



Scottish Canals

**External Audit Annual Report to the Board and the Auditor General for
Scotland for the financial year ended 31 March 2018**

Scottish Canals Board Meeting 28th June 2018

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Our audit at a glance



We have raised one audit recommendation around strategic leadership and governance. We have followed up on prior year audit recommendations and are satisfied that these have been addressed.



We have fulfilled our responsibilities per International Standards of Auditing (ISAs) (UK) and the Audit Scotland Code of Audit Practice throughout our work and this final report to the Accountable Officer and the Auditor General for Scotland concludes our work.



We have performed sufficient audit testing around our identified area of significant risk including: management override of controls; risk of fraud in revenue recognition; and the risk of fraud in expenditure recognition. We have not identified any issues to outline to you.



This report reflects our broader reporting obligations under the Code of Audit Practice. We have provided commentary against our specific wider scope risks. We recognise that Scottish Canals face significant financial challenges in maintaining the canals network. Over the medium term, based on current projected levels of funding, the organisation will be unable to continue to support the safe operation of a range of assets held.

An audit underpinned by quality



We received good quality unaudited annual report and accounts which had been through robust internal challenge by management and the Audit Committee. The audit process was effective and efficient and we continue to build a good working relationship with the finance team and Audit and Risk Committee.



We have issued an unmodified audit opinion.

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Adding value through our external audit work

First and foremost our objective is to ensure we deliver a quality external audit which fully complies with International Standards of Auditing (ISAs) UK and the Audit Scotland Code of Practice (2016). By ensuring our audit is efficient and effective, underpinned by our audit quality arrangements, gives you assurance over our opinion.

Through this Annual Report we seek to provide insight and commentary over certain aspects of Scottish Canals' arrangements, sharing relevant practices with the Audit and Risk Committee and Management.

We have continued to build on our working relationship with management and our understanding of Scottish Canals as an organisation. During the year we have shared relevant publications with management, in particular from Audit Scotland, and also supported with any technical queries. We also observed a Board meeting to provide greater understanding of your governance arrangements in operation.

Lastly we are committed to audit quality. We shared our Audit Scotland Transparency report with the Audit and Risk Committee in February 2018 and will share lessons learned on an annual basis, as our reporting in this area evolves.

Introduction

This report is a summary of our findings from our external audit work for the financial year ended 31 March 2018.

Our work has been undertaken in accordance with International Standards of Auditing (ISAs) (UK) and the Audit Scotland Code of Audit Practice 2016.

Our report is addressed to the Scottish Canals Board. In addition, in accordance with our reporting responsibilities the report is jointly addressed to the Auditor General for Scotland.

Once finalised this report will be made publically available on the Audit Scotland website (www.audit-scotland.gov.uk)

Our report was presented as a draft to the Scottish Canals Audit and Risk Committee on 14 June 2018. Once all outstanding matters were completed the report was finalised. Scottish Canals took this report alongside the final 2017/18 financial statements to the Board meeting on 28 June 2018.

We would like to thank Scottish Canals' management and the finance team for an effective year-end audit process and all their support and assistance in the audit process.

Structure of this report

In accordance with the Audit Scotland Code of Practice 2016, in addition to our core financial statements audit we provide conclusions on the four dimensions of wider-scope public audit. Our report is structured as follows:

Financial statements – Section 1

Financial management – Section 2

Financial sustainability – Section 3

Governance and transparency – Section 4

Value for money – Section 5



Our Opinion

For the financial year ended 31 March 2018 we have issued an **unmodified audit opinion**

- True and fair view of the financial statements
- Regularity – expenditure has been incurred in accordance with the purpose of Scottish Canals
- Other prescribed matters (which include the audited information in the remuneration report)



The audit process

We received a good complete set of financial statements including the strategic report, corporate governance statement, and directors' remuneration report.

This was in line with the timetable we agreed.

The draft financial statements were supported by good working papers and the audit was efficient.

We identified no unadjusted differences to report to the Audit and Risk Committee and the Board.

We identified minor disclosure enhancements and these have been reflected in the financial statements.

This included reclassification of movements in the defined benefit pension scheme liability.

These had no impact on the organisation's reported surplus for the year.



Our financial statements audit



Materiality was set at 1.5% of gross income based on 2017/18 un-audited information (£0.262 million). Previous year it was 1% of gross revenue (£0.197 million). We have calculated materiality as set out in our plan, and this remains unchanged.



The draft financial statements were of a good standard supported through detailed working papers. The transition to a new financial controller during the audit process was well managed and helped contribute to an efficient audit process.



We have issued an unmodified audit opinion on the financial statements, including the wider information contained in the financial statements, and regularity opinion. The audited parts of the Directors Remuneration Report are free from error.



Testing provided assurance on all identified areas of significant audit risks and there were no audit differences arising during the course of our audit.

Audit approach and materiality

Our audit approach was set out in our annual audit plan presented to the Audit and Risk Committee on 1 December 2017.

