



AUDIT COMMITTEE

Minutes of the Meeting of the Audit Committee (the Committee) held at British Waterways' London Office, Sheldon Square, Paddington on Wednesday, 12 January 2011 at 10.30 a.m.

PRESENT:

Mr. N. Hugill (Chairman), Mr J. Bridgeman, Mr R. Green, Mr. E. Prescott, Mr. P. Sarwal

IN ATTENDANCE:

Mr. T. Hales, Mr. R. Evans, Mr. N. Johnson, Mr. P. Ridal, Mr. J. Stirling (agenda item 11/A06), Mr. K. Labbett, (all from BW), Mr S. Maslin, Mr. T. Lincoln, Ms. C. Reid (all from Grant Thornton) and Mr. M. Devin (from Prism Cosec, minutes)

11/A01 MINUTES OF THE PREVIOUS MEETING

The minutes of the meeting of the Committee held on 15 September 2010 were amended and approved.

11/A02 MATTERS ARISING:

Risk Update and Compliance Report (minute 10/A24): With reference to the Civil Society Project, Mr. Evans stated that benchmarking of terms and conditions would apply only to directors, it being felt that wider benchmarking of all employees' terms and conditions would be best left to NWC. Replying to a question from Mr. Prescott, Mr Evans confirmed that the benchmarking criteria for directors were being prepared by the Executive for the Remuneration Committee.

RE

A review by the Property Director of property investment risk appetite in the third sector was underway and a report would be prepared for the Audit Committee.

RE

It was reported that a climate change report was in the process of being prepared for submission to Defra in April 2011.

RE

11/A03 ACCOUNTING POLICIES AND TAXATION ISSUES (BW/A314)

Mr. Ridal presented his report on accounting policies to be used in the preparation of the annual report and accounts for the year to 31 March 2011, together with an update on the current corporation tax strategy previously presented to the Audit Committee in 2006 and a report on employment tax compliance. The Committee was invited to (1) endorse the proposed accounting policies; and (2) note and comment on the content of the report on corporation tax strategy and endorse the approach being taken.

Mr. Hugill suggested that the preamble to Mr. Ridal's report should be amended to reflect the imminent change of status of BW and amplified to articulate the purpose of the proposed policies. This was agreed. In this regard, Mr. Ridal reported that an exercise was underway to recast BW's prior year accounts as if BW had been a charity. This was being done preliminary to the move to the third sector in order that the format of the accounts going forward and associated issued were fully understood. The Committee endorsed the proposed accounting policies.

PR

Mr. Ridal emphasised that BW's strategy on corporation tax was to utilise all reasonable tax planning mechanisms, to maximise deductions, allowances and reliefs and the timing of these in relation to BW's commercial transactions with the objective of mitigating the tax burden. BW did not engage in tax avoidance schemes, i.e. tax-driven transactions designed to create tax deductions and reliefs.

Replying to a question from Mr. Bridgeman, Mr. Ridal explained that there were numerous tax planning opportunities available to BW but that some of these were contentious given BW's public sector status and that Defra approval of such schemes may be difficult to procure. It was noted that NWC may wish to adopt a more aggressive tax strategy in due course. In the meantime, Mr. Bridgeman noted that BW had remitted tax to HMRC which other organisations might perhaps have shielded. Mr. Evans observed that this was one of the restrictions by which BW as a public sector body was currently bound.

Mr. Maslin opined that the key elements of tax strategy preparatory to moving to the third sector were (1) VAT issues; (2) charitable purposes; and (3) employment tax issues and suggested that the Committee should be provided with a list of potential tax planning opportunities and focus on the less aggressive end of the tax planning spectrum. Mr. Sarwal said that NWC would need in addition to consider tax losses in the new entity and be sure not to overlook existing losses in the transition to charitable status. In particular, the impact of tax on the commercial subsidiary and on its capital requirements should be assessed. Mr. Ridal assured Mr. Sarwal that this was part of the ongoing work stream. Mr. Hugill added that the completion and submission of prior year tax computations should be a priority preparatory to the planned move to the third sector.

Mr. Hugill concluded the discussion by enquiring how future tax planning preparatory to moving to the third sector would be implemented. Mr. Ridal replied that, following publication of the Public Bodies Bill, the tax management team were now focused on the tax consequences of the NWC's operational activities. It had become clear that the tax affairs through transition and the early years of charitable status would be complex and it was therefore imperative that nothing be overlooked. Mr. Pullinger, BW's tax manager, and his team were working closely with Deloitte to ensure that this was the case. Replying to a question from Mr. Hugill, Mr. Ridal said that it was too early to submit firm proposals to the Audit Committee.

