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Water Industry Commission for Scotland

Annual audit report

Audit: year ended 31 March 2013

18 October 2013

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 ("the Commission") 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.

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 overview, 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 2013.

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

Area	Summary observations	Analysis
Service overview		
Business issues and financial position	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. Subsequently, a further reduction of £1.43 million was agreed, spread over 2012-13 to 2014-15. In 2012-13 the Commission recognised a total deficit of £0.39 million, after £0.35 million levies were returned to Scottish Water and including an actuarial loss of £0.24 million in respect of the pension scheme. The Commission has agreed to freeze the Scottish Water levy in 2013-14, resulting in a £0.05 million reduction on the original agreement, and the overall budgeted net deficit is £0.06 million.	Page 4
Performance management		
Performance management	Overall, there is a rigorous budget setting process and we note that the Commission agreed a reduced budget for the period from 2010 to 2015 and is delivering on its efficiency agenda.	Page 6
Governance and narrative reporting		
Governance	Our review of governance arrangements did not identify any issues, we consider the arrangements to be appropriate for the size and operations of the Commission.	Page 8
Control observations	Our testing, combined with that of internal audit, of the design and operation of financial controls over significant risk points confirms that controls relating to financial systems and procedures are designed appropriately and operating effectively. Control observations identified within our 2011-12 audit report have been addressed during the year.	Page 12
Financial statements and accounting		
Accounting policies	There have been no changes to accounting policies in 2012-13. No newly effective accounting standards are expected to have a material impact on next year's financial statements.	Page 11
Audit conclusions	We have issued an unqualified audit opinion on the 2012-13 financial statements.	Page 12
Year-end process	The financial statements, management commentary, governance statement and remuneration report were received by the agreed date and were supported by high quality working papers.	Page 12

Service overview

Our perspective on key business issues and
the financial position of the Commission

Key business issues and financial position

The Commission continues to waive receipts from Scottish Water and licensed providers. In December 2011, agreement was reached with the Scottish Government to reduce funding by 15% over the current regulatory period.

As a result, the Commission is operating deficit budgets, drawing on cash generated in prior years. The 2013-14 deficit is budgeted to be lower than in 2012-13, as the 15% reduction was weighted towards the earlier years.

The Commission has 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.

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. In December 2011 the Commission agreed a further 15% reduction in funding, representing £1.43 million lower income over the 2012-13 to 2014-15 financial years.

The Commission is working with stakeholders to ensure that the Scottish Government's targets for Scottish Water and the sector are met at the lowest reasonable cost. The outcome of the next price review will apply for six years from 2015.

Financial position

	Actual 2011-12 £'000	Budget 2012-13 £'000	Actual 2012-13 £'000	Budget 2013-14 £'000
Income from activities	3,204	3,366	3,034	3,435
Other	29	-	15	-
Waterwatch Scotland	107	-	-	-
Total income	**3,340**	**3,366**	**3,049**	**3,435**
Staff costs	1,361	1,503	1,300	1,465
Other expenditure	1,707	2,063	1,899	2,030
Waterwatch Scotland	107	-	-	-
Total expenditure	**3,175**	**3,566**	**3,199**	**3,495**
Net surplus/ (deficit)	**165**	**(200)**	**(150)**	**(60)**

Source: KPMG analysis of management schedules

As in prior years, the Commission agreed to waive levies from Scottish Water, totalling £0.34 million in 2012-13. In common with other public sector bodies, efficiencies in operating expenditure are required to reflect reduced income; budgeted expenditure in 2012-13 was 7% (£0.27 million) lower than the 2011-12 budget.

Notwithstanding the waiver of levies, the Commission operated within budget, due to reduced staff costs and expenditure. Staff costs were £0.203 million lower than budgeted, arising from challenges in recruiting the required quality of applicants. This gives rise to a risk that objectives are not achieved or that consultancy or agency costs are greater than the cost of employing relevant staff.

Other expenditure was budgeted to increase compared to 2011-12, to reflect additional consultancy costs in preparation for the new pricing structure from 2015. The actual costs were £0.162 million lower than budgeted, reflecting delays in elements of budgeted licensing and regulation activity.

Budget 2013-14

In accordance with the agreed income structure, levies are budgeted to increase in 2013-14, as the £1.43 million reduction was weighted towards the earlier years.

The increase in staff costs reflects an increase in average FTEs from 16 in 2012-13 to 19 in 2013-14 from the recruitment of three analysts. An increase in other expenditure is primarily due to the expected greater consultancy costs, required pending recruitment of the director of analysis.

The general reserve is budgeted at £0.616 million as at 31 March 2014, compared to £0.676 million as at 31 March 2013.