As set out in our plan, we updated our materiality calculations based on the unaudited 2017/18 financial statements. Overall materiality has been set at £0.262 million (1.5% of gross income) and performance materiality is set at £0.197 (75% of materiality). We report to management any audit difference identified over £13,000 (Trivial as 5% of materiality).

We received a complete set of accounts including the strategic report in line with our audit timetable and these were of a high quality with only minor amendments required around the disclosure of defined benefit pension schemes. The accounts were supported by detailed working papers contributing to an effective audit process.

Audit opinion

Based on our audit procedures performed we have issued an unmodified audit opinion on the financial statements including:

- they give a true and fair view
- they have been properly prepared in accordance with relevant legislation and standards
- the wider information contained in the financial statements, e.g. Directors Report; Strategic Report and Corporate Governance Statement
- regularity of expenditure
- audited parts of the remuneration and staff report have been prepared in accordance with applicable guidance

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:

- Sought to understand procedures and controls around related parties, journal entries and other key entity level controls
- Performed procedures around entity level controls 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 revenue, expenditure and the recognition and valuation of Dundas Hill.

No material weaknesses in the accounting and internal control systems were identified based on our work undertaken 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.

We adopted a substantive based approach to the audit of the financial statements and therefore our review is limited to the design of controls rather than the operating effectiveness of these.

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 2017/18. 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.

Key audit issues – Our response to significant audit risks

	Identified audit risk at planning	Work completed	Our conclusion
Risk of fraud in revenue	As set out in ISA 240 there is a presumed risk that revenue may be misstated due to improper recognition of revenue. In 2016/17 Income received was: £11.672 million which includes larger income streams related to retail sales, funding from third parties for waterway maintenance and water and utility sales.	<ul style="list-style-type: none"> Developed our understanding of Scottish Canals' material revenue streams including walkthrough of key transactions. Performed targeted review and testing of key revenue streams during the year, including analytical procedures and transaction testing Performing revenue cut off procedures and substantive testing over pre and post year end balances Testing the existence and recoverability of balances at the year end 	From our audit procedures performed we are satisfied that revenue is free from material misstatement. We are satisfied that revenue has been recognised in the appropriate financial year. The impact of applying a financial close for retail units on 28 th March was considered immaterial to the accounts with the impact on unrecorded income and expenditure below our trivial threshold.
Operating expenditure is not treated correctly	Operating expenditure is understated or not treated in the correct period (risk of fraud in expenditure). As set out in Practice note 10 (revised) which applies to public sector entities.	<ul style="list-style-type: none"> Developed our understanding of Scottish Canals' material expenditure streams including walkthrough of key transactions. Performing targeted review and testing of key expenditure streams during the year, including analytical review of expenditure and targeted transaction testing, including consideration of the regularity of expenditure incurred. Performing cut-off testing of expenditure transactions around the year end to ensure these had been allocated to the appropriate financial year. Reviewing post year end payments for any potential unrecorded liabilities. 	Assurance gained that expenditure has been recorded within the appropriate financial year and that payables are free from material misstatement. We are satisfied that expenditure has been incurred in accordance with the type/nature of Scottish Canals as an organisation
Management override of controls	As set out in ISA 240 there is a presumed risk that management override of controls is present in all entities	<ul style="list-style-type: none"> Developed our understanding of the entity level controls in place at Scottish Canals that reduce the risk of management override Performed review of journal transactions for unusual transactions or balances. Evaluated key areas of judgement within the Financial statements and the basis for these judgements / application of accounting policies Reviewed unusual and/or significant transactions 	We did not identify any significant areas of bias in key judgements by management. We have not identified any unusual or significant transactions during the course of the year that would indicate management manipulation.
Accounting for Dundas Hill	In 2016/17 the Dundas Hill project was accounted for as work in progress within Scottish Canals balance sheet. As the project develops the accounting treatment may no longer be applicable.	<ul style="list-style-type: none"> We have reviewed the latest Board's position on the proposed use of Dundas Hill to consider if the current accounting treatment remains appropriate We have reviewed the expenditure incurred and performed sample testing to ensure that the costs incurred related to ongoing development works and correctly recognised. We have reviewed the latest financial plans in place and forecast to ensure that the carrying value of the land remains appropriate and that there is no indication of impairment in value. 	We are satisfied that the Dundas Hill development remains as ongoing work in progress and that expenditure incurred during the year has been appropriately recognised. Based on the latest financial plans in place for the site, there is no indication of impairment on the development.

Other key areas of the financial statements

As part of our audit there were other particular key areas of focus. While not considered a significant audit risk, these are areas of potential increased risk due to their complexity or magnitude.



Investment properties: Investment properties of £17.3 million were included in the March 2018 accounts. The Investment properties were revalued as at 31 March 2018 on the basis of market value by professional values' Cushman & Wakefield. We have reviewed the basis of the valuation and consider Scottish Canal's accounting treatment to be appropriate.

