



Scottish Water

Audit strategy
Year ending 31 March 2018
17 August 2017
For Audit Committee consideration on 29 August 2017

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About this report

This report has been prepared in accordance with the responsibilities set out within the Audit Scotland's *Code of Audit Practice* ("the Code").

This report is for the benefit of Scottish Water and is made available to Audit Scotland and the Controller of Audit (together "the Beneficiaries"). This report has not been designed to be of benefit to anyone except the Beneficiaries. In preparing this report we have not taken into account the interests, needs or circumstances of anyone apart from the Beneficiaries, even though we may have been aware that others might read this report. We have prepared this report for the benefit of the Beneficiaries alone.

Nothing in this report constitutes an opinion on a valuation or legal advice.

We have not verified the reliability or accuracy of any information obtained in the course of our work, other than in the limited circumstances set out in the scoping and purpose section of this report.

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

Complaints

If at any time you would like to discuss with us how our services can be improved or if you have a complaint about them, you are invited to contact Hugh Harvie, who is the engagement leader for our services to Scottish Water, telephone 0131 527 6682 email: hugh.harvie@kpmg.co.uk who will try to resolve your complaint. If your problem is not resolved, you should contact Alex Sanderson, our Head of Audit in Scotland, either by writing to him at Saltire Court, 20 Castle Terrace, Edinburgh, EH1 2EG or by telephoning 0131 527 6720 or email to alex.sanderson@kpmg.co.uk. We will investigate any complaint promptly and do what we can to resolve the difficulties. After this, if you are still dissatisfied with how your complaint has been handled you can refer the matter to Russell Frith, Assistant Auditor General, Audit Scotland, 4th Floor, 102 West Port, Edinburgh, EH3 9DN.

Headlines

Financial statement audit



Materiality

Group materiality for planning purposes has been based on last year's expenditure and set at £9.5 million, which equates to 1% total expenditure. This materiality is within the expected range. We will review the level of materiality on receipt of draft accounts for 2017-18.

In line with the Code of Audit Practice, we are obliged to report uncorrected omissions or misstatements other than those which are 'clearly trivial' to those charged with governance and this has been set at £0.2 million.

Significant risks

Those risks requiring specific audit attention and procedures to address the likelihood of a material financial statement error have been identified as:

- management override of controls fraud risk (assumed risk per ISA 240);
- fraud risk from revenue recognition;
- capital additions;
- bad debt provision; and
- net pension liability.

Other areas of audit focus

Those risks with less likelihood of giving rise to a material error but which are nevertheless worthy of audit understanding have been identified as:

- profit recognition;
- income uncertainty provision;
- credit note provision; and
- consideration of going concern.

See pages 6 to 12 for more details.

Wider Scope and Best Value



Our work is conducted under the Code of Audit Practice issued by Audit Scotland. This requires auditors 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 are also required to consider Scottish Water's participation in the National Fraud Initiative and response to relevant national reports.

See page 13 for more details.

Logistics



Our team is:

- Hugh Harvie – Partner; and
- Michael Wilkie – Senior Manager.

Our work will be completed in four phases from August 2017 to September 2018 and our key deliverables are this audit strategy, report on interim financial statements and an annual audit report as outlined on **page 17**.

Scope of audit

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 period of appointment is 2016-17 to 2020-21, inclusive.

Purpose

This document summarises our responsibilities as external auditor for the year ending 31 March 2018 and our intended approach to issues impacting Scottish Water's activities in the year.

KPMG's planned audit work in 2017-18 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 2018 and of the income and expenditure of the group for the year then ended; and
 - have been prepared in accordance with IFRS as adopted by the European Union, as interpreted and adapted by the 2017-18 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.

Auditors and audited bodies' responsibilities are set out in Audit Scotland's Code of Audit Practice ('the Code'). This Code states the responsibilities in relation to:

- the financial statements;
- corporate governance and systems of internal control;
- prevention and detection of fraud and irregularities;
- standards of conduct and arrangements for the prevention and detection of bribery and corruption;
- arrangements for preparing and publishing statutory performance information;
- financial position; and
- Best Value, uses of resources and performance.

