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Scottish Environment Protection Agency

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

Year ended 31 March 2016

21 June 2016

PricewaterhouseCoopers
141 Bothwell Street
Glasgow
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The Audit Committee
Scottish Environment Protection Agency
SEPA Corporate Office
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21 June 2016

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 2016. 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 2015. We have subsequently reviewed our audit plan and concluded that our original risk assessment remains appropriate. In addition to our original risk assessment, in line with Audit Scotland guidance we have also raised an elevated risk over financial sustainability, further details of our assessment of this risk and the procedures we have performed in response to our assessment of significant and elevated 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 2016. 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 completion procedures, receipt of the signed letter of representation from Management and final review of any changes made to the financial statements. We will provide an oral update on these matters at the meeting on 21 June 2016.

We look forward to discussing our report with you on 21 June 2016. Attending the meeting from PwC will be Jennifer Bell.

Yours faithfully

PricewaterhouseCoopers LLP

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Section 1. Executive summary

Introduction

We set out in this report our significant findings from our audit of the Scottish Environment Protection Agency ("SEPA") for 2015/16, 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 2015/16 audit plan that we presented to you on 15 December 2015. 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 2016; 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 2016.

Financial performance

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

- The final outturn was £38.381m against an operating resource limit of £38.388m, resulting in a £7k underspend.
- Capital expenditure in the period was £1.706 which was within the capital resource limit of £1.710.
- The budget for 2016/17 shows an operating resource limit (excluding capital) of £35.503m which is a decrease of £2.436m (6.42%) on 2015/16 (£37.939m). 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 £1.255m, which represents a 3.3% saving.
- Savings have been identified for 2016/17 to compensate for the reduction in grant-in-aid income as noted above.

Other Matters

Financial Sustainability

As noted in Section 3, Financial Sustainability has become an area of focus for our audit of entities within the public sector, which is a reflection of the funding pressures encountered by many public sector entities. In line with Audit Scotland guidance we have raised an elevated audit risk over financial sustainability for all our public sector body audits.

As part of addressing this elevated audit risk, we reviewed the long term financial plans in place to ensure SEPA can meet its outgoings and meet its objectives. We noted that while there is a financial performance forecast in place for 2016/17 which has Board approval, the longer-term (2017/18 onwards) financial plan is in progress and has been presented to AMT but has not yet been presented or approved by the Board. We understand that these are due to be submitted for consideration by the Board later in Q2 2016/17. Further details of work completed in this area and our recommendations and agreed management actions are detailed in Section 3.

Pension Valuation Assumptions

As in prior year, SEPA have requested a change in the expected salary growth rate used in the actuarial valuation as at 31 March 2016. This change in assumption has been proposed by SEPA to ensure the assumptions used in the pension liability calculation reflect the Government pay restrictions in place until 2020.. The salary growth rate assumption used until 2020 is 1.6% which is in line with the expected salary increase for 2016/17. We do note that the salary growth rate assumption used in the prior year was greater at 2.5% however, this has been updated to reflect the current estimated impact of the 2016/17 pay award.. Beyond 2020 a standard rate of CPI plus 0.5% has been used, which is in line with the assumption used in the prior year.

We have agreed this 1.6% growth rate to the pay remit submitted to the Government for 16/17. While the forecasted salaries for future years to 2020 may be lower, in the absence of robust forecasts we consider 1.6% to be a prudent estimate.

We consulted with our internal pensions experts who confirmed that the assumptions used are considered reasonable. The pay increase assumption optimism is offset by prudence with other financial assumptions such as the discount rate. The changes in financial assumptions resulted in a decrease in the pension liability of £42.259m from 2014/15. The net pensions liability on the Statement of Financial Position decreased from £80.957m in the prior year to £46.486m this year.

Property valuations

SEPA's land and buildings were subject to an external professional desktop review valuation during 2015/16. We consulted with our internal estates valuation experts to review the valuation report prepared by Cushman and Wakefield including their assumptions and methodology used. No issues were noted in this area.