Performance management

Our perspective on the performance management arrangements, including follow up work on Audit Scotland reports

Performance management

Management have considered the impact on management commentary within the financial statements from the Director General, Governance and Communities' letter regarding corporate expectations.

Best Value	In April 2002 the Scottish Ministers introduced a non-statutory duty on accountable officers to ensure there are arrangements designed to secure Best Value. Audit Scotland is committed to extending the Best Value audit regime across the whole public sector. 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). We reviewed some of the processes management has established to ensure Best Value is achieved throughout the organisation. This includes a review of expenditure authorisation by senior management and the Commission. The Commission follows Scottish Government procurement requirements, including receiving three tenders for all expenditure over £50,000, although there have been no such tender requirements in 2012-13. Significant procurement costs relates to external consultancy work procured through agreed Scottish Government frameworks. Internal audit performed a review of procurement during 2012-13 and made four recommendations, two of which were "medium graded", relating to the documentation of back-up designated authorisers and enhancements in respect of monitoring the performance of suppliers.
Performance management	Overall, there is a rigorous budget setting process and we note that the Commission agreed a reduced budget for the period from 2010 to 2015 and is delivering on its efficiency agenda. The results for the year to 31 March 2013 are within budget, primarily due to staff costs being less than expected arising from difficulties in recruiting for open positions.
Corporate expectations	The Scottish Government's Director General, Governance and Communities wrote to public bodies on corporate expectations in July 2012 asking for a preliminary assessment of progress towards these expectations. Management have considered progress against the expectations and provided narrative within their annual efficiency statement. The Commission is proactively reducing operating costs and management consider that this ethos aligns with the expectations.
Scotland's public finances: addressing the challenges	As part of its targeted approach to following-up a small number of performance audit reports each year, Audit Scotland has identified the *Scotland's public finances: Addressing the challenges for* follow-up by local auditors in 2012-13. The aim of the follow-up work is to assess how public bodies are responding to the challenges of public sector budget constraints and their efforts to achieve financial stability. The targeted follow up does not apply to the Commission, and we will not be reporting separately to Audit Scotland. As above, the Commission agreed a reduced budget for the period from 2010 to 2015 and is delivering on its efficiency agenda. The Commission has robust budgeting procedures and operated within budget in 2012-13.

Governance and narrative reporting

Our overall perspective on your narrative reporting, including the remuneration report and annual governance statement

Update on controls findings from our audit

Corporate governance arrangements

We updated our understanding of the governance framework and did not identify any issues in relation to governance.

Annual governance statement and governance arrangements	The statement for 2012-13 outlines the corporate governance and risk management arrangements in operation in the financial year. It 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. The statement, which is made by the accountable officer, considers the effectiveness of the system of internal control based on information provided by the audit and risk committee and internal audit. The statement identifies that there have been no significant risk-related matters. We have updated our understanding of the governance framework and documented this through our overall assessment of the Commission's risk and control environment. This work has formed part of our assessment of the Commission's annual governance statement. We consider the governance framework and annual governance statement to be appropriate for the Commission.
Annual report, including the management commentary	The financial statements form part of the annual report of the Commission the year ended 31 March 2013. We are required to consider the management commentary and provide our opinion on the consistency of it with the financial statements. We are satisfied that the information contained within the management commentary is consistent with the financial statements. Changes to the UK Corporate Governance Code, which will be applicable for the year ending 31 March 2014, will require that the 'front end' narrative reporting is 'fair, balanced and understandable.' Audit committees will be expected to consider this as part of their consideration of the annual report and financial statements. In our view, the annual report already complies well with this requirement, although we recommend early consideration of the requirements of the revised Code against the Commission's reporting format.

Corporate governance arrangements (continued)

Remuneration report	The remuneration report and pension figures were provided in advance of the commencement of the audit, and supported by good quality information to support the disclosures provided.
Internal audit	We reviewed the work of internal audit in 2012-13 to inform our assessment of risks that need to be considered and addressed during the audit. Our review of internal audit reports also helps ensure that any duplication of work is avoided.. 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: ■ travel and meeting arrangements; ■ communication arrangements; ■ data and information management arrangements; and ■ procurement arrangements. Internal audit completed their planned audit work for the year and concluded that "*based on the work we have completed we believe that there is an adequate and effective system of governance, risk management and internal control to address the risk that management's objectives are not fully achieved* ". 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 supported our understanding of the Commission's operations and assessment of overall systems of internal control.
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 2012-13 no significant or other fraud or irregularity was identified by management, internal audit, or through the course of our external audit work.

Financial statements and accounting

Our perspective on the preparation of the financial statements and key accounting judgements made by management

Accounting policies and going concern

There have been no changes to accounting policies in 2012-13. All accounting policies have been applied consistently.

