
Scottish Environment Protection Agency

Annual Report to Those Charged
with Governance and the Auditor
General for Scotland

Year ended 31 March 2015

23 June 2015

PricewaterhouseCoopers
141 Bothwell Street
Glasgow
G2 7EQ

The Audit Committee
Scottish Environment Protection Agency
SEPA Corporate Office
Strathallan House
Castle Business Park
Stirling
FK9 4TZ

23 June 2015

Ladies and Gentleman,

We are pleased to enclose our report to the Audit Committee in respect of our audit for the year ended 31 March 2015. The primary purpose of this report is to communicate the significant findings arising from our audit that we believe are relevant to those charged with governance.

The scope and proposed focus of our audit work was summarised in our audit plan, which we presented to the Audit Committee in December 2014. 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 audit risks are detailed in Section 2.

We have completed the majority of our audit work and expect to be able to issue an unqualified audit opinion on the financial statements on 28 July 2015. At the time of writing, the key outstanding matters, where our work has commenced but is not yet finalised, are completion of subsequent events review and receipt of the signed letter of representation from Management. We will provide an oral update on these matters at the meeting on 23 June 2015.

We look forward to discussing our report with you on 23 June 2015. Attending the meeting from PwC will be James Gray and Jennifer Bell.

Yours faithfully

PricewaterhouseCoopers LLP

Contents

<i>Section 1. Executive summary</i>	2
<i>Section 2: Significant audit and accounting matters</i>	5
<i>Section 3. Financial performance</i>	7
<i>Section 4. Governance and internal control</i>	11
<i>Section 5. Fraud</i>	14
<i>Section 6. Independence</i>	15
Appendix 1: Journals insight	16

Section 1. Executive summary

Introduction

We set out in this report our significant findings from our audit of Scottish Environment Protection Agency's ("SEPA") for 2014/15, together with those matters which auditing standards require us to report to you as "those charged with governance" of SEPA.

We carried out our audit work in line with our 2014/15 audit plan that we presented to you on 16 December 2014. Our audit is not designed to identify all matters that may be relevant to you. Accordingly, the audit does not identify all such matters. 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.

Framework for Our Audit

Our audit is conducted in accordance with Auditing Standards (International Standards on Auditing ('ISAs') (UK and Ireland)) and the Code of Audit Practice ('the Code').

The Code explains how external auditors should carry out their functions under the Public Finance and Accountability (Scotland) Act 2000. The audit of financial statements is covered by engagement and ethical standards issued by the UK Auditing Practices Board (APB), so the Code focuses more on the wider functions of public sector auditors. We have conducted our audit in accordance with the relevant requirements of the Code.

Respective Responsibilities of Management and Auditors

Management

It is the responsibility of the Board and the Chief Executive, as Accountable Officer, to prepare the financial statements in accordance with Section 45(2) of the Environment Act 1995 and directions made there under. This means:

- acting within the law and ensuring the regularity of transactions by putting in place systems of internal control to ensure that financial transactions are in accordance with the appropriate authority;
- maintaining proper accounting records;
- preparing financial statements timeously which give a true and fair view of the financial position of the entity and its expenditure and income for the year ended 31 March 2015; and
- preparing a Directors' Report, a Strategic Report, a Governance Statement and a Remuneration Report.

Auditors' responsibilities

Our responsibilities in accordance with the Code of Audit Practice are to provide you with an audit report stating whether, in our opinion the financial statements and the part of the Remuneration Report to be audited and give an opinion on:

- whether they give a true and fair view of the financial position of the entity and its expenditure and income for the year;
- whether they were prepared properly in accordance with relevant legislation, applicable accounting standards and other reporting requirements;
- whether the information which comprises the annual report included with the financial statements is consistent with the financial statements; and

- whether expenditure and receipts have been incurred and applied in accordance with guidance from Scottish Ministers (the regularity opinion).

We are also required to review and report as necessary on other information published with the financial statements, including the directors' report, annual governance statement, statement on internal control or statement on internal financial control and the remuneration report.

