

Scottish Water

Report to the Audit Committee

Audit plan and strategy for the year ending 31 March 2021

—

30 March 2021



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Restrictions on distribution

This report is intended solely for the information of those charged with governance of Scottish Water 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.

Introduction

To the Audit Committee of Scottish Water

We are pleased to have the opportunity to meet with you on 30 March 2021 to discuss our audit of the consolidated financial statements of Scottish Water, as at and for the year ending 31 March 2021.

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

We believe the content of this report should provide a good platform for our discussion when we meet and we will be pleased to elaborate on matters covered in it at the meeting.

The engagement team

The senior team involved in the engagement benefits from continuity and they are supported by specialists, all of whom work with a variety of public sector bodies. The senior members of the audit team are set out below and relevant contact details are provided on the back page of this report.

- Hugh Harvie – Engagement Leader;
- Kevin Ramsamy – Engagement Senior Manager; and
- Emma de Beer – Engagement In-Charge

Yours sincerely,

Hugh Harvie
Partner

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 and we have been granted an extension for an additional year to 2021-22.

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 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**.

Our 2020-21 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 2021 and of the income and expenditure of the group for the year then ended; and
 - have been prepared 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;
- completion of returns to Audit Scotland, Water Industry Commission for Scotland and certification of Whole of Government Accounts;
- a review and assessment of Scottish Water's governance arrangements, including a review of the adequacy of internal audit and review of the governance statement; and
- a review of National Fraud Initiative arrangements.

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 2020.

Overview of planned scope including materiality

Our materiality levels

Group materiality

We determined materiality for Scottish Water's 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 consider 'total expenditure' as an appropriate benchmark given the sector in which the entity operates, its ownership and financing structure, and the focus of users.

Group materiality for planning purposes has been based on prior year's total expenditure which stood at £1.36 billion (PY: £1.21 billion). We will review the level of materiality on receipt of draft accounts for 2020-21.

Reporting threshold

Whilst our audit procedures are designed to identify misstatements which are material to our opinion on the financial statements as a whole, we also report to the Audit Committee any unadjusted misstatements of lesser amounts to the extent that these are identified by our audit work.

This is in line with the Code of Audit Practice and ISA 260 (UK&I) 'Communications with those charged with governance', under which we are also obligated to report both corrected and uncorrected omissions or misstatements other than those which are 'clearly trivial' to those charged with governance and this has been set at £0.25 million (PY: £0.25m).



Overview of planned scope including materiality (cont.)

Significant risks, key audit matters and other areas of focus

Our risk assessment draws upon our 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.

The significant risks, key audit matters (those matters that, in our professional judgement, are of most significance in the audit) and other areas of focus requiring specific audit attention and procedures to address the likelihood of a material financial statement error are as follows:

Significant risks	<ul style="list-style-type: none">– Management override of controls fraud risk (assumed risk per ISA 240)– Fraud risk from revenue recognition (assumed risk per ISA 240)
Key audit matters	<ul style="list-style-type: none">– Capital additions– Bad debts provision– Pension liability
Other areas of focus	<ul style="list-style-type: none">– Intangible asset amortisation (Note 1)– Profit recognition (Note 1)– Income uncertainty provision– Credit note provision– Going concern– Impairment of investment in subsidiaries

Notes

Note 1 – the other areas of focus on amortisation of intangible assets and profit recognition relate to Scottish Water Business Stream Limited and Scottish Water Horizon Limited respectively; and

Note 2 – we draw attention to the fact that we have removed the other area of focus relating to purchase accounting this year. This was in respect to the Yorkshire Water acquisition by Scottish Water Business Stream in the previous year and it is not applicable in the current year.

Control environment

The impact of the control environment on our audit is reflected in our planned audit procedures. We will assess the impact of the COVID-19 pandemic on key controls, which may result in subsequent changes in our audit approach.

