Scottish Water

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

For the year ended 31 March 2019

—

5 June 2019

Contents

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.

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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 +44 (0)131 527 6682 email: 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, Fourth Floor, 102 West Port, Edinburgh, EH3 9DN.

Headlines

Audit conclusions	— We expect to issue unqualified audit opinions on the financial statements of Scottish Water for the year ended 31 March 2019	Page 8
Financial position and sustainability	— The Group surplus before tax increased by £14.3 million to £86.1 million compared with the prior year (£71.8 million). — Capital investment in the year amounted to £509.2 million (2018: £498.4 million). — The overall forecast finance requirement for delivering the 2015-2021 regulated business plan is approximately £8 billion. The fourth year of the regulatory period has now ended, with the closing cash balance ahead of that forecast in the March 2019 update. The forecast cash balance is £285 million as at 31 March 2020 which assumes £219 million of net new borrowing from Scottish Government in 2019-20. Preparation for the next regulatory period (2021-2027) has been underway throughout the year.	Page 5 – 7
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 financial statements, 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 were two audit misstatements identified, one of which has been adjusted and the other remained unadjusted as reported in Appendix six. There are no matters which we require to bring to your attention in respect of any group entities subject to audit.	Pages 8 – 29
Wider scope	— Scottish Water is subject to a high degree of oversight, including by the Drinking Water Quality Regulator, Water Industry Commission for Scotland, Scottish Environment Protection Agency, internal and external audit. — We considered and conclude positively on the wider scope audit dimensions of financial sustainability, governance and transparency and value for money.	Page 30 – 35

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 designed 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 dated 21 August 2018 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) 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 designed 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) ('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 focused on water quality, asset investment and maintenance, customer service, liaison with key stakeholders, and service improvement. Significant capital investment of up to £3.9 billion 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 and during the year it took over the activities of Scottish Water International of providing consultancy services to utilities, government and overseas clients. Scottish Water Business Stream ('Business Stream') supplies water to non-households in Scotland and England.

The group surplus before tax increased by £14.3 million to £86.1 million compared to £71.8 million in the prior year. Income was £45.1 million higher at £1,469.1 million offset by a £37.3 million increase in expenditure to £1,214.0 million. Increased income is primarily due to contracts secured by Business Stream and price increases. Increased costs primarily related to one-off costs for digital projects, weather related costs and energy price increases.

Group capital investment was £509.2 million (2017-18: £498.4 million) reflecting continued investment in significant projects and ongoing infrastructure upgrades.

Group net debt increased by £181.6 million to £3,319.5 million which was driven by additional borrowing from the Scottish Government of £165.3 million and external bank loans of £44.7 million within one of the companies acquired during the year.

Financial position: consolidated income statement

Scottish Water group has continued to experience strong performance in respect of regulated activities. Household income increased £20.8 million to £881.7 million reflecting a 1.6% tariff increase and increased connections.

Revenue from wholesale services supplied to Licensed Providers increased by £3.1 million (1.0%) to £323.6 million, reflecting an average tariff increase of 2%, partly offset by a reduction in consumption by customers. Revenue from other sales increased by £1.6 million to £11.6 million driven mainly by increased land rental income from windfarm developments.

Total operating costs increased by £22.5 million to £961.1 million (2018: £938.6 million) due to increased regulated costs of £32.2 million, depreciation and infrastructure maintenance costs of £10.0 million, partially offset by a lower IAS19 pension cost adjustment of £8.3 million and lower PFI costs of £11.4 million.

Consolidated income statement	2018-19 £m	2017-18 £m	Variance £m
Revenue	1,469.1	1,424.0	45.1
Cost of sales	(1,047.4)	(1,014.4)	(33.0)
Gross surplus	421.7	409.6	12.1
Administrative expenses	(166.6)	(162.3)	(4.3)
Operating surplus	255.1	247.3	7.8
Finance income	2.1	1.2	0.9
Finance costs	(171.1)	(176.7)	5.6
Surplus before taxation	86.1	71.8	14.3
Taxation	(17.9)	(13.7)	(4.2)
Surplus for the year	68.2	58.1	10.1

Source: Draft financial statements

Financial position and sustainability (cont.)

Financial position: balance sheets

Additions as a result of capital investment in the current year were £509.2 million (2018: £498.4 million). Depreciation costs remained similar to the prior year. Amortisation of £3.2 million (2018 £3.5 million) was charged on the Business Stream intangible asset relating to acquired customers, which has a year end net book value of £10.0 million.

Group current assets increased by £34.7 million, primarily due to the increase in cash and cash equivalents. Scottish Water Company remains in a net current liability position. The Group continues to be in a net asset position and the increase in the year is, as planned, related to continued capital investment.

Group net debt increased by £181.6 million to £3,319.5 million which was driven by additional borrowing from the Scottish Government of £165.3 million and external bank loans of £44.7 million (associated with financed assets) within one of the companies acquired during the year.

Scottish Water Company's cash balance at 31 March 2019 of £310.9 million is approximately £26.9 million ahead of that forecast in the updated 2019 regulatory delivery plan submitted to Scottish Ministers in March 2019. Although the Group's cash balance increased during the year, this is expected to decrease over the remaining regulatory plan period, associated with continued investment and Scottish Water expects to increase net Government borrowing by £439 million over the remaining period to 2021.

Net cash movement (Scottish Water Group)	£m
Balance at 1 April 2018	406.4
Increase during the year	28.4
Balance at 31 March 2019	434.8

Balance sheet (Group)	2019 £m	2018 £m	Variance £m
Non-current assets	6,226.5	5,996.5	230.0
Current assets	645.6	610.9	34.7
Current liabilities	(497.4)	(488.7)	(8.7)
Net current assets	**148.2**	**122.2**	**26.0**
Non-current liabilities	(997.5)	(923.0)	(74.5)
Net assets	**5,377.2**	**5,195.7**	**181.5**
Equity	**5,377.2**	**5,195.7**	**181.5**

Source: Draft financial statements

Capital expenditure (Scottish Water Company)

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

£659.9 million (on a regulated accounting basis) was invested during 2018-19 in respect of ongoing projects, making it the largest component of Scottish Water's total annual expenditure. An element is related to maintenance and is not considered to be capital for the purposes of the financial statements resulting in capitalised expenditure of £503.4 million (on an IFRS basis). Significant projects during the year included:

- Ayrshire Strategic Resilience – Highlees DSR;
- Inverurie Sewage Treatment Works Upgrade; and
- South Edinburgh Resilience.

Reflecting the significance of current projects, the balance of capital work in progress increased by £124.6 million (net) to £972.3 million in 2019.

Financial position and sustainability (cont.)

2015-2021 regulatory period and business plan

The overall forecast finance requirements for delivering the 2015-2021 business plan is £8 billion. The budget assumes that £7 billion will be received from customer revenue and £724 million from new Government borrowing (agreed in the 2014 Final Determination issued by the Water Industry Commission for Scotland). The delivery plan was updated in March 2019 and the key features are summarised in the table below:

£'m	2018 (actual)	2019 (actual)	2020 (forecast)	2021 (forecast)
Regulated capital investment	647	660	710	750
Total revenue	1,191	1,217	1,228	1,236
Surplus before tax	76	83	85	68
Closing cash	271	311	285	249

Source: KPMG analysis of Delivery Plan Update March 2019

Management strive to outperform the plan to try and generate maximum operational cash flows to ensure that cash balances remain higher than forecast in 2020-21 to invest in additional capital investment.

The fourth year of the regulatory period has now ended, with the closing cash balance ahead of that forecast in the March 2019 update. The forecast cash position at the end of 2021 is now £249 million, compared with £40 million 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.

Going concern (cont.)

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 continued work in respect of planning for the next delivery plan period 2021 to 2027 throughout the year.

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 continue to aim to outperform expectations in the next delivery plan period.

