

Scottish Canals

**Financial year ended
31 March 2022**

External Audit Plan (final subject to agreement of audit fee)

4 May 2022



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The contents of this report relate only to the matters which have come to our attention, which we believe need to be reported to you as part of our audit planning process. It is not a comprehensive record of all the relevant matters, which may be subject to change, and in particular we cannot be held responsible to you for reporting all of the risks which may affect the organisation or all weaknesses in your internal controls. This report has been prepared solely for your benefit and Audit Scotland (under the Audit Scotland Code of Practice 2016). We do not accept any responsibility for any loss occasioned to any third party acting, or refraining from acting on the basis of the content of this report, as this report was not prepared for, nor intended for, any other purpose.

Plan overview

The audit plan sets out our risk based audit approach for Scottish Canals. This plan outlines our risk assessment and is reported to those charged with governance (Audit and Risk Committee on behalf of Scottish Canals' Board and Accountable Officer).

1 Materiality

We have calculated planning materiality based on the total operating expenditure of £22.8 million recognised in the audited accounts for 2020/21:

- £386,000 planning materiality being 1.7% of total operating expenditure. Performance materiality of £250,000 is based on 65% of planning materiality and our trivial reporting threshold of £19,000 is based on 5% of planning materiality.
- Lower materiality of £20,000 has been set for the Senior Management Remuneration, within the Remuneration and Staff report.

We will revisit our materiality throughout our audit including updating to reflect the unaudited 2021/22 financial statements once received.

2 Financial statement audit risks

At planning, in accordance with the ISA's (UK) and FRC Practice Note 10 we have identified the following significant financial statement audit risks:

- Management override of controls (ISA UK 240);
- Risk of fraud in revenue recognition (Income from commercial activities including capital grant release, cut-off) (ISA UK 240);
- Risk of fraud in expenditure recognition (Materials, maintenance and repairs and Other costs, cut-off) (PN10);
- Valuation of operational infrastructure, freehold land and buildings (valuation);
- Valuation of investment property (valuation); and
- Defined benefit pension scheme liabilities (valuation).

Plan overview (continued)

3 Wider Scope Audit

In accordance with the Code, our planning considers the wider scope areas of audit. We have identified four wider scope risks and will conclude on these during the audit:

- Financial sustainability - We will focus on in-year financial performance for 2021/22 as well as considering the impact of Scottish Canals' performance on its medium to long term financial sustainability. We will review Scottish Canals' future plans and their consideration of recovery and re-mobilisation beyond the pandemic and the possibility of less COVID-19 monies being made available to Scottish Canals going forward.
- Financial management - We will review the progress made in relation to Scottish Canals' review of the Fixed Asset Register (FAR) and whether it is fit for purpose. We will review the progress made during 2021/22 in relation to the HR Job Evaluation (pay and reward review).
- Governance and transparency - We will consider how Scottish Canals has maintained good governance throughout the year, focused on any new governance arrangements introduced and the openness and transparency of decision making. We will review the plans that Scottish Canals have in place in respect of senior leadership team recruitment and succession planning.
- Best value - We will consider how Scottish Canals has ensured it has demonstrated value for money in its decision making in relation to the Bigg asset swap transaction, as well as balancing the organisation's priorities and the commercial benefit of this asset swap transaction.

Plan overview (continued)

4 Other audit matters

We summarise other audit matters for Audit and Risk Committee awareness. This includes:

- In accordance with the Code and planning guidance we also complete and submit a number of deliverables in year including sharing intelligence with Audit Scotland. This includes an NFI return.
- Consideration of going concern in accordance with Practice Note 10.
- We will also report on the risk of fraud and corruption in the procurement function in our 2021/22 final Annual Audit Report.

5 Our Audit Fee

Audit fees were shared by Audit Scotland with Scottish Canals in December 2021. We anticipate our audit fee will be higher than the baseline audit fee as shared by Audit Scotland with Scottish Canals. Our audit fee will be agreed with both Audit Scotland and Scottish Canals and will be shared with you in due course.

The fee includes pooled costs and a contribution to Audit Scotland costs. Audit fees are paid to Audit Scotland who in turn pay Grant Thornton UK LLP. We reserve the right to review our fee during the audit should significant delays be encountered and/or new technical matters arise.

Prior year audit opinion

Prior year audit opinion

For the financial year ended 31 March 2021 we issued a disclaimer of opinion on the annual report and accounts. Due to matters identified in relation to Property Plant and Equipment (PPE) we determined we had insufficient audit evidence to conclude that the accounts were not materially misstated or otherwise. This specifically related to £51million of assets held, classified as specialist-operational assets.

Scottish Canals will undertake a new valuation process for PPE during 2022. As part of this new valuation process they will review their current Fixed Asset Register (FAR), including specialist operational assets, and ensure that they are appropriately recorded and categorised. This will be a substantial piece of work for Scottish Canals and may result in material changes within the FAR. If this is the case, this may then also have a resulting material impact on the financial statements and Scottish Canals may therefore require Prior Period Adjustments (PPA) in the financial statements in relation to comparative balances for 2020/21. As a result, we anticipate that additional audit work will be required in relation to the audit of PPE in our 2021/22 external audit, including enhanced auditor challenge in relation to management judgements as well as heightened professional scepticism being applied by the audit team, in order to gain sufficient and appropriate audit evidence that the financial statements are not materially misstated.

Introduction

Purpose

This document provides an overview of the planned scope and timing of the external audit of Scottish Canals for those charged with governance.

