



# Scottish Water

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

For the year ended 31 March 2018

5 June 2018

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## About this report

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

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

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

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

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

## Complaints

If at any time you would like to discuss with us how our services can be improved or if you have a complaint about them, you are invited to contact Hugh Harvie, who is the engagement leader for our services to Scottish Water, telephone 0131 527 6682 email: [hugh.harvie@kpmg.co.uk](mailto:hugh.harvie@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 Caroline Gardner, Auditor General and Accountable Officer, Audit Scotland, 4<sup>th</sup> Floor, 102 West Port, Edinburgh, EH3 9DN.

# Executive summary headlines

## Audit conclusions

- We issued unqualified audit opinions on the financial statements of Scottish Water and its subsidiaries.

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## Financial position and sustainability

- The Group surplus before tax decreased by £22.4m to £71.8m compared with the prior year (£94.2m).
- The Group continues to have net current assets and the reduction in the year is largely in respect of continued capital investment. Capital investment in the year amounted to £498.4m (2016-17: £489.3m).
- The overall forecast finance requirement for delivering the 2015-2021 business plan is c.£8bn. The plan assumes that £7bn will be received from customer revenue and £760m from net new Government borrowing (agreed in the 2014 Final Determination issued by the Water Industry Commission for Scotland). The third year of the regulatory period has now ended, with the closing cash balance slightly ahead of that forecast in the March 2018 update. Preparation for the next regulatory period (2021-2027) has commenced.

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## Financial statements and accounting

- We have concluded satisfactorily in respect of each of the significant risks and audit focus areas identified in the audit strategy and plan document.
- The annual accounts, statement of responsibilities, governance statement and remuneration report were received in line with the agreed timetable and were supported by good quality audit workpapers.
- There are no adjusted or unadjusted audit differences or independence matters which we require to bring to your attention in respect of any group entities subject to audit.

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## Wider scope

- We considered the wider scope audit dimensions, concluding positively in respect of financial sustainability, governance and transparency and value for money.

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# Executive summary

## scope and responsibilities

### Purpose of this report

The Auditor General for Scotland has appointed KPMG LLP as auditor of Scottish Water in accordance with the Public Finance and Accountability (Scotland) Act 2000. The period of appointment is 2016-17 to 2020-21, inclusive.

Our annual audit report is designated to summarise our opinions and conclusions on significant issues arising from our audit. It is addressed to both those charged with governance at Scottish Water and the Auditor General for Scotland. The scope and nature of our audit were set out in our audit strategy document which was presented to the audit committee at the outset of our audit.

Audit Scotland's Code of Audit Practice ("the Code") sets out the wider dimensions of public sector audit which involves not only the audit of the financial statements but also consideration of areas such as financial performance and corporate governance.

### Accountable officer responsibilities

The Code sets out Scottish Water's responsibilities in respect of:

- Preparation of financial statements that show a true and fair view;
- Systems of internal control;
- Prevention and detection of fraud and irregularities;
- Standards of conduct and arrangements for the prevention and detection of bribery and corruption;
- Financial position; and
- Best value.

### Auditor responsibilities

This report reflects our overall responsibility to carry out an audit in accordance with our statutory responsibilities under the Act and in accordance with International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board and the Code. Appendix four sets out how we have met each of the responsibilities set out in the Code.

### Scope

An audit of the financial statements is not designated to identify all matters that may be relevant to those charged with governance.

Weaknesses or risks identified are only those which have come to our attention during our normal audit work in accordance with the Code, and may not be all that exist.

Communication by auditors of matters arising from the audit of the financial statements or of risks or weaknesses does not absolve management from its responsibility to address the issues raised and to maintain an adequate system of control.

Under the requirements of International Standard on Auditing (UK and Ireland) ('ISA') 260 *Communication with those charged with governance*. We are required to communicate audit matters arising from the audit of financial statements to those charged with governance of an entity.

This annual audit report to members and our presentation to the audit committee, together with previous reports to the audit committee throughout the year, discharges the requirements of ISA 260.

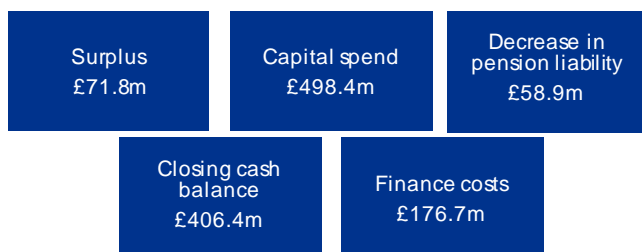
# Financial position and sustainability

## Overview

Scottish Ministers set objectives for Scottish Water for the period 1 April 2015 to 31 March 2021 in respect of regulated activities. These are focussed on water quality, asset investment and maintenance, customer service, liaison with key stakeholders, and service improvement. Significant capital investment of up to £3.9bn over the six year program underpins the regulatory delivery plan.

Scottish Water uses its peoples' skills and other assets to add value for stakeholders and Scotland's economy more broadly. These activities are primarily conducted through subsidiaries in respect of non-regulated activities. Scottish Water Horizons continues to pursue innovative sustainability objectives, Scottish Water International offers consultancy services to utilities, government and overseas clients and Scottish Water Business Stream ("Business Stream") supplies water to non-households in Scotland and England.

The group surplus before tax decreased by £22.4m to £71.8m compared with the prior year (£94.2m). Income was £210.5m higher at £1,424m offset by a £230m increase in expenditure to £1,176.7 both largely reflecting the impact of Business Stream's acquisition of the non-household customer base of Southern Water in April 2017. Company capital investment was £493.8m (2016-17: £484.5m) reflecting continued investment in significant projects and ongoing infrastructure upgrades. Group net debt increased by £143.2m to £3,137.9m due to utilisation of cash balances and additional borrowing of £120m.



## Financial position: consolidated income statement

Scottish Water group has continued to experience strong performance in respect of regulated activities. Household income increased £20.9m to £860.9m reflecting a 1.6% tariff increase and increased connections.

Total business sales income increased by £192.8m to £526.2m due to growth at Business Stream and the continuing work to identify unregistered properties and bring them to charge.

Total Business Stream revenue increased by £173m largely due to acquisition of the new customer base in England.

Operating cost increases are primarily as a result of costs incurred in relation to Business Stream's new activities in England (£172.5m) depreciation, weather related incident costs, new legislative costs, and the bad debt charge.

Comprehensive income and expenditure statement (Group)			
	2017-18 £m	2016-17 £m	Variance £m
Revenue	1,424.0	1,213.5	210.5
Cost of sales	(1,014.4)	(805.7)	(208.7)
Gross surplus	409.6	407.8	1.8
Administrative expenses	(162.3)	(141.0)	(21.3)
Operating surplus	247.3	266.8	(19.5)
Finance income	1.2	1.8	(0.6)
Finance costs	(176.7)	(174.4)	2.3
Surplus before taxation	71.8	94.2	(22.4)
Taxation	(13.7)	2.0	(11.7)
Surplus for the year	58.1	96.2	(38.1)

# Financial position and sustainability (continued)

## Financial position: balance sheets

Additions as a result of capital investment in the current year are £493.8 million (2016-17: £484.5m). Scottish Water's depreciation cost remained similar to prior year. Amortisation of £3.5m (2016-17 £nil) was recorded against the intangible asset acquired by Business Stream in respect of the Southern Water customer list. The net book value at year end is £13.9m.

Group current assets increased by £26.7m, primarily as a result of the increase in trade and other receivables. Scottish Water Company remains in a net current liability position. The Group continues to have net current assets and the reduction in the year is as planned, related to continued capital investment.

Consolidated net debt increased by £143.2m to £3,137.9m (being loans of £3,544.3m less cash balances of £406.4m). There was additional net new borrowing of £120m from the Scottish Consolidated Fund.

Scottish Water Company's cash balance at 31 March 2018 of £270.6m is c£23.6m ahead of that forecast in the updated 2018 regulatory delivery plan submitted to Scottish Ministers in March 2018.

The Group cash balance is forecast to continue to decrease over the regulatory plan period, associated with continued investment and Scottish Water expects to increase net Government borrowing by £640m over the remaining period to 2021.

Net cash movement	Scottish Water Group cash £m
Balance at 1 April 2017	429.6
Cash (utilisation)/ generation	(23.2)
Balance at 31 March 2018	406.4

Source: annual accounts.

Balance sheet (Group)	2017-18 £m	2016-17 £m	Variance £m
Non-current assets	5,996.5	5,759.8	236.7
Current assets	610.9	584.2	26.7
Current liabilities	(488.7)	(420.8)	(67.9)
<b>Net current assets</b>	<b>122.2</b>	<b>163.4</b>	<b>(41.2)</b>
Non-current liabilities	(923.0)	(973.5)	50.5
<b>Net assets</b>	<b>5,195.7</b>	<b>4,949.7</b>	<b>246</b>
<b>Equity</b>	<b>5,195.7</b>	<b>4,949.7</b>	<b>246</b>

Source: KPMG analysis of annual accounts 2017-18.