Defined benefit pension schemes: Scottish Canals participates in two defined benefit pension schemes: The Waterways Pension Fund (WPF) and the Strathclyde Pension Fund (SPF). Both schemes are subject to an actuarial valuation each year to determine Scottish Canals' share of the assets and defined benefit liabilities. The net defined benefit pension liability was £710,000. We have used our in house actuarial specialists and they are satisfied with the assumptions adopted. We raised disclosure adjustments during the course of our audit to the draft financial statements to ensure that the recognition of the pension schemes were in accordance with IAS 19: *Employee Benefits*.

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. We have also audited the required information in the remuneration report (marked audited) and have no matters we wish to bring to your attention.

Strategic Report

- The Strategic Report clearly defines the principal activities, risks and uncertainties of the organisation.
- It summarises Scottish Canals' financial results for the year as well as future developments
- The information contained within the report is consistent with the financial statements.

Directors' Remuneration Report

- The auditable part of the Directors' remuneration report has been properly prepared in accordance with the Transport Act 1962 and directions made thereunder by the Scottish Ministers.
- The information contained within the report is consistent with underlying records.



Overall observations

Scottish Canals continue to look at how the "front end" of the Annual Report and Accounts tells the story of Scottish Canals as an organisation including principal activities, risks, uncertainties and performance. There are further opportunities to enhance the report with more explicit reporting of performance indicators / measures.

Corporate Governance Statement

- Clearly defines the responsibilities and duties of the Accountable Officer
- No material issues of governance in year that are required to be reported
 - Describes the Scottish Canals governance arrangements and risk and internal control
- The information contained within the statement is consistent with the financial statements

Key aspects of your financial statements

As set out in our audit plan we consider particular aspects of your financial statements in relation to management judgements including estimates and where management may have particular options or choices in what accounting standards or disclosure requirements to apply. We have summarised where these apply, and our conclusions below.

Scottish Canals' accounting policies are in accordance with IFRS and the Companies Act (where relevant to Scottish Canals) and we consider these to be appropriate to the organisation and consistent with those adopted in prior years.

Accounting estimates and judgements

Scottish Canals' significant accounting estimates and judgement impacting on the annual accounts are the following:

- Investment property valuations: Where we are satisfied these are supported by qualified expert valuations.
- Bad debt provision calculations: Remains consistent with prior year and in line with management's experienced levels of bad debts (continues to be 0.5% of expenditure)
- Expected useful economic lives of property, plant and equipment impacting depreciation charges and deferred capital grants: Consistent with prior year and our expectations for the asset types.

We are satisfied that the estimates and judgements applied by management are reasonable and not subject to management bias.

Fraud and irregularity

There are no provisions or uncertainties related to the accounts.

In relation to the audit risk of fraud in respect of expenditure we tested Scottish Canals' cut of arrangements in particular (timing) and identified no issues in accruals or prepayments which would indicate potential fraud. There are no post balance sheet events or legal uncertainties at year-end

Going concern

Scottish Canals has an agreed budget for 2018/19 and continues to discuss future funding with Scottish Government.

For 2017/18 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.



Financial management



Scottish Canals has efficient and effective financial management arrangements in place. Based on our: minute review; review of financial monitoring reports; and attendance at the May 2018 Board meeting, we observed clear and transparent reporting to the Board which is in sufficient detail to allow assessment of underlying financial performance across the organisation.



Scottish Canals continues to operate within a challenging financial environment. To meet the costs of continued investment and maintenance in the canals network it is critical that Scottish Canals' financial planning and management arrangements remain robust. Scottish Canals financial plans need to link to the asset management plans of the organisation, and the investment decisions required.



Financial performance was broadly in line with budget set at the start of the year and is closely monitored. At a Board level financial performance was reported on a quarterly basis. In addition, Finance do a formal budget revision in year with financial forecasts undertaken on a quarterly basis.



Scottish Canals managed the transition to a new Financial Controller well during the course of our audit visit. While a small organisation, Scottish Canals have a skilled, experience and capable finance team.

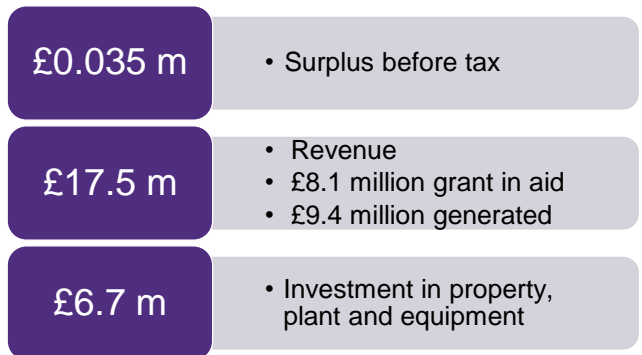
During our audit planning process, no specific financial management risks were identified for 2017/18. However, as noted in our annual audit plan, we considered Scottish Canals financial performance and financial management arrangements including review of policies and procedures and systems of internal financial control. Our work in this area reflects our judgement and conclusion on the organisation's financial management arrangements. This has been informed through review of Board and committee meetings; review of financial plans and monitoring reports, review of applicable policies and procedures; and discussion with management.

