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 2019

Final Report

Joanne Brown
Engagement Leader

John Boyd
Senior Manager

David Lochran
Audit Executive

Our audit at a glance – financial statements

We have fulfilled our responsibilities per International Standards of Auditing (ISAs) (UK) and the Audit Scotland Code of Audit Practice For the financial year ended 31 March 2019 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)

As outlined in our annual audit plan, our year end audit materiality was updated to reflect the draft 2018/19 financial results. Materiality was set at £1.469 million, representing 1.6% of gross expenditure.

An audit underpinned by quality

We have performed 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 assets. We are satisfied that these have been correctly reflected in the annual report and accounts.

We received the financial statements including the strategic report, corporate governance statement, and director's remuneration report in line with agreed timescales. Management continue 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.

Our audit at a glance – wider scope dimensions

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.

Management are in the process of reassessing financial forecasts and developing a new medium term financial plan. Current financial projections estimate that by 2023/24 there is a budget gap of over £12.7 million.

Wider scope audit dimensions

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 5 out of the 15 corporate targets. There are opportunities to enhance operational performance monitoring through the use of more outcome focused measures.

SEPAs 2019/20 financial plan forecasts an operating surplus of £2 million to support capital investment. The delivery of this will require SEPA to deliver savings of £3.533 million, primarily through staff costs. While financial planning assumptions appear reasonable, the delivery of these will be challenging for SEPA.

While we recognise SEPA focus on budget performance, it is important that there is continued focus on meeting Scottish Government funding limits.

Contents

Introduction

This report is a summary of our findings from our external audit work for the financial year ended 31 March 2019.

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.

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

Our report was presented as a progress update to the SEPA Audit Committee on 25 June 2019. The final 2018/19 financial statements were approved by the Board on 30 July 2019 and signed by the Chief Executive and Accountable Officer on the 19 August 2019. We have subsequently finalised this report and submitted to the SEPA Board and the Auditor General for Scotland.

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:

Our Opinion

For the financial year ended 31 March 2019 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)

Financial statements

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.

The audit process

We identified no unadjusted differences to report to the Audit Committee and the Board. There was one adjustment to the draft financial statements with regards an increase in defined benefit pension scheme liabilities following a court ruling on defined benefit pension schemes (details in appendix 1). We identified certain 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

As outlined in our annual audit plan, our year end audit materiality was updated to reflect the draft 2018/19 financial results. Materiality was set at £1.469 million, representing 1.6% of gross expenditure.

The draft financial statements were of a good standard supported through detailed working papers. We raised a number of disclosure adjustments to the financial statements to enhance users understanding of the accounts

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 assurance on identified areas of significant risks that these were not materially 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 in December 2018. As set out in our plan, our materiality calculations were based on the audited 2017/18 financial statements. These have been updated to reflect the draft 2018/19 financial statements. Consistent with the plan, we have used gross operating expenditure as the materiality benchmark. Overall materiality has been set at £1.469 million (1.6% of gross expenditure) and performance materiality is set at £1.1 million (75% of materiality). We report to management any audit difference identified over £74,000 (Trivial as 5% of materiality).

The draft financial statements were of a good standard supported through detailed working papers. The Audit process went well with timely completion of our audit procedures and early discussion around technical issues, including valuation of specialist assets.

Audit opinion

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

- give a true and fair view in accordance with sections (1) and (2) of the Environment Act 1995 and directions made thereunder by the Scottish Ministers of the state of the affairs of SEPA as at 31 March 2019 and of the net expenditure for the year then ended;
- have been properly prepared in accordance with IFRSs as adopted by the European Union, as interpreted and adapted by the 2018/19 FReM;
- have been prepared in accordance with the requirements of sections (1) and (2) of the Environment Act 1995 and directions made thereunder by the Scottish Ministers.
- the wider information contained in the financial statements, e.g. Performance Report and 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 property, plant and equipment.
- 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 2018/19. 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 our conclusions from the work performed by internal audit in the year.

Key audit issues

Responding to significant risks

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. SEPA anticipates grant in aid funding from the Scottish Government of £36.6 million. We consider this transaction stream to be well forecast and agreeable to third party confirmation and therefore rebut the presumed risk of improper recognition. SEPA's main revenue comes from charging schemes. The annual financial plan forecasts revenue of £40.7 million from these streams. In addition, SEPA generates approximately £6.2 million from other operating activities. SEPA's financial performance is measured through its outturn position at year end. We consider the risk to be prevalent around the year end where there is greatest incentive and opportunity for manipulation and therefore focus our testing on existence of debtor balances at the year end and cut-off i.e. overstatement of income transactions at the year end.	• Developed our understanding of SEPA's material revenue streams including walkthrough of key transactions. • Performing revenue cut off procedures and substantive testing over pre year end transactions to gain reasonable assurance that these had been recognised in the correct financial year. • Testing the existence and recoverability of balances at the year end through sample testing of debtor balances at the year end to gain assurance	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. As payroll expenditure is well forecast and agreeable to underlying payroll systems there is less opportunity for the risk of misstatement in this expenditure stream. We therefore focus on non-pay expenditure. We consider the risk to be particularly prevalent around the year end and therefore focus our testing on cut-off of non-pay 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. We have a particular focus on transactions recorded in April 2019 to ensure these did not relate to 2018/19. 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 including accruals and provisions • 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 £22.993 million of assets (PPE). Of these assets a number are specialised in nature e.g. gauging stations; and vessels. Given the specialist nature of the assets valued and volume of individual assets, 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 PPE is free from material misstatement. For land and buildings, these have been subject to revaluation in the year and we have agreed the amounts recorded in the financial statements to the independent valuation report and challenged Management and the Valuer on valuation movements out with our expectation, being the average movement in PPE. We have confirmed that the basis of valuation is consistent with the FReM. For gauging stations, we have reviewed Management's approach to applying indexation to these assets and have confirmed that the rates applied are appropriate through reference to an independent source of applicable indices.