## Capital expenditure (Scottish Water Company)

The overall forecast finance requirements for delivering the 2015-2021 business plan is £8bn, of which £3.9bn relates to planning infrastructure and capital investment across treatment works, water mains, sewers and networks.

£647m (on a regulated accounting basis) was invested during 2017-18 in respect of ongoing projects, making it the largest component of Scottish Water's total annual expenditure. An element of this investment related to maintenance and is not considered to be capital for the purposes of the financial statements resulting in capitalised expenditure of £493.8m (on an IFRS basis). Significant projects during the year included:

- Ayrshire Strategic Resilience water main installation;
- Shieldhall Tunnel improvement to the sewer network, expected to complete in June 2018;
- New treatment works and upgrades in Oban.

Reflecting the significance of current projects, the balance of capital work in progress increased by £25m to £626.7m in 2017-18. It is expected to begin to reduce from 2018-19.

# Financial position and sustainability (continued)

## 2015-2021 regulatory period and business plan

The overall forecast finance requirements for delivering the 2015-2021 business plan is £8bn. The budget assumes that £7bn will be received from customer revenue and £760m from net new Government borrowing (agreed in the 2014 Final Determination issued by the Water Industry Commission for Scotland).

The delivery plan was updated in March 2018 and the key features are summarised in the table below:

	2016-17	2017-18	2018-19	2019-20	2020-21
Regulated capital investment £m	627	640	700	769	784
Total revenue £m	1,149	1,182	1,196	1,221	1,233
Profit before tax £m	100	109	75	72	58
Closing cash £m	235	247	241	172	76

Source: KPMG analysis of Delivery Plan Update March 2018.

Management work to outperform the plan in an attempt to ensure that cash balances remain higher than forecast in 2020-21. Any achieved and forecast outperformance is allocated to support the capital programme.

The third year of the regulatory period has now ended, with the closing cash balance slightly ahead of that forecast in the March 2018 update. The forecast cash position at the end of 2020-21 is now £76m, compared with £40m in the original delivery plan.

## Going concern

The delivery plan update sets out key assumptions management have used in preparing revised financial forecasts to 31 March 2021. In addition, the financial statements include a viability statement in respect of Scottish Water's continued operations.

We considered key assumptions against our business and commercial understanding. The Final Determination provides for net additional borrowing over the plan period to support expected capital investment.

Management have begun preparatory work in respect of the next delivery plan period 2021 to 2027.

While there has been outperformance against the current plan which to date has been in part from one off gains as well as underlying efficiencies, management expect to focus on business transformation, including lean methodologies in order to continue to outperform expectations in the next delivery plan period.

## Conclusion

The SW Group cash balance decreased by £23.2m from prior year. While Scottish Water Regulatory Business experienced an increase in cash balances in the year, it maintains its position of net current liabilities, which is in line with the delivery plan for the current regulatory period to 2021. Management work to outperform the plan to ensure that cash balances remain higher than forecast in 2020-21.

Agreed Government borrowing of £640m is planned to be utilised over the remaining plan period and has not been required to date due to outperformance by Scottish Water Group in respect of financial forecasts.

We have considered capital investment and the allocation of costs between capital and maintenance and have not identified any adjustments.

We are satisfied that management's adoption of the going concern basis is appropriate in light of the matters set out in this section including our understanding of preparatory work commenced in respect of the next delivery plan period.

# Financial statements and accounting

## Audit conclusions

Audit opinion
<p>Our audit work is complete. Following approval of the annual accounts by the audit committee and board, we issued an unqualified opinion on the truth and fairness of the state of Scottish Water and its group's affairs as at 31 March 2018, and of the surplus for the year then ended. We also issued unqualified opinions on the truth and fairness of the state of the affairs of subsidiaries as at 31 March 2018. We also issued an unqualified opinion on the regularity of transactions within the year.</p> <p>We have prepared a separate annual audit report in respect of Business Stream which has been considered by its board.</p> <p>There are no matters identified on which we are required to report by exception.</p>
Financial reporting framework, legislation and other reporting requirements
<p>Scottish Water is required to prepare its financial statements in accordance with IFRS as adopted by the European Union, as interpreted and adapted by the 2016-17 FReM and in accordance with the requirements of the Water Industry (Scotland) Act 2002. Our audit confirms that the financial statements (after any relevant adjustments) are appropriately prepared.</p>
Other communications
<p>We did not encounter any significant difficulties during the audit. There were no other significant matters arising from the audit that were discussed, or subject to correspondence with management that have not been included within this report. There are no other matters arising from the audit, that, in our professional judgement, are significant to the oversight of the financial reporting process.</p>
Audit misstatements
<p>There have been no audit misstatements identified during the audit other than minor presentational adjustments.</p>
Written representations
<p>Our management representation letter has been separately provided within the joint paper.</p>



# Financial statements and accounting

## Audit conclusions (continued)

### Materiality

We summarised our approach to materiality in our audit strategy. On receipt of the financial statements and following completion of our audit testing we reviewed our materiality levels and concluded that the level of materiality set at planning was still relevant. Group materiality of 1% of gross expenditure incurred in 2016-17 was used (£9.5m). We report all misstatements greater than £200,000.

The levels outlined above are used in respect of the Scottish Water company and consolidated financial statements, however, lower level statutory materialities have been used for the subsidiary audits as detailed below.

Entity	Performance materiality	Reporting threshold
Scottish Water International Ltd	£22,000	£1,500
Scottish Water Horizons Ltd	£76,000	£5,000
Scottish Water Business Stream	£0.5m	£35,000
Scottish Water Horizons Holdings Ltd	£1.2m	£80,000
Scottish Water Solutions 2 Ltd	£0.2m	£12,000

### Forming our opinions and conclusions

In gathering the evidence for the above opinions and conclusions we:

- performed controls testing and substantive procedures to ensure that key risks to the annual accounts have been covered;
- communicated with internal audit and reviewed its reports as issued to the audit committee to ensure all key risk areas which may be viewed to have an impact on the annual accounts have been considered;
- reviewed estimates and accounting judgments made by management and considered them for appropriateness;
- considered the potential effect of fraud on the annual accounts through discussions with senior management and internal audit to gain a better understanding of the work performed in relation to prevention and detection of fraud; and
- attended audit committee meetings to communicate our findings to those charged with governance, and to update our understanding of the key governance processes.

### Financial statements preparation

High quality working papers and draft financial statements for relevant entities were provided at the start of the audit fieldwork on 10 April 2018. In accordance with the timetable provided by management, Scottish Water draft financial statements were provided on 21 April 2018.

The standard of work papers and supporting documentation provided by management continues to be high. We note in particular, that this was the case in 2017-18 despite the go-live of the new Oracle general ledger system in the year.

# Financial statements and accounting

## Significant risks and other focus areas

We summarise below the risks of material misstatement as reported within the audit strategy document. We set out the key audit procedures to address those risks and our findings from those procedures, in order that the audit committee may better understand the process by which we arrived at our audit opinion.

Significant risks:

- fraud risk from management override of controls;
- fraudulent income recognition;
- capital expenditure;
- household bad debt provision;
- retirement benefits; and
- profit recognition.

Other focus areas of:

- income uncertainty and credit note provisions; and
- going concern.

The application of the significant risks to each group entity is summarised in the table opposite.

In accordance with paragraph 19A of ISA 700, we are required to describe those assessed risks of material misstatement which had the greatest effect on: the overall audit strategy; the allocation of resources in the audit; and directing the efforts of the engagement team, in our audit opinion. We have separately **identified those in bold in the opposite table which we** consider to have had the greatest effect on our approach and on which we will report in our opinion in the financial statements.

Risk	SW	SW Business Stream	SW Horizons	SW Int'l	SW Sol'n 2
Fraud risk from management override of controls	✓	✓	✓	✓	✓
Fraud risk from income recognition		✓			
<b>Capital additions</b>	✓				
<b>Bad debt provision</b>	✓	✓			
<b>Pension liability</b>	✓	✓			
<b>Intangible asset amortisation</b>		✓			
Profit recognition			✓		

We have no changes to the risks above, or our approach to addressing the assumed ISA risks of fraud in management override of controls and risks of fraudulent revenue recognition. We do not have findings to bring to your attention in relation to these matters. No control overrides were identified.

