Scottish Water

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

For the year ended 31 March 2021

—

9 July 2021

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.

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

Complaints

If at any time you would like to discuss with us how our services can be improved or if you have a complaint about them, you are invited to contact Hugh Harvie, who is the engagement leader for our services to Scottish Water, telephone +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.

Executive summary

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 2021.	Pages 9 - 11
Financial position and sustainability	— The Group’s surplus before tax decreased by £51.7 million to £34 million compared with the prior year (£85.7 million). — Capital investment in the year amounted to £447.2 million (2020: £513.0 million). — The overall forecast finance requirement for delivering the 2015-2021 regulated business plan was approximately £8.1 billion. The sixth and final 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 during the year. — Scottish Water Business Stream (SWBS) which operates in the retail market continues to be adversely affected by the COVID pandemic and is forecast to experience slower customer payments and pressure on cash flow as a result. Consequently a package of financial support provided by the Scottish Water group of companies via Scottish Water Business Stream Holdings to SWBS is in place to ensure its ongoing viability.	Pages 5 - 8
Financial statements and accounting	— We have concluded satisfactorily in respect of each of the significant risks and audit focus areas (including those impacted by COVID-19) as set out in our audit strategy and plan document. — The annual financial statements, statement of responsibilities, governance statement and remuneration report received continue to be supported by good quality audit workpapers. — There were five audit misstatements identified, one of which was in Scottish Water and has been adjusted while the other four were in Scottish Water Business Stream, three of which were adjusted and one remained unadjusted as reported in appendix six. We draw attention that the unadjusted audit differences are immaterial, both individually and in aggregate.	Pages 9 - 27
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 28 - 33

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 2021-22, 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 30 March 2021 which was presented to the audit committee at the outset of our audit.

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

Accountable officer responsibilities

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

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

Auditor responsibilities

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

Scope

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

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

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

Under the requirements of International Standard on Auditing (UK) ('ISA') 260 *Communication with those charged with governance*, we are required to communicate audit matters arising from the audit of financial statements to those charged with governance of an entity. This annual audit report to members and our presentation to the audit committee, together with previous reports to the audit committee throughout the year, discharges the requirements of ISA 260.

Financial position and sustainability

Overview

Scottish Ministers set objectives for Scottish Water for the period 1 April 2015 to 31 March 2021 in respect of regulated activities. These are focused on water quality, asset investment and maintenance, customer service, liaison with key stakeholders, and service improvement. Significant capital investment of up to £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 £51.7 million to £34.0 million compared to £85.7 million in the prior year. Comments on the changes in the Consolidated Income Statement are set out below.

Group capital investment was £447.2 million (2020: £513.0 million) reflecting continued investment in significant projects and ongoing infrastructure upgrades.

Group net debt increased by £0.18 billion to £3.6 billion which was driven by net additional borrowing from the Scottish Government.

Financial position: consolidated income statement

Within revenue, an increase in household income is attributable to price increases and net new properties connected to the network while an increase in non-household income is largely as result of the full year effect of Business Stream's increased activity in England together with re-securing the Scottish public sector contract, offset by the impact of the COVID pandemic on sales volume.

Total operating costs increased by £111.7 million to £1,468.2 million (2020: £1,361 million) due to higher costs within Business Stream of £42.6 million net, as a result of increased activity in England, offset by COVID-19 related savings of £51.2 million on lower volumetric charges from wholesalers. Costs in Scottish Water increased by £42.7 million including higher depreciation charges of £11.0 million and COVID-related costs of £13.2 million.

Consolidated income statement	2021 £'m	2020 £'m	Movement £'m
Revenue	1,667.2	1,615.9	51.3
Cost of sales	(1,273.7)	(1,185.2)	(88.5)
Gross surplus	393.5	430.7	(37.2)
Administrative expenses	(194.5)	(175.8)	(18.7)
Operating surplus	199.0	254.9	(55.9)
Finance income	0.4	2.6	(2.2)
Finance costs	(165.4)	(171.8)	6.4
Surplus before taxation	34.0	85.7	(51.7)
Taxation	(7.9)	(65.1)	57.2
Surplus for the year	26.1	20.6	5.5

Source: Draft financial statements

Financial position and sustainability (cont.)

Financial position: balance sheets

Fixed asset additions as a result of capital investment in the current year were £447.2 million (2020: £513.0 million). Depreciation costs consequently increased by £11.8 million (from £297.0 million to £308.8 million). Amortisation of £2.4 million (2020: £2.0 million) was charged on the Business Stream intangible assets (acquired customer lists), which has a year end net book value of £11.6 million.

