

Water Industry Commission for Scotland

Annual report on the 2010/11 audit

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

November 2011

The logo for Audit Scotland, featuring a stylized blue 'A' with a white checkmark inside a circle to its left.

AUDIT SCOTLAND

Audit Scotland is a statutory body set up in April 2000 under the Public Finance and Accountability (Scotland) Act 2000. It provides services to the Auditor General for Scotland and the Accounts Commission. Together they ensure that the Scottish Government and public sector bodies in Scotland are held to account for the proper, efficient and effective use of public funds

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Key messages

2010/11

We have given an unqualified opinion on the financial statements of the Water Industry Commission for Scotland ("the Commission") for 2010/11. We have also concluded that, in all material respects, the expenditure and receipts shown in the financial statements were incurred or applied in accordance with applicable enactments and relevant guidance issued by the Scottish Ministers.

In 2010/11, the Commission's overall outturn on expenditure was £3.54 million (2010: £4.80 million). Staff and consultancy costs reduced over the year, reflecting a (non-recurring) change in pension costs; and lower activity levels from a peak in 2009/10 when the final price determination for 2010-15 was completed and published. Expenditure was £0.42 million (11 %) within the £3.96 million budget.

The Commission's financial statements show a net assets position of £1.12 million as at 31 March 2011 (2010: net assets £0.45 million). As in previous years, this mainly reflects the net position on pension assets and liabilities and bank balances.

Overall, the Commission's corporate governance and control arrangements operated satisfactorily during the year, as reflected in the Statement on Internal Control. These include an effective board and an Audit Committee which challenges senior management on key issues, as appropriate. During the year the Commission received a report from Christopher Bolt CB on its operations and methods of working over the previous four years and has since taken forward the recommendations contained in that report. In February 2011 the Commission published a "Mission, strategy and governance" paper. Also, the Commission has enhanced procurement and other procedures, including those to lessen reputational risk, and now publishes accountability information on its website as required by the Public Services Reform (Scotland) Act 2010.

Outlook

Scottish Ministers have approved the Commission's Corporate Plan and Budget for the period 2010 to 2015. This limits the Commission to an average annual budget of £3.96 million over the period. The Commission is permitted to vire between budget lines and between financial years, subject to limits (20% transfer between years and no virement into staff costs). It is important that the Commission operates within this budget framework, taking account of the cyclical nature of its activities and the flexibility available; and that the Commission sustains the continuous improvement in its governance and performance arrangements.

Introduction

1. This report is the summary of our findings arising from the 2010/11 audit of the Water Industry Commission for Scotland (the Commission or WICS). The purpose of the annual audit report is to set out concisely the scope, nature and extent of the audit, and to summarise the auditor's opinions (i.e. on the financial statements) and conclusions and any significant issues arising. The report is divided into sections which reflect the extent of our public sector audit model.
2. This report is addressed to the Commission and the Auditor General and should form a key part of discussions with audit committees, either prior to or as soon as possible after the formal completion of the audit of the financial statements. Reports should be made available to stakeholders and the public, where appropriate. Audit is an essential element of accountability and the process of public reporting.
3. This report will be published on our website after consideration by the Commission.
4. The management of the audited body is responsible for preparing financial statements that show a true and fair view and for implementing appropriate internal control systems. Weaknesses or risks identified by auditors are only those which have come to our attention during their normal audit work, and may not be all that exist. Communication by auditors of matters arising from the audit of the financial statements or of risks or weaknesses does not absolve management from its responsibility to address the issues raised and to maintain an adequate system of control.

Financial statements

5. Audited bodies' financial statements are an essential part of accounting for their stewardship of the resources made available to them and their performance in the use of those resources.
6. Auditors are required to audit financial statements in accordance with the timescales set by Audit Scotland, which may be shorter than statutory requirements, and give an opinion on:
 - whether they give a true and fair view of the financial position of audited bodies and their expenditure and income
 - whether they have been properly prepared in accordance with relevant legislation, the applicable accounting framework and other reporting requirements
 - the regularity of the expenditure and income (except for local government bodies).
7. Auditors review and report on, as appropriate, other information published with the financial statements, including the management commentary, statement on internal control and the remuneration report. Where required, auditors also review and report on the Whole of Government Accounts return. (WICS are below the reporting threshold.) This section summarises the results of our audit on the financial statements.

