



# Audit and risk committee report

I am pleased to present the committee’s report into the key activities undertaken during 2018/19, alongside its anticipated activities for 2019/20.

## Summary of work of the committee

During 2018/19 the committee continued to focus on the audit, assurance and risk management processes within the business, and maintained its oversight of financial and other regulatory requirements. There was particular focus on the significant and emerging risks facing the business, to enable the committee to better understand the areas of concern and provide assurance to the Board on the

effectiveness of the associated internal controls. These included deep dives on readiness for the December 2018 timetable change, continued scrutiny of timetable capability following the May 2018 timetable change and reviewing the introduction of a business controls framework to improve assurance activity across the group.

**Sharon Flood,**

Chair, audit and risk committee

15 July 2019

## Composition of the committee

The committee met four times during 2018/19. Members collectively have a broad range of financial, commercial, aviation/transport and rail sector expertise that enables them to provide effective oversight of financial, operational and risk matters and to advise the Board accordingly. All members of the committee are independent non-executive directors, and the chair has recent and relevant financial experience.

Committee members	Formal appointment to the committee	Number of meetings attended during the year
Sharon Flood	Sep 2014	4/4
Silla Maizey	Nov 2016	3/4
Bridget Rosewell CBE	Jul 2012	4/4
Rob Brighouse	Jan 2016	4/4

## Committee attendees

The chair of the Board, the chief executive, chief financial officer, director of risk and internal audit, group controller (finance), head of group risk and the group general counsel & company secretary attend meetings of the committee by invitation. Representatives from the National Audit Office (NAO) also attend each meeting and periodically meet with committee members without executive management present. Periodically the director of risk and assurance meets with the committee without executive management present.

## Role and responsibilities of the committee

The terms of reference govern the structure and operations of the audit and risk committee, including its delegated responsibilities and authority. The terms of reference are reviewed regularly to ensure the activities of the committee reflect current regulatory and governance requirements and best practice. The terms of reference can be found at [www.networkrail.co.uk](http://www.networkrail.co.uk)

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

#### Financial reporting

- Monitoring the integrity of the group's annual report and financial statements.
- Reviewing significant accounting judgements and policies and compliance with accounting standards.
- Reviewing the consistency of accounting policies both on a year-to-year basis and across the company; the methods used to account for significant or unusual transactions; applicable accounting standards followed or reconciled in the financial statements; and any other significant financial reporting judgements made by management.

#### Narrative reporting

- Considering whether the annual report and financial statements as a whole are fair, balanced and understandable.
- Providing information to shareholders to assess performance, business model and strategy.

#### Internal controls and compliance

- Reviewing the adequacy and effectiveness of financial reporting and internal control procedures.
- Reviewing and approving statements to be included in the annual report and financial statements.
- Reviewing compliance with statutory and regulatory requirements.
- Reviewing procedures for detecting fraud, malpractice and theft.
- Reviewing the adequacy and security of arrangements for employees and contractors to raise concerns.
- Reviewing systems and controls for preventing bribery.

#### Risk management

- Considering proposals for the level of risk appetite, tolerance and strategy, and reviewing the risk profile, current exposure and future strategy against the risk appetite.
- Considering management's report on potential major risks.
- Reviewing risk assessment processes, parameters and methodologies.
- Reviewing the capability to identify and manage new risk types.
- Reviewing the process undertaken and the associated work required to complete the viability statement.
- Considering the remit of the risk management function and to ensure its independence and adequate resourcing.
- Reviewing management's responsiveness to the risk findings and recommendations.
- Reviewing how risk mitigations and controls are tested.
- Advising the Board on the risk aspects of significant strategic transactions.

#### Internal audit function

- Reviewing the effectiveness of the internal audit function considering the need for independent reviews of its processes.
- Reviewing the internal audit programme and ensuring it is adequately resourced and is appropriately independent

from management.

- Reviewing internal audit reports on the effectiveness of systems for internal financial control, financial reporting and risk management.
- Reviewing and approving the internal audit plan.
- Considering major findings of internal investigations and management responses.

