Scottish Water

Annual report to Scottish Water Board Members and the Auditor General for Scotland

Year ended 31 March 2014

19 June 2014

Contents

Introduction

Scope and objectives

We are pleased to present to you the key matters arising from our audit for the year ending 31 March 2014.

Our audit was performed in accordance with the principles contained in the Code of Audit Practice issued by Audit Scotland in March 2011 and the scope and proposed focus of our work as set out in our Audit plan. Following the completion of our audit procedures, we confirm that the initial assessment of risk and scope remain appropriate. We have therefore made no significant changes to the audit plan previously presented.

During finalisation of our internal planning procedures we revisited the requirement for Scottish Water to be treated as a Public Interest Entity (PIE). This decision has relevance in terms of Auditing Standards. Usually it is a clear decision, in that all listed entities are treated as PIE. However, for Public Sector entities there are thresholds set in relation to total expenditure (excluding capital expenditure and interest). These thresholds are PwC policies rather than regulatory limits. We consulted with our head of Public Sector Risk Management and concluded that Scottish Water does not actually meet the current threshold (over £1bn expenditure) for being treated as a PIE. The impact that this has is firstly to reduce some of the internal procedures required for PIE's. However, it would also allow us to double the size of the materiality that we set in planning and performing our audit. Following discussion with the CFO, and taking into account the discussion we had at the Audit Committee meeting in November, we agreed that this was unlikely to meet your expectations, particularly given that materiality is now disclosed in our audit report. As a result, we have maintained materiality measures as we previously reported to you, at £10.8m. Materiality is discussed further below.

Status

At the date of preparing this report, we have completed our audit work over the Scottish Water and subsidiary companies, to the extent necessary to support the consolidated financial statements. The consolidated financial statements were signed on 9 June 2014, a copy of which has been provided to Audit Scotland.

Clearance meetings were held for the Group and subsidiary companies in April and May. Mark Hoskyns-Abrahall attended the Business Stream clearance meeting as a Group representative due to its financial significance within the Group results. We have also held clearance meetings with the PwC component auditor for all subsidiary audits to ensure that we have considered any matters arising that would have an impact on the Group results and that we have retained responsibility for the direction, supervision and performance of the Group audit engagement.

The Group organisation chart is included in appendix 1. At the time of writing unqualified audit opinions for the subsidiaries and jointly controlled operation have been issued.

Materiality

We have conducted our work in accordance with the overall materiality and SUM posting level previously communicated in our Audit Plan. The materiality levels used in the consolidated Scottish Water Group financial statements is outlined below:

- Overall materiality - £10.8m (£11.05m as communicated in November 2013). This is the amount that we used in assessing the overall impact on the financial statements of any potential adjustments and in reaching our audit opinion and is based on 1% of total expenses (including interest) in the consolidated income statement.

- Performance materiality - £8.1m. Performance materiality is used to plan the amount of work we perform, for example in determining sample sizes, and is calculated as 75% of overall materiality.

- De-minimis posting level - £200k (£200k as communicated in November 2013). Under ISA 450 (UK&I), we are required to report to the Audit Committee on all unadjusted misstatements in excess of a 'de-minimis' level or 'clearly trivial' amount. This is has been set at the pre-agreed level as confirmed with the Audit Committee in November 2013.

The levels outlined above have been used in our audit of the consolidated financial statements, however lower statutory materiality levels have been used for the subsidiary statutory audits. These levels are detailed below:

Subsidiary	Overall Materiality	Performance materiality	SUM posting level (Group)
Scottish Water Group company	£10.2m	£7.7m	£0.2m
Scottish Water Horizons Holdings Ltd	£1.2m	£0.9m	£0.2m
Scottish Water Horizons Ltd	£0.07m	£0.05m	£0.2m
Scottish Water Business Stream Holdings Ltd	£1.2m	£0.9m	£0.2m
Scottish Water Business Stream Ltd	£3.8m	£2.9m	£0.2m
Scottish Water International Ltd	£0.025m	£0.015m	£0.2m
Scottish Water Solutions 2 Ltd	£1.5m	£1.2m	£0.2m

There are no unadjusted items to report in respect of the Scottish Water Group or subsidiaries in excess of £0.2m.

Regulatory changes

We have been engaged with management throughout the audit process in addressing the regulatory changes that were applicable for the 31 March 2014 financial statements as set out below:

- ***Fair, balanced and understandable* -** The Members are now required to include a formal statement within the annual report that the report is fair, balanced and understandable. As auditors we are required to confirm within our audit report whether we agree with the Directors assessment. The annual report is not yet finalised but from our reviews carried out to date we have not identified anything to suggest to the contrary;

- ***Significant issues reporting* -** The audit committee is now required to include a section within the annual report detailing the significant issues in relation to the financial statements and how they were addressed. We have reviewed the current draft of this section of the annual report and believe it is an accurate reflection of our view of the significant issues based on our risk assessment and audit work completed; and

- ***Audit report* -** The audit report format has changed in reaction to the corporate governance regulatory changes and now includes a description of the risks of material misstatement which had the greatest effect on our overall audit strategy. A draft of our audit report is included in draft Annual Report and Accounts. This report may be subject to change as we finalise our audit procedures.