Audit opinion

8. We have given an unqualified opinion confirming that the financial statements of the Water Industry Commission for Scotland for 2010/11 give a true and fair view of the state of the body's affairs and of its net operating surplus for the year.
9. The Commission is required to follow the 2010/11 Government Financial Reporting Manual (the FReM) and we confirm that financial statements have been properly prepared in accordance with the FReM.

Regularity

10. In accordance with the requirements of the Public Finance and Accountability (Scotland) Act 2000, we have also provided an opinion, that in all material respects, the expenditure and receipts in the financial statements were incurred or applied in accordance with applicable enactments and guidance.

Remuneration report and statement on internal control

11. In our opinion, the audited part of the remuneration report has been properly prepared and the management commentary is consistent with the financial statements.
12. We also confirm that we have no issues to report to you on the Statement on Internal Control and its compliance with Scottish Government guidance.

Accounting issues

Accounts submission

13. The financial statements were submitted for audit on 22 July, in accordance with a pre-agreed timetable. The on-site audit fieldwork was completed on 26 August and matters arising from this work were reported to the Audit Committee on 14 September.

Presentational and monetary adjustments to the unaudited accounts

14. A number of presentational changes were required to the annual report and accounts as a result of our review of the disclosures required by the FReM. There were also some minor monetary changes identified during the audit process which have been adjusted to reflect these issues. There are no unadjusted errors in the financial statements.
15. As reported last year, following transition to IFRS, IAS 19 requires the recognition of any short term employee benefits expected to be paid as a liability in the accounts. This liability should include any untaken leave at the financial year end. As in 2009/10, the Commission considers this employee benefit liability of £4,791 at 31 March 2011 not to be sufficiently material to merit an adjustment to the accounts. We concur with this view and WICS intention to keep this under review.

Prior year adjustments

16. All central government bodies have been affected by the removal of the cost of capital in the 2010/11 FReM. The cost of capital change is identified within Note 1(h) as a change in accounting policy and appropriate amendments have been made to the prior year statements.

Pension costs and the movement in pension assets and liabilities

Exhibit 1

Commission assets and liabilities in the Falkirk Pension Fund

Description	31 March 2007 £000	31 March 2008 £000	31 March 2009 £000	31 March 2010 £000	31 March 2011 £000
Pension assets	1,045	1,206	1,464	2,081	2,466
Pension liabilities	(1,240)	(1,089)	(1,462)	(2,975)	(2,621)
Net surplus / (liability)	(195)	117	2	(894)	(155)

Water Industry Commission for Scotland 2010/11 financial statements

17. The movements over the past 5 year period are illustrated in Exhibit 1. As in previous years, there have been significant changes in the net position on pension assets and liabilities. Most

of the volatility is through the calculation of actuarial gains and losses on pension liabilities. The biggest component of the net movement in 2010/11 is the credit (reducing expenditure) of £409,000 to the revenue account for past service costs (2009/10: £24,000 expenditure). This reflects the change from Retail Prices Index (RPI) to Consumer Prices Index (CPI) in the pension uplift to be applied to pensions paid. The past service cost element of this relates to service already provided and is correctly credited to staff costs; and this is a major component of the overall reduction in staff costs recorded in the Statement of Comprehensive Income.

18. We note the pension scheme actuary has recommended that contribution rates increase again in 2011/12, which will help increase the pension asset available to meet liabilities going forward.

Year-end bank balance

19. The Commission's balance sheet at 31 March 2011 shows bank balances of £0.977 million. This reflects good progress in reducing the overall balance of £1.365 million at 31 March 2010, which we noted as being unusually high for a public sector body with the Commission's turnover. We note that the Commission will continue to keep its bank balances under review in light of the budget framework approved by Scottish Ministers for the period 2010 to 2015.