#### External audit

- Reviewing the nature and scope of the independent auditor, its approach, and the level of fees. Considering the results of external audit work and how any weaknesses are to be addressed.
- Approving the terms of engagement and reviewing the management letter and management's response.
- Reviewing wider implications of the external auditor's work across the company.
- Annually assessing and reporting to the Board on the independence and objectivity, expertise and resources of the independent auditor.

#### Complaints procedures

- Reviewing the procedures for dealing with complaints relating to accounting, internal audit controls, or auditing matters.

#### Cyber security

- Providing assurance that cyber risk is being appropriately managed.
- Annually reviewing cyber resilience.

Following each meeting, the chair provides a summary of the committee's activities, main discussion points and findings to the next Board meeting and makes recommendations as appropriate.

### Principal activities during the year

At each meeting the committee receives business updates from group finance, internal audit, group risk and the independent auditor. Updates are planned on a 12-monthly basis to coincide with key events within the financial reporting and audit cycle. If any matter is identified as in need of discussion sooner than 12 months, it is added to the agenda of a future meeting. In addition to regular updates, the committee undertakes deep dives on the emerging and principal risks facing the business and elevates these to the Board where necessary. The committee conducts an annual evaluation of its effectiveness, details of which are provided below.

The significant issues that the committee considered during 2018/19 were:

#### Accounting standards and judgements

The committee assessed whether suitable accounting policies had been adopted and whether management had made appropriate judgements and estimates. Following discussion, the committee was satisfied that neither IFRS 9 Financial Instruments nor IFRS 15 Revenue from Contracts

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with Customers had any significant impact on Network Rail’s accounts. The former because the changes largely relate to legacy activities regarding hedge accounting, the latter because the existing pattern of income recognition meets with the requirements of IFRS 15.

The changes in IFRS16 Leases are not expected to have a material effect on Network Rail’s profitability, but will increase net debt and non-current assets and have budgetary implications that will need to be borne in mind when entering future leases. Further details can be found in note 2 to the accounts on page 141.

**Fair, balanced and understandable**

At the request of the Board, the committee considered whether, in its opinion, the annual report and financial statements 2018/19, are fair, balanced and understandable and whether they provide the information necessary to assess the company’s position and performance, business model and strategy. The committee received an outline of the structure of the annual report and financial statements 2018/19 and a broad indication of its content in early stages. A full draft of the report was submitted prior to the meeting at which the committee was asked to provide its final opinion.

The assessment of such an opinion drew on work of the disclosure committee, the annual report and financial statements project group responsible for the coordination of content, verification, detailed review and challenge. Senior management confirmed that the content in respect of their areas of responsibility was fair, balanced and understandable.

The committee considered the following questions:

<p><b>Is the annual report fair?</b></p>	<ul style="list-style-type: none"> <li>• Has the whole story been presented and has any sensitive information been omitted that should have been included?</li> <li>• Is the messaging in the front half of the annual report consistent with the financial disclosures?</li> <li>• Is the score card disclosed at an appropriate level based on financial reporting?</li> </ul>
<p><b>Is the annual report balanced?</b></p>	<ul style="list-style-type: none"> <li>• Is there an over-emphasis of matters that are not material?</li> <li>• 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?</li> <li>• Is there an appropriate balance between statutory and non-statutory measures and are non-statutory measures clearly defined?</li> <li>• Are the risks in the narrative consistent with the committee’s risks and issues and key areas of uncertainty and judgments?</li> <li>• Are the key risks aligned with the audit report?</li> </ul>
<p><b>Is the annual report understandable?</b></p>	<ul style="list-style-type: none"> <li>• Is the document designed to suit the needs of the Department for Transport in its capacity as sole member?</li> <li>• Is the report understandable to a reasonably informed reader?</li> <li>• Are new messages and themes clearly articulated?</li> </ul>

Following its review, the audit and risk committee stated that the annual report and financial statements 2018/19 present a fair, balanced and understandable overview, providing the information necessary to assess the company’s position and performance, business model and strategy. The committee therefore proposed the document for approval to the Board.