These responsibilities are outlined in appendix six.

Financial statements audit

Our financial statements audit work follows a four stage audit process, which is identified below. Appendix one provides more detail on the activities this includes. This report focuses on the planning stage of the audit. Our control evaluation will include a review of internal audit in line with the requirements of the Code and we will assess if we can place reliance on its work to support controls testing.



Other audit activities

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 interim financial statements.



Financial statements audit planning

Materiality

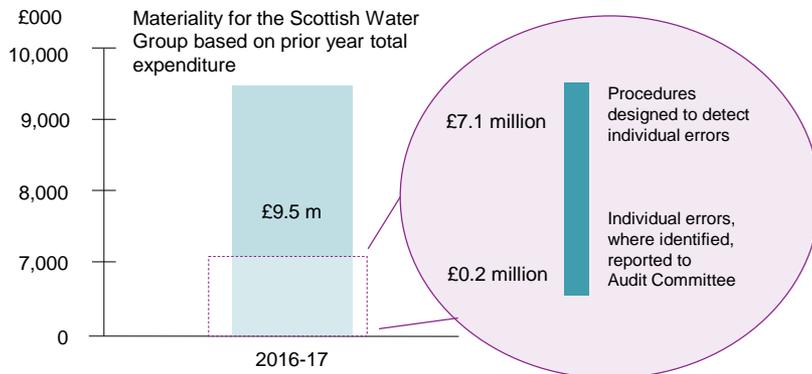
We are required to plan our audit to determine with reasonable confidence whether or not the financial statements are free from material misstatement. An omission or misstatement is regarded as material if it would reasonably influence the user of financial statements. This therefore involves an assessment of the qualitative and quantitative nature of omissions and misstatements.

Generally, we would not consider differences in opinion in respect of areas of judgement to represent 'misstatements' unless the application of that judgement results in a financial amount falling outside of a range which we consider to be acceptable.

Materiality for planning purposes has been set at £9.5 million for the group accounts, this equates to 1% total expenditure. We design our procedures to detect errors in specific accounts at a lower level of precision.

Reporting to the Audit Committee

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



Under ISA 260 (UK&I) 'Communication with those charged with governance', we are obliged to report uncorrected omissions or misstatements other than those which are 'clearly trivial' to those charged with governance. ISA 260 (UK&I) defines 'clearly trivial' as matters that are clearly inconsequential, whether taken individually or in aggregate and whether judged by any quantitative or qualitative criteria.

An individual difference is considered to be clearly trivial if it is less than £0.2 million.

If management has corrected material misstatements identified during the course of the audit, we will consider whether those corrections should be communicated to the Audit Committee to assist it in fulfilling its governance responsibilities.

Group audit

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

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

- final materiality in respect of each subsidiary (indicative below); and
- statutory reporting requirements.

| Entity | Performance materiality | Reporting threshold |
|---|-------------------------|---------------------|
| Scottish Water International Ltd | £22,000 | £1,500 |
| Scottish Water Horizons Ltd | £76,000 | £5,000 |
| Scottish Water Business Stream Holdings Ltd | £0.9m | £62,000 |
| Scottish Water Horizons Holdings Ltd | £1.2m | £80,000 |
| Scottish Water Solutions 2 Ltd | £0.2m | £12,000 |
| Scottish Water Business Stream | £0.5m | £35,000 |

Financial statements audit planning (continued)



Risk assessment: Our planning work takes place during August to September 2017. This involves: risk assessment; determining the materiality level; and issuing this audit plan to communicate our audit strategy. We use our knowledge of Scottish Water, discussions with management and review of committee papers to identify areas of risk and audit focus categorised into financial risks and wider dimension risks as set out in the Code.