Timing of our audit and communications

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

- Planning meeting with management to discuss key developments and areas relevant to the audit;
- Audit committee meeting on 30 March 2021 where we present our final audit plan;
- Status meetings with management throughout the duration of our fieldwork in April and early May where we communicate progress on the audit plan, any misstatements, control deficiencies and significant issues;
- Closing meeting with management on 10 May 2021 where we discuss the auditor's report and any outstanding deliverables; and
- Audit committee meeting on 19 May 2021 where we communicate any misstatements and significant control deficiencies arising from our audit.

Group audit

In addition to Scottish Water, we deem Scottish Water Business Stream Limited, Aberdeen Environmental Services Limited and Scottish Water Services (Grampian) Limited to be significant in the context of the group audit and we also consider that risk-focussed audit procedures in respect of profit recognition are necessary for Scottish Water Horizons Limited. Together these entities account for 99% of the group's result.

We will report the following matters in the annual audit report:

- Materiality in respect of each subsidiary;
- efficiencies in the system of internal controls or instances of fraud which we identify; and
- limitations on the group audit, for example, where the access to information may have been restricted.

Wider scope

Approach

We are required to assess and provide conclusions in the Annual Audit Report in respect of four wider scope dimensions: financial sustainability, financial management, governance and transparency and value for money. We set out below an overview of our approach to wider scope requirements of our annual audit. We provide our 2020-21 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 auditors' 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;
- The work of other stakeholders, such as the Water Industry Commission for Scotland; and
- We will also consider the impact that COVID-19 has had during the year.



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 dimensions.

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 auditors' decisions.



Reporting

We have completed our initial wider scope risk assessment and have not identified any significant risks relating to wider scope. 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 and these are in line with Audit Scotland’s 2020-21 guidance on audit planning.

Note that no assessment of risk is meant to be indicated by the placement of items on the chart.



Potential risk type: Wider scope Emerging (2020-21)

COVID-19 audit implications

The table below identifies the specific areas of our audit that are expected to be affected by the COVID-19 pandemic. We expect to continue to engage in frequent communications with management due to the increased risks of material misstatement, the anticipated challenges in completing our audit and the potential for rapidly developing events.

<p>Planned scope and timing See page 5</p>	<ul style="list-style-type: none"> – The planned scope and timing of our audit has not materially changed from the prior year. – Given the changing environment, we will continue to reassess the scope and timing of our audit to respond to new events or changing conditions. If we make significant changes, then we will communicate these to you.
<p>Accounting estimates See pages 14, 17 and 18</p>	<ul style="list-style-type: none"> – The risks of material misstatement relating to bad debt provisions, credit note provisions, income uncertainty and impairment of investment in subsidiaries have increased due to the higher degree of estimation uncertainty resulting from current economic conditions. – We will evaluate the appropriateness of the methods, assumptions and data used to derive these 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 will consider whether management has appropriately addressed the increased estimation uncertainty. – We will evaluate whether related disclosures comprise required disclosures, including significant assumptions about the future and other major sources of estimation uncertainty, and whether they include the information necessary to achieve the fair presentation of the financial statements as a whole.
<p>Going concern See page 18</p>	<ul style="list-style-type: none"> – Management’s assessment of the entity’s ability to continue as a going concern will continue to be challenging due to the unprecedented level of uncertainty about future economic conditions, particularly in the shorter term. – The rapidly changing conditions and our enhanced procedures under the revised ISA (UK) 570 on your risk assessment process will mean more audit effort in this key area.

COVID-19 audit implications (cont.)

