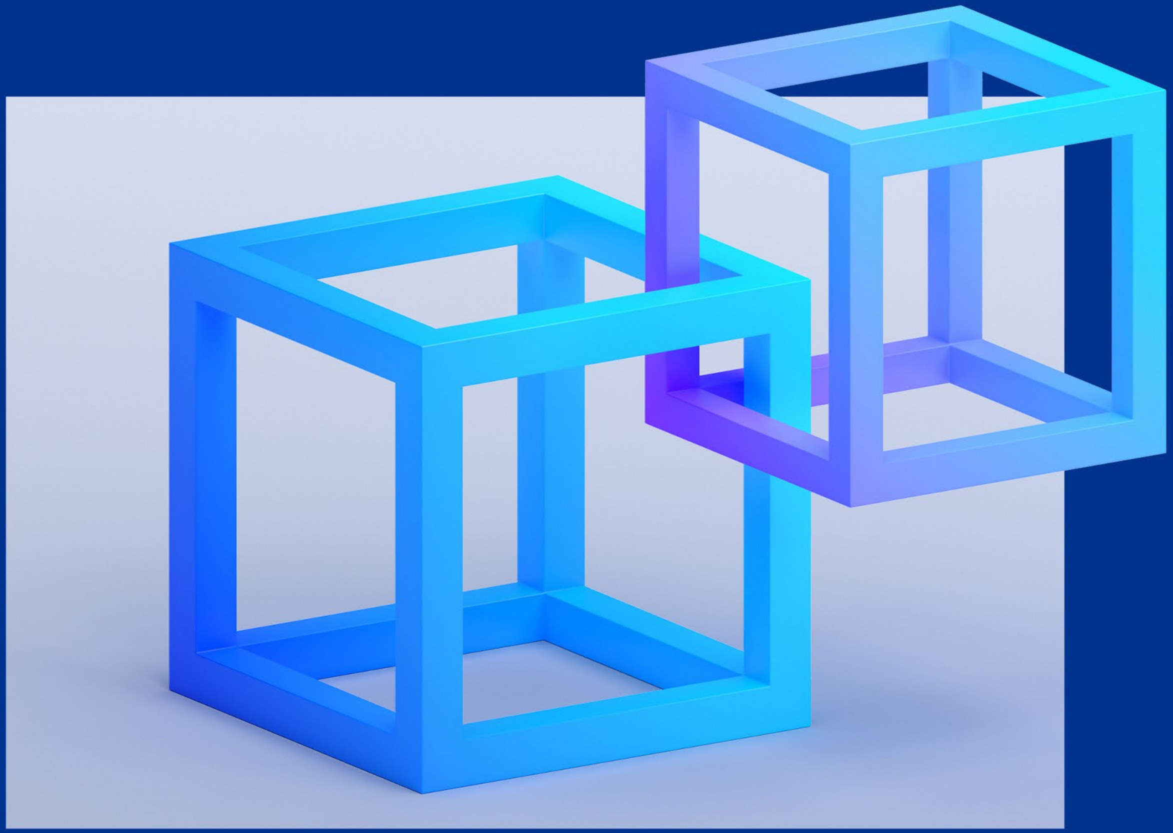
KPMG

Scottish Water Group

Report to the Audit and Risk Committee



Audit plan and strategy for the year ending 31 March 2025

25 March 2025

Introduction

To the Audit and Risk Committee of Scottish Water

We are pleased to have the opportunity to meet with you on 25 March 225 to discuss our audit of the consolidated financial statements of Scottish Water, as at and for the year ending 31 March 2025.

This report outlines our risk assessment and planned audit approach. Our planning and risk assessment activities are still ongoing and we will communicate any significant changes to the planned audit approach subsequently. We provide this report to you in advance of the meeting to allow you sufficient time to consider the key matters and formulate your questions.

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The engagement team

Tim Cutler, FCA, is the engagement partner on the audit. He has 27 years of public sector audit experience.

Tim shall lead the engagement and is responsible for the audit opinion.

Other key members of the engagement team include Carol Batchelor (engagement senior manager) and Emmanuel Afran (engagement in-charge) with 24 and 8 years of audit experience respectively.

Yours sincerely,

[Personal signature]

Tim Cutler

25 March 2025

How we deliver audit quality

Audit quality is at the core of everything we do at KPMG and we believe that it is not just about reaching the right opinion, but how we reach that opinion. We consider risks to the quality of our audit in our engagement risk assessment and planning discussions.

We define 'audit quality' as being the outcome when audits are:

- Executed consistently, in line with the requirements and intent of applicable professional standards within a strong system of quality controls and
- All of our related activities are undertaken in an environment of the utmost level of objectivity, independence, ethics and integrity.

We depend on well planned timing of our audit work to avoid compromising the quality of the audit. This is also heavily dependent on receiving information from management and those charged with governance in a timely manner. We have agreed with management actions designed to address specific prior period challenges around the quality of information received for audit. We aim to complete all audit work no later than 2 days before audit signing. As you are aware, we will not issue our audit opinion until we have completed all relevant procedures, including audit documentation.

Restrictions on distribution

This report is intended solely for the information of those charged with governance of the Group and the report is provided on the basis that it should not be distributed to other parties; that it will not be quoted or referred to, in whole or in part, without our prior written consent; and that we accept no responsibility to any third party in relation to it.

Overview of planned scope including materiality

Our materiality levels

We determined materiality for the consolidated financial statements at a level which could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements. We used a benchmark of total expenditure which we consider to be appropriate given the sector in which the entity operates, its ownership and financing structure, and the focus of users.

We considered qualitative factors such as the business environment when determining materiality for the financial statements as a whole.

To respond to aggregation risk from individually immaterial misstatements, we design our procedures to detect misstatements at a lower level of materiality £24.6m - 75% of materiality driven by our expectations of normal level of undetected or uncorrected misstatements in the period.

We will report misstatements to the audit committee including:

- Corrected and uncorrected audit misstatements above £1.64m.
- Errors and omissions in disclosure (Corrected and uncorrected) and the effect that they, individually in aggregate, may have on our opinion.
- Other misstatements we include due to the nature of the item.

Control environment

The impact of the group control environment on our audit is reflected in our planned audit procedures. Our planned audit procedures reflect findings raised in the previous year and management's response to those findings.