Significant audit and accounting matters

Significant and elevated audit risks

In our audit plan presented in November 2013 the following areas were identified as having a significant or elevated risk of material misstatement in the Group financial statements:

Risk	Significant / Elevated	Fraud	Error	Judgement
Management override of control	Significant	◉	○	○
Risk of fraud in revenue recognition	Significant	◉	○	○
Risk of fraud in expenditure recognition	Significant	◉	○	◉
Household bad debt provision	Elevated	○	◉	◉
Income uncertainty provision	Elevated	○	◉	◉

The audit procedures performed and conclusions reached in response to these significant and elevated risks are detailed within this report. We have also included below other areas which we have determined to have a higher level of judgement.

Areas of particular audit focus

It is now necessary for us to include a section in our audit report detailing those areas that were of a particular focus to the audit. These are the areas where the audit risk had the most significant impact on our audit strategy, allocation of resources and direction of efforts of the engagement team.

It is expected the 'significant issues' identified by the audit committee, and therefore communicated in the annual report, will be aligned with the areas of particular focus identified by us. The audit committee has identified the following areas in their risk assessment:

- Household bad debt provision;
- Delivery costs associated with Scottish Water capital investment programmes and appropriate classification of expenses; and
- Revenue recognition, in particular wholesale income.

These areas are consistent with the risk assessment included within our audit opinion. We have also included management override of control which is a required significant risk in the Auditing Standards.

Management override of controls

As stipulated in our audit plan, the risk of management override of control is assumed to be present on all engagements. As management remuneration incorporates an element of financial measures, we conclude that the key incentive for management relates to improving the performance of the profit and loss account through overstating revenue or inappropriately capitalising expenses. We have performed the following procedures to address the risk of management override:

- We have held discussions with management, internal audit and legal department on the assessment and consideration of fraud risk;
- We have performed manual journal testing using fraud risk criteria across the Scottish Water Group. These criteria included a bespoke test to identify material manual journals which had impacted both expenditure and fixed asset account codes. As part of our testing we used our Data Assurance specialists to run interrogation tools over the complete population of journals posted. The results show that 43% of all journal entries posted in the Group Company are manual journals, however there have been no journals posted by senior finance members. We will share additional insight into the journals posted across the Group with management as part of the audit close out process;
- We have reviewed areas of significant estimate and key judgement such as accruals, bad debt provisions and credit note provisions; and
- We have incorporated an element of unpredictability into our audit procedures for example, through selecting a sample of executive members' expenses and ensuring that they were adequately supported.

No issues have arisen from our testing.

Risk of fraud in revenue recognition

As outlined in our risk assessment, the risk of fraud in revenue recognition has been identified as a significant risk. This significant risk is heightened in respect of wholesale income and other non-regulatory income as these income streams could be manipulated by management. The risk of fraud in household income is not deemed to be a significant risk as both the collection of the household billings (controlled by local councils) and the price is not within the control of Scottish Water management. We also circulated confirmations directly to the local councils and confirmed closing debtor positions and total household billings in the year. We received a 100% response rate from the confirmation process and there were no significant reconciling items arising.

Revenue is recognised once services have been provided to customers and there is a risk that management may overstate this revenue to improve financial performance. We have performed the following procedures to address the risk of fraud in revenue recognition:

- We have reviewed the revenue recognition policy and confirmed that there have been no changes and that the policy remains appropriate;
- We have performed substantive testing over revenue transactions recognised in 2013/14 and agreed a sample of transactions to invoice and cash receipt; and
- We have reviewed and substantively tested the credit notes and invoices recognised at the period end and agreed the service date associated with the invoices to ensure that these have been recognised in the appropriate period.

No issues have arisen from our testing.

Risk of fraud in expenditure recognition

There is a risk that due to the capital investment programme and profit targets in place, management may feel pressure to manipulate expenditure recognition by inappropriately capitalising expenses to achieve planned capital investment targets, or to reduce expenses recognised in the income statement to achieve profitability targets. We have performed the following procedures to address this risk:

- We have evaluated and tested the controls and processes established by management to ensure that income statement expenditure and capital expenditure was recorded and classified correctly within the financial statements;
- We tested a sample of expenditure by agreeing transactions to invoices and by testing the appropriateness of expenses capitalised;
- We tested expenses incurred or capitalised around the year end to invoices to ensure that they had been recorded in the appropriate period; and
- We identified material manual journals posted to both fixed assets and expenditure accounts and understood the rationale for the adjustments by obtaining appropriate evidence such as invoices or contracts.

No issues have arisen from our testing.

Household bad debt provision

As at 31 March 2014, the Scottish Water balance sheet includes a household income debtor of £432.2 million and a corresponding bad debt provision of £398.8 million, leaving a net debtor position of £33.4 million (2012: £36.8 million). Scottish Water does not fully provide for any of its outstanding debt and therefore this total outstanding debt includes all years dating back to 1996/97. If Scottish Water adopted the working practices of certain Public Limited Companies or indeed some of the organisations in the Local Authority sector it would fully provide for or write off a significant amount of its older aged debt.

The key assumption in the bad debt provision is the forecast collection rate, and the level at which this is estimated could have a significant impact on the bad debt provision. The forecast collection rate is estimated individually for each financial year with reference to the actual cash that has been collected for each year to date, and consideration for relevant circumstances which will impact future collection levels.