Subsequent events disclosures	<ul style="list-style-type: none">– Due to the nature of the situation, determining whether subsequent events should be reflected (adjusting) vs. disclosed (non-adjusting) in the financial statements may require significant judgement, and more subsequent events may be identified.– Our audit procedures will be adjusted to respond to the increased risks of material misstatement.
Obtaining sufficient appropriate audit evidence	<ul style="list-style-type: none">– The fact that we plan to perform our audit entirely remotely means that in order to obtain sufficient appropriate audit evidence to support our audit opinion we may need to:<ul style="list-style-type: none">– modify our audit procedures when expected audit evidence is unavailable;– obtain more persuasive audit evidence when evaluating management’s assessment of the entity’s ability to continue as a going concern;– collate external confirmations or perform alternative audit procedures; or– allow for delays in the completion of component audits.– This will be the second year we will be performing our audit remotely. As such we are better prepared to face the challenges ahead and have put in place additional control measures to ensure that we complete our audit as planned. Should there be any changes in circumstances to cause us to believe otherwise, we will advise the Audit Committee accordingly.
Audit effort and audit fees	<ul style="list-style-type: none">– 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.

Audit risks and our audit approach

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 revenue recognition		✓					
Key audit matters							
Capital additions	✓						
Bad debt provision	✓	✓					
Pension liability	✓	✓					
Other areas of focus							
Intangible asset amortisation		✓					
Profit recognition					✓		
Income uncertainty provision	✓						
Credit note provision	✓	✓					
Going concern	✓	✓	✓	✓	✓	✓	✓
Impairment of investment in subsidiaries	✓		✓			✓	

Audit risks and our audit approach (cont.)

In accordance with paragraph 19A of ISA 700, we are required to describe in our financial statements audit opinion those assessed risks of material misstatement which have the greatest effect on the overall audit strategy, the allocation of resources in the audit and directing the efforts of the engagement team. A description of each of the significant risks, key audit matters and areas of focus are given hereafter.

Significant risk	Why	Audit approach
Fraud risk from management override of controls	<p>Professional standards require us to communicate the fraud risk from management override of controls as a significant risk.</p> <p>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.</p>	<ul style="list-style-type: none"> — Our audit methodology incorporates the risk of management override as a default significant risk. We have not identified any specific additional risks of management override relating to the audit of Scottish Water; — In line with our methodology, we will carry out appropriate controls testing and substantive procedures, including over journal entries, accounting estimates and significant transactions that are outside the normal course of business, or are otherwise unusual; — We will evaluate accounting estimates, including the consideration of bad debt provision, pension liabilities, income uncertainty provision and credit note provision; and — Remote working due to COVID-19 indicates an additional risk of management override of controls and we have factored in the effect of this in our procedures for journals testing.

Audit risks and our audit approach (cont.)

Significant risk	Why	Audit approach
Fraud risk from revenue recognition (Scottish Water Business Stream)	<p>Professional standards require us to make a rebuttable presumption that the fraud risk from revenue recognition is a significant risk.</p> <p>Our fraud and error risk considers the judgements and complexities of the accrued and deferred income calculations that exist in the revenue streams of Scottish Water Business Stream.</p> <p>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.</p>	<p>Our procedures in respect of the risk in Scottish Water Business Stream include:</p> <ul style="list-style-type: none"> — Confirming 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; — Performing cut off testing to assess whether sales 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; — Consider testing general IT controls of the automated HiAffinity billing system to ensure integrity; — Performing a reconciliation of all cash, debtors and accrued revenue for the year; — 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 — Considering the approach to recognising revenue in respect of vacant properties and shared supplies. <p>We rebut the risk in respect of Scottish Water and other subsidiaries.</p> <ul style="list-style-type: none"> — 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 Aberdeen Environmental Services Limited and Scottish Water Services (Grampian) Limited, their main source of revenue is (directly and indirectly) from Scottish Water.

Audit risks and our audit approach (cont.)

