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Scottish Environment Protection Agency

Annual Report to Board Members and the Auditor General for Scotland

For the financial year ended 31 March 2013

Board Meeting

30 July 2013

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

30 July 2013

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 2013. This report also discharges our obligations under International Standards of Auditing ("ISA") 260: Reporting to those charged with Governance. We have assumed that the responsibility for governance has been discharged to the Audit Committee by the SEPA Board. A draft version of this report was presented and discussed at the Audit Committee meeting in June 2013.

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 (May 2011).

The scope of our audit and audit risk assessment was set out in our audit plan, presented to the Audit Committee on 11 December 2012. 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 and elevated audit risks are set out within this report.

We have completed our year end substantive external audit work on the financial statements and will issue an unqualified opinion following Board approval and a signed letter of representation from the Accountable Officer.

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 Scottish Environment Protection Agency's (SEPA) financial statements for the year ended 31 March 2013.

We have discussed this report with the Acting Chief Officer Finance and the Acting Head of Finance as part of our audit process. The purpose of this report is to update the Audit Committee and Board on the outcome 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 Audit Scotland Code of Audit Practice. 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.

The audit process

We received a draft set of financial statements and supporting working papers within the timetable agreed and our audit fieldwork was undertaken over a 3 week period, the week commencing 13 May 2013.

The draft financial statements were of a reasonable standard. However, in future years the draft would benefit from additional review before audit work commences to ensure that all balances correctly cast and agree to the trial balance, are consistent throughout the financial statements and all disclosures are in line with the FReM. This would reduce the number of versions of accounts produced during the year end audit and increase the efficiency of the audit process **[See Action Point 1, Appendix 1].**

A small number of financial adjustments, and a number of disclosure amendments were discussed and agreed with Management and these are reflected in the final financial statements**.**

Opinion

Subject to confirmation there are no post balance sheet events, and a signed letter of representation, we will issue an **unqualified audit opinion** following the Board meeting on 30 July 2013, including regularity of expenditure and income.

Our opinion is unqualified in respect of the Remuneration Report [the section subject to audit] 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 communication required under International Standard on Auditing "Communication with those charged with governance". This section includes communication regarding any identified differences which have not been adjusted by management in the financial 2012/13 financial statements.

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 internal control, which are included in **Appendix 1.** However, these are not deemed to be significant to impact on SEPA's Governance Statement.

Section 2: Financial performance

Financial performance 2012/13

EXPENDITURE	**2012/13**	**2011/12**
	£m	**£m**
Staff costs	(50.120)	(47.982)
Depreciation and impairments	(3.007)	(2.577)
Other operating charges	(23.555)	(21.048)
	(76.682)	(71.607)
INCOME		
Income from charging schemes	35.151	34.830
Other Income	3.280	2.248
Interest receivable and similar income	0.003	0.085
Interest payable net cost of IAS 19 assets and liabilities	(0.638)	
Comprehensive net expenditure before interest	(38.884)	(34444)
EXCESS OF COMPREHENSIVE EXPENDITURE OVER INCOME FOR THE YEAR FUNDED BY GIA[1]	(39.251)	(35.344)

* As extracted from the 2012/13 Comprehensive Expenditure statement.

The £5 million increase in expenditure for 2012/13 is driven in part by an increase of £2 million in staff costs. This is due to payroll costs for salaried staff increasing as a result of the increase in staff numbers. Staff costs included one off payments of £1.134 million (2012 - £1.424 million) relating to 2012/13 voluntary severance exercise, which was taken up by 15 employees. For any employees which took voluntary severance and also met the criteria of early retirement under pension scheme rules, pensions strain costs are also included within the one off payments. Pension strain costs represent the additional costs incurred by the pension scheme for paying a pension before the normal retirement age. The costs of temporary staff have risen primarily due to specific funding being received to recruit staff on fixed term contracts.

