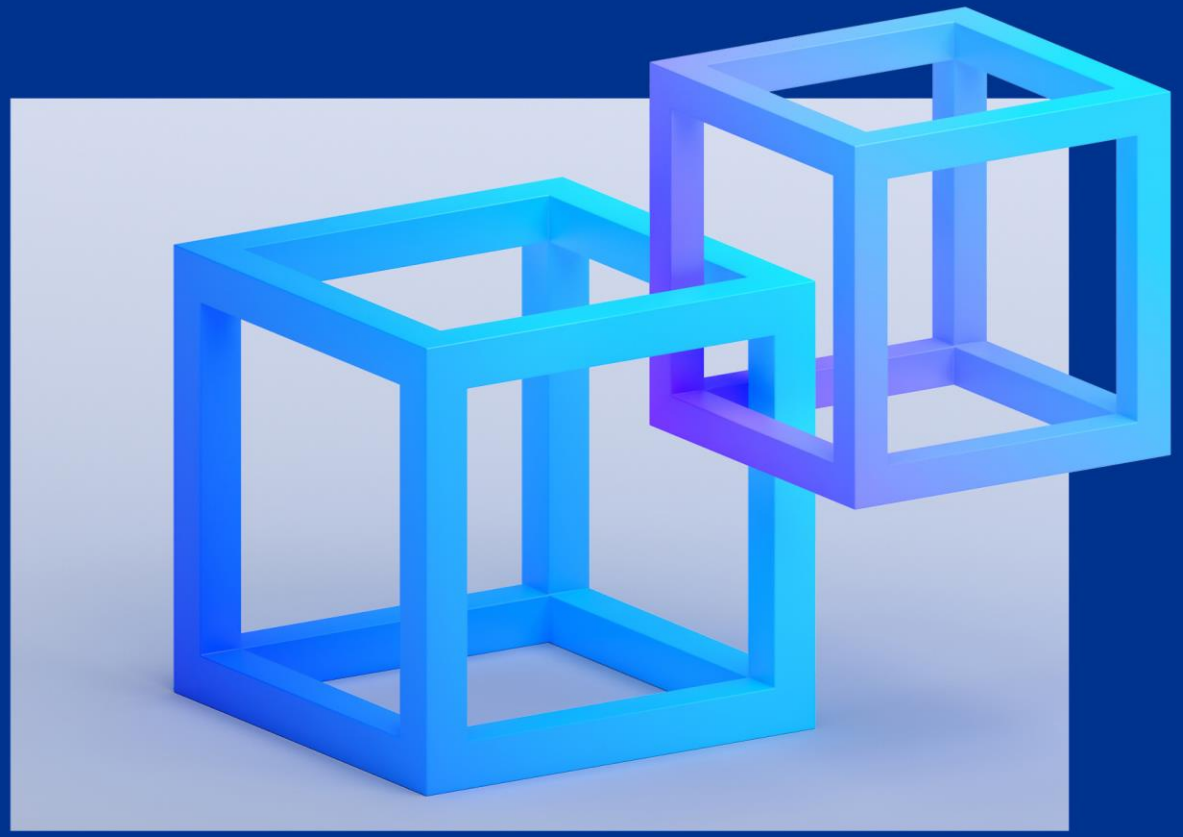
KPMG

Scottish Water Group



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

Annual report for the year ended 31 March 2026

16 July 2026

Introduction

To the Audit and Risk Committee of Scottish Water Group

We were pleased to have the opportunity to meet with you on 9 June 2026 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 2026.

This report should be read in conjunction with our audit plan and strategy report, presented on 24 March 2026.

The engagement team

Our audit is now complete. There have been no significant changes to our audit plan and strategy.

We expect to issue 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

Yours sincerely,

Tim Cutler

16 July 2026

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 management; and,
- All of our related activities are undertaken in an environment of the utmost level of objectivity, independence, ethics and integrity.

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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 International Financial Reporting Standards ('IFRSs') , using the cost model for property, plant and equipment, as directed under the Scottish Water Governance Directions and International Financial Reporting Interpretations Committee (IFRIC) interpretations, and where otherwise appropriate, as interpreted and adapted by the Government Financial Reporting Manual (FReM), as at and for the year ended 31 March 2026.

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.

Limitations on work performed

This Report is separate from our audit opinion and does not provide an additional opinion on the Group's financial statements, nor does it add to or extend or alter our duties and responsibilities as auditors reporting to the Entity's members.

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.

We have not designed or performed procedures outside those required of us as auditors for the purpose of identifying or communicating any of the matters covered by this Report.

The matters reported are based on the knowledge gained as a result of being your auditors. We have not verified the accuracy or completeness of any such information other than in connection with and to the extent required for the purposes of our audit.

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 tim.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 Auditor General and Accountable Officer, Audit Scotland, Fourth Floor, 102 West Port, Edinburgh, EH3 9DN

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Our audit findings

Significant audit risks		Page 5-17
Significant audit risks	**Risk change**	**Our findings**
Capital additions (SW fraud risk)	No change	The results of our testing were satisfactory. We considered the payroll costs capitalised to additions to be acceptable.
Management override of controls	No change	The results of our test were satisfactory. We did not identify any instances of management override of controls.
Revenue recognition (SWBS)	No change	The results of our testing were satisfactory. We considered the amount of revenue recognised to be acceptable
Household bad debt provision (SW)	No change	The results of our testing were satisfactory. We considered the household bad debt provision to be acceptable.
Defined Benefit Pension (SW)	Increase	The results of our testing were satisfactory. We considered the assumptions to be balanced and agreed with the surplus restriction applied.

Key accounting estimates	Page 18
Impairment of trade receivables	Management's judgement considered neutral
Defined benefit pension	Management's judgment considered neutral
Depreciation (useful life)	Management's judgement considered cautious

Uncorrected Audit Misstatements	Page 21
Understatement/ (overstatement)	**£m**
Understatement of P&L for missed employee pension contributions that should be part of PYA	13.0
Reclassification of provision to defined benefit obligation that should be part of PYA	13.0
Balance sheet reclassification between cash and receivables (SWBS)	3.1

Misstatements in respect of Disclosures	Page 22
Misstatement in respect of Disclosures	**Our findings**
Disclosure corrections were made to the final annual report	

Number of Control deficiencies	Page 28-30 and 33-35
Significant control deficiencies	🔴
Other control deficiencies	7
Prior year control deficiencies remediated	6

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Significant risks

We discussed the significant risks which had the greatest impact on our audit with you 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.

