

AUDIT AND RISK COMMITTEE REPORT



This report provides an insight into the committee’s activities in the past year, alongside its anticipated activities for the coming year.

2015/16 was the first full year since reclassification of Network Rail and becoming an arms’ length central government body. One of the effects of reclassification was an increase in public scrutiny of Network Rail and its spending, as its borrowing and debt are now included in measures of public sector borrowing and debt.

Supported by The National Audit Office (NAO), Comptroller and Auditor General (C&AG) was appointed as Network Rail’s independent auditor. He will also carry out value for money studies on the economy, efficiency and effectiveness of specific areas of Network Rail’s expenditure.

The chief executive was appointed as Network Rail’s accounting officer and is personally accountable to Parliament for safeguarding the public funds for which he has charge; for ensuring propriety, regularity, value for money and feasibility in the handling of those public funds; and for the day-to-day operations and management of Network Rail. To safeguard this appropriate and efficient spending, a core management assurance process has been introduced, requiring senior management to self-assess their compliance with legal and ethical requirements, Network Rail standards and policies and other management controls in their respective business units or functions. We reviewed the results of this compliance in great detail prior to submitting the results to the DfT. This focus on reviewing money efficiencies and internal core controls will continue to be key considerations of the committee during the coming year.

Rob Brighouse joined the committee in January 2016. Sharon Flood, Janis Kong and I look forward to working with him.

→ Further information on responsibilities and accountabilities of the Accounting Officer can be found on page 53.

Bridget Rosewell
Chair, audit and risk committee
30 June 2016

Committee members

Member	Date appointed to committee	Number of meetings attended
Bridget Rosewell*	July 2012	4/4
Sharon Flood**	September 2014	4/4
Janis Kong	January 2010	4/4
Rob Brighouse	January 2016	1/1

**Chair since September 2012*

***Sharon Flood has relevant financial experience having recently been a group chief financial officer of Sun European Partners LLP*

Committee attendees

The chair of the board, chief executive, chief financial officer, director, Risk and Assurance, and group general counsel and company secretary attend meetings of the committee by invitation. Representatives from the NAO also attend each meeting and periodically meet with the committee members without executive management present. Periodically the director, Risk and Assurance meets with the committee without executive management present.

Role of the committee

The role of the committee falls into the following broad areas:

Financial reporting

- Monitoring the integrity of the annual report and accounts of the company, major subsidiary undertakings and the group as a whole
- Reviewing significant accounting judgements and policies and compliance with accounting standards
- Considering whether the annual report and accounts is fair, balanced and understandable.

Internal controls

- Monitoring internal control systems and their effectiveness
- Compliance with the Code and other regulatory obligations.

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Risk management

- Reviewing Network Rail's risk management processes, risk identification and reporting any issues arising from such reviews to the board
- Making recommendations to the board on the level of risk appetite acceptable to Network Rail
- Reviewing the process undertaken and associated work required to complete the viability statement.

Internal audit

- Agreeing internal audit plans and reviewing reports of internal audit work
- Reviewing the effectiveness of the internal audit plans
- Implementation of actions from internal audits, and outstanding actions.

Independent auditor

- Overseeing the relationship with the National Audit Office as the independent auditor and C&AG.

Whistleblowing and fraud

- Reviewing the policy and procedures whereby employees can raise, in confidence, concerns about possible improprieties
- If required, reviewing reports of such incidents.

Following each meeting, the chair provides a summary of the committee's activities to the next board meeting and makes recommendations as appropriate.

→ The terms of reference of the committee can be found on our website: networkrail.co.uk

Principal activities during the year

Matters considered by the committee during the year included:

Internal controls and risk management

- Risk management reports, identifying high-level risks and the status of mitigation, current risk profile, changes to the risk profile during the year and the progress that has been made in mitigating the key strategic risks
- Risk reviews of the enhancement improvement programme, cyber security, critical resources, track renewals and information governance
- Regulatory escalator, a tool that captures and monitors issues of concern to the Office of Rail and Road (ORR).

→ Further information on Network Rail's internal control system can be found on pages 36-37.

Financial reporting

- Following reclassification, the C&AG was appointed as independent auditor of Network Rail Limited
- NAO's approach and scope of the audit work and the findings of their work
- The 2015/16 half-yearly report and full year financial statements with focus on the reporting judgements contained within them and the basis for preparing the accounts on a going concern basis
- The regulatory financial statements.

Internal audit

- The annual internal audit plan 2016
- The output from, and progress against, the internal audit plan
- Implementation of actions from internal audits, and review of outstanding and overdue actions.

Significant accounting judgements, key assumptions and estimates

With the support of the NAO, the committee assessed whether suitable accounting policies had been adopted, whether management had made appropriate estimates and judgements and disclosures were balanced and fair. The main areas of focus during the year are set out overleaf.

