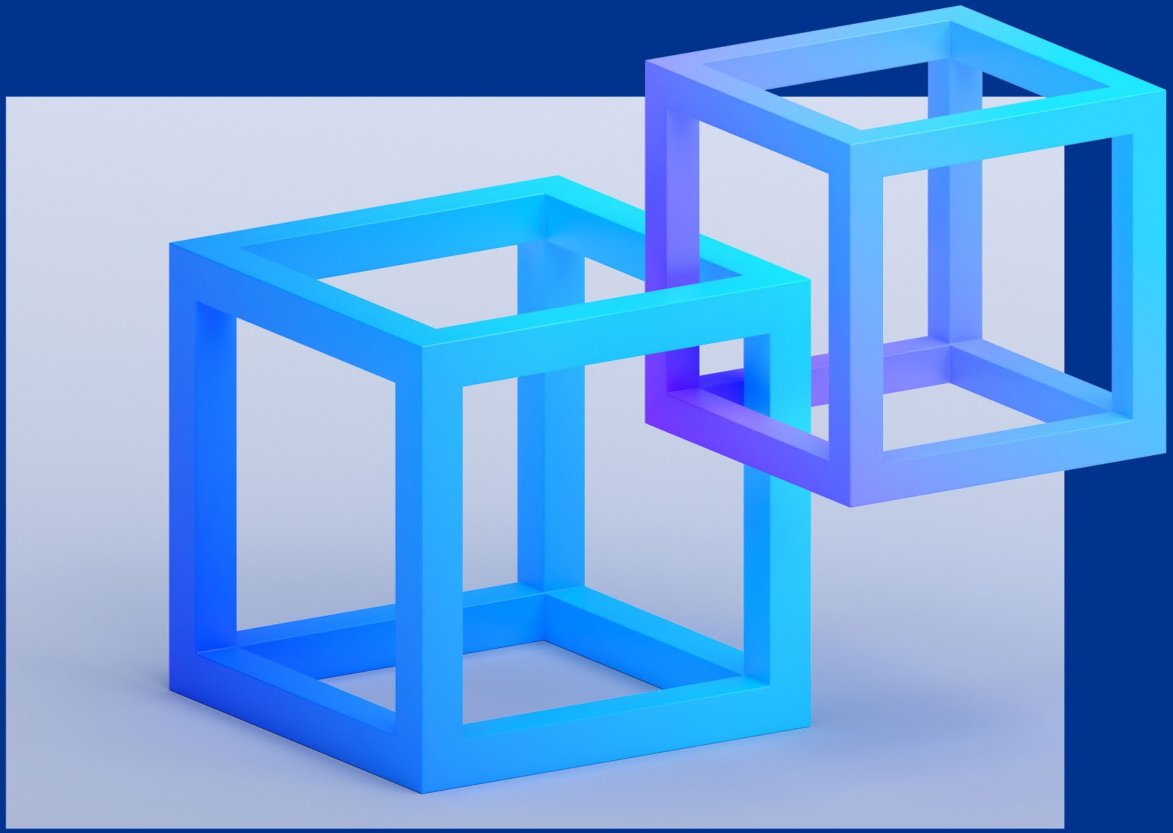
KPMG

Scottish Water

Annual Audit Report to the members of Scottish Water and the Auditor General for Scotland



Annual report for the year ended 31 March 2023

23 June 2023

Introduction

To the members of Scottish Water and the auditor general for Scotland

We were pleased to have the opportunity to meet with you on 24 May 2023 to discuss the results of our audit of the consolidated financial statements of Scottish Water (the 'Company') (and its subsidiaries (the 'Group'), as at and for the year ended 31 March 2023.

This report should be read in conjunction with our audit plan and strategy report, presented on 28 March 2023.

The engagement team

Our audit is now complete. There have been no significant changes to our audit plan and strategy other than those described on page 5.

We have issued an unmodified Auditor's Report.

We draw your attention to the important notice on page 3 of this report, which explains:

- The purpose of this report
- Limitations on work performed
- Restrictions on distribution of this report

Yours sincerely,

Tim Cutler
Key audit partner

23 June 2023

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.

Contents	Page

Important notice

This report is presented under the terms of our audit appointment letter with Audit Scotland.

The content of this report is based solely on the procedures necessary for our audit.

Purpose of this report

This Report has been prepared in connection with our audit of the consolidated financial statements of Scottish Water (the 'Company') (and its subsidiaries (the 'Group'), prepared in accordance with UK adopted international accounting standards, and where otherwise appropriate, as interpreted and adapted by the 2022/23 Government Financial Reporting Manual (the 2022/23 FReM) and in accordance with the requirements of the Water Industry (Scotland) Act 2002 and the directives made thereunder by the Scottish Ministers as at and for the year ended 31 March 2023.

This report has been prepared in accordance with the responsibilities set out within the Audit Scotland's Code of Audit Practice ('the Code').

This report is for the benefit of Scottish Water and is made available to Audit Scotland and the Auditor General (together 'the Beneficiaries'). This report has not been designed to be of benefit to anyone except the Beneficiaries. In preparing this report we have not taken into account the interests, needs or circumstances of anyone apart from the Beneficiaries, even though we may have been aware that others might read this report. We have prepared this report for the benefit of the Beneficiaries alone.

Nothing in this report constitutes an opinion on a valuation or legal advice.

We have not verified the reliability or accuracy of any information obtained in the course of our work, other than in the limited circumstances set out in the scoping and purpose section of this report.

This report is not suitable to be relied on by any party wishing to acquire rights against KPMG LLP (other than the Beneficiaries) for any purpose or in any context. Any party other than the Beneficiaries that obtains access to this report or a copy (under the Freedom of Information Act 2000, the Freedom of Information (Scotland) Act 2002, through a Beneficiary's Publication Scheme or otherwise) and chooses to rely on this report (or any part of it) does so at its own risk. To the fullest extent permitted by law, KPMG LLP does not assume any responsibility and will not accept any liability in respect of this report to any party other than the Beneficiaries.

Complaints

If at any time you would like to discuss with us how our services can be improved or if you have a complaint about them, you are invited to contact Tim Cutler, who is the engagement leader for our services to Scottish Water; email ttim.cutler@kpmg.co.uk, who will try to resolve your complaint. We will investigate any complaint promptly and do what we can to resolve the difficulties. After this, if you are still dissatisfied with how your complaint has been handled you can refer the matter to Stephen Boyle, Auditor General and Accountable Officer, Audit Scotland, Fourth Floor, 102 West Port, Edinburgh, EH3 9DN

Our audit findings

Significant audit risks		Page 6-25
Significant audit risks	**Risk change**	**Our findings**
Capital additions (SW)	Increase (fraud risk)	No issues identified.
Management override of controls (SW & SWBS)	No change	We identified that there is no evidence of the review of manual journals prior to posting. This has been raised as a control deficiency and is consistent with our finding in the prior year
Revenue Recognition (SWBS)	Increase (Data Migration)	No issues identified.
Impairment of trade receivables (SW & SWBS)	Increase (cost of living crisis and data migration for SWBS)	SW: No issues identified. Management judgement considered neutral. SWBS: No issues identified. Management judgement considered optimistic.
Defined benefit pension (SW & SWBS)	Increase (volatile market conditions)	SW: No issues identified. SWBS: No issues identified.

Key accounting estimates	Page 32
Impairment of trade receivables	SW: No issues identified. Management judgement considered neutral. SWBS: We assessed managements judgement as being optimistic.
Defined benefit pension	SW: We assessed managements judgement as being neutral. SWBS: We assessed managements judgement as being neutral.

Uncorrected Audit Misstatements	Profit and loss impact
Understatement/ (overstatement)	**(£1.2m)**

Misstatements in respect of Disclosures
Refer pages 34-35

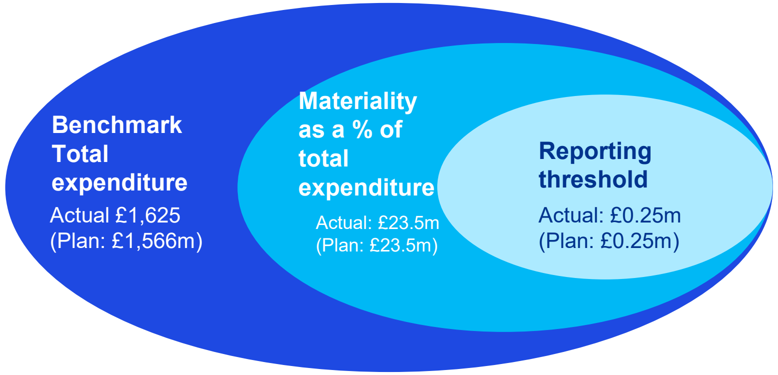
Number of Control deficiencies	Page 36
Significant control deficiencies	0
Other control deficiencies	4
Prior year control deficiencies remediated	3

Key changes to our audit plan

We have not made any changes to our audit plan as communicated to you on 28 March 2023 other than as follows:

Materiality

Materiality has remained unchanged.



Components

There has been no change to the scoping of components with only Scottish Water Business Stream Limited being included as a significant component for group reporting purposes.

Significant risks

There have been no changes to the significant risks as communicated on 28 March 2023, however, an additional process was identified within the significant risk for Capital Additions which is detailed below.

Account process	Effect on audit plan	Effect on audit strategy and plan
Indirect overheads allocated to capital additions	Based on our walkthroughs performed over capital additions, we identified an additional process with respect to the allocation of indirect overheads capitalised as part of capital additions.	The impact on the audit plan was that additional work was performed over the understanding of indirect overheads capitalised to capital additions. A separate procedure was performed to test a sample of indirect costs allocated to capitalised additions, including the testing of the source of the underlying information comprising the indirect costs.

Significant risks and Other audit risks

We discussed the significant risks which had the greatest impact on our audit when we were planning our audit.

Our risk assessment draws upon our 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 local audit teams and internal audit reports.

See the following slides for the cross-referenced risks identified on this slide.

Significant risks	
1.	Capital Additions (SW)
2.	Management override of controls (SW &SWBS)
3.	Revenue Recognition (SWBS)
4.	Impairment of trade receivables (SW & SWBS)
5.	Pension Liability (SW & SWBS)

Other audit risks	
6.	Going Concern (SW & SWBS)
7.	Impairment of Investment in Subsidiaries (SW)

Key:

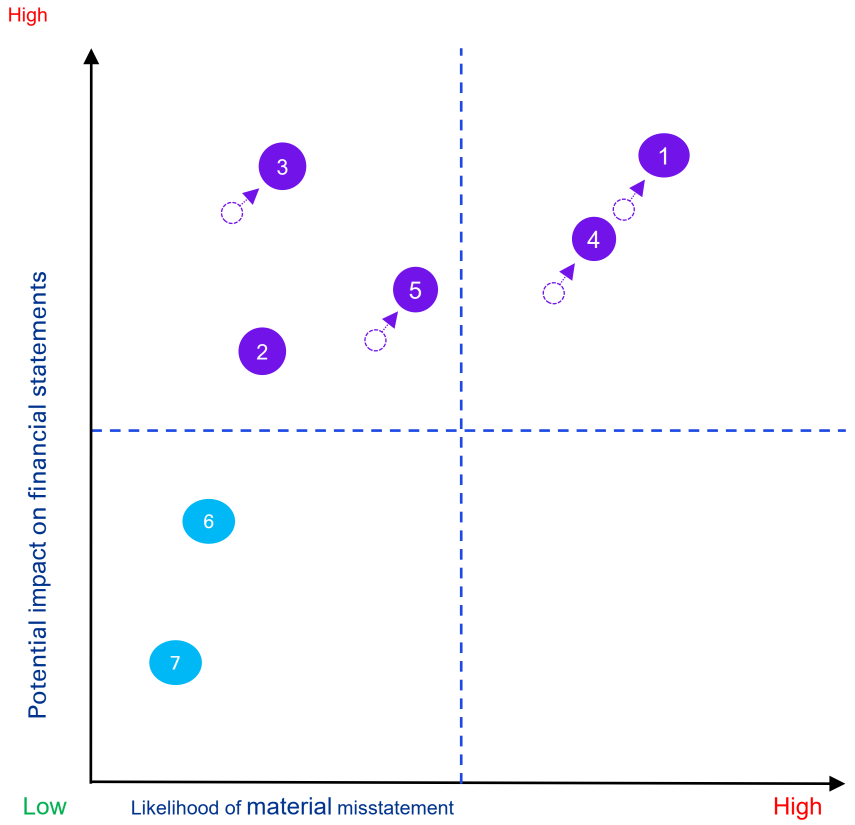
\# Significant financial statement audit risks

\# Other audit risk

Increasing or decreasing risk compared with prior year

SW – Scottish Water entity

SWBS – Scottish Water Business Stream



Audit risks

1 Capital Additions (SW) – Existence, Accuracy and Valuation

Fraud risk related to inappropriate capitalisation of assets.

