Scottish Water

Report to the Audit and Risk Committee

Audit plan and strategy for the year ending 31 March 2023

20 March 2023

Introduction

To the Audit and Risk Committee of Scottish Water

We are pleased to have the opportunity to meet with you again on 28 March 2023 to discuss our audit of the consolidated financial statements of Scottish Water, as at and for the year ending 31 March 2023.

This report outlines our risk assessment and planned audit approach. We provide this report to you in advance of the meeting to allow you sufficient time to consider the key matters and formulate your questions.

The engagement team

Tim Cutler, FCA, is the engagement partner on the audit. He has 25 years of public sector industry experience.

Tim Cutler shall lead the engagement and is responsible for the audit opinion.

Other key members of the engagement team include Debra Chamberlain (Engagement Director) and Carol Batchelor (Engagement Senior Manager) with 18 years and 22 years of experience respectively.

Yours sincerely,

Tim Cutler

20 March 2023

How we deliver audit quality

Audit quality is at the core of everything we do at KPMG and we believe that it is not just about reaching the right opinion, but how we reach that opinion. We consider risks to the quality of our audit in our engagement risk assessment and planning discussions.

We define 'audit quality' as being the outcome when audits are:

— **Executed consistently**, in line with the requirements and intent of **applicable professional standards** within a strong **system of quality controls** and

— All of our related activities are undertaken in an environment of the utmost level of **objectivity, independence**, **ethics** and **integrity**.

Restrictions on distribution

This report is intended solely for the information of those charged with governance of the Group and the report is provided on the basis that it should not be distributed to other parties; that it will not be quoted or referred to, in whole or in part, without our prior written consent; and that we accept no responsibility to any third party in relation to it.

Overview of planned scope including materiality

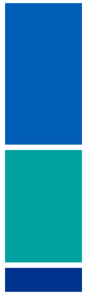
Our materiality levels

We determined materiality for the consolidated financial statements at a level which could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements. We used a benchmark of total expenditure which we consider to be appropriate given the sector in which the entity operates, its ownership and financing structure, and the focus of users.

We considered qualitative factors such as ownership structure, debt arrangements and the business environment when determining materiality for the financial statements as a whole.

To respond to aggregation risk from individually immaterial misstatements, we design our procedures to detect misstatements at a lower level of materiality £17.6m driven by our evaluation of the potential for misstatements in the period. Our evaluation considers the history of misstatements, the control environment and other relevant factors. We also adjust this level further downwards for items that may be of specific interest

Group materiality



£23.5m

Materiality for the consolidated financial statements as a whole (1.5% of total expenditure based on 6 month actual results annualised) (2022: £14.6m, 1% of total expenditure)

£17.6m

Performance materiality for the consolidated financial statements as a whole (2022: £10.9m)

£0.25m

Misstatements reported to the audit and risk committee (2022: £0.25m)

The calculation of materiality is subjective in nature and each year we challenge ourselves with respect to this calculation. The change in percentage applied from the prior year is driven by our assessment of the risks to which Scottish Water is exposed. It is a wholly owned entity of the Scottish government with no external borrowing. Given this, and the fact that it recovers the majority of revenue from local authorities rather than individual customers, we deem the primary users of the financial statements to be legislators and regulators.

We will report misstatements to the audit and risk committee including:

- Corrected and uncorrected audit misstatements above £250,000.
- Errors and omissions in disclosure (Corrected and uncorrected) and the effect that they, individually in aggregate, may have on our opinion.
- Other misstatements we include due to the nature of the item.

Control environment

The impact of the group control environment on our audit is reflected in our planned audit procedures. Our planned audit procedures reflect findings raised in the previous year and management's response to those findings. We have found in the past that the group's control environment is strong and there is a continuous drive to improve controls as the business evolves in an ever changing environment within increased reliance on technology.

Overview of planned scope including materiality (Cont.)

Timing of our audit and communications

We will maintain communication led by the engagement partner, director and senior manager throughout the audit. We set out below the form, timing and general content of our planned communications:

- Half year planning meeting on 2 November 2022.
- Debrief on half year and initial planning meeting for year end audit on 17 January 2023.
- Kick-off meeting with management on 10 March 2023 where we present our draft audit plan outlining our audit approach and discuss management's progress in key areas.
- Audit and risk committee meeting on 28 March 2023 where we present our final audit plan.
- Status meetings with management throughout the duration of our fieldwork in April 2023 and early May 2023 where we communicate progress on the audit plan, any misstatements, control deficiencies and significant issues.
- Closing meeting with management in late May 2023 where we discuss the auditor's report and any outstanding deliverables
- Audit and risk committee meeting on 24 May 2023 where we communicate audit misstatements and significant control deficiencies

Changes to our audit approach:

- ISA 315 (revised) is a revised audit standard relating to audit risk assessment, with an increased focus on IT environments and IT risk. This revised standard will impact the audit of the group for the first time for the year ending 31 March 2023. Further detail with respect to the impact of ISA 315r is detailed in the appendix to this document on pages 25 to 26.
- ISA 240 (revised) is a revised audit standard with minor wording changes, however, there are clear messages from the tone of this standard regarding clarification of the auditor's responsibility with respect to fraud. Further detail with respect to the impact of ISA 240r is detailed in the appendix to this document on page 27.

Using the work of others and areas requiring specialised skill

We outline below where, in our planned audit response to audit risks, we expect to use the work of others or require specialised skills/knowledge or expertise in a specialised area of accounting or auditing to perform planned audit procedures or evaluate results.

Specialists	Extent of planned involvement or use of work
IT Audit team	The IT team will assist with procedures involved in gaining an understanding of the IT environment and inline with revised ISA 315 requirements perform testing over relevant automated controls as well as performing testing over the general IT controls.
Actuarial	The KPMG Pensions specialists will assist the audit team by performing a review of the pension assumptions and providing a conclusion on whether they are appropriate in relation to KPMG acceptable ranges.

Planned Scope (continued)

Scope definition

Audit Scotland has appointed KPMG LLP as auditor of Scottish Water in accordance with the Public Finance and Accountability (Scotland) Act 2000). The initial period of appointment was 2016-17 to 2020-21, inclusive, which was further extended by one year to 2021-22. KPMG has been subsequently re-appointed for the period of 2022-23 to 2026-27.