Conclusion

The SW Group cash balance increased by £28.4 million from prior year. Scottish Water Regulatory Business experienced an increase in cash balances in the year while maintaining 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 £439 million is planned to be drawn down over the remaining plan period to fund investment requirements. We have also 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.

Audit conclusions

Audit opinion	— Our audit work is substantially complete. Following approval of the annual financial statements by the audit committee and board, we expect to issue unqualified opinions on the truth and fairness of the state of Scottish Water and its group's affairs as at 31 March 2019, and of the surplus for the year then ended as well as for the financial statements of its subsidiaries. We are also expecting to add an 'emphasis of matter' paragraph in our audit opinions of Scottish Water Solutions 2 Limited and Scottish Water International Limited to highlight that they have not been prepared on a going concern; — We also expect to issue an unqualified opinion on the regularity of transactions during the year in accordance with Water Industry (Scotland) Act 2002 and IFRSs as adopted by the European Union (as interpreted and adapted by the 2018-2019 FReM); — We prepared an audit strategy document which was submitted to the Audit Committee on 21 August 2018; and — We have prepared a separate annual audit report in respect of Business Stream which has been considered by its board. There are no matters identified on which we are required to report by exception.
Financial reporting framework, legislation and other reporting requirements	— 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 2018-19 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.
Other communications	— We did not encounter any significant difficulties during the audit and 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.
Audit misstatements	— There were two audit misstatements identified during the year, one has been adjusted by management and the other remained unadjusted as reported in Appendix six.
Written representations	— We will request a representation letter from management as required by ISA 580 *Written Representations* – refer to Appendix seven.

Audit conclusions (cont.)

Materiality

We summarised our approach to materiality in our audit strategy document. On receipt of the financial statements and following completion of our audit testing we reviewed our materiality levels and concluded that the level of materially set at planning was still relevant. Group materiality of 1% of gross expenditure incurred in 2018 was used (£11.8 million). We report all misstatements greater than £250,000.

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 Horizons Ltd	£83,625	£5,575
Scottish Water Business Stream	£750,000	£50,000
Scottish Water Horizons Holdings Ltd	£1,275,000	£85,000
Scottish Water Solutions 2 Ltd	£60,000	£4,000
Scottish Water International Ltd	£52,500	£3,500
Bandwidth Energy Ltd	£11,050	£850
Aberdeen Environmental Services Ltd	£519,000	£34,600
Scottish Water Services (Grampian) Ltd	£180,000	£12,000
Scottish Water Business Stream Holdings Ltd	£900,000	£60,000

Materialities of the subsidiaries are consistent with the prior year while those of the new entities, Aberdeen Environmental Services Ltd and Scottish Water Services (Grampian) Ltd, were set at 1% and 2.5% of total assets and total revenues respectively.

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 15 April 2019.
- In accordance with the timetable provided by management, Scottish Water's draft financial statements were provided on 24 April 2019.

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 and key audit matters

— Fraud risk from management override of controls;
— Fraud risk from income revenue recognition;
— Capital additions;
— Bad debt provision;
— Pension liability; and
— Onerous contract provision[b]
— Purchase of new entities[b]

Other areas of focus

— HM Treasury FReM 2018-19;
— Intangible asset amortisation[a];
— Profit recognition;
— Income uncertainty provision;
— Credit note provision;
— Going concern; and

[a] We continue to perform procedures over amortisation of intangible assets. However, now that we have established an audit approach to address this (being the second year since the intangible asset was acquired), we have not assessed this as one of the most significant risks in our current year audit and, therefore, it is not separately identified in our report this year.

[b] We draw attention to the fact that one additional 'significant risk' and one 'other area of focus' has been added after our strategy document dated 21 August 2018. They are both related to the acquisition by Scottish Water Group of the NE of Scotland PFI entities:

— Entity specific significant risk on onerous contract provision – this only applies to Scottish Water Services (Grampian) Limited; and
— Group other area of focus relating to the consolidation effect of the purchase of the new entities.

Key audit matters

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, being the 'key audit matters'.

We have separately **identified those in bold in the table on the next page** 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.

We have revised our assessment of the key audit matters compared with those anticipated in our audit strategy document dated 21 August 2018 in order to remove intangible asset amortisation and include accounting for the purchase of new entities as explained above.

Significant risks and other focus areas

The application of the significant risks, key audit matters and other areas of focus to each group entity is summarised in the table below.

Significant risks, key audit matters and other areas of focus	Scottish Water	Scottish Water Business Stream Limited	Scottish Water Business Stream Holdings Limited	Scottish Water Solutions 2 Limited	Aberdeen Environmental Services Limited	Scottish Water Horizons Limited	Scottish Water Horizon Holdings Limited	Scottish Water Services (Grampian) Limited	Bandwidth Energy Limited
Significant risks									
Fraud risk from management override of controls	✓	✓	✓	✓	✓	✓	✓	✓	✓
Fraud risk from income revenue recognition		✓							
Onerous contract provision								✓	
Key audit matters									
Capital additions	✓								
Bad debt provision	✓	✓							
Pension liability	✓	✓							
Purchase of new entities	✓				✓		✓	✓	
Other areas of focus									
HM Treasury FReM 2018-19	✓								
Intangible asset amortisation		✓							
Profit recognition						✓			
Income uncertainty provision	✓								
Credit note provision	✓	✓							
Going concern	✓	✓	✓	✓	✓	✓	✓	✓	✓

We also audited Scottish Water International Limited, which had no additional risks other than the presumed fraud risk from management override of controls.

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.

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Significant risks and other focus areas (cont.)

Significant risk	Our response	Audit conclusion
Fraud risk from management override of controls 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.	— 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; — In line with our methodology, we carried out appropriate controls 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; — We evaluated accounting estimates, including the consideration of the bad debt provision, income uncertainty provision and credit note provision; — Oversight of finances by management provided additional review of potential material errors caused by override of controls; and — We considered expenditure associated with operational challenges due to severe weather in both winter and summer in 2018-19, and Brexit related expenditure, primarily associated with the purchase of water treatment chemicals, giving rise to unusual transactions.	— 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; — We also discussed the significant unusual transaction relating to the purchase of new entities, more specifically about the accounting treatment of the transaction and related journal entries; and — There were no specific circumstances identified which would indicate additional risk of management override of controls.

Significant risks and other focus areas (cont.)

<table>
<tr><th>Significant risk</th><th>Our response</th><th>Audit conclusion</th></tr>
<tr><td>Fraud risk from income revenue recognition (Scottish Water Business Stream)

Professional standards require us to make a rebuttable presumption that the fraud risk from revenue recognition is a significant risk.

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. 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 estimation of revenue.</td><td>Our procedures in respect of the risk in Scottish Water Business Stream included:
— Performing cut off testing to assess whether sales transactions are recognised in the correct period;
— Testing general IT controls of the automated HiAffinity billing system to ensure integrity;
— Considering the deferral of revenue recognised in respect of advanced billing to ensure this is appropriate;
— Challenge of assumptions used in estimating the unbilled portion of revenue at the year end;
— Performing a reconciliation of all cash, debtors and accrued revenue for the year; and
— Considering the approach to recognising revenue in respect of vacant properties.

