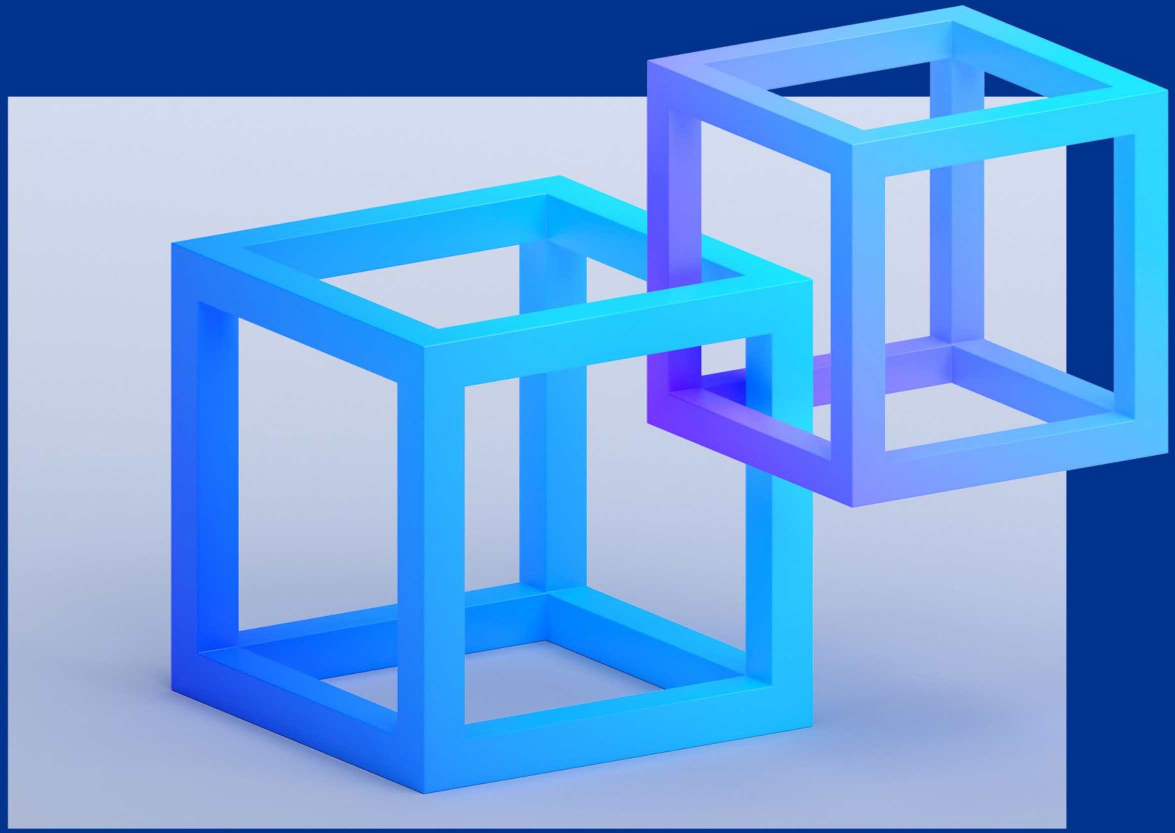
# Scottish Water Group

Report to the Audit and Risk Committee



**Audit plan and strategy for the year ending 31 March 2024**

26 March 2024

# Introduction

## To the Audit and Risk Committee of Scottish Water

We are pleased to have the opportunity to meet with you on 26 March 2024 to discuss our audit of the group financial statements of Scottish Water, as at and for the year ending 31 March 2024.

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

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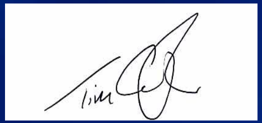
## The engagement team

Tim Cutler, FCA, is the engagement partner on the audit. He has 26 years of public sector industry experience.

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

Other key members of the engagement team include Carol Batchelor (engagement senior manager) and Emmanuel Afran (engagement in-charge) with 23 and 7 years of experience respectively.

Yours sincerely,



**Tim Cutler**

**19 March 2024**

## How we deliver audit quality

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

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

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

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

**Restrictions on distribution**

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

# Overview of planned scope including materiality

**Our materiality levels**

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

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

Materiality is calculated based on total expenditure. For the FY24 audit, the percentage applied to total expenditure to calculate materiality increased from 1.5% to 1.75%. This increase is attributable to the stabilised level of financing and business environment over the past 2 years.

