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Water Industry Commission for Scotland

Annual audit report to the Water Industry Commission for Scotland and the Auditor General for Scotland

Year ended 31 March 2012

7 December 2012

Contents

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About this report

This report has been prepared in accordance with the responsibilities set out within the Audit Scotland's *Code of Audit Practice* ("the *Code*").

This report is for the benefit of the Water Industry Commission for Scotland and is made available to Audit Scotland (together "the beneficiaries"), and has been released to the beneficiaries on the basis that wider disclosure is permitted for information purposes, but that we have not taken account of the wider requirements or circumstances of anyone other than the beneficiaries.

Nothing in this report constitutes an opinion on a valuation or legal advice.

We have not verified the reliability or accuracy of any information obtained in the course of our work, other than in the limited circumstances set out in the scope and objectives section of this report.

This report is not suitable to be relied on by any party wishing to acquire rights against KPMG LLP (other than the beneficiaries) for any purpose or in any context. Any party other than the beneficiaries that obtains access to this report or a copy and chooses to rely on this report (or any part of it) does so at its own risk. To the fullest extent permitted by law, KPMG LLP does not assume any responsibility and will not accept any liability in respect of this report to any party other than the beneficiaries.

We also draw your attention to the following:

- management of the Water Industry Commission for Scotland is responsible for preparing financial statements that show a true and fair view and for implementing appropriate internal control systems;
- weaknesses or risks identified by us are only those which have come to our attention during our normal audit work in accordance with the Code, and may not be all that exist; and
- communication by us of matters arising from the audit of the financial statements or of risks or weaknesses does not absolve the Water Industry Commission for Scotland management from its responsibility to address the issues raised and to maintain an adequate system of control.

Executive summary

The Commission is a non-departmental public body with statutory responsibilities over the regulation and licensing of Scottish Water and licensed providers. Its mission is to manage an effective regulatory framework which encourages the Scottish water industry to provide a high-quality service and value for money to customers.

The Commission has agreed a 15% reduction in funding over the 2010-15 regulatory period and this is reflected in the 2011-12 outturn and 2012-13 budget. Strong financial management arrangements have allowed the Commission to anticipate funding requirements, albeit that annual surpluses continue to be reported.

2011-12 was the first full year of the Commission's occupation of Moray House after its move in March 2011. Annual savings of £52,000 have been achieved through the reduced rent and utilities charges associated with the new premises.

In November 2011 internal audit reported on the Commission's governance arrangements. As a result, several changes have been made, such as a reduction in the frequency of the Commission's meetings. There have been significant changes in the Commission membership in the year, including a change in Chairman.

Management continued to ensure there is a system of internal control to ensure regularity of income and expenditure, including arrangements to demonstrate Best Value is achieved through effective procurement processes.

We have completed our audit for 2011-12 and have issued unqualified audit opinions on the financial statements and the regularity of transactions included within these financial statements.

Headlines

Our audit work is undertaken in accordance with Audit Scotland's *Code of Audit Practice* ("the *Code*"). This specifies a number of objectives for the audit.

We reported, in our audit strategy, our responsibilities in respect of the audit. The Commission's responsibilities are set out in appendix one.

This report summarises our work for the year ended 31 March 2012.

We wish to record our appreciation of the co-operation and assistance extended to us by Commission staff during the course of our work.

Financial statements	
Draft financial statements were provided on 18 May 2012, in line with the agreed timetable. These were primarily complete and of a high standard. Supporting information was received on the same date; the standard of requested analyses was very high and there was evidence of accountability and ownership of working papers. Management responses to all queries were prompt, detailed and accurate and demonstrated a detailed understanding of the financial statements. We have issued unqualified audit opinions on the 2011-12 financial statements and the regularity of transactions reflected in those financial statements.	-
A number of technical accounting matters were considered during the audit process, including accounting for retirement benefits, lease dilapidation provisions, income recognition and changes in HM Treasury's financial reporting manual.	Page 4
Overall, we consider arrangements in the control environment associated with the compilation of the financial statements to be appropriate for the Commission. We have raised one management recommendation over good practice regarding evidencing financial controls in place.	Page 10
Use of resources	
The Commission met its financial targets through effective financial planning and management throughout the year. A surplus of £165,000, prior to actuarial gains or losses, was reported against a budget surplus of £81,000. The 2012-13 budget forecasts a £395,000 surplus, although this does not take into account planned reductions in income from Scottish Water and licensed providers of £594,000 which will be made in 2012-13. The forecast loss of £199,000 will utilise cash balances carried forward from previous years.	Pages 5 and 6
Governance	
There have been significant changes to governance practices in the year as a result of the internal audit recommendations. The governance statement confirms the existence of a comprehensive framework. Arrangements to prevent and detect fraud are embedded in internal controls.	Page 9
Internal audit completed their planned audit work for the year and concluded that "*no critical control weaknesses that were considered to be pervasive in their effects on the organisation's overall system of internal control were found*".	Page 10
Mandatory communications	
We have no significant matters to communicate in respect of audit differences or management representation letter content.	Appendices 2 and 3

