Scottish Environment Protection Agency (SEPA)

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

For the financial year ended 31 March 2018

10 August 2018

Joanne Brown
Engagement Leader

John Boyd
Senior Manager

Our audit at a glance

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 Board and the Auditor General for Scotland concludes our work.

We have raised two audit recommendations around financial sustainability and performance management. We have followed up on prior year audit recommendations and note that one recommendation remains ongoing in relation to development of the annual report.

We have performed sufficient audit testing around our identified areas of significant risk including: management override of controls; risk of fraud in revenue recognition; the risk of fraud in expenditure recognition; and the valuation of specialist properties. We are satisfied that these have been correctly reflected in the accounts.

An audit underpinned by quality

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

We received the financial statements including the strategic report, corporate governance statement, and director's remuneration report in line with agreed timescales. Management continues to look to streamline and enhance the quality of the Annual Report and accounts.

We have built on our relationship with SEPA management during the year and this has ensured an efficient audit process to allow for the audit to be concluded by agreed timescales. In particular we undertook audit work around valuations and income in advance of the year end.

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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, gives you assurance over our opinion.

Through this Annual Report we seek to provide insight and commentary over certain aspects of the Scottish Environment Protection Agency's (SEPA) arrangements, sharing relevant practices with the Audit Committee and Management.

We have continued to build on our working relationship with management and our understanding of SEPA as an organisation. During the year we have worked with management to respond to technical queries around accounting for property, plant and equipment revaluations. We also supported SEPA through a risk presentation to the Board to share our risk management knowledge and understanding with the Board.

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 Board of SEPA. 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 SEPA Audit Committee on 26 June 2018. The report and the final 2017/18 financial statements were taken to the Board meeting on 28 July 2018 and finalised and signed by the Board on the 6 August 2018.

We would like to thank SEPA' 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 **unqualified audit opinion**

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

Status of the audit as at 10 August 2018

Our audit is complete and the final accounts submitted to Audit Scotland and the Scottish Government in accordance with the Audit Scotland planning guidance.

The audit process

We received financial statements including the strategic report, corporate governance statement, and director's 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 Committee and the Board. We identified minor disclosure enhancements and these have been reflected in the financial statements. These included enhancing the disclosure in relation to the non-current assets note to the financial statements as well as narrative contained within the annual report.

Our financial statements audit

Materiality is set at 1.6% of gross revenue based on 2016/17 audited information (£1.38 million). Previous year it was 1% of gross revenue.

The draft financial statements were of a good standard supported through detailed working papers. Management have reduced the volume of narrative within the Annual Report and will continue to look to develop future years' reports to focus on performance, risk and strategic outcomes.

We have issued a true and fair 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 sufficient assurance on all identified areas of significant risks that these were not material misstated in the financial statements 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 Committee on 1 December 2017. As set out in our plan, we have updated our materiality calculations to be based on the unaudited 2017/18 financial statements. Overall materiality has been set at £1.38 million (1.6% of gross income) and performance materiality is set at £1.035 (75% of materiality). We report to management any audit difference identified over £66,900 (Trivial as 5% of materiality).

Audit opinion

Based on our audit procedures performed we have issued an unqualified 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. Performance Report and Accountability report which includes the Corporate Governance Statement, is consistent with the financial statements
- 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 SEPA 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 valuation of injury benefit provisions.
- Undertaken substantive procedures across income and expenditure to reduce the workload on finance staff at the year end.

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 SEPA 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 do 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 Scott-Moncrieff, 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.

There was no significant impact on our audit approach or conclusions from the work performed by internal audit in the year.

