cutting through complexity

Water Industry Commission for Scotland

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

For the year ended 31 March 2016

28 October 2016

Contents

About this report

This report has been prepared in accordance with the responsibilities set out within the Audit Scotland's *Code of Audit Practice* ("the *Code*").

This report is for the benefit of the Water Industry Commission for Scotland ("the Commission") and is made available to Audit Scotland and the Auditor General (together "the Beneficiaries"). This report has not been designed to be of benefit to anyone except the Beneficiaries. In preparing this report we have not taken into account the interests, needs or circumstances of anyone apart from the Beneficiaries, even though we may have been aware that others might read this report. We have prepared this report for the benefit of the Beneficiaries alone.

Nothing in this report constitutes an opinion on a valuation or legal advice.

We have not verified the reliability or accuracy of any information obtained in the course of our work, other than in the limited circumstances set out in the introduction and responsibilities section of this report.

This report is not suitable to be relied on by any party wishing to acquire rights against KPMG LLP (other than the Beneficiaries) for any purpose or in any context. Any party other than the Beneficiaries that obtains access to this report or a copy (under the Freedom of Information Act 2000, the Freedom of Information (Scotland) Act 2002, through a Beneficiary's Publication Scheme or otherwise) 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.

Complaints

If at any time you would like to discuss with us how our services can be improved or if you have a complaint about them, you are invited to contact Andy Shaw, who is the engagement leader for our services to the Commission, telephone 0131 527 6673 email: andrew.shaw@kpmg.co.uk who will try to resolve your complaint. If your problem is not resolved, you should contact Alex Sanderson, our Head of Audit in Scotland, either by writing to him at Saltire Court, 20 Castle Terrace, Edinburgh, EH1 2EG or by telephoning 0131 527 6720 or email to alex.sanderson@kpmg.co.uk. We will investigate any complaint promptly and do what we can to resolve the difficulties. After this, if you are still dissatisfied with how your complaint has been handled you can refer the matter to Russell Frith, Assistant Auditor General, Audit Scotland, 4th Floor, 102 West Port, Edinburgh, EH3 9DN.

Executive summary

Executive summary

Audit conclusions

- We have issued an unqualified audit opinion on the financial statements of the Water Industry Commission Scotland ('the Commission'). There were no matters to follow up from previous audits.

Financial position

The result for 2015-16 was total comprehensive income of £1.074 million, including the recognition of actuarial gains in the year. Removing these gains, a surplus on ordinary activities of £0.219 million (2014-15: £0.516 million) was recognised. This compares to the budgeted surplus of £0.070 million. As a result of the strong performance, the Commission was able to return £0.2 million in total to Scottish Water and the Licensed Providers towards the end of the financial year.	Pages 6 – 7
The Commission held cash of £1.99 million as at 31 March 2016, with net assets of £1.226 million. The Commission has allocated a maximum of £1.5 million cash to be utilised on a Rural Connections pilot scheme and an audit of the market.	Pages 6 – 7
The 2016-17 budget was set in line with the corporate plan 2015-21 and shows a deficit of £0.534 million. The budget includes income of £2.032 million from Scottish Water and £1.460 million from Licensed Providers. Total budget expenditure is £4.026 million (2015-16: £3.176 million), the increased expenditure includes £0.25 million for the market audit and £0.34 million for the Rural Connections pilot scheme.	Page 7

Financial statements and related reports

We have concluded satisfactorily in respect of each of the significant risks and audit focus areas identified in the audit strategy document. We concur with management's accounting treatment and judgments. We have no matters to highlight in respect of: adjusted and unadjusted audit differences; independence; and changes to management representations.	Pages 8 – 14

