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Scottish Environment Protection Agency (SEPA)

External Audit Annual Report to the Board and the Auditor General for Scotland

2016/17 Financial Year

25 July 2017

Contents

Summary of our audit plan:

Materiality has been updated based on unaudited financial statements to £0.837million (1% of gross expenditure 2016/17).

Performance materiality is £0.544 million and we have reported to management everything identified over £8,387 (1% of materiality)

Audit risks identified were: management override of controls; risk of fraud in revenue recognition; asset valuations; and risk of fraud in operating expenditure.

Our wider scope work focused on the risk of future financial sustainability recognising the nature of SEPA's activities and income streams

We can confirm we are independent of the Scottish Environment Protection Agency (SEPA) 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 SEPA in 2016/17. Our audit fees were those agreed and set out in our audit plan (£50,570).

Key Messages

We have issued an unqualified opinion on:

- 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

This report has been discussed and agreed with management, and presented to the Audit Committee on 20 June 2017 alongside the final audited annual report and accounts. We would like to thank management and staff for their co-operation and assistance throughout our audit work.

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Our work included:

- An audit of the 2016/17 Annual report and accounts
- A review of the Performance Report and Accountability Report (including governance statement and remuneration report)
- Completion of the 'Role of Board's' return submitted to Audit Scotland to inform a future performance publication
- Completion of an EU Funding data return recognising SEPA does receive some funding via EU grants
- Completion of the National Fraud Initiative (NFI) return and review of data matching progress

We received a reasonable draft annual report and accounts which had been reviewed by Management on the first day of our audit and our audit was broadly completed to the timetable agreed with management.

Recognising this was year one of our appointment we have started to build good working relationships with the finance team and will have a lessons learned meeting post the signing of the accounts to further refine how we can work together in 2017/18 and onwards.

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 SEPA's arrangements as they relate to: financial management; financial sustainability; governance and transparency and value for money.

Overall SEPA continue to enhance its financial planning arrangements, looking at medium term financial forecasting and the key scenarios and assumptions. During the year a number of key strategies have been updated, clearly setting out the purpose and role of SEPA and the ambitions for the future. These are easily accessible, clearly set out and include high level performance metrics. There are a number of key strategy documents but a consistent thread/message runs through them all.

For and behalf of Grant Thornton UK LLP

25 July 2017.

The Financial Statements Audit

Our audit plan was presented to the Audit Committee on 13 December 2016. We have not altered our planned audit approach. However, we have updated our final materiality figures based on the draft 2016/17 accounts. Our planned materiality was £0.848 million., which we subsequently updated to £0.837 million taking 1% of unaudited 2016/17 gross expenditure.

Our audit work commenced on-site on 15 May 2017 following early substantive income and expenditure testing completed in April 2017.

We received the draft annual report and accounts within the audit timetable agreed alongside working papers to support the accounts. SEPA has a number of specialised assets and therefore the working papers in support of property; plant and equipment were complex to understand. In addition, for a number of other working papers we needed managements support to understand the numbers that flowed into the financial statements.

Looking ahead to the 2017/18 audit process we will work with management to provide greater clarity over the audit supporting documentation we require, and how best that information can be presented. **Action plan 1**.

In line with triviality we have reported all potential audit adjustments identified above £8,337 to management; along with identified disclosure enhancements.

A summary of corrected and uncorrected adjustments are set out in Appendix 1 including a note of the key disclosure changes to the draft annual report and accounts.

Internal Control Environment

During the year we have sought to understand SEPA's overall control environment as related to the annual report and accounts. 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 including the interface between Agresso.
- Performed walkthrough procedures on key controls around identified risk areas in particular the respective income streams.

Internal Control Environment

No material weaknesses in the accounting and internal control systems were identified during the audit which could have an adverse impact on SEPA's 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 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 plan we have not placed formal reliance on the work of internal audit during 2016/17. We have reviewed the internal audit plan, and the internal reports considered relevant to our audit: in particular budget management; charging schemes and strategic planning.

Internal Audit's annual opinion for 2016/17 was:

" In our opinion SEPA has a framework of controls in place that provides reasonable assurance regarding the organisations governance framework, effective and efficient achievement of objectives and the management of key risks, and proper arrangements to promote value for money and deliver best value"

The findings do not disagree with our knowledge and understanding of SEPA as an organisation and its risk profile. No risks were identified by internal audit that caused us to re-consider or alter our audit plan.

The Internal Audit annual report confirms that the service is provided in accordance with Public Sector Internal Audit Standards and that internal audit has sufficient resources to deliver a compliant internal audit service and an annual opinion covering SEPA's arrangements over governance, control and risk.

