Scottish Environment Protection Agency (SEPA)

External Audit Report to the Board and Auditor General for the financial year ended 31 March 2020

September 2020 – Final Report

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Financial statements audit at a glance

We have fulfilled our responsibilities under International Standards on Auditing (ISAs) (UK) and the Audit Scotland Code of Audit Practice throughout our work.
This final report to the Board and the Auditor General concludes our work.

We received a good draft of financial statements including the staff report and Accountability Report at the start of our audit. The performance report was received on 25 June 2020.
Good working papers were provided to support the audit process.
Remote working as a result of Covid-19 led to some additional challenges however these were overcome and we were able to deliver the audit in line with the timetable agreed at planning.
We thank management for their continued support and assistance throughout the audit.

Significant audit risks are:
management override of controls, the risk of fraud in expenditure recognition as set out in Financial Reporting Council's (FRC) Practice Note 10, the risk of fraud in income recognition, valuations in respect of the defined benefit pension scheme assets and liabilities and the valuation of property, plant and equipment.
An additional significant audit risk was identified in relation to Covid-19 which caused significant disruption to all public sector entities in the later half of March 2020.

An audit underpinned by quality and adding value to you

The Remuneration and Staff report has been prepared in accordance with the Public Finance and Accountability (Scotland) Act 2000, and directions thereunder. The disclosures in the Remuneration and Staff report are consistent with underlying payroll records.

Materiality has been set at £1.468 million, approximately 2% of gross expenditure and performance materiality is set at £1.101 million, 75% of materiality. Materiality has been updated based on the unaudited accounts. However, our planned benchmark of 2% has remained the same.

We have issued an unmodified audit opinion on the annual report and accounts.

Our opinion includes an emphasis of matter paragraph in relation to the material valuation uncertainty which was identified by professional property, plant and equipment valuers.

Wider scope commentary at a glance

In accordance with the Code of Audit Practice our audit work includes consideration of SEPA's arrangements compared to the wider scope audit dimensions: financial management; financial sustainability; governance and transparency; and, value for money.

Conclusions on wider scope risks to support SEPA strengthen arrangements

SEPAs 2020/21 financial plan forecasts an operating surplus of £2 million to support capital investment. The delivery of this will require SEPA to deliver savings of £3.764 million, primarily through staff costs. Relative to gross income this is achievable although there is a risk savings delivered will be non-recurring increasing the required savings in future years.

Management has developed a Financial Strategy for 2020-2024 which is principles based and focussed on both revenue and expenditure against a background of inherent financial uncertainty. Sensitivity analysis projections estimate that by 2023/24 there will be a budget gap between £6 million (best case scenario) and £17.914 million (worst case scenario). Looking out to 2023/24 there is a risk SEPA will no longer be financially sustainable.

SEPA has an established performance management framework and there is ongoing monitoring and scrutiny across management and the Board. SEPA continues to face challenges in meeting its performance targets, failing to deliver 2 out of the 17 corporate targets. There are opportunities to enhance operational performance monitoring through the use of more outcome focused measures.

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 on Auditing (ISAs) UK and the Audit Scotland Code of Practice (2016).

Through this Annual Report we seek to provide insight and commentary over certain aspects of Scottish Environment Protection Agency's 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. We continue to reflect and act on feedback from prior year audits albeit our year end audit faced additional challenges as a result of the need to work remotely as a result of Covid-19.

We have made a positive contribution at the Audit Committee during the year and continue to work with management on how we can add value through the audit process to support them strengthen their financial arrangements. We have worked proactively with management throughout the year, discussing emerging issues and seeking to give an early audit view where appropriate.

Contents

Introduction

Reporting

This report is a summary of our findings from our external audit work for the financial year ended 31 March 2020.

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 their role as those charged with governance). In addition, in accordance with our reporting responsibilities the report is jointly addressed to the Auditor General for Scotland.

This report will be made publicly available on the Audit Scotland website (www.audit-scotland.gov.uk) once the SEPA accounts are laid in parliament.

Our report was presented as a draft to the SEPA Audit Committee on 30 June 2020. The final 2019/20 financial statements were approved by the Board on 28 July 2020 and signed by the Chief Executive and Accountable Officer on 3 September 2020. We have subsequently finalised this report and submitted to the Board of SEPA and the Auditor General for Scotland.

We would like to thank SEPA's 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

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. We conclude on wider scope risks identified within our audit plan.

Our Opinion

For the financial year ended 31 March 2020 we have issued an **unmodified audit opinion**:

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

Our opinion includes an emphasis of matter paragraph in relation to the material valuation uncertainty which was identified by professional property, plant and equipment valuers.

The audit process

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

The draft financial statements were supported by good working papers. Although remote working as a result of Covid-19 created additional challenges, these were overcome and the audit was delivered broadly in line with the timetable agreed at planning.

We identified no unadjusted differences to report to the Audit Committee and the Board . Management identified two adjustments to the draft financial statements in respect of the pension liability and the revaluation of property, plant and equipment as detailed in appendix one.

We identified a number of improvements in respect of disclosures and narrative elements of the report to enhance the readability and user friendliness of the accounts. These have also been detailed in appendix one.

Materiality

Our audit approach was set out in our audit plan presented to the Audit Committee on 10 December 2019. Overall materiality has been updated and set at £1.468 million, approximately 2% of gross expenditure based on unaudited 2019/20 accounts. Performance materiality is set at £1.101 million, 75% of materiality.

In addition we set a lower materiality level for the Remuneration report. This was set at one banding, taking into account users of the financial statements likely interest in this statement.

Our planned approach has not changed from that set out in our plan.

We report to management any difference identified over £73,400.

An additional significant audit risk was identified in relation to Covid-19 which caused significant disruption to all public sector entities in the later half of March 2020. This was communicated to the Chief Officer Finance and the Audit Committee Chair during May 2020.

Internal control environment

During the year we sought to understand SEPA's overall control environment (design) as related to the financial statements. In particular, we have:

- Considered procedures and controls around related partied, journal entries and other key entity level controls.
- Performed walkthrough procedures of key financial processes including income and expenditure recognition, journal postings, payroll, property plant and equipment including valuation and ledger controls.

Our work over controls is limited to our ISA requirements in understanding an entities control environment. Our audit is not controls based and we do not place reliance on controls operating effectively as our audit is fully substantive in nature. We identified no material weaknesses or areas of concern from this work which would have caused us to alter the planned approach as documented in our plan.

Internal Audit

As set out in our external audit plan our audit approach is to comply with the ISA's and we do not place formal reliance on the work of Scott-Moncrieff, SEPA's internal audit provider during 2019/20. We have reviewed the internal audit plan and individual reports issued to date, to consider if any impact on our audit approach.

The opinion of Internal Audit for the year was:

"*Scottish Environment Protection Agency has a framework of controls in place that provides reasonable assurance regarding the organisation's governance framework, effective and efficient achievement of objectives and the management of key risks.*"

The findings of internal audit are consistent with our knowledge and experience of SEPA. From our review we are satisfied that there were no areas arising from the work of internal audit that would impact on our audit opinion or require specific disclosure in the annual governance statement. Additionally, we have no concerns with regards to the Internal Audit function or ability.