Group current assets increased by £27.8 million, primarily due to an increase in cash and cash equivalents.

Group net debt increased by £0.18 billion to £3.6 billion driven by additional net borrowing from the Scottish Government.

Scottish Water Company's cash balance at 31 March 2021 of £428.7 million is ahead of that forecasted in the updated regulatory delivery plan submitted to Scottish Ministers in March 2020 for the final year of this plan.

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 2020	531.6
Increase during the year	38.8
Balance at 31 March 2021	**570.4**

A summarised consolidated balance sheet is given below:

Balance sheet (Group)	**2021 £'m**	**2020 £'m**	**Movement £'m**
Non-current assets	6,568.4	6,447.8	138
Current assets	818.3	785.5	32.8
Current liabilities	(479.3)	(570.1)	(90.8)
Net current assets	**339.0**	**215.4**	**123.6**
Non-current liabilities	(985.4)	(994.7)	(9.3)
Net assets	**5,939.4**	**5,668.5**	**270.9**

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 £3.8 billion relates to infrastructure and capital investment across treatment works, water mains, sewers and networks.

£612 million (on a regulated accounting basis) was invested during 2020-21 in respect of ongoing projects, making it the largest component of Scottish Water's total annual expenditure.

An element of this investment is related to maintenance and is not considered to be capital for the purposes of the financial statements resulting in capitalised expenditure of £433.2 million (on an IFRS basis).

Financial position and sustainability (cont.)

2015-2021 regulatory period and business plan

The overall forecast finance requirement for delivering the 2015-2021 business plan was £8.1 billion. It was assumed that £7.2 billion will be received from customer revenue and £724 million from net new Government borrowing (agreed in the 2014 Final Determination issued by the Water Industry Commission for Scotland). The delivery plan for 2015 - 2021 was last updated in March 2020 and the key features are summarised in the table below.

£'m - actual	**2019**	**2020**	**2021**
Regulated capital investment	660	670	612
Total revenue	1,217	1,253	1,266
Operating surplus	273	286	250
Closing cash	311	391	429

Source: Annual Report and Delivery Plan Update

A delivery plan for 2021 to 2023 has also been submitted for approval with Scottish Ministers.

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 £100m of cash available to protect it against unplanned cost shocks etc.

The closing cash balance within the FD, as at 31 March 2021, was only £40m. The outcome of the out-performance plan has contributed to the closing cash balance as at 31 March 2021 of £429 million compared to £40 million forecast in the FD.

Going concern

Management have prepared forecasts covering at least 12 months from the date of signing of the financial statements. These take account of actual experience under COVID-19 and include scenarios with a severe but plausible downside. All scenarios reflect:

- Reduction in cash collection levels;
- Volumetric impact of up to a 10% reduction in water consumption by business customers; and
- Changes to the wholesale charge prepayment and deferral schemes in line with the current regulatory guidance

Under all 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 24.

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.

Financial position and sustainability (cont.)

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 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 in the second half of 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.

Scottish Water Business Stream (cont.)

Forecasts to reflect this, which comprise a low, mid and worst case scenario, were prepared by SWBS last year and again this year.

The prior year forecasts indicated that the level of support required were going to be between £44 million and £88 million. This support remained undrawn with the exception of an equity injection of £10 million as agreed with WICS. The non-utilization of the support was primarily due to the fact that SWBS has been performing ahead of its forecasts.

The current year forecasts prepared by SWBS, on the other hand, indicate that the level of support now expected to be required in the next 12 months has been reduced to a range of between £35 million and £45 million. As mentioned above, the level of support available in the prior year remained undrawn to-date and is therefore more than sufficient to cover SWBS needs for the foreseeable future.

As at the date of this report, SWBS performance continues to be resilient and hence the support has still not been utilised.

Audit conclusions

Audit opinions	— We prepared an audit strategy document which was submitted to the Audit Committee on 30 March 2021; 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 interpreted and adapted by the 2020-21 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 five audit misstatements identified, one of which was in Scottish Water and has been adjusted while the other four were in Scottish Water Business Stream, three of which were adjusted and one remained unadjusted as reported in appendix six. We draw attention that the unadjusted audit differences are immaterial, both individually and in aggregate.
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 2020 was used (£13.6 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.

