

AUDIT AND RISK COMMITTEE REPORT

I'm pleased to present the committee's report into the key activities undertaken during 2020/21, alongside its anticipated activities for 2021/22. This is my first report as chair of the committee and I would like to thank my fellow committee members for their contributions, insight and support in this period. I also welcome Michael Harrison, who joined the committee in September 2020.

During 2020/21, the committee continued to focus on the audit, assurance and risk management processes within the business in addition to its oversight of financial and other regulatory requirements. The committee's work focussed on the risks facing the business, to understand better the nature of the risks and provide assurance to the Board on the effectiveness of the associated internal controls.



Mark Bayley CBE,
chair, audit and risk committee
 15 July 2021

The committee met four times during 2020/21. Members collectively have a broad range of finance, 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
Mark Bayley CBE ¹	May 2020	4/4
Rob Brighthouse	Jan 2016	4/4
Sharon Flood ²	Sept 2014	1/1
Michael Harrison ³	Sept 2020	3/3
Silla Maizey	Nov 2016	4/4

1. Mark Bayley CBE was appointed to the Board and committee on 11 May 2020
2. Sharon Flood resigned from the Board and committee on 23 August 2020
3. Michael Harrison was appointed to the Board on 11 May 2020 and to the committee on 7 September 2020
4. Stephen Duckworth was appointed to the Board and committee on 1 April 2021

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. At each meeting, time is set aside for the representatives from the NAO and the director of risk and internal audit to meet with committee members without executive management present.

Role and responsibilities of the committee

The committee monitors the integrity of the financial reporting and the audit process and Network Rail’s system of internal control. The committee also oversees risk management, regulatory reporting and compliance. It makes recommendations to the Board on the level of risk appetite acceptable to the company.

Following each meeting, the chair provides a summary of the committee’s activities, main discussion points and findings to the next Board meeting along with a written report provided by the committee secretary, and makes recommendations as appropriate.

Principal activities during the year

The committee had presentations from four regional managing directors on the key risks affecting their business plans. There were also updates on the Putting Passengers First programme, cyber security, the competence management system, business contingency planning in

response to the Covid-19 pandemic, timetabling risks, and weather and climate change resilience.

At each meeting the committee receives business updates from group finance, internal audit, group risk and the independent external auditor. In addition to regular updates, the committee considers 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.

Fair, balanced and understandable

Following a review, the audit and risk committee confirmed that the annual report and financial statements for 2020/21 present a fair, balanced and understandable overview and provides the information necessary to assess the company’s position, 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 judgments	How the committee addressed those judgements
Valuation of rail network and compliance with regulatory requirements	<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 by the Office of Rail and Road (for example anticipated financial and operational outperformance in the Control Period (CP6). The committee reviewed reports from management on the key estimates and the methodology applied to the revaluation model.</p> <p>The committee also reviewed the work of management and findings of the external auditors in respect of the reasonableness of key judgements and estimates in respect of the forecast for CP6, and the impact of the recent White Paper; and the appropriateness of the associated disclosures in the financial statements.</p> <p>After this review, the committee confirmed the valuation derived from the estimates, key judgments and valuation methodology.</p>

Capital accruals	<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 2021. 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 COWD on capital projects appropriately, commercial managers with the appropriate level of experience 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>Reports on management's approach to measuring cost of work done were reviewed alongside details of internal validation and the external auditor's report on sample testing.</p>
Risk of management override of internal controls	<p>The independent auditor has focussed attention on this area and provided satisfactory reporting to the committee.</p>
<p>Deferred tax</p> <p>It was considered whether it was still appropriate for Network Rail not to recognise a deferred tax asset in relation to its brought forward tax losses.</p>	<p>The committee agreed not to recognise a deferred tax asset until it was satisfied when it could be exchanged for economic benefits. With the high levels of investment expected for the foreseeable future, the committee saw little prospect that taxable profits would exceed capital allowances, therefore requiring use of tax assets (including losses brought forward) to reduce tax liabilities.</p>
Valuation of investment properties	<p>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.</p>
Pension assumptions	<p>The group operates defined benefit and defined contribution pension schemes. Valuation of the defined benefit schemes is dependent on certain key assumptions and complex actuarial calculations. External actuaries are therefore engaged to assist in advising on key assumptions and determining the value of the pension obligations.</p> <p>The committee noted the conclusion of the triennial valuation in the year. The committee discussed the key assumptions, including the degree to which these were supported by professional advice from the actuaries. The independent auditor also focussed attention on this area and provided reporting to the committee on this matter.</p> <p>Finally, the committee considered the valuation of the scheme assets, noting the estimation uncertainty associated with Level 3 assets such as private equity holdings. This included a consideration of the work of management and the auditor to take account of movements to the year end, and the focussed work of the auditor in respect of higher risk assets.</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 or the ORR in relation to Network Rail's financial reporting during the 2020/21 financial year.