Our 2022-23 audit activities will include:

— an audit of the financial statements and provision of an opinion on whether the financial statements:
  - give a true and fair view in accordance with the Water Industry (Scotland) Act 2002 and directions made thereunder by the Scottish Ministers of the affairs of Scottish Water as at 31 March 2023 and of the income and expenditure of the group for the year then ended;
  - International Financial Reporting Standards using the cost model for property, plant and equipment and, where otherwise appropriate, as adapted and interpreted by the FReM;
  - Relevant statutes, and any other Directions or guidance issued by Scottish Ministers.

We have previously provided a Long Form Audit Report (LFAR). Whilst Scottish Water adhere to some of the principles of the UK Corporate Governance Code, you do not meet the criteria of ‘voluntary compliance’ and your governance directions have changed this year to remove the requirement to adhere to the Combined Code. There is no requirement to provide a Long Form Audit Report as a result.

Other reporting:

— Completion of returns to Audit Scotland (including National Fraud Initiative arrangements and Climate change).

— Reporting to Water Industry Commission for Scotland on Regulatory Accounts.

— Reporting to Scottish Government on Whole of Government Accounts (WOGA).

In addition to responsibilities under our appointment by Audit Scotland, Scottish Water has appointed us as auditor of its subsidiaries and for the provision of an opinion in respect of review of the interim financial statements for the six months ended 30 September 2022.

Significant risks and Other audit risks

Our risk assessment draws upon our historic knowledge of the business, the industry and the wider economic environment in which Scottish Water operates.

We also use our regular meetings with senior management to update our understanding and take input from component audit teams and internal audit reports.

Our approach to the significant risk relating to Capital Additions may change depending out on the outcome of the request to Scottish Government to change the directions issued for Scottish Water.

Due to the current levels of economic uncertainty there is an increased likelihood of significant risks emerging throughout the audit cycle that are not identified (or in existence) at the time we planned our audit. Where such items are identified we will amend our audit approach accordingly and communicate this to the Audit and Risk Committee.

Significant risks

1. Capital Additions
2. Management override of controls
3. Revenue Recognition
4. Bad Debt Provision
5. Pension Liability

Other audit risks

6. Going Concern
7. Impairment of investment in subsidiaries

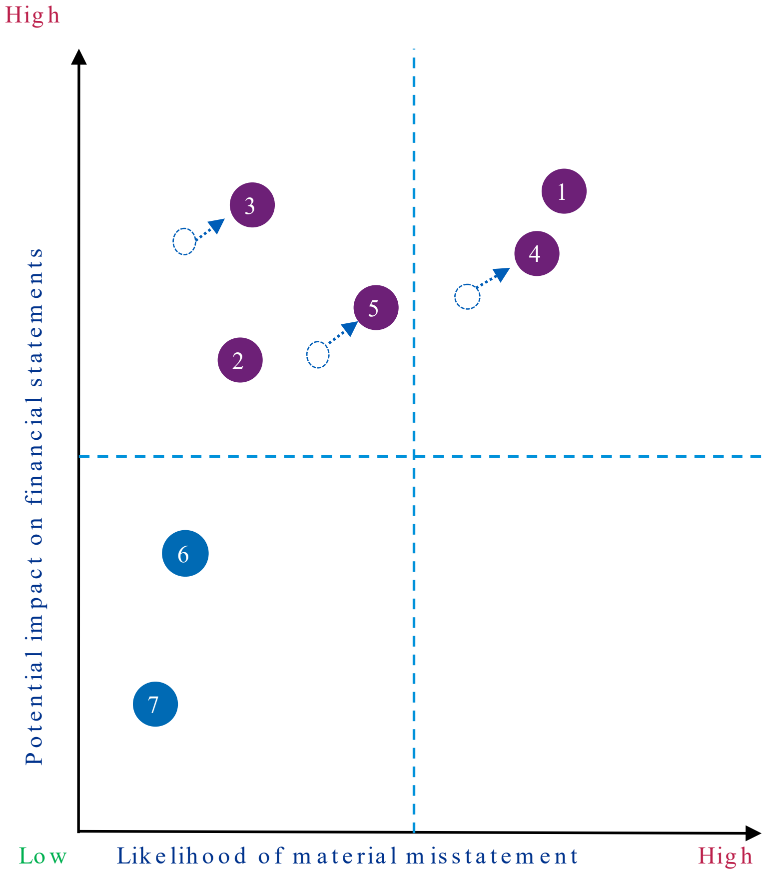
KEY

1 Significant financial statement audit risks

1 Other audit risk

Change compared to prior year

1 New key audit matter/significant audit risk



Wider scope

Approach

We are required to assess and provide conclusions in the Annual Audit Report in respect of four wider scope areas: financial sustainability, financial management, vision, leadership and governance, and the use of resources to improve outcomes. We set out below an overview of our approach to wider scope requirements of our annual audit. We provide our 2022-23 risk assessment in respect of these areas on the next page. We will provide narrative on these and other areas in the Annual Audit Report where relevant.

Risk assessment

We consider the relevance and significance of the potential business risks faced by public bodies, and other risks that apply specifically to Scottish Water. These are the significant operational and financial risks in achieving statutory functions and objectives, which are relevant to the auditor's responsibilities under the Code of Audit Practice. In doing so, we consider:

- Scottish Water’s own assessment of the risks it faces, and its arrangements to manage and address those risks;
- Evidence gained from previous audit work, including the response to that work; and
- The views of other stakeholders, such as the Water Industry Commission for Scotland.

Identification of significant risks

The Code identifies a matter as significant if, in the auditor’s professional view, it is reasonable to conclude that it would be of interest to the audited body or the wider public.

Significance has both qualitative and quantitative aspects.

If we identify any significant wider scope risks, we will highlight the risk to Scottish Water and consider the most appropriate audit response in each case, including to consider the results of work by Scottish Water and other stakeholders.

Concluding on wider scope

At the conclusion of the wider scope audit we will consider the results of the work undertaken and assess the assurance obtained against each of the wider scope audit areas.

If any issues are identified that may be significant to this assessment, and in particular if there are issues that indicate we may need to consider qualifying our wider scope conclusion, we will discuss these with management as soon as possible. Such issues will also be considered more widely as part of KPMG’s quality control processes, to help ensure the consistency of the auditor's decisions.

Reporting

We will perform a wider scope risk assessment and report on any related significant risks. We will update our assessment throughout the year and should any issues present themselves we will report them in our Annual Audit Report.

We will report on the results of our work in relation to wider scope through our Annual Audit Report. This will summarise any specific matters arising, and the basis for our overall conclusion.