Our identified audit risks

Audit plan identified risk and work completed	Our conclusion
Management override of controls Under ISA (UK&I) 240 there is presumed risk that the risk of management over-ride of controls is present in all entities (fraud risk). **Work undertaken:** Completed a walkthrough of the controls and procedures in place around journal entries Reviewed the key accounting estimates, judgements and decisions made by management in particular Property Plant and Equipment (PPE) valuation; pensions; and bad debt provisions. Tested journal entries with a focus on large and/or unusual values; posting sources; unexpected/unusual timing of journals, as identified using our IDEA data analysis software Reviewed unusual and/or significant transactions.	**Key accounting estimates:** We did not identify any significant areas of bias in key judgements by management and judgements were consistent with prior years for example method and valuation process and calculation of bad debt provisions. Key accounting estimates we considered were: valuations of PPE in particular the specialised assets; provisions including bad debt provisions and pensions. We used our pensions team (auditor expert) to review the pension assumptions and found these to be within our recommended benchmarks. The bad debt provision was calculated on the same basis as prior year which we found to be appropriate and reasonable. Included within accruals is a holiday pay accrual of £1.4m million as at 31 March 2017. The accrual is of this value as the SEPA holiday year runs per calendar year not financial year. We are comfortable over how this accrual has been calculated and have traced the calculations to underlying records. There is also an accrual of £0.444 million which relates to staff claims in respect of salary bandings as part of the job evaluation process. This accrual is supported by a list of employees provided by HR and the date of when a claim would need to be backdated to. Year on year this accrual has only moved slightly and we recommend Management continue to review this during 2017/18 and complete the job evaluation process as soon as practical. **Action plan 2** **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. We confirmed completeness of journals, identifying all journals during the year. We targeted large and/or unusual journals and noted no issues from our testing. Through our substantive audit testing we did not identify any significant transactions out with the normal course of business for SEPA.
The revenue cycle includes fraudulent transactions Under ISA 240 (UK&I) there is a presumed risk that revenue may be misstated. We rebutted this in relation to Scottish Government Grant-in-Aid funding given the nature of that income source. Therefore we focused our testing on other income streams (Charging schemes) which for 2016/17 was £38.994 million **Work undertaken:** Completed a walkthrough of the controls and procedures in place around charging scheme invoicing and recording receipt of income Performed cut off testing to gain comfort around the completeness and accuracy of recognised income Considered the recoverability of any outstanding balances at year end.	We performed our year-end cut-off procedures & assessed recoverability of outstanding amounts at year-end. SEPA receives income from 12 different income/charging schemes. We focused our testing on the material balances, in particular income from under the Environmental Regulation Scotland Act (£35.312 million). No exceptions were identified from our testing. We rebutted the risk of fraud related to the income stream from the Scottish Government (Grant-in-aid) given the nature of the funding received. For Grant-in-aid we agreed this to the cash draw downs in year and the letter of grant received from the Scottish Government as part of the financial settlement.

Audit plan identified risk and work completed	Our conclusion
Asset Valuations SEPA has a diverse range of assets including: property; specialised gauging stations; vessels and other environmental assets. There is a risk that these assets may not be valued correctly and/or subsequent impairments are not correctly or accurately recorded.. **Work undertaken:** Obtained the valuers report as at 31 March 2017 for land and buildings and confirmed the valuers qualifications; expertise and assumptions used including confirming the completeness of data passed to the Valuer. We confirmed movements per the updated valuations were appropriately accounted for in the annual accounts. Reviewed the basis of valuation; appropriateness of valuation method; and accounting policies Confirmed existence and ownership for a sample of assets through review of title deeds and physical verification. Substantively tested additions; disposals and assets under construction.	During the year land and buildings were subject to a full valuation by GVA Valuers. This resulted in an decrease in value of £1.2 million which was correctly treated within the annual report and accounts. Specialised assets e.g. gauging stations are due to a full valuation in 2017/18 in accordance with the FReM requirements for a full valuation every 5 years. Following discussion with management it was determined to enhance disclosure these assets would be treated as a separate asset class and disclosed separately rather than within land, buildings and property. This change has been made in the final accounts. Of the £1.1million asset value for vessels reflected in the accounts, a significant proportion of this value (£0.9 million) relates to one vessel. This is held at historic cost although a value was obtained in year to confirm this was still appropriate, as reflected in SEPA's accounting policies. The full asset class will be subject to a revaluation in 2017/18. We confirmed that asset lives were in accordance with the FReM and were being depreciated on a straight-line basis over the life of the assets.
Completeness of operating expenditure 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). **Work undertaken:** Completed walkthrough of the controls and procedures in place around purchase ordering, procurement and general payment and recording of expenditure. Reconciled creditors ledger to the general ledger and financial statements Performed cut-off testing on pre-year end and post year end transactions to gain comfort around the completeness and accuracy of recognised expenditure Gained comfort around the regularity of expenditure and the application of public funds in accordance with the FReM and various legal acts as set out in SEPA's direction from Ministers.	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 and guidance issued by the Scottish Ministers and the expenditure is valid and correctly classified. We confirm that SEPA has operated within the limits set out by the Scottish Government. The cash grant-in-aid drawn down by SEPA during 2016/17 was £33.353 million. Through our pre and post year end cut of testing we did not identify any expenditure that was incorrectly accounted for. Larger areas of expenditure were substantively tested in particular the accruals balances. No exceptions were identified from our testing.