Prepayments

20. The prepayments figures disclosed in the accounts includes £152,400 for payments that were made in March 2011 for consultancy services to be provided in April to June 2011. In discussions with WICS we noted that this has helped manage cash flows within the budget framework and WICS confirmed that they take care that payments of this nature provide value for money and do not expose WICS to inappropriate risk of the supplier failing to provide the service contracted for. The Commission agreed that they will continue to monitor proposed payments of this nature to establish that, overall, they will be striking the correct balance between their financial objectives.

Analysis of net expenditure by activity

21. We welcome the development of the disclosure of financial information by business segment through the "Analysis of net expenditure by activity" note to the accounts; and the related, further work that the Commission is carrying out on activity based costing. The Commission have agreed that they will also take stock of the "fees and charges" guidance as they further develop their approach. (Fees and charges guidance requires certain disclosures in relation to the financial objectives and performance for the provision of services by public bodies. The Commission's activities may not fall directly within the scope of this guidance, however, there are elements of the disclosures that may be relevant).

Outlook

22. The main change in the financial reporting framework (FReM) next year (2011/12) is that grants and funding for donated assets should be recognised immediately, unless there is a

condition that the recipient had not satisfied that would lead to repayment. Most grants and funding for donated assets should be recognised as income, but grants from a sponsoring department to an NDPB should be credited to general reserves. As a consequence, the government grant reserve and donated asset reserve will no longer exist. We note that the Commission currently does not hold either category of reserves.

23. Looking further ahead, from 1 January 2013 changes to international financial reporting standards (IFRSs) will become effective. This includes the introduction of:
 - IFRS 9 - financial instruments (replacing IAS39)
 - IFRS 10 - consolidated financial statements (replacing IAS27)
 - IFRS11 - joint arrangements (replacing IAS31)
 - IFRS12 - disclosure of interest in other entities (replacing IFRS12)
 - IFRS 13 - fair value.
24. Revisions to the FReM for 2013/14 are included in the Financial Reporting Advisory Board (FRAB) forward work programme for 1 December 2011.
25. The Commission has, in recent years, reported the amount of the statutory levy that it receives and subsequently pays to Waterwatch Scotland. Waterwatch Scotland closed on 15 August 2011, under the Public Services Reform (Scotland) Act 2010. The Act transferred the complaints handling function of Waterwatch Scotland to the Scottish Public Services Ombudsman (SPSO) and the customer representation function of Waterwatch Scotland to Consumer Focus Scotland. We understand that the Commission has no role in the funding of those functions subsequent to the closure of Waterwatch Scotland.

Audit appointment for 2011/12

26. Audit appointments are made by the Auditor General, either to Audit Scotland staff or to private firms of accountants for a five year term. 2010/11 is the last year of the current audit appointment. The procurement process for the next five years was completed in May 2011. From next year (2011/12) the auditor for the Water Industry Commission for Scotland will be KPMG LLP. As this is the last year of our audit appointment, we would like to acknowledge the good working relationship that existed during our current appointment term with the Commission, and thank officers and members of the Commission for their assistance during the last five years. We will be meeting with the incoming external auditors as part of a managed changeover process.

Financial position

27. Audited bodies are responsible for conducting their affairs and for putting in place proper arrangements to ensure that their financial position is soundly based.
28. Auditors consider whether audited bodies have established adequate arrangements and examine:
 - financial performance in the period under audit
 - compliance with any statutory financial requirements and financial targets
 - ability to meet known or contingent, statutory and other financial obligations
 - responses to developments which may have an impact on the financial position
 - financial plans for future periods.
29. These are key areas in the current economic circumstances. This section summarises the financial position and outlook for the organisation.

Financial results 2010/11

30. The Commission is required to operate within the statutory contribution from Scottish Water, licensing income, and other (regular) income received. This was achieved in 2010/11, with a total surplus of £353 thousand (2009/10: £167 thousand). The increase in the surplus from the previous financial year is largely as a result of reduced expenditure relating to consultants; and lower staffing costs. The reduced expenditure on staff mainly reflects a (non-recurring) change in the calculation of pension costs. Also, the Commission's average staffing has reduced from 26 whole-time equivalent staff in 2009/10 to 23 in 2010/11. We note that the Commission has not been part of the Scottish Government voluntary early retirement or redundancy schemes during 2010/11, nor has it operated any schemes of its own.

