

# Scottish Canals

External Audit Annual Report to the Board and  
the Auditor General for Scotland  
2016/17 Financial Year

26 June 2017



# Contents

Section	Page
Key Messages	3
Financial Statements Audit	5
Financial management and financial sustainability	10
Governance and transparency	15
Value for money	18
<b>Appendices</b>	
Audit Adjustments	21
Follow up on prior year recommendations	22
Action Plan	23
Reminder of Responsibilities	25

## Our audit plan at a glance:

<p>Materiality has been updated for year-end based on unaudited financial statements to £0.197million (1% of gross income)</p>	<p>Performance materiality is set at £0.128 million and we have reported to management everything identified over £1,970 (Trivial as 1% of materiality)</p>	<p>Financial statement significant audit risks were: management override of controls; risk of fraud in revenue recognition; and investment property valuation. Other identified risks were: completeness of expenditure and the carrying value of investments.</p>	<p>We identified two wider scope risks around financial sustainability and flexible governance</p>
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We can confirm we are independent of Scottish Canals and our objectivity is not compromised in accordance with International standards on Auditing (UK & Ireland) and APB ethical standards for Auditors. No non-audit services have been provided to Scottish Canals in 2016/17 and our audit fee was as set out in our audit plan.

# Key Messages

We have issued an unqualified opinion on the:

- True and fair view of the financial statements
- Regularity
- Other prescribed matters

This report is a summary of our findings from our external audit work for the financial year ended March 2017. Our work has been undertaken in accordance with International Standards on Auditing (UK & Ireland) and the Code of Audit Practice (2016).

Our report is addressed to the Board (in their role as those charged with governance) and the Auditor General for Scotland. This report will be published on the Audit Scotland website at: [www.audit-scotland.gov.uk](http://www.audit-scotland.gov.uk).

This report has been discussed and agreed with management, and presented to the Audit & Risk Committee on 13 June 2017. We would like to thank management and staff for their co-operation and assistance throughout our audit work.

## The main elements of our work included:

- An Audit of the 2016/17 Annual report and accounts
- A review of the Strategic Report, Corporate Governance Statement and Remuneration Report
- Completion of the 'Role of Board's return submitted to Audit Scotland to inform a future performance publication
- Submission of an EU Grant Funding return to Audit Scotland (nil return)

We received good quality unaudited annual report and accounts which had been through robust internal challenge by management and the Audit and Risk Committee. The audit process was effective and efficient and we have built up a good working relationship with the finance team. The audit working papers and supporting evidence was good and all audit queries were answered promptly.

This report reflects our broader reporting obligations under the Code of Audit Practice. We have provided commentary against our specific wider scope risks as well as certain aspects of Scottish Canals arrangements as they relate to: financial management; financial sustainability; governance and transparency and value for money.

Overall Scottish Canals is an ambitious organisation with a clear corporate plan focused on maintaining the Canal network, but also an organisation that has wider social, economic and environmental aims. As an organisation Scottish Canals continues to seek to be innovative, making broader use of the wider public sector asset base, taking these decisions in a measured manner through appropriate governance structures. As the external auditors of Scottish Canals we will continue to discuss with management how the corporate plan will be delivered in line with our wider scope reporting requirements, focused on how key risks will be mitigated.

GRANT THORNTON UK LLP

26 June 2017



# The Financial Statements Audit



We have not had to alter or change our audit approach set out in the audit plan presented to the Audit and Risk Committee on 1 December 2016 and updated in February 2017. As set out in our plan we have updated our materiality calculations to be based on the unaudited 2016/17 financial statements.

Overall we received a complete set of accounts including the strategic report on 28 April 2017 and this had been through internal challenge and Audit and Risk Committee review and were of a high quality. The accounts were supported by detailed working papers contributing to an effective audit process.

In line with materiality we have reported all audit adjustments identified above £1,970 to management.

A summary of corrected and uncorrected adjustments is set out in Appendix 1.

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## Internal Control Environment

During the year we sought to understand Scottish Canals overall control environment (design) as related to the financial statements. In particular we have:

- Considered procedures and controls around related parties, journal entries and other key entity level controls
- Performed procedures around IT general controls. A separate IT Key Issues Memorandum has been issued and there are no significant matters that we wish to draw to your attention.
- Performed walkthrough procedures on key controls around identified risk areas including investment property valuation and carrying value of investments

No material weaknesses in the accounting and internal control systems were identified during the audit which could have an adverse impact on Scottish Canals ability to record, process, summarise and report financial and other relevant data so as to result in a material misstatement in the financial statements.

Under International Auditing Standards (ISA's) we are required to report to those charged with governance the main issues arising from our audit of the Annual Accounts and Report.

This report discharges our obligations under the relevant ISA's.

## Internal Audit

As set out in our external audit plan we have not placed formal reliance on the work of Audit Glasgow, the internal audit provider, during 2016/17. We have reviewed the internal audit plan and individual reports issued to date, to consider if any impact on our audit approach, with none being noted.

The opinion of Internal Audit for the year was:

*“Based on the audit work undertaken and the assurances provided by the Executive Team it is our opinion that reasonable assurance can be placed upon the adequacy and effectiveness of the governance and control environment which operated during 2016/17 within Scottish Canals.”*

The findings of internal audit do not disagree with our knowledge and understanding of Scottish Canals as an organisation and its risk profile. We consider the work of internal audit to be proportionate and relevant to Scottish Canals key activities.

