Water Industry Commission for Scotland

2022/23 Annual Audit Report

Prepared for the Water Industry Commission for Scotland and the Auditor General for Scotland

7 December 2023

Contents

Key messages

2022/23 annual report and accounts

1 Audit opinions on the annual report and accounts are unmodified.

2 Despite issues with the quality of the accounts presented for audit, the 2022/23 annual report and accounts were certified in line with the agreed audit timetable.

3 We will review the fee level for the 2023/24 audit to reflect the extent of the issues encountered this year but expect management to take corrective action to ensure similar issues are not encountered next year.

Wider scope audit work

4 The Commission reported an operating surplus of £1.3 million for 2022/23 and we do not currently have any concerns about the financial sustainability of the organisation.

5 We identified widespread issues with staff submitting expense claims that significantly exceeded the approved subsistence rates and were not supported by itemised receipts. The Commission also identified an obligation of £8,818 in respect of the UK tax and national insurance contributions due on previous payments, dating back as far as 2018/19, that should have been treated as taxable benefits to staff.

6 The current sub-lease agreement with Zero Waste Scotland does not include any requirement for it to contribute to dilapidations costs at the end of the Commission's lease with Stirling Council.

7 The Accountable Officer needs to take immediate action to address the issues identified during the 2022/23 audit and to promote a culture of Best Value across the organisation. Management has accepted the findings from the audit and agreed actions to address the weaknesses reported.

Introduction

1. This report summarises the findings from the 2022/23 annual audit of the Water Industry Commission for Scotland (the Commission) and will be published on Audit Scotland's website: www.audit-scotland.gov.uk.

2. The scope of the audit was set out in our annual audit plan presented to the May meeting of the Audit and Risk Committee. This Annual Audit Report comprises significant matters arising from the audit of the Water Industry Commission for Scotland's annual report and accounts and conclusions on wider scope areas, as set out in the *Code of Audit Practice 2021*, which for less complex bodies includes conclusions on financial sustainability and Best Value.

3. We would like to thank Commission members and officers, particularly those in finance, for their cooperation and assistance during the audit and we look forward to continuing to work together constructively over the course of the five-year appointment.

Responsibilities and reporting

4. The Commission has responsibility for ensuring the proper financial stewardship of public funds. This includes preparing an annual report and accounts in accordance with the accounts direction from Scottish Ministers. The Commission is also responsible for establishing appropriate and effective arrangements for governance, propriety, and regularity.

5. The responsibilities of the independent appointed auditor are established by the Public Finance and Accountability (Scotland) Act 2000; the Code of Audit Practice 2021 and supplementary guidance and International Standards on Auditing in the UK.

6. This report contains an agreed action plan at Appendix 1 setting out specific recommendations, responsible officers and dates for implementation. Weaknesses or risks identified in this report are only those which have come to our attention during our audit work and may not be all that exist. Communicating these does not absolve management of its responsibility to address the issues we raise and from maintaining adequate systems of control.

Auditor Independence

7. We can confirm that we comply with the Financial Reporting Council's Ethical Standard and that we have not undertaken any non-audit related services. We are not aware of any relationships that could compromise our objectivity or our independence.

Part 1. 2022/23 annual report and accounts

Public bodies are required to prepare an annual report and accounts comprising financial statements and other related reports. These are the principal means of accounting for the stewardship of public funds.

Audit opinions on the annual report and accounts are unmodified.

Despite issues with the quality of the accounts presented for audit, the 2022/23 annual report and accounts were certified in line with the agreed audit timetable.

We will review the fee level for the 2023/24 audit to reflect the extent of the issues encountered this year but expect management to take corrective action to ensure similar issues are not encountered next year.

Audit opinions on the annual report and accounts are unmodified

8. The Board approved the annual report and accounts for the Water Industry Commission for Scotland for the year ended 31 March 2023 on 7 December 2023. The independent auditor's report included the following audit opinions on the annual report and accounts:

- the financial statements give a true and fair view and were properly prepared in accordance with the financial reporting framework
- expenditure and income were in accordance with applicable enactments and guidance
- the audited part of the remuneration and staff report was prepared in accordance with the financial reporting framework
- the performance report and governance statement were consistent with the financial statements and properly prepared in accordance with the relevant legislation and directions made by Scottish Ministers.

Despite issues with the quality of the accounts presented for audit, the 2022/23 annual report and accounts were certified in line with the agreed audit timetable

9. We received the unaudited annual report and accounts on 25 July 2023. A number of issues were identified with the accounts presented for audit, particularly in relation to first time adoption of *International Financial Reporting Standard 16 – Leases* accounting, as detailed in Exhibit 3. These issues impacted upon the audit resources required to deliver the 2022/23 audit although finance staff did provide good support to the team during the audit process. This allowed us to still complete the final accounts audit in line with the agreed audit timetable, and the 2022/23 annual report and accounts were certified on 7 December 2023.