We are appointed by the Auditor General as the external auditors of Scottish Canals for the 6 year period (2016/17 until 2021/22)

Respective responsibilities

Audit Scotland has issued a document entitled Code of Audit Practice ('the Code') dated 2016 covering this audit appointment period. This summarises where the responsibilities of auditors begin and end and what is expected from the audited body. Our respective responsibilities, and that of Scottish Canals are summarised on page 8 of this plan. We draw your attention to this and the Code.

Scope of our audit

The scope of our audit is set in accordance with the Code and International Standards on Auditing (ISAs) (UK). We are responsible for forming and expressing an opinion on Scottish Canals' financial statements that have been prepared by management with the oversight of those charged with governance (the Audit and Risk Committee).

The audit of the financial statements does not relieve management or the Audit and Risk Committee of your responsibilities. It is the responsibility of Scottish Canals to ensure that proper arrangements are in place for the conduct of its business, and that public money is safeguarded and properly accounted for. We will consider how Scottish Canals is fulfilling these responsibilities.

Our audit approach is based on a thorough understanding of Scottish Canals and is risk based.



Responsibilities

The Code sets out auditor responsibilities and responsibilities of the audited body. Key responsibilities are summarised below. Please refer to the Code for further detail.

Scottish Canals

Responsibilities include:

- Preparing financial statements that give a true and fair view
- Maintaining accounting records
- Establishing and maintaining systems of internal control
- Effective internal controls including controls to achieve objectives and secure value for money
- Establish arrangements for proper conduct of affairs including legality of transactions
- Arrangements for prevention and detection of fraud, error, irregularity, bribery and corruption
- Appropriate corporate governance arrangements and arrangements to monitor the effectiveness of governance

External Audit

Responsibilities include:

- Comply with professional engagement and ethical standards
- Provide an ISA compliant audit and opinion on the financial statements including regularity of transactions
- Demonstrate compliance with the wider scope public audit as detailed in the Code and applicable guidance
- Liaise with and notify Audit Scotland when circumstances indicate a statutory report may be required. This includes sharing awareness of current and/or sector issues
- Notify Audit Scotland of any known or suspected frauds greater than £5,000
- Contribute to relevant performance studies (as set out in the planning guidance for the year)

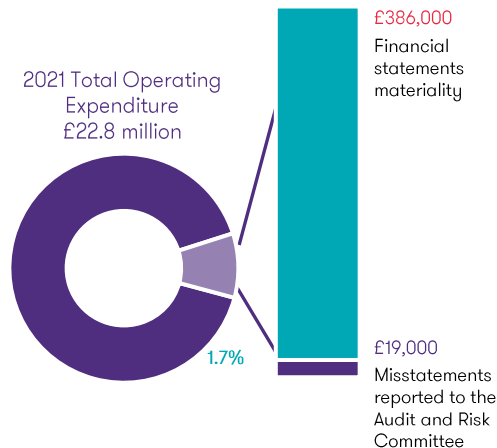


Audit approach



Materiality

Financial statement materiality is determined based on a proportion of Scottish Canals' total operating expenditure. We have determined **planning materiality** to be £386,000 (PY: £340,000), which equates to approximately 1.7% (PY: 1.7%) of total operating expenditure as per 2020/21 audited financial statements.



Performance materiality represents the amount set for the financial statements as a whole to reduce the probability that the aggregate of uncorrected and undetected misstatements exceed materiality. We use this to determine our testing approach to the financial statements. We have set this at 65% (PY: 70%) of planning materiality, resulting in a performance materiality of £250,000 (PY: £238,000). This decrease of 5% on the prior year performance materiality rate is based on our understanding of Scottish Canals, our overall risk assessment procedures and the level and value of adjusted and unadjusted misstatements identified in the prior year audit as well as the impact of these adjustments on the Statement of Comprehensive Net Expenditure.

Materiality reflects our professional judgement of the magnitude of an omission or misstatement that, individually or in the aggregate, could reasonably be expected to influence the economic decisions of the users of the financial statements.

On this basis we apply a separate **lower materiality level** to the following account balance and disclosure:

- **Remuneration and Staff Report - Senior Management Remuneration.** This is set at £20,000 in order to ensure a high level of precision in this area of the financial statements.

Under ISA 260 (UK) 'Communication with those charged with governance', we are required by auditing standards to report uncorrected omissions or misstatements other than those which are '**clearly trivial**' to those charged with governance. We have determined this threshold to be £19,000 (PY: £17,000), being 5% (PY: 5%) of planning materiality.

We will update our materiality based on the unaudited 2021/22 financial statements when received in July/early August 2022. During the course of our audit engagement, we will continue to assess the appropriateness of our materiality.

Significant audit risks

Significant risks are defined by ISAs (UK) as risks that, in the judgement of the auditor, require special audit consideration. In identifying risks, audit teams consider the nature of the risk, the potential magnitude of misstatement, and its likelihood. Significant risks are those risks that have a higher risk of material misstatement.

Management Override of Controls (as required within Auditing Standards – ISA 240)

As set out in ISA 240 there is a presumed risk that management override of controls is present in all entities. Our risk focuses on the areas of the financial statements where there is potential for management to use their judgement to influence the financial statements alongside the potential to override Scottish Canals' internal controls, related to individual transactions. Our work focuses on critical estimates and judgements as set out within the financial statements, including accounting policies.