However, the desktop review relies upon property information from Management. The last full valuation including an inspection of the properties by the external valuer was performed 8 years ago, on 31 March 2008.

Our valuation experts considered that given the recent downward trend in the Aberdeen market (where SEPA owns its highest value property), specialised nature of some properties and length of time since the last full inspection, it would be recommended that SEPA commission a full valuation including inspecting the properties in the coming year to ensure that their understanding of the properties and locations remains reasonable.

We have noted that it is common practice for a formal full valuation to be completed every 5 years, as detailed in the FReM, with less detailed valuation methods used in between years (such as a desktop valuation or indexation).

Additional insight – journals

A key focus in our audit is sharing insight. As noted within our audit plan, we used 'Halo for Journals' as our data analytics system which allowed us to interrogate the journals posted in the year. We have presented some of this data in appendix 1 which highlights tends identified through this review, for information purposes.

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

We would like to take this opportunity to 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, including our assessment and audit response to the significant and elevated audit risks.

Matters identified in our audit plan

We identified two significant risks in our initial audit plan; the risk of fraud and management override of controls and the recognition of income and expenditure. A further elevated risk was since added around Financial Sustainability, as detailed in Section 3.

Significant risks	Audit response
Fraud and management override of controls 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.	We obtained an understanding of the Period End Financial Reporting processes and controls. See control observations noted in Appendix 2. We performed the following substantive procedures: • Tested the appropriateness of journal entries using Computer Assisted Audit Techniques. We have provided an analysis of the trends we identified in our review of journals posted in Appendix 1. • Reviewed accounting estimates for bias (such as assumptions used in the pension valuation and property valuations) and evaluated whether circumstances producing any bias represent a risk of material misstatement due to fraud; • Evaluated the business rationale underlying significant transactions; and • Performed 'unpredictable' procedures, see a summary of the 'unpredictable' procedures performed with conclusions on the page below. **We did not identify any issues to report to you as a result of our work.**

Significant risks	Audit response
Recognition of income (except Grant in Aid) and expenditure 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 in such a way as to lead to material misstatement in the reported revenue position. **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.**	We obtained an understanding of the Revenue and Expenditure steams, processes and controls. See control observations noted in Appendix 2. We evaluated and tested the accounting policies for income and expenditure recognition to ensure that they are consistent with the requirements of the Financial Reporting Manual (FReM). We performed detailed testing of revenue and expenditure transactions, including any deferred revenue, focussing on the areas we consider to be of greatest risk. This included testing around the cut-off of expenditure around year-end and the unpredictable procedures around revenue cut-off and completeness, as detailed below. **We did not identify any issues to report to you from our work.**

Elevated risk	Audit response
Wider scope audit risk – financial sustainability There is unprecedented financial pressure on the public sector as a result of ever increasing demand during a period of financial austerity in UK public services. This is leading to public sector bodies across the country finding it increasingly difficult to fill budget gaps through the identification of efficiency savings. As a result there is an increasing audit risk that entities do not have detailed plans to show financial sustainability over the next 3-5 years.	We obtained an understanding of processes in place around budgetary controls and forecasting. We performed the following substantive procedures: • Reviewed financial performance forecasts and budgets for 2016/17 and beyond, and assessed these for accuracy against known budget cuts. Assumptions used were assessed for reasonableness. • Reviewed evidence of Board approval of budgets; and • Reviewed evidence of cost saving measures being implemented. **We found that plans for 2016/17 were in place and approved by the Board. However, forecasts and cost saving measures for future years were still in progress and not yet sent for Board approval.** **See details of the findings in this area in Section 3.**

Unpredictable procedures

Unpredictable procedures are audit tests performed over areas that would not be routinely reviewed as part of the audit. Performing this type of testing allows us to identify any potential areas of fraud. This year, the main unpredictable procedure performed was additional cut-off and completeness revenue testing, which is in addition to the work we already perform in this area.