Responding to significant risks

Risk area	Identified audit risks at planning
Risk of fraud in expenditure recognition	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. Similarly, capital costs including depreciation are well forecast and based on underlying assets value and reconciled to SEPA's fixed asset register therefore presenting less opportunity for misstatement. We therefore focus on other operating expenditure (2019/20: £19 million; 2018/19: £23 million). As financial performance targets are measured on year end outturn, including Scottish Government resource levels, we consider the risk to be particularly prevalent around the year end and therefore focus our testing on cut-off of other operating expenditure. In the context of medium term financial pressures facing the organisation, there is an incentive for both over and understatement of revenue either to support the delivery of in year performance targets or to support next years. Consequently, at our planning stage we attach the risk to both occurrence and completeness of expenditure transaction around the year end. We will continue to assess this throughout the year.

Work completed

- Walkthroughs of the controls and procedures over other operating expenditure streams
- Substantive testing (at an elevated risk level) expenditure recognised post year end to identify if there is any potential understatement
- Substantive testing (at an elevated risk level) of expenditure in the final two months of the year to identify if this has been potentially overstated
- Testing of post year end bank statements and review of minutes and legal fees/correspondence, including legal account codes, to identify any potential unrecorded liabilities
- Considered the regularity of expenditure incurred to ensure alignment with the type/nature of SEPA as an organisation.

Our conclusion

Based on our testing we conclude:

- We did not identify any exceptions in our cut-off testing of year end expenditure.
- We did not identify any potential unrecorded liabilities.
- We did not identify any exceptions in the completeness and accuracy of accruals, deferred income or provisions balances at the year end.
- Through our substantive procedures and sample testing we confirmed expenditure testing was in accordance with the nature of SEPA (regularity).

Risk area	Identified audit risks at planning
Risk of fraud in income recognition	As set out in ISA 240 there is a presumed risk that revenue may by misstated due to improper recognition of revenue. In 2019/20, SEPA received £34 million in grant-in-aid resource funding from the Scottish Government (2018/19: £35 million). While material, we consider this funding to be well forecast and directly agreed to Scottish Government funding letter and draw down. We therefore consider the opportunity and incentive to manipulate this revenue stream as low and rebut the presumed risk around revenue recognition over revenue resource allocation. Similarly, SEPA recognised £2.4 million of grant income (Other income) during 2019/20 (2018/19: £5.5 million) which we agree to the underlying grant agreement and cash receipt. This reduces the opportunity for manipulation and the inherent risk of material misstatement in revenue recognition. We therefore consider the risk of fraud in revenue recognition to be present in material revenue streams recognised within contract income, being charging scheme fees and charges and grant income. In 2019/20 SEPA generated £44 million of income from these revenue streams (2018/19: £42.6 million). As financial performance targets are primarily set for year end outturn position, including financial performance against the Scottish Government grant, we therefore consider the risk is prominent around year end revenue transactions and receivable balances. In the context of medium term financial pressures facing the organisation, there is an incentive for both over and understatement of revenue either to support the delivery of in year performance targets or to support next years. Consequently, at our planning stage we attach the risk to both occurrence and completeness of revenue. We will continue to assess this throughout the year.

Work completed

- Walkthroughs of the controls and procedures over charging scheme fees and charges and grant income.
- Substantive testing (at an elevated risk level) over income recognised in the final two months of the year and post year end transactions where there is an increased risk of fraudulent recognition of revenue.
- Evaluation of the existence of receivables balances held at 31 March 2020 through agreeing balances held to invoices and/or other supporting records.
- Assessment of recoverability of balances by agreeing a sample of debtor balances (at an elevated risk level) and agreeing to post year end cash receipt.

Our conclusion

Based on our testing we conclude:

- We did not identify any exceptions in our cut-off testing of year end revenue.
- We did not identify any potential recoverability issues of debtor balances or evidence to suggest receivable balances at 31 March 2020 did not exist.

Risk area	Identified audit risks at planning
Valuation of property plant and equipment	In accordance with the HM Treasury Financial Reporting Manual (FReM), subsequent to initial recognition, SEPA is required to hold property, plant and equipment at current value. The exact valuation basis depends on the nature and use of the assets. For assets with short term useful economic lives such as computer Equipment, fixtures, fittings and vehicles, depreciated historical cost is considered a suitable proxy for current value and therefore lower inherent risk of material misstatement in carrying value. However for Land and buildings, these require regular revaluation to ensure that carrying value within the financial statements reflects the current value of the asset. As at 31 March 2020, SEPA held land and buildings of £5 million (2018/19: £6.3 million) and gauging stations of £16.3 million (2018/19: £16.6 million). Given the value of these assets held by the SEPA and the level of complexity and judgement in the estimation of valuations, there is an inherent risk of material misstatement in the carrying value within land and buildings and gauging stations.

Work completed

Management expert

- We considered the independence and objectivity of the appointed valuer in addition to their competence and experience as a suitable management expert.
- We confirmed the completeness of underlying information provided by SEPA to the valuer, including instructions provided, to ensure that these are in line with the requirements of the FReM and IAS 16: Property, plant and equipment.
- We challenged the valuation report provided by the valuer and reconciled to the underlying accounting entries made by SEPA.

Valuation

- We assessed the suitability of the valuation methodology to ensure consistent with the FReM and IAS 16.
- We challenged the appropriateness of the assumptions adopted by the valuers, including where relevant, reference to third party information (indices etc)
- We assessed the valuation across land and buildings and compared actual valuation movements against expectation (based on average revaluation movements) to identify any large or unusual movements. We assessed the reasonableness of these through discussion with Management and the valuer to gain assurance over valuations applied.
- We assessed the valuation of gauging stations by corroborating the indices used by Management to industry indices and compared actual valuation movements against expectation (based on average revaluation movements) to identify any large or unusual movements. We assessed the reasonableness of these through discussion with Management to gain assurance over valuation applied.
- We engaged an auditor expert valuer to assess the valuations applied also to assist in our discussions with management.

Our conclusion

Based on our testing we conclude:

- The valuers Cushman and Wakefield (land and buildings) and Century Marine (the vessel) are suitable management experts and are independent of SEPA.
- The indices applied by management in the valuation of the gauging stations are appropriate
- The underlying assumptions in respect of the land and buildings and gauging stations valuations are appropriate.
- Valuation movements are in line with expectation given the current economic climate.

Risk area	Identified audit risks at planning
Defined benefit pension scheme	SEPA participates in the Falkirk Pension Fund, a local government pension scheme. The scheme is a defined benefit pension scheme and in accordance with IAS 19: Employee Benefits, SEPA is required to recognise its share of the scheme assets and liabilities on the statement of financial position. As at 31 March 2020 SEPA have a net pension liability of £116.8 million (2018/19: £132.7 million). Hymans Robertson UK LLP provide an annual IAS 19 actuarial valuation of SEPA's net liabilities in the pension scheme. There are a number of assumptions contained within the valuation, including: discount rate; future return on scheme assets; mortality rates; and, future salary projections. Given the material value of the scheme liabilities and the level of estimation in the valuation, there is an inherent risk that the defined benefit pension scheme could be materially misstated within the financial statements.

