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# Water Industry Commission for Scotland

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

Audit: year ended 31 March 2014

3 November 2014

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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.**

**In accordance with ISA (UK and Ireland) 260: *Communication with those charged with governance,* this report summarises our work in relation to the financial statements for the year ended 31 March 2014.**

**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 | 2013-14 is the penultimate year of the funding agreed with the Scottish Government in June 2010. Total funding for the period from 2010 to 2015 was £19.8 million, representing annual income of £3.96 million. A further reduction of £1.43 million was agreed subsequent to June 2010, spread over 2012-13 to 2014-15.<br><br>In 2013-14 the Commission recognised a total deficit of £0.44 million, after £0.34 million levies were returned to Scottish Water in light of the Commission's reserves position. In addition a repayment was received from the Customer Forum of £0.24 million and an actuarial loss of £0.14 million was recognised in respect of the pension scheme. | Page 6 |
| **Financial statements and accounting** | | |
| Audit conclusions | We have issued an unqualified audit opinion on the 2013-14 financial statements, following their approval by the Board in November 2014. | Page 8 |
| Significant risks and audit focus areas | As set out in the audit strategy document, we considered revenue recognition and management override of controls during the audit; both inherent significant risks that the ISAs requires us to raise with you . In addition to these, we considered the effects of the changes to IAS19 *Employee Benefits* and the related pensions assumptions.<br><br>We identified no misstatements in respect of revenue recognition and no instances of management override of controls. We are content with the assumptions used to derive the pension scheme deficit, and management's treatment of the change in IAS 19, as noted below. | Page 9 |
| Accounting policies | The Commission applied the revised IAS 19 standard as required, opting not to restate the comparatives in the consolidated statement of income on grounds of materiality. We concur with this approach and note that there is no impact on net assets following the adoption of the revised standard. No newly effective accounting standards are expected to have a material impact on next year's financial statements.<br><br>The financial statements have been appropriately prepared on a going concern basis, with which we concur. | Page 11 |
| Year-end process | The financial statements, management commentary and remuneration report were received by the agreed date and were supported by high quality working papers. The Chairman's foreword was not available at the time of the audit. During the audit we supported management in addressing the requirement to include a Strategic Report for the first time, the report was completed during the fieldwork. | Page 8 |

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| Area | Summary observations | Analysis |
|---|---|---|
| **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 13 |
| Control observations | Our testing 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. | Page 8 |
| **Performance management** | | |
| Performance management | Overall, there is a robust 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, notwithstanding challenges in respect of senior management recruitment. | Page 16 |

# Scope and responsibilities

## Purpose of this report

The Auditor General for Scotland ("the Auditor General") has appointed KPMG LLP as auditor of the Water Industry Commission for Scotland ("the Commission") under the Public Finance and Accountability (Scotland) Act 2000 ("the Act"). The period of appointment is 2011-12 to 2015-16, inclusive.

Our annual audit report is designed to summarise our opinion and conclusions on significant issues arising from our audit. It is addressed to both those charged with governance at the Commission and the Auditor General for Scotland. The scope and nature of our audit were set out in our audit strategy document which was presented to the audit and risk committee at the outset of our audit.

## Responsibilities

Audit Scotland's *Code of Audit Practice* ("the Code") sets out the Commission's responsibilities in respect:

- preparation of financial statements;
- systems of internal control;
- prevention and detection of fraud and irregularities;
- standards of conduct and arrangements for the prevention and detection of bribery and corruption;
- financial position; and
- Best Value.

This report reflects our overall responsibility to carry out an audit in accordance our statutory responsibilities under the Act and in accordance with International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board and the Code.

The Code sets out the wider dimensions of 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. Weaknesses or risks identified 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. Communication by auditors of matters arising from the audit of the financial statements or of risks or weaknesses does not absolve management from its responsibility to address the issues raised and to maintain an adequate system of control.