## ➤ 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 below.

Accounting judgements	How the committee addressed these judgements
<p><b>Valuation of rail network and compliance with regulatory requirements</b></p> <p>The revaluation model used to measure the value of the rail network consists of a number of estimates and judgements made both by the company and the Office of Rail and Road (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 auditors on:</p> <ul style="list-style-type: none"> <li>• The reasonableness of key judgements and estimates in respect of the forecast for CP6.</li> <li>• The appropriate level of disclosures in the annual report and accounts around the valuation process and the related assumptions and judgements.</li> </ul>
<p><b>Capital accruals</b></p>	<p>The estimate of cost of work done in a key judgement in Network Rail's accounts.</p> <p>The additions to Property, plant and equipment are valued at an estimate of the cost of work done (COWD) in the year to 31 March 2019. To the extent that the COWD is greater than the invoiced amount, fixed asset accruals are recognised based on expected amounts required to settle contractual obligations.</p> <p>To value the cost of work done on, capital projects, appropriately skilled commercial managers assess the progress to completion of the project at the expected cost. Both progress and expected costs have elements that are estimates and require accounting judgement.</p>
<p><b>Risk of management override of internal controls</b></p>	<p>Reports on managements approach to measuring cost of work done were reviewed alongside details of internal validation and the external auditors report on sample testing. It was noted that managements approach had a tendency towards optimism bias concerning estimates of progress and cost. When taken together these judgements were unlikely to cause a material misstatement. Management advised that improvements will be made towards eliminating bias in future estimates.</p> <p>The independent auditors have focussed attention on this area and provided satisfactory reporting to the committee on this matter.</p>

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<p><b>Deferred tax</b></p> <p>It was considered whether it was still probable that Network Rail could 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 rail 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 derecognise deferred tax assets.</p>
<p><b>Valuation of investment properties</b></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><b>Hedge accounting and derivatives</b></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 reviewed reports from management showing that all the forward starting interest swaps had now been utilised in hedging the borrowing rate on the DfT loan facility. The fair value at utilisation will amortise from the hedge reserve in line with the loan tranches to which they relate. The derivative portfolio will now reduce year-on-year and there are no plans to enter into new derivative hedging programmes.</p>
<p><b>Pension assumptions</b></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 auditors also focused attention on this area and provided reporting to the committee on this matter.</p>

The committee is required to review any correspondence received from regulators in respect of financial reporting. There has been no correspondence from the FRC in relation to Network Rail's financial reporting during the 2018/19 financial year.

## External audit

### ► Committee effectiveness

The committee continued to monitor and implement the action plan developed from the self-evaluation effectiveness review which had been completed in 2017/18. The review had shown that overall the committee was functioning effectively.

### ► The approach taken to the appointment of the external auditor

The Comptroller and Auditor General (C&AG), Sir Amyas Morse CBE, supported by the NAO, was appointed as Network Rail's independent auditor in 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.

PricewaterhouseCoopers (PwC) acted as the independent auditors for the remaining subsidiaries in 2018/19. The obligation to appoint the C&AG as Network Rail's independent auditor is a direct impact of the reclassification of Network Rail as an arm's-length government body and is in line with standard arrangements for other public sector bodies.

The company is, therefore, unable to comply with the Competition and Markets Authority's Order or the UK Corporate Governance Code 2018 in respect of tendering prior to the appointment of an auditor and this will remain the company's position for the foreseeable future.

Gareth Davies took over the post of C&AG from Sir Amyas on 1 June 2019.

### ► Effectiveness of the external auditor

A review of the independent auditor's performance and effectiveness is undertaken as part of the overall effectiveness review of the auditing process. Following the conclusion of the reporting cycle, the auditing process was assessed. The independent auditor was also invited to comment on what worked well and where improvements could be made. The committee was satisfied that the independent auditor was fully effective and performed as expected in discharging its duties and obligations.

### ► Objectivity and independence of the independent auditor

The NAO is independent of Network Rail in accordance with the ethical requirements relevant to the audit of financial statements in the UK, including the FRC's Ethical Standard as applied to listed entities/public interest entities.

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 established a policy whereby employment of the independent auditor on work for the company is prohibited without prior approval by the committee, other than for audit services or tax compliance services. Such requests are unlikely as the NAO does not offer non-audit services. The NAO does carry out value for money assessments for Network Rail, but this does not represent a service to Network Rail as it is performed under statute and on behalf of Parliament.