Wider scope (cont.)

Risk assessment

We have not identified any financial statement significant risks in relation to wider scope. The key aspects of Scottish Water's arrangements which we intend to consider in respect of wider scope responsibilities are set out below. The chart below summarises the areas we commented on in our 2021-22 audit and those identified during review of the 2022-23 guidance on audit planning. Note that no assessment of risk is meant to be indicated by the placement of items on the chart.

Financial

- Internal audit & corporate governance arrangements
- Final Determination and Delivery Plan
- Vision, leadership and governance
- Budget setting and monitoring
- Complying with FReM disclosure requirements
- Authorisation and approvals

- Remuneration disclosures
- Decision making
- Capital programme
- Dependency on key suppliers
- Response to fraud and error
- Openness and transparency

Financial sustainability

- Changing landscape for public financial management
- Business planning
- Inflationary pressures
- Government funding

- Procurement arrangements
- Performance at a glance KPIs
- Use of resources to improve outcomes

Potential risk type: Wider scope | FY 2022-23 risks

Group involvement - Significant component audits

KPMG perform the audit of Scottish Water as well as its subsidiary entities. The only significant component to the group audit is Scottish Water Business Stream Limited.

The remaining four subsidiary entities are not significant and these audits are scheduled to be completed after the sign off of the group financial statements of Scottish Water.

For the significant component, we will review the planned procedures in relation to significant risk areas and we will assess the execution of this work.

From 1 October 2022 the activities of the Aberdeen Environmental Services Limited (AES) have been absorbed into the regulated activities of Scottish Water. AES ceased trading from that date. It is expected that AES will be deregistered and not subject to audit for the 2023 period.

Components	1	2	3	4	5	6	7
	Areas of audit risk						
Scottish Water	✓	✓		✓	✓	✓	✓
Scottish Water Business Stream Limited		✓	✓	✓	✓	✓	
Risks impacting statutory audits only (not group audit)							
Scottish Water Business Stream Holdings Limited		✓				✓	
Scottish Water Horizons Limited		✓				✓	
Scottish Water Horizons Holdings Limited		✓				✓	
Scottish Water Services (Grampian) Limited		✓				✓	

KPMG

Audit risks and our audit approach

1	*Capital additions – existence and accuracy of amounts capitalised to property, plant and equipment*	Fraud risk related to the inappropriate capitalisation of assets.	Increase from prior year due to fraud risk applied ⬆

Significant audit risk

The risk that additions to property, plant and equipment are recorded Inappropriately when: the expenditure is not eligible for capitalisation, the Items are not accurately recorded, the entity does not have the rights to the assets or the assets do not exist.

The risk

- Capital additions are significant, comprising the largest element of Scottish Water's annual expenditure, related to the delivery plan for regulated activities.
- Members are incentivised across a number of financial and other measures including capital spend 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.

Business risks related to audit risks include:

- Inappropriate amounts capitalised and deviation from delivery plan

Planned response

- 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;
- Testing the design and operating effectiveness of controls over the consistency between total capital expenditure reported in the financial statements and that reported to those charged with governance as part of ongoing capital project monitoring;
- Testing the design and operating effectiveness of controls over:
  - the approval stages of capital expenditure on projects;
  - the allocation of costs between capital and revenue;
  - he the appropriateness of reclassification from assets in the course of construction;
- Comparing the reports of Scottish Water's capital project monitoring group to the capital additions recorded in the financial statements;
- Use of sampling methods to evaluate the appropriateness of the classification of expenditure as capital by considering the nature of the expenditure to ensure it is enhancing with reference to invoice, certificate or timesheets and considering the application of the relevant policies and accounting standards;
- Review of high risk manual journals relating to capital additions; and
- Use of KPMG's D&A capabilities to analyse the general ledger transactions and testing any outliers by agreeing transactions back to valid source documents, such as invoices, certificates, contracts, timesheets.

Audit risks and our audit approach (cont.)

2 **Management override of controls**

Fraud risk related to unpredictable way management override of controls may occur

Consistent with prior year

Significant audit risk

The risk the financial statements are misstated due to management override of controls

The risk

— Professional standards require us to communicate the fraud risk from management override of controls as significant.

— Management is in a unique position to perpetrate fraud because of their ability to manipulate accounting records and prepare fraudulent financial statements by overriding controls that otherwise appear to be operating effectively.

— Members are incentivised across a number of key financial performance measures, including capital investment which increases the risk of manipulation.

Business risks related to audit risks include:

— Risk of misappropriation of assets and erroneous financial reporting.

Planned response

Our audit methodology incorporates the risk of management override as a default significant risk.

We plan to:

— In line with our methodology, evaluate the design and implementation of controls over journal entries and post closing adjustments;

— Identify journal entries to test based on high risk criteria and comparing the identified entries to valid supporting documentation as well as considering whether such journals are appropriately authorized and have a valid business rationale.;

— Evaluate accounting estimates, including the consideration of bad debt provision, pension liabilities, income uncertainty provision, revenue recognition in SWBS and credit note provision;

— Evaluate the selection and application of accounting policies;

— Assess the appropriateness of changes compared to the prior year to the methods and underlying assumptions used to prepare accounting estimates; and

— Assess the business rationale and the appropriateness of the accounting for significant transactions that are outside normal course of business, or are otherwise unusual.

— We will understand any corporate and personal objectives of directors and whether these would provide any incentive for management to override controls to achieve them. We will design audit procedures to address any areas of concern.

Audit risks and our audit approach (cont.)

3	Revenue recognition (Scottish Water Business Stream) – risk that revenue does not exist	Fraud risk related to misstatement of revenues	Increase from prior year due to system change at SWBS

Significant audit risk

Revenue is recognized for arrangements that; do not exist or do not meet the definition of a contract under the standard .

The risk

- Professional standards require us to presume (unless rebutted) that the fraud risk from revenue recognition is a significant risk.
- There is a risk that revenue is recognized for arrangements that; do not exist or do not meet the definition of a contract under the standard.
- Performance-based remuneration gives management an incentive to achieve certain financial results which increases the risk of fraudulent premature revenue recognition.
- Accrued revenue includes subjective measurements as it 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. Thus requiring management to exercise significant judgment with respect to this estimation.
- To note, there has been a change in the billing system in the current year. All customer data was migrated to a new billing system - Gentrack during February 2023. There is a risk that the data is not completely and accurately migrated impacting on the revenue recognised in the current year.