We rebutted the risk in Scottish Water and other subsidiaries
— For Scottish Water, we requested and received confirmation of household revenue from all 32 councils. We also requested and received confirmation of wholesale revenue from licensed providers;
— For Scottish Water Horizons Limited, revenue is recognised based on contract values;
— For Scottish Water Solutions 2 Limited, management fee income is received for the delivery of the capital management programme for Scottish Water;
— The activity of Scottish Water International has been transferred to Scottish Water Horizons Limited; and
— The activities of Aberdeen Environmental Services Limited and Scottish Water Services (Grampian) Limited are mainly from their contract with Scottish water and are therefore eliminated on consolidation.</td><td>— We originally planned to rely on automated controls within the HiAffinity billing system. As a part of our interim audit work, we identified a number of control deficiencies through our testing of the general IT control environment for HiAffinity and concluded that these could not be relied upon throughout the period under audit. The findings have been communicated to the Scottish Water Business Stream Audit Committee. Additional substantive testing and larger sample sizes were used throughout our revenue testing to mitigate this risk;
— Our testing of the following areas is in progress: credit note authorisation, accrued and deferred income, reconciliation of revenue in the year and revenue recognised around the year end date;
— Although we have substantially completed our audit overall, our procedures on accrued income and revenue are still in progress due to the extended testing required caused by the IT control deficiencies mentioned above. However, we are not expecting any issues to come out from this given the nature of the outstanding audit procedures.</td></tr>
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Significant risks and other focus areas (cont.)

Significant risk	Our response	Audit conclusion
Capital additions (Scottish Water Company) **(£503.4 million, 2018: £493.8 million)** Capital additions are significant related to the delivery plan for regulated activities for the period 2015-16 to 2020-21. Directors are incentivised across a number of financial and other measures including profit and completion of capital investment programmes. There is judgement involved in the allocation of expenditure between capital additions and revenue which can affect profit and investment measures reported in the financial statements.	Our procedures included: **Control design:** — 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; and — 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. **Test of details:** — Building on our work over control design we compared the reports of Scottish Water's capital project monitoring group at the year end to amounts recorded as capital additions; — 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; — 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; and — We also reviewed material manual journals.	— During the year, assets with a nil net book value, and original book cost of £102 million were written off following management's determination that they were no longer in beneficial use; — This was a continuation of an exercise commenced in the prior years (write off in 2017 and 2018 – £297 million and £28 million respectively). We understand the assets disposed in the current year required minimal judgement but this was not documented. Refer to Appendix three; and — The outcome of our testing was satisfactory and we concur with management's treatment of additions as capital or revenue.

Significant risks and other focus areas (cont.)

Significant risk	Our response	Audit conclusion
Capital additions (Scottish Water Company) (Cont.) *Other considerations (not significant risk):* Scottish Water has received contractor claims for additional costs in respect of the cost of the major projects and incurred associated expenditure. Judgement is required to ensure that any associated costs which are borne by Scottish Water are correctly classified as revenue or capital. In addition, during 2018-19, there has been increased cost to deliver the capital programme and repairs and maintenance, associated with a high demand and a number of increased repairs associated with the cold winter and dry summer periods. The company has depreciation charges of £281.1 million (2018: £272.7 million) which is calculated based on the useful lives of the individual asset.	*Other testing (not related to significant risk):* **Test of details:** — Testing material disposals, by reference to supporting documentation; — Assessment of the commercial position surrounding the Sheildhall Tunnel, including review of management's response to claims received and treatment of any additional contractor payments; and — We performed an independent recalculation of depreciation using Computer Assisted Audit Techniques (CAATs) and compared with the company's calculation.	— The outcome of our testing was satisfactory and we concur with management's treatment of additions as capital or revenue; and — On performance of our work on depreciation, we noted instances where depreciation charges were different with our recalculation. We challenged management on these and based on the explanation received, we are satisfied that depreciation is correctly calculated.

Significant risks and other focus areas (cont.)

Significant risk	Our response	Audit conclusion
Household bad debt provision **(£399.0 million, 2018: £388.2 million)** **Forecast-based valuation** 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. As at 31 March 2019, the Scottish Water regulated business reported a household revenue debtor of £435.5 million (2018: £422.6 million) and a corresponding bad debt provision of £399.0 million (2018: £388.2 million) 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.	Our procedures included: **Control design:** — Testing the design and operating effectiveness of controls over the review and approval of the provision and associated assumptions by the Directors during the year and at the year end; and — 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. **Tests of detail:** — 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; and — We agreed the total amount billed and collected in respect of 2019 as recorded in Scottish Water's records, to confirmations received from individual local authorities. **Historical comparison** — We compared the change in forecast collection rate in the current year, to the historical trend of increasing collection rates since 1996-97. **Sensitivity analysis** — 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. **Assessing transparency** — We assessed the disclosure of sensitivities by the Directors, and description of the provision in note 27 of financial statements.	— As at 31 March 2019, the average forecast collection rate, applied to billings, is 96.6% resulting in an equivalent provision of 3.40%. This compares with a provision as at 31 March 2018 of 3.48%; — There is a trend over the past years of improving collection rates (except for the current year where there was a slight drop), particularly in respect of the first year of billings which supports the trend in forecast collection rate; — 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; — The largest movement in collection rate between any two years, over the historic period, is 0.016%. In our sensitivity analysis, this would give rise to an increase or decrease in the provision of £2.5 to £1.9 million indicating the potential outcome is within a reasonable range; and — Overall we consider the provision to be appropriate and in line with the requirements of IFRS 9, 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.

Significant risks and other focus areas (cont.)

Significant risk	Our response	Audit conclusion
Bad debt provision – general (Scottish Water Business Stream) There are a number of assumptions included in the calculation of the bad debt provision; the most sensitive of these assumptions is the overall forecast collection rate based on historical data. There is an inherent risk of error such that incorrect assumptions are made about the provision, with the total provision being £23.9 million, which includes £17.9 million relating to non-vacant properties (vacant properties separately considered)	Our procedures included: **Substantive work:** — Comparing of the amount of cash received after the year end to the year-end ledger balances for all customers one month after the year end in order to assess the level of post balance sheet cash receipts; and — Evaluating the adequacy of the provisions against trade receivables by critically assessing the assumptions made in determining the level of provision for each category of aged debt, with reference to the profile of aged debts at the balance sheet date compared with equivalent data observed subsequent to and at prior year ends.	— Overall the bad debt provision has increased from £20.1 million to £23.9 million. The provision increase also corresponds to the overall increase in revenue and trade receivables. £11.7 million of the general revenue provision relates to debts greater than 360 days old that is 100% provided; — The basis of the bad debt provision calculation for Scottish debtors and those associated with the acquisition of the Southern Water customer list is consistent with the prior year with those debts aged 30 to 90 days being 25% provided, 90 to 360 days being 50% provided and all debts greater than 360 days being 100% provided. Other customers, known as ‘Organic England customers,’ typically larger customers who are supplied across the country (national accounts), are deemed less risky as they are large corporates with close relationship management in place. The provision applied is 5% between 30 and 360 days, and 100% for all debts Greater than 360 days; — Specifically we noted a significant exposure to Debenhams (Approximately £700,000 including accrued income). While this situation continues to develop we concur with management’s view that any exposure is covered by existing provisions; and — Our work over the underlying data used in the calculation has been completed with no issues noted.

Significant risks and other focus areas (cont.)

Significant risk	Our response	Audit conclusion
Bad debt provision – vacant properties (Scottish Water Business Stream) Within the operating expenditure for Business Stream for the year, there are bad debt charges of £7.3 million, with £0.5 million relating to vacant properties. Due to the level of judgment required to conclude on the level of provision required by management, we consider this to be of significance.	Our procedures included: **Substantive work:** — Comparing of the amount of cash received after the year end date to the year-end ledger balances for customers one month after the year end in order to assess the level of post balance sheet cash receipts; and — Evaluating the adequacy of the provisions against vacant property receivables by critically assessing the assumptions made in determining the level of provision. This was performed using historical write-off and collection data in order to assess the levels of recoverability across the portfolio of vacant property receivables.	— Vacant property debt has been provided across 3 categories: aged not paying (100% provided), not aged not paying (20% provided), and paying (5% provided); — There remains limited historical data in relation to collection rates and as such this provision is considered to be more judgmental that the ‘general’ bad debt provision noted on the previous page; — Our assessment of the bad debt provision is based upon the level of collection in prior periods in comparison to the current provision; — We have discussed this area with management and understand the provision level is based upon experience to date, prudently assessed in order to account for the limited historical experience. We are satisfied with this approach and on that basis consider the provision to be materially correct. However, we are in the process of completing our work over the underlying data; and — Given the judgement involved we have sought specific management representations in this area.