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. Whilst not considered a significant risk, these are areas of increased risk due to their complexity or magnitude. This includes areas of key estimation and judgement and application of accounting policies.

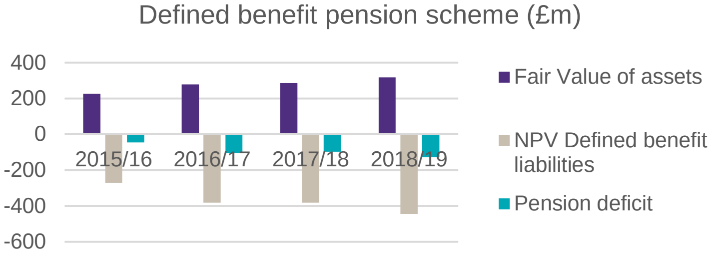
Commentary:

SEPA accounting policies are in accordance with IFRS as interpreted and adapted by the FReM and we consider these to be appropriate to the organisation. These have been applied consistently to the previous year with the exception of the adoption of two new accounting standards IFRS 9: *Financial Instruments* and IFRS 15: *Revenue from contracts with customers*. The primary impact on the financial statements was in relation to classification of income which has resulted in the prior period income classification being restated but did not impact on total income recognised.

Accounting estimates and judgements:

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

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 2019, the defined benefit pension deficit within the draft financial statements was £128.297 million, representing a £31.365 million increase in the net liability from 2018. The increase was primarily due to the impact of changes in financial assumptions used to estimate scheme liabilities. The pension deficit continues 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 appendix 6).

In December 2018, the Court of Appeal ruled that the transitional protection offered to some members of public sector pension schemes as part of reforms to those schemes amounts to unlawful discrimination ("McCloud/Sargeant"). This ruling was subject to potential right to appeal from the UK Government, leading the Pension Fund to exclude any potential impact from the IAS 19 valuation included in the draft accounts. On 27 June 2019, the Supreme Court ruled that the government had not raised an arguable point of law, the court of appeal ruling was upheld. Consequently, given the increased certainty around future economic output arising from the ruling, the McCloud/Sargeant Case should be incorporated into the IAS 19 valuation.

As the initial IAS 19 valuation included within the draft accounts did not incorporate the impact of the McCloud/Sargeant case, Management have obtained a revised IAS 19 valuation from the scheme's actuary, this included revisiting asset values as at 31 March 2019. This valuation increased the net liability reported above by £4.380 million (Appendix 1).

We are satisfied that, following the adjustment, SEPA has appropriately disclosed its share of the defined benefit pension schemes assets and liabilities within the financial statements in accordance with IAS 19. There remains some uncertainty around the final arrangements for meeting the McCloud obligations and we recommend that Management engage with the FPF and actuaries during to ensure SEPA maintain an accurate understanding of pension liabilities.

Action plan point 1

Other key accounting issues:

SEPA holds £4.74 million of leasehold improvements, being capital expenditure on premises SEPA utilise through an operating lease arrangement. While the lease agreements differ, there are clauses contained within the lease agreements that require SEPA to return the property to its condition at the start of the lease. Given the level of investment in the properties to date, as well as the outstanding lease term, SEPA do not consider the present value of any future obligations to be significant. However, it is critical that this is kept under review to ensure the Board recognise obligations in a timely manner. To obtain a reasonable estimate of the cost of any future obligation, it is likely the Board will need support from a professional valuer.

IFRS 16: *Leases*, is due to be adopted by the FReM and effective from the financial year 2020/21. The standard no longer differentiates between finance and operating leases. Under the standard, a number of operating lease arrangements will need to be recognised on SEPA's statement of financial position, recognising both the leased asset and liability. Under the arrangement, it is anticipated that a number of the properties currently leased under operating leases will need to be recognised as property, plant and equipment within SEPA's financial statements. This will require an independent valuation to ensure that these are recorded at fair value within the accounts. As Management engage with independent valuers to support that valuation of PPE, we recommend that they consider any potential future obligations under leases and obtain an independent valuation of the present value of any future obligations and provide for these in future financial statements.