# Financial statements and accounting

## Significant risks and other focus areas (continued)

SIGNIFICANT RISK	OUR RESPONSE	AUDIT CONCLUSION
<p><b>Fraud risk from management override of controls</b></p> <p><i>Professional standards require us to communicate the fraud risk from management override of controls as a significant risk; as management is typically in a unique position to perpetrate fraud because of its ability to manipulate accounting records and prepare fraudulent financial statements by overriding controls that otherwise appear to be operating effectively.</i></p>	<p>Our audit methodology incorporated the risk of management override of controls as a default significant risk. We did not identify any specific additional risks of management override of controls relating to the audit of Scottish Water.</p> <p>Strong oversight of finances by those charged with governance provides additional review of potential material errors caused by management override of controls.</p> <p>In line with our methodology, we carried out appropriate control testing and substantive procedures, including over journal entries and significant transactions that are outside the organisation's normal course of business, or are otherwise unusual.</p> <p>We evaluated accounting estimates, including the consideration of the bad debt provision, income uncertainty provision, credit note provision and accounting for the acquisition of Southern Water's customer list by Business Stream.</p> <p>We also discussed the risk with senior members of management and internal audit and conducted tests of unpredictability, such as subjective review of repairs and maintenance expenditure, journals and reconciling items.</p>	<p>We did not identify any indicators of management bias and note that management present sensitivity analysis and trend information related to key judgements and provisions to those charged with governance as part of standard reporting.</p> <p>We discussed a significant unusual transaction, specifically, the acquisition of Southern Water's customer list by Business Stream with management. This included accounting for the acquisition and an impairment assessment.</p> <p>We also discussed accounting related to the new arrangement regarding billing for vacant properties in 2017-18.</p> <p>There were no specific circumstances identified which would indicate additional risk of management override of controls.</p>

# Financial statements and accounting

## Significant risks and other focus areas (continued)

SIGNIFICANT RISK	OUR RESPONSE	AUDIT CONCLUSION
<p><b>Fraud risk from income revenue recognition (Business Stream)</b></p> <p><i>Professional standards require us to make a rebuttable presumption that the fraud risk from revenue recognition is a significant risk.</i></p> <p>Due to the reduction in customer base as more competitors enter the market and cost pressures on Business Stream, we have not rebutted this risk for this entity only.</p> <p>Additionally, accrued revenue is estimated based on historic data from past bills to create an expectation of the unbilled amount between the last bill and the year end. This introduces a further risk around the estimation of revenue.</p>	<p>Our procedures in respect of the risk in Scottish Water Business Stream included:</p> <ul style="list-style-type: none"> <li>– Assessing whether sales transactions either side of the balance sheet date as well as credit notes issued after year end are recognised in the correct period.</li> <li>– Testing of general IT controls of the HiAffinity billing system to ensure integrity of the automated billing system. This system contains customer information such as consumption and property details.</li> <li>– Considering the deferral of revenue recognised in respect of advanced billing to ensure this is appropriate.</li> <li>– Walkthrough of revenue accrued in respect of amounts not yet invoiced, including challenge of assumption used in estimating the unbilled portion of revenue at the year end.</li> <li>– Performing a reconciliation of revenue globally and by key customer account for the year.</li> </ul> <p><b>We rebut the risk in respect of Scottish Water and other subsidiaries.</b></p> <ul style="list-style-type: none"> <li>– For Scottish Water, we requested confirmation of household revenue from all 32 councils and received all 32 requested and we requested confirmation of wholesale revenue from licensed providers.</li> <li>– For SW Horizons, revenue is recognised based on contract values.</li> <li>– For SW International, revenue relates to consultancy services with no complex recognition criteria identified.</li> <li>– For SW Solutions2, management fee income is received for the delivery of the capital management programme for Scottish Water.</li> </ul>	<p>General IT controls were tested. HiAffinity was found to be operating effectively, however there were deficiencies found over Twinfield. We obtained revenue information directly from HiAffinity and agreed the amounts to the Twinfield system.</p> <p>Calculation of accrued revenue is based on the average of past 500 days billed. We consider this to be an appropriate basis on which to form the estimate. Revenue billed post year end in relation to accrued income was in line with our expectation.</p> <p>Deferred revenue calculations were found to be reasonable.</p> <p>A reconciliation of all cash in the year, debtors and accrued / deferred revenue was reconciled back for every customer to the revenue for the year. No issues were noted.</p> <p>Cut off testing did not identify any revenue recorded in the incorrect period.</p> <p>We are satisfied that income is recognised appropriately, in the correct financial year.</p>

# Financial statements and accounting

## Significant risks and other focus areas (continued)

SIGNIFICANT RISK	OUR RESPONSE	AUDIT CONCLUSION
<p><b>Capital additions (Scottish Water Company)</b></p> <p><b>(£493.8m, 2016-17: £484.5m)</b></p> <p><b>Accounting application</b></p> <p>Capital additions are significant, comprising the largest element of Scottish Water's annual expenditure, related to the delivery plan for regulated activities for the period 2015-16 to 2020-21.</p> <p>Directors are incentivised across a number of financial and other measures including profit and completion of capital investment programmes.</p> <p>There is judgement involved in the allocation of expenditure between capital additions and revenue which can affect profit and investment measures reported in the financial statements.</p>	<p>Our procedures included:</p> <p><b>Control design:</b></p> <p>Testing the design and operating effectiveness of controls over the allocation of costs between capital and revenue within the financial ledger at the project initiation stage and on an ongoing basis.</p> <p>Testing the design and operating effectiveness of controls over the consistency between total capital expenditure reported in the financial statements and that reported in reports to those charged with governance as part of ongoing capital project monitoring arrangements.</p> <p><b>Test of details:</b></p> <p>Building on our workover control design we compared the reports of Scottish Water's capital project monitoring group at the year end to amounts recorded as capital additions.</p> <p>In respect of a sample of capitalised additions, we evaluated the appropriateness of the classification as capital by considering the nature of the expenditure with reference to invoice, certificate or timesheets and considering the application of the relevant accounting policies.</p> <p>We assessed a sample of items allocated to revenue expenditure and considered whether they were correctly classified by considering the application of the relevant accounting policies.</p> <p>We also reviewed material manual journals.</p>	<p>During the year, assets with a nil net book value, and original book cost of £28m were written off following management's determination that they were no longer in beneficial use.</p> <p>This was a continuation of an exercise commenced in the prior year (write off in 2016-17 - £297m). While we have understood that regular meetings with those responsible for assets occurred to consider their disposal, these were not routinely documented or recorded so there is limited evidence of the consideration or challenge which occurred.</p> <p style="text-align: right;"><b>Recommendation one</b></p> <p>A regular exercise is carried out to review repairs and maintenance ledger codes for key words which management have determined may indicate an amount is capital rather than revenue. Our testing of amounts adjusted as a result of this process was satisfactory.</p> <p>The remainder of testing was satisfactory and we concur with management's treatment of additions as capital or revenue.</p>

# Financial statements and accounting

## Significant risks and other focus areas (continued)

SIGNIFICANT RISK	OUR RESPONSE	AUDIT CONCLUSION
<p><b>Bad debt provision</b> <b>(£388.1m, 2016-17: £446.6m)</b></p> <p><b>Forecast-based valuation</b></p> <p>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.</p> <p>As at 31 March 2018, the Scottish Water regulated business reported a household revenue debtor of £422.6m (2017: £478.9m) and a corresponding bad debt provision of £388.1m (2017: £446.6m) on household billings from all years dating back to 1996-97. 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.</p>	<p>Our procedures included:</p> <p><b>Control design:</b></p> <ul style="list-style-type: none"> <li>— Testing the design and operating effectiveness of controls over the review and approval of the provision and associated assumptions, by those charged with governance during the year and at the year end.</li> <li>— Testing the design and operating effectiveness of controls in respect of the reconciliation of information provided on a monthly basis by local authorities to Scottish Water in respect of amounts billed and collected. This historical information forms the basis of the forecast collection rate.</li> </ul> <p><b>Tests of detail:</b></p> <ul style="list-style-type: none"> <li>— We compared the information on historical collection rates, recorded by Scottish Water as the basis for the current year provision calculation, to the records held in respect of prior years.</li> <li>— We agreed the total amount billed and collected in respect of 2017-18, as recorded in Scottish Water's records, to confirmations received from individual local authorities.</li> </ul> <p><b>Historical comparison</b></p> <ul style="list-style-type: none"> <li>— We compared the change in forecast collection rate in the current year, to the historical trend of increasing collection rates since 1996-97.</li> </ul> <p><b>Sensitivity analysis</b></p> <ul style="list-style-type: none"> <li>— We performed sensitivity analysis and challenged management in respect of the forecast collection rate by increasing and decreasing it based on our judgement and assessing the impact on the provision.</li> </ul> <p><b>Assessing transparency</b></p> <ul style="list-style-type: none"> <li>— We assessed the disclosure of sensitivities by the Directors, and description of the provision in note 27 of financial statements.</li> </ul>	<p>As at 31 March 2018, the average forecast collection rate, applied to billings, is 96.52% resulting in an equivalent provision of 3.48%. This compares with a provision as at 31 March 2017 of 3.59%.</p> <p>There is a long term trend of improving collection rates, particularly in respect of the first year of billings which supports the upward trend in forecast collection rate.</p> <p>Management exclude the most recent three years collection rate from the calculation as insufficient time has passed to assess the collection rate. This is consistent with the prior year and we consider it to be reasonable.</p> <p>The largest movement in collection rate between any two years, over the historic period, is 0.02%. In our sensitivity analysis, this would give rise to an increase or decrease in the provision of £3.2 to £2.1m which we do not consider to be material.</p> <p>Overall we consider the provision to be appropriate, however it is at the cautious end of the scale. Small movements in the assumption give rise to large movements in the provision and we will request specific Director representation in respect of the appropriateness of the assumptions.</p>