Key audit matter	Why	Audit approach
Capital additions	<p>Capital additions are significant, comprising the largest element of Scottish Water's annual expenditure, related to the delivery plan for regulated activities for the period 2015-16 to 2020-21.</p> <p>Directors are incentivised across a number of financial and other measures including profit and completion of capital investment programmes.</p> <p>There is judgement involved in the allocation of expenditure between capital additions and revenue which can affect profit and investment measures reported in the financial statements.</p>	<p>Our audit approach includes:</p> <p>Control design</p> <ul style="list-style-type: none">— Testing the design and operating effectiveness of controls over the allocation of costs between capital and revenue within the financial ledger at the project initiation stage and on an ongoing basis; and— Testing the design and operating effectiveness of controls over the consistency between total capital expenditure reported in the financial statements and that reported in reports to those charged with governance as part of ongoing capital project monitoring. <p>Tests of detail</p> <ul style="list-style-type: none">— 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. We will consider the classification of expenditure incurred during the lockdown period caused by the COVID-19 pandemic, for example those that did not add any value to a capital project should be classified as a revenue expenditure;— Assessing a sample of items allocated to revenue expenditure by considering the application of relevant accounting policies to ensure that these have been appropriately accounted for; and— Review of manual journals.

Audit risks and our audit approach (cont.)

Key audit matter	Why	Audit approach
Bad debt provision	<p>There are a number of assumptions included in the calculation of the bad debt provision; the most sensitive of these is the overall forecast collection rate based on historical data.</p> <p>Scottish Water</p> <p><i>Household bad debt provision</i></p> <p>Household water debt is a statutory debt recoverable from the occupier. The household billing and cash collection is performed by local authorities and cannot be influenced by Scottish Water.</p> <p>Scottish Water Business Stream</p> <p><i>General</i></p> <p>There is an inherent risk of error such that incorrect assumptions are made about this provision which also includes non-vacant properties.</p> <p><i>Vacant properties</i></p> <p>Due to the level of judgment required to conclude on the level of provision required by management, we consider this to be of significance.</p>	<p>Our procedures include:</p> <p>Control design</p> <ul style="list-style-type: none"> — 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. — 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 (for household bad debt provision) in respect of amounts billed and collected. This historical information forms the basis of the forecast collection rate. <p>Tests of detail</p> <ul style="list-style-type: none"> — We will compare the information on historical collection rates 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 2020-21, as recorded in Scottish Water's records, to confirmations received from individual local authorities for household debtors. — We will evaluate the adequacy of the provisions against vacant property receivables (for Scottish Water Business Stream) by critically assessing whether the assumptions made in determining the level of provision is in compliance with IFRS 9 considering the COVID-19 pandemic. This will be performed using historical write-off and collection data in order to assess the levels of recoverability across the portfolio of vacant property receivables. <p>Historical comparison</p> <ul style="list-style-type: none"> — We will compare the change in forecast household collection rate in the current year, to the historical trend of collection rates since 1996-97. <p>Sensitivity analysis</p> <ul style="list-style-type: none"> — 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. <p>Assessing transparency</p> <ul style="list-style-type: none"> — We will assess the disclosure of sensitivities by the Directors, and description of the provision in the financial statements.

Audit risks and our audit approach (cont.)

Key audit matter	Why	Audit approach
Pension liability	<p>Small changes in the assumptions and estimates used to value the pension obligation (before deducting scheme assets) would have a significant effect on the net pension liability.</p> <p>Employees of Scottish Water participate in the Scottish Local Government Pension Scheme through three funds; North East Scotland pension fund, the Lothian pension fund and the Strathclyde pension fund.</p>	<p>Our audit approach to IAS 19 includes:</p> <p>Control design</p> <ul style="list-style-type: none">— 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. <p>Benchmarking assumptions</p> <ul style="list-style-type: none">— 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. <p>Assessing transparency</p> <ul style="list-style-type: none">— Considering the adequacy of the disclosures in respect of the sensitivity of the deficit to these assumptions. <p>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 economic climate caused by the pandemic, we expect some significant fluctuations in the pension liability primarily driven by changes to assumptions.</p>

Audit risks and our audit approach (cont.)