| Significant risk | Why | Audit approach |
|--|--|--|
| Financial statement risks | | |
| Fraud risk from management override of controls | <i>Professional standards require us to communicate the fraud risk from management override of controls as a significant risk; as management is typically in a unique position to perpetrate fraud because of its ability to manipulate accounting records and prepare fraudulent financial statements by overriding controls that otherwise appear to be operating effectively.</i> | <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. — Strong oversight of finances by management provides additional review of potential material errors caused by management override of controls. — 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. |
| Fraud risk from income revenue recognition | <p><i>Professional standards require us to make a rebuttable presumption that the fraud risk from revenue recognition is a significant risk.</i></p> <p>Due to the reduction in customer base as more competitors enter the market and cost pressures on Business Stream, we have not rebutted this risk for this entity only.</p> <p>Additionally, accrued revenue is estimated based on historic data from past bills to create an expectation of the unbilled amount between the last bill and the year end. This introduces a further risk around 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"> — Assessing whether sales transactions either side of the balance sheet date as well as credit notes issued after year end are recognised in the correct period. — Testing of general IT controls of the HiAffinity billing system to ensure integrity of the automated billing system. — Considering the deferral of revenue recognised in respect of advanced billing to ensure this is appropriate. — Walkthrough of revenue accrued in respect of amounts not yet invoiced, including challenge of assumption used in estimating the unbilled portion of revenue at the year end. — Performing a reconciliation of revenue globally and by key customer account for the year. <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 revenue from individual local authorities. — For SW Horizons, revenue is recognised based on contract values. — For SW International, revenue relates to consultancy services with no complex recognition criteria expected. — For SW Solutions 2, management fee income is received for the delivery of the capital management programme for Scottish Water. |

Financial statements audit planning (continued)



| Significant risk | Why | Audit approach |
|----------------------------------|--|---|
| <p>Bad debt provision</p> | <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>As at 31 March 2017, the Scottish Water regulated business reported a household revenue debtor of £478.9m (2016: £459.2m) and a corresponding bad debt provision of £446.6m (2016: £431.4m) on household billings from all years dating back to 1996-97. Household water debt is a statutory debt recoverable from the occupier. The household billing and cash collection is performed by local authorities and cannot be influenced by Scottish Water.</p> <p>We note that there will be significant write-offs of household debt in the current year as Scottish Water aligns its reporting with council tax debt write-offs that councils have made. The impact will be on disclosure only as these debts have already been provided against by Scottish Water.</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 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, recorded by 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 2017-18, as recorded in Scottish Water's records, to confirmations received from individual local authorities. <p>Historical comparison</p> <ul style="list-style-type: none"> — We will compare the change in forecast collection rate in the current year, to the historical trend of increasing 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. |

Financial statements audit planning (continued)



| Significant risk | Why | Audit approach |
|--|--|---|
| <p>Capital additions (Scottish Water Company)</p> | <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>We understand the Shieldhall Tunnel contractor continues to face significant cost overruns, which it is trying to recover from Scottish Water. Judgement will be required to ensure that any such costs which are borne by Scottish Water as a result of a successful claim can be appropriately capitalised.</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 capital projects — Testing the design and operating effectiveness of controls in respect of the review of costs allocated to capital and revenue projects. <p>Control re-performance:</p> <ul style="list-style-type: none"> — Comparing the total capital expenditure reported in the financial statements with that reported in reports to those charged with governance. <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 capital or revenue accounting classification. — Assessment of the commercial position surrounding the Shieldhall Tunnel, including review of Counsel's opinion and consideration of the accounting position adopted. — Assessing a sample of items allocated to revenue expenditure to determine whether they are correctly classified. — Review of manual journals. |

Financial statements audit planning (continued)



| Significant risk | Why | Audit approach |
|-----------------------------------|--|---|
| <p>Retirement benefits</p> | <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 three local government defined benefit pension schemes; North East Scotland pension fund, the Lothian pension fund and the Strathclyde pension fund.</p> | <p>Our audit approach to IAS19 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 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. — Testing the assets recorded and disclosed using our actuary. |