Entity	Performance materiality	Reporting threshold
Scottish Water Company	10,050,000	250,000
Scottish Water Horizons Ltd	112,500	7,500
Scottish Water Business Stream Ltd	2,000,000	130,000
Scottish Water Horizons Holdings Ltd	1,425,000	95,000
Aberdeen Environmental Services Ltd	1,562,000	104,000
Scottish Water Services (Grampian) Ltd	272,000	18,000
Scottish Water Business Stream Holdings Ltd	693,000	46,000

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 committees of both SW and SWBS;
- 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 at Scottish Water continue to provide working papers of high quality and they were provided in line with our agreed timetable. The audit of SWBS has been subject to some delays, in particular relating to information over ex-Yorkshire Water customers where the company is dependent on Yorkshire Water for the maintenance of billing records.
- A set of consolidated financial statements (excluding completed front end disclosures) was provided in week commencing 3 May 2021.

Audit conclusions (cont.)

COVID-19 audit implications

The table below identified the specific areas of our audit that were expected to be affected by the COVID-19 pandemic, and how our audit differs from that of the year pre-COVID.

Audit area	**Considerations**
Significant risks and key areas of focus	▪ The significant risks and key areas of focus identified at our planning stage remained unchanged as we had already considered and assessed the impact of COVID-19 on our audit.
Accounting estimates	▪ The risks of material misstatement relating to bad debts provision and pension liability increased due to the higher degree of estimation uncertainty resulting from the current economic conditions. ▪ To assess the risks, we gained an understanding of how management has understood the range of possible measurement outcomes, selected reasonable assumptions and data sources and selected a point estimate and the related disclosures for the financial statements. ▪ We evaluated the methods, assumptions and data used to derive the estimates to obtain evidence that they are appropriate in the context of the financial reporting framework and are, when appropriate, based on conditions and events at the measurement date. We also considered whether management has appropriately increased estimation uncertainty when selecting the point estimate.
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.
Audit effort and fees	As a consequence of the changes in the scope of our audit due to COVID-19, we estimate that the additional fee for this will be £12,000 and it is included in our 2020-21 fee proposal. This has been discussed with management.

Significant risks and other focus areas

We summarise below the risks of material misstatement as reported within the audit strategy document. We set out on the following pages 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; and
- Pension liability;

Other areas of focus

- Going concern
- Profit recognition (Scottish Water Horizons);
- Income uncertainty provision;
- Credit note provision; and
- Impairment of investment in subsidiaries

Note (a): We draw attention that we have removed 'amortisation of intangible assets' in Business Stream as an 'other area of focus'.

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	✓	✓					
Other areas of focus							
Profit recognition					✓		
Income uncertainty provision	✓						
Credit note provision	✓	✓					
Impairment of investment in subsidiaries	✓		✓			✓	
Going concern	✓	✓	✓	✓	✓	✓	✓

We have not made any changes to the significant risks above, or our approach to addressing the assumed risks of fraud in management override of controls and risks of fraudulent revenue recognition as required by the International Standards on Auditing (ISA).

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 were 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. We note that accrued revenue is estimated based on historical data from past bills to create an expectation of the unbilled amount between the last bill and the year end. This therefore introduces risk around the estimation of revenue.	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. — In line with last year, 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 44 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 46 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 was satisfactorily completed with no issues noted.

Significant risks and other focus areas (cont.)

Significant risk	Our response	Audit conclusion
Capital additions (Scottish Water Company) **(£433.2 million, 2020: £502.7 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. *Other considerations (not significant risk):* The company has depreciation charges of £303.3 million (2020: £292.2 million) which is calculated based on the useful lives of the individual asset.	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. — Testing the design and operating effectiveness of controls over the approval stages of a sample of projects. **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; — We also reviewed material journals related to capital additions; and — We performed an independent recalculation of depreciation using Computer Assisted Audit Techniques (CAATs) and compared with the company's calculation.	— The outcome of our testing was satisfactory and we concur with management's treatment of additions as capital or revenue, in particular those capitalised during the lockdown period of April to June 2020. — On performance of our work on depreciation, we noted instances where depreciation charges were different to our recalculation. We challenged management on these and received satisfactory explanations, corroborated with supporting documentation. We have raised a control deficiency due to the time lag noted between an asset being put into use (accounting date) and when depreciation starts to be charged (in-service date). Refer to page 41 for more information on the control deficiency.

Significant risks and other focus areas (cont.)

Significant risk	Our response	Audit conclusion
Household bad debt provision **(£427.7 million, 2020: £408.8 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 2021, the Scottish Water regulated business reported a household revenue debtor of £483.0 million (2020: £450.2 million) and a corresponding bad debt provision of £427.7 million (2020: £408.8 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 2021 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 2021, the average forecast collection rate applied to billings is 96.72% resulting in an equivalent provision of 3.28%. This compares with a provision as at 31 March 2020 of 3.31%; — Management excludes 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. It was noted that this was taken into account as the rise in the forecast % collection rate was only 0.03%, a lower rise than in previous years. — We have also performed a reverse stress-test over the forecast collection rate and note that for it to be materially misstated the rate would have to be 96.66%, an average actual collection rate not experienced since 2006-07. We do not consider this change in collection rate to represent a reasonably possible change in assumption. — 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 that the actual collection rate, 96.69%, was consistent with the forecast made in the prior year.