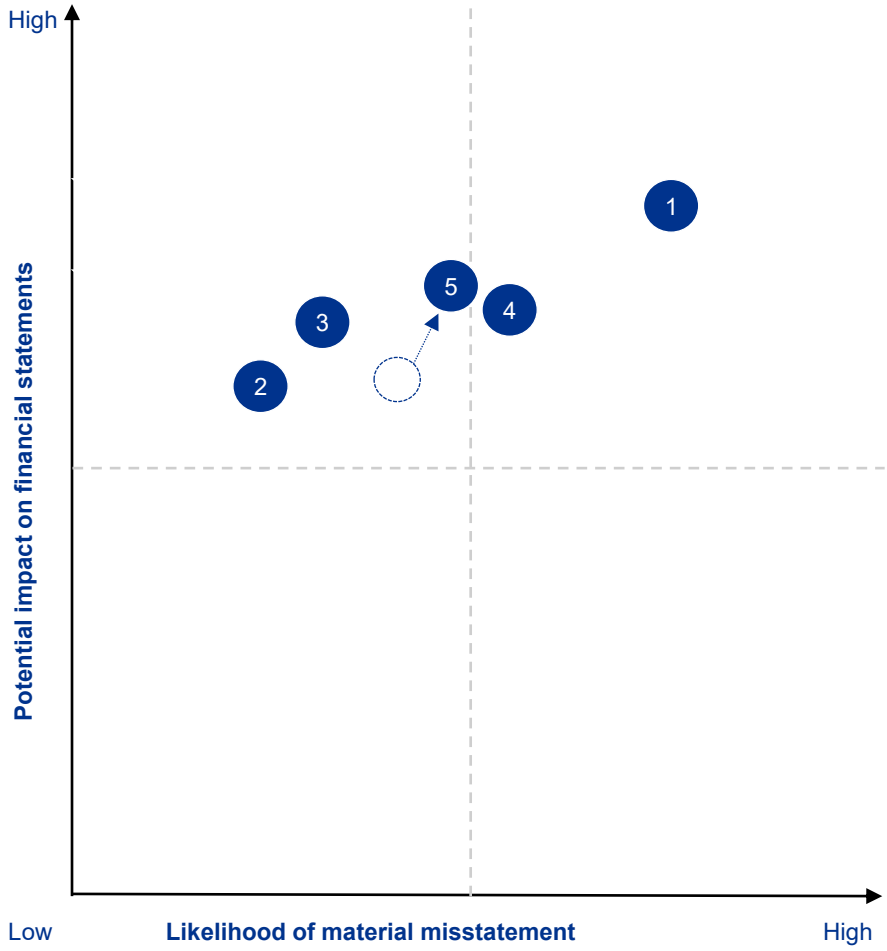
We also use our regular meetings with senior management to update our understanding and take input from local audit teams and internal audit reports.

The increase in the defined benefit pension significant risk, as noted in our Audit Plan, was due to Project Atlas. Our Audit plan and approach was refined once information was shared by management's specialists. We have involved our Pension Actuarial Specialists and Pensions COE (Centre of Excellence) team to support in the audit of Project Altas which is complex and has resulted in a prior period restatement.

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

Key: # Significant financial statement audit risks

Change compared to prior year



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Audit risks and our audit approach

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

No change vs prior year

Significant audit risk

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

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

Business risks related to audit risks include:

- Inappropriate amounts capitalised to PPE, thus overstating assets and understating expenditure which could result in inappropriate business decisions.

* Tier 1 costs: Operating costs, PFI and interest relative to WICS Final Determination expectations, (as adjusted by out-tun inflation), excluding responsive repair and refurbishment, developer contributions and tax.

Planned response

- Confirming our understanding of the capital additions process by flowcharting and completing walkthroughs of the key capitalisation activities.
- Verifying the design and implementation of key controls: the capital approval processes and allocation of internal costs, including indirect overheads.
- Testing the design and operating effectiveness of controls over:
  - the approval stages of capital expenditure on projects;
  - the appropriateness of reclassification of assets out of the category: assets under construction to fixed asset categories and repairs expenditure, where appropriate;
- 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 payroll costing records and timesheets and considering the application of the relevant policies and accounting standards;
- The judgement applied to the basis of payroll costs allocated to capital additions will be tested by reference to the roles of the underlying staff whose costs are capitalised and the basis of this allocation (e.g. time basis or other allocation method). The audit team will challenge management, where appropriate, on the judgements applied. The audit team will re-calculate the accuracy of the allocated payroll costs and agree such costs to underlying payroll and HR records.
- Audit of capitalised payroll accruals at year end to valid timesheet records, payroll costing records and project details to confirm the existence and accuracy of capital additions over the year end period.
- Audit of indirect costs allocated to capital additions by vouching a sample of costs to invoices, timesheets and other relevant supporting documentation to confirm the validity of such costs being capitalised.

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Audit risks and out audit approach (cont.)

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

Significant risk

Capitalised payroll costs: 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.

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* Tier 1 costs: Operating costs, PFI and interest relative to WICS Final Determination expectations, (as adjusted by out-tun inflation), excluding responsive repair and refurbishment, developer contributions and tax.

Our findings

- We tested the design and operation of key controls and found them to be effective. The controls we tested were:
- (1) the appropriateness of approval of capital projects, and
- (2) the appropriateness of reclassification of assets from the category "assets under construction" to the relevant asset category and repairs expense account, where appropriate, by inspection of signed completed capital approval forms.
- We performed information testing over the capital projects report by agreeing key data elements (e.g. expenditure type, project description, amount and date) to supporting documentation. We identified inconsistencies of expenditure type description when compared to supporting documentation for one department within the business. See below for further detail.
- A sample of capitalised staff costs were agreed to valid supporting documentation, being, time sheets, approved employee rate cards and staff cost reports. It was identified that a number of costs classified as capitalised staff costs were capitalised third party costs (i.e. non staff costs). Additional analysis was performed and it was identified that £6.9m non-payroll costs were coded as capitalised staff costs (time-sheet code) and £5.4m of payroll costs (time sheet code) were capitalised as non-payroll costs to capital additions. The miscoding has been noted as a control deficiency but has not had any impact on the testing of capital additions as the items capitalised to PPE met the requirements for capitalisation.
- Indirect overhead testing to capital has been completed satisfactorily.
- The judgement applied to the basis of payroll costs allocated to capital additions was tested by reference to the role of the underlying staff whose costs were capitalised and the basis of the allocation (e.g. time basis or other allocation method). The audit team re-calculated the allocated payroll costs and agreed the cost per employee to the underlying payroll and HR records. No misstatements were identified.
- High risk journals that capitalised payroll costs to additions were tested satisfactorily with the journals being supported by a valid business rationale and appropriate audit evidence.

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Audit risks and our audit approach (cont.)

2 Management override of controls (SW and SWBS)

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

No change vs prior year

Significant audit risk

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

- Professional standards require us to communicate the fraud risk from management override of controls as significant.
- Management is in a unique position to perpetrate fraud because of their ability to manipulate accounting records and prepare fraudulent financial statements by overriding controls that otherwise appear to be operating effectively.
- Through our review of the journals process, and as noted in prior years, there is no enforced segregation of duties of journal entries at the point of posting into the general ledger.
- We have not identified any specific additional risks of management override relating to this audit.

