Scottish Water

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

For the year ended 31 March 2020

—

23 November 2020

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 Stephen Boyle, 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 (SW) and its subsidiaries for the year ended 31 March 2020.	Page 10
Financial position and sustainability	— The Group's surplus before tax decreased by £0.4 million to £85.7 million compared with the prior year (£86.1 million). — Capital investment in the year amounted to £513.0 million (2019: £509.2 million). — The overall forecast finance requirement for delivering the 2015-2021 regulated business plan is approximately £8.1 billion. The fifth year of that regulatory period has ended, with the closing cash balance ahead of that forecast in the March 2020 update. Preparation for the next regulatory period (2021-2027) continued to be underway during the year. — COVID-19 has impacted customers in the non-household market for water and waste water services. To assist the market, the Water Industry Commission for Scotland ("WICS") has put in place short term financial support mechanisms. — Scottish Water Business Stream (SWBS) which operates in the retail market has and is forecast to continue to experience lower sales volumes and pressure on cash flow as with many other businesses. Consequently financial support will be provided by the Scottish Water group of companies via Scottish Water Business Stream Holdings to SWBS to ensure its ongoing viability.	Pages 5 – 9
Financial statements and accounting	— We have concluded satisfactorily in respect of each of the significant risks and audit focus areas as set out in our audit strategy and plan document. — Our work in key areas, specifically those impacted by COVID-19 has been satisfactorily concluded with no issues noted. Details of work performed and observations in each of those areas are described on pages 15 to 28. — The annual financial statements, statement of responsibilities, governance statement and remuneration report received continue to be supported by good quality audit workpapers. — There were two audit misstatements identified which were adjusted as reported in appendix six.	Pages 10 – 30
Wider scope	— Scottish Water is subject to a high degree of oversight, including by the Drinking Water Quality Regulator, WICS, 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.	Pages 31 – 36

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 19 August 2019 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.

Executive summary

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 £4.0 billion over the six year program underpins the regulatory delivery plan.

Scottish Water uses the skills of its people and its 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 while Scottish Water Business Stream ('Business Stream') supplies water to non-household customers in Scotland and England.

The group surplus before tax decreased by £0.4 million to £85.7 million compared to £86.1 million in the prior year. Comments on the changes in the Consolidated Income Statement are set out below.

Group capital investment was £513.0 million (2019: £509.2 million) reflecting continued investment in significant projects and ongoing infrastructure upgrades.

Group net debt increased by £0.1 billion to £3.4 billion which was driven by net additional borrowing from the Scottish Government.

Financial position: consolidated income statement

Scottish Water group has continued to experience strong performance in respect of regulated activities. The increase in household income is primarily attributable to price increases and net new properties connected to the network while the increase in non-household income is primarily attributed to the acquisition by Business Stream of the customer base of Yorkshire Water Business Services.

Total operating costs increased by £147.0 million to £1,361.0 million (2019: £1,214.0 million). The main elements of the movement are higher costs within Business Stream of £119.8 million, as a result of increased activity in England and higher depreciation charges in Scottish Water of £14.4 million.

Consolidated income statement	**2020 £'m**	**2019 £'m**	**Movement £'m**
Revenue	1,615.9	1,469.1	146.8
Cost of sales	(1,185.2)	(1,047.4)	(137.8)
Gross surplus	430.7	421.7	9.0
Administrative expenses	(175.8)	(166.6)	(9.2)
Operating surplus	254.9	255.1	(0.2)
Finance income	2.6	2.1	0.5
Finance costs	(171.8)	(171.1)	(0.7)
Surplus before taxation	85.7	86.1	(0.4)
Taxation	(65.1)	(17.9)	(47.2)
Surplus for the year	20.6	68.2	(47.6)

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 £513.0 million (2019: £509.2 million). Depreciation costs consequently increased by £14.4 million (from £282.6 million to £297.0 million). Amortisation of £2.0 million (2019: £3.2 million) was charged on the Business Stream intangible assets (acquired customer lists), which has a year end net book value of £14.0 million.

Group current assets increased by £139.9 million, primarily due to increases in cash and cash equivalents and trade and other receivables.

Group net debt increased by £0.1 billion to £3.4 billion driven by additional net borrowing from the Scottish Government.

Scottish Water Company's cash balance at 31 March 2020 of £391.4 million is ahead of that forecasted in the updated regulatory delivery plan submitted to Scottish Ministers in March 2020. Although the Group's cash balance increased during the year, this is expected to reduce significantly over the year to March 2021 as a result of capital spending under the current regulatory plan and forecast cash outflows of Business Stream due to the impact of COVID 19 on its non-domestic customer base.

A summary of the group cash movement during the year is given in the table below:

Net cash movement (Scottish Water Group)	**£'m**
Balance at 1 April 2019	434.8
Increase during the year	96.8
Balance at 31 March 2020	**531.6**

A summarised consolidated balance sheet is given below:

Balance sheet (Group)	**2020 £'m**	**2019 £'m**	**Movement £'m**
Non-current assets	6,447.8	6,226.5	221.3
Current assets	785.5	645.6	139.9
Current liabilities	(570.1)	(497.4)	(72.7)
Net current assets	**215.4**	**148.2**	**67.2**
Non-current liabilities	(994.7)	(997.5)	(2.8)
Net assets	**5,668.5**	**5,377.2**	**291.3**

Source: Draft financial statements

Capital expenditure (Scottish Water Company)

The overall forecast for delivering the 2015-2021 business plan amounts to £8.1 billion, of which £3.9 billion relates to infrastructure and capital investment across treatment works, water mains, sewers and networks.

£673.0 million (on a regulated accounting basis) was invested during 2019-20 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 £502.7 million (on an IFRS basis).

Financial position and sustainability (cont.)

2015-2021 regulatory period and business plan

The overall forecast finance requirements for delivering the 2015-2021 business plan was £8.1 billion. It was assumed that £7,135 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 2020 and the key features are summarised in the table below. We understand that the borrowing for the remaining year (i.e. 2021) under the current Delivery Plan is not likely to be affected by the COVID-19 pandemic:

£'m	**2018 (actual)**	**2019 (actual)**	**2020 (actual)**	**2021 (forecast)**
Regulated capital investment	647	660	673	730
Total revenue	1,191	1,217	1,254	1,264
Operating surplus	278	273	292	264
Closing cash	271	311	391	363

Source: Annual Reports and Delivery Plan Update

When the Board of Scottish Water accepted the Final Determination (FD) in 2014 for the 2015-21 Regulatory period Officers of Scottish Water were tasked with developing a plan to out-perform on the commitments therein in order to boost the cash balances within the FD to align them with the risk appetite of Scottish Water to always have available c£100m of cash available to protect it against unplanned cost shocks etc.

The closing cash balance within the FD, as at 31 March 20201, was only £40m. The outcome of their out-performance plan has contributed to the closing cash balance as at 31 March 2020 was £391 million compared to £70 million forecast in the FD.