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Significant risks and other focus areas (cont.)

Significant risk	Our response	Audit conclusion
Household bad debt provision (cont.)		— We note that the first year-in-year collections fell recently and we have challenged management on this, but note that whilst this has decreased, past experience has shown that these are subsequently recovered given the robust process put in place by the Councils for debt recovery. This meant that actual average collection continues to increase and therefore supports the upward trend in forecast collection rate.

Significant risks and other focus areas (cont.)

Significant risk	Our response	Audit conclusion
Bad debt provision (Scottish Water Business Stream) There are a number of assumptions included in the calculation of the bad debt provision; the most sensitive of these assumptions is the overall forecast collection 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 2021 was £19.9 million with a bad debt provision balance at the same date of £60.3 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 £40.4 million to £60.3 million. The provision increase of 49% is consistent with an overall increase in revenue and trade receivables of 21.2% and 18.7% respectively. £18.2 million (2020: £14.3 million) of the provision relates to debts greater than 360 days old that are 100% provided. Within the provision, £11.9m relates to new Yorkshire customers acquired in the prior year. — The provision approach was adjusted to take into consideration the impact of COVID-19 and split the debt by those customers that were actively paying, and those that had not paid any amounts in the last 12 months but remain consistent with IFRS 9 with respect to the requirements for expected credit losses. Paying customers were provided for in line with the same basis as previously (see below), while the customers identified as not paying were assessed against an external credit score with their risk of failure aggregated to a flat percentage applied to the entire not paying population of debt. This accounts for approximately 89% of the provision balance. We have examined this calculation, evaluated the methodology, assumptions and data used, challenged these and discussed in detail with management. We have concluded the assumptions and methods used were reasonable; — The basis of the bad debt provision calculation on paying customers is consistent with the prior year with those debts aged 31 to 90 days being 25% provided, 91 to 360 days being 50% provided and all debts greater than 360 days being 100% provided. Other customers, known as 'Organic England customers,' typically larger customers who are supplied across the country (national accounts), are deemed less risky as they are large corporates with close relationship management in place. The provision applied is 5% between 30 and 360 days, and 100% for all debts Greater than 360 days. — 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 – Net liability as at 31 March 2021 is £209 million (2020: £217.0 million)** **Scottish Water Business Stream – Net liability as at 31 March 2021 is £12.8 million (2020: £3.4 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.	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 at year end. **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 balanced relative to our central rates and within our acceptable range. **GMP indexation** — Management's actuary has made an allowance of £7.3m for full indexation of GMP which was recorded as an actuarial loss recognised through OCI. Our view is that the cost should be recognised as past service cost through the income statement. The proposed audit adjustment has been corrected by management. **Pension assets** — We have also reviewed pension assets for consistency and confirmed the share of scheme assets for last three years to current year. We have also compared employer's assets to the total value of the pension fund to check consistency with the expectation of percentage share. No issues have been noted. .

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 — Our work over the revenue recognition has been satisfactorily completed.

Significant risks and other focus areas (cont.)

Other areas of focus

Income uncertainty provision

(£15.4 million, 2020: £22.6 million)

Forecast-based valuation

As at 31 March 2021, the Scottish Water company income uncertainty provision was £21.5 million (2020: £30.3 million) while at group level the provision was £15.4 million (2020: £22.6 million). The breakdown of the provision at group level is as follows:

	2021 £'m	2020 £'m
3rd parties (closed years)	**1.5**	3.5
Vacant properties	**-**	2.0
Open years	**13.9**	15.1
	15.4	22.6

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

Our response

Our procedures included:

Control design:

— Testing the design and operating effectiveness of controls over the review and approval of the provision and associated assumptions, by those charged with governance during the year and at the year end.

Tests of detail:

— We compared the information on historical billings and updated billed amounts, recorded by Scottish Water as the basis for the current year provision calculation, to the records held in respect of prior years;

Audit conclusion

The provision includes:

— £13.9 million covering third party licence providers for the most recent two years in which market reconciliations for usage are still ongoing.

— £1.5 million in respect of closed years no longer covered by the open years income uncertainty provision, reduced from £3.5 million in prior year.

We draw attention that a provision of £7.5m was made in the prior years with respect to market changes and this has been reversed during the year on the basis that the likelihood of future challenge is remote. This is based on the low level of cases filed against Scottish Water over the past few years.