Accounting policies; technical accounting matters

There have been no changes to accounting policies in 2011-12.

The financial reporting framework, as set out in HM Treasury's *Financial Reporting Manual* ("FReM") 2011-12, included a number of amendments. These have been correctly implemented in the management commentary and financial statements.

All other accounting policies have been applied consistently.

Accounting policies	There have been no changes to accounting policies in 2011-12. The accounting policies for the Commission remain appropriate.
Financial reporting framework ("FReM")	The Commission prepares financial statements having regard to HM Treasury's *Financial Reporting Manual* ("FReM"). The 2011-12 FReM has some new requirements, including: ▪ disclosure of median pay as part of the remuneration report; ▪ reference to the preparation of sustainability reports within the directors' report; and ▪ a governance statement, replacing the statement of internal control. We discussed the changes to the FReM with management and these have been appropriately reflected in the management commentary and financial statements.
Retirement benefits	There has been a significant increase (£134,000) in the net retirement benefit obligation. Within the net balance, assets increased by £507,000 and liabilities increased by £641,000. In line with IAS 19 *Retirement benefits,* management engaged actuaries to value the assets and liabilities at 31 March 2012. The actuaries use a number of assumptions. Using our actuarial team, we considered these assumptions as part of our audit and confirmed that the assumptions used are within KPMG's benchmark ranges. We reviewed the disclosure of pensions assets and liabilities throughout the financial statements and recorded one adjustment (appendix three), relating to the disclosure of the net liability rather than gross assets and liabilities.
Accounting for lease dilapidation costs	In March 2011 the Commission moved into its new premises on a 15 year lease (with a ten year break clause). We reviewed the terms of the lease agreement, which include a requirement that the Commission pays the landlord, at the end of the lease, for costs relating to "*any dilapidations within one month after the expiry of the lease*". In 2010-11 the Commission paid one-off dilapidation costs of £70,000 to their previous landlord. IAS37 *Provisions, contingent liabilities and contingent assets* requires that a provision is recognised when there is a liability, i.e. a present obligation resulting from past events. As the liability is being incurred through the Commission's occupation of its current premises, a provision should be established based on an appropriate estimate of the future costs relating to dilapidation payments for the current lease. The Commission is currently considering the best method of assessing the costs, and plans to recognise this from 2012-13 onwards. As this is the first year in a minimum ten year lease, any provision relating for 2011-12 is considered to be insignificant to the financial statements. We acknowledge that this accounting treatment may appear, like other areas such as depreciation, to be inconsistent with timing of cash received from Scottish Water and licensed providers, but it is required by the accounting framework in which the Commission prepares its financial statements.

Financial position

The Commission continues to waive receipts from Scottish Water and licensed providers.

Agreement has been reached with the Scottish Government to reduce funding by 15% over the current regulatory period. This will be supplemented by using cash generated from previous surpluses to cover increased costs during the peak regulatory period from 2012-14.

The regulatory cycle in which the Commission operates requires flexibility in funding and financial planning because activity levels differ across the five year period. In June 2010, the Scottish Government agreed total funding of £19.8 million for the period 2010 to 2015, representing annual income of £3.96 million.

Similar to all publicly funded bodies, the Commission has been required to deliver efficiency savings and reduce recurring expenditure. The Commission has responded positively to this requirement and, in December 2011, agreed a reduced five year funding envelope of £16.9 million. This 15% saving is primarily the result of increased partnership working with Scottish Water and reduced regulatory bureaucracy.