We will review the fee level for the 2023/24 audit to reflect the extent of the issues encountered this year but expect management to take corrective action to ensure similar issues are not encountered next year

10. As detailed in our annual audit plan, in determining the fee for the 2022/23 audit we took account of the risk exposure of the Commission and the planned management assurances in place. Our fee was also set based on an assumption that the Commission had effective governance arrangements, would prepare comprehensive and accurate accounts for audit, and there would be no major change in respect of the scope of the audit during the year.

11. Due to the extent of the issues we identified during the year, both in terms of the financial statements and wider audit issues, we had to use additional resources to deliver the 2022/23 audit. We will take account of this when setting the fee for the 2023/24 audit although we expect management to take corrective action to ensure similar issues are not encountered next year.

Our audit approach and testing was informed by the overall materiality level of £83,000

12. The concept of materiality is applied by auditors to determine whether misstatements identified during the audit could reasonably be expected to influence the economic decisions of users of the financial statements, and impact the opinion set out in the independent auditor’s report. Auditors set a monetary threshold when considering materiality, although some issues may be considered material by their nature and it is ultimately a matter of the auditor’s professional judgement.

13. Our initial assessment of materiality was carried out during the planning phase of the audit and was based on the financial results reported in the audited 2021/22 annual report and accounts. These materiality levels were reported in our annual audit plan to the May meeting of the Audit and Risk Committee.

14. On receipt of the unaudited 2022/23 annual report and accounts we revised our materiality levels to reflect the financial results for the year ended 31 March 2023. These are detailed in Exhibit 1.

Exhibit 1
Materiality values

Materiality level	Amount
Overall materiality	£83,000
Performance materiality	£62,000
Reporting threshold	£4,000

Source: Audit Scotland

15. Performance materiality is used by auditors when undertaking work on individual areas of the financial statements. It is a lower materiality threshold, set to reduce the probability of aggregated misstatements exceeding overall materiality. Performance materiality was set at 75 per cent of overall materiality, reflecting the scale of previous year's adjustments, the extent of estimation in the accounts and the planned testing in proportion to the scale of the organisation.

Our audit work responded to the risks of material misstatement we identified in the annual report and accounts

16. Exhibit 2 sets out the significant and non-significant risks of material misstatement to the financial statements. It also summarises the further audit procedures we performed during the year to obtain assurances over these risks and the conclusions from the work completed.

Exhibit 2
Significant and other risks of material misstatement

Nature of risk	Audit response	Conclusion
Significant risks of material misstatement		
1. Risk of material misstatement due to fraud caused by management override of controls As stated in International Standard on Auditing (UK) 240, management is in a unique position to perpetrate fraud because of management's ability to override controls that otherwise appear to be operating effectively.	• Detailed testing of transactions and journals with a focus on significant risk areas, including year-end and post-close down entries. • Focussed testing of accruals and prepayments. • Substantive testing of income and expenditure transactions around the year-end to confirm they are accounted for in the correct financial year. • Review of significant accounting estimates. • Evaluated significant transactions outside the normal course of business.	We are satisfied that there is no material misstatement arising from this risk.

<table>
<tr><th>Nature of risk</th><th>Audit response</th><th>Conclusion</th></tr>
<tr><td colspan="3">Other non-significant risks of material misstatement</td></tr>
<tr><td>2. Introduction of IFRS 16

International Financial Reporting Standard 16 – Leases is effective for accounting periods starting from 1 April 2022.

Under IFRS 16, lessees are required to recognise assets and liabilities for leases with a term of more than 12 months, unless the underlying asset is of low value.

The standard is expected to bring right-of-use assets totalling £0.236m onto the Statement of Financial Position, with an associated lease liability of the same amount.</td><td>• Reviewed list of leases to assess for completeness.

• Tested lease agreements to ensure they had been correctly assessed and accounted for in the 2022/23 financial statements.</td><td>We reviewed the accounting treatment adopted for the Moray House lease agreement between Stirling Council and the Commission, and the sub-lease agreement between the Commission and Zero Waste Scotland. This identified that neither lease agreement had been correctly accounted for in accordance with the requirements of IFRS16 – see issue 1 in Exhibit 3 for details.</td></tr>
<tr><td>3. Estimation in the valuation of pension assets and liabilities

As at 31 March 2022, the Commission recognised a net pension liability of £2.201 million.

Actuarial estimates are a complex combination of liabilities over significant future periods based on life expectancy, CPI growth and discounting (based on corporate bond rates).

Assets are based on an individual employer body's share of assets at the last triennial valuation. Roll forward adjustments are provided to members data and to asset valuations.

There is a risk that small changes in the assumptions used can lead to large changes in the resulting valuations resulting in material misstatement in the annual report and accounts.</td><td>• Assessed the scope, independence and competence of the professionals engaged in providing estimates for pensions.

• Reviewed the appropriateness of actuarial assumptions and results including comparison with other member bodies and the pension fund as a whole.