# Financial statements and accounting

## Significant risks and other focus areas (continued)

SIGNIFICANT RISK	OUR RESPONSE	AUDIT CONCLUSION
<p><b>Net pension liability</b> (£145.5m, 2016/17:£194.4m)</p> <p><b>Subjective valuation</b></p> <p>Small changes in the assumptions and estimates used to value the pension obligation (before deducting scheme assets) would have a significant effect on the net pension liability.</p> <p>Employees of Scottish Water participate in three local government defined benefit pension schemes; North East Scotland pension fund, the Lothian pension fund and the Strathclyde pension fund.</p>	<p>Our procedures included:</p> <p><b>Control design:</b></p> <ul style="list-style-type: none"> <li>— Testing the design and operating effectiveness of controls over the provision of membership information to the actuary who uses it, together with the assumptions, to calculate the pension obligation.</li> </ul> <p><b>Benchmarking assumptions</b></p> <ul style="list-style-type: none"> <li>— 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.</li> <li>— Challenging the rate of increase in pensionable salaries assumption, by comparing it to other evidence such as the regulatory delivery plan and our understanding of Scottish Government expectations.</li> </ul> <p><b>Assessing transparency</b></p> <ul style="list-style-type: none"> <li>— Considering the adequacy of the disclosures in respect of the sensitivity of the deficit to these assumptions.</li> </ul>	<p>We have completed benchmarking analysis which is set out at appendix one.</p> <p>The overall assumptions applied by management are considered to be reasonably balanced for a scheme with a duration of 17-19 years.</p>

# Financial statements and accounting

## Significant risks and other focus areas (continued)

OTHER FOCUS AREA	OUR RESPONSE	AUDIT CONCLUSION
<p><b>Intangible asset amortisation (Scottish Water Business Stream)</b></p> <p>Following the acquisition of the non-domestic business of Southern Water a purchase price allocation exercise will be required in order to ascertain the fair value of the assets and liabilities acquired, and any resulting goodwill.</p> <p>The key element of this is the valuation of the customer list acquired, which is a separately identifiable intangible assets. This will be calculated using a discounted cash flow model which will be based upon expected sales, less direct costs and incremental costs incurred with taking on the new customers, discounted at an appropriate rate.</p> <p>Amortisation of the customer list is judgemental being based upon the period of time over which the business is expected to benefit from this intangible.</p> <p>Any goodwill will be subject to an annual impairment review.</p>	<p>Our procedures included:</p> <p><b>Sensitivity analysis:</b></p> <ul style="list-style-type: none"> <li>— Performing sensitivity analysis over the expected life of the customer list by increasing and decreasing each based upon our judgement and assessing the impact.</li> </ul> <p><b>Tests of detail:</b></p> <ul style="list-style-type: none"> <li>— Comparing the expected customer attrition rate with that experienced in the period since acquisition to assess management's assessment of customer retention rates (ie the period over which the business is expected to benefit from this intangible).</li> </ul> <p><b>Assessing transparency:</b></p> <ul style="list-style-type: none"> <li>— We will assess the disclosure of the transaction and relevant information in the financial statements</li> </ul>	<p>We assessed the transaction using guidance from IFRS3 "Identifying a Business Combination." We note that only the customer list is being acquired, and not the embedded process. Business Stream will utilise their existing processes to service the acquired customer list. The BPA also stipulates that no liabilities of Southern Water will be assumed by Business Stream. This further supports Business Stream's accounting of the transaction as an asset purchase.</p> <p>IAS38 "Intangible Assets" is the guidance used to determine the value of the customer list. Scottish Water Business Stream has adopted the cost model and recognised the consideration of £17.4m as an intangible asset.</p> <p>We reviewed the original valuation, sensitivity analysis and attrition rates experienced to 31 March 2018. These indicate that the current useful life could be more optimistic than required but it is currently management's best estimate. The results of our sensitivity analysis did not highlight any issues in this area.</p> <p>A full impairment review is required under IAS 36 in the first year of purchase, therefore management has considered the valuation for impairment. We have reviewed these assessments and concur with the view that no impairment is required.</p>



# Financial statements and accounting

## Significant risks and other focus areas (continued)

OTHER FOCUS AREA	OUR RESPONSE	AUDIT CONCLUSION
<p><b>Income uncertainty provision (Scottish Water company level)</b></p> <p><b>(£19.5m, 2016-17: £13.5m)</b></p> <p><b>Forecast-based valuation</b></p> <p>There are a number of assumptions included in the calculation of the income uncertainty provision; the most sensitive of these is the overall forecast collection rate based on historical data.</p> <p>As at 31 March 2018, the Scottish Water company income uncertainty provision is £19.5m (2016-17: £13.5m).</p>	<p>Our procedures included:</p> <p><b>Control design:</b></p> <ul style="list-style-type: none"> <li>— Testing the design and operating effectiveness of controls over the review and approval of the provision and associated assumptions, by those charged with governance during the year and at the year end.</li> </ul> <p><b>Tests of detail:</b></p> <ul style="list-style-type: none"> <li>— We compared the information on historical billings and updated billed amounts, recorded by Scottish Water as the basis for the current year provision calculation, to the records held in respect of prior years.</li> <li>— We agreed a sample of movements in the provision to confirmations received from the Competition and Markets Authority and obtained copies of the final settlements for 2013-14, 2014-15 and 2015-16.</li> <li>— In respect of Scottish Water Business Stream, we confirmed that final settlements for 2013-14, 2014-15, and 2015-16 have now been reached</li> <li>— We also compared the provision in respect of 2016-17 to amounts agreed with Scottish Water Business Stream (£0.95m). The closing provision in respect of Scottish Water Business Stream is £4.9m, agreed between Scottish Water and SWBS</li> </ul> <p><b>Historical comparison</b></p> <ul style="list-style-type: none"> <li>— We compared the provision for other third party licenced providers to historical information. The rate previously applied was 2.4% of total billings, this has slightly decreased to 2.0%. The difference is not material to the financial statements.</li> </ul>	<p>The provision at group level is not material, following elimination of the uncertainty provision relating to Scottish Water Business Stream (SWBS).</p> <p>As other licensed providers continue to increase market share, the materiality of the income uncertainty provision will increase.</p> <p>We are content with management's inclusion of an additional 0.1% provision in respect of the potential for previously 'agreed' final settlements with providers to be re-opened based on customer interaction with those providers which may suggest overbilling.</p> <p>The elements of the income uncertainty provision are largely in line with prior year. The increase at a group level is primarily driven by the vacant property charging, which has led to a £4.5m provision in the current year. SW have billed wholesale charges for vacant properties of £14.2m. Of this, £10.2m was to SWBS which is eliminated on consolidation. The remaining £4m was billed to various licensed providers.</p> <p>Business Stream hold a separate provision of £6.7m. Overall, the provision for vacant charges is prudent but appropriate.</p>