- For example, we anticipate that we will adopt a controls-based approach on the authorisation of capital expenditure.
- We will perform some substantive procedures at an interim date due to the effective control environment

Group Materiality

	Group
Materiality for the consolidated financial statements as a whole	**£32.8m** (2024: £29.1m 1.5% of total group expenditure)
Performance materiality for the consolidated financial statements as a whole	**£24.6m** (2024: £21.8m)
Misstatements reported to the audit and risk committee	**£1.64m** (2024: £1.455m)

Parent Materiality

£24m

1.8% of parent total expenditure

(2024: £21m)

Overview of planned scope including materiality (cont.)

Timing of our audit and communications

- We will maintain communication led by the engagement partner and senior manager throughout the audit. We set out below the form, timing and general content of our planned communications:
- Kick-off meeting with management on 3 March 2025 where we discussed the audit plan outlining our audit approach and discuss management's progress in key areas
- Audit committee meeting on 25 March 2025 where we present our final audit plan
- Status meetings with management from the week of 28 April to end of May where we communicate progress on the audit plan, any misstatements, control deficiencies and significant issues
- Closing meeting with management on 29 May 2025 where we discuss the auditor's report and any outstanding deliverables
- Audit committee meeting on 11 June 2025 where we communicate audit misstatements and significant control deficiencies

Scope definition and other reporting

- Audit Scotland has appointed KPMG LLP as auditor of Scottish Water in accordance with the Public Finance and Accountability (Scotland) Act 2000 for the period 2022/23 to 2026/27.
- We will provide an opinion on whether the financial statements:

❖ Give a true and fair view in accordance with the Water Industry (Scotland) Act 2002 and directions made thereunder by the Scottish Ministers of the affairs of Scottish Water as at 31 March 2025 and of the income and expenditure of the group for the year then ended.

As appointed auditors, we are required to consider the areas defined in the Code of Audit Practice (2021) as wider-scope audit. Refer to slide 14 for consideration of areas of wider-scope.

Other reporting

- Completion of returns to Audit Scotland (including National Fraud Initiative)
- Reporting to Scottish Government on Whole of Government Accounts (WoGA)
- Reporting to Water Industry Commission for Scotland on Regulatory Accounts

Using the work of others and areas requiring specialised skill

We outline below where, in our planned audit response to audit risks, we expect to use the work of others such as Internal Audit or require specialised skill/knowledge to perform planned audit procedures and evaluate results.

Specialist and other team members	Extent of planned involvement or use of work
IT Audit	The IT team will assist with procedures involved in gaining an understanding of the IT environment and in-line with revised ISA315 requirements perform testing over relevant automated controls as well as performing testing over the general IT controls.
Actuarial	The KPMG pension actuarial specialist will assist the audit team by performing a review of the pension assumptions and providing a conclusion on whether they are appropriate in relation to KPMG acceptable ranges. This specialist will also review the principles applied for recognizing an asset with respect to any pension surplus.
Taxation	The KPMG tax specialist will assist the audit team by performing a review of the income tax and deferred tax computation as well as disclosures in the group financial statements.
Data and analytics team	Performance of accounts analysis on all journals for the year under audit. This analysis will be used for our journal testing/. Performance of Capital additions data analysis to separate data into specific data-sets (i.e. capitalized payroll costs, capitalized indirect costs and capitalized third party costs) to focus testing. See further information on page 15.

Significant risks

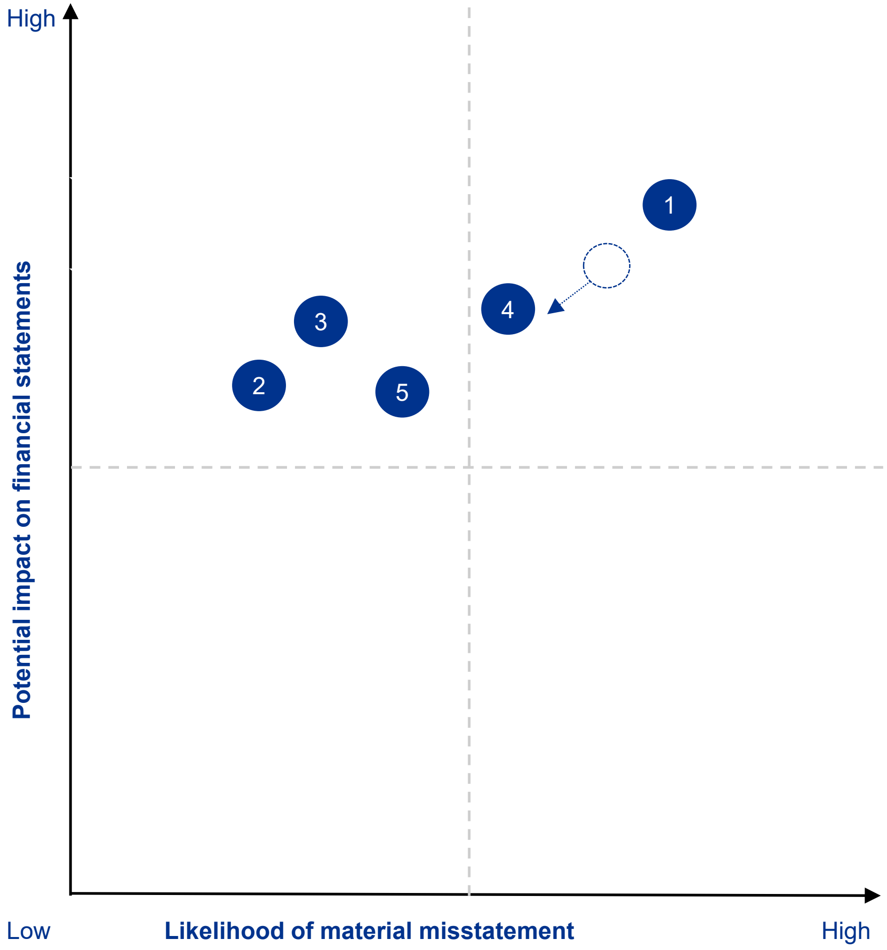
Our risk assessment draws upon our understanding of the applicable financial reporting framework, historic knowledge of the business, the industry and the wider economic environment in which Scottish Water operates.

We also use our regular meetings with senior management to update our understanding and take input from component audit teams and internal audit reports.

The decrease in the bad debt provision significant risk is due to SWBS expected credit loss provision no longer being considered a significant risk at a Scottish Water group level.

We will remain vigilant throughout the audit process of significant risks emerging. Where such items are identified we will amend our audit approach accordingly and communicate this to the Audit and Risk Committee.