The financial context is evident in the table opposite, which summarises budget and actual positions over the period 2010 -13.

In both 2010-11 and 2011-12 the Commission waived receipts from Scottish Water and licensed providers, reducing income from the £3.96 million annual average. This will continue in line with the reducing funding profile agreed with the Scottish Government. Management information and finance reports have accurately forecast movements against budget, allowing the Commission to anticipate reduced income requirements, albeit that significant surpluses continued to be reported.

In 2012-13 management plans to use £0.2 million of cash generated by these previous surpluses, which will result in an accounting loss in the financial year. This is permitted by the terms of their financial agreement with the Scottish Government, which allows up to 20% of funding to be transferred between one year and the next.

	Actual 2010-11 £'000	Budget 2011-12 £'000	Actual 2011-12 £'000	Budget 2012-13 £'000
Income from activities	3,278	3,660	3,204	3,366
Other	1	-	29	-
Waterwatch Scotland	613	-	107	-
Total income	**3,892**	**3,660**	**3,340**	**3,366**
Staff costs	1,349	1,529	1,361	1,503
Other expenditure	1,578	2,310	1,708	2,063
Waterwatch Scotland	613	-	107	-
Total expenditure	**3,550**	**3,839**	**3,176**	**3,566**
Net surplus/ (deficit)	**352**	**(179)**	**164**	**(200)**

- The anticipated increase in staff costs was not achieved due to challenges in recruiting the required quality of applicant. While we understand there has been no significant impact to date, there is an ongoing risk that objectives are not achieved or that consultancy or agency costs are greater than the cost of employing relevant staff.
- Regulation, licensing and consultancy expenditure is the underlying driver of movements in other expenditure. Regulatory activity is expected to peak between 2012-14 as the Commission prepares to set prices for the five year period from 2015.
- Both income and expenditure reduced in 2011-12 due to the winding up of Waterwatch Scotland in July 2012 and the corresponding reduction in levy received from Scottish Water and funding provided to Waterwatch Scotland. This reduction has no impact on the surplus because income and expenditure were equal.

Best Value

We have considered arrangements to achieve Best Value and regularity of income and expenditure.

We have noted one recommendation to enhance the existing expenses policy.

Audit area	Overview	Findings
Best Value	In April 2002 the Scottish Ministers introduced a non-statutory duty on accountable officers to ensure arrangements exist to secure Best Value. Audit Scotland has been committed to extending the Best Value audit regime across the whole public sector for some time now. Using the Scottish Executive's nine Best Value principles as a basis for audit activity, Audit Scotland previously selected five areas as priority development areas (use of resources, governance and risk management, accountability, review and option appraisal, and joint working). A series of toolkits covering financial, performance and governance processes are available for public sector organisations and auditor to use, but auditors were not required to complete specific toolkit(s) in 2011-12.	We reviewed some of the processes management has established to ensure Best Value is achieved throughout the organisation. This included a review of expenditure authorisation by senior management and the Commission. The Commission follows with Scottish Government procurement requirements, including receiving three tenders for all expenditure over £5,000. Significant procurement costs relates to external consultancy work procured through agreed Scottish Government frameworks.
Regularity	As part of our audit of the Commission's financial statements, we are required by the Public Finance and Accountability (Scotland) Act 2000 to give an opinion on the regularity of expenditure and receipts shown in the financial statements.	As part of our work on the regularity of expenditure we reviewed the expenses policy – applicable to Commission members and staff – and tested a sample of expenses for reasonableness and authorisation in line with the Commission's procedures. Our sample testing did not identify any weaknesses. The expenses policy is generally consistent with good practice, particularly in respect of requiring receipts to support all claims, clearly stating the responsibility of employees and the implications of non-compliance, use of corporate travel agents, the underlying principle of obtaining value for money, and clarity that limits on expenses such as subsistence are limits and not allowances. We have identified some areas that would enhance the policy by reducing ambiguity or interpretation. ***Recommendation one***

Corporate governance framework and supporting arrangements

Over-arching and supporting corporate governance arrangements were subject to significant change and continue to provide a sound framework for organisational decision-making.

We have noted one recommendation to improve evidence of key financial controls.