• Reviewed officers' arrangements for ensuring the reasonableness of professional estimations and the accuracy of information provided to the actuary by the Commission.</td><td>The IAS19 valuation was correctly reflected in the unaudited accounts but a minor adjustment was required to recognise the present value of the Commission's unfunded pension liabilities at 31 March 2023 – see issue 3 in Exhibit 3 for details.</td></tr>
</table>

Nature of risk	Audit response	Conclusion
4. Potential tax implications of international work The Scottish Government's Hydro Nation strategy aims to develop Scotland's water resources to bring the maximum benefit to the Scottish economy. As part of the Hydro Nation International programme WICS are involved in international work in New Zealand. As this project has been extended beyond the original timetable there is a risk that the threshold for having being deemed to have a 'permanent establishment' in New Zealand will be exceeded, which could have tax implications for WICS.	Reviewed the tax position of this project to establish whether a contingent liability or provision requires to be recognised under *IAS37 – Provisions, Contingent Liabilities and Contingent Assets*.	We have accepted that there does not appear to be any tax liability to the Commission at 31 March 2023 in relation to its international work – see issue 4 in Exhibit 3 for details.

We reported the significant findings from the audit to those charged with governance prior to the annual report and accounts being approved and certified

17. International Standard on Auditing (UK) 260 requires us to communicate significant findings from the audit to those charged with governance, including our view about the qualitative aspects of the board's accounting practices.

18. The significant findings are summarised in Exhibit 3. Our audit also identified a number of other presentation and disclosure issues which were discussed with management. These were all adjusted in the audited annual report and accounts and were not considered significant enough to be separately reported under ISA260.

Exhibit 3
Significant findings and key matters from the audit of the annual report and accounts

Issue	Resolution
1. IFRS 16 lease accounting requirements International Financial Reporting Standard 16 – Leases is effective for accounting periods starting from 1 April 2022. Under IFRS 16, lessees are required to recognise assets and liabilities for leases with a term of more than 12 months, unless the underlying asset is of low value. The 2022/23 annual report and accounts presented for audit did not adequately reflect the accounting requirements of IFRS16 in terms of the recognition of the right of use asset and lease liability for the Commission's agreement to lease Moray House from Stirling Council until March 2026, the lease asset and transfer of the right of use asset for the sub-lease agreement with Zero Waste Scotland to September 2024, and the related accounting policies and disclosure notes required by the 2022/23 FReM.	During the audit we reviewed the lease and sub-lease agreements, and worked with finance staff, to ensure the audited financial statements correctly reflected the accounting requirements of IFRS16 and the 2022/23 FReM. This resulted in a number of revisions being made to: • Reverse the previous rent accounting entries. • Initially recognise a right of use property lease asset, and corresponding lease liability, of £0.409 million in the Statement of Financial Position, in respect of the lease agreement with Stirling Council. • Write down the right of use property asset by £0.250 million to £0.159 million, and creating a corresponding lease debtor, to reflect the impact of the sub-lease agreement with Zero Waste Scotland. • Create a separate 'Note 3.5.7 Leases' to disclose the cost, in-year movement and carrying value of the right of use property asset, and the split of future lease payments due to Stirling Council and from Zero Waste Scotland. • Revise the accounting policies to explain the accounting requirements of IFRS16 and how these have been interpreted and applied to the Commission's current lessee and lessor agreements. We are content that the 2022/23 audited annual report and accounts accurately reflect the IFRS 16 accounting requirements for the Commission's current lessee and lessor agreements.

Issue	Resolution
2. Dilapidation provision for Moray House The unaudited annual report and accounts included a provision of £0.115 million (£0.074 million at 31 March 2022) for the costs that will be incurred to return Moray House to its pre-lease condition when the lease agreement ends in March 2026. As the value of the provision at 31 March 2023 was a material balance, and had increased by £0.041 million (55 per cent) from the prior year, we reviewed the methodology used to calculate it to ensure it satisfied the requirements of IAS37 - Provisions, Contingent Liabilities and Contingent Assets. Our review established that the provision calculation is based on the cost per square feet per year of the dilapidation costs that the Commission had to pay when it vacated a former office at Ochil House in April 2011, and applying this to the size of Moray House and the length of the lease agreement with Stirling Council. Adjustment had also been made to reflect the projected impact of inflation up to March 2026. Based on our discussions with management about the modifications made to Moray House during the current lease, and the dilapidation costs incurred for Ochil House, we do not believe the current methodology represents a reliable and robust approach to calculate the dilapidation charge that the Commission is likely to incur at the end of the current lease agreement.	Our review of the nature of the provision confirmed that it satisfies the conditions for a provision to be created under IAS 37 (i.e. represents a present obligation based on a past event) as there is an obligation for the Commission to meet these costs when the current lease ends. We have also concluded that the value of the provision is not materially misstated and have accepted this for the 2022/23 annual report and accounts. However, the current calculation methodology is unlikely to have produced an accurate estimate of the dilapidation charge that the Commission will incur at the end of the current lease agreement. Management should engage with the Estates Team from Stirling Council during 2023/24 to obtain a realistic estimate of what dilapidation payment they anticipate will be sought when the Commission vacate Moray House at the end of the lease in March 2026. **Recommendation 1** (Appendix 1, action plan)
3. Unfunded pension liabilities The Commission is a member of Falkirk Pension Fund. Pension assets and liabilities are valued annually for each individual member body, by the actuary Hymans Robertson LLP, for inclusion in the annual report and accounts. Annual valuations are dependent on a number of external variables, including projected rates of return on assets, projected rates of price and pay inflation, interest rates and mortality estimates. The Commission's 2022/23 IAS19 valuation showed a pension asset at 31 March 2023 of £2.802 million (pension liability of £2.201 million at 31 March 2022). However, where a pension asset is identified under IAS19, an IFRIC14 asset ceiling calculation is required to be undertaken by the	The required adjustment was made in the audited financial statements to recognise the present value of the Commission's unfunded pension liabilities at 31 March 2023 of £0.034 million.