It is noted that of the £321 million improvement in cash over the five years of this six-year regulatory period approximately £78 million is due to timing differences related to planned capital projects and would be expected to reverse over the remainder of the regulatory period. However the impact of COVID on the ability to complete all capital works may result in further delays and consequently higher cash balances. We understand, the cash balance, excluding those timing differences, over that amount which was forecast will be used to support the capital investment programme for customers in addition to the new challenges arising from the consequences of the COVID-19 pandemic.

Going concern

The Delivery Plan Update set out key assumptions management used in preparing revised financial forecasts to 31 March 2021. However, further forecasts covering the period of 12 months from the date of signing of the financial statements have also been prepared. These take account of actual and forecast experience under COVID-19 and include scenarios with a severe but plausible downside. All scenarios reflect:

- Reduced cash collection levels;
- Volumetric impact of up to a 40% reduction in water consumption by business customers;
- The impact of lockdown on capital investment programme; and
- Changes to the wholesale charge prepayment deferral scheme in line with the current regulatory guidance

Financial position and sustainability (cont.)

Going concern (cont.)

Under all of the scenarios, Scottish Water will be able to operate within its available facilities and is well placed to withstand the challenges presented by the pandemic.

Detailed audit procedures performed on going concern are set out on page 26.

Conclusion

We are satisfied that management's adoption of the going concern basis in preparing the financial statements is appropriate in light with the matters set out above.

Impact of COVID-19

The financial impact of the COVID-19 pandemic on the domestic market of Scottish Water has to date been limited, with collection rates for household charges affected to only a limited degree.

However the impact on the non-domestic market in both Scotland and England, within which SWBS operates, has been more significant with reduced water consumption and delays to customer payments being prevalent. The difficulties for customers in these market have been mitigated by their respective regulators with financial protection measures being put in place.

Assistance provided to the operators in the non-domestic market by the WICS included a relaxation of the need for them to prepay for 2 months of wholesale charges. The financial strength of Scottish Water from its out-performance in the regulatory period has allowed it to support this measure which resulted in a short term cash impact of approximately £60m. This is expected to reverse fully by mid-2021.

Scottish Water Business Stream

As noted in the earlier section, SWBS was impacted by the issues in the non-household market. While the breadth of its customer base has mitigated the impact, elements of it, in particular retail, hospitality and the SME sectors have been significantly affected. This has impacted it through reduced water consumption and increased exposure to bad debt risk should elements of the customer base fail to recover from the economic impact of COVID-19.

Forecasts to reflect this, which comprise a low, mid and worst case scenario, have been prepared by SWBS which indicate that as a result it will require support through the period of economic recovery following COVID 19.

These forecasts indicate that the level of support required in the next 24 months could be between £44 million and £88 million. To date no such support has been required given that SWBS has been generating profits since inception which have allowed it to return £65 million to Scottish Water Business Stream Holdings by way of dividends and repay £78.5 million of debt that was made available to it in order to establish its business.

As noted above the financial strength of Scottish Water means it is in the position to provide such support.

Financial position and sustainability (cont.)

Scottish Water Business Stream (cont.)

The relevant officers and Board Members within the Scottish Water group of companies have been fully engaged in establishing the funding facilities required by SWBS and in discharging their obligations. This has included:

- A review of the governance and legal framework between Scottish Water and SWBS to ascertain the requirements to be met to allow support in the form of an additional equity injection of £10 million and a loan facility sufficient to meet the forecast requirements of SWBS to be provided;
- Discussions between and approvals obtained from the WICS and senior civil servants within the Scottish Government which have included ensuring that the regulatory capital programme will not suffer as a result of the provision of financial support to SWBS;
- Consideration of the requirements of State Aid legislation to ensure the funding facility would meet those requirements, with appropriate input from independent advisors;
- An assessment of robustness of the forecasts provided by SWBS and the timescale within which the any financial support given will be capable of being repaid; and
- Consideration and approval of processes to monitor the level of draw-down of funding and subsequent ability of SWBS to repay the funding in line with the five-year period currently forecast.

These considerations have been concluded and the support required, including sufficient contingency, has been formally agreed upon.

We are satisfied that this process has been sufficiently robust and carried out in a diligent and professional manner.

Audit conclusions

Audit opinions	— We prepared an audit strategy document which was submitted to the Audit Committee on 19 August 2019; and — We have prepared a separate annual audit report in respect of Business Stream which has been considered by its board.
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 2019-20 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 both of which were adjusted 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 2019 was used (£12 million). We report all identified misstatements greater than £250,000.

The levels outlined above are used in respect of the Scottish Water consolidated financial statements. However, lower level statutory materialities have been used for the company and subsidiary audits as detailed below (all in £'000).

Entity	Performance materiality	Reporting threshold
Scottish Water Company	8,910	250
Scottish Water Horizons Ltd	83	6
Scottish Water Business Stream Ltd	1,500	100
Scottish Water Horizons Holdings Ltd	1,328	88
Aberdeen Environmental Services Ltd	1,500	100
Scottish Water Services (Grampian) Ltd	275	18
Scottish Water Business Stream Holdings Ltd	785	52

We have considered the effect of COVID-19 on our materiality levels and concluded that they remain appropriate.

Forming our opinions and conclusions

In gathering the evidence to support our audit opinions and conclusions we:

- performed controls testing and substantive procedures to address the risks we identified;
- communicated with internal audit and reviewed its reports as issued to the audit committee;
- 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

- Management continue to provide working papers of high quality. These were provided in line with our agreed timetable.
- A complete set of consolidated financial statements (including front end) was provided in week commencing 11 May 2020.
- The delay in signing the financial statements is due to the issues related to the COVID-19 pandemic, specifically reaching a conclusion in relation to going concern.

Audit conclusions (cont.)

Changes to our audit approach as a result of COVID-19

As part of our ongoing commitment to deliver a quality audit, we have adapted our audit approach to factor in the new and changing risks caused by the pandemic. The table below identifies the key considerations:

Audit area	**Considerations**
Significant risks and key areas of focus	We have considered the effect of COVID-19 on the significant risks/areas of focus we identified at our planning stage and have added ‘impairment of investment in subsidiaries’ as an added area of focus. Refer to page 27 for more details on this new area.
Obtaining sufficient appropriate audit evidence	Our year-end audit was performed entirely remotely and we considered our ability to obtain sufficient appropriate audit evidence to support our audit. We have observed the following: ▪ Delayed response to confirmations – we had put in place additional tracking procedures to encourage counterparties to reply directly at the earliest opportunity. All confirmation replies have been duly received; and ▪ Obtaining more persuasive audit evidence when evaluating management’s assessment of the going concern assertion.
Internal consultation	In light of COVID-19, we had internal mandatory requirements for additional consultations with our Technical Specialists. This exercise has been successfully completed.
Two-way communication	We have engaged in more frequent communications with the Audit Committee and management due to the increased risks of material misstatement, the challenges in completing our audit and the rapidly developing events.
Audit effort and fees	We have incurred additional time in completing our audit as a consequence of COVID-19 which has largely consisted of Manager, Partner and our Technical Team’s time. This was not included in our initial fee and we are currently in discussion with management to finalise the additional amount.