# Financial statements and accounting

## Significant risks and other focus areas (continued)

OTHER FOCUS AREA	OUR RESPONSE	AUDIT CONCLUSION																		
<p><b>Credit note provision</b> (£34m, 2016-17: £33.3m)</p> <p><b>Accounting basis</b></p> <p>There is a risk that credit notes will have to be issued due to previous billing inaccuracies. This is applicable to both Scottish Water (adjustments to household billings issued by Councils in respect of prior years) and Scottish Water Business Stream (relating to business customers).</p>	<p>Our procedures included:</p> <p><b>Scottish Water Business Stream</b></p> <ul style="list-style-type: none"> <li>Critically assess the assumptions made in determining the level of provision, with reference to data observed subsequent to and at prior year ends.</li> <li>Perform sensitivity analysis on the provision model.</li> </ul> <p><b>Scottish Water (company)</b></p> <p><b>Historical comparison</b></p> <ul style="list-style-type: none"> <li>We compared the provision made in each of the past five years, with the provision that would now be made by management, with the benefit of having now obtained additional information on the required credit notes in respect of those and prior years.</li> </ul> <table border="1" data-bbox="571 819 1238 1139"> <thead> <tr> <th>Year</th> <th>Provision in year</th> <th>Provision that would now be applied</th> </tr> </thead> <tbody> <tr> <td>2016-17</td> <td>1.00</td> <td>1.011</td> </tr> <tr> <td>2015-16</td> <td>1.015</td> <td>1.024</td> </tr> <tr> <td>2014-15</td> <td>1.032</td> <td>1.048</td> </tr> <tr> <td>2013-14</td> <td>1.057</td> <td>1.080</td> </tr> <tr> <td>2012-13</td> <td>1.062</td> <td>1.100</td> </tr> </tbody> </table> <ul style="list-style-type: none"> <li>As a consequence, the average difference is 0.027%. The rate applied in 2017-18 is 0.985%, compared with 1.00% in the prior year. Applying the above sensitivity of 0.027%, the overall provision would vary by £3.4m which we do not consider to be material.</li> </ul>	Year	Provision in year	Provision that would now be applied	2016-17	1.00	1.011	2015-16	1.015	1.024	2014-15	1.032	1.048	2013-14	1.057	1.080	2012-13	1.062	1.100	<p>The calculation of the provision remains in line with the prior year. The key judgement is the use of the average of credit notes issued over the past years to estimate the current provision required. Overall the provision is reasonable based on the historic data available.</p> <p><b>Scottish Water Business Stream</b></p> <p>The credit note provision has increased from £12.4m to £13.8m. £1.2m (50%) of historical credit notes relating to public sector organisation have been excluded from the calculation on the basis that such organisations tend to be more stable with long standing billing and monitoring arrangements. This is a balanced approach. We reviewed the historical data and note that the provisions created in prior years are being utilised in line with expectations.</p> <p><b>Scottish Water (company)</b></p> <p>Our sensitivity analysis does not give rise to a material difference in required provision. Information is received monthly from each local authority in respect of historic billings and added to Scottish Water records. While the Excel records are retained evidence of their receipt from local authorities and review of this process is not.</p> <p style="text-align: right;"><b>Recommendation two</b></p>
Year	Provision in year	Provision that would now be applied																		
2016-17	1.00	1.011																		
2015-16	1.015	1.024																		
2014-15	1.032	1.048																		
2013-14	1.057	1.080																		
2012-13	1.062	1.100																		

# Financial statements and accounting

## Significant risks and other focus areas (continued)

OTHER FOCUS AREA	OUR RESPONSE	AUDIT CONCLUSION
<p><b>Profit recognition</b></p> <p>Scottish Water Horizons recognises revenue on construction activities based on the percentage completion method. As revenue is agreed on entering into the contract, there is a risk that the profit margin is not recognised consistently across the life of the project due to inaccurate budgeting with either too much or too little cost being released.</p>	<p>Testing of key controls around the project management process including allocation of costs to projects and challenge of project managers on budgeting and costs to complete; and</p> <p>Detailed testing of specific contracts in the year which were significant by nature or value.</p>	<p>Management have a robust control framework in place which includes regular monitoring of all projects by both finance and quantity surveyors to challenge the project managers on costs.</p> <p>Revenue is recognised based on the percentage of completion method. Revenue is recognised equal to cost while the project is &lt; 50% complete. This approach is considered to be appropriately prudent given the size and complexity of the projects.</p> <p>The Tomagrain project was the largest in the year with a total contract value of £5.7m. Management have recognized revenue in line with costs of 93%.</p>

# Financial statements and accounting

## Significant risks and other focus areas (continued)

OTHER FOCUS AREA	OUR RESPONSE	AUDIT CONCLUSION
<p><b>Going concern</b></p> <p>All entities are required to provide appropriate disclosure in the financial statements in regard to the going concern assumption.</p> <p>Under ISAs (UK &amp; 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.</p>	<p>Our procedures included:</p> <ul style="list-style-type: none"> <li>— reviewing the cash flow forecasts;</li> <li>— reviewed the repayment profile for government borrowing and the external financing limited set by the Government for the period to 2020-21;</li> <li>— reviewing the regulatory delivery plan update (March 2018) and considering the associated economic assumptions against our commercial understanding;</li> <li>— considering the business plan for 2015 – 2021 regulatory period which provides Scottish Water with an agreed income stream (household income) and associated tariff caps for this period.</li> </ul>	<p>We have nothing material to draw your attention to in this respect.</p>

# Financial statements and accounting

## Management reporting in financial statements

### Qualitative aspects

ISA 260 requires us to report to those charged with governance our views about significant qualitative aspects of the entity's accounting practices, including accounting policies, accounting estimates and financial statement disclosures.

We consider the accounting policies adopted by Scottish Water to be appropriate. There are no significant accounting practices which depart from what is acceptable under IFRS or the FReM.

Significant accounting estimates relate to the present value of defined benefit obligations and the various provisions outlined in the previous pages. For defined benefit obligations, the estimate is calculated under IAS 19 (as calculated by Scottish Water's actuary, Hyman Robertson using agreed financial assumptions). We found the assumptions and accounting for pensions to be appropriate. We did not identify indications of management bias.

Financial statement disclosures were considered against requirements of the FReM, relevant legislation and IFRS. No departures from these requirements were identified.

### Assessment of principal risks and uncertainties

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.

We 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, and that they are in line with the risk register and other relevant documents we have considered throughout the audit.

We have nothing further to draw your attention to.

### 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.

We reviewed the viability statement in the Annual Report and Accounts, together with the going concern paper presented to those charged with governance, cash flow forecasts and documentation supporting the regulatory delivery plan update (March 2018).

We have nothing further to add or draw your attention to.