Issue	Resolution
actuary to assess whether the net present value of estimated future service costs exceed the net present value of future contributions. If this is the case then no pension asset should be recognised and an asset ceiling adjustment should be applied to reduce the pension asset to zero. The actuary's asset ceiling calculation identified that an asset ceiling adjustment of £2.802 million was required to reduce the Commission's pension asset at 31 March 2023 to zero. The asset ceiling adjustment was correctly reflected in the unaudited accounts resulting in a pension asset of zero at 31 March 2023 in the Statement of Financial Position. However, a further minor adjustment was also required to recognise the present value of the Commission's unfunded pension liabilities at 31 March 2023 of £0.034 million (£0.040 million at 31 March 2022) which relates to the element of retirement benefits of former staff which require to be paid directly from employer contributions rather than from the fund assets.	
4. Tax implications of international work The Commission entered a contract with the Department of Internal Affairs (DIA) in New Zealand to provide services relating to the Three Waters Reform Programme. The contract activity was performed both physically in New Zealand and remotely from the United Kingdom. As a result of the Commission's extended presence in New Zealand, it decided to make a voluntary disclosure to the Inland Revenue Department (IRD) to ensure all taxation obligations arising from the project were met. As a statutory body, the Commission does not undertake projects with an intention to make profit and instead budgets project activity to break-even. From the 1 June 2023, WICS has been registered as an employer in New Zealand. On the basis that there was no intention to make a profit on the activities in New Zealand, the IRD provided the Commission with a special tax rate certificate confirming that no corporation tax would be due. The services provided to the DIA by the Commission would likely be liable to Goods and Services Tax (the New Zealand equivalent of VAT) at a rate of 15 per cent. As the DIA is able to reclaim GST paid, there would be no financial gain	As part of our audit we considered the Commission's assessment of the potential tax implications of the international work, including consideration of the latest exchanges with Grant Thornton who the Commission has engaged to provide advice on New Zealand tax arrangements. We have accepted that there does not appear to be any tax liability to the Commission at 31 March 2023 in relation to its international work. However, we asked management to include a contingent liability disclosure to reflect the residual risk that the Commission may still face a tax liability in relation to this work. This disclosure has been included at 'Note 3.5.12' in the audited financial statements and also included in the Parliamentary Accountability Report section of the Annual Report. We noted that there are likely to be personal tax implications for any individuals who work in New Zealand for longer than six months in any financial

Issue	Resolution
for any parties in charging GST on invoices from the Commission to the DIA. Therefore, the Commission submitted a voluntary disclosure to the IRD on the basis that GST is technically required to be charged, but that there would be no benefit to filing returns. This approach has been accepted by the IRD and all income from the DIA included in the annual report and accounts excludes GST.	year. Management should ensure that relevant staff are aware of this so they can make appropriate arrangements to pay the required income tax due in the UK and other jurisdictions.
5. Scottish Government approval of expenditure Our audit identified two items of expenditure incurred during 2022/23 that required Scottish Government approval which had not been obtained. These were: • The cost of a training course attended by the Chief Operating Officer at Harvard Business School in Boston at a total cost, including flights, of £77,350. As the value of this service exceeded £20,000 and had not been awarded via a competitive tender exercise, it required to be approved by the Scottish Government. • The purchase of £100 gift vouchers for a retail outlet for all Commission staff (at a total cost of £2,600) as a Christmas gift in December 2022. As this exceeded the Commission's delegated limit of £75 for gifts, it required to be approved by the Scottish Government. Due to the nature of this payment it also represents a non-salary reward to the recipients and should have been treated as a taxable benefit but management has confirmed it was not and the £1,133 of tax and national insurance payments due on these payments has been paid by the organisation.	On 3 November 2023, the Deputy Director of the Scottish Government's Water Policy Division (the Commission's sponsor division) provided retrospective approval for both items of expenditure. As the purchase of the gift vouchers represented both a gift paid by the organisation and a non-salary reward received by staff during 2022/23, we asked management to include relevant disclosures in the remuneration and staff report and the parliamentary accountability report. These have both been included in the audited annual report and accounts. Appropriate disclosures were also added to the governance statement in relation to the control weaknesses identified during the year. Management should ensure that all expenditure incurred is in accordance with the requirements of the Commission's Finance Policies and Guidelines, and the rules and guidance set out in the Scottish Public Finance Manual (SPFM). Where there is any dubiety as to whether this is the case, approval should be sought from the sponsor division prior to the expenditure being incurred. **Recommendation 2** (Appendix 1, action plan)

Source: Audit Scotland

All misstatements identified during the 2022/23 audit were corrected in the audited annual report and accounts

19. It is our responsibility to request that all misstatements, other than those below our reporting threshold, are corrected, although the final decision on making the correction lies with those charged with governance.