We will:

- Evaluate the design effectiveness of management controls over journals;
- Analyse the journals listing and determine the criteria for selecting high risk unusual journals;
- Test unusual journals made during the year and at year end for appropriateness and corroboration;
- Gain an understanding of the accounting estimates and critical judgements applied and made by management and consider their reasonableness; and
- Evaluate the rationale for any changes in accounting policies, estimates or significant unusual transactions.

Significant audit risks (continued)

Risk of Fraud in Revenue (as required within Auditing Standards – ISA 240)

As set out in ISA 240 there is a presumed risk that revenue may be misstated due to improper recognition of revenue for all entities.

Scottish Canals is primarily funded by the Scottish Government through Grant-in-Aid (“GIA”). GIA is received throughout the year and is accounted for as financing on a cash basis, not as income, and in accordance with the FReM is credited to the “General Fund” reserves in the Statement of Taxpayers’ Equity. Whilst material, we consider this funding to be well forecast and it can be directly agreed to Scottish Government funding reducing the opportunity for manipulation and the inherent risk of material misstatement. As such, we rebut the risk of fraud in revenue in relation to GIA income.

Scottish Canals recognised £718,000 of grant income (in relation to the Job Retention Scheme) and £655,000 of third party funding in revenue in 2020/21. Again, whilst material, we consider grant income and third party funding easily agreed to funding and award letters, reducing the opportunity for manipulation and the inherent risk of material misstatement. As such, we rebut the risk of fraud in revenue in relation to grant income and third party funding.

Scottish Canals generates other revenue through a range of sources including the sale of goods (water, utility and retail sales) and rendering services (including capital grant release). These represent material revenue streams. We therefore consider the risk of fraud in revenue recognition to be present in material revenue streams recognised within sale of goods and rendering of services. Our planned testing procedures includes a specific focus on year end cut-off arrangements, where it may be advantageous for management to manipulate year end revenue results.

In response to this risk we will:

- Evaluate your revenue recognition accounting policy for appropriateness and compliance with HM Treasury’s Government Financial Reporting Manual (the “FREM”);
- Perform detail testing of revenue transactions at and around year end to verify the accounting period transactions relate to and confirm that transactions have been recognised in the correct financial period; and
- Review the judgements and estimates made by management when recognising accrued and deferred income at year end within the financial statements and challenge management accordingly.

Significant audit risks (continued)

Risk of Fraud in Expenditure (as recommended in FRC Practice Note 10 for Public Sector entities)

As set out in Practice Note 10 (revised) which applies to public sector entities, we consider there to be an inherent risk of fraud or error in expenditure recognition.

Scottish Canals' expenditure includes both payroll and non-payroll costs. We consider payroll costs to be well forecast and are able to agree these costs to underlying payroll systems. As such we believe there is less opportunity for a material misstatement as the result of fraud to occur in this area.

We focus our risk on the following non-payroll expenditure streams: Materials, maintenance and repairs and Other costs. Our testing will include a specific focus on year end cut-off arrangements, where it may be advantageous for management to manipulate year end expenditure results.

In relation to these material expenditure streams we will:

- Evaluate your expenditure recognition accounting policy for appropriateness and compliance with the FREM;
- Perform detail testing of expenditure transactions at and around year end to verify the accounting period transactions relate to and confirm that transactions have been recognised in the correct financial period;
- Review the judgements and estimates made by management when recognising accruals and provisions at year end within the financial statements and where appropriate challenge management accordingly.

Significant audit risks (continued)

Valuation of operational infrastructure, freehold land and buildings

In accordance with the HM Treasury's Government Financial Reporting Manual (FRoM), subsequent to initial recognition, Scottish Canals is required to hold property, plant and equipment on a valuation basis. The exact valuation basis depends on the nature and use of the assets. Specialised land, buildings, equipment, installations and fittings are held at depreciated replacement costs, as a proxy for fair value. Non-specialised land and buildings, such as offices, are held at fair value. There are further modifications to values depending on the nature and use of assets to ensure PPE is approximately stated. As at 31 March 2021, Scottish Canals held PPE of £105.1 million including operational infrastructure, freehold land and buildings of £58.5 million. Given the value of operational infrastructure, freehold land and buildings held by Scottish Canals and the level of complexity and judgement in the estimation valuations, there is an inherent risk of material misstatement in these assets.

Scottish Canals will appoint independent expert valuers to undertake a rolling programme of valuations across the assets base, valuing operational infrastructure, freehold land and buildings at a minimum of once every five years. Based on our planning procedures to date and subject to the results of the final valuation we focus the risk on:

- Operational infrastructure, freehold land and buildings where the valuation movement is not in line with the audit team's expectation;
- Operational infrastructure, freehold land and buildings which have been valued by the valuers without any physical inspection of relevant data; and
- Operational infrastructure, freehold land and buildings which have not been formally valued during the year and management's assessment of impairment in relation to such assets.

(continued)

Significant audit risks (continued)

Valuation of operational infrastructure, freehold land and buildings (continued)

Our testing in relation to **operational infrastructure** will include:

- Walkthroughs of the controls and procedures over the valuation of operational infrastructure;
- Consideration of the arrangements in place at Scottish Canals for ensuring completeness and accuracy of operational infrastructure assets recorded in the Fixed Asset Register;
- Review of component revaluations made during the year, confirming valuations have been input correctly into the fixed asset register and accounted for correctly in the financial statements;
- Evaluation of the competence, capability and objectivity of Scottish Canals' professional valuer of operational infrastructure assets who represent management's experts under ISA 500, and consideration of the suitable experience of the valuer, recognising certain operational infrastructure assets are specialist in nature but other assets such as public amenity land and land based assets require a valuation by a RICS qualified specialist;
- Review of component useful economic lives and whether they are appropriate given the nature of the component;
- Engaging our own valuations expert to assess the instructions issued by Scottish Canals to their valuers, the final valuers' reports and the assumptions used that underpin the final valuations; and
- Performing focused testing in relation to management's impairment assessment, particularly in relation to assets which have not been subject to a formal valuation during the year, and consider the appropriateness of the assumptions used as part of this assessment.