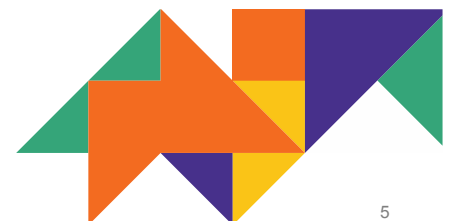
We note management continue to actively engage with internal audit and are implementing the recommendations agreed, and this progress is reported to the Audit and Risk Committee at each meeting.

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## Accounting for Dundas Hill

We have reviewed the accounting for the land at Dundas Hill, as a significant transaction out with the normal course of business. The purchase of the land is reflected in the annual accounts as “Stock – Work in progress”. We have reviewed the accounting treatment to ensure it meets the requirements under IAS 2. We agree that this accounting treatment is appropriate on the assumption that the intention is for Scottish Canals to decontaminate the land and then subsequently sell the land.

Should this change, and Scottish Canals plan to keep some of the land under the ownership of Scottish Canals then the accounting treatment would then be an asset under construction, and then recognised in Plant, Property and Equipment.



# Our identified audit risks

Our audit plan identified a number of significant and other audit risks and our planned approach. We have set out below a summary of the work undertaken over these risks and our conclusions.

Audit plan identified risk and work completed	Our conclusion
<p><b>Management override of control</b></p> <p>Under ISA (UK&amp;I) 240 there is a mandated risk that the risk of management over-ride of controls is present in all entities (fraud risk).</p> <p><b>Work undertaken</b></p> <p>Completed walkthrough of the controls and procedures in place around journal entries</p> <p>Reviewed the key accounting estimates, judgements and decisions made by management.</p> <p>Tested journal entries with a focus on unusual posting sources, times or amounts identified using our IDEA data analysis software</p> <p>Reviewed unusual and/or significant transactions.</p>	<p>Key accounting estimates: We did not identify any significant areas of bias in key judgements by management and judgements were consistent with prior years.</p> <p>Journals: We made inquires of those members of staff who can post and authorise journals related to inappropriate or unusual activity with no concerns noted. Only 5 numbers of staff can post journals, with 715 authorised during the year. The Director of Finance did not post or authorise journals during the year, as expected based on our understanding. We confirmed completeness of journals and tested those we determined to be large or unusual</p> <p>We reviewed the Dundas Hill purchase as a significant transaction out with the normal course of business.</p>
<p><b>The revenue cycle includes fraudulent transactions</b></p> <p>Under ISA 240 (UK&amp;I) there is a presumed risk that revenue may be misstated due to the improper recognition of revenue. Scottish Canals income is composed of £11.7 million of revenue and £8.0 million of grant funding.</p> <p><b>Work undertaken</b></p> <p>Completed walkthrough of the controls and procedures in place around sales invoicing and sales ledger</p> <p>Agreed revenue to supporting documentation and cash receipts in the year / post period end to gain comfort over validity of these transactions</p> <p>Performed cut-off testing to gain comfort around the completeness and accuracy of recognised income</p> <p>Considered the recoverability of any outstanding balances at year end</p>	<p>We have performed our year-end cut-off procedures and assessed recoverability of outstanding amounts at year-end.</p> <p>For all revenue balances we completed detailed procedures on material income streams.</p> <p>No issues noted from our review of the treatment of revenue in the year.</p> <p>We considered recoverability of a sample of year end debtors and noted no issues arising from this work.</p> <p>We rebutted the risk of fraud related to the grant income stream from the Scottish Government given the nature of the funding received. For Scottish Government income we agreed this to the grant letter from Transport Scotland and income received to bank.</p>

Audit plan identified risk and work completed	Our conclusion
<p><b>Investment property valuation</b></p> <p>Investment properties of £16.5 million were included in the March 2016 accounts. Included within this total is a general moorings balance of £3.3 million which is fair valued based on annual income subject to a multiplier.</p> <p><b>Work undertaken</b></p> <p>Completed an assessment of the credentials and independence of the valuer, who are Cushman &amp; Wakefield.</p> <p>Obtained and reviewed the valuers report. The top 10 assets and up to 10 assets with material changes by value were specifically covered alongside the general moorings balance. The remainder were considered with reference to relevant market indicators.</p> <p>Recalculated and agreed valuation movements for all assets revalued.</p>	<p>Scottish Canals independent valuer is Cushman &amp; Wakefield and we confirmed their experience and qualifications through independent third party confirmation.</p> <p>The increase in the moorings value from £3.3 million to £3.6 million has been driven by the uplift in moorings income in line with our revenue testing. We assessed the general moorings multiplier for reasonableness, which remained at a multiple of 5.8 in line with 2015/16.</p> <p>No issues noted from the work performed.</p>
<p><b>Completeness of operating expenditure</b></p> <p>Operating expenses are understated or not recorded in the right period. This risk also relates to Practice Note 10 (revised) in respect of public sector entities which outlines that auditors should also consider the risk that misstatement may occur by the manipulation of expenditure recognition (Fraud risk).</p> <p><b>Work undertaken:</b></p> <p>Completed walkthrough of the controls and procedures in place around purchase ordering, procurement and general payment and recording of expenditure.</p> <p>Reconciled creditors ledger to the general ledger and financial statements</p> <p>Performed cut-off testing on pre-year end and post year end transactions to gain comfort around the completeness and accuracy of recognised expenditure</p> <p>Gained comfort around the regularity of expenditure and the application of public funds in accordance with the Scottish Public Finance Manual (SPFM).</p>	<p>We have concluded through the performance of our year end procedures that the expenditure and receipts were incurred or applied in accordance with the applicable enactments of the Transport Act 1962 and guidance issued by the Scottish Ministers and the expenditure is valid and correctly classified between revenue and capital.</p> <p>Through our pre and post year end cut of testing on a sample basis we did not identify any expenditure that was incorrectly accounted for.</p> <p>Material areas of expenditure were substantively tested. In particular we considered the towpath expenditure of £3.3 million, agreeing this to invoice and/or other supporting documentation.</p>
<p><b>Carrying value of investments</b></p> <p>Scottish Canals hold a £5.2 million investment in Bigg Regeneration Limited Partnership, a property rental entity. There is a risk that the carrying value of this investment is not recoverable given the nature of assets held.</p> <p><b>Work undertaken</b></p> <p>Obtained a breakdown of all movements in the period and audited all material movements being £0.438 million share of profits.</p> <p>Reviewed the work performed by the auditor of Bigg on the year to 31 December 2016 and performed our own procedures on the period to 31 March 2017. We also obtained latest financial information for this entity to assess the carrying value and recoverability of this investment.</p> <p>Review of work performed by the auditors of Bigg, BDO LLP for the year ended 31 December 2016, particularly focused around revenue recognition to gain comfort over the net assets of this entity and hence the value of the Scottish Canals share.</p>	<p>We have concluded through the performance of our year end procedures that the investment in Bigg Regeneration is not impaired and that the carrying value is appropriate.</p> <p>We are satisfied that Bigg has sufficient assets to underpin the investment carrying value, and that a significant cash balance provides assurance around the liquidity of the investment.</p>