Under the requirements of International Standard on Auditing (UK and Ireland) ('ISA') 260 *Communication with 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 and our presentation to the audit committee, together with previous reports to the committee throughout the year, discharges the requirements of ISA 260.

# Service overview

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

# Key business issues

**As in prior years, the Commission waived levies from Scottish Water in the current year. In December 2011, agreement was reached with the Scottish Government to reduce funding by 15% over the current regulatory period.**

**The Commission is operating deficit budgets, drawing on cash generated in prior years. The 2014-15 deficit is budgeted to be lower than in 2013-14, as the current year has seen higher cost in relation to Retail Competition and Strategic Review of Charges as well as preparation for the new pricing structure from 2015.**

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 price review for the regulatory period 2015-21 was published in draft in March for consultation. The Scottish Government published directions and principles of charging in late September and the final determination is expected to be completed in November. The Commission will continue to work closely with Ofwat and Defra on common rules and procedures to benefit customers both in Scotland and England.

## Financial position

| | Actual 2012-13 £'000 | Budget 2013-14 £'000 | Actual 2013-14 £'000 | Budget 2014-15 £'000 |
|---|---|---|---|---|
| Income from activities | 3,034 | 3,435 | 3,117 | 3,470 |
| Other | 15 | - | - | - |
| **Total income** | **3,049** | **3,435** | **3,117** | **3,470** |
| Staff costs | 1,300 | 1,449 | 1,260 | 1,259 |
| Other expenditure | 1,899 | 2,092 | 2,160 | 2,309 |
| **Total expenditure** | **3,199** | **3,541** | **3,420** | **3,568** |
| **Net deficit** | **(150)** | **(106)** | **(303)** | **(98)** |

*Source: KPMG analysis of management schedules*

The deficit in 2013-14 reflects the decision and agreement to waive levies from Scottish Water. These totalled £0.34 million and were waived in the context of the £0.68 million reserves brought forward as at 1 April 2013.

Budgeted expenditure in 2013-14 was 2% (£0.07 million) lower than the 2012-13 budget, as a result of the continued need to realise efficiencies. The Commission operated within the agreed budget, with expenditure of £3.42 million compared to the budget of £3.5 million. A significant part of the saving is due to the £0.24 million repayment from Consumer Futures, following its abolition.

Staff costs were £0.21 million lower than budgeted, arising from challenges in recruiting for senior positions. Headcount is consistent with the prior year although new starters were more junior than the leavers in the year.

Other expenditure was budgeted to increase compared to 2012-13, reflecting consultancy costs incurred in preparation for the new pricing structure from 2015 as well as advice for Retail Competition and Strategic Review of Charges. The actual costs were £0.13 million higher than budgeted, comprising greater licensing and regulation activity.

## Budget 2014-15

Levies are budgeted to increase in 2014-15 by £0.34million, as the £1.43 million reduction was weighted towards the earlier years.

The savings due to more junior staff profile are offset by a planned restructuring of the organisation.

An increase in other expenditure is primarily due to the expected greater consultancy costs in preparation for the new pricing structure from 2015.

The budgeted deficit would result in a general reserve balance of £0.134 million as at 31 March 2015.

# Financial statements and accounting

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

# 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

Following approval of the financial statements by the Board we have issued an unqualified opinion on the truth and fairness of the state of the Commission's affairs as at 31 March 2014, and of the Commission's deficit for the year then ended. We also issued an 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 controls testing and substantive procedures to ensure that key risks to the financial statements have been covered;
- communicated with internal audit and reviewed their reports as issued to audit committee to ensure all key risk areas which may be viewed to have an impact on the financial statements have been considered;
- reviewed estimates and accounting judgements made by management and considered these for appropriateness;
- considered the potential effect of fraud on the financial statements through discussions with senior management and internal audit to gain a better understanding of the work performed in relation to prevention and detection of fraud; and
- attended audit committee to communicate our findings to those charged with governance, and to update our understanding of the key governance processes.