Business risks related to audit risks include:

- Risk of incorrect revenue recognised resulting in erroneous financial reporting

Planned response

Our procedures in respect of the risk in Scottish Water Business Stream include:

- Confirming our understanding of the revenue streams identified by flowcharting and completing a walkthrough of each separately identifiable revenue stream in both the old and new systems;
- Considering the design and implementation of key controls (covering both systems), the revenue recognition processes and management's calculation of accrued and deferred revenues;
- Performing cash receipts to revenue predictive analysis on revenue recognised in the year; a reconciliation of all cash, debtors and accrued revenue for the year. This predictive analysis will be done in three phases, pre-migration, post migration and at year end;
- Performing year end cut off testing to assess whether sales transactions are recognised in the correct period;
- Considering the deferral of revenue recognised in resect of advanced billing to ensure this is appropriate and correctly calculated;
- Challenge of assumptions used in estimating the accrued revenue in relation to the unbilled portion of revenue at the year end and reperformance of the calculations used by management to arrive at the estimate; and
- Testing the completeness and accuracy of the data in the new billing system post migration.

We rebut the risk in respect of Scottish Water and other subsidiaries.

We rebut the revenue fraud risk in Scottish Water as there is limited opportunity for management to manipulate revenue recognised and revenue transactions are non complex with low level of judgement and estimation.

- For Scottish Water, we will request confirmation of household and wholesale revenue from individual local authorities and licenced providers respectively;
- For Scottish Water Horizons Limited, revenue is recognised based on contract values; and
- For Scottish Water Services (Grampian) Limited, the main source of revenue is (directly

Audit risks and our audit approach (cont.)

4 **Bad debt provision – risk that the valuation of the bad debt provision is misstated**

Significant risk due the judgemental nature of the bad debt provision calculation

Increased risk due to new billing system in SWBS

Significant audit risk

The risk receivables are overstated.

Provision for doubtful debts at 30/09/22:

Scottish Water: £465m

Scottish Water Business Stream: £51m

— 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.

Scottish Water

Household bad debt provision.

— Household water debt is a statutory debt recoverable from the occupier. The household billing and cash collection is performed by local authorities and cannot be influenced by Scottish Water.

Scottish Water Business Stream

General

— The bad debts provision for SWBS is highly judgemental in nature and the risk is expected to have increased due to the change in billing system during the 2022-23 financial year.

— There is therefore an inherent risk of error such that inappropriate assumptions are made to inform this provision.

Business risks related to audit risks include:

— Increased economic and financial pressures increase the risk of default by customers resulting in financial loss to the business

Planned response

— Testing the design and implementation 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.

— Sample testing of the reconciliation of information provided on a monthly basis by local authorities for household bad debt provision in respect of amounts billed and collected. This historical information forms the basis of the forecast collection rate.

— We will compare the information on historical collection rates (for Scottish Water) as the basis for the current year provision calculation, to the records held in respect of prior years.

— We will agree the total amount billed and collected in respect of 2022-23, as recorded in Scottish Water's records, to confirmations received from individual local authorities.

— For Scottish Water Business Stream, we will evaluate 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 debts, 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.

— We will test the relevance and reliability of underlying data used for the computation. In addition, we will assess whether data from HiAffinity was accurately and completely migrated to the new billing system – Gentrack. Our testing will include attribute testing (on relevant data elements such as invoice date) and reconciliation of data from both billing systems.

— We will compare the change in forecast household collection rate in the current year, to the historical trend of collection rates since 1996-97.

— We will perform sensitivity analysis and challenge management in respect of the forecast collection rate by increasing and decreasing it based on our judgement and assessing the impact on the provision.

— We will assess the disclosure of sensitivities by the members, and description of the provision in the financial statements.

Audit risks and our audit approach (cont.)

5 **Pension Liability – risk that the valuation of the defined benefit obligation is misstated**

Significant risk over inaccurate valuation of pension liability.

Increased risk due to market volatility and demographic data (e.g. mortality tables)

Significant audit risk

An inappropriate amount is estimated and recorded for the defined benefit obligation

The risk

- Small changes in the main assumptions and estimates (i.e. discount rate, inflation rate and mortality rate) used to value the pension obligation would have a significant effect on the net pension liability.
- Employees of Scottish Water participate in the Scottish Local Government Pension Scheme through three funds; North East Scotland pension fund; the Lothian pension fund; and the Strathclyde pension fund.
- Employees of Scottish Water Business Stream participate only in the Strathclyde Pensions Fund.

Business risks related to audit risks include:

- Market volatility and wider economic uncertainty increases the risk of pensions being misstated.

Planned response

Our audit approach to IAS 19 covering both Scottish Water and Scottish Water Business Stream includes:

- Testing the design and operating effectiveness of controls over the provision of membership information to management's actuary who uses it, together with the assumptions, to calculate the pension obligation.
- Review of management's expert used in the valuation of the defined benefit pension obligation.
- 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.
- Challenging the rate of increase in the pensionable salaries assumption, by comparing it to other evidence such as the regulatory delivery plan and our understanding of Scottish Government expectations.
- Considering the adequacy of the disclosures in respect of the sensitivity of the deficit to these assumptions.
- Our approach to the audit of pension schemes continues to include enhanced quality procedures, accordingly, we will liaise with the scheme actuaries and fund auditors regarding the underlying data and procedures at those entities. Given the current volatile market conditions caused by local and global economic uncertainty, we expect some significant fluctuations in the pension liability primarily driven by changes to assumptions.

Audit risks and our audit approach (cont.)

6	Going Concern	Risk relating to disclosures related to going concern including the judgement of whether there is material uncertainty	Consistent with prior year

Other audit risk

Risk that the entity will not be a going concern into the foreseeable future.

The risk

— Management's assessment of the group's ability to continue as a going concern involves significant judgment with respect to it being based on an evaluation of the inherent risks to Scottish Water's business model, as well as that of its subsidiary entities, and how those risks might affect its financial resources or ability to continue operations over a period of at least 12 months from the date of approval of these financial statements.

— Disclosures in the financial statement and the annual report are not adequate with regard to the effect of identified risks to the entity's financial position, performance, business model and strategy.

Business risks related to audit risks include:

— Due to the current economic uncertainty, increased cost of living and market volatility, the ability to accurately forecast is difficult and involves estimates and judgements thus impacting an assessment on going concern.

Planned response

— Evaluate how management's risk assessment process identifies business risks relating to events and conditions that may cast significant doubt on the group's ability to continue as a going concern.