Significant risks and other focus areas (cont.)

Significant risk	Our response	Audit conclusion
Pension liability **Scottish Water – £202 million (2018: £144.2 million)** **Scottish Water Business Stream – £4.1 million (2018: £1.3 million)** **Subjective valuation** 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. 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. **GMP equalisation** Following a UK High Court judgement on 26 October 2018, gender equalisation of guaranteed minimum pensions is required to remediate the unequal benefits and retirement ages for men and women from 1990 onwards.	Our procedures included: **Control design:** — 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. **Benchmarking assumptions** — 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; and — 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. **Assessing transparency** — Considering the adequacy of the disclosures in respect of the sensitivity of the deficit to these assumptions.	**Subjective valuation** — We have completed benchmarking analysis which is set out at appendix one; and — The overall assumptions applied by management are considered to be reasonably balanced for a scheme with a duration of 17-19 years; **GMP equalisation** — The UK Government consultation on GMP ended in December 2018 and extended the interim solution already in place for GMP equalisation from 2016 for the period 2018-2021. A review of the process in respect of normalising this arrangement is ongoing; — Scottish Water's actuaries do not include the effect of the interim equalisation solution in the calculation of scheme liabilities on the basis of materiality. We concur with this judgement; — No liability is recognized in respect of the effect of GMP post 2021 on the basis that a 'trigger event' has not occurred, i.e. the UK Government consultation on any potential future scheme amendment is ongoing; and — We consider appropriate for the disclosure of the above to be made in the pension note of the financial statements.

Significant risks and other focus areas (cont.)

Significant risk	Our response	Audit conclusion
Onerous Contract Provision (Scottish Water Services (Grampian) Limited) Scottish Water Services (Grampian) Limited has a contract with Aberdeen Environmental Services Limited for the operation and maintenance of the Grampian project. A provision was deemed necessary in the prior years due to forecast continuing losses for unavoidable costs of meeting the obligations under the contract exceeding the economic benefits expected to be received under it. As at 31 March 2019, a provision of £42.9 million (2018 – £21.0 million) was recorded in the financial statements.	Our procedures included: **Substantive work** — Assessing reasonableness of discount rate and other forecasting assumptions used in the model; — Discussing rationale of the provision with management challenging them on the approach taken; — Checking arithmetical accuracy of the model; and — Involving our tax specialists to consider the current and deferred tax treatment. **Sensitivity analysis** — Performing a sensitivity analysis of the changes in assumptions and assessed impact on the overall provision. **Historical comparison** — Performing a retrospective review of financial numbers used in the model and comparing with actuals.	— We obtained the onerous contract provision workings from management and confirmed mathematical accuracy. We performed analysis over the assumptions and where relevant challenged management in order to substantiate conclusions reached; — The two main assumptions used in the model are discount rate and revenue forecasting which is based on past experience of the company's management; — At Scottish Water consolidation level, this provision is eliminated because it arose between two subsidiaries and the tax effect is adjusted accordingly; and — We have concluded satisfactorily in respect of the provision.

Significant risks and other focus areas (cont.)

Other areas of focus	Our response	Audit conclusion
HM Treasury FReM 2018-19 The 2018-19 FReM introduces the requirements of IFRS 15 Revenue from Contracts with Customers. A five stage model for assessing and recognising revenue requires to be followed, together with enhanced disclosure requirements.	Our procedures included: — Assessing management's review of the revised income recognition requirements, particularly in respect of income from domestic customers and developer contributions; and — Review of management's assessment of the impact of IFRS 15 and any associated adjustments in the financial statements.	— Management has concluded that IFRS 15 will not have any impact on their existing accounting policies for revenue recognition; and — We consider management's assessment to be appropriate and in line with IFRS 15.

Significant risks and other focus areas (cont.)

Other areas of focus	Our response	Audit conclusion
Intangible asset amortisation (Scottish Water Business Stream) Following the acquisition of the non-domestic business customer list of Southern Water in the prior year, an intangible asset was recognised and is subject to amortisation. 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.	Our procedures included: **Sensitivity analysis** — Performed sensitivity analysis and challenged management over the expected life of the customer list by increasing and decreasing each based upon our judgement. **Test of detail** — Compared the expected customer attrition rate with that experienced in the period since acquisition to assess management's assessment of customer retention rates (i.e. the period over which the business is expected to benefit from this intangible). **Assessing transparency** — We assessed the disclosure of the intangible asset and relevant information surrounding the valuation sensitivities, in the financial statements	— Management has amortised the customer list in line with an estimated useful life of 5 years. We consider this to be appropriate.

Significant risks and other focus areas (cont.)

Other areas of focus	Our response	Audit conclusion
Profit recognition 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.	— 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 — Detailed testing of specific contracts in the year which were significant by nature or value.	— Management has 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; — Revenue is recognised based on the percentage of completion method, i.e. over time. Revenue is recognised equal to cost while the project is less than 50% complete. This approach is considered to be appropriately prudent given the size and complexity of the projects. We are content that this policy complies with the requirements of IFRS 15; and — Revenue from developer projects totaled £7.3 million which comprised 242 projects and also include revenue of £1.2 million being the last portion of revenue generated from the completed Tornagrain project.

Significant risks and other focus areas (cont.)

Other areas of focus	Our response	Audit conclusion

Other areas of focus

Income uncertainty provision (Scottish Water company level)

(£32 million, 2018: £19.5 million)

Forecast-based valuation

As at 31 March 2019, the Scottish Water company income uncertainty provision was £32 million (2018: £19.5 million) while at group level the provision was £23.4 million (2018: £14.6 million). The breakdown of the provision at group level is given in the table below.

	2019 £'m	2018 £'m
3rd parties (closed years)	**5.6**	5.5
Vacant properties	**2.5**	2.0
Revenue risk	**7.5**	-
Open years	**7.8**	7.1
	23.4	14.6

There are a number of assumptions included in the calculation of the income uncertainty provision.

Our response

Our procedures included:

Control design:

— 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.

Tests of detail:

— 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;

— 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;

— In respect of Scottish Water Business Stream, we confirmed that final settlements for 2014-15, 2015-16, and 2016-17 have now been reached; and

— We also compared the provision in respect of 2017-18 to amounts agreed with Scottish Water Business Stream (£2.1 million). The closing provision in respect of Scottish Water Business Stream is £6.6 million, agreed between Scottish Water and SWBS.

Historical comparison

— We compared the provision for other third party licensed providers to historical information. The rate previously applied was 2.0% of total billings. This has remained at 2.0% in the current year.

Audit conclusion

— **Third party** – management's included an additional provision of £0.1 million with respect to the potential for previously 'agreed' final settlements with licensed providers to be re-opened based on customer interaction with those providers which may suggest overbilling;

— **Vacant properties** – This relates to the billing of wholesale vacant properties that started in the prior year. It increased by £0.5 million compared to last year;

— **Revenue risk** – This provision relates to the risk of potential claims with respect to prior charges. We challenged management on the adequacy of this provision and although we agree with the rationale for a provision, we believe the quantum may be subject to challenge. Consequently, we proposed a judgmental audit adjustment of £7.5 million which is below our performance materiality and hence management has proposed to keep this unadjusted – see Appendix six;

— **Open years** pertains to the uncertainties in income recognition from wholesale revenue for 'open years';

— The provision related to balances from Scottish Water Business Stream of £6.6 million is correctly eliminated at Scottish Water group level; and

— Overall, the provision for income uncertainty is prudent but appropriate.

Significant risks and other focus areas (cont.)