Financial Performance

Scottish Canals generated a surplus for the year before tax of £35,000 (2017: £1,047,000). The reduction in profitability from the prior year is primarily due mainly to movement in the revaluation of investment properties. The performance was broadly in line with budget and represents the challenging year of continued investment in the canals network.

During 2017/18, Scottish Canals received Grant-In-Aid funding from Scottish Government was £12.4 million of which £8.1 million relates to revenue. The organisation continues to rely upon commercial revenue, which constitutes over 50% of their total revenue, to support continued expenditure and investment on the Canals network.

Scottish Canals invested £6.7 million in capital expenditure during the year as part of the continued investment and development of the canals network. This was funded through Scottish Government capital grant funding of £4.3 million in third party funded works. As set out in the related party note, Scottish Canals have a link to the Millennium Link Trust. A number of assets are held within this Trust, and are not assets of Scottish Canals for example the Falkirk Wheel.



Financial management



Financial performance is monitored by management and reported to the Board on a quarterly basis. As part of the budget monitoring reports, Scottish Canals reforecast the budget for the remainder of the financial year to ensure that there is an up to date and remains appropriate. From review of the financial reporting and minutes of the Board meetings we found:

- Financial performance reports were clear and concise
- There is challenge and scrutiny of performance in the year and key variances between actual and outturn performance.
- Financial pressures and challenges are discussed.
- Management are continuing to enhance reporting arrangements, including clearer reporting of budget movements in each quarter.

Financial capacity and capability

Scottish Canals has strong leadership from an experienced and qualified finance team. While the Financial Controller left during the year, the organisation has recruited quickly to fill the post and we observed a good transition process.

We observed that controls over key financial processes were designed effectively and appropriate for a small finance function. The financial management arrangements are underpinned through documented financial policies and procedures and scheme of delegation.



Financial sustainability



The 2017-20 Corporate Plan outlines Scottish Canals' strategic priorities over the three year period of the plan. The Plan recognises the financial and operational challenges faced by Scottish Canals in undertaking its statutory obligations with regards the operation and maintenance of the waterways.



Management has forecast that the level of future investment required over the medium to long term to sustain the canals network, vastly exceeds the current level of grant-in-aid and self-funding that Scottish Canals generates. This is a critical risk to long term financial and operational performance of the organisation.



The 2018/19 budget has been developed through a zero based budget (bottom up) approach. We have reviewed the key assumptions contained within the budget and consider these to be reasonable.

Within our audit plan we identified risk around financial sustainability at Scottish Canals. In accordance with the Code of Audit Practice, we have undertaken appropriate procedures to allow us to form a conclusion around the identified areas of risk and the organisation's financial sustainability. This includes review of corporate and financial strategies and plans as well as discussion with senior management.

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.

Identified audit risk at planning	Conclusion
<p>Scottish Canals have multiple income stream out with core Scottish Government funding but this is subject to potential risks for example retail income variations, reductions in third party funding, income from property lets decline. In addition, the core SG Grant funding may stay static or fall. Therefore the "cost" base of Scottish Canals needs to be agile and a medium term financial plan in place setting out various scenarios to ensure longer term financial viability.</p> <p>Our Response:</p> <p>We discussed financial sustainability with Scottish Canals Management. We reviewed the financial plans in place, including the scenarios set out, the governance of the plans and regular reporting</p>	<p>The 2017-20 Corporate Plan outlines Scottish Canal's strategic priorities over the three year period of the plan. The Plan recognises the financial and operational challenges faced by Scottish Canals in undertaking its statutory obligations with regards the operating and maintenance of the waterways. These include both the immediate pressure of meeting the day to day operating and maintenance costs of the canals network, against a context of relatively static Government funding, as well as focusing on longer term strategic investment required to maintain the canals assets.</p> <p>During 2018, Scottish Canals developed a 20 year asset management strategy. The strategy reflected managements deeper understanding of the canals infrastructure and knowledge and experience that changing climactic factors and diverse usage have on the network. The strategy aims to:</p> <ul style="list-style-type: none"> • describe an optimised risk-based approach to managing, maintaining and operating the network to meet the Scottish Canals Corporate Plan; • set out a strategy which is realistic and considers resources, timescales and enabling activities; • Maintain a clear line of sight from Corporate Plan and canal visions to asset maintenance and operation; • Identify challenges and opportunities within asset management and set objectives to develop and mature asset management within Scottish Canals; and • Optimise the deployment of finite resources in an open, evidence based and analytical way. <p>Underpinning the strategy is a risk based maintenance model for the network. This includes a comprehensive and ongoing evaluation of the assets held, their condition and consequence of the asset failing. The model is aligned to available financial resources, both Grant in aid and self generated funding to priorities spend.</p> <p>Management has forecast that the level of future investment required over the medium to long term to sustain the canals network, vastly exceeds the current level of grant-in-aid and self generating funding that Scottish Canals generates.</p> <p>Historically, Scottish Canals' approach has been to maintain all of the canals to a similar level of service, maintaining navigation and supporting a variety of additional uses and benefits. Whilst this has been achievable in the short term, it has developed a growing backlog of work and defects and further deterioration in the serviceability of assets, which has now been identified as unsustainable. This has been reflected with the requirement for additional funding of £1.3 million of Scottish Government to support capital investment in the year.</p> <p>The current level of service provision, based on projected asset data, is unsustainable. Without a significant change in the levels of investment in the infrastructure, in order to ensure that public safety and operability of open infrastructure, Management envisage that the number of assets supported and services offered may need to significantly reduce. This is a period of significant challenge for the organisation looking to maximise the use of infrastructure while prioritising public safety. Scottish Canals is actively engaged with the Scottish Government and other stakeholders around the consequences of not securing sufficient investment in the canals network.</p>