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 to allow a better understanding of 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 (Scottish Water Business Stream);
- Capital additions;
- Bad debt provision;
- Pension liability; and
- Going concern

Other areas of focus

- Intangible asset amortisation (Scottish Water Business Stream);
- Profit recognition (Scottish Water Horizons);
- Income uncertainty provision;
- Credit note provision;
- Impairment of investment in subsidiaries; and
- Purchase accounting (Scottish Water Business Stream)

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.

Significant risks and other focus areas (cont.)

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**	**Aberdeen Environmental Services Limited**	**Scottish Water Horizons Limited**	**Scottish Water Horizon Holdings Limited**	**Scottish Water Services (Grampian) Limited**
Significant risks							
Fraud risk from management override of controls	✓	✓	✓	✓	✓	✓	✓
Fraud risk from income revenue recognition		✓					
Key audit matters							
Capital additions	✓						
Bad debt provision	✓	✓					
Pension liability	✓	✓					
Going concern	✓	✓	✓	✓	✓	✓	✓
Other areas of focus							
Intangible asset amortisation		✓					
Profit recognition					✓		
Income uncertainty provision	✓						
Credit note provision	✓	✓					
Impairment of investment in subsidiaries (note (a) below)	✓		✓			✓	
Purchase accounting		✓					

Note (a): In light of COVID-19, we have added 'impairment of investment in subsidiaries' as an additional area of focus. There has not been any other changes to our strategy document dated 19 August 2019.

We have not made any changes to the significant risks above, or our approach to addressing the assumed ISA risks of fraud in management override of controls and risks of fraudulent revenue recognition.

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 — Remote working due to the COVID-19 lockdown indicates an additional risk of management override of controls and we have factored in the effect of this in our procedures for journals testing.	— 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; — Our testing of journal entries was satisfactory and we have obtained sufficient audit evidence as a result of our planned procedures. No issues were identified. — There we no other specific circumstances identified which would indicate additional risk of management override of controls.

Significant risks and other focus areas (cont.)

Significant risk	Our response	Audit conclusion
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 pressure on the customer base as more competitors enter the market and cost pressures on Business Stream, we have not rebutted this risk for this entity only. Our fraud and error risk considers the judgements and complexities of the accrued and deferred income calculations that exist in those revenue streams identified.	Our procedures in respect of the risk in Scottish Water Business Stream included: — Confirm our understanding of the revenue streams identified by flowcharting and completing a walkthrough of each separately identifiable revenue stream; — Considering the design and implementation of key controls, the revenue recognition processes, and management's calculation of accrued and deferred revenues; — Considering the design and implementation of controls over bank account reconciliations; — Performing cut off testing to assess whether revenue transactions are recognised in the correct period; — Considering the deferral of revenue recognised in respect of advanced billing to ensure this is appropriate and correctly calculated; and — Challenge of assumptions used in estimating the accrued revenue in relation to unbilled revenue at the year end, and re-performance of the calculations used by management to arrive at the estimate. **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; and — The activities of Aberdeen Environmental Services Limited and Scottish Water Services (Grampian) Limited are primarily from their contract with Scottish water and are therefore eliminated on consolidation.	— We discussed each revenue stream with management to confirm our understanding of the end-to-end process for revenue recognition. This process was confirmed through walkthroughs and by flowcharting the revenue recognition process. — We have not placed reliance on IT controls in the current year as during our planning and risk assessment period management indicated to us that action points raised in the prior year had not yet been implemented due to forthcoming operational changes. We adjusted our audit approach accordingly. Refer to page 46 for the control deficiency. — Whilst a process is in place to regularly reconcile the calculation of accrued and deferred revenue to the billing system, this does not operate at a sufficiently precise level to prevent or detect a material misstatement from occurring. Refer to page 47 for the control deficiency. — We reviewed the controls surrounding the reconciliation of bank accounts to the general ledger and found no issues. — Our reperformance of the calculations used by management and cut off procedures were satisfactorily completed with no issues noted.

Significant risks and other focus areas (cont.)

Significant risk	Our response	Audit conclusion
Capital additions (Scottish Water Company) **(£502.7 million, 2019: £503.4 million)** Capital additions related to the delivery plan for regulated activities for the period 2015-16 to 2020-21 are significant. 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 appropriateness of reclassification from assets in the course of construction. **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 journals related to capital additions.	— During the year, assets with a nil net book value, and original book cost of £132 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 2018 and 2019 – £28 million and £102 million respectively). We understand the assets disposed in the current year required minimal judgement but this was not documented; 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):* The company has depreciation charges of £292.2 million (2019: £281.1 million) which is calculated based on the useful lives of the individual asset.	*Other testing (not related to significant risk):* **Test of details:** — We performed an independent recalculation of depreciation using Computer Assisted Audit Techniques (CAATs) and compared with the company's calculation.	— On performance of our work on depreciation, we noted instances where depreciation charges were different to our recalculation. We challenged management on these and based on the explanation received, we corroborated with supporting documentation and then concluded that depreciation is correctly calculated.

Significant risks and other focus areas (cont.)

Significant risk	Our response	Audit conclusion
Household bad debt provision **(£408.8 million, 2019: £399.0 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 2020, the Scottish Water regulated business reported a household revenue debtor of £450.2 million (2019: £435.5 million) and a corresponding bad debt provision of (£408.8 million, 2019: £399.0 million) on household billings from all years dating back to 1996-97. Household water & wastewater charges 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 2020 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 2020, the average forecast collection rate, applied to billings, is 96.69% resulting in an equivalent provision of 3.31% and this compares with a provision as at 31 March 2019 of 3.40%; — 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; — We have challenged this assessment as the calculation remains consistent year on year, despite the COVID-19 emergency. IFRS 9 expects a weighted average model, considering different collection scenarios to be used to calculate the provision. Management's model uses historical collection rates which are considered to be the best method to predict future collection. These rates have seen a long term trend of improvement. On performance of a retrospective review of actual collection rates after year-end, we observed a drop as a result lockdown which then slowly started to pick up in August 2020. The impact of the drop in collection rates post year-end on year-end household debtors balances is not materially significant. — We note that recently there have been drops in respect of the first year of billings. We have challenged management on this basis, but note that despite this, actual average collection continues to increase. This supports the upward trend in forecast collection rate.

Financial statements and accounting

Significant risks and other focus areas (cont.)

