



Audit and risk committee report

I am pleased to present the committee's report into the key activities undertaken during 2019/20, alongside its anticipated activities for 2020/21.

My thanks go to Bridget Rosewell CBE, who left the Committee and the Company at the end of March 2020, for her immense contribution to the Committee over many years.

I also welcome Mark Bayley CBE, who joined the Committee and the Company on 11 May 2020.

During 2019/20 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 the Putting Passengers First programme, cyber security, Brexit and reviewing enhancements to the business controls framework to improve assurance activity across the group.

This is my last report as Chair of the Committee as I will be retiring from the Network Rail Board in August 2020 having served as a director for six years. I would like to thank my fellow committee members for their very valuable challenge and insight. I believe Network Rail's Internal Audit and Risk functions are stronger than ever and I am confident that their future plans will continue their development.

Sharon Flood,
chair, audit and risk committee

16 July 2020

Composition of the committee

The committee met four times during 2019/20. 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	Sept 2014	4/4
Mark Bayley CBE ¹	May 2020	0/4
Rob Brighouse	Jan 2016	4/4
Silla Maizey	Nov 2016	4/4
Bridget Rosewell CBE ²	July 2012	2/4

1. Mark Bayley CBE was appointed to the Board and Committee on 11 May 2020

2. Bridget Rosewell CBE resigned from the Board and Committee on 31 March 2020

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Committee attendees

The chief financial officer, director of risk and internal audit, group controller (finance), head of group risk and the group general counsel & company secretary will normally attend meetings of the committee by invitation. The chair of the board, the chief executive and other board or executive leadership committee members attend meetings when invited by the committee. 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 the committee without executive management present. The committee is supported by the company secretary.

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.

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.

Regulatory Escalator

- Report of Office of Rail and Road regulatory matters

Following each meeting, the chair provides a summary of the committee's activities, main discussion points and

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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 external 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 2019/20 were:

Accounting standards and judgements

The changes in IFRS16 Leases have not had a material effect on Network Rail's profitability, but have increased net debt and non-current assets and have budgetary

implications. We will bear the budgetary implications in mind when entering future leases. Further details can be found in note 2 to the accounts on page 137.

Fair, balanced and understandable

At the request of the Board, the committee considered whether, in its opinion, the annual report and financial statements 2019/20, 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 2019/20 and a broad indication of its content in early stages. A 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:

Is the annual report balanced?

- 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 score card disclosed at an appropriate level based on financial reporting?

Is the annual report understandable?

- 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 view on risks and issues and key areas of uncertainty and judgments?
- Are the key risks aligned with the audit report?

Following its review, the audit and risk committee stated that the annual report and financial statements 2019/20 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.

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➤ 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>Valuation of rail network and compliance with regulatory requirements</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"> • The reasonableness of key judgements and estimates in respect of the forecast for CP6. • The appropriate level of disclosures in the annual report and accounts around the valuation process and the related assumptions and judgements.
<p>Capital accruals</p>	<p>The estimate of cost of work done is 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 2020. 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>Risk of management override of internal controls</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 in the prior year 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 has implemented changes to ensure that information after the balance sheet date is taken into account when determining the estimate.</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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Deferred tax

It was considered whether it was still appropriate for Network Rail to not recognise a deferred tax asset in relation to its brought forward tax losses.

With continued high levels of investment in the rail network, 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 not recognise a deferred tax asset.

Valuation of investment properties

Investment properties are stated at fair value. The valuations are based on assumptions and estimates that require judgement.

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.

Pension assumptions and asset valuations

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.

The committee discussed the key assumptions, including the degree to which these were supported by professional advice from the actuaries. The independent auditors also focussed attention on this area and provided reporting to the committee on this matter.

Given the market volatility at year end caused by the Coronavirus pandemic, we have also focussed greater attention on the valuation of the scheme assets.

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 2019/20 financial year.

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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. In addition, as part of the Board effectiveness evaluation undertaken in July 2019, feedback was provided on the effectiveness of the committee. No areas of concern related to the committee were raised during this review.

