

members' report

The Members present their first annual report together with the audited financial statements for the year ended 31 March 2003.

TRANSFER OF UNDERTAKINGS, ASSETS AND LIABILITIES

The undertakings, assets and liabilities of the former North of Scotland Water Authority, East of Scotland Water Authority and West of Scotland Water Authority were transferred to Scottish Water on 1 April 2002 in terms of the Water Industry (Scotland) Act 2002. The closing reserves of the previous authorities were restated to reflect the harmonisation of accounting policy across Scottish Water and to incorporate the revised calculation of the closing deferred tax liability. See note 18.

ACCOUNTING REQUIREMENTS

The Financial Statements have been prepared in a form directed by Scottish Ministers in accordance with section 45(2) of the Water Industry (Scotland) Act 2002.

PRINCIPAL ACTIVITIES

Scottish Water's principal activities during the year were the supply of water and waste water services to around 5 million customers in homes and businesses across Scotland covering an area of 30,410 square miles.

Scottish Water also performed a number of related but non-core operating activities, which fall outside the range of services that it is legally obliged to provide.

A review of the business and future developments for Scottish Water are presented in the Chair's Statement on page 3, the Chief Executive's Statement on page 5 and in the Operating and Financial Review on pages 8 to 28.

MEMBERS

The Chair and other Non Executive Members are appointed by Scottish Ministers. Executive Members are appointed by Scottish Water after receiving consent to the appointment from Scottish Ministers. The Members as at the date of the Annual Report and their biographies are set out on pages 29 to 32.

MEMBERS AND THEIR INTERESTS

All members have declared that they had no material interests in any contracts awarded during the year by Scottish Water. A register of members' interests is maintained at Scottish Water's head office and is open for inspection during normal office hours.

RESULTS

The surplus for the year, after taxation amounted to £34.9 million. Details of the financial results and associated accounting policies are set out on pages 41 to 56 and a review of the year's performance is included in the Operating and Financial Review on pages 8 to 28.

RESEARCH AND DEVELOPMENT

To ensure that Scottish Water derives benefit from the most up-to-date research being undertaken within the industry, research expenditure is targeted towards collaborative research with other water operators and regulators within the UK. This ensures that access is gained to high value, widely based research programmes in the Environmental, Quality, Engineering, Operational and Regulatory fields. Research into issues common to the UK water industry is procured through membership of the UK Water Industry Research Centre and the Foundation of Water Research.

POLITICAL AND CHARITABLE CONTRIBUTIONS

No political or charitable contributions were made during the year. Scottish Water supports WaterAid, a charity founded by the UK water industry which raises funds for water related projects overseas. Employees represent Scottish Water on regional fundraising committees, which are periodically provided with facilities and other incidental support.

EMPLOYEE RELATIONS AND INVOLVEMENT

Scottish Water employed an average of 5,007 staff during the year, details of the costs incurred in relation to these staff can be found in note 5 to the financial statements on page 49. Scottish Water is committed to a policy of equal opportunities for all employees irrespective of race, religion, sex, disability or age.

Scottish Water has established a number of innovative forum designed to encourage employee involvement and interest to develop their awareness of the business aims and objectives. Employees are kept involved through a process of regular team meetings, employee newsletters and representation on the Scottish Water and Business Unit Councils. These facilitate a partnership approach to the development of Scottish Water and associated employee relations issues.

Scottish Water is committed to continually improving its performance in relation to Health and Safety. Through an extensive safety awareness campaign, safety briefings and ongoing training, awareness of health and safety issues is being increased amongst employees.

PAYMENT OF SUPPLIERS

Scottish Water agrees terms and conditions with suppliers before business takes place. Provided that all trading terms and conditions have been complied with, it is Scottish Water's policy and practice to pay agreed invoices in accordance with the terms of payment. At the 31 March 2003, the amount owed to trade creditors was equivalent to 30 days of purchases from suppliers.

AUDITORS

KPMG LLP chartered accountants and registered auditor were appointed as auditors by the Auditor General for Scotland in accordance with the Public Finance and Accountability (Scotland) Act 2000.

corporate governance

Scottish Water is committed to the principles of good governance and the code of best practice with regard to corporate governance. The members of Scottish Water's Board are accountable to the Scottish Executive through the Scottish Water (Corporate Governance) etc. Directions 2002. This statement describes how the members comply with the requirements of the above Direction and the provisions set out in the Combined Code (section 1) of the listing rules of the Financial Services Authority.

COMPLIANCE

As a new business that commenced operation on 1 April 2002, Scottish Water developed arrangements during the year to comply with:

- a) The Scottish Water (Corporate Governance) etc. Directions 2002; and
- b) The relevant sections of the Combined Code of Corporate Governance as set out in the listing rules of the Financial Services Authority.

The members confirm that following implementation of those arrangements and up to the date of approval of the Annual Report and financial statements, Scottish Water complied with the above requirements.

THE MEMBERS OF THE BOARD

The Board of Scottish Water comprises 12 members, 7 non-executive board members and 5 executive Board members (see members biographies on pages 29 to 32). The Board has a formal schedule of matters specifically reserved to it for decision making. Reporting to the Board are the Chief Executive and the Executive Members who have responsibility for the management of Scottish Water, and the three Board Committees detailed below.

In accordance with the best practice recommended by the Cadbury Committee, there is a clear division of responsibilities between the Chair and the Chief Executive. Scottish Water also benefits from the expertise of its non-executive members whose range of experience brings independent judgement on issues of strategy and performance, which are vital to the success of Scottish Water.

During the year, the Board met on 11 occasions to review Scottish Water's operational and financial performance, business strategy and risk management.

BOARD COMMITTEES

REMUNERATION COMMITTEE

The Remuneration Committee which is chaired by a non-executive member, Mr Graeme Crombie, comprises three other non-executive members: Mr Bill Cameron, Professor Paul Jowitt and Ms Rita Theil.

The Committee, in accordance with requirements of the Corporate Governance Direction, monitors the contract terms, remuneration and other benefits for each of the executive members, directors and senior managers including performance related bonus schemes. The committee met on 5 occasions during the year.

The committee has access to external independent advice as it sees fit.

AUDIT COMMITTEE

The Audit Committee, which is chaired by a non-executive member with a financial background, Mr David Gray, comprises three other non-executive Members: Mr Graeme Crombie, Professor Paul Jowitt and Mr Ian McMillan. The Committee met on 4 occasions during the year.

The Committee reviews the financial reports of Scottish Water and considers the results of the Auditors examination and review of the financial statements. It meets with management and with internal and external auditors to review the effectiveness of internal controls and business risk management. The Chair of the Audit Committee reports to the Board on internal control and risk management matters following each Audit Committee meeting.

COMMERCIAL COMMITTEE

The Commercial Committee which is chaired by a non-executive member, Mr Ian McMillan, comprises 3 other non-executive members: Mr David Gray, Mr Bill Cameron and Ms Rita Theil.

The Committee met on 5 occasions during the year to review commercial and property proposals and monitor performance thereon and reports to the Board on specific proposals.