Other areas of focus	Why	Audit approach
Intangible asset amortisation (Scottish Water Business Stream)	<p>Following the acquisition of the non-domestic business customer lists of Yorkshire Water and Southern Water an intangible asset was recognised and is subject to amortisation.</p> <p>Amortisation of the customer list intangible asset is judgemental being based upon the period of time over which the business is expected to benefit from it.</p>	<p>Our procedures include:</p> <p>Sensitivity analysis</p> <ul style="list-style-type: none"> — Performing sensitivity analysis and challenge management over the expected life of the customer list by increasing and decreasing it based upon our judgement. <p>Tests of detail</p> <ul style="list-style-type: none"> — Comparing the expected customer attrition rate with that experienced in the period since acquisition to assess management’s assessment of customer retention rates (i.e. the period over which the business is expected to benefit from this intangible). <p>Assessing transparency</p> <ul style="list-style-type: none"> — Assessing the disclosure of the intangible asset and relevant information surrounding the valuation sensitivities, in the financial statements
Profit recognition (Scottish Water Horizons)	<p>Scottish Water Horizons recognises revenue on construction activities based on the percentage completion method. As revenue is agreed on entering into the contract, there is a risk that the profit margin is not recognised consistently across the life of the project and in accordance with IFRS 15 due to inaccurate budgeting with either too much or too little cost being released.</p>	<p>Our procedures include:</p> <ul style="list-style-type: none"> — 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 are significant by nature or value.

Audit risks and our audit approach (cont.)

Other areas of focus	Why	Audit approach
Income uncertainty provision	<p>There are a number of assumptions included in the calculation of the income uncertainty provision; the most sensitive of these is the overall forecast collection rate based on historical data.</p> <p>As the number of licensed providers increases, and complexity of revenue charged by those providers increases, there is increasing uncertainty. This includes the approach to vacant charging (and ability to recover income due) and in respect of billing for shared supplies.</p>	<p>Our procedures include:</p> <p>Control design</p> <ul style="list-style-type: none"> — Testing the design and operating effectiveness of controls over the review and approval of the provision and associated assumptions. <p>Tests of detail</p> <ul style="list-style-type: none"> — Comparing 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; — Agreeing a sample of movements in the provision to confirmations received from the Competition and Markets Authority and obtaining copies of the final settlements for previous periods; and — Reviewing the closing provision in respect of Scottish Water Business Stream and relevant agreements reached in respect of prior periods. <p>Historical comparison</p> <ul style="list-style-type: none"> — Comparing the provision for other third party licenced providers to historical information.
Credit note provision	<p>There is a risk that credit notes will have to be issued due to previous billing adjustments. This is applicable to both Scottish Water (adjustments to household billings issued by Councils in respect of prior years) and Scottish Water Business Stream (relating to business customers).</p>	<p>Our procedures include:</p> <p>Scottish Water Business Stream</p> <ul style="list-style-type: none"> — Critically assessing the assumptions made in determining the level of provision, with reference to data observed subsequent to and at prior year ends; and — Performing sensitivity analysis on the provision model. <p>Scottish Water (company)</p> <ul style="list-style-type: none"> — Comparing 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.

Audit risks and our audit approach (cont.)

Other areas of focus	Why	Audit approach
Going concern	<p>All entities are required to provide appropriate disclosure in the financial statements in regard to the going concern assumption.</p> <p>Under ISAs (UK) we are ultimately required to report to you if we have anything material to add or to draw attention to in relation to the Directors' statement, set out in the Annual Report and Accounts about whether they considered it appropriate to adopt the going concern basis in preparing the financial statements.</p> <p>That judgement is based on an evaluation of the inherent risks to Scottish Water's business model 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.</p> <p>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</p>	<p>Our procedures will include:</p> <p>Funding assessment</p> <ul style="list-style-type: none"> Consider the availability of existing funding from the Scottish Government, including reviewing the repayment profile and the external financing limit set for the period 2021-22; <p>Retrospective review</p> <ul style="list-style-type: none"> Consider the budget to actual results for the year ended 2020-21 and make enquiries with management to obtain explanations for variances; <p>Sensitivity analysis</p> <ul style="list-style-type: none"> Compute a sensitivity of the key assumptions used in the cash flow forecasts and assessed their related impact on the financial resources and headroom available; <p>Review of regulatory framework</p> <ul style="list-style-type: none"> Reviewing the regulatory delivery plan update and considering the associated economic assumptions against our commercial understanding; and <p>Assessing transparency</p> <ul style="list-style-type: none"> Assess 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.
Impairment of investment in subsidiaries	<p>COVID-19 has triggered the risk of impairment in subsidiaries in the separate financial statements of Scottish Water as at 31 March 2021, with a higher risk in relation to the investment of Scottish Water Business Stream Holdings in Scottish Water Business Stream.</p>	<p>Our procedures will include:</p> <ul style="list-style-type: none"> 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.



