



Audit procedures for retail cost analysis 2014-15

This document sets out the procedures we expect all independent auditors to follow in checking the information that water companies in England and Wales provide about their customer-facing ('retail') services in their regulatory accounts for 2014-15.

Regulatory accounts are the yearly financial statements that water companies have to make about their regulated business. In preparing their accounts companies must follow our [regulatory accounting guidelines \(RAGs\)](#). The information that companies provide is checked by auditors.

As part of its regulatory accounts each company has to report the accounts (costs, revenues, assets and liabilities) for the different activities ('business units') it carries out in delivering services. This is known as accounting separation. Each company also has to prepare a statement that explains how it has carried out accounting separation (its 'accounting separation methodology statement').

1. Background and key risks

The requirements for accounting separation of costs across nine business units (water, sewerage and retail) have formed part of the regulatory accounting guidelines (RAGs) since 2012-13 and are therefore subject to the overall audit of the regulatory accounts.

Ofwat recently set separate controls for companies' wholesale and retail activities for 2015-20. The accounting separation information in companies' regulatory accounts provided a key input to these price controls.

In 2013 we commissioned a targeted review of companies' 2011-12 retail cost allocations, to give us confidence that the data to be used for price setting was robust. The review concluded that, while the retail data was largely robust, additional agreed-upon procedures would provide greater confidence to Ofwat and other stakeholders. For 2014-15 we have retained some of the procedures that cover key areas that we feel would benefit from additional audit procedures and disclosure.

Key concerns for Ofwat are the following.

- The retail costs in table A8 may be considered immaterial within the overall regulatory accounts audit.
- Cost allocations between wholesale and retail business units may be inconsistent with the regulatory accounting guidelines.
- Cost allocations between wholesale and retail business units may contain errors.
- The drivers used to allocate costs may be inconsistent with the company's methodology statement.
- Companies fail to provide the level of disclosure in their methodology statements required by Ofwat.

2. Procedures

1. Obtain and read the methodology statement prepared by the water company. Walk through and test the process used to prepare the tables to determine that it is in accordance with the methodology statement. Document the nature of the testing performed. Report exceptions.
2. Agree total operating expenditure per the retail table (table A8) and total operating expenditure per the wholesale table (table A7) to total operating expenditure per the regulatory accounts. Where it does not agree obtain and report company explanation.
3. Review the company's comparison of current year and prior year figures in the Retail Table and explanations for significant movements (that is, movements in excess of 10%) provided in its methodology statement. Report any cost movements where the company has not provided a supported explanation.
4. From discussions with management and performance of the walkthrough test above, document any change of cost drivers or methods of allocation from prior year which the company has not highlighted or explained in its methodology statement.
5. Agree customer services costs to the general ledger. Report exceptions.

6. Agree the doubtful debt cost to the general ledger. Report exceptions.
7. Re-perform the general and support (G&S) cost allocation calculations using cost drivers set out in the methodology statement through the following. For a sample of G&S expenditure (including the five largest cost items or, where these total less than 50% of total G&S the sample should total a minimum of 50% of total G&S) agree the total cost to the general ledger and the cost data to source data. Provide description of source data for the costs and drivers.
8. Agree total CCD per retail table to total CCD per table A10. Agree total CCD per table A10 to current cost fixed asset register.
9. For a documented sample of general and support assets (including the five largest asset types or, where these total less than 50% of total G&S the sample should total a minimum of 50% of total G&S assets), agree the company's allocations between retail and wholesale back to source data for costs and drivers and to the company's methodology statement. Provide description of source data.
10. For each row within the retail table, understand the basis of allocation between household and non-household and re-perform the calculation using the cost drivers set out in the methodology statement. Agree the cost driver figure used in the calculation to source data. Provide description of source data.

3. Reporting

The auditor will provide a report summarising each procedure undertaken and any exceptions or issues identified with the company's retail data or methodology statement.