20. Two misstatements were identified during the audit which exceeded our reporting threshold (issues 1 and 3 in Exhibit 3). These were both corrected in the audited accounts. We considered whether further audit procedures were required and reviewed the nature and causes of these misstatements, which related to the new IFRS 16 lease accounting requirements and recognition of the Commission's unfunded pension liabilities at 31 March 2023. We concluded that these were isolated errors that had been identified in their entirety and did not indicate further systemic error.

Part 2. Wider scope audit work

For less complex bodies wider-scope audit work considers the financial sustainability of the body and the services that it delivers over the medium to longer term, and the arrangements for securing Best Value.

The Commission reported an operating surplus of £1.3 million for 2022/23 and we do not currently have any concerns about the financial sustainability of the organisation.

We identified widespread issues with staff submitting expense claims that significantly exceeded the approved subsistence rates and were not supported by itemised receipts. The Commission also identified an obligation of £8,818 in respect of the UK tax and national insurance contributions due on previous payments, dating back as far as 2018/19, that should have been treated as taxable benefits to staff.

The current sub-lease agreement with Zero Waste Scotland does not include any requirement for it to contribute to dilapidations costs at the end of the Commission's lease with Stirling Council.

The Accountable Officer needs to take immediate action to address the issues identified during the 2022/23 audit and to promote a culture of Best Value across the organisation. Management has accepted the findings from the audit and agreed actions to address the weaknesses reported.

The Commission reported an operating surplus of £1.3 million for 2022/23

21. The Commission is funded by a levy paid by Scottish Water and the licensed providers that participate in the non-household retail market. For 2021-2027 the Scottish Government approved levies totalling £24.68 million, Exhibit 4, to fund the Commission's activities over the six-year regulatory control period.

Exhibit 4
Levy income for 2021-2027 regulatory control period

	21/22 £m	22/23 £m	23/24 £m	24/25 £m	25/26 £m	26/27 £m	Total £m
Scottish Water levy	2.36	2.28	2.30	2.32	2.35	2.37	**13.88**
Licensed Provider's levy	1.67	1.72	1.77	1.82	1.88	1.93	**10.79**
Total levy income	**3.92**	**4.00**	**4.07**	**4.15**	**4.23**	**4.31**	**24.68**

Source: Water Industry Commission for Scotland Corporate Plan 2021-2027

22. For 2022/23 the Commission reported an operating surplus of £1.251 million (£0.610 million in 2021/22), Exhibit 5. This reflected annual income of £5.288 million (including levy income of £3.997 million) and expenditure of £4.036 million (with 67 per cent relating to staff costs). The increased surplus reported for the year was largely attributable to an increase of £0.706 million (247 per cent) in Hydro Nation income from £0.479 million in 2021/22 to £1.185 million in 2022/23.

Exhibit 5
Financial outturn

	2021/22 £m	2022/23 £m	Cumulative position for 2021-2027 control period £m
Income	4.481	5.288	9.769
Expenditure	(3.871)	(4.036)	(7.907)
Operating surplus / (deficit)	**0.610**	**1.251**	**1.861**

Source: Water Industry Commission for Scotland 2022/23 Annual Report and Accounts

The Commission's cash reserves increased to £3.5 million at 31 March 2023, any excess funds at the end of the regulatory period will be returned to Scottish Water and Licensed Providers

23. At the end of the previous six-year regulatory period the Commission held a cash and cash equivalents balance of £2.452 million. This has increased to £3.457 million at 31 March 2023 as a result of the operating surpluses achieved in the first two years of the new 2021-2027 regulatory period, Exhibit 5.

24. The level of the cash reserves held at 31 March 2023 represented 83 per cent of the Commission's 2022/23 expenditure, and current liabilities at the year-end totalled only £0.523 million.

25. Management advised that due to the nature of the Commission's work, the annual expenditure during a regulatory period can vary significantly. To allow Scottish Water and Licensed Providers a predictable payment schedule, the income is agreed at a set rate for each year at the outset of the regulatory period, as shown in Exhibit 4 above. The impact of this is that the Commission can have unusually high cash balances at certain points in the regulatory cycle. At the end of a regulatory period, if there are excess funds, they are returned to Scottish Water and the Licensed Providers, as appropriate.