Wider scope matters

We consider that the Commission's finance department has appropriate financial capacity for current operations. Sound budgetary processes are supported by a strong internal control environment, and no control deficiencies or audit adjustments were identified. This is supported by regular accurate reporting and scrutiny by senior management and those charged with governance. Given the small team, financial experience is inherently concentrated on a limited number of individuals.	Page 16
The Commission has sound and well-established governance arrangements, which ensure effective scrutiny, challenge and transparency on decision making. The Audit Committee is provided with a comprehensive information pack ensuring transparency over decision making.	Page 17
We consider that the Commission is financially sustainable. 2015-16 was the first year of the 2015-2021 regulatory period, during which its income streams are agreed with a 1.6% uplift year on year. The Commission holds significant cash balances and demonstrates sound management of delivery against budget.	Page 18
The Commission has strong procurement processes, with all expenditure over £5,000 being subject to approval by an approvals panel and expenditure reported routinely to the Audit Committee.	Page 18

Executive summary
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 the audit strategy document which was presented to the audit committee at the outset of the 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 management and sustainability, governance and transparency and value for money.

Accountable officer responsibilities

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 with 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. Appendix one sets out how we have met each of the responsibilities set out in 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. Management of the audited body is responsible for preparing financial statements that show a true and fair view and for implementing appropriate internal control systems.

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 directors and our presentation to the audit committee, together with previous reports to the audit committee throughout the year, discharges the requirements of ISA 260.

Financial position

Financial position

Overview

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.

2015-16 is the first year covered by the 2015-21 Strategic Review of Charges. The Commission proposed and agreed an initial decrease in Scottish Water's levy to £2 million with a 1.6% uplift each year. The licensed providers' levy was £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.

Following the completion of the 2015-21 review, the Commission is in the process of developing and enhancing its approach and methodology for the regulatory control period that begins in April 2021.

The accumulated surpluses from the regulatory period 2010-15 will be utilised to contribute to a rural connections pilot scheme, a project aiming to test innovative approaches to improving water supplies to remote, private water supplies. Of the cash balance of £1.99 million, approximately £1 million will be allocated to this project. A further £0.5 million will be ring-fenced for audits of the Market to allow wider consideration of Code compliance to ensure customer protection.

Financial position: statement of comprehensive income

As shown in the table below there was a 2015-16 net surplus of £0.219 million (2014-15: £0.516 million) before actuarial gains. Expenditure was broadly in line with the prior year, although the lower than budgeted regulatory, licensing and consultancy costs enabled £0.2 million to be returned from income. £0.1 million was returned to Scottish Water and £0.1 million to Licensed Providers.

Other income of £0.141 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 ended in May 2015 resulting in a decrease in costs incurred and related recharges compared to the prior year.

Statement of comprehensive income

	2015-16 £000	2014-15 £000	Movement £000
Income from core activities	3,253	3,239	14
Other income	141	351	(210)
Total income	**3,394**	**3,590**	**(196)**
Staff costs	1,351	1,347	4
Depreciation	31	30	1
Other expenditure	1,797	1,699	98
Total expenditure	**3,179**	**3,076**	**103**
Operating surplus	**215**	**514**	**(299)**
Interest receivable	**4**	**2**	**2**
Net surplus	**219**	**516**	**(297)**
Actuarial gains/(losses)	855	(596)	1,451
Total comprehensive income/(expenditure)	**1,074**	**(80)**	**1,154**

Source: KPMG analysis of the Commission's annual accounts 2015-16.

Financial position (continued)

Financial position: balance sheet

Net assets as at 31 March 2016 increased compared to the prior year, as a result of the surplus for the year. Cash balances were £0.769 million higher and the pension scheme liability fell by £0.761 million as a result of the £0.855 million actuarial gain.

The decrease in other receivables reflects the recovery of prior year other receivables, including £0.262 million outstanding from Open Water Market Limited.