Work completed

- Walkthroughs of the controls and procedures over the valuation of pension scheme liabilities, including information and instructions provided to the pension fund and actuary;
- Understanding the arrangements in place at the SEPA for reviewing the assumptions adopted by the actuary and suitability of these for the authority;
- We considered the suitability and reasonableness of the underlying assumptions adopted by the actuary in arriving at the defined benefit pension scheme liability, including ensuring underlying data used is appropriate in informing the valuation;
- Audit Scotland have established a protocol between the auditors of Scottish local government pension schemes and auditors of participating bodies to provide assurances over the arrangements in place over pension information managed by the pension fund. Due to the timing of SEPAs financial statements audit being in advance of work over the pension fund, we relied upon alternative audit procedures to gain assurances over information managed separately from SEPA. We did this through direct liaising with Falkirk Council, as administrators of the Falkirk Pension Fund; and
- Reviewed the underlying data supporting the valuation to ensure these are consistent with the SEPA's underlying records.

Our conclusion

Based on our testing we conclude:

- The underlying assumptions in respect of the defined benefit pension assets and liabilities are appropriate.
- The movements in the pension liability year on year were corroborated to information supplied by the pension fund administrator and agreed to underlying transactions.

Risk area	Identified audit risks at planning
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. This risk area includes the potential for management to use their judgement to influence the financial statements as well as the potential to override SEPA's controls for specific transactions. We consider those key judgements that are most susceptible to significant audit risk of management override are those over income and expenditure recognition transactions around the year end. These are areas where management has the potential to influence the financial statement through estimate and judgement.

Work completed

- Considered the design of controls in place over key accounting estimates and judgements through performance of walkthrough procedures.
- Reviewed accounting estimates for management bias / indication of fraud that could result in material misstatement. This included review of estimates as at 31 March 2020 and retrospective review of those estimates as at 31 March 2019.
- Journals testing including:
    - Assessment of the design of controls in place over journal entries, including journal preparation, authorisation and processing onto the financial ledger;
    - Risk assessment of the journals population to identify large or unusual journal entries, such as those that are not incurred in the normal course of business, or those entries that may be indicative of fraud or error that could result in material misstatement. We tested these journals to ensure they are appropriate and suitably recorded in the financial ledger;
    - Target testing of transactions around the financial year end, reviewing large journals and those which appear unusual to understand the rationale for the transaction.

Our conclusion

Based on our testing we conclude:

- There was no evidence of management override in our testing of controls.
- The material judgements in SEPA's financial statements, the defined pension scheme liability, valuation of property, plant and equipment and provisions are based on management experts advice and underlying assumptions appeared appropriate and in line with industry assumptions.
- We did not identify any unusual or significant transactions throughout the financial year or during the financial close period which were out with the ordinary operations of SEPA.

Risk area	Identified audit risks at planning
Covid-19	The global outbreak of the Covid-19 virus pandemic has led to unprecedented uncertainty for all organisations, requiring urgent business continuity arrangements to be implemented. We expect current circumstances will have an impact on the production and audit of the financial statements for the year ended 31 March 2020, including and not limited to; • Remote working arrangements and potential redeployment of staff, or staff change in focus, may impact on the quality and timing of the production of the financial statements, and the evidence we can obtain through physical observation • Volatility of financial and property markets will increase the uncertainty of assumptions applied by management to asset valuation, receivable recovery estimates, and pension estimates and the reliability of evidence we can obtain to corroborate management estimates • Financial uncertainty will require management to reconsider financial forecasts supporting their going concern assessment and whether material uncertainties for a period of at least 12 months from the anticipated date of approval of the audited financial statements have arisen; and • Disclosures within the financial statements will require significant revision to reflect the unprecedented situation and its impact on the preparation of the financial statements as at 31 March 2020 in accordance with IAS1, particularly in relation to material uncertainties. We therefore identified the global outbreak of the Covid-19 virus as a significant financial statement risk, and potential for increased risk of misstatement.

Work completed

- Worked with management to understand the implications the response to the Covid-19 pandemic has had on the organisation's ability to prepare the financial statements and update financial forecasts, and assessed the implications for our materiality calculations;
- Liaised with other audit suppliers, regulators and government departments to co-ordinate practical cross sector responses to issues as and when they arose;
- Inspection of professional valuation reports for Property, Plant and Equipment, testing assumptions underlying the valuations and engaging with the professional valuer;
- Evaluated the adequacy of the disclosures in the financial statements that arose in light of the Covid-19 pandemic;
- Evaluated whether sufficient audit evidence could be obtained through remote technology;
- Evaluated whether sufficient audit evidence could be obtained to corroborate significant management estimates such as recovery of receivable balances; and
- Evaluated management's assumptions that underpin the revised financial forecasts and the impact on management's going concern assessment.

Our conclusion

Based on our testing we conclude:

- Covid-19 and remote working did not restrict SEPA's ability to prepare the financial statements or restrict the audit evidence required to complete the audit.
- Management's assumptions underpinning financial forecasts and the going concern assessment have adequately considered the potential impact of Covid-19.
- Management have adequately assessed the impact of Covid-19 on SEPA's governance arrangements.
- The professional valuers have identified a material valuation uncertainty over the Property, Plant and Equipment valuation. As a result our audit opinion includes an emphasis of matter paragraph.

Accounting policies

Accounting area	Summary of policy	Comments	Assessment
Revenue recognition	SEPA recognise grant funding from the Scottish Government based on the budget allocated. Income from contracts including charging schemes, application fees and annual subsistence charges, is recognised as performance obligations are met and not on a cash basis.	SEPA's revenue recognition policies are in line with IFRS 15 as interpreted and adapted by the FReM. Contract income including charging fees, annual subsistence charges and charging scheme income are recognised as contract obligations are met. While we recognised the risk of fraud within revenue in respect of contract income the presumed risk was rebutted in relation to government funding. Our audit testing addressed the risk of revenue being recognised incorrectly through cut-off testing. Our testing did not identify any exceptions.	● (GREEN)
Judgements and estimates	SEPA have the following balances which are subject to judgements and estimates: • Property, Plant and Equipment (PPE) subject to revaluation; • Defined benefit pension scheme; and • Decommissioning provision for leasehold improvements. Land and buildings and Gauging stations are subject to annual revaluation to ensure that they are held at current value in line with the FReM. Defined benefit pension scheme balances have been subject to an IAS 19 valuation by an independent actuary.	**PPE revaluation** SEPA's accounting policies over PPE and its revaluation is compliant with IAS 16 as interpreted and adapted by the FReM. Our audit testing has considered the independence and objectivity of the valuer used for year end valuations. Procedures have also been used to challenge and assess the estimates and assumptions used by the valuer. We are satisfied that the year end valuation is appropriate. Note that the property valuations were provided on the basis of material uncertainty as a result of COVID-19. This has been disclosed by SEPA and an emphasis of matter has been included in our audit opinion in respect of this matter. **Defined benefit pension scheme** SEPA's accounting treatment in respect of the defined benefit pension scheme is in accordance with IAS 19. Our audit testing has considered the independence and objectivity of the actuary as well as specific audit procedures over the transactions within pension assets and liabilities year on year. Audit procedures include assessment of the disclosure included within the annual accounts and we are satisfied that disclosure is in line with the FReM.	● (GREEN)

