



**OFFICIAL REPORT**  
AITHISG OIFIGEIL

# Public Audit Committee

**Thursday 24 March 2022**

**Session 6**



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Pàrlamaid na h-Alba

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**PUBLIC AUDIT COMMITTEE**

**10<sup>th</sup> Meeting 2022, Session 6**

**CONVENER**

\*Richard Leonard (Central Scotland) (Lab)

**DEPUTY CONVENER**

\*Sharon Dowey (South Scotland) (Con)

**COMMITTEE MEMBERS**

\*Colin Beattie (Midlothian North and Musselburgh) (SNP)

\*Willie Coffey (Kilmarnock and Irvine Valley) (SNP)

\*Craig Hoy (South Scotland) (Con)

\*attended

**THE FOLLOWING ALSO PARTICIPATED:**

Hugh Gillies (Transport Scotland)

Sarah Jane Hannah (Scottish Canals)

Fran Pacitti (Transport Scotland)

Lee Shedden (Transport Scotland)

Andrew Thin (Scottish Canals)

Catherine Topley (Scottish Canals)

**CLERK TO THE COMMITTEE**

Lynn Russell

**LOCATION**

Committee Room 4



## Scottish Parliament Public Audit Committee

Thursday 24 March 2022

*[The Convener opened the meeting at 09:00]*

### Decision on Taking Business in Private

**The Convener (Richard Leonard):** Good morning and welcome, everyone, to the 10th meeting in 2022 of the Public Audit Committee.

Before we begin, I remind members, witnesses and staff present that the Parliament's social distancing rules apply. If you are entering, walking around or leaving the room, I ask that you wear a face covering, please. You do not have to do that when you are seated or when giving evidence.

Item 1 is a decision on whether to take agenda items 3 and 4 in private. Do we agree to take those items in private?

**Members** *indicated agreement.*

## Section 22 Report: “The 2020/21 audit of Scottish Canals”

09:00

**The Convener:** Item 2 is consideration of a section 22 report on Scottish canals that was published by the Auditor General earlier this year. I welcome our witnesses. From Scottish Canals, we have Catherine Topley, who is the chief executive; Andrew Thin, who is the chair of the board; and Sarah Jane Hannah, who is the director of finance and business services. We also have a team from Transport Scotland, which is led by Hugh Gillies, who is the interim chief executive. We are also joined by Fran Pacitti, who is the director of aviation, maritime, freight and—this fits in with the purpose of this morning's item—canals; and Lee Shedden, who is the financial controller.

I invite Catherine Topley to make a short opening statement, which will be followed by a series of questions from committee members.

**Catherine Topley (Scottish Canals):** Thank you, convener. In July 2012, Scottish Canals became a stand-alone public body, marking the end of a 50-year cross-border public corporation. In accordance with the Transport Act 1968, waterways, reservoirs and towpaths were written off in a capital reconstruction and have never been disclosed in Scottish Canals' annual accounts, nor valued for audit purposes since that date.

No asset valuation was conducted at the time of transition, and the framework of statutory reporting saw the canal infrastructure being left off Scottish Canals' books. No external audit concerns were raised on the transition figures by Grant Thornton UK LLP at the time, and Audit Scotland approved our 2012-13 accounts.

The assets, liabilities and operations in Scotland began reporting to the Scottish Government under the management of Scottish Canals, the operating name of the British Waterways Board, which was sponsored through Transport Scotland.

In October 2012, Audit Scotland presented an audit plan at Scottish Canals' board meeting, identifying non-departmental public body reclassification as a key future risk, and stating that the value of the canals would have to be considered if that reclassification occurred. However, it was decided for accounting purposes that Scottish Canals would remain a public corporation until at least 2015-16, and that an Office for National Statistics review would be conducted.

In 2017, Scottish Canals performed a high-level valuation of the canal infrastructure in line with the ONS review. In May 2018, we published “Scottish

Canals Asset Management Strategy 2018-2030”, which set out a risk-based approach to managing the complex range of the 4,100 assets in our care. We also published an overall canal replacement value of an estimated £1.78 billion. We were not asked to include the replacement value on our books and records, and the assessment was not a technical accounting valuation.

In September 2019, the ONS advised us that it had analysed the accounts on our website and concluded that we did not meet the quantitative market test to remain a public corporation. That was confirmed to us in writing in November 2019, and we were asked to reclassify four months later, in April 2020. The board sought assurance on the budgetary impact of not being able to retain reserves across accounting years, and we began preparing our 2019-20 annual accounts in the usual format.

A Grant Thornton paper that was sent to the board in January 2021 stated that operational freehold land, buildings and structures would need to be held at current value, and that Scottish Canals would have to review the way that we value vehicles plant, equipment and public art works.

Scottish Canals followed up in March 2021 with a proposal on how that would be achieved. However, the structures were not part of the valuation plan at the time, and the proposal was accepted by Grant Thornton.

In July 2021, Grant Thornton raised the issue of £51 million of structures that had been added to the canal infrastructure since 2012. That included—to name but a few—the reservoir and canal improvements at Helix park in Falkirk, and Bowling harbour in north Glasgow.

Previous audit reports had not raised any concerns about those projects or the fixed asset register, but a hot review in June 2021 led to Grant Thornton advising that additional audit testing on the capitalisation of the assets was required. At that point, we were some way into our external audit.

Once Scottish Canals had completed assessment of the additions, and the audit work was finalised by Grant Thornton, Scottish Canals sought a specialist valuer for those additions. Grant Thornton assessed the valuer’s qualifications as suitable because existing Royal Institution of Chartered Surveyors-qualified valuers were unable to value such varied assets. Grant Thornton approved a sample of the methodology that was used for the valuations and the Scottish Government confirmed that the use of such a specialist was an appropriate interpretation of Her Majesty’s Treasury’s financial reporting manual, which is known as FReM.