The outstanding debtor levels, actual cash collection rates and forecast cash collection rates for the past five years are detailed below:

	2009/2010	**2010/2011**	**2011/2012**	**2012/2013**	**2013/2014**
Total billings (£m)	739,788	744,378	749,293	755,453	785,495
Cash collected (£m)	(709,659)	(713,358)	(717,254)	(712,843)	(723,403)
Outstanding debtor (£m)	30,129	31,020	32,039	42,610	62,092
Actual collection %	95.93%	95.83%	95.72%	94.36%	92.10%
Forecast collection %	96.04%	95.97%	95.96%	95.02%	95%

As expected, the actual cash collection rates for earlier years is close to the forecast collection rate as given the passage of time it is not anticipated that a significant amount of the outstanding debtor position for these years will be recovered. 2012/13 and 2013/14 financial years show both the largest difference between actual and forecast collection rates and also the largest outstanding debtor balances. These years therefore carry the greatest level of estimation and also have the most significant impact on the bad debt provision level. The total average forecast collection rate across all years is 96.02% (2012/2013: 95.96%).

The forecast collection rates for 2012/13 and 2013/14 have been set at lower level than the actual cash that has been collected to date in each financial year up to 2011/2012 and lower than the average cash collected as percentage of total billings for all years to date of 95.68% (2012/13: 95.56%). The reason for the lower forecast collection levels is supported by the following matters:

- Collection years 2003 – 2008 are higher than the other financial years (greater than 96%) due to specific collection programmes and incentives run by Scottish Water with the councils;
- Scottish Water cannot directly influence the collection rates at the Councils; and
- Management have concerns in regard to the impact of the new welfare reforms and council tax benefit changes. Management have discussed the impact of the welfare reform with English and Welsh water companies and they have communicated a decrease in overall collection rates.

In considering the appropriateness of the forecast cash collection rates, we have performed sensitivity analysis as to what impact a change in the assumptions used would have on the overall provision level. The sensitivity has been performed over the 2013/14 forecast collection rates, as the year with the largest difference between actual and forecast collection rates and therefore subject to the greatest level of estimation. The results of the sensitivity analysis are detailed in the table below:

Change in assumption	**Impact on provision**
0.25% increase/decrease	£2m
0.50% increase/decrease	£3.9m
0.75% increase/decrease	£5.9m
1% increase/decrease	£7.9m

The results above demonstrate that changing the forecast collection rate for 2013/14 from 95% to either 94% or 96% would not have a material impact on the overall Group financial statements. As the lowest actual cash collection rate (prior to 2012/13) was 95.56% in 1996/97 it is considered unlikely that the actual cash collected in the 2013/14 year will fall below 94% and due to the recent changes in welfare reform it is similarly considered unlikely that the actual cash collected for this year will exceed the collection rates experienced in the years from 2003 – 2008 which were in excess of 96%.

We concluded that the bad debt provision is within the range parameters we would expect and is supported by detailed working papers and historical collection data.

Income uncertainty provision

In the 2013/14 financial statements the income uncertainty provision in the Company balance sheet is £13.5m. This provision is £13.4m in respect of Scottish Water Business stream and £0.1m for other licenced providers. Management consider a provision necessary due to issues regarding the accuracy of the Central Marketing Agency's (CMA) data arising from incorrect calculations, estimated usages and vacant properties. A proportion of revenue recognised in the year may therefore be required to be refunded to the licensed providers.

The income uncertainty level has been agreed between Scottish Water and Scottish Water Business Stream and the same adjustment recognised in the Scottish Water wholesale revenue and Scottish Water business stream cost of sales. The PwC audit teams have reviewed the adjustments made in both Scottish Water and Scottish Water Business Stream with no issues or intercompany differences noted. The income uncertainty provision in the Scottish Water Group balance sheet is immaterial as the intercompany position with Scottish Water Business Stream is removed on consolidation.

We note that Scottish Water and Scottish Water Business Stream management have made progress towards closing out the 2010/11 years with the CMA and look forward to progress being made in 2014/15 between the two companies in conjunction with the CMA to close out the unsettled periods.

Other areas of judgement and provisioning

In addition to the significant and elevated audit risks outlined above, we have provided an overview of the work performed and findings over other judgemental areas, which could have a significant impact on the quality of earnings for the year or the financial position at March 2014.

Accrual for credit note adjustments

The credit note accrual of £30.5m (2013: £28.3m) has been recognised to account for future issue of credit adjustments to customers for balances previously paid.

The provision is calculated by applying a historic accrual rate of 1.057% (2013: 1.062%) to total billings up to 31 March 2014, less the total credits raised to March 2014. This historic accrual rate represents the average percentage of credit adjustments issued to customers after the close of the financial year over the period from 1996/97 to 2007/08. Management will also make additional adjustments for any periods where they consider there to have been unexpected lower levels of credits issued. In 2013/14 an additional accrual of £1.1m has been created (2012/13: £0.9m). This methodology is consistent with the approach adopted in previous years.

The key areas of judgement in the credit note accrual are the historic accrual percentage rate applied, and any additional adjustments made by management. We have verified the inputs to the historic accrual percentage rate including billings and credit adjustments with no issues noted. The calculation does not incorporate the percentage of credit notes received on years after 2007/08, which we concur with, as there is less data on which to base a reliable long term run rate.