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

Planned response

- Our audit methodology incorporates the risk of management override as a default significant risk.
- Assess accounting estimates for biases by evaluating whether judgements and decisions in making accounting estimates, even if individually reasonable, indicate a possible bias. There will be a particular focus on the provision for doubtful debt estimate for Scottish Water.
- Evaluate the selection and application of accounting policies.
- In line with our methodology, evaluate the design and implementation of controls over journal entries and post closing adjustments.
- A fully substantive approach is to be taken with respect to the audit of journals due to the control deficiency identified of journals not requiring to be reviewed at the point of posting.
- Inquire with staff who process manual journals as to whether they have been requested to process unusual or unsupported journal entries.
- Assess the appropriateness of changes compared to the prior year to the methods and underlying assumptions used to prepare accounting estimates.
- Assess the business rationale and the appropriateness of the accounting for significant transactions that are outside the component's normal course of business or are otherwise unusual.
- Identify journal entries to test based on high-risk criteria and comparing the identified entries to valid supporting documentation as well as considering whether such journals are appropriately authorized and have a valid business rationale.
- Audit of manual journals relating to capital additions which meet our high-risk criteria (i.e. capital additions journals with unexpected account pairings).
- Material post close and consolidation journals, as well as those meeting our high-risk criteria, will be selected for testing.

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Audit risks (cont.)

2 Management override of controls (SW and SWBS)

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

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- Through our review of the journals process, and as noted in prior years, there is no enforced segregation of duties of journal entries at the point of posting into the general ledger.
- We have not identified any specific additional risks of management override relating to this audit.

Our findings

- We performed screening of the journals population, using the Journals 2.0 data analytic tool, which contains the full journals population for the year. The journals were screened according to the high-risk criteria established during our fraud risk assessment procedures. Examples of high-risk criteria included: Revenue, Capital Additions and Cash journals with unusual account pairings and journals containing unusual descriptions in the narration.
- We identified 45 journal entries and other adjustments meeting our high-risk criteria for Scottish Water and 5 high-risk criteria journals for SWBS. Our examination did not identify unauthorised, unsupported or inappropriate entries for SW or SWBS.
- As a result of the journal testing performed thus far, we did not identify any disconfirming audit evidence indicating management override of controls in relation to journal entries and other adjustments.
- Our procedures, to date, did not identify any significant unusual transactions.
- Post close and consolidation journals were found to be appropriate with no evidence of management override of controls.

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Audit risks and our audit approach

3 Revenue Recognition (E,A) (SWBS only)

Fraud risk related to existence and accuracy of revenue



Significant Audit Risk

Revenue is recognised for arrangements that do not exist or do not meet the definition of a contract under the standard

Accrued income is recorded inappropriately when it is not accurately recorded and/or does not exist.

- 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 revenue recognition.
- Accrued revenue involves subjective measurement as it is calculated from annualised revenue data from the market, allocated on a pro-rata basis to the period between the last billing date and the year-end.

Key:
Prior year Current year

Our response

- Confirmed our understanding of the revenue streams by flowcharting and completing walkthroughs of each separately identifiable revenue stream.
- Considered the design and implementation of key controls, the revenue recognition processes, and management's calculation of accrued and deferred revenues.
- Reviewed cash receipts-to-revenue predictive analysis on revenue recognised during the year, along with a reconciliation of all cash, debtors, and accrued revenue for the year.
- Performed year-end cut-off testing to assess whether sales transactions were recognised in the correct accounting period.
- Assessed the deferral of revenue recognised in respect of advanced billing to ensure it was appropriate and accurately calculated.
- Accrued income recalculated based on market data volumes.

We rebut the revenue recognition risk in respect of Scottish Water

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

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

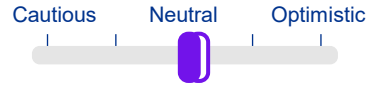
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Audit risks and our audit approach (cont.)

3 Revenue Recognition (E,A)

Fraud risk related to existence and accuracy of revenue



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- 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 revenue recognition.
- Accrued revenue involves subjective measurement as it is calculated from annualised revenue data from the market, allocated on a pro-rata basis to the period between the last billing date and the year-end.

Our findings

- We reperformed a reconciliation of cash receipts received in the period to revenue recorded (cash to revenue substantive analytic), with the difference in the reconciliation being within our acceptable range.
- To support the bank receipts information relied upon in the cash to revenue substantive analytic, we vouched a sample of cash receipts into the bank during the year to the relevant sales invoice; inspecting the date, amount and customer details.
- We performed risk assessment procedures over sales cut-off by inspecting monthly revenue trends for the major revenue streams as well as recalculating ratios of accrued revenue versus revenue recognised at the current and prior year ends. A sample of invoices issued during March 2026 were inspected, noting the period to which the invoice related, to test whether the revenue was recognised in the appropriate period. We found that the revenue, and applicable deferred revenue, had been recorded in the appropriate period for the sampled items.
- We sampled accrued revenue amounts and performed a recalculation of the accrual amount and agreed key data elements within the calculation to invoices and market data. No material misstatement was identified. We raised a control deficiency for the incorrect application of tariffs which resulted in a trivial error.
- We vouched a sample of advance billings recorded to the underlying customer invoices, and where applicable bank receipts, noting the period to which the sales invoice related. We found that revenue had been appropriately recorded as deferred revenue at the period end.
- Post year end credit note testing did not identify incorrect revenue recognition at year end.

Key:
Prior year | Current year

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Audit risks and our audit approach (cont.)

4 Impairment of Household trade receivables – valuation (SW) (risk of error)

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

No change vs prior year

Significant audit risk

The risk that receivables are overstated

Provision for doubtful debts at 30/09/25:
Scottish Water: £498m

- 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.

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 the senior finance leadership team 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 2025-26, as recorded in Scottish Water's records, to confirmations received from individual local authorities.

Planned response :

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

This estimate is considered on page 18.

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

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Audit risks (cont.)

4 Impairment of Household trade receivables – valuation (SW) (risk of error)

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



Significant audit risk

The risk that household receivables are overstated
Provision for Household doubtful debts at 31/03/2025:
Scottish Water: £485.5m

- 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.

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.

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 findings

- We tested the design and implementation of the monthly impairment provision for trade receivables. The design and implementation of the control was effective.
- Management use the forecast collection rate to calculate the impairment for household bad debt.
- The data used for the impairment computation is historical household billing and collection data. Total amounts billed in respect of households for the 2025/26 year were agreed to confirmations received from individual Councils. Total amounts collected in respect of households for the 2025/26 year have been vouched on a sample basis to bank statements. The data is assessed as reliable and relevant.
- As at 31 March 2026, the average forecast collection rate applied to billings was 97.05% resulting in an in-year charge of £19m and a resultant household bad debt provision of £497.2m against total debt outstanding of £600.6m. This is an increase of 0.08% in average forecast collection rate from the prior year. Management's model uses historical collection rates and trends which are considered to be the best method to predict future collection as household debt collection is controlled and managed by the Councils
- We performed analysis and re-calculated the forecast collection rates based on the minimum, average and maximum historic collection rates from 2002/03 to date. We compared the assumption used by management to our analysis and confirmed this fell between the minimum historic collection rate and the average historic collection rate. We concluded the assumption is neutral.
- We challenged the assumption through use of KPMG's own economic forecasts. We noted that changes to inflation, and household disposable income does not necessarily have a direct material impact on collection rates based on historical collection data analysis. The historical collection rates utilised in management's model show evidence of long-term debt still being collected and therefore recoverable, although the pace in which long-term debt (over five years old) is slow.