The revenue testing sought to address the risk that subsistence income relating to licences issued during 2015/16 would not be billed and recognised until 2016/17. The system used to recognise this type of income, only recognises the income when it has received final authorisation within the CLAS system.

Our review of the revenue controls in place identified that it is possible a licence could be issued before year end but the revenue recognised post year end, when it has received final Registry authorisation in in CLAS system. Therefore resulting in a risk that revenue from 2015/16 could be recognised in 2016/17.

We performed testing over the listing of unapproved licences in the CLAS system at year end to determine if there could be any risk of material misstatement or possible fraudulent misstatement. We noted no issues.

Materiality

We have conducted our work in accordance with the materiality levels detailed below. We have applied a de-minimis level of £84,861, which is an increase of £1,861 on the de-minimis level presented in our audit plan. 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	**£1,697,220**
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	**£1,272,915**
De-minimis 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-minimis' or 'clearly trifling' amount	**£84,861**

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 reviewed and tested the material disclosures in the financial statements. We identified a small amount of 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 controls, operational controls, and those relating to 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 2015/16

	Outturn £ 000	Budget £ 000	Underspend/ (Overspend) £ 000
Total Capital Resource	1,706	1,710	4
Operating Expenditure (Cash)	35,208	35,246	38
Depreciation / Impairments (Non-cash)	3,173	3,142	(31)
Total Operating Resource	38,381	38,388	7
Annually Managed Expenditure Limit	7,746	6,210	(1,536)

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

- Staff costs (70% of total operating expenditure) — Staff costs have increased by £2.931m from the prior year, due to exit package costs as well as pay uplifts and increased pension costs.
- Other operating charges (26% of total operating expenditure) — other operating charges have decreased by £0.738m from the prior year, mainly due to reduced costs incurred through SEPA's supplies and services and transport costs.
- Capital expenditure — this has decreased by 0.788m from the prior year, mainly since the prior year expenditure was significant including high software purchase costs including the purchase of a water modelling IT system.

Financial sustainability

Per Audit Scotland guidance, Financial Sustainability has been added as an elevated risk in addition to those risks identified in our audit plan. Financial sustainability has become a key matter for consideration by all public sector entities and given the announced cut to SEPA's Grant-in-aid funding from the Government for 2016/17, which equates to an approximate 6.8% decrease, it is vital that consideration of longer term financial plans has taken place.

SEPA have agreed a number of savings to make up for the Grant in Aid funding shortfall in 2016/17. The initial proposals were approved by the Board in February 2016 and updates have been provided regularly. The final savings proposals and budget is to be presented to the Board later in June 2016 having been shared with the AMT.

The main source of savings has been a Voluntary Severance Scheme which is expected to achieve savings of £1.720m in the 2016/17 budget. Other lower-level savings identified amount to £0.273m across the portfolios. The rest of the shortfall is forecast to be covered by turnover savings of £1.471m, whereby any new staff vacancies will not immediately be filled during 2016/17.

Efficiency savings

The Scottish Government has set an overall expectation of 3% efficiency savings for public sector bodies. SEPA reduced running costs by £1.255 million (3.3%) in the year 2015/16, having identified these savings in 2014/15.

The Financial Plan for 2016/7 below identifies the following key areas of income and expenditure, recurring and non-recurring:

Table 5: 2016/17 Financial Plan

SEPA	Board Approved Budget 2016/17 £ 000	*Draft Updated for Board Approval Budget 2016/17 £ 000*
Grant in Aid	37,199	*37,540*
Charging Schemes	39,778	*39,778*
Other Income	2,125	*5,445*
Total income	**79,102**	***82,763***
Expenditure	75,102	*78,763*
Depreciation / Impairments	2,900	*2,900*
Total operating costs	**78,002**	***81,663***
Surplus / (Deficit) to fund capital expenditure	**1,100**	***1,100***

Note: This financial plan was approved by the Board in February 2016. There have since been a number of significant changes to this, in terms of other income stream increases and adjustments to specific savings identified. The bottom line is unchanged, however. The draft figures have been submitted in an update to AMT and are due to go for board approval in June 2016.

