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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 2015

8 October 2015

Contents

The contacts at KPMG in connection with this report are:

Andy Shaw
Director, KPMG LLP

Tel: 0131 527 6673
Fax: 0131 527 6666
Andrew.Shaw@kpmg.co.uk

Carol Alderson
Engagement Manager, KPMG LLP

Tel: 0141 309 2502
Fax: 0141 204 1584
Carol.Alderson@kpmg.co.uk

Carla Danczyszak
Audit in-charge, KPMG LLP

Tel: 0131 451 7775
Fax: 0131 527 6666
Carlajoy.Danczyszak@kpmg.co.uk

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 and is made available to Audit Scotland and the Auditor General for 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 circumstances set out in the executive summary: scope and responsibilities.

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.

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 2015.

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

Area	Summary observations	Analysis
Strategic overview		
Key issues and update	2014-15 was the final year of the Water Industry Commission for Scotland's ("the Commission") five year corporate plan. During the period of the corporate plan to 2015, the Commission carried out its duties with a budget significantly lower than that originally agreed, demonstrating efficiency savings over the period. A new corporate plan 2015-21 was approved by the Commission and sets out the priorities of the Commission over the next six years agreed by Scottish Ministers in March 2015. The Commission published the final determination of water and sewerage charges for 2015-21 in November 2014. The Commission was approached by OFWAT to act as a delivery partner in the Open Water programme. In 2014-15 there was £0.351 million expenditure relating to work on this programme which was recharged to Open Water Market Limited.	Page 6
Financial position	In 2014-15 there was a trading surplus of £0.516 million, prior to a net actuarial loss in respect of the pension scheme of £0.596 million. As a result of lower than budgeted regulatory, licensing and consultancy costs and due to the recovery of some salaries from Open Water Market Limited, the Commission was able to return £0.25 million to licensed providers. The Commission held cash of £1.221 million as at 31 March 2015, with net assets of £0.152 million.	Page 7
Financial statements and accounting		
Audit conclusions	We have issued an unqualified audit opinion on the 2014-15 financial statements, following their approval by the Board. The financial statements, strategic report, directors' report, governance statement and remuneration report were received by the start of audit fieldwork and were supported by high quality working papers. The finalised chairman's foreword was received on 24 August 2015.	Page 10
Going concern	The financial statements have been prepared under the assumption that the organisation is a going concern, reflecting the relatively high cash balance and an income budget agreed for the next six years. The 2015-16 budget assumes a small surplus.	Page 13
Accounting policies	There have been no changes to accounting policy applied by the Commission n 2014-15. No newly effective accounting standards are expected to have a material impact on the 2015-16 financial statements.	Page 13

Headlines (continued)

Area	Summary observations	Analysis
Financial statements and accounting (continued)		
Significant risks and audit focus areas	The areas highlighted below are the significant risks and specific audit focus areas identified within our audit strategy document: ■ management override of controls; ■ revenue recognition fraud risk; ■ Open Water expenditure; and ■ retirement benefit obligations. The audit work has been completed to satisfy the requirements of ISA 330 'The auditor's procedures in response to assessed risks', including tests of key financial controls. In respect of each matter, we are content with management's judgements and accounting treatment.	Pages 11 and 12
Governance and narrative reporting		
Governance	Our review of the governance arrangements did not identify any issues, we consider the arrangements to be appropriate for the size and operations of the Commission.	Page 16
Internal controls	Testing of the design and operation of financial controls over significant risk points concluded that that controls relating to financial systems and procedures are designed appropriately and operating effectively.	Page 16
Performance Management		
Performance management	Our review of the Commission's performance management arrangements in the year to 31 March 2015 indicates that these continue to be appropriate. The Commission continues to monitor and control its expenditure to make sure procurement provides value for money. Internal audit reviews, conducted as part of the 2014-15 internal audit plan, provided assurance over Best Value considerations in the year to 31 March 2015 and did not indicate significant weaknesses.	Page 19

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. The scope and nature of our audit were set out in our audit strategy document which was presented to the audit committee at the outset of our audit.