Based on the work we have performed, the overall provision for income uncertainty is consistent with the prior years and therefore considered to be balanced.

Significant risks and other focus areas (cont.)

Other areas of focus

Credit note provision

(£42.4 million, 2020: £44.1 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.
- The average variance is 0.0267%. The rate applied in 2020/21 is 0.922%, compared with 0.950% in the prior year. Applying the above sensitivity of 0.0267%, the overall provision would vary by £4.3 million which we consider to be within our expectations.

Audit conclusion

- The results of our comparison of the past five years provision that would now be made compared to the provision made in the year is given in the table below:

Year	Provision in year	Provision that would now be applied
2019/20	0.9500%	0.9662%
2018/19	0.9700%	0.9870%
2017/18	0.9850%	1.0100%
2016/17	1.0000%	1.0336%
2015/16	1.0150%	1.0566%

- 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 historical data available.

Scottish Water Business Stream

- The credit note provision has decreased from £9.1 million in 2019-20 to £8.1 million in 2020-21.
- Four adjustments are made to the provision: a reduction of £0.45 million (50%) for historical credit notes relating to public sector organisations; a reduction of £0.1 million (50%) for customers who have transferred from Business Stream; and an increase of £0.3 million relating to Southern Water customers. There was an increase in the provision of £0.4 million relating to Organic England customers – this provision was new in the current year and are within our expectations.
- In addition to this, In addition to this, a further adjustment of £1.3 million is made relating to differences in the calculation of the year end income uncertainty provision with Scottish Water as based on market data, Business Stream believe they will potentially owe this amount back to customers.
- In line with the change in the prior year, the estimation approach is continued to be based on 3 years of historical data.
- 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* ▪ 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 £38.8m from the prior year. — Agreed Government borrowing of £180 million is planned to be drawn down in March 2022; — We have considered in detail the going concern assessment of Scottish Water with no issues noted; — Our challenge of the forecasts prepared by each entity within the Scottish Water Group has noted no issues; and — We have received a draft letter of support for: 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, 2020: £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.

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 relating to 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 the Outline Strategic Plan for 2021-27 period is currently being reviewed.

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 2020-21 outline the corporate governance and risk management arrangements in operation in the financial year. They provide detail on the overall governance framework, review of effectiveness, group entities and analyses the efficiency and effectiveness of these elements of the framework.	We are satisfied with the information contained in the report.

Wider scope

Audit dimensions risk map and conclusions

We have not identified any financial statement significant risks in relation to wider scope. The key aspects of Scottish Water's arrangements which we considered in respect of wider scope responsibilities have not changed from those set out in the audit strategy dated 30 March 2021 as we had considered Audit Scotland's 2020-21 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 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 monitor 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.

Management continue to monitor the impact of EU withdrawal which is considered 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 2020-21 FReM, implementation of IFRS 16 *Leases* has been delayed until 2021-22. 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 during the current year with no major findings noted.

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, only one significant control deficiency was identified during the year. Refer to page 43 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 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 2021 and future budgets and forecasts, in particular the most recent regulatory delivery plan update. Scottish Water Company continues to outperform in respect of its regulatory activities with the actual cash position of £429 million as opposed to a forecasted balance of £363 million as at 31 March 2021; 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 the Final Determination in December 2020 as part of its strategic review of charges for the years 2021-27 which restricts Scottish Water's ability to increase income through charging (except through increases in the number of households). The most recent 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 Government.

Delivery plan update (March 2020)

The regulatory delivery plan update (last updated in March 2020) included revised financial forecasts in respect of the remaining period to March 2021 which is also the sixth year of the regulatory period. This shows continued outperformance of the regulatory delivery plan achieved to date. The key highlights related to financial sustainability in the update were:

— 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 (to the March 2020 one) was not prepared since it as the final year of the regulatory period. Management has instead channeled their efforts in preparing the forecasts for the next regulatory period.

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 (including annual updates) and preparation for SR 21. These consider both revenue and the significant capital investment program.

Consideration of underlying assumptions and sensitivity analysis supplements this work.

Wider scope

Financial management

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

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

A summary of performance measures for the current year is as follows:

- the Household Customer Experience Measure Delivery Plan commitment was 88.45 during the year against a target of exceeding 82.6;
- The Overall Performance Assessment was 404 as at March 2021 against a target of 385; and
- Overall Measure of Delivery of 229 as at March 2021 against a target of 240.

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.

Management's 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: Based on our work, we are content that Scottish Water has relevant policies and procedures in place 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 seven 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 in so far as it is relevant and applicable. As a 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 its 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, it has adopted the legislation for transparency and therefore disclose a 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 the 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 tested 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 30.