Committee Effectiveness

The committee completed a self-evaluation effectiveness review, supported by more detailed interviews with committee members and key attendees. The review has shown that the committee was functioning effectively, and no significant areas of concern were raised. The recommendations are being taken forward to improve the work of the committee.

In addition, as part of the Board effectiveness evaluation undertaken in early 2021, 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 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.

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

PricewaterhouseCoopers (PwC) acted as the independent auditors for the remaining subsidiaries in 2020/21. 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, not in a position 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.

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 normally 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 other 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 2020/21 the fee for audit services was £0.597m (£0.57m in 2019/20). 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 £155k in 2020/21 (£150k in 2019/20).

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 2020/21 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. For the second year, the external audit has been completed in a remote way due to Covid-19 and yet has remained effective with good communication between teams.

Internal audit

The committee approved the annual internal audit plan and reviewed throughout the year to check alignment 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, notable audits, overdue actions, themes, and key issues arising from internal audit's work. Despite restrictions presented by the pandemic, internal audit activities continued throughout the year and the audit programme was updated based on the assessment of risk in what was a changing environment.

In addition to formal risk-based audit, independent reviews have been undertaken to support key programmes and the response to emerging issues. These reviews have included the response to the pandemic, preparations for the UK's exit from the EU, and the progress of our intelligent infrastructure programme.

During the year, a root cause framework has been introduced to identify common themes arising from audit activity. These include:

Governance: audits identified cases of less mature governance, risk and control (GRC) frameworks both in design and operating effectiveness – for example, in our audits of post-contract management and stations management.

Processes and procedures: audits flagged evidence of gaps that meant the operation of controls could not be demonstrated – for example, in our audits of our joiners-movers-leavers process where system access was not periodically reviewed, and leavers were not removed in a timely manner.

Assurance and monitoring: audits found weaknesses in assurance and monitoring arrangements – for example, contract and procurement controls, tunnel evaluations, and monitoring overcrowding incidents at stations.

Where areas for improvement have been identified through audit activity, these are being actively managed and the improvements closely monitored by the committee. Examples of improvements include: the governance, risk, assurance and improvement (GRAI) model that is being embedded to strengthen line of sight between the business strategy and how this is to be achieved, and the revised procurement management framework rolled out in 2020.

The committee 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 112.

The committee reviews progress against agreed action plans to manage identified risks. Detailed oversight of safety related risks is delegated from the Board to the safety, health and environment compliance 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 77 to 86.

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 hostile or malicious acts exploiting vulnerabilities in Network Rail's cyber systems
- the risk of being unable to produce a robust timetable that is both high quality and high performance
- the risk of failing to manage the competence of Network Rail's employees
- the risk of failing to deliver and embed the outcomes and benefits of the Putting Passengers First programme
- the risk of the railway not meeting normal levels of performance during adverse and extreme weather events, today and in the future as a result of climate change
- the opportunity to transform how we operate through the Putting Passengers First programme to create more localised decision making
- there was an exceptional business continuity planning session in relation to Network Rail's Covid-19 response.

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 Risk Management 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 our principal risks with appropriate plans and monitoring. Where risks have been identified, appropriate actions are 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 in support of the viability statement. Further details of the analysis/ scenario testing for the viability statement can be found on page 87.

Business ethics

The committee reviews and makes recommendations to the Board on the company's whistleblowing procedures and arrangements for the independent investigation and follow-up of such matters. It also discusses major findings of internal investigations and management's response to them.

In February 2021 the committee assured the Board that the whistleblowing policy and procedures were adequate and effective. The committee was updated on action taken to further enhance the existing framework in the year. 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

- 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
- implementing an upgraded Speak Out system, which included improved wording, question sets and analytics
- publishing an updated Speak Out policy, which included new sections on anonymous vs confidential reporting, how to raise a grievance, and signposting to additional support
- including Speak Out as a company-wide process within the information management system programme.

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.

In 2020/21, 387 confidential reports were made to the Speak Out service, which is broadly consistent with the number of reports made in 2019/20, albeit a slightly reduced figure which has been attributed to the pandemic. Each year, on average, 49 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 41,500 employees.

Planned activities for 2021/22

In the 2021/22 financial year, the committee will continue its oversight of the risk management and internal control systems and internal audit, monitoring the integrity of the financial statements including the interim statements, and reviewing the external audit process.

The committee will focus on ensuring that the structure and focus of meetings adapt to the devolved nature of the organisation and take into account the key challenges facing the organisation and wider industry. This will include oversight of the risks specific to each new region; continued monitoring of the GRAI; assurance of the capital delivery programme as Project SPEED; is adopted, embedding of the Putting Passengers First programme, and; the company's response to changing passenger demand following the pandemic.