Key audit issues

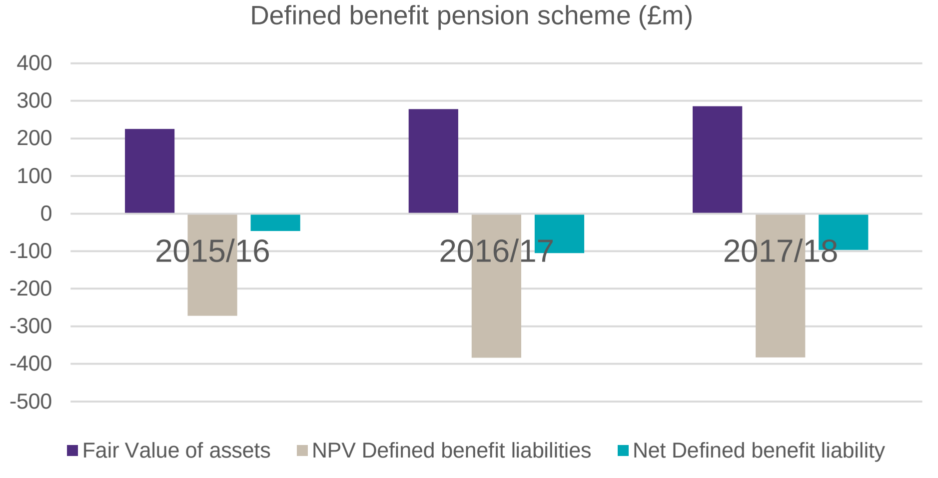
Within our annual external audit plan we identified significant audit risks and our planned approach. We have set out below a summary of the work undertaken over these risks and our audit conclusions

	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 by misstated due to improper recognition of revenue. £44.79 million is generated from income from charging schemes and other sources of income (not gran-in-aid related). We consider the risk to be prevalent around the year end and therefore focus our testing on cut-off of income.	• Developed our understanding of SEPA's 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.
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. We consider the risk to be particularly prevalent around the year end and therefore focus our testing on cut-off of expenditure.	• Developed our understanding of SEPA's 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 form material misstatement. We are satisfied that expenditure has been incurred in accordance with the type/nature of SEPA 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. Override of controls is present in all entities.	• Developed our understanding of the entity level controls in place at SEPA 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.
Valuation of specialised assets	SEPA hold £34.8 million million of assets (PPE). Of these assets a number are specialised in nature e.g. gauging stations; and a vessel. There is a risk that the valuation either under or overstates the asset values reflected in the accounts. There is also a potential risk around impairment.	• We have reviewed the reasonableness of management's judgments and assertions including the use of qualified valuers • We have agreed the valuation recognised in the accounts and agreed to independent valuation reports • Reviewed managements assessment of potential impairment of assets. • Reviewed the classification of PPE to ensure that it is appropriate and in accordance with the FReM.	We are satisfied that the management has taken a reasonable approach to ensure that property, plant and equipment are free from material misstatement. An independent professional valuation of gauging stations, land buildings as well the Vessel was undertaken during the year. We are satisfied that these have been appropriately reflected in the financial statements however work is ongoing to ensure the fixed asset register is updated to record individual asset values.

Other key areas of the financial statements

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

Defined benefit pension scheme: SEPA participates in the Falkirk Council Pension Fund, a local government defined benefit pension scheme. In accordance with IAS 19, SEPA recognises their share of the scheme assets and defined benefit pension liabilities within the financial statements. Hymans Robertson have provided an actuarial valuation of SEPA's pension liabilities. As at 31 March 2018, the defined benefit pension liability was £96.93 million, representing an £8 million reduction in the net liability from 2017. The reduction was primarily due to an increase in the fair value of scheme assets. The net pension obligations continue to be subject to significant volatility, reflecting the variable nature of the underlying assumptions.



We have reviewed the actuarial assumptions applied in the valuation and are satisfied that these are appropriate for SEPA. See further information in Appendix 6.

Narrative elements of your annual accounts

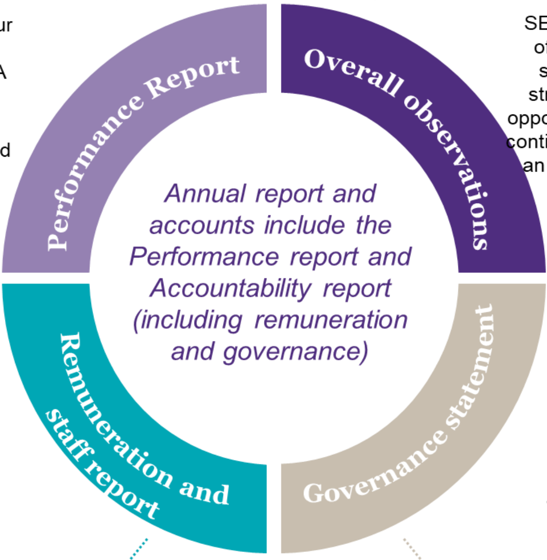
In accordance with our responsibilities we have reviewed your narrative aspects of the Annual Accounts and Report. We have considered the consistency of this narrative with our understanding and the financial statements and have set out our observations below. We have also audited the required information in the remuneration report (marked audited) and have no matters we wish to bring to your attention.