Financial statements audit planning (continued)



| Other focus area | Why | Audit approach |
|--|--|---|
| <p>Purchase accounting (Scottish Water Business Stream)</p> | <p>Following the acquisition of the non-domestic business of Southern Water a purchase price allocation exercise will be required in order to ascertain the fair value of the assets and liabilities acquired, and any resulting goodwill.</p> <p>The key element of this is the valuation of the customer list acquired, which is a separately identifiable intangible assets. This will be calculated using a discounted cash flow model which will be based upon expected sales, less direct costs and incremental costs incurred with taking on the new customers, discounted at an appropriate rate.</p> <p>Amortisation of the customer list is judgemental being based upon the period of time over which the business is expected to benefit from this intangible.</p> <p>Any goodwill will be subject to an annual impairment review.</p> | <p>Our procedures include:</p> <p>Benchmarking assumptions</p> <ul style="list-style-type: none"> — Challenging the key assumptions applied in ascertaining the value of the customer list, specifically the discount rate, against externally derived data. <p>Sensitivity analysis</p> <ul style="list-style-type: none"> — Performing sensitivity analysis over both the discount rate and expected life of the customer list by increasing and decreasing each based upon our judgement and assessing the impact. <p>Tests of detail:</p> <ul style="list-style-type: none"> — Assessing the accuracy of the forecast data used in valuing the customer list to actual results post acquisition (sales, direct and incremental costs). — Comparing the expected customer attrition rate with that experienced in the period since acquisition to assess management's assessment of customer retention rates (ie the period over which the business is expected to benefit from this intangible). <p>Assessing transparency</p> <ul style="list-style-type: none"> — We will assess the disclosure of the transaction and relevant information surrounding the valuation sensitivities, in the financial statements |

Financial statements audit planning (continued)



| Other focus area | Why | Audit approach |
|--|---|---|
| <p>Income uncertainty provision</p> | <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 at 31 March 2017, the Scottish Water company income uncertainty provision was £13.5m (2015-16: £16.0m).</p> <p>There is an increase in the number of third party licensed providers supplying water and waste water retail services to business customers which contributes to increased uncertainty.</p> | <p>Our procedures included:</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. — 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. |
| <p>Credit note provision</p> | <p>There is a risk that credit notes will have to be issued due to previous billing inaccuracies. This is applicable to both Scottish Water (adjustments to household billings issued by Councils in respect of prior years) and Scottish Water Business Stream (relating to business customers).</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. — 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. |

Financial statements audit planning (continued)



| Other focus area | Why | Audit approach |
|---------------------------|--|--|
| Profit recognition | Scottish Water Horizons recognises revenue on construction activities based on the percentage completion method. As revenue is agreed on entering into the contract, there is a risk that the profit margin is not recognised consistently across the life of the project due to inaccurate budgeting with either too much or too little cost being released. | <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. |
| 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 & Ireland) 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>Our procedures include:</p> <ul style="list-style-type: none"> — reviewing cash flow forecasts; — reviewing the repayment profile for government borrowing and the external financing limited; — reviewing the regulatory delivery plan and business plan update and considering the associated economic assumptions against our commercial understanding. |

In accordance with paragraph 19A of ISA 700, we are required to describe 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, in our audit opinion. We have separately **identified those in bold the table opposite which we consider at planning to have the greatest effect on our approach and on which we will report in our opinion in the financial statements. We will update this assessment in our annual audit report.**

| Risk | SW | SW Business Stream | SW Horizons | SW International | SW Solutions 2 |
|---|----|--------------------|-------------|------------------|----------------|
| Fraud risk from management override of controls | ✓ | ✓ | ✓ | ✓ | ✓ |
| Fraud risk from income recognition | | ✓ | | | |
| Capital additions | ✓ | | | | |
| Bad debt provision | ✓ | ✓ | | | |
| Pension liability | ✓ | ✓ | | | |
| Profit recognition | | | ✓ | | |
| Acquisition accounting | | ✓ | | | |