Significant risks	
1.	Capital additions (SW)
2.	Management override of controls
3.	Revenue Recognition (SWBS)
4.	Bad debt provision (SW)
5.	Defined benefit pension (SW)



Key: # Significant financial statement audit risks

Change compared to prior year

Audit risks and our audit approach

1 Capital Additions (SW only) – Existence and accuracy of amounts capitalised to property, plant and equipment (PPE) (fraud risk)

No change vs prior year

Significant audit risk

The risk that additions to property, plant and equipment are recorded inappropriately when: the expenditure is not eligible for capitalisation, the Items are not accurately recorded, the entity does not have the rights to the assets or the assets do not exist.

- Capital additions are significant, comprising the largest element of Scottish Water's annual expenditure, related to the delivery plan for regulated activities.
- Members and management are incentivised across a number of financial and other measures including Tier 1 actual costs being below plan by 30%
- There is judgement involved in the allocation of expenditure (specifically payroll costs) between capital additions and revenue which can affect profit and Tier 1 cost measures reported in the financial statements.

Business risks related to audit risks include:

- Inappropriate amounts capitalised

Planned response

- Confirming our understanding of the capital additions process by flowcharting and completing walkthroughs of the key capitalisation activities.
- Considering the design and implementation of key controls: the capital approval processes and allocation of internal costs, including indirect overheads.
- Testing the design and operating effectiveness of controls over:
  - the approval stages of capital expenditure on projects;
  - the allocation of costs between capital and revenue;
  - the appropriateness of reclassification from assets high-risk construction;
- Use of sampling methods to evaluate the appropriateness of the classification of expenditure as capital by considering the nature of the expenditure to ensure it is enhancing with reference to supplier invoices, certificates or timesheets and considering the application of the relevant policies and accounting standards;
- Use of KPMG's D&A capabilities to analyse the general ledger transactions for capital additions and testing any outliers by agreeing transactions back to valid source documents, such as invoices, certificates, contracts, timesheets.
- The judgement applied to the basis of payroll costs allocated to capital additions will be tested by reference to the roles of the underlying staff whose costs are capitalised and the basis of this allocation (e.g. time basis or other allocation method). The audit team will challenge management, where appropriate, on the judgements applied. The audit team will. re-calculate the accuracy of the allocated payroll costs and agree such costs to underlying payroll and HR records.
- Audit of capital accruals at year end to supporting contracts, certificates and other valid project details to confirm the existence and accuracy of capital additions over the year end period.
- Audit of indirect costs allocated to capital additions by vouching a sample of costs to invoices, timesheets and other relevant supporting documentation to confirm the validity of such costs being capitalised.

Audit risks and our audit approach (cont.)

2 Management override of controls

Fraud risk related to unpredictable way management override of controls may occur (fraud risk)

No change vs prior year

Significant audit risk

The risk that the financial statements are misstated due to management override of controls

- Professional standards require us to communicate the fraud risk from management override of controls as significant.
- Management is in a unique position to perpetrate fraud because of their ability to manipulate accounting records and prepare fraudulent financial statements by overriding controls that otherwise appear to be operating effectively.
- We have not identified any specific additional risks of management override relating to this audit.

Note: Significant risk that professional standards require us to assess in all cases.

Planned response

- Our audit methodology incorporates the risk of management override as a default significant risk.
- Assess accounting estimates for biases by evaluating whether judgements and decisions in making accounting estimates, even if individually reasonable, indicate a possible bias. There will be a particular focus on the provision for doubtful debt estimate for Scottish Water.
- Evaluate the selection and application of accounting policies.
- In line with our methodology, evaluate the design and implementation of controls over journal entries and post closing adjustments.
- Inquire with staff who business or process manual journals as to whether they have been requested to process unusual or unsupported journal entries.
- Assess the appropriateness of changes compared to the prior year to the methods and underlying assumptions used to prepare accounting estimates.
- Assess the business rationale and the appropriateness of the accounting for significant transactions that are outside the component's normal course of business or are otherwise unusual.
- Identify journal entries to test based on high-risk criteria and comparing the identified entries to valid supporting documentation as well as considering whether such journals are appropriately authorized and have a valid business rationale.
- Audit of manual journals relating to capital additions which meet our high-risk criteria (i.e. capital additions journals with unexpected account pairings).
- Material post close and consolidation journals, as well as those meeting our high-risk criteria, will be selected for testing.

Audit risks and our audit approach (cont.)

3 Revenue recognition (SWBS only) – the risk that revenue does not exist

Fraud risk related to misstatement of revenue

No change vs prior year

Significant audit risk

The risk that revenue is recognised for arrangements that do not exist or do not meet the definition of a contract in terms of the standard

- Professional standards require us to presume (unless rebutted) that the fraud risk from revenue recognition is a significant risk.
- Performance-based remuneration gives management an incentive to achieve certain financial results which increases the risk of fraudulent premature revenue recognition.
- Accrued revenue includes subjective measurements as it is estimated based on historical data from past bills to create an expectation of the unbilled amount between the last bill and the year end. Thus requiring management to exercise significant judgment with respect to this estimation.

Business risks related to audit risks include:

- Risk of incorrect revenue recognition resulting in erroneous financial reporting.

Note: Presumed risk that professional standards require us to assess in all cases and which can be rebutted if there is no entity-specific significant risk relating to revenue recognition.

Planned response

- Confirming our understanding of the revenue streams identified by flowcharting and completing a walkthrough of each separately identifiable revenue stream.
- Considering the design and implementation of key controls , the revenue recognition processes and management's calculation of accrued and deferred revenues.
- Performing cash receipts to revenue predictive analysis on revenue recognised in the year; a reconciliation of all cash, debtors and accrued revenue for the year.
- Performing year end cut off testing to assess whether sales transactions are recognised in the correct period.
- Considering the deferral of revenue recognised in respect of advanced billing to ensure this is appropriate and correctly calculated.
- Recalculation of accrued income derived from estimated volumes.

We rebut the revenue recognition risk in respect of Scottish Water

We rebut the revenue fraud risk in Scottish Water as there is limited opportunity for management to manipulate revenue recognised and revenue transactions are non-complex with low level of judgement and estimation.

- For Scottish Water, we will request confirmation of household and wholesale revenue from individual local authorities and licenced providers respectively;

Audit risks and our audit approach (cont.)

4 Bad debt provision (SW) (risk of error)

Significant risk due to the judgemental nature of the bad debt provision calculation

Decrease vs prior year

Significant audit risk

The risk that receivables are overstated

Provision for doubtful debts at 30/09/24:

Scottish Water: £484m

- There are a number of assumptions included in the calculation of the bad debt provision; the most sensitive of these is the overall forecast collection rate based on historical data.