As noted above, management have included an additional accrual of £1.1m due to a lower than expected amount of in year credits issued in 2013/14. The total credits issued were £0.5m which is significantly lower than the annual average of £2.2m experienced in the three preceding years. We have verified that £0.9m of credits were issued in April 2014 which supports the additional accrual.

No issues have arisen from our testing.

Pension assumptions

Employees of Scottish Water participate in three pensions funds; North East Scotland pension fund, the Lothian pension fund and the Strathclyde pension fund which are all part of Local Government defined benefit pension schemes. A full actuarial valuation was carried out at 31 March 2011 for all three funds and has been updated at 31 March 2014 by Hymans Robertsons (independent actuary). We understand that a full actuarial valuation based on data at 31 March 2014 will be performed in 2014.

During the year an amendment to IAS 19 became effective and has been adopted within the accounts for the year ended 31 March 2014. The effect of this amendment has resulted in the restatement of the 31 March 2013 accounts. We have reviewed the adjustments and the disclosure of the prior year restatement with no issues noted. The impact of the restatement has been detailed in note 1 of the financial statements.

We have independently confirmed the pension assets and accuracy of the census data held by the pension funds as part of our audit procedures. We have also reviewed the key assumptions applied to the pension schemes valuations and compared these with our own actuarial specialists' expectations, which included benchmarking the assumptions against a range of other schemes with March year ends.

The key assumptions are included below:

Assumption	2013	2014
Rate of increase in pensionable salaries	2.5%	2.3%
Rate of increase in pensions payment	2.7%	2.6%
Discount rate	4.3%	4.3%
Inflation rate	2.7%	2.6%

Mortality	North East (years)	Lothian (years)	Strathclyde (years)
Male – retiring at 31/03/2014	22.4	20.7	21.3
Female – retiring at 31/03/2014	24.7	23.1	23.6
Male – retiring at 31/03/2034	25.2	22.7	23.3
Female – retiring at 31/03/2034	27.6	25.0	25.0

Overall these assumptions are in line with our expected assumption range. It has been noted that both the Strathclyde and Lothian pension funds are using the medium cohort models for the base mortality tables and our actuarial specialists are seeing more pension schemes using the more up to date CMI projections (as used in the North East pension scheme). We understand that the mortality tables remain unchanged from the 2011 valuations and the approach is consistent with 2012/13 financial statements. We also appreciate that the mortality base tables and methodology will be reviewed as part of the March 2014 full valuation. We have provided a benchmark analysis over the key pension assumptions within appendix 2.

We note that the assumptions used are highly sensitive and given the magnitude of the pension deficit the Board must ensure that the assumptions used are appropriate and represent the best estimate. This will be included in the letter of representation.

Financial performance

2013/14 financial performance

The financial performance for 2013/14 as reported in the Consolidated Income Statement is included below:

	2013/14 £ Million	2012/13 £ Million
Revenue	1,179.7	1,145.7
Cost of sales	(742.6)	(722.2)
Gross surplus	**437.1**	**423.5**
Administrative expenses	(145.4)	(144.2)
Operating Surplus	**291.7**	**279.3**
Finance Income	1.1	0.9
Finance Costs	(191.8)	(194.0)
Surplus on ordinary activities before tax	**101.0**	**86.2**
Taxation	64.5	(4.0)
Surplus for the year	**165.5**	**82.2**

The results show an overall increase at the revenue, gross profit and profit before tax level from 2012/13. The gross margin percentage of 37% has remained consistent with 2012/13 and there has been an increase in margin on profit before tax from 8% to 9%. The primary factors in these movements are set out in the sections below.

Revenue

The split of revenue in the Group by entity has remained in line with previous years being 67% from Scottish Water, 31% from Business Stream and 2% from Horizons and International. There has been an overall £34m increase in revenue due the following factors:

- Increase of £28m in household revenue due to a 2.8% increase in household charges and a net increase of 12,749 properties being connected in the year.
- Increase in business revenue of £4.5m due to an increase in revenue from business and wholesale customers licenced providers.
- Increase of £1.2m in other non-regulated revenue primarily due to increased revenue from the consultancy arm within Business Stream.

The increase in revenue is in line with our testing performed over the Group.

Operating costs

Total cost of sales and operating expenses have increased by £21.6m to £888m. This was driven partly by a £16.1m increase in Scottish Water's operating and PFI costs and a £7.8m increase in Business Stream operating costs. There was also a £15.6m decrease in IFRS credit adjustments.

In Horizons there was a decrease of £8.2m in non-regulated operating costs, of which the largest movement was a write down of assets relating to the green waste and composting business in the prior year. Similarly there was a decrease of £10.7m in Scottish Water depreciation, however included in this amount is a £10.3m gain on disposal in 2013/14.

The movement in operating costs is in line with our testing performed.

2015 – 2021 regulatory period and business plan

Final agreement of the Scottish Water business plan for the 2015 – 21 period was reached with the Customer Forum in January 2014 and this plan has now been formally published following the Water Industry Commission's (WICs)draft determination of charges. The final determination will be issued by the WICs in November 2014.

The WICs draft determination has endorsed a nominal increase in household charges of 1.6% per annum for the years 2015/16 – 2017/18, and for wholesale customers Scottish Water is planning for below CPI average increases over the 2015 – 21 period.