# The narrative elements of your annual accounts

In accordance with our responsibilities we have reviewed your narrative aspects of the Annual Accounts and Report. We have considered the consistency of this narrative with our understanding and the financial statements and have set out our observations below:

## Directors Report & Strategic report

- The strategic report outlines performance analysis and highlights the key issues and risks facing Scottish Canals.
- Key performance indicators are set out, although these are driven by Scottish Government national outcomes and how Scottish Canals contribute to these rather than directly aligned to the Corporate Plan
- All required disclosures included in line with accounting requirements
- Financial performance analysis included is in line with our understanding and work performed.
- There is clear narrative setting out analysis of performance against planned savings and use of the legacy cash balance
- Risks identified including financial sustainability and canal network maintenance are in line with our discussions with management and review of Board minutes.

## Corporate Governance Statement

- All key required elements included within the corporate governance statement.
- Each Executive Director has signed off to the Chief Executive to provide assurances to allow him to provide overall assurance in the governance statement.
- In addition, the Executive Directors have completed an internal controls checklist as provided by the Scottish Government. There were no matters identified in any of the statements that require to be disclosed

## Directors Remuneration report

- We have audited the financial information included in the remuneration report
- We have no matters that we wish to bring to your attention.





# Judgements and estimates

In addition we consider other aspects of your annual report and accounts in particular key areas of judgement. We have summarised below our observations in these areas:

## Accounting Policies

- Accounting policies are in accordance with IFRS and the Companies Act (where relevant) and we consider these to be appropriate to Scottish Canals.

## Accounting estimates and judgements

- Scottish Canals have a number of significant accounting judgements or estimates in the accounts, in particular:
- Investment property valuation (and particularly moorings multiplier)
- Bad debt provision calculations – bad debt provision remains at £0.1 million and represents 0.5% of expenditure
- We are satisfied that assumptions are reasonable and not subject to management bias

## Going Concern

- Scottish Canals has an agreed budget for 2017/18 and continues to discuss future funding with Scottish Government.
- For 2016/17 57% of Scottish Canals income was from other sources than Grant-in-aid. They will continue to receive grant funding to support the maintenance of the canal towpaths and have ongoing discussions with Transport Scotland around capital funding. Income will continue to be generated through the investments they hold albeit this is subject to fluctuations.

## Pension assumptions

- Pension increase rate of 2.25% (Waterways) and 2.4% (Strathclyde)
- Salary increase rate of 2.7% (Waterways) and 4.4% (Strathclyde)
- Discount rate of 2.6% (Waterways) and 2.7% (Strathclyde)
- All rates within the reasonable range assessed by our in-house actuarial team.

## Timing of transactions and period in which they are recorded (Cut off assertion)

- Through our substantive audit resting we did not identify any concerns over timing of transactions or the period in which they were recorded.

## Impact on the financial statements of any uncertainties

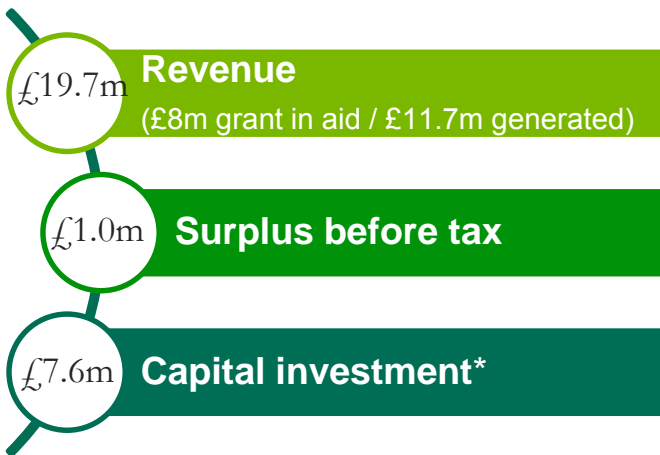
- No uncertainties have been identified which have an impact on the financial statements.