78 per cent of central support costs were allocated to network regulation and retail activity in 2022/23, with the remaining 22 per cent allocated to international work

26. As part of our audit we reviewed the methodology for the allocating central support costs to operating segments to ensure this provided an accurate basis for attributing these costs to the activities they related to. This identified that central support costs are currently allocated based on head count with the total overheads of £1.779 million being allocated £0.697 million (39 per cent) to network regulation, £0.697 million (39 per cent) to retail, and £0.385 million (22 per cent) to international work.

27. We have accepted that this as a reasonable basis for allocating central overheads to operating segments during the year, but we noted that finance are looking at whether improvements could be made to provide a better basis for allocating costs based on activity.

We do not currently have any concerns about the financial sustainability of the Commission

28. As shown in Exhibit 5, the Commission has reported an operating surplus in each of the first two years of the current regulatory control period and has achieved a cumulative surplus of £1.861 million over that period.

29. In 2022/23, the Commission's expenditure totalled £4.036 million which was £0.039 million more than the levy income of £3.997 million received during the year. The additional expenditure was funded through Hydro Nation income.

30. We do not currently have any concerns about the financial sustainability of the Commission as the in-year costs of the Hydro Nation work significantly exceeded £0.039 million, and therefore even if this activity ceased entirely, we would expect there to be sufficient cost savings (i.e. through reduced travel and subsistence costs) to enable the organisation to operate within the levy income.

We identified widespread issues with staff submitting expense claims that significantly exceeded the approved subsistence rates and were not supported by itemised receipts

31. Our testing for the 2022/23 audit identified an expense claim submitted by the Chief Executive in March 2023 that included two items that were not supported by itemised receipts as required by the Commission's Finance Policies and Guidelines. We therefore conducted a wider review of expense claims submitted during 2022/23.

32. Our review of expense claims identified widespread issues with staff submitting claims that were not supported by itemised receipts. We also noted multiple instances where the amounts claimed significantly exceeded the approved rates set out at Appendix A of the Commission's Finance Policies and Guidelines. This included one instance where the cost per head for a dinner claimed exceeded £200 per person, the approved non-city limit was £25, and included the purchase of alcohol.

33. The description of many of these claims suggest it related to business entertaining costs. However, the Commission does not have a separate budget for this type of expenditure, and the Finance Policies and Guidelines have no dispensation for staff to exceed the approved subsistence rates when engaged in this type of activity.

Recommendation 3

Management should ensure that all expense claims are supported by itemised receipts and staff are only reimbursed at the approved subsistence rates set out in the Commission's Finance Policies and Guidelines.

The Commission identified an obligation of £8,818 in respect of the UK tax and national insurance contributions due on previous payments, dating back as far as 2018/19, that should have been treated as taxable benefits to staff

34. During the 2022/23 audit we identified an accrual of £8,818 relating to an obligation for a PAYE settlement agreement (PSA) for UK tax and national insurance due on taxable benefits that had been paid to employees. A PSA allows an organisation to make one annual payment to cover all the tax and national insurance due on minor, irregular or impracticable expenses or benefits to its employees.

35. Management advised that a review had been undertaken during the year to identify previous payments made by the Commission that should have been treated as taxable benefits to staff and that would have incurred national insurance contributions and been liable for income tax. This identified payments dating back as far as 2018/19 that should have been treated as taxable benefits and would have incurred national insurance contributions and income tax payments of £8,818. The Commission settled its 2022/23 obligation in October 2023 and are awaiting a response to the voluntary disclosure for prior years.

36. Our review of the items identified found that the majority related to leaving lunches, birthday gifts and other minor items of expenditure. However, it also included the purchase of the £100 gift vouchers for Commission staff, detailed at issue 5 in Exhibit 3.

Recommendation 4

Management should ensure that adequate arrangements are in place to attribute taxable benefits to relevant staff so that they incur the related income tax and national insurance contributions.

The current sub-lease agreement with Zero Waste Scotland does not include any requirement for it to contribute to dilapidations costs at the end of the Commission's lease with Stirling Council

37. As part of our work on the IFRS 16 lease accounting requirements, issue 1 in Exhibit 3, we reviewed the Commission's agreement with Stirling Council for the lease of Moray House. This identified that the agreement with Stirling Council included a clause that granted the Commission a 9-month rent free period after it had leased the premises for 10 years which occurred in 2021/22 and reduced the lease payments made during the year. It also included a standard clause relating to dilapidations that requires the Commission to return Moray House to its pre-lease condition when the lease agreement ends in March 2026.

38. During our discussions of the Commission's sub-lease agreement with Zero Waste Scotland we were advised by management that, prior to the original sub-lease being signed, it was agreed that if Zero Waste Scotland leased Moray House to the end of the Commission's original lease agreement with Stirling Council, then the full rent free period saving would be passed on to Zero Waste Scotland. We were also advised that there was an expectation that Zero Waste Scotland would make a contribution towards the dilapidation charge that the Commission will incur at the end of its lease agreement with Stirling Council, to reflect the element of the charge that relates to the period that they sub-leased the premises.