Scottish Water

Household bad debt provision.

- Household water debt is a statutory debt recoverable from the occupier. The household billing and cash collection is performed by local authorities and cannot be influenced by Scottish Water.

The decrease in the bad debt provision significant risk is due to SWBS expected credit loss provision no longer being considered a significant risk at a Scottish Water group level.

Business risks related to audit risks include:

- Increased economic and financial pressures increase the risk of default by customers resulting in financial loss to the business.

Planned response

Scottish Water household bad debt provision (risk of error):

- Testing the design and implementation of controls over the review and approval of the provision and associated assumptions, by those charged with governance during the year and at the year end.
- Sample testing of the reconciliation of information provided on a monthly basis by local authorities for household bad debt provision in respect of amounts billed and collected. This historical information forms the basis of the forecast collection rate.
- We will agree the total amount billed and collected in respect of 2024-25, as recorded in Scottish Water's records, to confirmations received from individual local authorities.

Planned response :

- We will perform a walkthrough of management's process for collating data, identifying relevant assumptions and calculating the bad debt provision.
- We will perform sensitivity analysis and challenge management in respect of the forecast collection rate by increasing and decreasing it based on our judgement and assessing the impact on the provision.
- We will assess the disclosure of sensitivities and description of the provision in the financial statements.

Note: The expected credit loss in SWBS is not considered a significant risk for the group audit of Scottish Water. This estimate is considered on page 12.

Audit risks and our audit approach (cont.)

5 Defined benefit pension (SW) – risk over valuation of defined pension liability

The risk that the valuation of the defined benefit obligation/surplus is misstated

No change vs prior year

Significant audit risk

An inappropriate amount is estimated and recorded for the defined benefit obligation

- Small changes in the main assumptions and estimates (i.e. discount rate, inflation rate and mortality rate) used to value the pension obligation would have a significant effect on the net pension liability.
- Employees of Scottish Water participate in the Scottish Local Government Pension Scheme through three funds; North East Scotland pension fund; the Lothian pension fund; and the Strathclyde pension fund.
- Recognition of any surplus as an asset requires consideration and application of IFRIC14 requirements.
- Employees of Scottish Water Business Stream participate only in the Strathclyde Pension Fund.

Business risks related to audit risks include:

- Market volatility and wider economic uncertainty increases the risk of pensions being misstated.

Planned response

Our audit approach to IAS 19 includes:

- Testing the design and operating effectiveness of controls over the provision of membership information to management's actuary who uses it, together with the assumptions, to calculate the pension obligation.
- Review of management's expert used in the valuation of the defined benefit pension obligation.
- Challenging, with the support of our own actuarial specialists, the key assumptions applied, being the discount rate, inflation rate and mortality/life expectancy against externally derived data.
- Challenging the rate of increase in the pensionable salaries assumption, by comparing it to other evidence such as the regulatory delivery plan and our understanding of Scottish Government expectations.
- Considering the adequacy of the disclosures in respect of the sensitivity of the surplus/deficit to these assumptions.
- Our approach to the audit of pension schemes continues to include enhanced quality procedures, accordingly, we will liaise with the scheme actuaries and fund auditors regarding the underlying data and procedures at those entities. Given the current volatile market conditions caused by local and global economic uncertainty, we expect some fluctuations in the measurement of the pension liability/surplus.

Group audit – Revised requirements

	Key Changes	Impact on our audit
Risk-based approach	• More granular risk assessment, and greater emphasis on the group auditor's overall responsibility for identifying and assessing the risks to the group financial statements (group financial statements).	• We lead the identification and assessment of risks to the group financial statements with involvement from component auditors as appropriate. **As there is only one significant component to Scottish Water Group, being Scottish Water Business Stream Limited (SWBS) and that the audit partner for SW Group and SWBS is the same, there is no additional impact due to ISA600r.** • The approach to identifying and assessing risks to the group financial statements is more consistent, and risks are more clearly linked to the components in which they arise.
Approach that is more responsive to risks to the group financial statements	• New requirement for the group auditor to take overall responsibility for determining the nature, timing and extent of audit procedures to be performed to respond to risks to the group financial statements.	• We lead the design of the response to risks to the group financial statements with involvement from component auditors as appropriate, which means a continued targeted, consistent response to identified risks to the group financial statements. • We exercise more judgment in determining the components at which audit work will be performed and the type of work performed. Compared to the prior year, there is no change to the number of components at which audit work will be performed. • A full scope audit will continue to be performed at SWBS and these accounts will be signed at the same time as that of the Group.
Enhanced quality management	• Enhanced leadership, direction, supervision and review responsibilities of the group engagement partner to proactively manage and achieve audit quality in a group audit.	• We determine the resources needed to perform the group audit, including the nature, timing and extent to which component auditors are to be involved in audit work at components. When making this judgement, we evaluate whether we can be sufficiently and appropriately involved in the work of component auditors.
Strengthened communication	• Reinforcing/strengthening requirements for more robust and frequent communications and interactions between the group auditor and component auditors during the audit.	• Interactions and two-way communications between the group and component auditor are strengthened, including in relation to our respective responsibilities and how these will be met; relevant ethical requirements, including independence standards; determining the competence and capabilities of the component auditor; and determining the nature and extent of our involvement in their work.

Scottish Water parent and SWBS comprise 76% and 24% of Scottish Water Group's revenue respectively. Scottish Water parent comprises 96% of Scottish Water Group's total assets with the remaining 4% arising from SWBS. Thus, consistent with prior years, SWBS is the only significant component for Scottish Water Group. A full scope audit is performed for SWBS and as noted above, this is performed by the same audit partner as Scottish Water Group.