There have been no substantive changes to the financial reporting framework as set out in the Government's *Financial Reporting Manual* ("FReM").

The financial statements have been prepared on a going concern basis

Accounting framework and application of accounting policies	
Area	**KPMG comment**
Financial reporting framework	■ The Commission prepared the financial statements in accordance with the Government's Financial Reporting Manual 2012-13 ("FReM"). ■ During the year there have been no substantive changes in financial reporting requirements, and consequently there are no material changes to the Commission's accounting policies. ■ We are satisfied that the accounting policies adopted remain appropriate to the Commission.
Impact of revised accounting standards	■ Disclosure has been included in the financial statements highlighting that the impact of revisions to IAS 19 `*Employee benefits*' if the standard had been adopted early in 2012-13 would not have been material, with the estimated change to finance costs being of around £28,000. ■ No other newly effective accounting standards are considered to have a material impact on the Commission's financial statements.
Going concern	■ The financial statements have been prepared under the assumption that the organisation is a going concern. Given the nature of the Commission's activities and the income stream agreed with the Scottish Government through to 2014-15, this is a reasonable assumption. The budget for 2013-14 is broadly balanced and the Commission holds cash of over £0.7 million.

Audit conclusions

We have issued an unqualified audit opinion on the financial statements and the regularity of transactions reflected in those financial statements.

The financial statements were made available on a timely basis and were accompanied by high quality working papers.

Audit conclusions

We have issued an unqualified opinion on the truth and fairness of the state of the Commission's affairs as at 31 March 2013, and of the Commission's deficit for the year then ended. We also provide our unqualified opinion on the regularity of transactions within the year. There are no matters identified on which we are required to report by exception.

In gathering the evidence for our opinion we have:

- performed a mixture of substantive and controls testing to ensure an efficient approach that covers all the key risks;
- liaised with internal audit and reviewed their reports to ensure all key risk areas having a potential financial statements impact have been considered;
- reviewed assumptions and judgements made by management and considered these for appropriateness;
- considered if the financial statements may be affected by fraud through discussions with senior management and internal audit to gain a better understanding of their work in relation to prevention and detection of fraud with the potential to impact on the financial statements; and
- attended the audit committee to communicate our findings to those charged with governance, but also to update our understanding of the key governance processes and obtain key stakeholder insights.

Financial statements preparation

Preparation of the financial statements

- High quality working papers and substantially complete draft financial statements were provided at the start of the audit fieldwork in June 2013. This included the management commentary and remuneration report, although not the chairman's foreword and the business review.
- In advance of our audit fieldwork, we issued a 'prepared by client' request setting out a list of required analyses and supporting documentation. The standard of documentation was good.
- Throughout the course of the year we have had regular correspondence with the finance team to ensure that disclosure within the financial statements was consistent with the requirements of the FReM. We provided feedback to management on the content of the financial statements, annual report and remuneration report, and we are pleased to report that these were consequently prepared appropriately.
- There are no significant matters in respect of (i) audit differences; (ii) auditor independence and non-audit fees; and (iii) management representation letter content.

Overview assessment

Overall, in respect of the key judgements made in the preparation of the financial statements, we are satisfied that management's judgements are generally balanced, and do not represent either an overly optimistic, or overly cautious, position.

Assessment of subjective areas

Asset/liability class	Current year	Prior year	Balance (£'000)	KPMG comment
Pensions IAS 19 pension deficit	3	3	(481)	We have reviewed the assumptions used by the actuary in calculating the pension deficit. The assumptions are with in the acceptable range of the guideline assumptions that KPMG actuaries have calculated. Overall, the assumptions are considered to represent a balanced approach to valuation of the net pension deficit. Consideration of the key assumptions are presented on the next page.
Lease dilapidations	3	n/a	(14)	Management have recognised a provision in respect of lease dilapidations, as required by IAS37 *Provisions, contingent liabilities and contingent assets*. The dilapidation obligation is in respect of the 15 year Moray House lease and is being charged over the 10 years to March 2021, being the month of the first lease break. Management have estimated the ultimate dilapidation cost by reference to the actual cost per square foot from the 2011 exit from the Ochil House property, adjusted for inflation. This gives a required provision as at March 2021 of £70,000. No provision was recognised in 2011-12 on grounds of materiality, and management have charged two years' provision in 2012-13 in order to appropriately reflect the period of occupation as at 31 March 2013. We concur with management's assumptions, the application of the Ochil House rates and the accounting treatment. While a surveyor would give a more accurate ultimate provision, the process applied is considered to be materially appropriate given the relatively small office space and uncomplicated dilapidation requirements, in common with Ochil House.