Financial position at 31 March 2011

31. The balance on the General Reserve as at 31 March 2011 was £1.13 million (2010: £452 thousand). The most significant factor in this increase was the reduction of the net pension liability, from £894 thousand at 31 March 2010 to £155 thousand at 31 March 2011.

Outlook

Audit Scotland's report: "Scotland's public finances: addressing the challenges"

32. The main messages outlined in the above report, which was prepared for the Auditor General for Scotland, were that Scotland's public sector is in the first year of major spending cuts and public bodies must focus on their long-term financial sustainability to ensure effective public services in the future. Scotland's public sector budget in 2011/12 for running costs and day-to-day spending is £27.5 billion, a drop of 6 per cent or £1.7 billion in real terms from £29.2 billion

in 2010/11. It will continue to drop until at least 2014/15. Public bodies have budgeted for this in 2011/12, but they need to make significant savings during the year and there is a risk they won't achieve this due to cost pressures being greater than expected or unforeseen events. At the same time, they are facing increasing pressures and demands, such as Scotland's ageing population, the effects of the recent recession, and the public sector's maintenance backlog. Therefore, public bodies need to have clear priorities, and plan their budgets and workforces to deliver these. Pay restraint and reducing workforces are the most common approaches being taken by public bodies to reduce costs over the next few years. Many bodies have already reduced staff numbers through recruitment freezes and voluntary redundancy schemes, and further reductions are planned.

The Commission's budget for 2011/12 and future years

33. At present, the Commission has a stable budget, with Scottish Ministers having approved the Commission's Corporate Plan and Budget for the period 2010 to 2015, reflecting the present Determination period for water and sewerage charges. Scottish Ministers have approved an average annual budget of £3.96 million during the period. The budget approval provides some flexibility that will assist in peak periods approaching the finalisation of the next price Determination towards the end of the period. The Commission is permitted to vire between budget lines and between financial years, subject to certain limits: 20% of the revenue budget can be transferred from one year to the next, subject to the Commission living within the total available for 5 years; and the Commission cannot vire into the staff costs element of the budget. As explained in paragraph 31 the Commission expenditure on staff reduced in 2010/11. Also, towards the end of 2010/11, the Commission moved to new, smaller offices, which should generate further savings.
34. It is important that the Commission continues to operate within this budget framework, taking account of the flexibility and the cyclical nature of its activities, while being prepared to respond to any challenges that may arise as a result of developments in the broader public sector landscape in Scotland.

Governance and accountability

35. The three fundamental principles of corporate governance – openness, integrity and accountability – apply to all audited bodies, whether their members are elected or appointed, or whether they comprise groups of people or an individual accountable officer.
36. Through its chief executive or accountable officer, each body is responsible for establishing arrangements for ensuring the proper conduct of its affairs including the legality of activities and transactions, and for monitoring the adequacy and effectiveness of these arrangements. Audited bodies usually involve those charged with governance (including audit committees or similar groups) in monitoring these arrangements.
37. Consistent with the wider scope of public audit, auditors have a responsibility to review and report on audited bodies' corporate governance arrangements as they relate to:
 - corporate governance and systems of internal control
 - the prevention and detection of fraud and irregularity
 - standards of conduct and arrangements for the prevention and detection of corruption
38. In this part of the report we comment on key areas of governance.

Corporate governance

Processes and committees

39. The Commission Members, as a Board, are responsible for ensuring that the Commission fulfils its statutory functions. The role of the Board includes establishing the overall strategic direction, monitoring performance against agreed objectives and ensuring that statutory requirements for the use of public funds are complied with.
40. The Audit Committee monitors and reviews risk, control and corporate governance, challenging senior management on key issues as appropriate and reports to the Board.
41. Our audit procedures have confirmed the operation of these arrangements and their continued further development over the year.