Key accounting estimates and management judgements

Significant estimates and judgements

We have included here the significant estimates and judgements from the prior year annual report and our assessment of the quality of disclosure made about the estimation uncertainty within the estimate:

Estimates and judgements	Balance £m	Further comments
Impairment of trade receivables (SW)	(477.4)	A key assumption is the forecast collection rate which is based on historical data and current market conditions. A small change in the forecast collection rate will have a significant impact on the provision for doubtful debts. Details of the assumption were clearly disclosed in the prior year accounts, together with the sensitivity of this assumption.
Impairment of trade receivables (SWBS)	(43.6)	There is judgement involved in calculating the expected credit loss which is impacted by trading, market conditions and the general economic environment.
Defined benefit pension - asset	2,335.2	There are judgements and estimation applied to the fair value of plan assets due to current fluctuating market conditions and wider economic uncertainty at a global and local level. Disclosures with respect to plan assets were found to be adequate in the past.
Defined benefit pension - liability	(1,495.4)	There are a number of assumptions and estimates that impact the value of the retirement benefit obligation. A small change in these assumptions has a significant impact on the defined benefit pension obligation. These judgements and estimates as well as their sensitivities were appropriately disclosed in the prior year annual report.
Depreciation charge	305.5	The judgement applied with respect to useful lives of assets is a key assumption and any change would have a significant impact on the depreciation charge. The useful life of assets varies from short life assets to long life assets, such as infrastructure assets. An incorrect application of useful lives would have a significant impact on the financial statements. Disclosure of useful lives was clearly described in the prior year annual report after recommendations were made by the audit team to increase disclosure of short life assets.
Capitalisation of payroll costs to PPE	150	Management exercise judgement in the capitalisation of payroll costs to capital additions of PPE during the financial year. Certain staff working directly on the capital investment programme and many other staff work a portion of their time on the capital investment programme and thus there is judgement applied in the allocation of these costs as capital additions.

There are a number of other accounting estimates and judgements that are not considered significant due to their values but for which the audit team perform risk assessment and limited procedures. These include: Credit note provision and income uncertainty provision.

Other significant matters related to our audit approach

The Code of Audit Practice sets out four areas that constitute the wider scope of public audit in Scotland. These are summarised below:

1. Financial Management

Entities are required to have sound budgetary processes and should have a clear understood financial environment where internal controls are operating effectively.

Auditors response:

To consider whether the body has effective arrangements to secure sound financial management including the strength of the financial management culture, accountability and arrangements to prevent and detect fraud, error and other irregularities, bribery and corruption.

2. Financial Sustainability

Entities are required to be able to meet the needs of the present without compromising the ability of future needs not being met.

Auditors response:

The audit team will perform detailed assessment over going concern, including assessment of the capital investment programme. Audit actions planned:

- Inspection of future cashflow forecasts
- Review of assumptions applied to future cashflow forecasts
- Sensitivities of assumptions applied to future cashflow forecast
- Inspect adequacy of disclosures over going concern
- Inspection of the capital investment programme for the remainder of the SR21 regulatory period as well as assessment of the future capital investment programme for the SR27 period.

3. Vision, Leadership and Governance

Entities are required to have a clear vision and strategy and set priorities for improvement within this vision and strategy. They work together with partners and communities to improve outcomes and foster a culture of innovation.

Auditors response:

To consider the clarity of plans to implement the vision, strategy and priorities adopted by the leaders of Scottish Water. The audit team also considered the effectiveness of governance arrangements for delivery, which includes openness and transparency of decision-making; robustness of scrutiny and shared working arrangements; and reporting of decisions and outcomes, and financial and performance information.

4. Use of Resources to Improve Outcomes

Entities need to make best use of their resources to meet stated outcomes and improvement objectives, through effective planning and working with strategic partners and communities. This includes demonstrating economy, efficiency and effectiveness through the use of financial and other resources, and reporting performance against outcomes.

Auditors response:

To consider the clarity of the arrangements in place to ensure that resources are deployed to improve strategic outcomes, meet the needs of service users taking account of equalities, and deliver continuous improvements in priority services. Included in this response will be the auditor's assessment of how effective the entity is with respect to prioritisation of capital projects.

Other significant matters related to our audit approach (cont)

Impacts of climate risk and climate change disclosures

We will evaluate management's assessment of the potential financial implications of climate risk on the financial statements, including estimates and disclosures.

As part of our procedures on other information, we will obtain and read your climate change disclosures. We will consider whether there is a material inconsistency between this information included in the annual report and the financial statements, or with our knowledge obtained in the audit; or whether this information appears to be materially misstated.

IFRS 16 adoption

IFRS 16 has been adopted by Scottish Water for the first time for the FY25 financial year. Audit work was performed on the transition to IFRS 16 during the FY24 audit. The audit team will update their assessment of adoption to IFRS 16 including consideration of applicable leases as well as PFI contracts. The measurement of lease liabilities considering a change in future lease payments arising from a change in an index or rate has been considered as part of initial planning procedures. Disclosure testing of IFRS 16 will be performed at year end and management's approach to such disclosure in the half year accounts was found to be adequate.

Going concern

We will assess the risk relating to management's judgement on the use (or otherwise) of the going concern basis and the adequacy of related disclosures, including any possible material uncertainty.

We will evaluate management's assessment, risk assessment process and how the information system captures events and conditions that may cause significant doubt as to the going concern basis.

The areas considered in our assessment are:

- Budgets and forecasts – whether management's assessment considers different scenarios, including reasonably plausible downside scenarios/impacts of the current events and conditions on operations and forecast cash flows

Contractor/repair costs

After depreciation costs, repair (contractor) costs are the second highest costs to Scottish Water and equate to approximately 24% of operating expenditure. There is a risk that these costs are incorrectly capitalised to PPE and this is considered as part of the capital additions significant risk testing. There is also as risk that these costs do not exist or are not accurately recorded and thus a substantive test of detail is planned at an elevated risk to audit this expenditure. The approval, governance and management of these costs will also be considered as part of the wider-scope considerations, particularly with respect to the area of: Use of resources to improve outcomes.

Other significant matters related to our audit approach (cont.)

Our use of Data and analytics

We will be integrating Data & Analytics (D&A) procedures into our planned approach for the audit of Scottish Water.

Risk Assessment

- Account Analysis allows us to compare journal entry postings to our industry expectations. This provides us greater insight into your accounting processes and can highlight unexpected entries or transaction flows.
- Digital Media Analytics scans newsfeeds, social media and public data to get a real time view of Scottish Water sentiment in the outside world and can monitor how sentiment of specific events is evolving throughout the audit cycle. We will get access to global trends and identify hotspots by location that could have a financial impact on the financial statements. This analysis can enable us to make better informed challenges of management assumptions.
- KPMG Clara General Ledger Analysis provides analysis over key movements, trends and relationships within the data at transactional level in addition to financial statement caption level. These insights provide us with a better understanding of the data, highlight inconsistencies and aid us in identifying potential risks of material misstatement.

Substantive testing

- We will analyse 100% of capital additions in the period and categorise these additions into: Direct additions, capitalised overheads, capital accruals and other credit entries to capital additions. We will perform additional procedures on the exceptions identified and on items where there is manual intervention.

Our use of Data and analytics (cont.)

Management override of controls surrounding journal entries

- KPMG Clara Journal Entries Analysis provides insights such as the breakdown between manual and automated entries, time series analysis and stratification of journal populations by user, amount and line numbers. This provides us a better understanding of your processes, highlights inconsistencies and aids us in identifying high-risk entries requiring substantive testing.