The narrative elements of your annual report and accounts

In accordance with our responsibilities we have reviewed your narrative aspects of the Annual report and accounts. We have considered the consistency of this narrative with our understanding of SEPA and the financial information set out in the accounts and have set out our observations below. During the year Audit Scotland produced a guidance note on the performance and accountability reports in the NHS. Although only relevant to the NHS, the NHS also like SEPA comply with the FReM and SPFM therefore there is learning in this publication which can be used by SEPA in 2017/18 to enhance the narrative elements of the annual report and accounts. **Action plan 3**

Performance report

- The report includes a detailed financial analysis of SEPA's in-year performance. Following discussion with management, the financial numbers shown were changed to be shown in millions rather than pounds to improve the readability of the section. However, this section is very detailed and Management should consider how this can be further streamlined in 2017/18 and made easier to read. **See Action Plan 4**
- The front end of the annual report is very detailed and in places difficult to follow and/or repetitive. There is scope to further streamline this in 2017/18 as a lot of the information included is extracts from publically available information on the SEPA website.
- There are good use of graphics to show income and expenditure which are easy to read and see trends.

Annual Governance Statement

- All key required elements within the FReM are 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. This approach is in line with best practice and provides a clear paper trail behind the annual governance process.
- The risk and control framework is effectively summarised. This could be further enhanced by setting our the key strategic risks facing SEPA as captured in the Agency wide risk register and the key actions to be taken by Management to mitigate the risks.

Remuneration report

- The remuneration report has been completed in line with guidelines and the FReM
- We have audited the financial information included in the remuneration report. A number of the employees/Non-Executives shown in this note had their remuneration incorrectly banded which has been corrected. We have no further matters we wish to bring to your attention.
- We noted that the median pay disclosed was not calculated per the FReM guidance. This has now been updated in the final annual report and accounts including an update to the prior year comparative.

Judgements and estimates

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

Accounting Policies

- Accounting policies are in accordance with the FReM and we consider these to be appropriate to SEPA and have been applied consistently in practice.

Accounting estimates and judgements

- We have identified and gained comfort over the following key estimates and judgements:
- Property valuation including impairment risk
- Bad debt provision which is £0.135 million (0.3% of total income)
- Plant, Property and Equipment (PPE) depreciation policies are in line with prior year and the FReM
- Pension assumptions are within our expected range and continue to represent a significant liability to SEPA

Going Concern

- SEPA has an agreed budget for 2017/18 and continues to discuss future funding with the Sponsor Department. To achieve a balanced budget SEPA identified savings of 5% of its cash grant-in-aid for the year.
- Given the nature of the services delivered by SEPA which are set out in various legislation we have no reason to doubt that SEPA won't continue to operate beyond 12 months of the date of our opinion. SEPA does receive income via charging schemes which is taken into account when their budget for grant-in-aid is set. SEPA has a new corporate plan and is working on a longer term financial strategy.

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

- Through our substantive audit testing we did not identify any concerns over timing of transaction 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 final annual report and accounts.

Financial management and financial sustainability

Financial management and sustainability

SEPA managed to achieve a small underspend in year compared with financial targets

Slightly lower than forecasted income was offset by a reduction in staff costs and other costs in year

Financial monitoring monthly returns are detailed, covering income; expenditure and balance sheet movements

The finance team has sufficient experience and qualifications

The 2017/18 budget was approved by the Agency Board in February 2017 and reflects a reduction in Grant-in-aid of 5%

SEPA has started a longer term financial scenario planning process which sets out a number of assumptions and risks

Throughout the year financial performance compared to budget and is reported to the Agency Management team, produced from the monthly Portfolio Financial Monitoring returns. These reports are detailed, and outline associated risks and consequences. This information is then reported every two months to the Agency Board. The report makes good use of graphs and dashboards to display what it at times complex financial information. Narrative is split out across income (all streams); expenditure and key balance sheet activity as well as cash flow analysis. Lastly the report shows spend per grant funded projects on a year to date basis, including EU projects.