To respond to aggregation risk from individually immaterial misstatements, we design our procedures to detect misstatements at a lower level of materiality £21.8m (75% of materiality) driven by our expectations of normal level of undetected or uncorrected misstatements in the period. We also adjust this level further downwards for items that may be of specific interest to users for qualitative reasons, such as members' remuneration.

**We will report misstatements to the audit committee including:**

- Corrected and uncorrected audit misstatements above £1,455,000.
- Errors and omissions in disclosure (Corrected and uncorrected) and the effect that they, individually in aggregate, may have on our opinion.
- Other misstatements we include due to the nature of the item.
- The cap on "clearly trivial" threshold for accumulating and reporting misstatements of £0.25m has been removed in the Audit Scotland Planning Guidance for 2023/24 audits For the current year audit, the "clearly trivial" threshold has been calculated at 5% of materiality which is in accordance with Auditing Standard, ISA320

**Control environment**

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

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

## Group Materiality

| | Group |
|---|---|
| Materiality for the consolidated financial statements as a whole | **£29.1m**<br>(2023: £23.5m<br>1.5% of total group expenditure) |
| Performance materiality for the consolidated financial statements as a whole | **£21.8m**<br>(2023: £17.6m) |
| Misstatements reported to the audit committee | **£1.455m**<br>(2023: £0.25m) |

**Parent Materiality**

**£21m**

**1.75% of Parent total expenditure**

**(2023: £16.6m)**

# Overview of planned scope including materiality (cont.)

## Timing of our audit and communications

- We will maintain communication led by the engagement partner and senior manager throughout the audit. We set out below the form, timing and general content of our planned communications:
- Kick-off meeting with management on 18 March 2024 where we present our audit plan outlining our audit approach and discuss management's progress in key areas.
- Audit committee meeting on 26 March 2024 where we present our final audit plan.
- Weekly status meetings with management from the week of 15 April to end of May where we communicate progress on the audit plan, any misstatements, control deficiencies and significant issues.
- Closing meeting with management on 30 May 2024 where we discuss the auditor's report, joint report and any outstanding deliverables.
- Audit committee meeting on 13 June 2024 where we communicate audit misstatements and significant control deficiencies.
- We expect to sign the group financial statements on 27 June 2024.

## Scope definition and other reporting

- Audit Scotland has appointed KPMG LLP as auditor of Scottish Water in accordance with the Public Finance and Accountability (Scotland) Act 2000 for the period 2022/23 to 2026/27.
- We will provide an opinion on whether the financial statements:
  - ❖ Give a true and fair view in accordance with the Water Industry (Scotland) Act 2002 and directions made thereunder by the Scottish Ministers of the affairs of Scottish Water as at 31 March 2024 and of the income and expenditure of the group for the year then ended.
  - ❖ Relevant statutes and any other Directions or guidance issued by Scottish Ministers.

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

## Other reporting

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

In addition to responsibilities under our appointment by Audit Scotland, Scottish Water has appointed us to perform a review of the interim financial statements for the six months ended 30 September 2023.

## Using the work of others and areas requiring specialised skill

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

| Specialist | Extent of planned involvement or use of work |
|---|---|
| **IT Audit** | The IT team will assist with procedures involved in gaining an understanding of the IT environment and in-line with revised ISA315 requirements perform testing over relevant automated controls as well as performing testing over the general IT controls. |
| **Actuarial** | The KPMG pension specialist will assist the audit team by performing a review of the pension assumptions and providing a conclusion on whether they are appropriate in relation to KPMG acceptable ranges. This specialist will also review the principles applied for recognizing an asset with respect to any pension surplus. |
| **Taxation** | The KPMG tax specialist will assist the audit team by performing a review of the income tax and deferred tax computation as well as disclosures in the group financial statements. |

# Group involvement – Significant component audits

KPMG perform the audit of Scottish Water as well as its subsidiary entities: Scottish Water Business Stream Limited (SWBS) and Scottish Water Horizons Limited (SWH).

The only significant component to the group audit is SWBS, which comprises approximately 36% of the group's revenue.

For the significant component, we will review the planned procedures in relation to significant risk areas and we will assess the execution of this work.

KPMG will also perform the audit of SWH, however, this is not a significant component to the group.

Scottish Water have taken parent company guarantees for the first time this year (FY2023/24) for:

- Scottish Water Business Stream Holdings Limited (SWBSH),
- Scottish Water Horizons Holdings Limited (SWHH) and
- Scottish Water Services (Grampian) Limited (SWG).