Performance Report

- The accountability report is in line with our understanding of SEPA and in particular the vision and strategic priorities of SEPA
- It defines the organisations purpose and strategy as well as performed
- The report continues to be developed and refined to ensure focus on key strategic performance and there are potentially opportunities to enhance presentation of performance

Overall observations

SEPA continue to look at how the "front end" of the Annual Report and Accounts tells the story of SEPA as an organisation including strategic priorities, risks and challenges and opportunities. There is further opportunities to continue to focus on the outcomes of SEPA as an organisation and continue to make use of graphics as appropriate.



Remuneration and Staff Report

- Report has been prepared in accordance with applicable guidance
- The senior managers reflected in the report have been correctly identified in accordance with FReM

Governance Statement

- As required by the FReM the Governance statement is included in the Accountability report
- No material issues of governance in year that are required to be reported
- The governance statement is in accordance with the FReM
- The statement is supported by individual assurances to the Accountable Officer over internal controls

Management has made progress in reviewing the Performance and Accountability reports, However there are opportunities to enhance the current disclosure to 'tell the story' of SEPA as an organisation including strategic priorities, risks, challenges and opportunities. See the appendix **Follow up Action 2016/17**

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.

Commentary:

SEPA's Accounting policies are in accordance with IFRS as interpreted and adapted by the 2017/18 FReM (where relevant to SEPA) and we consider these to be appropriate to the organisation and consistent with those adopted in prior years.

Accounting estimates and judgements

SEPA significant accounting estimates and judgement impacting on the annual accounts are the following:

- Defined benefit pension assumptions: Management use independent actuarial advice to support assumptions applied in actuarial valuation.
- Expected useful economic lives and valuations of property, plant and equipment, including gauging stations and vessels and intangible assets. Management regularly consider the rapidly changing external environment when assessing useful economic life and valuation, including consideration of the work of independent valuers.. We consider the useful economic lives adopted by management as appropriate.

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 SEPA's cut of arrangements in particular (timing) and identified no issues in accruals, prepayments or provisions which would indicate potential fraud.

There are no post balance sheet events or legal uncertainties at year-end.

Going concern

SEPA has an agreed budget for 2018/19 and a draft Resource Allocation letter from the Scottish Government.

SEPA will continue to receive grant funding to support the provision of regulatory services. The organisation also generates significant proportion of revenue through fees and charges and whilst income generated in the current year was below expectation, management are satisfied that SEPA will continue to meet its obligations as they fall due and that the organisation continues to represent a going concern. We concur with this view.

Financial management

SEPA has efficient and effective financial management arrangements in place. Financial performance information is reported regularly to senior management and the Board and provides clear and concise information on the Board's performance.

SEPA reported net expenditure of the year of £44.385 million (2016/17: £39.966 million).SEPA reported an underspend against Department Expenditure Limit (DEL) of £0.324 million

SEPA continues to operate under a challenging financial environment. Rising pressures on payroll costs coupled with revenue generation being below target means SEPA continues to be significantly reliant on grant-in-aid funding

Financial performance is monitored by senior management and reported on a quarterly basis to the Board. Financial performance reports are clear and concise.

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 SEPA financial performance and financial management arrangements including review of polices 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

SEPA reported net expenditure of the year of £44.385 million (2016/17: £39.966 million). This was £0.407 million more than budget, primarily due to income from fees and services being less than planned. This was partially offset through savings on staff costs through unfilled vacancies and underspends in other operating costs. SEPA reported an underspend against Department Expenditure Limit (DEL) of £0.324 million, being the net underspend against the Scottish Governments grant-in-aid. Due to the impact of IAS 19 pension adjustments and the market reductions on fixed assets, SEPA exceeded the Scottish Government's Annually Managed Expenditure (AME) budget limit of £6.3 million by £2.919 million. These non-cash costs are borne by SEPA.

