

Scottish Canals

Annual report on the 2013/14 audit



Prepared for Scottish Canals and the Auditor General for Scotland
August 2014

Audit Scotland is a statutory body set up in April 2000 under the Public Finance and Accountability (Scotland) Act 2000. It provides services to the Auditor General for Scotland and the Accounts Commission. Together they ensure that the Scottish Government and public sector bodies in Scotland are held to account for the proper, efficient and effective use of public funds.

Contents

Key Messages	4
Introduction	5
Financial statements	6
Conduct and scope of the audit	6
Audit opinion & accounting issues	6
Significant findings and key judgements (ISA260)	6
Corporate governance and systems of internal control	10
Best value	11
Appendix A: Key Audit Risks	13
Key Audit Risks and Associated Audit Work	13
Appendix B: Action Plan	15
Key Risk Areas and Planned Management Action	15

Key Messages

We have given an unqualified opinion that the financial statements of Scottish Canals for 2013/14 give a true and fair view of the state of the body's affairs and of its deficit for the year.

During the year, we considered the accounting treatment of capital expenditure and funding arrangements for the Helix project, which included contributions from other public sector partners, and the effect of this has been reflected in the audited financial statements.

We concluded that Scottish Canals has met its statutory requirement under the Transport Act 1968 to "breakeven" taking one year with another, but recognise that further discussion is required to clarify the meaning of this requirement moving forward.

Scottish Canals continues to increase its percentage of total revenue generated from commercial activities and we have no concerns over the current financial position, while recognising the challenging financial targets in 2014/15 that are faced by many bodies in the public sector.

We concluded that action is still to be taken to fully address a number of the control weaknesses identified in 2012/13. However, the new Director of Finance has been reviewing the arrangements in place and is in the process of putting in place appropriate controls to address the remaining weaknesses. Progress against this is currently being monitored through the updates provided to the Audit and Risk Committee

Introduction

1. This report is the summary of our findings arising from the 2013/14 audit of Scottish Canals. The purpose of the report is to set out concisely the scope, nature and extent of the audit. It summarises our opinions (i.e. on the financial statements) and conclusions on significant issues arising.
2. The report also reflects our overall responsibility to carry out an audit in accordance with the public sector audit model which is based on the Code of Audit Practice prepared by Audit Scotland (May 2011). This sets out the wider dimensions of the public sector audit which involves not only the audit of the financial statements but also consideration of areas such as financial performance and corporate governance. An audit of the financial statements is not designed to identify all matters that may be relevant to those charged with governance. It is the auditor's responsibility to form and express an opinion on the financial statements prepared by management; however this does not relieve management of their responsibilities in this respect. This report has been prepared for the use of Scottish Canals and no responsibility to any third party is accepted.
3. Appendix A sets out the key audit risks identified at the planning stage and details how we addressed each risk in arriving at our opinion on the financial statements.
4. Appendix B is an action plan setting out the high level risks we have identified from the audit. Officers have considered the issues and agreed to take the specific steps in the column headed "planned management action". We do not expect all risks to be eliminated or even minimised. What we expect is that Scottish Canals understands its risks and has arrangements in place to manage these risks. Members should ensure that they are satisfied with the proposed management action and have a mechanism in place to assess progress.
5. This report is also addressed to the Auditor General for Scotland and will be published on our website after consideration by the Audit and Risk Committee.

Financial statements

Conduct and scope of the audit

6. Information on the integrity and objectivity of the appointed auditor and audit staff, and the nature and scope of the audit, were outlined in the Annual Audit Plan presented to the Audit and Risk Committee on 6 February, and follow the requirements of the Code of Audit Practice prepared by Audit Scotland in May 2011.
7. As part of the requirement to provide full and fair disclosure of matters relating to our independence we can confirm that we have not undertaken non-audit related services. The 2013/14 agreed fee for the audit was £32,000 and as we did not require to carry out any additional work outwith our planned audit activity this fee remains unchanged.

