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Scottish Environment Protection Agency

Annual Report to Board Members and the Auditor General for Scotland

FINAL

Report to the Board

24 July 2012

141 Bothwell Street
Glasgow
G2 7EQ

For the attention of the Board
Scottish Environment Protection Agency
SEPA Corporate Office
Erskine Court
Castle Business Park
Stirling
FK9 4TR

24 July 2012

Dear Sirs

We are pleased to enclose our External Audit Annual Report to Board Members and the Auditor General for Scotland for the financial year ended 31 March 2012. This report also discharges our obligations under International Standards of Auditing ("ISA") 260: Reporting to those charged with Governance.

The primary purpose of this report is to communicate the significant findings arising from our external audit that we believe are relevant to those charged with governance and to meet our obligations, as set out within the Audit Scotland Code of Practice.

The scope and proposed focus of our audit work was summarised in our audit plan, which we presented to the Audit Committee on 13 December 2011. We have subsequently reviewed our audit plan and concluded that our original risk assessment remains appropriate. The procedures we have performed in response to our assessment of significant audit risks are detailed within the section on key areas of Audit risk section within this report.

We have completed our year end external audit work on the financial statements and have issued an unqualified audit opinion, following the meeting of the SEPA Board on 24 July 2012 to approve the financial statements.

We would like to take this opportunity to thank SEPA staff and management for their cooperation and assistance throughout the audit process.

Yours faithfully

PricewaterhouseCoopers LLP

PricewaterhouseCoopers LLP

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Section 1: Introduction

We have pleasure in presenting this report relating to our external audit of the financial statements of the Scottish Environment Protection Agency (SEPA) for the year ended 31 March 2012.

We have discussed this report with the Director of Finance and Head of Finance as part of our audit process. The purpose of this report is to update the Audit Committee on the output of the audit and of any significant matters that have arisen during the course of our work.

Scope, nature and extent of our audit

Our overall responsibility as external auditor of SEPA is to undertake our audit in accordance with the principles contained in the Code of Audit Practice issued by Audit Scotland in May 2011. In this regard, the Code sets out the need for public sector audits to be planned and undertaken from a wider perspective than in the private sector, involving not only assurance on the financial statements but also consideration of areas such as regularity, propriety, performance and the use of resources. It also sets out the need to recognise that the overall audit process is a co-ordinated approach involving the "appointed auditor" and the Auditor General for Scotland.

Our audit has been planned and conducted to take account of these wider perspectives. Under the requirements of International Standard on Auditing (UK and Ireland) ('ISA') 260: "Communication of audit matters to those charged with governance", we are required to communicate audit matters arising from the audit of financial statements to those charged with governance of an entity. This Annual Audit Report to Members, together with previous reports to the Audit Committee throughout the year, discharges the requirements of ISA 260.

Management responsibility

It is the responsibility of the Board and the Chief Executive, as Accountable Officer, under Section 45(2) of the Environment Act 1995, to prepare financial statements for each financial year in the form and on the basis determined by the Scottish Ministers. This means:

- acting within the law and ensuring the regularity of transactions by putting in place systems of internal control to ensure that financial transactions are in accordance with the appropriate authority;
- maintaining proper accounting records;
- preparing financial statements timeously which give a true and fair view of the financial position of the Board and its expenditure and income for the period ended 31 March 2012; and
- preparing a Directors' Report, an Operating and Financial Review, a Governance Statement and a Remuneration Report.

Auditor's responsibilities

We audit the financial statements and the part of the Remuneration Report to be audited and give an opinion on:

- whether they give a true and fair view of the financial position of the Agency and its expenditure and income for the period 1 April 2011 to 31 March 2012;
- whether they were prepared properly in accordance with relevant legislation, applicable accounting standards and other reporting requirements;
- whether the information which comprises the annual report included with the financial statements is consistent with the financial statements; and
- whether expenditure and receipts have been incurred and applied in accordance with guidance from Scottish Ministers (the regularity opinion).