SEPA obtained approval for the new charging scheme which has been in operation since 01 April 2016 in February 2016. The new scheme has adjusted the spread of fees charges across regulatory activities to more fairly reflect the costs. It is assumed that income will increase by CPI as at September each year going forward.

2017/18 and beyond

SEPA are in the process of preparing a comprehensive Financial Plan for 2017/18 and beyond, however, progress has been slower than expected, partially due to a lack of clarity around grant in aid funding in coming years. We understand that a restructuring exercise is being carried out at senior management level which will yield some strategies and options for cost saving measures going forward. It was noted in the February 2016 Board meeting that a forward financial plan will be compiled and reported later in 2016/17 once this process is complete and detailed financial analysis has been performed.

Whilst the lack of certainty over Governmental funding prevents a fully accurate plan being made at present, it is important to consider longer-term financial plans and cost saving opportunities regardless. These will be necessary to meet Scottish Government efficiency requirements as well as any further cuts to grant-in-aid. If funding were cut each year going forward the cumulative effect could be significant, and management would need to consider how SEPA how it would address the funding gap.

Despite the cut in funding this year and lack of detailed long term comprehensive forecasts to evidence how funding cuts will be addressed in the long term, we do not consider this to cast doubt over SEPA's ongoing operation as a going concern. SEPA has its own source of income through charging schemes which is not expected to decline, and does not rely solely on grant in aid. SEPA's expenditure has also historically been managed against budget well, with robust budgetary processes and controls in place (see below).

Cost pressures and efficiencies

In the prior year, SEPA's financial strategy 2015 to 2019 highlighted various cost pressures and funding issues which could result in significant budget gap over the forthcoming 3 financial years. The strategy clearly set out the financial risks and their potential financial impact.
It highlighted the impact of a number of financial risks and potential cost pressures. The plan noted that if the cost pressures identified materialised, even with the full utilisation of the contingency allowance, SEPA would have to deliver £2.946m of annual recurring savings by 2018/19 in order to address the budget gap.

We raised a deficiency in the prior year that there were no detailed plans to identify the areas for savings, and how these would subsequently be delivered.

This deficiency remains this year, as again, the high-level forecast for years beyond 2017/18 has been prepared and shared with the AMT, but there are no specific plans laid out for how the budget gaps will be addressed. It has also not been prepared in detail and approved by the Board. See the updated finding below.

Deficiency	Recommendation	Management Response
SEPA had a financial strategy in the prior year which clearly identified 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. The financial strategy set 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. However, no detailed savings plan existed to identify the savings and set out how they might be delivered. **2016 Update:** A clear and comprehensive financial plan has not yet been drafted for the years beyond 2016/17. A high-level summary has been presented to the AMT, but not yet to the Board. Savings have been considered and agreed to account for known budget cuts in 2016/17, but there is a lack of savings plan in place to identify how further savings might be delivered in future.	a) Management should complete their refreshed Financial Strategy which clearly lays out forecasted income and costs, and any shortfalls anticipated for which cost saving measures need to be implemented. This should also include some consideration of the possibility of further funding cuts and how SEPA would respond to these, rather than only assuming a flat rate of Grant in Aid. b) As raised in prior year, management should then undertake an exercise to identify potential savings areas, and develop costed savings proposals to take to the Board for approval. Detailed plans should then be developed to set out how the changes will be implemented to realise the savings.	The financial strategy required to underpin SEPA's Corporate Plan 2017/21 will be drafted in summer 2016 for discussion with AMT and agreement with the Board as part of the corporate planning process. It has been agreed that Portfolios will consider how future savings can be made. At the same time the work that has been done looking at future structure of various functions across SEPA will be completed. AMT will then discuss these proposals with the Board as part of the process to reach agreement of SEPA's financial strategy for 2017/2021. **Completion by Chief Officer Finance 31/12/16**

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 indicating how SEPA intends to meet its financial challenges over this five year period. As noted above, the Financial Plan for 2017 onwards which sets out overall budgets and projections including capital expenditure plans beyond 2016/17 is not yet complete. It is anticipated that a forward financial plan for 2017/18 onwards will be prepared and presented for Board Approval during Q2 2016/17.