Financial Statements

As a result of our work, we proposed a number of disclosure audit adjustments to the draft financial statements. There are no unadjusted misstatements at the conclusion of our audit, as these have been resolved and accepted by management.

We have completed the majority of our audit work and expect to be able to issue an unqualified audit opinion on 28 July 2015.

Financial performance

SEPA's key financial performance for the period is as follows:

- The final outturn was £37.890m against an operating resource limit of £37.924m, resulting in a £0.034m underspend.
- Capital expenditure in the period was £2.494m which was within the capital resource limit of £2.495m.
- The budget for 2015/16 has an operating resource limit of £37.939m which is an increase of £0.015m (0.04%) on 2014/15 (£37.924m). We have not identified any key indicators or been made aware of any factors that would suggest that SEPA will fail to meet its financial targets.
- The Scottish Government has set an overall 3% savings target for all public sector entities. SEPA has achieved savings in the year of £1.2m and identified a further £1.1m for 2015/16.

Other Matters

Pension

Management identified that the assumptions used by the actuary to prepare the actuarial valuation as at 31 March 2015, differed from prior year. The specific assumptions affected were the expected salary growth rate and the gap between CPI and RPI. Management requested that these assumptions be amended to be more appropriate for SEPA. PwC consulted with our internal pension's team who confirmed that the suggested assumptions were appropriate. As a result of the change in original assumptions used by the actuary, the net pension liability went from £124m to £81m as being disclosed on the Statement of Financial Position.

Dilapidations

SEPA occupies a number of leased properties which have dilapidation clauses attached, requiring the property to be reinstated to the same level of condition as at the inception of the lease. Management reviews the leases in place and if a lease break has been activated or a lease is going to expire in the next 12 months; they then consider if a dilapidation cost is likely to be incurred. If a dilapidations cost is agreed with the landlord it is accounted for in property costs in year. If the dilapidations cost can only be estimated by management a provision is created in the financial statements.

Additional insight – journals

A key focus in our audit is sharing insight. During our audit procedures, for testing manual journals, we have interrogated the data from which we performed our manual journals testing to identify observations for your consideration. These are included within Appendix 1.

Please note that copies of this report will be sent to the Audit Scotland in accordance with their requirements.

We thank the management and staff of SEPA for their co-operation and assistance during the course of our work.

Section 2: Significant audit and accounting matters

We have set out in this section the significant matters arising from our audit.

Matters identified in our audit plan

Set out below is a summary of our response to matters identified in our audit plan:

Matter arising	Audit response
<p><i>Fraud and management override of controls</i> ISA (UK&I) 240 requires that we plan our audit work to consider the risk of fraud, which is presumed to be a significant risk in any audit. This includes consideration of the risk that management may override controls in order to manipulate the financial statements.</p>	<p>We performed procedures to:</p> <ul style="list-style-type: none"> • Test the appropriateness of journal entries using Computer Assisted Audit Techniques, we have provided an analysis of the type of journals posted, see appendix 1 for more details; • Review accounting estimates for bias and evaluate whether circumstances producing any bias, represent a risk of material misstatement due to fraud; • Evaluate the business rationale underlying significant transactions; and • Perform ‘unpredictable’ procedures. <p>We did not identify any issues to report to you as a result of our work.</p>
<p><i>Recognition of income (charging schemes) and expenditure</i> Under ISA (UK&I) 240 there is a (rebuttable) presumption that there are risks of fraud in revenue recognition. There is a risk that SEPA could adopt accounting policies or treat income transactions (specifically charging scheme income) in such a way as to lead to material misstatement in the reported revenue position.</p> <p>We extend this presumption to the recognition of expenditure in the public sector, as there is arguably greater risk associated with the recognition of expenditure in SEPA due to the nature of its funding.</p>	<p>We obtained an understanding of key revenue controls around Charging Schemes and expenditure controls.</p> <p>We evaluated and tested the accounting policy for income and expenditure recognition to ensure that this is consistent with the requirements of the Financial Reporting Manual (FRM).</p> <p>We performed detailed testing of revenue and expenditure transactions, including any deferred revenue, focussing on the areas we consider to be of greatest risk.</p> <p>We did not identify any issues to report to you as a result of our work.</p>

Materiality

We have conducted our work in accordance with the materiality levels detailed below. We have applied a de-minimus level of £82,600, which differs from the de-minimus level presented in our audit plan by £1,600. This

is as a result of updating the materiality levels with the actual results per the financial statements, as agreed with the Audit Committee upon submission of our annual audit plan.