Valuations of £45 million of the £51 million additions were conducted, representing 88 per cent of the valuation. However, on reflection, Grant Thornton felt unable to conclude on the judgments and estimates applied without the underlying valuation of the canal infrastructure that was being incorporated. That is the main element of Grant Thornton’s concerns and resulted in the disclaimer opinion on the annual accounts.

In his evidence to the committee, the Auditor General said that he had

“not identified core financial sustainability issues with ... Scottish Canals.”—[*Official Report, Public Audit Committee*, 24 February 2022; c 37-38.]

At the same meeting, Audit Scotland’s senior manager said that it was not “uncommon” for the ONS to recommend a change in status and not look at the implications for the organisation.

Since the disclaimer was placed on our 2020-21 accounts, we have worked collaboratively with all parties and now have in place a robust plan with an ambitious delivery date of December 2022 to meet the statutory reporting timetable, subject to there being no unforeseen issues with procurement, availability of resources or delivery. That is an ambitious plan. Grant Thornton, Transport Scotland and HMT have reviewed our critical path for the action plan and support the approach that we are planning to take.

Grant Thornton’s final external audit report to the board was dated December 2021. It considered management’s processes to be appropriate, that key assumptions were neither optimistic nor cautious, and only the valuation of specialist operational assets was raised as a significant issue. That demonstrates that the other areas associated with our accounts were all appropriate.

No issues in relation to fraud or irregularity were identified, and all accounting policies had been updated in accordance with FReM, with the exception of the valuation of specialised operational assets, which remained at historic cost in the annual report and accounts due to the disagreement on the valuation techniques that were undertaken.

We are bolstering our in-house expertise on FReM with external consultancy and specialist valuation support, developing a methodology for categorising different components of canal investments, reviewing our capital policies and procedures, and undertaking a valuation of all canal infrastructure and related assets as noted in the Auditor General and Grant Thornton’s recommendations.

We will then create prior year adjustments and restate our accounts for 2019-20 onwards. That is a substantial piece of work, but it will allow

Scottish Canals to continue to deliver significant public value for the people of Scotland in areas of tourism, net zero, placemaking and tackling health inequalities.

**The Convener:** Thank you very much, indeed, for that comprehensive opening statement, which is useful. I am sure that it will provoke lots of questions.

Craig Hoy will put the opening question to you.

**Craig Hoy (South Scotland) (Con):** The Auditor General's report explains that, in 2012, the network was transferred to Scottish Canals as a

"heritage asset, with no value attributed to it in the financial statements."

It goes on to state that

"the canal network has never been valued in its entirety or disclosed in Scottish Canals' financial statements since"

that transfer took place. Why has no value ever been attributed to the canal network? Did someone drop the ball at the beginning of the process?

**Catherine Topley:** You need to bear in mind the fact that I was not present at the time, but I have been advised that, when the canals transferred in 2012, there was no requirement to do so. However, we have engaged with HMT throughout the process, and it was surprised that a valuation was not undertaken at the time.

I will ask Sarah Jane—SJ—Hannah, our finance director, to elaborate on that further, given the technical nature of the question.

**Sarah Jane Hannah (Scottish Canals):** The original report by Audit Scotland on auditing our first set of accounts in 2012-13 stated that we should perhaps consider undertaking some valuation if we transferred to an NDPB. It is clear that, at the time, Audit Scotland did not think it necessary to do a valuation. There was no requirement under the international financial reporting standards and, at the time, the type of accounting came under the Companies House regime rather than that of NDPBs.

Only the specialised operational assets are affected by the change in the FReM. We valued all our other assets appropriately at the time and from 2012 onwards. It is only those assets that fall into the category of specialised operational assets that pose a problem. The original heritage asset description that was made in 2012 is not the same as in the FReM, so that is what makes a difference.

**Craig Hoy:** It is obviously quite a technical accounting issue. For people watching the committee, could you explain the impact of the present situation on the day-to-day operation of

the organisation and on the integrity of the financial statements?

**Catherine Topley:** I will address the day-to-day impact. I cannot overstate the volume of work that needs to be done to undertake the valuations. To simplify the situation—although to do that is unfair to the technical nature of the work to be undertaken—the issue is that we do not have the canals on the books. Every time we build something or add an asset, we are creating a bigger asset as we progress and project forward 10, 20, or 30 years. Consequently, a conscious decision must be made about whether we value the assets—as the auditor from Grant Thornton said when she gave evidence—or build an asset over a period of time. The accounts allow for our doing that, but we have to make a conscious decision to do so.

The day-to-day impact of that is that we must identify a team to address the issue and undertake a substantial piece of work while running an organisation that has gone through significant change to become an NDPB, as well as—this is not an excuse—dealing with the aftermath of Covid. We have an ambitious plan to meet the December deadline for the accounts, but that is with a fair wind and everything going well.

SJ can talk about the implications for the accounting and our books.

**Sarah Jane Hannah:** The issue that Grant Thornton had was that, although the assets and additions are all in our books and records and stand at £51 million, they are valued at historic cost, rather than a revaluation amount. Until we do the work, we do not know what the monetary value of those assets will be. The issue for Grant Thornton was that it was not just a case of one item on a balance sheet that was worth £51 million and might change value by £10 million or whatever, but that it was something that will affect our statement of comprehensive net income and expenditure. It related to so many different figures across the accounts that the auditors determined it was pervasive. The determination was made quite late in the day, in December. At that point, we believed that there would be a limitation of scope and that it would be a ring-fenced issue. However, after the auditor liaised with her technical team in Grant Thornton, it became clear that, because of the pervasive nature of the issue and the fact that it would affect many figures, Grant Thornton would put a disclaimer on the accounts.