Detailed budgets are prepared each year for the next financial year. The plan for 2016/17 has been prepared, as noted above. Performance against these annual plans are monitored monthly, and reported to AMT/Board regularly.

We noted that overall actual surplus/deficit has been roughly in line with budget throughout the year with no significant variances month by month. Thus, the shorter-term budgetary planning and control is considered to be effective within SEPA.

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.

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 Appendix 2. The first is an update on a significant matter first raised in 2013/14. There were no matters raised in 2014/15. No significant deficiencies in internal control were noted during the 2015/16 audit. However, a number of more minor control observations were noted which we will bring to your attention as a matter of interest. They have not had any impact on the audit procedures or conclusions. These are also listed in Appendix 2.

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

Risk management

SEPA has an established risk management process. There is a risk register in place for each Portfolio and the Chief Executive's Office which are 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 Scott-Moncrieff, SEPA's internal auditors. PwC staff have attended Audit Committee meetings where internal audit reviews were presented by Scott-Moncrieff. 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 Internal Audit.

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

38 voluntary redundancy agreements have taken place during the 2015/16 year. Management have confirmed that formal agreements with confidentiality agreements have not been drafted as standard this year, following Audit Scotland guidance, as they were not considered to be necessary.

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.

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. There were four instances of whistle blowing in 2015/16. All four were investigated and recommendations that arose were implemented.

Based on audit work performed we consider 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' staff providing services to you and of those responsible in the UK Firm for compliance matters.

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

Independence conclusion

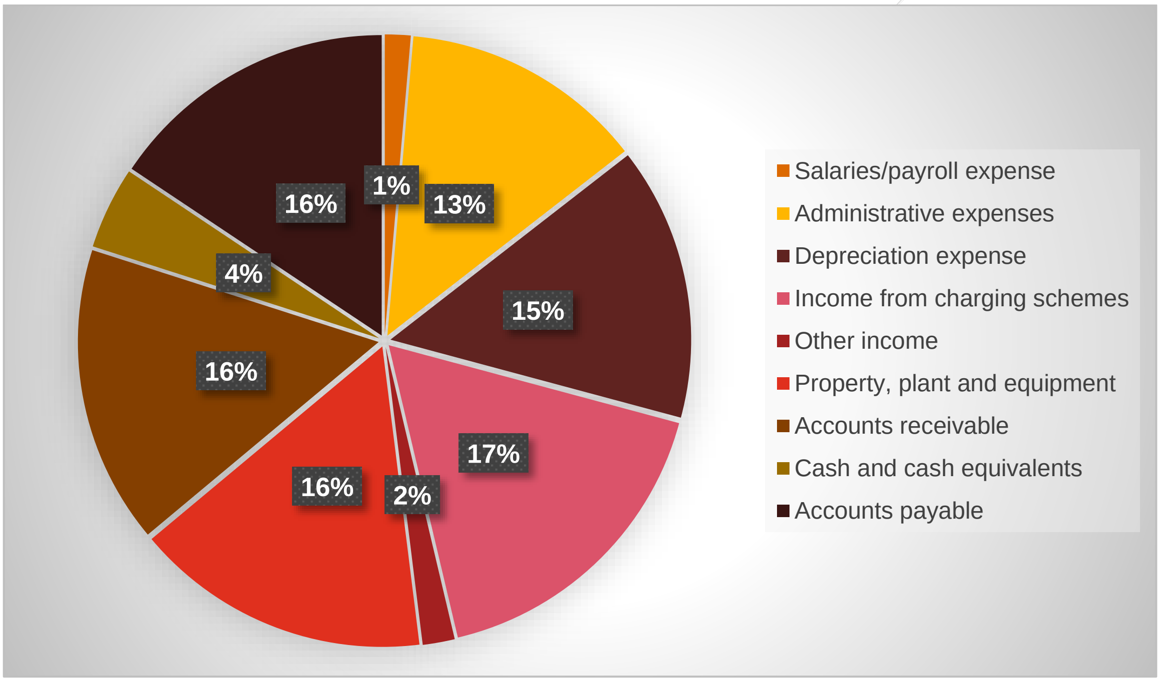
At the date of writing we confirm that in our professional judgement, we are independent accountants with respect of SEPA, within the meaning of UK regulatory and professional requirements and that the objectivity of the audit team is not impaired.