Statement of financial position

	2015-16 £000	2014-15 £000	Movement £000
Total non-current assets	97	120	(23)
Other receivables	46	489	(443)
Cash and cash equivalents	1,990	1,221	769
Total current assets	**2,036**	**1,710**	**326**
Total assets	**2,132**	**1,829**	**303**
Trade payables and other liabilities	(300)	(316)	16
Total current liabilities	**(300)**	**(316)**	**16**
Pension scheme liability	(572)	(1,333)	761
Non-current liabilities- provisions	(35)	(28)	(7)
Net assets	**1,226**	**152**	**1,074**

Source: *KPMG analysis of the Commission's annual accounts 2015-16.*

Financial plans 2016-17 and beyond

The proposed budget for 2016-17, set in line with the 2015-21 corporate plan, incorporates expenditure of £4.026 million which is almost £1.061 million higher than the estimate for 2015-16.

The budget includes an increase of £0.835 million in regulatory, licensing and consultancy expenditure. This is largely a result of the cost of the market audit (£0.25 million), the Rural Connections pilot scheme (£0.34 million) and £0.245 million expected increase in expenditure on the professional services contracts.

There is also a budgeted increase of £0.227 million in staff costs, based on 21 FTEs. This compares to an average FTE of 18 in 2015-16 and reflects an increased level of activity planned for 2016-17.

The budget assumes income of £3.492 million, as noted on the previous page. This results in a budgeted deficit of £0.534 million.

Going concern

Management considers it appropriate to adopt the going concern basis for the preparation of financial statements. It considers that the Scottish Water levy, license fees, other income and the available cash balance are sufficient to ensure that the Commission is able to meet debts as they fall due.

As at 31 March 2016 the Commission had net assets and net current assets of £1.226 million and £1.736 million respectively. The 2016-17 budgeted deficit will reduce the assets although we concur that the going concern assumption is appropriate on the basis of the forecast strong working capital.

Conclusion

The Commission has maintained a strong financial position in 2015-16, whilst returning £0.1 million to Scottish Water and £0.1 million to Licensed Providers. The Commission's cash balance increased to £1.99 million as a result of the surplus for the year.

We are content that the going concern assumption is appropriate for the Commission,.

Financial statements and related reports

Audit conclusions

Audit opinion
We have issued an unqualified opinion on the truth and fairness of the state of the Commission's affairs as at 31 March 2016 and of the surplus for the year then ended. There were no matters on which we were required to report by exception.
Financial reporting framework, legislation and other reporting requirements
The Commission is required to prepare its financial statements in accordance with International Financial Reporting Standards, as interpreted and adapted by the FReM. Our audit confirmed that the financial statements have been prepared in accordance with the FReM and relevant legislation.
Regularity
Our audit work, as outlined on the following pages, has concluded that in all material respects the expenditure and income in the financial statements were incurred or applied in accordance with any applicable enactments and guidance issued by the Scottish Ministers.
Statutory reports
We have not identified any circumstances to notify the Auditor General that indicate a statutory report may be required.
Other communications
We did not encounter any difficulties during the audit. There were no significant matters arising from the audit that were discussed, or subject to correspondence with management that have not been included within this report. There are no other matters arising from the audit, that in our professional judgement, are significant to the oversight of the financial reporting process.
Audit misstatements
There were no audit adjustments required to the draft annual accounts and there are no unadjusted audit differences.
Written representations
There are no changes to the standard representations required for our audit from last year.

Materiality

We summarised our approach to materiality in the audit strategy document. On receipt of the financial statements we reviewed our materiality levels. Whilst total expenditure per the financial statements was lower than that used to calculate planning materiality (£3.179 million per financial statements; £3.360 million budgeted), we concluded that our planning materiality for of £67,000 (1.99% of budgeted expenditure) remains appropriate. We report all misstatements greater than £3,350.

Forming our opinions and conclusions

In gathering the evidence for the above opinions and conclusions we have:

- performed controls testing and substantive procedures to ensure that key risks to the annual accounts have been covered and that the regularity of income and expenditure was in accordance with regulations;
- communicated with internal audit and reviewed its reports as issued to the 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 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 committees 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 31 May 2016. This included the performance report and the accountability report, which encompasses the corporate governance report and the staff report. There was evidence of accountability and ownership of working papers. The chairman's foreword has not yet been received.