# Financial management and sustainability



# Financial Management

## Financial Performance in focus



\* £5.3 million of tangible and investment property additions and £2.3 million investment into Dundas Hill land within stock.

## Financial performance against budget

The budget was set based on best estimates of income levels, and did not incorporate the significantly higher spend around towpath income and expenditure in the year. The key variances noted were:

- Towpath income (third party funding) and expenditure (materials and contracts, towpath works) were £2.5 million higher than budgeted
- Retail income was £0.6 million behind budget and was reforecast during the year
- Professional fees were £0.5 million over budget due to an increase in third party projects beyond the original budget set.

Overall the budget setting and in year budget monitoring is as expected and is tracked closely during the year.

## Financial performance reporting

Papers are taken to the Board quarterly, usually 6 weeks after quarter end, covering the following key areas:

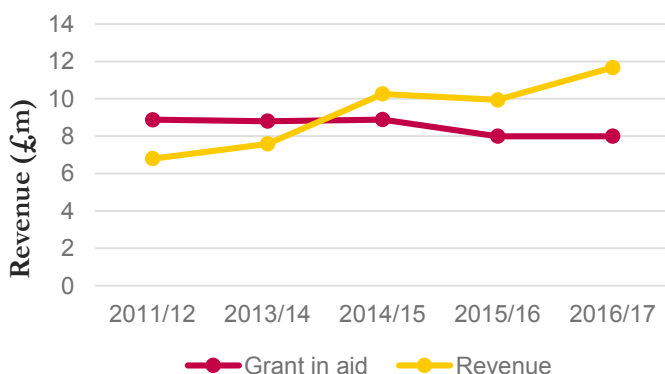
- Overall management accounts
- Working capital
- Aged debt
- Joint Ventures
- Capital

Supporting appendices clearly set out the profit and loss account and balance sheet for both the month and the year to date, with variances against budget noted. Income is split out by income stream (more detailed than year end accounts split) and expenditure is split out by nature, with the salary costs split: core wages; overtime; casual and seasonal work. Reforecast figures are provided in quarters two and four, and are provided for reference alongside the initial budget set alongside an explanation for the reforecast

## Review of performance

Financial performance in year was good, with a surplus before tax of £1.0 million. The Government grant remained consistent with prior year at £8.0 million, while self-generated revenues further increased in the period to 59% of total revenue (£11.7 million, compared to £9.9 million in 2015/16). 2016/17 included £3.9 million of revenue related repairs to public towpaths, maintaining and improving these assets for wider public use. Scottish Canals recognise the key challenges around long-term financial sustainability and focus on generating income to further invest into the Canal corridor. Trends in income are shown below.

Trends in revenue composition



# Financial Management

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## Capacity and Capability of financial team

The finance team has strong leadership from an experienced and qualified senior finance team. We are comfortable that the Finance team has appropriate status and strategic input within the organisation.

As with any small team, there is a risk around segregation of duties, and Scottish Canals are mindful of this and ensure that appropriate authorisation processes are in place around bank accounts, payment authorisation and setting up of new suppliers / changes to supplier details.

The month end process is streamlined. The year end financial accounts closure process is also efficient, with a good first draft of accounts and analytical review document provided ahead of our audit commencing on 1 May - one month after year end. Detailed audit files were provided on day one of the audit.

# Financial Sustainability

We identified a specific audit risk in our plan related to Scottish Canals longer term financial sustainability. We have outlined below our response to this risk and overall conclusion.

Risk of financial sustainability in 2017/18 and beyond (Financial sustainability wider scope risk)	Conclusion
<p>On creation of Scottish Canals, a cash dowry of circa £10 million was received which was invested by Scottish Canals. This money has now been notionally committed in full across a number of projects, including investment opportunities which will create additional income to fund Scottish Canals activities. However, revenue grant funding from the Scottish Government is declining in real terms and therefore Scottish Canals need to continue to look to generate income in order to fund core Scottish Canals activities for example maintenance of the canals network in line with the 30 year asset management plan. There is a risk that they are unable to self generate sufficient income to deliver the Scottish Canals corporate plan.</p> <p><b>Work undertaken:</b></p> <p>Considered Scottish Canals new Corporate plan (2017-2020) and underlying financial plans.</p> <p>Reviewed key investments made by Scottish Canals and plans to utilise the additional income generated, and the period of time the income will be generated over.</p> <p>Reviewed the 30 year asset management capital plan and underlying assumptions.</p> <p>Considered ongoing discussion and dialogue with Scottish Government on longer term financial planning and the future financial sustainability of the organisation.</p> <p>Reviewed the budget setting and financial forecasting process including how income is forecasted and the sensitivities in the budget setting process.</p>	<p>Scottish Canals have circa 140 commercial projects which the organisation would like to fund built into an investment model. These are focused on the above water element of Scottish Canals activities, with the underwater element of work focused upon maintenance of the existing assets.</p> <p>This model was built by a consultant and ranks projects based on contribution to four key outcomes: Customer approval; Regeneration contribution; Stakeholder approval; and Direct impact on Canals</p> <p>All legacy dowry funds are notionally allocated, and therefore Scottish Canals are facing difficult decisions around future capital investments. Significant capital funding will be required to deliver on the pipeline of projects in place</p> <p>Scottish Canals generates income through charges and certain investment projects. However, in order to maintain the canal network to the required standards it does continue to need at least the current level of funding from the Scottish Government.</p> <p>The substantial capital repair costs over the next 30 years to maintain the network, including protect land from flooding, and continue to meet health and safety requirements are significant. The anticipated costs are set out in the 30 year capital plan and management should continue to discuss this with the Scottish Government Sponsor Department to ensure all risks associated risks are known and projects appropriately prioritised..</p> <p>Scottish canals should continue to be transparent in its future financial forecasts recognising the desire to grow income whilst constrained by state-aid requirements alongside the significant capital maintenance required to maintain the assets. Even if Scottish Canals continued to generate additional income at the rate it has over the prior years this would not be sufficient to fund the necessary capital expenditure. See <b>Action Plan 1</b>.</p>