— Evaluate the models management uses in its assessment, including use of the work of management's specialists, and evaluate how the information system captures events and conditions that may cast significant doubt on ability to continue as a going concern.

— Evaluate whether management's assessment has failed to identify events or conditions that may cast significant doubt on going concern and whether the method used by management is appropriate.

— Evaluate whether sufficient and appropriate audit evidence has been obtained to conclude whether a material uncertainty exists and the appropriateness of management's use (or otherwise) of the going concern basis of accounting.

— Evaluate whether there is adequate support for the assumptions underlying management's assessment, whether they are realistic and achievable and consistent with the external and/or internal environment and other matters identified in the audit.

Audit risks and our audit approach (cont.)

7 **Impairment in investment of Subsidiaries (valuation assertion)**

Risk that investments should be impaired

Consistent with prior year

Other audit risk

The value of investments are overstated

The risk

— Inflationary pressures and wider economic uncertainty trigger the risk of impairment in subsidiaries in the separate financial statements of Scottish Water as at 31 March 2023, with a higher risk in relation to the investment of Scottish Water Business Stream Holdings in Scottish Water Business Stream and the investment in Scottish Water Horizons Limited.

Business risks related to audit risks include:

— The uncertain economic environment, inflationary pressures and ever increasing costs increases the risk of error in forecasting accurately, thus impacting impairment assessments for investment in subsidiary entities.

Planned response

— From 1 October 2022 the activities of the Aberdeen Environmental Services Limited (AES) have been absorbed into the regulated activities of Scottish Water. AES ceased trading from that date. The activities for Scottish Water Services (Grampian) were also absorbed into the trading activities of Scottish Water from 1 October 2022. This restructure will impact the investments held by Scottish Water. The journals relating to the restructure, will be audited, including disclosure relating thereto in the annual report;

— We will compare 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;

— We will also further consider the carrying amount of the investment in trading subsidiary entities with the expected value of the business based on a discounted cash flow basis; and

— Challenge management, where appropriate, on the reasonableness of assumptions used in their discounted cash flow workings.

Other significant matters related to our audit approach

Impacts of climate risk

As per the 2022/23 audit planning guidance issued by Audit Scotland, auditors of Public bodies will be required to provide feedback on the below six questions on climate change to Audit Scotland.

Public bodies have statutory duties to act on climate change, including helping to deliver Scotland's net zero emissions target by 2045. Auditors need to be aware of how audited bodies are planning and responding to climate change. Our audit approach towards climate change will continue to evolve and align with future auditing standards.

The six questions to which Audit Scotland requires responses are noted below:

1. What targets has the body set for reducing emissions in its own organisation or in its local area?
2. Does the body have a climate change strategy or action plan which sets out how the body intends to achieve its targets?
3. How does the body monitor and report progress towards meeting its emissions targets internally and publicly?
4. Has the body considered the impact of climate change on its financial statements?
5. What are the areas of the financial statements where climate change has, or is expected to have, a material impact?
6. Does the body include climate change in its narrative reporting which accompanies the financial statements and is it consistent with those financial statements?

As part of our procedures on other information, we will obtain and read your draft ESG/climate change disclosures to be included in the annual report. Our audit approach will be adapted based on the extent of such disclosures.

Other significant matters related to our audit approach (cont.)

Our Use of Data and analytics

We will be integrating Data & Analytics (D&A) procedures into our planned approach for the audit of Scottish Water.

Risk assessment

— Account Analysis allows us to compare journal entry postings to our industry expectations. This provides us greater insight into your accounting processes and can highlight unexpected entries or transaction flows.

Substantive testing

— We will analyse PPE transactions in the period and, use our D&A analysis to identify any unusual items that have been capitalised. We will perform additional procedures on the exceptions identified.

Management override of controls surrounding journal entries

— KPMG Clara General Ledger Analysis provides insights such as the breakdown between manual and automated entries, time series analysis and stratification of journal populations by user, amount and line numbers. This provides us a better understanding of your processes, highlights inconsistencies and aids us in identifying high-risk entries requiring substantive testing.

Mandatory communications

Type	Statements
Management's responsibilities (and, where appropriate, those charged with governance)	Prepare financial statements in accordance with the applicable financial reporting framework that are free from material misstatement, whether due to fraud or error. Provide the auditor with access to all information relevant to the preparation of the financial statements, additional information requested and unrestricted access to persons within the entity.
Auditor's responsibilities	Our engagement letter dated 18 March 2022 communicates our responsibilities to form and express an opinion on the financial statements that have been prepared by management with the oversight of those charged with governance. The audit of the financial statements does not relieve management or those charged with governance of their responsibilities.
Auditor's responsibilities - Fraud	This report communicates how we plan to identify, assess and obtain sufficient appropriate evidence regarding the risks of material misstatement of the financial statements due to fraud and to implement appropriate responses to fraud or suspected fraud identified during the audit.
Independence	Our independence confirmation letter on page 25 discloses matters relating to our independence and objectivity including any relationships that may bear on the firm's independence and the integrity and objectivity of the audit engagement partner and audit staff.

Appendix

Contents

Confirmation of independence

We confirm that, in our professional judgement, KPMG LLP is independent within the meaning of regulatory and professional requirements and that the objectivity of the Partner, Director and audit staff is not impaired.

Assessment of our objectivity and independence as auditor of Scottish Water

Professional ethical standards require us to provide to you at the planning stage 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's 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.

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 FRC 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 the FRC Ethical Standard in relation to this audit engagement 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

We have considered the fees charged by us to Scottish Water Group for professional services provided by us during the reporting period.

Total fees (excluding VAT) charged by us for the period ended 31 March 2022 and agreed for the 2023 were as follows:

	2023 £000	2022 £000
Audit fee – Audit Scotland allocation	355.0	135.0
Review fee – Half year	17.6	21.0
Audit fee – other areas of scope (ISA 315r)	25.0	29.7
Audit fee – Subsidiary entities	135.8	138.1
Audit fee – Regulatory reporting	17.0	15.4
Total non-audit services	2.5	2.5
Total Fees	552.9	341.7

Audit Scotland code of audit practice (cont.)