Financial planning 2018/19

The Board approved the Business Plan 2018/19, including the operating budget for the year in February 2018. The financial plan is developed using a zero based budgeting approach to ensure that forecast income and expenditure is developed on key planned activity during the year. Financial forecasts are reviewed during the year to ensure these remain appropriate.

The financial plan for 2018/19 projects an operating surplus of £150,000, consistent with the 2017/18 original forecast. We consider the key assumptions below:

Key assumption	Budget £ million	Considered reasonable	Comment
Grant-in-aid income	8.1	✓	Budgeted Grant in Aid has been agreed to 2018/19 grant funding letter for the year.
Joint Venture Income:	0.540	✓	Canals adopt a relatively prudent forecast for this income stream as over the last two years, actual contributions from Joint Ventures has been higher than budgeted.
Other income	10.596	✓	Other income (including JV income) is based on 42% of total revenue which is slightly higher than 2017/18. However, where possible, Management adopt an 'earn before spend' approach and therefore any fall in income would be offset by fall in expenditure.
Staff costs	(9.849)	✓	The budget numbers reflect the Scottish Government Pay Policy settlement for 2018/19 of a 3% increase for all employees earning under £30,000 per annum, 2% for those earning between £30,000 and £80,000 and £1,600 for employees earning over £80,000.
Major works (including towpaths)	(1.658)	✓	Consistent with current year activity and based on planned activity for the year.
Depreciation	(1.350)	✓	Consistent with current carrying value of assets and depreciation policy.
Other costs	(6.229)	✓	Represents a mixture of costs primarily materials and contracts. We are satisfied that the assumed level of expenditure is consistent with current year and expected activity in 2018/19.
Forecast surplus / (deficit)	0.150		

Scottish Canals have a number of key costs pressures including the impact of the Scottish Government's pay settlement on staff costs as well as ongoing pressures on contribution rates in managing the defined benefit pension scheme.

We are satisfied that the financial plans in place are based on reasonable assumptions and appropriate based on our understanding of Scottish Canals. Scottish Canals continue to monitor these forecasts to ensure that they continue to be appropriate.

Governance and transparency



Scottish Canals is in a period of significant transition across the Board and senior management team with the Chief Executive (Accountable Officer) leaving the organisation in May 2018 and the appointments of non-executive board members coming to an end. The Chief Executive played a critical role in setting and delivering Scottish Canals strategic vision and there will be key decisions on the organisations' strategy going forward.



The Board are due to replace three of the existing non-executive members over the coming months. Given the strategic challenges facing the organisation, it will be critical that the Board continues to focus on the key issues faced. Providing insight, support, scrutiny and challenge to management.



With the changes across Board members in the coming months, it is important that the focus of Board members activity is at the strategic organisational level, and supports the Executive team bringing their relevant experience as well as independently scrutinising and challenging the Executive and the decisions to be taken. Since the inception as Scottish Canals significant work has taken place to ensure policies and procedures are appropriate to Scottish Canals. This will give the new Board Members confidence in the underlying policies and the ability to think at the bigger picture level.

Scottish Canals is in a period of significant transition across the Board and senior management team. A robust recruitment process was put in place to support the appointment of two new Board members and the organisation has interim arrangements in place while it seeks the appointment of a new Chief Executive.

While effective governance arrangements are in place, we recognise the strategic importance that the former Chief Executive played within the organisation. In the context of the forthcoming challenges facing the organisation, the appointment of the new Chief Executive and Board members is critical.

Identified audit risk at planning

Governance and transparency

A number of the Scottish Canals Board members terms of appointment come to an end in July 2018. In particular, the Chair of the Audit and Risk Committee's term ends at the start of July 2018. There is a risk that significant knowledge and experience may be lost without sufficient handovers.

Our Response:

We considered Scottish Canals succession plans in relation to the Board and the Audit and Risk Committee membership and the planned induction and training for new members

Conclusion

Scottish Canals is in the middle of significant changes across its Board and Senior Management Team. In May 2018, the Chief Executive left the organisation. The Board has established interim arrangements to fill the position as it goes through a recruitment process to seek to find a permanent replacement for the role.