## Corporate plan 2017-20

A new Corporate plan was approved in year for the period 2017-2020. The plan sets out an ambitious vision focused around delivering financial sustainability, with three key strategic themes:

<b>Increasing financial sustainability</b>	<ul style="list-style-type: none"> <li>• Collaborating with business</li> <li>• Growing sustainable income</li> <li>• Optimising asset utilisation</li> </ul>
<b>Growing public value</b>	<ul style="list-style-type: none"> <li>• Safeguarding our Canals</li> <li>• Increasing and diversifying use</li> <li>• Driving inclusive regeneration</li> </ul>
<b>Empowering and motivating people</b>	<ul style="list-style-type: none"> <li>• Enabling our workforce</li> <li>• Working through partnership</li> <li>• Promoting diversity and inclusion</li> </ul>

These priorities build on the 2014-2017 corporate plan, and on the Scottish Government’s aspirations for the Canal, set out within ‘Making the most of Scotland’s Canals’.

## Financial plan 2017/18

This 2017/18 budget was presented to the February Board and is aligned with the new corporate plan. The budget is developed bottom up (zero based) annually.

### Income

Overall income is estimated to fall by £2.5 million, given the high level of non-recurring towpath income and expenditure during 2016/17.

	2017/18 budget £000s	2016/17 actual £000s	Movement £000
Grant in aid income	8,100	8,000	100
JV income	265	534	(269)
Other	7,932	7,791	141
Third party	1,398	3,881	(2,483)
<b>Total</b>	<b>17,695</b>	<b>20,206</b>	<b>(2,511)</b>

The key movements around income from joint ventures is driven by the cyclical nature of this business and the timing of cash flows into the joint ventures. 2017/18 is expected to be an investment year with more income from this investment expected in 2018/19 when further plots are sold.

Third party income was significantly higher than average due to the significant towpath work in 2016/17, and is expected to revert to normal levels. Significant income was received from various Local Authorities and Regional Transport Partnerships. As noted during 2016/17, this is dependent on work commissioned so there is the potential for significant variation in the year.

## Expenditure

Forecast expenditure for 2017/18 is slightly lower at £17.5 million:

	2017/18 £000s	2016/17 £000s	Movement £000s
Staff costs	8,737	8,336	401
Major works including towpaths	1,350	3,704	(2,354)
Professional fees	482	1,028	(546)
Depreciation	1,260	1,134	126
Other costs	5,716	5,641	75
<b>Total</b>	<b>17,545</b>	<b>19,843</b>	<b>(2,298)</b>

The key movements are a reduction in major works driven by towpath income reduction, a reduction in professional fees and an uplift in staff costs due to increased pension costs through auto pensions enrolment and a forecast 1% salary increase.

The budget includes forecasted savings related to travel, plant hire and security costs. Performance against budget, including planned savings will be reported during the year.

# Governance and transparency



# Governance and Transparency

Risk around flexible governance (Governance and transparency wider scope risk)	Conclusion
<p><b>Flexible governance to support the ambitions of Scottish Canals</b></p> <p>Scottish Canals are an ambitious organisation with plans to develop new opportunities using wider public sector assets to generate new sources of income and continue to work in partnership with organisation across the public and the private sectors. Recognising the strategy, Scottish Canals governance arrangements need to be suitably flexible to quickly adapt to new opportunities and governance should support the entrepreneurial nature of Scottish Canals for example by adopting a risk management approach which allows for measured risk taking to achieve opportunities whilst continuing to meet governance recommended practices</p> <p><b>Work undertaken</b></p> <p>Reviewed Scottish Canals governance arrangements including work plans of key committees and engagement in partnership working and key Scottish Canals investment opportunities</p> <p>Reviewed the risk management framework to ensure opportunity risks are captured and measured / assessed consistently.</p> <p>Specifically considered the Dundas Hill project as an opportunity for Scottish Canals to demonstrate the degree to which the governance arrangements in place have been able to be flexible when external events have provided an opportunity to the organisation.</p>	<p>The acquisition at Dundas Hill demonstrated Scottish Canals innovation and ambitious plans. The Board were kept well informed and papers clearly set out the opportunities and the risks to Scottish Canals. This represents an area of innovation for the public sector, contributing to the wider social and economic regeneration of the North Glasgow area, and also demonstrates how city deal funding can be used out-with the Local Government setting in partnership and collaboration.</p> <p>Scottish Canals should continue to progress this project, through the project groups set up and regularly update the Board. In particular, aligned to the new corporate plan, Canals should continue to be open to future projects of this nature and share the innovations more widely with Government and other public and potentially private sector partners. <b>Action Plan 2.</b></p>

## Dundas Hill: balancing opportunity and risk

Scottish Canals identified former Diageo site in North Glasgow as a potential development opportunity in the Canal corridor. The original intention was that the land would be purchased, decontaminated and redeveloped into residential housing through the Bigg Joint Venture. Discussions had taken place with various key stakeholders including Glasgow City Council and Scottish Government. Bigg, the joint venture chose not to proceed with the transaction in February 2017.