Cautious | Neutral | Optimistic

Significant risk

The risk:

- Capital additions are significant, comprising the largest element of Scottish Water's annual expenditure, related to the delivery plan for regulated activities.
- Members are incentivised across a number of financial and other measures including the level of "tier 1" costs* and completion of capital investment programmes.
- There is judgement involved in the allocation of expenditure between capital additions and revenue which can affect profit and investment measures reported in the financial statements.

Business risks related to audit risks include:

- Inappropriate amounts capitalised and deviation from delivery plan

** Operating costs, PFI and interest costs relative to WICs final determination expectations*

Key:
Prior year   Current year

Our response

Our Response:

- Testing the design and operating effectiveness of controls over the allocation of costs between capital and revenue within the financial ledger at the project initiation stage and on an ongoing basis;
- Testing the design and operating effectiveness of controls over the consistency between total capital expenditure reported in the financial statements and that reported to those charged with governance as part of ongoing capital project monitoring;
- 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 in the course of construction;
- Comparing the reports of Scottish Water's capital project monitoring group to the capital additions recorded in the financial statements;
- 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 invoice, certificate or timesheets and considering the application of the relevant policies and accounting standards;
- Review of high risk manual journals relating to capital additions; and
- Use of KPMG's D&A capabilities to analyse the general ledger transactions and testing any outliers by agreeing transactions back to valid source documents, such as invoices, certificates, contracts, timesheets.

Audit risks (cont.)

1 Capital Additions (SW) – Existence, Accuracy and Valuation

Fraud risk related to inappropriate capitalisation of assets

Cautious Neutral Optimistic

Significant risk

The risk:

- Capital additions are significant, comprising the largest element of Scottish Water's annual expenditure, related to the delivery plan for regulated activities.
- Members are incentivised across a number of financial and other measures including the level of "tier 1" costs* and completion of capital investment programmes.
- There is judgement involved in the allocation of expenditure between capital additions and revenue which can affect profit and investment measures reported in the financial statements.

Business risks related to audit risks include:

- Inappropriate amounts capitalised and deviation from delivery plan

** Operating costs, PFI and interest costs relative to WICs final determination expectations*

Our findings

- The design and operating effectiveness of controls over the allocation of costs between capital and revenue within the financial ledger at the project initiation stage and on an ongoing basis were found to be effective.
- The design and operating effectiveness of controls over the consistency of reporting of capital expenditure in the financial statements and that reported to those charged with governance as part of ongoing capital project monitoring were found to be effective.
- The design and operating effectiveness of controls over: (1) the approval stages of capital expenditure on projects, (2) the allocation of costs between capital and revenue, and (3) the appropriateness of reclassification of assets from the category "assets under construction" to the relevant asset category were found to be effective.
- The sample of capital additions selected for testing were agreed to valid supporting documentation and the appropriateness of the classification of expenditure as capital or expenditure was found to be appropriate.
- The sample of indirect overheads were agreed to valid supporting documentation and the appropriateness of the classification of expenditure as capital or expenditure was found to be appropriate.
- The audit team challenged management as to the replacement of Infrastructure assets and the removal of the underlying assets replaced. Management treat Infrastructure assets within groups to practically manage the accounting for such assets. These Infrastructure assets have extensive useful lives of between 80 and 150 years and the assets are enhanced and maintained over this period, rather than replaced. Due to the extensive useful life period, disposals are not expected to occur for many more years.
- The audit of high risk manual journals to capital additions identified no issues.

Key:
Prior year Current year

Audit risks (cont.)

2 Management override of controls (SW & SWBS) [(a)]

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

Significant audit risk

The risk:

- 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.
- Members are incentivised across a number of key financial performance measures, including capital investment which increases the risk of manipulation.

Business risks related to audit risks include:

- Risk of misappropriation of assets and erroneous financial reporting.

Our response

Our Response:

- In line with our methodology, we evaluated the design and implementation of controls over journal entries and post closing adjustments;
- We identified journal entries to test based on high risk criteria and compared the identified entries to valid supporting documentation as well as considering whether such journals were appropriately authorized and had a valid business rationale;
- We evaluated accounting estimates, including the consideration of bad debt provision, pension liabilities, income uncertainty provision, revenue recognition in SWBS and credit note provision;
- We evaluated the selection and application of accounting policies;
- We assessed the appropriateness of changes compared to the prior year, to the methods, and underlying assumptions used to prepare accounting estimates;
- We assessed the business rationale and the appropriateness of the accounting for significant transactions that are outside normal course of business, or are otherwise unusual;
- We gained an understanding any corporate and personal objectives of directors and whether these provided any incentive for management to override controls to achieve them. We designed audit procedures to address any areas of concern.

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

Audit risks (cont.)

2 Management override of controls (SW & SWBS)[a]

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

Significant audit risk

The risk

- 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.
- Members are incentivised across a number of key financial performance measures, including capital investment which increases the risk of manipulation.

Business risks related to audit risks include:

- Risk of misappropriation of assets and erroneous financial reporting.

Our findings

- We identified that there is no evidence of the review of manual journals. This has been raised as a control deficiency and is consistent with our finding in the prior year (page 36).
- We have identified journal entries and other adjustments meeting our high-risk criteria and we have inspected the relevant supporting documents to support such journals. No discrepancies were noted.
- We did not identify any significant unusual transactions.
- Our conclusions on accounting estimates are detailed on page 32. No significant issues were identified.
- We have performed 'unpredictable' audit procedures over high risk audit areas throughout the audit, including how we selected individual items for substantive testing (for example capital additions transactions).

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

Audit risks (cont.)

3 Revenue Recognition (SWBS) – Existence

Fraud risk related to misstatement of revenues

Significant audit risk

The risk:

- Professional standards require us to presume (unless rebutted) that the fraud risk from revenue recognition is a significant risk.
- There is a risk that revenue is recognized for arrangements that; do not exist or do not meet the definition of a contract under the standard.
- 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.

Our response

Our procedures:

- We considered the design and implementation of key controls (covering both systems), in the revenue recognition processes and management's calculation of accrued and deferred revenues;
- We performed cash receipts to revenue predictive analysis on revenue recognised in the year; a reconciliation of all cash, debtors and accrued revenue for the year, to confirm existence of revenue. This predictive analysis will be done in three phases, pre-migration, post migration and at year end;
- We performed year end cut off testing to assess whether sales transactions are recognised in the correct period;
- We considered the deferral of revenue recognised in respect of advanced billing to ensure this is complete and accurately calculated;
- We challenged of assumptions used in estimating the accrued revenue in relation to the unbilled portion of revenue at the year end and reperformance of the calculations used by management to arrive at the estimate, to confirm the existence of the revenue recognised; and
- We tested the completeness and accuracy of the data in the new billing system post migration.

Audit risks (cont.)

3 Revenue Recognition (SWBS) - Existence

Fraud risk related to misstatement of revenues

Significant audit risk

The risk

- To note, there has been a change in the billing system in the 2022/23 year. All customer data was migrated to a new billing system- Gentrack during February 2023. There is a risk that the data is not completely and accurately migrated impacting on the revenue recognised in the current year.

Business risks related to audit risks include:

- Risk of incorrect revenue recognised resulting in erroneous financial reporting

Our response

We rebut the risk in respect of Scottish Water and other subsidiaries.

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 requested confirmation of household and wholesale revenue from individual local authorities and licenced providers respectively;
- For Scottish Water Horizons Limited*, revenue is recognised based on contract values; and
- For Scottish Water Services (Grampian) Limited*, the main source of revenue is (directly and indirectly) from Scottish Water.

* Note: Debra Chamberlain is the RI for the audits of these subsidiary entities.

Audit risks (cont.)

3 Revenue Recognition (SWBS) - Existence

Fraud risk related to misstatement of revenues

Significant audit risk

- Revenue is recognized for arrangements that; do not exist or do not meet the definition of a contract under 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 increasing the risk over the existence of revenue.
- To note, there has been a change in the billing system in the current year. All customer data was migrated to a new billing system- Gentrack during February 2023. There is a risk that the data is not completely and accurately migrated impacting on the existence of revenue recognised in the current year.

Our findings

- Automated controls surrounding revenue were operating effectively, however there were some underlying deficiencies in the General Information Testing environment that undermines the effectiveness of these automated controls. Control deficiencies identified are communicated on page 36.
- We did not identify any significant discrepancies between data migrated from the legacy billing system to new billing system.
- We did not identify any audit misstatement in revenue.

Audit risks (cont.)

4 Impairment of trade receivables (SW & SWBS) - Valuation

Significant risk due to judgmental nature of impairment provision calculation

Cautious Neutral Optimistic

Significant audit risk

Provision for impairment of trade receivables at 31 March 2023:

Scottish Water: £466m

Scottish Water Business Stream: £50m

- Inappropriate expected credit loss (ECL) is estimated for trade receivables due to: un-reliable data and inappropriate assumptions)
- 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.

Our response

Our Procedures:

- Tested 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 formed the basis of the forecast collection rate.
- Compared the information on historical collection rates (for Scottish Water) as the basis for the current year provision calculation, to the records held in respect of prior years.
- Agreed the total amount billed and collected in respect of 2022-23, as recorded in Scottish Water's records, to confirmations received from individual local authorities.
- Compared the change in forecast household collection rate in the current year, to the historical trend of collection rates since 1996-97.

Key:
Prior year Current year

Audit risks (cont.)

4 Impairment of trade receivables (valuation) (SW & SWBS) - Valuation

Significant risk due to judgmental nature of impairment provision calculation

Cautious | Neutral | Optimistic

Significant audit risk

Scottish Water Business Stream

- The bad debt provision for SWBS is highly judgemental in nature and there are a number of assumptions included in the calculation. The most sensitive of these assumptions is the overall forecast collection rate based on historical data.
- There is therefore an inherent risk of error such that inappropriate assumptions are made to inform the valuation of the provision.
- The data relied upon is voluminous and was subject to migration to a new billing system in February 2023. Data migration increases the risk around the completeness and accuracy of that data, which could also impact on the valuation of the provision.

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

Our response

Our Procedures:

- Tested 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.
- Compared the information on historical collection rates as the basis for the current year provision calculation, to the records held in respect of prior years.
- Assessed the appropriateness of method used for the impairment computation.
- Evaluated the adequacy of the provisions against trade receivables by critically assessing the assumptions made in determining the level of provision for each category of aged debts, with reference to the profile of aged debts at the balance sheet date compared with equivalent data observed subsequent to and at prior year-ends along with an assessment of the level of post balance sheet cash receipts.
- Tested the relevance and reliability of underlying data used for the computation. In addition, we assessed whether data from HiAffinity was accurately and completely migrated to the new billing system – Gentrack. Our testing included attribute testing (on relevant data elements such as invoice date) and reconciliation of data from both billing systems.
- Performed sensitivity analysis and challenged management in respect of the forecast collection rate by increasing and decreasing it based on our judgement and assessing the impact on the provision.
- Assessed the disclosure of sensitivities by the members, and description of the provision in the financial statements.