In 2018/19 the fee for audit services was £0.59m (£0.51m in 2017/18). This includes the NAO's cost of auditing Network Rail Infrastructure Limited, Network Rail Infrastructure Finance plc, Network Rail (High Speed) Ltd, the regulatory accounts and review of interim financial statements of Network Rail Limited and Network Rail Infrastructure Finance plc. It excludes the cost of the audit of some smaller subsidiaries which continue to be audited by PwC.

The fee to PwC for auditing the smaller subsidiaries was £90k in 2018/19.

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**Internal audit**

The committee reviews the annual internal audit plan to ensure it aligns with the group’s strategic priorities and key risks. At each meeting the director of risk and internal audit updated the committee on any changes to the plan and the reasons for deviation from the plan, notable audits, overdue actions, and themes and key issues arising from the internal auditor’s work.

Our assurance processes have identified areas for improvement in our internal controls, and activities to address these are being monitored closely by the committee. Examples of these include:

**– Cyber security risk**

This was highlighted by internal audit as an area requiring focused, continuous improvement of control activity and the committee requested a deep dive into the risk. A detailed plan to mitigate identified weaknesses was then reviewed by the committee and it continues to monitor the risk.

**– Commercial contract assurance**

In response to commercial control issues identified, internal audit will run a standalone commercial contract assurance programme to assess contracts and transactions that may have a high fraud risk. By conducting the proposed work, we will be one of the first government agencies to run a comprehensive programme to detect fraud in high risk areas.

**– Business continuity management (BCM)**

In response to the business continuity risk identified by internal audit, development of an effective BCM framework is on track and work continues on embedding BCM activity into core processes.

**– Business controls framework (BCF)**

The work of internal audit found that controls were either not fit for purpose or not always operated as designed, usually due to the absence of clearly defined or up to date processes and controls. In response, a pilot was initiated in the South East route to test the concept of a business-wide BCF and understand how it could be rolled out across the business.

The committee approved the 2019 internal audit plan (the 2019 plan), which was developed through a review of the enterprise risk register, taking into consideration industry trends including technological change and disruption. The 2019 plan also follows up on the group assurance letter findings, focussing on control areas with a less than “substantial” rating. These areas include: (i) safety, health and environment risk, (ii) response to emergency situations, (iii) access to systems, (iv) critical systems and recovery, (v) change management and (vi) people systems and processes.

The committee also approved the internal audit charter, which defines internal audit’s purpose, authority, responsibility and position within the company.

**➤ Evaluating the effectiveness of internal audit**

As well as assessing the 2019 plan and receiving regular reports on the results of the internal auditor’s work, the committee met with the director of risk and internal audit without the presence of management to assess the role and effectiveness of the internal audit function in the overall context of the company’s risk management system, taking into account the actions management has taken to implement the recommendations of the function. The committee is satisfied that internal audit is operating effectively.

An independent review of internal audit effectiveness and processes was conducted by PwC in June 2018 and the committee considers it appropriate for the next independent review to be commissioned in the 2019/20 financial year.

**➤ Risk management and internal controls**

The Board has ultimate responsibility for Network Rail’s risk management and internal control systems, but delegates detailed oversight of the function to the committee, which then reports its findings and makes recommendations to the Board. This covers all material controls including financial, operational and compliance controls and risk management systems. The risk management systems and internal controls are designed to manage rather than eliminate risk and can only provide reasonable but not absolute assurance that the group’s risks are being appropriately managed and mitigated. The delegated responsibilities for risk management and internal control are detailed in ‘Role and responsibilities of the committee’ on page 97.

The committee receives regular reports from the internal and independent auditors and reviews progress against

agreed action plans to manage identified risks. Detailed oversight of safety related risks is delegated to the safety, health and environment committee.

Network Rail's approach to risk management and identification, its risk appetite, and an assessment of principal and emerging risks is provided on pages 70 to 77.