Appendix 1: Journals insight

Headline Figures

Criteria	Number/Percentage
Total number of journals	**38,769**
Number of journals <£10	1,247
Percentage of total journals <£10	**3.2%**
Average number of lines per manual journal	4
Number of users	**17**
Number of users posting <10 journals	1
Average number of journals per user (excluding user posting <10)	**2,423**

Volume of journals, by Financial Statement Line Item



Note: A number of Financial Statement Line Items had a very low number of journals posted; less than 1% of the total population. These were accruals, provisions and other liabilities, non-operating income/expense, grant in aid, share capital and investment income. These line items have been excluded from the pie chart above for visual clarity.

Appendix 2: Control Observations

Listed below are a number of control observations noted during the course of our audit, which could be subject to improvement to give management greater assurance over the achievement of organisational objectives around financial reporting and prevention of fraud. These have been split out by severity.

A separate area for improvement of budgetary forecasting was included in Section 3, and is not included below.

Control Deficiencies

The below deficiency was identified first in the 2013/14 audit. This has been updated following understanding gathered in the 2015/16 audit.

Deficiency	**Recommendation**	**Management Response**
1) PEFR: Journal Authorisation: six users within the SEPA Finance team have access to post manual journal entries without the authorisation of a designated approver in the system. This includes both posting and approving their own journal entries and 'forcing through' the upload of a large journal. This means that the standard workflow authorisation control to prevent erroneous or fraudulent journal entries is not currently designed effectively as it can be bypassed. From the 2013/14 audit, the nature of journals which were processed without authorisation was understood to be large entries with more lines than Agresso could process in the standard way. They are 'forced through' the system via a batch upload instead. **PEFR=Period End Financial Reporting control*	a) Management should review those users with access to both create and approve journals and determine whether this access level is necessary, and consider restricting this. (See point 3). *If access to create and approve journals/ force through journals is considered necessary and not revoked:* b) Management should perform a regular review of all journal entries posted by these users to identify any which were not authorised and agree these back to supporting documentation and assess for validity. This review should be formally documented.	a) Two members of staff have had their access removed, leaving the four Agresso Support staff, who need this access level. **Completed** b) Management have reviewed journals. Three journals went through in the year. Formal evidence of the review will be kept in future. **Completed**
2) Property Valuation: Land and Buildings were last formally inspected and valued in March 2008 and have been subject to desktop review annually since to revalue them. A full valuation every 5 years is considered common practice, per the FReM, with less thorough valuation methods in between years (such as desktop valuations or indexation).	Management should consider commissioning a full inspection and valuation of properties in the coming year, since the last time this occurred was March 2008. This is to ensure that the valuer's understanding of the properties and their locations remains reasonable, given market decline and the specialised nature of some.	Management will discuss with the external auditors appointed to undertake the 2016/17 audit the format of the valuation reports they require. **Completion by 31/12/16** **Head of Finance**

Other control observations

In response to significant audit risks around management override of controls and recognition of revenue and expenditure, we performed a walkthrough of processes and controls in these areas. We have also gained and understanding of the key IT General Controls in place.

We have identified some opportunities for improvement below however do note that these have not had an impact on the accuracy of the financial statements.