Assessment

- ● Marginal accounting policy which could potentially be open to challenge and/or interpretation
- ● Accounting policy appropriate but scope for improved disclosure
- ● Accounting policy appropriate and disclosures sufficient

Accounting policies

Accounting area	Summary of policy	Comments	Assessment
Judgements and estimates (continued)	An inspection was undertaken in the year by an independent valuer to assess the value of obligation in respect of decommissioning leasehold improvements.	The value of the decommissioning provision has been disclosed in line with IAS 37 as interpreted and adapted by the FReM. SEPA holds £2.76 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. After seeking the advice of professional valuers in the year, SEPA have provided for £2.448 million in respect of decommissioning the leasehold improvements. Our audit procedures have assessed the independence and objectivity of the third party valuer. Additionally we inspected the valuation reports and assessed the clients inclusion of provision balances. We are satisfied that the balances have been accurately included and discounted appropriately. We are satisfied that there are no further transactions or balances within the accounts which are subject to significant judgement or estimation.	
Other critical policies	None identified by SEPA.	We have reviewed SEPA's accounting policies against the FReM requirements. Where appropriate SEPA has tailored accounting policies, whilst still complying with the FREM. We recommended a small number of minor disclosure changes, which have been made in the audited financial statements.	(GREEN)

Assessment

- Marginal accounting policy which could potentially be open to challenge and/or interpretation
- Accounting policy appropriate but scope for improved disclosure
- Accounting policy appropriate and disclosures sufficient

Narrative elements of your annual accounts

In accordance with our responsibilities we have reviewed the 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.

Annual Report and Accounts include the performance report and accountability report (including remuneration and governance)

Performance Report

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

Progress has been made in developing the Performance Report to provide a more focused assessment of SEPA's performance during the year and this is something which will continue to be developed by management.

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.

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 contained within the statement is inconsistent with our audit knowledge and understanding of SEPA.

Other key elements of the financial statements

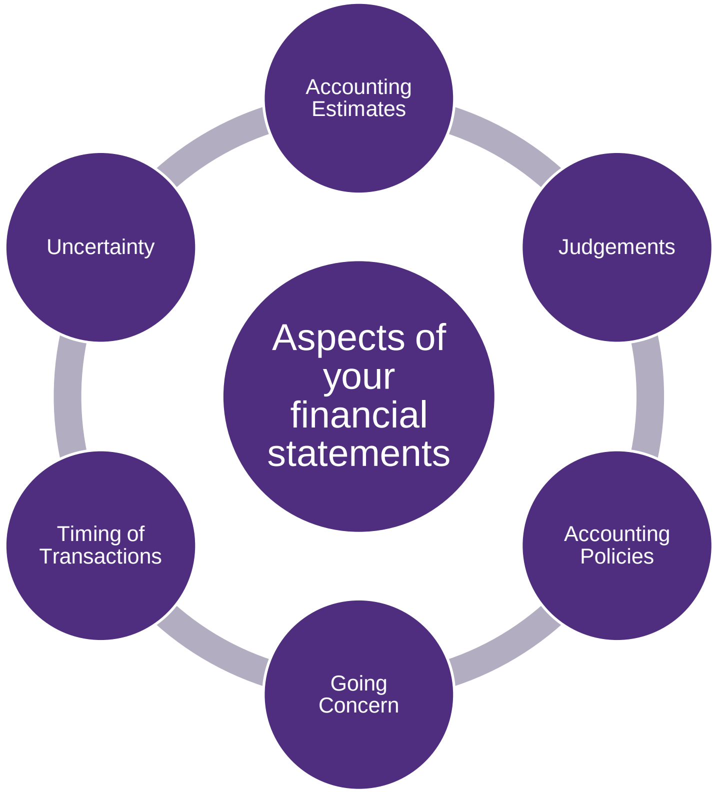
Scottish Environmental Protection Agency Accounting policies are in accordance with IFRS as interpreted and adapted by the FReM and we consider these to be appropriate to the organisation. These have been applied consistently to the previous year. No new International Financial Reporting Standards (IFRS) have been adopted in the year as the adoption of IFRS 16 for public bodies has been delayed by a year as a result of the Covid-19 pandemic.

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

Property, Plant and Equipment (PPE): SEPA hold £35.0 million of tangible assets (2018/19: £34.7 million). Of these assets a number are specialised in nature e.g. gauging stations; and vessels. Land and buildings and Gauging stations are subject to annual revaluation with assistance from management's expert valuers. A net loss on revaluation of £1.1 million was recognised at 31 March 2020.

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 2020, the defined benefit pension deficit within the draft financial statements was £116.806 million, representing a £15.871 million decrease in the net liability from 2019. The decrease 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).



Fraud and irregularity:

Management have confirmed that they received four reports of suspected fraud within the year. Of the four reports received, two have been investigated and no fraud has been identified. The remaining two reports are still being investigated at the time of the audit however these relate to HR processes and have no financial implications on the financial statements.

Our audit procedures throughout the course of the audit have not identified any indication of fraud or irregularity.

Post Balance Sheet Events

One post balance sheet event was identified in relation to the defined benefit pension scheme.

In August 2020, SEPA's actuary informed them that the previously proposed remedy in respect of the 2015 McCloud judgement, an increase in liability of £1.9 million, may now be less than half the value originally proposed. Through discussions with the actuary and the client it was determined that the potential adjustment in the current year may therefore be up to £1 million, which is below materiality.

As this information came to light in the final stages of accounts finalisation and any adjustment would be below materiality, SEPA decided to disclose this as a post balance sheet event in the annual accounts as opposed to requesting an updated IAS 19 valuation.

Having considered the likely impact on the financial statements, increasing net pension value by up to £1 million and reducing the pension reserves deficit by the same value, we are satisfied that not adjusting the accounts for this matter would not have a material impact on the financial statements. This is appropriately disclosed.

Going concern

SEPA has an agreed budget for 2020/21 and a Resource Allocation letter from the Scottish Government.

SEPA's statement of financial position continues to report significant net liabilities of £88.6 million. However, this was primarily due to £116.8 million pension liabilities and the underlying income and expenditure reserve balance is £12.9 million while the revaluation reserve balance is £15.2 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 2020/21 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 a 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 agree with this view.

Financial management

While we have not identified any significant wider scope risks in relation to financial management, we have reviewed SEPA's financial management arrangements including the extent to which there is effective scrutiny over financial performance.