The overall forecast finance requirements for delivering the 2015 – 21 business plan is £8 billion. The budget assumes that £7 billion will be received from customer revenue and £720 million from Government borrowing. Additional financing will be received from disposal of non-core capital assets, and from opening cash balances.

The significant elements of the business plan for the 2015 – 21 regulatory period are detailed in the table below:

Outturn prices	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
Total capital expenditure (£m)	536	550	565	564	579	595
Total operating expenditure (£m)	548	564	578	591	605	620
Total revenue (£m)	1,100	1,123	1,161	1,187	1,213	1,240
Cash balance (£m)	194	143	92	73	49	20

The table above demonstrates that the cash balances will decrease to £20m by 2021 if the current business plan is met. Management therefore plan to outperform this business plan to ensure that cash balances remain higher than the £20m forecast. The primary areas identified for potential out-performance include; energy management (including self-generation opportunities), fleet management, capital project design, scoping and construction, rationalisation of IT platforms/applications and driving a "right-first-time" culture across the business.

Governance and Internal Control Arrangements

Overall Governance Arrangements

We have updated our understanding of Scottish Water's overall governance arrangements, including a review of the key Committee structures and composition, internal audit and risk management. An appropriate governance framework is in place.

Systems of Internal Control

Over the term of our external audit appointment, we review those key financial processes and controls which could have a direct impact on the statement of balances within the financial statements. We test controls over significant risk cycles every year and on a rotational basis (every three years), we undertake more detailed testing other financial controls over non-significant risk areas. We also consider Scottish Water's Information Technology (IT) general control environment, as it relates to the financial statements.

We consider that Scottish Water continues to have in place an appropriate control environment for the size and nature of the organisation. There were no significant control matters identified through our work performed.

In order to review the final close out of existing projects being delivered under SR10 through Scottish Water Solutions 2, management have engaged Deloitte to perform a review of lessons learned to be incorporated into arrangements for the delivery plan under SR15. This remains an area of key focus for management.

Risk Management

On an annual basis the corporate risk register is approved by the Board. In addition, quarterly risk updates are provided to the Board and on an annual basis to the Audit Committee. The identified corporate risks are scored on the basis of consequence to the Board (very serious, serious, material or insignificant) and likelihood of impact (inconceivable, conceivable but highly unlikely, possible, probable, almost certain). Consequences are defined in one of four contexts – reputational, financial, operational or external.

We reviewed the Risk Register as at March 2014, and at that date there were two "red" risks facing Scottish Water. These risks related to:

- Risk of delivery of water into customer premises which is not fit to drink due to contamination; and
- Operational, reputational and financial risk arising from a contractor engaged to deliver water infrastructure improvements not fulfilling their obligations/liabilities.

Management has recorded a range of specific actions to mitigate the risks identified in the risk register and has set timeframes and allocated ownership for the actions.

Overall, risk management appears regularly on the Senior Management Team's agenda.

Internal Audit

As part of our controls work, we also considered Scottish Water's Internal Audit function, in particular Internal Audit staffing and work undertaken during 2013/14. In addition to its normal quarterly reporting to the Audit Committee, Internal Audit also reports on relevant Audit Scotland publications and national report findings. Action plans are put in place by management for any control weaknesses identified by Internal Audit. These will be followed up by Internal Audit and reported to the Audit Committee.

The Head of Internal Audit presents a quarterly report to the Audit Committee and an Internal Audit annual report at the May Audit Committee prior to approval of the Annual Report and Accounts. The head of Internal Audit has also performed a "fair, balanced and understandable" review of the Annual Report and Accounts.

Fraud

Management engaged Ernst and Young to perform a fraud risk assessment over the anti-fraud governance and the tone at the top in respect of fraud risk at Scottish Water. The fraud risk assessment was presented to the Audit Committee in November 2013 and management have prepared an action plan in response to this report which was discussed and agreed at the Audit Committee in March 2014.

As part of the action plan an Ethics Committee has been established to govern the anti-fraud strategy and related proactive and reactive investigations. The committee is chaired by Geoff Aitkenhead (Asset Management Director) and comprises the leadership team and senior management representatives from a range of departments.

An external whistleblowing hotline will be established in 2014 with any activity reported to and monitored by the head of Internal Audit. Management have also developed a proactive communication plan, with fraud and ethics featuring in a Scottish Water internal magazine and also at the Scottish Water management team event.

National Fraud Initiative

The 2012/13 and 2013/14 National Fraud Initiative (NFI) exercise commenced in October 2012 and is being carried out under new powers for data matching which were included in the Criminal Justice and Licensing (Scotland) Act. The aim of this exercise is to identify potential inconsistencies or circumstances that could indicate fraud or error.

Scottish Water submitted both payroll and supplier payment data file for the 2013/14 NFI. From these data files, there were 443 matches recommended for investigation. Work has been completed over the 443 recommended matches and none of the matches investigated identified any fraudulent transactions. In addition, all instances of duplicate transactions had already been identified by Scottish Water. Scottish Water will submit data file for the 2014/13 NFI before the end of the year.

Other reporting matters

Relationships and Independence

We confirm that, as at the date of this document, in our professional judgement, we comply with UK regulatory and professional requirements, including the Ethical Standards issued by the Auditing Practices Board, and that the firm is independent of Scottish Water and its subsidiaries. In order to be able to report this to you, we have made enquiries of all PwC team members providing services to the Group.