We also review the Agency's Governance Statement by considering the adequacy of the process put in place by the Chief Executive as Accountable Officer to obtain assurances on systems of internal control; and assess whether disclosures in the statement are consistent with our knowledge of the Agency.

The audit process

We received a draft set of financial statements and supporting working papers within the timetable agreed. Draft financial statements were on the whole of a reasonable standard. However, in future years the draft would benefit from additional review before audit to ensure that all balances correctly add up and agree back to the trial balance, are consistent throughout the financial statements and all disclosures are in line with the FReM.

A small number of financial adjustments, as well as a significant number of disclosure amendments were discussed and agreed with Management and have been reflected in the final financial statements. We will discuss potential improvements that could be made with management before our next on site visit with a view to agreeing an approach for future years.

Opinion

Following the approval by the Board on 24 July 2012, we have issued an unqualified audit opinion on the financial statements, including the regularity of expenditure and income. In addition, our opinion is unqualified in respect of the Remuneration Report and of consistency of the Management Commentary with the financial statements.

Significant auditing and accounting matters

Section 4 contains other matters for the attention of those charged with governance, including elements of communication required under International Standard on Auditing "Communication with those charged with governance". This section includes communication regarding identified misstatements, a summary of which is included in **Appendix 1**.

We are also required to communicate with you regarding any significant deficiencies in internal control of which we are aware. We identified some minor recommendations for improving SEPA's systems of internal control which will be communicated to management in a separate management letter. However, these are not deemed to be significant to impact on SEPA's Governance Statement or merit inclusion with this Annual Report.

Staff Assistance

We would also like to take this opportunity to express our thanks for the co-operation and assistance we have received from management and staff throughout our work.

Section 2: Financial performance

Financial performance 2011/12

Expenditure	2011/12 £m	2010/11 (restated) £m
Staff costs	(47.982)	(38.307)
Depreciation and impairments	(2.577)	(2.579)
Other operating charges	(21.048)	(23.804)
	(71.607)	(64.690)
Income		
Income from charging schemes	34.830	34.133
Other Income	2.248	1.928
	37.078	36.061
Comprehensive net expenditure before interest	(34.529)	(28.629)
Excess of Comprehensive expenditure over income for the year funded by Grant In Aid (GIA)	(35.344)	(29.997)

* As extracted from the 2011/12 Comprehensive Expenditure statement.

Performance against budget[1]

	Budget 2011/12 £m	Actual 2011/12 £m	Variance £m
Grant in Aid	39.007	39.007	0
Income from Charging Schemes	34.400	34.830	0.430
EU Income	0	0.122	0.122
Other Income	1.954	2.142	0.188
Total Income	**75.361**	**76.101**	**0.740**
Staff Costs	46.129	47.496	1.367
Other Operating Costs	20.297	20.050	(0.247)
Revenue Projects	4.417	4.292	(0.125)
Depreciation	3.515	3.515	0
Total Expenditure	**74.358**	**75.353**	**0.995**

[1] Extracted from the *SEPA Financial Monitoring Report for the period ended 31 March 2012* and Agency Board Reports 29 May 2012

The £7 million increase in expenditure for 2011/12 is driven in part by an increase of £10 million in staff costs. Although total payroll costs for salaried staff have fallen as a result of the reduction in staff numbers due to the programme of early retirements and voluntary redundancies (£2.2 million[2]). In addition, there was a significant gain of £14 million in relation to the pension charge (ISA 19).

Overall, payroll costs were slightly greater than budgeted due to an additional payment being made to the pension fund of £1.5 million, to reduce future SEPA Pension liabilities. This transaction was approved by the Scottish Government, and was in line with an earlier payment made in the 2010/11 financial year.

Income from charging schemes and other income has increased marginally from the prior year and against the budgeted figures shown above. This is due to small levels of unplanned income in a number of areas including European Union grant, Her Majesty's Revenues and Customs (HMRC) fuel duty, and Radioactive Substances Act (RSA) contract income.