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.

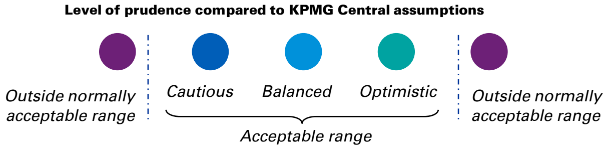
Conclusion: Through oversight by and reporting to various regulators we consider value for money and performance against the Delivery Plan are embedded in Scottish Water's operations.

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

Appendices

Appendix one

Assessment of key pension assumptions



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

Employer: Scottish Water **Fund: Lothian, Strathclyde and North East Scotland Pension Funds** **Fund Actuary: Hymans Robertson**	**OVERALL ASSESSMENT OF ASSUMPTIONS FOR IAS 19** The overall assumptions adopted by the Employer are 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	1.95%	1.99%	The Employer's proposed assumption is considered to be balanced and within our normally acceptable range.	●
Pension Increase Rate (CPI)	2.85%	2.82%	The Employer's proposed assumption is considered to be balanced and within our normally acceptable range	●
Salary increases	In line with CPI	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 2019 projections model 1.75% LPF/ SPF CMI 2019 model 1.5%	CMI 2020 projections Model 1.25%	The mortality rates are the best estimate based on a mortality table reflecting the current expected experience and an allowance for future improvements in longevity. The figures are in line with our best estimate scheme experience and are considered to be cautious.	●

Appendix one

Assessment of key pension assumptions (cont.)

Level of prudence compared to KPMG Central assumptions

●	●	●	●	●
Outside normally acceptable range	*Cautious*	*Balanced*	*Optimistic*	*Outside normally acceptable range*
	Acceptable range			

In respect of employee benefits, 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 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	1.95%	2.03%	The Employer's proposed assumption is considered to be cautious and within our normally acceptable range.	●
Pension Increase Rate (CPI)	2.85%	2.82%	The Employer's proposed assumption is considered to be cautious and within our normally acceptable range.	●
Salary increases	3.35%	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 2019 projections model 1.5%	CMI 2020 projections model 1.25%	The mortality rates are the best estimate based on a mortality table reflecting the current expected experience and an allowance for future improvements in longevity. The figures are in line with our best estimate scheme experience and are considered to be cautious.	●

Appendix two

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 2021 can be analysed as shown on the following page.

Auditor independence (cont.)

	2020-21 (£)
Audit fees	
Scottish Water	133,733
Scottish Water Business Stream	70,000
Scottish Water Interim Review	15,507
Scottish Water Business Stream Holdings Limited	3,850
Scottish Water Horizons Holdings Limited	3,850
Scottish Water Horizons Limited	17,651
Aberdeen Environmental Services Limited	18,740
Scottish Water Grampian (Services) Limited	10,130
Regulatory accounts	14,973
IT Controls	3,006
Going concern	2,026
Procurement fraud risk	3,039
Wider scope	6,078
IFRS 16	2,500
Additional procedures as a result of COVID-19	12,000
Total audit fees	**317,083**
Non-audit fees	
Provision of P11D Solutions software	**2,896**
Total fees	**319,979**

The ratio of non-audit to audit fees was 0.001:1. 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 2021

Disclosure	Information technology services
Description of services	Provision of P11D Solutions software
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

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 Management Review Controls (MRCs) – Pensions and Provisions ***Audit dimension**: Financial management* ***Entity**:* Scottish Water and Scottish Water Business Stream			**Grade three**
Finding: We have assessed a number of management review controls in significant risk areas and estimates (i.e. review of provisions and pension assumptions). Whilst these controls may be achieving the control objective set by management, due to the way they are performed and/or evidenced, they do not meet the requirements for an effectively designed control as defined by the FRC. This is due to the difficulty in achieving an appropriate level of precision, in particular when considering the size of the balance relative to materiality. **Risk**: An ineffective MRC could lead to the risk of a material misstatements in the financial statements.	**Recommendation:** Management should consider adopting a policy to standardise the review process and pre-set threshold that are sufficiently precise for these management review controls. **Note**: We draw attention that we do not place reliance on these controls because of the absence of documented evidence of the review process occurring and how they are conducted and the lack of clear or appropriate precision in their operation.	Accepted. **Responsible officer:** Finance team **Implementation date:** N/A	

Appendix three

Action plan (cont.)