Headlines

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 in the year of £48.591 million (2018/19: £49.054 million). SEPA reported an underspend against Department Expenditure Limit (DEL) of £0.087 million (2018/19: £0.0259 million) however reported an overspend against Annually Managed Expenditure (AME) of £6.499 million (2018/19: £6.187 million overspend).

SEPA continues to operate under a challenging financial environment. Continued 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.

Financial management – Detailed findings

Financial Performance 2019/20

SEPA reported net expenditure for the year of £48.591 million, following adjustments in respect of the IAS 19 pension movement and revaluation of property, plant and equipment, SEPA reported comprehensive net expenditure of £20.215 million (2018/19: £72.373 million).

The outturn position against the Scottish Government's Departmental Expenditure Limit (DEL) was an underspend of £0.087 million.

The outturn position against the allocated Annually Managed Expenditure (AME) budget limit, SEPA reported an overspend of £6.499 million. This was largely a result of IAS 19 pension charges and interest payable being higher than forecast, the establishment of a provision for leased property decommissioning and movement in the market value of fixed assets.

In 2019/20, SEPA made £6.5 million efficiency savings; £4.6 million in staff costs of which £1.0 million were recurring through the removal of 20 FTE and £3.6 million were non-recurring through increased turnover targets which resulted in vacant positions. This was in addition to £1.9 million in non-staff costs of which £0.9 million were recurring and £1.0 million non-recurring.

	2019/20	2018/19
Net Expenditure for Year	£48.591 m	£49.054 m
IAS 19 (gains) / losses	(£29.451 m)	£22.883 m
PPE valuation (gains) / losses	£1.075 m	£0.436 m
Comprehensive Net Expenditure for Year	**£20.215 m**	**£72.373 m**
SG Department Expenditure Limit (budget)	£37.261 m	£38.152 m
SG Department Expenditure Limit (actual)	£37.174 m	£37.893 m
(Overspend) / Underspend	**£0.087 m**	**£0.259m**
Annually Managed Expenditure (budget)	£10.411 m	£7.166 m
Annually Managed Expenditure (actual)	£16.910 m	£13.353 m
(Overspend) / Underspend	**(£6.499 m)**	**(£6.187 m)**

Financial management – Detailed findings (continued)

SEPA has net liabilities of £88.614 million (2018/19: £102.383 million) on the Statement of Financial Position. This reflects the net pension liabilities of £116.806 million. While the organisation continues to have a positive cash position and meet 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.

SEPA's main area of expenditure continues to be staff costs. During 2019/20 costs were slightly higher than prior year at £69.355 million (2018/19: £68.409 million). The increase was primarily a result of the annual pay award in the year. Other operating expenditure for 2019/20 was down significantly from prior year at £19.335 million (2018/19: £23.110 million) which was mainly down to an underspend in the supplies and services annual budget.

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 the workforce is in place to deliver operational goals while operating within the funding boundaries of the Scottish Government.

Capital Expenditure

SEPA invested £1.965 million in capital expenditure during the year and reported a small underspend of £0.035 million against the capital resource budget. Due to COVID-19, £0.098 million of orders were not delivered by March 31st 2020. Funds will be allocated from 2020/21 capital allocation for these items. The purchase of the Nuvideo upgrade, an audio visual communication software, did not go ahead as there was insufficient time to undertake the tendering process. These underspends were offset by an overspend of £0.051 million in electric charging points as the grant received from the Energy Trust was less than budgeted.

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.
- There appears to be challenge and scrutiny of performance in the year and key variances between actual and outturn performance from review of Board and committee papers.
- The financial planning process considers wider economic conditions when basing assumptions around level of fees and charges.

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

Financial sustainability

We identified the following risk in relation to financial sustainability in our annual audit plan:

Financial sustainability (risk identified in the plan and our planned response)

SEPA face significant financial challenges over the short to medium term. Management's financial projections forecast that by 2023/24, there will be a budget gap (shortfall between forecast operating costs and available revenue) of £12.7 million.

SEPA recognise that it is critical that resources are prioritised on delivering the organisations key strategic outcomes. With limited capacity to bridge the funding gap through additional revenue support, a key area of focus for SEPA is in managing cost pressures. With between 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 recognise that to ensure long term financial sustainability it needs an efficient and affective workforce, designed and focused on delivering 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. During 2018/19, 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 important that these are taken forward as a matter of urgency.

Significant wider scope risk identified: Like many public bodies, SEPA face financial challenges through rising pressures on payroll costs, as well as inflationary increases on other operating expenditure. With forecasts levels of Scottish Government and other income sources not offsetting these, SEPA faces an estimated budget gap of £12.7 million. It is critical that SEPA has an operating model that is financially sustainable while supporting the delivery of key strategic priorities. Critical to this will be robust workforce plans to maximise the use of available human resource.

Audit response

Response to significant wider scope risk

We will review the financial plans in place, including the scenarios set out, and how these align resources to the delivery of SEPA's corporate priorities. We will assess the progress made by SEPA in developing financially sustainable operating plans that continue to support the delivery of these priorities. We will consider the progress made by SEPA in developing comprehensive workforce plans that aim to maximise the use of human resource in line with financial plans. In addition we will consider the extent to which SEPA evaluate the potential impact on service performance either through pursuing additional revenue generating activities or through delivering operational efficiencies.

Other wider scope procedures

In relation to broader financial sustainability we will continue to develop our understanding of SEPA's financial planning arrangements including workforce plans and how these developed both supporting and recognising the financial and operational challenges facing the organisation.

The headlines identified from our wider scope work in this area alongside detailed narrative are included overleaf.

Headlines

Management has developed a Financial Strategy for 2020-2024 which is principles based and focussed on both revenue and expenditure against a background of inherent financial uncertainty. Sensitivity analysis projections estimate that 2023/24 there will be a budget gap between £6,000 (best case scenario) and £17.914 million (worst case scenario).

SEPA recognise that it is critical that resources are prioritised on delivering the organisations key strategic outcomes. The ongoing Change Programme includes plans to remove 50 Full Time Equivalent posts thereby reducing staff costs by £2.5 million. The programme aims to utilise resources in a more effective and efficient manner by increasing cross-departmental working and focussing on the organisation's priorities as opposed to individual departments.

The budget and financial plan for 2020/21, approved by the Board in March 2020 forecasts a surplus of £2 million following cost savings of £3.764 million (£2.5 million in staff costs and £1.264 million in non-staff costs). The delivery of these savings will be challenging for SEPA particularly given the economic impact of Covid-19.