Appendices

Appendix 1

Mandated communications with the Audit Committee

Type	Statements
Management's responsibilities (and, where appropriate, those charged with governance)	<p>Prepare financial statements in accordance with the applicable financial reporting framework that are free from material misstatement, whether due to fraud or error.</p> <p>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.</p>
Auditor's responsibilities	<p>Our engagement letter dated 31 May 2016 (page 1 - section 1) 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.</p>
Auditor's responsibilities - Fraud	<p>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.</p>
Independence	<p>Our independence confirmation in the next page refer to 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.</p>

Appendix 2

Confirmation of independence

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.

We will communicate any significant judgments 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 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.

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 2020 and proposed fee for the 2020-21 audit:

Services	2019-20	2020-21
Audit of the financial statements and associated services	355,059	318,083
Total non-audit services	2,896	2,896

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 Committee.

Business relationships

Various KPMG offices in the UK are supplied by Scottish Water Business Stream, a wholly owned subsidiary of Scottish Water. The annualized revenue to the Company amounted to circa. £95,000. These are not considered material to us and are governed by strict market regulations.

Confirmation of audit independence

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

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

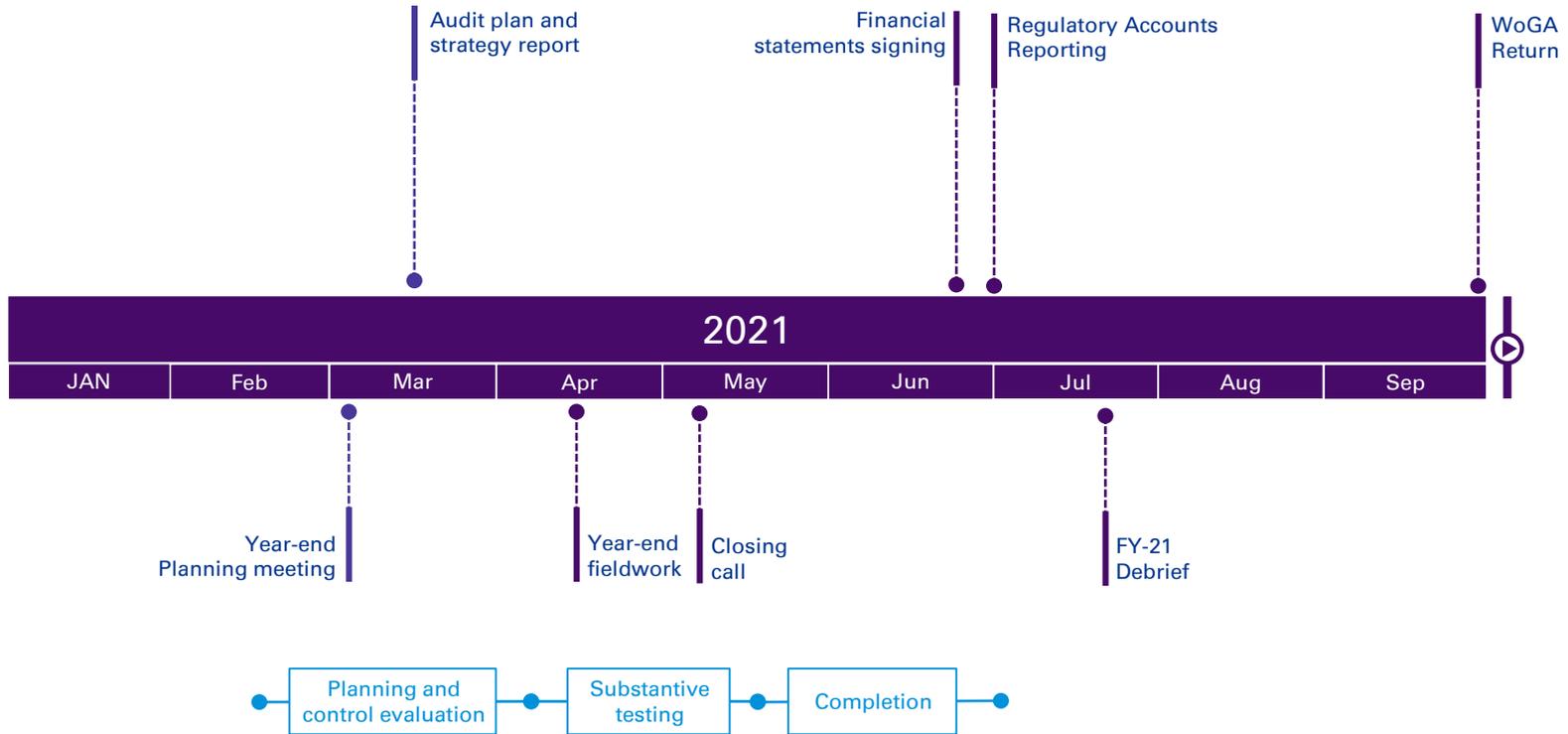
We would be very happy to discuss the matters identified above (or any other matters relating to our objectivity and independence) should you wish to do so.