	£
Overall materiality – This is the amount we have applied in assessing the overall impact on the group financial statements of potential adjustments	£1,652,340
Performance materiality - We have applied this to direct the amount of work performed over each financial statement line item – for example in calculating sample sizes	£1,239,255
De-minimus posting level - Under ISA (UK & I) 450, we are required to report to the Audit Committee on all unadjusted misstatements in excess of a ‘de-minimus’ or ‘clearly trifling’ amount	£82,600

Misstatements and significant audit adjustments

There are no uncorrected misstatements arising from our audit to report to you.

Qualitative aspects of accounting practices

Financial statement disclosures

We have also reviewed, and tested, the material disclosures in the financial statements. We identified some errors within the disclosures of the financial statements and these were addressed by Management. We identified no significant issues as part of this work.

Governance Statement

The Financial Reporting Manual requires the Chief Executive to sign a Governance Statement which covers all controls including financial, operational, compliance and the management of risk.

We reviewed the governance statement and considered the following:

- Compliance with the required elements as published by the Scottish Public Finance Manual; and
- Consistency with the remainder of information presented within the annual accounts and our overarching understanding of the entity.

Based on our normal audit procedures, **we do not disagree** with the disclosures contained in the Statement.

Section 3. Financial performance

Financial targets

Table 1: Financial targets summary 2014/15

	Outturn £ 000	Budget £ 000	Underspend/ (Overspend) £ 000
Total Capital Resource	2,494	2,495	1
Operating Expenditure (Cash)	34,487	34,824	337
Prior Year Adjustment	271	0	(271)
Depreciation / Impairments (Non-cash)	3,132	3,100	(32)
Total Operating Resource	37,890	37,924	34
Annually Managed Expenditure Limit	6,364	6,400	36

SEPA had no significant variances to budgeted resource limits during the year. Key areas of expenditure include:

- Staff costs (68% of total operating expenditure) – Staff costs have increased by £2.772m from the prior year, mainly due to pay uplifts and progressions as well as an increase in IAS 19 pension costs. SEPA has also experienced an increase in permanent staff numbers partly due to an increase in EU funded projects in the year.
- Other operating charges (28% of total operating expenditure) – Other operating charges have decreased by £1.083m from the prior year, mainly due to reduced costs incurred through SEPA's supplies and services as well as lease payments.
- Capital expenditure – A significant majority of capital expenditure was incurred during the year as part of the fit out of SEPA's new Stirling office, as well as the purchase of a water modelling IT system.

Efficiency savings

The Scottish Government has set an overall expectation of 3% efficiency savings for public sector bodies. SEPA reduced running costs by £1.2 million in year following the identification of these savings in 2013/14. A further £1.1 million savings have been identified in 2014/15, which have been removed from budgets set for 2015/16.

Financial sustainability

Financial sustainability has become a key matter for consideration by all public sector entities and it is vital that consideration of longer term financial plans has taken place.

The Financial Plan for 2015/16 identifies the following key areas of income and expenditure, recurring and non-recurring:

Table 5: 2015/16 Financial Plan

SEPA	2015/16 Planned Budget £ 000
Grant in Aid	39,810
Charging Schemes	37,520
Other Income	1,368
Total income	78,698
Expenditure	74,235
Depreciation / Impairments	3,363
Total operating costs	77,598
Surplus / (Deficit) to fund capital expenditure	1,100

SEPA received approval to increase charging fees detailed in a consultation set out in December 2013. Approval was obtained for increases in fees for 2015/16 at CPI (2.7%) and an additional 5% for waste. The new charging scheme which will operate from 01 April 2016 is assumed to generate the same level of income as the old scheme, so the financial model has assumed that the income from fees will increase by CPI each year.