Wider scope and Best Value



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 some of the areas we will consider as part of the wider scope requirements of our annual audit. We will provide narrative on these areas in the annual audit report.

| Risk | Why | Audit approach |
|--|---|--|
| Wider dimension risks | | |
| Financial sustainability and financial management | <p>Financial sustainability looks forward to the medium and longer term to consider whether Scottish Water is planning effectively to continue to deliver its services or the way in which they should be delivered.</p> <p>Financial management is concerned with financial capacity, sound budgetary processes and whether the control environment and internal controls are operating effectively.</p> | <ul style="list-style-type: none"> ■ We will consider Scottish Water's long term financial plans and its ability to adapt to the changing landscape in government funding. This will involve consideration of the 2018-19 budget and longer term financial plans from 2018-19 and beyond, including sensitivity analysis. ■ We will consider how the Scottish Water outperforms in respect of regulatory activities. ■ We will consider progress in forming the delivery plan for the next period from April 2021 and updates in respect of the current delivery plan period. ■ We will continue to consider the budget setting and monitoring process and participation in the National Fraud Initiative. |
| Governance and transparency | Governance and transparency is concerned with the effectiveness of scrutiny and governance arrangements, leadership and decision making, and transparent reporting of financial and performance information. | <ul style="list-style-type: none"> ■ We will consider the effectiveness of scrutiny and governance arrangements, by evaluating the challenge and transparency of the reporting of financial and performance information. ■ Our approach will include consideration of relevant internal audit reports and findings. |
| Value for money | Value for money is concerned with how effectively resources are used to provide services. | <ul style="list-style-type: none"> ■ We will specifically consider performance reporting and arrangements to provide for continuous improvement. ■ In the context of Scottish Water's capital plan and procurement procedures, we will consider the arrangements to provide for value for money. |



Appendices

Mandated communications with the Audit Committee

| Matters to be communicated | Link to Audit Committee papers |
|--|--|
| <ul style="list-style-type: none"> ■ Relationships that may bear on the firm's Independence and the integrity and objectivity of the audit engagement partner and audit staff (ISA 260 and Combined Code) | <ul style="list-style-type: none"> ■ See next page |
| <ul style="list-style-type: none"> ■ The general approach and overall scope of the audit, including levels of materiality, fraud risks, business risks and audit responses and engagement letter (ISA 260) | <ul style="list-style-type: none"> ■ Main body of this paper |
| <ul style="list-style-type: none"> ■ Disagreement with management about matters that, individually or in aggregate, could be significant to the entity's financial statements or the auditor's report (ISA 260) | <ul style="list-style-type: none"> ■ In the event of such matters of significance we expect to communicate with the Audit Committee throughout the year. ■ Formal reporting will be included in our annual audit report for the May 2018 Audit Committee meeting, which focuses on the financial statements. |
| <ul style="list-style-type: none"> ■ The potential effect on the financial statements of any material risks and exposures, such as pending litigation, that are required to be disclosed in the financial statements (ISA 260) | |
| <ul style="list-style-type: none"> ■ Audit adjustments, whether or not recorded by the entity that have, or could have, a material effect on the entity's financial statements (ISA 260) | |
| <ul style="list-style-type: none"> ■ The selection of, or changes in, significant accounting policies and practices that have, or could have, a material effect on the entity's financial statements (ISA 260) | |
| <ul style="list-style-type: none"> ■ The auditor's view on valuations and related disclosures (ISA 260) | |
| <ul style="list-style-type: none"> ■ Material uncertainties related to events and conditions that may cast significant doubt on the entity's ability to continue as a going concern (ISA 260) | |
| <ul style="list-style-type: none"> ■ Expected modifications to the auditor's report (ISA 260) | |
| <ul style="list-style-type: none"> ■ Other matters warranting attention by those charged with governance, such as effectiveness of internal controls relevant to financial reporting, material weaknesses in internal control, questions regarding management integrity, and fraud involving management (ISA 260 and ISA 240) | |

Auditor 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 judgements made about threats to objectivity and independence and the appropriateness of safeguards put in place.