Observation	**Recommendation**	**Management response**
3) System Access controls: a) Joiner controls: Finance and HR staff require additional access rights in Agresso than other users. The process for requesting these individual access levels is informal with no documented request forms or management authorisation evidenced prior to access being granted. b) Periodic review control: As noted in deficiency 1, a number of users are able to both create and post manual journal entries, bypassing authorisation. There is no regular review performed of user access profiles within key financial systems such as Agresso, to ensure that individual access rights are in line with job responsibilities.	a) Management should ensure that access for HR and Finance staff is formally requested, specifying access profiles required, and approved prior to access being granted, with evidence of approval retained. b) Management should perform regular formal reviews of staff access levels and access profiles, particularly for those with administrator access, to ensure that they are in line with job responsibilities. Any inappropriate or unnecessary access rights within should be removed in a timely manner. Access levels should also be reviewed to identify any 'toxic access combinations' which represent a lack of segregation of duties. E.g. where a staff member can set up a supplier, process a PO and process payment.	Management will formally agree the process to authorise back office user profiles and maintain evidence of approvals. Agresso support team will periodically request managers to confirm that staff access rights are appropriate to their current duties. Agresso support will periodically report to management those users who have ability to process a requisition and complete a GRN. We will review the current GRN process with a view to making improvements **Completion by 31/12/16** **Head of Finance**
4) Program Change Management: There was no evidence that tests of system changes to Agresso in the year were completed and authorised prior to implementation since test scripts were not completed and signed off. Without formal testing and sign-off, there is a risk that changes to Agresso could have a financial reporting impact without adequate records or approval.	All changes should have the formal change process followed including the testing and authorisation of changes prior to implementation. This could be evidenced through completion and sign-off of test scripts which are then retained.	The member of staff, who completed the testing, has been on sick leave. The help desk team could not find the fully completed test script evidence in their absence. Management agree that there should be test evidence and authorisation accessible to all the Agresso team and in future will agree where and how this is kept. **Completion by 31/8/16** **Head of Finance**

5) <u>Revenue: Delayed licence billing</u> PwC noted that charging scheme revenue is recognised at the point of approval by Registry within the CLAS system, which may be after the original application and licence issuance. There is a risk that revenue may not be billed in the correct period to which it relates, if a licence is issued but then only billed later if final approval is delayed. **PwC performed substantive testing to address this risk. No risk of material misstatement was noted in 2015/16 since the number of licence amendments awaiting authorisation and billing at year-end was insignificant. However, there is a risk that a delay to authorisation of more licences in future could cause a material misstatement.**	*As noted, the delay in authorisation of a licence amendment/issuance is not common and did not represent a risk of material misstatement at year-end. Nevertheless, he below actions are recommended:* a) The revenue recognition point should be reviewed to ensure that it is appropriate. If possible, adjusting this to the date of licence issuance would prevent any future misstatements occurring. b) Management should review the number of licences issued but not yet authorised and billed at the end of each period to consider whether accruals of revenue are necessary based on value and volume.	Management will review its revenue recognition principles. **Completion by 31/8/16** **Head of Finance** Management regularly review forecasts of income based on CLAS license numbers**. Completed.** A report will be run quarterly to review licenses that have been issued but not invoiced. **Completion by 31/8/16** **Head of Finance**
6) <u>Expense claim Authorisation:</u> Expense claims under £500 in value are not subject to authorisation prior to posting to Agresso. We understand that only expense claims above £500, or those which exceed another specific threshold, are authorised by a manager before they are recorded and processed for payment. While there are sample checks of around 10% of expense claims back to receipts, there is a risk that expense claims under £500 could be incorrect or invalid and these are being posted to Agresso and paid out without any prior review.	a) The expense claim authorisation limit should be reviewed to ensure that it is appropriate and that the Board accept this risk. b) Management should consider implementing a pre-payment authorisation check for all expense claims. This would be authorisation by at least a line manager prior to upload and payment. This could be performed via a system workflow authorisation or manual sign-off.	Management considered expenses processing in summer 2015 and decided not to change the limits and not to reintroduce approval of expenses claims before payment. **Completed.**