Risk Assessment

The IT Audit team has performed a risk assessment over the IT environment to determine whether there are any key risks that should be considered as part of the wider audit approach. The procedures performed include obtaining an understanding of the IT systems, IT organisation, cybersecurity environment, reliance on service organisations and the formality of IT processes in place at Scottish Water.

The IT Audit team has commenced fieldwork and has not identified any observations to date. We note that formal IT processes are in place, and there have not been any cybersecurity incidents that would impact financial reporting.

Year-end procedures will be performed in April to determine whether there have been any changes to the IT environment (including cybersecurity incidents).

Mandatory communications

Type	Statements
Management's responsibilities (and, where appropriate, those charged with governance)	Prepare financial statements in accordance with the applicable financial reporting framework that are free from material misstatement, whether due to fraud or error. Provide the auditor with access to all information relevant to the preparation of the financial statements, additional information requested and unrestricted access to persons within the entity.
Auditor's responsibilities	Our engagement contract with Audit Scotland dated 18 March 2022 communicates our responsibilities to form and express an opinion on the financial statements that have been prepared by management with the oversight of those charged with governance. The audit of the financial statements does not relieve management or those charged with governance of their responsibilities.
Auditor's responsibilities – Fraud	This report communicates how we plan to identify, assess and obtain sufficient appropriate evidence regarding the risks of material misstatement of the financial statements due to fraud and to implement appropriate responses to fraud or suspected fraud identified during the audit.
Auditor's responsibilities – Other information	Our engagement contract communicates our responsibilities with respect to other information in documents containing audited financial statements. We will report to you on material inconsistencies and misstatements in other information.
Independence	Our independence confirmation letter dated 3 December 2024 discloses matters relating to our independence and objectivity including any relationships that may bear on the firm's independence and the integrity and objectivity of the audit engagement partner and audit staff.

Appendix

Confirmation of independence

We confirm that, in our professional judgement, KPMG LLP is independent within the meaning of regulatory and professional requirements and that the objectivity of the Partner and audit staff is not impaired.

Assessment of our objectivity and independence as auditor of Scottish Water

Professional ethical standards require us to provide to you at the planning stage of the audit a written disclosure of relationships (including the provision of non-audit services) that bear on KPMG LLP's objectivity and independence, the threats to KPMG LLP's independence that these create, any safeguards that have been put in place and why they address such threats, together with any other information necessary to enable KPMG LLP's objectivity and independence to be assessed.

This letter is intended to comply with this requirement and facilitate a subsequent discussion with you on audit independence and addresses:

- General procedures to safeguard independence and objectivity;
- Independence and objectivity considerations relating to the provision of non- audit services; and
- Independence and objectivity considerations relating to other matters.

General procedures to safeguard independence and objectivity

KPMG LLP is committed to being and being seen to be independent. As part of our ethics and independence policies, all KPMG LLP partners and staff annually confirm their compliance with our ethics and independence policies and procedures including in particular that they have no prohibited shareholdings. Our ethics and independence policies and procedures are fully consistent with the requirements of the FRC Ethical Standards. As a result we have underlying safeguards in place to maintain independence through:

- Instilling professional values;
- Communications;
- Internal accountability;
- Risk management; and
- Independent reviews

The conclusion of the audit engagement partner as to our compliance with the FRC Ethical Standard in relation to this audit engagement is subject to review by an engagement quality control reviewer, who is a partner not otherwise involved in your affairs.

We are satisfied that our general procedures support our independence and objectivity.

Independence and objectivity considerations relating to the provision of non-audit services

We have considered the fees charged by us to Scottish Water Group for professional services provided by us during the reporting period.

Total fees (excluding VAT) charged by us for the period ended 31 March 2024 and agreed for the 2025 were as follows:

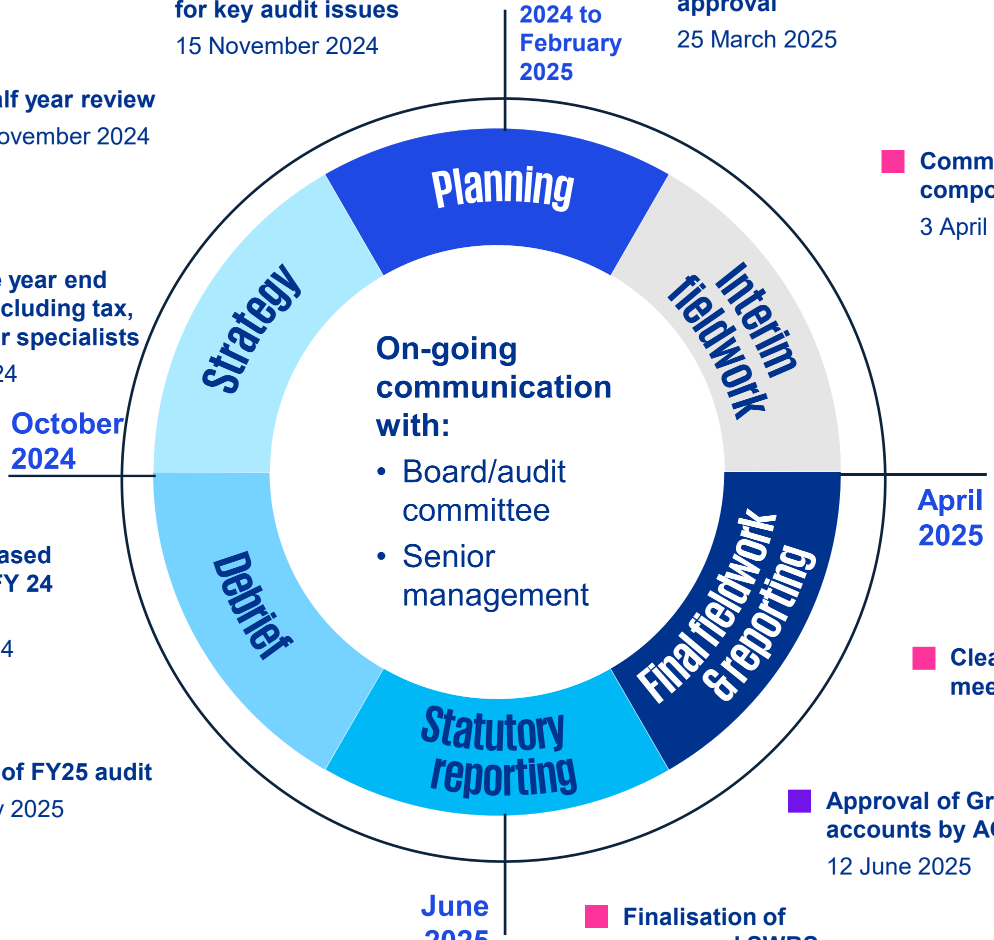
	2025 £'000	2024 £'000
Audit fee – Audit Scotland allocation	386.6	371.0
Review fee - Half year	26.5	24.5
Audit fee – other areas of scope	26.0	25.0
Audit fee – subsidiary entities	275.6	216.0
	714.7	636.5
Overrun fee	-	17.9
Non-audit services	2.8	2.5
Total fees	717.5	656.9