# Significant risks and Other audit risks

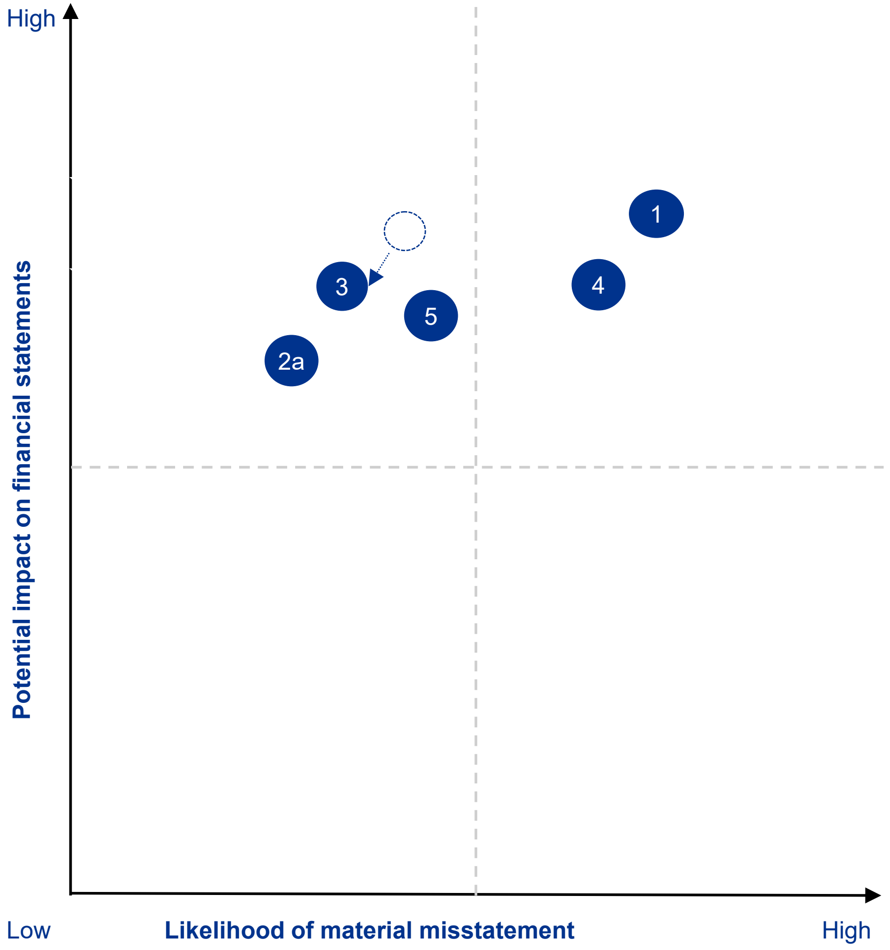
**Our risk assessment draws upon our understanding of the applicable financial reporting framework, historic knowledge of the business, the industry and the wider economic environment in which Scottish Water operates.**

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

Due to the current levels of uncertainty there is an increased likelihood of significant risks emerging throughout the audit cycle that are not identified (or in existence) at the time we planned our audit. Where such items are identified we will amend our audit approach accordingly and communicate this to the Audit Committee.

| Significant risks | |
|---|---|
| **1.** | Capital additions (SW) |
| **2a.** | Management override of controls |
| **3.** | Revenue Recognition (SWBS) |
| **4.** | Bad debt provision (SW & SWBS: fraud risk) |
| **5.** | Defined benefit pension (SW) |

**Key:**
- # Significant financial statement audit risks
- # Other audit risk
- Change compared to prior year
- # New other audit risk



# Audit risks and our audit approach

## 1 Capital Additions (SW only) - Existence and accuracy of amounts capitalised to property, plant and equipment (PPE)

The above risk includes a fraud risk

No change in risk vs prior year

### Significant audit risk

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

- Capital additions are significant, comprising the largest element of Scottish Water's annual expenditure, related to the delivery plan for regulated activities.
- Members are incentivised across a number of financial and other measures including capital spend 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

### Planned 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 the Executive Leadership Team (ELT) 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 the appropriateness of reclassification from assets in the course of construction;
- Reconcile 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;
- Audit of manual journals relating to capital additions which meet our high risk criteria (i.e. capital additions journals with unexpected account pairings); 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 and our audit approach (cont.)

## 2a Management override of controls(a)

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

No change in risk vs prior year

### Significant audit risk

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

- Professional standards require us to communicate the fraud risk from management override of controls as significant.
- Management is in a unique position to perpetrate fraud because of their ability to manipulate accounting records and prepare fraudulent financial statements by overriding controls that otherwise appear to be operating effectively.
- As with prior years, there is no evidence of review of journals prior to them being processed. This increases the risk of management override of controls.