General procedures to safeguard independence and objectivity

KPMG LLP is committed to being and being seen to be independent. As part of our ethics and independence policies, all KPMG LLP partners and staff annually confirm their compliance with our ethics and independence policies and procedures including in particular that they have no prohibited shareholdings. Our ethics and independence policies and procedures are fully consistent with the requirements of the 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 charged by us for the period ended 31 March 2017 can be analysed as follows:

| Services provided to the Scottish Water and its group in respect of: | 2016-17 (ex VAT) |
|--|------------------|
| Audit of the financial statements | 244,517 |
| Total non-audit services | 28,500 |
| Total | 278,098 |

The ratio of non-audit fees to audit fees for the year was 0.1:1. 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.

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.

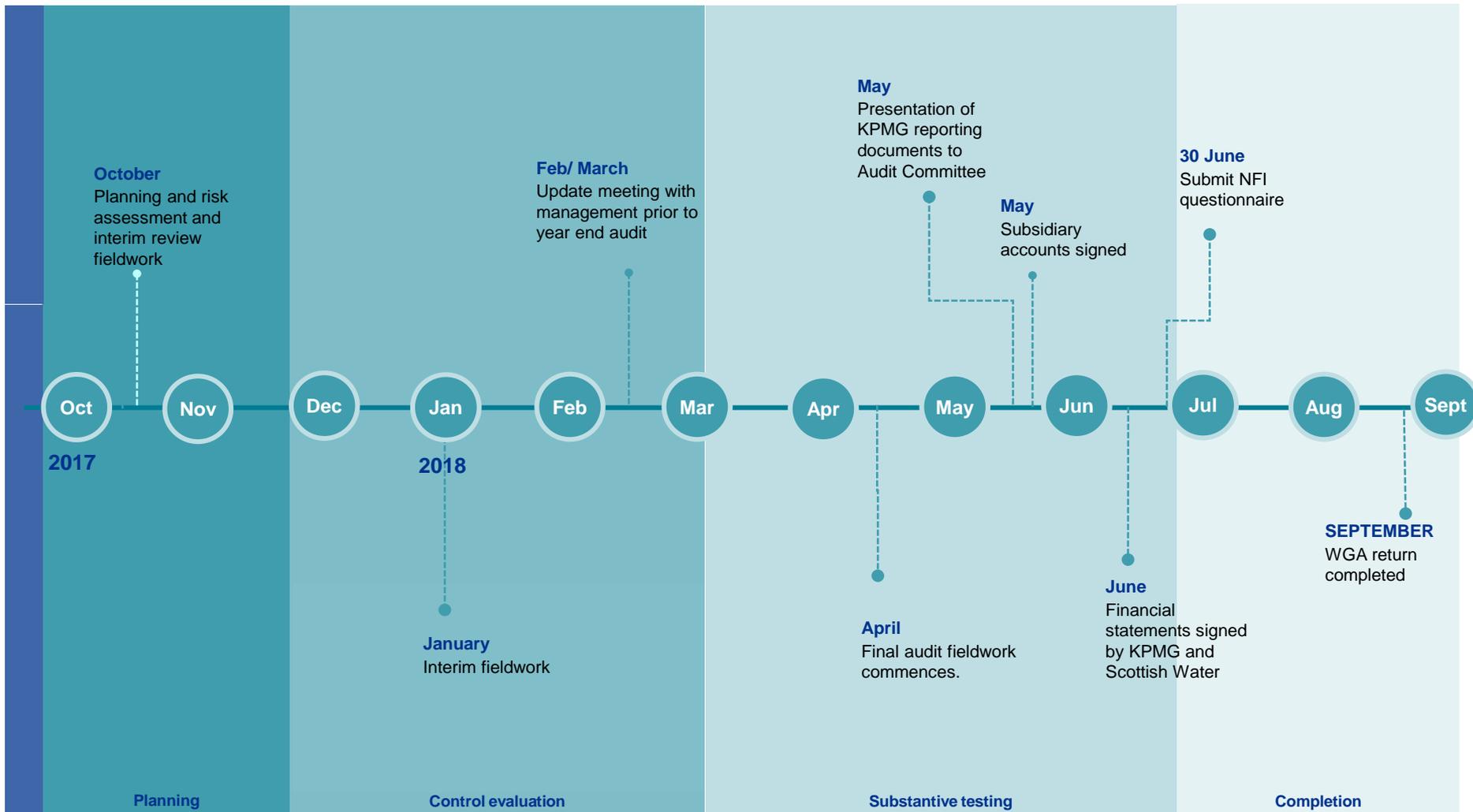
This report is intended solely for the information of the Audit Committee of Scottish Water and should not be used for any other purposes.