CPI has been assumed at 1% at 30 September 2015, which will be used to set the fees in the new charging scheme, then to rise to 2.5% for the following two years.

2016/17 and beyond

Cost pressures and efficiencies

SEPA's financial strategy 2015 to 2019 highlights various cost pressures and funding issues which could result in significant budget gap over the forthcoming 3 financial years. The strategy clearly sets out the financial risks and their potential financial impact.

In the baseline financial model, SEPA makes the following key assumptions;

- A flat cash GiA funding settlement;
- The same level of income generation from the new charging scheme, followed by annual increases of over 2% per annum;
- An annual 1% pay award (and provision for additional NIC employer contributions arising from the end of contracting out from 2016/17);
- Limited inflationary increases over non-pay expenditure

However, the strategy highlights the impact of a number of financial risks such as potential cost pressures. If the cost pressures identified materialise, even with the full utilisation of the contingency allowance, the planned efficiency savings will have to deliver £2.946m of annual recurring savings by 2018/19 in order to address the budget gap.

At present, there are no detailed plans to identify the areas for savings, and how these will subsequently be delivered.

Deficiency	Recommendation	Management Response
<p>SEPA has a financial strategy that clearly identifies that even by utilising the full contingency allowance, a budget gap of £1.3m in 2017/18 and £2.9m in 2018/19 could develop.</p> <p>The financial strategy sets out a target to deliver recurring efficiency savings of £1.1m in each of the next 3 financial years, resulting in cumulative savings of £3.3m per year by 2018/19.</p> <p>However, no detailed savings plan exists to identify the savings and set out how they might be delivered.</p>	<p>Management should undertake an exercise to identify potential savings areas, and develop costed savings proposals to take to the Board for approval.</p> <p>Detailed plans should then be developed to set out how the changes will be implemented to realise the savings.</p>	<p>Management has agreed a plan for the identification of efficiency savings in 2015/16, for removal from budgets in 2016/17 and future years. This is monitored on a quarterly basis. The plan has been outlined as follows:</p> <ul style="list-style-type: none"> • Workshop in summer 2015 to consider options and ideas. • September 2015: Begin identifying savings. • December 2015: 75% of required savings to be identified. • March 2016: 100% of required savings to be identified.

The financial strategy also sets out a £2m capital funding shortfall in 2016/17 and 2017/18. SEPA is currently in discussions with the Scottish Government regarding a solution to this.

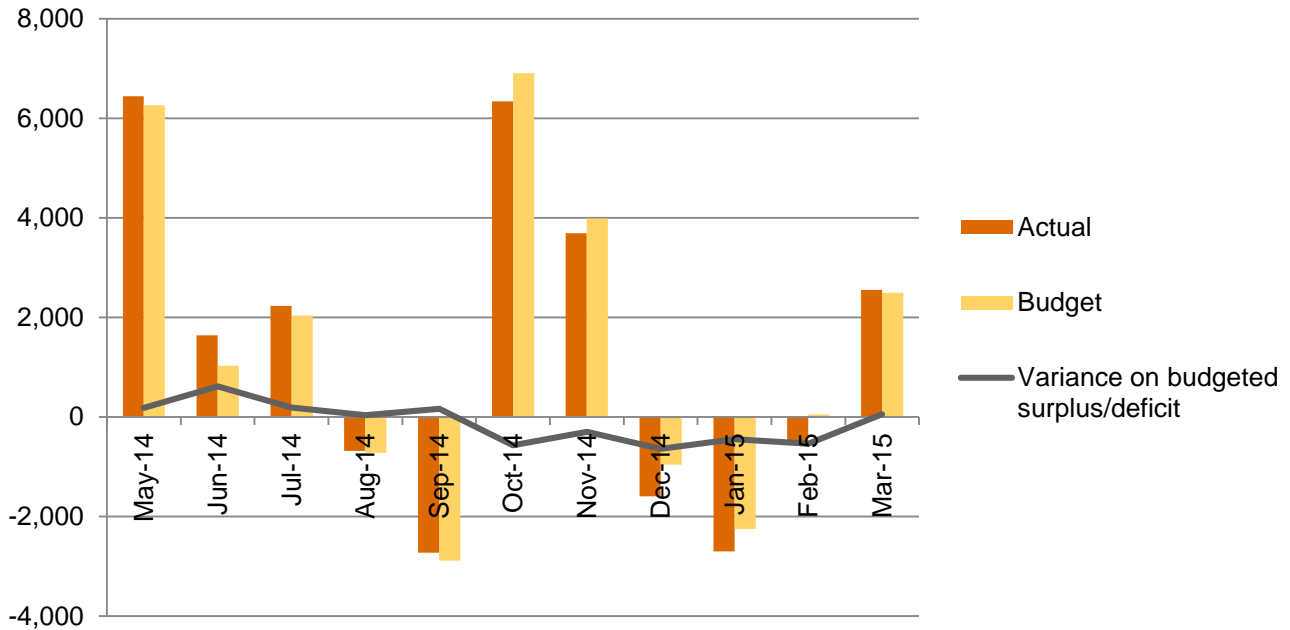
Financial planning and budgetary control

