

Introduction

The purpose of this submission is to provide committee members with additional background information on Audit Scotland's Section 22 report on the audit of Scottish Canals' Annual Report & Accounts for the year ended 31 March 2022.

This aims to provide clarity and assurance over the significant steps taken, and our continued focus to address the external audit recommendations regarding the valuation of our entire infrastructure assets in accordance with the Government Financial Reporting Manual (FreM).

Background

In July 2012, the British Waterways Board's functions and assets were divided, with the England and Wales waterways and assets being removed to form a charitable trust. At this time, Scottish Canals remained a public corporation reporting under International Financial Reporting Standards (IFRS) with no requirement to value its infrastructure assets in the same way as under the FreM.

Furthermore, under the Transport Act 1968, the canal infrastructure had been written down to a historic cost of £nil, therefore the canal infrastructure assets built pre-2012 have never been recognised in Scottish Canals' accounts. This holding of infrastructure assets at a historic cost of £nil was deemed to be appropriate at the time. All other capital expenditure assets were disclosed at historic cost in our Fixed Asset Register (FAR) and depreciated in line with applicable International Financial Reporting Standards, audited and accepted by external auditors (Grant Thornton and Audit Scotland) between 2012 and 2020.

Following a 2019 Office for National Statistics (ONS) review, in September 2019, Transport Scotland informed Scottish Canals that from 1st April 2020 the organisation would be reclassified as a non-departmental public body (NDPB) under the FreM. At that time, Scottish Canals and Transport Scotland requested a more reasonable timeframe to undertake the change. This was declined in November 2019. As such, Scottish Canals accepted the challenge and made every conceivable effort to make the transition a success in just five months. This included communicating to employees, partners, and stakeholders; transforming organisational culture; changing finance policies and procedures; and moving to annual budgeting requirements without being able to retain capital or revenue reserves whilst the organisation dealt with the effects of covid.

The overriding reason for both disclaimers and subsequent Section 22 reports from Audit Scotland is a change of applicable accounting rules on becoming a NDPB, and the demanding timeframe afforded to undertake the huge transition. Whilst we recognise and acknowledge that accounting for assets is a serious matter for any public body, Grant Thornton stated in their external audit report that there were no material concerns out-with the assets' valuation issue on property, plant, and equipment. All other changes to the accounting and reporting requirements under the FreM have been applied, audited, and accepted.

To adequately respond to a task of this magnitude and complexity for an organisation of any size would require time. Had there been an allowance agreed for a longer transition period to comply with the new financial reporting framework, then Scottish Canals is of the view that the disclaimer opinions could have been potentially avoided.

Steps to address the Disclaimer Opinion – Annual Report & Accounts 2020/21

At the Public Audit Committee held in March 2022, Scottish Canals former CEO accepted the requirement to value the entire canal infrastructure (circa £1.8bn re-build value) for incorporation into Scottish Canals' books and records for the first time.

Despite Scottish Canals having valued its £51m additions since its separation from England in Wales in 2012, it was determined that the asset additions had not been fully broken down into components with an agreed methodology assessed for each component, and therefore was insufficient to meet Grant Thornton's audit requirements and the assets remained at historic cost in the Annual Report & Accounts.

The auditors were also unable to obtain sufficient audit evidence to conclude on the appropriateness of capitalisation of the expenditure without a valuation of the underlying existing assets which were held at £nil value. A full valuation of the canal infrastructure was therefore necessary to address the 2020/21 disclaimer from Grant Thornton. It was reassuring, however, that despite the disclaimer opinion, no matters of concern were noted on other aspects of the financial statements.

Scottish Canals' former CEO assured the committee that Scottish Canals would give 'everything we have' to complete a full valuation exercise in compliance with the FReM, however clearly stated that she had concerns around the scale of the task within the tight timeframe for a small organisation with limited resources: "As the accountable officer, I have to be honest here and say that I have concerns that we will be unable to meet the deadline".

Before undertaking the resource-intensive, expensive, and complex programme of work, Grant Thornton and Scottish Canals met to discuss a possible change in the Accounts Direction for the Annual Report & Accounts to avoid the necessity of a valuation. The proposal would specifically allow Scottish Canals to attribute its capital funding on the large-scale replacements and enhancements of its canal infrastructure to revenue expenditure. In July 2022, Scottish Canals applied for this proposal to be considered by Scottish Government through Transport Scotland, however after consideration it was deemed inappropriate at that time, and there would be no such allowance or exemption to reporting under the FReM applied.

The significant undertaking of valuing Scotland's 141 miles of canal assets and network infrastructure to provide assurance over the capitalisation of expenditure on assets was challenging. The entire asset portfolio currently comprises 2,766 components. The canal infrastructure elements include land value and length of each canal, embankments, and associated towpaths; 246 pontoons, jetties, and moorings; 67 reservoirs and associated culverts and feeders; 60 weirs, 186 bridges, 52

aqueducts, 164 lock gates, and lock chambers covering a 200+ year life span. More recent successful partnership regeneration projects are also included in our register such as active travel improvements across the network, and projects such as the Claypits Nature Reserve in Glasgow, Caledonian Canal Centre, the Millenium Link and The Falkirk Wheel, the Helix and The Kelpies, and the Bowling Harbour Regeneration project. Each individual class of asset required a specific methodology, with associated valuation calculations.