Audit opinion & accounting issues

8. We have given an unqualified opinion that the financial statements of Scottish Canals for 2013/14 give a true and fair view of the state of the body's affairs and of its deficit for the year.
9. We received the unaudited financial statements on 5 May in accordance with the timetable, and, as agreed, the tax figures were provided later. These were due on 16 May but were not provided until 3 June. The working papers were of a good standard and staff provided support to the audit team which enabled us to complete our on-site fieldwork on 23 May 2014.
10. The main changes to the accounts as a result of the audit process were the inclusion of financial transactions identified by the actuary in the IAS 19 (Employee Benefits) report, preparation of a strategic report and additional disclosures in the remuneration report, as described in paragraphs 17 and 20. The financial impact of these changes was to reduce the unaudited surplus for the year from £7,000 to a deficit of £153,000. The total comprehensive surplus was unaffected by this change.
11. In accordance with their Accounts Direction, Scottish Canals is required to comply with:
 - International Financial Reporting Standards
 - the accounting and disclosure requirements of companies legislation currently in force and
 - the accounts disclosure requirements of the Financial Conduct Authority listing rules section 9.8
12. We can confirm that the financial statements have been properly prepared in accordance with these requirements.

Significant findings and key judgements (ISA260)

13. During the course of the audit we identified a number of significant issues regarding the appropriateness of accounting policies or accounting estimates and judgements, the timing of

transactions, the existence of material unusual transactions or the potential effect on the financial statements of any uncertainties.

14. **Helix:** In our 2013/14 Annual Audit Plan we reported on discussions with officers to agree the correct accounting treatment for the Helix project income and expenditure, including the construction costs of the new canal section, the visitors' centre and the Kelpies.
15. This included agreement on how to account for the various funding sources. Scottish Government income used to fund the Helix project are deferred over the life of the related assets as required by *IAS20 – Accounting for Government Grants and Disclosure of Government Assistance*. Contributions from other public sector development partners are reflected in the donated asset reserve.
16. The Kelpies and new canal section came into use at the end of the financial year, but depreciation charges will not be incurred until 2014/15, in accordance with Scottish Canals' accounting policy. Depreciation will be based on useful lives of these assets, which have been indicated as 100 years (Kelpies) and 120 years (new canal section). Due to the unusual nature of the assets and length of lives, we will review the underlying evidence for these assessments during 2014/15.

Refer Action Plan No 1

17. **Pension accounting adjustments and prior period adjustments:** The unaudited accounts did not include any debits/ credits for *IAS 19 - Employee Benefits* identified in the actuary's report. This was on the basis that the funding arrangement agreed with CRT meant that there is no net impact on the overall asset/ liability borne by Scottish Canals. However the actuary's report does allocate elements of movements between the operating costs and comprehensive income, in accordance with the underlying accounting standard and this needed to be reflected in the accounts. The changes meant that pension costs within operating expenditure and interest income increased by £160,000 and the surplus of £7,000, changed to a deficit for the year of £153,000. Adjustments for changes in actuarial assumptions in the Statement of Comprehensive Income, results in no net impact on the total comprehensive deficit or movement in the balance sheet.
18. The relevant accounting standard (IAS 19) was revised during 2014/15 to reflect a different allocation between operating costs/ comprehensive income. This resulted in prior year balances having to be restated.
19. **Group accounts:** Scottish Canals has investments in subsidiaries and associates as indicated in Note 12 in the financial statements. We reviewed the accounting policy decision not to prepare consolidated financial statements on the basis of materiality and confirmed that this was appropriate following consideration of the financial results of BWB (General Partner) Limited for the year ended 31 March 2014 (Net profits for the year were £32,000 and net assets were £35,000).
20. **Companies Act 2006:** There were changes to Companies Act legislation which came into force for 2013/14 but these were not reflected in the accounts presented for audit. The audited Annual Report and Accounts have been revised to reflect these changes:

- The unaudited accounts did not contain a strategic report, however much of the required information was already included within the Directors' report. The accounts were revised to include additional disclosures and a separate Strategic report and Directors' report.
- Directors' remuneration report was amended to include pension benefits in total remuneration. Details for a new disclosure, which shows the percentage increase in remuneration for the chief executive alongside the average percentage change for employees as a whole, were not available for this year and this disclosure will be included for 2014/15.

Refer Action Plan No 2

21. **Corporate governance statement:** Following discussions during the audit, the statement was updated to include information on the ICT control weaknesses raised by internal audit, and actions put in place to address them, and the changes made during 2014/15 to budget setting, reporting and control processes.
22. **Reclassification of moorings as investment properties:** During 2013/14 General Moorings were reclassified as investment properties on the basis that they generate commercial income for the business and are not used by Scottish Canals for other operational purposes.
23. **Pinkston Paddlesports:** The non-current assets at 31 March 2014 in the Statement of Financial Position included an Assets Under Construction (AUC) balance of £2.887 million relating to Pinkston Paddlesports. This asset came into use in May. This asset will be leased to Glasgow Watersports for a nominal rent (i.e. £1 a year) for the majority of the asset's useful life and the correct treatment of this asset needs to be discussed/ agreed as part of the 2014/15 audit. This may mean impairing/ derecognising the value/ asset, as the rights and obligations associated with the asset would appear to rest with Glasgow Watersports and the recoverable amount will be less than the current carrying value. Any impairment may be matched by amortisation of deferred capital grants and contributions, but there could be a residual impact on next year's operating surplus. We will follow-up this issue with officers as part of our planning for 2014/15.