Action plan point 2

Fraud and irregularity

Management have confirmed that there were no material fraud or irregularity during 2018/19. Our audit procedures throughout the course of the audit have not identified any indication of fraud or irregularity.

Post balance sheet events

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

Going concern

SEPA has an agreed budget for 2019/20 and a Resource Allocation letter from the Scottish Government.

SEPA's statement of financial position continues to report significant net liabilities of £102 million. However, this was primarily due to £132 million pension liabilities and the underlying income and expenditure reserve balance is £30 million. The pension liabilities represent longer term liabilities for which SEPA as an admitted body to the pension scheme makes employer contributions towards the deficit. These are agreed in the triennial valuation and SEPA are satisfied that it continues to have sufficient resources to meet these obligations as they fall due.

SEPA has received confirmation of funding for 2019/20 from the Scottish government and Management have no concerns that the organisation won't 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.

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 performance report provides information on SEPA's financial and non-financial performance during the year.

Management have continued to develop the report to incorporate graphics and visuals to demonstrate performance. There are opportunities to continue to develop the Performance report to provide a more focused assessment of SEPA's performance during the year.

The Accountability report is in line with our understanding of SEPA. In particular, the vision and priorities of the organisation.

Overall observations

SEPA's "front end" of the annual report and accounts have been prepared in accordance with the requirements of the FReM as well as Accounts Direction.

Management will continue to look to develop the annual reporting each year.

Annual Report and accounts

Remuneration and staff report

The Remuneration and Staff Report has been properly prepared in accordance with sections (1) and (2) of the Environment Act 1995 and directions made thereunder by the Scottish Ministers.

The disclosures in the Remuneration and Staff report are consistent with underlying payroll records.

Governance statement

All key information required by the FReM has been included within the Governance Statement.

No material issues of governance in the year have been required to be disclosed.

None of the information continued within the statement is inconsistent with our audit knowledge and understanding of SEPA

Adding value through our external audit work

Our overall 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 SEPA's arrangements, sharing relevant practices with the Audit Committee and Management.

During 2018/19, we have added value through our audit work and engagement through the following arrangements:

- Audit Engagement Lead / Senior Manager attendance at Audit Committee meetings throughout the year to provide insight and challenge across the financial year
- Early engagement, interaction with Management, and audit testing over new or emerging technical accounting issue or standards including IFRS 15 and IFRS 9 as well as early discussion and agreement on approach for valuing specialist assets
- Engagement Lead meetings with the Chief Officer Finance during the financial year to develop our knowledge and understanding of the organisation and support our wider scope audit work.

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 information on the Board's performance.

SEPA reported net expenditure of the year of £49.054 million (2017/18: £44.385 million). SEPA reported an underspend against Department Expenditure Limit (DEL) of £0.259 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 It is important that SEPA continue to maintain a focus on Scottish Government funding targets and operate within these funding boundaries.

During our audit planning process, no specific financial management risks were identified for 2018/19. 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.

Financial Performance

SEPA reported net expenditure of the year of £49.054 million (2017/18: £44.385 million). Due to the impact of IAS 19 pension adjustments (actuarial losses on the pension scheme of £22.883 million), and the loss on the valuation of property, plant and equipment of £0.436 million, SEPA reported comprehensive next expenditure of £72.373 million (2017/18: £ 27.077 million). The outturn position against the Scottish Government's Departmental Expenditure Limit (DEL) was an underspend of £0.259 million. Against allocated Annually Managed Expenditure (AME) budget limit SEPA reported an overspend £6.187 million, due to IAS 19 pension charges being higher than forecast.

£49.054 million	• Net expenditure for the year
£102 million	• Net liabilities • Represents total assets less total liabilities
£22.883 million	• Actuarial loss on pension scheme
£0.259 million	• Underspend against DEL

SEPA has net liabilities of £102.383 million (2017/18: £66.297 million) on the statement of Financial Position. This reflects the net pension liabilities of £132.677 million. While the organisation continues to have a positive 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. Furthermore, the IAS 19 pension liabilities continue to represent a long term financial challenge for SEPA.

Capital Expenditure

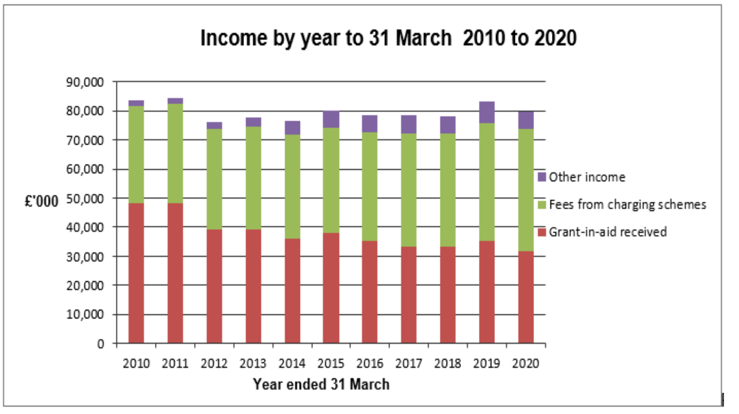
SEPA invested £1.756 million in capital expenditure during the year and reported a small overspend of £0.07m against Capital DEL, which was offset against the underspend on Operating DEL ££0.33m. The investment primarily related to investment in plan and machinery and is consistent with capital plan.