It is interesting that Her Majesty's Treasury, which is responsible for the Government finance reporting manual, sympathises with the technicality of the issue. We have liaised with HM Treasury on the issue and I will summarise some of what it has said. It recognises the burden of the requirement on reporting entities across the public

sector. The previous technical requirement was historic cost and it is now a revaluation requirement.

HM Treasury is beginning a thematic review of the valuation methodology in the Government financial reporting manual for non-investment assets—that is exactly what we are talking about. The review is planned to start in April and will assess the additional effort and burden on public bodies of requiring such complex valuations. It will also assess the overall cost benefit analysis associated with that. Although HM Treasury is not willing to say whether that might change the accounting practice for 2022-23 disclosures—it would be a bit early to see any such recommendations being put in place—it will be interesting to see the journey from HM Treasury's point of view.

09:15

**The Convener:** Catherine Topley, can I take you back to your opening statement? It was not entirely clear to me whether you accept the analysis and recommendations that the Auditor General for Scotland has made. Do you accept those recommendations?

**Catherine Topley:** We do. We recognise the recommendations that have been made to Scottish Canals and we will seek to comply with them. That is why we have worked together to create an action plan that will meet the requirements of reporting in FReM at the current value. I must reiterate that it is not an easy task. If it were, we would have concluded it last year during the process. It will be a complex undertaking.

**The Convener:** Okay. We will return to some of those issues later.

**Colin Beattie (Midlothian North and Musselburgh) (SNP):** In September 2019, the ONS advised Scottish Canals of the intended change of status to become an NDPB. In December 2020, the external auditor shared a paper with Scottish Canals' management that set out the various accounting requirements arising from the change in status and pointed out where management needed to pay particular attention in undertaking and drafting the financial statements for the year ahead. How did Scottish Canals plan to take account of its change of status? Do you consider that it has successfully transitioned to become an NDPB?

**Catherine Topley:** Once we were notified, we prepared our team to address the key changes, such as the finances and operations. There were significant changes in how we prepare accounts in terms of both the presentation and content. We

had very little time to respond to that, so we sought to address it immediately.

We discussed the issue at the board and we agreed the approach that we would take. I will ask Andrew Thin to comment on that in a moment. In addition, and as I said in my opening statement, we discussed our approach with Grant Thornton and wrote to them with an overall action plan to address some of the more substantial changes. Grant Thornton provided us with a summary of the areas that we should investigate, and that is exactly what we did.

The fundamental issue is that, although, when we were last asked to look at our fixed assets and ensure that they were revalued, we did so, the canals were not on the fixed asset register in the first place but were on an engineering register. The key issue is that we have £51 million of assets in the historic cost that have not been valued. With hindsight, we should have identified that.

**Colin Beattie:** Given the timeline, at what point did Transport Scotland, as the sponsor body, become involved?

**Catherine Topley:** Transport Scotland has worked with us collaboratively since I came in as chief executive. We were notified in September by the ONS about becoming an NDPB. Transport Scotland was engaged right through that process. We met other colleagues in the Scottish Government who were also engaged in the process and therefore in the transition and in understanding what the consequences were—for example, our not being able to hold reserves. We had to talk about working capital reserves; how we would change our operational delivery, given that we were no longer able to do multiyear projects; how we would manage that in the 12-month window; and budget planning and budget discussions. Transport Scotland has been alongside us the whole way through. Fran Pacitti might want to comment on that.

**Fran Pacitti (Transport Scotland):** I echo those comments. We have been on a journey with Scottish Canals through its transition. We have supported Scottish Canals in understanding the requirements and what they mean for expenditure and compliance with FReM and the accounts direction that was issued in 2020. It is a good collaborative relationship. We have supported that with access to expertise in Transport Scotland and the Scottish Government's sponsorship and financial departments. We have gone through the process step by step.

**Colin Beattie:** I am looking at everything that has been said. I asked about making a successful transition to becoming an NDPB, and the reasons all seem to be financial. Did you have to do anything outside financial matters to comply?

**Catherine Topley:** There is a change in culture and behaviours. As a public corporation, Scottish Canals was renowned for delivering things such as the Claypits local nature reserve, the Helix park and other fabulous regenerative assets across communities. Such developments do not happen in one financial year, so Scottish Canals was committed to aspects of plans and of the regeneration of community assets over several years. We had to re-identify how to do such work within one-year envelopes, and we worked closely with the Scottish Government and Transport Scotland in doing that.

I echo the point that our capital has increased substantially. We are now at £12.2 million, and we were baselining at circa £3 million when I came into my role. Our revenue has also increased from about £8.5 million to £10.2 million. Transport Scotland absolutely understands the challenges of running Scottish Canals.

As for whether the transition has been successful, even on the financial element, the rest of the accounts were concluded as per the transition to meet the needs. One area was raised that involved £51 million, although I do not undervalue or underestimate that important area of work. I would say that the transition has been successful. Does my organisation's chair wish to comment?

**Andrew Thin (Scottish Canals):** I will address, head on, Colin Beattie's question whether the transition has been a success. If I say that it has been a success, you will say that it clearly has not been, which is why we are here. However, we need to be clear that the transition had operational consequences that had to be addressed, as well as cultural, organisational and human consequences and technical financial consequences. The board was clear that we had to get all of that right. On the technical financial point, the board was clear that we had inherited a financial team that was designed to operate under the old regime, so we had to shift that.

I think that the transition has been successful in organisational terms and in operational terms. We have continued to deliver more and more public value from canals. A culture is difficult to shift, but it has shifted—we are closer to the Scottish Government and much clearer about our relationship with the Government and with the Scottish people.

In technical financial terms, we were too slow—let us not beat about the bush. At the time, we did not have the right skills. We needed to get the skills and we tried to recruit them—the committee has seen all the documented evidence. Getting in place the right skills took too long, and we ended up with a technical financial issue, which is why we are here.