Significant risk	Our response	Audit conclusion
Bad debt provision (Scottish Water Business Stream) A bad debt provision exists covering the following main business areas; Scotland, Yorkshire, England, Southern and Vacant Properties. 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 rates based on historical data in each business area. There is an inherent risk of error such that incorrect assumptions could be made about the provision. The total charge for the year to 31 March 2020 was £19.2 million with a bad debt provision balance at the same date of £40.4 million.	Our procedures included: **Control testing:** — Testing the design and implementation of key audit controls over the receivables collection processes. — Testing the operating effectiveness of key audit controls over the receivables collection processes; **Substantive work:** — Performing sensitivity analysis on the provision model; 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 along with an assessment of the level of post balance sheet cash receipts.	— Overall the bad debt provision has increased from £23.9 million to £40.4 million. This includes a £13.2m provision increase for the expected impact of COVID-19. The remaining element of the increase of £3.3 million is a 'standard' provision and corresponds to an overall increase in revenue and trade receivables of 28.4% and 26.0% respectively. £14.3 million (2019: £11.7 million) of the general provision relates to debts greater than 360 days old that are 100% provided; — The provision in relation to COVID-19 was calculated in addition to the standard provision. We have examined its calculation, evaluated the methodology, assumptions and data used, challenged these and discussed in detail with management. The model was based on splitting the analysis between key customers assessed at individual basis and Small and Medium Enterprises treated as a grouping due to their numbers and characteristics. We have concluded the assumptions and methods used were reasonable; — 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 by management 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. The Yorkshire customers list represents new debtors since October 2020, when acquired by the Business Stream, which we assessed as low risk and with appropriate bad debt provision. — Vacant property debt has been provided across 4 categories: aged not paying (100% provided), not aged not paying – new customer (20% provided), not aged not paying – old customer (100% provided), and paying (5% provided); — Our work over the underlying data used in the calculation did not reveal any issues. — We concluded that both 'standard' bad debt provision and the additional COVID-19 element were reasonable and supported by sufficient evidence.

Significant risks and other focus areas (cont.)

Significant risk	Our response	Audit conclusion
Pension liability **Scottish Water – £176.0 million (2019: £202 million)** **Scottish Water Business Stream – £2.6 million (2019: £4.1 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 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 16-18 years; **GMP equalisation** — The Actuary has not made any allowance for full indexation of GMP equalisation as at 31 March 2020. Our view is that the effective date of this event is 26 October 2018 and therefore allowance should have been made as a past service cost in the year ended 31 March 2019. However, the potential impact, which was estimated by our own actuarial specialist, was found to be immaterial. **Pension assets** — Although our significant risk on pension is specific to the liability, we draw attention to the fact that given market volatility caused by the COVID-19 pandemic we challenged management on the appropriateness of the roll-forward methodology to value of pension assets. Management subsequently instructed their actuary to update their report to reflect the actual valuation as at 31 March 2020. This resulted in an adjustment to increase the pension asset by £16.3m. We acknowledge that under normal reporting timetables the actual 31 March valuations are not available and that, provided there is not excessive market volatility, the roll-forward methodology is appropriate.

Significant risks and other focus areas (cont.)

Other areas of focus	Our response	Audit conclusion
Amortisation of intangibles (Scottish Water Business Stream) Amortisation of the intangible assets is considered an audit focus area as the determination of useful life of the assets requires management judgement and estimation. Amortisation of the customer list is judgemental as it is based upon the period of time over which the business is expected to benefit from the asset. The previous assumption of five years has been extended to eight years based on management's assessment at the time of the new acquisition (of the Yorkshire customer base). As a result of this change, additional audit procedures are required to understand the rationale and impact of this change.	Our procedures included: — Discussing with management the process over the monthly amortisation of the customer lists. **Sensitivity analysis** — Performed sensitivity analysis and challenged management over the expected life of the customer list by increasing and decreasing based upon our judgement in order to assess the potential impact. **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). — Obtaining and assessing other supporting evidence for the change in useful life; — Reviewed management's approach to identify any indicators for impairment, including any adjustments for those contracts where there has been a successful subsequent tender by Business Stream. **Assessing transparency** — We assessed the disclosure of the intangible asset and relevant information surrounding the valuation sensitivities, in the financial statements	— We discussed with management the process for amortising the intangible asset throughout the year, and continued to be satisfied with the process of amortisation. — A change of useful life from five years to eight years was been made with the newly acquired Yorkshire customer list intangible asset. Management has prepared an assessment to rationalise this change and calculate the financial impact. We are satisfied that this change is 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.	Our procedures included: — 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

Income uncertainty provision

(£22.6 million, 2019: £23.4 million)

Forecast-based valuation

As at 31 March 2020, the Scottish Water company income uncertainty provision was £30.3 million (2019: £32.0 million) while at group level the provision was £22.6 million (2019: £23.4 million). The breakdown of the provision at group level is as follows:

	2020 £'m	2019 £'m
3rd parties (closed years)	**5.5**	5.6
Vacant properties	**2.0**	2.5
Revenue risk	**-**	7.5
Open years	**15.1**	7.8
	22.6	23.4

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

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;

The provision includes:

- £6.0 million in respect of billing of wholesale **vacant properties** which has decreased by £1.0 million compared to the prior year.
- A total amount of £15.1 million was provided at year-end for **third party licence providers** for the most recent two years in which usage reconciliations were still ongoing. It also includes a provision of £6.3m added during the year for market changes as a result of the legal risk involved;
- **Revenue risk** – This provision was with respect to the risk of potential claims with respect to prior charges. An amount of £7.5 million was provided in the prior year and has been reversed during the year.

Based on the work we have performed, the provision for income uncertainty is considered to at an appropriately prudent level.

Significant risks and other focus areas (cont.)

Other areas of focus

Credit note provision

(£44.1 million, 2019: £44.4 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 assessing 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
2018/19	0.970%	0.9814%
2017/18	0.985%	1.0047%
2016/17	1.000%	1.0286%
2015/16	1.015%	1.0519%
2014/15	1.032%	1.0747%

- The average difference is 0.0119%. The rate applied in 2018-19 is 0.97%, compared with 0.985% in the prior year. Applying the above sensitivity of 0.0119%, the overall provision would vary by £2.5 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 £10.5 million to £9.1 million.
- Three adjustments are made to the provision: a reduction of £0.35 million (50%) for historical credit notes relating to public sector organisations; a reduction of £0.65 million (50%) for customers who have transferred from Business Stream; and an increase of £0.2 million relating to Southern Water customers.
- In addition to this, a further adjustment of £1.0 million is made relating to differences in the calculation of the year end uncertainty provision with Scottish Water as based on market data, Business Stream believe they will potentially owe this amount back to customers.
- In the current year, the data used in the estimation was reduced from four years of historical data to three years to account for winning back the public sector contract in Scotland and a perceived lower liability of claims from these 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 did not give rise to a material difference in the required provision.

Significant risks and other focus areas (cont.)