Performance against Annual Operating Plan

At the start of the financial year, SEPA set an annual financial plan, a key part of the organisations annual operating plan. Within the plan, SEPA had forecast income, including Grant in Aid Income, of £82.58 million and expenditure of £80.96 million. During 2018/19, the Scottish Government provided an additional £2.3 million for additional services and depreciation funding. SEPA also generated an additional £1.4 million of income from operating activities. The overall net operating outturn position of £2.5 million was £0.886 million ahead of the annual operating plan. The impairment charges and the impact of IAS 19 movements, at 31 March resulted in outturn position against Annually Managed Expenditure (AME) resource budget being overspent by £6.187 million.

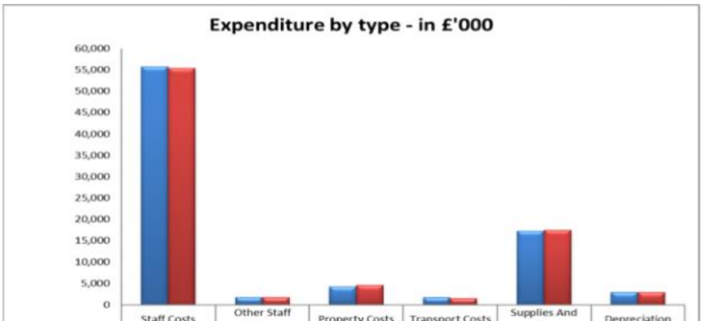
Delivery in the current year

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.



SEPA has gradually moved towards generating the majority of revenue from fees and charges and other income sources and less around Scottish Government Grant in aid funding and this trend is expected to continue into 2020.

Overall income for 2018/19 was higher than initial budget as grant in aid funding was increased for in year activities including flood warning protection and EU activities.



	Staff Costs	Other Staff Costs	Property Costs	Transport Costs	Supplies And Services	Depreciation
Outturn	55,764	1,861	4,268	1,789	17,171	2,959
Annual Budget	55,418	1,832	4,671	1,604	17,406	3,011

SEPA main area of expenditure continues to be staff costs. During 2018/19 costs were slightly higher than budgeted staff costs primarily through overtime and costs for staff on standby of £205,000. Other areas of expenditure were in in line with or below budget. In particular, supplies and services annual budget which includes a contingency spend was not fully utilised during the year as overruns did not materialise. In addition, property costs were £0.4 million lower than budget, primarily through lower rent and rates charges and property maintenance costs.

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. It is important that SEPA continue to maintain a focus on Scottish Government funding targets and operate within these funding boundaries.

Financial management and capacity

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 and committee 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 these estimates were overly optimistic and Finance continue to explore reasons for the variations

SEPA has an experienced finance team to support both financial planning and financial management.

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 2023/24 there is a budget gap of over £12.7 million.

SEPA recognise that it is critical that resources are prioritised on delivering the organisations key strategic outcomes. Given that 65-70% of operating expenditure is staff costs, it is critical that SEPA develop robust workforce plans to ensure staffing resources are used efficiently and effectively as possible to deliver corporate objectives in a financially sustainable operating model.

SEPA's 2019/20 financial plan forecasts and operating surplus of £2 million. The delivery of this will require SEPA to deliver savings of £3.533 million, primarily through staff costs. While financial planning assumptions appear reasonable, the delivery of these will be challenging for SEPA.

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

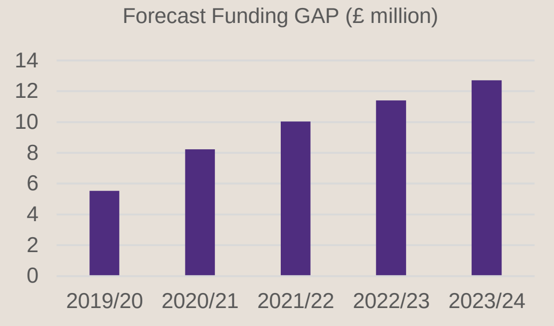
With rising pressure on payroll and operating costs, as well as envisaged reductions in the level of government funding, it is important that SEPA has an operating model that is financially sustainable over the medium to long term while supporting strategic goals. This is likely to require greater levels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

Our Response: We have reviewed the financial plans in place, including scenario plans set out by management, the governance of the plans and regular reporting on future financial scenarios. We assessed the extent to which savings are identified and delivered while ensuring that the organisation maintains the skills and experience within its workforce to deliver its corporate objectives.

Conclusion

In February 2019, SEPA approved the draft budget for 2019/20 and medium term financial forecasts to 2024. 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 2023/24 there is a budget gap of over £12.7 million. This represents approximately 15% of SEPAs total forecast income.