Business risks related to audit risks include:

- Risk of misappropriation of assets and erroneous financial reporting.

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

### Planned response

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

# Audit risks and our audit approach (cont.)

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

Fraud risk related to misstatement of revenues

Decrease in risk vs prior year

### Significant audit risk

**The risk that revenue is recognised for arrangements that do not exist or do not meet the definition of a contract 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.

Business risks related to audit risks include:

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

### Planned response

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

**We rebut the revenue recognition risk in respect of Scottish Water**

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

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

# Audit risks and our audit approach (cont.)

## 4 Bad debt provision (SW & SWBS; fraud risk) – risk that the valuation of the bad debt provision is misstated

Significant risk due the judgemental nature of the bad debt provision calculation (there is a fraud risk linked to SWBS provision for doubtful debts)

No change in risk vs prior year

### Significant audit risk

**The risk that receivables are overstated**

Provision for doubtful debts at 30/09/23:

Scottish Water: £473m

Scottish Water Business Stream: £52m

- 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.

Scottish Water Business Stream

General

- The bad debt provision for SWBS is highly judgemental in nature and there is a fraud risk due to management bonus incentives being driven by profit targets which increase the risk of management bias.
- There is therefore an inherent risk of fraud, such that inappropriate assumptions are made to inform this 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.

### Planned response

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

- Testing the design and implementation of controls over the review and approval of the provision and associated assumptions, by those charged with governance during the year and at the year end.
- Sample testing of the reconciliation of information provided on a monthly basis by local authorities for household bad debt provision in respect of amounts billed and collected. This historical information forms the basis of the forecast collection rate.
- We will agree the total amount billed and collected in respect of 2023-24, as recorded in Scottish Water's records, to confirmations received from individual local authorities.

**Scottish Water Business Stream bad debt provision (risk of fraud and error):**

- For Scottish Water Business Stream, we will evaluate 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.
- We will test the relevance and reliability of underlying data used for the computation.. Our testing will include attribute testing (on relevant data elements such as invoice date) and reconciliation of data from the billing system.

**Planned response for both SW and SWBS:**

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

# Audit risks and our audit approach (cont.)

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

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

No change in risk vs prior year

### Significant audit risk

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

- Small changes in the main assumptions and estimates (i.e. discount rate, inflation rate and mortality rate) used to value the pension obligation would have a significant effect on the net pension liability.
- Employees of Scottish Water participate in the Scottish Local Government Pension Scheme through three funds; North East Scotland pension fund; the Lothian pension fund; and the Strathclyde pension fund.
- There is a triennial valuation impacting the 2023/24 year end. Updated membership data will be taken into account , together with updated "experience" adjustments.
- Recognition of any surplus as an asset requires consideration and application of IFRIC14 requirements.
- Employees of Scottish Water Business Stream participate only in the Strathclyde Pension Fund.

Business risks related to audit risks include:

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

### Planned response

Our audit approach to IAS 19 covering both Scottish Water and Scottish Water Business Stream includes:

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

# Key accounting estimates and management judgements

## Significant estimates and judgements

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

| Estimates and judgements | Balance £m | Further comments |
|---|---|---|
| Impairment of trade receivables (SW) | (466.2) | A key assumption is the forecast collection rate which is based on historical data and current market conditions. A small change in the forecast collection rate will have a significant impact on the provision for doubtful debts. Details of the assumption were clearly disclosed in the prior year accounts, together with the sensitivity of this assumption. |
| Impairment of trade receivables (SWBS) | (50.3) | There is judgement involved in calculating the expected credit loss which is impacted by trading, market conditions and the general economic environment. Management are in the process of aligning their current provision matrix with the requirements of IFRS 9. |
| Defined benefit pension - asset | 2,093.9 | There are judgements and estimation applied to the fair value of plan assets due to current fluctuating market conditions and wider economic uncertainty at a global and local level. Disclosures with respect to plan assets were found to be adequate in the past. |
| Defined benefit pension - liability | (1,153.9) | There are a number of assumptions and estimates that impact the value of the retirement benefit obligation. A small change in these assumptions has a significant impact on the defined benefit pension obligation. These judgements and estimates as well as their sensitivities were appropriately disclosed in the prior year annual report. |
| Depreciation charge | 293.9 | The judgement applied with respect to useful lives of assets is a key assumption and any change would have a significant impact on the depreciation charge. Disclosure of useful lives was clearly described in the prior year annual report. |

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

# Other significant matters related to our audit approach

## Our use of Data and analytics

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

### Risk Assessment

- Account Analysis allows us to compare journal entry postings to our industry expectations. This provides us greater insight into your accounting processes and can highlight unexpected entries or transaction flows.
- Account analysis to identify trends in operation expenditure over the financial year and in comparison to budget. Outliers and exceptions identified will be followed up for substantive testing
- Digital Media Analytics scans newsfeeds, social media and public data to get a real time view of Scottish Water sentiment in the outside world and can monitor how sentiment of specific events is evolving throughout the audit cycle. This analysis can enable us to make better informed challenges of management assumptions.