INTERNAL CONTROL

The members of the Board recognise their responsibility for establishing, maintaining and reviewing the systems of internal control and risk management from both a financial and operational perspective. These systems are designed to manage, rather than eliminate, the risk of failure to achieve business and operational objectives and to provide reasonable, but not absolute, assurance against material misstatement or loss.

The systems of internal control are based on an ongoing process designed to identify those risks material to the achievement of Scottish Water's policies, aims and objectives, to evaluate those risks and to manage them effectively in accordance with good risk management practices. The risk management process has been in place for the full year under review and up to the date of approval of the Annual Report and financial statements.

CONTROL ENVIRONMENT

The Board maintains overall control over appropriate financial, operational and strategic issues.

Scottish Water operates within a broad strategic framework set by Scottish Ministers. Policies for delivering objectives are set out in the Strategic Business Plan, which details service and quality objectives, financial targets for both capital and revenue expenditure and charging proposals.

Scottish Water recognises the importance of fulfilling its social responsibilities. To this aim the Board has a Sustainable Development Policy that includes social, economic and environmental aspects.

Scottish Water has prepared and is consulting on a draft Consultation Code that will establish a framework for public consultation prior to undertaking significant activities.

High quality personnel are viewed as an essential part of the control environment. Ethical behaviour is incorporated into staff conditions of service and demanding recruitment criteria and a policy for the development and training of staff supports ethical standards.

CONTROL ACTIVITIES

Scottish Water's Internal Control Framework incorporates:

- Policymaking and strategic direction at board level. There is a formal schedule of matters reserved for decision by board members
- An organisational structure which clearly defines lines of authority and accountability
- A statement of general principles pertaining to rules and procedures for the regulation of the business
- Financial authority limits governing delegation of authority by the Board
- Regular review by the Board and management of service, quality and financial performance compared to plan
- Development of procedure manuals for staff instruction and guidance
- Project approval, monitoring and control processes specifically developed for capital expenditure
- High profile given by Board and management to Health & Safety issues

CONTROL EFFECTIVENESS REVIEW

Reviewing control effectiveness is a continuous process throughout the year. The Board gains assurance as to the effectiveness of internal control through a collaborative approach, based on the work of internal and external audit, other internal and external review agencies, and executive members' reports. The controls assurance process is co-ordinated by internal audit and is being further formalised to incorporate self-assessment by management, independent assessment by audit, and annual statements of assurance from senior management.

RISK MANAGEMENT

Scottish Water has established a Risk Policy that defines risk appetite and sets out a consistent approach to management of risk. The business identifies key risks at corporate and functional levels. Risks are evaluated by considering their consequences, in terms of impact and likelihood, on the achievement of service delivery and business objectives. Existing arrangements for managing the risks are considered and, where these are not perceived to be effective, action plans are drawn up which aim to achieve the right balance between risk and control.

Risk Management is closely linked to the Business Planning process in Scottish Water and this continues to develop in line with business needs. Escalation procedures are in place.

The risk register and risk management processes are reviewed annually by the Board.

INFORMATION AND COMMUNICATION

Scottish Water has developed an annual budgeting and financial reporting system that compares results with budget on a monthly basis, providing information for internal and external reporting. Key Performance Indicators have been established for non-financial performance and are reported regularly to the Board and to external regulators.

Scottish Water has an ongoing programme of developing systems to assist customer service and decision making in financial and operational areas of the business. The overall aim is to produce relevant, reliable and timely operational, financial, and compliance related information, consistent with the objectives of the business, to enable management to exercise effective control and direction.

Scottish Water recognises the critical role of IT in achieving business objectives and extends its corporate governance activities to IT governance through:

- aligning IT strategies with business strategies
- developing a strong internal control framework in IT to maintain systems integrity, availability and confidentiality
- giving a high profile to IT security

INDEPENDENCE OF AUDITORS

The Auditor General for Scotland is responsible to the Scottish Parliament for securing the audit of the financial statements of Scottish Water. For 2002/03 to 2005/06, the Auditor General appointed KPMG LLP as the auditors of Scottish Water.

Under the terms of KPMG LLP's appointment, they may not carry out any non-audit work for Scottish Water without the prior approval of Audit Scotland.

members' remuneration report

Since 1st January, 2003, quoted companies have been required to include in their Annual Report a Directors' Remuneration Report with specified contents. Despite the fact that Scottish Water is not a quoted company, the Members of Scottish Water have approved this report. The report follows the format and content required of quoted companies, where that is not possible, it is explicitly noted.

1 REMUNERATION COMMITTEE

Membership

For the whole of the Financial Year under review, the Remuneration Committee has consisted of:

Mr Graeme Crombie	(Chair of the Committee, Non-Executive Member)
Prof Paul Jowitt	(Non-Executive Member)
Ms Rita Theil	(Non-Executive Member)
Mr Bill Cameron	(Non-Executive Member)

Advisors to the Committee

During the year advice has been provided by Hay Group Management Limited. The consultancy was appointed by the Remuneration Committee in October, 2002.

2 GENERAL REMUNERATION POLICY

Scottish Water considers staff remuneration to be a major contributor to achieving success. To be a successful public sector business, Scottish Water must create a viable and successful water services business over the short to medium term in an increasingly competitive utilities market, where value for money is an imperative. Attainment of this ambition calls for profound and ongoing improvement in business performance requiring progressively more challenging efficiency frontiers to be realised through the endeavours of its people. Accordingly, Scottish Water must ensure its working environment matches the expectations it places on its people to deliver best value outcomes.

This requires terms of employment for all employees that together ensure Scottish Water is perceived as a fair employer that encourages and rewards productivity and empowerment as well as providing scope for personal development.

Scottish Water's overall remuneration policy aims are to:

- Attract, develop, motivate and keep talented people at all levels of the organisation
- Pay competitive salaries and benefits to all its people. When pay levels are set, account is taken of the work an employee does, what is paid in other organisations for similar work and how well Scottish Water is performing
- Incentivise and reward good individual performance in a remuneration structure that is seen as fair when viewed as a whole

3 POLICY ON EXECUTIVE MEMBERS' REMUNERATION

Comparator Organisations

Scottish Water is publicly owned, accountable to the Scottish Parliament and Scottish Ministers. However, it requires to attract, retain and motivate leadership talent in competition not just with other utilities, nor just with other organisations in the public sector, but with organisations all across the economy – as do other public sector organisations which have to operate commercially.

Scottish Water uses the remuneration database of Hay Group Management Ltd to determine the remuneration practices of industry in general. This is the largest remuneration database in the UK with each job subjected to the same method of job sizing.

Remuneration Elements

Scottish Water's Remuneration Policy for Executive Members consists of three principal elements:

- Base Salary
- Annual Incentive Scheme
- Pension

Relative Importance of Performance Related Elements

Scottish Water is a performance orientated organisation. It believes that Executive Members' remuneration should be closely related to performance – both corporate performance and individual performance.

The aim is to pay a base salary that is competitive and provide the opportunity for extra, discretionary pay to be earned for achievement against demanding targets.

The potential annual incentives attainable by the Executive Members range from 20-40% of base salary and are non-pensionable. Non Executive Members are not eligible for incentive payments.