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

Timeline



Fees

Audit Scotland has yet to communicate the indicative fee range for 2017-18.

An expected fee is calculated by Audit Scotland to each entity within its remit. This expected fee is made up of four elements:

- Auditor remuneration
- Pooled costs
- Contribution to Audit Scotland’s Performance Audit and Best Value team
- Contribution to Audit Scotland costs

The expected fee for each body assumes that it has sound governance arrangements in place and operating effectively throughout the year, prepares comprehensive and accurate draft accounts and meets the agreed timetable for the audit.

We will discuss the proposed fees with management regarding the auditor remuneration for 2017-18. Should we be required to undertake significant additional audit work in respect of any of the areas of audit focus or other matters arise, we will discuss with management the impact of this on our proposed fee.

| Fees payable | 2017-18 £ (ex VAT) |
|---|-----------------------|
| Scottish Water | TBC |
| Scottish Water Business Stream | TBC |
| Scottish Water Interim Review | 14,500 |
| Scottish Water International Limited | 7,500 |
| Scottish Water Business Stream Holdings Limited | 3,600 |
| Scottish Water Solutions 2 Limited | 10,300 |
| Scottish Water Horizons Holdings Limited | 3,600 |
| Scottish Water Horizons Limited | 15,500 |
| Regulatory accounts | 14,000 |
| Total audit fees | TBC |

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 | KPMG's identification of fraud risk factors | KPMG's response to identified fraud risk factors | KPMG's identified fraud risk factors |
|--|---|--|--|
| <ul style="list-style-type: none"> ■ 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. ■ Disclose to Audit Committee and auditors: <ul style="list-style-type: none"> – any significant deficiencies in internal controls. – any fraud involving those with a significant role in internal controls. | <ul style="list-style-type: none"> ■ 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. ■ Evaluate broad programmes and controls that prevent, deter, and detect fraud. | <ul style="list-style-type: none"> ■ 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. ■ Communicate to Audit Committee and management. | <ul style="list-style-type: none"> ■ 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. <ul style="list-style-type: none"> – Revenue recognition – Cash – Procurement – Management control override – Assessment of the impact of identified fraud. |

Audit Scotland code of audit practice – responsibility of auditors and management

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 appropriate Council;
- 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.

Audit Scotland code of audit practice – responsibility of auditors and management

Responsibilities of management

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.

Audit Scotland code of audit practice – responsibility of auditors and management

Responsibilities of auditors

Appointed auditor responsibilities

Auditor responsibilities are derived from statute, this Code, International Standards on Auditing (UK and Ireland), 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.

Audit Scotland code of audit practice – responsibility of auditors and management

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| Responsibilities of auditors |
| 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. |
| 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. |

Audit Scotland code of audit practice – responsibility of auditors and management

| 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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