Appointment of the independent auditor

From 2010 to 2015, Pricewaterhouse Coopers LLP (PwC) acted as Network Rail's independent auditors. One impact of the reclassification of Network Rail as a central government body was the appointment of the C&AG as Network Rail's independent auditor, in line with standard arrangements for central government bodies. Supported by the NAO, C&AG operates independently to help Parliament scrutinise how public funds have been used in practice.

In May 2015, the NAO presented to a panel of management, the chair of the committee and an independent expert a proposal for the appointment of the C&AG. Following a further presentation to the committee, the committee recommended to the board that the C&AG be appointed as the independent auditor. The board agreed and the resolution for the C&AG's appointment was passed at the annual general meeting in September 2015.

In addition to providing an opinion on the group accounts, the C&AG also audits the individual accounts of Network Rail Infrastructure Finance PLC, Network Rail Infrastructure Limited and Network Rail (High Speed) Limited. PwC continue as the independent auditors for the remaining subsidiaries.

The committee has followed regulatory developments in relation to audit tendering and other audit and non-audit associated matters. In particular, it considered the Competition and Markets Authority (CMA) Order and its requirement for listed companies to undertake a competitive tender process prior to the appointment of the auditors.

As outlined above, Network Rail is required to appoint the C&AG. As such, the company is unable to comply with the CMA's Order requirements.

The committee is also aware that the authority for appointment, re-appointment and approval of the remuneration of independent auditors now rests with audit committees rather than boards. The committee has therefore recommended to the SoS to re-appoint C&AG as Network Rail's independent auditor.

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Accounting judgements	How the committee addressed these judgements
<p>Valuation of railway network and compliance with regulatory requirements</p> <p>The revaluation model used to measure the value of the railway network consists of a number of estimates and judgements made by Network Rail (for example anticipated financial and operational outperformance in the control period).</p>	<p>Detailed reports from management were considered by the committee and the methodology applied to the revaluation model was also reviewed and agreed.</p> <p>The committee also challenged management and the independent auditor on:</p> <ul style="list-style-type: none"> • The reasonableness of key judgements and estimates in respect of the forecast for the remainder of CP5. • The appropriate level of disclosures in the annual report and accounts around the valuation process and the related assumptions and judgements.
<p>Risk of management override of internal controls</p>	<p>Reports on management’s approach to implementing, operating and monitoring the system of internal control are considered by the committee on a regular basis. The committee considered a letter of responsibility from the chief executive regarding the standard of internal controls and integrity that has prevailed in the business during the financial year.</p> <p>The independent auditor has also focused attention on this area and provided satisfactory reporting to the committee on this matter.</p>
<p>Deferred tax</p> <p>It was considered there remains insufficient certainty with regard to when Network Rail can expect to use its brought forward tax losses.</p>	<p>Reports indicated that the reclassification of Network Rail as a public body, when taken together with continued high levels of investment in the railway network, meant that it was hard to judge that Network Rail would return within a predictable period to the level of taxable profits that would allow for the utilisation of tax losses. It was agreed to continue to derecognise deferred tax assets.</p>
<p>Valuation of investment properties</p> <p>Investment properties are stated at fair value. The valuations are based on assumptions and estimates that require judgement.</p>	<p>The committee agreed the appropriate methodology had been used. The methodology was consistent with prior years and included valuations and additional assistance from external valuation specialists. The valuations were reviewed by management and the external valuation specialists.</p>
<p>Hedge accounting and derivatives</p> <p>Forward starting interest rate swaps are accounted for as cash flow hedges where it is believed that future sterling issuances are highly probable.</p>	<p>The committee agreed with the assessment that it is highly probable that Network Rail will borrow more than required to utilise all the forward starting interest swaps. The borrowing agreement in place with the DfT is greater than the original value of the interest rate swaps. Network Rail’s CP5 capital investment programmes will use substantially all of the borrowing facility.</p>
<p>Pension assumptions</p> <p>The group operates defined benefit and defined contribution pension schemes. Valuation of these schemes is dependent on certain key assumptions and complex calculations. External actuaries are engaged to assist in advising on key assumptions and determining the value of the pension obligations.</p>	<p>The committee discussed the key assumptions, including the degree to which these were supported by professional advice from the actuaries. The independent auditor also focused attention on this area and provided reporting to the committee on this matter.</p>

Objectivity and independence of the independent auditor

The committee has put in place safeguards to maintain the independent auditor’s objectivity and independence.

To enhance independence and in line with established auditing standards, a new senior statutory auditor of the independent auditor is appointed every five years, with other key audit principals within that firm rotated every seven years.

The committee has also established a policy whereby employment of the independent auditor on work for the company is prohibited, other than for audit services or tax compliance services, without prior approval by the committee.

The committee is responsible for the oversight of compliance with the policy and considers any requests to use the independent auditor for non-audit work.