Key movements in year comparing actual income and expenditure to budget include:

Expenditure:

Staff costs were £52.960 million, which generated a small underspend compared to budget of £0.647 million due to the active management of vacancies in year, and a lower than forecasted take up on the Voluntary Early Release Scheme (VERS)

Income:

Charging scheme income was £38.994 million compared with a budget of £39.934 million (a shortfall of £0.936 million). The target of 98% full cost recovery was achieved for charging schemes. The main reason for the lower than forecast income is due to fewer applications (728 less applications compared with prior year)

Recognising a substantial proportion of SEPA's costs are staff related, on a monthly basis there is a detailed analysis of departmental staff spend; vacancies; VERS take up; and analysis of pay across all staff related costs..

Actual financial performance compared to 2016/17 targets is set out in note 23 in the annual report and accounts.

Overall, Departmental Expenditure Level limits were:

- £1.1million for Capital, with SEPA spending £1.243 million in year
- Cash of £33.853 million, with actual cash of £33.260 million, an underspend of £0.593 million.

2017/18 Budget

The draft budget for 2017/18 was presented to the Agency Board on 21 February 2017 for approval. This draft budget demonstrated that SEPA could for 2017/18 manage its operating expenditure to deliver the strategic priorities, within the level of income available.

The limits SEPA are required to operate to in 2017/18 are:

Revenue income of £82.6 million

Capital Funding of £1.9 million

A year end cash limit of £0.5 million

No formal efficiency target has been set by the Scottish Government but there is an expectation that SEPA will continue to identify and deliver efficiencies year on year. Therefore, SEPA has identified annual savings for 2017/18 of £1.6 million which were built into the budget.

2017/18 Income

Grant-in-aid income received to support operating costs reduced by £1.62 million, which was offset by an increase in Grant-in-aid received for capital investment of £0.87million for 2017/18, a net overall reduction of £0.760 million. Management has assumed they will continue to receive additional income in 2017/18 to support the Scottish Flood Forecasting Service and Flood Warning implementations.

RPI of 2% was applied to the Environment Regulation Scotland Scheme, with all other charges for the various income streams remaining at the same level. Management have assumed a lower volume of applications in 2017/18 reflective of the reduction experienced in 2016/17. Management need to continue to focus on achieving as close to full cost recovery as possible through the income charging schemes. The intention is for all income received through charging, 98% of costs will be recovered. This is carefully monitored and tracked.

2017/18 Expenditure

Expenditure budgets for 2016/17 have been reviewed and if no change anticipated carried forward as the starting point.. In certain areas resources have been flexed, increasing in areas that are priority for the year, and reducing where an activity is expected to be less.

The expenditure budgets assume staff savings of £1.150 million through continued management of vacancies; deleting vacant posts; and from the current VERS scheme. An inflationary pay award has been built into the pay assumptions.

During 2016/17 SEPA updated its corporate plan which sets out clear strategic aims for SEPA. Looking forward; management may wish to consider priority based budgeting to ensure savings are aligned with priorities rather than the roll forward of historic budgets. **Action plan 6.**

The budget paper sets out a number of assumptions and risks, including:

- A possible reduction in activity and income due to economic conditions
- Grant-in-aid may further reduce
- Staff turnover and management may impact on service delivery of critical projects
- Capital replacement may need to be accelerated or greater need than forecast which may not be affordable.

A budget contingency of £0.4million has been factored in to give some flexibility, but this is limited.

Longer term financial forecasting

A paper on SEPA's longer term financial forecasting arrangements was discussed at the March Strategy Board meeting. This paper outlined proposed financial planning arrangements for 2017-2022. This is built on a number of financial scenarios.

2017/18 saw a reduction of Grant-in-Aid of 5% and this trend is expected to continue.

The paper to the Board sets out examples of how SEPA has already reviewed its business model and generated efficiencies for example:

- The creation of the Performance and Innovation portfolio, going from 110 posts across 14 units to 63 posts across 4 units (completed)

- Reductions in the volume of organisational process work which over time will reduce costs and lead to efficiencies e.g. full scale time recording system being replaced with a targeted system; establishment of the key contacts system; removal of certain ISO accreditation systems without reducing SEPA's approach to quality (completed)

And where in future it plans to review its business model, to generate savings to manage its expenditure within the income that SEPA is expected to receive, these including

- Reviewing the applications process and restructuring the team to deliver improved customer service using less resource
- Replacing 4 regulatory systems into one IT system, with savings anticipated from year 3 onwards (2020).

It is clear a number of ideas are possible to generate the efficiencies, within the parameters of the new corporate plan and supporting strategies.