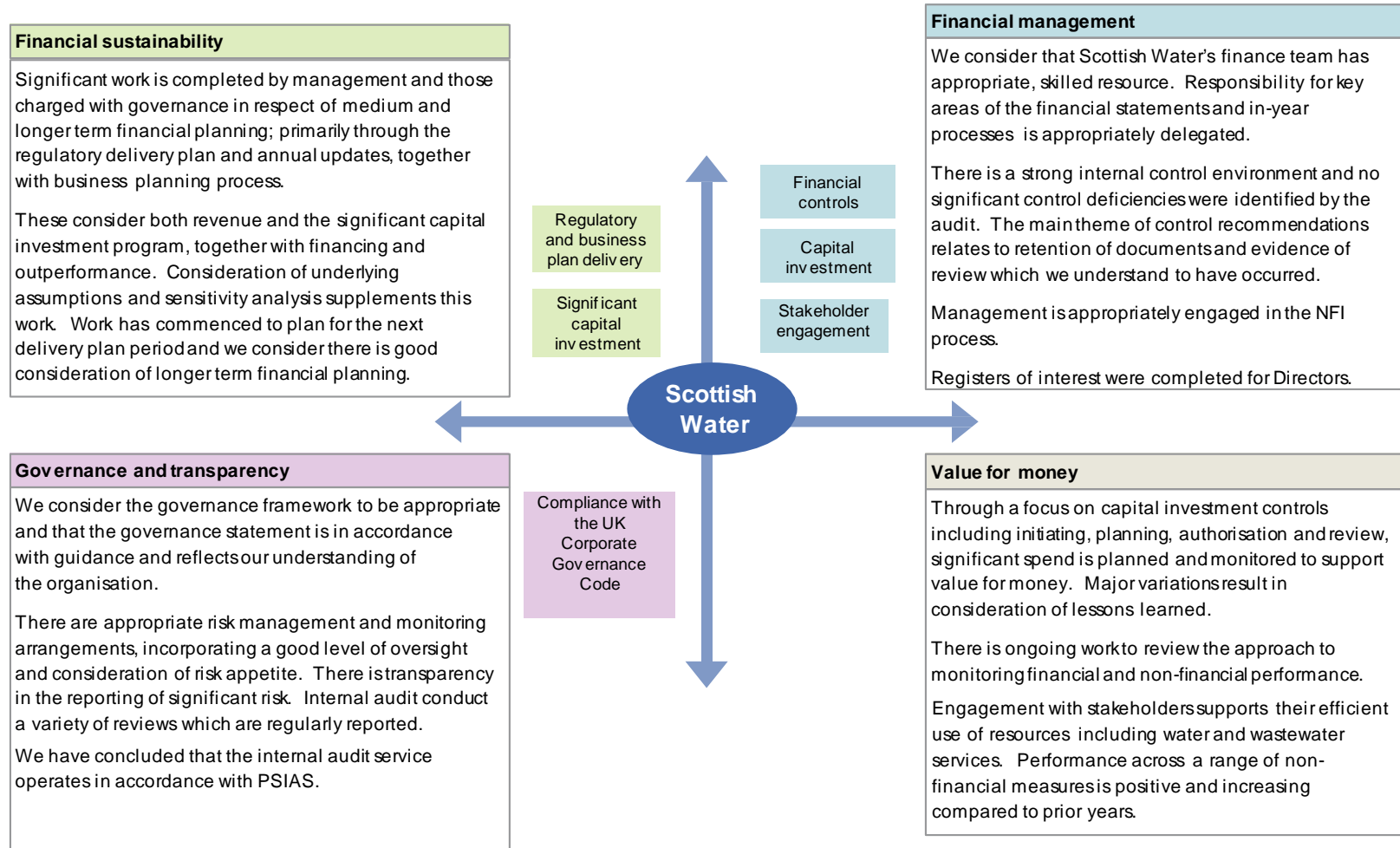
# Financial statements and accounting

## Management reporting in financial statements (continued)

REPORT	SUMMARY OBSERVATIONS	AUDIT CONCLUSION
Strategic report	<p>We are required to read the strategic report and express an opinion as to whether it is consistent with the information provided in the annual accounts.</p> <p>We also review the contents of the strategic report against relevant guidance. We considered whether it included relevant information in respect of:</p> <ul style="list-style-type: none"> <li>■ strategy and objectives;</li> <li>■ business model</li> <li>■ principal risks and uncertainties; and</li> <li>■ fair review of the business.</li> </ul>	<p>We are satisfied that the information contained within the strategic report is consistent with the annual accounts.</p> <p>We considered the disclosure of risks and uncertainties, strategy and objectives, performance and future plans and consider that it is consistent with our understanding.</p>
Remuneration report	<p>The remuneration report was included within the unaudited annual accounts and supporting reports and working papers were provided.</p>	<p>We are satisfied that the information contained within the remuneration report is consistent with the underlying records and the annual accounts and all required disclosures have been made.</p> <p>Our independent auditor's report confirms that the part of the remuneration report subject to audit has been properly prepared.</p>
Governance statement and audit committee report	<p>The statements for 2017-18 outline the corporate governance and risk management arrangements in operation in the financial year. They provide detail on the overall governance framework, review of effectiveness, group entities and analyse the efficiency and effectiveness of these elements of the framework.</p>	<p>We are satisfied with the information contained in the reports.</p>

# Wider scope

## Audit dimensions risk map and conclusions



# Wider scope

## Financial sustainability

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

Considering financial sustainability of Scottish Water we performed the following work:

- *Reviewing the financial position as at 31 March 2018 and future budgets and forecasts, particular the regulatory delivery plan update (March 2018).* Scottish Water Company has outperformed in respect of regulatory activities as part of planned outperformance. The surplus for the year supports the ability to continue to maintain average household charges below the average bill in England and Wales.
- *Reviewing financial forecasting, financial strategies and key risks over financial sustainability.* In 2014, the Water Industry Commission for Scotland set out the six year regulatory plan price caps in respect of the household water and wastewater charges which can be levied. This restricts Scottish Water's ability to increase income through charging (excepting increases in the number of households). Consequently, outperformance of the planned income from regulated activities continues to be a key part of the ability to fund planned capital investment. In the next delivery plan period, focus on productivity will be increasingly required.
- *Reviewing management's reports on financial sustainability.* The Financial Controller presented a financial sustainability report to the senior leadership team. Key elements of this report included looking at achievements for the SR15 regulatory period, remaining challenges for this period, and the importance of planning for the future regulatory period SR21.

### Delivery plan update (March 2018)

The regulatory delivery plan update includes revised financial forecasts in respect of the remaining period to March 2021. This incorporates continued outperformance of the regulatory delivery plan which has been built into the annual budget for 2018-19 onwards and which has been incurred to date (although previously not included in budgets). The main changes reflected in this update are:

- inclusion of the audited actual results for 2016-17;
- updated forecasts for 2017-18 and 2019 to 2021;
- revised delivery profile and costs for the investment programme;
- customer charges to be applied in 2018-19; and
- revised profile for the £760 million net new borrowing which was approved by Scottish Ministers when the delivery plan for the six year period to 2021 was developed.

Key assumptions and financial projections are included in the delivery plan update representing good practice.

Scottish Water have already begun discussions on the formation of the delivery plan for the next period from April 2021, while these are at very early stages, this also represents good practice in forward financial planning.

**Conclusion:** Significant work is completed by management and those charged with governance in respect of medium and longer term financial planning; primarily through the regulatory delivery plan and annual updates, together with business planning process. These consider both revenue and the significant capital investment program, together with financing and outperformance. Consideration of underlying assumptions and sensitivity analysis supplements this work. We consider that there is sufficient consideration of medium and longer term financial planning.



# Wider scope

## Financial management

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

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

- *Assessing the budget setting and monitoring processes*

The budget setting and monitoring process demonstrates strong financial management in the short, medium and longer term. The process for preparation was clearly set out in a budget guidance note for staff involved, which included a clear timetable. Revenue and capital monitoring reports receive appropriate review by committee. The approved budget is set out together with a reconciliation to the regulatory delivery plan, summarising planned outperformance and non-regulated activities. It incorporates key performance indicators which are regularly monitored in 'Performance at a Glance' ("PAAG") reports.

Tier one KPIs for 2017/18 included PAAG KPIs, the overall measure of delivery ("OMD"), overall customer experience ("OPA") and Household Customer Experience Measure ("hCEM"). Scottish Water are on track to exceed the 2015 Delivery Plan OPA commitment of achieving 385 by 2020/21. hCEM rose to 86.4 at December 2017, above the 82.6 Delivery Plan target. A number of second tier indicators are also monitored, together with targets across water, wastewater, customer service, business environmental and people headings.

- *Consideration of the finance function and financial capacity within Scottish Water*

The accountable officer is the CEO. Key members of the finance function are suitably experienced and qualified. Finance function capacity is considered to be appropriate and activity is appropriately delegated to operational areas.

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

### National fraud initiative ("NFI")

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

Scottish Water submitted datasets as required to participate in NFI. Matches are reviewed in conjunction between the People Directorate and the Accounts Payable Team.

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

### Prevention and detection of fraud

No material fraud or other irregularities were identified during the year. The arrangements include policies and codes of conduct, together with declarations of interest and a register of directors interests.

**Conclusion:** Scottish Water has appropriate arrangements to prevent and detect fraud.

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

Scottish Water has arrangements including policies and codes of conduct, supported by a whistleblowing policy. Management and directors are responsible for setting the 'tone at the top' and are responsible for abiding by the code of conduct and disclosing interests which may be of importance, material or otherwise, to their work at Scottish Water.

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

**Conclusion:** Scottish Water has appropriate arrangements to prevent and detect corruption.

# Wider scope

## Financial management (continued)

### Internal controls

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

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

As part of this report, we raised four recommendations in relation to control enhancement.

**Conclusion:** Our testing, combined with that of internal audit, of the design and operation of financial controls over significant risk points confirms that controls relating to financial systems and procedures are designed appropriately and operating effectively.

# Wider scope

## Governance and transparency

Governance and transparency is concerned with the effectiveness of scrutiny and governance arrangements, leadership and decision making, and transparent reporting of financial and performance information.

In considering governance and transparency we performed the following work

- *Reviewing the organisational structure, reporting lines and level of scrutiny within Scottish Water.* There is effective scrutiny, challenge and transparency on decision making through various levels of committee reporting reviewed. Decisions and actions are documented within detailed minutes.
- *Reviewing financial and performance reporting within the organisational structure.* Reporting is of high quality. Financial reporting includes analysis of revenue and capital. Reports are sufficiently detailed, giving narrative explanations to key movements from budget.
- *Reading the annual governance statement;* as discussed previously. A review of audit committee and board effectiveness was conducted during the year and the governance statement was considered by the audit committee, together with supporting evidence.
- *Consideration of scrutiny over key risks.* The business identifies key risks at corporate and functional levels. Risks are evaluated by considering their consequences, in terms of impact and likelihood, against risk appetite for the achievement of service delivery and business objectives. The risk register and risk management processes are reviewed annually by the Board, and twice a year by the Audit Committee and the Executive Leadership Team. In addition, each quarter, the Board reviews the status of the most significant business risks. The Group is looking to create one assurance map that shows all assurance work done over all aspects of the business.
- *Employee roadshows.* We attended Vision in Focus, an employee event led by the Executive Team. This was aimed at enhancing customer experience by increasing employee awareness on these issues.

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

**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.

### Internal audit

Internal audit is provided by an in-house team.