Management have considered a number of scenarios, particularly around the level of grant-in-aid funding. For 2019/20, Management have developed detailed proposals to meet the funding gap. However, over the longer term, SEPA face more significant challenges to deliver a financially sustainable operating mode.



With limited capacity to bridge the funding gap through additional revenue support, a key area of focus for SEPA is in managing cost pressures. As between 65 – 70% of SEPAs operating costs are staff costs, a critical challenge is efficient and effective use of staffing resource ensuring that this is aligned to the organisations key strategic objectives. As noted below, for 2019/20, Management has forecast significant cost savings through vacancy management and staff turnover to achieve financial balance. However, a significant element of this is non-recurring, savings and a more strategic outlook is required for longer term savings.

Pivotal to long term financial sustainability will have an efficient and affective workforce, designed and focused on delivering SEPA's corporate priorities. Therefore, a clear and concise workforce plan and strategy are required to support the delivery of a an operating model that both supports the delivery of strategic goals, but does so in a financially sustainable way. Due to the volume of work between the restructuring of portfolios and devising sector plans, the preparation of workforce plans have been put on hold. It is critical that these are taken forward as a matter of urgency.

Action plan point 3

Financial planning 2019/20

The financial plan for 2019/20 has been set in the context of medium-term financial challenges. The initial financial forecast in February 2019 projected that SEPA required in year savings requirement of £5.533 million to meet financial targets. The final approved budget in March, projected a targeted surplus of £2 million, incorporating savings initiatives of £3.533 million to achieve this (£2.343 million in staff costs and £1.19 million in non-staff costs).

We consider the key assumptions below:

Key assumption	Budget £ million	Considered reasonable	Comment
Grant-in-aid income	36.562	✓	Budgeted Grant in Aid has been agreed to 2019/20 grant funding letter for the year.
Charging schemes	41.955	✓	Environment Regulation Scotland Scheme fees for 2019/20 are increased by RPI at 30 September 2018 by 3.27% as approved by Scottish Government. The financial plan assumes that 2018/19 forecast volume of applications and subsistence fees is generated in 2019/20. We do not consider the planning assumptions to be unreasonable. Management are aware that charging schemes can have consequential impact on service users behaviours including levels of licencing and this is an area kept under focus to ensure balance between charges uplift and income generated.
Other income	6.001	✓	Other income includes a range of income from commercial services. The assumed level of income is consistent with previous years (£6 million) and considered to be a reasonable estimation for 2019/20.
Staff costs	(57.140)	**Challenging**	SEPA has incorporated the Scottish Government pay policy (published December 2018) recommendations within planning assumptions. To meet the original forecast overspend of £5.533 million, SEPA have reduced 17 vacancies, generating a recurring saving of £0.889 million. In addition, SEPA forecast a net saving of £3.454 million through staff turnover and unfilled vacancies. However, this is on a non-recurring basis. The delivery of the level of savings required through staff costs will represent a significant challenge. Balancing operational demand while managing within resource constraints could create significant pressures on the organisation.
Third party costs & other costs	(25.378)	✓	This includes supplies and services costs of £14.864 million. The assumed level of expenditure is broadly consistent with previous years with inflationary uplifts. The plan includes planned cost reductions of £1.19 million on a recurring basis While there can be unplanned costs through adhoc activity, the financial plan includes a contingency of £500,000 to meet these unplanned costs or overspends. The planning assumptions in this forecast appear reasonable.
Forecast surplus / (deficit)	**2.000**		**Planned surplus to support capital investment.**

Financial plans are in place at SEPA for 2019/20. There are a number of operational challenges where delivery of the financial plan will be challenging due to the nature of the costs incurred. SEPA continue to monitor these forecasts to ensure that they continue to be appropriate. A key area of focus to meet financial targets for the year will be cost control, in particular workforce costs. In addition, for charging schemes and commercial income it will be critical that these are kept under regular review to ensure timely identification of potential shortfalls in revenue.

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.

SEPA recognises the need to work with key strategic partners to deliver its Corporate Plan. SEPA has been developing sector plans with key partners across regulated sectors. Through these plans SEPA develop an understanding of the ambitions of the sector and find ways to facilitate growth in ways that provides for effective environmental protection and improvement.

During our audit planning process no specific governance and transparency risks were identified for 2018/19.

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.

Partnership working

SEPA recognises the need to work with key strategic partners to deliver its Corporate Plan.
SEPA has been developing sector plans with key partners across regulated sectors. Through these plans SEPA develop an understanding of the ambitions of the sector and find ways to facilitate growth in ways that provides for effective environmental protection and improvement. Sector plans aim to identify ways to tackle outstanding compliance issues and will where there are opportunities for innovation enabling better environmental outcomes as the sector develops. This will include social issues such as recognising the importance of creating local jobs in rural communities and any issues that non-compliance is creating in the communities the sector is operating in. Twelve plans were opened for consultation during 2018/19 with one plan (Whisky) published during the year:

- Chemicals manufacturing
- Crop production
- Dairy processing
- Dairy production
- Housing
- Leather
- Nuclear power generation and decommissioning
- Strategic infrastructure (transport and utilities)
- Water supply and waste water
- Oil and gas decommissioning
- Tyres
- Forestry

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 2018/19 to be satisfactory. The NFI exercise identified 389 matches relating to SEPA of which 7 (1.7%) were recommended for investigation (high risk). As at June 2019, SEPA had investigated all recommended higher risk matches with no instances of fraud or error identified and had substantially completed investigation of other matches for which no issues had been identified. The Board has effective arrangements in place for the submission of data and investigation of potential matches.