Yours faithfully

KPMG LLP

Appendix 3

Timeline



Key dates	
Year-end audit start	19 April
Closing call	10 May
Audit Committee	19 May & 21 June
Financial statements approval and signing	29 June

Appendix 4

Responsibility in relation to fraud

We are required to consider fraud and the impact that this has on our audit approach.

We will update our risk assessment throughout the audit process and adapt our approach accordingly.

Management responsibilities

- Adopt sound accounting policies;
- With oversight from those charged with governance, establish and maintain internal control, including controls to prevent, deter and detect fraud;
- Establish proper tone/culture/ethics;
- Require periodic confirmation by employees of their responsibilities;
- Take appropriate action in response to actual, suspected or alleged fraud; and
- Disclose to Audit Committee and auditors:
 - any significant deficiencies in internal controls; and
 - any fraud involving those with a significant role in internal controls.

KPMG's identification of fraud risk factors

- Review of accounting policies;
- Results of analytical procedures;
- Procedures to identify fraud risk factors;
- Discussion amongst engagement personnel;
- Enquiries of management, Audit Committee, and others; and
- Evaluate broad programmes and controls that prevent, deter, and detect fraud.

KPMG's response to identified fraud risk factors

- Accounting policy assessment;
- Evaluate design of mitigating controls;
- Test effectiveness of controls;
- Address management override of controls;
- Perform substantive audit procedures;
- Evaluate all audit evidence; and
- Communicate to Audit Committee and management.

KPMG's identified fraud risk factors

- Whilst we consider the risk of fraud at the financial statement level to be low, we will monitor the following areas throughout the year and adapt our audit approach accordingly.
 - Management override of control;
 - Revenue recognition;
 - Cash; and
 - Procurement.

Audit Scotland code of audit practice

Responsibilities of management

Financial statements

Audited bodies must prepare an annual report and accounts containing 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 financial statements 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 requirements;
- Maintaining proper accounting records; and
- Preparing and publishing, along with their financial statements, an annual governance statement, management commentary (or equivalent) and a remuneration report that are consistent with the disclosures made in the financial statements. Management commentary should be fair, balanced and understandable and also clearly address the longer- term financial sustainability of the body.