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.

Accountable officer responsibilities

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

- preparation of financial statements that show a true and fair view;
- 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.

Auditor responsibilities

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.

Scope

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 scrutiny committee throughout the year, discharges the requirements of ISA 260.

Strategic overview

Our perspective on key business issues and financial position

Key business issues

2014-15 represents the final year of the 2010-15 funding agreement.

The 2015-21 strategic review and corporate plan to 2021 were approved during the year.

During the period of the corporate plan to 2015, the Commission carried out its duties with a budget significantly lower than that originally agreed, demonstrating efficiency savings over the period.

Expenditure of £0.351 million was incurred in respect of the Open Water programme, and recharged to Open Water Limited.

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.

2014-15 is the last of the five year regulatory period. Total funding for the five years was agreed in June 2010 at £19.8 million, representing annual income of £3.96 million. A 15% reduction in funding was subsequently agreed for the three years to 31 March 2015; requiring a further £1.43 million savings over this period.

Over the five year period efficiencies have been realised, notably in respect of headcount; full time equivalents were 23 in 2010-11 and 17 in 2014-15. Wages and salaries in 2010-11 and 2014-15 were £1.31 million and £1.06 million respectively. Non-payroll savings are partly a result of a shift in the way the Commission carries out its work, reflecting a move towards a 'trust but verify' approach, with less reliance on analysing business planning information.

2015-21 strategic review and corporate plan

The final determination price review for the regulatory period 2015-21 was published in November 2014. The final determination was published following significant engagement with stakeholders and with customers at the heart of the outcomes. The Customer Forum was established to interact with Scottish Water on behalf of customers and to identify customer priorities for consideration in the determination.

The six year corporate plan was established during a period of transition; prior to the finalisation of the determination. The 2015-21 corporate plan was approved by Scottish Ministers in March 2015, set in line with current resources. The Commission proposed an initial decrease in Scottish Water's levy to £2 million with a 1.6% uplift each year. The licensed providers' levy is £1.4 million in 2015-16, giving a total levy in 2015-16 of £3.4 million, rising to £3.8 million by 2020-21.

Open Water

The Open Water programme was set up by the UK Government to deliver the competitive market for water and sewerage services for non-household customers by 2017. The Commission was approached by OFWAT to act as a delivery partner in this programme.

In 2014-15 the Commission worked closely with OFWAT and Open Water Market Limited in support of the objectives of the Open Water programme. The activities were conducted in line with the Memorandum of Understanding between the Commission and Open Water Market Limited. This primarily represents drawing on the experience of the Commission's chief executive and employees, and contracting professional services.

In 2014-15 £0.351 million expenditure was incurred from 8 September 2014 to 31 March 2015, and recharged to Open Water Market Limited. The expenditure includes staff costs, charged at the rate agreed within the Memorandum of Understanding. Following advice received during the year, it was determined that the activities represent a VATable supply and accordingly the Commission registered for VAT.

The expectation was that the Commission would continue to work with OFWAT in the delivery partner role through 2015-16 however OFWAT have instead appointed a delivery partner through a competitive tender process.

Financial position

The Commission has historically operated deficit budgets, drawing on reserves generated in prior years.

The outturn for 2014-15, excluding the pension scheme actuarial loss, was a surplus of £0.516 million, compared to the budgeted deficit of £0.098 million.

Net assets as at 31 March 2015 were £0.08 million lower than the prior year, as a result of a £0.596 million actuarial loss, net of the surplus of £0.516 million.

Financial position

Statement of comprehensive income

Following a refund to licensed providers of £0.25 million in March 2015, income from core activities of £3.239 million was lower than the budget of £3.47 million.

Other income of £0.351 million represents recharges to Open Water Market Limited in respect of costs incurred by the Commission on the Open Water programme. The Commission's involvement in the programme evolved during 2014-15 and was therefore not included in the original budget.

Staff costs increased from the prior year and budget, as a result of a 1% pay increase (backdated to November 2013) and from additional short-term roles in respect of the Open Water programme.