Key:
Prior year | Current year

Audit risks (cont.)

4 Impairment of trade receivables (valuation) (SW & SWBS) - Valuation

Significant risk due to judgmental nature of impairment provision calculation

Cautious | Neutral | Optimistic

Significant audit risk

- Inappropriate expected credit loss (ECL) is estimated for trade receivables due to: un-reliable data and inappropriate assumptions)
- 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.

Key:
Prior year | Current year

Our findings

Household bad debt provision (SW)

- We have tested the design and implementation of the monthly impairment provision for trade receivables. The design and implementation of the control is effective.
- Management use the forecast collection rate to calculate the impairment for household bad debt. We assessed this as being appropriate.
- The data used for the impairment computation is assessed as reliable and relevant.
- Total amounts billed and collected in respect of the 2022/23 year as used in the bad debt provision calculation were agreed to confirmations received from individual calculations.
- As at 31 March 2023, the average forecast collection rate applied to billings was 96.81% resulting in an in-year charge of £19m and a resulting household bad debt provision of £463m against total debt outstanding of £506m. This is an increase of 0.07% in average forecast collection rate from the prior year. The relevant accounting standard, IFRS 9 and associated guidance expects a weighted average model, considering different collection scenarios, to be used in order to calculate the expected credit loss. Management's model uses historical collection rates and trends which are considered to be the best method to predict future collection.
- We challenged management over the selection of 0.07% increase in average forecast collection rate in the context of the cost-of-living crisis, as well as the lack of alternative scenarios modelled by Scottish Water. On consideration of management's responses and rationale, we note that the first-year collections fell in 2020/21 due to the impacts of Covid-19 however they have subsequently recovered such that 2022/23 has seen the highest first-year collection rate since 2017/18 and it is equivalent to, or higher, than any other year going back to 1996/97. This is mostly due to the robust process put in place by the Councils for debt recovery and the Scottish Government 'Cost of Living Allowance' support to councils in 2022/23.

Audit risks (cont.)

4 Impairment of trade receivables (valuation) (SW & SWBS) - Valuation

Significant risk due to judgmental nature of impairment provision calculation

Cautious | Neutral | Optimistic

Significant audit risk

- Inappropriate expected credit loss (ECL) is estimated for trade receivables due to: un-reliable data and inappropriate assumptions)
- 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.

Our findings

Household bad debt provision (SW)

- We have also performed a reverse stress-test over the forecast collection rate and note that for the bad debt provision to be materially misstated the rate would have to experience a year-on-year change in average collection rate above 0.07%. A year-on-year change of 0.07% in average collection rate has only been experienced between 2019/20 and 2020/21 when Covid-19 caused a decline in 2020/21 first-year collections. No larger change has been seen between any of the last 15 years therefore we do not consider this change in collection rate to represent a reasonably possible change in the average collection rate from that selected by management.
- We challenged management to consider, under IFRS 9, the impact of increased unemployment and financial hardship on collection rates as alternative scenarios. We note that changes to unemployment rates or in household disposable incomes do not necessarily have a direct material impact on collection rates. The historical collection rates, utilised in management's model, have seen a long-term trend of collection rates improving, despite short-term decline over the last few years.
- We are satisfied with the approach adopted by management in arriving at the household bad debt provision for the current year.

Key:
Prior year | Current year

Audit risks (cont.)

4 Impairment of trade receivables (valuation) (SW & SWBS) - Valuation

Significant risk due to judgmental nature of impairment provision calculation

Cautious | Neutral | Optimistic

Significant audit risk

Scottish Water Business Stream

- The bad debt provision for SWBS is highly judgemental in nature and there are a number of assumptions included in the calculation. The most sensitive of these assumptions is the overall forecast collection rate based on historical data.
- There is therefore an inherent risk of error such that inappropriate assumptions are made to inform the valuation of the provision.
- The data relied upon is voluminous and was subject to migration to a new billing system in February 2023. Data migration increases the risk around the completeness and accuracy of that data, which could also impact on the valuation of the provision.

Our findings

- We have tested the design and implementation of monthly impairment provision for trade receivables. The design and implementation of the control is effective.
- Management use the provision matrix to calculate the impairment calculation. We assessed this as being appropriate.
- The data used for the impairment computation is assessed as reliable and relevant.
- We completed our review of management assumptions and noted the following:
- Our audit testing concluded that management were optimistic in their judgement over the loss rate, however overall the judgement was appropriate and we did not identify any material differences to the balance included in the financial statements.
- A control deficiency was identified ; management did not initially have reliable and supportable evidence for loss rates used. We noted that management used theoretical loss rate which was not based on historical trend and it was not adjusted for forward looking information. (refer to page 36).

Key:
Prior year   Current year

Audit risks (cont.)

5 Pension Liability (SW & SWBS) - Valuation

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

Cautious | Neutral | Optimistic

Significant audit risk

The Risk:

Scottish Water – Net recognised surplus as at 31 March 2023 is £24.6 million (2022: Deficit of £42.9 million)

Scottish Water Business Stream – Net recognised surplus as at 31 March 2023 is £2.5 million (2022: Deficit of £8.9 million)

Subjective valuation

A small change in the assumptions used to value the entity's defined benefit obligation, in particular those relating to discount rate, CPI inflation and mortality assumptions can have a significant impact on the valuation of the defined benefit obligation.

Employees participate in three local government defined benefit pension schemes; North East Scotland pension fund, the Lothian pension fund and the Strathclyde pension fund.

Our response

Our Procedures:

Control design

- Testing the design and operating effectiveness of controls over key assumptions used to calculate the pension obligation at year end.

Benchmarking assumptions

- Challenging, with the support of our own actuarial specialists, the key assumptions applied, being the discount rate, CPI inflation rate and mortality/life expectancy to our independently compiled expected ranges based on market observable indices and our market experience.
- Challenging the rate of increase in pensionable salaries assumption, by comparing it to other evidence such as the regulatory delivery plan and our understanding of Scottish Government expectations.
- Challenging, with the support of our own actuarial specialists, the calculation of asset restriction for Lothian or North-East Scotland Funds and the partial recognition of surplus for Strathclyde Fund in accordance with IRFIC 14.

Assessing transparency

- Considering the adequacy of the disclosures in respect of the sensitivity of the deficit to these assumptions.

Key:
Prior year Current year

Audit risks (cont.)

5 Pension Liability (SW & SWBS) - Valuation

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

Cautious | Neutral | Optimistic

Significant audit risk

A small change in the assumptions used to value the entity's defined benefit obligation, in particular those relating to discount rate, CPI inflation and mortality assumptions can have a significant impact on the valuation of the defined benefit obligation.

Employees participate in three local government defined benefit pension schemes; North East Scotland pension fund, the Lothian pension fund and the Strathclyde pension fund.

Below is a summary of the pension asset restriction with further detail in the appendix to this document:

Summary of Net recognised sur 6000000000000000000000***plus	Scottish Water	SWBS
	---£ in m---	
Gross surplus as at 31 March 2023	580.0	15.7
Adjustment in respect of asset restriction	(555.4)	(13.2)
Net recognised surplus as at 31 March 2023	24.6	2.5

Key:
Prior year Current year

Our findings

Subjective valuation

- We have completed benchmarking analysis which is set out at appendix one; and
- The overall assumptions applied by management for both Scottish Water and Scottish Water Business Stream are considered to be balanced relative to our central rates and within our acceptable range.

Surplus recognition

- We have assessed the methodology, data and assumptions used in the valuation of the defined benefit obligation and the resulting surplus. Based on the procedures performed , we are in agreement with the partial recognition of the proposed surplus in relation to Strathclyde Pension Fund (SPF) of £24.6m and £2.5m for Scottish Water and Scottish Water Business Stream respectively. We have also challenged and obtained evidence to support the non-recognisable surplus for Lothian Pension Fund (LPF) or North-East Scotland Pension Fund (NESPF).

Pension assets

- We have reviewed the gross pension assets for consistency, confirmed the share of scheme assets for the last three years to current year and compared employer's assets to the total value of the pension fund to check consistency with the expectation of percentage share. The return on pension assets for the last quarter to 31 March 2023 is based on estimated returns as the information on actual return is available towards the end of May 2023.
- The Actual return on plan assets are outstanding and once obtained, they will be compared against the estimated returns to assess any material impact.

Audit risks (cont.)

5 Pension Liability (SW & SWBS) - Valuation

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

Cautious | Neutral | Optimistic

Significant audit risk

A small change in the assumptions used to value the entity's defined benefit obligation, in particular those relating to discount rate, CPI inflation and mortality assumptions can have a significant impact on the valuation of the defined benefit obligation.

Employees participate in three local government defined benefit pension schemes; North East Scotland pension fund, the Lothian pension fund and the Strathclyde pension fund.

Below is a summary of the pension asset restriction with further detail in the appendix to this document:

Summary of Net recognised surplus	Scottish Water	SWBS
	---£ in m---	
Gross surplus as at 31 March 2023	580.0	15.7
Adjustment in respect of asset restriction	(555.4)	(13.2)
Net recognised surplus as at 31 March 2023	24.6	2.5

Our findings

Other considerations

- We have identified a control deficiency in relation to management's review of actuarial assumptions – see page 36.
- On review of the financial statements of SWBS, we noted that the financial statements were missing certain disclosures that were required by IAS 19.
- For SW, we identified one corrected audit misstatement. The misstatement related to the underpayment of funded benefits paid by the employer to the pensioners and dependants. The amount as per IAS 19 report for the benefits paid was £58,659,000 and as per the confirmation from administrators was £57,607,471. KPMG identified the difference of £ 1,051,529 and the management has passed the adjustment entry of £1,027,000 with the remaining balance considered trifling. Refer to page 35.

Key:
Prior year Current year

Audit risks (cont.)

6 Going Concern (SW & SWBS)

Risk relating to disclosures related to going concern including the judgement of whether there is material uncertainty

Other audit risk

The risk:

- Management's assessment of the group's ability to continue as a going concern involves significant judgment with respect to it being based on an evaluation of the inherent risks to Scottish Water's business model, as well as that of its subsidiary entities, and how those risks might affect its financial resources or ability to continue operations over a period of at least 12 months from the date of approval of these financial statements.
- Disclosures in the financial statement and the annual report are not adequate with regard to the effect of identified risks to the entity's financial position, performance, business model and strategy.

Business risks related to audit risks include:

- Due to the current economic uncertainty, increased cost of living and market volatility, the ability to accurately forecast is difficult and involves estimates and judgements thus impacting an assessment on going concern.

Our response

Our Procedures:

- Evaluated how management's risk assessment process identifies business risks relating to events and conditions that may cast significant doubt on the group's ability to continue as a going concern.
- Evaluated the models management uses in its assessment, including use of the work of management's specialists, and evaluated how the information system captures events and conditions that may cast significant doubt on ability to continue as a going concern.
- Evaluated whether management's assessment failed to identify events or conditions that may cast significant doubt on going concern and whether the method used by management is appropriate.
- Evaluated whether sufficient and appropriate audit evidence was been obtained to conclude whether a material uncertainty exists and the appropriateness of management's use (or otherwise) of the going concern basis of accounting.
- Evaluated whether there is adequate support for the assumptions underlying management's assessment, whether they are realistic and achievable and consistent with the external and/or internal environment and other matters identified in the audit.

Audit risks (cont.)

6 Going Concern (SW & SWBS)

Risk relating to disclosures related to going concern including the judgement of whether there is material uncertainty

Other audit risk

- Management's assessment of the group's ability to continue as a going concern involves significant judgment with respect to it being based on an evaluation of the inherent risks to Scottish Water's business model, as well as that of its subsidiary entities, and how those risks might affect its financial resources or ability to continue operations over a period of at least 12 months from the date of approval of these financial statements.
- Disclosures in the financial statement and the annual report are not adequate with regard to the effect of identified risks to the entity's financial position, performance, business model and strategy.