### Substantive testing

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

### Management override of controls surrounding journal entries

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

## Audit of IT

### Risk Assessment

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

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

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

### Migration of the Billing System – Scottish Water

During our inquiries, it was noted that the Water Utility Billing (WUB) billing system was migrated to Cloud Customer Service (Oracle CCS) in January 2024. This has been considered as part of the wider audit approach. As a result of the migration additional procedures will be performed to gain assurance over the completeness and accuracy of the data migrated. The following procedures will be performed:

- The IT Audit team will evaluate the formality of IT processes for program development across Oracle CCS.
- The Financial Audit team will perform a reconciliation of data from WUB to Oracle CCS to determine whether the data migrated completely and accurately.
- The Financial Audit team will assess the planned audit procedures to determine whether they are sufficiently designed to address risks relating to the data migration.

The IT Audit team is also performing an IT risk assessment (covering the above areas) for Scottish Water Business Stream Limited which is currently ongoing.

### Impacts of climate risk and climate change disclosures

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

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

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

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

### 1. Financial Management

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

**Auditors response:**

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

The audit team will perform inquiries of various levels of management as well as perform system walkthroughs and risk assessment procedures over fraud and the financial reporting process.

### 2. Financial Sustainability

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

**Auditors response:**

To consider whether the body is planning effectively to continue to deliver services into the future.

The audit team will perform detailed assessment over going concern including:

- Inspection of future cashflow forecasts
- Review of assumptions applied to future cashflow forecasts
- Sensitivities of assumptions applied to future cashflow forecast
- Inspect adequacy of disclosures over going concern

### 3. Vision, Leadership and Governance

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

**Auditors response:**

To consider the clarity of plans to implement the vision, strategy and priorities adopted by the leaders of Scottish Water.

The audit team will also consider the effectiveness of governance arrangements for delivery, which includes openness and transparency of decision-making; robustness of scrutiny and shared working arrangements; and reporting of decisions and outcomes, and financial and performance information.

The audit team will perform inquiries of those charged with governance, review board and committee meeting minutes and inspect performance information disclosures in the annual report.

### 4. Use of Resources to Improve Outcomes

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

**Auditors response:**

To consider the clarity of the arrangements in place to ensure that resources are deployed to improve strategic outcomes, meet the needs of service users taking account of equalities, and deliver continuous improvements in priority services.

The audit team will perform inquiries of those charged with governance, review board and committee meeting minutes and inspect performance information disclosures in the annual report.

# Mandatory communications

| Type | Statements |
|---|---|
| **Management's responsibilities (and, where appropriate, those charged with governance)** | Prepare financial statements in accordance with the applicable financial reporting framework that are free from material misstatement, whether due to fraud or error.<br><br>Provide the auditor with access to all information relevant to the preparation of the financial statements, additional information requested and unrestricted access to persons within the entity. |
| **Auditor's responsibilities** | Our engagement letter dated 18 March 2022 communicates our responsibilities to form and express an opinion on the financial statements that have been prepared by management with the oversight of those charged with governance. The audit of the financial statements does not relieve management or those charged with governance of their responsibilities. |
| **Auditor's responsibilities – Fraud** | This report communicates how we plan to identify, assess and obtain sufficient appropriate evidence regarding the risks of material misstatement of the financial statements due to fraud and to implement appropriate responses to fraud or suspected fraud identified during the audit. |
| **Auditor's responsibilities – Other information** | Our engagement letter dated 18 March 2022 communicates our responsibilities with respect to other information in documents containing audited financial statements. We will report to you on material inconsistencies and misstatements in other information. |
| **Independence** | Our independence confirmation on page 17 discloses matters relating to our independence and objectivity including any relationships that may bear on the firm's independence and the integrity and objectivity of the audit engagement partner and audit staff. |

# Appendix

# Confirmation of independence

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

*Assessment of our objectivity and independence as auditor of Scottish Water*

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

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

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

*General procedures to safeguard independence and objectivity*

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

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

The conclusion of the audit engagement partner as to our compliance with the FRC Ethical Standard in relation

to this audit engagement is subject to review by an engagement quality control reviewer, who is a partner not

otherwise involved in your affairs.