Notwithstanding £0.086 million incurred in respect of the Open Water Programme, 'other expenditure' was 25% lower than budget, as a result of significantly less consultancy and licensing costs than anticipated.

The Commission generated a surplus of £0.516 million, even after returning £0.25 million to licensed providers. This reflects the fact that the Commission continued to deliver core activities alongside the Open Water delivery partner role, for which it invoiced Open Water Market Limited for hours worked.

Statement of financial position

Net assets decreased compared to 31 March 2014, reflecting a net actuarial loss of £0.596 million and the net surplus from activities of £0.516 million. As the actuarial loss is 'non-cash', the Commission's cash balance increased by £0.399 million to £1.221 million.

Other receivables include £0.262 million outstanding from Open Water Market Limited, which was settled after the year end.

The increase in trade payables and other liabilities primarily reflects £0.061 million VAT payable in respect of the other income, as well as a number of other small variances arising from the timing of invoicing.

Statement of comprehensive income	2014-15 actual £'000	2014-15 budget £'000	2013-14 actual £'000
Income from core activities	3,239	3,470	3,117
Other income (OWML)	351	-	-
Total income	**3,590**	**3,470**	**3,117**
Staff costs	1,347	1,259	1,260
Depreciation	30	52	54
Other expenditure	1,699	2,259	2,107
Total expenditure	**3,076**	**3,570**	**3,421**
Operating surplus/(deficit)	**514**	**(100)**	**(304)**
Interest receivable	**2**	**2**	**1**
Net surplus/(deficit)	**516**	**(98)**	**(303)**

Statement of financial position	2015 £'000	2014 £'000
Total non-current assets	**120**	**152**
Other receivables	489	128
Cash and cash equivalents	1,221	822
Total current assets	**1,710**	**950**
Total assets	**1,829**	**1,102**
Trade payables and other liabilities	(316)	(184)
Total current liabilities	**(316)**	**(184)**
Pension Scheme liability	**(1,333)**	**(665)**
Non-current liabilities	**(28)**	**(21)**
Total liabilities	**(1,677)**	**(870)**
Net assets	**152**	**232**

Source: KPMG analysis of Commission financial statements and budget 2014-15

Financial position (continued)

A small surplus is budgeted for 2015-16, achieved through lower expenditure.

Whilst staff costs are budgeted to increase by 14%, there will be lower regulation, licensing and consultancy costs incurred.

Budget 2015-16

The 2015-16 budget was set in line with the corporate plan 2015-21. The budget assumes income from the Scottish Water statutory contribution will decrease by £0.08 million to £2 million.

The reduction in regulatory, licensing and consultancy work is largely a result of the timing of the strategic pricing review and publication of the final determination.

Staff costs are budgeted to increase by 14%, reflecting the fact that four analysts were recruited in the second half of 2014-15. Three remained as at May 2015 and the number of analysts is expected to increase in 2015-16 to deal with the extra workload as a result of Hydro Nation and the Anglo-Scottish market changes. The Scottish Governments Hydro Nation initiative seeks to maximise the benefits to the Scottish economy through the economic development and good stewardship of Scotland’s abundant water resources

Other operating costs are budgeted to decrease by £0.181 million as a result of a number of one-off costs in 2014-15 which are not expected to reoccur in 2015-16.

Reserves brought forward as at 1 April 2015 were £0.152 million, with a cash balance of £1.221 million. Cash and reserves are budgeted to increase during 2015-16.

	2015-16 budget £’000	2014-15 budget £’000
Income		
Income from activities	3,424	3,470
Total income	***3,424***	***3,470***
Expenditure		
Commission costs	181	152
Staff remuneration and expenditure	1,537	1,353
Regulation, licensing and consultancy	1,251	1,447
Accommodation costs	116	112
Administration and office costs	128	178
Other operating costs	92	273
Finance and non cash costs	31	53
Hydro Nation	21	-
Total expenditure	***3,357***	***3,568***
Surplus / (deficit)	**67**	**(98)**

Source: Draft budget 2015-16.