**Colin Beattie:** Before the transition to being an NDPB was made, you worked with Transport Scotland. When the ONS decided that the change should take place, what steps did Transport Scotland take with you to ensure that the change went smoothly? I would expect Transport Scotland, as the sponsor organisation, to be fully on board.

**Catherine Topley:** It was. When we were informed of the decision in writing, in November 2019, I was unhappy with the timeline that was associated with the change and I wished to pursue an extension, which is not unusual, to delay the decision's implementation by a year. Transport Scotland supported me in advocating for that with the ONS and it supported me with internal discussions in the Scottish Government core. Transport Scotland attended all the meetings and was very supportive throughout them. When it became apparent that an extension into the next financial year would not be supported, Transport Scotland worked with us to ensure that we were ready to deliver our accounts.

**Colin Beattie:** You have highlighted changes to finances and culture, but, across the board, what key differences has the change in status made to your operation? Will you give us a bit more detail of that?

**Catherine Topley:** As with all NDPBs, there are restrictions under FReM with which we have to comply, and that is what we do. That means it is much more difficult for us to engage on larger projects than it was previously. There are some projects that we used to engage with that would not meet the requirements of the Scottish public finance manual or FReM. That makes it more challenging for Scottish Canals to be innovative and creative in delivering public value as we used to do.

However, as Andrew Thin has stated, that does not mean that Scottish Canals does not add public value to Scotland. We have an economic analysis of the work that we have done since 2012 as a public corporation, and it shows that we have created £1.53 billion of economic value to Scotland from regenerating the canals. That is not to be sniffed at. We want to make sure that there is still a way to do such work creatively in the future. We want to maximise the revenue and income coming to Scottish Canals, lowering the burden on the grant in aid, while recognising the public value of the canals across Scotland.

**Colin Beattie:** Are you indicating that there is a constraint on what you can achieve in comparison to what you could do before? If so, are there ways around that? Is there now some sort of cap on your activities?

**Catherine Topley:** As I mentioned, the constraints are restrictive for all NDPBs. The cap means that we must re-engage with Transport Scotland to identify and understand what we can and cannot do, how that affects our plans and how we move in that new space. We have discussed that with Transport Scotland, so Fran Pacitti might want to comment.

**Fran Pacitti:** The transition to NDPB has not altered the strategic objectives of ministers for Scottish Canals—we still want to maximise the value of Scotland's canals for the people of Scotland as a whole. The transition has introduced some practical changes to how we do that. Specifically, it means that Scottish Canals has lost the ability to spend its reserves without that impacting on the expenditure charged to the core Scottish Government budget. That means that Scottish Canals has lost the flexibility to carry funds over for multiyear projects and is moving towards a more annualised budget. As Catherine Topley mentioned, that brings different challenges and affects the approach to multiyear projects. Those challenges are inherent to all NDPBs—they are not unique to Scottish Canals.

From the view of the sponsorship function, it means that, as we support Scottish Canals and look for reassurance around its performance, we have changed the way in which we engage so that there is much closer scrutiny and alignment to our budget allocation processes. However, as I said, that is not unique to Scottish Canals as an organisation but is common to all NDPBs.

**Colin Beattie:** Just to be clear, are you saying that it is not a question of Scottish Canals no longer being able to do the grander projects that it used to do? Scottish Canals will be able to undertake such projects, but it will have to justify it in a more bureaucratic way.

**Fran Pacitti:** I would not choose the phrase "more bureaucratic". [*Laughter.*] It means that we have to plan for such activity differently and treat it differently from an accounting perspective. We have the same aspiration and level of ambition, but we need to manage that through the budget process in a different manner.

**Colin Beattie:** Are those ambitions still achievable?

**Fran Pacitti:** They are more difficult to deliver in practical terms, but they are still achievable.

**Colin Beattie:** I am not sure how to take that answer. I will accept it at face value.

As an NDPB, Scottish Canals does not have the ability to carry budget forward, year on year, but I think that you said that the capital had gone from £3 million when you took over to £9.3 million now.

**Catherine Topley:** It is £12.3 million.

**Colin Beattie:** I was close. How does that happen?

**Catherine Topley:** It happens through engagement. One of the early discussions that I had with Transport Scotland was to look at the asset management strategy and identify how we could secure appropriate funding to ensure maintenance and that the asset was well looked after. Through those discussions with Transport Scotland, we were able to provide an evidence base of what the asset required and demonstrate the need for that funding, bid for it and secure it. That has worked really well so far.

**The Convener:** Willie Coffey has a question in the same area.

09:30

**Willie Coffey (Kilmarnock and Irvine Valley) (SNP):** Good morning to the panel. Catherine Topley, I have a wee question on the status change that occurred. Were you taken by surprise by the decision of the ONS to change Scottish Canals into an NDPB? The only explanation that we have in front of us is that, because it carried out administrative, commercial, executive or regulatory functions, it had more of the characteristics of an NDPB. However, it had been doing that for years, I presume. Why did the change suddenly occur? Were you taken by surprise? Why were you not granted the extension that you requested in order to prepare the organisation for that NDPB status?

**Catherine Topley:** I say whole-heartedly that not only was I taken by surprise, but so was our board, and so was Transport Scotland.

As I mentioned in my opening statement, the review that the ONS undertook was based on our website accounts. It engaged with us after it had concluded that review by notifying us in September that that was what it had done, with a transition date of literally five months later. That is why, with Transport Scotland's support, we engaged with the ONS and the Scottish Government core to say that that felt unrealistic and had come as a bit of a surprise.