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

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

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

during the reporting period.

Total fees (excluding VAT) charged by us for the period ended 31 March 2023 and agreed for the 2024 were as follows:

| | 2024<br>£'000 | 2023<br>£'000 |
|---|---|---|
| Audit fee – Audit Scotland allocation | 376.3 | 355.0 |
| Review fee - Half year | 24.5 | 17.6 |
| Audit fee – other areas of scope | 26.5 | 25.0 |
| Audit fee – subsidiary entities | 216.0 | 135.8 |
| Audit fee – regulatory reporting | 18.5 | 17.0 |
| | 661.8 | 550.4 |
| Non-audit services | 2.5 | 2.5 |
| Total fees | 664.3 | 552.9 |

# KPMG's Audit quality framework

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

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

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

**Commitment to continuous improvement**

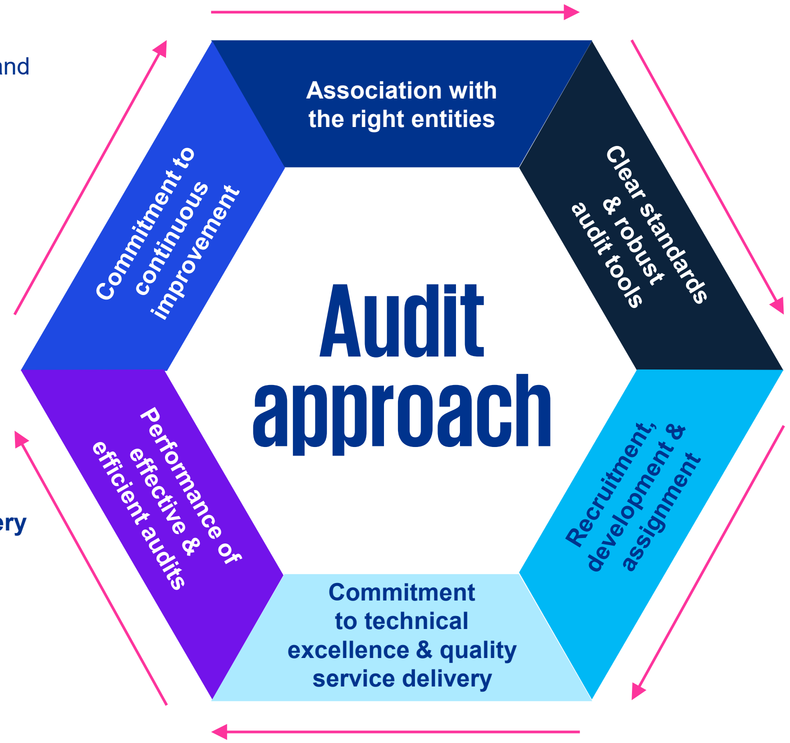
- Comprehensive effective monitoring processes
- Significant investment in technology to achieve consistency and enhance audits
- Obtain feedback from key stakeholders
- Evaluate and appropriately respond to feedback and findings

**Performance of effective & efficient audits**

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

**Commitment to technical excellence & quality service delivery**

- Technical training and support
- Accreditation and licensing
- Access to specialist networks
- Consultation processes
- Business understanding and industry knowledge
- Capacity to deliver valued insights




**Association with the right entities**

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

**Clear standards & robust audit tools**

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

**Recruitment, development & assignment of appropriately qualified personnel**

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

# ISA (UK) 315 Revised: Overview


## Summary

**In the prior period, ISA (UK) 315 Revised "Identifying and assessing the risks of material misstatement" was introduced and incorporated significant changes from the previous version of the ISA.**

These were 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 was effective for periods commencing on or after **15 December 2021**.

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


### What impact did the revision have on audited entities?

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 result in additional audit awareness and therefore clear and impactful communication to those charged with governance in relation to (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.

### Implementing year 1 findings into the subsequent audit plan

Entering the second year of the standard, the auditors will have demonstrated, and communicated their enhanced insight into their understanding of your wider control environment, notably within the area of IT.

In year 2 the audit team will apply their enhanced learning and insight into providing a targeted audit approach reflective of the specific scenarios of each entity's audit.

A key area of focus for the auditor will be understanding how the entity responded to the observations communicated to those charged with governance in the prior period.

Where an entity has responded to those observations a re-evaluation of the control environment will establish if the responses by entity management have been proportionate and successful in their implementation.

Where no response to the observations has been applied by entity, or the auditor deems the remediation has not been effective, the audit team will understand the context and respond with proportionate application of professional scepticism in planning and performance of the subsequent audit procedures.