Financial sustainability – Detailed findings

Financial Strategy

SEPA has developed a Financial Strategy for 2020-2024. It is based on the characteristics of revenue and expenditure and on the inherent financial uncertainty over the next four years. The strategy is based upon six key principles which have been adopted to drive the long-term financial strategy and includes:

- Planning for potentially significant volatility. This has been considered through SEPA's expenditure model which includes sensitivity analysis for a range of scenarios which could materialise in terms of SG funding and income levels.
- Implement the *One Planet Prosperity* business model and using this reduce expenditure for the same or better service delivery outcomes. Resulting efficiency and effectiveness gains will be planned for, modelled and captured.
- Substantially leverage investment (cash and in kind support) from other organisations to both create better outcomes and reduce expenditure and other financial pressures.
- Further alignment of regulatory expenditure with charging. In some cases, this will lead to increased charging and revenue. In other cases, the efficiency gains will lead to reduced charging and revenue.
- Initiating regular reviews of expenditure classes across the organisation to identify potential efficiencies and cost savings.
- Continual monitoring of workforce planning to ensure staff costs are controlled while continuing to allow the organisation to achieve strategic objectives and deliver services.

SEPA have run a range of scenarios from increases in Grant in Aid of 7.5% per annum to reductions in Grant in Aid of 7.5%. This range would provide a funding gap of between £6,000 and £17.914 million.

Financial Planning 2020/21

The Financial Plan for 2020/21 has been set in the context of medium-term financial challenges . The initial financial forecast in February 2020 projected that SEPA required in year savings of £4.5 million to meet its financial targets. The final approved budget in March, projected a targeted surplus of £2.0 million, incorporating savings initiatives of £3.764 million to achieve this (£2.5 million in staff costs and £1.264 million in non-staff costs).

The projected costs within the 2020/21 Budget do not include:

- Expenditure funded directly by EU grants but includes the costs of SEPA's contributions to these projects.
- Costs associated with pension fund movements.
- Movements in market value of non-current assets.
- The change in accounting treatment of leases (IFRS 16).

Key assumption	Budget £ million	Comment
Grant-in-aid income	37.638	Budgeted Grant in Aid has been agreed to 2020/21 grant funding letter for the year.
Charging schemes	42.695	The budgeted figure is £0.835 million greater than the 2019/20 charging scheme revenue of £41.86 million. The increase reflects forecasts and is not a significant movement year on year.
Other income	4.154	Other income includes a range of income from other sources. The budgeted figure is largely in line with the income recognised in 2019/20.
Staff costs	(59.667)	Budgeted staff costs have incorporated the Scottish Government's pay policy published in February 2020 and also include the target reduction of £2.5 million costs through the Change Programme (discussed further below). Additionally each portfolio has a turnover target which reduces staff costs. The reduction included in the budget for 2020/21 equates to £3.3 million.
Third party costs & other costs	(19.881)	This includes supplies and services costs of £13.712 million. The assumed level of expenditure is broadly consistent with previous years with inflationary uplifts. The plan includes planned cost reductions of £1.264 million in relation to non staff costs. While there can be unplanned costs through adhoc activity, the financial plan includes a contingency of £1.025 million to meet these unplanned costs or overspends.
Depreciation / Amortisation	(2,939)	The depreciation and amortisation charge budgeted for the year is broadly consistent with the charge for 2019/20.
Forecast surplus / (deficit)	**2.000**	**Planned surplus to support capital investment (replacement of essential scientific and hydrology equipment).**

Financial sustainability – Detailed findings (continued)

SEPA have outlined within their Annual Operating Plan (AOP) 2020/21 that the operating surplus, £2.0 million will be used to fund capital investments in year of £2.0 million. The bulk of these funds are expected to be used to replace essential scientific and hydrology equipment. The planned use of resources was agreed before the public health emergency COVID-19 arose. The full impact of COVID-19 is unknown at this point. Whilst still in the 'emergency phase', the world that emerges on the other side will be very different. The impact from the pandemic means that the way SEPA conducts its business in this coming year will be very different. SEPA is going to manage the prioritisation of its resources as flexibly as it can, by following a few key principles for the emergency and recovery period:

1. It will only recruit business critical posts.
2. Expenditure is restricted to essential business priority items only.

While financial planning assumptions appear reasonable, the delivery of these will be challenging for SEPA particularly given the economic impact of Covid-19. 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.

Change Programme

SEPA's Phase 2 way of working is designed to be both more efficient and more effective and should enable the organisation to deliver the same outcomes for less money. The resultant savings will fund increased outcomes and / or meet budget reductions. SEPA is still in a very early stage of implementing the Phase 2 way of working and expect it will take up to five years to move to fully operating in a Phase 2 way.

A key challenge of moving to Phase 2 is that SEPA has traditionally deployed resources based on department and once resources are allocated to a unit or function, it is presumed that those resources remain with the unit or function. Several actions are in place to change this operational culture. The AOP has been developed with much more cross-portfolio interaction and reflects genuine corporate priorities as opposed to individual portfolio priorities. Crucially, a formal process will be established to undertake a series of reviews of programmes and expenditure. This will include the removal of 50 FTEs to generate a minimum of £2.5 million annual salaries and operating cost savings (50 FTE's at an average cost of £50,000 each per annum).

Under the Board's approved Change Programme, SEPA have established a Change Programme Delivery Board. This Delivery Board will meet monthly and will consider reviews of programmes and areas of work or functions. It will also conduct workforce planning and review all vacancies as they occur.

Governance and Transparency

While we have not identified any significant wider scope risks in relation to governance and transparency, in accordance with the Code of Audit Practice, we have undertaken appropriate procedures to allow us to form a conclusion around the organisation's governance and transparency arrangements. This includes review of governance structures and committee and Board minutes.

Headlines

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.

SEPA recognises the need to work with key strategic partners to deliver its Corporate Plan. SEPA developed 16 sector plans with key partners across regulated sectors in 2019/20 and aims to develop a further 17 plans with additional key partners in 2020/21. Using 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.

Governance and transparency – Detailed findings

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. From attendance at the Audit Committee and our review of board minutes and papers, we found the level of reporting to the Board and its committees to be appropriate. Both key performance reports that are transparent and reports which are aligned to the Boards strategic priorities are presented and there is a good level of scrutiny, debate and challenge.

During 2019/20 five new board members were appointed to the Board including a new Chair of the Audit Committee (previously a member of the Audit Committee)

Due to the real and substantial risk to public health due to infection or contamination with coronavirus and the guidance from Scottish Government around office closures all SEPA Board and Committee meetings are being held virtually for the foreseeable future. This decision was made by the Board in April 2020 and will be reviewed, at least every two months. Agency and Strategy Board agenda's and approved Minutes will continue to be published on SEPA's website as will public papers.

Strategic vision and tone from the top

SEPA's Corporate Plan 2017-2022, articulates the Board's strategic outcomes. This defines the organisations vision and the framework in place to deliver it. 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 the changing financial, environmental and technological environment. 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.

Governance and Transparency – Detailed findings (continued)

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 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. SEPA have produced 16 sector plans (in final and draft format) in 2019/20 and have identified a further 17 sectors that they would like to develop sector plans for by March 2021. The development of the plans will be phased between now and March 2021. The proposed new sectors are as follows:

- Commercial and public premises development and use
- Defence activities regulated by SEPA
- Drink manufacture
- Electricity and heat protection
- Food manufacture and processing
- Healthcare and clinical
- Livestock production
- Materials recovery
- Mining and quarrying
- Oil and gas product manufacturing and distribution
- Other manufacturing
- Packaging manufacturing, reuse and reprocessing
- Pig production
- Poultry production
- Recreational, blue and green space
- Shellfish production
- Textiles and apparel manufacture
- Risk management

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.