Financial outlook – 2012/13 and beyond

The SEPA Board approved the annual budget for 2012/13 and financial strategy for 2012-2017 in April 2012. A balanced budget was approved for 2012/13.

The 2012/13 budget estimates total revenue of £74.4 million, with a capital allocation of £1.6 million for use in fitting out the new central facility in Glasgow. This estimate takes account of a reduction in Grant in Aid of £1.1 million (£0.6 million related to revenue and £0.5 million related to capital grant) and an additional one-off payment of £1.5 million from the Scottish Government to assist with the central facility fit out.

While SEPA has the ability to apply an automatic annual increase in charging scheme fees in line with inflation, it has once again decided to postpone this increase for 2012/13, taking into account wider economic circumstances and that SEPA has managed to reduce costs in order to still achieve a balanced budget. The Agency has agreed with the Scottish Government a financial target of delivering 98% cost recovery on its charging schemes. In 2011/12, SEPA delivered 96% cost recovery, an increase of 2 percentage points from the prior year. However, as SEPA continues to restrict fee increases, cost recovery may become more challenging if there is not a matched reduction in costs. Robust financial management and regular monitoring will be required to assist in achieving this ambitious target.

The financial strategy highlights the expectation that SEPA will need to identify efficiency savings year on year from 2012/13 to 2016/17 in order to achieve a breakeven position. It is estimated that, on average, approximately £1.0 million per annum will be required. The Flood Programme is expected to meet roughly £0.1 million each year, with the remainder to come from a combination of staff savings, increased productivity, supplies savings and better procurement. SEPA expects to continue to improve estates usage and will enter into shared accommodation arrangements when opportunities arise.

The achievement of these savings is reflected in the summary expenditure shown in the financial strategy, enabling SEPA to break even year on year.

Debt management will continue to be essential in future years, particularly if licensed businesses continue to struggle financially, which could increase instances of non-payment. As with prior years, work will be undertaken to ensure that such a deficit does not result. In addition, there is an expectation that, as with recent years, the Scottish Government will announce further efficiency savings targets, meaning that savings will need to be found year on year, estimated at about £1 million per annum for SEPA. Management expects to achieve this through staff savings, increased productivity, supplies savings and better procurement (see **Appendix 2: Action plan**).

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[2] Reduction in actual staff costs as reported in *SEPA Financial Monitoring Report for the period ended 31 March 2012*, Agency Board Reports 29 May 2012

Section 3: Key areas of audit focus

Our audit followed the strategy set out in our Audit Plan which was presented to the Audit Committee on 13 December 2011. We confirm that there has been no cause for us to vary the planned scope of our work.

Our response to the areas of audit focus identified in the audit plan:

Audit risk identified/area of audit focus	Audit response
Management override of controls	In accordance with our audit plan, we have reviewed management's overall fraud arrangements and policies. We have reviewed a sample of significant journal entries and examined management's accounting estimates for bias. We have also carried out testing around the use of government procurement cards and fixed assets as part of our response to this risk. This work did not identify any material errors that required adjustment to the financial statements.
Revenue recognition	We examined and tested the revenue and receivables process as part of our interim audit. We also performed substantive testing on a sample of income transactions with additional focus on ensuring that income is recognised in the period to which it relates. This work did not identify any material errors that required adjustment to the financial statements. However, we have highlighted in Appendix 2 the need for Management to review the controls in respect of debt management, and the accounting treatment where appropriate.
Recognition of operating expenditure	We obtained an understanding of the purchasing and payables process as part of our interim audit. We performed substantive testing on a sample of expenditure transactions and reviewed management's estimates of future expenditure, such as accruals and provisions. We have undertaken specific cut-off testing to identify potentially unrecorded liabilities. This work did not identify any material errors that required adjustment to the financial statements.
Accounting for accruals and provisions	As part of our consideration of accounts payable balances, we examined a sample of accrued expenses and the related supporting documentation. In particular, we have had detailed discussions with management around the appropriateness of the bad debt provision in light of the current economic climate. While this work did not identify any material errors that required adjustment to the financial statements, this is an area we will continue to keep under review and will work with management to ensure that the provision remains prudent and appropriate to the climate in which SEPA operates.