£44.385 million	• Net expenditure for the year
£66.297 million	• Net liabilities • Represents total assets less total liabilities
£17.138million	• Actuarial gain on pension scheme
£0.324 million	Underspend against DEL

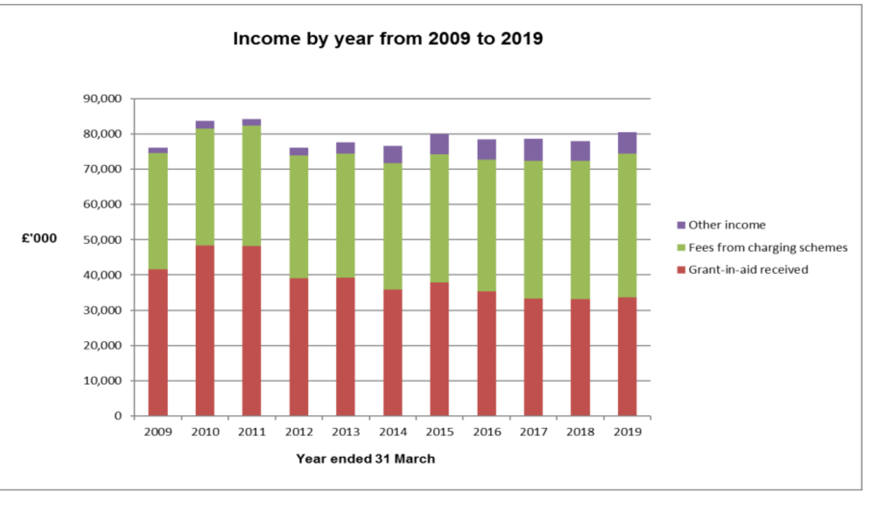
SEPA has net liabilities of £66.297 million on the statement of Financial Position. This reflects the net pension liabilities of £96.932 million. While the organisation continues to have a healthy cash position and service its obligations, the Board recognise they face significant challenges in both maximising revenue generation while ensuring an efficient and effective operating model is in place.

Capital Expenditure

SEPA invested £1.976 million in capital expenditure during the year and reported a small overspend of £6,000 against Capital Resource Limit. The investment primarily related to investment in plan and machinery and is consistent with capital plan.

Delivery in the current year

To support operating costs, SEPA generates funding through three main streams: grant-in-aid funding; fees and charging schemes; and other income including grant funding. The table highlights the general trend of reducing reliance on grant-in-aid.
One of SEPAs most significant cost pressures is payroll costs which attribute to 68% of total operating costs. During 2017/18, SEPA underspent against payroll budgets due to higher level of vacancies than planned .



With rising pressure on payroll and operating costs, as well as envisaged reductions in the level of government funding, it is important that SEPA has an operating model that is financially sustainable over the medium to long term while supporting strategic goals. This is likely to require greater levels of income generation and more focused use of resources ensuring that workforce is in place to deliver operational goals.

Financial management

Financial performance is monitored by management and reported to the Board on a quarterly basis. From our review of the financial reports and Board papers:

- Financial performance reports were clear and concise
- Based on review of Board papers there appears to be challenge and scrutiny of performance in the year and key variances between actual and outturn performance.
- Financial planning process consider wider economic conditions when basing assumptions around level of fees and charges. We note that some of these estimates were overly optimistic, including revenue generation levels. Finance continue to explore reasons for the variations to ensure future forecasts remain robust.

Financial sustainability

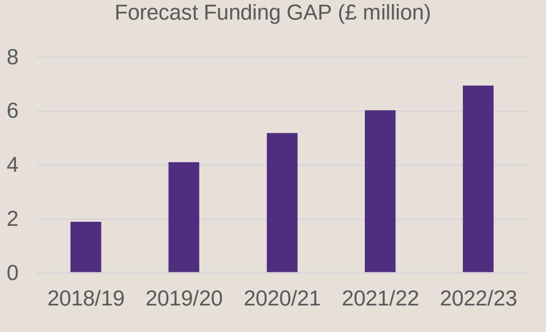
Management are in the process of reassessing financial forecasts and developing a new medium term financial plan. Current financial projections estimate that by 2022/23 SEPA will have a funding gap of £6.93 million.

SEPA recognise that it is critical that resources are prioritised on delivering the organisations key strategic outcomes. The organisation is going through a significant period of transition and internal restructure however we recognise that delivering this at the pace required is a challenge.

We recognise that SEPA have been proactive in considering the potential impact of EU withdrawal on the organisation. While considerable uncertainty still exists, based on our experience, SEPA are further ahead in their arrangements than many other public bodies.

Within our audit plan we identified risk around financial sustainability at SEPA. 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 SEPA longer term financial sustainability. We have outlined below our response to this risk and overall conclusion.