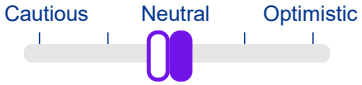
Key:
Prior year
Current year

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Audit risks (cont.)

4 Impairment of Household trade receivables – valuation (SW)

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



Significant audit risk

The risk that household receivables are overstated
Provision for Household doubtful debts at 31/03/2025: Scottish Water: £485.5m

- 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.

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.

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 findings

- We have performed a reverse stress-test over the forecast collection rate and note that for it to be materially misstated the rate would have to experience a year-on-year change in average collection rate above 0.13%. The likelihood of this level of change is considered remote based on historical data as well as the improved economic outlook.
- We are satisfied with the approach adopted by management in arriving at the bad debts provision for the current year. Based on historical actual collection trends which have been higher than the forecast collection rates in those years, as well as the increasing collection trend, the provision is deemed neutral and within an acceptable range and is not materially misstated.
- We challenged management to provide more informative detail regarding the sensitivity disclosure of the forecast collection rate to enable a reader of the annual report to understand the impact of a realistic change in the forecast collection rate. As a result, management updated the sensitivity analysis for the overall household collection rate assumption to align to the possible percentage change with historically observed movements in collection rates and reasonable expectations of future economic conditions. The accompanying narrative was also revised to provide greater clarity over the trends in collection performance. This is documented in Note 26 to the financial statements.

Key:
Prior year
Current year

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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

Increase vs prior year

Significant audit risk

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

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

Business risks related to audit risks include:

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

As disclosed in the interim report we are aware that the Group are investigating the definition of “pensionable pay” and the implications thereof on past deductions and contributions.

Planned response

Our audit approach to IAS 19 includes:

- Testing the design and operating effectiveness of controls over the provision of membership information to management’s actuary who uses it, together with the assumptions, to calculate the pension obligation.
- Review of management’s expert used in the valuation of the defined benefit pension obligation.
- Review of management’s expert used in considering the expanded definition of pensionable pay and impact (if any) on the defined pension position.
- Challenging, with the support of our own actuarial specialists, the key assumptions applied, being the discount rate, inflation rate and mortality/life expectancy against externally derived data.
- Challenging the rate of increase in the pensionable salaries assumption, by comparing it to other evidence such as the regulatory delivery plan and our understanding of Scottish Government expectations.
- Considering the adequacy of the disclosures in respect of the sensitivity of the surplus/deficit to these assumptions.
- Our approach to the audit of pension schemes continues to include enhanced quality procedures, accordingly, we will liaise with the scheme actuaries and fund auditors regarding the underlying data and procedures at those entities. Given the current volatile market conditions caused by local and global economic uncertainty, we expect some fluctuations in the measurement of the pension liability/surplus.
- We will review the analysis and calculations prepared by management with respect to the review of the definition of pensionable pay. We will also look at the basis of the proposed resolution, including correspondence with the relevant pension funds to ensure the accounting and disclosure at 31 March 2026 is appropriate.

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Audit risks (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



Significant audit risk

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

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

Business risks related to audit risks include:

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

Key:
0 Prior year
Current year

Our findings

Defined benefit obligation
- We assessed the methodology and significant assumptions used to calculate the defined benefit obligation, including the discount rate, inflation, salary increases and mortality assumptions. The assumptions were individually within our acceptable ranges and, in aggregate, were assessed as balanced relative to our central assumptions—see page 20. We also assessed the impact of Project Atlas on the funded and unfunded obligations. Subject to the uncorrected misstatement on page 21, no material misstatement was identified.

Membership data
- We performed risk assessment procedures over the membership data and movements in active, deferred and pensioner membership populations. The movements were consistent with our expectations and did not identify indicators of material misstatement..

Subjective valuation
- The overall assumptions applied by management for Scottish Water are considered to be balanced relative to our central rates and within our acceptable range (refer to page 20)

Management specialist:
- We evaluated the competence, capabilities and objectivity of management's actuarial specialists, including their professional qualifications, experience and the scope of their work. No matters were identified that affected our planned reliance on their work.

Surplus recognition
- At 31 March 2026, the funded schemes were in surplus. However, no funded net defined benefit asset has been recognised because Scottish Water did not have an unconditional right to a refund or another available economic benefit sufficient to support recognition under IAS 19 and IFRIC 14. Accordingly, the funded surplus was restricted to £nil through application of the asset ceiling.
- We have considered the employer's approach adopted for the calculation of recognisable surplus and the presentation of unfunded liabilities and consider it to be reasonable.

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Audit risks (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



Significant audit risk

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

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

Business risks related to audit risks include:

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

Key:
Prior year | Current year

Our findings

Pension assets

- We have reviewed the gross pension assets for consistency and confirmed the share of scheme assets for the last three years to the current year. We compared the employer's assets to the total value of the pension fund to check consistency with the expected percentage share. We have independently verified the rate of return from the LGPS fund and compared that with the one used in the IAS 19 report. Based on the procedures performed, the results were within our acceptable range.

Pensionable Pay definition updated

- During the financial year, following legal and actuarial assessment, Scottish Water determined that AOIP payments had not historically been treated as pensionable pay in accordance with the applicable pension scheme and employment arrangements.. This resulted in a material increase in the defined benefit obligation for the group of £122m, split £111.5m and £10.5m across the funded and unfunded liabilities, respectively.
- This has been corrected retrospectively in accordance with IAS 8, *Accounting policies, Changes in Accounting Estimates and Errors.* The impact was an increase in the prior year opening reported defined benefit obligation of the Group of £121.3m and parent entity of £116.6m. Due to the funds being in surplus, the impact on opening retained earnings was limited to the unfunded liability portion of £10.4m (before tax).
- Missed employee contributions, including interest, over prior periods totalling £13m were booked into the FY26 accounts as a current year expense. Management indicated this treatment was allowable for regulatory reporting, however, for the statutory accounts prepared in terms of IFRS, this amount should have been included as part of the prior year adjustment to the DBO and an uncorrected misstatement has been noted on page 21.
- We challenged management as to the disclosure of the restatement and further narrative and clarity was included in the final pensions and prior period adjustment notes in the annual report.