Other areas of focus	Our response	Audit conclusion
Going concern All entities are required to provide appropriate disclosures 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 Members' 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. That judgement is based on an evaluation of the inherent risks to the group's and company's business model and how those risks might affect the group's and company's financial resources or ability to continue operations over a period of at least 12 months from the date of approval of these financial statements. The evaluation of going concern is based on forecast cash flows which have a greater level of estimation risk because of the impact of the COVID-19 pandemic.	Our procedures included: *Funding assessment* ▪ We have considered the availability of existing funding from the Scottish Government, including reviewing the repayment profile and the external financing limit set for the period 2020-21; *Review of regulatory framework* ▪ We have reviewed the regulatory framework between Scottish Water and SWBS to ascertain the ability to provide such financial support to SWBS as is required, including sources of funds for the latter in the event of any shortfall. This is necessary to support the going concern assumption of SWBS; ▪ Reviewing the regulatory delivery plan update (March 2020) and considering the associated economic assumptions against our commercial understanding; *Retrospective review* ▪ We have considered the budget to actual results for the period from year end to the date of signing of these financial statements; *Sensitivity analysis* ▪ We considered sensitivities of the key assumptions used in the cash flow forecasts and assessed their related impact on the financial resources and headroom available; and *Assessing transparency* ▪ We assessed the completeness and accuracy of the matters covered in the going concern disclosure through procedures performed above, along with our assessment of the viability statement.	— The Scottish Water Group's cash balance has increased by £96.8m from the prior year. — Agreed Government borrowing of £220 million is planned to be drawn down in 2020/21, the final year of the current regulatory delivery plan period; — We have considered in detail the going concern assessment of Scottish Water with no issues noted; — Our consideration of the regulatory framework between Scottish Water and SWBS in tandem with the structure of the support package being made available with no issues noted; — Our challenge of the forecasts prepared by each entity within the Scottish Water Group has noted no issue; and — We have received a letter of support for: Scottish Water Business Stream Limited from Scottish Water Business Stream Holdings Limited, and (2) Scottish Water Services (Grampian) Limited from Scottish Water Horizons Holdings Limited. — Based on work performed, we have concluded that the application of the going concern basis in preparation of the financial statements is appropriate.

Significant risks and other focus areas (cont.)

Other areas of focus	Our response	Audit conclusion
Impairment of investment in subsidiaries **(£37.5 million, 2019: £37.5 million)** COVID-19 has triggered the risk of impairment of investment in subsidiaries in the separate financial statements of Scottish Water as at 31 March 2020, with a higher risk on the investment of Scottish Water Business Stream Holdings in Scottish Water Business Stream.	Our procedures included: — comparing the carrying amount of investment in subsidiaries with the relevant subsidiaries' net assets to identify whether their net assets, being an approximation of their minimum recoverable amount, were in excess of their carrying amount; — further considering the carrying amount of the investment in subsidiaries with the expected value of the business based on a discounted cash flow basis; and — challenge management on the reasonableness of assumptions used in their discounted cash flow workings.	— We have reviewed the impairment analysis documentation prepared by management and are satisfied that there is no requirement for an impairment.

Significant risks and other focus areas (cont.)

Other areas of focus	Our response	Audit conclusion
Purchase accounting (Scottish Water Business Stream) On 1 October 2019, Business Stream acquired the non-household customer book of Yorkshire Water Business Services and Three-Sixty from Kelda Group. The purpose of the acquisition was to support Business Stream's expansion in the English retail market for business customers. The initial consideration of £8.3m, was paid in October 2019. The initial consideration has been capitalised and carried as an intangible asset on the balance sheet. The initial purchase is considered a significant unusual transaction which additional audit procedures will be required to gain comfort over the accounting treatment, transaction price, and any subsequent re-measurement. The useful life of both the new and existing customer list intangible assets has been set to eight years and this is considered further in the amortisation of intangibles other focus area on page 22.	Our procedures included: — Assessing management's treatment of the initial transaction as an intangible asset or business combination in accordance with relevant accountancy standards. **Benchmarking assumptions** — Challenging the key assumptions applied in ascertaining the value of the customer list, specifically the discount rate, against externally derived data. **Sensitivity analysis** — Performed sensitivity analysis and challenged management over both the discount rate and expected life of the customer list by increasing and decreasing each based upon our judgement and assessing the impact. **Test of detail** — Assessed the accuracy of the forecast data used in valuing the customer list by comparing to actual results post acquisition. — 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 transaction, as well as relevant information surrounding the valuation sensitivities, in the financial statements	— We have concluded that it is appropriate to account for the initial acquisition as an intangible asset under IAS 38 rather than as a business combination under IFRS 3. — The initial purchase price of £8.3 million has been re-measured to £4.8 million in line with the purchase agreement for customers who were out to tender at the date of acquisition. However, we would expect the purchase price to change due to the impact of contingent consideration. This is currently assessed at £1.6m. Based on evidence of the true-up payment this was deemed appropriate. — We have considered the accounting treatment of the contingent consideration and concluded it was appropriate. — The total intangible asset carrying value at 31 March 2020 is £14 million (2019: £10.0 million) which includes the previous Southern Water customer list acquisition. — We have reviewed the impairment analysis documentation prepared by management and satisfied that there is no requirement for an impairment.

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.

We have also reviewed the changes made to the notes to the financial statements in consideration of the impact of COVID-19. We are satisfied that they are appropriate.

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 2020) and Outline Strategic Plan for the 2021-27 period.

Based on discussion with management, we understand that both the regulatory delivery plan update and the Outline Strategic Plan for 2021-27 period is being reviewed in light of the current economic climate under the COVID-19 pandemic.

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 financial statements. We also review the content of the strategic report against relevant guidance and 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 in the strategic report is consistent with the financial statements. We considered the disclosure of risks and uncertainties, strategy and objectives, performance and future plans and consider they are consistent with our understanding.
Remuneration report	The remuneration report has been included within the Annual Report and working papers were made available to us for review.	We are satisfied that the information contained within the remuneration report are consistent with the underlying records and the annual report, including required disclosures were made.
Governance statement and audit committee report	The statements for 2019-20 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 report.

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 19 August 2019 following Audit Scotland releasing its 2019-20 guidance on planning the audit.

Scottish Water

Financial sustainability

Management and those charged with governance have completed significant work in respect of medium and longer term financial planning; primarily through the update of the regulatory delivery plan and SR 21 planning process in respect of the period to 2027.

COVID-19 is a unique challenge in the face of which management continue to reassess the Group's financial sustainability and the different areas affected by it, including funding needs and the ability of the various Group entities to continue as a going concern and the impact on the longer term financial requirements and sustainability. This requires assessment of the business impact, environmental changes, legislative requirements and liaison with various regulators and the Scottish Government.

The impact of EU withdrawal continue to be assessed to have limited effect on the Group.

Financial management

We consider that Scottish Water's finance team is made up of an appropriate mix of skills and resources.

We reiterate our consideration that Scottish Water's finance team has the appropriate skilled resources. It has also demonstrated a good awareness of succession planning.

Under the 2019-20 FReM, implementation of IFRS 16 *Leases* has been delayed until 2020-21. Scottish Water's preparation for the implementation is well underway.