The approach taken to the appointment of the external auditor

The Comptroller and Auditor General (C&AG), supported by the NAO, was appointed as Network Rail's independent auditor in 2015. In addition to providing an opinion on the Network Rail Limited group accounts, the C&AG also audits the Network Rail Infrastructure Limited group accounts and the individual accounts of Network Rail Infrastructure Finance PLC and Network Rail (High Speed) Limited.

Gareth Davies assumed the post of C&AG on 1 June 2019.

PricewaterhouseCoopers (PwC) acted as the independent auditors for the remaining subsidiaries in 2019/20. 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.

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 at most every seven years (five years in the case of subsidiaries administering listed debt).

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 2019/20 the fee for audit services was £0.57m (£0.59m in 2018/19). 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 paid to PwC for auditing the smaller subsidiaries was circa £150k in 2019/20 (£134k 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. Activities to address these are being monitored closely by the committee. Examples of these include:

– Asset Management

This was highlighted by internal audit as an area requiring focussed, continuous improvement of control activity. Through the Engineering community and as part of the Intelligent Infrastructure Programme, activities are under way to shift to 'predict and prevent' maintenance and management of the railway – fixing faults before they cause disruption to passengers.

– Track Worker Safety

In response to control issues identified across the business relating to the planning and delivery of safe work, a Safety Task Force was created, bringing together multiple strands of work from across the company aimed at improving safety for employees and contractors that work on the railway.

– Corporate Security

Further to internal audit activity assessing the national security control framework, progress is being made to establish a Security Management System and to implement the organisational structures and processes required for sustainable implementation. Risk Records are being revised to provide an enterprise view of security risk.

– Business controls framework

The work of internal audit continued to find some instances where 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 both in the second and first lines. In response, the quality improvement programme in Southern has provided a platform to identify key processes, risks and controls to which assurance activities can be aligned. Separately, a governance, risk, assurance and improvement framework is in development, identifying accountable owners for core processes and the mechanism by which risk, assurance and improvement will be managed.

The committee approved the 2020 internal audit plan (the 2020 plan), which was developed through a review of the enterprise risk register, taking into consideration industry trends. The 2020 plan also follows up on previous group assurance letter findings, focussing on control areas with a less than "substantial" rating. These areas include: (i) safety, health and environment risk, (ii) access to systems, (iii) project delivery, (iv) contracts and procurement and (v) competency management.

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

➤ 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 89.

The committee receives regular reports from Internal Audit and the independent auditor 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 64 to 69.

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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 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 failing to identify deficient business and/or route performance against agreed trajectory in a sufficiently detailed or timely manner;
- The risk of failing to deliver and embed the benefits of the Putting Passengers First programme;
- The risk of a gap in critical service provision, due to loss of strategic or critical suppliers;
- The opportunity to transform how we operate through the Putting Passengers First programme to create more localised decision making;
- The risk of failure to deliver the planned scale of enhancement investment in CP6 in the Eastern region;
- The risk of a security event in a Network Rail region;
- The risk that Network Rail was unprepared for a “no deal” BREXIT scenario.

In addition, the committee invited executive leadership team members to attend meetings to discuss how they were managing risks.

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.

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 70.

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. It also discusses reports on major findings of internal investigations and management’s response to them.

In February 2019, the committee assured the Board that the whistleblowing policy and procedures were adequate and effective. In February 2020, the committee was updated on action taken to further enhance the existing framework. This included:

- Distributing posters and wallet cards to promote Network Rail’s confidential reporting service (known as ‘Speak Out’);
- Testing staff confidence in the whistleblowing arrangements in the biennial employee engagement survey. The results indicate that a large majority of staff have confidence in the arrangements; and
- An independent review of the whistleblowing policy and procedures, leading to the policy being updated to reflect the review’s recommendations. The policy was published in spring 2020.

Network Rail’s confidential reporting service and ‘Speak Out’ 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 counter fraud and investigation services team (previously known as the ‘business integrity department’).

In 2019/20, 476 confidential reports were made to the Speak Out service, which is broadly consistent with the number of reports made in 2018/19. Each year, on average, 44 per cent of reports made are substantiated and action taken.

Training modules are in place, designed to enhance our people’s knowledge and understanding of business ethics, including information about our whistleblowing policy and how to report concerns. To date, the training has been completed by over 30,000 employees.

Planned activities for the coming year

In the 2020/21 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.