Audit cycle & timetable

Our schedule October 2024 to June 2025

Key:
Key events
Timing of AC communications

A change to our approach this year based on the FY24 debrief is to commence information testing of journals, PPE and payroll earlier



Planning meeting with management for key audit issues
15 November 2024

Audit plan discussion and approval
25 March 2025

Half year review
November 2024

Communications with component auditors
3 April 2025

Commence year end planning including tax, IT and other specialists
October 2024

Audit strategy discussions based on debrief of FY 24 audit
September 2024

Final fieldwork
29 May 2025

Clearance meetings: Group: 29 May 2025

Debrief of FY25 audit
End July 2025

Approval of Group accounts by AC
12 June 2025

Finalisation of group and SWBS accounts
27 June 2025

KPMG's Audit quality framework

Audit quality is at the core of everything we do at KPMG and we believe that it is not just about reaching the right opinion, but how we reach that opinion.

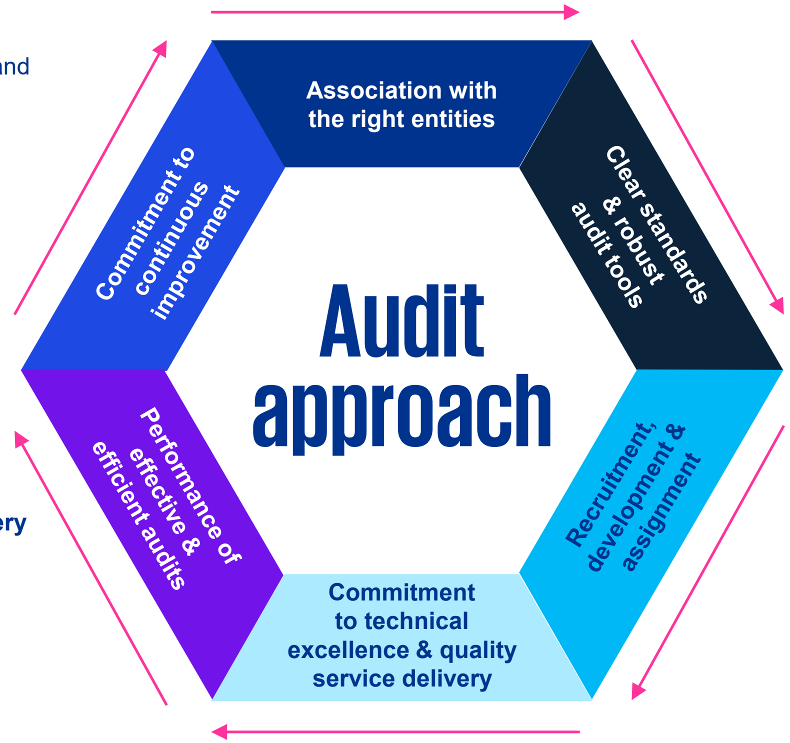
To ensure that every partner and employee concentrates on the fundamental skills and behaviours required to deliver an appropriate and independent opinion, we have developed our global Audit Quality Framework.

Responsibility for quality starts at the top through our governance structures as the UK Board is supported by the Audit Oversight Committee, and accountability is reinforced through the complete chain of command in all our teams.

Commitment to continuous improvement
- Comprehensive effective monitoring processes
- Significant investment in technology to achieve consistency and enhance audits
- Obtain feedback from key stakeholders
- Evaluate and appropriately respond to feedback and findings

Performance of effective & efficient audits
- Professional judgement and scepticism
- Direction, supervision and review
- Ongoing mentoring and on the job coaching, including the second line of defence model
- Critical assessment of audit evidence
- Appropriately supported and documented conclusions
- Insightful, open and honest two way communications

Commitment to technical excellence & quality service delivery
- Technical training and support
- Accreditation and licensing
- Access to specialist networks
- Consultation processes
- Business understanding and industry knowledge
- Capacity to deliver valued insights



Association with the right entities
- Select entities within risk tolerance
- Manage audit responses to risk
- Robust client and engagement acceptance and continuance processes
- Client portfolio management

Clear standards & robust audit tools
- KPMG Audit and Risk Management Manuals
- Audit technology tools, templates and guidance
- KPMG Clara incorporating monitoring capabilities at engagement level
- Independence policies

Recruitment, development & assignment of appropriately qualified personnel
- Recruitment, promotion, retention
- Development of core competencies, skills and personal qualities
- Recognition and reward for quality work
- Capacity and resource management
- Assignment of team members and specialists

Statement on the Effectiveness of our system of quality management

Based on the annual evaluation of the Firm's System of Quality Management as of 30 September 2023, the System of Quality Management provides the Firm with reasonable assurance that the objectives of the System of Quality Management are being achieved.

Our full Statement on the effectiveness of the System of Quality Management of KPMG UK LLP as at 30 September 2023 can be found here.

The extract below is the Statement on the Effectiveness of our system of quality management taken from our Transparency Report:

As required by the International Auditing and Assurance Standards Board (IAASB)'s, International Standard on Quality Management (ISQM1), the Financial Reporting Council (FRC)'s International Standard on Quality Management (UK) 1 (ISQM (UK) 1), and KPMG International Limited Policy, KPMG UK LLP (the "Firm" and/or "KPMG UK") has responsibility to design, implement and operate a System of Quality Management for audits or reviews of financial statements, or other assurance or related services engagements performed by the Firm.

The objectives of the System of Quality Management are to provide the Firm with reasonable assurance that:

a) The Firm and its personnel fulfil their responsibilities in accordance with professional standards and applicable legal and regulatory requirements, and conduct engagements in accordance with such standards and requirements; and

b) Engagement reports issued by the Firm or engagement partners are appropriate in the circumstances.

KPMG UK outlines how its System of Quality Management supports the consistent performance of quality engagements in the 2023 Transparency Report.