To go back to what SJ mentioned, the history is that, in the 2012 transition to being British Waterways, trading as Scottish Canals, there was an expectation that Scottish Canals would grow its investments, income and revenue returns and would demonstrate its ability to operate with more than 50 per cent of its income consistently being over and above what was provided by grant in aid—that Scottish Canals would prove to be financially sustainable over and above grant in aid. Two assessments were undertaken by the ONS, at the three-year points. The ONS gives three bites at the cherry, essentially. Scottish Canals

failed those two assessments, as it was unable to demonstrate that it had met the requirements. The third assessment was very visible on the ONS's timeline, but it was not visible on mine.

**Willie Coffey:** What was its explanation to you for its not granting the extension?

**Catherine Topley:** Sadly, it was very simple: we were a small organisation and should not need it. Our external auditor, Grant Thornton, advocated for the extension as well. Scottish Canals may be small, but we are complex. We deal with third-party funding. We have businesses, joint ventures, retail income and the letting of contracts. It has been an extremely complex process, and we advocated for that extension. Again, I will support Transport Scotland in saying that we did that together. Our voice was just not heard loudly enough, potentially.

**Willie Coffey:** Okay. Thank you.

**The Convener:** Before we leave that point, Catherine Topley was asked by Colin Beattie about the support that Scottish Canals had from Transport Scotland, but I would like to ask Hugh Gillies about the degree to which he feels any responsibility for the situation.

The Audit Scotland report is fairly strong. Paragraph 4 says that there were fundamental problems with the qualifications of the person who carried out the valuation of assets. Paragraph 18 talks about the classification of revenue spend as capital spend. Those sound like technical matters, but they are fairly fundamental failings in the approach to the accounts—to such an extent that Audit Scotland issued that rare thing: a disclaimer.

Recently, we heard from the Scottish Environment Protection Agency, which had a disclaimer because of a cyberattack, in which virtually all of its data was wiped out. Scottish Canals has had a disclaimer. Hugh Gillies, how do you reflect on the situation that has occurred? What lessons are you learning as a result?

**Hugh Gillies (Transport Scotland):** I will bring in Fran Pacitti and Lee Shedden but, from my point of view, having come into my role as accountable officer for Transport Scotland in the middle of November last year and picked up the background to all of this, it is clear that the situation is to be regretted. There are technical accountancy issues; I am not an expert in that, which is why I have asked Lee and Fran to support me, because they have the necessary background.

Lessons need to be learned, and we will endeavour to learn them, along with Scottish Canals. We will also reflect on those learnings with other NDPB chief executives, for whom there is a forum.

What I have seen in my role, which reflects what Catherine Topley has seen, is that Transport Scotland and Scottish Canals, in the journey to its change of status, have tried to work together collaboratively. When issues have been raised, such as the technical accountancy issues that Scottish Canals raised towards the back end of last year and prior to that, some of the issues that we have heard about to do with financial capability back in September 2019, which Andrew Thin described, we have tried to go towards those issues and recognise them. Obviously, the fact that we are having to sit here today is to be regretted, and I absolutely say to the committee that we need to learn lessons from that.

Fran Pacitti or Lee Shedden might want to add to that.

**Fran Pacitti:** One of the questions was about our reflections on Transport Scotland's role. I will first talk about the generality of how, in our capacity as sponsor, we obtain assurance on the activities of Scottish Canals, and I will then answer on the specifics of this example.

Plainly, the two organisations have distinct accountable officer accountabilities, and legitimate professional judgments are exercised by the executive team at Scottish Canals. It is not our function to superimpose our judgment on the legitimate judgments that are made, but we obtain assurance on them through a number of means. First, we know that the executive team has access to appropriate professional support and advice. We supplement that with access to professional support and advice from within Transport Scotland and the broader Scottish Government finance teams. There is a robust internal audit and audit and risk committee function in Scottish Canals, and of course the board brings extensive scrutiny to bear. All of that provides us with a reasonable degree of assurance on how Scottish Canals manages its finances and business.

The specific question that we are facing today and that led to the section 22 report is a fairly narrow point. That is not to diminish its significance, but it is a narrow point about the evaluation of assets. It is regrettable that, collectively, we did not pick up on that, but that was not through any negligence or failure to address the question. A judgment was made, informed by professional advice, which turned out to have been the wrong judgment, albeit that it was reasonably made and supported. We accept that and we accept the auditor's recommendations in the report on moving forward.

To obtain assurance around the approach to date and going forward, we have worked closely with Scottish Canals. The issue was identified relatively late in the year. Even in discussions in October and November, when we were working

closely with Scottish Canals and Grant Thornton, the nature of the issue had not quite crystallised. We will work closely with Scottish Canals to move forward on the issue. We are aware of the critical path in the action plan that Scottish Canals has identified, and we take assurance from that. As Hugh Gillies mentioned, we are thinking about what that means more broadly for other NDPBs, both within Transport Scotland's portfolio and more broadly across the Scottish Government.

**The Convener:** That is helpful, but I do not read the report as simply being about a narrow technical issue that has led to a snag. For example, one of the critiques in the report is that the people who were appointed to carry out the asset valuation did not appear to be qualified to do so. How on earth could that happen?

**Catherine Topley:** That is an interesting statement. I will ask SJ Hannah and Lee Shedden to comment on this, but we worked with Grant Thornton to identify the scope of the valuation that was required. We agreed the scope and methodology, and we agreed on the individual who was going to undertake the valuation. It was not until after the valuation was concluded that Grant Thornton reviewed it and came to the conclusion that it was not sufficient.

I ask SJ to expand on that, and I know that Lee will also have a comment to make on the timing, which is ultimately what led us to this position.

**Sarah Jane Hannah:** To be clear, we use valuers with the appropriate Royal Institution of Chartered Surveyors qualifications when valuing investment properties. We are talking about a very different set of assets.