Other areas of focus

Credit note provision

(£44.4 million, 2017-18: £47.8 million)

Accounting basis

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).

Our response

Our procedures included:

Scottish Water Business Stream

— Critically assess the assumptions made in determining the level of provision, with reference to data observed subsequent to and at prior year ends; and

— Perform sensitivity analysis on the provision model.

Scottish Water (company)

Historical comparison

— 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.

Year	Provision in year	Provision that would now be applied
2017-18	0.985%	0.996%
2016-17	1.000%	1.020%
2015-16	1.015%	1.044%
2014-15	1.032%	1.067%
2013-14	1.057%	1.098%

— 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 £3.4 million which we do not consider to be material.

Audit conclusion

— 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.

Scottish Water Business Stream

— The credit note provision has decreased from £13.8 million to £10.4 million.

— Three adjustments are made to the provision: a reduction of £0.8 million (50%) for historical credit notes relating to public sector organisations; a reduction of £0.9 million (50%) for customers who have transferred from Business Stream; and an increase of £0.2 million relating to Southern Water customers.

— We reviewed the historical data and note that the provisions created in prior years are being utilised in line with expectations.

Scottish Water (company)

— Our sensitivity analysis does not give rise to a material difference in required provision; and

— 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.

Significant risks and other focus areas (cont.)

Other areas of focus	Our response	Audit conclusion
Going concern All entities are required to provide appropriate disclosure in the financial statements in regard to the going concern assumption. Under ISAs (UK) 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.	Our procedures included: — reviewing the cash flow forecasts; — reviewed the repayment profile for government borrowing and the external financing limited set by the Government for the period to 2020-21; — reviewing the regulatory delivery plan update (March 2019) and considering the associated economic assumptions against our commercial understanding; and — 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.	— We have nothing material to draw your attention to in this respect; — We will seek a letter of support for Scottish Water Services (Grampian) Limited from Scottish Water Horizons Holdings Limited; and — We also expect to add an emphasis of matter paragraph in each of the audit opinions of Scottish Water Solutions 2 Limited and Scottish Water International Limited to highlight the fact that their financial statements for the year ended 31 March 2019 are being prepared on a basis other than going concern.

Significant risks and other focus areas (cont.)

Other areas of focus	Our response	Audit conclusion
Purchase of the new entities (Scottish Water Horizons Holdings) **Accounting judgement** Scottish Water entered into a PFI contract with Aberdeen Environmental Services Limited (formerly part of Kelda Group) pre 2002 for the design, build and finance of a wastewater treatment scheme. On 19 December 2018, Scottish Water Horizons Holdings Limited acquired the project and associated four legal entities, namely Aberdeen Holdco Limited, Aberdeen Environmental Services (Holdings) Limited, Aberdeen Environmental Services Limited and Scottish Water Services (Grampian) Limited in exchange for consideration of £16.2 million. There is judgement in respect of the application of accounting standards and accounting for various elements of the transaction within the Group.	Management engaged with us early during the process of acquiring the related entities in order to share their proposed accounting paper and judgements. This facilitated early consideration of the required accounting entries and associated judgements. We held a number of meetings with management to specifically consider and challenge the approach taken and a number of complexities arising in respect of the continuation of the underlying PFI agreement between Scottish Water and Aberdeen Environmental Services while the contract and associated PFI assets and liabilities are eliminated from a Group perspective and replaced with owned assets and external financing. Our procedures included: **Accounting analysis** — We critically assessed the accounting standards and policy applied to the transaction by challenging the relevant accounting standards and their interpretation. **Testing application** — We assessed the completeness of management's consideration of accounting for the elements of the transaction by comparing it against the acquisition agreement and relevant account balances in affected entities; — We agreed the net proceed paid by Scottish Water Horizon Holdings to the outgoing shareholders to the respective bank statements; and — We recalculated the consolidation and acquisition adjustments prepared by management and compared them to the journals posted to reflect the transactions. **Assessing transparency** — We considered the adequacy of the associated disclosures in the financial statements of Scottish Water Horizons Holdings in note 8.	— Management has concluded that the transaction is deemed a business combination at Scottish Water Horizons Holdings Limited's level but a settlement of a contract at Scottish Water (company and group) level; — A gain of £0.5 million was recognised in the consolidated income statement as a result of the acquisition; and — We consider that management has correctly accounted for and presented the transaction.

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, Hymans 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) 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 to report in respect of the above.

Viability

Under ISAs (UK) we are required to report to you if we have anything material to add or to draw attention 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 2019) and Outline Strategic Plan for the 2021-27 period.

We have noted that Members gave consideration to extending the viability period from three to eight years, on the basis of the publication of the Outline Strategic Plan and planning work underway for the SR21 delivery plan period to 2027.

We considered the risks included in the viability assessment and their potential implications on the going concern assessment.

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

Management reporting in financial statements (cont.)

Report	Summary observations	Audit conclusion
Strategic report	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. We also review the contents of the strategic report against relevant guidance. We considered whether it included relevant information in respect of: — strategy and objectives; — business model; — principal risks and uncertainties; and — fair review of the business.	We are satisfied that the information contained within the strategic report is consistent with the annual accounts. We considered the disclosure of risks and uncertainties, strategy and objectives, performance and future plans and consider that it is consistent with our understanding.
Remuneration report	The remuneration report was included within the unaudited annual accounts and supporting reports and working papers were provided.	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. Our independent auditor's report confirms that the part of the remuneration report subject to audit has been properly prepared.
Governance statement and audit committee report	The statements for 2018-19 outlines 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 analyses the efficiency and effectiveness of these elements of the framework.	We are satisfied with the information contained in the reports.

Wider scope

Audit dimensions risk map and conclusions

We have not identified any financial statement significant risks in relation to wider scope. The key aspects of Scottish Water's arrangements which we considered in respect of wider scope responsibilities have changed from those set out in the audit strategy dated 21 August 2018 following Audit Scotland releasing its 2018-19 guidance on planning the audit on 1 October 2018.

Financial sustainability

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 updated and SR 21 planning process in respect of the period to 2027. An Outline Strategic Plan 2021-27 has also been prepared in the context of longer term financial challenges.

The impact of EU withdrawal has been considered and is expected to have limited effect on the Group. Approximately £1.7 million incurred during 2018-19 in respect of preparation. These costs primarily relate to accelerated purchase of treatment chemicals. We assessed the quality of your disclosures in relation to Brexit and concluded that they provide a clear description of the nature of the impact on future performance of the business, the principal risks arising from Brexit and how these are monitored.

Financial management

We consider that Scottish Water's finance team has appropriate, skilled resource.

There is a strong internal control environment and no significant control deficiencies were identified by the audit.

The main area that requires government funding through borrowings is capital investment which is closely monitored and manage by Scottish Water. Internal controls in that area are well developed and were subject to internal audit review of forecasting and cost control during 2018-19 with no major findings. A review of general ledger controls was also completed by internal audit with minor recommendations.

EU Withdrawal

Changing landscape for public financial management

Scottish Water

Care income, financial assessments and financial guardianship

Dependency on key suppliers

Openness and transparency

Governance and transparency

We consider the governance framework to be appropriate and that the governance statement is in accordance with guidance. Scottish Water is required to follow aspects of the UK Corporate Governance Code.

There are appropriate risk management and monitoring arrangements, incorporating a good level of oversight and consideration of risk appetite. There is transparency in the reporting of principal risks and uncertainties in the annual report.

Internal audit conducted a high level review of the effectiveness of controls around selection of suppliers in 2018-19 with moderate findings noted.

Value for money

Scottish Water is subject to water quality and economic regulation which supports value for money objectives. A corporate approach to robust capital project planning effectively helps to reduce inefficiency and overruns.

Internal audit's review of procurement strategy in 2018-19 included two minor recommendations.

Engagement with stakeholders supports their efficient use of resources including water and wastewater services. Performance across a range of non-financial measures continues to increase compared to prior years.