Corporate governance and internal control arrangements **Standards of conduct and prevention and detection of corruption**	The Commission maintains an integrated governance framework to provide an appropriate structure for decision-marking, accountability, control and behaviour. During the year there were significant changes to governance practices as a result of recommendations made by internal audit. These included: ▪ a reduction in the frequency of Commission meetings; ▪ a review and update to the Commission's code of conduct and rules of procedure; and ▪ the dissolution of the remuneration committee, with their responsibilities to be taken over by non-executive members of the Commission. Our testing of the design and operation of financial controls over significant risk points confirms that controls are designed appropriately and operating effectively. However, some controls over monthly review of financial activity and authorisation of expenditure were not always evidenced. Management should ensure all controls, including review and authorisation, are evidenced by signing and dating. ***Recommendation two***
Governance statement	The governance statement provides detail on the governance framework, the system of internal control, internal audit, internal financial controls and risk management arrangements, and analyses the effectiveness of these elements of the framework. It describes a number of sources of assurance for the accountable officer. We have reviewed the governance statement and have confirmed that it is in line with new guidance and reflects our understanding of the Commission.
Internal audit	As set out in our audit plan and strategy, we reviewed the work of internal audit in 2011-12. The content of the internal audit plan is, in our view, appropriate for the size and nature of the Commission. During the year internal audit submitted the following reports to the Commission: ▪ governance arrangements; ▪ office relocation process in 2010-11; and ▪ follow up of the status of previous recommendations. Internal audit completed their planned audit work for the year and concluded that "*no critical control weaknesses that were considered to be pervasive in their effects on the organisation's overall system of internal control were found*". Due to the areas of focus of internal audit in the year, we did not place specific reliance on any the reports issued in the year, but they assisted our understanding of the Commission's operations and overall systems of internal control.

Corporate governance framework and supporting arrangements (continued)

Prevention and detection of fraud	Procedures and controls related to fraud are designed and implemented effectively. Expenditure is reviewed and authorised by appropriate finance personnel and senior management. Where required, staff have company credit cards, for which expenditure is reviewed and authorised in line with other expenditure policy. In 2011-12 no significant or other fraud or irregularity was identified by management, internal audit, or through the course of our external audit work.

Appendices

Audit Scotland code of audit practice – responsibilities of the Commission

Financial statements

Audited bodies' financial statements are an essential part of accounting for their stewardship of the resources made available to them and their performance in the use of those resources. Audited bodies are responsible for:

- ensuring the regularity of transactions, by putting in place systems of internal control to ensure that they are in accordance with the appropriate authority;
- maintaining proper accounting records;
- preparing financial statements which give a true and fair view of their financial position and their expenditure and income, in accordance with the relevant financial reporting framework (eg, the Financial Reporting Manual or an Accounting Code of Practice);
- preparing and publishing with their financial statements an annual governance statement, statement on internal control or statement on internal financial control and a remuneration report; and
- preparing consolidation packs and, in larger bodies, preparing a Whole of Government Accounts return.

Systems of internal control

Audited bodies are responsible for developing and implementing systems of internal control, including risk management, financial, operational and compliance controls. They are required to conduct annual reviews of the effectiveness of their governance, systems of internal control, or internal financial control, and report publicly that they have done so. Such reviews should take account of the work of internal audit and be carried out by those charged with governance, usually through bodies' audit committees.

Prevention and detection of fraud and irregularities

Audited bodies are responsible for establishing arrangements to prevent and detect fraud and other irregularity. This includes:

- developing, promoting and monitoring compliance with standing orders and financial instructions;
- developing and implementing strategies to prevent and detect fraud and other irregularity;
- receiving and investigating alleged breaches of proper standards of financial conduct or fraud and irregularity; and
- participating, when required, in data matching exercises carried out by Audit Scotland.

Standards of conduct and arrangements for the prevention and detection of bribery and corruption

Audited bodies are responsible for ensuring that their affairs are managed in accordance with proper standards of conduct and should put proper arrangements in place for:

- implementing and monitoring compliance with appropriate guidance on standards of conduct and codes of conduct for members and officers;
- promoting appropriate values and standards; and
- developing, promoting and monitoring compliance with standing orders and financial instructions.