## 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 2014. This included management commentary and remuneration report, although not the chairman's foreword or strategic report. The strategic report was compiled by management during the audit fieldwork and was available for our review prior to completion.
- During the year we had 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, as reported in appendix one.

# Significant risks and audit focus areas

**The main audit focus areas are significant risks in respect of:**

- **management override of controls; and**
- **revenue recognition fraud risk;**

**and an other focus area in respect of post-employment employee benefits.**

## Significant risks that ISAs require us to raise in all cases

Professional standards require us to consider two specific risks for all organisations:

- management override of controls; and
- fraudulent revenue recognition.

Our audit approach to address these was set out in our audit plan and strategy. Whilst the income stream is relatively simple, we have assessed that the fraud risk from income recognition is a significant risk, in line with Professional Standards. We agreed levy income to supporting documentation and performed cut-off testing, we did not identify any misstatements.

As part of our work to address the significant risk of management override of controls we performed the following tests:

- testing of journals at the year end, and during the year;
- review of unusual transactions in the year;
- enquiries with employees outside the finance department;
- a test of unpredictability; and
- controls testing, including higher level controls.

We do not have any findings to bring to your attention in relation to these matters. No control overrides were identified.

## Other areas of audit focus

Our audit strategy and plan included an other area of focus in respect of post-employment employee benefits, and the results of our audit work are set out on the next page.

# 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) | | |
|---|---|---|
| **2014** | **2013** | **KPMG comment** |
| (665) | (481) | 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.<br><br>Details of key actuarial assumptions are included in the table, along with our commentary. |

| Assumption | WICS | KPMG central | Comment |
|---|---|---|---|
| **Discount rate** | 4.30% | 4.30% | Acceptable. The actuarial assumption has been calculated using a different approach from the prior year. It is KPMG's view that this represents an enhancement in methodology. |
| **RPI inflation** | RPI - 0.8% | RPI – 1% | Acceptable – The Commission's assumption is more prudent (higher liability) than KPMG's central rate, but is within the acceptable range. |
| **CPI inflation** | 1.40% - 1.50% | 1.65% - 1.75% | Acceptable – the Commission's assumption is more prudent (higher liability) than KPMG's central rate, but is within the acceptable range. |
| **Salary growth (long term)** | 1% pa until 31 March 2015.<br>1.5% above RPI | 0% - 1.5% above RPI/CPI inflation | Acceptable – the Commission's assumption reflects 1% salary increases until 31 March 2016. |

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 £0.184 million from 2012-13, primarily due to the falling real bond yields; an actuarial loss of £0.14million is presented with Other Comprehensive Income.

# Accounting policies and going concern

**The Commission has applied the revisions to IAS 19 Employee Benefits. All other accounting policies have been applied consistently.**

**Other than revisions to IAS 19 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 prepares financial statements in accordance with the principles of the Government's Financial Reporting Manual 2013-14 ("FReM").<br>■ Changes to the FReM in 2013-14 require the Commission to prepare a strategic report in line with section 414C of the Companies Act 2006 as interpreted by the FReM. The strategic report requirements include disclosures previously required within the directors report or management commentary and new disclosures (if not previously included) on social, community and human rights issues, a description of the body's strategy and business model and a gender break down of directors, senior managers and employees. Appropriate disclosure has been included within the strategic report as noted on page 13.<br>■ We are satisfied that the accounting policies adopted remain appropriate to the Commission. |
| **Impact of revised accounting standards** | ■ The Commission has applied the revisions to IAS 19 *Employee Benefits,* opting not to restate the prior year comparatives on ground of materiality. We concur with this approach as there were no changes to the statement of financial position as a result of the retrospective application of IAS19R, and the impact on the statement of consolidated income and expenditure are not material. Appropriate disclosure has been provided within the accounting policies note.<br>■ There are no other newly effective accounting standards that are considered to have a material impact on the Commission's financial statements in the current year. Appropriate disclosure to this effect is included within the accounting policies note to the financial statements. |
| **Going concern** | ■ The financial statements have been prepared under the assumption that the organisation is a going concern. Agreement of funding for the five years from 2015-16 is ongoing, resulting in there not being committed income beyond 31 March 2015. We concur with the going concern assumption as the budget for 2014-15 is broadly balanced, the Commission held cash of over £0.8 million as at 31 March 2014 and discussions with the Scottish Government do not indicate a significant change in funding. |