Audit Scotland's report: The role of boards

42. Audit Scotland reported that public bodies and their boards have evolved over time. There is great variety in the size and make-up of boards and the roles they have. Accountability can be complex, with chief executives and boards reporting in different ways to the Scottish Government, ministers and the Scottish Parliament. This risks causing confusion about who leads an organisation and is responsible for its decisions.

43. We recognise the significant work on governance that the Commission has completed over the year and the further work that is underway; and the use that has already been made of the findings of the Audit Scotland report, which coincided with the review by Christopher Bolt CB on the Commission's operations and methods of working over the previous four years. We note that WICS has taken forward the recommendations of the Bolt review and has published a "Mission, strategy and governance" paper in February 2011. Also, there is the work by internal audit and WICS in 2011/12 on corporate governance.
44. We note that the Scottish Government are considering their response to Audit Scotland's report and, therefore, there may be further relevant developments. We recommend WICS monitor developments and consider there may be some merit (at a suitable future point) in WICS taking stock of their developments in governance against Audit Scotland report's key findings and assessment checklist or any updated guidance to determine whether any further areas for development may be identified.

Internal control

45. While auditors concentrate on significant systems and key controls in support of the opinion on the financial statements, our wider responsibilities require them to consider the financial systems and controls of audited bodies as a whole. However, the extent of this work should also be informed by their assessment of risk and the activities of internal audit.
46. Our audit approach includes a review of the high level controls operating within the Commission's key financial systems. Our overall conclusion from the 2010/11 review was that key controls were operating effectively and that the Commission has adequate systems of internal control in place.
47. The Commission's internal audit function is provided by PricewaterhouseCoopers (PwC). In November 2010, Audit Scotland completed an assessment of the internal audit function provided by PwC for relevant central government bodies including the Commission. The review covered the range and quality of work carried out by their internal audit service and concluded that the internal audit service operates in accordance with Government Internal Audit Standards, and has sound documentation standards and reporting procedures in place.
48. Locally, we reviewed the arrangements in place at the Commission with satisfactory results, and confirmed that we could place formal reliance on internal audit's work for our audit of the financial statements audit (in terms of ISA 610) in the following areas:
 - Review of segmental reporting and budgetary control arrangements;
 - Follow up – staff travel and subsistence expenses, procurement and payroll and expenses; and
 - Review of relocation costs.

Prevention and detection of fraud and irregularities

49. Audited bodies are responsible for establishing arrangements to prevent and detect fraud and other irregularity. Auditors review and report on these arrangements.

- 50. The Commission has appropriate arrangements in place to prevent and detect instances of fraud and corruption including detailed policies which have recently been reviewed and updated.
- 51. There were no instances of fraud or corruption reported by the Commission in 2010/11.

Standards of conduct and arrangements for the prevention/ detection of bribery and corruption

- 52. Audited bodies are responsible for ensuring that their affairs are managed in accordance with proper standards of conduct and have proper arrangements in place for implementing and monitoring compliance with standards and codes of conduct, standing orders and financial instructions. Auditors consider whether bodies have adequate arrangements in place. We have concluded that the arrangements in the Water Industry Commission for Scotland are satisfactory and we are not aware of any specific issues that we need to identify in this report.

Best Value, use of resources and performance

53. Accountable officers have a specific responsibility to ensure that arrangements have been made to secure Best Value.
54. The Auditor General may require that auditors consider whether accountable officers have put in place appropriate arrangements to satisfy their corresponding duty of Best Value. Where no requirements are specified for auditors in a period they may, in conjunction with their audited bodies, agree to undertake local work in this area.
55. As part of their statutory responsibilities, the Auditor General and the Accounts Commission may procure, through Audit Scotland, examinations of the use of resources by audited bodies and publish reports or guidance. Auditors may be requested from time to time to participate in:
 - a performance audit which may result in the publication of a national report
 - an examination of the implications of a particular topic or performance audit for an audited body at local level
 - a review of a body's response to national recommendations.
56. Auditors may also consider the use of resources in services or functions, where the need for this is identified through local audit risk assessments
57. During the course of their audit appointment auditors should also consider and report on progress made by audited bodies in implementing the recommendations arising from reviews in earlier years.
58. This section includes a commentary on the Best Value/ performance management arrangements within the Water Industry Commission for Scotland. We also note any headline performance outcomes/ measures used by the Commission and any comment on any relevant national reports and the body's response to these.

