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Scottish Water

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

Year ended 31 March 2016

7 June 2016

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 2016.

Our audit was performed in accordance with the principles contained in Audit Scotland's Code of Audit Practice ("the Code") and the scope and proposed focus of our work as set out in our Audit plan presented in December 2015. 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.

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 audit opinion for the consolidated financial statements was signed on 7 June 2016. A copy of the financial statements 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 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.

The Group structure chart is included in appendix 1. At the time of writing unqualified audit opinions have been issued for the subsidiaries.

Materiality

We have conducted our work in accordance with the overall materiality and de-minimis 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 - £10.9m (£10.1m as communicated in December 2015). 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 - £8.2m (£7.6m as communicated in December 2015). 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 December 2015). 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 December 2015.

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 - Company	£10.4m	£7.8m	£0.2m
Scottish Water Business Stream Ltd	£2.2m	£1.6m	£0.2m
Scottish Water Horizons Holdings Ltd	£1.5m	£1.1m	£0.2m
Scottish Water Horizons Ltd	£0.14m	£0.1m	£0.2m
Scottish Water Business Stream Holdings Ltd	£1.2m	£0.9m	£0.2m
Scottish Water International Ltd	£0.03	£0.02	£0.2m
Scottish Water Solutions 2 Ltd	£0.7m	£0.5m	£0.2m

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

Significant audit and accounting matters

Significant and elevated audit risks

In our audit plan presented in December 2015 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 and capital additions	Significant	◉	○	◉
Household bad debt provision	Elevated	○	○	◉
Pension assumptions	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

Consistent with FY15, we will 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:

- Sensitivities on future household cash collection rates and the associated level of bad debt provisioning;
- Delivery costs associated with Scottish Water capital investment programmes and the associated expenditure classification; and
- Key assumptions associated with determining the actuarial valuation of pension obligations.

These areas are consistent with the risk assessment included within our audit opinion.

Management override of controls – Significant risk

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 held discussions with management and internal audit on the assessment and consideration of fraud risk;
- We re-performed control account reconciliations over key balance sheet accounts, including bank reconciliations and tested a sample of reconciling items;
- We 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 been posted to reduce operating costs and increase fixed assets. As part of our testing we used our Data Assurance specialists to run interrogation tools over the complete population of journals posted. We provided management with the key statistics gathered through the data interrogation tools and they will review this as part of their regular finance meetings;
- 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, and testing a sample of immaterial bank reconciling items.

No issues have arisen from our testing.

Risk of fraud in revenue recognition – Significant risk

As outlined in our risk assessment, the risk of fraud in revenue recognition has been identified as a significant risk for the wholesale and other non-regulatory income streams, 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 confirmations from 32 of the 32 councils, covering 100% of the revenue 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 2015/16 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 and capital additions – Significant risk

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, in particular if assets capitalised have been authorised by appropriate individuals;
- We have discussed the progress of the projects under the new alliance framework with members of the commercial team and reviewed the status of projects with reference to original budget and latest estimated forecasts. As part of these discussions we have also understood the controls in place over the forecasting and monitoring of the capital projects;
- We tested a sample of expenditure by agreeing transactions to invoices and by testing the appropriateness of expenses capitalised. For expenditure allocated to cost of sales or operating expenses we agreed the classification as appropriate;
- We tested additions transferred from assets under construction to fixed assets around the period end for evidence of asset completion; and
- We identified material manual journals posted from expenditure accounts to fixed asset 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 – Elevated risk

As at 31 March 2016, the Scottish Water balance sheet includes a household income debtor of £459.2 million and a corresponding bad debt provision of £431.4 million, leaving a net debtor position of £27.8 million (2015: £20.8 million). Scottish Water is not permitted to write off any of its outstanding debt and therefore this total outstanding debt includes all years dating back to 1996/97.

The provision is established by applying an average forecast collection rate to the total household billing, and by deducting the forecast recoverable amount from the outstanding receivable. This is demonstrated in the table below:

	1996 - 2012	2012/2013	2013/2014	2014/2015	2015/2016	Total
Total billings (£m)	8,464	755	782	802	824	11,627
Cash collected (£m)	8,155	725	750	766	772	11,168
Forecast total collection (£m)	8,157	726	751	770	792	11,196
Outstanding debtor (£m)	309	30	32	36	52	459
Provision (£m)	307	29	31	32	32	431
Net debtor (£m)	2	1	1	4	20	28

The key components of the bad debt provision are the total household billings, cash collected to date and the forecast collection rate. The household billing amounts and cash collected are communicated by the councils and these figures cannot be influenced by Scottish Water. As part of our audit procedures we have agreed the total billings and cash collected in 2015/16 to confirmations received directly from the councils. Historic billings and cash collection included in the provision calculation were agreed to prior year audit work papers where these were confirmed with the councils in previous years.