Significant risks and other focus areas in relation to the audit of the financial statements

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 on the following pages, in order that the audit committee may better understand the process by which we arrived at our audit opinion.

Significant risks:

- Income and expenditure recognition fraud risk; and
- Management override of controls fraud risk.

Other focus areas:

- Retirement benefits; and
- Cash and reserves.

We have no changes to the assumed ISA risk of fraud in management override of controls. We do not have findings to bring to your attention in relation to this matter. No control overrides were identified.

Significant risks

SIGNIFICANT RISK	OUR RESPONSE	AUDIT CONCLUSION
Fraud risk from income and expenditure recognition 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. The risk around expenditure is that expenditure relating to 2015-16 is recognised in the incorrect period.	The following substantive testing was performed, with no exceptions identified: ■ We agreed 100% of income to bank statements. We also agreed the vast majority of levies from Scottish Water and the Licenced Providers to correspondence and invoices, and all Open Water invoices to cash receipts. ■ Predictive analytical procedures over expenditure, comparing the final position to prior year and investigating significant variances. ■ Cut-off testing of pre and post year expenditure as recorded in the financial ledger. ■ Search for unrecorded assets and liabilities as recorded in the Commission's bank accounts. ■ We tested controls over the authorisation of expenditure and supplier pay runs.	We concluded that income and expenditure is correctly recognised in the financial statements.

OTHER FOCUS AREA	OUR RESPONSE	AUDIT CONCLUSION
Retirement benefit obligations The Commission accounts for its participation in the Falkirk 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.	Our work consisted of: ■ KPMG specialists reviewing the financial assumptions underlying actuarial calculations and comparison to central benchmarks; ■ testing of scheme assets and rolled-forward liabilities; ■ testing of the level of contributions used by the actuary to those actually paid during the year; ■ testing of membership data used by the actuary to data from the Commission; and ■ agreeing actuarial reports to financial statement disclosures.	We are satisfied that the retirement benefit obligation: ■ is correctly stated in the balance sheet as at 31 March 2016; ■ has been accounted for and disclosed correctly in line with IAS19 *Retirement benefits*; and ■ assumptions used in calculating this estimate and management's judgements are appropriate and within the acceptable KPMG range. We set out further information in respect of the defined benefit obligation and the related assumptions on page 23. The defined benefit obligation decreased by £0.761 million compared to 31 March 2015, driven by an increase in discount rate (0.3% higher), and decreases in future salary increases (0.1% lower), RPI (0.1% lower) and future pension increases (0.2% lower).
Cash and reserves The cash balance as at 31 March 2016 was £1.99 million and general reserves £1.23 million. Given the value of the cash balance, we consider that there is a risk of misstatement.	We tested the bank reconciliation controls in operation during the year. We also vouched all cash balances to third party bank confirmations and verified that the year end bank reconciliation was appropriately performed.	We concluded that the cash and reserves balances are correctly stated.

REPORT	SUMMARY OBSERVATIONS	AUDIT CONCLUSION
Performance and accountability report	The annual report is now required to comprise a performance report and an accountability report. We assessed these reports against a disclosure checklist and we are satisfied that these have been properly prepared.	We are satisfied that the information contained within performance and accountability reports are consistent with the financial statements and in line with requirements. We reviewed the contents of the strategic and directors' report against the guidance issued by HM Treasury and are content with the proposed report.
Remuneration and staff report	The remuneration and staff reports were included within the unaudited annual accounts and supporting reports and working papers were provided. As in previous years' financial statements, the original remuneration report did not disclose the directors' pension cash equivalent transfer values as this information had not been provided by the scheme actuary. We agreed with the Financial Controller that the disclosure should be included and the information was provided by the actuary.	We are satisfied that the information contained within the remuneration report is consistent with the underlying records and the annual accounts. Our independent auditor's report confirms that the part of the remuneration report subject to audit has been properly prepared.
Annual governance statement	Changes were made to the Scottish Public Finance Manual guidance on governance statement requirements for reporting on controls for programme and project management, including compliance with the ICT assurance framework (where applicable) as well as details of any significant lapses of data security. The statement for 2015-16 outlines the corporate governance and risk management arrangements in operation in the financial year. It provides detail on the Commission's governance framework, operated internal controls, the work of internal audit, and risk management arrangements and analyses the efficiency and effectiveness of these elements of the framework.	We are satisfied that the annual governance statement is prepared in line with relevant guidance and is consistent with the governance framework in place at the Commission and our understanding of the organisation.