However, management should ensure that sufficient skills and capacity are in the organisation to deliver on these plans and that momentum is maintained. **Action plan 7**

Capacity and Capability of Financial Leadership

The Finance function is overseen by a Chief Officer Finance, who is a member of the Agency Senior Management Team; a Head of Finance and a Deputy Head of Finance.

We consider the team to have sufficient financial skills and capability to ensure an appropriate financial control environment operates, particularly recognising the differing income streams SEPA receives.

Governance and transparency

Risk Management

SEPA has in place a risk management framework and completes an annual risk management review which is reported to the Agency Management Team. The risk management group meets routinely during the year to continue to develop SEPA's approach to risk management; review management of risks on the corporate risk register; and assess potential new corporate risks. Risks are reported half yearly to the Audit Committee and then annually to the Agency Board.

As at 18 May 2017 SEPA reflected 9 risks on the corporate risk register including: failure to comply with environmental and business legislation applicable to SEPA; inadvertent disclosure of sensitive data to internal or external parties; insufficient grant-in-aid and charging income is available to SEPA to deliver the outcomes committed to in the corporate plan; and the pensions deficit continues to grow.

Audit Committee

SEPA has an Audit Committee that meets quarterly during the year, and is a sub committee of the Board.

During the year the Committee has considered a number of areas including the outputs from the work of internal audit; risk management arrangements; corporate governance and implementation of outstanding recommendations. From attending these meetings during the year we would highlight that Committee members are well informed; ask good questions which are strategic in focus and sufficiently challenging to management.

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:

- are governance, decision making and scrutiny arrangements effective?.
- To what extent do non-executives and staff demonstrate high standards of behaviour
- To what extent do non-executives and staff receive sufficient training and development

There were no significant matters from this return that we wish to highlight in this report.

Fraud, regularity and whistleblowing arrangements

Our audit was planned to provide a reasonable expectation of detecting material misstatements in the financial statements resulting from fraud and irregularity.

We found that SEPA's arrangements for the prevention and detection of fraud and other irregularities to be adequate.

There is a fraud policy in place and fraud updates are regularly circulated to staff.

National Fraud Initiative

The National Fraud Initiative (NFI) is a counter fraud exercise co-ordinated by Audit Scotland working together with a range of Scottish public bodies, external auditors and the National Audit Office to identify fraud and error.

We found SEPA's arrangements for participation in the NFI were satisfactory. Regular progress on NFI continues to made and regular updates are provided to the Audit Committee.

We have completed and submitted the NFI checklist to Audit Scotland.

Standards of Conduct

In our opinion SEPA's arrangements in relation to standards of conduct and the prevention and detection of bribery and corruption are adequate.

Our conclusion has been informed by a review of the arrangements for adopting and reviewing standing orders, financial instructions and schemes of delegation.

Value for money

Corporate Plan 2017-2022

During the year SEPA published its new 5 year corporate plan, setting out the strategic priorities for the next 5 years; how SEPA will go about achieving them and how performance will be monitored.

SEPA's purpose as set out in statue is to "protect and improve the environment in ways that, as far as possible, also create health and wellbeing benefits and sustainable economic growth". SEPA delivers two core services: regulation and flood risk management.

The corporate plan recognises the ambitious objectives and that SEPA as an organisation needs to evolve to deliver the objectives by making fundamental changes to the way the organisation is structured and operates.

From a review of the corporate plan and associated strategies we can see how the corporate objectives translate across the core SEPA activities, they are referred to consistently using the same language throughout all documents and set out the 'organisational characteristics' which will guide SEPA's approach.

There are 4 strategic outcomes: 1) Scotland is thriving in a low carbon world; 2) Scottish businesses are prospering from better environmental performance; 3) the impact of flood is reducing; and 4) People benefit from Scotland's improving environment.

These strategic outcomes are supported by a series of actions including:

- The development of sector plans and sustainable growth agreements
- Through a new integrated authorisation framework will improve customer service
- Use all tools to ensure regulated sectors meet compliance requirements including a focus on waste crime
- Will continue to work in partnership with flood partners
- Improvements to enforcements

The actions are underpinned by a number of strategies: regulatory strategy; people strategy; information and evidence strategy; commercial services strategy and finance strategy.

The corporate plan refers to the nine Scottish Government national outcomes that SEPA directly contributes to out of 16 national outcomes.

It is a well laid out plan, clear to understand and sets out in a very useable way the role of SEPA and its key aims.

Cultural change

Underpinning the achievement of the new strategies is organisational cultural change. Six key organisational characteristics are described in the corporate plan, which will be in place by 2020:

1) Producing information and evidence that people use to make decisions
2) Helping people implement successful innovation, not minor improvements on business as usual
3) Helping communities see the environment as an opportunity to create social and economic success
4) Routinely interacting with regulated businesses through their boardrooms, executive teams and owners
5) An organisation that people are clamouring to work for
6) Using partnerships as our principal way of delivering outcomes

This change will involve different styles; ways of working and differing skills for the future operating models of SEPA. This will take time to develop and may be difficult to measure early on in the plan, although planned measurements are set out.