The table also illustrates that the majority of the outstanding receivable relates to historic periods (75% pre 2012) and these are substantially provided for. If Scottish Water adopted the working practices of most 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 this older aged debt.

The most sensitive assumption is the forecast collection rate, and the level at which this is estimated has 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 overall forecast collection rate is also reviewed with reference to the overall average cash collection levels (excluding the two most recent years).

The actual cash collection rates and forecast total cash collection rates for the past five years are detailed below:

	1996/2011	**2011/2012**	**2012/2013**	**2013/2014**	**2014/2015**	**2015/2016**
Actual collection to date %	96.36%	96.24%	96.10%	95.92%	95.53%	93.52%
Forecast total collection %	96.38%	96.29%	96.22%	96.08%	96.08%	95.90%

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. 2013/14, 2014/15 and 2015/16 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 96.29% (2014/2015: 96.13%).

In 2015/16 both the in year cash collection rate (93.52%) and the average actual collection rate excluding 2014/15 and 2015/16 (96.30%) have reached the highest rates ever and in response to this the 2015/16 forecast collection rate has increased to 95.90% (previously held at 95.15%), and the overall forecast collection rate is increased to 96.29% (2014/15: 96.13%). Following the increase in rates, the overall forecast collection rate is only 0.01% lower than the average actual cash collection rate excluding the two most recent years (2015: differential 0.09%), however the forecast rates for 2013/14 – 2015/16 remain below the actual cash collection rates for 2011/12 years and earlier (on average 96.25%). Management have confirmed that the reason for the lower forecast collection level is due to the following matters:

- Collection years 2003 – 2008 are higher than the other financial years (average 96.6%) due to specific collection programmes and incentives run by Scottish Water with the councils at that time and which have not reoccurred;
- Previous collection performance is not a guarantee of future collection performance, in particular the cash collections for 2015/16 may represent a peak year for cash collection rates; and
- Management have concerns in regard to economic uncertainty and impact of government(s) policy initiatives that could influence future collection levels of year end debt.

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 upper range of sensitivity applied assumed that the average actual collection rate (excluding 2014/15 and 2015/16) (96.30%) would hold for the most recent years, the mid-range assumed that the actual cash collected in the most recent substantially complete years (2008 – 2012) of 96.25% would hold and the low end sensitivity shows the current forecast rates. The sensitivity analysis has been applied to the 2013/14, 2014/15 and 2015/16 years as these years have the lowest forecast collection rates and highest debtor levels:

	2013/14 forecast collection rate	2014/15 forecast collection rate	2015/16 forecast collection rate	Impact on provision (£m)	Bad debt provision (£m)
Actual historic rate applied (max)	96.30%	96.30%	96.30%	6.8	424.6
2008 – 2012 actual rate applied (mid)	96.25%	96.25%	96.25%	5.6	425.8
Current position (low)	96.08%	96.08%	95.90%	-	431.4

The above sensitivities demonstrate that were forecast collection rates increased to the actual average collection rates the year end provision would fall by £6.8m. We believe that this is an unlikely scenario as this average includes the 2003 – 2007 period where specific collection programmes were run with the council and this is reflected in higher collection rates for this period (96.5% - 96.7%) which is unlikely to be experienced again without a similar programme, but note that this remains below our materiality level. We believe a more likely scenario is presented in the mid case, which is that the actual collection rates experienced to date in the years after this period is experienced in the 2013 – 2016 years. This would result in a £5.6m reduction to the bad debt provision, however we note that the cumulative net debt for years before 2011 is £1.4m and many corporations would fully provide for this and therefore reallocating this to the most recent years would result in a £4.2m reduction in the bad debt provision. This is also not material.

While we have, therefore, been able to conclude that the household bad debt provision is not materially misstated, we do believe that it continues to be at the cautious end of a range. Sensitivity information is disclosed in the notes to the accounts, showing that a 0.01% movement in the forecast collection rate will have £1m impact on the bad debt provision. We note that the forecast cash collection assumptions are highly sensitive and given the magnitude of outstanding receivables and provision, the Board must ensure that these assumptions are appropriate and represent the best estimate. This will be included in the letter of representation.

Pension assumptions – Elevated risk

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 triannual valuation was carried out at 31 March 2014 for all three funds and has been updated at 31 March 2016 by Hymans Robertson LLP (independent actuary).