Openness and transparency

There is an increased focus on how public money is used and what is achieved. This includes the extent to which SEPA keeps pace with public expectations and good practices in this area. Including: increased public availability of papers, insight into why any business is conducted in private and development of the form and content of annual reporting.

The focus on public entities performance reporting will be under increasing security, including that of SEPA and how public funds are used. We have considered the extent to which the performance report provides an accessible account of SEPA's overall performance and impact of its public spending and transparency of reporting.

SEPA publishes minutes of Board meetings and supporting papers on the website as well as key corporate publications, including the corporate plan. While some information, including financial information is redacted due to commercial sensitivity, SEPA has transparent reporting around governance decisions and performance.

EU Withdrawal

There is considerable uncertainty around the potential impact of Brexit. Likely areas to impact the SEPA are: workforce implications; funding; and regulation. We have used Audit Scotland's planning guidance to evaluate the Board's readiness for EU withdrawal across workforce (People and Skills); Finance; and Regulations.

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.

Overall, we conclude that SEPA demonstrates a good level of preparation for EU Withdrawal. We conclude that SEPA is well prepared for the implications of EU Withdrawal. Management recognise that there remains considerable risk and uncertainty around the full potential implications. However, Management keep these under continuous focus.

Changing the landscape for public financial management

Recognising the changing landscape of Scottish public finances, including significant tax –raising powers as well responsibility for 11 social security benefits provides the Scottish Parliament with more policy choices. Subsequently, there is potentially greater volatility and complexity around Scottish budget and greater focus on the use of Scottish funds. SEPA's financial statements demonstrate that the organisation is trending towards greater reliance on revenue generated through fees and charges and reducing amounts from Scottish Government Grant in aid. While Scottish Government funding continues to be a significant revenue source, SEPA recognises the importance in demonstrating value to service users, customers and the wider public. This is reflected in the transparent reporting in the annual accounts and performance reports.

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 5 out of the 15 corporate targets. There are opportunities to enhance operational performance monitoring through the use of more outcome focused measures.

SEPA look to work with partner organisations go ‘beyond compliance’ with regards environmental legislation. SEPA continue to work with strategic partners to agree Sustainable Growth Agreement: voluntary, formal agreements to implement practical approaches to supporting environmental policy.

We conclude on our assessment of SEPA's arrangements for securing value for money

Performance framework

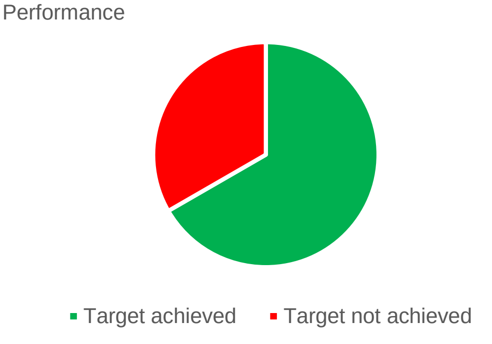
SEPA has a number of overarching strategies including the Corporate Plan, the annual operating plan and the People Strategy. These are focused on delivering key performance measures which report on the outcomes of SEPA as an organisation, including the impact of SEPA as a regulator.

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.

Our Annual Operating Plan 2018/19 identified 15 performance measures which we monitored throughout the year. These have been refined during the year from the previous 18 measures reported in 2017/18. SEPA continues to face challenges in meeting its performance targets. The following table summarises the annual performance against the 15 outcomes during the year:

During 2018/19 SEPA failed to deliver 33% (5) of its performance targets. These were the following targets:

- Increase the length of river or loch shore where physical condition is restored (target 2.5km)
- Increase the number of finalised sector plans to at least 16
- Develop at least five new sustainable growth agreement that focus on regulated businesses
- Increase, in targeted sectors, in the percentage of permits which have obligations that are clearer (sectors targeted: Operational Non-Hazardous Landfills, Metal Processing, and whiskey distilleries)
- Make the waste sector less attractive to criminals



The annual report and accounts provides a summary of the progress made against these actions as well as work out standing to address these. The performance targets align to operational plan targets and subsequently supporting the assessment of progress towards strategic outcomes. However, these could be more focused on SEPAs outcomes and deliverables as there are a number of the measures focused on inputs. In addition, for targets such as 'Make the waste sector less attractive to criminals" these are very subjective and difficult to quantify the performance outcomes from SEPA's activities. SEPA continue to refine performance information to enable ongoing scrutiny of operational performance against corporate priorities. ***Action Plan Point 4***

Sustainable Growth Agreements

SEPA look to work with partner organisations go 'beyond compliance' with regards environmental legislation. Sustainable Growth Agreements are voluntary, formal agreements between SEPA and individual organisation with a focus on delivering practical action to deliver environmental outcomes. During 2018/19 SEPA signed an outcome agreement with Scottish Water, focused on finding new ways to recover more resources from the wastes Scottish Water manages and generates. Scottish Water continues to look to engage with key partners to develop sustainable Growth Agreements over the coming years.