Performance Conditions for Annual Incentives

For the 2002/03 financial year, performance targets against which potential bonus payments would be judged for each Executive Member were established by the Remuneration Committee in three areas. In two areas, performance was measured by team achievement and in one area, against individual goals. The areas together with the share of the overall bonus potential, were as follows:

• Operating expense reduction (Team)	50%
• Key performance indicator attainment (Team)	35%
• Personal objectives (Individual)	15%

Operating Expense Reduction

The bonus potential for reduction in operating expenses was based on efficiencies to be achieved versus the 2001/02 combined operating expenditure of the three previous authorities. The audited base operating expenditure achieved in 2002/03 was £330.8 million (an improvement of c. £30 million) attracting a 36.2% award against the 50% of total potential bonus attaching to this area.

Key Performance Indicators (KPI'S) Attainment

A set of KPI's (excluding operating expense reduction) were established in the areas of Customer Service, Asset Management and Quality, Safety & Environment and other Financial areas. The targets attaching to each of these KPI's required performance improvement over the previous authorities attainment and in line with progress towards the four-year performance improvement targets expected of Scottish Water by its regulators. Examples of the KPI's against which performance was tracked monthly over the year were: customer satisfaction rating; number of complaints; reduction in number of population affected by flooding; % bacteriological compliance of all regulatory samples; number of non compliant waste water treatment works; capital efficiency in the investment programme; overdue debtors; and health and safety performance. At the year-end 85% of the KPI targets had been met or exceeded. In assessing the overall balance of results, the Remuneration Committee awarded the team 22.75% versus the 35% of total potential bonus allocated to this area.

Individual Performance

Against a set of personal objectives set for each Executive Member to drive personal performance, awards were made within the range 9.75% to 12.0 % versus the 15% of potential bonus attaching to this area.

4 PERFORMANCE GRAPH

Scottish Water is not a quoted company. It is, therefore, not possible to include in this report one of the standard elements of Members' Remuneration Reports in quoted companies – a graph comparing total shareholder return on shares in the company against a broad equity market index over the latest five financial years.

5 SERVICE CONTRACTS

Details of Executive Members' contracts are set out below.

Executive Member	Name	Date of Contract	Unexpired Term	Notice Period
Chief Executive	Jon Hargreaves	19th March 02		
Asset Management Director	Geoff Aitkenhead	1st April 02	All Members have permanent contracts	All Members are required to give six months' notice of resignation. Scottish Water is required to give Members twelve months' notice of termination.
Finance Director	Douglas Millican	1st April 02		
Customer Service Director	Cheryl Black	1st April 02		
Commercial Director	Christopher Banks	1st April 02		

There are no provisions for pre-determined compensation in service contracts. In the event of the termination of any service contract or appointment, the Board would seek to ensure that legally appropriate mitigation factors would be applied to any compensation that may be payable.

6 MEMBERS' REMUNERATION (AUDITED INFORMATION)

Details of Members' Remuneration and other Directors, as defined in the Accounts Direction for 2002/03 by Scottish Ministers, are set out below for the year.

	Salary / fee £'000	Bonus £'000	Benefits £'000	Total excluding pension contributions £'000
Executive Members				
Jon Hargreaves	150	21	4	175
Geoff Aitkenhead	110	31	4	145
Christopher Banks	105	29	5	139
Cheryl Black	105	29	5	139
Douglas Millican	110	31	5	146
Non-Executive Members				
Professor Alan Alexander – Chair	70		5	75
William Cameron	18			18
Graeme Crombie	18			18
David Gray	18			18
Paul Jowitt	18			18
Ian McMillan	18			18
Rita Theil	18			18
Total Members Remuneration	758	141	28	927
Other Directors				
Mark Adderley	95	19	5	119
Paul Pagliari	100	21	5	126
Total	953	181	38	1,172

Notes: All Members were in post for the full financial year. Relocation costs of £40,640 have been charged and relate to the appointment of Christopher Banks (£22,648), Cheryl Black (£11,545) and Paul Pagliari (£6,447). These are not included in the above table.

7 OPTIONS ON SHARES

There are no shares in Scottish Water.

8 LONG TERM INCENTIVE SCHEME

There was no long-term incentive scheme in operation in 2002/03.

9 PENSION (AUDITED INFORMATION)

The Executive Members and other Directors participate in the Lothian Pension Fund – a defined benefit scheme. Details of their benefits under this scheme are set out below.

	Increase in accrued benefits during the year ended 31 March 2003 £'000		Total accrued benefits at 31 March 2003 £'000		Transfer Values (note 5) £'000		
	Pension	Lump Sum	Pension (note 3)	Lump Sum (note 3)	At 31 March 2003	At 1 April 2002	Increase in 2002/03 net of members own contributions
Jon Hargreaves	1	3	3	9	41	29	12
Mark Adderley	1	3	3	9	25	18	7
Geoff Aitkenhead	13	39	33	99	487	285	202
Douglas Millican	2	6	12	36	125	97	28
Cheryl Black	1	3	2	6	21	14	7
Christopher Banks	1	3	1	3	13	7	6
Paul Pagliari	1	3	1	3	14	8	6

Notes:

- (1) Members of the pension scheme have the option to pay additional voluntary contributions; neither the contributions nor the resulting benefits are included in the above table.
- (2) The normal retirement age of Executive Members is 65.

- (3) The pension entitlement shown is that which would be paid annually on retirement along with the lump sum, based on service to the end of the year.
- (4) The increase in accrued pension, lump sum and transfer value during the year excludes any increase for inflation.
- (5) The transfer value of accrued pension is calculated in a manner consistent with Actuarial Guidance Note GN11.
- (6) Professor Alan Alexander, the Chair of Scottish Water, does not participate in the pension scheme but Scottish Water does contribute to a private money purchase scheme for him. For 2002/03 the contribution was £11k and represented 15.9% of his fee, the same employer contribution rate for members of the Lothian Pension Fund.
- (7) In addition to the above Dr Hargreaves will receive an additional lump sum from a top-up arrangement of £72k payable at age 62, an increase in the year of £40k.
- (8) On death, a spouse's pension is payable equal to one half of the members pension and children's pension may also be payable.
- (9) With the exception of Mr Aitkenhead (due to his period of membership of the pension scheme) retirement benefits are restricted to the Inland Revenue earnings cap of £97,200 pa. Scottish Water does not contribute to unfunded retirement benefits for salary above the Inland Revenue cap.

10 PROVISION OF CARS (AUDITED INFORMATION)

A car or a car allowance is provided to all Executive Members for business needs. The associated benefit is included in the table of members' remuneration above.

statement of members' responsibilities for the preparation of the financial statements

The following statement, which should be read in conjunction with the statement of auditors' responsibilities included in the Auditors' Report below, is made with a view to distinguishing the respective responsibilities of the Members and of the auditors in relation to the financial statements.