Non audit services

Before the firm takes on any engagement for other services with the Group, we have, and will continue give full consideration as to whether the service would conflict with our role as auditors or impair our independence. We are also required to obtain pre approval from Audit Scotland for any non-audit services provided to Scottish Water. We have considered the threats and safeguards in respect to all services and considered no issues which would have prevented us from performing the non-audit services. The services provided in 2013/14 were to Scottish Water Business Stream only and comprised corporation tax services, employee tax services and an FRS 101 impact assessment.

Fraud

Based upon discussions with management and internal audit we are aware of a number of instances of alleged fraud in the period. These matters have been brought to the Audit Committees attention in the fraud letter prepared by internal audit. Any confirmed instances of fraud will be reported to Audit Scotland in the fraud reports to be issued on 30 May 2014. No instances of material fraud have been brought to our attention and we ask the Audit Committee to confirm if they are aware of any suspected or actual fraud having been conducted during the year.

Related parties

We have not identified any significant matters in relation to related parties or related party transactions. The disclosure of related party transactions in the consolidated financial statements is reasonable.

Uncorrected misstatements

No uncorrected misstatements in excess of £200k have been identified through our audit procedures.

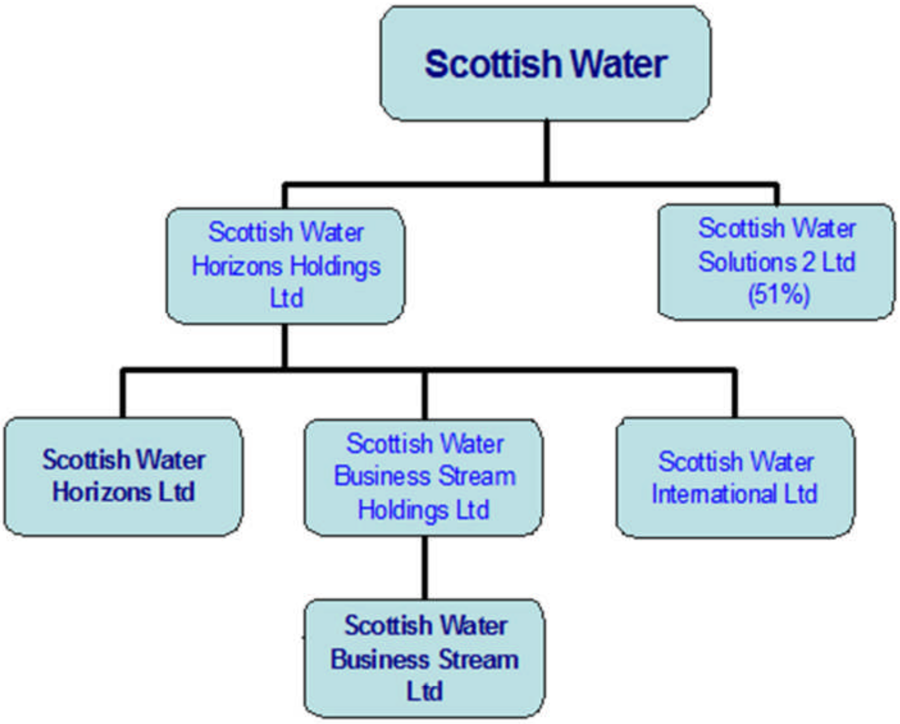
Going concern

We are not aware of any events or conditions which would cast doubt over the Groups ability to continue as a going concern. We have obtained and reviewed the going concern assessment and note no issues. As a result we consider that the Board's adoption of the going concern basis of preparation is appropriate.

Appendices

Scottish Water Group Organisation Chart

In addition to our appointment as auditors for Scottish Water under our Audit Scotland appointment, we are also the statutory auditors for each of the Group subsidiaries. The companies below are 100% owned, with the exception of Scottish Water Solutions 2 Ltd which is 51% owned and accounted for as a jointly operation.