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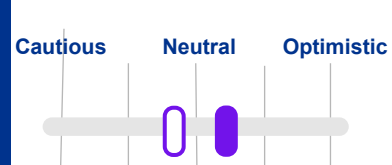
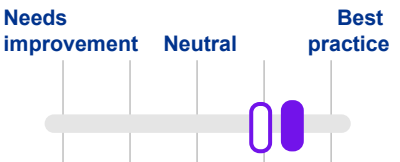
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Key accounting estimates and management judgements– Overview

Key:
Prior year
Current year

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.

Asset/liability class	Our view of management judgement	Balance (£m)	YoY change (£m)	Our view of disclosure of judgements & estimates	Further comments
Impairment of trade receivables (SW)		497.2	11.7		We confirmed the forecast collection rate assumption to be neutral. Management made improvements to the sensitivity analysis disclosed in relation to the estimate in Note 26 Financial instruments and risks.
Defined Benefit – Pension Asset		2,461.6	139		Based on the audit procedures completed, the fair value of plan assets was not materially misstated and the related disclosures were appropriate.
Defined Benefit - Pension Liability		(1,457.7)	(8.1)		The actuarial assumptions applied by management were, in aggregate, balanced and within our acceptable ranges. The defined benefit obligation and related disclosures, including the Project Atlas prior-period restatement, were considered appropriate.
Depreciation charge		391.4	15.9		Management were found to be cautious in the application of useful lives to calculate depreciation. This was driven by the one year useful life of investigative assets within the PMV (Plant, Machinery, Vehicle) category.
Capitalised payroll costs		150	-		Management exercise judgement in the capitalisation of payroll costs to capital additions of PPE during the financial year (see pages 6-7). Capitalised payroll costs are disclosed in the annual report.

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Key accounting estimates and management judgements– Overview

Depreciation

Depreciation is a key accounting estimate with management judgement applied to the useful lives of items of property, plant and equipment

Audit procedure performed:

- Recalculate depreciation expense for the year ended 31 March 2026, considering appropriateness of useful lives

Catch up depreciation:

Depreciation testing was performed on items of property, plant and equipment and it was identified (as in the prior year), that there is an element of “catch-up” depreciation due to the timing of the finalisation of the capital asset finance form. The impact of this “catch-up” depreciation in the current year was £5.1 million. This amount was not considered material against total depreciation of £391.4m.

Fully depreciated assets:

It was identified that the entity has fully depreciated assets totalling £994.2m at year end. The entity considers fully depreciated assets over a five-year period to consider whether they are still in use or should be disposed. The total of fully depreciated assets held up to 5 years totalled £881.1m with £113.1m fully depreciated assets being held for longer than 5 years. Whilst this could indicate some prudency in the estimation of asset lives, given the length of total asset lives, the impact of this is negligible given the net book value is nil on these assets.

Investigative type assets with short useful lives:

At 31 March 2026, there were “investigation” assets with a cost of £78m and net book value of £27.2m. The audit team inspected supplier invoices and/or supplier work certificates for these costs and agreed that these met the requirements of IAS 16 for capitalisation of items of PPE (Property, plant and equipment). The audit team challenged management with respect to the one-year useful life period applied to these assets as costs that meet the requirements of capitalisation per IAS 16 imply a useful life of longer than one year. The audit team challenged management to consider the useful life in line with the asset being supported. The financial impact of extending the useful life by more than one year for these projects is not expected to be material for the FY26 year, however with the increase in investigative projects for SR27, this value is expected to increase for the FY27 year.

Provisions

Scottish Water entity and group have a number of provisions (e.g. the income uncertainty provision) which is viewed as prudent. The group has not provided for a supply contract which is impacted by fluctuating market prices due to the volatility of pricing and complexity of estimating a fair value. This is viewed as optimistic. Thus, on an overall basis, provisions at a Scottish Water group level, which are not material, are viewed as balanced.

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Defined Benefit Pension assumptions



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**	**Key assumptions**
Discount rate		AA yield curve	✓	✓	6.25%	6.13%		✓
CPI inflation		Deduction to RPI inflation curve	✓	✓	3.00%	3.04%		✓
Pension increases		In line with CPI	✓	✓	3.00%	3.02%		✓
Salary increases		Employer best estimate	-	✓	FY 26/27: 5.38% FY 27/28: 3.62% FY 28/29: 3.50% FY 29/30 – 32/33: 3.20% 4.00% thereafter	In line with long-term remuneration policy		
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 Fund best-estimate		✓
	Future improvements	In line with most recent Fund valuation	-	✓	CMI 2024 projections model, 1.5% (LPF / SPF / NESPF) long-term trend rate, A=0.25% and No overlay and default other parameters	CMI 2025, 1.25% long-term trend rate and default other parameters		✓
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 Fund experience		

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Audit Misstatements

We have identified two uncorrected audit misstatement for **Scottish Water** and these are summarised in the table below.
One uncorrected factual audit misstatement was identified relating to **Scottish Water Business Stream** and is summarised in the table below.
Disclosure misstatements are detailed on page 22
In line with ISA (UK) 450 we request that you correct uncorrected misstatements.

Corrected Audit Misstatement - none

Uncorrected Audit Misstatement:

	Account Name	Type of misstatement	Dr	Cr
1.	Retained earnings	Factual	13,000,000	
	Defined benefit pension expense			13,000,000
SW: Missed prior period employee contributions, including interest, as a result of the updated definition of pensionable pay should be included as part of the prior year adjustment and not included in the current year expenditure				
2.	Provisions	Factual	13,000,000	
	Revenue Bank Account			13,000,000
SW: Missed prior period employee contributions, including interest, raised to general provision account but should increase Defined Benefit Obligation as part of the prior year adjustment.				
3.	Trade Debtors	Factual	3,137,850	
	Revenue Bank Account			3,137,850
SWBS: Reclassification of direct debits to trade receivables, as the related bank transactions cleared after year-end. Due to timing of management's process this is likely a recurring reclassification misstatement.				

Types of misstatement

Factual: Misstatements about which there is no doubt

Projected: Our best estimate of misstatements in the audited populations

Judgemental: Differences arising from judgments of management that we consider unreasonable or inappropriate

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Audit Misstatements

Under UK auditing standards (ISA (UK) 260) we are required to provide the you with a summary of adjusted audit differences (including disclosures) identified during the course of our audit. Below outlined the following misstatements in respect of disclosures.