The road, rail and council infrastructure networks have an established, agreed and previously audited methodology for their valuations, with multiple public sector agencies applying similar valuation rules accepted by auditors across the UK. With Scottish Canals' unique assets and reporting requirements, there has never been a UK-wide or generally accepted methodology and associated bench-marked historical cost data that could be relied upon as the basis of the valuation. This resulted in a complex piece of work for the valuation team to bench-mark the costs of assets against more recent projects, verifying the cost data with our suppliers, and comparing against other infrastructure programmes across the UK.

Since 2012, Scottish Canals has had an extensive engineering FAR in place detailing all its infrastructure assets which is used to continually monitor and assess asset condition. This has provided all the information for our Asset Management Strategy and represents the backbone to a risk-based assessment to prioritise both capital and revenue expenditure.

Scottish Canals was fully committed to deliver against the tight timescale. The work was split into two separate stages to maintain momentum, (1) develop an analysis of the requirements of the FreM and comparison with other bodies with similar assets, and (2) develop a detailed methodology and infrastructure valuation for the years ended 31 March 2020, 31 March 2021 and 31 March 2022.

The initial analysis work was presented to Grant Thornton, the Audit & Risk Committee and Transport Scotland finance colleagues as well as Scottish Canals' finance and engineering teams to provide additional scrutiny and assurance.

In line with Scottish Government robust procurement rules, an experienced external multi-disciplinary valuation team was appointed to produce the full valuations. Multiple years were required to be valued to comply with the technical disclosure requirements.

In July 2022, the valuation team began the extensive work needed to build the valuation and provide the basis for a comprehensive FAR for the canal infrastructure. By August 2022, a detailed methodology for valuation was accepted by Scottish Canals Audit & Risk Committee, Grant Thornton, and Transport Scotland, allowing the valuation of canal infrastructure to commence.

The valuation was submitted to Grant Thornton in November 2022. The auditors concluded that the evidence provided fell short of their requirements within a reasonable timescale, and this ultimately led to the second disclaimer of opinion.

Disclaimer of opinion – Annual Report & Accounts 2021/22

On 17th February 2023 Grant Thornton advised Scottish Canals and its Audit & Risk Committee that a clean opinion for the 2021/22 audit was likely, but they would need to consider how to reflect the historic disclaimer opinion (2020/21) as they could not attribute more time to completing additional audit tests to review that year.

However, on 19th April 2023 Grant Thornton reported there had been a change and they were unable to issue a clean opinion, or even consider a less robust opinion and ring-fence the issue around the valuation of Property Plant and Equipment (PPE).

Grant Thornton's external audit report for 2021/22 does, however, reassure that, 'no matters of significance were identified out-with audit testing of Property Plant and Equipment'. Despite this positive report, the auditors determined that a disclaimer opinion and subsequent Section 22 Audit Scotland Report was required as the valuation 'affects a number of accounting entries, it would take too long to hold the 2021/22 accounts open to undertake this work.'

Steps to address the Disclaimer Opinion – Annual Report & Accounts 2021/22

We remain committed to resolving this issue and have given the matter top priority, focus and allocated appropriate available resource.

As advised by the Auditor General in June 2023 and prior to committing additional resources to undertaking this valuation exercise, alternative approaches were considered – including either a permanent or temporary change to the Accounts Direction, and changes in the methodology and categorisation of assets whilst maintaining compliance with the FreM. Working closely with Transport Scotland, it was agreed that we should continue to develop and improve the existing FAR and associated valuations for the canal infrastructure.

The Chief Executive chairs a Project Board which has been established to address the valuation issues by the end of October 2023. This is intended to ensure Scottish Canals' finance team have the right information in time for Audit Scotland to begin their audit in November. This remains a challenging deadline and we are on track at present.

Several workstreams have been identified within a detailed project plan which will better evidence our valuation to meet required audit thresholds:

1. Establishing a FAR for the canal infrastructure for the first time fully reconciled to the Annual Report & Accounts. This will provide a single reliable set of data for audit testing
2. Re-assess all additions, work in progress, assets under construction within the last three years to ensure the risk of duplication and capitalisation date errors are minimised
3. Review the classification of all assets to ensure assets are categorised on a consistent basis

4. Re-record judgements and estimates with historical cost data
5. Consider changes to the residual values and useful economic lives methodology and provide additional evidence around the judgements and estimates
6. There is no automated system that will correlate all our assets to their appropriate title deeds and/or historic record of rights of ownership, and so this will form part of a longer-term improvement plan, reconciling the asset register with the title deeds register and Geographic Information System (GIS)

Our commitment

We are fully committed to delivering a set of accounts free from a disclaimer opinion and will continue to dedicate the necessary resources to this goal. We will continue to work closely with our new auditors, Audit Scotland, to ensure they have a satisfactorily reconciled FAR on which to base their audit testing during their timetabled audit in November and December 2023, including the valuation of the canal infrastructure. Based on the audit timeline, we anticipate laying our Annual Report & Accounts in the new year.

John Paterson
Accountable Officer and CEO
4th September 2023