The main area that requires government funding through borrowings is capital investment which is closely monitored and managed by Scottish Water. Internal controls in that area, including in relation to fraud risk surrounding procurement of assets, are well developed and were last subject to internal audit review of forecasting and cost control during 2018-19 with no major findings.

Governance and transparency

We consider the governance framework to be appropriate and that the governance statement made in the Annual Report 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.

The internal audit team has an annual programme of work which is carried out. No significant findings were noted during the course of their work.

Based on our work, we came across only one significant control deficiency was identified during the year. Refer to page 46 of this report.

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. Scottish Water's drinking water quality in 2019 was in line with their highest ever level previously achieved.

Internal audit's last review of their procurement strategy in 2018-19 included two minor recommendations. We did not come across any weaknesses in that area during the course of our work

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.

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.

Scottish Water is regarded as a public sector organization of trading nature. It borrows from the Government to deliver essential services mainly to the Scottish community. Considering financial sustainability of Scottish Water we performed the following work:

- Reviewing the financial position as at 31 March 2020 and future budgets and forecasts, particular the regulatory delivery plan update. Scottish Water Company continue to outperform in respect of its regulatory activities with the actual cash position of £391 million as opposed to a forecasted balance of £70 million as at 31 March 2020; 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. The Commission released a Draft Determination in October as part of its strategic review of charges for the years 2021-27. This restricts Scottish Water's ability to increase income through charging (excepting increases in the number of households). The annual Delivery Plan update includes a 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, including the impact of EU withdrawal. The Plan is in the process of being reviewed by management in the context of the recently released Draft Determination by the Regulator and in consideration of the impact of the pandemic.

Delivery plan update (March 2020)

The regulatory delivery plan update (last updated in March 2020) includes revised financial forecasts in respect of the remaining period to March 2021. This incorporates continued outperformance of the regulatory delivery plan achieved to date which has been built into the annual budget for 2019-20 onwards. The key highlights related to financial sustainability in this update are:

- Maintenance of momentum in investment delivery programme;
- Connection of over 115,000 new properties to Scottish Water's network;
- Update of the closing cash position at the conclusion of SR15 investment; and
- Publishing a Strategic Plan for the next 25 years.

Key assumptions and financial projections are included in the delivery plan update representing good practice. It is our understanding from discussion with management that a revised Delivery plan update will be prepared in March 2021 to consider the impact of the COVID-19 pandemic.

Impact of COVID-19

As noted on page 8, COVID-19 has impacted SWBS to the extent that it is forecast to require financial support for a period of time from the Scottish Water group of companies via Scottish Water Business Stream Holdings. The ability to provide this support from out-performance against the regulatory plan has been carefully considered to ensure it does not impact on existing priorities.

Conclusion: Significant work has been 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 the business planning process. These consider both revenue and the significant capital investment program. Consideration of underlying assumptions and sensitivity analysis supplements this work.

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. These 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 2020 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 88.0 during the year;
- The Overall Performance Assessment slightly higher than the Delivery Plan target range and was 401 as at March 2020, against an aspiration of 400; and
- Capital investment is significant and results in an Overall Measure of Delivery of 216 as at March 2020 against a target of 209.

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. The finance function’s capacity is considered to be appropriate and activity is appropriately delegated to operational areas. There is a clear succession plan in place.

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 a sound structure of controls in place to prevent and detect fraud.

Financial management

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

Scottish Water has a number of policies in place which are reviewed every 2 years, these are: Anti-Slavery, Code of Ethical Conduct, Whistleblowing and Fraud Management which are also supported by routine mandatory compliance training. The Company further rolls out an annual Policy Awareness Communication plan to ensure its employees are aware of their rights and obligations.

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.

We also considered fraud risk relating to procurement which we see is primarily linked to the acquisition of assets. We have performed test of controls in that area.

Conclusion: We are content that Scottish Water has appropriate arrangements to prevent and detect fraud and 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: Based on our work, and that of internal audit, on the design and operation of financial controls over significant risk points we are content 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. Discussions and actions are documented in minutes of meetings;
- Reviewing financial and performance reporting within the organisational structure. Reporting is of high quality. Financial reporting includes analysis of revenue and capital. Reports are sufficiently detailed, giving narrative explanations to key movements from budget;
- Reading the annual governance statement; as discussed previously; 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.

Scottish Water complies with the UK Corporate Governance Code 2016 so far as it is relevant and applicable. As public corporation, the FCA listing rules do not apply and an Annual Consultative Meeting is held in place of an Annual General Meeting. Further, no Senior Independent Director has been appointed as management consider other arrangements are in place to consult with stakeholders.

Section 172 statement

Scottish Water has also considered their duties under Section 172 of the Companies Act 2006 (Strategic Report and Directors' Report) Regulations 2013 as well as the 'Guidance on the Strategic Report' issued by the Financial Reporting Council and the UK Corporate Governance Code 2016.

Gender pay gap

Gender pay gap legislation applies for the UK private sector companies and requires pay comparisons be made between the contractual pay of men and women including base salary, paid leave, pay allowances, shift pay and on-call and standby payments. Although Scottish Water is a public corporation, they have adopted the legislation for transparency and therefore disclose their gender pay gap in line with the private sector calculation but using the two-year frequency of Public Sector Equality Duties (PSED) reporting.

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.

COVID-19

Management has considered the forward looking impact of the pandemic in their Annual Report. This includes impact on governance practices, risk management and its impact on the capital investment programme in its viability statement.

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. We are also content that the internal audit function is operating as appropriate.

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 considered fraud risk around procurement and continued to test a range of controls around the process in respect of new capital project assessment through to initiation, monitoring and payment, including performing test of details and manual journals.

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 33.

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, overall 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 cautious approach, in accordance with the requirements of IAS 19. We set out below the assumptions in respect of defined benefit obligations.

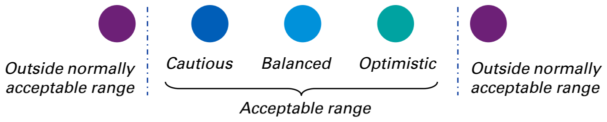
Employer: Scottish Water	**OVERALL ASSESSMENT OF ASSUMPTIONS FOR IAS 19**	
Fund: Lothian, Strathclyde and North East Scotland Pension Funds **Fund Actuary: Hymans Robertson**	The overall assumptions adopted by the Employer are considered to be cautious relative to our central rates but within our normally acceptable range overall.	🔵 *Cautious*

Assumption	**Company**	**KPMG Central**	**Commentary**	**Assessment versus KPMG Central**
Discount rate	2.30%	2.25%	The Employer's proposed assumption is considered to be balanced and within our normally acceptable range.	🔵
Pension Increase Rate (CPI)	1.90%	1.78%	The Employer's proposed assumption is considered to be cautious but within our normally acceptable range.	🔵
Salary increases	1.90%	In line with long-term remuneration policy	The Employer's proposed assumption is considered to be balanced and within our normally acceptable range.	🔵
Mortality	NESPS CMI 2016 model 1.75%/1.5% LPF CMI 2016 model 1.25% SPF CMI 2015 model 1.5%/1.25%	CMI 2019 Model 1.25%	Although the mortality improvements assumptions in isolation are outside of our normally acceptable range, the overall assumptions remains within our normally acceptable range.	🟣

Appendix one

Assessment of key pension assumptions (cont.)