Significant audit risks (continued)

Valuation of operational infrastructure, freehold land and buildings (continued)

Our testing in relation to **freehold land and buildings** will include:

- Walkthroughs of the controls and procedures over the valuation of land and buildings;
- Consideration of the arrangements in place at Scottish Canals for ensuring completeness and accuracy of the land and buildings recorded in the Fixed Asset Register;
- Evaluation of the competence, capability and objectivity of Scottish Canals' professional valuer of land and buildings who represent management's experts under ISA 500;
- Confirming the completeness and accuracy of underlying information provided by Scottish Canals and used by their expert valuer in arriving at the valuation of land and buildings as at 31 March 2022;
- Challenging the appropriateness of the assumptions adopted by the valuer in valuing land and buildings;
- Performing focused testing in relation to management's impairment assessment, particularly in relation to assets which have not been subject to a formal valuation during the year, and consider the appropriateness of the assumptions used as part of this assessment; and
- Using our auditor's valuation expert in order to challenge Scottish Canals' management of the valuation instructions issued and approach adopted in valuing land and buildings as at 31 March 2022.

Significant audit risks (continued)

Valuation of investment property

In accordance with the HM Treasury's Government Financial Reporting Manual (FReM), subsequent to initial recognition, Scottish Canals is required to hold investment property at fair value and must subsequently revalue these assets at each balance sheet date. At 31 March 2021 Scottish Canals held £24.3 million of investment property including land and buildings let at open market rents, land and buildings held for capital appreciation and moorings. Scottish Canals engage valuation expert Gerald Eve to determine an appropriate valuation for these investment properties, with valuations being based on a number of key assumptions including an estimate of future rental income associated with these properties.

Given the value of investment property held by Scottish Canals and the level of complexity and judgement in the estimation valuations, we have recognised a significant risk in relation to the valuation of investment property at 31 March 2022. We focus this risk on the appropriateness and reasonableness of the underlying rental yield assumptions used by Scottish Canals.

Our testing in relation to this identified risk will include:

- review of revaluations made during the year, confirming valuations have been input correctly into the asset register;
- Understanding the basis on which valuations are carried out and challenge the information and assumptions used in the valuation process, particularly in relation to rental yields used; and
- engaging our own valuations expert to assess the instructions issued by Scottish Canals to their valuers, the final valuers' report and the assumptions used that underpin the final valuations.

Significant audit risks (continued)

Valuation of defined benefit pension scheme liabilities

Scottish Canals participates in two defined benefit pension schemes: the Waterways Pension Fund and the Strathclyde Pension Fund, a local government pension scheme. In accordance with IAS 19: Employee Benefits, Scottish Canals is required to recognise its share of both scheme's assets and liabilities in the Statement of Financial Position. As at 31 March 2021 Scottish Canals had pension fund liabilities of £1.2 million.

Scottish Canals obtain an annual IAS 19 actuarial valuation of Scottish Canals' net liabilities in both of these pension schemes. There are a number of assumptions contained within the valuations, 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 schemes could be materially misstated within the financial statements. We focus this risk on the appropriateness and reasonableness of the underlying assumptions adopted by the actuary and suitability of these for Scottish Canals.

We will:

- perform walkthroughs of the controls and procedures over the valuation of defined benefit pension liabilities, including management's oversight of the valuation;
- consider the work of the actuary for Strathclyde Pension Fund (Hymans Robertson UK LLP), including the assumptions applied, using work performed by PwC (commissioned on behalf of Audit Scotland to review actuarial assumptions proposed by LGPS actuaries);
- consider the work of KPMG as the Pension Auditor for the Waterways Pension Fund and our auditor experts, within our Pensions team, to review pension assumptions;
- seek the necessary assurances over assets held and membership data, and employer and employee contributions in the year, for both Pension Schemes;
- under the Audit Scotland Pension Fund protocols we will write to, and request a response from, Audit Scotland as the external auditor of Strathclyde Pension Fund.
- perform substantive analytical procedures over the pension fund movements, investigating any significant deviations from audit expectation;

Significant audit risks (continued)

Valuation of defined benefit pension scheme liabilities (continued)

- review the accounting entries and disclosures made within Scottish Canals' financial statements in relation to IAS 19; and
- evaluate the competence, capability and objectivity of the work performed by management's expert and the work performed by auditor's expert under ISA 500 (UK) and ISA 620 (UK).

We will communicate significant findings on these areas as well as any other significant matters arising from the audit to you in our Annual Report to those Charged with Governance and the Auditor General for Scotland in concluding our audit.

Other matters

Auditor Responsibilities

We have a number of audit responsibilities as set out in the Code and planning guidance:

- We audit parts of your Remuneration and Staff Report in your Annual Report and check whether these sections of your Annual Report have been properly prepared (opinion).
- We read the sections of your Annual Report which are not subject to audit and check that they are consistent with the financial statements on which we give an opinion (opinion).
- We carry out work to satisfy ourselves that disclosures made in your Annual Governance Statement are in line with requirements set out in the FReM (opinion).
- We consider our other duties under the Code and planning guidance (2021/22), as and when required, including:
 - Supporting Audit Scotland in Section 22 reporting.
 - Providing regular updates to Audit Scotland to share awareness of current issues.
 - Contributing to Technical Guidance Notes.
 - Contribute to the National Fraud Initiative (NFI) report.
 - Notifying Audit Scotland of any cases of money laundering or fraud.