The Members are required by the Water Industry (Scotland) Act 2002 and directions made thereunder to prepare financial statements for each financial year which give a true and fair view of the state of affairs of Scottish Water and of its income and expenditure for that period. In preparing those financial statements, the Members are required to:

- select suitable accounting policies and then apply them consistently;
- make judgements and estimates that are reasonable and prudent;
- state whether applicable accounting standards have been followed, subject to any material departures disclosed and explained in the financial statements; and
- prepare the financial statements on a going concern basis unless it is inappropriate to do so.

The Members are responsible for keeping proper accounting records, which disclose with reasonable accuracy, at any time, the financial position of Scottish Water and to enable them to ensure that the financial statements comply with statute and any financial reporting requirements. They are also responsible for taking reasonable steps to safeguard the assets of the business and to prevent and detect fraud and other irregularities.

independent auditors' report to the members of the Board of Scottish Water, the Scottish Parliament and the Auditor General for Scotland

We have audited the financial statements on pages 43 to 56 under the Water Industry (Scotland) Act 2002. The financial statements have been prepared under the historical cost convention and in accordance with the accounting policies set out on page 47. We have also audited the information in the Members' remuneration report that is described as having been audited.

This report is made solely to the members of the Board of Scottish Water and to the Auditor General for Scotland, in accordance with sections 21 and 22 of the Public Finance and Accountability (Scotland) Act 2000. Our audit work has been undertaken so that we might state to those two parties those matters we are required to state to them in an auditor's report and for no other purpose. In accordance with the Statement of Responsibilities of Auditors and of Audited Bodies prepared by Audit Scotland, this report is also made to the Scottish Parliament, as a body. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the members of the Board of Scottish Water and the Auditor General for Scotland, for our audit work, for this report, or for the opinions we have formed.

RESPECTIVE RESPONSIBILITIES OF THE BOARD MEMBERS, ACCOUNTABLE OFFICER AND AUDITORS

As described on page 41 the Board and the Accountable Officer are responsible for the preparation of the financial statements in accordance with the Water Industry (Scotland) Act 2002 and directions made thereunder and for ensuring the regularity of expenditure and income. Our responsibilities, as independent auditors, are established by the Public Finance and Accountability (Scotland) Act 2000 and the Code of Audit Practice approved by the Auditor General for Scotland, and guided by the auditing profession's ethical guidance.

We report to you our opinion as to whether the financial statements give a true and fair view and whether the financial statements and the part of the Members' Remuneration Report to be audited have been properly prepared in accordance with statute and whether, in all material respects, the expenditure and income shown in the financial statements have been incurred or applied in accordance with any applicable enactments and guidance issued by the Scottish Ministers. We also report if, in our opinion, the Members' Report is not consistent with the financial statements, if the Board has not kept proper accounting records or if we have not received all the information and explanations we require for our audit or if information specified by law regarding Members' remuneration and transactions with Scottish Water is not disclosed.

We review whether the Corporate Governance Statement on pages 35 to 36 reflects the Board's compliance with those provisions in the Combined Code as specified for our review in the Accounts Requirements. We report if, in our opinion, the statement does not comply with these provisions or if it is misleading or inconsistent with other information we are aware of from our audit. We are not required to consider whether the statement covers all risks and controls, or form an opinion on the effectiveness of the Board's corporate governance procedures or its risk and control procedures.

We read the other information contained in the Annual Report and the unaudited part of the Members' Remuneration Report and consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the financial statements.

BASIS OF AUDIT OPINIONS

We conducted our audit in accordance with the Public Finance and Accountability (Scotland) Act 2000 and the Code of Audit Practice, which requires compliance with relevant United Kingdom Auditing Standards issued by the Auditing Practices Board.

An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures and the regularity of the expenditure and income shown in the financial statements and the part of the Members' Remuneration Report to be audited. It also includes an assessment of the significant estimates and judgements made by the Board Members and Accountable Officer in the preparation of the financial statements and of whether the accounting policies are appropriate to Scottish Water's circumstances, consistently applied and adequately disclosed.

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the financial statements and the part of the Members' Remuneration Report to be audited are free from material misstatement, whether caused by fraud or other irregularity or error and that, in all material respects, the expenditure and income shown in the financial statements were incurred or applied in accordance with any applicable enactments and guidance issued by the Scottish Ministers. In forming our opinion, we also evaluated the overall adequacy of the presentation of information in the financial statements and the part of the Members' Remuneration Report to be audited.

OPINIONS

Financial statements

In our opinion the financial statements give a true and fair view of the state of affairs of Scottish Water as at 31 March 2003 and of its surplus and cash flows for the year then ended; and the financial statements and the part of the Remuneration Report to be audited have been properly prepared in accordance with the Water Industry (Scotland) Act 2002 and directions made thereunder.

Regularity

In our opinion, in all material respects, the expenditure and income shown in the financial statements were incurred or applied in accordance with any applicable enactments and guidance issued by the Scottish Ministers.

KPMG LLP

KPMG LLP
Chartered Accountants
Registered Auditor
18 June 2003

income and expenditure account

for the year ended 31 March 2003

	Notes	2003 £m
Turnover	2	895.3
Cost of sales		543.1
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Gross Surplus		352.2
Administrative expenses		138.6
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Operating surplus before exceptional items	2, 3	213.6
Exceptional items	4	24.6
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Operating surplus on ordinary activities before interest		189.0
Net interest payable	7	137.6
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Surplus on ordinary activities before taxation		51.4
Taxation	8	16.5
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Retained surplus for the financial year		34.9

statement of total recognised gains and losses

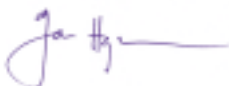
There are no recognised gains or losses other than the surplus for the year.

balance sheet

at 31 March 2003

	Notes	2003 £m
Fixed assets		
Tangible assets	9	2,437.3
Investments	10	0.1
Current assets		
Stocks	11	3.8
Debtors	12	201.6
Cash at bank and in hand		1.7
		<hr/> 207.1
Creditors: amounts falling due within one year	13	248.2
		<hr/> (41.1)
Net current liabilities		
		2,396.3
Total assets less current liabilities		
Creditors: amounts falling due after more than one year	14	68.6
Provisions for liabilities and charges		
Deferred taxation	15	21.4
Other provisions	16	67.0
		<hr/> 2,239.3
Net assets		
Capital and reserves		
Government loans	17	2,071.0
Other reserves	18	133.4
Income and expenditure account reserve		34.9
		<hr/> 2,239.3

These Financial statements were approved by the Board of Members on 18th June and signed on their behalf by



Dr Jon Hargreaves, Chief Executive
18 June 2003

notes to the cash flow statement

for the year ended 31 March 2003

(i) Reconciliation of operating surplus to net cash inflow from operating activities

	2003 £m
Operating surplus	213.6
Exceptional items charged	(24.6)
Depreciation of tangible fixed assets	105.1
Infrastructure maintenance charge	140.0
Amortisation of grants and PFI assets	1.2
Surplus on disposal of tangible fixed assets	(0.8)
Decrease in debtors	6.2
Decrease in stocks	0.1
Increase in creditors	25.3
Decrease in provisions	(14.4)
Net cash inflow from operating activities	451.7

(ii) Returns on investment and servicing of finance

	2003 £m
Interest received	0.7
Interest paid	(139.0)
Net cash outflow from returns on investments and servicing of finance	(138.3)

(iii) Financing

	2003 £m
Borrowings due within one year - repayment of loans	(205.5)
- increase in loans	191.0
Borrowings due after one year - repayment of loans	(74.4)
- increase in loans	140.0
Net cash inflow from financing	51.1

notes to the financial statements

for the year ended 31 March 2003

1. PRINCIPAL ACCOUNTING POLICIES

Basis of accounting

The financial statements have been prepared under the historical cost convention, in a form directed by Scottish Ministers in accordance with section 45(2) of the Water Industry (Scotland) Act 2002. The financial statements comply with all applicable United Kingdom accounting and financial reporting standards.