In order to support the balance between achieving targets in year and longer term financial planning it is vital that SEPA has in place a sound system of financial planning and budgetary control.

SEPA has a Corporate plan which sets out on a high level income and expenditure from 2012/17 as well as indicates how SEPA intends to meet its financial challenges over this five year period. Underlying this Corporate Plan, there is a Financial Plan which sets out overall budgets and projections including capital expenditure plans, reaching out to the 2018/19 year. Both plans have been reviewed and approved by the Board. The plans are forward thinking, covering a period of four years beyond 2014/15 which is considered good practice in supporting long term sustainability.

Incorporating the elements of the overall Corporate and Financial plans, detailed annual budgets are then prepared by finance and approved by the SEPA Board each year. We performed an analysis of the month-by-month budgeted surplus/deficit vs actual for SEPA and have noted that overall actual surplus/deficit has been roughly in line with budget throughout the year with no significant variances month by month.

Actual vs Budgeted surplus/deficit



Section 4. Governance and internal control

Governance structure

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 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.

In June 2014, Stuart McGregor was appointed as Chief Officer of Finance. In addition, in April 2015 Terry A'Hearn replaced James Curran as Chief Executive.

We consider that the governance arrangements in place are appropriate.

System of internal control

The Chief Executive Officer in conjunction with management and the Audit Committee is responsible for developing and implementing systems of internal financial control and having in place proper arrangements to monitor their adequacy and effectiveness in practice.

We review these arrangements for the purposes of our audit of the financial statements and for our review of the annual governance statement and report to you any significant deficiencies in internal control that we find during our audit.

The significant matters that, in our professional judgement, we believe we should bring to your attention are set out in the table below. No significant matters were identified in the current year; however, we have provided an update on prior year recommendations.

Deficiency	Recommendation	2015 Update
<p>Two individuals within the SEPA finance team have AGRESSO systems database access to post manual journals for unclaimed staff expenses at the year end. This is outwith the standard authorisation workflow process and no audit trail of whether these postings have been reviewed and authorised outside of the system by senior management is maintained.</p> <p>The journals processed during the 13/14 year have been reviewed and discussed with management to determine whether this access is</p>	<p>Regular downloads of the journals posted by the two individuals provided with this access should be generated by management and each journal reviewed and agreed as appropriate, with any inconsistencies investigated on a timely basis. This should be documented, either through an email confirmation by appropriate senior management or through physical print and sign off of the downloaded report. The review process interval should be agreed by management taking into consideration the expected</p>	<p>Management have confirmed that the only journals forced through the system outwith the Agresso workflow during the year were the two year end journals for the accrual of goods received not invoiced and staff expenses.</p> <p>Note: As at the date of submission of the audit committee papers PwC have still to follow up on the action taken by management. An update will be provided in the final document.</p>

<p>required. Due to the significant volume of line items it is deemed inefficient to process this manually through the standard workflow, therefore the individual transactions are 'forced' onto the system via a batch upload.</p>	<p>frequency of these journal postings, i.e. monthly, quarterly, etc.</p> <p>Management response:</p> <p>All future journals will be authorised</p> <p>Periodic checks will be carried out to make sure all journals are authorised</p> <p>Responsible Officer: Head of Finance</p> <p>Implementation date: Immediate</p>	
--	--	--

Based on our work performed we consider the systems of internal control to be appropriate.