We will also report on the risk of fraud and corruption in the procurement function in our 2021/22 final Annual Audit Report.

Other material balances and transactions

Under International Standards on Auditing, "irrespective of the assessed risks of material misstatement, the auditor shall design and perform substantive procedures for each material class of transactions, account balance and disclosure". All other material balances and transaction streams will therefore be audited. However, the procedures will not be as extensive as the procedures adopted for the risks identified in this report.

Internal control environment

Throughout our audit planning and fieldwork we will continue to develop our understanding of the overall control environment (design) as related to the financial statements. In particular we will:

- Consider procedures and controls around related parties, journal entries and other key entity level controls.
- Perform walkthrough procedures on key controls around identified risk areas including: material sources of income, material expenditure streams, valuation of operational infrastructure, freehold land and buildings, valuation of investment property, valuation of defined benefit pension scheme liabilities, journal entries and areas of material management estimate and judgement.
- Our focus is on design and implementation of controls only. We do not place reliance on controls when it comes to our year end financial statement audit work.

Other matters (continued)

Going concern assessment

As auditors, we are required to obtain sufficient appropriate audit evidence regarding, and conclude on:

- whether a material uncertainty related to going concern exists; and
- the appropriateness of management's use of the going concern basis of accounting in the preparation of the financial statements.

The Public Audit Forum has been designated by the Financial Reporting Council as a "SORP-making body" for the purposes of maintaining and updating Practice Note 10: Audit of financial statements and regularity of public sector bodies in the United Kingdom (PN 10). It is intended that auditors of public sector bodies read PN 10 in conjunction with (ISAs) (UK).

PN 10 has recently been updated to take account of revisions to ISAs (UK), including ISA (UK) 570 on going concern. The revisions to PN 10 in respect of going concern are important.

In particular, PN 10 allows auditors to apply a 'continued provision of service approach' to auditing going concern, where appropriate. In considering going concern we will refer to Audit Scotland's Going Concern publication (December 2020).

Within our wider scope work we will conclude on Scottish Canals' arrangements to ensure financial sustainability.

Accounting estimates

Under ISA (UK) 540 auditors are required to understand and assess an entity's internal controls over accounting estimates, including:

- The nature and extent of oversight and governance over management's financial reporting process relevant to accounting estimates;
- How management identifies the need for and applies specialised skills or knowledge;
- How the entity's risk management process identifies and addresses risks relating to accounting estimates;
- The entity's information system;
- The entity's control activities in relation to accounting estimates; and
- How management reviews the outcomes of previous accounting estimates.

To ensure compliance with this revised auditing standard, we will be requesting further information from management and those charged with governance during our audit. Based on our knowledge of Scottish Canals we have identified some material accounting estimates for which this is likely to apply: Valuation of operational infrastructure assets, valuation of freehold land and buildings, valuation of investment property, depreciation and impairment, valuation of investments, prepayments and accrued income, accruals, VAT liability assessment, valuation of defined benefit pension scheme liabilities and deferred income/deferred capital income. Further detail is set out in our Appendix on page 37.

Other matters (continued)

Financial accounting updates — International Financial Reporting Standard 16 Leases implementation

Following the previous deferrals of IFRS 16 Leases, this accounting standard will now be implemented from 1 April 2022.

The new standard brings significant changes for lessee accounting. Key points that Scottish Canals will need to consider on transition include:

- The need to recognise the cumulative effects of initially applying IFRS 16 on 1 April 2022 as an adjustment to the opening balances of taxpayers' equity. This means prior year comparators will not need to be restated at 31 March 2023.
- The need to recognise the right-of-use asset for leases previously classified as operating leases at an amount equal to the outstanding lease liability.
- No adjustments are needed for leases for which the underlying asset is of low value (less than £5,000 new) or where the lease term ends on or before 31 March 2023.
- Assets where there is no or a below market rate peppercorn lease premium should be recognised as a right-of-use asset measured at current value in existing use or fair value as appropriate. Any difference between this and the lease liability will be recognised as part of the adjustment to the opening balances of taxpayers' equity.

- Irrecoverable VAT should not be included in the lease liability nor the value of the right of use asset.
- Existing finance lease and PFI liabilities that have an element based on an index or other rate will need to be reviewed and possibly amended as such variable payments are incorporated into the measurement of the lease liability under IFRS 16. HM Treasury is expected to provide further guidance regarding the implementation of changes to accounting for PFI arrangements.
- The 2021/22 financial statements will need to disclose the anticipated impact of adopting IFRS 16 from 1 April 2022.
- Systems will need to be in place to capture the relevant information for new leases entered into on or after 1 April 2022.

Scottish Canals will need to ensure that controls are in place to identify all of its contracts and any other arrangements which might contain the use of an asset, in order to ensure that the disclosures made within the financial statements are complete and accurate.