Audit Scotland code of audit practice – responsibilities of the Commission (continued)

Financial position

Audited bodies are responsible for conducting their affairs and for putting in place proper arrangements to ensure that their financial position is soundly based having regard to:

- such financial monitoring and reporting arrangements as may be specified;
- compliance with any statutory financial requirements and achievement of financial targets;
- balances and reserves, including strategies about levels and future use; and
- the impact of planned future policies and foreseeable developments on their financial position.

Best Value

Achievement of Best Value or value for money depends on the existence of sound management arrangements for services, including procedures for planning, appraisal, authorisation and control, accountability and evaluation of the use of resources. Audited bodies are responsible for ensuring that these matters are given due priority and resources, and that proper procedures are established and operate satisfactorily.

Management representations

You are required to provide us with representations on specific matters such as your financial standing, application of accounting policies, and whether the transactions within the financial statements are legal and unaffected by fraud.

In the representation letter, we requested your specific confirmation that:

a) all significant retirement benefits, including any arrangements that are:
   - statutory, contractual or implicit in the employer's actions;
   - arise in the UK and the Republic of Ireland or overseas;
   - funded or unfunded; and
   - approved or unapproved,
   - have been identified and properly accounted for.

b) all settlements and curtailments have been identified and properly accounted for; and

c) the consolidation of retirement benefits arrangements in the year has been appropriately accounted for.

Audit differences

Two adjusted audit differences were identified during the audit process; they have no impact on the retained surplus total comprehensive income.

Adjusted caption	£'000
Income	107
Expenditure	(107)
Pension asset	(2,973)
Net pension liability	2,973
Total	-

Unadjusted caption	Nature of difference	£'000
No unadjusted audit differences have been identified.		
Total		-

Minor presentational amendments were made to the disclosures in respect of the remuneration report, related parties disclosure and pension disclosure note. In addition, some amendments to the management commentary were made to ensure it reflects best practice.

Action plan

Priority rating for recommendations		
Grade one (significant) observations are those relating to business issues, high level or other important internal controls. These are significant matters relating to factors critical to the success of the Council or systems under consideration. The weaknesses may therefore give rise to loss or error.	**Grade two** (material) observations are those on less important control systems, one-off items subsequently corrected, improvements to the efficiency and effectiveness of controls and items which may be significant in the future. The weakness is not necessarily great, but the risk of error would be significantly reduced if it were rectified.	**Grade three** (minor) observations are those recommendations to improve the efficiency and effectiveness of controls and recommendations which would assist us as auditors. The weakness does not appear to affect the availability of the control to meet their objectives in any significant way. These are less significant observations than grades one or two, but we still consider they merit attention.

Finding(s) and risk(s)	Recommendation(s)	Agreed management actions
1 Expenses policy – compliance with best practice		**Material**
We have identified some areas of the existing expenses policy that could be enhanced by reducing ambiguity or interpretation. There are ongoing reputational risks associated with the application of expenses policies and use of taxpayers' funds.	Areas for consideration include: ▪ Air travel – guidance on when first class is or is not appropriate, in a similar way to the requirements in respect of rail travel. We also suggest that the requirement that "fully flexible fare must be obtained" for frequent flyers is amended to say that it can be considered and provide guidance on when this may be appropriate. ▪ There are a number of areas where claimants are required to "ensure" that value for money is obtains, e.g. commission members booking their own travel. This could be strengthened by requiring that value for money can be "demonstrated". ▪ Accommodation – the policy provides guidance on the type/quality of hotels that should be used, but would be strengthened by adding financial guidelines for one or more cities. ▪ Entertaining and hospitality – consider whether internal entertainment provided solely for Commission staff is appropriate. ▪ Meeting refreshments – the policy does not include guidance on when it is appropriate, or not, to purchase refreshments for internal meetings.	These changes have been noted and the expense policy will be updated accordingly and re-issued to staff. **Responsible officer:** Financial controller **Implementation date:** 31 July 2012

Action plan (continued)

Finding(s) and risk(s)	Recommendation(s)	Agreed management actions
2 Financial controls – evidence of review		**Low**
The monthly review of financial activity and authorisation of expenditure were not always evidenced. There is a risk that effective operation of key controls cannot be demonstrated.	Management should ensure all controls, including review and authorisation, are evidenced by signing and dating.	The monthly management pack will be updated to include a ‘reviewed by:’ section, to be signed by either the chief executive or director of corporate affairs. **Responsible officer:** Financial controller **Implementation date:** 31 July 2012

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