Identified audit risk at planning	Conclusion
SEPA have developed a medium term financial plan which reflects on a number of circumstances, including at which point Grant-in-aid funding reductions would have a direct impact on SEPA activities and SEPA would have to in effect stop providing some services. As well as focusing on how SEPA can operate as efficiently as possible, SEPA are also focused on ensuring they maximise income through the respective charging schemes and recovery of costs of these schemes. Our Response: We discussed financial sustainability with SEPA Management. We reviewed the financial plans in place, including the scenarios set out, the governance of the plans and regular reporting on future financial scenarios.	Management are in the process of reassessing financial forecasts and developing a new medium term financial plan. The financial strategy is one part of a wider planning exercise underway which is considering how SEPA operate and how it will look in the future. This considers the use of the current estate and critically, on the future shape of the workforce. Based on current projections, SEPA have estimates the following funding shortfall over the next five years. This estimates that due to both rising cost pressures as well as limitations on available Scottish Government funding that based on current forecasts by 2022/23 there is a budget gap of over £6.9 million. Management have considered a number of scenarios, particularly around the level of grant-in-aid funding. In the absence of long term budget settlement from the Scottish Government, management have made assumptions on the level of future funding that will be received. The plan identifies that the Board needs to critically assess its operating model.  A critical challenge is efficient and effective use of staffing resource ensuring that this is aligned to the organisations key strategic objectives. The 2017/18 financial position reflected unplanned savings from staff costs from higher than envisaged vacancy levels. Management recognise that this is not a sustainable model or the most effective use of resources and therefore workforce plans play a critical role in supporting the financial plan. Finance, in conjunction with individual services are in the process of refreshing the financial strategy. Given the required levels of funding gaps to address, it is doubtful that these would be achieved through general operating efficiencies. Management acknowledge that more strategic review of what SEPA does and how it generates and prioritises its resources is critical to ensure it remains financially sustainable. Key to this is alignment between strategic, operational and financial plans. It is critical that the organisation can deliver the required changes, including ongoing organisational structures, with sufficient pace to delivery the required levels of savings to support a sound financial platform. **Action plan 1**

EU Withdrawal (Brexit)

SEPA has recognised that impact of EU Withdrawal could have significant implications for the organisation. With its functions and responsibilities being entrenched within legislation, there could be significant consequences from the departure from EU regulations.

Management have been proactive in this area and have established a working group to continue to assess and monitor the potential opportunities and threats from EU withdrawal.

While there remains considerable uncertainty around the extent and implications of the UK's withdrawal from the EU, we recognise that SEPA have made good progress, ahead of many other public bodies, in considering the potential implications of EU withdrawal on the organisation.

Governance and transparency

SEPA has a relatively stable governance structure with the Board and its committees well established. The Board meets regularly during the year and from attendance at audit committee and review of board minutes and papers we can see that there is a good level of scrutiny and debate and challenge.

The Corporate Plan defines SEPA's strategic targets between 2017 and 2022. This defines the organisations vision and the framework in place to deliver it. Delivery of the plan comes at a time of significant financial and operational challenge. It will be key that the organisation focuses resources on key strategic areas.

During our audit planning process no specific governance and transparency risks were identified for 2017/18.

We considered, through discussions with management and review of minutes, SEPA's overarching governance arrangements and how the Service ensure that they are transparent and open to Service's stakeholders including members of the public.

Governance arrangements

SEPA has a relatively stable governance structure with the Board and its committees well established. The Board meets regularly during the year to both set and monitor the delivery of the Board's strategic priorities. We found the level of reporting to the Board and its committees to be appropriate with key performance reports are transparent and reports are aligned to the Boards strategic priorities.

Strategic vision and tone from the top

SEPA's Corporate Plan 2017-2022, articulates the Board's strategic outcomes. The strategy aims to align the organisations regularity role, including compliance and regulation as well as flood risk management. It recognises that the organisation must both support business and partners as well as managing and addressing areas of non-compliance.

The organisation continues to evolve to support the delivery of the strategy as well as changing financial, environmental and technological environment. The organisation has two core services: regulation and flood risk management.

