



Chartered Institute of
Internal Auditors

Parliamentary Briefing: Making Internal Audit Mandatory for Water Suppliers - A Regulatory Imperative

Issued: Tuesday 26th March 2024

Strengthening Audit, Assurance and Governance across the UK Water Sector by mandating Internal Audit Functions

This briefing aims to bring to the attention of parliamentarians the pressing need for Ofwat to introduce a regulatory requirement to make it mandatory for all water suppliers to establish and maintain an independent internal audit function. As reported by the **Financial Times**, the Chartered Institute of Internal Auditors (Chartered IIA) has identified that several water-only suppliers facing significant financial and operational challenges do not have an internal audit function. This includes Portsmouth Water, South East Water, and Sutton and East Surrey Water (SES Water).

We believe this gap in internal audit and the associated independent oversight and assurance, is likely to be hampering these water suppliers' ability to effectively identify, manage, and mitigate the broad spectrum of operational and financial risks they face. In response to this issue, the Chartered IIA wrote to the Chief Executive of Ofwat, outlining our concerns and suggesting the need for regulatory action.

Parliamentarians will be aware of the current financial and operational issues faced by several water suppliers in the UK. Considering their vital role in maintaining critical national infrastructure and providing homes and businesses with safe and clean drinking water, the discovery that numerous water suppliers are operating without an internal audit function is both surprising and concerning.

These suppliers may lack sufficient independent assurance in key areas such as operational resilience, business continuity, corporate reputation, and compliance with regulatory standards. A strong, competent, and appropriately resourced internal audit function can also provide invaluable support by evaluating financial health, technological vulnerabilities, climate-related risks, and economic uncertainties. This includes supporting processes like climate risk assessments, economic stress testing, and scenario planning – all things internal audit helps to support in other regulated sectors like financial services.

The operational necessity for an internal audit function is key for safeguarding the water supply sector, strengthening risk management, internal control and governance, and helping to secure the long-term sustainability of water supply and wastewater services in the UK.

We therefore urge parliamentarians to support our call and advocate for Ofwat to introduce a mandatory regulatory requirement for water suppliers to have an internal audit function. This would align with best practices across other regulated sectors to help ensure the long-term sustainability and resilience of water suppliers.

Research Insights: A Spotlight on Water Sector Audit and Assurance Vulnerabilities

Our findings indicate that among the five independent water-only suppliers in the UK, only two have an internal audit function. Currently, Portsmouth Water, South East Water, and SES Water have no internal audit functions in place. This is particularly concerning given these three water-only suppliers provide an essential service for around 3.7 million customers.

In addition to operating without an internal audit function, both SES Water and South East Water, due to substantial operational and financial issues, are currently under the **"Action Required"** category in Ofwat's recent Monitoring Financial Resilience Report¹. Portsmouth Water, the other supplier operating without internal audit, has only recently been downgraded from **'Action Required'** status regarding its financial resilience. Even more alarming, in Ofwat's latest Water Company Performance Report², South East Water has been categorised as "lagging behind" and Ofwat has launched a separate investigation into their supply resilience.

Ofwat's Monitoring Financial Resilience Report describes the importance of water suppliers maintaining financial

¹ **The Monitoring Financial Resilience Report, Ofwat**

² **Ofwat launches investigation into South East Water's supply resilience**

reserves to navigate short-term fluctuations and fulfil their commitments. In this context, an internal audit function could become a vital source of independent assurance and oversight. These findings further emphasise the need for an enhanced and robust audit, assurance, and risk management framework, underpinned by the presence of a strong, competent, and appropriately resourced internal audit function.

While the presence of internal audit wouldn't be a cure-all for the challenges faced by these water suppliers, we believe it's important to highlight the vital role internal audit plays in this area through the independent assurance and oversight it provides.

Mandating Internal Audit in the UK Water Sector: A Call to Action

Despite Ofwat's current regulatory frameworks and corporate governance measures, there's a notable silence on the mandate for an internal audit function, an area in need of enhancement. The water sector is not alone in facing this issue. In 2022, the Chartered IIA identified that none of the thirty recently bankrupted energy suppliers, including the then-seventh largest supplier in the UK, Bulb, had an internal audit function. With our support, Ofgem then updated its Financial Responsibility Principle. Energy suppliers are now required to report on their internal audit capabilities and those without such a function must conduct annual reviews to determine its necessity. Given the water sector's importance to critical national infrastructure, we believe a similar approach would bolster both its operational and financial resilience.

Making internal audit mandatory for water suppliers would also align with other key regulated sectors. In the financial services sector, regulations set by the Financial Conduct Authority and the Prudential Regulation Authority mandate that companies establish and maintain a separate internal audit function. Similarly, the need for an internal audit function is also a regulatory requirement across the public sector.

Key sectors in the economy recognise the value of internal audit in helping organisations safeguard against financial mismanagement, operational inefficiencies, and compliance failures. By drawing lessons from other sectors, the water sector can enhance its audit and assurance framework, helping water suppliers be better equipped to address the myriad risks they face.

In addition, mandating internal audit functions in water suppliers could support Ofwat in delivering its statutory duties under the Water Industry Act. The presence of internal audit could help support Ofwat's duty to ensure that water suppliers can finance the proper carrying out of their statutory duties and secure the long-term operational resilience of water suppliers and wastewater systems.

Recommendations for Parliamentarians

Given that parliamentarians are likely to share our concerns about the difficulties faced by water suppliers and the issues we have highlighted regarding the lack of internal audit, we would like to work together to address the audit and assurance weaknesses of these suppliers. We want to see an efficient, sustainable, and secure water sector, where constituents, businesses, and suppliers are safeguarded. Considering our findings and the important role of internal audit in contributing to good corporate governance, strong risk management and a rigorous control environment, we recommend parliamentarians support regulatory changes mandating the establishment of internal audit functions within all UK water suppliers. Such a change would not only align with practices in other key regulated sectors but also reinforce the sector's ability to manage current and future challenges effectively, helping to ensure the sustainability of water supply and wastewater services.

Contact us: We hope that you find this briefing useful so you can better understand the lack of internal audit presence in the water sector. For any enquiries regarding this briefing or if you would like to set up a meeting to find out more about how we can support your work as a parliamentarian, please contact **Gavin Hayes, Head of Policy and Public Affairs** at gavin.hayes@iia.org.uk.