# 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 2013-14 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.<br><br>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.<br><br>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 strategic and director's report** | The financial statements form part of the annual report of the Commission for the year ended 31 March 2014. Following amendments to the Companies Act becoming effective for 2013-14, the Commission is required to include both a strategic and a director's report as part of the annual report. We have reviewed the contents of the strategic and directors' report against the revised disclosure requirements and are content with the proposed reports. We provided management with some relatively minor suggestions relating to how the reports could be enhanced and / or where additional information disclosures should be made.<br><br>We are required to consider the strategic and directors' reports, and provide our opinion on the consistency of it with the financial statements. We are satisfied that the information contained within the strategic and directors' report is consistent with the financial statements. |

# Corporate governance arrangements (continued)

**The remuneration report incorporates the new requirement to disclose a single remuneration figure.**

**We reviewed the work of internal audit, to inform our testing. We consider that the internal audit plan is appropriate for size and nature of the Commission.**

**No matters of a fraud nature or in respect of conduct were identified during the audit.**

| | |
|---|---|
| **Remuneration report** | The remuneration report was included within the draft financial statements and supported by good quality information and working papers. The 2013-14 FReM included an additional requirement for disclosure of total directors' remunerations as a single figure; this has been correctly included within the financial statements. |
| **Internal audit** | We reviewed the work of internal audit in 2013-14 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.<br><br>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:<br><br>■ financial planning arrangements;<br>■ IT systems and business continuity; and<br>■ risk management<br><br>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 2013-14 no significant or other fraud or irregularity was identified by management, internal audit, or through the course of our external audit work. |
| **Arrangements for maintaining standards of conduct and the prevention and detection of corruption** | We consider that the Commission has appropriate arrangements to prevent and detect inappropriate conduct and corruption. The arrangements include policies and codes of conduct for staff and board members, supported by whistle blowing procedures consistent with the Public Interest Disclosure Act, are Board members are responsible for setting the 'tone at the top' and are responsible for abiding by the code of conduct and disclosing interests which may be of importance – material or otherwise – to their work at the Commission. |

# Performance management

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

# Performance management

**We set out the Commissions approach to Best Value and Performance Management.**

| | |
|---|---|
| **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).<br><br>We reviewed 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. There were no contracts requiring procurement through OJEU process; the Oxera framework agreements having been issued through Scottish Government procurement frameworks in 2010-11. All expenditure over £5,000 require approval by the Commissions procurement panel, which meets as required throughout the year. Two approvals panel meetings were tested and found effective. |
| **Performance management** | Overall, there is a robust 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 Corporate plan 2015 – 21 has not yet been approved by the Scottish Government. Expenditure for the year to 31 March 2014 was within budget, primarily due to the customer forum refund and lower staff costs. |

# 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**<br>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.<br>A small number of minor presentational adjustments were required to some of the financial statements notes. | - |
| **Unadjusted audit differences**<br>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.<br>There are no unadjusted audit differences. | - |
| **Confirmation of Independence**<br>Letter issued by KPMG to the Audit Committee | We have considered and confirmed our independence as auditor and our quality procedures, together with the objectivity of our Audit Director and audit staff. | Appendix two |
| **Schedule of Fees**<br>Fees charged by KPMG for audit and non-audit services | £11,750 Audit fee<br>£24,000 WICS pricing model review | - |
| **Draft management representation letter**<br>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 3 November 2014, 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

cutting through complexity