Risk areas identified by Audit Scotland in their 2018-19 guidance on planning the audit

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 2019 and future budgets and forecasts, particular the regulatory delivery plan update (March 2019). Scottish Water Company has outperformed in respect of regulatory activities as part of planned outperformance. In 2018-19, approximately £10 million costs were associated with the exceptionally dry summer in 2018 and severe winter weather which preceded that; and
- 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 waste water charges which can be levied. This restricts Scottish Water's ability to increase income through charging (excepting increases in the number of households). The annual Delivery Plan update includes comprehensive review of planned income and expenditure in the medium-term and is summarised opposite.

An Outline Strategic Plan 2021-27 has also been prepared in the context of longer term financial challenges. The impact of EU withdrawal has been considered by management and is expected to have limited effect on the Group. Approximately £1.7 million incurred during 2018-19 in respect of preparation. These costs primarily relate to accelerated purchase of treatment chemicals.

Delivery plan update (March 2019)

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. The main changes reflected in this update are:

- inclusion of the audited actual results for 2017-18;
- updated forecasts for 2018-19 and 2019 to 2021;
- revised delivery profile and costs for the investment programme; and
- customer charges to be applied in 2019-20.

Key assumptions and financial projections are included in the delivery plan update representing good practice. These are underpinned by the limits set for the current Delivery Plan period and begin to look forward to the next delivery plan period (SR21).

External debt brought into the Group following he acquisition of the NE of Scotland PFI companies in December 2018 has contributed to a reduced forecast total borrowing from Scottish Government (now £724 million).

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.

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 is clearly set out in a budget guidance note for staff. 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.

The Delivery Plan Update includes a summary of performance measures:

- the Household Customer Experience Measure Delivery Plan commitment was greater than 82.6. The result has exceeded that since 2015-16, rising continuously to 87.54 during the year. Customer complaints dropped this year by 27.2%;
- The Overall Performance Assessment has exceeded the Delivery Plan target since 2015 and was 403 as at March 2019, against an aspiration of 400; and
- Capital investment is significant and results in an Overall Measure of Delivery of 193 as at March 2019 against a target of 175.

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.

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. We also considered two aspects of correspondence received from members of the public, via Audit Scotland, during the year, neither of which require additional reporting.

Management 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.

Financial management

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.

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.

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;

— 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 to facilitate member challenge and scrutiny;

— Reading the annual governance statement; as discussed previously; and

— 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. Details of principal risks and uncertainties are included in the Annual Report and considered within the Audit Committee's report.

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 conducted by an in-house team. Extensive reviews are undertaken and reported throughout the year on a range of financial and non-financial topics. The breadth and depth of reviews is good. The conclusion of the Head of Internal Audit for the year 2018/19 was:

"My overall opinion is that the control framework within Scottish Water was effective during 2018/19, although Internal Audit reports did highlight control weaknesses and limitations in some audited systems and processes. The control framework provides substantial assurance that all material risks and issues identified during the year were being actively managed. There are no qualifications to this opinion and there are no significant issues that the Audit Committee should consider in preparing its Annual Report to the Board."

Audit Scotland's Code of Audit Practice sets out the wider dimension of public sector audit. We previously 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.

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.

Value for money

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

Scottish Water is a member of 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 continued to test a range of controls around the process in respect of new capital project assessment through to initiation, monitoring and payment. Internal audit reviews also considered capital project monitoring during the year.

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

These have been summarised on page 32.

Outperformance of the regulatory delivery plan targets demonstrates a commitment to improving financial performance through efficient working. Scottish Water is subject to scrutiny under Scottish Government's Output Monitoring Group, which was established to monitor the delivery of Ministers Objectives for each regulatory period.

The group is chaired by the Scottish Government and includes Scottish Water's main regulators: Water Industry Commission for Scotland (WICS), Drinking Water Quality Regulator (DWQR), Scottish Environmental Protection Agency (SEPA) and Citizens Advice Scotland (CAS). The Output Monitoring Group reports quarterly on the delivery of Ministerial Objectives and each of the regulators produce regular reports on Scottish Water's performance and on individual matters of interest.

Monitoring of KPIs against targets supports improving performance.

Conclusion: Through oversight by and reporting to various regulators we consider value for money and performance against the Delivery Plan are embedded in Scottish Water's operations.

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

Appendices

Appendix one

Assessment of key pension assumptions

Level of prudence compared to KPMG Central assumptions

Outside normally acceptable range | *Cautious* | *Balanced* | *Optimistic* | *Outside normally acceptable range*

Acceptable range

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 **Fund: Lothian, Strathclyde and NES Pension Funds** **Fund Actuary: Hymans Robertson**	**OVERALL ASSESSMENT OF ASSUMPTIONS FOR IAS 19** The overall set of assumptions proposed by the Employer can be considered to be balanced relative to our central rates and within our normally acceptable range overall.			*balanced*
Assumption	**Company**	**KPMG Central**	**Commentary**	**Assessment versus KPMG Central**
Discount rate	2.40%	2.36%	The Employer's proposed assumption is considered to be balanced and within our normally acceptable range.	balanced
Pension Increase Rate (CPI)	2.45%	2.45%	The Employer's proposed assumption is considered to be balanced and within our normally acceptable range.	balanced
RPI Inflation	3.45%	3.47%	The Employer's proposed assumption is considered to be balanced and within our normally acceptable range.	balanced
Mortality	NES CMI 2015 model:1.75%/1.5% LPF CMI 2016 model: 1.25% SPF CMI 2016 model 1.25%/1.5%	CMI 2018 Model 1.25%	The mortality rates are the best estimate based on a mortality table reflecting the current expected experience and an allowance for future improvements in longevity. The figures are in line with our best estimate scheme experience and can be considered acceptable.	balanced

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 versus the KPMG central assumption (or approach) is performed in accordance with the guidelines in Appendix 2.

Assessment of key pension assumptions (cont.)

Level of prudence compared to KPMG Central assumptions

Outside normally acceptable range | *Cautious* | *Balanced* | *Optimistic* | *Outside normally acceptable range*

Acceptable range

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 Business Stream **Fund: Strathclyde** **Fund Actuary: Hymans Robertson**	**OVERALL ASSESSMENT OF ASSUMPTIONS FOR IAS 19** The overall set of assumptions proposed by the Employer can be considered to be balanced relative to our central rates and within our normally acceptable range overall.	*balanced*

Assumption	**Company**	**KPMG central**	**Commentary**	**Assessment versus KPMG central**
Discount rate	2.40%	2.36%	The Employer's proposed assumption is considered to be balanced and within our normally acceptable range.	
Pension Increase Rate (CPI)	2.45%	2.45%	The Employer's proposed assumption is considered to be balanced and within our normally acceptable range.	
RPI Inflation	3.45%	3.47%	The Employer's proposed assumption is considered to be balanced and within our normally acceptable range.	
Mortality	SPF CMI 2016 model 1.25%/1.5%	CMI 2018 Model 1.25%	The mortality rates are the best estimate based on a mortality table reflecting the current expected experience and an allowance for future improvements in longevity. The figures are in line with our best estimate scheme experience 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 versus 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 2019 can be analysed as shown on the following page.

Auditor independence (cont.)

Fees payable	2018-19 £
Scottish Water	127,875
Scottish Water Business Stream	59,000
Scottish Water Interim Review	14,935
Scottish Water International Limited	3,708
Scottish Water Business Stream Holdings Limited	3,708
Scottish Water Solutions 2 Limited	3,708
Scottish Water Horizons Holdings Limited	3,708
Scottish Water Horizons Limited	17,000
Aberdeen Environmental Services Limited	18,500
Scottish Water Grampian (Services) Limited	10,000
Bandwidth Energy Limited	8,000
Regulatory accounts	14,420
Review of accounting for the NE of Scotland PFI companies	13,773
Total audit fees	**298,335**
Non-audit fees	
Assessment of IT project governance	2,896
Total non-audit fees	**2,896**
Total fees	**301,231**

The ratio of non-audit to audit fees was 0.01:1. 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.