Misstatements in disclosures

Audit Misstatements in disclosures		
No.	**Disclosure**	**Comments**
1	Members Remuneration Report Table A – Single total figure table Table C – Total pension entitlements to end of financial year	We made three observations to management to ensure the disclosure agreed to supporting audit evidence. Two differences were caused by rounding (change of £1k), and one correction had an impact of £3k. These have been amended by management.
2	Members Remuneration Report Table D – Pay multiples Remuneration ratio calculations, excluding movement in pension and LTIP.	We made one observation to management in order to fully comply with the FREM in respect of including all staff members within the median pay calculations (except where exclusion is required in the FREM, such as non-executives). We identified not all employees were included within this calculation. This impacted the pay multiples and the remuneration ratio calculations and have been amended by management.
3	Prior period adjustment note	Additional narrative about the prior period restatement was recommended and corrected as well as additional line disclosure within the note to reference back to the impact on the primary statements
4	Forecast collection rate sensitivity disclosure	Management updated the sensitivity analysis for the overall household collection rate assumption to align to the possible percentage change with historically observed movements in collection rates and reasonable expectations of future economic conditions. The accompanying narrative was also revised to provide greater clarity over the trends in collection performance.

Factual: Misstatements about which there is no doubt

Projected: Our best estimate of misstatements in the audited populations

Judgemental: Differences arising from judgments of management that we consider unreasonable or inappropriate

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Other significant matters related to our audit approach

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

1. Financial Management

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

Auditors response:

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

Auditors findings:

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 budget guidance. Revenue and capital monitoring reports receive appropriate review by committees. 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, Alex Plant. The CFO is Alan Dingwall.

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.

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 regularly, these are: Anti-Slavery, Code of Ethical Conduct, Whistleblowing and Fraud Management which are also supported by routine mandatory compliance training.

The entity also has a Counter Fraud Group (CFG) that monitor whistleblowing reports and alleged fraud as well as fraud training to staff compliance.

Management and members 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 receive quarterly reports in respect of whistleblowing and fraud, as well as relevant internal audit reports.

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.

Prevention and detection of fraud

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

Conclusion:

Scottish Water has a good internal control environment and appropriate capacity. It is engaged with the NFI process and has a good structure of controls in place to prevent and detect fraud.

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Other significant matters related to our audit approach

Wider scope of public audit in Scotland (continued)

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.

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:

Auditors response:

The audit team performed audit procedures over financial forecasts and models, considering levels of capital investment planned.

Auditors findings:

The main business and strategic planning processes cover the regulatory period to March 2027, based on key assumptions in respect of the funding of the business. In December 2020, the WICS published their Final Determination for the 2021-27 period. Management consider forecasts and the performance of the group, as well as liquidity levels over the regulatory period. Particular focus and time is spent assessing the affordability and phasing of the 6 year rolling investment programme.
Our audit testing identified the high level of repairs which are disclosed in the annual report. The increased consumer demand, climate change challenges and an ageing asset basis contribute to increased repairs required on the network. Continued capital investment is essential to meet these challenges.

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 funding from revenue and government loans and the significant capital investment program. Members clearly communicate the challenges foreseen with key stakeholders of the entity.

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Other significant matters related to our audit approach

Wider scope of public audit in Scotland (continued)

3. Vision, Leadership and Governance

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

Auditors response:

To consider the clarity of plans to implement the vision, strategy and priorities adopted by the leaders of Scottish Water, the audit team also considered the effectiveness of governance arrangements for delivery. This 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.

Auditors findings:

The audit team performed inquiries of those charged with governance, inspected board and committee meeting minutes, inspected evidence of communication of the entity's vision and strategy to staff and to the public via reports and website communication.

The entity 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.

Pensionable pay updated definition

As detailed on page 17, the entity identified that pension contributions had not been accurately applied to all elements of pay, particularly, AOIP payments. This resulted in the establishment of a specific project within the group, referred to as "Project Atlas". Due to the sensitivity of the matter and the potential for conflict of interest with the executive members and senior management, a steering group of the board comprising non-executive directors (who by the nature of their role are not pension scheme members) was formed to lead the resolution of Project Atlas.

The board of Scottish Water took a considered approach to Project Atlas stakeholder engagement and ensured the matter was communicated appropriately with all relevant parties, including the relevant Pensions Funds, Regulators and other key stakeholders. Conflicts of interest were managed through the appointment of independent professional advisors to support the steering group to navigate the process of confirming the breach, applying appropriate responses, quantifying the likely impact and liaising with the pension funds on the appropriate remediating actions.

In order to gain assurance that the emergence of this issue was not indicative of a current gap in the internal control framework, the Steering Group commissioned a 'Causal Learnings' Review led by the Head of Internal Audit. This review confirmed the issues stemmed from a historic conflict between Local Government Pension Scheme and the long-standing employment and remuneration policies of Scottish Water and its predecessor bodies being the three regional water boards in Scotland.

Internal audit

Internal audit is conducted by an in-house team which reports directly to the head of the Audit and Risk Committee. Internal Audit activities are carried out in compliance with the Public Sector Internal Audit Standards. Internal Audit Extensive reviews are undertaken and reported throughout the year on a range of financial and non-financial topics. The breadth and depth of reviews are good and follow up reviews and performed timeously.

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. The governance processes followed with respect to Project Atlas provide insight as to the priority of good governance applied by the board. We are also content that the internal audit function is operating as appropriate.

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Other significant matters related to our audit approach

Wider scope of public audit in Scotland (continued)

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.

Auditors findings:

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.

The board delegates responsibility for business activities to directors and managers and employees through a Delegated Levels of Authority (DLA) Scheme. This control was found to be operating effectively.

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

The entity monitors key performance measures, such as water quality, customer satisfaction ratings, leakage and other reported incidents, to name a few. This monitoring is performed by third party professionals which are independent to the entity.

Monitoring of KPIs against targets supports improving performance.

Continued capital investment in accordance with the Delivery Plan is essential for the entity to continue to provide high quality water and waste water services. The executives communicate challenges to stakeholders on a regular basis and provide regular updates to stakeholders with respect to anticipated resource constraints.

Repair costs continue to increase in line with budget and commensurate with the scale and value of the asset base and audit procedures included performing tests of detail to agree the expenses to valid, approved supplier invoices.

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.

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Other significant matters related to our audit approach (cont)

Best Value

The Scottish Public Finance Manual (SPFM) explains that Accountable Officers have specific responsibility to ensure that arrangements have been made to secure Best Value. Ministerial guidance to Accountable Officers for public bodies sets out their duty to ensure that arrangements are in place to secure Best Value in public services.

Auditor's Response

To consider best value assessments covering the themes of: Leadership; Effective Partnerships; Governance and Accountability; Use of Resources; Performance Management; and the cross-cutting themes of Equality and Sustainability.

Auditor's Findings:

The first 5 themes of best value are included on the previous pages of wider scope reporting. The additional two themes are detailed below.

Performance is monitored and reported on an ongoing basis with key metrics being independently audited and assessed – e.g. Water quality compliance, customer experience measures, leakage and interruptions to supply

Equality and Sustainability are covered via policies and strategies in place and are monitored on a continuous basis. The entity is committed to ensuring equality is mainstreamed into all aspects of organisational culture and practice. This is reported on via employee surveys and external stakeholder forums. The entity is committed to sustainability and has had clear targets and reporting in this regard for many years. The capital investment programme is focussed on sustainability with clear decisions made, considering climate and the environment.