Finding and risk	Recommendation	Management action
2 Calculation of depreciation ***Audit dimension**: Financial management* ***Entities**:* Scottish Water		**Grade three** 🟩
Finding: As part of our audit procedures, we performed a recalculation of depreciation charged for the year and noted that there is a time delay between the 'in service date' and 'accounting date' of assets, the former being the point at which depreciation is calculated and charged by the system. Consequently, a catch-up depreciation charge is then calculated and booked to account for the depreciation charge from the date the asset was ready for use. On discussion with management, we understand that this is an issue the capital finance team are aware of and are working to resolve. **Risk**: The risk arises when the in service date and accounting date of a particular asset spans over different financial periods. This gives rise to a cut off issue whereby depreciation is not charged to the correct accounting period which could result in a correction of an accounting error as required by IAS 8 if material.	We understand that management is aware of this issue and has already a number of actions to reduce the gap between in service and accounting dates.	Accepted. **Responsible officer:** Capital Finance team **Implementation date:** FY-2022

Action plan (cont.)

Finding and risk	Recommendation	Management action
3 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-2022

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 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 over the IPE.	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-2022

Appendix three

Action plan (cont.)

Finding and risk	Recommendation	Management action
5 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. **Note**: We draw attention that this provision is eliminated on consolidation and therefore this control deficiency is not relevant at Scottish Water group level but instead only at Scottish Water Services (Grampian) Limited.	Accepted. **Responsible officer:** Finance team **Implementation date:** FY-2022

Appendix three

Action plan (cont.)

Finding	Risk and Recommendations	Management actions
6 Privileged user access management ***Audit dimension**: Financial management* ***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, P3M, 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 approved by management to be used for monitoring privileged access accounts on in-scope applications and systems as part of the Cyber Security Programme. A risk based approached is being followed to implement the automated tool on key applications and system by the end of Q2 2021**.**	**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. **Recommendation**: We recommend that management 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. An automated tool for monitoring privileged access has been approved and will be implemented on a risk based approach as follows: Financial Systems Fusion – due to go live late May following the quarterly Oracle upgrade. P3M (Oracle Unifier & Primavera) – due to go live late May. Other critical accounts such as Domain Admins, Unix, Local Admins - due to go live in stages during May into early June. The new tool will be a segregated control point for our highest risk privilege accounts and includes session recording of activities and relevant approval controls. Session records will be reviewed by exception with random auditing and governance on a regular basis. **Responsible Persons**: Head of Corporate Data & Compliance, and Head of Digital Security & Services. **Target Date:** Q2 FY-2022

Action plan (cont.)

Finding and risk	Recommendation	Management actions
7 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. Since the previous year, a control to manually sample entries in both the accrued and deferred income balances has been implemented. This mitigates the risk previously presented and we have therefore lowered the priority rating to grade three as noted above. Although review processes and a mitigating control are in place, there remains a risk that a material misstatement in respect of the accrued and deferred revenue calculation may arise due to the material nature of the balances and relatively low coverage provided by the review control implemented. **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 challenge of the assumptions against independent expectations, to ensure the assumptions selected are appropriate.	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-2022

Appendix three

Action plan (cont.)

Finding and risk	Recommendation	Management actions
8 Yorkshire transactions ***Audit dimension****: Financial management* ***Entity****: Scottish Water Business Stream*		**Grade Two**
Finding: SWBS acquired the Yorkshire Water non-household customer list in the prior year and the current year transactions continued to be maintained under a white label service agreement by the latter. We faced significant delays in the provision of accurate information for the purpose of our audit on balances associated with this customer list. There were also issues identified by SWBS in the classification of revenue and split of cash between SWBS and the previous owners which has resulted in more money due to SWBS at year end and numerous reconciling items. **Risk**: There is the risk that errors occurring might remain undetected and also causing delays in approval of the company's financial statements and that of the group. We highlight that this finding has already caused significant delays in the audit process for the current year.	We recommend that appropriate controls are put in place for review of the transactions regularly and necessary arrangements be made for relevant information and supporting evidence to be made available for a timely audit.	Accepted **Responsible officer:** Head of Financial Control **Implementation date:** FY-2022

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 32 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	Page 3 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 26 – 27 reports on the other information contained in the financial statements, covering the annual governance statement, management commentary and remuneration report. We will separately report on the Whole of Government Accounts.
Financial statements and related reports	Notify the Auditor General when circumstances indicate that a statutory report may be required	We do not consider any notifications necessary.
Financial statements and related reports	Review and conclude on the effectiveness and appropriateness of arrangements and systems of internal control, including risk management, internal audit, financial, operational and compliance controls	Pages 39 – 47 sets out our conclusion on these arrangements.

Appendix four

Appointed auditors responsibilities (cont.)