Our findings

- Management's risk assessment process identifies business risks relating to events and conditions that may cast doubt on the ability to continue as a going concern.
- We have not identified any events and conditions that may cast doubt on the ability of SW Group and SWBS to continue as a going concern.
- We have assessed managements budget and forecast, including cash flow forecasts, and the use of going concern remains appropriate.
- Adequate disclosures were made in the financial statements.

Audit risks (cont.)

7 Impairment of Investment in Subsidiaries (SW) - Valuation

The risk that investments should be impaired

Other audit risk

The risk:

- Inflationary pressures and wider economic uncertainty trigger the risk of impairment in subsidiaries in the separate financial statements of Scottish Water as at 31 March 2023, with a higher risk in relation to the investment of Scottish Water Business Stream Holdings in Scottish Water Business Stream and the investment in Scottish Water Horizons Limited.

Business risks related to audit risks include:

- The uncertain economic environment, inflationary pressures and ever increasing costs increases the risk of error in forecasting accurately, thus impacting impairment assessments for investment in subsidiary entities.

Our response

Our Procedures:

- From 1 October 2022 the activities of the Aberdeen Environmental Services Limited (AES) were absorbed into the regulated activities of Scottish Water. AES ceased trading from that date. The activities for Scottish Water Services (Grampian) were also absorbed into the trading activities of Scottish Water from 1 October 2022. This restructure impacts the investments held by Scottish Water. The journals relating to the restructure, were therefore audited, including disclosure relating thereto in the annual report;
- We compared the carrying amount of investment in subsidiaries with the relevant subsidiaries' net assets to identify whether their net assets, being an approximation of their minimum recoverable amount, were in excess of their carrying amount;
- Further considered the carrying amount of the investment in trading subsidiary entities with the expected value of the business based on a discounted cash flow basis; and
- Challenged management, where appropriate, on the reasonableness of assumptions used in their discounted cash flow workings.

Audit risks (cont.)

7 Impairment of Investment in Subsidiaries (SW) - Valuation

The risk that investments should be impaired

Other audit risk

- Inflationary pressures and wider economic uncertainty trigger the risk of impairment in subsidiaries in the separate financial statements of Scottish Water as at 31 March 2023, with a higher risk in relation to the investment of Scottish Water Business Stream Holdings in Scottish Water Business Stream and the investment in Scottish Water Horizons Limited.

Our findings

- Through our audit work, we have not identified any indicators of impairment of investments in subsidiaries.
- For the remaining subsidiary entities being: Scottish Water Horizons Holdings Limited, Scottish Water Business Stream Holdings Limited, Scottish water Horizons Limited and SW Services (Grampian) Limited, there have been no indicators of the investments in these entities being impaired based on our initial inquiries with management and limited planning procedures performed. The audits of these entities will take place during June/July 2023.

Wider scope

We have not identified any financial statement significant risks in relation to wider scope. The key aspects of Scottish Water's arrangements which we considered in respect of wider scope responsibilities have not changed from those set out in the audit strategy on 28 March 2023 as we had considered Audit Scotland's 2022-23 guidance on planning the audit.

Scottish Water

Financial sustainability

Management and those charged with governance have completed significant work in respect of medium and longer term financial planning; primarily through SR 21 planning process in respect of the period to 2027.

COVID-19 and the resultant economic impact is a unique challenge in the face of which management continue to monitor the Group's financial sustainability and the different areas affected by it, including funding needs and the ability of the various Group entities to continue as a going concern and the impact on the longer term financial requirements and sustainability. This requires assessment of the business impact, environmental changes, legislative requirements and liaison with various regulators and the Scottish Government.

Management continue to monitor the impact of the current uncertain economic environment, in particular the impact of inflation on the cost base and with respect to customer charges.

Financial management

We consider that Scottish Water's finance team is made up of an appropriate mix of skills and resources.

We reiterate our consideration that Scottish Water's finance team has the appropriate skilled resources. It has also demonstrated a good awareness of succession planning.

Implementation of IFRS 16 *Leases* has been delayed until 2025. Scottish Water's preparation for the implementation is well underway.

The main area that requires government funding through borrowings is capital investment which is closely monitored and managed by Scottish Water. Internal controls in that area, including in relation to fraud risk surrounding procurement of assets, are well developed and were last subject to internal audit review during the current year with no major findings noted.

Vision, leadership and governance

We consider the governance framework to be appropriate and that the governance statement made in the Annual Report is in accordance with guidance. Scottish Water voluntarily follows some aspects of the UK Corporate Governance Code. There are appropriate risk management and monitoring arrangements, incorporating a good level of oversight and consideration of risk appetite. There is transparency in the reporting of principal risks and uncertainties in the annual report.

The internal audit team has an annual programme of work which is carried out. No significant findings were noted during the course of their work.

Use of resources to improve outcomes

Scottish Water is subject to water quality and economic regulation which supports use of resources to improve outcomes. A corporate approach to robust capital project planning effectively helps to reduce inefficiency and overruns. Scottish Water's drinking water quality continued to remain very high during the 2023 year at 99.92%.

Engagement with stakeholders supports their efficient use of resources including water and wastewater services.

Performance across a range of non-financial measures continues to improve.

Wider scope

Financial Sustainability

Financial sustainability looks forward to the medium and longer term to consider whether the body is planning effectively to continue to deliver its services or the way in which they should be delivered.

Scottish Water is regarded as a public sector organization of trading nature. It borrows from the Government to deliver essential services mainly to the Scottish community. Considering financial sustainability of Scottish Water we performed the following work:

- Reviewing the financial position as at 31 March 2023 and future budgets and forecasts. Scottish Water Company continues to outperform in respect of its regulatory activities with the actual cash position of £390.3 million being within the forecasted range balances as at 31 March 2023; and
- Reviewing financial forecasting, financial strategies and key risks over financial sustainability. In 2014, the Water Industry Commission for Scotland set out the six year regulatory plan price caps in respect of the household water and waste water charges which can be levied. The Commission released the Final Determination in December 2020 as part of its strategic review of charges for the years 2021-27 which restricts Scottish Water's ability to increase income through charging (except through increases in the number of households). The most recent modelling update includes a comprehensive review of planned income and expenditure in the medium-term and is summarised opposite.

Modelling for the 2027/2208 regulatory period

The WICS' Final Determination / Strategic Review of Charges 2021-27 was issued in December 2020 with commitments to Scottish Water and its financial sustainability for the long-term.

The budget for 2023/24, which was approved by the Board in February 2023, has Tier 1 costs £16m below the Final Determination level (updated for inflation), and cash levels at 31 March 2024 at £275m within a target range of £200m to £335m.

The modelling for the 2021-27 regulatory period, underpinned by the letter from Scottish Ministers (dated 21 December 2022) on charge levels and borrowing for the remaining 4 years of the regulatory period, is that Scottish Water will be able to fund £4.4bn (in 2017/18 prices) of investment over the 2021-27 regulatory period. While this is £0.5bn lower than the amount allowed for in the Final Determination it is still 25% more than was financed for the in the 2015-21 regulatory period.

The cash balances for Scottish Water (regulated business) at March 2024 are forecast to be £288m.

Conclusion: Significant work has been completed by management and those charged with governance in respect of medium and longer term financial planning via financial modelling.. These plans consider both revenue and the significant capital investment program.

Consideration of underlying assumptions and sensitivity analysis supplements this work.

Wider scope (Cont.)

Financial Management

Financial management is concerned with financial capacity, sound budgetary processes and whether the control environment and internal controls are operating effectively.

Our conclusion is derived from the following audit tests, carried out to determine the effectiveness of the financial management arrangements. These included:

- **Assessing the budget setting and monitoring processes:** The budget setting and monitoring process demonstrates strong financial management in the short, medium and longer term. The process for preparation is clearly set out in a budget guidance note for staff. Revenue and capital monitoring reports receive appropriate review by committee. The approved budget is set out together with a reconciliation to the final determination, summarising planned outperformance and non-regulated activities.
- **Consideration of the finance function and financial capacity within Scottish Water:** The accountable officer is the CEO. Key members of the finance function are suitably experienced and qualified. The finance function's capacity is considered to be appropriate and activity is appropriately delegated to operational areas. There is a clear succession plan in place.

Conclusion: There is a strong internal control environment and appropriate capacity.

National fraud initiative ('NFI')

The National Fraud Initiative ('NFI') is a data matching exercise which compares electronic data within and between participating bodies in Scotland to prevent and detect fraud. This exercise runs every two years and provides a secure website for bodies and auditors to use for uploading data and monitoring matches.

Conclusion: Scottish Water is appropriately engaged in the NFI process.

Prevention and detection of fraud

No material fraud or other irregularities were identified during the year.

Management's arrangements include policies and codes of conduct, together with declarations of interest and a register of directors interests.

Conclusion: Scottish Water has a sound structure of controls in place to prevent and detect fraud.

Wider scope (Cont.)

Financial Management

Arrangements for maintaining standards of conduct and the prevention and detection of fraud and corruption

Scottish Water has a number of policies in place which are reviewed every 2 years, these are: Anti-Slavery, Code of Ethical Conduct, Whistleblowing and Fraud Management which are also supported by routine mandatory compliance training. The Company further rolls out an annual Policy Awareness Communication plan to ensure its employees are aware of their rights and obligations.

Management and directors are responsible for setting the 'tone at the top' and are responsible for abiding by the code of conduct and disclosing interests which may be of importance, material or otherwise, to their work at Scottish Water.

The Audit and Risk committee receives reports in respect of whistleblowing and fraud, as well as relevant internal audit reports.

We also considered fraud risk relating to procurement which we see is primarily linked to the acquisition of assets. We have performed test of controls in that area.

Conclusion: Based on our work, we are content that Scottish Water has relevant policies and procedures in place to prevent and detect fraud and corruption.

Internal controls

Staff are responsible for designing and implementing appropriate internal control systems to ensure a true and fair view of operations within the annual accounts. Our testing, combined with that of internal audit, of the design and operation of financial controls over significant risk points confirms that controls relating to financial systems and procedures are designed appropriately and operating effectively.

The findings of our controls testing relate only to those matters identified during our normal audit work, in accordance with the Code, and there may still be weaknesses or risks within the control environment which have not been identified through this work.

Conclusion: Based on our work, and that of internal audit, on the design and operation of financial controls over significant risk points we are content that controls relating to financial systems and procedures are designed appropriately and operating effectively.

Wider scope (Cont.)

Vision, leadership and governance

Governance and transparency is concerned with the effectiveness of scrutiny and governance arrangements, leadership and decision making, and transparent reporting of financial and performance information.
In considering governance and transparency we performed the following work:

- Reviewing the organisational structure, reporting lines and level of scrutiny within Scottish Water. There is effective scrutiny, challenge and transparency on decision making through various levels of committee reporting. Discussions and actions are documented in minutes of meetings;
- Reviewing financial and performance reporting within the organisational structure. Reporting is of high quality. Financial reporting includes analysis of revenue and capital. Reports are sufficiently detailed, giving narrative explanations to key movements from budget;
- Reading the annual governance statement; as discussed previously; and
- Consideration of scrutiny over key risks. The business identifies key risks at corporate and functional levels. Risks are evaluated by considering their consequences, in terms of impact and likelihood, against risk appetite for the achievement of service delivery and business objectives. The risk register and risk management processes are reviewed annually by the Board, and twice a year by the Audit and Risk Committee and the Executive Leadership Team.

Scottish Water complies with the UK Corporate Governance Code 2016 in so far as it is relevant and applicable. As a public corporation, the FCA listing rules do not apply and an Annual Consultative Meeting is held in place of an Annual General Meeting. Further, no Senior Independent Director has been appointed as management consider other arrangements are in place to consult with stakeholders.

Section 172 statement

Scottish Water has also considered its duties under Section 172 of the Companies Act 2006 (Strategic Report and Directors' Report) Regulations 2013 as well as the 'Guidance on the Strategic Report' issued by the Financial Reporting Council and the UK Corporate Governance Code 2016.