Conclusions:

The entity has appropriate arrangements in place to secure best value.

Going concern

We have not identified any events or conditions that may case doubt on the ability of the Company to continue as a going concern.

We have assessed management's budgets and cash flow forecasts, as well as plausible downside scenarios and concluded that the use of the going concern assessment remains appropriate.

The going concern disclosure under the basis of preparation note in the accounts was adequate and aligned with audit work performed.

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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 Company's internal control.

Key:

- These are significant control deficiencies which increase the likelihood and potential magnitude of a material misstatement in the financial statements. We have not identified any significant control deficiencies in the current year.
- These are matters of sufficient importance to note such as weaknesses which were subsequently corrected and matters that could be significant in the future if left unaddressed. We have identified 2 of such deficiencies in the current year.
- These are less significant weaknesses but which we considered to be of sufficient importance to merit management's attention. We have raised 1 related observations in the current year.

SW: Fully depreciated assets

Fully depreciated assets for longer than 5 years amounted to £113m at 31 March 2026. It is entity policy to write off fully depreciated assets longer than 5 years, assets which are no longer in use. This balance was higher than prior periods. Management should perform a thorough review of fully depreciated assets older than 5 years and dispose of those no longer in use or consider the appropriateness of the useful lives of assets where the fully depreciated assets are still in use.

Management Response:

We will conduct a review of fully depreciated assets during this financial year to assess whether write-offs or changes to useful lives are appropriate and share our output with KPMG. We will calibrate the level of review to the size and nature the assets, guided by materiality. We will also consider if any process changes are required.

SW: Allocation of project costs via journals

We identified three journals that re-classified costs to underlying capital projects. Upon challenge to management, it was identified that these journals should not have occurred. Although the values are not material, it is recommended that management provide updated training and guidance to staff regarding journal allocations to capital projects.

Management Response:

We acknowledge the findings and will take the opportunity prior to completing our interim accounts to refresh and re-issue guidance to key personnel involved in posting journals to capital projects.

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Other significant matters

SW: accuracy and appropriateness of expenditure type classification

- We identified instances where hours incurred within the CWS department were not recharged through the standard timesheet process but were instead posted through manual journals to cost centre ID 1200 (DV non specific costs). This is inconsistent with the time and labour expenditure types, namely: 1201, 1203, 1204, 1205, 1206, 1208, 1209 and 1903. We also identified non staff costs, such as electricity, fleet charges and legal expenses totalling £80K recharged through expenditure type 1201 (CSD timesheets).
- KPMG recommends that management review the process and implement a control to identify incorrect expenditure coding/classification to reduce the risk of error of incorrect financial reporting which may impact business decisions.

Management Response:

To clarify, the codes references are cost breakdown structure codes (categories of spend) rather that cost centre IDs (assets, departments etc.). We will review the expenditure types used for manual journal postings and cost reallocations prior to interim and year-end reporting to ensure the appropriateness of cost capture in projects, and review and reissue cost breakdown structure guidance to journal posters.

SWBS: Allocation of customer receipts without remittance

- When testing the ageing of customer debt, it was identified that where receipts are not accompanied by remittance information and the amount cannot be easily allocated to an invoice, that the receipt is allocated to the oldest outstanding debt.
- KPMG recommend that management develop a policy for the allocation of receipts in these circumstances.

Management Response:

A default position is required where no remit is received to ensure that funds are allocated to the customer's account. The payment allocation criteria were set within the GCW system, and were signed off as part of GCW system specification.

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Other significant matters (cntd)

SWBS: No manual control over billing calculation within GCW

- As billing calculations are performed automatically by Gentrack and no SOC report exists to cover the sales calculation, KPMG noted that no manual controls were in place that could be relied upon for audit purposes to determine if invoices had been calculated correctly.
- KPMG recommend that while a SOC report cannot be obtained a manual control is put in place to address the risk of incorrect calculation. KPMG note that controls are in place over inputs to the calculation on both the tariffs and consumption volumes used in calculation. KPMG also recalculated a sample of invoices and noted no exceptions in calculation therefore do not believe this matter would result in a material misstatement.

Management Response:

There are preventative controls operating to verify billing accuracy, including validation checks prior to issue of invoices. In addition to this, the review by account of wholesale to retail identifies any significant variances which are investigated by the settlements team and any required action taken. This is an effective detect control to identify any issues.

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Appendix

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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 2025 and agreed for the 2026 were as follows:

	2026	2025
	£'000	£'000
Audit fee – Audit Scotland allocation	401.3	386.6
Review fee - Half year	24.2	26.5
Audit fee – Increased scope (ISA 315, ISA 240)	27.0	26.0
Audit of WOGA	14.8	14.0
Audit fee – subsidiary entities	287.0	275.6
	754.3	728.7
Audit fee overrun for FY26 (Project Atlas) *	94.9	-
Regulatory reporting - Agreed upon procedures (estimate)	48.5	47.5
Non-audit services	2.8	2.5
Total fees	900.5	778.7

* Additional costs to 10 July amount to £86.3K (328 hours) and estimated costs to completion are £8.6K (33 hours) which includes technical consultations and underlying data testing.

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Prior Year Control Deficiencies

We have also followed up the recommendations from the previous years audit, in summary:

Total number of recommendations	Number of recommendations implemented	Number outstanding (repeated below):
5	4	1

#	Risk	Issue	Current Status (July 2026)	Updated Management Response/Officer/Due Date
1		**(SWBS and SW) No enforced segregation of duties of journal entries into the accounting system at point of posting** 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 the risk of inappropriate or erroneous journal entries being posted, however this is a detective control rather than a preventative control **Recommendation** KPMG 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.	Inherent limitations within the accounting system prevent the functionality for a two-step approval process. Management are satisfied with their current review processes for month end.	Not applicable.

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Prior Year Control Deficiencies (cont.)

#	Risk	Issue	Current Status (July 2026)	Updated Management Response/Officer / Due Date
2		**(SW) Investigative assets – short useful life (SW)** Investigative assets are depreciated over a period of one year. However, the nature of costs capitalised in terms of IAS 16 implies a useful life of more than one year. The audit team challenged management to consider the useful life in line with the asset being supported or to consider a period within or aligned with the regulatory period.	Management have prepared an updated accounting paper and increased disclosure of short life assets in the annual accounts. The audit team continue to challenge management on the appropriateness of a one year useful life.	Not applicable.
3		**(SW) Reasonable cost contribution (RCC) provision – timing of release of accumulated provision** The RCC provision is utilised when developers reclaim their costs. Amounts not claimed by developers are maintained for the current and previous two regulatory periods and thereafter released to assets. Where more than two regulatory periods have passed since the projects have been completed, the likelihood of the developers claiming such costs is considered remote. We recommend management monitor the ageing of the provision on a more detailed basis (e.g. per year) and to monitor the utilisation of the provision to more accurately maintain a realistic provision, considering the likelihood of claims from developers.	.Ageing of the provision has been provided and there is evidenced this is monitored. The audit team challenged management as to the appropriateness of the provision being assessed against the regulatory period and not against historical claim activity.	Not applicable.
4		**(SW) Bank reconciliations – timely preparation and evidence of review** Two bank reconciliations were identified as being prepared late during the financial year and for several months there was no evidence of review of the monthly bank reconciliations There is a risk that unreconciled items on the bank accounts are not identified and resolved timeously.. We recommend management considers their policy with respect to preparation and review of bank reconciliations	KPMG has inspected evidence that bank reconciliations are prepared timeously and there is evidence of review.	Not applicable

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Prior Year Control Deficiencies (cont.)