Area	Appointed auditors responsibilities	How we've met our responsibilities
Standards of conduct – prevention and detection of fraud and error	Review and conclude on the effectiveness and appropriateness of arrangements for the prevention and detection of fraud and irregularities, bribery and corruption and arrangements to ensure the bodies affairs are managed in accordance with proper standards of conduct Review National Fraud Initiative participation and conclude on the effectiveness of bodies engagement	Pages 30 – 31 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 30.
Financial position	Review and conclude on financial position including balances and strategies and longer term financial sustainability	Pages 5 – 8 sets out our conclusion on the body's financial position and sustainability.
Best Value	Be satisfied that proper arrangements have been made for securing Best Value	Page 33 sets out our conclusion on these arrangements.

Appendix five

Tax summary

Tax charge	— The £7.9m tax charge (2020: £65.1m charge) within the consolidated income statement is made up of: – Corporation tax of £7.3m; and – Deferred tax charge of £0.6m. — The tax charge of the prior year included an amount of £45.1m relating to a remeasurement due to the cancelled reduction of the corporation tax rate as mentioned below. — 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 is primarily due to expenditure being disallowed for tax purposes and depreciation on assets that do not qualify for capital allowances. — We draw attention that the Chancellor announced 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 31 March 2020.
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 £441.3 million consists predominantly of a deferred tax liability of £498.2 million on qualifying fixed assets and deferred tax assets of £42.1 million on retirement benefit obligations and £6 million on tax losses. The remaining deferred tax asset of £14.6 million is made up of general provisions and deferred tax provided on rolled over gains; and — For the period ended 31 March 2021 the current tax debtor was £4.2 million. Scottish Water is the main tax paying company with some smaller balances due within the subsidiaries.
UK tax status	— All tax returns for 2020 were submitted to HMRC within 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 during our audit.

Scottish Water - adjusted

	Type of misstatement	Balance sheet		Income statement		Other comprehensive income	
		Dr £'000	Cr £'000	Dr £'000	Cr £'000	Dr £'000	Cr £'000
Dr Past service cost	Factual			7,309			
Cr Actuarial gain or loss							7,309
Adjustment for reclassification of GMP indexation							

Scottish Water Business Stream - unadjusted

	Type of misstatement	Balance sheet		Income statement		Other comprehensive income	
		Dr £'000	Cr £'000	Dr £'000	Cr £'000	Dr £'000	Cr £'000
Dr Other receivables	Factual	274					
Cr Trade payables			274				
Adjustment for reclassification of debit balances in the trade payables ledger							

Appendix six

Summary of audit differences (cont.)

Scottish Water Business Stream - adjusted

	Type of misstatement	Balance sheet		Income statement		Other comprehensive income	
		Dr £'000	Cr £'000	Dr £'000	Cr £'000	Dr £'000	Cr £'000
Dr Pension liabilities	Factual	349					
Cr Pension assets			349				
Reclassification of pension benefits paid during the year							
Dr Revenue	Factual			900			
Cr Cost of sales					900		
Reallocation adjustment between revenue and cost of sales							
Dr Deferred income	Factual	386					
Cr Other payables			386				
Reclassification adjustment for incorrect posting of credit notes							

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 2021, 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 2021 and of the Group's profit or loss for the financial year then ended;
- ii. whether the group financial statements have been properly prepared in accordance with international accounting standards as interpreted and adapted by the 2020-21 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 Sheets, the Group Statement of Comprehensive Income, the Group and Parent Company Statements of Cash Flows, the Group and Parent Company Statements of Changes in Equity and notes, comprising a summary of significant accounting policies and other explanatory notes.

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

The Board confirms 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 and Parent Company's profit or loss for that financial year;

   ii. have been properly prepared in accordance with international accounting standards as interpreted and adapted by the 2020-21 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. There were no uncorrected audit misstatements during the year.

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.

Appendix seven

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 or overseas;
    - funded or unfunded; and
    - approved or unapproved,
    - have been identified and properly accounted for; and
    - all plan amendments, curtailments and settlements have been identified and properly accounted for.

14. The Board further confirms that the average forecast collection rate of 96.72% (2020: 96.69%) that has been applied to the total outstanding household debtors balance as at 31 March 2021 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,

Douglas Millican, Chief Executive

The key contacts at KPMG in connection with this report are:

Hugh Harvie
Partner

T: +44 (0)131 527 6673
E: hugh.harvie@kpmg.co.uk

Kevin Ramsamy
Senior Manager

T: +44 (0)131 451 7729
E: kevin.ramsamy@kpmg.co.uk

Emma de Beer
Assistant Manager

T: +44 (0)141 527 6804
E: emma.debeer@kpmg.co.uk