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	2015	2016
Rate of increase in pensionable salaries	2.3%	2.3%
Rate of increase in pensions payment	2.3%	2.3%
Discount rate	3.3%	3.6%
Inflation rate	2.3%	2.3%

Mortality	North East years		Lothian years		Strathclyde years	
	2015	2016	2015	2016	2015	2016
Male – retired	22.0	22.1	22.2	22.3	22.3	22.4
Female – retired	24.6	24.7	23.8	23.9	23.7	23.8
Male – retiring in 20 years	24.2	24.3	24.3	24.4	24.9	25.0
Female – retiring in 20 years	27.5	27.6	26.4	26.4	26.3	26.4

Overall these assumptions are in line with an expected assumption range. We have provided a benchmark analysis over the key pension assumptions within appendix 2 and these show that the Scottish Water assumptions are at the prudent to median range in comparison with other companies assumptions at 31/03/2016. This is consistent with the positioning of the assumptions at 31/03/2015 and there has therefore been no significant change in approach or position against benchmarks in respect of the pension assumptions.

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.

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 2016.

Income uncertainty provision

In the 2015/16 financial statements the income uncertainty provision in the Company balance sheet is £16m. This provision is £12.8m in respect of Scottish Water Business stream and £3.2m for other licenced 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 for third party licenced providers 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 agreed the out turns for 2012/13 2013/14, however these recalculations have not been processed by the CMA prior to the year end and £9.1m of the provision relates to these years. Progress will be made in 2016/17 on finalising the out turn for the 2014/15 period.

Accrual for credit note adjustments

The credit note accrual of £31.6m (2015: £31.0m) 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 1.015% (2014/15: 1.032%) to total billings up to 31 March 2016, less the total credits raised to March 2016. This historic accrual rate represents the average percentage of credit adjustments issued to customers after the close of the financial year dating back to 1996/97. This accrual rate excludes the most recent 5 years of credit adjustments as sufficient time has not past to allow a trend to develop in these years. This methodology is consistent with the approach adopted in previous years. Management will also make additional adjustments for any periods where they consider there to have been unexpected lower levels of credits issued, or if the future rate of credits is expected to increase. In 2014/15 an additional accrual of £0.8m was created, however due to the decrease in post year credits received in 2015/16, no additional adjustment was proposed at March 2016.

The key area of judgement in the credit note accrual is the historic accrual percentage rate applied. 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 for the most recent 5 years, which we concur with, as there is less data on which to base a reliable long term run rate.

No issues have arisen from our testing.

Financial performance

2015/16 financial performance

The financial performance for 2015/16 as reported in the Consolidated Income Statement is included below:

	2015/16 £ Million	2014/15 £ Million
Revenue	1,196.8	1,187.4
Cost of sales	(769.2)	(754.6)
Gross surplus	**427.6**	**432.8**
Administrative expenses	(143.4)	(135.5)
Operating Surplus	**284.2**	**297.3**
Finance Income	3.2	2.0
Finance Costs	(181.2)	(188.6)
Surplus on ordinary activities before tax	**106.2**	**110.7**
Taxation	17.8	(19.7)
Surplus for the year	**124.0**	**91.0**

The results show an increase at the revenue level from 2014/15, but a reduction in gross profit, operating surplus and surplus before tax. The gross margin percentage of 35.7% has decreased by 0.8%, and the margin on surplus before tax has decreased by 0.4% from 2014/15. 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 75% (2015: 71%) from Scottish Water, 22% (2015: 27%) from Business Stream and 2% (2015: 2%) from Horizons and International. There has been an overall £9.4m increase in revenue due the following factors:

- Increase of £19.9m in household revenue due to a 1.6% increase in household charges and a net increase of 18,072 properties being connected in the year;
- Decrease of £4.7m in other non-regulated revenue primarily due to a reduction in Business Solution revenue in Business Stream and delayed contracts within Scottish Water Horizons; and
- Decrease in business revenue of £5.8m. There was a decrease in Business Stream revenue of £35.1m reflecting the increased market activity of new entrants with 23 companies now licensed to operate in the retail market, and this was partially offset by an increase in Scottish Water's sales to other licensed providers of £29.3m.