Notable time, cost and effort had already been invested into the project, and there was the potential for significant reputational impact should this development not proceed.

Scottish Canals are not allowed to take on debt and therefore a substantial investment of the residual cash dowry would be required to finance this transaction.

Scottish Canals chose to proceed on their own with the project, and purchased the site in March 2017. City Deal funding has been transferred from the joint venture to Scottish Canals, and the project will proceed with all risks and rewards sitting with Scottish Canals.

Key financials underpinning the project had already been approved in draft by the Board, and generated a good return on investment based on the professional advice received around valuation ranges. While the project is not without risk, a decision has been taken to pursue this investment opportunity. A project manager has been appointed and a separate project board will monitor the progress and development of the project as it progresses.

The Dundas Hill development demonstrates that sufficient flexibility is in place to react to new opportunities while maintaining good governance and clear communication with the Board and Scottish Government.

We will continue to monitor the progress of the project and the effectiveness of the governance in place during 2017/18.



# Governance and Transparency

## Committee structure

Scottish Canals has a simple committee structure reflecting the organisational size, with Audit and Risk and Remuneration committees supplementing the work of the Board. The ‘Corporate and Operational Governance Arrangements’ document sets out key governance matters and was last updated in April 2017. The Board delegates matters as follows:

- Operational matters – to the executive team (with an oversight role performed)
- Audit & risk – scrutiny and advice (but primary responsibility for risk management sits with the Board)
- Remuneration – performance and pay awards to directors, succession planning, other significant remuneration matters

There are terms of reference in place which highlight the remits for the two Committees and the Board and set out clear arrangements for the executive meetings.

The committee structure is broadly in line with our expectations, and our experience of similar bodies. The relatively simple structure allows for clear lines of communication and clarity of roles and responsibilities, and we are comfortable that it is appropriate.

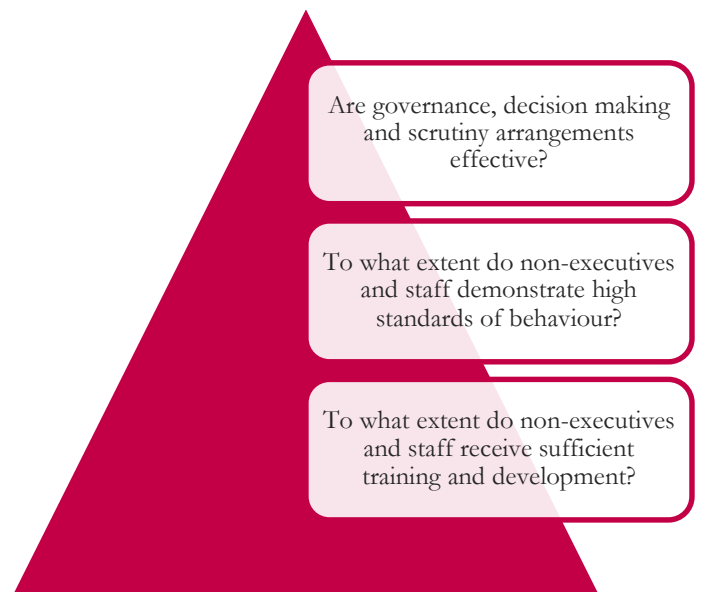
## Fraud, regularity and whistleblowing arrangements

A report is taken annually to the June Audit and Risk Committee which covers all fraud and theft issues in the year. It is a brief report which highlights no known fraud issues. Training has been provided to staff on phishing and financial scams. An attempted supplier details fraud was identified and averted by the finance team during the year. The only theft issue noted was of a Company mobile phone. The theft was quickly identified and action taken to remotely wipe all data from the device.

There is an anti-bribery policy in place, and reviews of the whistleblowing policy and code of conduct have taken place in the year.