Gender pay gap

Gender pay gap legislation applies for the UK private sector companies and requires pay comparisons be made between the contractual pay of men and women including base salary, paid leave, pay allowances, shift pay and on-call and standby payments. Although Scottish Water is a public corporation, it has adopted the legislation for transparency and therefore disclose a gender pay gap in line with the private sector calculation but using the two-year frequency of Public Sector Equality Duties (PSED) reporting.

Internal audit

Internal audit is conducted by an in-house team. Extensive reviews are undertaken and reported throughout the year on a range of financial and non-financial topics. The breadth and depth of reviews is good.

Conclusion: We consider the governance framework to be appropriate and that the governance statement is in accordance with guidance and reflects our understanding of the organisation. We are also content that the internal audit function is operating as appropriate.

Wider scope (Cont.)

Use of resources to improve outcomes

Use of resources to improve outcomes is concerned with using resources effectively and continually improving services.

Scottish Water is a member of the Scottish Government's Suppliers' Charter. The Charter details the Policies and Procedures promoted by the Public Procurement Reform Programme with respect to supporting all current and potential Suppliers.

A key way in which resources are used to improve outcomes is through the effectiveness of procurement. Scottish Water incurs significant annual capital expenditure related to the investment program.

We considered fraud risk around procurement and tested a range of controls around the process in respect of new capital project assessment from the approvals process through to initiation, monitoring and payment, including performing test of details and manual journals.

Key performance indicators include a variety of measures related to use of resources, through effective improvement in customer service and water quality.

Outperformance of the final determination targets demonstrates a commitment to improving financial performance through efficient working. Scottish Water is subject to scrutiny under Scottish Government's Delivery Assurance Group, which was established to monitor the delivery of Ministers Objectives for each regulatory period.

The group is chaired by the Scottish Government and includes Scottish Water's main regulators: Water Industry Commission for Scotland (WICS), Drinking Water Quality Regulator (DWQR), Scottish Environmental Protection Agency (SEPA) and Consumer Scotland. The Delivery Assurance Group reports quarterly on the delivery of Ministerial Objectives and each of the regulators produce regular reports on Scottish Water's performance and on individual matters of interest.

Monitoring of KPIs against targets supports improving performance.

Conclusion: Through oversight by and reporting to various regulators we consider use of resource to improve outcomes to be embedded in Scottish Water's operations.

Engagement with stakeholders also supports the efficient use of resources including water and wastewater services.

Key accounting estimates and management judgements– Overview

Our view of management judgement

Our views on management judgments with respect to accounting estimates are based solely on the work performed in the context of our audit of the financial statements as a whole. We express no assurance on individual financial statement captions.

Cautious | Neutral | Optimistic

Asset/liability class	Our view of management judgement (Cautious / Neutral / Optimistic)	Balance (£m)	YoY change (£m)	Our view of disclosure of judgements & estimates (Needs improvement / Neutral / Best practice)	Further comments
Impairment of trade receivables (SW)		466	11.8		The impairment provision for the household bad debt which is based on the forecast collection rate of 96.81% was found to be appropriate.
Impairment of trade receivables (SWBS)		50.1	1.1		We completed an independent calculation of the impairment loss and concluded that management were optimistic in their judgement. For example there was a 5% loss rate for aged debts above 365 for organic customers and 0% loss rate for balances within payment terms, hence assuming that there is no/low probability of default of balances in these categories, where historically management has made write offs in these categories. However, overall the judgement was appropriate and we did not identify any material differences to the balance included in the financial statements. Management should consider the alignment of their current provision matrix with the requirements of IFRS 9
Defined benefit pension		27.1	79		Refer to the next slide for details of key assumptions which reflect an overall "balanced" view.

Defined benefit pension assumptions

Level of prudence compared to KPMG central assumptions

Outside normally acceptable range | *Cautious* | *Balanced* | *Optimistic* | *Outside normally acceptable range*

Acceptable range

Overall assessment of assumptions for audit consideration							Balanced	
Underlying assessment of individual assumptions		**Methodology**	**Consistent methodology to prior year?**	**Compliant methodology with accounting standard?**	**Employer**	**KPMG central**	**Assessment vs KPMG central**	**Key assumptions**
Discount rate		AA yield curve	✓	✓	4.75%	4.70%		✓
CPI inflation		Deduction to inflation curve	✓	✓	2.90%	2.80%		✓
Salary increases		Employer best estimate	✓	✓	In line with CPI (10% for FY24)	In line with long-term remuneration policy		✓
Pension increases		In line with CPI	✓	✓	2.90%	3.05%		
Mortality	Base tables	In line with most recent Fund valuation	✓	✓	LPF / SPF: Fund-specific Club Vita curves NESPF: S3PA mortality tables with category-specific weightings	In line with Scheme best-estimate. COVID-19 adjustment with rationale		✓
	Future improvements	In line with most recent Fund valuation		✓	CMI 2021 projections model, 1.50% long-term trend rate and default smoothing, 2020/2021 weight parameters and initial addition of 0.25%	CMI 2021,1.25% long-term trend rate and default other parameters. COVID-19 adjustment with rationale		✓
Other demographics		In line with most recent Fund valuation	✓	✓	In line with the approach taken by each Fund at the latest triennial Valuation	In line with Scheme experience		

Uncorrected audit misstatements

	Account	Account name	Dr(£)	Cr(£)
	8409	Accrual for expenditure	£1,232k	
	3049-3263	Contractor expenses		-£1,232k
Scottish Water: Contractor operating expenditure overstatement (extrapolated misstatement from one factual error of £4.7k – refer below)				
	7864	Revenue bank account	£2,301k	-
	8803	Refund account	-	£2,301k
Business Stream: Reclassification of refunds (i.e. stale cheques and refunds issued in GCW) from cash to liabilities				

As part of the statistical sampling of the sub-contractor expense in the Income Statement expenditure testing, a difference of £4.7K was found on one accounting entry. The difference arose as the accounting entry at the year-end was an accrual and the associated actual amount invoiced post year-end was lower by the above amount. All the other accounting entries tested as part of this statistical sample were found to be accurate. The projected misstatement is the extrapolated difference across the entire subcontractor expense population of £283.7 million. The extrapolated error of £1.228K is not factual.

Uncorrected disclosure misstatements

For SWBS, pensions related disclosures were not in line with the requirements of IAS 19. IAS 19 para 145-147 requires disclosures in relation to duration of scheme, sensitivity for all significant assumptions and expected contribution to plan and others. We noted that these disclosures were missing from the financial statements of SWBS.

Corrected audit misstatements

	Account	Account name	Dr(£)	Cr(£)
	Pension asset	Gross defined benefit plan assets	£1,027k	-
	Pension liability	Gross defined benefit plan liabilities	-	£1,027k
Scottish Water: Correction in defined benefit obligations paid				
	7660	Accrued income	£3,321k	-
	7401	Trade receivables	-	£3,321k
Business Stream: Reversal of wrong customer booking from trade receivables (this is a reclassification adjustment)				

Corrected disclosure misstatements (Scottish Water)

1. Management have updated the PPE accounting policy in relation to the useful economic lives of assets (e.g. specialised operational buildings and structures) to be consistent with the lives of assets held within the fixed asset register.
2. Certain disclosures within the strategic report were updated for consistency to the financial statements section of the annual report.

Other significant matters

Control deficiencies

We obtain an understanding of internal control to design appropriate audit procedures, but not to express an opinion on the effectiveness of the Group's internal control.

We have not identified any significant control deficiencies. Below is the list of control deficiencies identified:

1. No evidence of review of manual journal entries.
2. Management review control of estimates relating to pensions and provisions
3. Insufficient review of consistency of disclosures within the annual report and certain specific pensions disclosures
4. Business Stream – review of provision matrix used for expected credit loss calculation.

ISA 315r

Our planning and strategy document noted that the audit this year would be impacted by ISA315r.

Our IT specific team members performed detailed process walkthroughs to understand the IT systems used by Scottish Water. Enquiries were held to confirm controls in place. A full ITGC (IT General Controls) audit was not performed.

The team found no additional automated controls, thus confirming our understanding of the key processes followed by Scottish Water over the significant risk areas.

Additional testing of underlying information was performed by the audit team to confirm the completeness and accuracy of data elements where reports were relied upon from a system used by Scottish Water.

Other significant matters

Finding	Risk/ Mitigation	Recommendation	Management Response
SW and SWBS: **No enforced segregation of duties of journal entries into the accounting system at point of posting (raised in prior year)** Through our review of the journals process we noted there is no enforced segregation of duties of journal entries at the point of posting into the general ledger. Management do have controls in place around the Financial Reporting process, which mitigate this risk, including monthly review of management accounts, which should identify any journals that have been inappropriately posted, however this is a detective control rather than a preventative control.	**Risk:** There is a risk that erroneous or fraudulent journals are posted undetected.	**Recommendation:** We recommend that all journals require segregation of duties between the preparer and authoriser of each journal prior to that journal being posted to the ledger, and that a trail of audit evidence is maintained.	**Response:** SWBS: Management will look to put an approval process in place however note also that we have significant other controls that would pick this up including review by GL account for month on month variances, reconciliations prepared and approved etc. SW: There is an audit trial for all journals processed and current mitigating controls are considered sufficient to address the risk.
SW and SWBS: **Management Review Controls (raised in prior year)** We have assessed a number of management review controls in significant risk areas and estimates (i.e. review of provisions and pension assumptions). Whilst these controls may be achieving the control objective set by management, due to the way they are performed and/or evidenced, they do not meet the requirements for an effectively designed control as defined by the FRC. This is due to the difficulty in achieving an appropriate level of precision, in particular when considering the size of the balance relative to materiality.	**Risk:** An ineffective MRC could lead to the risk of a material misstatements in the financial statements.	**Recommendation:** Management should consider adopting a policy to standardise the review process and pre-set threshold that are sufficiently precise for these management review controls.	**Response:** The group makes use of actuarial specialists as well as other specialists as and when required and the current processes are considered adequate to address the risk even if the FRS requirements of a MRC are not met.

Other significant matters

Finding	Risk/ Mitigation	Recommendation	Management Response
SW and SWBS: **Insufficient review of financial statement disclosures** On review of the annual report of Scottish Water, we identified some inconsistences between the strategic report disclosures and the notes in the financial statements On review of the financial statements of SWBS, we noted that the financial statements were missing disclosures that were required by IAS 19.	**Risk:** There is a risk that financial statements do not include all required disclosures or there are inconsistencies	**Recommendation:** We recommend that a thorough review of the annual report and accounts are performed so that all required disclosures are included and there is consistency within the other reports and financial accounts.	**Response:** SWBS: Disclosures were consistent with prior years and there were no new standards impacting in the current year. A full review of disclosures will be done in advance of next year end. SW: Enhanced review processes over the annual report will be considered for the future.
SWBS: **Review of provision matrix used for ECL computation** We noted that the provision matrix used for ECL computation was based on a theoretical loss rates that were not adequately supported by historical data and forward looking information.	**Risk:** There is a risk that impairment made for trade receivables could be materially misstated.	**Recommendation:** We noted that the provision matrix used for ECL computation was based on theoretical loss rates that were not adequately supported by historical data and forward looking information. From our challenge of these numbers and our independent assessment, we identified that management were optimistic in their calculation.	**Response:** The historical position on recovery of bad debt has been significantly impacted by the pandemic and regulator restrictions on credit control actions, and therefore can distort the present day picture. In light of this, historical data analysis of payments was limited to the last six months of the financial year. This supported that of the £84m debt balance, £0.7m (0.4%) remained unpaid or unprovided at the year end. Evidence was also provided of further receipts against this balance post year end, thereby further reducing the perceived risk of underprovision. Management are satisfied that the historical analysis supported the basis of provision as at the year end.