Dependency on key suppliers

The collapse of Carillion and the subsequent impact across the public sector, has brought into focus the risk of key supplier failure and underperformance. We will consider the arrangements in place for identifying key supplier and risks, if any associated with these and how effectively these are being managed.
While SEPA do not have any significant third party supplier contracts, there is recognition by Management that further contingency arrangements need to be established if a supplier fails. Work is planned during 2019/20 to understand and document contingency arrangements in the event of supplier failure.

Appendices

- Audit adjustments
- Action plan
- Follow up of 2017/18 recommendations
- Fees, independence and fraud arrangements
- Defined benefit pension scheme assumptions
- Communication of audit matters

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. There was one corrected misstatement to the draft financial statements relating to defined benefit pension scheme calculation estimate updated to reflect the impact of the McCloud case as at 31 March 2019.

Item		Dr (£'000)	(Cr) (£'000)	Description
1	Other operating costs (Pension reserve) Defined benefit pension liability	4,380	(4,380)	*Being adjustment to recognise defined benefit pension scheme net liabilities reflecting the impact of the McCloud case on defined benefit liabilities (Note includes actuarial loss of £1.734 million, increase in staff costs of £2.611 million and increase in finance costs of £0.035 charged to the Pension Reserve). The adjustment also reflects the asset values being revisited by the actuary to reflect the actual asset valuations as at 31 March 2019 rather than a forecast.*

Significant Disclosure recommendations

In accordance with auditing standards we are required to highlight significant disclosure misstatements to allow the Audit Committee to evaluate the impact of these matters on the financial statements.

Disclosure omission	Detail	Adjusted
Updated discloser notes to the accounts	We recommended disclosure adjustments to enhance disclosures around material notes to the financial statements to enhance the readers understanding of the accounts	✓
Accounting policies	Minor changes to accounting policies, including property, plant and equipment around the valuation of leasehold improvements.	✓
Pension fund disclosures	We have recommended disclosures within the annual accounts relating to recognising two ongoing legal cases that could potentially have an impact on SEPA's defined benefit pension liabilities. SEPA has enhanced disclosure within the pension fund note to recognise the additional estimation uncertainty that these ongoing legal cases could have on the defined benefit pension schemes.	✓
Remuneration report	Disclosures within the remuneration report amended to reflect remuneration and CETV disclosures for all directors	✓
Creditors classification	Transposition error within the creditors note within the draft accounts between EU creditors and Accruals and deferred income. No impact on overall creditors	✓
Property, plant and equipment	Being allocation adjustment between classes of property, plant and equipment of £23,000 (trivial) between buildings and fixtures and fittings. No impact on overall PPE value.	✓

Action plan 2018/19

We have set out below, based on our audit work undertaken in 2018/19, those risks and recommendations we consider are of a higher risk to SEPA that Management may wish to consider in the future.

Recommendation	Agreed management response
Pension fund As the initial IAS 19 valuation included within the draft accounts did not incorporate the impact of the McCloud/Sargeant case, Management have obtained a revised IAS 19 valuation from the scheme's actuary, this included revisiting asset values as at 31 March 2019. This valuation increased the net liability reported above by £4.380 million (Appendix 1). We are satisfied that, following the adjustment, SEPA has appropriately disclosed its share of the defined benefit pension schemes assets and liabilities within the financial statements in accordance with IAS 19. There remains some uncertainty around the final arrangements for meeting the McCloud obligations and we recommend that Management engage with the FPF and actuaries during to ensure SEPA maintain an accurate understanding of pension liabilities.	**Management response:** Management will continue to engage with FPS and its actuaries to ensure its pensions liabilities are appropriately estimated **Action owner:** Chief Officer Finance **Timescale for implementation:** Ongoing, with review date of 31 March 2020
Corporate performance IFRS 16: *Leases*, is due to be adopted by the FReM and effective from the financial year 2020/21. The standard no longer differentiates between finance and operating leases. Under the standard, a number of operating lease arrangements will need to be recognised on SEPA's statement of financial position, recognising both the leased asset and liability. Under the arrangement, it is anticipated that a number of the properties currently leased under operating leases will need to be recognised as property, plant and equipment within SEPA's financial statements. This will require an independent valuation to ensure that these are recorded at fair value within the accounts. As Management engage with independent valuers to support that valuation of PPE, we recommend that they consider any potential future obligations under leases and obtain an independent valuation of the present value of any future obligations and provide for these in future financial statements.	**Management response:** Management will seek appropriate professional advice on the valuation of PPE. The actions required to implement IFRS 16 will be taken in 2019/20. **Action owner:** Chief Officer Finance **Timescale for implementation:** 31 December 2019