The principal accounting policies are summarised below and have been applied consistently.

Depreciation

Freehold land and assets under construction are not depreciated.

The infrastructure network which comprises a network of water and wastewater systems including mains, sewers, impounding and pumped raw water storage reservoirs, dams, sludge pipelines and sea outfalls are considered to have an infinite life. Expenditure to maintain the network infrastructure is dealt with under a renewals accounting approach whereby the annualised planned expenditure to maintain the operating capacity of this infrastructure is treated and charged as depreciation to the income and expenditure account. The actual expenditure incurred on infrastructure assets is capitalised, as is any expenditure that increases the capacity of the network.

Depreciation is provided on other tangible fixed assets to write-off cost, less residual values, on a straight-line basis over their estimated operational lives, from the date of beneficial use as follows:

	Years
Non operational buildings and structures	60
Specialised operational buildings and structures	20 to 60
Plant, machinery, vehicles and fencing	3 to 20
Fixtures and fittings, furniture and temporary buildings	5

The carrying values of tangible fixed assets are reviewed for impairment when events or changes in circumstances indicate that the carrying value may not be justified. The resulting impairment charge is included within depreciation.

Capital grants and customer contributions

Capital grants and customer contributions in respect of infrastructure assets are deducted from the cost of the fixed asset. This treatment is not in accordance with the Companies Act 1985 but has been adopted to show a true and fair view since, as explained above, infrastructure assets have an infinite economic life and hence no basis exists on which to recognise such contributions as deferred income. Grants and contributions received in respect of non-infrastructure assets are credited to deferred income and are released to the income and expenditure account over the expected useful lives of the relevant fixed assets.

Stock provisioning

Stocks and work in progress are stated at the lower of cost or net realisable value. Cost includes all costs incurred in bringing each asset to its present location and condition. The valuation of work in progress is based on the cost of labour and materials plus appropriate overheads.

Income recognition

Turnover comprises charges to customers for water and wastewater services, excluding value added tax. For measured customers, turnover includes an estimate of the value of water and wastewater services supplied to customers between the date of the last meter reading and the year-end. For unmeasured customers billed in advance, income is deferred and released to the income and expenditure account throughout the year.

Leased assets

Rentals payable under operating leases are charged to the income and expenditure account over the term of the lease on a straight-line basis. Scottish Water has no amounts due under finance leases.

Private Finance Initiative (PFI) costs

All costs incurred in relation to the development of PFI schemes are charged to the income and expenditure account as incurred. However, costs relating to other tangible fixed assets belonging to Scottish Water and transferred to the PFI operator are treated as a debtor and amortised over the length of the service contract. PFI land transferred to the operator is not amortised. Rental costs arising under PFI operating leases are expensed to the income and expenditure account over the terms of the lease.

Research and development costs

Research and development expenditure is charged to the income and expenditure account in the year in which it is incurred.

Indebtedness to the Scottish Ministers and other long term loans

Loans from the National Loans Fund, the Scottish Consolidated Fund and other Government borrowings are treated as part of capital and reserves, including loan repayments due within one year.

Overdrafts and temporary loans where the period of repayment is less than 365 days are included under current liabilities.

Derivatives and financial instruments

Scottish Water's financial instruments comprise borrowing, some cash and liquid resources, and various items such as debtors and creditors that arise directly from operations.

Scottish Water's policy is not to trade or speculate in financial instruments. All treasury activities are undertaken in accordance with the permitted activities as set out in the Delegated Limits Direction made under the Water Industry (Scotland) Act 2002.

Taxation

Deferred tax is recognised in respect of all timing differences, which have originated but not reversed at the balance sheet date, subject to certain exceptions. Deferred tax assets are recognised to the extent that they are recoverable.

Pensions

Employees of Scottish Water participate in the Local Government Pension Scheme administered by Aberdeen, Glasgow and Edinburgh City Councils. Contributions to these funds are charged to the income and expenditure account in order to spread the cost of pensions over the average service lives of employees. The contributions are determined by a qualified actuary on the basis of triennial valuations. The capital cost of ex gratia and supplementary pensions is charged to the income and expenditure account in the accounting period in which they are granted.

2. TURNOVER AND SEGMENTAL ANALYSIS

All turnover and surplus before taxation arises from continuing operations within Great Britain.

Scottish Water's principal activity is the supply of water and wastewater services to household and business customers across Scotland. In view of the integrated nature of Scottish Water's operational activities, the financial statements include all of the costs of water and wastewater collection, treatment and distribution within cost of sales. An analysis of turnover, operating surplus and net assets by activity is provided below:

	Water £m	Wastewater £m	Other £m	Total £m
Turnover	421.6	452.9	20.8	895.3
Operating surplus before exceptional items	105.3	107.9	0.4	213.6
Net assets	1,058.1	1,413.1	4.2	2,475.4
Unallocated net liabilities				(236.1)
Net assets employed				2,239.3

Unallocated net liabilities include provisions, loans and accrual balances, which cannot be directly allocated to business segments.

Turnover includes £0.2m of revenue grants received from Scottish Ministers in respect of the current year.

3. OPERATING SURPLUS

Operating surplus is arrived at after charging/(crediting):

	2003 £m
Infrastructure maintenance charge	140.0
Depreciation of tangible fixed assets	105.1
PFI operating costs	
- service charges	92.8
- other	12.6
Operating lease rentals - hire of other assets	6.9
Amortisation of assets transferred to PFI service companies	1.6
Gain on sale of assets	(0.8)
Release of deferred income in relation to capital grants	(0.4)
Auditors remuneration	0.2
- audit services	
- others	0.1
Research and development expenditure	0.4

4. EXCEPTIONAL ITEMS

Exceptional costs charged to the income and expenditure account total £24.6m and relate to restructuring and transformation costs undertaken as part of the £200m Spend to Save programme allowed for by the Water Industry Commissioner for Scotland in the Strategic Review of Charges. These exceptional costs incurred during the year, include staff severance costs of £9.3m and £15.3m of other external and internal costs, predominantly IT related, associated with the fundamental restructuring and transformation of the business.

5. STAFF COSTS

	2003 £m
Wages and salaries	123.8
Social security costs	9.4
Pension costs (note 20)	13.0
	<hr/>
	146.2
Less: charged as capital expenditure	(26.9)
	<hr/>
	119.3
	<hr/>
The monthly average number of people (including executive and non-executive members) employed by Scottish Water during the year was 5,007:	
	2003
Water	2,735
Wastewater	2,190
Other	82
	<hr/>
	5,007
	<hr/>

The number of people employed at 31 March 2003 was 4,927.