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 £22.5m to £912.6m and margins have remained relatively consistent with gross margin at 36% (2015: 36%) and operating profit margin at 24% (2015: 25%). The increase has arisen due to:

- Increase of £4.7m in depreciation and amortisation costs due to the profile of capital investment in the year;
- Decrease in Business Stream, Horizons and International operating costs of £2m reflecting the decreased activity in these companies;
- Increase of £1.6m in Scottish Water PFI operating costs;
- Increase of £3.7m in IFRS and consolidation adjustments; and
- Increase of £14.5m in Scottish Water regulatory operating costs due to one off credits to operating costs in 2014/15 not repeated in 2015/16 for a local authority rates refund associated with a successful revaluation appeal (£14.5m) and release of land fill tax accrual (£5.5m), increases in energy prices, carbon reduction charges and operating costs associated with new capital investment (£4.9m), offset by a reduction of £7m in the bad debt charge.

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

2015 – 2021 regulatory period and business plan

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 £760 million from Government borrowing. Additional financing will be received from disposal of non-core capital assets, and from opening cash balances.

Following the first year of the regulatory period, the closing cash balance was £369m which was £122m ahead of the original delivery plan, however, £224m of short term borrowing was repaid by Scottish Water to the Scottish Government subsequent to the year end. While regulatory capital expenditure was £30m behind the original delivery plan at £479m, management anticipate that the total regulatory capital expenditure in the delivery plan will be achieved. Total regulatory revenue was £1,120m which was £22m ahead of the original delivery plan.

In March 2016 Scottish Water submitted an update to the delivery plan for the 2015 – 21 regulatory period to the Scottish Ministers for approval. The key elements from this update are detailed in the table below:

	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
Total capital expenditure (£m)	454	580	610	669	719	720
Total revenue (£m)	1,119	1,122	1,157	1,183	1,206	1,228
Profit before taxation (£m)	87	65	75	70	60	43
Closing cash balance (£m)	390	226	252	224	145	62

The table above demonstrates that the cash balances will decrease to £62m by 2021 if the March 2016 refresh delivery plan is met and an outperformance plan is in place to ensure that cash balances remain higher than the £62m forecast.

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.

In the 2015/16 audit plan, the test of controls included the following key areas:

- Authorisation for changes to supplier details and ensuring appropriate support was in place to approve the changes; and
- Authorisation and approval of fixed asset additions at various stages of capitalisation.

We performed detail testing over the payroll control cycle in 2014/15 and therefore no detailed controls testing was performed over this cycle in the current year, however we did re-confirm our understanding of the controls and processes in place.

There were no control recommendations identified which would have a significant impact on the financial statements.

Corporate governance code – Going concern, Risk assessment and viability statement

The 2014 revisions to the UK Corporate Governance Code requires companies to make a number of new disclosures from 30 September 2015. These include a 'viability statement', which requires directors to explain, given the company's current position and principal risks, "how they have assessed the prospects of the company, over what period they have done so and why they consider that period to be appropriate" and a new formal statement with regards to risk management and internal control, confirming that the directors have carried out a robust assessment of the principal risks, how they are being managed or mitigated and reviewed the effectiveness of controls.

Our responsibilities over the code revisions and the procedures we have performed to address these responsibilities are as follows:

Area	Responsibility	Procedures performed and conclusion
Robust assessment of principal risks	Under ISAs (UK & Ireland) we are required to report to you if we have anything material to add or to draw attention to in relation to: • The members confirmation made in accordance with provision C.2.1 of the code that they have carried out a robust assessment of the principal risks facing the Group, including those that would threaten its business model, future performance, solvency or liquidity; and • The disclosures in the Annual Report that describe those risks and explain how they are being managed or mitigated.	• Reviewed the most recent corporate risk register and confirmed that all 'red' risks currently facing Scottish Water are included within the Principal Risks and Uncertainties section in the Annual Report and Accounts; • Risk updates are provided to the Audit Committee on a bi-annual basis. We attended both of these Audit Committee meetings in 2015/16 and observed detailed discussions and challenge over the risk wording, trending of the risk and scoring in the risks register; • Reviewed the risk management control schedule prepared for the Board and the Audit Committee by Group Finance which included a checklist recording the evidence sources and examples of review of risk management and internal control by the Board and Audit Committee. • Reviewed the disclosures in the Annual Report and Accounts and confirmed that they describe the principal risks and how they are being managed or mitigated. Overall, risk management and internal control appears regularly on the Senior Management Team's agenda. 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. We have nothing material to add or to draw attention to in respect of this responsibility.