39. From our review of the current sub-lease agreement between the Commission and Zero Waste Scotland which runs until September 2024, we noted that this does not include a clause in relation to either the Commission passing on the rent free period to Zero Waste Scotland, or Zero Waste Scotland contributing towards the Commission's dilapidation charges at the end of the lease agreement with Stirling Council in March 2026. As such, neither organisation could enforce these conditions as there is no legally binding agreement between the parties in relation to them.

Recommendation 5

Management should ensure that any future sub-lease agreement with Zero Waste Scotland accurately reflects the obligations and liabilities of both parties for Moray House.

The Performance Report in the 2022/23 Annual Audit Report detailed the Commission's progress against its 9 outcomes for the 2021-2027 regulatory period

40. Within the Corporate Plan 2021-27, published in December 2020, the Commission identified a suite of 11 Key Performance Indicators (KPIs) to be used in measuring performance against a set of 9 outcomes supporting the 3 Strategic Objectives:

- To support the sector to achieve its long-term vision and the Scottish Ministers' Objectives for the regulatory control period.
- To challenge Scottish Water to achieve best in class levels of service for its customers and communities.
- To become an international leader in the field of economic regulation.

41. The Performance Analysis section of the Performance Report in the 2022/23 Annual Audit Report detailed the Commission's progress against its 9 outcomes for the 2021-2027 regulatory period, including the achievement of key milestones expected during 2022/23.

The Accountable Officer needs to take immediate action to address the issues identified during the 2022/23 audit and to promote a culture of Best Value across the organisation

42. *Ministerial guidance to Accountable Officers* for public bodies and the *Scottish Public Finance Manual* (SPFM) sets out the accountable officer's duty to ensure that arrangements are in place to secure best value. The guidance sets out the key characteristics of best value and states that compliance with the duty of best value requires public bodies to take a systematic approach to self-evaluation and continuous improvement.

43. As detailed in this report, we have identified multiple instances during the 2022/23 audit that indicate that the Commission is not currently demonstrating the highest standards of financial management and propriety in its business activities. The Accountable Officer needs to take immediate action to address these issues and to promote a culture of Best Value across the organisation.

Management has accepted the findings from the audit and agreed actions to address the weaknesses reported

44. Management has accepted the findings from the audit and agreed actions to address the weaknesses reported, as detailed in Appendix 1.

45. Management advised that it recognises that some of the processes that worked well when they were based in Moray House lapsed when the Commission started to work remotely. They have relied on the new Approvals Max system for review of expenditures and there was insufficient discussion of these expenditures. They acknowledge that this was clearly an oversight on their part. Previously, an approvals panel met regularly to discuss all significant expenditures. This always involved active debate. Management commits to restarting this approvals panel meeting in person at least fortnightly and ensuring that there is appropriate detailed scrutiny of all proposed expenditures. They also note that there is an opportunity to use the approvals panel to review potential future expenditures and ensure that they are aligned to the corporate plan and international activities.

46. Management also recognises that the work to support the Scottish Government's Hydro Nation initiative has grown faster than they could reasonably have foreseen. What they thought were ambitious corporate plan targets for the regulatory period have already been exceeded. However, this has required significant time from the senior management team. Ideally, office systems, processes, and legal structures would have been proactively tailored to deal with this growth. Management has committed to conducting a lessons learned exercise on what they could and should have done differently. This review will include the personal tax implications of staff working internationally for prolonged periods of time and will also review the financial and legal disclosures required to be in place for staff prior to delivering such contracts. They will ensure that all appropriate training identified as part of this lessons learned exercise will be completed in the first half of 2024. Management are also in active discussions with Scottish Government officials to determine how the Commission should take forward the Hydro Nation ambitions of Government. Scottish Government is currently progressing legislation which will extend the expectations it has of the Commission in this area. Management is working closely with officials and the policy development team to ensure that the systems and processes required to deliver the Government's ambitions are established over the next 12 to 18 months.

Appendix 1. Action plan 2022/23

2022/23 recommendations

Issue/risk	Recommendation	Agreed management action/timing
1. Dilapidation provision for Moray House The provision calculation is based on the dilapidation costs that the Commission had to pay when it vacated a former office in April 2011. **Risk:** The value of the provision does not represent a reliable estimate of the dilapidation charge that the Commission will incur at the end of the current lease agreement.	Management should engage with the Estates Team from Stirling Council during 2023/24 to obtain a realistic estimate of what dilapidation payment they anticipate will be sought when the Commission vacate Moray House at the end of the lease in March 2026. Issue 2 in Exhibit 3	We agree. We will reach out to the Estates Team at Stirling Council as soon as possible to obtain a realistic estimate of what dilapidation payment they anticipate. Management recognise that the current provision may not be appropriate and will ensure that the views of Stirling Council determine our future approach. We will liaise annually with Stirling Council to check that the amounts that we are provisioning remain reasonable. **Responsible officer:** Director of Corporate and International Affairs **Agreed date:** December 2023