The Corporate Risk Register, as reviewed at March 2020 includes both strategic, financial and operational risks. Key risks faced by SEPA include:

- Insufficient Grant in Aid and charging income is available to SEPA to deliver the outcomes committed to in the Corporate Plan 2017-2022.
- SEPA does not meet Scottish Ministers’ and SEPA’s aim to have all EU designated bathing waters in Scotland of at least sufficient water quality and avoiding deterioration.
- The pension deficit continues to grow.

Governance and Transparency – Detailed findings (continued)

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.

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 2019/20 to be satisfactory. The NFI exercise identified 391 matches relating to SEPA which were all investigated by SEPA during 2019/20 with no instances of fraud or error 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.

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

We identified the following risk in relation to value for money in our annual audit plan:

Value for money		
SEPA has an established performance management framework and there is ongoing monitoring and scrutiny across management and the organisation. SEPA continues to face challenges in meeting its performance targets. During 2019/20 SEPA reported failing to deliver 2 out of the 17 corporate targets (2018/19: 5 out of 15 corporate targets failed). Area where corporate objectives have not been delivered include increasing the length of river or loch shore where physical condition; finalising sector plans; making waste sector less attractive to criminals; increasing, in targeted sectors, in the percentage of permits which have obligations that are clearer; and develop new sustainable growth agreements. SEPA recognise the importance of working with partners to support the delivery of corporate objectives. **Significant risk identified:** ***With forecast budget pressures over the next five years, it is increasingly important that SEPA ensure they maximise the use of resources to support the delivery of corporate objectives. Working with key strategic partners will be critical to this as well as ensuring that performance targets and measures align to corporate objectives.***	Audit response	***Response to significant wider scope risk:*** We will assess the extent to which SEPA works with key strategic partners to enhance performance improvement and deliver corporate objectives. A key part of this will be ensuring that performance measures are clearly aligned to corporate priorities and SEPA's statutory requirements to ensure performance monitoring is aligned to the delivery of these. We will consider the extent to which there is consideration of how resources can be best utilised in supporting the delivery of these and how SEPA ensure they can monitor the organisation's performance in targeting outcomes, particularly in areas reliant on strategic partners. ***Other wider scope procedures:*** We will consider the extent to which SEPA can demonstrate that they deliver value for money through the delivery of services, using resources efficiently and effectively to deliver outcomes. We will consider the progress made by SEPA in working with strategic partners to support the delivery of corporate outcomes.

The headlines identified from our wider scope work in this area alongside detailed narrative are included overleaf.

Headlines

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.

SEPA has an established performance management framework and there is ongoing monitoring and scrutiny across management and the Board. SEPA continues to face challenges in meeting its performance targets, failing to deliver 2 out of the 17 corporate targets in 2019/20. There are opportunities to enhance operational performance monitoring through the use of more outcome focused measures.

Value for Money – Detailed findings

Performance framework

SEPA has a number of overarching strategies including the Corporate Plan, the AOP 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.

The Annual Operating Plan 2019/20 identified 17 performance measures which were monitored throughout the year and reported to the Board within the quarterly corporate performance report. SEPA continues to face challenges in meeting its performance targets as during 2019/20 SEPA failed to deliver 11.7% (2) of its performance targets. These were the following targets:

- This year we will have new permit templates for four sectors: Finfish aquaculture; Landfill; Metals and Scotch Whisky sectors.
  - We will begin issuing permits in the new template in the following sectors:

    Finfish aquaculture sector: 60 – 70% of 286 permits for operational sites;

    Landfill sector: all permits for the 12 priority sites

    Metals sector: all permits for the 30 priority sites
- This year we will carry out duty of care campaigns in the housing and infrastructure sectors.

The annual report and accounts provides a summary of the progress made against these actions as well as work outstanding to address these. The performance targets align to AOP targets and subsequently support the assessment of progress towards strategic outcomes. For 2019/20, the performance measures appear more focused on SEPAs outcomes and deliverables as there are several measures focused outputs as well as inputs. However, in line with prior year, targets such as 'Make the waste sector less attractive to criminals" are very subjective and difficult to quantify the performance outcomes from SEPA's activities. SEPA should continue to refine performance information to enable ongoing scrutiny of operational performance against corporate priorities.

Environmental Change

SEPA's general purpose is to make sure that the environment and human health are protected, to ensure that Scotland's natural resources and services are used as sustainably as possible and contribute to sustainable economic growth. SEPA have set out their long-term aspirations in the One Planet Prosperity Strategy. The strategy is on SEPA's website and there is clear information relating to: it's ambitions and aspirations, how they use it to regulate (e.g. Sector Planning, compliance/ beyond compliance), how they will work with others to achieve these ambitions (e.g. Sustainable Growth Agreements), and how they contribute to Sustainable Development goals and Climate Change commitments. These set out clearly the effective organisational context from which public services can deliver key outcomes and achieve best value.

SEPA look to work with partner organisations to go 'beyond compliance' with regards to 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.

Within the 2019/20 Annual Operating Plan, SEPA outlined the following performance measure: Agree at least two Sustainable Growth Agreements to specifically showcase low carbon innovation. This target was achieved by signing The Leven Programme Partnership Sustainable Growth Agreement and the Midlothian Council and Shawfair LLP Sustainable Growth Agreement's in quarter 1 and 3 respectively.

Dependency on key suppliers

The collapse of Carillion in 2018 and the subsequent impact across the public sector, brought into focus the risk of key supplier failure and underperformance. We considered the arrangements in place for identifying key supplier and risks, if any associated with these and how effectively these are being managed.

Improvements around contingency planning for supplier failure is a key objective in the Procurement Operating Plan 2019-21 and will be a focus in 2020/21. The Procurement Team have been assisting with the drafting of Scottish Government Guidance which was issued in 2019/20 around supplier failure. Work is now being undertaken to ensure appropriate contingency plans are in place for Tier 1 suppliers (as identified through prioritisation using the UK Government Commercial Function methodology.

In the current circumstances with COVID-19, SEPA have been working to follow SG guidance on supporting suppliers through this difficult time, protecting critical suppliers through supplier relief where appropriate.

Appendices

- Audit adjustments
- Audit recommendations
- Follow up of prior year recommendations
- Audit fees and independence
- Fraud arrangements
- Communication of audit matters

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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.

