determining the present value of future pension liabilities. Over 2006/07 there was a reduction in discount rate adopted by the Actuary from 6.0% to 5.4%, which increased the value of the pension liabilities. Over 2007/08 there was an increase in the discount rate from 5.4% to 6.9%, which reduced the value of the liabilities. This pattern of movement in liabilities is consistent with our experience of accounting for other pension arrangements.

Regularity assertion

18. The Public Finance and Accountability (Scotland) Act 2000 imposes a responsibility on auditors that requires us to certify that, in all material respects, the expenditure and receipts shown in the accounts were incurred or applied in accordance with applicable enactments and guidance issued by the Scottish Ministers. We have addressed the requirements of the regularity assertion through a range of procedures, including written assurances from the Accountable Officer as to his view on adherence to enactments and guidance. No significant items were identified for disclosure.



Governance

Overview of arrangements

19. This section sets out our main findings arising from our review of WICS's governance arrangements and key systems of internal control. We also discharged our responsibilities as they relate to the prevention and detection of fraud and irregularity, standards of conduct and the organisation's financial position (see paragraphs 9 to 13). Overall, we concluded that the arrangements within the WICS were satisfactory.

Statement on Internal Control

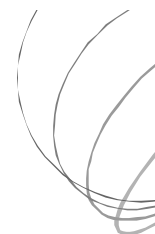
20. The Statement on Internal Control provided by the Chief Executive, as Accountable Officer, recorded his responsibility for maintaining a sound system of internal control and set out the Commission's approach and the arrangements for reviewing effectiveness.

21. In 2006/07 the accounting treatment and disclosures adopted in the accounts to reflect the activities of Waterwatch Scotland were considered carefully, including those for the Statement on Internal Control. There has been further progress in developing the arrangements in relation to Waterwatch Scotland over the year; and, as with 2006/07 we are content that the treatment in the accounts and Statement on Internal Control is appropriate.

22. No material weaknesses in the accounting and internal control systems were identified during the audit which could adversely affect the ability to record, process, summarise and report financial and other relevant data so as to result in a material misstatement in the accounts. We are content therefore that the Statement on Internal Control discloses the position for WICS appropriately.

23. We are satisfied that the Statement complies with the relevant guidance in the Scottish Public Finance Manual; the process put in place by the Accountable Officer to obtain assurances on systems of internal control is adequate; and the contents of the Statement are not inconsistent with the information emerging from our normal audit work.

24. Following updated guidance on audit committees, practice is evolving with, for example, some audit committees planning to take a more explicit role in reviewing the assurances obtained by the relevant Accountable Officer in support of the Statement on Internal Control. We note that WICS has been pro-active in considering the role and responsibilities of the Audit Committee in light of the new guidance, updating the annual plan for the Committee's activity and look forward to working with the Committee as it further considers these developments.



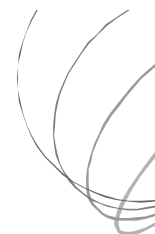
Systems of internal control

Matters arising on accounting and internal control systems

25. We welcome the further development and recording of financial and other procedures over the latter period of the audit, following the appointment of a Financial Controller. As part of our sample of transactions tested, we noted a few instances of non-compliance with the extant WICS procedures for purchase order approvals; we discussed these with staff and satisfied ourselves that in all cases the purchases were appropriate. However, we consider that, as part of the updating of financial procedures referred to above, there is scope to further clarify the procedures or approvals required for the different categories of purchases WICS undertakes.
26. We also welcome the improvement in the procedures and documentation relating to expenditure on hospitality and travel and subsistence. This is an important area for WICS given that the nature of WICS activity involves relatively more expenditure of this nature than many public sector organisations. Hospitality and travel is an area of potential risk to reputation and it is important that WICS maintains high standards of documentation demonstrating compliance with procedures.

Arrangements for accounting services

27. WICS have made use of accounting and financial support services provided by Scott-Moncrieff over recent years. We note that WICS has taken on full responsibility for financial administration from 2008-09. We welcome this change which should streamline arrangements for accounting and the development of systems and controls (per above). However, the new post of Financial Controller becomes key, concentrating expertise, and WICS should consider this as part of its risk assessment process.



Looking Forward

28. WICS faces a number of challenges in 2008/09, which include:

- **Achieving objectives and developing the control environment** – the Commission has identified a range of operational aims and objectives for 2008-09 and future years (price limits for the 2010-14 regulatory control period; maintain pressure on Scottish Water to deliver the requirements of the 2006-10 review; and consider how the market for business and public bodies is developing); and also a number of areas for the further development of their control environment. The proposed activity across these areas could put a strain on staff and resources and it will be important to monitor the position carefully during the year.
- **International Financial Reporting Standards (IFRS)** – the transition to IFRS commences in 2008/09, with a timetable that requires WICS to prepare a re-stated IFRS opening balance sheet as at 1 April 2008, followed by full “shadow” IFRS accounts for 2008/09, in addition to the statutory accounts under the existing framework. Although this process should be reasonably straightforward for WICS it will be important to undertake a scoping exercise to consider any broader accounting issues that may be involved.
- **Data handling** – in response to failures in UK government bodies’ procedures and practices during 2007, the Scottish Government carried out a review of data handling arrangements in Scotland. The review considered current policies and procedures in data protection, consistency with government standards and local arrangements for implementation of procedures. An interim report published in April 2008 made some initial recommendations and a final report was published in June 2008. It is also likely that the Financial Reporting Manual (FRoM) will be updated to require the Statement on Internal Control to comment on data handling arrangements. We will liaise with WICS on these developments during 2008/09.
- **Waterwatch Scotland** – as part of its response to the Crerar review the Scottish Government have indicated that complaints about the water industry would be considered by the Scottish Public Services Ombudsman and that Waterwatch Scotland would be abolished; the change in arrangements will have implications for WICS.

**Audit Scotland
November 2008**