### What will this mean for our on-going audits?

To meet the on-going requirements of the standard, auditors will each year continue to focus on risk assessment process, including the detailed consideration of the IT environment.

Subsequent year auditor observations on whether entity actions to address any control observations are proportionate and have been successfully implemented will represent an on-going audit deliverable.

Each year the impact of the on-going standard on your audit will be dependent on a combination of prior period observations, changes in the entity control environment and developments during the period. This on-going focus is likely to result in the continuation of enhanced risk assessment procedures and appropriate involvement of technical specialists (particularly IT Audit professionals) in our audits which will, in turn, influence auditor remuneration.

# ISA (UK) 240 Revised: changes embedded in our practices

## Ongoing impact of the revisions to ISA (UK) 240

ISA (UK) 240 (revised May 2021, effective for periods commencing on or after 15 December 2021) The auditor's responsibilities relating to fraud in an audit of financial statements included revisions introduced to clarify the auditor's obligations with respect to fraud and enhance the quality of audit work performed in this area. These changes are embedded into our practices and we will continue to maintain an increased focus on applying professional scepticism in our audit approach and to plan and perform the audit in a manner that is not biased towards obtaining evidence that may be corroborative, or towards excluding evidence that may be contradictory.

We will communicate, unless prohibited by law or regulation, with those charged with governance any matters related to fraud that are, in our judgment, relevant to their responsibilities. In doing so, we will consider the matters, if any, to communicate regarding management's process for identifying and responding to the risks of fraud in the entity and our assessment of the risks of material misstatement due to fraud.

| Area | Our approach following the revisions |
|---|---|
| **Risk assessment procedures and related activities** | 1. Increased focus on applying professional scepticism – the key areas affected are:<br>• the need for auditors not to bias their approach towards obtaining evidence that is corroborative in nature or excluding contradictory evidence,<br>• remaining alert for indications of inauthenticity in documents and records, and<br>• investigating inconsistent or implausible responses to inquiries performed.<br>2. Requirements to perform inquiries with individuals at the entity are expanded to include, amongst others, those who deal with allegations of fraud.<br>3. We will determine whether to involve technical specialists (including forensics) to aid in identifying and responding to risks of material misstatement due to fraud. |
| **Internal discussions and challenge** | We will have internal discussions among the audit team to identify and assess the risk of fraud in the audit, including determining 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. |

# Newly effective standards and relevant IFRIC items

| Standards | Expected impact: High | Expected impact: Moderate | Expected impact: Low | Expected impact: None | Effective for years beginning on or after: 1 Jan 2023 | Effective for years beginning on or after: 1 Jan 2024 |
|---|---|---|---|---|---|---|
| IFRS 17 Insurance Contracts, including amendments Initial Application of IFRS 17 and IFRS 9 – Comparative Information | ● | ● | ● | ● | ✓ | |
| Definition of Accounting Estimates – Amendments to IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors | ● | ● | ● | ● | ✓ | |
| Disclosure Initiative: Accounting Policies – 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 | ● | ● | ● | ● | ✓ | |
| Leases - IFRS 16 | ● | ● | ● | ● | | ✓ |

IFRS 16 is applicable for Scottish Water for FY25 and thus there is a requirement to disclose the estimated impact of the application of IFRS 16 in the FY24 financial statements.

# Subsidiary audit exemption

**The Companies Act allows UK groups that produce consolidated accounts to take advantage of the audit exemption for any UK subsidiaries included within the consolidated accounts provided that the parent company is willing to provide a parent company guarantee.**

## 01

### Which companies can use the subsidiary audit exemption?

UK subsidiaries which are included within UK consolidated accounts can elect to take the audit exemption, provided they do not have listed shares or debt and certain other restrictions. Please see the link below for the full listing of companies unable to take the exemption.

## 02

### What is the impact of taking the audit exemption?

The parent company is guaranteeing the liabilities of the subsidiary that exist as at the balance sheet date for the life of the liability and careful consideration of the risks that this entails needs to be undertaken before giving the guarantee as this increases the risk to the parent company. Intermediate holding companies with no external liabilities or contingent liabilities may be the most suitable to take the exemption.

## 03

### How do we claim the exemption?

The consolidated accounts need to state that subsidiary X is in receipt of a parental guarantee to take advantage of the audit exemption for that year. The ICAEW Technical Release provides details of the forms to submit to Companies House to take the exemption. This process must be repeated for all subsequent years where the company wishes to make use of the exemption.