The remainder of the expenditure increase is driven by a £2.5 million increase in other operating costs, mainly due to an increase in the cost of supplies and service costs.

Income from charging schemes and other income has increased marginally from the prior year and against the budgeted figures. This is due to small levels of unplanned income in a number of areas including Waste Management Licensing, Water Framework Directive and European Union grant for SEWeb LIFE+, the project to develop Scotland's Environment Web, which SEPA is leading.

SEPA was not set an official efficiency savings target in 2012/13. However, it has been recognised that there is an expectation that each public sector body should aim to deliver annual operating efficiency savings of at least 3%. SEPA reduced running costs by £1.710 million as part of the budget setting exercise for 2012/13.

Capital expenditure in the year included the fit out of the Angus Smith Building, which will accommodate 350 of SEPA's scientific, advisory, and regulatory and support staff. It is expected that staff will transfer to the building in August 2013. The facility has provided the opportunity for SEPA to rationalise its laboratories.

[1] Grant in Aid ("GIA")

During the audit, we had detailed discussions with management around the appropriateness of the bad debt provision (£0.014 million in 2012/13) in light of the current economic climate. We noted that management have strengthened their debt collection procedures resulting in more debts being promptly passed to debt collection. Management also assess the recoverability of debt on a case by case basis, using judgement to determine the likelihood of the debt being paid. Following a review during the year, £0.285m of bad debts were written off. However, no provision for bad debts is recognised within the account, therefore, this is an area which management should continue to keep under review. **See Action Point 3, Appendix 1.**

Performance against budget (excluding EU income and expenditure)[2]

	Budget 2012/13	Actual 2012/13	Variance
	£m	£m	£m
Grant in Aid	39.244	39.246	0.002
Income from Charging Schemes	35.068	35.150	0.082
Other Income	2.833	3.280	0.447
Total Income	**75.361**	**76.101**	**0.531**
Staff Costs	45.798	45.918	0.120
Other Operating Costs	22.133	21.963	(0.170)
Revenue Projects	4.529	4.571	0.042
Depreciation	3.175	3.175	0
Total Expenditure	**75.635**	**75.627**	**(0.008)**

Throughout the year SEPA continued to monitor performance against budget. There were no significant variances noted. SEPA's resource limit outturn for 2012/13 was as follows:

	Outturn	Budget	Variance
DEPARTMENT EXPENDITURE LIMIT	**£'000**	**£'000**	**£'000**
Capital Expenditure (Cash)	4,772	4,585	(187)
Total Capital Expenditure	4,772	4,585	(187)
Operating Expenditure (Cash)	34,496	34,661	165
Depreciation / Amortisation (Non-cash)	3,179	2,973	(206)
GIA not drawn down - Flood	-	120	120
Total Operating Expenditure	37,675	37,754	79
TOTAL EXPENDITURE	42,447	42,339	(108)
ANNUALLY MANAGED EXPENDITURE LIMIT	1,840	-	(1,840)

[2] *SEPA Financial Monitoring Report for the period ended 31 March 2013*, Agency Board Reports 28 May 2013.

Financial outlook – 2013/14 and beyond

The 2013/14 budget estimates total revenue of £75.100 million, comprising £37.771 million from Grant in Aid, £35.773 million from charging schemes and £1.556 million of other income. Compared to 2012/13, this represents an anticipated reduction in Grant in Aid of £1.480 million, a reduction in other income of £1.277 million, coupled with a slight increase in income from charging schemes of £0.700 million.

Fees for the majority of Scottish charging schemes have increased by 2% and will be subject to annual review. In 2013/14, the following schemes will not have increased charges applied:

- Special Waste Notifications,
- Producer Responsibility (Packaging Waste)
- Transfrontier Shipments
- Waste Electrical and Electronic Equipment
- Waste Batteries and Accumulators

The Scotland Act 2012 devolved to the Scottish Parliament powers to determine the tax regime for disposals to landfill. The Scottish Government introduced a Bill on 17 April 2013 which proposed that Scotland will have its own landfill tax regime, to replace the currently applicable UK-wide regime. SEPA will be responsible for the administration and collection of the tax from 2015 and are currently liaising with relevant stakeholders regarding the implications of this.