We will continue to consider how this develops during 2017/18.

People Strategy

SEPA has established a people strategy aligned to the new corporate plan period.

The plan is founded on the need to be more innovative and collaborative in working together. The strategy is built on core values of: each of us will lead by example; each of us will be skilled and motivated to perform at our best; each of us will work together to deliver; and each of us will be flexible and agile.

The core values are split out into what this means for SEPA as an organisation and as individuals. Success in achieving the strategy will be measured through people surveys; customer and partner feedback; specific measures to assess the delivery and effectiveness of changes made and annual reports on progress against agreed actions.

There is good diagram setting out the strategy on a page which is very easy for staff to understand.

Annual Operating Plan 2017/18

An annual operating plan is in place for 2017/18 which sits under the Corporate plan, and is how the plan will be delivered operationally in-year. The document contains a clear road map of the high level initiatives for 2017/18 alongside the performance measures for the 4 outcomes SEPA wants to achieve.

From a review of the planned metrics, the majority of these are easy to quantify and collect data to measure.

Regulatory Strategy

The regulatory strategy outlines SEPA's wider environmental sustainability role and objectives, and sets out SEPA's statutory purpose as set out in the Regulatory Reform (Scotland) Act.

In terms of environmental regulation, this means:

1.) Get those SEPA regulate to meet their legal obligation and reach compliance; and

2.) Help as many regulated entities as possible move "beyond compliance"

A key element of the strategy is the development of sector plans with each sector SEPA regulate.

These plans will be developed via engagement with the sectors, internal experts, relevant regulators and other key stakeholders. It is anticipated that these sector plans will also make it easier to work with other parts of Scottish Government, to provide integrated services to regulated businesses.

Key actions for 2017/18 include: SEPA sustainable growth agreements; reform of permissions; improvements to enforcements and tackling non-compliance.

We will review progress against this action plan during 2017/18.

Appendices

Audit adjustments

Set out below is a summary of uncorrected and corrected misstatements

Uncorrected misstatements

	£000	£000	£000
There are no misstatements we identified above our reporting thresholds which have not been adjusted by Management in the final annual report and accounts.			

Corrected misstatements

	£000	£000	£000
We discussed with management a number of minor number changes to the draft annual report and accounts. These only moved certain balances between lines in the accounts (classification) and did not change the primary statements. For example: - A provision of £0.05million was re-classified as an accrual - Gauging stations were shown as a separate asset class in the property, plant and equipment notes - A minor adjustment to cash flow where numbers were transposed - A number of balances were incorrectly classed as impairments – these were re-classified as disposals and the accounting treatment confirmed as correct.			

Disclosure misstatements

In accordance with auditing standards we are required to highlight significant disclosure misstatements to allow audit committees to evaluate the impact of these matters on the financial statements. During the course of our audit process we identified some disclosure enhancements to the performance and accountability reports as well as within the financial statements. These were agreed with management and updated in the final annual report and accounts.

There were no material and/or significant disclosure misstatements identified we wish to bring to your attention.

Follow up on prior year recommendations

We have undertaken a follow up of outstanding recommendations from prior years raised by the previous external auditors (PricewaterhouseCoopers LLP). The results of our work are outlined below:

Prior year finding	Action in 2016/17	
Financial Strategy: Management should complete their refreshed Financial Strategy which clearly lays out forecasted income and costs, and any shortfalls anticipated for which cost saving measures need to be implemented. This should also include some consideration of the possibility of further funding cuts and how SEPA would respond to these, rather than only assuming a flat rate of Grant in Aid. b) As raised in prior year, management should then undertake an exercise to identify potential savings areas, and develop costed savings proposals to take to the Board for approval. Detailed plans should then be developed to set out how the changes will be implemented to realise the savings.	The high level financial model was updated in July 2016, and used to develop the 2017/18 budget and forward financial strategy. The range of likely funding levels where discussed and agreed The business is adopting new ways of working, it has reviewed and restructured the portfolios to improve alignment of management units with the delivery of core services. It has agreed to redesign the permitting process to improve service quality and ensure efficient effective use of resources. Management is continuing the dialogue with the Board on how it is identifying future improvements and savings areas.	**Green**
Journal processes: a) Management should review those users with access to both create and approve journals and determine whether this access level is necessary, and consider restricting this. (See point 3). If access to create and approve journals/ force through journals is considered necessary and not revoked: b) Management should perform a regular review of all journal entries posted by these users to identify any which were not authorised and agree these back to supporting documentation and assess for validity. This review should be formally documented.	A review of back office user access has been periodically completed. This only happens at year end. Management has reviewed journal entries.	**Green**