On an interim basis, a six month appointment has been made to the position of Chief Executive. The outgoing Chief Executive provided the Board with appropriate assurances to support the governance statement.

The role of Chief Executive is critical at Scottish Canals in providing a strategic vision and leadership to the organisation as well as playing a critical role in engaging with key stakeholders from across political and commercial sectors. Scottish Canals is at a key stage where it faces critical decisions on its longer term strategic approach to managing the Canals network. The Board has launched a recruitment process to find a suitable replacement. It is critical that a suitable individual is identified in a timely manner.

The Board is in the process of finalising the appointment of two new Non-Executive Directors. As well as a standard recruitment process, the Chair and Deputy Chair held two board recruitment sessions as well as Skype sessions during the year. An induction programme is being developed for the new members who are due to be announced in July.

Governance arrangements

Scottish Canal's has a relatively simple governance and committee structure, reflecting the size of the organisation with the Board supported by two committees. The Audit and Risk Committee supplements the work of the Board, providing a scrutiny and risk oversight role. The Remuneration Committee supports succession planning and performance payments to directors. As external auditors, we regularly attend the Board's Audit and Risk Committee meetings. In February 2018, we observed the Scottish Canal's Board meeting to support our understanding of how the governance arrangements worked in action and the level of debate and strategic discussion at the meeting.



We observed clear commitment from both non-executive and executive members to deliver the organisation's strategic goals. Committee meetings are well attended and there is a good level of debate. The Board recognise the challenges facing the organisation.

Given the change in leadership across executive and non-executive members of the Board and in light of the strategic challenges facing the organisation, it is critical that the Board focus on the key strategic issues facing the organisation. This will require strong leadership from the top of the organisation. **Action Plan – 1.**

Fraud and Irregularity

Scottish Canals has arrangements in place to help prevent, detect and mitigate the risk of fraud or irregularity, including anti-bribery and whistleblowing policies. A report is taken each June to the Audit and Risk Committee which covers all fraud and theft issues in the year. While we consider these to be reasonable, no arrangements can fully prevent against the risk of fraud, theft or irregularity. During the year, Scottish Canals was subject to an break-in which resulted in the loss of approximately £6,000 of equipment. While the theft was reported to the police it is unlikely the equipment will be recovered.

Value for money



Scottish Canals have clear performance management arrangements in place which are aligned to the delivery of the organisations strategic priorities.



Scottish Canals continued to progress with the ongoing development of the Dundas Hill site project. Although no formal decision has been taken on the future development, management has estimated that the project will incur total costs of £12.528 million and a capped net profit to Scottish Canals of £3.86 million. The Board are in the process of developing a suite of performance information to support the ongoing monitoring and project delivery.



The organisation continues to look to partners to both work with and financially support investments to support the businesses financial sustainability. The joint venture vehicle, Bigg Regeneration Limited Partnership, provides a vehicle to promote and develop business and commercial opportunities across the canal network.

During our audit planning we identified a risk around the ongoing development at Dundas Hill. We conclude on our assessment of the risk below as well as our wider consideration of Scottish Canals' performance management arrangements.

We identified a specific audit risk in our plan related to Dundas Hill and value for money. We have outlined below our response to this risk and overall conclusion.

Identified audit risk at planning	Conclusion
<p>The Dundas Hill project is significant project for Scottish Canals, which has associated reputational risks as well as opportunities for further income generating activities in the future.</p> <p>Our Response:</p> <p>We reviewed the progress of the project including considering the overall project governance and reporting to the Scottish Canals Board and other relevant Stakeholders. As part of our audit of the financial statements we considered whether the accounting treatment of the project remains correct (as stock rather than an asset on the balance sheet). We considered how Scottish Canals are evaluating the outcomes of the project and capturing project benefits and lessons learned.</p>	<p>Following the acquisition of the site in March 2017, only a moderate level of expenditure has been incurred during the year around legal and enabling works on the site. During 2017/18, following a competitive single stage design and build tender process, a preferred contractor had been selected for the site remediation and enabling works.</p> <p>The financial forecasts continue to be reviewed to ensure that the project will deliver value for money for the Board.</p> <p>Going forward the Board has agreed to establish a dashboard of key performance indicators associated with the Dundas Hill project and this will be included in the quarterly business Board report following commencement of the project.</p> <p>During the year Scottish Canals secured City Deal Funding to undertake the site and remediation works, This was critical to the development as the works are essential to the future development of the site to promote future opportunities</p> <p>We will continue to monitor the progress made by Scottish Canals with the development, ensuring that the Board continue to maintain a focus on value from the development.</p>

Performance Management

Scottish Canals operates a performance management system based on the Scottish Government's National Performance Framework as well as locally set strategic priorities.



The annual Business Plan outlines the planned activities and priorities in year to support the delivery of the strategic objectives. The monitoring of these allows for clear scrutiny of the delivery against strategic priorities.