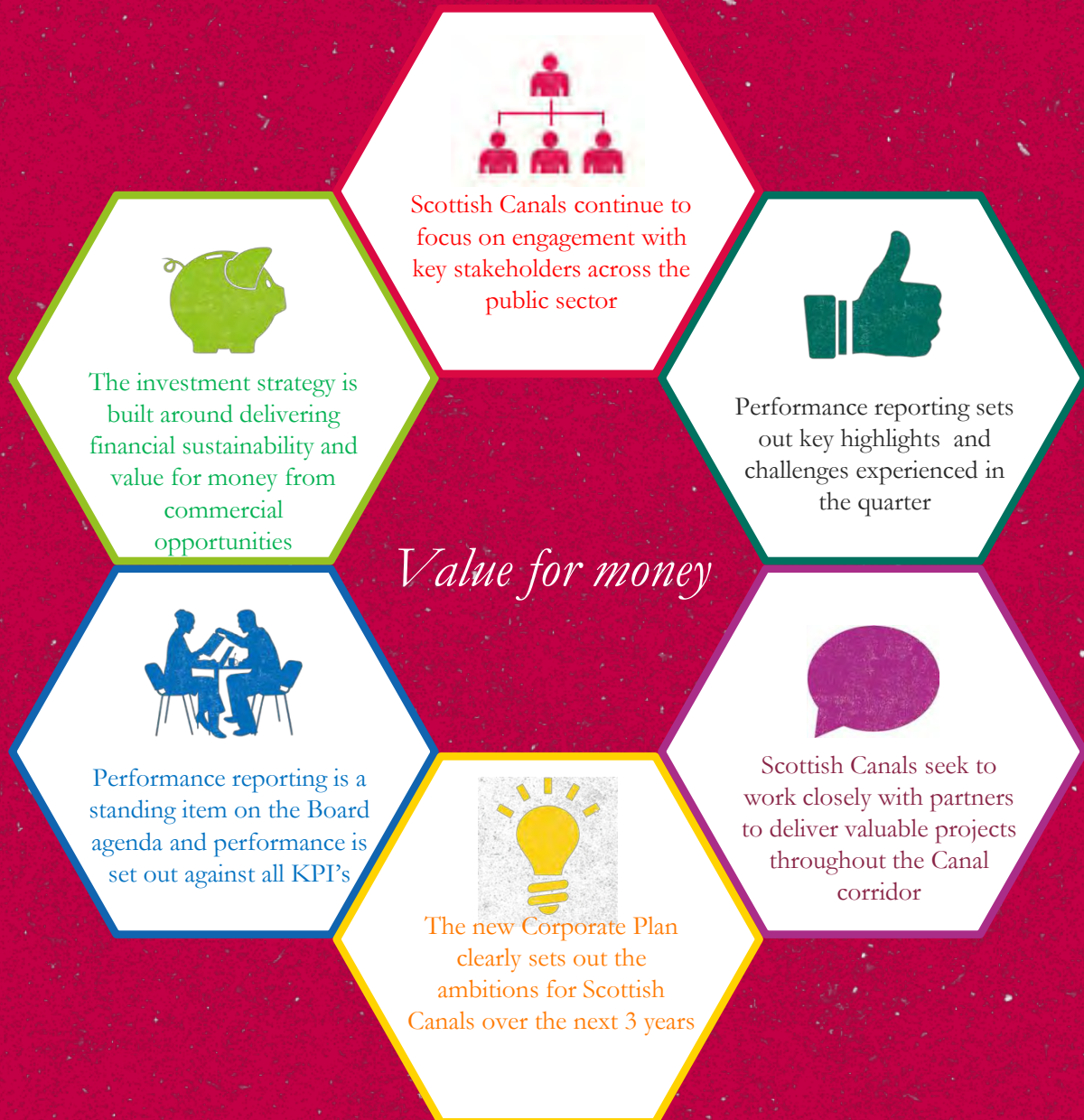
## Role of Boards

We submitted a return to Audit Scotland in June 2017 in relation to the Role of Boards as part of their wider follow up work in this area. It considered three key areas:



The return was discussed and agreed with the Director of Finance, Chief Executive and the Chair of the Board. The return confirms the arrangements Scottish Canals has for governance and is supported by terms of reference for the Board and Committees.

# Value for money



# Value for Money

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## Investment strategy and value for money

The investment strategy is built around delivering value for money and generating income to support future financial plans.

The investment prospectus identifies those projects which contribute strongly against Scottish Canals outcomes and supports future investment through income generation. There is a desire to take on and improve redundant public sector assets to generate commercial returns and contribute to regeneration in the Canal corridor. Scottish Canals are a public sector organisation with a strong focus on commerciality.

Recognising the historic underinvestment in the Canal network, Scottish Canals have sought to proactively identify and exploit opportunities which both contribute to financial sustainability of the organisation as well as support regeneration in the Canal corridor. This represents an excellent example of the benefits of pursuing a more commercial approach to improve key outcomes and proactively contribute to the organisations future financial sustainability.

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## Stakeholder engagement

Stakeholder engagement is a focus for Scottish Canals, with the nature and geography of Scottish Canals operations providing significant geographical overlap with Local Authorities and other public sector bodies. Bespoke arrangements are in place in each area, with strong links and engagement with Falkirk Council and Glasgow City Council noted. Scottish Canals have a strong focus on building and maintaining relationships with key stakeholders, and this is likely to prove valuable as the organisation seeks to deliver its ambitious strategic aims, investing in the Canal corridor and delivering regeneration.

Scottish Canals has a good relationship with Scottish Government, and have built their strategic plan and performance reporting around key Scottish Government ambitions. Scottish Canals have a key focus on delivering financial sustainability and regeneration and as noted within our financial sustainability work, the ability to deliver in these areas will be dependent on the level of funding available to invest.

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## Scottish Canals Performance Reporting

Performance is reported to the Board quarterly. Given time and seasonality, this means that the ability to report performance for subsequent quarters in certain areas is limited.

The format of the reporting is split into key performance highlights, challenges, matters arising since quarter end and KPI reporting. Key matters highlighted include:

- Highlights – Asset condition updates, capital investment progress, traffic volumes
- Challenges – Level of unplanned closures, other asset problems, legal matters

The main body of KPI's relate to wider Scottish Government national targets, of which Scottish Canals can contribute to the wider delivery of alongside other Scottish Government bodies but are not solely responsible for delivering. We note there have been discussions at the Board around developing specific Scottish Canals KPI's as related to the Corporate plan and we will consider the progress around this as part of our planned 2017/18 work.

# Appendices

Contents	Page
Audit adjustments	21
Follow up on prior year recommendations	22
Action plan for 2016/17	23
Reminder of responsibilities	25



# Audit adjustments

Set out below is a summary of uncorrected and corrected misstatements.