I will run through the example of the £51 million, which will bring things more to life. About £25 million of the additions were in 2013-14, so they have been on our books and in our records for quite a long time. Some of that related to reservoir improvements and some related to sea locks and gates associated with Helix park. About £17 million was associated with Helix park, £2 million was on Pinkston paddlesports in Glasgow, about £6 million was on the Bowling harbour regeneration, £1.6 million was on Ardrishaig pier and about £6 million was on the Claypits local nature reserve in north Glasgow.

RICS-qualified specialists would not have felt comfortable valuing those assets, as they are wide ranging. That gets to the core of the issue. Although those assets were on our fixed asset register appropriately, they were capitalised on a project basis. Big figures were involved, so the assets were not componentised—that is another accounting term—or split into elements of land, elements of engineering construction and all the various other elements involved in landscaping,

embankment improvements, weirs and so on. Therefore, we could not use a RICS-qualified valuer. We asked colleagues from Transport Scotland, the Scottish Government and Her Majesty's Treasury whether an alternative type of valuer was needed, and it was determined that a specialist engineer should do the valuations.

Grant Thornton now says that some of the land assets and other elements could have instead been valued by someone with RICS qualifications. Part of the journey that we are planning involves breaking down the assets into components, which is a really technical issue, so that we can use a range of appropriate valuers to determine values in the future.

**The Convener:** Fran Pacitti, I do not want to put the blame on your shoulders at all, but I observe that your job title is director of aviation, maritime, freight and canals, which gives a flavour of the scope of the areas in which Transport Scotland is involved. I presume that, in those sectors, there are engineering-related assets as well as land and natural assets, so did you not have expertise that you could have brought to bear in order to give advice to Scottish Canals about carrying out the work?

**Fran Pacitti:** Yes, and we did. We have experience in valuing assets not just in our non-departmental public bodies but through the trunk road network, for example. In our portfolio, NDPBs with experience in valuing assets include Highlands and Islands Airports Ltd and Caledonian Maritime Assets Ltd, so we brought that common approach to bear. However, the assets in Scottish Canals' portfolio are unique in nature, so despite that engagement and the best efforts to achieve common ground on how we should do the work, the valuations that were undertaken did not find favour with the auditors.

**The Convener:** Okay. I will move things on by inviting Sharon Dowe to ask some questions.

**Sharon Dowe (South Scotland) (Con):** Good morning, everybody. The Auditor General's report outlines that

"The auditor issued a disclaimer on the audit opinion on Scottish Canals' financial statements for 2020/21"

because

"insufficient audit evidence was available to conclude on the overall valuation of Scottish Canals' ... infrastructure and inland waterways".

That was largely because Scottish Canals did not obtain an appropriate valuation, using depreciated replacement cost, for about £51 million of specialist operational assets that had been capitalised between 2012 and 2021. We have touched on some of those issues. Why did Scottish Canals not identify the need to undertake

a DRC valuation of its specialist operational assets as part of preparing its 2020-21 accounts?

**Catherine Topley:** There are two parts to that. I will refer back to my opening statement. In March, we wrote to Grant Thornton to advise it on the approach that we were going to take. That did not include an assessment of those assets. At that point, we had not received feedback to say otherwise. Notwithstanding that—hindsight is a wonderful thing—we should have done that.

09:45

On the DRC, we undertook the valuation—we have just discussed that issue. Following that valuation, and after a period in which Grant Thornton was crystallising the issue with Scottish Canals, Grant Thornton concluded that the valuations that the specialist engineer had returned were not sufficient for its requirements.

By that time, we were in November and coming close to the statutory deadline for reporting. Therefore, we were limited in our ability to challenge the auditor's opinion on that and to work with it to identify how best to move that into a delivery space beyond that.

I ask Lee Shedden, who was involved in the trunk road valuations and who provided specialist advice around the valuations for Scottish Canals, to comment on that.

**Lee Shedden (Transport Scotland):** At the nub of all that is the complexity of undertaking a valuation exercise of this size, which SJ Hannah mentioned when talking about the components—a figure of 4,000-odd assets was referred to earlier—that make up the canal network.

The critical aspect is the information that is required to generate a valuation. It does not necessarily require an RICS-qualified valuer to do all that work, although it might be appropriate for such a valuer to do some of it. We are talking about complex and unmarketable assets. First, you need the information, then you need to be able to apply a process to that information to generate a complex valuation. Essentially, that is what we do for the trunk road network. That is not undertaken specifically by an RICS valuer; it is done by a technical company, which, incidentally, does the valuations for all roads authorities in the United Kingdom.

I think that that gives you an indication of how complex things will be. Catherine Topley has recognised the challenge of the December 2022 deadline, and I support her view on that.

**Sharon Dowey:** As you said, it sounds complex. Will you tell us a bit about the progress in updating the fixed asset register, so that all

assets will be appropriately recorded and categorised?

**Catherine Topley:** I ask SJ Hannah to comment on that.

**Sarah Jane Hannah:** That will be complicated; I will not underestimate the complexity. Although we have clearly said that our aim is to meet the December 2022 deadline, which is our statutory deadline for our annual report and accounts, that will be challenging.

We have a detailed action plan, which has been agreed by Transport Scotland and Scottish Government colleagues. The plan also has the support of HMT, which will advise us on our methodologies along the way. More important, the plan has been agreed with Grant Thornton.

During the year, we will be changing auditors—just to add some fun to the process. Our new auditors, which Audit Scotland will appoint, will be involved in the process as well. We just do not know who they will be as yet.

We will be engaging with a consultancy firm. We will have to go through a procurement process, which will take time. At the moment, we are doing pre-market engagement with key accountancy firms that have a huge amount of knowledge in the NDPB area and the public sector in general, but particularly with regard to the UK Government's financial reporting manual, which is key. We are working closely with those firms to understand the specification that we can then go out to market with.

We will also have to appoint an array of valuers. However, for the first few months, we will literally be looking at all the methodologies of all the different component parts of our assets.