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 on the regularity of transactions reflected in those financial statements.

The financial statements, including the governance statement and strategic report, were made available on a timely basis and were accompanied by high quality working papers.

The chairman's foreword was received after the onsite audit work had concluded.

Audit conclusions

Following approval of the financial statements by the Board have issued an unqualified opinion on the truth and fairness of the state of the Commission's affairs as at 31 March 2015, and of the Commission's surplus for the year then ended. We have 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 its 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

- High quality working papers and draft financial statements were provided at the start of the audit fieldwork on 8 June 2015. This included the strategic report, directors' report, remuneration report and governance statement. The finalised chairman's foreword was received on 24 August, after the onsite work had concluded.
- Throughout the course of the year we have had regular communication and discussion with the chief executive and the financial controller, to ensure that disclosure within the financial statements was consistent with the requirements of the FReM. We provided minor feedback to management on the content of the financial statements, annual report and governance statement and we are pleased to report that these were 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.
- We consider that management has maintained a robust control environment, updating the finance manual in August 2014 and enhancing controls in respect of travel and expense claims.

Significant risks and audit focus areas

The significant areas of risk identified in our audit strategy document were in respect of:

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

and other focus areas of:

- **Open Water expenditure; and**
- **Retirement benefit obligations.**

We summarise below the risks of material misstatement as reported within the audit strategy document. We set out the key audit procedures to address those risks and our findings from those procedures, in order that the audit committee may understand the process by which we arrived at our audit opinion.

We have no changes to the risk or our approach to addressing the assumed ISA risk of fraud in management override an we do not have findings to bring to your attention in relation to this matter; no control overrides were identified.

Significant risks	Our response	Audit findings
Revenue recognition fraud risk Professional standards require us to make a rebuttable presumption that the fraud risk from income recognition is significant. Whilst the income stream is relatively simple, we assessed that the fraud risk from income recognition is a significant risk, in line with Professional Standards.	In respect of income from core activities, we agreed 100% of the transactions to bank statements, no exceptions were identified. For the £0.351 million invoiced to Open Water Limited, we verified each invoice to the schedule of income and confirmed that the amounts were either settled or included within debtors at the year end. We agreed all except for £0.073 million of the invoices to cash receipts, before and after the year end whilst onsite for the audit. The remaining amount was confirmed as received subsequent to the onsite audit.	We are satisfied that income is appropriately stated in the financial statements.

Significant risks and audit focus areas (continued)

<table>
<tr><th>Other focus area</th><th>Our response</th><th>Audit findings</th></tr>
<tr><td>Retirement benefits

The Commission accounts for its participation in the Falkirk Council Pension Fund in accordance with IAS 19 Retirement benefits, using a valuation report prepared by actuarial consultants. The Commission's actuaries use membership data and a number of assumptions in their calculations based on market conditions at the year end, including a discount rate to derive the anticipated future liabilities back to the year end date and assumptions on future salary increases.
IAS 19 requires the discount rate to be set by reference to yields on high quality (i.e. AA) corporate bonds of equivalent term to the liabilities.
The determination of the retirement benefit obligation is inherently judgemental and there is a financial statement risk as a result.</td><td>Our audit work consisted of:
■ KPMG specialists reviewing the financial assumptions underlying actuarial calculations and comparison to our central benchmarks, the result of which are on page 24;
■ testing the scheme assets and rolled-forward liabilities;
■ testing the level of contributions used by the actuary to those actually paid during the year;
■ testing the membership data used by the actuary to data from the Commission; and
■ agreeing actuarial reports to financial statement disclosures.</td><td>We are satisfied that the retirement benefit obligation:
■ is correctly stated in the balance sheet as at 31 March 2015;
■ has been accounted for and disclosed correctly in line with IAS19 Retirement benefits; and
■ assumptions used in calculating this estimate and managements judgements are appropriate and within the acceptable KPMG range.