Other significant matters related to our audit approach

Impacts of climate risk

As per the 2022/23 audit planning guidance issued by Audit Scotland, auditors of Public bodies are required to provide feedback on the below six questions on climate change to Audit Scotland.

Public bodies have statutory duties to act on climate change, including helping to deliver Scotland's net zero emissions target by 2045. Auditors need to be aware of how audited bodies are planning and responding to climate change. Our audit approach towards climate change will continue to evolve and align with future auditing standards.

As part of our procedures on other information, we have obtained and read your ESG/climate change disclosures included in the annual report.

The six questions to which Audit Scotland requires responses, alongside our responses, are noted in the table below:

Question	KPMG Response
What targets has the body set for reducing emissions in its own organisation or in its local area?	Scottish Water has the ambition to be a Net Zero organisation by 2040, five years ahead of the Scottish Government's national target.
Does the body have a climate change strategy or action plan which sets out how the body intends to achieve its targets?	Scottish Water has produced a Net Zero Emissions Routemap which responds to the Government's plan to be carbon neutral by 2045. The Routemap sets out how the entity will lead the industry to net zero emissions by 2040 and beyond, and make a greater contribution to Scotland's overall emissions ambition. The Routemap focussed on: • Becoming more energy efficient • Embracing low carbon construction • Using lower-carbon energy products • Storing emissions that cannot be avoided • Investing in renewable power technologies.
How does the body monitor and report progress towards meeting its emissions targets internally and publicly?	As part of the quarterly business performance reporting, Scottish Water detail their journey towards Net Zero which includes YTD actual Operational Emissions Benefit (tCO_2e) against annual targeted ranges. These indicators also influence annual out performance rewards staff. Annually, through the Annual Report and Accounts, Scottish Water reports on operational and investment emissions, tracking progress to Net Zero.
Has the body considered the impact of climate change on its financial statements?	Scottish Water have included a section in their Annual Report and Accounts on 'Beyond Net Zero Emissions' which provides Streamlined Energy and Carbon Reporting and Task Force Climate Disclosures. Management have also considered the impact of climate change on different areas of the accounts.

Other significant matters related to our audit approach

Impacts of climate risk (continued)

Question	KPMG Response
What are the areas of the financial statements where climate change has, or is expected to have, a material impact?	Climate change could impact the following areas: • Investments in subsidiaries considering the activities of those subsidiaries. • Property plant and equipment, with the possibility of assets becoming impaired or having reduced useful lives and climate risk factors being considered for all new additions. • Government loans and any climate based considerations attached to those loans. • Underlying pension assets that may be impacted upon by climate related risk factors. • Accounting policy choices. • Going concern based on the investment for new property plant and equipment required and the risk of reputational damage from not meeting the required targets. In auditing the above areas, climate risk has been considered, no additional risks or misstatements have been identified due to climate change.
Does the body include climate change in its narrative reporting which accompanies the financial statements and is it consistent with those financial statements?	Scottish Water have included a section in their Annual Report and Accounts on 'Beyond Net Zero Emissions' which provides Streamlined Energy and Carbon Reporting and Task Force Climate Disclosures. We have not identified inconsistencies between this narrative and the financial statements.

Appendix A

Contents

ISA (UK) 315 Revised: Overview

Summary

ISA (UK) 315 Identifying and assessing the risks of material misstatement incorporates significant changes from the previous version of the ISA.

These have been introduced to achieve a more rigorous risk identification and assessment process and thereby promote more specificity in the response to the identified risks. The revised ISA is effective for periods commencing on or after **15 December 2021**.

The revised standard expands on concepts in the existing standards but also introduces new risk assessment process requirements – the changes had a significant impact on our audit methodology and therefore audit approach.

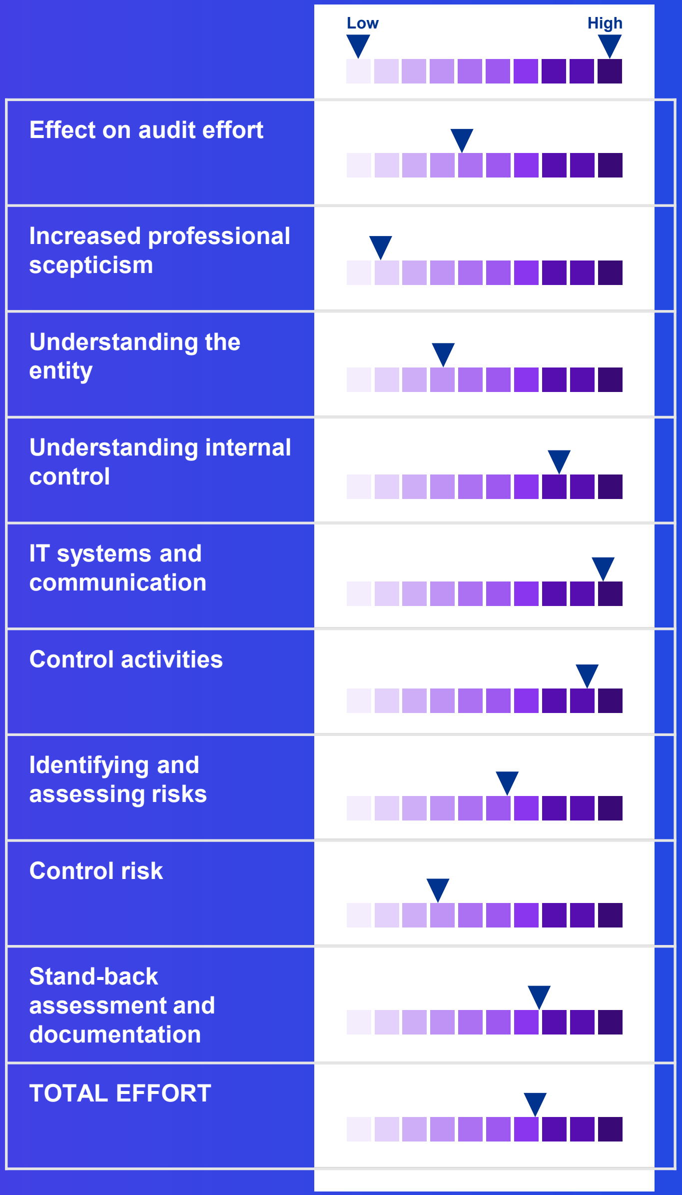
Why have these revisions been made?

With the changes in the environment, including financial reporting frameworks becoming more complex, technology being used to a greater extent and entities (and their governance structures) becoming more complicated, standard setters recognised that audits need to have a more robust and comprehensive risk identification and assessment mechanism.

The changes are aimed at (i) promoting consistency in effective risk identification and assessment, (ii) modernising the standard by increasing the focus on IT, (iii) enhancing the standard's scalability through a principle based approach, and (iv) focusing auditor attention on exercising professional scepticism throughout risk assessment procedures.

What did this mean for our audit?

To meet the requirements of the new standard, auditors have been required to spend an increased amount of time across the risk assessment process, including more detailed consideration of the IT environment. These changes have resulted in significantly increased audit effort levels which in turn, has affected auditor remuneration. This additional effort is a combination of time necessary to perform the enhanced risk assessment procedures and the need to involve more technical specialists (particularly IT Audit professionals) in our audits.



ISA (UK) 240 Revised: Summary of key changes

Low High

Summary and background

ISA (UK) 240 The auditor's responsibilities relating to fraud in an audit of financial statements includes revisions introduced to clarify the auditor's obligations with respect to fraud and enhance the quality of audit work performed in this area. The revised ISA (UK) is effective for periods commencing on or after **15 December 2021**. Unlike ISA (UK) 315 which mirrors updates in the international ISA, the updated UK fraud standard is not based on international changes by the IAASB.

The impact of the revisions to ISA (UK) 240 is less extensive compared to ISA (UK) 315, but nevertheless resulted in changes to our audit approach. The table to the right summarises the main changes and our final assessment of their impact.

What did this mean for our audit?

The changes introduced new requirements which increased audit effort and therefore the audit fee. The additional work is largely the result of investing more time identifying and assessing the risk of fraud during risk assessment and involving specialists to aid with both risk identification and the auditor's response to risk.

Area	Effect on audit effort	Summary of changes and impact
Risk assessment procedures and related activities		1. Increased focus on applying professional scepticism – the key areas affected are: – Areas involving judgement and estimates; – Additional testing of underlying information; – Our inquiries with individuals at the entity were expanded to include, amongst others, those who deal with allegations of fraud 2. We determined whether to involve technical specialists (including forensics) to aid in identifying and responding to risks of material misstatement due to fraud. This resulted in increased involvement of specialists and an expanded scope of work for these specialists, on our audit engagement
Internal discussions and challenge		We complied with enhanced requirements for internal discussions among the audit team to identify and assess the risk of fraud in the audit, including a requirement to determine the need for additional meetings to consider the findings from earlier stages of the audit and their impact on our assessment of the risk of fraud.
Communications with management / TCWG		We have complied with new requirements for communicating matters related to fraud with management and those charged with governance, in addition to the reporting in our audit reports.

Newly effective standards

Standards	Expected impact: High	Expected impact: Moderate	Expected impact: Low	Expected impact: None	Effective for years beginning on or after: 1 Jan 2022	Effective for years beginning on or after: 1 Jan 2023
Interest Rate Benchmark Reform Phase 2 (Amendments to IFRS 9, IAS 39, IFRS 7, IFRS 4 and IFRS 16)				●	✓	
Onerous Contracts – Cost of Fulfilling a Contract (Amendments to IAS 37)			●		✓	
Annual Improvements to IFRS Standards 2018-2020			●		✓	
Property, Plant and Equipment: Proceeds Before Intended Use (Amendments to IAS 16)			●		✓	
Reference to the Conceptual Framework (Amendments to IFRS 3)			●			✓
IFRS 17 Insurance contracts			●			✓
Amendments to IFRS 17 Insurance Contracts: Initial application of IFRS 17 and IFRS 9 – Comparative Information			●			✓
Accounting Policies, Changes in Accounting Estimates and Errors: definition (Amendments to IAS 8)			●			✓
Amendments to IAS 1 Presentation of Financial Statements and IFRS Practice Statement 2 Making Materiality Judgements		●				✓
Deferred Tax Related to Assets and Liabilities Arising from a Single Transaction – Amendments to IAS 12 Income Taxes			●			✓

Required communications

Type	Response
Our draft management representation letter OK	We have not requested any specific representations in addition to those areas normally covered by our standard representation letter for the year ended 31 March 2023
Adjusted audit differences OK	We have identified 2 adjusted audit differences. Refer to page 35.
Unadjusted audit differences OK	We have identified 2 unadjusted audit differences. Refer to page 34.
Related parties OK	There were no significant matters that arose during the audit in connection with the entity's related parties.
Other matters warranting OK	There were no matters to report arising from the audit that, in our professional judgment, are significant to the oversight of the financial reporting process.
Control deficiencies OK	We have identified 4 control deficiencies. Refer to page 36.
Actual or suspected fraud, noncompliance with laws or regulations or illegal acts OK	No actual or suspected fraud involving group or component management, employees with significant roles in group-wide internal control, or where fraud results in a material misstatement in the financial statements identified during the audit.

Type	Response
Significant difficulties OK	No significant difficulties were encountered during the audit.
Modifications to auditor's report OK	None.
Disagreements with management or scope limitations OK	The engagement team had no disagreements with management and no scope limitations were imposed by management during the audit.
Other information OK	Found to be consistent with the financial statements.
Breaches of independence OK	No matters to report. The engagement team and others in the firm, as appropriate, have complied with relevant ethical requirements regarding independence.
Accounting practices OK	No issues identified.
Significant matters discussed or subject to correspondence with management OK	The significant matters arising from the audit were discussed, or subject to correspondence, with management.