Management arrangements

Best Value

59. In March 2011, the Scottish Government issued new guidance for accountable officers on Best Value in Public Services. The new guidance, in essence, required public bodies to take a systematic approach to self-evaluation and continuous improvement.
60. The guidance identifies the themes which an organisation needs to focus on in order to deliver the duty of Best value, but notes that implementation should be appropriate and proportionate to the priorities, operating environment, scale and nature of the body's business.

61. The five themes and two cross-cutting themes (some of which we have commented on earlier in this report) are:
- vision and leadership
 - effective partnership
 - governance and accountability
 - use of resources
 - performance management
 - equality (cross-cutting)
 - sustainability (cross-cutting)
62. The Commission comment on aspects of Best Value and their management arrangements in the Management Commentary and the Statement on Internal Control sections of their annual accounts. In preceding sections of this report we have commented on aspects of use of resources and governance and accountability. A feature in 2010/11 is that the Commission complied with new duties under the Public Services Reform (Scotland) Act 2010 to publish specific information on expenditure, and statements outlining the steps it has taken to promote and increase sustainable growth and to improve efficiency, effectiveness and economy.

Overview of performance in 2010/11

The Commission's performance measurement outcomes

63. WICS is the economic regulator of the Scottish water and sewerage industry, with a statutory duty to promote the interests of households and businesses.
64. As recorded in the Commission's annual report, it has 4 main areas of activity: ensuring value for money for customers; improving Scottish Water's performance; achieving greater value and choice through competition; and, managing its office.
65. The Commission does not publish key performance indicators or performance against those. However, its report highlights the following performance achievements in respect of the 4 activities:
- household customers experienced stable prices, with charges frozen for both 2010/11 and 2011/12;
 - around 42% of the retail market enjoyed direct benefits of open competition;
 - growing savings in administrative costs as a result of the introduction of retail competition, estimated at £330 million over time;
 - Scottish Water continues to respond well to targets and incentives by improving customer service and tackling leakage;
 - substantial reductions in the Commission's operating costs during 2010/11, with the move to new offices expected to generate further savings, including in respect of energy, carbon and water use;

- good progress in planning to simplify the regulatory system and encourage greater participation by customers in the next price review.

National performance reports

66. Audit Scotland carries out a national performance audit programme on behalf of the Accounts Commission and the Auditor General for Scotland. We have commented on 2 reports in earlier sections of this report: Scotland's public finances: addressing the challenges (see Financial Position section); and The role of boards (see Governance and Accountability section). The performance report in the last year of direct interest is: Improving energy efficiency: a follow-up report.

Improving energy efficiency: a follow-up report

67. The report highlights that, in the two years since Audit Scotland had last reported on this subject, action has been taken at both national and local levels. The Scottish Government has recently published an action plan to improve energy efficiency, and 85 per cent of public bodies now have energy efficiency strategies. However, our report identifies that greater urgency is now needed for public bodies to cut their energy use, in order to minimise the impact of predicted price rises and to reduce carbon emissions. In the three years to March 2009, public bodies' energy use increased by one per cent overall but spending on electricity, gas and oil rose by 21 per cent. In 2008/09 the public sector spent more than £322 million on energy. While energy prices had dropped, they have since start rising again. Additionally, Scotland's public bodies are also expected to contribute towards ambitious national targets to reduce greenhouse gas emissions.
68. The Commission moved into new, smaller offices closer to Stirling city centre in March 2011. It anticipates that this will result in energy savings in terms of both carbon and water - around 21 tonnes of CO2 equivalent and 11,000 litres of water a year, respectively. The relocation also provides staff and visitors with better access to sustainable forms of transport.

Outlook

69. The Commission should review and have regard to the outcomes of Audit Scotland's programme of performance audits and consider Best Value self assessment toolkits, as appropriate to circumstances.