We set out further information in respect of the defined benefit obligation on pages 24 and 25.
The defined benefit obligation increased by £0.668 million compared to 31 March 2014, driven by a reduced discount rate and increased mortality assumption.</td></tr>
<tr><td>Open Water expenditure

The Commission incurred expenditure in relation to Open Water, which was recoverable from Open Water Market Limited.

There is a risk that expenditure is not appropriately recognised and disclosed in the financial statements.</td><td>We tested the design, implementation and operating effectiveness controls in respect of bank reconciliations, monthly management accounts, journal postings and expenditure authorisation.

Specifically for Open Water expenditure we:
■ reviewed management's processes for capturing and allocating expenditure;
■ tested a sample of direct expenditure; agreed to supporting documentation and disclosure in the financial statements; and
■ agreed a sample of related hours charged for the programme to timesheets.</td><td>No exceptions were identified from the testing and the supporting documentation was readily available.

We are satisfied that Open Water expenditure is appropriately recognised and disclosed in the financial statements.</td></tr>
</table>

Accounting policies

The financial statements have been appropriately prepared on a going concern basis, having due consideration of the agreement of budgeted levy income in respect of 2015-16.

Accounting framework and application of accounting policies		
Area	**Summary observations**	**Audit findings**
Accounting policies	■ There have been no changes to adopted accounting policies in the year. ■ Critical accounting judgements continue to relate to the present value of defined benefit obligations under IAS 19 (as calculated by the Commission's actuary, Hymans Robertson) using agreed financial assumptions. We considered the appropriateness of these assumptions and the accounting for pensions on page 12.	We are satisfied that accounting policies and critical estimates adopted in the preparation of the financial statements remain appropriate. We have not identified indications of management bias.
Financial reporting framework	■ The Commission prepares financial statements in accordance with the principles of the Government's Financial Reporting Manual 2014-15 ("FReM"). ■ There have been no changes to the financial reporting framework in the year, other than those required under the first-time adoption of updated consolidation standards which does not impact on the Commission. Minor changes were also made to the requirement for disclosure of compensation payments within the remuneration report, however these have had no impact for the Commission.	We are satisfied that the accounting policies adopted remain appropriate to the Commission.
Going concern	■ The financial statements have been prepared under the assumption that the organisation is a going concern. ■ Funding for the period from 2015-16 is agreed with the Scottish Government and the 2015-16 budget assumes a surplus. The Commission held cash balances of £1.221 million as at 31 March 2015, with net assets and net current assets.	We concur with management's view that the going concern assumption remains appropriate.

Management reporting in financial statements

The annual report and remuneration report were prepared on a consistent basis to the prior year and remain appropriate.

Area	Summary observations	Audit findings
Annual report, including the strategic and directors' reports	The financial statements form part of the annual report of the Commission for the year ended 31 March 2015. 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. The finalised chairman's foreword was received on 24 August and we have confirmed that the information is consistent with our understanding the Commission.	We are satisfied that the information contained within the strategic and directors' report is consistent with the financial statements.
Remuneration report	The remuneration report was included within the draft financial statements and supported by good quality information and working papers. There was a change in the composition of the board in that John Reynolds resigned on in April 2014, which is appropriately disclosed in the financial statements.	We are satisfied that the information contained within the remuneration report is consistent with the underlying records and the financial statements.

Governance and narrative reporting

Our overall perspective on narrative reporting, including the annual governance statement

Update on controls findings from our audit

Corporate governance arrangements

Over-arching and supporting corporate governance arrangements remain primarily unchanged and provide a sound framework for organisational decision-making.

Our testing of the design and operation of financial controls over significant risk points identified no issues.