From a regulatory perspective SEPA focus not only on being strong in tackling environmental criminals and non-compliance, but also provide help and support to businesses to meet their legal obligations in an efficient and effective manner. Furthermore, SEPA aims to support and promote businesses move "beyond compliance", providing low carbon, low materials. Low water and low waste operating model. For flood management, SEPA continue to play a key role in flood risk management through flood forecasting and warning as well as promoting preventative action to protect vulnerable people and communities at risk of flooding.

To deliver against the multi-facetted strategy, it is critical that SEPA maximise its use of resources, including people and technology. The Corporate Strategy is underpinned by a range of supporting strategies including the people and finance strategies. The "Our People Strategy" outlines how SEPA will ensure it has a skilled capable workforce to meet its strategic challenges and this is underpinned through workforce plans.

The organisation clearly acknowledges the challenges it faces. The Corporate Strategy, supporting strategies and plans articulate the organisation's vision and where it sees itself by 2022. It is important that these are viewed as live documents which continue to evolve in response to the organisations strategic challenges and priorities.

Risk management

SEPA has good arrangements for the identification and management of key strategic risks facing the organisation. SEPA has in place a Risk Management Group to direct and oversee the management of risks across the organisation. This includes scrutiny of the corporate risk register as well as overview of portfolio risk registers On a half yearly basis, the Group reports to the Audit Committee on risks and annually to the Board. This ensures that there is strategic overview and scrutiny of risks.

Fraud and Irregularity

SEPA has arrangements in place to help prevent, detect and mitigate the risk of fraud or irregularity, including anti-bribery and whistleblowing policies. While we consider these to be reasonable, no arrangements can fully prevent against the risk of fraud, theft or irregularity. We are not aware of any material frauds at SEPA during the course of the year and have confirmed this with management.

SEPA participates in the National Fraud Initiative (NFI), 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 exercise during 2017/18 to be satisfactory. The Board has effective arrangements in place for the submission of data and investigation of potential matches.

Transparency

SEPA demonstrate committed to clear and transparent public reporting. SEPA Board minutes and supporting papers are published online as well as a range of corporate publications detailing the agency's underlying performance and activities.

Value for money

SEPA has an established performance management framework an there is ongoing monitoring and scrutiny across management and the Board. SEPA continues to face challenges in meeting its performance targets, failing to deliver 6 out of the 18 corporate targets. There are opportunities to enhance operational performance monitoring through the use of more outcome focused measures.

In line with plan, SEPA successfully recovered 97% of costs in administering fees and charges (in line with target). This continues to be a critical area for the organisation to ensure financial viability in undertaking statutory responsibilities.

During our audit planning we identified a risk around SEPAs performance management arrangements. We conclude on our assessment of the risk below as well as our wider consideration of SEPA's wider arrangements for securing value for money

Identified audit risk at planning

SEPA has a number of overarching strategies including the Corporate Plan, the annual operating plan and the People Strategy. These are focused on delivering key performance measures which report on the outcomes of SEPA as an organisation, including the impact of SEPA as a regulator.

Our Response: We considered SEPA's performance management framework and how they capture and measure performance and outcomes. We also considered progress against the key strategic corporate plans and how this is being reported and monitored.

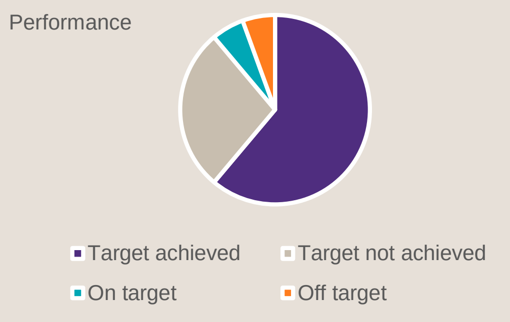
Conclusion

SEPA has an established framework for setting performance targets and monitoring progress against these and the organisation's corporate plan. The performance information aims to ensure strategic outcomes and targets flow through to annual operating planning process and subsequently operational delivery measures.

18 corporate performance indicators have been identified and these are monitored both by senior management and then formerly on a quarterly basis by the Board. With the range of activities the depth of performance information to support the indicators can vary and there are certain measures where performance is measured against indicators rather than an explicit target. Overall, the measures align to operational plan targets and subsequently supporting the assessment of progress towards strategic outcomes. There are opportunities to enhance the measures. Critically, these could be more outcome focused and less measures of SEPA input activity. This may require a degree of judgement as a lot of the overall measures of the 'success' of SEPA will require stakeholders to deliver. However these may be more informative measures of the success of SEPA policy, strategy and delivery rather than just the extent to which how effectively the organisation is working operationally.