Risk management

SEPA has a establish risk management process within the organisation. Each Portfolio, and the Chief Executive's Office, have a risk register which is considered at least quarterly by the Portfolio Management Teams. For some of the larger departments in Portfolio, departmental risk registers are also maintained.

SEPA's Risk Management procedures ensure that all risks are regularly reviewed by the Risk Management Group every six months. 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 Portfolio, Single Change Programme and Project risk registers periodically to ensure that these areas of SEPA are carrying out routine risk management and reporting activities.

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. PwC staff has attended Audit Committee meetings where internal audit reviews were presented by KPMG. We assessed the internal audit reports issued during the year and considered any potential impact on our audit. As in prior years, we have taken no reliance on the work performed by KPMG.

Based on audit work performed we do consider the Internal Audit function to be appropriate for the needs of the Board.

Other matters

Compensation and Confidentiality Agreements

SEPA has agreed nine voluntary redundancy agreements during the 2014/15 year. As standard practice, all nine of these agreements have a confidentiality clause within the contract.

Section 5. Fraud

International Standards on Auditing (UK&I) state that we, as auditors, are responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error. The respective responsibilities of auditors and management are summarised below:

Auditors' responsibility

Our objectives are:

- to identify and assess the risks of material misstatement of the financial statements due to fraud;
- to obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement due to fraud, through designing and implementing appropriate responses; and
- to respond appropriately to fraud or suspected fraud identified during the audit.

Management's responsibility

Management's responsibilities in relation to fraud are:

- to design and implement programmes and controls to prevent, deter and detect fraud;
- to ensure that the entity's culture and environment promote ethical behaviour; and
- to perform a risk assessment that specifically includes the risk of fraud addressing incentives and pressures, opportunities, and attitudes and rationalisation.

National Fraud Initiative (NFI)

SEPA participates in the National Fraud Initiative (NFI). They have identified 427 matches for the 2014/15 year and management have investigated and uploaded results on to the national NFI system. In accordance with our responsibilities as your appointed auditor, we are in the process of completing the NFI questionnaire and have the following observations at this stage:

- all 427 matches, including 48 recommended, have been processed at this stage, with commentary included on the NFI website; and
- no frauds or overpayments have been identified through investigations made.

Prevention and detection of fraud and corruption

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 published anti-fraud policies and procedures, segregation of duties and authorisation processes. All fraud is investigated by the Fraud Response Group and communicated to the Board and Audit Committee. There is a whistleblowing policy in place, which was last reviewed in 2013/14. No instances of fraud/corruption were reported during the year through the whistleblowing policy.

Based on audit work performed we consider that the controls in place to prevent and detect fraud or corruption to be suitable for the operations of the Board.

Section 6. Independence

Independence and objectivity

We have made enquiries of all PricewaterhouseCoopers' teams providing services to you and of those responsible in the UK Firm for compliance matters.

There are no matters which we perceive may impact our independence and objectivity of the audit team.