Qualitative aspects

ISA 260 requires us to report to those charged with governance our views about significant qualitative aspects of the entity's accounting practices, including accounting policies, accounting estimates and financial statement disclosures.

We consider the accounting policies adopted by the Commission to be appropriate, and there have been no changes to adopted accounting policies in the year. There are no significant accounting practices which depart from what is acceptable under the FReM.

Significant accounting estimates relate to the present value of defined benefit obligations under IAS 19 (as calculated by the Commissions' actuary, Hymans Robertson) using agreed financial assumptions. We found the assumptions and accounting for pensions to be appropriate, as discussed on page 23. We did not identify indications of management bias.

Financial statement disclosures were considered against requirements of the FReM. No departures from these requirements were identified.

Future accounting and audit developments

There are no significant changes to the FReM for 2016-17.

ISA (UK & Ireland) 700 and 720 have been revised for accounting periods beginning on or after 17 June 2016. These revise the requirements for the structure and content of the independent auditor's report. Audit Scotland is considering whether to early adopt the standards for 2016-17.

Wider scope

Financial management is concerned with financial capacity, sound budgetary processes and whether the control environment and internal controls are operating effectively.

We carried out audit tests to determine the effectiveness of the financial management arrangements. This included:

- *Assessing the budget monitoring processes.* We found these to be robust, with regular accurate reporting and scrutiny by senior management, Audit Committee and the Commission.
- *Consideration of the finance function and financial capacity.* The Commission's finance team is relatively small, putting 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.

Conclusion:

The Commission's finance department has appropriate financial capacity for current operations. Sound budgetary processes are supported by a strong internal control environment, and no significant control deficiencies were identified.

We are required to provide specific conclusions on the following areas which relate to financial management and support our overall conclusion on this audit dimension.

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.

Controls tested around significant risks include: authorisation over expenditure; pay run authorisation; expense payments; and procurement.

Conclusion: Our work concluded that the above controls relating to financial systems and procedures are designed appropriately and operating effectively.

Arrangements for the prevention and detection of fraud and error

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 2015-16 no significant or other fraud or irregularity was identified by management, internal audit or through the course of our external audit work.

Conclusion: The Commission has appropriate arrangements to prevent and detect fraud.

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. Entity level controls at the Commission were considered, such as the staff handbook and register of interests.

Conclusion: The Commission has appropriate arrangements to prevent and detect inappropriate conduct and corruption.

Governance and transparency is concerned with the effectiveness of scrutiny and governance arrangements, leadership and decision making, and transparent reporting of financial and performance information.

In considering governance and transparency at the Commission we performed the following work:

- *Reviewing the organisational structure, reporting lines and level of scrutiny within the Commission.* The Commission demonstrates effective scrutiny, challenge and transparency on decision making through various levels of reporting that we reviewed, including the management reporting pack to the Commission and the Chief Executive's activity report which goes to Audit Committee. Decisions are transparent as actions are documented within the Commission minutes.
- *Reviewing financial and performance reporting within the organisational structure.* Reporting was found to be of a high quality, accurate and transparent. Management reports are comprehensive and allow senior management and those charged with governance good oversight over the Commission.
- *Reading the annual governance statement*; as discussed on page 13.

We are required to provide specific conclusions on the following areas which relate to governance and transparency and support our overall conclusion on this audit dimension.