Viability	Under ISAs (UK & Ireland) we are required to report to you if we have anything material to add or to draw attention to in relation to: • The members explanation in accordance with provision C.2.2 of the Code as to how they have assessed the prospects of the Group, over what period they have done so and why they consider that period to be appropriate, and their statement as to whether they have a reasonable expectation that the Group will be able to continue to meet its liabilities as they fall due over the period of their assessment.	• Reviewed the documentation prepared by Group Finance for the Board to support their disclosures surrounding the viability of the company; • Evaluated the consistency of the viability statement in the Annual Report and Accounts with knowledge obtained during our audit of the financial statements; • Made inquiries of the Board and Audit Committee, and attended the Audit Committee meetings where risk management and viability was discussed. The Audit Committee discussed the impact that the 'red' risks could have on the viability of the Group and reviewed qualitative and quantitative stress testing performed by Group Finance; and • Considered whether the disclosures made in the Annual Report and Accounts are consistent with the discussions we observed and papers reviewed, and if the statement meets the disclosure requirements of the 2014 Corporate Governance Code revisions. We have nothing material to add or to draw attention to in respect of this responsibility.
Going concern	Under ISAs (UK & Ireland) we are required to report to you if we have anything material to add or to draw attention to in relation to the Directors' statement, set out in the Annual Report and Accounts about whether they considered it appropriate to adopt the going concern basis in preparing the financial statements.	• Reviewed the current and forecast Group and Company cash position; • Reviewed the repayment profile for short and long term government borrowing and the external financing limited set by the Government for 2015/16; and • Considered the business plan for 2015 – 2021 regulatory period which provides Scottish Water with an agreed income stream (household income) for this period. We have nothing material to add or to draw attention to in respect of this responsibility.

Internal Audit

As part of the planning for the 2015/16 audit, we also considered Scottish Water's Internal Audit function, in particular work undertaken during 2015/16. 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. As requested by the Audit Committee, the Head of Strategy and Economic Regulation and the head of Internal Audit performed a "fair, balanced and understandable" review of the Annual Report and Accounts based on their knowledge and understanding of Scottish Water's performance over 2015/16.

Fraud

Fraud risk assessment, anti-fraud governance and the tone at the top in respect of fraud risk continues to be a focus for the Senior Management team.

An Ethics Committee is in place to govern the anti-fraud strategy and related proactive and reactive investigations. The committee is chaired by Geoff Aitkenhead (Executive Director Capital Investment) and comprises the leadership team and senior management representatives from a range of departments. The Committee meets at least four times a year and is responsible for a number of activities including oversight, development and implementation of appropriate counter-fraud strategies across Scottish Water and the review of investigation reports and corrective action plans. There is also an external whistleblowing hotline with any activity reported to and monitored by the head of Internal Audit.

The chair of the Ethics Committee provided an annual update to the Audit Committee in February 2016, including the results of a follow up fraud risk assessment review performed by EY in 2015, the results of which showed improvement from the first review performed in 2013.

National Fraud Initiative

The 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 participated in the 2014/15 NFI exercise and provided Audit Scotland with payroll and supplier payments data. We understand that 495 supplier data and 63 payroll data recommended matches were Communicated to Scottish Water and fully investigated by Internal Audit alongside members of the finance team. There were no significant findings arising from the review.

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 2015/16 to Scottish Water Business Stream were the continued provision of a VAT and HRS helpline as previously communicated to the Audit Committee as part of our audit plan in December 2015 and the provision of corporate tax compliance and iXBRL tagging services.

There was one non audit service provided to Scottish Water in respect challenge over the methodology used to perform project assurance over an IT and Business Change project. Approval was obtained from Audit Scotland for us to provide this service.

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 by internal audit. Any confirmed instances of fraud will be reported to Audit Scotland in the fraud reports to be issued in May 2016. 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.

We have requested that all Non-Executive and Executive Directors confirm any transactions they were aware of between Scottish Water companies and close family members, or other companies over which they had control or influence over. The register of declared interests is included within the representation letter and we request that the Directors re-confirm that this listing is complete prior to signing.