SEPA continues to face challenges in meeting its performance targets. The following table summarises the annual performance against the 18 outcomes during the year.

During 2017/18 SEPA failed to deliver or is off target in delivering over 33% (6) of the Corporate Performance targets. While progress has been made by the organisation in year against the Corporate Plan, there are clearer opportunities to enhance performance delivery.



Operationally, management utilise a suite of performance information through the Agresso tool to highlight areas of focus including financial performance and operational workforce Issues such as annual leave levels or sickness absence.

Action plan 2

Charging schemes

During 2017/18 SEPA earned more than £39 million in fees and charges through statutory charging schemes. Underpinning the organisations financial performance is ensuring that the costs of recovering these are carefully managed. The Board has a corporate performance indicator of a 97% recovery of costs administering these fees and charges in the year. SEPA met this target in year.

Appendices

Audit adjustments

Uncorrected and corrected misstatements

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

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. There were no material/significant disclosure misstatements identified we wish to bring to your attention. Minor changes included:

- Disclosure adjustments to financial statements including disclosure of property, plant and equipment and intangible asset notes;
- Financial statements disclosure requirements in accordance with the FReM and applicable legislation; and
- enhancing the disclosure in relation to the narrative contained within the annual report to provide greater focus on ‘telling the story’ of the organisation during the year.

Action plan 2017/18 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 SEPA 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
Financial sustainability SEPA are in the process of refreshing the financial strategy to reflect the changing financial and operating environment. Initial forecasts indicate that there are significant funding gaps over the next five years. Management acknowledge that more strategic review of what SEPA does and how it generates and prioritises its resources is critical to ensure it remains financially sustainable. Key to this is alignment between strategic, operational and financial plans ensuring that resources is aligned to strategically important areas. It is critical that the organisation can deliver the required changes, including ongoing organisational structures, with sufficient pace to delivery the required levels of savings to support a sound financial platform	**Management response:** A refreshed high level forward financial strategy will be prepared by the end of July 2018 with a view to presenting it to AMT in August / September . This will inform further debate on our scenario plans and our deliberations on how we can ensure that SEPA manages its expenditure to operate within available funding. This work will link into the longer-term workforce planning exercise planned for this year, it will also incorporate a review of efficiency targets, commercial services future income streams, our pricing strategy for charge schemes activities and other income. **Action owner:** Chief Officer Finance **Timescale for implementation:** March 2019
Corporate performance While SEPA made progress against its operational plan during the year, there were a number of areas where the Agency's performance is behind target. This includes environmental, regulatory as well as organisational wide objectives. Management recognise that work is required to address these issues. From assessment of the performance indicators, while there is a wealth of information to support these, these could be more outcome focused and less measures of SEPA input activity. This may require a degree of judgement as a lot of the overall measures of the 'success' of SEPA will require stakeholders to deliver. However these may be more informative measures of the success of SEPA policy, strategy and delivery rather than just the extent to which how effectively the organisation is working operationally.	**Management response:** We recognise the need to develop measures that are more informative of the success of SEPA's strategy. When the Board set our ambitious strategic direction in our 2017-2022 Corporate Plan we agreed with the Board that we would have activity-focused transitional targets as opposed to outcome-focused measures. This is because it will only be when our new approaches are embedded that we will be able to understand what can be achieved in practice by way of outcomes. We are still following that approach to performance measures and agree each year's performance measures with the Board. When we have more sector plans up and running, we will be able to move to more outcome focused measures. Action owner: Chief Officer Innovation and Performance **Timescale for implementation:** Our performance measures are agreed with the Board annually as part of the Annual Operating Plan