Responsibilities of auditors	
Appointed auditor responsibilities	Auditors appointed by the Auditor General and the Accounts Commission undertake the audit of accounts including the wider-scope responsibilities and, where appropriate, Best Value. Once appointed, auditors act independently in carrying out their responsibilities and in exercising professional judgement. The appointed auditor reports to the audited body and others on the results of audit work Appointed auditor responsibilities are derived from statute, International Standards on Auditing (UK) and the Ethical Standard for auditors, other professional requirements and best practice, the Code and guidance from Audit Scotland. Weaknesses or risks, including fraud and other irregularities, identified by auditors are only those which come to their attention during their normal audit work in accordance with the Code and may not be all that exist Appointed auditors' statutory duties are derived from appointment by the Auditor General under the Public Finance and Accountability (Scotland) Act 2000. Appointed auditors' reports (ie, the independent auditor's report in relation to the accounts) must set out the auditor's findings on: • whether the expenditure and receipts shown in the accounts were incurred or applied in accordance with: – any enactment by virtue of which the expenditure was incurred or the income received – the Budget Act(s) for the financial year, or any part of the financial year, to which the accounts relate – Sections 4-7 of the 2000 Act, relating to the Scottish Consolidated Fund (the Fund) • where sums have been paid out of the Fund for the purpose of meeting such expenditure, whether the sums were applied in accordance with Section 65 of the Scotland Act 1998 • whether the expenditure and receipts shown in the accounts were incurred or applied in accordance with any applicable guidance (whether as to propriety or otherwise) issued by the Scottish ministers • whether the accounts comply with any applicable direction by virtue of any enactment. Appointed auditors must send the accounts, including the independent auditor's report, to the Auditor General who may prepare a statutory report on the accounts under Section 22 of the 2000 Act.
General principles	This code describes the high level, principles based purpose and scope of public audit in Scotland. The code reflects the legal requirements for audit. It also reflects the professional and ethical standards with which auditors must comply

Confirmation of independence (Cont)

We confirm that, in our professional judgement, KPMG LLP is independent within the meaning of regulatory and professional requirements and that the objectivity of the Partner, Director and audit staff is not impaired.

The ratio of non-audit fees to audit fees for the year was 0.01:1. We do not consider that the total non-audit fees create a self-interest threat since the absolute level of fees is not significant to our firm as a whole.

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 and Risk 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 and Risk 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

ISA (UK) 315 Revised: Overview

Summary

ISA (UK) 315 *Identifying and assessing the risks of material misstatement* incorporates significant changes from the previous version of the ISA. These have been introduced to achieve a more rigorous risk identification and assessment process and thereby promote more specificity in the response to the identified risks. The revised ISA is effective for periods commencing on or after 15 December 2021.

The revised standard expands on concepts in the existing standards but also introduces new risk assessment process requirements – the changes will have a significant impact on our audit methodology and therefore audit approach.

Why have these revisions been made?

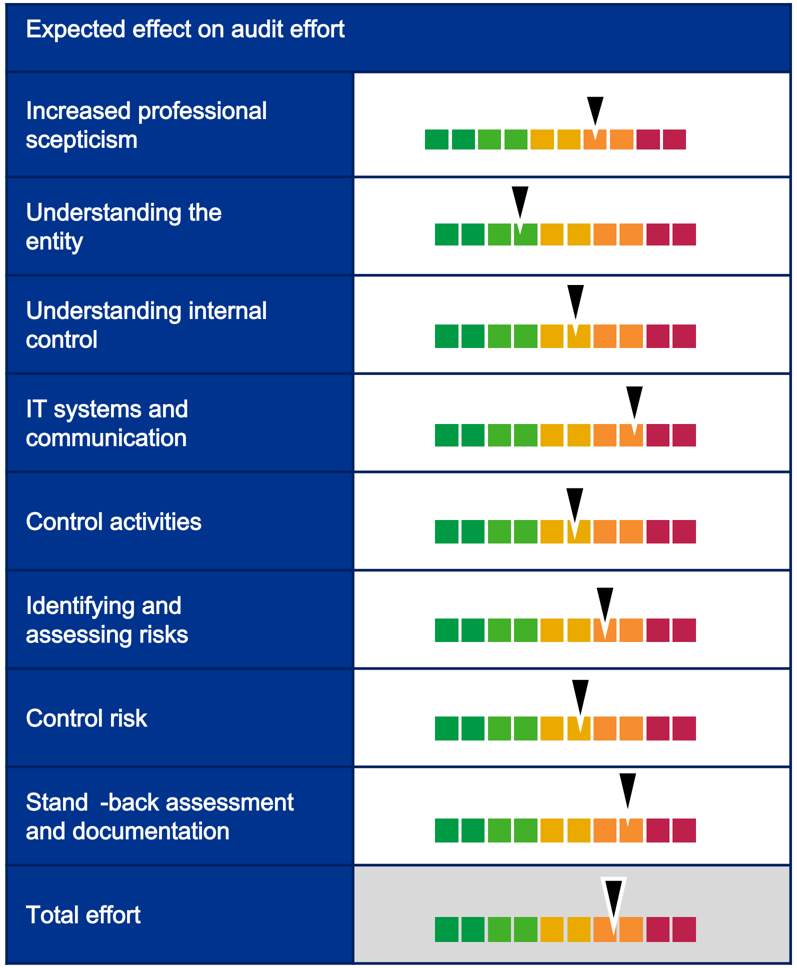
With the changes in the environment, including financial reporting frameworks becoming more complex, technology being used to a greater extent and entities (and their governance structures) becoming more complicated, standard setters recognised that audits need to have a more robust and comprehensive risk identification and assessment mechanism.

The changes are aimed at (i) promoting consistency in effective risk identification and assessment, (ii) modernising the standard by increasing the focus on IT, (iii) enhancing the standard's scalability through a principle based approach, and (iv) focusing auditor attention on exercising professional scepticism throughout risk assessment procedures.

What does this mean for an audit?

To meet the requirements of the new standard, auditors will be required to spend an increased amount of time across the risk assessment process, including more detailed consideration of the IT environment. We expect these changes to result in significantly increased audit effort levels which will, in turn, affect auditor remuneration. This additional effort is a combination of time necessary to perform the enhanced risk assessment procedures and the anticipated need to involve more technical specialists (particularly IT Audit professionals) in our audits.

Given the level of changes to the standard, debate remains ongoing about the extent of impact on application of some paragraphs. Global regulators have committed to providing further clarification in this area in advance of adoption, and there may therefore be some later updates to our initial assessment of relative impact.