Refer Action Plan No. 3

2013/14 Financial position

24. As part of our review of the financial position of Scottish Canals, we reviewed the requirements indicated in the Framework Document with Transport Scotland and with the Transport Act 1968.
25. Section 41(2) of the Transport Act 1968 identifies that: *'It shall be the duty of each of the authorities to whom this section applies.....to secure that combined revenues of the authority and of their subsidiaries taken together are not less than sufficient to meet their combined charges properly chargeable to revenue account, taking one year with another.'*
26. The Framework document states *"SC is required (under section 41(2) of the Transport Act 1968) to break even each year and budgets will reflect this for each year of the business plan."*

SC will produce quarterly forecasts and adapt expenditure to achieve break even throughout the financial year."

27. In our opinion, the requirement contained within Scottish Canals' framework document is not consistent with the requirements in the Act and may be interpreted as being unduly onerous. We have therefore concentrated on assessing the requirement in the Act.
28. The results for the past two years are as follows:

Exhibit 1: 2012/13 and 2013/14 Outturn

	2013/14	2012/13
	£000	£000
(Deficit)/Surplus on continuing operations after taxation	(153)	727

Source: Scottish Canals Annual Report and Accounts 2013/14

29. Scottish Canals planned for a break even position for 2012/13 and 2013/14. We recognise that 2012/13 included discontinued operations with the transfer of operations to Canal and River Trust. Therefore, the deficit/surplus from continuing operations figure has been used as the basis on which we have assessed compliance with the Act and have concluded that the requirement has been met.
30. However we believe that moving forward into 2014/15 further discussion is required on the meaning of the Act requirement and discussions should be held with the sponsor department (Transport Scotland) over the appropriateness of the requirement indicated in the framework document.

Refer Action Plan No. 4

31. As reported last year, Transport Scotland, Scottish Canals' sponsor department, confirmed that Scottish Canals would retain its status as a public corporation until 2015/16, for the purposes of accounting. At this point the classification would be reviewed. In order to retain their status as a public corporation Scottish Canals will require to demonstrate that they are generating the majority of their income from commercial activities (i.e. Scottish Government funding would represent less than fifty per cent of total income).
32. Commercial revenue represented 46% of total revenue in 2013/14 (43% in 2012/13). We note the growth in this and will continue to monitor up to the re-assessment in 2015/16.
33. On the basis of the net asset position (£48 million); net current asset/ liability position, cash position and the positive cashflows from operating activities, we conclude that we have no concerns over the current financial position. However we do note that for 2014/15, Scottish Canals has budgeted to achieve a break-even position based on an 8% reduction in operating expenditure and an 11% increase in commercial revenue from 2013/14. These targets may be challenging.

Corporate governance and systems of internal control

Overall governance arrangements

34. The Code of Audit Practice gives auditors a responsibility to review and report on audited bodies' corporate governance arrangements and overall we found that Scottish Canals had sound overall governance arrangements in place which included a number of standing committees overseeing key aspects of governance.

Review of policies and procedures

35. Due to the split from CRT on 2 July 2012, Scottish Canals required to review all existing policies and procedures to ensure they reflect revised business practices and satisfy their new requirements as a Scottish public sector body. Given the scale and resource intensive nature of this exercise, an eighteen-month compliance programme was initially agreed to review every policy, procedure, process document, guidance note and standing order. Progress with the programme is reported to, and monitored by, the Audit and Risk committee.
36. During the year progress has continued with the compliance programme with the complete process expected to be concluded during 2014/15. During the period of the review Scottish Canals will continue to adhere to the requirements of the relevant British Waterways' legacy policies.