Audit risk identified/area of audit focus	Audit response
Valuation of specialised tangible fixed assets	We reviewed the valuations presented in the accounts for specialised fixed assets and examined the supporting documentation and calculations. We have consulted with our internal valuations experts in order to confirm the appropriateness of management's chosen treatment. We substantively tested a sample of properties in order to ensure they had been valued in line with the agreed methodology. We found one error in management's depreciated replacement cost calculations in respect of gauging stations in respect of the VAT rate applied not having been updated. We have proposed an adjustment in respect of this. However, we did not find any material misstatements in this area.
Professional scepticism	As auditors, we are required to display professional scepticism when we plan and perform our audits. This involves providing challenge to management in areas such as critical assumptions, judgements, explanations and inconsistencies. During this audit, we have displayed professional scepticism in a range of areas including, for example, • Valuations: we discussed the appropriateness of management's proposed methodology for valuing SEPA's vessels and we reviewed the assumptions and inputs used to calculate the depreciated replacement cost of gauging stations; and • Disclosures: we challenged the costs included within termination benefits and the format of the fixed asset note to ensure correct presentation. • Provisions: We have considered Managements approach to provisions and the underlying assumptions, including review of the bad debt provision.

Section 4: Significant audit and accounting matters

Required communications on significant matters

The following table contains communication required under ISA 260 (revised and re-drafted) "Communication with those charged with governance".

Requirement	Delivery of requirement
Uncorrected and corrected misstatements	We identified two misstatements that we believe should be brought to your attention. Of these, one has been corrected and one remains uncorrected. Details of these can be found in Appendix 1.
Significant accounting principles and policies	Significant accounting principles and policies are disclosed in the notes to the financial statements. We have asked management to represent to us that they have considered the accounting policies and that here have not been any material changes in the accounting principles and policies used during the year.
Significant qualitative aspects of accounting practices and financial reporting, management's judgments and accounting estimates	We reviewed management's judgements and accounting estimates in respect of land and buildings valuations, provisions for unfunded pension liabilities and the provision for bad debts. We are satisfied with management's methodology and use of experts in estimating the market value of land and buildings and the depreciated replacement cost in the case of specialised buildings We will continue to review the assumptions used in estimating the bad debt provision to ensure that it remains appropriate in future years.
Deficiencies in the internal control environment	The purpose of our audit was to express an opinion on the financial statements. The audit included consideration of internal control relevant to the preparation of the financial statements in order to design audit procedures that were appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of internal control. Any deficiencies in internal controls identified during our audit have either been reported in our Interim Management letter (March 2012) or reported separately to Management.
Details of material uncertainties related to events and conditions that may cast significant doubt on SEPA's ability to continue as a going concern	We have not encountered any material uncertainties which cast doubt upon the ability of SEPA to continue as a going concern.
Significant difficulties encountered during the audit	While we did not encounter any significant difficulties which would prevent us from undertaking the audit, we have identified some improvements with a view to streamlining the audit process for future years. This will be discussed and agreed with management before the commencement o f the next audit cycle.
Confirmation of audit independence	We confirm that, in our professional judgment, as at the date of this document, we are independent auditors with respect to SEPA within the meaning of UK regulatory and professional requirements and that the objectivity of the audit engagement leader and the audit staff is not impaired.