Corporate governance

We updated our understanding of the governance framework and documented this though our overall assessment of the Commission's risk and control environment. This involved testing entity wide controls, such as procedures around related party declarations and organisational oversight via a review of Audit Committee and Commission minutes.

Conclusion: Governance controls were found to be operating effectively and we consider the governance framework to be appropriate for the Commission.

Internal audit

Internal audit (PwC) completed its agreed plan for the year ended 31 March 2016 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 considered the activities of internal audit against the requirements of Public Sector Internal Audit Standards ('PSIAS'). This review focused on the public sector requirements of the attribute and performance standards contained within PSIAS. We updated the review we undertook in 2014-15, which included a review of the internal audit charter, reporting lines, independence, objectivity and proficiency and the range of work carried out by internal audit. We also considered the requirements of International Standard on Auditing 610 *(Considering the Work of Internal Audit)*.

Conclusion: We apply internal audit's work to inform our procedures, where relevant. The review of internal audit reports and conclusions did not indicate additional risks and there was no impact on our planned substantive testing.

Conclusion:

The Commission has sound and well-established governance arrangements that ensure effective scrutiny, challenge and transparency on decision making, through high quality reporting.

Financial sustainability looks forward to the medium and longer term to consider whether the body is planning effectively to continue to deliver its services or the way in which they should be delivered.

In considering financial sustainability of the Commission we performed the following work:

- *Consideration of key risks over financial sustainability.* The Commission is at the early part of the 2015-2021 regulatory period, in which the Scottish Government has agreed funding levels for the six year period. Management monitors performance against budget and seeks to be efficient in the Commission's operations.
- *Considering the use of underspend.* The Commission delivered a surplus for the last two financial years. £1.5 million of the accumulated surpluses are to be reinvested in projects in 2016-17.
- *Consideration of diversity of income streams.* While the Commission has the levy as a core income stream, it has been diversifying its activities. Hydro Nation builds on the experience gained during the Open Water Market project by advising other countries on how to open up their water markets.

Conclusion:

The Commission has an agreed level of income for its core activities until the end of the current regulatory period, sufficient to cover core expenditure. The Commission has sought to diversify its income streams by taking on new work such as Hydro Nation which will provide further comfort over the Commission's financial sustainability. We consider that the Commission is financially sustainable.

Value for money is concerned with using resources effectively and continually improving services.

We consider value for money throughout our testing. Some of the areas where we had a specific focus on value for money are:

- *Reviewing the procurement policy and performing controls testing over the procurement of goods and services.* No exceptions were found through our testing and the procurement policy was found to be in line with best practice. The tendering process provides evidence of scrutiny for value for money in the use of resources.
- *Updating our understanding of improvements made to the commissions regulatory processes.* The Commission is continuing to develop and improve its approach for the regulatory period beginning in April 2021 and has prepared a series of papers putting forward its thinking on a long-term vision for the sustainable governance and financing of the Scottish water industry.

To consider the controls and processes to support Best Value aims, internal audit performed reviews in 2015-16 over:

- procurement act compliance; and
- payroll and expenses.

Conclusion:

The Commission strives to achieve value for money in its delivery of services. This has been seen through strong controls over procurement and the existence of the approval panel who discuss and approve all expenditure over £5,000. We are content that the value for money arrangements are appropriate to the Commission.

Wider scope
Local follow up work

In November 2013 the Accounts Commission and Auditor General for Scotland published a report on Scotland's public sector workforce. The report highlighted a number of key messages on workforce changes across Scotland in the public sector and made recommendations to the Scottish Government.