Level of prudence compared to KPMG Central assumptions



In respect of employee benefits, 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	2.30%	2.24%	The Employer's proposed assumption is considered to be balanced and within our normally acceptable range.	●
Pension Increase Rate (CPI)	1.90%	1.73%	The Employer's proposed assumption is considered to be balanced and within our normally acceptable range.	●
RPI Inflation	2.80%	In line with long-term remuneration policy	The Employer's proposed assumption is considered to be balanced and within our normally acceptable range.	●
Mortality	CMI 2016 projections model 1.5%/ 1.25%	CMI 2019 projection 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.	●

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 2020 can be analysed as shown on the following page.

Auditor independence (cont.)

	2019-20 (£)
Audit fees	
Scottish Water	130,475
Scottish Water Business Stream	59,000
Scottish Water Interim Review	15,308
Scottish Water Business Stream Holdings Limited	3,801
Scottish Water Horizons Holdings Limited	3,801
Scottish Water Horizons Limited	17,425
Aberdeen Environmental Services Limited	18,500
Scottish Water Grampian (Services) Limited	10,000
Regulatory accounts	14,781
IT Controls	2,968
Going concern	2,000
Procurement fraud risk	3,000
Wider scope	6,000
Impact of adoption of IFRS 16	5,000
Additional procedures as a result of COVID-19 (as mentioned on page 12, this is currently in discussion)	48,000
Total audit fees	**340,059**
Non-audit fees	
Assessment of IT project governance (refer to next paragraph for more information)	**2,896**
Total fees	**342,955**

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 2020

Disclosure	Information technology services
Description 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 judgements
Basis of fee	Fixed fee

Independence and objectivity considerations relating to other matters

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

Confirmation of audit independence

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

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

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

Yours faithfully

KPMG LLP

Appendix three

Action plan

The action plan summarises specific recommendations arising from our work, together with related risks and management's responses. We present the identified findings across four audit dimensions:

- financial sustainability;
- financial management;
- governance and transparency; and
- Value for money

Priority rating for recommendations

Grade one - significant

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

Grade two - material

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

Grade three - minor

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

Action plan (cont.)

Finding and risk	Recommendation	Management action
1 Onerous contract provision review ***Audit dimension**:* Financial management ***Entity**:* Scottish Water Services (Grampian) Limited		**Grade three**
Finding: The onerous contract provision is a large estimate within the Scottish Water Services (Grampian) Ltd entity. This involves significant judgement and relies on future assumptions to derive the provision value. From discussion with management, we understand that there is already a review process in place which is not formally documented. **Risk**: Lack of formally documented review in areas of judgment increases the risk of errors and irregularities.	We recommend that procedures and challenge with respect to onerous contract provision should be appropriately documented/evidenced. The following criteria should be considered when performing review of estimates: ▪ The control satisfies the corresponding control objective; ▪ Precision of the control is sufficient to achieve its objective; ▪ Steps involved in identifying and resolving outliers are properly designed using the established criteria of investigation; ▪ Those performing the control have the appropriate competence and authority to satisfy the objective; ▪ The control is performed with sufficient frequency to achieve its objective in a timely manner; ▪ Information used in the control are relevant and sufficiently reliable to achieve its objective; and ▪ The control is designed to address management bias.	Accepted. **Responsible officer:** Finance team **Implementation date:** FY-2021

Appendix three

Action plan (cont.)

Finding and risk	Recommendation	Management action
2 Control over journal entries ***Audit dimension:*** Financial management ***Entities**:* Scottish Water, Scottish Water Business Stream, Aberdeen Environmental Services Ltd and Scottish Water Services (Grampian) Ltd		🟩 **Grade three**
Finding: The presumed risk of management override of controls includes consideration of the design of controls relating to journals. During the course of our audit, we noted that there are a number of controls over preparation and review of journal entries. However, controls over the review function is not formally documented. On discussion with management, we understand that there are alternative remediating controls in place, for instance monthly reconciliations, whereby incorrect journal entries are likely to be identified. **Risk**: Lack of formal documentation in the review of journal entries makes it difficult to ascertain whether they have been reviewed or not. There is therefore the risk that materially incorrect journals could be posted, whether due to fraud or error, without being reviewed.	We recommend that management considers documenting evidence of reviews over journals.	Accepted. **Responsible officer:** Finance team of each entities **Implementation date:** FY-2021

Appendix three

Action plan (cont.)

Finding and risk	**Recommendations**	**Management actions**
3 Privileged user access management ***Audit dimension**: General IT controls* ***Entity**: Scottish Water*		**Grade two**
Finding: Scottish Water does not proactively monitor privileged IT system administrator activities (inc.IT and third party staff) to detect any unauthorised access to data or changes in the production environment for all IT systems in scope of the audit (e.g. Oracle Fusion, CISP, Ellipse). Events that are not monitored include changes to important system settings such as security events (e.g. changes to logs), as well as financial system controls and configuration. We understand that an automated tool has been selected and is in the process of being implemented to monitor privileged access accounts on in-scope applications and systems as part of the Cyber Security Programme. No further testing was performed by KPMG in this area as an alternative approach was taken to the external audit. **Risk**: Where logging and monitoring is not established, the risk is increased that: ▪ Unauthorised access is gained to process erroneous or fraudulent transactions, make changes to data, and system settings; ▪ Unauthorised changes are not detected and appropriate action taken; ▪ IT/Operational system downtime is experienced; and ▪ The system does not function as intended by management.	Management should consider: ▪ Implementing procedures to monitor access to privileged accounts on applications and systems, including access to generic privileged accounts. ▪ Implementing event log auditing based on a formal and documented risk assessment agreed between the business and IT; and ▪ Reviewing the audit logs and demonstrate appropriate follow up and investigation, as well as consider maintaining integrity of the logs by preventing changes from being made by users.	Cross functional identity management forums are in place and consist of membership from our partners and both our Access, Data & Cyber functions, these are informal with no minutes, but do drive forward conversation & improvements together. Privileged access at our application level continues to be governed on a month to month basis, and we continue to improve our reviews at database level, which is a reducing risk as many of our higher risk applications are now software as a service solutions. (i.e. only Ellipse is left on premise for the systems within the audit scope & restricted to a very small number of admin users). Scottish Water has embarked on a Cyber Security Programme of change & development, and as part of this substantial programme new capabilities around privileged access monitoring will be developed. We have settled on a tool, this is now under implementation and will manage all privileged access for relevant accounts along with introducing session recording where relevant to enable change monitoring. This is still under implementation and is now in final phases having passed design, and initial testing, and expected to be implemented in FY-2021 into live service. However, compensating controls are very much still in place which mitigate the risk associated with privileged access. **Responsible officer**: Head of Corporate Data & Compliance and Head of Security & Service Operations **Implementation date**: FY-2021

Appendix three

Action plan (cont.)