Area	Summary observations	Audit findings
Annual governance statement and governance arrangements	The statement for 2014-15 outlines the corporate governance and risk management arrangements in operation in the financial year. It provides detail on the governance framework, operated internal controls, the work of internal audit, internal financial controls and risk management arrangements and analyses the efficiency and effectiveness of these elements of the framework. It describes a number of sources of assurance for the accountable officer. The statement, which is made by the accountable officer, considers the effectiveness of the system of internal control based on information provided by the audit and committee and internal audit. The statement identifies that there have been no significant risk-related matters.	We updated our understanding of the governance framework and documented this though our overall assessment of the Commission's risk and control environment. We consider the governance framework and annual governance statement to be appropriate for the Commission and that the governance statement is in accordance with guidance and reflects our understanding of the organisation.
Internal controls	The Commission's management is responsible for designing and implementing appropriate internal control systems to ensure a true and fair view of operations within the financial statements. Our testing, combined with that of internal audit, of the design and operation of financial controls over significant risk points confirms that controls relating to financial systems and procedures are designed appropriately and operating effectively. The findings of our controls testing relate only to those matters identified during our normal audit work, in accordance with the Code, and there may still be weaknesses or risks within the control environment which have not been identified through this work. KPMG's identification of weaknesses, where applicable, does not absolve management from its responsibility to address the issues raised and to maintain an adequate system of control.	Our work concluded that that controls relating to financial systems and procedures are designed appropriately and operating effectively.
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 2014-15 no significant or other fraud or irregularity was identified by management, internal audit or through the course of our external audit work.	We consider that the Commission has appropriate arrangements to prevent and detect fraud.

Corporate governance arrangements (continued)

Area	Summary observations	Audit findings
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. 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.	We consider that the Commission has appropriate arrangements to prevent and detect inappropriate conduct and corruption.
Internal audit	Internal audit is provided by PwC and supports management in maintaining sound corporate governance and internal controls through the independent examination and evaluation of control systems and the reporting of any weaknesses to management for action. Audit Scotland's Code of Audit Practice sets out the wider dimension of public sector audit. It requires external auditors to perform an annual assessment of the adequacy of the internal audit function. We considered the activities of internal audit against the requirements of Public Sector Internal Audit Standards ('PSIAS'), focusing our review on the public sector requirements of the attribute and performance standards contained within PSIAS. This included a review of the internal audit charter, reporting lines, independence, objectivity and proficiency and the range of work carried out by internal audit. From this assessment, and considering the requirements of International Standard on Auditing 610 *(Considering the Work of Internal Audit)*, we can apply PwC's work to inform our procedures, where relevant. The review of internal audit reports and conclusions did not indicate additional risks and there is no impact on our planned substantive testing. Internal audit completed its agreed plan for the year ended 31 March 2015 and the annual report states that *"based on the risk appetite and the internal audit plan agreed with you, we have completed our programme of work and we believe there are adequate and effective governance, risk management and control processes to enable the related risks to be managed and objectives to be met."*	We have concluded that the internal audit service operates in accordance with Public Sector Internal Audit Standards. Internal audit has concluded that the Commission has an adequate and effective framework of governance, risk management and control to address the risk that management's objectives are not fully achieved.

Performance management

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

Performance management

Our work has identified that the Commission's Best Value and performance management arrangements are generally robust.

Area	Summary observations	Audit findings
Performance management and best value	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. Management remains committed to leveraging resources in an efficient way and made continuing savings during 2010-2015. This required sound financial management and innovative ways of working and service redesign. To consider the controls and processes to support Best Value aims, internal audit performed reviews in 2014-15 over: ■ competition review; ■ contractor management; ■ Open Water market arrangements; and ■ staff development review We reviewed the processes established to ensure Best Value is achieved, 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 relating to 2014-15 requiring procurement through OJEU process; the Oxera framework agreements having been issued through Scottish Government procurement frameworks in 2010-11. Three tenders were completed for work to be undertaken from 1 April 2015. All expenditure over £5,000 requires approval by the Commissions procurement panel, which meets as required throughout the year. Two approvals panel meetings were reviewed and found effective.	We consider that the Commission has appropriate arrangements to effectively manage performance and achieve Best Value in processes.