We performed follow up work on this report, and submitted a return to Audit Scotland summarising our findings and conclusions. This work concluded on the following key issues:

- Planning: There is no formal workforce plan in place. The Commission's headcount remains fairly static with a standard recruitment process to replace any leavers. Reliance on key individuals has been defined as a risk and a full review of structure, pay and progression processes was undertaken in 2014 in an effort to maintain a well trained and motivated workforce.
- Service delivery: The Commission prepares a Corporate Plan for each regulatory period and this is used to inform staff planning. As part of the process of drafting a new Corporate Plan, a review of staff requirements is undertaken for the full regulatory period and any training or recruitment required is identified.
- Partnership working: The Commission works with other organisations to arrange secondments for the further development and training of staff, where such training is not available within the Commission.
- Reporting: The Corporate Plan is approved by the Commission and costs are considered as part of this process.
- Challenge and scrutiny: On a monthly basis, the Commission reviews the management reports comparing the budgeted staff cost position to actual. This allows management to make informed decisions on a timely basis.

A number of the points above were considered best practice in workforce planning and the Commission has demonstrated a commitment to implementing the recommendations in the report. Staff requirements are reviewed regularly in the short term, as well as over the course of a regulatory period.

Appendices

To the audit committee members

Assessment of our objectivity and independence as auditor of the Water Industry Commission for Scotland (the Commission)

Professional ethical standards require us to provide to you at the conclusion of the 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 and addresses:

- General procedures to safeguard independence and objectivity;
- Independence and objectivity considerations relating to the provision of non-audit services; and
- Independence and objectivity considerations relating to other matters.

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 partners 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
- Communications
- Internal accountability
- Risk management
- Independent reviews.

We are satisfied that our general procedures support our independence and objectivity except for those detailed below where additional safeguards are in place.

Independence and objectivity considerations relating to the provision of non-audit services

Summary of fees

We have considered the fees charged by us to the company and its affiliates for professional services provided by us during the reporting period.

We have detailed the fees charged by us to the company and its related entities for significant professional services provided by us during the reporting period in the attached appendix, as well as the amounts of any future services which have been contracted or where a written proposal has been submitted. Total fees charged by us for the year ended 31 March 2016 are analysed as follows:

	Current year £000	Prior year £000
Audit of the Commission	11,870	13,365
Total Audit	*11,870*	*13,365*
Tax Compliance Services (i.e. related to assistance with corporate tax returns)	3,600	-
Tax Advisory services	2,580	4,560
Total non-audit services	*6,180*	*4,560*
Total Fees	**18,050**	**17,925**

Appendix one
Auditor independence (continued)

The ratio of non-audit fees to audit fees for the year was 0.52:1.

Facts and matters related to the provision of non-audit services and the safeguards put in place that bear upon our independence and objectivity, are set out in the table opposite.

Independence and objectivity considerations relating to other matters

We set out below our consideration of other matters which, in our professional judgement, have a bearing on our independence and objectivity.

Confirmation of audit independence

We confirm that as of the date of this letter, in our professional judgment, KPMG LLP is independent within the meaning of regulatory and professional requirements and the objectivity of the audit director and audit staff is not impaired.

This report is intended solely for the information of the audit committee and should not be used for any other purposes.

We would be very happy to discuss the matters identified above (or any other matters relating to our objectivity and independence) should you wish to do so.

Yours faithfully

KPMG LLP

Disclosure	Description of scope of services	Principal threats to Independence	Safeguards Applied	Basis of fee	Value of Services Delivered in the year ended 31 March 2016 £000	Value of Services Committed but not yet delivered £000
Tax compliance services	Completion of the corporation tax return.	Self-review Management	Work performed by a team separate from the audit team. Work does not commence until after the financial statements to which the tax return relates are signed. Services do not result in any material judgments within the financial statements. Management remain responsible for any decisions.	Fixed	£3,600	Nil
Tax advisory services	Provision of VAT advice.	Self-review Management	Work performed by a team separate from the audit team. Work does not commence until after the financial statements to which the tax return relates are signed. Services do not result in any material judgments within the financial statements. Management remain responsible for any decisions.	Fixed	£2,580	Nil

Appendix two
Defined benefit obligations

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 are of the view that this therefore represents a reasonable and balanced approach, in accordance with the requirements of IAS 19.

We set out below the assumptions in respect of defined benefit obligations.