Follow up of 2016/17 External Audit Recommendations	Action as at May 2018
Audit Process 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.	**Complete** Following a lessons learned meeting in July 2017, for the current years audit we undertook the following steps to support an effective audit process: - Issues a 'Prepared by client' list of deliverables to support the audit - Had early engagement with Finance to agree approach to the revaluation of property, plant and equipment. These steps, coupled with our increased knowledge and understanding of the organisation and Finance's understanding of our audit approach resulted in a significant improvement to the audit process.
Employee claims Management should continue to progress the job evaluation process and adjust the accrual as required.	**Complete** Management regularly reviewed the accrual throughout the financial year to determine if it was still required and the appropriate level on which it should be set based on forecast costs at the balance sheet date. Satisfied that the year end position is free from material misstatement.
Asset valuations In accordance with the FReM the vessels and gauging stations held by SEPA should be subject to a full valuation in 2017/18.	**Complete** In early 2018 audit met with SEPA Finance team to agree suitable approach to the valuation of property, plant and equipment during the year. Management engaged an independent valuer to value the gauging stations. This included a representative sample of the stations and applied across the total population. Material vessels held were revalued however the difference between valued amount and carrying valued was below our trivial amount and no valuation was applied.
Performance and Accountability Reports The Performance and Accountability reports should be reviewed by Management during 2017/18 using available guidance including the Audit Scotland best practice guide.	**Complete** To support the annual report and accounts preparation process, Finance reviewed the requirements of the FReM and other applicable guidance. While we found that there continues to be opportunities to refine and enhance the reporting arrangements, there were not fundamental gaps in the reporting arrangements.

Follow up of 2016/17 External Audit Recommendations	Action as at May 2018
Annual Report 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.	**Partially complete** Management reviewed the format and content of the annual report to ensure that it continued to be clear and concise for the user of the accounts. The volume of information presented has been significantly reduced and there is a greater focus on reporting on key strategic messages. Management acknowledge there are opportunities to continue to enhance the annual report and will continue to look to develop the report over the coming years to remain focused while continuing to meet statutory reporting requirements.
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 unchallenged and / or money is not always directed to the areas of greater benefit.	**Complete** Management are in the process of refreshing the financial strategy and supporting financial plans. As part of this process, Finance and been working closely with Portfolios to develop a sound understanding of pressures and financial requirements. There continues to be areas of uncertainty where estimates are used, such as forecast revenue through fees and charges as well as workforce costs.
Long 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 out with SEPA's direct control. 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.	**Superseded** Management are in the process of refreshing their medium to longer term financial strategy. This will need to supplement and inform existing strategies. We have raised a recommendation covering this action above.

Fees, independence, fraud arrangements

External Audit Fee

Service	Fees £
External Auditor Remuneration	39,490
Pooled Costs	9,610
Contribution to Audit Scotland costs	2,420
Contribution to Performance Audit and Best Value	0
2017-18 Fee	**51,520**

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 £51,520.

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 SEPA.

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 SEPA 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 SEPA’s 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 SEPA 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 SEPA's financial statements:

International Financial Reporting Standard16: *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 lessees 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.

Defined benefit pension scheme assumptions

SEPA participates in the Falkirk Council Pension Fund, a local government defined benefit pension scheme. In accordance with **IAS 19: *Employee Benefits***, SEPA recognise its share of the scheme assets and liabilities. This is informed through an annual actuarial valuation.

As at 31 March 2018, the defined benefit pension liability was £96.932 million, representing an £8 million reduction in the net liability from 2017.

Key assumptions

The actuarial valuation is an area of significant judgement and estimation within the financial statements. SEPA, using advice from the actuary agree assumptions used within the valuation. As part of our annual audit process we consider the reasonableness of the assumptions applied. To support our assessment, Audit Scotland commissioned PricewaterhouseCoopers (PwC) to undertake an assessment of the work performed, including assumptions adopted, across of local government pension fund actuarial valuations. We have used this assessment to support our own analysis of the assumptions applied locally by SEPA.

Assumption	Commentary	Within Acceptable Range
Pension increases SEPA rate: 2.4%	• While dependent on duration, 2.4% has been applied across most employers being equal to RPI less 1%.	✓
Salary increases SEPA rate: 2.9%	• This is set based on local scheme, employer specific rates. Generally across employers set on basis of RPI plus adjustment for local factors. Based on longer term forecast rates and not inconsistent with SEPA or other Falkirk Council Pension Fund participants	✓
Discount rate SEPA rate: 2.7%	• The rate used to reflect the time value of money and characteristics of the defined benefit liability • General range adopted by Hymans Robertson 2.6% to 2.7% and therefore SEPA sit at the more optimistic end of acceptable range	✓
Mortality assumptions	• Hymans Robertson apply a 'Club Vita' model to provide a tailored mortality rate. • For male and female (current and future pensioners) the actuarial life expectancy is at the lower range of acceptable rates.	✓

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 SEPA 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 SEPA 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 SEPA Management and the Audit Committee.

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