## Uncorrected misstatements

	Statement of Comprehensive Income	Statement of Financial Position	Statement of Changes in Equity
	£000	£000	£000
<b>Credit balances in debtors ledger</b>			
Dr Debtors	-	57	-
Cr Creditors	-	(57)	-
<b>Debit balances in creditors ledger</b>			
Dr Debtors	-	13	-
Cr Creditors	-	(13)	-
<b>Deferred tax gross up</b>			
Dr Deferred tax asset	-	118	-
Cr Deferred tax liability	-	(118)	-
<b>Total</b>	-	-	-

These adjustments were not processed on the grounds of materiality.

## Corrected misstatements


	Statement of Comprehensive Income	Statement of Financial Position	Statement of Changes in Equity
	£000	£000	£000
<b>Release of donated assets reserve</b>			
Dr Donated Assets reserve	-	-	212
Cr Retained earnings	-	-	(212)




## Disclosure misstatements

In accordance with auditing standards we are required to highlight significant disclosure misstatements to allow Audit & Risk Committees to evaluate the impact of these matters on the financial statements. There were no material/significant disclosure misstatements identified we wish to bring to your attention. Minor changes included amendment of financial instruments disclosure, and disclosing the nature and purpose of each reserve.

# Follow up on prior year recommendations

We have undertaken a follow up of outstanding recommendations from prior years raised by the previous auditors, Audit Scotland. The results of our work are outlined below:

Prior year finding	Action in 2016/17	Status
<p><b>Long term financial planning</b></p> <p>Medium financial and long term planning is being developed. Scottish Canals recognise there are medium/long term issues with asset sustainability and are beginning to emunerate this.</p> <p>A stable short term operational budget is maintained but there is a risk that long term operation is dependent on reactive and substantial investment when failures arise in operational assets.</p> <p>We recommend that the long term financial strategy is agreed and published. This should set out scenario plans (best, worst, most likely); the contribution of ay measures to close funding gaps; the residual funding gap and any residual risks.</p>	<p><b>Status: Partially implemented</b></p> <p>Scottish Canals have a Corporate Plan to 2020, and formal financial plans for 2017/18. While there are not formal financial plans over a longer time period, there is evidence of longer-term financial planning through the investment strategy which is focused around investing to generate income to continue to invest in the Canal corridor.</p> <p><b>Further Action:</b> Scottish Canals’ long term financial plans will continue to be shaped by the aims and objectives of its shareholder, Scottish Government. These plans will be significantly impacted by the outcome of government comprehensive spending reviews, subsequent budget allocations and decisions taken by both Scottish Ministers and the Board. One year, or short, budget cycles are highly likely to continue and will give rise to significant challenges in formulating long term financial plans. The Board is responsible for and is currently formulating a long term financial strategy, which is due for completion mid 2017/18.</p>	

 Fully implemented
  Partially implemented
  Not implemented

# Action plan for 2016/17

During the course of our 2016/17 audit work we have identified the following actions for management:

	Area	Issue & Risk	Priority	Recommendation
1	<b>Financial Sustainability</b>	<p>Scottish Canals, although it does generate income through charges and certain investment projects, in order to maintain the canal network to the required standards it does continue to need the current level of funding from the Scottish Government via Grant-in-aid.</p> <p>The anticipated costs are set out in the 30 year capital plan and management should continue to discuss this with the Scottish Government Sponsor Department to ensure all risks are transparent and decisions around funding are continued to be taken aligned to the risks and strategic priority of Canals.</p> <p>Recognising the income and investment opportunities to Canals, by working across the public sector, Scottish Canals should consider how this income can be further utilised, in line with state-aid requirements, to ensure the delivery of the social and economic regeneration aims of Canals.</p>	Medium	<p><b>Management response:</b></p> <p>Scottish Canals is in a continual cycle of review of its available funding and investment opportunities to maximise social and economic returns and wider public benefits for the communities in and around the canal network – this is part of the nature and culture of the organisation</p> <p><b>Timescale:</b> Ongoing / review by March 2018</p> <p><b>Action Owner:</b> Chief Executive</p>
2	<b>Innovation</b>	<p>Scottish Canals should continue to progress the Dundas Hill project, through the project groups set up and regularly update the Board. In particular, aligned to the new corporate plan, Canals should continue to be open to future projects of this nature and share the innovations more widely with Government and other public sector partners.</p>	Medium	<p><b>Management Response:</b></p> <p>Scottish Canals will work to bring the Dundas Hill project to fruition over the next 24 months. This project will be subject to appropriate levels of scrutiny and governance and will be reported to the Board on a regular basis given its profile and reach.</p> <p>Scottish Canals will always be open to future projects of this nature and remains willing to share its innovations with government and other public sector partners.</p> <p><b>Timescale:</b> June 2019 (&amp; ongoing)</p> <p><b>Action Owner:</b> Chief Executive</p>

# Reminder of responsibilities

The Code of Audit Practice sets out responsibilities of the audited body (pages 10, 11 and 12) across: Corporate governance; financial statements and related reports; standards of conduct for prevention and detection of fraud and error; financial position; and value for money (as described in the Scottish Public Finance Manual). As appointed auditors our responsibilities are set out on page 13 and are summarised below.



*An audit of the financial statements is not designed to identify all matters that may be relevant to those charged with governance. Weaknesses or risks are only those that have come to our attention during our normal audit work in accordance with ISA's and the Code and may not be all that exist*

*Communication of the matters arising from our audit work does not absolve management from its responsibility to address the issues raised and to maintain an adequate system of control.*







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