Other matters (continued)

Other financial reporting developments - Changes in the FReM for 2021/22

One of the main changes to the FReM 2021/22 is to expanded requirements for Fair Pay Disclosures within the remuneration and staff report. This is in line with changes made to the FReM for 2021/22. The main changes are:

- A new requirement to disclose the percentage year on year changes in salary and allowances, and performance pay and bonuses, for the highest paid director and for the employees of the entity taken as a whole;
- total pay and benefits, and the salary component separately, for the 25th, 50th and 75th percentiles (previously just the median remuneration). This should be based on annualised, full-time equivalent remuneration of all staff (including temporary and agency staff) as at 31 March 2022. For the purpose of this disclosure, pay and benefits excludes the value of pension benefits and severance payments.
- a summary for 2021/22 explaining:
 - whether movement in the ratios is attributable to a change in the highest paid director's remuneration or the employees, or a change in the body's employment models;
 - trends in the median pay ratio; and,
 - whether the body believes that the median pay ratio reflects the pay, rewards and progression policy for employees as a whole.

We will review Scottish Canals' Remuneration and Staff report disclosures in the draft financial statements to evaluate whether the disclosures are complete, clear, concise, and free from material misstatement.

Wider scope risks identified in planning

Our responsibilities under Audit Scotland's Code of Audit Practice extend beyond the audit of the financial statements. The Code sets out four audit dimensions that frame wider scope into identifiable areas; Financial Sustainability, Financial Management, Governance and Transparency and Value for Money. We consider each of these areas through our audit planning process and have included below where we have identified areas of significant wider scope risk.

Financial Sustainability

Scottish Canals set an original budget overspend of £1.2 million for 2021/22, however the expectation of Scottish Government and Transport Scotland was that Scottish Canals would look for ways to reduce this overspend during the year. As at 31 December 2021 Scottish Canals was projecting a year end breakeven position, with £10.4 million Grant-in-Aid having been received during the year (consisting of an original budget allocation of £9.7 million and additional Covid-19 funding of £0.7 million). We will focus on in-year financial performance for 2021/22 as well as considering the impact of Scottish Canals' performance on its medium to long term financial sustainability. We will review Scottish Canals' future plans and their consideration of recovery and re-mobilisation beyond the pandemic and the possibility of less COVID-19 monies being made available to Scottish Canals going forward.

Disclosed in the 2020/21 annual report and accounts was a VAT liability of £8.9 million. This was an existing liability arising due to an investigation by HMRC in the recoverability of input VAT on expenditure. Scottish Canals VAT advisers KPMG are involved in the discussions alongside Scottish Government VAT experts. Whilst Scottish Government recognise the liability, this has not been built into their funding for 2021/22. Scottish Government have advised that Scottish Canals looks to raise the monies for any eventual liability to date and any potential future pressures through their existing funding and resources. If savings cannot be generated by Scottish Canals to meet the liability there is an expectation that Scottish Government will offer support. We will consider HMRC's latest position in relation to this matter and the financial plans Scottish Canals have in place in relation to this liability as well as any further potential future liabilities.

Wider scope risks identified in planning

Financial Management

In recent years, Scottish Canals have noted an increase in capital funding via capital Grant-in-Aid from Scottish Government, resulting in significant increases in capital expenditure. A capital accountant has been employed, on a fixed term contract for two years to support Scottish Canals capital accounting arrangements. Included within this role will be a review of the current Fixed Asset Register (FAR) and whether it is fit for purpose, alongside ensuring all assets are recorded on the FAR, subject to valuation and/or impairment review, and depreciated per Accounting Policies. We will review the progress made in relation to this area during 2021/22.

It is anticipated that the ongoing HR Job Evaluation (pay and reward review) will result in an increase in costs to Scottish Canals. We will review the progress made during 2021/22 in relation to this review and if increases in costs have been identified we will gain an understanding of how Scottish Canals plan to fund these costs going forward.

Wider scope risks identified in planning

Governance and transparency

Opportunities for improvement were identified as part of the 2020/21 external audit in relation to enhancing governance arrangements within Scottish Canals, namely a review of the frequency of Board meetings and the constitution of the Remuneration Committee. We will consider how Scottish Canals has maintained good governance throughout the year, focused on any new governance arrangements introduced and the openness and transparency of decision making.

We will also review the plans that Scottish Canals have in place in respect of senior leadership team recruitment and succession planning.

Wider scope risks identified in planning

Value for money

As noted in the 2020/21 annual report and accounts was the disclosure of the asset swap between Scottish Canals and BIGG, the Scottish Canals Joint Venture Partner. Scottish Canals purchased Bigg 100 Borron Street Business Park and Payne Street Industrial Estate in exchange for the sale of 3 development plots at Dundashill to Bigg. This was approved in December 2020 by Scottish Government with the transactions legally concluded in June 2021 and will therefore be accounted for within the 2021/22 financial statements.

We will consider how Scottish Canals has ensured it has demonstrated value for money in its decision making, as well as balancing the organisation's priorities and the commercial benefit of this asset swap transaction.

Audit timeline



Audited bodies responsibilities

Where audited bodies do not deliver to the timetable agreed, we need to ensure that this does not impact on audit quality or absorb a disproportionate amount of time, thereby disadvantaging other audited bodies. Where additional resources are needed to complete the audit due to a client not meeting their obligations we are not able to guarantee the delivery of the audit to the agreed timescales. In addition, delayed audits will incur additional audit fees.

Our requirements

To minimise the risk of a delayed audit, you need to ensure that you:

- produce draft financial statements of good quality by the deadline you have agreed with us, including all notes, the Annual Report and the Annual Governance Statement
- ensure that good quality working papers are available at the start of the audit, in accordance with the working paper requirements schedule that we will share with you
- ensure that the agreed data reports are available to us at the start of the audit and are reconciled to the values in the accounts, in order to facilitate our selection of samples for testing
- ensure that all appropriate staff are available (or as otherwise agreed) over the planned period of the audit
- respond promptly and adequately to audit queries.