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INDEPENDENT AUDITOR'S REPORT

Independent auditor's report to the members of Scottish Water, the Auditor General for Scotland and the Scottish Parliament

Reporting on the audit of the financial statements

Opinion on financial statements

We have audited the financial statements in the annual report and accounts of Scottish Water for the year ended 31 March 2023 under the Water Industry (Scotland) Act 2002. The financial statements comprise the Group and Company Balance Sheets, the Group and Company Income Statements, the Group and Company Statements of Comprehensive Income, the Consolidated and Company Statements of Changes in Equity, the Group and Company Statements of Cash Flow and notes to the financial statements, including significant accounting policies. The financial reporting framework that has been applied in their preparation is applicable law and UK adopted international accounting standards, and, where otherwise appropriate, as interpreted and adapted by the 2022/23 Government Financial Reporting Manual (the 2022/23 FReM).

In our opinion the accompanying financial statements:

- give a true and fair view of the state of the group's and company's affairs as at 31 March 2023 and of the group's and company's surplus for the year then ended;
- have been properly prepared in accordance with UK adopted international accounting standards, and, where otherwise appropriate, as interpreted and adapted by the 2022/23 FReM; and
- have been prepared in accordance with the requirements of the Water Industry (Scotland) Act 2002 and directions made thereunder by the Scottish Ministers.

Basis for opinion

We conducted our audit in accordance with applicable law and International Standards on Auditing (UK) (ISAs (UK)), as required by the **Code of Audit Practice** approved by the Auditor General for Scotland. Our responsibilities under those standards are further described in the auditor's responsibilities for the audit of the financial statements section of our report. We were appointed by the Auditor General on 18 May 2022. Our period of appointment is for five years, covering 2022/23 to 2026/27. Including a previous appointment, the period of total uninterrupted appointment will be 11 years. We are independent of the group and company in accordance with the ethical requirements that are relevant to our audit of the financial statements in the UK including the Financial Reporting Council's Ethical Standard, and we have fulfilled our other ethical responsibilities in accordance with these requirements. Non-audit services prohibited by the Ethical Standard were not provided to the group and company. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for /our opinion.

Conclusion relating to going concern basis of accounting

We have concluded that the use of the going concern basis of accounting in the preparation of the financial statements is appropriate.

Based on the work we have performed, we have not identified any material uncertainties relating to events or conditions that, individually or collectively, may cast significant doubt on the group and company's ability to continue to adopt the going concern basis of accounting for a period of at least twelve months from when the financial statements are authorised for issue.

These conclusions are not intended to, nor do they, provide assurance on the group and company's current or future financial sustainability. However, we report on the company's arrangements for financial sustainability in a separate Annual Audit Report available from the **Audit Scotland website**.

Risks of material misstatement

We report in our separate Annual Audit Report the most significant assessed risks of material misstatement that we identified and our judgements thereon.

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INDEPENDENT AUDITOR'S REPORT **CONTINUED**

Responsibilities of the Accountable Officer and Board Members for the financial statements

As explained more fully in the Members' Responsibilities Statement, the Accountable Officer and Board Members are responsible for the preparation of financial statements that give a true and fair view in accordance with the financial reporting framework, and for such internal control as the Accountable Officer and Board Members determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, the Accountable Officer and Board Members are responsible for assessing the group and company's ability to continue as going concerns, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless there is an intention to discontinue the group and company's operations.

Auditor's responsibilities for the audit of the financial statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs (UK) will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the decisions of users taken on the basis of these financial statements..

Irregularities, including fraud, are instances of non-compliance with laws and regulations. We design procedures in line with our responsibilities outlined above to detect material misstatements in respect of irregularities, including fraud. Procedures include:

- using our understanding of the central government sector to identify that the Water Industry (Scotland) Act 2002 and directions made thereunder by the Scottish Ministers are significant in the context of the group and company;
- inquiring of the Accountable Officer and legal officer as to other laws or regulations that may be expected to have a fundamental effect on the operations of the group and company;
- inquiring of the Accountable Officer and legal officer concerning the company's and group's policies and procedures regarding compliance with the applicable legal and regulatory framework;
- discussions among our audit team on the susceptibility of the financial statements to material misstatement, including how fraud might occur; and
- considering whether the audit team collectively has the appropriate competence and capabilities to identify or recognise non-compliance with laws and regulations.

The extent to which our procedures are capable of detecting irregularities, including fraud, is affected by the inherent difficulty in detecting irregularities, the effectiveness of the company's and group's controls, and the nature, timing and extent of the audit procedures performed.

Irregularities that result from fraud are inherently more difficult to detect than irregularities that result from error as fraud may involve collusion, intentional omissions, misrepresentations, or the override of internal control. The capability of the audit to detect fraud and other irregularities depends on factors such as the skilfulness of the perpetrator, the frequency and extent of manipulation, the degree of collusion involved, the relative size of individual amounts manipulated, and the seniority of those individuals involved.

A further description of the auditor's responsibilities for the audit of the financial statements is located on the Financial Reporting Council's website **www.frc.org.uk/auditorsresponsibilities**. This description forms part of our auditor's report.

Auditor's report

INDEPENDENT AUDITOR'S REPORT **CONTINUED**

Report on regularity of expenditure and income

Opinion on regularity

In our opinion in all material respects the expenditure and income in the financial statements were incurred or applied in accordance with any applicable enactments and guidance issued by the Scottish Ministers.

Responsibilities for regularity

The Board Members are responsible for ensuring the regularity of expenditure and income. In addition to our responsibilities in respect of irregularities explained in the audit of the financial statements section of our report, we are responsible for expressing an opinion on the regularity of expenditure and income in accordance with the Public Finance and Accountability (Scotland) Act 2000.

Report on other requirements

Opinion prescribed by the Auditor General for Scotland on audited part of the Members' Remuneration Report

We have audited the parts of the Members' Remuneration Report described as audited. In our opinion, the audited parts of the Members' Remuneration Report have been properly prepared in accordance with the Water Industry (Scotland) Act 2002 and directions made thereunder by the Scottish Ministers.

Other information

The Accountable Officer and Board Members are responsible for the other information in the annual report and accounts. The other information comprises the Overview, Strategic Report, Corporate Governance Report and the unaudited parts of the Members' Remuneration Report.

Our responsibility is to read all the other information and, in doing so, consider whether the other information is materially inconsistent with the financial statements or our knowledge obtained in the course of the audit or otherwise appears to be materially misstated. If we identify such material inconsistencies or apparent material misstatements, we are required to determine whether this gives rise to a material misstatement in the financial statements themselves. If, based on the work we have performed, we conclude that there is a material misstatement of this other information, we are required to report that fact. We have nothing to report in this regard.

Our opinion on the financial statements does not cover the other information and we do not express any form of assurance conclusion thereon except on the Performance and Prospects sections on pages 21 to 93 within the Strategic Report and the Corporate Governance Report to the extent explicitly stated in the following opinions prescribed by the Auditor General for Scotland.

Opinion prescribed by the Auditor General for Scotland on Performance and Prospects and Corporate Governance Report

In our opinion, based on the work undertaken in the course of the audit,

- the information given in the Performance and Prospects sections on pages 21 to 93 within the Strategic Report for the financial year for which the financial statements are prepared is consistent with the financial statements and that report has been prepared in accordance with the Water Industry (Scotland) Act 2002 and directions made thereunder by the Scottish Ministers; and
- the information given in the Corporate Governance Report for the financial year for which the financial statements are prepared is consistent with the financial statements and that report has been prepared in accordance with the Water Industry (Scotland) Act 2002 and directions made thereunder by the Scottish Ministers.

ANNUAL REPORT & ACCOUNTS 2022/23:
PERFORMANCE AND PROSPECTS

INDEPENDENT AUDITOR'S REPORT **CONTINUED**

Matters on which we are required to report by exception

We are required by the Auditor General for Scotland to report to you if, in our opinion:

- adequate accounting records have not been kept; or
- the financial statements and the audited part of the Members' Remuneration Report are not in agreement with the accounting records; or
- we have not received all the information and explanations we require for our audit.

We have nothing to report in respect of these matters.

Conclusions on wider scope responsibilities

In addition to our responsibilities for the annual report and accounts, our conclusions on the wider scope responsibilities specified in the Code of Audit Practice are set out in our Annual Audit Report.

Use of our report

This report is made solely to the parties to whom it is addressed in accordance with the Public Finance and Accountability (Scotland) Act 2000 and for no other purpose. In accordance with paragraph 108 of the Code of Audit Practice, we do not undertake to have responsibilities to members or officers, in their individual capacities, or to third parties.

Timothy Cutler
for and on behalf of KPMG LLP
KPMG LLP
St Peter's Square
Manchester
M2 3AE

23 June 2023

KPMG

Confirmation of independence

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Audit
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Scottish Water
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KY11 8GG

Our ref SW23

21 June 2023

To the Audit Committee members of Scottish Water

Assessment of our objectivity and independence as auditor of Scottish Water

Professional ethical standards require us to provide to you at the final 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 Standard. As a result we have underlying safeguards in place to maintain independence through:

- Instilling professional values
- Communications
- Internal accountability
- Risk management
- Independent reviews.

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

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

Summary of non-audit services

We confirm that all non-audit services were approved by the audit committee and Audit Scotland.

Facts and matters related to the provision of non-audit services and the safeguards put in place that bear upon our independence and objectivity, are set out in the following table

Analysis of Non-audit services for the year ended 31 March 2023

Disclosure	Description of scope of services	Principal threats to Independence	Safeguards Applied	Basis of fee [ie fixed/time and materials/ contingent]	Value of Services Delivered in the year ended 31 March 2022 £000	Value of Services Committed but not yet delivered £000
Services related to provision of P11D software	P11D Solutions Software is a compliance tool used to ensure employer tax compliance. Under this engagement we will only be providing technical advice on the use of the software and no tax advice will be provided. P11D Solutions tool is provided to the client and is stored on their laptop locally. Therefore no client data is seen or held by KPMG.	n/a	n/a	Fixed fee	2.5	1.0

Summary of fees

We have considered the fees charged by us to the body and its subsidiaries for professional services provided by us during the reporting period.

Total fees (excluding VAT) charged by us for Scottish Water and its subsidiaries for prior years and agreed for the 2023 year can be analysed as follows:

	2023 £000	2022 £000	2021 £000
Total Audit	605.0	339.0	318.1
Total non-audit services	2.5	2.5	2.9
Total Fees	607.5	341.5	321.0

Fee ratio

The ratio of non-audit fees to audit fees for the year was 0.01 : 1

Application of the FRC Ethical Standard 2019

We communicated to you previously the effect of the application of the FRC Ethical Standard 2019. That standard became effective for the first period commencing on or after 15 March 2020, except for the restrictions on non-audit and additional services that became effective immediately at that date, subject to grandfathering provisions.

We confirm that as 21 June 2023 we were not providing any non-audit or additional services that required to be grandfathered.

Independence and objectivity considerations relating to other matters

There are no other matters that, in our professional judgment, bear on our independence which need to be disclosed to the Audit Committee.

Confirmation of audit independence

We confirm that as of the date of this letter, in our professional judgment, KPMG LLP is independent within the meaning of regulatory and professional requirements and the objectivity of the partner and audit staff is not impaired.

This report is intended solely for the information of the Audit Committee/Board of the body and should not be used for any other purposes.

We would be very happy to discuss the matters identified above (or any other matters relating to our objectivity and independence) should you wish to do so.

Yours faithfully

KPMG LLP

Management representation letter

SCOTTISH WATER

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G33 6FB

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E: customer.service@scottishwater.co.uk

KPMG LLP
Saltire Court
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EH1 2EG

31 May 2023

Dear Tim

This representation letter is provided in connection with your audit of the Group and Parent Company financial statements of Scottish Water ("the Company"), for the year ended, 31 March 2023, for the purpose of expressing an opinion:

i. as to whether these financial statements give a true and fair view of the state of the Group's and of the Parent Company's affairs as at 31 March 2023 and of the Group's and Parent Company's profit or loss for the financial year then ended;
ii. whether the financial statements have been properly prepared in accordance with UK adopted international accounting standards, and, where otherwise appropriate, as interpreted and adapted adopted by the 2022-23 Government Financial Reporting Manual ("the 2022/23 FReM"); and
iii. whether the financial statements have been prepared in accordance with the requirements of the Water Industry (Scotland) Act 2002 and directions made thereunder by the Scottish Ministers.