Fully implemented (green)

Partially implemented (amber)

Not implemented (red)

Prior year finding	Action in 2016/17	
Valuations: Management should consider commissioning a full inspection and valuation of properties in the coming year, since the last time this occurred was March 2008. This is to ensure that the valuer's understanding of the properties and their locations remains reasonable, given market decline and the specialised nature of some.	**Completed.** A full valuation of properties was undertaken during 2016/17 and reflected in the financial statements.	Green
System access controls: a) Management should ensure that access for HR and Finance staff is formally requested, specifying access profiles required, and approved prior to access being granted, with evidence of approval retained. b) Management should perform regular formal reviews of staff access levels and access profiles, particularly for those with administrator access, to ensure that they are in line with job responsibilities. Any inappropriate or unnecessary access rights within should be removed in a timely manner. Access levels should also be reviewed to identify any 'toxic access combinations' which represent a lack of segregation of duties. E.g. where a staff member can set up a supplier, process a PO and process payment.	A review was undertaken of back office staff access. Access profiles for roles were agreed. Regular reviews are completed	Green
Programme change management: All changes should have the formal change process followed including the testing and authorisation of changes prior to implementation. This could be evidenced through completion and sign-off of test scripts which are then retained.	Completed, testing and upgrade to milestone 6 in February 2017. Formal testing evidence maintained.	Green
Revenue delayed licence billing: a) The revenue recognition point should be reviewed to ensure that it is appropriate. If possible, adjusting this to the date of licence issuance would prevent any future misstatements occurring. b) Management should review the number of licences issued but not yet authorised and billed at the end of each period to consider whether accruals of revenue are necessary based on value and volume.	Revenue recognition points reviewed and they are appropriate. Management has kept oversight of licenses in progress.	Green

Action Plan for 2016/17

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

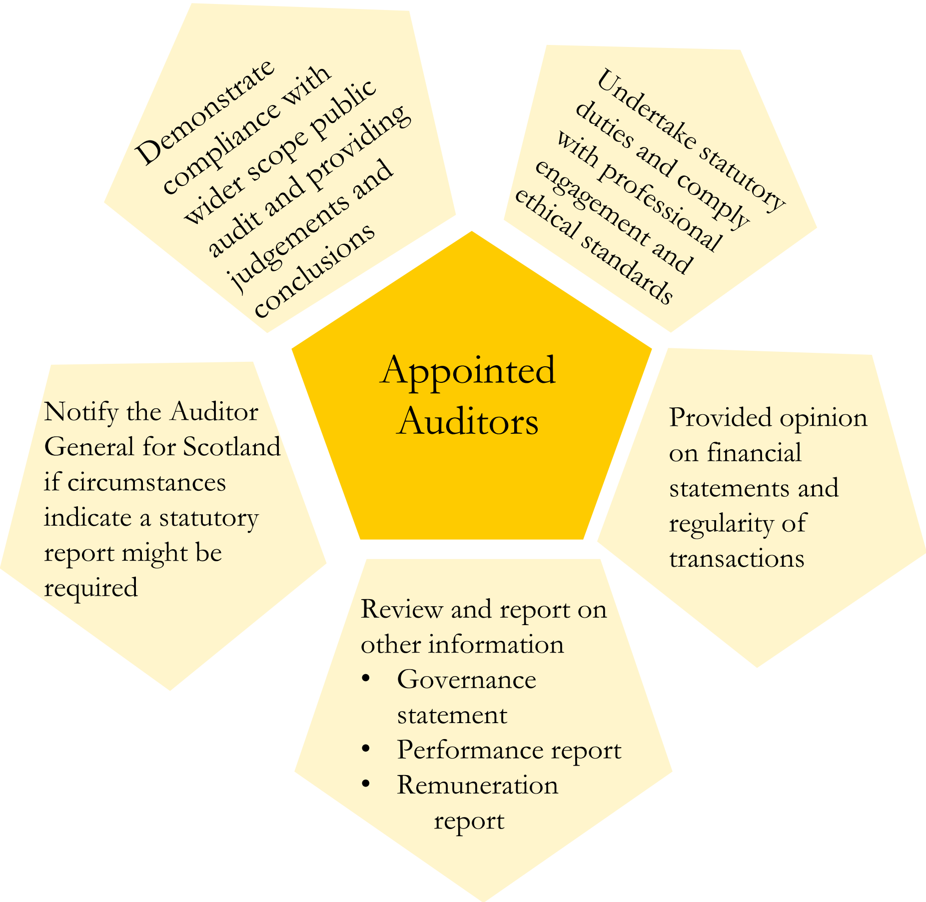
	Area	Issue & Risk	Priority	Recommendation
1	**Audit process**	Although all key workings in the financial statements were supported by finance working papers, some of these were difficult to understand and didn't necessary all tie through to supporting system information. Risk: Management produce documents which are not needed and/or additional time is required to work through audit queries	Low	We will work with Finance during 2017/18 to ensure that Finance only need to produce working papers which support the audit, and that we can agree what we need upfront to ensure we can continue to build an efficient audit process. **Management response:** In previous years audit has sent us a detailed list of the documents and workings they require to be presented at the start of the audit. Finance team pull all this information together in what is colloquially referred to as the "audit file" which we hand over to the auditors when they start their audit. **Timescale:** Lessons Learned meeting 31/7/17. Agreement of Interim and final audit plans appropriately scoped, resourced and timed 31/12/17 **Action Owner:** Head of Finance
2	**Employee claims**	An accrual is included in the accounts for £0.444million which relates to potential employee claims relating to pay bandings and the period this would need to be backdated for. This accrual has not moved much over the last two years and although relates to a list of staff provided by HR, this accrual may be over-estimated.	Low	Management should continue to progress the job evaluation process and adjust this accrual as required. **Management response:** Management regularly reviewed this accrual to ascertain if it is still needed. JE process is a joint process with TU and management. The audit recommendation will be shared with JNCC **Timescale:** 31 July 2017 **Action Owner:** Head of Finance