Audit Scotland's Code of Audit Practice sets out the wider dimension of public sector audit. It requires external auditors to perform an annual assessment of the adequacy of the internal audit function. We considered the activities of internal audit against the requirements of Public Sector Internal Audit Standards ('PSIAS'), focusing our review on the public sector requirements of the attribute and performance standards contained within PSIAS. This included a review of the internal audit charter, reporting lines and the range of work carried out by internal audit. Internal audit formally reports to the chair of the audit committee and is line managed by the finance director. We also considered the requirements of International Standard on Auditing 610 (*Considering the Work of Internal Audit*).

From this assessment, and considering the requirements of International Standard on Auditing 610 (*Considering the Work of Internal Audit*), we can apply internal audit's work to inform our procedures, where relevant.

**Conclusion:** We have concluded that the internal audit service operates in accordance with PSIAS.

We can apply internal audit's work to inform our procedures, where relevant. The review of internal audit reports and conclusions did not indicate additional risks and there is no impact on our planned substantive testing.

# Wider scope

## Value for money

Value for money is concerned with using resources effectively and continually improving services.

Scottish Water has signed up to the Scottish Government's Suppliers' Charter. The Charter details the Policies and Procedures promoted by the Public Procurement Reform Programme with respect to supporting all current and potential Suppliers.

A key way in which value for money is obtained is through the effectiveness of procurement. Scottish Water incurs significant annual capital expenditure related to the investment program. We tested a range of controls around the process in respect of new capital project assessment through to initiation, monitoring and payment.

Where projects are significantly over budget, 'lessons learned' reviews are conducted and major changes to planned and authorised expenditure review and updated authorisation.

Key performance indicators include a variety of measures related to value for money, through effective improvement in customer service and water quality. We note water quality is at its highest level ever, at 99.9%. Additionally, Scottish Water, through its engagement with stakeholders and activities of subsidiaries, supports households and industry with improving their efficiency in terms of water and wastewater. Customer complaints reached their lowest level with a 17% reduction from prior year. In the most recent wave of the UK Customer Satisfaction Index, Scottish Water achieved a score of 76.4, meaning they have outperformed the utility sector by 2 points and the water sector by 1.3 points.

Outperformance of the regulatory delivery plan targets demonstrate a commitment to improving financial performance through efficient working.

**Conclusion:** Through a focus on capital investment controls including initiating, planning, authorisation and review, significant spend is planned and monitored to support value for money. Major variations result in consideration of lessons learned.

Monitoring of KPIs against targets supports improving performance.

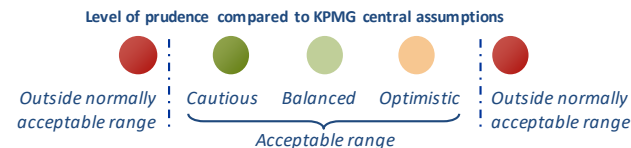
Engagement with stakeholders supports their efficient use of resources including water and wastewater services.

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# Appendices

# Assessment of key pension assumptions



In respect of employee benefits, each of the assumptions used to value the net pension deficit are within an acceptable range of KPMG's expectations. We are of the view that this therefore represents a reasonable and balanced approach, in accordance with the requirements of IAS 19. We set out below the assumptions in respect of defined benefit obligations.

Employer: Scottish Water				OVERALL ASSESSMENT OF ASSUMPTIONS FOR IAS 19	 <i>balanced</i>
Fund: Lothian, Strathclyde and NES Pension Funds					
The overall set of assumptions proposed by the Employer can be considered to be balanced relative to our central rates for a typical UK scheme with a duration of 17 years and within our normally acceptable range.					
Fund Actuary: Hymans Robertson					
Assumption	Company	KPMG central	Commentary	Assessment vs. KPMG central	
Discount rate	2.60%	2.50%	The Employer's proposed assumption is considered to be optimistic but within our normally acceptable range.		
Pension Increase Rate	2.30%	2.16%	The Employer's proposed assumption is considered to be cautious but within our normally acceptable range.		
Salary increases	3.25% until April 2019 CPI plus 0.0% thereafter	CPI plus 0% to 2.0%	We would typically expect salary increases to fall in the range of CPI plus 0% to 2%. The employer's salary assumption has been set in line with the actuarial valuation. Provided this reflects both the short and long-term remuneration policy expectations of the Employer (based on evidence) then we would consider this approach to be reasonable.		
Life expectancy	23.4 / 21.4 25.8 / 23.7	23.5 / 22.1 25.4 / 23.9	The life expectancies are the same as those used in the most recent Fund valuation and can be considered acceptable.		

Due to the degree of estimation included we recognise there is a range of generally acceptable values for each assumption. The assessment of each assumption vs the KPMG central assumption (or approach) is performed in accordance with the guidelines in Appendix 2.

# Auditor independence

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

Professional ethical standards require us to communicate to you at the conclusion 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 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.

We will communicate any significant judgements made about threats to objectivity and independence and the appropriateness of safeguards put in place.

### 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 APB 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 APB Ethical Standards in relation to this audit engagement and that the safeguards we have applied are appropriate and adequate 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

#### Summary of fees

We have considered the fees charged by us to Scottish Water and its affiliates for professional services provided by us during the reporting period. We have detailed the fees charged by us to Scottish Water for significant professional services provided by us during the reporting period in the table below, as well as the amounts of any future services which have been contracted or where a written proposal has been submitted. Total fees proposed by us for the period ending 31 March 2018 can be analysed as shown on the following page.

## Appendix two

# Auditor independence (continued)

Fees payable	2017-18 £
Scottish Water	126,167
Scottish Water Business Stream	49,547
Scottish Water Interim Review	14,500
Scottish Water International Limited	7,500
Scottish Water Business Stream Holdings Limited	3,600
Scottish Water Solutions2 Limited	10,300
Scottish Water Horizons Holdings Limited	3,600
Scottish Water Horizons Limited	15,500
Regulatory accounts	14,000
<b>Total audit fees</b>	<b>252,174</b>
<b>Non-audit fees</b>	
Assessment of IT project governance	46,428
Assessment of P11D related software tool	1,085

The ratio of non-audit to audit fees was 0.1:1. We do not consider that the total non-audit fees create a self-interest threat since the absolute level of fees is not significant to our firm as a whole.

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

Analysis of non-audit services for the year ended 31 March 2018

Disclosure	Description of scope of services	Principal threats to Independence	Safeguards Applied	Basis of fee	Value of Services Delivered in the year ended 31 March 2018
Information technology services	Assessment of IT project governance associated with the implementation of a new general ledger	Self-review	Work performed by a separate team from those working on the audit. This work does not result in any accounting judgments.	Fixed fee	£46,428
Information technology services	Provision of software tool related to P11D reporting	Self-review	No work performed by KPMG team other than provision of access to standard software tool. This does not result in any material judgments within the financial statements.	Fixed fee	£1,085



## Appendix two

# Auditor independence (continued)

### **Independence and objectivity considerations relating to other matters**

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

### **Confirmation of audit independence**

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

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

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

Yours faithfully

*KPMG LLP*

# Appendix three

## Action plan

The action plan summarises specific recommendations arising from our work, together with related risks and management's responses.

We present the identified findings across four audit dimensions:

- financial sustainability;
- financial management;
- governance and transparency; and
- value for money.

### Priority rating for recommendations

**Grade one** (significant) observations are those relating to business issues, high level or other important internal controls. These are significant matters relating to factors critical to the success of the organisation or systems under consideration. The weaknesses may therefore give rise to loss or error.

**Grade two** (material) observations are those on less important control systems, one-off items subsequently corrected, improvements to the efficiency and effectiveness of controls and items which may be significant in the future. The weakness is not necessarily great, but the risk of error would be significantly reduced if it were rectified.

**Grade three** (minor) observations are those recommendations to improve the efficiency and effectiveness of controls and recommendations which would assist us as auditors. The weakness does not appear to affect the availability of the control to meet their objectives in any significant way. These are less significant observations than grades one or two, but we still consider they merit attention.