Details of non-audit services for the year ended 31 March 2019

Disclosure	Information technology services
Description of scope of services	Assessment of IT project governance associated with the implementation of a new general ledger.
Principal threats to Independence	Self-review
Safeguards applied	Work performed by a separate team from those working on the audit. This work does not result in any accounting judgments.
Basis of fee	Fixed fee
Value of services delivered in the year ended 31 March 2019	£2,896

Auditor independence (cont.)

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.

We draw attention that findings 1 to 4 raised in this section are those that were also raised in the prior year.

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**
1 Nil net book value disposals *Audit dimension: financial management* *Entity: Scottish Water*		**Grade three**
There was a continuation of an exercise commenced in the prior year (disposal 2018 £28 million) which resulted in £102 million of disposals/write off 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.	It is recommended that the annual review of nil net book value assets, and other long standing assets is continued, to determine whether they are in use or should be disposed. However, a record of assets considered and the evidence of their review and conclusion on disposal or retention should be retained.	Accepted. **Responsible officer:** Group Financial Controller **Implementation date:** 30 September 2019

Action plan (cont.)

Finding(s) and risk(s)	Recommendation(s)	Agreed management actions
2 Credit note data *Audit dimension: financial management* *Entity: Scottish Water*		**Grade two**
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. While the Excel records are retained evidence of their receipt from local authorities and review of this process is not.	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.	Accepted. **Responsible officer:** GM Revenue and Risk **Implementation date:** 30 September 2019

Action plan (cont.)

Finding(s) and risk(s)	Recommendation(s)	Agreed management actions
3 Privileged user access management *Audit dimension: governance* *Entities: Scottish Water & Scottish Water Business Stream*		**Grade two**
In 2018, 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 important system changes such as security events (i.e. changes to logs), as well as financial system controls and configuration. In 2019, at the time of our audit, planned systems for monitoring privileged user access had not been implemented across all in-scope systems. We also noted that the Group agreed processes are to review user access assigned to IT systems on an annual basis, to ensure they remain appropriate to individuals role. This did not operate consistently during the audit period. No further testing was performed by KPMG in this area as an alternative substantive approach was taken to the external audit.	Management should consider — implementing an event log auditing based on formal and documented risk assessment agreed between the business and IT; and — 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.	Accepted. **Responsible officer:** Business Systems Manager **Implementation date:** 31 March 2020

Action plan (cont.)

Finding(s) and risk(s)	Recommendation(s)	Agreed management actions
4 Leavers not removed in a timely manner *Audit dimension: governance* *Entity: Scottish Water*		**Grade two**
In 2018, it was noted that there were no processes and controls established to remove user accounts of leavers from the IT systems. An automated batch job was designed and implemented by management in 2018, and the objective was to remove users from Windows network and Oracle Fusion (amongst other systems). The batch job did not operate consistently during the audit period (e.g. 9 Oracle Fusion users in January/February 19 were not disabled). As mitigation, management implemented a monthly manual review for the Windows network (used to authenticate Oracle Fusion users also) and CISP to identify leavers that had not been removed by the batch process. The monthly reviews have not operated consistently during the audit period. Further, sample testing identified 37 Ellipse users in March 19 where access had not been removed. KPMG did not perform procedures to assess if leavers had accessed the systems following the date of leaving, as an alternative substantive approach was taken to the external audit.	Management should consider — implementing an event log auditing based on formal and documented risk assessment agreed between the business and IT; and — 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.	Accepted. **Responsible officer:** Business Systems Manager **Implementation date:** 31 March 2020

Appendix three

Action plan (cont.)

Finding(s) and risk(s)	Recommendation(s)	Agreed management actions	
5 Twinfield Accounting System – Third Party Assurance *Audit dimension: governance* *Entity: Scottish Water Business Stream*			Grade one
In 2018, we noted that the Group relies on the third party (Twinfield International) to operate controls on its behalf for the outsourced system. Twinfield have access to view and change the underlying system application, but require prior approval and login details to be provided by Business Stream to be able to view and change underlying data and configuration settings within the system. An International Standard on Assurance Engagements (ISAE) 3402 report was provided to us by management to demonstrate assurances were obtained over the effective operation of controls at the third party. We noted that the report did not provide assurance over the instance used by the Group, therefore could not be relied upon. Third party risk management and assurance is now a significant consideration for organisations of a similar size and complexity. The objective is to understand if sufficient governance and controls are in place to appropriately mitigate significant risks that third parties pose to the Group. The risks include: — Unauthorised access and/or change to IT systems and data; — IT/operational system downtime; and — IT systems not functioning as intended by management.	We recommend that management should consider requesting an ISAE 3402 report to provide assurance over the Group's instance of the system, or consider performing its own auditing using 'right to audit' arrangements (where in place), or establishing ongoing monitoring and reporting of controls.	Accepted. **Responsible officer:** Graeme Ferguson **Implementation date:** 2019/20	

Action plan (cont.)

Finding(s) and risk(s)	Recommendation(s)	Agreed management actions
6 HiAffinity – Generic User Accounts *Audit dimension: governance* *Entity: Scottish Water Business Stream*		**Grade two**
In 2018, we noted two generic highly privileged user accounts exist and are used by Group IT to develop reporting queries for HiAffinity. There is no process to disable the accounts when no longer needed and the password has not been set with an expiry date. The accounts can be permanently accessed by third parties and a log is not maintained of when the accounts have been used and for what purpose. In 2019, this has not yet been implemented by management. **Risk:** Where unique user accounts are not assigned, the risk is increased that unauthorised changes and transactions are made within IT systems that cannot be attributed to a named individual.	We recommend that management should review the generic user accounts and ensure that uniquely identifiable accounts are established instead for individuals. These accounts should be subject to Group IT password parameters as defined within the Group's agreed information security policies and procedures.	Accepted. **Responsible officer:** Graeme Ferguson **Implementation date:** 2019/20

Action plan (cont.)

Finding(s) and risk(s)	Recommendation(s)	Agreed management actions
7 Control over journal entries *Audit dimension: financial management* *Entities: Aberdeen Environmental Services Ltd & Scottish Water Services (Grampian) Ltd*		**Grade two**
There are no adequate controls over review and authorisation of journal entries within Aberdeen Environmental Services Limited (AES) and Scottish Water Services (Grampian) Limited (SWSG).	It is recommended that a thorough review takes place prior to posting a journal entry to ensure that the information is accurate and posted appropriately.	Accepted. **Responsible officer:** Finance Manager, AES & SWSG **Implementation date:** 30 September 2019

Action plan (cont.)

Finding(s) and risk(s)	Recommendation(s)	Agreed management actions
8 Hedging documentation *Audit dimension: financial management* *Entity: Aberdeen Environmental Services Ltd*		**Grade two**
It is a requirement under both IFRS and FRS 102, for entities to put in place hedge documentation at the very inception of the hedge. Upon requesting this information from AES management, we observed that the document was only prepared on request. We understand that this was earlier centrally managed by Kelda explaining why it was not readily available.	Now that AES is part of Scottish Water group, we recommend that the complete set of hedge documentation, as required by the accounting standards, is put in place.	Accepted. **Responsible officer:** Finance Manager, AES **Implementation date:** 30 September 2019

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 34 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 8 – 27 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 28 – 29 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 42 – 49 sets out our conclusion on these arrangements.

Appointed auditors responsibilities (cont.)

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 30 – 35 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 it's financial targets. Our consideration of non-financial performance measures is on page 31.
Financial position	Review and conclude on financial position including balances and strategies and longer term financial sustainability.	Pages 5 – 7 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 35 sets out our conclusion on these arrangements.