#	Risk	Issue	Current Status (June 2026)	Updated Management Response/Officer / Due Date
5		**(SWBS) Management Review Controls – Expected Credit Losses** KPMG have assessed the Management Review Control ("MRCs") over Expected Credit Losses. We do not place reliance on these because of the absence of documented evidence of the review process occurring and how it is conducted and the lack of clear or appropriate precision in the operation of the management review control. Whilst these controls may be achieving the control objective set by management (we have not confirmed this), 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 in its auditing standards. This is due to the difficulty in achieving an appropriate level of precision, particularly when considering the size of the balance relative to materiality We recommend management considers whether further amendments should be made to the design and implementation of these MRCs in order to meet the FRC standards.	KPMG has inspected evidence of management review of the ECL model for FY26.	Not applicable.
6		**(SWBS) Management Review Controls – Written off during the year.** KPMG has assessed the Management Review Controls (MRCs) related to debt write-offs during the year. We have not placed reliance on these controls due to the lack of documented evidence in some instances—both regarding whether the review occurred and how it was performed. While these controls may be achieving management's intended objectives (though we have not been able to confirm this with sufficient certainty), they do not meet the definition of an effectively designed control under FRC auditing standards. This is primarily due to limitations in evidencing the review and challenges in achieving the necessary level of precision, particularly given the size of the balance relative to materiality.	KPMG has seen sufficient evidence of the approval of write offs in year.	Not applicable.

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Prior Year Control Deficiencies (cont.)

#	Risk	Issue	Current Status (June 2026)	Updated Management Response/Officer/Due Date
7		**(SWBS) Twinfield - Privileged Access** Through our IT and process walkthroughs, we noted that administrator privileges within the Twinfield application are assigned to members of the Finance team. The absence of segregation between IT administrative access and business process roles presents a risk that users may execute inappropriate or unauthorized activities. This could compromise the control environment and affect the integrity of financial data.	KPMG notes this deficiency has been remediated in year, so only ineffective for part of the audit period.	Not applicable.
8		**(SWBS) Estimation of Meter Read** The Gentrack Cloud for Water (GCW) system is configured to include only prior billed actual reads when calculating estimated reads for the period between the last validated reads and the billing date. GCW is not considering validated actual reads if they have not been billed to the customer. KPMG performed audit procedures over the revenue and accrued revenue recognized during the year, and no disconfirming evidence was found as all the meter reads are validated with market data	KPMG notes this deficiency has been remediated in year, so only ineffective for part of the audit period.	Not applicable.

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Required communications with the Audit and Risk Committee

Type	Response
Our management representation letter	We have not requested any specific representations in addition to those areas normally covered by our standard representation letter, however, reference to the prior period restatement has been included in the representation letter for the year ended 31 March 2026.
Adjusted audit misstatements	There were nil adjusted audit misstatements
Unadjusted audit misstatements	The aggregated profit impact of unadjusted audit misstatements would be £13m. In line with ISA 450 we request that you adjust for these items. However, they will have no effect on the opinion in the auditor's report, individually or in aggregate. See page 21
Related parties	There were no significant matters that arose during the audit in connection with the entity's related parties.
Other matters warranting attention by the Audit Committee	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	We communicated to management in writing all deficiencies in internal control over financial reporting of a lesser magnitude than significant deficiencies identified during the audit that had not previously been communicated.
Actual or suspected fraud, non-compliance with laws or regulations or illegal acts	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	No significant difficulties were encountered during the audit.
Modifications to auditor's report	None.
Disagreements with management or scope limitations	The engagement team had no disagreements with management and no scope limitations were imposed by management during the audit.
Other information	No material inconsistencies were identified related to other information in the annual report.
Breaches of independence	No matters to report. The engagement team and others in the firm, as appropriate, the firm have complied with relevant ethical requirements regarding independence.
Accounting practices	Over the course of our audit, we have evaluated the appropriateness of the Group's accounting policies, accounting estimates and financial statement disclosures. In general, we believe these are appropriate.
Significant matters discussed or subject to correspondence with management	The matter of Project Atlas and the prior period restatement was discussed with management throughout the audit.

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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

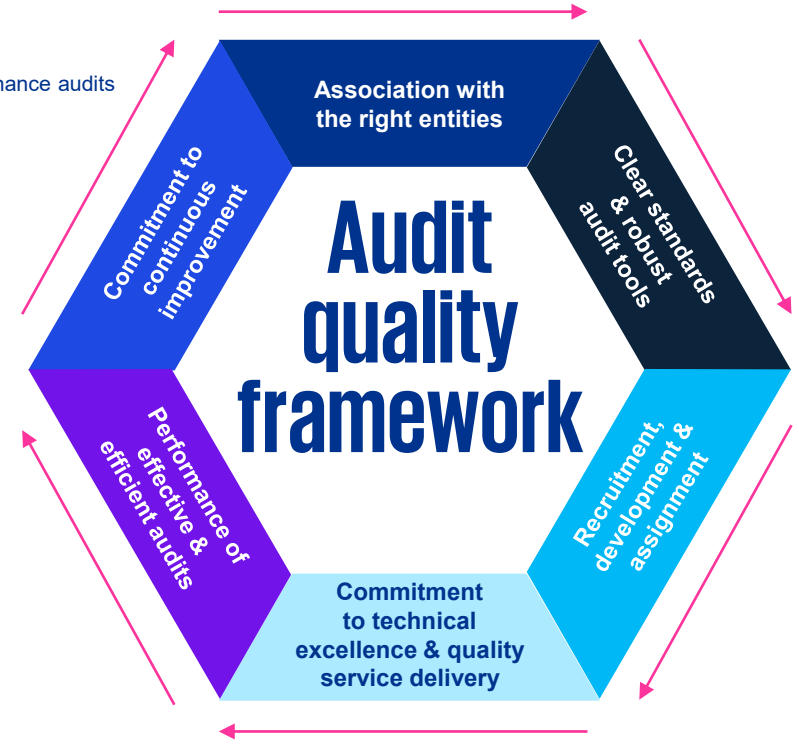
- Comprehensive effective monitoring processes
- Significant investment in technology to achieve consistency and enhance audits
- Obtain feedback from key stakeholders
- Evaluate and appropriately respond to feedback and findings

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

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