Finding(s) and risk(s)	Recommendation(s)	Agreed management actions
<p><b>1 Nil net book value disposals</b></p> <p><i>Audit dimension: financial management</i></p>		<b>Grade three</b>
<p>There was a continuation of an exercise commenced in the prior year (disposal 2016-17 £268m) which resulted in £28m of disposals in respect of assets with nil net book value. While we understood that regular meetings with those responsible for assets occurred to consider their disposal, these were not routinely documented or recorded and there is a risk that they are retained in use.</p>	<p>It is recommended that the annual review of nil net book value assets, and other long standing assets is continued, to determine where they are in use or should be disposed.</p> <p>However, a record of assets considered and the evidence of their review and conclusion on disposal or retention should be retained.</p>	<p>Accepted.</p> <p><b>Responsible officer:</b> Group Financial Controller</p> <p><b>Implementation date:</b> 30 September 2018</p>

## Appendix three

# Action plan (continued)

Finding(s) and risk(s)	Recommendation(s)	Agreed management actions
<p><b>2 Credit note data</b></p> <p><i>Audit dimension: financial management</i></p>		<p><b>Grade two</b></p>
<p>Information is received monthly from each local authority in respect of historic billings and added to Scottish Water records. This information forms the basis of the credit note provision.</p> <p>While the Excel records are retained evidence of their receipt from local authorities and review of this process is not.</p>	<p>It is recommended that copies of the emails received from local authorities containing the updated billing information are retained, or that the monthly updating process is subject to evidence of independent review and authorisation as checked to original documentation.</p>	<p>Accepted.</p> <p><b>Responsible officer:</b> GM Revenue &amp; Risk</p> <p><b>Implementation date:</b> 30 September 2018</p>
<p><b>3 General IT controls: leavers (Scottish Water)</b></p> <p><i>Audit dimension: governance and transparency</i></p>		<p><b>Grade three</b></p>
<p>It was determined that some users had retained access to in-scope systems at the time of testing. Three users had retained access to the CISP system and twenty several users had retained access to Oracle following their date of leave/transfer.</p> <p>There is a risk the unauthorised access could lead to inaccurate records, fraud or loss of information.</p>	<p>Management should ensure that user accounts are disabled in a timely manner when no longer needed.</p> <p>A review should be performed of the Windows network user accounts to establish if they should be disabled.</p>	<p>Accepted.</p> <p><b>Responsible officer:</b> Business Systems Manager</p> <p><b>Implementation date:</b> December 2018</p>

## Appendix three

# Action plan (continued)

Finding(s) and risk(s)	Recommendation(s)	Agreed management actions
<b>4 Privileged user access management (Scottish Water)</b>		<b>Grade two</b>
<i>Audit dimension: governance</i>		
It was noted that IT system administrator activities (including IT and third party staff) are not proactively monitored to detect any unauthorised access to data or changes in the production environment for all IT systems in scope for the audit (Oracle Fusion, Ellipse, and CISP). Events that are not monitored include changes to important system changes such as security events (ie changes to logs), as well as financial system controls and configuration.	<p>Management should consider</p> <ul style="list-style-type: none"> <li>implementing an event log auditing based on formal and documented risk assessment agreed between the business and IT</li> <li>Reviewing the audit logs and demonstrating appropriate follow up and investigation, as well as consider maintaining the integrity of the logs by preventing changes from being made by users.</li> </ul>	<p>Accepted.</p> <p><b>Responsible officer:</b> Business Systems Manager</p> <p><b>Implementation date:</b> March 2019</p>
<b>5 Password parameters</b>		<b>Grade three</b>
<i>Audit dimension: governance</i>		
All IT systems in scope of the audit (oracle, CISP, Ellipse, and Windows Active Directory) require the user to logon using a username and password. The Group have a minimum password policy for all systems, however we noted that actual password parameters used are not in line with the approved policy.	<p>Management should consider</p> <ul style="list-style-type: none"> <li>Reviewing the password parameter settings against the Group's agreed password policy. Where gap exist, a formal and documented risk assessment should be performed to assess if changes should be made to strengthen the current parameters.</li> </ul>	<p>Accepted.</p> <p><b>Responsible officer:</b> Business Systems Manager</p> <p><b>Implementation date:</b> July 2018</p>

## Appendix four

# Appointed auditors responsibilities

Area	Appointed auditors responsibilities	How we've met our responsibilities
Corporate governance	Review and come to a conclusion on the effectiveness and appropriateness of arrangements to ensure the proper conduct of the bodies affairs including legality of activities and transactions, Conclude on whether the monitoring arrangements are operating in line with recommended best practice.	Page 22 sets out our conclusion on these arrangements.
Financial statements and related reports	Provide an opinion on audited bodies' financial statements on whether financial statements give a true and fair view of the financial position of audited bodies and their expenditure and income Provide an opinion on whether financial statements have been properly prepared in accordance with relevant legislation, the applicable accounting framework and other reporting requirements Provide an opinion on the regularity of the expenditure and income	Pages 10-20 summarises the opinions we have provided.
Financial statements and related reports	Review and report on, as appropriate, other information such as annual governance statements, management commentaries, remuneration reports, grant claims and whole of government returns.	Page 22 reports on the other information contained in the financial statements, covering the annual governance statement, management commentary and remuneration report.  We will separately report on the Whole of Government Accounts
Financial statements and related reports	Notify the Auditor General when circumstances indicate that a statutory report may be required.	We do not consider any notifications necessary.
Financial statements and related reports	Review and conclude on the effectiveness and appropriateness of arrangements and systems of internal control, including risk management, internal audit, financial, operational and compliance controls.	Pages 23-28 sets out our conclusion on these arrangements.

## Appendix four

# Appointed auditors responsibilities (continued)

Area	Appointed auditors responsibilities	How we've met our responsibilities
Standards of conduct – prevention and detection of fraud and error	Review and conclude on the effectiveness and appropriateness of arrangements for the prevention and detection of fraud and irregularities, bribery and corruption and arrangements to ensure the bodies affairs are managed in accordance with proper standards of conduct. Review National Fraud Initiative participation and conclude on the effectiveness of bodies engagement.	Pages 23-28 set out conclusions in these areas.
Financial position	Review and conclude on the effectiveness and appropriateness of arrangements to ensure that the bodies financial position is soundly based.	Pages 5-7 sets out our conclusion on these arrangements.
Financial position	Review performance against targets	Pages 5-7 summarise our review of how the body has performed against its financial targets. Our consideration of non-financial performance measures is on page 24.
Financial position	Review and conclude on financial position including balances and strategies and longer term financial sustainability.	Pages 7-8 sets out our conclusion on the body's financial position and sustainability.
Best Value	Be satisfied that proper arrangements have been made for securing Best Value.	Page 28 sets out our conclusion on these arrangements.

# Tax summary

<b>Tax charge</b>	<ul style="list-style-type: none"> <li>■ The £13,696k tax charge (2016/17: £1,981k credit) within the consolidated income statement is made up as follows:             <ul style="list-style-type: none"> <li>■ Corporation tax – current year £1,637k</li> <li>■ Corporation tax – prior year £30k</li> <li>■ Foreign tax - £51k</li> <li>■ Deferred tax charge - £11,977k</li> </ul> </li> <li>■ The deferred tax charge mainly arises in Scottish Water and relates to the movements in fixed asset timing differences and utilisation of tax losses brought forward.</li> <li>■ The effective tax rate of 19.1% is slightly higher than the headline UK tax rate of 19%. The higher tax rate arises predominantly as a result of routine disallowable expenditure including depreciation on buildings, disallowable legal fees, disallowable entertaining and disallowable capital items, although this is offset by a non-taxable gain on the disposal of fixed assets.</li> </ul>
<b>Tax matters</b>	<ul style="list-style-type: none"> <li>■ Given the nature of the business, the deferred tax and current tax is primarily driven by the fixed assets. The Scottish Water group focus on different types of capital expenditure each year (often due to regulatory focus) and therefore the amount of spend allocated to the various capital allowance pools varies year on year. At the tax provisioning stage, the spend allocated to each capital allowance pool is estimated based on the information derived from a capex monitoring database and then tried up after the statutory accounts are signed when the tax computations are finalised.</li> </ul>
<b>Balance sheet</b>	<ul style="list-style-type: none"> <li>■ The closing deferred tax balance of £359,222k consists predominantly of a deferred tax liability of £420,628k on qualifying fixed assets and deferred tax assets of £29,793k on the pension and £21,999k of tax losses. The remaining deferred tax asset of £9,615k is made up of general provisions and deferred tax provided on rolled over gains.</li> <li>■ For the period ended 31 March 2018 the current tax liability was £1,637k. Scottish Water is the main tax paying company with some smaller balances due within the subsidiaries.</li> </ul>
<b>UK tax status</b>	<ul style="list-style-type: none"> <li>■ All tax returns for 2017 were submitted to HMRC in March 2018, ahead of the filing deadline.</li> <li>■ It is our understanding that there are no enquiries in to open tax periods. HMRC have 12 months from the due filing date to open an enquiry in to an accounting period.</li> <li>■ The only period currently open to enquiry for the Scottish Water group of companies is 31 March 2017 (the enquiry window will close on 31 March 2019).</li> </ul>



The contacts at KPMG in connection with this report are:

Hugh Harvie

*Partner*

Tel: 0131 527 6673

[hugh.harvie@kpmg.co.uk](mailto:hugh.harvie@kpmg.co.uk)

Michael Wilkie

*Senior Manager*

Tel: 0141 300 5890

[michael.wilkie@kpmg.co.uk](mailto:michael.wilkie@kpmg.co.uk)



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