ISA (UK) 315 Revised: Summary of key changes

Area	Impact on audit effort	Summary of changes and impact
Increased professional scepticism		Increased focus on applying professional scepticism – particularly the need for auditors not to bias their approach towards obtaining evidence that is corroborative in nature or excluding contradictory evidence, which requires more independent evidence to be sought. In all cases, there will be enhanced documentation requirements in this area.
Understanding the entity		Requirements to obtain an understanding of the entity have been restructured and enhanced. The changes are focused on the importance of understanding the applicable financial reporting framework and the entity's accounting policy choices, as well as the extent of IT usage in the business' processes. This will result in increased risk assessment procedures and documentation requirements.
Understanding internal control		The previous standard included requirements for understanding components of the entity's system of internal control. The revisions add another step by requiring auditors perform evaluation procedures over these. This may require additional effort to evaluate the entity's processes over risk assessment and monitoring activities over internal control systems to assess their appropriateness to the entity's size and complexity.
IT systems and communication		The requirements introduce an increased focus on understanding the entity's own management of IT. This may entail performing additional risk assessment procedures and taking a broader view across the IT environment, considering more systems and systems in greater depth, than previously. Given the complexity and specialist knowledge required to perform these procedures, increased use of IT Auditors will be a natural consequence of this revision.
Control activities		The revised standard enhances the way we identify IT applications and aspects of the IT environment that are subject to assessed risks arising from IT. This may result in significant expansion of risk assessment procedures to obtain and evaluate the necessary information. Further, the standard adds new requirements in control testing activities to mandate evaluation of general IT controls that address risks arising from IT associated with significant risks and certain journal entries. For these controls, the auditor is required to evaluate the design and implementation of the individual controls. This could result in a significant change in approach, with more emphasis and effort spent on evaluating control activities. Again, we anticipate integrating more specialised expertise into our audit team to meet the revised requirements.
Identifying and assessing risks		The changes require more detailed assessment of risks at both the financial statement and assertion levels for classes of transactions, account balances and disclosures than previously. Further, the revisions introduce an inherent risk spectrum and new inherent risk assessment factors, each of which the auditor evaluates to assess the level of risk and thereby shape the audit response. This will increase the audit effort needed to evaluate and document the risks of material misstatement.
Control risk		New requirement to assess inherent risk and control risk separately for each risk of material misstatement identified where the auditor plans to test the operating effectiveness of controls. The separation of assessments will require individual attention, increased documentation and is likely to affect sample sizes for substantive procedures.
Stand-back assessment		New requirement to perform a stand-back assessment for material classes of transactions, account balances or disclosures which have not been identified as significant, to assess whether this determination remains appropriate in the context of the overall audit. This will require increased consideration of aggregation risk and introduce additional documentation requirements.

ISA (UK) 240 Revised: Summary of key changes

Low High

Summary and background

ISA (UK) 240 *The auditor's responsibilities relating to fraud in an audit of financial statements* includes revisions introduced to clarify the auditor's obligations with respect to fraud and enhance the quality of audit work performed in this area. The revised ISA (UK) is effective for periods commencing on or after 15 December 2021. Unlike ISA (UK) 315 which mirrors updates in the international ISA, the updated UK fraud standard is not based on international changes by the IAASB.

The impact of the revisions to ISA (UK) 240 is less extensive compared to ISA (UK) 315, but will nevertheless result in changes to our audit approach. The table below summarises the main changes and our initial assessment of their impact.

Area	Summary of changes and impact	Effect on audit effort
Risk assessment procedures and related activities	affected are: — the need for auditors not to bias their approach towards obtaining evidence that is corroborative in nature or excluding contradictory evidence, — remaining alert for indications of inauthenticity in documents and records, and — investigating inconsistent or implausible responses to inquiries performed. [2] Requirements to perform inquiries with individuals at the entity are expanded to include, amongst others, those who deal with allegations of fraud. [3] Every audit now requires a specific determination as to whether to involve technical specialists (including forensics) to aid in identifying and responding to risks of material misstatement due to fraud. This will result in increased involvement of specialists and an expanded scope of work for these specialists on audit engagements.	
Internal discussions and challenge	Enhanced requirements for internal discussions among the audit team to identify and assess the risk of fraud in the audit, including a requirement to determine the need for additional meetings to consider the findings from earlier stages of the audit and their impact on our assessment of the risk of fraud.	
Communications with management / TCWG	New requirements for communicating matters related to fraud with management and those charged with governance, in addition to the reporting in our audit reports.	

What does this mean for an audit?

The changes introduce new requirements which will increase audit effort. The additional work is largely the result of investing more time identifying and assessing the risk of fraud during risk assessment and involving specialists to aid with both risk identification and the auditor's response to risk.

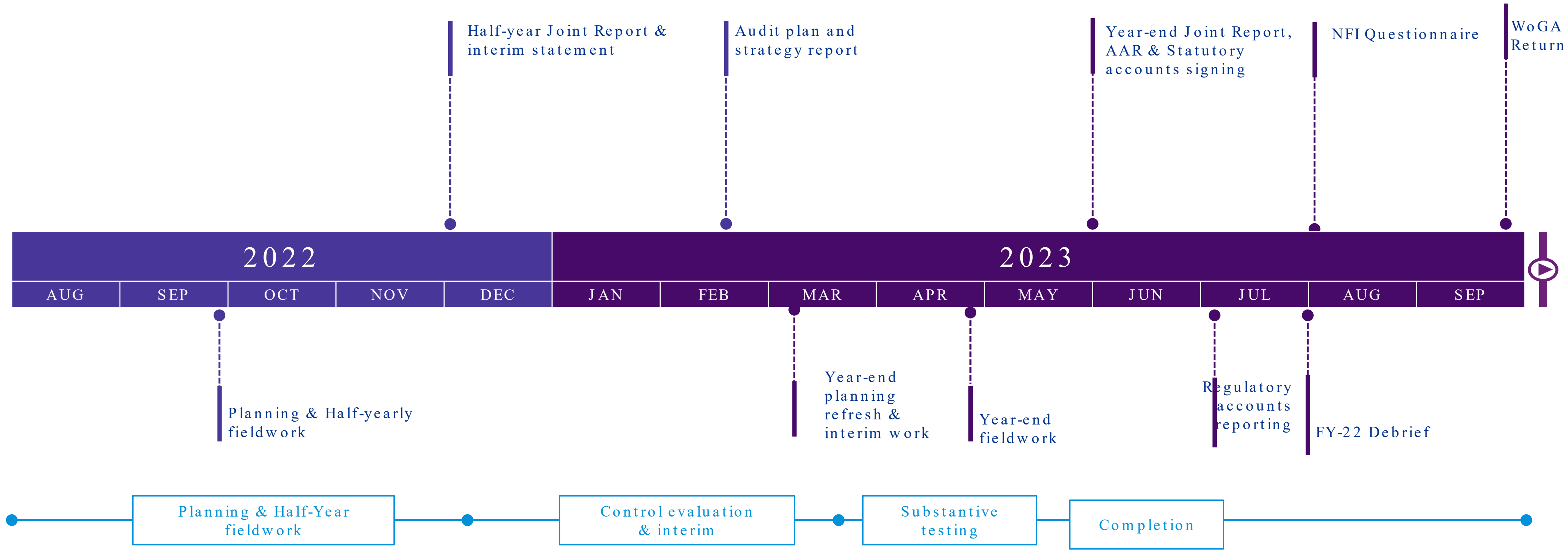
Newly effective standards and relevant IFRIC items