Performance management (continued)

Area	Summary observations	Audit findings
Local response to national studies	Audit Scotland periodically undertakes national studies on topics relevant to the performance of central government bodies. To ensure that added value is secured through the role of Audit Scotland and its appointed auditors, auditors will continue to ensure that audited bodies respond appropriately to reports from Audit Scotland's programme of national performance audits. The Commission's finance team review Audit Scotland report outputs on a quarterly basis and anything relevant to the Commission is brought to the attention of the Board. Given the size and activities of the Commission a number of the reports are not directly relevant.	We consider that the Commission has appropriate arrangements to effectively respond to national studies.
Financial capacity in public bodies	Through the process of feedback through Annual Audit Reports, current issues reports and sector meetings, Audit Scotland identified that overall reductions in staff numbers in public bodies may be affecting the capacity of back-office functions and specifically finance. Audit Scotland has requested the collation of baseline data across the public sector to inform sector specific overview reports and may inform a follow-up to the joint report on the public sector workforce which was published in November 2013 or support the development of the future performance audit programme. We have completed a return to Audit Scotland in respect of our findings. Our review in response to the request for data collection identified that there is appropriate financial capacity within the organisation to ensure effective management, as supported by the effectiveness of the routine financial management and annual accounts process. The Commission's finance team is relatively small and this puts inherent constraints on the amount of strategic considerations and modelling performed. However we note there were no audit adjustments and the financial statements were received in line with the agreed timetable. The finance function had appropriate input into the formation of the latest Corporate plan. We have completed a return to Audit Scotland in respect of our findings. Our review in response to the request for data collection identified that there is appropriate financial capacity within the organisation to ensure effective management.	We consider that the Commission has appropriate financial capacity to effectively manage the organisation.

Appendices

Mandatory communications

There were no changes to the core financial statement and there are no unadjusted audit differences

Area	Key content	Reference
Adjusted audit differences Adjustments made as a result of our audit	There were no audit adjustments required to the draft financial statements which impacted on the net assets or net operating cost for the year. A small number of minor numerical and presentational adjustments were required to some of the financial statement notes.	-
Unadjusted audit differences Audit differences identified that we do not consider material to our audit opinion	We are required by ISA (UK and Ireland) 260 to communicate all uncorrected misstatements, other than those which are trivial, to you. There are no unadjusted audit differences.	-
Confirmation of Independence Letter issued to the Audit and Risk Committee	We have considered and confirmed our independence as auditors and our quality procedures, together with the objectivity of our Audit Director and audit staff.	Appendix two
Schedule of Fees Fees charged by KPMG for non-audit services	We have concluded that non-audit fees of £8,760 in respect of tax do not compromise our independence.	Appendix two
Draft management representation letter Proposed draft of letter to be issued by the Commission to KPMG.	There are no changes to the standard representations required for our audit from last year.	-
Materiality The materiality applied to audit testing	We consider quantitative and qualitative factors in setting materiality and in designing our audit procedures. We assessed our level of materiality based on our knowledge and understanding of the Commission's risk profile and, therefore, financial statements. Materiality was set at £61,500 which is approximately 2% of total expenditure in 2014-15, and is lower than the materiality identified in our audit strategy (£72,000) as a result of actual expenditure being lower than that budgeted. We design our procedures to detect errors at a lower level of precision, i.e. £46,000. We report identified errors greater than £3,075 to the audit committee.	

Auditor independence

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 Water Industry Commission for Scotland and its related entities 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 board of directors.

Confirmation of audit independence

We confirm that as of 8 October 2015, in our professional judgement, 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 letter is intended solely for the information of the audit committee and should not be used for any other purpose.

Yours faithfully

KPMG LLP

Defined benefit obligation

In respect of 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 set out below the assumptions in respect of employee benefits.

Defined benefit pension liability		
2015 £'000	2014 £'000	KPMG comment
(1,333)	(665)	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 scheme valuation. Details of key actuarial assumptions are included in the table, along with our commentary.