SEPA's change programme, including Better Regulation and the related Funding Model, is continuing and the output from this programme will form the basis of SEPA's charging scheme from 2015 onwards. The Financial Strategy will be reviewed to assess the impact once the outputs from the programme are known.

Staff costs have been budgeted at full establishment less budgeted turnover savings of £0.4million. A 1% inflationary uplift has been applied. As of 1 September 2013, all SEPA employees will be auto-enrolled in SEPA's pension scheme. In devising the 2013/14 budget, it has been assumed that staff who have opted out of the current pension arrangements will continue to do so following the introduction of auto-enrolment.

At SEPA's Board strategy meeting on 23 October 2013, a paper on 'Efficiency Savings Proposals 2012/13 to 2014/15' was presented. The paper highlighted that in order to produce a balanced budget in 2013/14 and 2014/15, further cash savings of £1.654million were required. It was proposed and agreed that the deficit would be generated from areas including generating additional Charging Scheme income by £0.310million, reducing travel costs by £0.100 million and reducing the estates refurbishment programme by £0.100million.

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 11 December 2012. 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:

Risk identified/area of audit focus	Audit response
Management override of controls	We have reviewed management's overall fraud arrangements and policies. We have reviewed a sample of significant journal entries (based on our assessment of risk) and examined management's accounting estimates for bias. We also carried out unpredictability testing on immaterial income balances to ensure income was recognised appropriately. This work did not identify any errors that required adjustment to the financial statements.
Risk of fraud in 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. We also performed testing over manual journals entries in order to obtain comfort that manual journals processed were appropriate and that they were supported by a clear business rationale. This work did not identify any errors that required adjustment to the financial statements.
Risk of fraud in 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 errors that required adjustment to the financial statements. However, we have raised a control weakness around the identification and processing of accruals at year end. **See Action Point 2, Appendix 1.**
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 (£0.014 million in 2012/13) in light of the current economic climate. During 2012/13, management have strengthened their debt collection procedures resulting in more debts being promptly passed to debt collectors for collection. Management also assess the recoverability of debt on a case by case basis, using judgement to determine the likelihood of the debt being paid. Following a review during the year, £0.285m of bad debts were written off. **See Action Point 3, Appendix 1.**

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 and verified a sample of input to back up documentation. SEPA's land and buildings and vessels were revalued in the year, resulting in impairments to land and buildings and vessels, which have been reflected in the 2012/13 financial statements.

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 differences	Three differences were identified, one by management and two during the course of our audit, which have been adjusted by management in the 2012/13 financial statements.
Significant accounting principles and policies	Significant accounting principles and policies are disclosed in the notes to the financial statements. We have asked the Accountable Officer to represent to us that they have considered the accounting policies and that there 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 2013) or in Appendix 1 to this report. No significant control weaknesses have been identified which affect SEPA's Governance Statement.
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 of the next audit cycle.

Requirement	Delivery of requirement
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 2012/13, a major part of this work has been our follow up of Audit Scotland's national performance report, Scotland's Public Finances: Addressing the challenges.

We provide brief comment on 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 three matters which are raised within **Appendix 1: Action plan**.

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. There are no matters we wish to bring to your attention concerning fraud.

SEPA's internal control environment is designed to prevent and detect instances of fraud, specifically through segregation of duties and authorisation processes. All fraud is communicated to the Board and Audit Committee.

Following the identification of a small petty cash fraud at a local office, Internal Audit visited four of SEPA's offices and reviewed compliance with SEPA's standing financial instructions (SFIs). Internal Audit found some areas of non-compliance with SFIs including timeliness of reconciliations and adequate segregation of duties, which were reported to management for action.