11/A04 **EXTERNAL AUDIT APPROACH (BW/A315)**

Mr. Lincoln presented Grant Thornton's Audit Approach Memorandum, noting in his preliminary remarks that, although specific to the year ending 31 March 2011, the report had been written with the proposed move to the third sector in mind and cognisant of the recent cut in Defra's grant to BW.

Mr. Lincoln further noted that, as principal auditors, Grant Thornton were responsible for the audit opinion given on the consolidated accounts whilst certain entities in the BW group were audited by other firms.

The report noted that Grant Thornton had provided initial advice to BW on the potential accounting implications and issues associated with the transfer to charitable status. Mr. Lincoln commented that, whilst there was likely to be little impact on the accounts, the Audit Committee may deem it appropriate that the narrative sections of the annual report should make reference to transitional issues. Mr. Maslin requested greater clarity on key deliverables and milestones in the period prior to the switch to charitable status, offering Grant Thornton's support across a range of topics including, inter alia, VAT, tax issues associated with the transfer, pensions, BW Scotland and the transfer of assets and liabilities from the Environment Agency. Good progress was being made in understanding the key issues. Notwithstanding this, Mr. Maslin requested guidance as to how pro-active the Audit Committee wished to be going forward, for example, working with the executive team to identify milestones and benchmarking these against other organisations who were going through a similar process. Mr. Evans, whilst suggesting that this issue be re-visited later in the meeting during Mr. Stirling's presentation on Civil Society projects, noted that this project was ultimately being driven by Defra.

Mr. Green enquired as to what was the convention on management letters when a business closes part way through a financial year and whether an early version of the final management letter should be submitted before 31 March 2012. Mr. Maslin replied that the key issue was that there should be a clear audit trail throughout the financial year. The management letter for the last full financial year prior to the change to charitable status would in addition need to address issues relevant to the new entity. Mr. Sarwal added that these would include the effectiveness of systems and controls. Mr. Lincoln suggested that Grant Thornton attend the financial health check meetings of BW's Internal Audit function, which addresses these issues.

The Committee discussed the issue of the pension deficit. Mr. Sarwal enquired whether the BW Board would be provided with details as to how the deficit split between BW's employees in England and Wales and those employed by BW Scotland. Mr. Johnson replied that there were no plans at present to split the deficit; Mr. Ridal endorsed this view, saying that there were a number of technical challenges in doing so, for example, identifying how many employees were affected at the vesting date. Nonetheless, Mr. Sarwal said that at some point this work would need to be done so that the BW Board would be properly informed in advance of making a decision. Mr. Hales reminded the Audit Committee that the BW Board was responsible for BW staff in Scotland as well as England and Wales and that accurate information on the deficit split was required in order that the Board act fairly as regards both shareholders. Mr. Hales requested a paper for the working party on the options available.

PR/NJ

Mr. Hales enquired of the auditors whether they should seek an assurance of the integrity of the business being transferred to the charitable sector, i.e. whether there was a sufficiency of resource to satisfy the trustees of the new entity that the business was sustainable. This was especially relevant in the light of the reduction in BW's grant from Defra. Mr. Sarwal reminded the Committee that the auditor's duty was to opine on BW's obligations rather than its aspirations.

Mr. Maslin replied that the management letter would address the issue of viability but that this would not prevent the auditors from signing off the going concern statement, adding that this should be one of the key milestones alluded to earlier in the Committee's discussions.

Mr. Lincoln concluded his presentation by confirming that he did not expect the audit fee to be materially different to the prior year and assured the Audit Committee of the continuity of staff during the transitional period. Mr. Lincoln drew to the attention of the Audit Committee the measures taken to maintain the auditors' independence as set out in Section 4 of his written report. A copy of the independent assessor's report on Grant Thornton would be provided to Mr Labbett.

SM

11/A05 **RISK UPDATE AND COMPLIANCE REPORT (BW/A316)**

Mr Evans supplemented his written report with specific comments on the main movements in risks. The reduction in Defra's grant to BW would inevitably require a reduction in BW's cost base, including headcount. Whilst this carried with it an increase in reputational risk, i.e. on account of possible acts of omission in relation to planning or environmental issues, Mr. Evans assured the Committee that the business was moving from a position of strength as regards risk management.

Commenting on political support for the proposed move to the third sector, Mr. Evans reported the appointment of John Kittner who had replaced Sarah Nason, Deputy Director of Defra, and who has been tasked to lead the Government's flagship Big Society project to create the NWC.

Replying to a question from Mr. Hales as to whether BW Scotland represented a risk, Mr. Evans replied that the Scottish minister would have to be a joint signatory to the order authorising the transfer of BW England and Wales to the NWC, adding that this would be an issue for NWC to address in due course.