Quality and adding value through the audit

Our overall approach for the audit is clear and upfront communication, founded on our public sector credentials and a methodology to ensure delivery of a quality audit.

The diagram opposite summarises our key approach to adding value to you throughout our audit.

Our methodology is risk based. We comply with Auditing standards and as a Firm we are regulated by the FRC. We take findings on audit quality seriously and continue to invest as a Firm through our audit investment plan. The audit investment plan is supported by a specific national Public Sector audit plan.

We comply with Audit Scotland's quality arrangements including submitting an annual quality report over our Audit Scotland portfolio. As part of Audit Scotland's quality arrangements, ICAS review our work on a rotational basis. Audit Scotland's quality report can be found at www.audit-scotland.co.uk

Our wider quality arrangements are set out in our annual transparency reports which are available on our website (www.granthornton.co.uk).

Project management

- Use of Inflo to track progress and deliverables throughout the audit
- Clear roles and ownership of responsibilities within our team
- Clarity over expectations and timetable
- Track record delivering public sector audits on behalf of Audit Scotland

Clear reporting

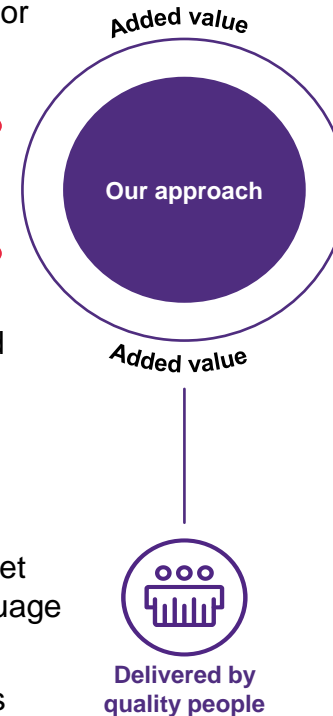
- Clear audit outputs at planning and within our final Annual Report
- Practical, risk based, recommendations for you to take forward
- Our judgements and conclusions set out transparently and in clear language
- Senior presence at Audit and Risk Committees to present our findings and support wider dialogue

Pragmatism and early attention of issues

- Accessible and proactive engagement team
- Working with you to reach the right solution – flexing the workplan, recognising Covid-19
- Audit partner takes ultimate decision on technical matters, consulting with our technical experts

Public sector understanding

- Using our public sector insight to inform our audit and identify improvements you could make
- Regular meetings throughout the year sharing our observations and wider sector knowledge
- Wider scope conclusions to support you in considering key risks and the improvement actions to take



Audit Fees

Across all sectors and firms, the FRC has set out its expectation of improved financial reporting from organisations and the need for auditors to demonstrate increased scepticism and challenge and to undertake additional and more robust testing

As a firm, we are absolutely committed to meeting the expectations of the FRC over audit quality and public sector financial reporting. This includes, for Audit Scotland contracts, meeting the expectations of the Audit Scotland Quality Team and the ICAS quality framework.

Audit fees were shared by Audit Scotland with Scottish Canals in December 2021. We anticipate our audit fee will be higher than the baseline audit fee as shared by Audit Scotland with Scottish Canals. Our audit fee will be agreed with both Audit Scotland and Scottish Canals and will be shared with you in due course.

Audit fees are paid to Audit Scotland who in turn pay Grant Thornton. We reserve the right to review our fee during the audit should significant delays be encountered and/or new technical matters arise.

Relevant professional standards

Audit Scotland set the baseline audit fee. We can increase the fee, from the baseline, for the inclusion of additional risks, new technical matters or specific client matters identified. We are required to consider all relevant professional standards, including paragraphs 4.1 and 4.2 of the FRC's Ethical Standard (revised 2019) which state that the Engagement Lead must set a fee sufficient to enable the resourcing of the audit with partners and staff with appropriate time and skill to deliver an audit to the required professional and Ethical standards.

Independence

Auditor independence

Ethical Standards and ISA (UK) 260 require us to give you timely disclosure of all significant facts and matters that may bear upon the integrity, objectivity and independence of the firm or covered persons relating to our independence.

We encourage you to contact us to discuss these or any other independence issues with us.

We will also discuss with you if we make additional significant judgements surrounding independence matters.

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 Financial Reporting Council's Ethical Standard (Revised 2019) and we as a firm, and each covered person, 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 Ethical Standard.

Our team complete annual fit and proper declarations including independence confirmations on a client by client basis as well as confirming when completing timesheets. The work of our Ethics team is overseen by the Ethics partner and all staff undergo ethics training in year.

We confirm we are independent of Scottish Canals.



Appendices

Communication

ISA (UK) 260 as well as other ISAs set out prescribed matters which we are required to report to those charged with governance (we assume this to be the Audit and Risk Committee on behalf of Scottish Canals). Our reporting responsibilities are set out below. We communicate all matters affecting the audit on a timely basis, to management and/or the Audit and Risk Committee.

	Audit Plan	Annual Report (considered our ISA 260 Report)
Our communication plan		
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	•	•
Views about the qualitative aspects of Scottish Canals' accounting and financial reporting practices, including accounting policies, accounting estimates and financial statement disclosures		•
Significant findings from the audit		•
Significant matters and issues arising during the audit and written representations that have been sought		•
Significant difficulties encountered during the audit		•
Significant deficiencies in internal control identified during the audit		•
Significant matters arising in connection with related parties		•
Identification or suspicion of fraud involving management and/or which results in material misstatement of the financial statements		•
Non-compliance with laws and regulations		•
Unadjusted misstatements and material disclosure omissions		•
Expected modifications to the auditor's report or emphasis of matter		•

Fraud responsibilities

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 Scottish Canals.