6. MEMBERS' REMUNERATION

Information concerning Members' remuneration, incentive schemes and pensions is detailed in the Remuneration Report on pages 37 to 40. No member or director had, during the year or at the end of the year, any material interest in any contract of significance in relation to Scottish Water's business.

7. NET INTEREST PAYABLE

	2003 £m
Interest receivable	
Interest from short-term deposits	0.6
Other interest receivable	0.1
	<hr/>
	0.7
	<hr/>
Interest payable	
Government capital loans	130.5
Other loans	7.8
	<hr/>
	138.3
	<hr/>
Net interest payable	137.6
	<hr/>

8. TAXATION

Analysis of tax charge in the year	2003
	£m
Current tax : UK corporation tax on surplus for the year	-
Deferred tax : origination and reversal of timing difference	16.5
<hr/>	
Tax on surplus on ordinary activities	16.5
<hr/>	
Factors affecting current tax charge	2003
	£m
Tax on surplus on ordinary activities at standard UK corporation tax rate of 30%	15.4
Expenses not deductible for tax purposes	0.1
Increase in general provisions not deductible for tax purposes	20.9
Capital allowances in excess of depreciation	(55.4)
Gain on disposal of fixed assets and other non taxable income	0.4
Tax losses	18.6
<hr/>	
Current tax charge for the year	0
<hr/>	

9. TANGIBLE FIXED ASSETS

	Specialised operational properties & structures £m	Non- specialised operational properties £m	Infra- structure assets £m	Plant, machinery and vehicles £m	Assets in the course of construction £m	Total £m
Cost						
Inherited at 1 April 2002	1,519.9	52.7	878.1	264.6	336.8	3,052.1
Additions	-	-	-	-	369.7	369.7
Disposals	(6.1)	(1.6)	-	(2.0)	-	(9.7)
Transfers	45.5	2.8	134.6	61.6	(244.5)	-
At 31 March 2003	1,559.3	53.9	1,012.7	324.2	462.0	3,412.1
Depreciation						
Inherited At 1 April 2002	275.2	10.0	335.8	115.6	-	736.6
Charge for the year	60.8	1.6	140.0	42.7	-	245.1
Disposals	(5.0)	(0.1)	-	(1.8)	-	(6.9)
At 31 March 2003	331.0	11.5	475.8	156.5	-	974.8
Net Book Value						
At 31 March 2003	1,228.3	42.4	536.9	167.7	462.0	2,437.3
Net Book Value						
At 1 April 2002	1,244.7	42.7	542.3	149.0	336.8	2,315.5

All capital investment is recognised initially within assets in the course of construction. When assets are capable of performing the function for which they were constructed and come into beneficial use, they are reclassified and transferred from assets under construction to the appropriate fixed asset category.

The classification of inherited assets between categories was harmonised resulting in the opening costs and accumulated depreciation being restated across the asset categories above. In addition, the opening accumulated depreciation at 1 April 2002 was restated to reflect the harmonisation of asset lives. This resulted in a cumulative catch-up depreciation charge of £30.1m, the impact of which was charged to opening reserves (note 18).

£0.2m of capital grants were received during the year and credited to deferred income. These amounts will be released to the income and expenditure account over the expected useful lives of the relevant fixed assets. An analysis of the amounts received is provided below:

Source	Purpose	2003 £m
National Security Grant	Improvements to security at service reservoirs	0.2

10. INVESTMENTS

	2003 £m
At 31 March	0.1

Investments at cost represent 8% of unsecured loan stock and 38,792 £1 Ordinary 'A' shares in the Water Research Council plc, valued at £78k.

Scottish Water owns shares in nine companies, which did not trade during the year ended 31 March 2003. The companies' financial statements have not been consolidated as permitted by Section 229 of the Companies Act 1985, as they did not trade during the year and the issued share capital is immaterial.

11. STOCKS

	2003 £m
Raw materials and consumables	3.4
Work in progress: recoverable work	0.4
	3.8

12. DEBTORS

	2003 £m
Amounts falling due within one year:	
Trade debtors	100.0
Other debtors	19.3
Prepayments and accrued income	43.4
	162.7
Amounts falling due after more than one year:	
Other debtors	0.4
PFI assets transferred to service contractors	38.5
	201.6

13. CREDITORS: AMOUNTS FALLING DUE WITHIN ONE YEAR

	2003 £m
Non-government loans	25.6
Trade and capital creditors	85.7
Payments received in advance	8.2
Other taxes and social security	2.1
Other creditors	19.2
Accruals and other deferred income	107.4
	248.2

14. CREDITORS: AMOUNTS FALLING DUE AFTER MORE THAN ONE YEAR

	2003 £m
Non-government loans	54.2
Accruals and deferred income	14.4
	68.6

15. DEFERRED TAXATION

	2003 £m
Inherited at 1 April 2002	4.9
Deferred tax charged to the income and expenditure account	16.5
	21.4
Closing provision for deferred tax liability as at 31 March 2003	21.4
Analysed as follows:	
Accelerated capital allowances on fixed assets	146.4
Other timing differences	(64.2)
Tax losses carried forward	(60.8)
	21.4
Provision for deferred tax	21.4

16. PROVISIONS FOR LIABILITIES AND CHARGES

	Restructure £m	Others £m	Total 2003 £m
Inherited at 1 April 2002	77.8	3.6	81.4
Charged to income and expenditure account	9.3	-	9.3
Utilised during the year	(22.1)	-	(22.1)
Transfer to accruals	-	(1.6)	(1.6)
	65.0	2.0	67.0

The restructuring provision relates to expected costs associated with the continuing rationalisation of the business. The costs mainly comprise employee related costs, principally redundancy and early retirement costs. The majority of this expenditure is expected to be incurred over the next two years.

The other provision of £2.0m relates to onerous property rental costs, which will be utilised over the next eight years.

17. GOVERNMENT AND OTHER LOANS

Scottish Waters' borrowing powers are defined in Section 42 of the Water Industry (Scotland) Act 2002. The limit at 31 March 2003 on these powers was that total net new borrowings for the year ended 31 March 2003 should not exceed £60.6m. Net new government borrowings were £51.3m in the year.

At 31 March 2003 Scottish Water had outstanding debt on long term borrowings from Scottish Ministers of £2,071.0m. This consisted of £834.2m of debt issued prior to 1 April 1999 and £1,236.8m issued on or after that date. In addition Scottish Water had a committed bank overdraft facility of £40.0m which is guaranteed by Scottish Ministers.

Government loans, both short and long-term, are recorded on the balance sheet under Capital and Reserves in accordance with the Accounts Direction. Other debt is recorded under short and long-term creditors in accordance with the Companies Act.