These financial statements comprise the following: the group and company statement of financial position as at 31 March 2023, the related group and company statements of profit or loss and other comprehensive income, the group and company statements of changes in equity, and cash flows for the year then ended and the notes, comprising a summary of significant accounting policies and other explanatory information.

The Board confirms that the representations it makes in this letter are in accordance with the definitions set out in the Appendix to this letter.

The Board confirms that, to the best of its knowledge and belief, having made such inquiries as it considered necessary for the purpose of appropriately informing itself:

Financial statements

1. The Board has fulfilled its responsibilities, as set out in the terms of the requirements of the Water Industry (Scotland) Act 2002 and the Scottish Water Governance Directions 2023, for the preparation of financial statements that:

i. give a true and fair view of the state of the Group's and of the Parent Company's affairs as at the end of its financial year and of the Group's and Parent's profit or loss for that financial year.

ii. have been properly prepared in accordance with UK adopted international accounting standards, and, where otherwise appropriate, as interpreted and adapted adopted by the 2022-23 Government Financial Reporting Manual ("the 2022/23 FReM"); and

iii. have been prepared in accordance with the requirements of the Water Industry (Scotland) Act 2002 and directions made thereunder by the Scottish Ministers.

The financial statements have been prepared on a going concern basis.

2. The methods, the data and the significant assumptions used in making accounting estimates and their related disclosures are appropriate to achieve recognition, measurement or disclosure that is reasonable in the context of the applicable financial reporting framework.

3. All events subsequent to the date of the financial statements and for which IAS 10 *Events after the reporting period* requires adjustment or disclosure have been adjusted or disclosed.

4. The effects of uncorrected misstatements are immaterial, both individually and in aggregate, to the financial statements as a whole. A list of the uncorrected misstatements is attached to this representation letter in Annexure A.

Information provided

5. The Board has provided you with:

. access to all information of which it is aware, that is relevant to the preparation of the financial statements, such as records, documentation and other matters;
i. additional information that you have requested from the Board for the purpose of the audit; and
ii. unrestricted access to persons within the Group and the Company from whom you determined it necessary to obtain audit evidence.

6. All transactions have been recorded in the accounting records and are reflected in the financial statements.

7. The Board confirms the following:

The Board has disclosed to you the results of its assessment of the risk that the financial statements may be materially misstated as a result of fraud.

Included in the Appendix to this letter are the definitions of fraud, including misstatements arising from fraudulent financial reporting and from misappropriation of assets.

Management representation letter

8. The Board has disclosed to you all information in relation to:

a) Fraud or suspected fraud that it is aware of and that affects the Group and the Company and involves:
- management;
- employees who have significant roles in internal control; or
- others where the fraud could have a material effect on the financial statements; and

b) allegations of fraud, or suspected fraud, affecting the Group and the Company's financial statements communicated by employees, former employees, analysts, regulators or others.

In respect of the above, the Board acknowledges its responsibility for such internal control as it determines necessary for the preparation of financial statements that are free from material misstatement, whether due to fraud or error. In particular, the Board acknowledges its responsibility for the design, implementation and maintenance of internal control to prevent and detect fraud and error.

9. The Board has disclosed to you all known instances of non-compliance or suspected non-compliance with laws and regulations whose effects should be considered when preparing the financial statements.

10. The Board has disclosed to you and has appropriately accounted for and/or disclosed in the financial statements, in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, all known actual or possible litigation and claims whose effects should be considered when preparing the financial statements.

11. The Board has disclosed to you the identity of the Group and the Company's related parties and all the related party relationships and transactions of which it is aware. All related party relationships and transactions have been appropriately accounted for and disclosed in accordance with IAS 24 *Related Party Disclosures*.

Included in the Appendix to this letter are the definitions of both a related party and a related party transaction as we understand them and as defined in IAS 24.

12. The Board confirms that:

- The financial statements disclose all of the key risk factors, assumptions made and uncertainties surrounding the Company's and the Group's ability to continue as a going concern as required to provide a true and fair view and to comply with IAS 1 *Presentation of Financial Statements*.
- No material events or conditions exist that may cast significant doubt on the ability of the Company and the Group to continue as a going concern.

13. On the basis of the process established by the Board and having made appropriate enquiries, the Board is satisfied that the actuarial assumptions underlying the valuation of defined benefit obligations are consistent with its knowledge of the business and are in accordance with the requirements of IAS 19 (revised) Employee Benefits.

The Board further confirms that:

- all significant retirement benefits, including any arrangements that are:
  - statutory, contractual or implicit in the employer's actions;
  - arise in the UK and the Republic of Ireland or overseas;
  - funded or unfunded; and
  - approved or unapproved,

  have been identified and properly accounted for; and
- all plan amendments, curtailments and settlements have been identified and properly accounted for.

This letter was tabled and agreed at the meeting of the Board of Directors on 31 May 2023.

Yours faithfully,

Douglas Millican
Chief Executive

SW Internal Commercial

SW Internal Commercial

Management representation letter

SCOTTISH WATER

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EH1 2EG

21 June 2023

Dear Tim,

This letter is provided in connection with your audit of the Group and Parent Company financial statements of Scottish Water ("the Company"), for the year ended 31 March 2023, for the purpose of expressing an opinion:

i. as to whether these financial statements give a true and fair view of the state of the Group's and of the Parent Company's affairs as at 31 March 2023 and of the Group's and Parent Company's profit or loss for the financial year then ended;
ii. whether the financial statements have been properly prepared in accordance with UK adopted international accounting standards, and, where otherwise appropriate, as interpreted and adapted adopted by the 2022-23 Government Financial Reporting Manual ("the 2022/23 FReM"); and
iii. whether the financial statements have been prepared in accordance with the requirements of the Water Industry (Scotland) Act 2002 and directions made thereunder by the Scottish Ministers.

This letter confirms that the contents of the representation letter, signed and dated on the 31 May 2023, remain unchanged and confirms agreement on the amount of the additional unadjusted audit difference as summarised below. The impact from which was found not to be material, but I note that these will be included as unadjusted audit differences in your report to the Auditor General.

The unadjusted audit difference relating to the reclassification of refunds within Business Stream was tabled in the original representation letter, dated and signed on the 31 May 2023, at £1,958,196 but this subsequently increased by £342,643 to £2,300,838 and is summarised below.

Scottish Water Business Stream Limited

Dr Bank	£2,300,839
Cr Credit Note Provision	(£2,300,839)

(Re-classification of refunds)

The additional unadjusted audit differences are as follows:

SW Internal
Personal

Overstatement of subcontractor expense accrual

Scottish Water

Dr Accruals	(factual misstatement)	£4,771
Dr Accruals	(projected misstatement)	£1,227,507
Cr Subcontractor expense	(factual misstatement)	(£4,771)
Cr Subcontractor expense	(projected misstatement)	(£1,227,507)

As part of the statistical sampling of the sub-contractor expense in the Income Statement a difference was found on one accounting entry. The difference arose as the accounting entry at the year-end was an accrual and the associated actual amount invoiced post year-end was £4,771 lower. All the other accounting entries tested as part of this statistical sample were found to be accurate.

The projected misstatement is the extrapolated difference across the entire subcontractor expense population of £283.7 million. Although it is understood the factual misstatement of £4,771 relates to a year-end accrual and thus would impact the last month of expenditure, the sampling applied to expense testing reflects statistical sampling and thus needs to be extrapolated in order to comply with KPMG audit methodology. The extrapolated error is not factual and management's view is that, because both positive and negatives differences arise between accruals (which are accounting estimates) and the amounts finally invoiced, the level of projected misstatement from simply factoring up from one accrual outturn by assuming this applies to all expenditure over the year in this expense category is likely to significantly overstate any projected misstatement.

Yours sincerely,

Brian Strathie
Director of Finance

SW Internal
Personal

KPMG

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

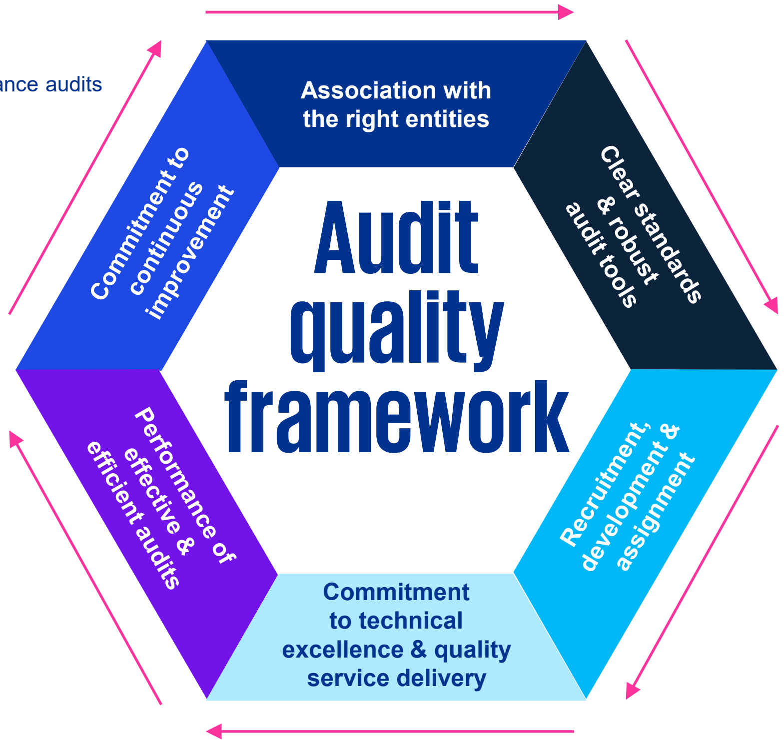
- Comprehensive effective monitoring processes
- Significant investment in technology to achieve consistency and enhance audits
- Obtain feedback from key stakeholders
- Evaluate and appropriately respond to feedback and findings

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 clients 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 employed KPMG specialists and specific team members

Audit quality and the timeline of completion activities

Audit quality is at the core of everything we do

The timeline below is for illustration only and shows the timing of our completion activities around the signing of the audit opinion. 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 aim to complete all audit work no later than 2 days before audit signing.

Key:
- One day activity
- Activity over a period of time
- Year end
- Signing date of the Audit Report

Weeks before signing Audit Opinion	-3 weeks	-2 weeks			-1 week		Completion week			Teams involved in the process
Individual day's activities		Day 1	Day 3	Day 5	Day 1	Day 5	Day 1	Day 3	Day 5	
Arrange Pre-Issuance Review, Long Form Audit Report reviews and Going concern consultation, if applicable										Audit Team
Final audit fieldwork										Audit Team
Review audit field work & provide points to the audit team										2nd Line of Defence
Review significant risk audit areas and challenge work performed										RI and EQCR
Going Concern consultation										DPP Accounting & Reporting
Review of the Pre-Issuance Review and Long Form Audit Report										DPP Accounting & Reporting
Review of the financial statements as part of the Pre-Issuance Review										DPP Accounting & Reporting
Ensure points raised by the Pre-Issuance Review and Long Form Audit Report review are dealt with										RI and EQCR
Review Audit and Risk Committee report and draft accounts										RI and EQCR
Completion panel to discuss the draft Audit and Risk Committee report and draft accounts										Audit Risk Review Panels
KPMG Audit and Risk Committee report issued										Audit Team
Final Audit and Risk Committee										Audit Team
Ensure Pre-Issuance Review, Long Form Audit Report review and Going Concern consultation points have been satisfactorily dealt with										Audit Team & DPP Accounting & Reporting
Final audit field work completed and signed off										Audit Team
Stand-Back review										Audit Team
Ensure all points raised are cleared										RI / EQCR / 2nd Line of Defence

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