Action plan 2018/19

Recommendation	Agreed management response
Workforce planning Between 65-75% of operating expenditure relates to staff costs. Pivotal to long term financial sustainability will have an efficient and affective workforce, designed and focused on delivering SEPA's corporate priorities. Therefore, a clear and concise workforce plan are required to support the delivery of a an operating model that both supports the delivery of strategic goals, but does so in a financially sustainable way. Due to the volume of work between the restructuring of portfolios and devising sector plans, the preparation of workforce plans have been put on hold. It is critical that these are taken forward as a matter of urgency.	**Management response:** AMT will take forward workforce planning in 2019/20. **Action owner:** Chief Officer People and Property **Timescale for implementation:** 31 March 2020
Performance management The annual report and accounts provides a summary of the progress made against these actions as well as work out standing to address these. The performance targets align to operational plan targets and subsequently supporting the assessment of progress towards strategic outcomes. However, these could be more focused on SEPAs outcomes and deliverables as there are a number of the measures focused on inputs. In addition, for targets such as 'Make the waste sector less attractive to criminals" these are very subjective and difficult to quantify the performance outcomes from SEPA's activities. SEPA continue to refine performance information to enable ongoing scrutiny of operational performance against corporate priorities.	**Management response:** Performance targets continue to be refined and aligned to priorities **Action owner:** Chief Officer Performance and Innovation **Timescale for implementation:** 31 March 2020

Action plan 2018/19

Recommendation	Agreed management response
Leasehold SEPA operates from a number of properties under operating leases. While the lease terms vary per property, there are obligations within the agreements that require SEPA to return the property at the end of lease in the condition of its initial condition. SEPA has invested £4.7 million in enhancing and developing these premises for operational use and therefore does not consider any future obligation to be immaterial. However, going forward, Management should obtain expert advice on any potential obligations. With the forthcoming adoption of IFRS 16 in 2020/21, these longer term operating leased assets will be required to be recognised in SEPA's property, plant and equipment and therefore revalued. This would be an opportunity to engage with the independent valuer to obtain an estimate of future liabilities.	**Management response:** Management will seek professional advice regarding future liabilities associated with leased properties. **Action owner:** Chief Officer Finance and Chief Officer People and Property **Timescale for implementation:** 31 December 2019

Follow up of 2017/18 recommendations

Follow up of 2017/18 External Audit Recommendations	Action as at May 2019
Financial sustainability 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.	Ongoing, while financial forecast has been developed further work is required to develop comprehensive plans around delivery of a financially sustainable operating model. Critical to this will be the development of workforce plans. – See **2018/19 Action plan point 3**
Corporate performance 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	**Ongoing – 2018/19 Action plan point 2**

Fees, independence, fraud arrangements

External Audit Fee

Service	Fees £
External Auditor Remuneration	40,410
Pooled Costs	9,720
Contribution to Audit Scotland costs	2,420
Contribution to Performance Audit and Best Value	0
2018-19 Fee	**52,550**

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 £52,550

Fees for other services

Service	Fees £
We can confirm there are no non-audit fees for the 2018/19 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.

Anti-Money Laundering Arrangements

As required under the Money Laundering, Terrorist Financing and Transfer of Funds Regulations 2017 there is an obligation on the Auditor General (as set out in the planning guidance) to inform the National Crime Agency if she knows or suspects that any person has engaged in money laundering or terrorist financing.

Should we be informed of any instances of money laundering at SEPA we will report these to the Auditor General for Scotland.

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 discussion with those charged with governance.
- 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.

Client service

We take our client service seriously and continuously seek your feedback on our external audit service. Should you feel our service falls short of expected standards please contact Joanne Brown, Head of Public Sector Assurance Scotland in the first instance who oversees our portfolio of Audit Scotland work (joanne.e.brown@uk.gt.com). Alternatively, should you wish to raise your concerns further please contact Jon Roberts, Partner and Head of Assurance, 30 Finsbury Square, London, EC2A 1AG. If your feedback relates to audit quality and we have not successfully resolved your concerns, your concerns should be reported to Elaine Boyd, Assistant Director, Audit Scotland Quality and Appointments in accordance with the Audit Scotland audit quality complaints process.

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 2019, the defined benefit pension liability was £128.297 million (2018: £96.932 million).

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.

		Within Acceptable Range
Pension increases SEPA rate: 2.5%	• While dependent on duration, 2.5% has been applied across most employers being equal to RPI less 1%.	✓
Salary increases SEPA rate: 3%	• 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: 2.4%	• The rate used to reflect the time value of money and characteristics of the defined benefit liability • General range adopted by Hymans Robertson 2.4% to 2.5% for most employers and therefore SEPA sit within the range of assumptions	✓
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 to those charged with governance

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 letter of representation that includes representations around reference to valuations of property, plant and equipment and IAS 19 pension assumptions.**		•
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. In accordance with the Audit Scotland planning guidance we submit quarterly returns to Audit Scotland on each of our audited bodies. Nil returns were submitted during the year for SEPA.**		•
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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