Assumption	WICS 2013-14	WICS 2014-15	KPMG central	Comment
Discount rate (duration dependent)	4.3%	3.3%	3.21% - 3.36%	Acceptable. The corporate bond yield curve used to calculate the discount rate has been updated from the prior year.
CPI inflation	RPI-0.8%	RPI -0.9%	RPI – 1.0%	We consider that the CPI inflation used in calculating the liability is prudent, resulting in a higher liability. Taken into consideration with the net discount rate (below), however, we are comfortable that the assumption is within the acceptable range.
Net discount rate (discount rate – CPI)	1.4-1.5%	0.8%	1.02% - 1.05%	Acceptable. The Commissions assumption falls within the acceptable range of +/- 0.3%.
Salary growth	1% pa until 31 March 2016. 1.5% above RPI	1% pa until 31 March 2016. 1.0% above RPI	Typically 0% – 1.5% above RPI	Acceptable. The assumption is acceptable under IAS19.

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

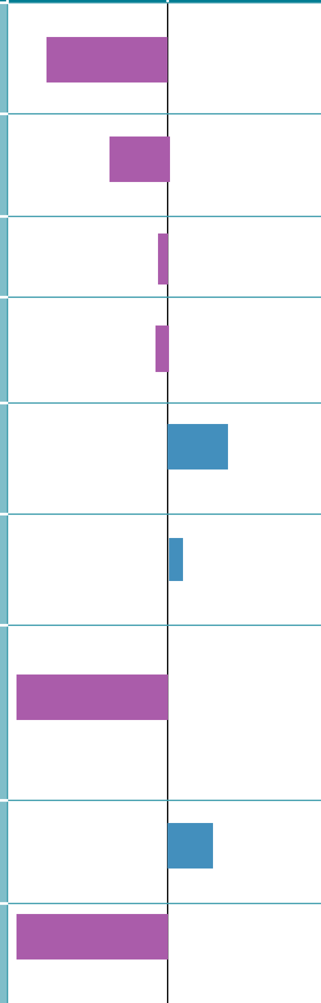
The closing deficit increased by £0.668 million from 2013-14, primarily due to a change in financial assumptions, driven by the decrease in discount rate and changes to demographic assumptions, the latter having been driven by the latest triennial valuation as at 31 March 2014. The Commission's assumptions are towards the prudent end of KPMG's acceptable range.

Defined benefit obligation (continued)

The table opposite shows the reconciliation of the movement in the statement of financial position.

Increases to the pension scheme deficit in the year have been driven by changes to financial assumptions, primarily as a result of a decrease to the discount rate and demographic assumptions.

	£'000	Deficit / loss	Surplus / gain	Impact	Commentary
	Opening pension scheme deficit			**(665)**	The opening IAS19 deficit at 31 March 2014 for the Scheme was £665,000 (consisting of assets of £4.153 million and defined benefit obligation of £4.818 million).
I & E	Service cost			(230)	The Scheme remains open. The employer's share of the cost of benefits accruing over the year is £230,000.
I & E	Past service cost			(7)	The employer's share of the cost of past service benefits accruing over the year is £7,000.
I & E	Net interest			(29)	This is the interest on the opening deficit of £665,000, adjusted for contributions paid during the period.
Cash	Contributions			194	The Commission made cash contributions over the year of around £194,000, which is broadly in line with contributions made last year £182,000, allowing for assumed salary increases.
OCI	Actuarial gain/(loss) – demographic assumptions			47	There was an actuarial gain of £47,000 due to changes in the demographic assumptions.
OCI	Actuarial loss – financial assumptions			(752)	There was an actuarial loss on the financial assumptions of around £752,000. This is primarily due to a 1.1% decrease in the discount rate assumption as a result of falls in corporate bond yields. This is broadly what we would expect for a scheme with liabilities of £4.818 million and a duration of 17 years.
OCI	Return on assets			109	The return on Plan assets, excluding interest on assets, was £109,000.
	Closing pension scheme deficit			**(1,333)**	The closing IAS19 deficit for the Scheme at 31 March 2015 is £1.333 million (consisting of assets of £4.659 million and defined benefit obligation of £5.992 million).



I&E – impacts on surplus /(deficit) within statement of comprehensive net expenditure

Cash – cash-flow impact

OCI – charged through other comprehensive income cutting through complexity