As Catherine Topley mentioned, it is not that we do not have the canal infrastructure noted anywhere. We have a complex engineering asset management system that details our canal infrastructure in its entirety. The issue is that that is not tied up to any financial asset register. I do not want anybody to think that we do not know what our assets are—we absolutely do. The issue is that they not have been appropriately valued under the FReM.

We will be working with engineers and a consultancy firm to componentise all the assets to get a financial valuation relative to what Grant Thornton expects. We will be supported in our judgments and estimates. The critical path is to get Grant Thornton to agree our methodologies and our capital policies as we develop them, so that, by September or October, we are in a position to finalise all the valuations so that the audit can be completed.

We are running two different programmes: we are getting in a project manager who has NDPB experience and huge experience in FReM accounting, while our internal team concentrates on producing the annual report and accounts. Although it might seem like just one adjustment, it will be slightly more complicated than that.

I reassure the committee that we have a fixed asset register, so we are not starting from scratch in any way, shape or form. However, it will be quite a journey.

**Sharon Dowey:** The completion date is December 2022 and it looks as though you are on target.

**Sarah Jane Hannah:** So far, we are on target, but December is an ambitious target. We and Grant Thornton will report to board on progress on a monthly basis, and any issues that arise will be flagged very quickly.

**The Convener:** You said that you accept the recommendations and analysis in the Auditor General's report. That includes paragraph 5, which says:

"Scottish Canals will now undertake a new valuation process of the canal infrastructure estate in its entirety during 2022."

You are committed to doing that, I presume. Audit Scotland goes on to explain why that is important. It is not just a technical exercise of ticking a box to comply with ONS, Her Majesty's Treasury or Scottish Government requirements; it is about supporting

"preparation of Scottish Canals' medium-term financial strategy",

so it is an important and central part of how you plan for the future. You have accepted the deadline. What happens if you do not meet it?

**Catherine Topley:** 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. There is recognition that, at the moment, market forces are really challenging and the availability of staff and specialists is really challenging—and we need those individuals to support us to deliver the project and meet the deadline.

There is also the complexity of agreeing the methodology. The evidence to support the delivery of the valuations has to meet the standards that the auditor has set out, and we do not yet know what the standards are. The issue is that we are retrospectively creating a value for assets, some of which are 250 years old and some of which are 10 or 20 years old but all of which were put on our books in a very different way from the way in which the auditor is now asking us to present them.

In simple terms, we do not have the evidence set out in the way in which the auditor might like it to be presented, in a nice, tidy binder, so we have to create that evidence trail—with the methodology, and with the valuations—with the auditor. We tried to do that between July and August last year, when we did the valuations, but when the auditor looked at them she felt that what we had done was not sufficient.

My concern, therefore, is a fundamental one about resources, timing and how we ensure that the valuations can be done to an appropriate standard, so that the auditor can sign them off. At this point, we are no longer just talking about assets of £51 million. What the auditor was able to crystallise and articulate in December, which led, ultimately, to the disclaimer, was that we are being asked to look at not just the £51 million but the canal infrastructure. We have been asked to consider whether the canals should be on Scottish Canals' books—and if they are on the books we are talking about adding circa £2.5 billion to the Scottish Government's accounts.

Lee Shedden went through the process of identifying how to put the roads on the Scottish Government's books. As he said, in the UK roads, there is a comparator in relation to the books on another set of Government accounts. We do not have a comparator for canals, because England's canals are held as a charity and do not sit on Government books.

I do not want to labour the point. We are being ambitious because we have a statutory reporting deadline. We will aim to meet that deadline, with everything that we have, and I am confident that my team understands the need. The issue is whether all the other moving parts come into play at the right time—those are the challenges that we will have to manage.

**The Convener:** Thanks. I ask Willie Coffey to come in with a number of questions.

**Willie Coffey:** I would like to start with a question for Catherine Topley on financial sustainability. Did you say in your opening remarks that the Auditor General said that he had no core financial sustainability issues with Scottish Canals? Did I pick up correctly what you said? Did you say that at the outset of the meeting?

**Catherine Topley:** I did. I will quote from the *Official Report* of the meeting. The Auditor General said that he had

"not identified core financial sustainability issues with ... Scottish Canals."—[*Official Report, Public Audit Committee*, 24 February 2022; c 37-38.]

Audit Scotland's senior manager said that it was "not ... uncommon" for the ONS to recommend a change in status and not look at the implications

for the organisation. That was said in the meeting on 24 February.

**Willie Coffey:** Thanks for that. I could not see that in the Audit Scotland report that we have in front of us. However, I saw a comment on the financial statements from 2020-21, which show your income at £18.8 million and your expenditure at £22.7 million. That is a deficit of £3.9 million. How can that comment be squared with those facts in the financial statements? We think that there is a maintenance backlog of £70 million or so. How can the comments about there being no concerns about financial sustainability be squared with the figures that I have just read out?

**Catherine Topley:** As the accountable officer, the first thing that I would say—I am sure that Andrew Thin, as the chairman, would agree with me—is that we would not say that there are no concerns. We are a public sector organisation, so we have the same challenges and burdens placed on us that other public sector organisations have. With that in mind, we work to balance the books.

Obviously, the past two to three years have been impacted by Covid. We have not been able to trade, and that has substantially affected our income. As a consequence of that, we have had deficits, and we have recognised them in our accounts.

Members will see that, in the years before, it was a matter of breaking even in the accounts. We have been working with Transport Scotland for it to understand the revenue challenges in Scottish Canals.

Our biggest cost in Scottish Canals is, of course, staffing. Beyond that, in relation to medium and long-term financial sustainability, we are looking at how we can adapt the operating model to be more efficient. That includes things such as ensuring that the efficiencies come from operating models that are user dependent, through to systems that can take away the need for more manual interventions. We are very aware of the opportunities that are presented to us there.