Analysis of borrowings by type and maturity

	Up to 1 Year £m	1-2 Years £m	3-5 Years £m	6-10 Years £m	Over 10 Years £m	Total 2003 £m
Scottish Consolidated Fund	67.0	40.5	25.0	100.4	601.3	834.2
National Loans Fund	20.0	20.0	65.0	85.0	701.9	891.9
Public Works Loan Board	2.9	17.2	65.0	94.2	165.6	344.9
Total Government Loans	89.9	77.7	155.0	279.6	1,468.8	2,071.0
Other Loans	25.6	12.7	23.5	15.6	2.4	79.8
At 31 March 2003	115.5	90.4	178.5	295.2	1,471.2	2,150.8

Interest rate profile

The interest rate profile of total borrowings was as follows:

	Total £m	Floating rate £m	Fixed rate £m
At 31 March 2003	2,150.8	3.4	2,147.4

Fixed rate borrowings

	Weighted average interest rate %	Weighted average period for which rate is fixed Years
At 31 March 2003	6.45	16

Fair values

The table below sets out a comparison of the book and fair values of the loan debt.

	Book value £m	Fair value £m
At 31 March 2003	2,150.8	2,464.9

18. MOVEMENT IN OPENING RESERVES

The opening reserves inherited from the three previous water authorities have been restated to reflect:

- the harmonisation of asset lives across Scottish Water's non infrastructure assets which reduced the net book value of fixed assets by £30.1m; and
- a reduction in the inherited tax liability of £19.2m. This was determined following a detailed review on a Scottish Water basis, of the tax liabilities inherited from the three previous authorities and reflects the impact of the harmonisation of assets lives detailed above.

The net effect on opening reserves was as follows:

	£m
Closing reserves at 31 March 2002	144.3
Less the impact of harmonisation of asset lives	(30.1)
Plus reduction in prior year tax liability	19.2
Opening reserves at 1 April 2002	133.4

19. OBLIGATIONS UNDER LEASES

Scottish Water had no amounts due under finance leases.

Annual commitments under non-cancellable operating leases are as follows:

	Land and buildings £m	Others £m	PFI Schemes £m	Total £m
Operating leases which expire:				
Within one year	0.1	0.6	-	0.7
Between two and five years	0.2	2.7	-	2.9
After five years	1.8	-	117.7	119.5
As at 31 March 2003	2.1	3.3	117.7	123.1

PFI Schemes

As at 31 March 2003, there were 9 PFI contracts in operation with contract start dates ranging from December 1996 to October 2000 and contract end dates ranging from December 2021 to October 2040. The estimated capital value of these projects is £577m.

20. PENSIONS

Employees of Scottish Water participate in the Aberdeen City Council Pension Fund, the Lothian Pension Fund, and the Strathclyde Pension Fund, which are part of the Local Government Pension Scheme, a defined benefit scheme administered by Aberdeen, Edinburgh and Glasgow City Councils respectively. The three schemes are funded by the payment of contributions to the separately administered funds.

Pension costs are determined with the advice of independent qualified actuaries on the basis of triennial valuations using the projected unit method. The results of the most recent valuations, which were conducted as at 31 March 2002, were as follows:

	Aberdeen Pension Fund	Lothian Pension Fund	Strathclyde Pension Fund
Main assumptions:			
Investment return %	6.1	6.5	6.5
Rate of salary increase %	4.3	4.1	4.1
Inflation/Rate of pension increase %	2.8	2.6	2.6
Total market value of assets £m	1,138.2	1,783.8	6,039.2
Funding level as a % of fund liabilities	94.2	96.0	108.0

Pension costs for the year for each fund as a % of employees contributions, were 230%, 265% and 220% respectively.

Total pension costs for Scottish Water were £13.0m (note 5). The unpaid contributions outstanding at the year-end, included in other creditors (note 13) was £1.7m.

FRS 17 Retirement Benefits

The valuation used for FRS 17 disclosures has been based on an actuarial valuation as at March 2002 and updated at March 2003 by a qualified independent actuary to take account of the requirements of FRS 17.

The financial assumptions used to calculate scheme liabilities under FRS17 are:

	2003
	%
Rate of increase in pensionable salaries	4.0
Rate of increase in pensions payment	2.5
Discount rate	5.4
Inflation rate	2.5

Scottish Water's share of the assets in the schemes and the expected rate of return were:

	Long term rate of return	Value 2003 £m
Equities	8.0	270.8
Bonds	4.8	46.9
Property	6.0	37.5
Other	4.0	15.3
Total market value of assets		370.5
Present value of scheme liabilities		(578.4)
Gross deficit in the scheme		(207.9)
Related deferred tax asset		62.4
Net pension liability		(145.5)

The amount of this net pension liability would have a consequential effect on reserves.

Movement in the deficit during the year:

	2003 £m
Gross surplus in scheme at the beginning of year	2.3
Current service cost	(18.2)
Contributions paid	17.5
Other finance income (cost)	4.1
Actuarial loss	(213.6)
Gross deficit in the scheme at year end	(207.9)

If FRS 17 had been fully adopted in these financial statements the pension costs for defined benefit pension schemes would have been:

Analysis of other pension costs charged in arriving at operating surplus:	2003 £m
Current service cost	18.2
Past service costs which have been charged against the reorganisation provision	-
Curtailment and settlements which have been charged against the reorganisation provision	-
	18.2

Analysis of amounts included in other finance income (costs):	2003 £m
Expected return on pension scheme assets	32.2
Interest on pension scheme liabilities	(28.1)
	4.1

Analysis of amount recognised in statement of total recognised gains and losses:	2003 %	2003 £m
Difference between the expected and actual return on scheme assets		
Amount		(128.7)
Percentage of year end scheme assets	(34.7)	
Experienced gains/losses arising on scheme liabilities		
Amount		(62.7)
Percentage of present value of year end scheme liabilities	(10.8)	
Changes in assumptions underlying the present value of scheme liabilities		
Amount		(22.2)
Percentage of present value of year end scheme liabilities	(3.8)	
Total amount to be recognised in Statement of Total Recognised Gains & Losses being 36.9% of the present value of liabilities		(213.6)

21. CAPITAL COMMITMENTS

Amounts contracted for but not provided in the financial statements amounted to £158.6m.

22. CONTINGENT LIABILITIES

There are no material contingent liabilities.

23. RELATED PARTY TRANSACTIONS

Scottish Water is a public corporation of a trading nature sponsored by The Scottish Executive Environment and Rural Affairs Department (the 'Department'). In terms of Financial Reporting Standard 8 'Related Party Transactions', the Department is regarded as a related party. During the year Scottish Water has had various material transactions with the Department, with Local Authorities and with entities for which the Department is regarded as the parent.

24. ULTIMATE CONTROLLING BODY

Scottish Water is a public sector body, classified as a public corporation of a trading nature, and is answerable to the Scottish Parliament through Scottish Ministers.

25. CURRENT COST ACCOUNTS

Scottish Water is obliged under the Directions from Scottish Ministers under section 45(2) of the Water Industry (Scotland) Act 2002 to prepare accounts on a current cost basis. These are available on request from Scottish Water, Castle House, 6 Castle Drive, Carnegie Campus, Dunfermline, KY11 8GG.

compliance with government targets

a) RETURN ON CAPITAL

Scottish Water has a duty to discharge its functions with a view to achieving an operating surplus giving a return on its averaged deemed capital value for the year of not less than 6%. For this purpose, the operating surplus comprises the total of the current cost surplus for the year and all other gains and losses in respect of net operating assets, after the adjustment for inflation in respect of financial capital. The average deemed capital value for the year is determined as the deemed capital value at the beginning of the year together with the average level of investment in net operating assets made during the year.