Defined benefit pension liability

2016 £000	2015 £000	KPMG comment
(572)	(1,333)	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	KPMG central	Comment
Discount rate (duration dependent)	3.50%	3.50%	Acceptable. The proposed assumptions are within the acceptable range.
CPI inflation	RPI less 1.0%	RPI less 1.0%	Acceptable. The proposed assumptions are within the acceptable range.
Net discount rate (discount rate – CPI)	1.30 – 1.40%	1.25%	Acceptable. The proposed assumptions are within the acceptable range of +/- 0.3% from the KPMG central range.
Salary growth	RPI + 1%	Typically 0% - 1.5% above inflation	Acceptable. The proposed assumptions are within the acceptable range.

The overall assumptions applied by management are considered to be reasonably balanced for a scheme with a liability duration of between 17 and 23 years. The closing deficit decreased by £0.761 million compared to 2014-15, primarily due to an increase in discount rate (0.3% increase), and decreases in future salary increases (0.1% decrease), RPI (0.1% decrease) and future pension increases (0.2% decrease).

Appendix three
Appointed auditors responsibilities

Area	Appointed auditors responsibilities	How we've met our responsibilities
Corporate governance	Review and come to a conclusion on the effectiveness and appropriateness of arrangements to ensure the proper conduct of the bodies affairs including legality of activities and transactions. Conclude on whether the monitoring arrangements are operate and operating in line with recommended best practice.	Page 17 sets out our conclusion on these arrangements.
Financial statements and related reports	Provide an opinion on audited bodies' financial statements on whether financial statements give a true and fair view of the financial position of audited bodies and their expenditure and income. Provide an opinion on whether financial statements have been properly prepared in accordance with relevant legislation, the applicable accounting framework and other reporting requirements. Provide an opinion on the regularity of the expenditure and income.	Page 9 summarises the opinions we expect to provide.
Financial statements and related reports	Review and report on, as appropriate, other information such as annual governance statements, management commentaries, remuneration reports and grant claims.	Page 13 reports on the other information contained in the financial statements, covering the annual governance statement, management commentary and remuneration report.
Financial statements and related reports	Notify the Auditor General when circumstances indicate that a statutory report may be required.	Page 9 sets out any notifications we have made to the Auditor General.
Financial statements and related reports	Review and conclude on the effectiveness and appropriateness of arrangements and systems of internal control, including risk management, internal audit, financial, operational and compliance controls.	Page 16 sets out our conclusion on these arrangements.
WGA returns and grant claims	Examine and report on WGA returns Examine and report on approved grant claims and other returns submitted by local authorities.	The Commission is below the threshold for the completion of audit work on the WGA return.

Appendix three

Appointed auditors responsibilities (continued)

Area	Appointed auditors responsibilities	How we've met our responsibilities
Standards of conduct – prevention and detection of fraud and error	Review and conclude on the effectiveness and appropriateness of arrangements for the prevention and detection of fraud and irregularities, bribery and corruption and arrangements to ensure the bodies affairs are managed in accordance with proper standards of conduct. Review National Fraud Initiative participation and conclude on the effectiveness of bodies engagement.	Page 16 sets out our conclusion on these arrangements. The Commission did not participate in the National Fraud Initiative.
Financial position	Review and conclude on the effectiveness and appropriateness of arrangements to ensure that the bodies financial position is soundly based.	Pages 6 and 7 set out our conclusion on these arrangements.
Financial position	Review performance against targets	Page 6 summarise our review of how the body has performed against it's financial targets.
Financial position	Review and conclude on financial position including reserves balances and strategies and longer term financial sustainability.	Page 6 sets out our conclusion on the bodies financial position including reserves balances. Page 7 sets out our conclusion on the bodies financial strategies and longer term financial sustainability.
Best Value	Review and conclude on the effectiveness and appropriateness of arrangements of accountable officers specific responsibility to ensure that arrangements have been made to secure Best Value.	Page 18 sets out our conclusion of the bodies arrangements.

cutting through complexity

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