	Expected impact				Effective for years beginning on or after	
Standards	**High**	**Moderate**	**Low**	**None**	**1 January 2022**	**1 January 2023**
Onerous Contracts – Cost of Fulfilling a Contract (Amendments to IAS 37)			●	○	✓	
Annual Improvements to IFRS Standards 2018-2020			●		✓	
Property, Plant and Equipment: Proceeds Before Intended Use (Amendments to IAS 16)			●		✓	
Reference to the Conceptual Framework (Amendments to IFRS 3)			●	○	✓	
Classification of Liabilities as Current or Non-current (Amendments to IAS 1)			●	○		✓
IFRS 17 Insurance contracts			●	○		✓
Accounting Policies, Changes in Accounting Estimates and Errors: definition (Amendments to IAS 8)		●				✓
Amendments to IAS 1 Presentation of Financial Statements and IFRS Practice Statement 2 Making Materiality Judgements			●			✓
IFRS 16 - Leases						✓
Deferred Tax Related to Assets and Liabilities Arising from a Single Transaction – Amendments to IAS 12 Income Taxes						✓

The above assessment is our high level view at this planning stage of the audit. An assessment of the impact of each new standard and IFRIC item will be considered during the audit.

Appendix 3

Timeline



Key dates

Year-end audit start	17 April 2023
Closing meeting	15 May 2023
Audit and Risk Committee	24 May 2023
Financial statements approval and signing	31 May 2023

Audit Scotland code of audit practice

Responsibilities of management	
Financial statements	Audited bodies must prepare annual accounts comprising financial statements and other related reports. They have responsibility for: • preparing financial statements which give a true and fair view of their financial position and their expenditure and income, in accordance with the applicable financial reporting framework and relevant legislation • maintaining accounting records and working papers that have been prepared to an acceptable professional standard and that support their accounts and related reports disclosures • ensuring the regularity of transactions, by putting in place systems of internal control to ensure that they are in accordance with the appropriate authority • preparing and publishing, along with their financial statements, related reports such as an annual governance statement, management commentary (or equivalent) and a remuneration report in accordance with prescribed requirements • ensuring that the management commentary (or equivalent) is fair, balanced and understandable. It is the responsibility of management of an audited body, with the oversight of those charged with governance, to communicate relevant information to users about the entity and its financial performance, including providing adequate disclosures in accordance with the applicable financial reporting framework. The relevant information should be communicated clearly and concisely. Audited bodies are responsible for developing and implementing effective systems of internal control as well as financial, operational and compliance controls. These systems should support the achievement of their objectives and safeguard and secure value for money from the public funds at their disposal. They are also responsible for establishing effective and appropriate internal audit and risk-management functions.
Prevention and detection of fraud and irregularities	Audited bodies are responsible for establishing arrangements for the prevention and detection of fraud, error and irregularities, bribery and corruption and to ensure that their affairs are managed in accordance with proper standards of conduct by putting proper arrangements in place.

Audit Scotland code of audit practice (cont.)

Responsibilities of management (cont.)	
Corporate governance arrangements	Each body, through its chief executive or accountable officer, is responsible for establishing arrangements to ensure the proper conduct of its affairs including the legality of activities and transactions, and for monitoring the adequacy and effectiveness of these arrangements. Audited bodies should involve those charged with governance (including audit committees or equivalent) in monitoring these arrangements.
Financial position	Audited bodies are responsible for putting in place proper arrangements to ensure that their financial position is soundly based having regard to: • such financial monitoring and reporting arrangements as may be specified • compliance with any statutory financial requirements and achievement of financial targets • balances and reserves, including strategies about levels and their future use • how they plan to deal with uncertainty in the medium and longer term • the impact of planned future policies and foreseeable developments on their financial position.
Best Value, use of resources and performance	The Scottish Public Finance Manual sets out that accountable officers appointed by the Principal Accountable Officer for the Scottish Administration have a specific responsibility to ensure that arrangements have been made to secure best value.

KPMG

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Your digital audit - Introducing KPMG Clara

To deliver a quality audit, not only do we need to understand your business and risks, we also need to implement market-leading technology. Technology is the core of our audit, assisting our risk assessment, delivering powerful data analytics and collaborating with management in real time on our audit. KPMG Clara is our global audit platform through which we plan, execute and manage the audit.

Full transparency and real-time collaboration

Throughout the audit, management will have 24/7 access to the KPMG Clara collaboration portal and status of the audit. The technology provides easy access to key audit status information, including:

- How the audit is progressing
- Tracking of engagement tasks
- Finding out who from our KPMG team is leading on a deliverable.

A clear and transparent view on milestones, progress, and accountabilities facilitates direct collaboration with management.

Globally efficient execution

At the core of the KPMG Clara workflow is a modern, intuitively written, easily applicable audit methodology, that coupled with our new functionality:

- Drives globally consistent and efficient execution
- Enables early detection of issues so they can be quickly and effectively addressed.

Insights-driven, efficient operations

Valuable insights help you better understand our independent audit assessment and should be relevant to the entity. Through KPMG Clara analytics, we are empowered to leverage the latest technologies, including data & analytics.

We use D&A to:

- Visualise the flow of transactions through your system
- Identify risks in your financial data
- Perform more specific audit procedures.

Value from our transformative capabilities

We are committed to ensuring continuous improvement of the audit experience.

Our alliances with technology leaders such as Microsoft and IBM enable us to stay at the forefront of disruption and leverage our capabilities to deliver even more value through our audit.

With KPMG Clara, our relationship will be more impactful.

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