We observed that performance against these KPIs was scrutinised by senior management and the Board and that the underlying performance of the organisation was transparent. The Board continues to look to develop its performance reporting arrangements and work is underway to incorporate reporting from the Asset Management Strategy into corporate performance reports.

Partnership working

Scottish Canals works closely with partners both to secure funding support for investments as well as joint working arrangements. This included supporting £0.75 million of towpath repairs through the support of third party funding.

Scottish Canals participates in a joint venture vehicle, Bigg Regeneration Limited Partnership which supports the development of new build homes on the canal bank. The vehicle acts as an important method for promoting and delivering commercial opportunities on the canals network.



Appendices

Audit adjustments

Action plan and follow up of 2016/17 recommendations

Fees, independence and fraud arrangements

Financial reporting future developments

Communication of audit matters

Audit adjustments

Uncorrected and corrected misstatements and disclosure amendments

We are pleased to report that there were no uncorrected misstatements to the financial statements arising during our audit.

There were a number of disclosure adjustments to the draft accounts received for audit inspection.

In the draft accounts movements in the defined benefit pension scheme the draft accounts these were shown as a single line on the face of the Statement of Comprehensive Expenditure. In accordance with IAS 19 these have been reclassified between operating costs and finance costs. Management has amended the accounts to recognise the net interest expense (£22,000) within Finance Income in the Comprehensive Income and Expenditure Account.

Action plan and follow up of 2016/17 recommendations

We have set out below, based on our audit work undertaken in 2017/18, those risks and recommendations we consider are of a higher risk to Scottish Canals that Management may wish to consider in the future. We have also completed follow up of our 2016/17 recommendations and this is reflected below for information.

Recommendation

Agreed management response

Strategic Leadership and governance

Scottish Canals is going through a significant period of change through the departure of the Chief Executive as well as the terms of appointment of a number of non-executive members coming to an end. The former Chief Executive played a critical role in setting and delivering the strategic vision of the organisation. In particular the promotion of commercial revenue generating activities.

With the loss of a key senior leader, and in light of the significant challenges facing the organisation particularly around the medium to long term financial sustainability of the canals network, there is a significant risk that the organisation may lose its strategic focus to address these challenges. It is critical that with new Board members there is focus on strategic challenges facing the organisation to both support and challenge management on the delivery of these.

Management response:

The immediate focus of the organisation is as articulated within the Corporate Plan and Business Plan.- Financial sustainability / Public value / empowered and motivated people. The on-boarding and induction process for new Board members will be comprehensive and will demonstrate clearly the aims and objectives of the corporate plan and business plan and will highlight the significant contribution that Scottish Canals makes to the Scottish Government's wider aims and objectives as articulated in the National Performance Framework.

Action owner: Chair of the Board

Timescale for implementation: September 2018

Long term financial planning (outstanding from 2015/16)

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 a measures to close funding gaps; the residual funding gap and any residual risks.

Complete

In December 2017, the Board formally reviewed and refreshed the Corporate Financial plan. The financial strategy was updated in light of the challenging outlook for public finances and growing liabilities.

The financial strategy support the Boards Corporate Plan 2017 – 2020 as well as being cognisant of longer term corporate strategy.

Innovation

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, Scottish 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.

Complete

Scottish Canals secured City Deal funding during 2017/18 to undertake remediation and infrastructure works on the Dundas Hill site. In addition, the organisation completed the tender process for the design and build of the project.

The development is now entering a critical stage in its development and, given the level of investment involved, it will be important that there continues to be regular scrutiny and monitoring of the development by the Board. Potentially, Scottish Canals may want to include a standing item on the Board meeting agenda to ensure regular updates are provided to the Board,

Financial sustainability

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

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 continue to be taken aligned to the risks and strategic priority of Canals.

Recognising the income and investment opportunities to Scottish 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 Scottish Canals.

Complete

Scottish Canals have refreshed the Asset Management Strategy, Financial Strategy and Corporate Plan which clearly articulate the financial pressures facing the organisation.

Management have ongoing dialogue with various levels within the sponsoring department and this will be critical to support the level of investment in the canals network.

Fees, independence, fraud arrangements

External Audit Fee

Service	Fees £
External Auditor Remuneration	28,700
Pooled Costs	6,990
Contribution to Audit Scotland costs	1,760
Contribution to Performance Audit and Best Value	0
2017-18 Fee	37,450

The audit fee was calculated in accordance with guidance issued by Audit Scotland and agreed with Management.

The above fee has not changed and our final fee was £37,450

Fees for other services

Service	Fees £
We can confirm there are no non-audit fees for the 2017/18 financial year	Nil

Independence and ethics

We confirm that there are no significant facts or matters that impact on our independence as auditors that we are required or wish to draw to your attention.

We have complied with the Auditing Practices Board's Ethical Standards and therefore we confirm that we are independent and are able to express an objective opinion on the financial statements.

We confirm that we have implemented policies and procedures to meet the requirements of the Auditing Practices Board's Ethical Standards.