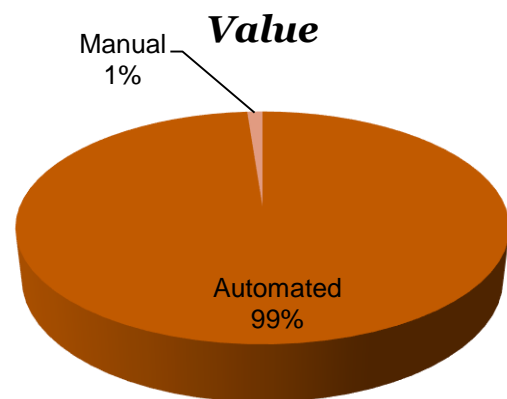
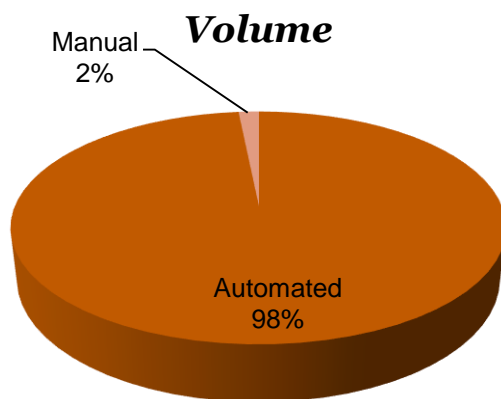
Independence conclusion

At the date of this plan we confirm that in our professional judgement, we are independent accountants with respect to SEPA, within the meaning of UK regulatory and professional requirements and that the objectivity of the audit team is not impaired.

Appendix 1: Journals insight

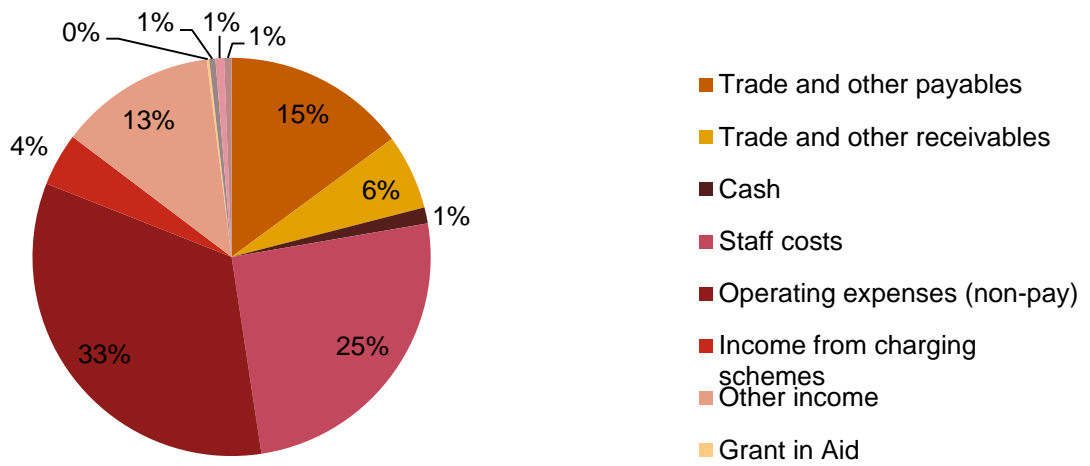
Automated vs Manual

Summary Profile		
	Quantity	Value (GBP)
Total journals	41,241	£10,169,635,753
Total manual journals	653	£121,273,289
Average no. of lines per manual journal	25	



This table shows that by value, only 1% of journals are performed manually. That should provide the organisation with comfort that the processing of journals is a largely automated control, which we have testing and found to be operating adequately.

Volume of journals, by Financial Statement Line Item



In the event that, pursuant to a request which SEPA has received under the Freedom of Information Scotland Act 2002, it is required to disclose information contained in this report, it will notify PwC promptly and consult with PwC prior to disclosing such report. SEPA agrees to pay to any representations which PwC may make in connection with such disclosure and SEPA shall apply any relevant exemptions which may be available under the Act to such report. If, following consultation with PwC, SEPA discloses this report or any part thereof, it shall ensure that any disclaimer which PwC has included or may subsequently wish to include in the information is reproduced in full in any copies disclosed.

©2015 PricewaterhouseCoopers LLP. All rights reserved. PricewaterhouseCoopers refers to PricewaterhouseCoopers LLP (a limited liability partnership in the United Kingdom) or, as the context requires, other member firms of PricewaterhouseCoopers International Limited, each a separate and independent legal entity.