Level of prudence

Cautious means a smaller asset or bigger liability; Optimistic is the reverse

Employee benefits

Each of the assumptions used to value the Commission's net pension deficit are within an acceptable range of KPMG's expectations.

We are of the view that this therefore represents a reasonable and balanced approach, in accordance with the requirements of IAS 19.

Defined benefit pension liability		
Value (£'000s)		
2013	2012	KPMG comment
(481)	(289)	In line with our established practice and in advance of the audit fieldwork, our actuarial specialists reviewed the approach and methodology of the actuarial assumptions used in the IAS19 pension report. Details of key actuarial assumptions are included in the table, along with our commentary.

Assumption	WICS	KPMG central	Comment
Discount rate	4.5%	4.25%	Acceptable – the Commission's rate is weaker (lower liability) than KPMG's central rate and is at the top end of the range we consider acceptable
RPI inflation	3.6%	3.6%	Acceptable – consistent
CPI inflation	2.8% RPI - 0.8%	2.6% RPI – 1%	Acceptable – the Commission's assumption is more prudent (higher liability) than KPMG's central rate, and is within the acceptable range.
Salary growth (long term)	5.1% 1.5% above RPI	1-2% above RPI/CPI inflation	Acceptable – the Commission's assumption reflects the extension of the public sector pay freeze to 2016, followed by a long term assumption of RPI plus 1.5%.

The overall assumptions applied by management are considered to be reasonably balanced for a scheme with a liability duration of around 17 years.

The closing deficit increased by £0.192 million from 2011-12, primarily due to the application of an updated discount rate; an actuarial loss of £0.24 million is presented with Other Comprehensive Income.

Appendices

Mandatory communications

There were no changes to the core financial statements and one unadjusted difference, the most likely difference in the financial statements.

Area	Key content	Reference
Adjusted audit differences Adjustments made as a result of our audit	There were no audit adjustments required to the draft financial statements which impacted on the net assets or the net expenditure for the year. A small number of minor presentational adjustments were required to some of the financial statements notes.	-
Unadjusted audit differences Audit differences identified that we do not consider material to our audit opinion	We are required by ISA (UK and Ireland) 260 to communicate all uncorrected misstatements, other than those which are trivial, to you. There are no unadjusted audit differences.	-
Confirmation of Independence Letter issued by KPMG to the Audit Committee	We have considered and confirmed our independence as auditors and our quality procedures, together with the objectivity of our Audit Director and audit staff.	Appendix one
Schedule of Fees Fees charged by KPMG for audit and non-audit services	No non-audit services were provided in 2012-13.	-
Draft management representation letter Proposed draft of letter to be issued by the Commission to KPMG prior to audit sign-off	There are no significant changes to the standard representations required for our audit from last year.	-

Auditor independence and non-audit fees

Auditing Standards require us to consider and confirm formally our independence and related matters in our dealings with the Commission.

We have appropriate procedures and safeguards in place to enable us to make the formal confirmation in our letter included opposite.

Auditor independence

Professional ethical standards require us to provide to you at the conclusion of an audit a written disclosure of relationships (including the provision of non-audit services) that bear on KPMG LLP's objectivity and independence, the threats to KPMG LLP's independence that these create, any safeguards that have been put in place and why they address such threats, together with any other information necessary to enable KPMG LLP's objectivity and independence to be assessed. This letter is intended to comply with this requirement and facilitate a subsequent discussion with you on audit independence.

We have considered the fees paid to us by the Commission for professional services provided by us during the reporting period. We are satisfied that our general procedures support our independence and objectivity.

General procedures to safeguard independence and objectivity

KPMG LLP is committed to being and being seen to be independent. As part of our ethics and independence policies, all KPMG LLP Audit Directors and staff annually confirm their compliance with our ethics and independence policies and procedures including in particular that they have no prohibited shareholdings. Our ethics and independence policies and procedures are fully consistent with the requirements of the APB Ethical Standards. As a result we have underlying safeguards in place to maintain independence through:

- Instilling professional values
- Regular communications
- Internal accountability
- Risk management
- Independent reviews

Please inform us if you would like to discuss any of these aspects of our procedures in more detail.

There are no other matters that, in our professional judgement, bear on our independence which need to be disclosed to the Chief Executive.

Confirmation of audit independence

We confirm that as of 4 October 2013, in our professional judgment, KPMG LLP is independent within the meaning of regulatory and professional requirements and the objectivity of the Audit Director and audit staff is not impaired.

This report is intended solely for the information of the Audit Committee and should not be used for any other purpose.

Yours faithfully

KPMG LLP

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