Mr. Evans, replying to a question from Mr. Hales on the transfer of EA navigations, opined that this issue represented a challenge for Defra, in particular, identifying the extent of the liability.

It was noted that Mr. Labbett was leading the project to mitigate risk in relation to the Olympic project. Responsibilities had been identified although a project manager had yet to be appointed.

KL

11/A06 **CIVIL SOCIETY PROJECT RISKS (BW/A317)**

(Mr. Stirling joined the meeting)

By way of an introduction to his written report, Mr. Stirling commented that the risks associated with the planned move to the third sector were well understood. Two risks in particular were deemed high. First, the unsustainability of the business plan following the reduction in Defra's grant to BW and, second, the pension deficit, especially with regard to future liabilities. With regard to viability, Mr. Stirling confirmed that models previously used had been deployed and that the underlying financial projections would be verified to assist the new trustees in their negotiations with Government officials. The Committee believed there should be an audit of the current quality of the infrastructure and of the process and assumptions used in the model that supports its long term sustainability of the track.

JS

JS

The deficit valuation would need to be agreed with the trustees and a pensions project team would be established to deal with the separation of BW Scotland and possible transfer of EA staff.

Mr. Evans added that overall the project was tracking to plan but that there remained a risk that the NWC would not be in place from April 2012 due to delays in the Public Bodies Bill and State aid clearance. Mr. Hales added that any anti NWC campaign or other adverse publicity arising from the public consultation process would pose a further risk. Mr. Evans therefore recommended that consideration be given to identifying the key questions likely to be raised during these processes so that appropriate answers could be formulated.

JS

Mr. Green raised a number of questions in relation to (1) the reaction of staff to the CARE pension proposals (currently the subject of extensive staff consultation); (2) the sustainability of the business plan; (3) EA navigations; and (4) the position regarding BW Scotland. Mr. Evans replied that a number of staff were negative about the CARE proposals but he expected the proposal to be implemented. The sustainable business plan would cover a 5-10 year timescale and deal with issues including climate change and risk mitigation. However, the economics of climate change were such that catastrophes on the scale of the Queensland floods could only be addressed by central government responding to the needs, and coordinating the responses, of many NGOs. As noted in minute 10/A05 above, greater clarity was required as to the extent of the liability associated with the transfer of EA navigations. As regards BW Scotland, the key task was to ensure alignment of the key protagonists around a set of shared values.

Mr. Hugill enquired what plans were in place for Defra to deal with the funding gap. Mr. Evans replied that Defra were unwilling to engage on this issue until the trustees had been appointed. Mr. Johnson envisaged that the trustees would be appointed in April 2011 and, following an induction process expected to take five to six weeks, the trustees would be in a position to engage with Government about the business plan, probably in September. It was hoped that the ministerial order would be signed during the autumn/winter of 2011; negotiations would therefore need to be complete by October at the latest. Mr. Johnson forewarned the Committee that there was a strong possibility that a super affirmation process may be required whereby a Select Committee reports to Parliament.

(Mr. Stirling left the meeting)

11/A07 **INTERNAL AUDIT PLAN 2011-12 (BW/A318)**

Mr. Labbett's report was received. Mr. Labbett invited the Audit Committee to review the internal audit plan and, subject to any amendments, approve the plan.

The plan was very different to the prior year, the number of projects undertaken being approximately half the number in 2010/11. About 80% of the proposed audit plan was concentrated on the continuation of financial health checks, and on support for key strategic tasks including the transitional process to third sector status, the transfer of EA navigations, grant reduction and risk mitigation in connection with the 2010 Olympic Games. The remaining items related to risk and fraud prevention.

Mr. Prescott queried the reduction in the number of secondees in delivering these projects. Mr. Evans replied that with the focus being primarily on transitional issues and ensuring the viability of the business plan in the wake of the reduction in BW's grant from Defra, even if secondees identified areas where internal audit resource should be focused, there was insufficient management resource to address these, at least not until after the move to the third sector.

The Audit Committee approved the plan.

11/A08 INTERNAL AUDIT PROGRESS REPORT (BW/A319)

Mr. Labbett's report was noted. It was reported that a list of KPI's had been provided to the BW Board in November 2010, that the critical few had been selected by the Executive and that Mr. Evans had requested that these be given greater visibility. This was being done via the intranet.

KL

11/A09 DATE OF NEXT MEETING

Wednesday 8 June 2011 at 10:00am, to be held at British Waterways' London office, Sheldon Square, Paddington.

There being no other business the meeting concluded at 1:00pm.

Chairman