	2003 £m
Current cost operating surplus for rate of return purposes (see Current Cost Accounts)	187.8
Average deemed capital value (see Current Cost Accounts)	2,588.6
Rate of return achieved	7.3%

b) SUFFICIENCY OF REVENUE

Scottish Water reported a surplus before tax of £51.4m for the year. The surplus before tax consisted of a trading surplus £76.0m before charging exceptional costs of £24.6m.

c) RESOURCE ACCOUNTING AND BUDGETARY TARGETS

Scottish Water is also subject to financial targets set by the Government as part of the resource accounting and budgetary approach to managing public finances. The target for Scottish Water in 2002/03 was to operate within a RAB score of £202.3m, being the excess of capitalised expenditure over surplus before interest and tax after adjustment for any gain on asset sales. Performance was £21.7m better than target at £180.6m.

direction by the scottish ministers in accordance with section 45(2) of the Water Industry (Scotland) Act 2002

1. The Report and Accounts which it is the duty of Scottish Water to prepare in respect of its financial year ending on 31 March 2003 and each subsequent financial year shall comprise:
 - 1.1. a foreword;
 - 1.2. an income and expenditure account;
 - 1.3. a statement of total recognised gains and losses;
 - 1.4. a balance sheet; and
 - 1.5. a cashflow statement.together with such further information as may be necessary to comply with this Direction.
2. The Report and Accounts referred to in paragraph 1 shall give a true and fair view of the income and expenditure and cash flows for the financial year, and of the state of affairs at the end of the financial year.
3. The Report and Accounts shall also meet in as far as they are appropriate:
 - 3.1. the accounting and disclosure requirements of the Companies Act 1985;
 - 3.2. generally accepted accounting practice including financial reporting standards issued by the Accounting Standards Board;
 - 3.3. the accounts disclosure requirements of paragraph 43 of Chapter 12 of the Listing Rules issued by the Financial Services Authority (formerly the London Stock Exchange);
 - 3.4. the accounting and disclosure requirements given in 'The Scottish Public Finance Manual' as amended or augmented from time to time; and
 - 3.5. the accounting and disclosure requirements contained in other guidance issued by the Scottish Ministers from time to time in respect of Accounts, which are required to give a true and fair view.
4. Clarification of the application of the accounting and disclosure requirements of the Companies Acts and financial reporting standards is given in Schedule 1 attached. Additional disclosure requirements are set out in Schedule 2 on page 60.
5. The Report and Accounts referred to in paragraph 1 shall be prepared under the historical cost convention.
6. The Report and Accounts shall reflect the transfer of the property and liabilities to Scottish Water from the new water and sewerage authorities in accordance with the guidance in Financial Reporting Standard 6 (FRS6) 'Acquisitions and Mergers'.
7. The foreword and balance sheet shall be signed by the Chief Executive of Scottish Water and dated.
8. The Report and Accounts shall be audited and laid before the Parliament not later than 6 months after the end of the financial year.
9. These requirements shall be reproduced as an appendix to the Report and Accounts.

schedule 1

Application of the accounting and disclosure requirements of the Companies Act 1985 and Accounting Standards

1. The income and expenditure account shall be prepared in accordance with profit and loss account format 1 set out in Schedule 4, Companies Act 1985.
2. The Report and Accounts need not include a 'Note of historical cost profits and losses' as required by Financial Reporting Standard 3.
3. The balance sheet shall be prepared in accordance with balance sheet format 1 set out in Schedule 4, Companies Act 1985.
4. The balance sheet shall include indebtedness to the Scottish Ministers under the heading 'capital and reserves'. The notes thereto shall show separately any amounts falling due for payment within 12 months of the date of the balance sheet.
5. Grants and contributions in respect of expenditure on fixed assets shall be treated as deferred income and recognised in the income and expenditure account over the expected useful lives of the related assets, except that grants and contributions specifically relating to infrastructure assets shall be deducted from the cost of those assets.
6. The Accounts' presentation and disclosure exemptions permitted by the Companies Act 1985 shall not apply unless specifically approved by the Scottish Ministers.

schedule 2

Additional disclosure requirements

1. The notes to the income and expenditure account shall disclose:
 - a) an analysis of turnover and operating surplus before interest and tax over the following activities – water, sewerage and other services;
 - b) in turnover, separately identified, the amount of revenue grants received from the Scottish Ministers and the source and authority for each grant, broken down between payments in respect of earlier years and the current year;
 - c) an analysis of the interest charge, showing separately the interest on capital loans.
2. The notes to the balance sheet shall disclose:
 - a) Scottish Water's maximum borrowing powers;
 - b) indebtedness to the Scottish Ministers, showing separately loans issued prior to 1 April 1999 and loans issued on and after that date, and other borrowings and showing when repayments are due;
 - c) an analysis of net assets over the activities set out in paragraph 1a) above; and
 - d) the amount, source and purpose of capital grants received and receivable.
3. The foreword to the Report and Accounts shall contain, insofar as it is appropriate:
 - a) a statement that the Accounts have been prepared in a form directed by Scottish Ministers in accordance with section 45(2) of the Water Industry (Scotland) Act 2002;
 - b) a brief history of Scottish Water and its statutory background;
 - c) a statement confirming compliance by Scottish Water with any Directions, requirements and guidance issued by the Scottish Ministers insofar as such matters relate to the functions of Scottish Water;
 - d) a statement of Scottish Waters Members' responsibilities in respect of the preparation of the Report and Accounts;
 - e) the information required by the Companies Act 1985 to be included in the directors report; and
 - f) a discussion and analysis of Scottish Water's performance and the factors underlying its results and financial position, having regard to the guidance in the Statement 'Operating and Financial Review' published by the Accounting Standards Board.
4. The notes to the Report and Accounts shall include:
 - a) an explanation of the circumstances surrounding, and the mechanisms used to effect, the transfer of the business from any predecessor body to Scottish Water;
 - b) an analysis of operating costs and assets having regard to prevailing practice in the water industry;
 - c) details of Scottish Waters members' and senior employees' remuneration in accordance with the guidance contained in the Resource Accounting Manual published by HM Treasury for the financial year, except that the amounts disclosed should be to the nearest £'000 and not in bands;
 - d) a statement of the achieved rate of return earned by Scottish Water in accordance with the Scottish Water (Rate of Return) (Scotland) Order 2002 together with an explanation of the manner in which the return has been computed; and.
 - e) a comparison of Scottish Water's financial targets set for a financial year by the Scottish Ministers with the outturn for that year.
5. Notwithstanding the requirements relating to corporate governance contained in paragraph 12.43 of the Listing Rules issued by the Financial Services Authority referred to above, the Report and Accounts shall also include such additional disclosures relating to corporate governance as may be required by any Directions or guidance issued by the Scottish Ministers from time to time.