Additionally, in respect of income, we have opportunities to trade. Earlier, we talked about being an NDPB versus being a public corporation. We need to work through those issues. The aspirations of ministers have not disappeared; they still want us to be innovative and creative, and to generate our own income. We have to constantly balance the challenge and pressures of today's financial burden with taking the burden off the revenue requirements in future years by investing wisely today, and we continue to do that.

We in Scottish Canals absolutely recognise the maintenance backlog. Even if the Scottish Government said to me today, "Here's £70 million. Go and fix it," I could not, sadly, do that in one

financial year. I do not have the technical expertise and resources to do that.

The asset management strategy is the strategy that we are taking and it sets out our blueprint. Essentially, that works on safety, risk and economic impact. Like other public bodies—Historic Environment Scotland, for example—we will not always have the money to bring those things up to today's standards overnight. There has to be an asset management register that identifies where the higher risks are, where the funds need to be deployed more immediately, and what the longer-term implications are of not spending money.

That is where that backlog comes from.

**Willie Coffey:** Has the £70 million been factored into your financial planning? Has it been agreed with anyone? Where is the money to address the maintenance backlog coming from?

**Catherine Topley:** We have not agreed that £70 million will come to Scottish Canals from Transport Scotland, but we agreed the asset management strategy with it in 2019. You will remember from earlier that our capital went from £3 million to £12.2 million, which is absolutely wonderful. That allows us to start to address the backlog at pace.

I remind the committee that some of the canals are 250 years old, so that as quickly as we are remedying, fixing and replacing assets on the canals, there is degradation on other elements because we cannot work on all the 140-odd miles at the same time, at any given time.

10:00

However, we must not think of the canals as a burden. We all know what they looked like 20 years ago, with the brown water, shopping trolleys, cars and couches. More importantly, there was infestation and there were issues around public health. What we have now is a beautiful canal that contributes to economic growth. We have generated and been able to offer 8,000 homes across the canal network, although we have not done that personally. As a result of the regeneration of the canals, builders have come and said, "This is a wonderful place to live and to build." That then creates little ecosystems. As you know, tourism is massive in Scotland and we really benefited from that during Covid. We hope to leverage off that, going forward.

On your point about the medium-term financial planning, the SG and I have commissioned an organisation to undertake that work for us. We have looked at our previous investments to see which have been more successful and in the coming months we are looking to present to

Transport Scotland a business case that will outline the kind of activities that we would want to be engaged in, why we should be engaged in them and how they would benefit Scotland as a whole, as well as the economic benefit for Scottish Canals.

**Willie Coffey:** You are bound to need some kind of allocation to assist you with the maintenance backlog. We cannot wait year after year for that. There surely has to be some kind of annual recognition of that and an allocation of funding to support the good work that you described. However, it is not clear to me that the money that you said you need for the work that you intend to do will be forthcoming next year and the year after.

**Catherine Topley:** I will ask Fran Pacitti to comment on that, as our sponsor.

**Fran Pacitti:** Again, the issue is not unique to Scottish Canals. It brings us back to the discussion that we had at the outset about how the change to NDPB status means that we are working within annualised budget cycles. With the £70 million backlog, there is both an affordability and a capacity challenge. Therefore, we have to look right across the portfolio of assets that we own and prioritise where to invest in that maintenance backlog through a risk-based approach. I think that we are successful in doing that, but we also have a capability and a capacity challenge, so the Scottish Canals maintenance plan programmes that investment over number of years, based on priority and the ability to programme those works in a sustained fashion.

As sponsor body, we sit hand in glove with Scottish Canals in going through those budget processes, so that we have a common understanding of what is available, what the priority allocations are and how we spend that going forward. There is a backlog, but we are managing that. It is not without risk, but we are aware of those risks. Again, those challenges are not unique to Scottish Canals, but replicated across a number of assets in the transport portfolio and a number of NDPBs.

**Willie Coffey:** Would the committee be able to see at some point whether there has been any allocation towards that maintenance backlog, so that we can see whether progress is being made on it? It is great to be able to talk in terms like this at the meeting, but the committee would appreciate information on real changes on the ground or at the canals, so that we can see that moving forward.

Lastly, Catherine Topley talked about how the status change gives Scottish Canals other opportunities to generate income. Could the committee also see some indication of how those

are being embraced by Scottish Canals and how that might impact on your future financial statements?

**Catherine Topley:** We would be happy to share that information. Because it is very important, I reiterate that there was a £70 million backlog when we published the asset management strategy and I can demonstrate what the funding that has been provided between then and now has done to that.

That does not mean that £70 million is the figure today. I reiterate that there is the maintenance that has been addressed historically versus what is coming up and what we now know about. Therefore, the figure will always move, but from that baseline we have been able to track our investment from Transport Scotland and the additional budget.

In terms of the additional opportunities, we would be happy to share that information with the committee.

**Willie Coffey:** Many thanks.

**The Convener:** That draws to an end the questions that we have for you. We will reflect on the evidence that you have given and we may pursue some lines of inquiry with you after the meeting. Thank you for coming and being present in the committee room. It was good to have people sat in front of us, so that we could properly inquire into your response to the very serious report that Audit Scotland published. I thank Catherine Topley for leading on the evidence; it is appreciated. I also thank Andrew Thin, Sarah Jane Hannah and the team from Transport Scotland—Hugh Gillies, Fran Pacitti and Lee Shedden—for their evidence.

10:06

*Meeting continued in private until 11:25.*

This is the final edition of the *Official Report* of this meeting. It is part of the Scottish Parliament *Official Report* archive and has been sent for legal deposit.

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Published in Edinburgh by the Scottish Parliamentary Corporate Body, the Scottish Parliament, Edinburgh, EH99 1SP

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