Issue/risk	Recommendation	Agreed management action/timing
2. Scottish Government approval of expenditure Our audit identified two items of expenditure incurred during 2022/23 that required Scottish Government which had not been obtained. **Risk:** The Commission incurs expenditure that is not in accordance with applicable enactments and guidance issued by Scottish Ministers.	Management should ensure that all expenditure incurred is in accordance with the requirements of the Commission's Finance Policies and Guidelines, and the rules and guidance set out in the Scottish Public Finance Manual (SPFM). Where there is any dubiety as to whether this is the case, approval should be sought from the sponsor division prior to the expenditure being incurred. Issue 5 in Exhibit 3.	There was an oversight on both instances which we accept and regret. Reverting to our approvals panel should ensure that such oversights do not happen in future. Management also commits to reviewing its delegated authorities with the board to help ensure greater board oversight of such expenditures. We will provide training to management and staff with respect to financial rules and expectations, particularly with respect to expenditure over £20,000 which isn't competitively tendered. Separately, as mentioned above, we will work with Scottish Government officials to ensure that appropriate rules and procedures for our international activities are put in place. **Responsible officer:** Chief Executive **Agreed date:** Approvals Panels will be implemented immediately and the minutes shared with the board / Audit and Risk Committee at all subsequent meetings. Training will be provided by the end of January 2024. Three months after the passing of the government's water bill for agreeing and implementing the appropriate arrangements for international activities.

Issue/risk	Recommendation	Agreed management action/timing
3. Expense claim issues We identified widespread issues with staff submitting expense claims that significantly exceed the approved subsistence rates and were not supported by itemised receipts. **Risk:** The Commission incurs expenditure that is not in accordance with applicable enactments and guidance issued by Scottish Ministers.	Management should ensure that all expense claims are supported by itemised receipts and staff are only reimbursed at the approved subsistence rates set out in the Commission's Finance Policies and Guidelines. Paragraphs 31. to 33.	Management recognise that there has been insufficient clarity between expenses which relate to normal travel and subsistence, and expenses arising both internationally and further strengthening working relationships with key advisers. Management regret this lack of clarity and will ensure that all future expenditures are properly explained and justified. The new expenses policy, which was trialled from 1 January 2023, has proven to be successful and has been implemented permanently having been approved by the Audit and Risk Committee and the Board. With immediate effect, management will ensure that the revised expense policy is adhered to, which includes guidance on itemised receipts, and increase its monitoring and reporting in this area to the Audit and Risk Committee. Management will revise the expense policy to ensure that there is a separate policy relating to hospitality and events so that there is sufficient distinction made between this type of expenditure and regular subsistence expenses. This will help ensure that a retirement dinner, as referenced in paragraph 32, is treated differently to a subsistence allowance. Management commits to ensuring that all staff are appropriately trained in this area, including how to tag and describe expenses to ensure that there is clarity between subsistence expenses and expenditure relating to business development or hospitality / events. Management also commits to sharing the minutes of our approvals panel with the Audit and Risk Committee. **Responsible officer:** Director of Strategy and Governance **Agreed date:** Training to be completed by 30 January 2024.

Issue/risk	Recommendation	Agreed management action/timing
4. Identification of taxable benefits to staff The Commission identified an obligation of £8,818 in respect of the UK tax and national insurance contributions due on previous payments, dating back as far as 2018/19, that should have been treated as taxable benefits to staff. **Risk:** The Commission incurs additional costs that should be met by the individual employees receiving the taxable benefit.	Management should ensure that adequate arrangements are in place to attribute taxable benefits to relevant staff so that they incur the related income tax and national insurance contributions. Paragraphs 34. to 36.	We agree. Management will take further advice to establish appropriate rules and procedures. Management will ensure that this advice is implemented in full and ensure adequate arrangements are in place to attribute taxable benefits to relevant staff so that they incur the related income tax and national insurance contributions. **Responsible officer:** Chief Executive **Agreed date:** 30 January 2024 for the advice and March 2024 for its implementation.
5. Sub-lease agreement The current sub-lease agreement with Zero Waste Scotland does not include any requirement for it to contribute to dilapidations costs at the end of the Commission's lease with Stirling Council. **Risk:** The Commission will be unable to obtain a payment from Zero Waste Scotland towards the dilapidation charge from Stirling Council.	Management should ensure that any future sub-lease agreement with Zero Waste Scotland accurately reflects the obligations and liabilities of both parties for Moray House. Paragraphs 37. to 39.	Management accept that it is likely that Zero Waste Scotland may not contribute towards the dilapidation charge. When the contract next comes up for renewal, we will again explore the dilapidations question with Zero Waste Scotland. Management's focus at the time was to ensure that it could recover some of the costs of its lease and the contract with Zero Waste Scotland was the only deal available. **Responsible officer:** Chief Executive **Agreed date:** Contract renewal September 2024

Water Industry Commission for Scotland

2022/23 Annual Audit Report

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