Appendix five

Tax summary

Tax charge	— The £17,920,000 tax charge (2017/18: £13,696,000 charge) within the consolidated income statement is made up as follows: – Corporation tax – current year £2,869,000; – Corporation tax – prior year £638,000; – Foreign tax – £35,000; and – Deferred tax charge – £14,378,000 — 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; and — The effective tax rate of 19% is in line with the headline UK tax rate of 19%.
Tax matters	— 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 trued up after the statutory accounts are signed when the tax computations are finalised.
Balance sheet	— The closing deferred tax balance of £366,370,000 consists predominantly of a deferred tax liability of £439,400,000 on qualifying fixed assets and deferred tax assets of £42,218,000 on the pension and £19,200,000 of tax losses. The remaining deferred tax asset of £11,500,000 is made up of general provisions and deferred tax provided on rolled over gains; and — For the period ended 31 March 2019 the current tax debtor was £2.6 million. Scottish Water is the main tax paying company with some smaller balances due within the subsidiaries.
UK tax status	— All tax returns for 2018 were submitted to HMRC in March 2019, ahead of the filing deadline; and — 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.

Appendix six

Summary of audit differences

The tables below lists the adjusted and unadjusted differences identified during the course of our audit procedures.

Summary of adjusted audit difference

	Balance sheet		Income statement	
	Dr £'000	*Cr £'000*	*Dr £'000*	*Cr £'000*
Dr SOCI			*108*	
Dr Deferred tax asset	*1,753*			
Cr Reserves		*1,861*		
Being deferred tax on interest rate swap in Aberdeen Environmental Services Limited				

Summary of unadjusted audit difference

	Balance sheet		Income statement	
	Dr £'000	Cr £'000	Dr £'000	Cr £'000
Dr Income uncertainty provision	7,500			
Cr Provision charged to income statement				7,500
Judgemental adjustment for overprovision of revenue risk in Scottish Water				

Management representation letter

KPMG LLP
Saltire Court
20 Castle Terrace
Edinburgh
EH1 2EG

[Date]

Dear Hugh

This representation letter is provided in connection with your audit of the Group and Parent Company financial statements of Scottish Water ('the Company'), for the period ended 31 March 2019, for the purpose of expressing an opinion:

— as to whether these financial statements give a true and fair view of the state of the Group's and of the Parent Company's affairs as at period end and of the Group's profit or loss for the financial period then ended;

— whether the group financial statements have been properly prepared in accordance with International Financial Reporting Standards as adopted by the EU and as interpreted and adapted by the 2018-19 Government Financial Reporting Manual; and

— whether the financial statements have been prepared in accordance with the requirements of the Water Industry (Scotland) Act 2002 and directions made thereunder by the Scottish Ministers.

These financial statements comprise the Group and Parent Company Balance Sheets, the Group Statement of Comprehensive Income, the Group and Parent Company Statements of Cash Flows, the Group and Parent Company Statements of Changes in Equity and notes, comprising a summary of significant accounting policies and other explanatory notes.

The Board confirms that the representations it makes in this letter are in accordance with the definitions set out in the Appendix to this letter.

The Board confirms the representations it makes in this letter are in accordance with the definitions set out in the Appendix to this letter.

The Board confirms that to the best of its knowledge and belief, having made such inquiries as it considered necessary for the purpose of appropriately informing itself:

Financial statements

1. The Board has fulfilled its responsibilities, as set out in the terms of the audit engagement dated 31 May 2016, for the preparation of financial statements that:

   – give a true and fair view of the state of the Group's and of the Parent Company's affairs as at the end of its financial period and of the Group's profit or loss for that financial period;

   – have been properly prepared in accordance with International Financial Reporting Standards as adopted by the EU (IFRSs) and adapted by the 2018-19 Government Financial Reporting Manual; and

   – have been prepared in accordance with the requirements of the Water Industry (Scotland) Act 2002 and directions made thereunder by the Scottish Ministers.

The financial statements have been prepared on a going concern basis.

2. Measurement methods and significant assumptions used by the Board in making accounting estimates, including those measured at fair value, are reasonable.

Management representation letter (Cont.)

3. All events subsequent to the date of the financial statements and for which IAS 10 *Events after the reporting period* requires adjustment or disclosure have been adjusted or disclosed.

4. The effects of uncorrected misstatements are immaterial, both individually and in aggregate, to the financial statements as a whole. The uncorrected misstatement is attached to this representation letter.

Information provided

5. The Board has provided you with:

   – access to all information of which it is aware, that is relevant to the preparation of the financial statements, such as records, documentation and other matters;

   – additional information that you have requested from the Board for the purpose of the audit; and

   – unrestricted access to persons within the Group and the Company from whom you determined it necessary to obtain audit evidence.

6. All transactions have been recorded in the accounting records and are reflected in the financial statements.

7. The Board confirms the following:

The Board has disclosed to you the results of its assessment of the risk that the financial statements may be materially misstated as a result of fraud.

Included in the Appendix to this letter are the definitions of fraud, including misstatements arising from fraudulent financial reporting and from misappropriation of assets.

8. The Board has disclosed to you all information in relation to:

   a. Fraud or suspected fraud that it is aware of and that affects the Group and the Company and involves:

      — management;

      — employees who have significant roles in internal control; or

      — others where the fraud could have a material effect on the financial statements; and

   b. allegations of fraud, or suspected fraud, affecting the Group and the Company's financial statements communicated by employees, former employees, analysts, regulators or others.

In respect of the above, the Board acknowledges its responsibility for such internal control as it determines necessary for the preparation of financial statements that are free from material misstatement, whether due to fraud or error. In particular, the Board acknowledges its responsibility for the design, implementation and maintenance of internal control to prevent and detect fraud and error.

9. The Board has disclosed to you all known instances of non-compliance or suspected non-compliance with laws and regulations whose effects should be considered when preparing the financial statements.

10. The Board has disclosed to you and has appropriately accounted for and/or disclosed in the financial statements, in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets,* all known actual or possible litigation and claims whose effects should be considered when preparing the financial statements.

Management representation letter

11. The Board has disclosed to you the identity of the Group and the Company's related parties and all the related party relationships and transactions of which it is aware. All related party relationships and transactions have been appropriately accounted for and disclosed in accordance with IAS 24 *Related Party Disclosures.*

Included in the Appendix to this letter are the definitions of both a related party and a related party transaction as we understand them and as defined in IAS 24.

12. The Board confirms that:

    – The financial statements disclose all of the key risk factors, assumptions made and uncertainties surrounding the Company's and the Group's ability to continue as a going concern as required to provide a true and fair view.

    – No events or conditions have been identified that may cast significant doubt on the ability of the Company and the Group to continue as a going concern.

13. On the basis of the process established by the Board and having made appropriate enquiries, the Board is satisfied that the actuarial assumptions underlying the valuation of defined benefit obligations are consistent with its knowledge of the business and are in accordance with the requirements of IAS 19 (revised) Employee Benefits.

14. The Board further confirms that the average forecast collection rate of 96.6% (2018: 96.5%) that has been applied to the total outstanding household debtors balance as at 31 March 2019 is appropriate and represents its best estimate for future collection rates.

15. The Board further confirms that the amount of income uncertainty provision in respect of revenue risk of £7.5m represents a reasonable judgement of the potential amount the Group may be liable for at this stage.

The Board further confirms that:

— all significant retirement benefits, including any arrangements that are:

  – statutory, contractual or implicit in the employer's actions;

  – arise in the UK and the Republic of Ireland or overseas;

  – funded or unfunded; and

  – approved or unapproved,

have been identified and properly accounted for; and

— all plan amendments, curtailments and settlements have been identified and properly accounted for.

This letter was tabled and agreed at the meeting of the Board on [date].

Yours faithfully,

……………………………………

Douglas Millican, Chief Executive

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