As part of our audit work we are responsible for:

- identifying and assessing the risks of material misstatement of the financial statements due to fraud in particular in relation to management override of controls.
- leading a discussion with those charged with governance 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 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 management's assessment of fraud risk, including internal controls, and any known or suspected fraud or misstatement. We also make inquiries of internal audit around internal control, fraud risk and any known or suspected frauds in year.

Fraud responsibilities (continued)

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

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

Throughout the audit we work with Scottish Canals 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 Scottish Canals' arrangements in response to the National Fraud Initiative.

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 he 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 Scottish Canals we will report to the Auditor General as required by Audit Scotland.

Accounting estimates and related disclosures

The Financial Reporting Council issued an updated ISA (UK) 540 (revised): *Auditing Accounting Estimates and Related Disclosures* which includes significant enhancements in respect of the audit risk assessment process for accounting estimates. The first year this impacted on the audit was the 2020/21 financial year.

Introduction

Under ISA (UK) 540 (Revised December 2018) auditors are required to understand and assess an entity's internal controls over accounting estimates, including:

- The nature and extent of oversight and governance over management's financial reporting process relevant to accounting estimates;
- How management identifies the need for and applies specialised skills or knowledge related to accounting estimates;
- How the entity's risk management process identifies and addresses risks relating to accounting estimates;
- The entity's information system as it relates to accounting estimates;
- The entity's control activities in relation to accounting estimates; and
- How management reviews the outcomes of previous accounting estimates.

As part of this process auditors also need to obtain an understanding of the role of those charged with governance, which is particularly important where the estimates have high estimation uncertainty, or require significant judgement.

Specifically do **Audit and Risk Committee** members:

- Understand the characteristics of the methods and models used to make the accounting estimates and the risks related to them;
- Oversee management's process for making accounting estimates, including the use of models, and the monitoring activities undertaken by management; and
- Evaluate how management made the accounting estimates?

Additional information that will be required

To ensure our compliance with this revised auditing standard, we will be requesting again this year further information from management and those charged with governance during our audit for the year ended 31 March 2022.

Based on our knowledge of the Scottish Canals, in particular from the prior year audit, we have identified the following material accounting estimates: valuation of operational infrastructure assets, valuation of freehold land and buildings, valuation of investment property, depreciation and impairment, valuation of investments, prepayments and accrued income, accruals, VAT liability assessment, valuation of defined benefit pension scheme liabilities and deferred income/deferred capital income.

Scottish Canals' Information Systems

In respect of Scottish Canals' information systems we are required to consider how management identifies the methods, assumptions and source data used for each material accounting estimate and the need for any changes to these. This includes how management selects, or designs, the methods, assumptions and data to be used and applies the methods used in the valuations.

If management has changed the method for making an accounting estimate we will need to fully understand management's rationale for this change.

Any unexpected changes are likely to raise the audit risk profile of this accounting estimate and may result in the need for additional audit procedures.

Future Auditing developments (2022/23)

There are changes to the following ISA (UK):

- ISA (UK) 315 (Revised July 2020) 'Identifying and Assessing the Risks of Material Misstatement' - This will impact audits of financial statement for periods commencing on or after 15 December 2021.
- ISA (UK) 220 (Revised July 2021) 'Quality Management for an Audit of Financial Statements' - This will impact audits of financial statement for periods commencing on or after 15 December 2022.
- ISA (UK) 240 (Revised May 2021) 'The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements' - This will impact audits of financial statement for periods commencing on or after 15 December 2021.

A summary of the impact of the key changes on various aspects of the audit is included below:

Area of change	Impact of changes
Risk assessment	<ul style="list-style-type: none"> • The nature, timing and extent of audit procedures performed in support of the audit opinion may change due to clarification of: <ul style="list-style-type: none"> • the risk assessment process, which provides the basis for the assessment of the risks of material misstatement and the design of audit procedures • the identification and extent of work effort needed for indirect and direct controls in the system of internal control • the controls for which design and implementation needs to be assessed and how that impacts sampling • the considerations for using automated tools and techniques.
Direction, supervision and review of the engagement	<ul style="list-style-type: none"> • Greater responsibilities, audit procedures and actions are assigned directly to the engagement lead, resulting in increased involvement in the performance and review of audit procedures.
Professional scepticism	<ul style="list-style-type: none"> • The design, nature, timing and extent of audit procedures performed in support of the audit opinion may change due to: <ul style="list-style-type: none"> • increased emphasis on the exercise of professional judgement and professional scepticism • an equal focus on both corroborative and contradictory information obtained and used in generating audit evidence • increased guidance on management and auditor bias • additional focus on the authenticity of information used as audit evidence • a focus on response to inquiries that appear implausible

Area of change	Impact of changes
Fraud	<ul style="list-style-type: none"> • The design, nature, timing and extent of audit procedures performed in support of the audit opinion may change due to: <ul style="list-style-type: none"> • clarification of the requirements relating to understanding fraud risk factors • additional communications with management or those charged with governance.
Documentation	<ul style="list-style-type: none"> • The amendments to these auditing standards will also result in additional documentation requirements to demonstrate how these requirements have been addressed.



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