Further, 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 also to ensure that their affairs are managed in accordance with proper standards of conduct by putting proper arrangements in place.

Appendix 5

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; and
 - 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.

Appendix 5

Audit Scotland code of audit practice (cont.)

Responsibilities of auditors

Appointed auditor responsibilities

Auditor responsibilities are derived from statute, this Code, International Standards on Auditing (UK), professional requirements and best practice and cover their responsibilities when auditing financial statements and when discharging their wider scope responsibilities. These are to:

- Undertake statutory duties, and comply with professional engagement and ethical standards;
- Provide an opinion on audited bodies' financial statements and, where appropriate, the regularity of transactions;
- Review and report on, as appropriate, other information such as annual governance statements, management commentaries, remuneration reports, grant claims and whole of government returns;
- Notify the Auditor General when circumstances indicate that a statutory report may be required;
- Participate in arrangements to cooperate and coordinate with other scrutiny bodies (local government sector only);
- Demonstrate compliance with the wider public audit scope by reviewing and providing judgements and conclusions on the audited bodies:
 - Effectiveness of performance management arrangements in driving economy, efficiency and effectiveness in the use of public money and assets;
 - Suitability and effectiveness of corporate governance arrangements; and
 - Financial position and arrangements for securing financial sustainability.

Weaknesses or risks identified by auditors are only those which have come to their attention during their 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.

General principles

This Code is designed such that adherence to it will result in an audit that exhibits these principles.

Independent

When undertaking audit work all auditors should be, and should be seen to be, independent. This means auditors should be objective, impartial and comply fully with the Financial Reporting Council's (FRC) ethical standards and any relevant professional or statutory guidance. Auditors will report in public and make recommendations on what they find without being influenced by fear or favour.

Appendix 5

Audit Scotland code of audit practice (cont.)

Responsibilities of auditors (cont.)

Proportionate and risk based

Audit work should be proportionate and risk based. Auditors need to exercise professional scepticism and demonstrate that they understand the environment in which public policy and services operate. Work undertaken should be tailored to the circumstances of the audit and the audit risks identified. Audit findings and judgements made must be supported by appropriate levels of evidence and explanations. Auditors will draw on public bodies' self-assessment and self-evaluation evidence when assessing and identifying audit risk.

Quality focused

Auditors should ensure that audits are conducted in a manner that will demonstrate that the relevant ethical and professional standards are complied with and that there are appropriate quality-control arrangements in place as required by statute and professional standards.

Appendix 5

Audit Scotland code of audit practice (cont.)

Responsibilities of auditors

Coordinated and integrated

It is important that auditors coordinate their work with internal audit, Audit Scotland, other external auditors and relevant scrutiny bodies to recognise the increasing integration of service delivery and partnership working within the public sector. This would help secure value for money by removing unnecessary duplication and also provide a clear programme of scrutiny activity for audited bodies.

Public focused

The work undertaken by external audit is carried out for the public, including their elected representatives, and in its interest. The use of public money means that public audit must be planned and undertaken from a wider perspective than in the private sector and include aspects of public stewardship and best value. It will also recognise that public bodies may operate and deliver services through partnerships, arm's-length external organisations (ALEOs) or other forms of joint working with other public, private or third sector bodies.

Transparent

Auditors, when planning and reporting their work, should be clear about what, why and how they audit. To support transparency the main audit outputs should be of relevance to the public and focus on the significant issues arising from the audit.

Adds value

It is important that auditors recognise the implications of their audit work, including their wider scope responsibilities, and that they clearly demonstrate that they add value or have an impact in the work that they do. This means that public audit should provide clear judgements and conclusions on how well the audited body has discharged its responsibilities and how well they have demonstrated the effectiveness of their arrangements. Auditors should make appropriate and proportionate recommendations for improvement where significant risks are identified.



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