	Area	Issue & Risk	Priority	Recommendation
3	**Asset valuations**	During the year, as set out in SEPA's accounting policies, the largest vessel was valued to sense check the NBV reflected in the accounts. In addition, we noted that gauging stations are due to a full review during 2017/18. Recognising the specialist nature of these assets it is important management engage the valuer earlier and ensure it is completed by year end.	Low	In accordance with the FReM the Vessels and Gauging stations should be subject to a full valuation in 2017/18. **Management response:** A valuation of all vessels was obtained in 2016/17. An external valuer will be appointed to undertake a full valuation of the gauging stations as at 31 march 2018. **Timescale:** Appointment by 31 December 2017 **Action Owner:** Head of Finance
4	**Performance and Accountability Reports**	Whilst these statements generally comply with the FReM and SPFM guidance they could be reviewed to ensure that the are easy to read; the financial information could be less cluttered and the reports would benefit from less text and more use of diagrams and/or case studies.	Low	The Performance and Accountability reports should be reviewed by Management during 2017/18 using available guidance including the Audit Scotland best practice guide (although produced for the NHS there are still relevant learnings) **Management response:** Finance and performance and Innovation will undertake a full review of the Annual Report and Accounts **Timescale:** 30 November 2017 **Action Owner:** Head of Finance and Head of Governance

	Area	Issue & Risk	Priority	Recommendation
5	**Annual Report**	There is a detailed annual report prepared and published by SEPA with the annual report and accounts. However this is currently very detailed (circa 80 pages) and contains information already available via the SEPA website. Recognising the work that has been completed on SEPA's various strategy documents to ensure clarity of message and focus, the same thought process could be applied to this publication.	Low	The Annual report should be reviewed to ensure it is concise, reflects all the key messages SEPA wish to portray and makes greater use of material already available through for example hyperlinks. **Management response:** Finance and performance and Innovation will undertake a full review of the Annual Report and Accounts **Timescale:** 30 November 2017 **Action Owner:** Head of Finance and Head of Governance
6	**Budget setting arrangements**	Management should consider how it can improve the alignment of its financial resources to the priorities set out in the corporate plan for supporting innovation and cultural change. There is a risk with existing budgeting practice that previous practices continue or remain un-challenges and/or money is not always directed to the areas of. greater benefit.	Low	**Management response:** Finance will continue to work with Portfolios to identify areas that need more resource to achieve corporate priorities and areas where resources can be reduced. **Timescale:** Ongoing **Action Owner:** Chief Officer Finance and Head of Finance
7	**Longer term financial sustainability**	There are a number of key assumptions in SEPA's longer term financial forecasting, with identified sensitivities in particular over charging scheme income which are subject to economic conditions and factors out with SEPA's direct control. Therefore, it is important that management continue to focus on the improved business operations and achieve the planned savings on a sustainable recurring basis whilst recognising the ambitions in the corporate plan and need to further invest in key activities.	Low	**Management response:** AMT are continuing to consider SEPA's strategies necessary to deliver a world class EPA. The dialogue with the Board also continues regarding the range of service SEPA can deliver within its expecting funding. **Timescale:** Ongoing. Budget set 31 January 2018 **Action** Owner:Chief Officer Finance and Head of Finance

D 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 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