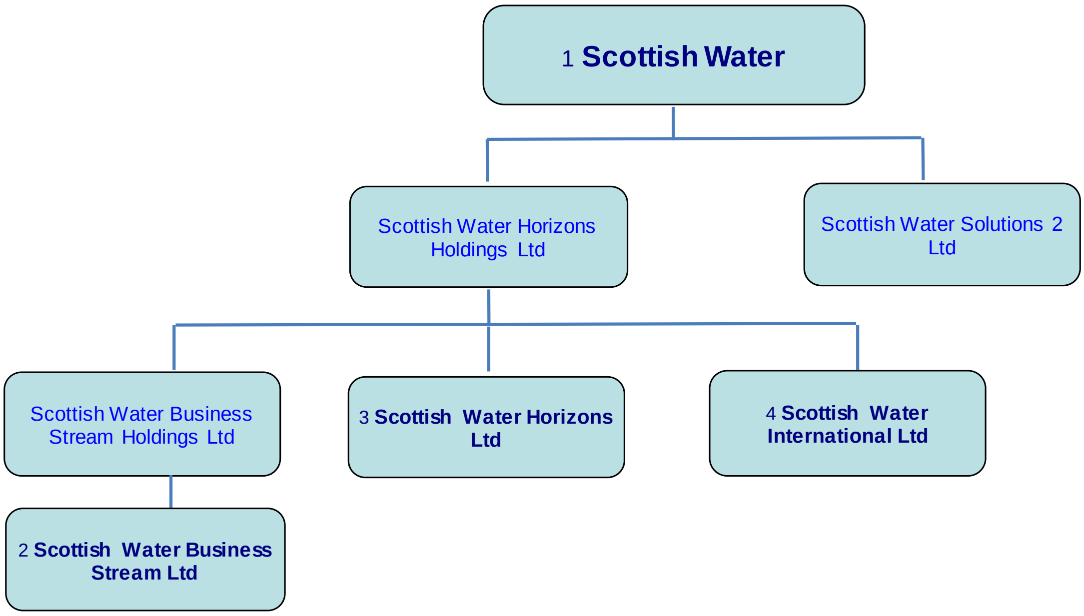
Uncorrected misstatements

No uncorrected misstatements in excess of £200k have been identified through our audit procedures. Disclosure omissions which were not considered to be material to the financial statements were included in the Management Representation letter.

Appendices

Scottish Water Group Structure 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 all 100% owned.