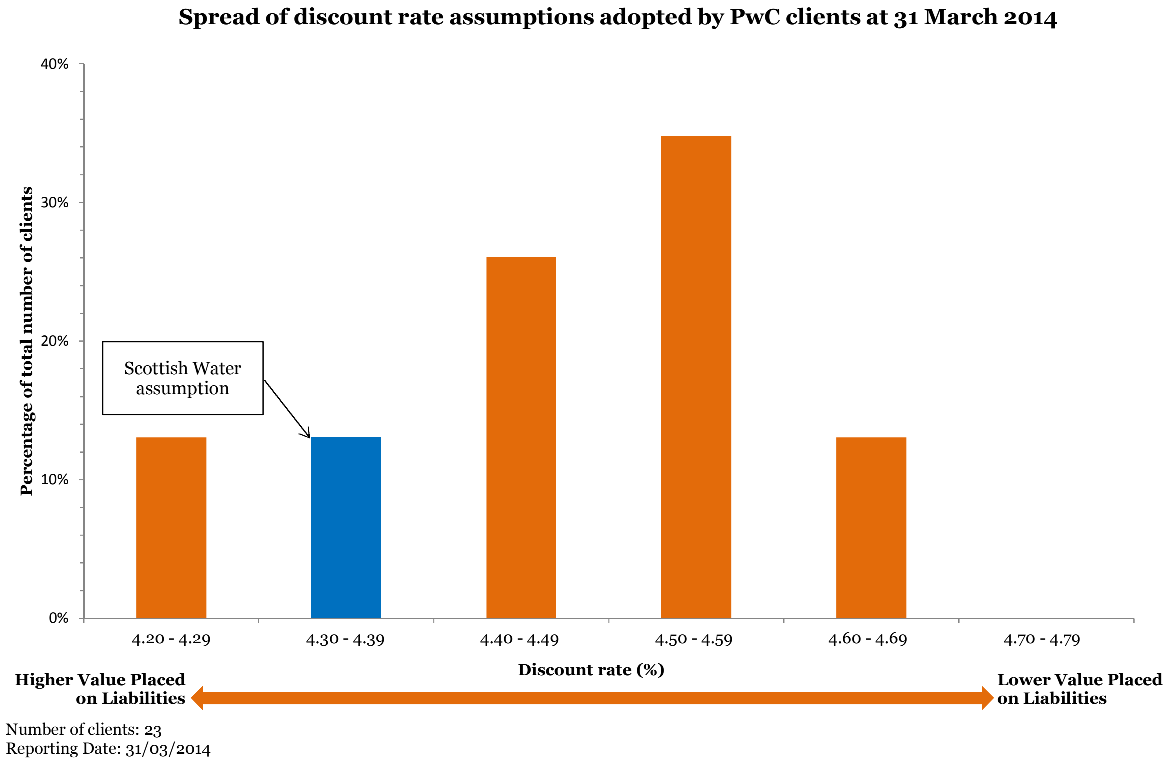


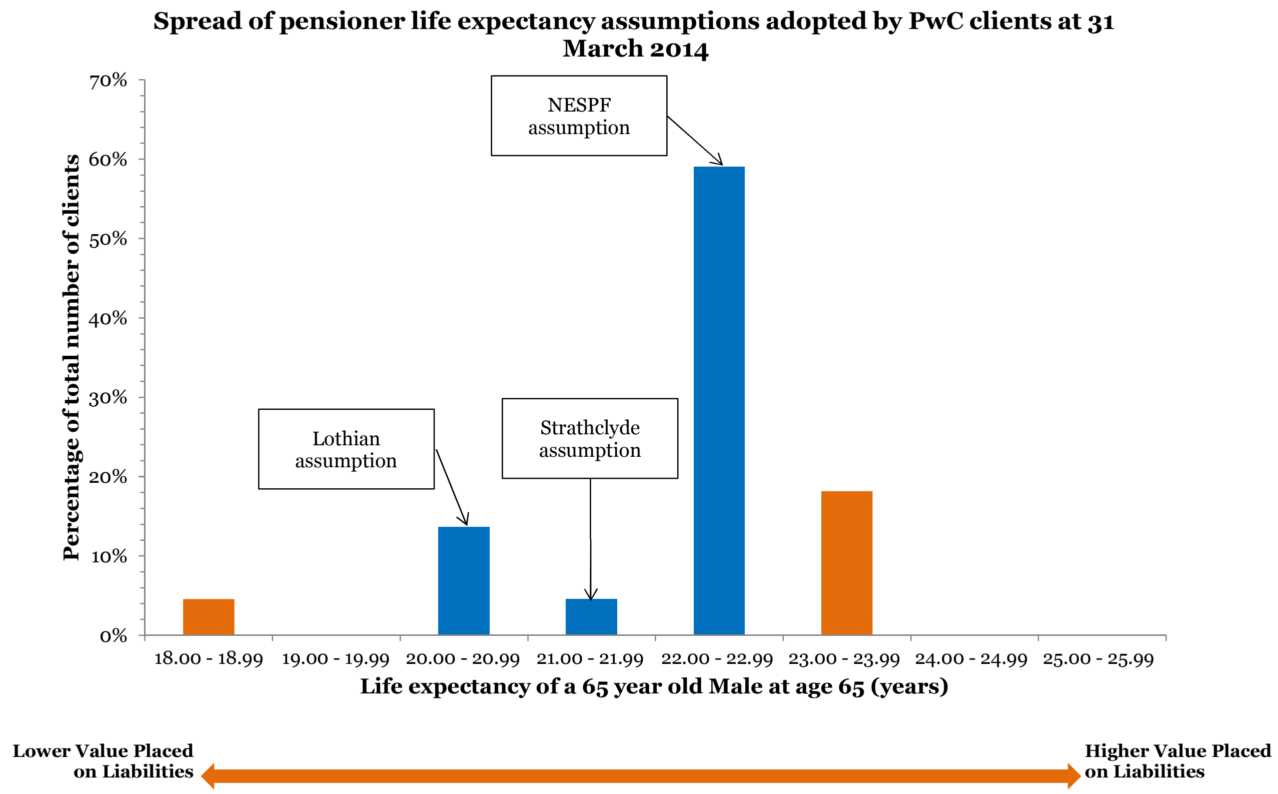
Pensions benchmarking

We have benchmarked the key pension assumptions included in the Scottish Water financial statements with a range of other clients reporting at 31/03/2014. The assumptions we have benchmarked are:

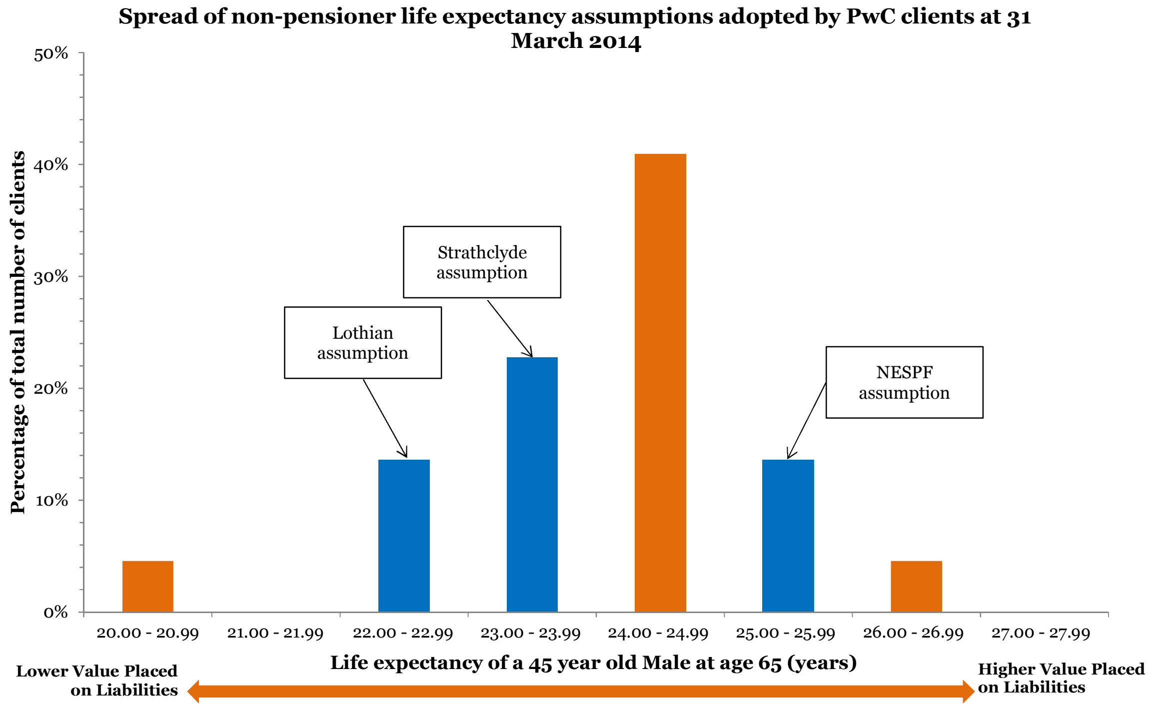
- Discount rate; and
- Mortality assumptions.

The results are included within the following graphs:





Number of clients: 21
Reporting Date: 31/03/2014



Number of clients: 22
Reporting Date: 31/03/2014

Communication to those charged with governance

International Standards on Auditing ("ISA") (UK&I) 260 – Reporting to those charged with Governance, requires that the External Auditor communicates certain matters to those charged with governance. Those charged with Governance is taken to be the Members of the Audit Committee with responsibility discharged through the regular meetings of the Committee during the year. Summarised below are the requirements set out within ISA 260 together with reference to the relevant communication with you during 2013/14 or comments as appropriate.

Communication Required under ISA 260		Reference/Comment
Copy of engagement letter to those charged with governance	✓	Signed Engagements Letter with Audit Scotland at the start of our 5 year appointment and updated annually.
Independence and objectivity confirmation	✓	Audit planning document reported to Audit Committee in November 2013 confirmed there are no matters which we perceive may impact our independence and objectivity of the audit team. This has been reconfirmed within this report.
Details of all non-audit work performed by the firm and related fees	✓	Details of non-audit work have been included within this report.
Nature and scope of work together with timing of expected reports	✓	Audit planning document reported to Audit Committee in November 2013 confirmed the nature and scope of work and expected timings of reports.
Uncorrected misstatements	✓	There are no uncorrected misstatements to report. This has been confirmed within this report.
Expected modifications to audit report	✓	No modifications expected. Final audit opinion issued in financial statements reviewed by Audit Committee in May 2014.
Materiality	✓	Materiality has been confirmed with the Audit Committee in our audit plan from November 2013 and final levels re-confirmed within this report
Views about the qualitative aspects of the entity's accounting practices and financial reporting	✓	Significant matters and qualitative aspects of accounting practices and financial reporting are included within this report.
Correspondence with management on significant matters	✓	Discussed and resolved matters arising with management throughout audit process and the presentation on the audit to the Audit Committee on 22 May 2014.
Final draft of representation letter	✓	Final draft of the representation letter has been included within the joint accounting paper issued to Audit Committee in May 2014.
Any other audit matters of governance interest	✓	None identified.
Related Parties	✓	Other than those transactions disclosed in the Financial Statements we have not identified any further transactions requiring disclosure. This is confirmed within this report.
Fraud	✓	Discussed fraud arrangements with the Audit Committee members, review of internal audit findings and management throughout audit process.
Significant deficiencies in internal control identified during the audit	✓	Internal Controls findings are discussed within this report. No material weaknesses were identified that would impact adversely on our audit approach or opinion.