Accounting and internal control systems

37. While auditors concentrate on significant systems and key controls in support of the opinion on the financial statements, their wider responsibilities require them to consider the financial systems and controls of audited bodies as a whole. However, the extent of this work should also be informed by their assessment of risk and the activities of internal audit.
38. In our audit plan we stated that we had decided not to place any specific reliance on the internal control environment for 2013/14 for the purposes of the audit of the financial statements and would instead undertake a substantive approach. However, to establish the progress made in addressing the significant control weaknesses identified during 2012/13, and to inform our review of the Corporate Governance Statement included in the annual report and accounts, we discussed the key controls within the main financial systems with finance staff in January 2014 and reviewed relevant supporting documentation.
39. We concluded that action is still to be taken to fully address a number of the control weaknesses identified in 2012/13. However, since taking up her post in October 2013 the new Director of Finance has been reviewing the arrangements in place and is in the process of putting in place appropriate controls to address the remaining weaknesses. Once this process is completed the revised controls will be documented in procedural instructions covering the main financial systems at Scottish Canals. Progress against this is currently being monitored through the updates provided to the Audit and Risk Committee and has been identified as a key milestone for the finance team.

Refer Action Plan No. 5

40. Auditing standards require internal and external auditors to work closely together to make best use of available audit resources and as such we seek to rely on the work of internal audit wherever possible. Internal audit is provided by BDO LLP.
41. We considered the findings of the internal auditor in terms of our wider responsibilities under the Code of Audit Practice and used this work to inform our review of the contents of the Corporate Governance Statement included in the annual report and accounts. BDO identified a number of control weaknesses during the year, which were highlighted in their internal audit reports, with the main issues reflected in the Corporate Governance Statement.

Prevention and detection of fraud and irregularity

42. In our Annual Audit Plan we highlighted the responsibility audited bodies have for establishing arrangements to prevent and detect fraud and other irregularities. At the August meeting of the Board the new Fraud, Theft and Bribery policies were approved. Based on the results of our testing and internal audit findings, the overall arrangements for the prevention of fraud are satisfactory.

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

43. 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. Auditors consider whether bodies have adequate arrangements in place. We have not noted any issues in connection with arrangements.

Best value

Best value

44. Scottish Government guidance for accountable officers on best value in public services requires a systematic approach to self-evaluation and continuous improvement. The guidance identifies the themes an organisation needs to focus on in order to deliver the duty of best value, but notes that implementation should be appropriate and proportionate to the priorities, operating environment, scale and nature of the body's business.
45. At the February 2013 meeting of the Audit and Risk Committee we delivered a presentation on the duty of best value, as set out in the SPFM, and discussed possible different approaches to demonstrating best value. At that time Scottish Canals agreed to establish a programme of best value self-assessments which will demonstrate a systematic approach to self-evaluation and continuous improvement.
46. In 2013/14 executive directors have undertaken work to improve management arrangements over planning and control. In 2013 and 2014 the management team has prepared a new corporate plan for Scottish Canals, which is currently with the Scottish Government for final approval. Since October 2013, the new Director of Finance has been reviewing the financial

and budgetary controls and management accounting arrangements to improve overall financial control.

47. We will continue to review the approach and actions adopted by Scottish Canals to meet the Scottish government's expectations around Best Value.

Acknowledgements

48. We would like to express our thanks to the staff of Scottish Canals for their help and assistance during the audit of this year's financial statements which has enabled us to provide an audit report within the agreed timetable.

Appendix A: Key Audit Risks

Key Audit Risks and Associated Audit Work

Audit Risk	Overview of the scope of audit work to address the risks
Wider Code of Audit Practice risks	
<p>Projected outturn</p> <p>The budget set for the year had not been phased to reflect the anticipated patterns of income and expenditure and at planning stage there was a degree of uncertainty over the actual final outturn position and that Scottish Canals would fail to achieve a break-even position for 2013/14</p>	<ul style="list-style-type: none"> Reviewed the accounting treatment of capital expenditure Reviewed and assessed the relevant legislative requirement for breakeven Tested income and expenditure transactions and reviewed key management estimates.
Risks of material misstatement	
<p>Helix project expenditure</p> <p>Accounting for the Helix project was complicated. This includes the basis on which new assets should be capitalised, the value of the amounts recognised and the recognition of associated government grants</p>	<ul style="list-style-type: none"> Agreement of basis of accounting for Property, Plant and Equipment under IAS16 and for Government Grants under IAS20. Review of classification, valuation, accuracy and completeness of transactions prepared by officers.
<p>Governance statement disclosures</p> <p>Scottish Canals to consider results from internal audit's review on IT general controls and improvements required, and other risks from risk register when preparing governance statement.</p>	<ul style="list-style-type: none"> Reviewed the governance statement presented for audit and challenged disclosures in light of internal audit findings and financial outturn for the year.
<p>Potential financial liabilities</p> <p>A number of potential financial liabilities exist that may require provisions or contingent liabilities to be recognised within the 2013/14 financial statements.</p>	<ul style="list-style-type: none"> Review of management judgements of actual and potential liabilities. Review of board papers/ media etc for events subsequent to reporting period.
<p>Regularity</p> <p>The nature of Scottish Canals' business operations presents a potential risk that certain transactions,</p>	<ul style="list-style-type: none"> Consideration of the break-even requirement of Section 41(2) of the Transport Act 1968.