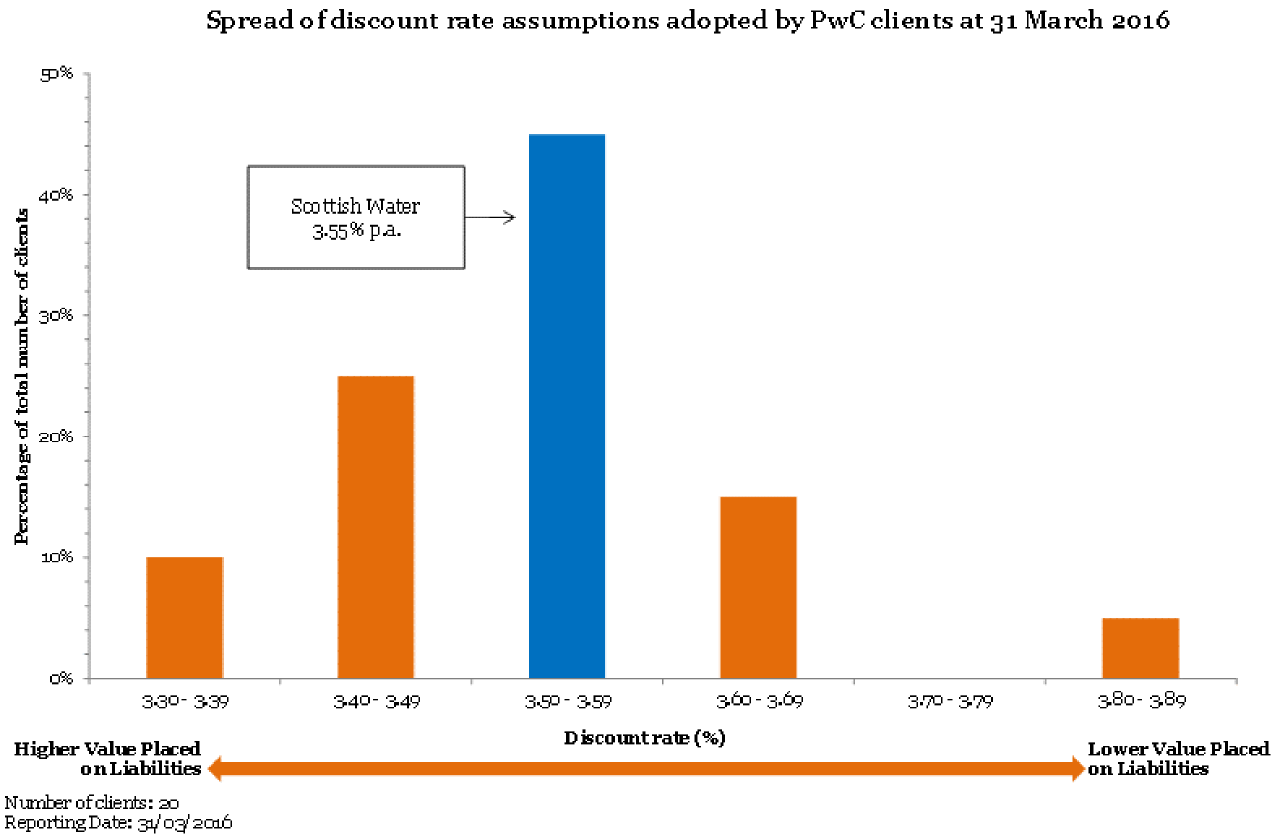


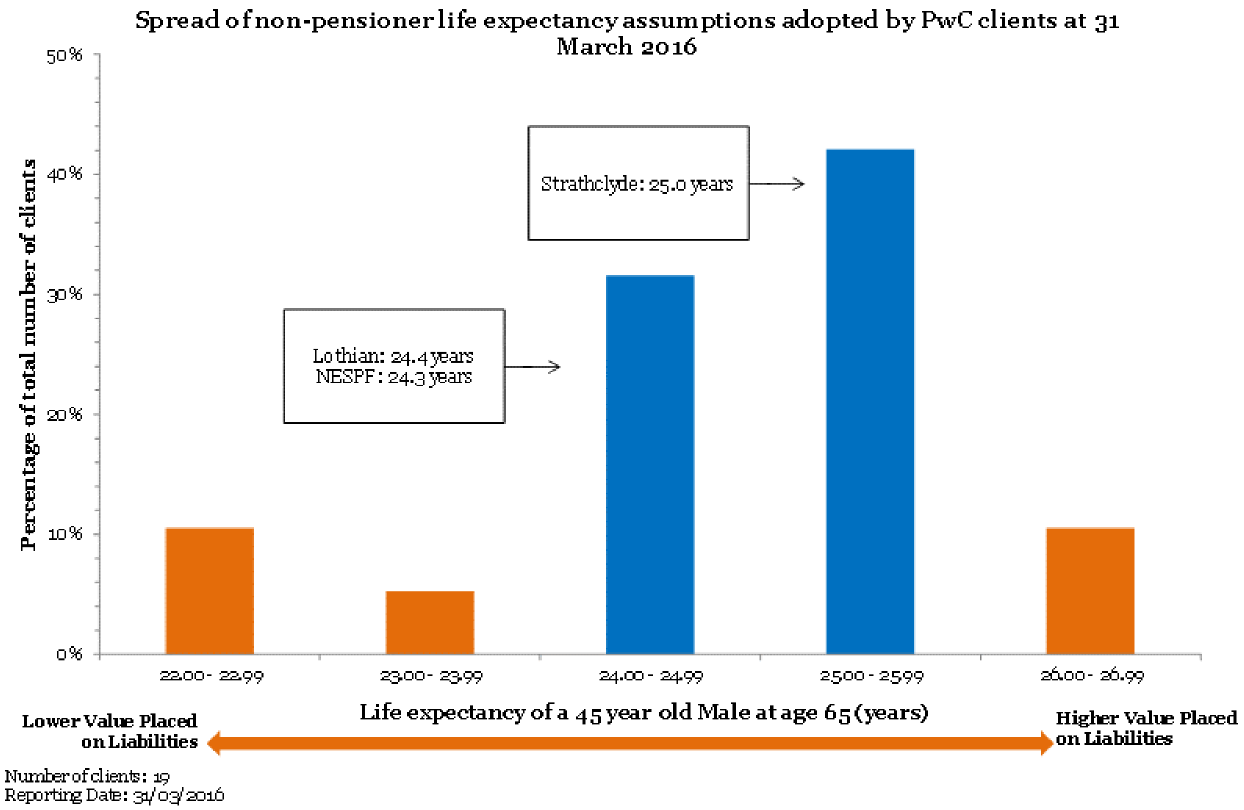
Pensions benchmarking

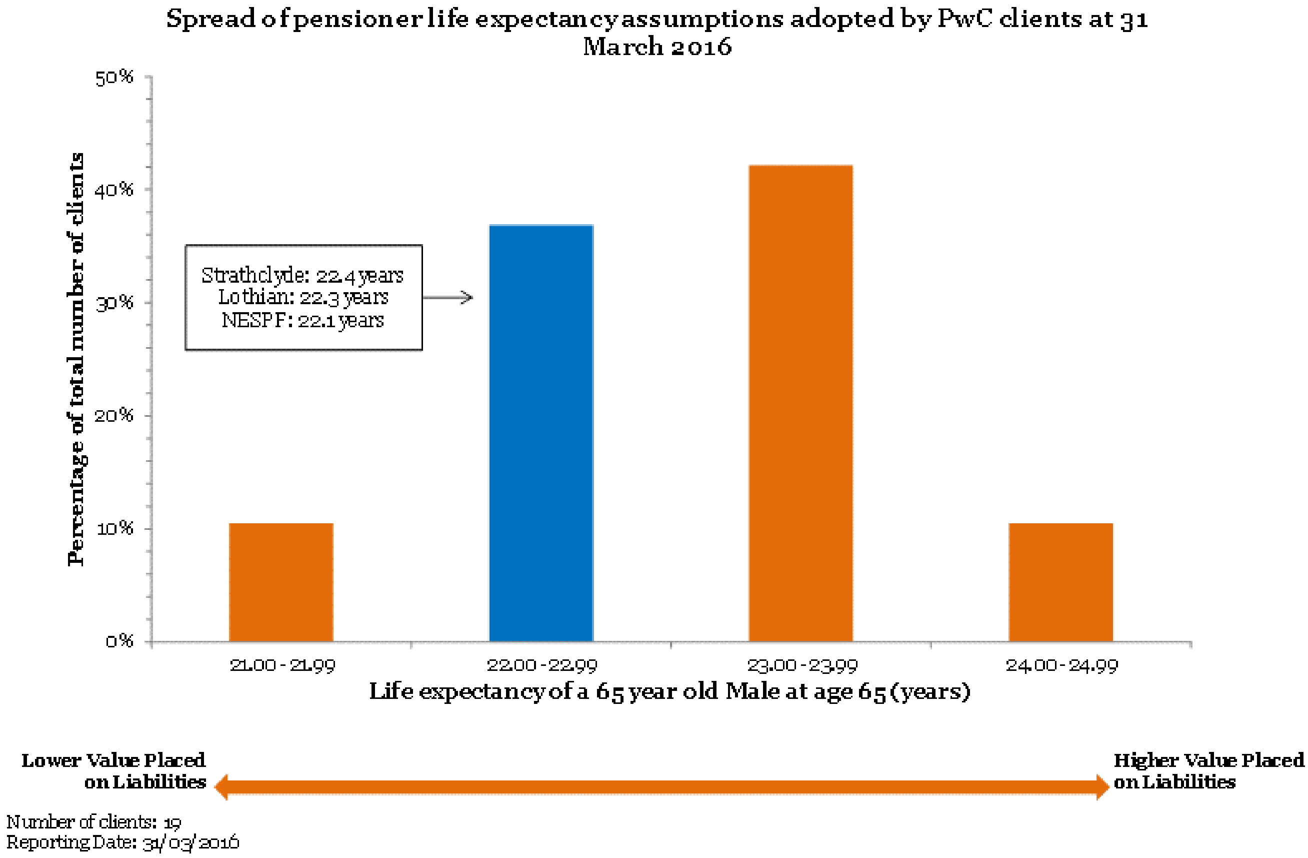
We have benchmarked the key pension assumptions included in the Scottish Water financial statements with a range of other clients reporting at 31/03/2016 (20 in total). The assumptions we have benchmarked are:

- Discount rate; and
- Mortality assumptions.

The results are included within the following graphs:




Spread of non-pensioner life expectancy assumptions adopted by PwC clients at 31 March 2016
Percentage of total number of clients
50%
40%
30%
20%
10%
0%
Strathclyde: 25.0 years
Lothian: 24.4 years
NESPF: 24.3 years
22.00 - 22.99
23.00 - 23.99
24.00 - 24.99
25.00 - 25.99
26.00 - 26.99
Life expectancy of a 45 year old Male at age 65 (years)
Lower Value Placed on Liabilities
Higher Value Placed on Liabilities
Number of clients: 19
Reporting Date: 31/03/2016


Spread of pensioner life expectancy assumptions adopted by PwC clients at 31 March 2016
Percentage of total number of clients
50%
40%
30%
20%
10%
0%
Strathclyde: 22.4 years
Lothian: 22.3 years
NESPF: 22.1 years
21.00 - 21.99
22.00 - 22.99
23.00 - 23.99
24.00 - 24.99
Life expectancy of a 65 year old Male at age 65 (years)
Lower Value Placed on Liabilities
Higher Value Placed on Liabilities
Number of clients: 19
Reporting Date: 31/03/2016

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 2015/16 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 December 2015 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 December 2015 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 2016.
Materiality	✓	Materiality has been confirmed with the Audit Committee in our audit plan from December 2015 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 in May 2016.
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 2016.
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.