Finding and risk	Recommendation	Management action
4 IT Control Environment ***Audit dimension**: Financial management* ***Entity**: Scottish Water Business Stream*		Grade one
Finding: Previous work performed by our specialist IT colleagues over the HiAffinity billing system identified a number of control deficiencies. This system is a key source of information for our work on revenue recognition. **Risk**: There is a risk, due to either fraud or error, that the recording of revenue is incorrect within the HiAffinity billing system. As this is heavily relied upon by the business, any access to manipulate records maintained by this system presents a risk to the business and to our audit approach.	We recommend management to review the previously reported IT control environment findings and implement the necessary controls and review procedures necessary to mitigate the risks identified. These risks primarily focused on privileged user account access and generic user account usage. We draw attention that for the purposes of our audit we did not rely on these GITCs but instead obtained alternative audit evidence as appropriate.	Given the system limitations of the Hi Affinity billing system around limiting user privileges and our planned move to a new billing platform the control deficiencies are recognised as an acceptable risk in the short-term. Management will continue to restrict the number of privileged user accounts issued on a needs basis. **Responsible officer:** Infrastructure & Service Delivery Manager **Implementation date:** FY-2021

Appendix three

Action plan (cont.)

Finding and risk	Recommendation	Management actions
5 Calculation of accrued and deferred revenue ***Audit dimension**: Financial management* ***Entity**: Scottish Water Business Stream*		**Grade Two**
Finding: Our presumed risk of fraud over revenue requires us to consider relevant controls within the revenue recognition process. Due to the manual nature of the accrued/deferred income adjustments we have identified this as a specific area for audit consideration in relation to both error and fraud. Although review processes are in place, we could not identify any controls that individually or in combination with other controls would prevent or detect a material misstatement in respect of the accrued and deferred revenue calculation. **Risk**: There is a risk, due to either fraud or error, that the calculation of accrued and deferred revenue is incorrect prior to being uploaded into the general ledger system.	We recommend that management introduces a detailed review control that demonstrates the calculations of accrued and deferred income are appropriately performed, are free from error, and are correctly posted to the general ledger.	The current monthly review processes undertaken by the Financial Controller will be standardised and documented to show both the analytical review and substantive testing undertaken as part of each monthly close cycle. **Responsible officer:** Head of Financial Control **Implementation date:** FY-2021

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 30 sets out our conclusion on these arrangements.
Financial statements and related reports	Provide an opinion on audited bodies' financial statements on whether financial statements give a true and fair view of the financial position of audited bodies and their expenditure and income Provide an opinion on whether financial statements have been properly prepared in accordance with relevant legislation, the applicable accounting framework and other reporting requirements Provide an opinion on the regularity of the expenditure and income	Pages 10 – 30 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	Pages 29 – 30 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 have kept the Auditor General informed that the delay to completion of our audit work related to the process to consider the package of financial support required for Business Stream.
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 – 47 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 31 – 36 set out conclusions in these areas.
Financial position	Review and conclude on the effectiveness and appropriateness of arrangements to ensure that the body's financial position is soundly based.	Pages 5 – 9 sets out our conclusion on these arrangements.
Financial position	Review performance against targets	Pages 5 – 9 summarise our review of how the body has performed against it's financial targets. Our consideration of non-financial performance measures is on page 33.
Financial position	Review and conclude on financial position including balances and strategies and longer term financial sustainability	Pages 5 – 9 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 36 sets out our conclusion on these arrangements.

Appendix five

Tax summary

Tax charge	— The £65.1m tax charge (2019: £17.9m charge) within the consolidated income statement is made up of: – Corporation tax of £10.9m; and – Deferred tax charge of £54.2m. — The effective underlying tax rate (based on the total tax charge excluding prior year adjustments and rate changes) for this year was higher than the headline UK tax rate of 19%. This arises as a result of the Chancellor announcing the cancellation in the main UK corporation tax rate from 19% to 17% in his Budget Speech on 11 May 2020. The deferred tax effect of this cancellation has been adjusted accordingly as at the balance sheet date.
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 £432.7 million consists predominantly of a deferred tax liability of £495.5 million on qualifying fixed assets and deferred tax assets of £41.9 million on retirement benefit obligations and £12.4 million on tax losses. The remaining deferred tax asset of £11.5 million is made up of general provisions and deferred tax provided on rolled over gains; and — For the period ended 31 March 2020 the current tax debtor was £1.5 million. Scottish Water is the main tax paying company with some smaller balances due within the subsidiaries.
UK tax status	— All tax returns for 2019 were submitted to HMRC in March 2020, 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 table below lists the audit differences identified in Scottish Water and Scottish Water Business Stream both of which were adjusted by management.

Scottish Water

	Type of misstatement	Balance sheet		Other comprehensive income	
		Dr £'000	Cr £'000	Dr £'000	Cr £'000
Dr Pension assets	Factual	13,203			
Dr Deferred tax		3,097			
Cr Other comprehensive income					16,300
Adjustment on recalculation of pension asset values as at 31 March 2020					

Scottish Water Business Stream

	Type of misstatement	Balance sheet		Income statement	
		Dr £'000	Cr £'000	Dr £'000	Cr £'000
Dr Wholesale prepayments	Factual			381	
Cr Credit note provision			381		
Reclassification of a wholesale refund posted against cost of sales and credit note provision.					

Management representation letter

FAO Mr Hugh Harvie
KPMG LLP
Saltire Court
20 Castle Terrace
Edinburgh
EH1 2EG

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 year ended 31 March 2020, for the purpose of expressing an opinion:

i. 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 31 March 2020 and of the Group's and Parent Company's profit or loss for the financial year then ended;
ii. whether the group financial statements have been properly prepared in accordance with International Financial Reporting Standards as adopted by the EU and the parent company financial statements have been properly prepared in accordance with IFRSs as adopted by the EU and as interpreted and adapted by the 2019-20 Government Financial Reporting Manual; and
iii. 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 following the Group and Parent Company Balance Sheet, 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 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:

   i. 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 year and of the Group's profit or loss for that financial year;

   ii. have been properly prepared in accordance with International Financial Reporting Standards as adopted by the EU ("IFRSs") and adapted by the 2019-20 Government Financial Reporting Manual; and

   iii. 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.

Appendix seven

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. A list of the uncorrected misstatements 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 (cont.)

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 and to comply with IAS 1 Presentation of Financial Statements.
    - No material 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.

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

14. The Board further confirms that the average forecast collection rate of 96.69% (2019: 96.60%) that has been applied to the total outstanding household debtors balance as at 31 March 2020 is appropriate and represents its best estimate for future collection rates.

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

Yours faithfully,

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Douglas Millican, Chief Executive

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