We are required by auditing and ethical standards to communicate any relationships that may affect the independence and objectivity of the audit team.

We can confirm no independence concerns have been identified.

Fraud arrangements

In assessing our audit risks, the audit team was alert to the possibility of fraud at Scottish Canals.

As part of our audit work we are responsible for:

- identifying and assessing the risks of material misstatement of the financial statements due to fraud in particular in relation to management override of controls.
- Leading a discussion with those charged of governance (for Scottish Canals this is assumed to be the Audit Committee) on their view of fraud. We did this when presenting our audit plan and in the form of management and those charged with governance questionnaires.
- designing and implementing appropriate audit testing to gain assurance over our assessed risks of fraud
- responding appropriately to any fraud or suspected fraud identified during the audit. – None were identified in-year

As auditors we obtain reasonable but not absolute assurance the financial statements as a whole are free from material misstatement, whether due to fraud or error.

We will obtain annual representation from management regarding managements assessment of fraud risk, including internal controls, and any known or suspected fraud or misstatement.

It is **Scottish Canals'** responsibility to establish arrangements to prevent and detect fraud and other irregularity. This includes:

- developing, promoting and monitoring compliance with standing orders and financial instructions
- developing and implementing strategies to prevent and detect fraud and other irregularity
- receiving and investigating alleged breaches of proper standards of financial conduct or fraud and irregularity.

Throughout the audit we worked with Scottish Canals to review specific areas of fraud risk, including the operation of key financial controls.

We also examined certain policies in place, strategies, standing orders and financial instructions, as relevant to the fraud framework, to ensure that they provide a reasonable framework of internal control.

No suspected frauds or irregularities have been identified by Management and reported in-year.

Financial reporting - future developments

As financial reporting standards continue to develop we highlight to management those areas which are most likely to have an impact on Scottish Canal's financial statements:



International Financial Reporting Standard 16: Leases (IFRS 16) supersedes IAS 17 Leases and its associated interpretations. IFRS 16 introduces a single lessee accounting model whereby assets and liabilities for all leases with a term greater than 12 months are expected to be recognised within the lessee's financial statements. This is expected to result in a number of lease arrangements, currently recognised as operating leases, coming on to the balance sheet. The standard is expected to apply in the public sector from 2019/20 and therefore it is important that organisations consider the impact on the current accounting treatment of their lease agreements.

IFRS 15: Revenue from Contracts with Customers is effective from 1 January 2018. The standard introduces a five-step model to determine when to recognise revenue, and at what amount. Revenue is recognised as a company transfers control of goods or services to a customer at the amount to which the company expects to be entitled. Given the nature of the organisation's revenue streams, it is unlikely that the new standard will materially impact on revenue recognised.

Management are in the early stages of considering the impact of the revised accounting standards. We will continue to monitor the progress made by the organisation, particularly where these are likely to result in a material change to financial reporting.

Communication of audit matters

Our communication plan	Audit Plan	Audit Findings
Respective responsibilities of auditor and management/those charged with governance	•	
Overview of the planned scope and timing of the audit, including planning assessment of audit risks and wider scope risks	•	
Confirmation of independence and objectivity	•	•
We are independent of Scottish Canals and have not identified any conflicts of interest		
A statement that we have complied with relevant ethical requirements regarding independence. Relationships and other matters which might be thought to bear on independence. Details of non-audit work performed by Grant Thornton UK LLP and network firms, together with fees charged. Details of safeguards applied to threats to independence	•	•
We have not incurred any non-audit fees during the year and no threats to independence identified		
Significant matters in relation to going concern	•	•
No significant going concern matters identified		
Views about the qualitative aspects of Scottish Canals accounting and financial reporting practices, including accounting policies, accounting estimates and financial statement disclosures		•
Set out in the Financial statements Section		
Significant findings from the audit		•
No significant findings from our audit		
Significant matters and issues arising during the audit and written representations that have been sought		•
Letter of representation will be shared and signed by the Accountable Officer when signing the financial statements. This is our standard, unmodified letter of representation.		
Significant difficulties encountered during the audit		•
No difficulties encountered		
Significant deficiencies in internal control identified during the audit		•
None identified		
Significant matters arising in connection with related parties		•
None identified		
Identification or suspicion of fraud involving management and/or which results in material misstatement of the financial statements		•
None identified. A nil fraud return was submitted to Audit Scotland in April 2018 in accordance with the planning guidance.		
Non-compliance with laws and regulations		•
None noted		
Unadjusted misstatements and material disclosure omissions		•
None noted. Minor disclosure amendments only and these were not material in nature		
Expected modifications to the auditor's report, or emphasis of matter		•
None, an unqualified opinion		

International Standards on Auditing (UK) (ISA) 260, as well as other ISAs, prescribe matters which we are required to communicate with those charged with governance, and which we set out in the table above.

We communicate any adverse or unexpected findings affecting the audit on a timely basis, either informally or via a report to Scottish Canals Management and the Audit and Risk Committee.