## 04

### Audit implications

The parent company's going concern evaluation, which its auditors would then need to evaluate, would need to examine the likelihood and impact of the guarantee being called upon to settle the liabilities of the subsidiary receiving the guarantee.

## 05

### Where can I find further guidance?

Further guidance setting out which entities are eligible and the process that needs to be taken to apply the audit exemption can be found at https://www.icaew.com/technical/technical-releases/legal/tech-0620bl-exemption-from-audit-by-parent-guarantee.

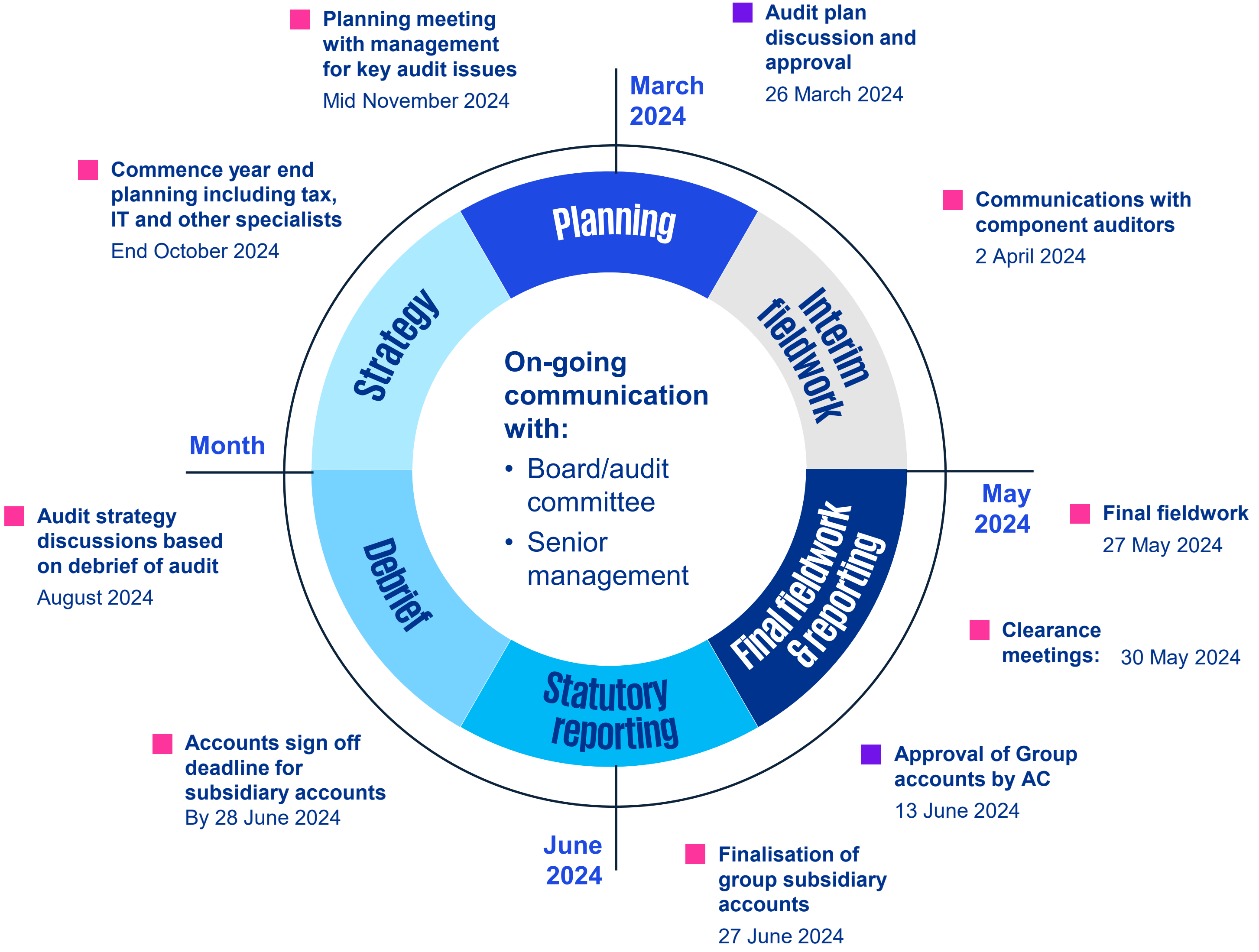
# Audit cycle & timetable

## Our schedule November 2023 – June 2024

Key:

- Timing of AC communications
- Key events

Following our debrief meeting in August 2023, we are have committed to completing our planning and risk assessment procedures earlier and to bring audit work forward, where possible.



KPMG

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

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