Integrated quality monitoring and compliance programmes enable KPMG UK to identify and respond to findings and quality deficiencies both in respect of individual engagements and the overall System of Quality Management.

If deficiencies are identified when KPMG UK performs its annual evaluation of the System of Quality Management, KPMG UK evaluates the severity and pervasiveness of the identified deficiencies by investigating the root causes, and by evaluating the effect of the identified deficiencies individually and in the aggregate, on the System of Quality Management, with consideration of remedial actions taken as of the date of the evaluation.

Based on the annual evaluation of the Firm's System of Quality Management as of 30 September 2023, the System of Quality Management provides the Firm with reasonable assurance that the objectives of the System of Quality Management are being achieved.

Understanding of IT

Summary

The release of ISA 315 (UK) revised brought an increased focus on Understanding of IT in the audit, and it continues to be an area of focus.

Stakeholders now expect auditors to not only understand IT in detail, but also to consider the impact of the findings from their risk assessment procedures on their planned audit approach.

Why is Understanding of IT so important?

Businesses continue to embrace increasingly complex and sophisticated IT systems and place more and more reliance on automated IT processing not simply for a competitive advantage, but also for "business as usual" operations.

This increased reliance means that to effectively audit accounts, balances and transactions, auditors are required to understand and challenge more around how those IT system and process work.

Therefore, Understanding of IT is a crucial building block of our audit strategy and influences our planned audit approach at every stage.

This is true regardless of whether controls reliance is planned or the audit is expected to be fully substantive in nature.

What kind of things might we identify?

As part of our risk assessment procedures, we perform:

- An assessment of the formality, or otherwise, of certain financially relevant IT processes
- An evaluation of the design and implementation of related general IT controls
- An evaluation of the design and implementation of automated process level controls

As a result of these procedures, we may identify IT control deficiencies or IT process informalities that may have an impact on our planned audit approach.

Additionally, we may identify findings related to the wider control environment or threats to the accuracy or completeness of the information used by both entity management and auditors alike.

What does this mean for our audits?

Auditors are being asked to consider the findings from their risk assessment procedures over IT in relation to the planned audit approach.

The findings may impact any area of the audit, however there are three main areas of focus where we anticipate that most impact as a result of identifying IT deficiencies or IT process informality;

- Increased risk to data integrity
- Additional fraud risk factors
- Additional high-risk criteria to be used in journals analysis

It is important to understand that these findings may have an impact regardless of planned reliance on automated controls and general IT controls.

Newly effective accounting standards and relevant IFRIC items

Standards	Expected impact: High	Expected impact: Moderate	Expected impact: Low	Expected impact: None	Effective for years beginning on or after: 01 Jan 2024	Effective for years beginning on or after: 1 Jan 2025	Early adoption permitted
Lease Liability in a Sale and Leaseback (Amendments to IFRS 16)	●	●	●	○	✓		✓
Classification of liabilities as Current or Non-Current and Non-current Liabilities with Covenants (Amendments to IAS 1 Presentation of Financial Statements)	●	●	●	○	✓		✓
Supplier Finance Arrangements (Amendments to IAS 7 and IFRS 7)	●	●	●	○	✓		✓
Lack of exchangeability (Amendments to IAS 21)	●	●	●	○		✓	✓
Sale or Contribution of Assets between an Investor and its Associate or Joint Venture (Amendments to IFRS 10 Consolidated Financial Statements and IAS 28 Investments in Associates and Joint Ventures) *	●	●	●	○			✓
UK legislation on international tax system reform (BEPS)	●	●	●	○	✓		✓
IFRS S1** General Requirements for Disclosure of Sustainability-related Financial Information and IFRS S2** Climate-related Disclosures	●	●	●	○	✓		✓

* The effective date for these amendments was deferred indefinitely. Early adoption continues to be permitted.
** The implementation and the effective dates of IFRS® Sustainability Disclosure Standards are subject to local regulation

ISA (UK) 600 Revised: Summary of changes

Summary

ISA (UK) 600 (Revised): Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors) is effective for periods commencing on or after 15 December 2023.

The new and revised requirements better aligns the standard with recently revised standards such as ISQM 1, ISA (UK) 220 (Revised) and ISA (UK) 315 (Revised). The revisions also strengthen the auditor's responsibilities related to professional skepticism, planning and performing a group audit, two-way communications between the group auditor and component auditors, and documentation.

Area	Summary of changes and impact	Effect on audit effort
Risk-based approach	The nature and extent of risk assessment procedures performed by the group auditor at group level may increase, which may include further inquires of group and/or component management and those charged with governance; analytical procedures, attendance of walkthroughs at components, and inspection and/or observation of additional component information. Consequently, while we will continue to work across the group audit to be as efficient in our interactions with you as possible, group and component management will typically receive additional, and more specific/granular requests, for information from both the group and component auditors.	
Group auditor responsibilities	Through a more targeted audit response to address the group Risks of Material Misstatement, we may perform audit work and communicate with component management at a greater number of components within the group, and we may request less information from component management at certain components where we previously performed full scope audits for the Group audit, if we determine that a full scope audit is no longer necessary. While statutory audit requirements will still apply, this change may be beneficial for overall audit effort where a statutory audit is not required.	
Flexibility in defining components	You may also see changes in the planned scope and timing of the audit in communications to group management and those charged with governance, such as changes to the identification of components and the work to be performed on their financial information, and/or changes to the nature of the group auditor's planned involvement in the work to be performed by component auditors. The impact will be greater where there are more components.	
Quality management	Enhanced leadership, direction, supervision and review responsibilities of the group engagement partner may result in the group engagement partner needing to engage more extensively with group management, your component management and component auditors throughout the audit.	
Robust communication	If the group auditor determines that the increased work effort is needed, this determination will impact how much, and the type of, information you will need to provide to the group auditor or component auditors. The group auditor is required to prescribe required work at a more granular level. This may mean there is increased work for component auditors, particularly in year one, to align the requirements of the group audit and local statutory audits. We will continue to work closely to minimise this.	
Application of materiality and aggregation risk	Changes in component performance materiality may result in changes to the nature, timing and extent of component auditor's work. If so, this may impact how much, and the type of, information you will need to provide to the group auditor or component auditors.	
Revised independence principles	This may make it more challenging to address auditor rotation and other independence requirements for component auditors we may plan to involve in the group audit and mean more matters impacting independence may need to be communicated to you. Potential changes to the component auditor firms engaged to perform work on financial information of components.	

Some or all of the services described herein may not be permissible for KPMG audited entities and their affiliates or related entities.

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