Section 5: Governance, accountability and internal control

As part of our wider external audit remit, stemming from our responsibilities under Audit Scotland's Code of Audit Practice, we are required to consider SEPA's governance and accountability arrangements in our audit work. For 2011/12, a major part of this work has been our follow up of Audit Scotland's national performance report, The Role of Boards. A separate report of our findings will be reported to the Agency's Audit Committee. In particular, this work has enabled us to gain an understanding of SEPA's existing governance arrangements as they concern:

- corporate governance and systems of internal control;
- the prevention and detection of fraud and irregularity; and
- standards of conduct and arrangements for the prevention and detection of corruption.

We have provided brief high level commentary on certain aspects of SEPA's governance systems and structures below.

Corporate governance and internal control

The Board is responsible for ensuring that SEPA fulfils the aims and objectives set by Scottish Ministers. The role of the Board includes establishing the overall strategic direction, monitoring performance against agreed objectives and ensuring that statutory requirements for the use of public funds are complied with. The Board has recently been involved in the development of SEPA's corporate plan for 2012-2017.

The Board is supported by the Audit Committee, which has responsibility for monitoring risk and internal control, and the Strategy Committee, which considers matters such as planning, finance, human resources and remuneration.

As your external auditors, we are required to review the governance statement before publication and report as to whether the statement complies with relevant guidance, is misleading, or is inconsistent with other information obtained during the audit. We do not consider whether the statement covers all risks and controls, or form an opinion on the effectiveness of internal control or risk management arrangements. We have reviewed the governance statement and confirm that there are no matters to report.

We have considered internal control as it concerns the key financial systems and to an extent based on our audit risk assessment. The purpose of our audit is for us to express an opinion on the financial statements. This includes consideration of internal control relevant to preparation of the financial statements in order to design appropriate audit procedures. It does not extend to expressing an opinion on the effectiveness of internal control.

We are required by ISA 265 to report to those charged with governance and management deficiencies in internal controls that the auditor has indentified during the audit and that, in the auditor's professional judgment, are of sufficient importance to merit their respective attentions.

We have not identified any significant weaknesses in the current system of internal controls, except from one matter which is raised within **Appendix 2: Action plan**.

We have previously identified a number of minor deficiencies in internal control during our interim external audit visit. These have been reported to management in our internal controls report and we will monitor management's progress towards these objectives. Any other deficiencies identified during our final visit are not judged to be significant and will therefore be reported separately to Management for action.

Prevention and detection of fraud

Audited bodies are responsible for establishing arrangements to prevent and detect fraud and other irregularity. As part of our external audit, we have reviewed SEPA's high level arrangements for preventing and detecting instances of fraud and corruption. We are aware that SEPA has in place a policy framework designed deal with the risk of fraud in the organisation. This framework covers an Anti-Corruption, Fraud and Bribery Policy (the "Policy") and a separate Gifts and Hospitality policy. All members of staff are made aware of these policies and their responsibilities under them.

SEPA has a formal Fraud Response Plan which sets out the actions SEPA will take when suspected frauds are reported. From the external audit work we have undertaken, there are no matters we wish to bring to your attention concerning fraud.

Standards of conduct

Audited bodies are responsible for ensuring that their affairs are managed in accordance with proper standards of conduct and have proper arrangements in place for implementing and monitoring compliance with standards and codes of conduct, standing orders and financial instructions. We have not become aware of any issues concerning SEPA's arrangements that we need to identify in this report.

Risk Assessment

Through our discussion with management, we are aware that SEPA has invested time in reviewing and updating their risk assessment and management process. The stated purpose of the process is to identify and prioritise risks to the achievement of the SEPA's policies, aims and objectives; to evaluate the likelihood of those risks being realised and the impact should they be realised; and to manage them efficiently, effectively and economically.

The primary mechanism for monitoring risk is through the Directorate Management Teams. Risk registers are managed at directorate level, with the corporate risk register managed by Audit Committee.

There is a risk management group, with responsibility for the efficient and effective management of risk, including assurance that SEPA complies with all relevant legislation and the responsibilities of corporate governance. The group reports quarterly to the Agency Management Team and annually to the Audit Committee.