Audit Risk	Overview of the scope of audit work to address the risks
contracting or partnership agreements are not appropriately authorised/ approved.	<ul style="list-style-type: none"> • Review of Scottish Government approval for termination payments paid in year. • Review of sample of expense claims.
<p>Group statements</p> <p>Scottish Canals are currently involved in a number of joint projects with different partner organisations, which may require to be consolidated into group statements.</p>	<ul style="list-style-type: none"> • Review of management's group boundary assessment. • Review of financial results of group entities and consideration of basis for not producing consolidated financial statements.
<p>Valuations</p> <p>The financial statements of Scottish Canals include a range of assets and liabilities that rely on the provision of valuations by management experts.</p>	<ul style="list-style-type: none"> • Consideration of expertise and competence of actuary and valuer. • Review of assumptions used in actuarial and property valuations
<p>Moorings</p> <p>Reclassification of general moorings as investment assets</p>	<ul style="list-style-type: none"> • Consideration of whether general moorings satisfy the conditions of IAS40 - Investment Property. • Review of valuation by valuer. • Review of annual moorings income used as basis of valuation.
<p>Risk of fraud in revenue recognition</p> <p>ISA 240 presumes a risk of fraud where income streams are significant.</p>	<ul style="list-style-type: none"> • Analytical review and modelling of income streams. • Substantive verification of retail and other operating income.
<p>Third party service organisation</p> <p>Scottish Canals' payroll function is provided by an external payroll agency.</p>	<ul style="list-style-type: none"> • Substantive payroll testing was carried out to provide assurance as to the completeness and accuracy of the staff costs in the 2013/14 financial statements

Appendix B: Action Plan

Key Risk Areas and Planned Management Action

Action Point	Refer Para No	Issue	Planned Management Action	Responsible Officer	Target Date
1	16	<p>Asset lives for Kelpies and canal</p> <p>The Kelpies and new canal section have been assessed as having useful lives of 100 and 120 years, respectively. The basis of the assessed lives will be provided and assessed by audit during 2014/15</p>	The assumptions made in 2013/14 will be validated.	Finance Director / Director of Heritage, Environment and Sustainability	October 2014
2	20	<p>Remuneration Report</p> <p>The remuneration report does not include a new requirement to show the percentage increase in remuneration for the chief executive alongside the average percentage change for employees as a whole.</p>	This information will be collated over the course of the financial year and included in the 2014/15 financial statements.	Financial Controller	March 2015
3	23	<p>Pinkston Paddlesports Centre</p> <p>This asset came into use after the year end and the lease arrangements with Glasgow Watersports may entail significant adjustments to the associated assets/liabilities with a potential impact on 2014/15 operating expenditure. The basis of accounting for this project will be</p>	<p>Management are confident that the correct accounting treatment has been applied and that there will be no impact to the P&L in 2014/15.</p> <p>The Financial Controller will discuss the treatment with Audit Scotland during the financial year to satisfy them that the appropriate treatment</p>	Financial Controller	October 2014

Action Point	Refer Para No	Issue	Planned Management Action	Responsible Officer	Target Date
		discussed in 2014/15.	has been applied.		
4	30	Break-even requirement Future discussion is required with Transport Scotland / Audit Scotland of the legislative requirements of Section 41(2) of the Transport Act 1968 to establish what constitutes break-even.	Discussions are ongoing with the Scottish Government and are being led for Scottish Canals by the Chief Executive and Chair of the Board.	Chief Executive	Ongoing / March 2015
5	39	Internal control environment Action is still ongoing to ensure Scottish Canals has a robust control environment and revised controls will be documented in procedural instructions covering the main financial systems.	A financial controls and procedures manual has now been published and will be updated as and when necessary as the business evolves and / or the financial control environment changes. This document will be subject to audit and review by internal audit during 2014/15.	Finance Director	June 2014 / Ongoing