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.

Audit Scotland National Reports

At the request of Audit Scotland, we are required to follow up on Audit Scotland's National Report 'Scotland's Public Finances: Addressing the Challenges'. The results from this follow up will be reported in a separate letter.

Any relevant Audit Scotland National Performance reports issued in the year are discussed at the Audit Committee, including any actions arising.

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. As part of our audit, we partially relied on internal audit's work over financial management (property, plant and equipment, payroll and income from charging schemes (where relevant to our external audit approach). We reviewed internal audit's working papers to obtain an understanding of the controls tested and incorporated this testing into our audit work.

For 2012/13, Internal Audit were of the opinion that that "the SEPA's systems provide a reasonable basis for maintaining control and that the control framework provides reasonable assurance regarding the effective and efficient achievement of strategic objectives".

Risk Management Arrangements

Within SEPA each Directorate, and the Chief Executive's Office, have a risk register which is considered at least quarterly by the Directorate Management Teams. For some of the larger departments in Directorates, departmental risk registers are also maintained.

SEPA's Risk Management procedures ensure that all risks are regularly reviewed by the Risk Management Group. Management of risk is reported quarterly to the Agency Management Team (AMT) and annually to SEPA's Audit Committee and Board. The Risk Management Group also reviews Directorate, Change

Programme and Project risk registers every six months to ensure that these areas of SEPA are carrying out routine risk management and reporting activities.

SEPA undertook a review of the Agency's risk register in June 2012 to ensure the risk register accurately reflected the 2012-2013 Annual Operating Plan and the Corporate Plan (2012 - 2017). Residual risks rated as 'High' include the Impact from restricted funding/ Need for efficiencies and Security & Data Handling.

4 risk were removed from the risk register during 2012/13, including risks associated with strike action and poor business continuity planning. Two new risks, both of which were classified as medium risk, were added which related to SEPA's estates strategy and landfill sites/waste transfer stations.

Appendices

Appendix 1: 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 future years the draft financial statements would benefit from additional review before audit work commences to ensure that all balances correctly cast and agree to the trial balance, are consistent throughout the financial statements and all disclosures are in line with the FReM. This would reduce the number of versions of accounts produced and increase the efficiency of the audit process.	Additional audit time is incurred/inefficient year end process/risk errors/omissions are missed	Finance staff should perform a check of the financial statements prior to audit work commencing to check for internal consistency and ensure figures cast correctly. In order to minimise version control, a complete draft set of financial statements should be available for audit work commencing. **Management response:** We will review future years accounting changes complexity and amend timetable accordingly. **Responsible Officer:** Jennifer Welsh, Head of Finance **Implementation date:** 1 November 2013
2	In the course of our audit work on accounts payable cut-off, we identified three expenditure items which related to 2012/13 but had not been accrued for.	That expenses incurred relating to the financial year but not invoiced are not accrued for thus understating expenses and liabilities for the period.	Finance staff should review all expenditure items, above the £1,000 threshold, posted in the period after year end to ensure that items are accrued for appropriately. **Management response:** Agreed we shall remind budget holders of year end processes and implement robust checks. **Responsible Officer:** Jennifer Welsh, Head of Finance **Implementation date:** 1 November 2013

No	Finding	Risk	Recommendation
3	Management also assess the recoverability of debt on a case by case basis, using judgement to determine the likelihood of the debt being paid. Following a review during the year, £285,000 of bad debts were written off. However, SEPA have only recognised a provision of £14,000 within their accounts.	Debtor balances are not recoverable.	Finance should continue to review aged debtors periodically to assess the likelihood of recoverability to ensue the level of bad debt provision remains appropriate. **Management response:** We will continue to review aged debtors on a monthly basis to ensure bad debt provision remains appropriate. **Responsible Officer:** Jennifer Welsh, Head of Finance **Implementation date:** Immediate