In addition to regular updates, the committee reviews the emerging and principal risks that require particular attention. During the year, these were:

- The risk of failure to attract, retain and develop the full potential of talent for business-critical roles;
- The risk of failure to secure support from our people and from trade unions for our programme of organisational change;
- The risk of failure to attract and retain suitably qualified and skilled individuals in executive and leadership roles;
- The risk of project and programme delays or increased cost;
- The risk of not securing funding for our preferred CP6 plan;
- The risk of a gap in critical service provision, due to loss of strategic or critical suppliers;
- The risk of failure to deliver the digital railway train control and signalling systems targets for CP6;
- The risk of prolonged business interruption caused by poor business continuity planning and exercising;
- The risk of cyber threats impacting the availability or integrity of systems that support key business processes;
- The risk of failure to effectively manage data, information, and knowledge management;
- The risk of failure to deliver a safe and resilient timetable.

In addition, the committee discussed the December 2018 timetable assurance process and the May 2019 timetable process and emerging assurance, and key milestones for both timetable introductions.

### ➤ Evaluating the effectiveness of internal control and risk management systems

The committee regularly reviews the corporate risk profile, including the status of mitigating actions, and reviews and approves any changes to the Enterprise Risk Management (ERM) framework, which determines the design, implementation, monitoring and review and identification of risks. In advance of the new control period, the head of group risk undertook a thorough review of the ERM framework and the committee discussed the findings before approving the preferred option for developing the framework. The committee will continue to review the outcome of the changes.

During the year the committee also reviewed and approved changes to Network Rail's risk appetite statements and reviewed the remit of the risk management function to ensure it remained appropriate for the company's strategy. The committee was satisfied

that a robust risk process was in place to manage and mitigate risks with appropriate plans and monitoring. Where risks had materialised, appropriate actions were being taken to manage the impact on passengers, customers and the organisation.

The committee had oversight of the process and assessment of the group's prospects to carry on its business under severe but plausible scenarios undertaken by the risk management and internal audit functions. Further details of the analysis/scenario testing for the viability statement can be found on page 79.

### ➤ Whistleblowing

The committee reviews and makes recommendations to the Board on the company's whistleblowing procedures and any arrangements for the independent investigation and follow-up of such matters.

Over the year, the committee discussed reports on major findings of internal investigations (and management's response to them), reviewed the whistleblowing policy and procedures, and assured the Board that these were adequate and effective. This was supported by the findings of an independent review carried out by Protect (experts in whistleblowing), which stated that Network Rail is "an organisation with good policies and structures in place in relation to whistleblowing. Network Rail is well placed to build on current practice and reach best practice".

Network Rail's confidential reporting service and 'Speak Out' (whistleblowing) policy has been in place since 2012. The Speak Out service is run by an external company on behalf of Network Rail, and all reports undergo an initial review by our business integrity team.

The Speak Out policy provides guidance on when people should speak out, how they can do this, how concerns are handled and how confidentiality is maintained, alongside information on the most appropriate channels to report concerns related to safety or individual grievances.

Mandatory company-wide ethics training, which includes content on whistleblowing, has been fundamental in raising awareness of the Speak Out line. In January 2018, we launched two new ethics training modules designed to consolidate our people's knowledge and understanding of business ethics at Network Rail. To date, both new modules have been completed by over 24,000 people.

In 2018/19, 410 confidential reports were made to the Speak Out service. This represents a 39 per cent increase on the previous year and aligns with the launch of the new training modules, which raise awareness of potential ethical issues at work and include a reminder of our whistleblowing policy and how to report concerns. Each year, on average, 55 per cent of reports made are substantiated and action taken.



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## Audit and risk committee report continued

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The Speak Out policy will be updated in 2019/20 to incorporate recommendations made by Protect following their review of Network Rail's whistleblowing processes and procedures.

### **Planned activities for the coming year**

In the 2019/20 financial year, the committee will continue its oversight of the risk management and internal control systems and the internal audit function, monitoring the integrity of the financial statements including the interim statements, and reviewing the external audit process. Specific focus will be on ensuring that the structure and focus of the committee meetings adapt to the increasingly devolved nature of the organisation in CP6. This will include oversight of the risks specific to each new region; continued monitoring of the Putting Passengers First programme; and review of the CP6 assurance framework.