Workshops have taken place with all Directorate Management Teams on risk identification, management and control, with these being developed further developed to provide risk awareness training for all SEPA staff.

Internal Audit

As described in our Annual Plan, International Standard on Auditing (UK and Ireland) 610: "Using the work of internal auditors" requires us to:

- Consider the activities of Internal Audit and the extent that their work can be relied upon for external audit procedures;

- Obtain sufficient understanding of internal audit activities and the effectiveness of the function to enable us to identify areas of risk and develop an effective and targeted audit approach; and

- Evaluate and test the quality and timeliness of internal audit work, where we seek to rely on the findings, in order to confirm its adequacy for our purposes.

Throughout the year, we have liaised with KPMG, SEPA's internal auditors, and have used their work to inform our risk assessment.

Appendices

Appendix 1: Summary uncorrected misstatements

In the course of our audit work, we record the errors or misstatements we find except those that are clearly trivial, which in the case of SEPA are those considered to be less than £71,000 (this represents 5% of our overall materiality level as set out in our External Audit Planning document presented to the Audit Committee).

Presented below is a record of the misstatement which remains uncorrected by mutual agreement.

No	Description of misstatement (factual (F), judgemental (J), projected (P))		Income statement		Balance sheet		Cash flow	
			Dr	Cr	Dr	Cr	Inflow	Outflow
1	Dr Fixed assets Cr Accumulated depreciation Cr Reserves Being an adjustment to increase the gross replacement cost of gauging stations and their associated depreciation by 2.5% to account for the increase in the VAT rate. Agreed reasonable to leave uncorrected due to volume of work required to update Fixed Asset Register for a relatively minor adjustment. **Status: uncorrected**	F			£231k	 £154k £77k		
Total uncorrected misstatements					£231k	 £154k £77k		

Disclosure Adjustments

In addition to the number adjustments presented above, we have proposed a significant number of disclosure adjustments to the draft financial statements namely to correct typing errors, ensure relevant notes cross cast to the primary statements and rounding errors.

Appendix 2: Action plan

We have identified three areas for development during the course of our audit. Our recommendations for improvement are as follows:

No	Finding	Risk	Recommendation
1	In the course of our audit work, we identified that throughout 2011/12 SEPA's debt collection procedures did not operate effectively, with debts not being passed to debt collectors on a timely basis. As at 31 March 2012, a large number of debts (amounting to approximately 50% of the debtor balance) were overdue by more than 90 days, and our sample testing identified invoices relating to 2007. We understand that debt collection measures have slipped in the last year due to the level of staff absence through sickness within the finance team. Management have assured us that efforts recommenced in March and April 2012.	If debts are not passed to debt collectors to pursue on a timely basis, there is a greater likelihood that debts will become irrecoverable. Given that debt collection procedures lapsed for a considerable portion of 2011/12, there is a risk that management will have to write off more bad debts.	Management should ensure that the policy for debt management is followed, including referring debts to debt collectors on a timely basis. **Management Response:** Credit control processes are being followed. Improvements to outstanding invoice reminder processes are being made, including reviewing the appropriate use of 28 day notices with the Operations Team and regular referrals to the debt collection agency are being made. **Head of Finance** *Action completed at 30 June 2012 and ongoing*
2	Management will have to identify further efficiency savings in future years in order to deliver a balanced budget.	If cost savings plans are not developed and implemented early, the actions required to deliver agreed savings may not be carried out in time and savings targets may not be met.	In accordance with the recent instruction from the Agency Board, management should ensure that cost savings plans are developed and approved. Plans should identify areas where savings will be made, estimate the level of expected saving and set out the actions required by management to ensure the plan is achieved. **Management Response:** It is planned to have identified the budget reductions that are required to balance 2013/14 budget by 31 December 2012, and the actions required by management to ensure the cash saving are released. **Director of Finance & Corporate Services**