Such requests are now unlikely in practice as the NAO does not offer non-audit services. The NAO does carry out Value for Money work on Network Rail, but this does not represent a service to Network Rail as it is performed under statute and on behalf of Parliament.

In 2015/16 the fee for audit services was £0.5m (£0.7m in 2014/15). This includes the NAO’s cost of auditing Network Rail Infrastructure Limited, Network Rail Infrastructure Finance plc, Network Rail (High Speed) Ltd and the Regulatory Accounts, and excludes the cost of the audit of some smaller subsidiaries which continue to be performed by PwC.

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Internal Audit

The primary role of an Internal Audit function is to provide objective and independent assurance regarding the adequacy of the group's internal control framework and compliance with policies, laws and regulations. The work of Internal Audit is focused on the areas of priority as identified by risk and materiality analysis and is in accordance with an annual audit plan which is approved by the committee.

At each meeting, the Internal Audit function reports on its activities and on the results of the Internal Audit reports to the committee. In particular, the committee looks in detail at any unsatisfactory or unacceptable audit ratings and checks that the shortcomings are being investigated and timely remedial actions are undertaken.

Risk management

Whilst the ultimate responsibility for risk management rests with the board, it delegates the more detailed oversight of risk management to the committee which reports its findings to the board.

The Risk function reports on the risk management processes and effectiveness of those processes. Further, it reviews the group risk profile and any changes in the profile. Through the assessment and a review of the principal and specific risks, the Risk function identifies a group risk appetite and recommends its adoption to the board.

→ Further information on Network Rail's approach to risk management can be found on pages 36-43.

Speak Out

Network Rail's whistleblowing or 'Speak Out' policy and confidential reporting 'hotline' have been in place since 2012. Significant effort has gone into communicating both the policy and the reporting line to employees through a variety of channels including intranet stories, case studies, and most importantly, by training.

Company-wide ethics training was launched in October 2015 covering a number of key topics including whistleblowing. To date, almost 18,000 employees have been trained.

Usage of the Speak Out line has been consistently rising since implementation in 2012. 2015/16 saw 253 reports submitted to the line, which is a 23 percent increase on the previous year. Next year, due to the training and heightened awareness, call volumes are expected to increase further.

Network Rail is a signatory of Public Concern at Work's First 100 campaign. Their statutory Code of Practice supports whistleblowing arrangements for employers and employees. Being a signatory means Network Rail has agreed to abide by the principles set out in the Code of Practice and work towards compliance.

Viability statement

The committee also reviewed management's work undertaken in preparation of the viability statement, which can be found on page 43.

Fair, balanced and understandable

The committee acknowledges that, taken as a whole, the annual report and accounts needs to be 'fair, balanced and understandable' and needs to allow assessment of the group's performance and prospects. The committee advises the board on whether it believes that the annual report and accounts meets this requirement.

In order for the committee to make this assessment, it considers reports received from management during the year, monitoring financial performance, and at year end in support of the accounts. The committee also receives reports from the independent auditor on the findings of their annual audit. Formal review processes are in place to ensure the annual report and accounts is factually accurate.

The committee has considered whether the annual report and accounts for 2015/16 is fair, balanced and understandable and provides the information necessary for an informed reader to assess Network Rail's performance, business model and strategy.

The committee considered the following questions:

Is the annual report fair?

- Has the whole story been presented and has any sensitive information been omitted that should have been included?
- Is the messaging in the front-half of the annual report consistent with the financial disclosures?
- Is the scorecard disclosed at an appropriate level?

Is the annual report balanced?

- Is there an over-emphasis of matters that are not material?
- Is the narrative report in the strategic report consistent with the financial reporting in the accounts, and does the messaging reflected in each remain consistent when read independently of each other?
- Is there an appropriate balance between statutory and non-statutory measures and are non-statutory measures clearly defined?
- Are the risks in the narrative consistent with the committee's risks and issues and key areas of uncertainty and judgments?
- Are the key risks aligned with the audit report?

Is the annual report understandable?

- Is the document designed to suit the needs of the Secretary of State for Transport in its capacity as a member?
- Is the report understandable to a reasonably informed reader?
- Are new messages and themes clearly articulated?
- Has all undue complication been removed?

The committee considers that the annual report for 2015/16 is fair, balanced and understandable and allows assessment of Network Rail's performance and prospects.

CORPORATE GOVERNANCE REPORT CONTINUED

Planned activities for the coming year

During the coming year, the committee will remain focused on the audit, assurance and risk process within the business, and maintain its oversight of financial and other regulatory requirements.

Particular areas of focus for 2016/17 will include:

- Internal Audit and other assurance plans with particular focus on key strategic priorities and significant audit actions
- Integrity of internal controls including risk management
- Oversight of the specific business presentations relating to the most significant risks within the group's risk profile
- Monitoring and oversight of new accounting and regulatory developments.