The adjustments made are detailed below:

Item		Dr (£'000)	(Cr) (£'000)	Description
1	Pension fund assets	1,432		*Being adjustment for the updated IAS19 financial information received after the commencement of the audit.*
	Actuarial gain on pension assets		(1,432)	
SEPA did not receive the updated IAS19 report until the audit was underway and the first draft of financial statements had been prepared. On receipt of the report management notified the audit team that the above adjustment would be required. This has been posted by management and agreed to the final set of financial statements.				
2	Property, Plant and Equipment	196		*Being adjustment to update PPE valuations with the March 2020 indices not available at the time the first draft of financial statements were prepared.*
	Loss on revaluation		(6)	
	Revaluation reserve		(190)	
Due to the Covid-19 pandemic there was a delay in the publication of indices used by management for the revaluation of property, plant and equipment. As a result management prepared the first draft of financial statements using the indices published as at 31 January 2020. On publication of the indices as at 31 March 2020 it was identified by management that the movement required adjustment for the final accounts. Management notified the audit team and posted the journal above.				

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.

Disclosure error / omission	Detail	Adjusted
Correction of median pay disclosure	The first set of draft accounts had used the actual highest paid salary to calculate the median pay as opposed to the mid point in the range.	✓
Wording in respect of revaluations	The first set of draft accounts refer to “fair value” of land and buildings and the vessel subject to revaluation. This should be updated to “current value”.	✓

Audit adjustments

Disclosure misstatements (continued)

Disclosure error / omission	Detail	Adjusted
Disclosure of material valuation uncertainty	The first set of draft accounts did not include disclosure of the material uncertainty which was identified in respect of property, plant and equipment valuations as a result of the Covid-19 pandemic.	✓
Calculation of FTE	While the total FTE number included in the staff report is factually correct, SEPA use a pro-rating of staff costs to determine the FTE numbers to be allocated across categories of staff as opposed to factual numbers. A narrative disclosure should supplement the figures disclosed to explain management’s methodology for this calculation.	✓

Audit recommendations 2019/20

We set out below our recommendation based on the 2019/20 audit.

Recommendation
Professional valuations (Property, Plant and Equipment)
The vessel
In our correspondence with the professional valuers of the Sir John Murray, Century Marine Services Limited, they noted that while the valuation of the vessel at March 2020 reflected the impact of Covid-19 it did not consider the prolonged period which Covid-19 would impact the economy. As a result, there may be a fall in the value of the vessel in financial year 2020/21.
We recommend SEPA liaises with its valuer in order to ensure the depreciation charge for the vessel is appropriate for 2020/21.
Initial management response
We will liaise with the valuer as recommended and make appropriate accounting adjustments in the accounts for the year to 31 March 2021.
Action owner: Director of Finance. Due date: 31 March 2021.

Follow up of 2018/19 recommendations

We set out below our follow up of our 2018/19 recommendations and these are reflected below for information.

Recommendation

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 by £4.380 million.

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.

Initial management response

Management will continue to engage with FPS and its actuaries to ensure its pensions liabilities are appropriately estimated

Follow up – recommendation is closed

Management have engaged with both FPS and its actuaries to ensure pension liabilities are appropriately estimated as at 31 March 2020. The movement on the pension liability and underlying associated costs have been accounted for correctly in the year end accounts.

Corporate performance

IFRS 16: Leases, is due to be adopted by the FReM and effective from the financial year 2020/21. 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.

Initial 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.

Follow up – recommendation is closed

Management have assessed the transition to IFRS 16 adoption and have submitted relevant papers to the Scottish Government outlining the impact of IFRS 16 adoption. These have been inspected by Grant Thornton and preparatory work appears appropriate. The transition to IFRS 16 will be audited in year ended 31 March 2021.

Recommendation

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.

Initial management response

AMT will take forward workforce planning in 2019/20.

Follow up – recommendation is closed

Management have incorporated workforce planning into their Annual Operating Plan for 2020/21 including plans to remove 50 FTE posts, reducing costs by £2.5 million. This aims to promote effectiveness and efficiency through better cross-departmental working. The AOP has been inspected by Grant Thornton as part of our wider scope audit work as detailed in this report.

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.

Initial management response

Performance targets continue to be refined and aligned to priorities

Follow up – Partially complete, ongoing

Progress has been made in refining performance information as evidenced in the front end of the accounts. This is an area which management continue to look to improve and will continue to be monitored by Grant Thornton.

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.

Initial management response

Management will seek professional advice regarding future liabilities associated with leased properties.

Follow up – recommendation is closed

Management engaged with valuation experts in the year to identify potential obligations in respect of restoring leasehold properties. This resulted in the establishment of a decommissioning provision in the annual accounts which has been audited by Grant Thornton as at 31 March 2020.

Audit fees and independence

External Audit Fee

Service	Fees £
External Auditor Remuneration	44,850
Pooled costs	9,610
Contribution to Audit Scotland costs	2,290
Contribution to Performance Audit and Best Value	-
2019/20 Fee	**56,750**

Fees for other services

Service	Fees £
We confirm there are no non-audit fees	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 FRC'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 FRC'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.

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.

Fraud arrangements

The term fraud refers to intentional acts of one or more individuals amongst management, those charged with governance, employees or third parties involving the use of deception that result in a material misstatement of the financial statements. In assessing risks, the audit team is 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 relations 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. Typically we do 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.

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.

The primary responsibility for the prevention and detection of fraud rests with management and those charged with governance including establishing and maintaining internal controls over the reliability of financial reporting effectiveness and efficiency of operations and compliance with applicable laws and regulations.

It is SEPA 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 work with SEPA to review specific areas of fraud risk, including the operation of key financial controls. We also examine the policies in place, strategies, standing orders and financial instructions to ensure that they provide a strong framework of internal control.

In addition, as set out in the Audit Scotland Code of Audit Practice we have a role in reviewing SEPA arrangements in response to the national fraud initiative exercise.

All suspected frauds and/or irregularities over £5,000 are reported to Audit Scotland by us as your auditors on a quarterly basis.

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 to the Auditor General as required by Audit Scotland.

Communication of audit matters

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 below.

This document, our Annual Report is issued prior to approval of the financial statements and presents key issues and other matters arising from the audit, together with an explanation as to how these have been resolved.

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	•	•
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	•	•
Significant matters in relation to going concern - **No significant matters identified.**	•	•
Views about the qualitative aspects of SEPA's accounting and financial reporting practices, including accounting policies, accounting estimates and financial statement disclosures - **Summarised on slides 14 – 18.**		•
Significant findings from the audit - **Captured within this report.**		•
Significant matters and issues arising during the audit and written representations that have been sought - **No significant matters arising and letter of representation signed as at date of signing the accounts.**		•
Significant difficulties encountered during the audit - **No difficulties were encountered during the audit.**		•
Significant deficiencies in internal control identified during the audit - **No significant deficiencies in internal control identified during the audit.**		•
Significant matters arising in connection with related parties - **No significant matters identified in connection with related parties.**		•
Identification or suspicion of fraud involving management and/or which results in material misstatement of the financial statements – **None identified.**		•
Non-compliance with laws and regulations – **None identified.**		•
Unadjusted misstatements and material disclosure omissions – **None identified.**		•
Expected modifications to the auditor's report, or emphasis of matter – **No modifications. Emphasis of Matter included on PPE Valuation uncertainty.**		•

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