

AUDIT AND RISK COMMITTEE REPORT

I'm pleased to present the committee's report into the key activities undertaken during 2022/23, alongside its anticipated activities for 2023/24. During 2022/23, 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 mitigations and internal controls.

Mark Bayley CBE

chair, audit and risk committee

13 July 2023



Committee members	Formal appointment to the committee	Number of meetings attended during the year
Mark Bayley CBE	May 2020	4/4
Rob Brighthouse	Jan 2016	4/4
Stephen Duckworth OBE	April 2021	2/4
Michael Harrison	Sept 2020	4/4
Silla Maizey OBE	Nov 2016	4/4

Committee attendees

The chief financial officer, director of risk and internal audit, group controller (Finance), and the group general counsel and company secretary attend meetings of the committee by invitation. Representatives from the National Audit Office (NAO) also attend each meeting. At the quarterly meetings, 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. Ismail Amla attends the meeting by invitation when matters related to cyber security are discussed.

Representatives from Great British Railways Transition Team (GBRTT) were invited to attend a special meeting of the ARC which was convened to focus on GBRTT. Ismail Amla was also in attendance at the meeting as an invitee with special expertise on cyber security and to cover representation from the GBRTT Board.

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. The committee makes recommendations to the Board on the level of risk appetite acceptable to the company. In June 2022, the remit of the Committee was expanded to include oversight and assurance of GBRTT.

Following each meeting, the chair provides a summary of the committee's activities, main discussion points and findings to the next Board meeting. This is accompanied by a written report provided by the committee secretary with any recommendations to the Board.

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 cyber security, supply chain disruption, HS2, train service delivery, winter power disruption, weather resilience and climate change, the counter-fraud programme, the whistleblowing procedure, and the Code of Business Ethics. 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. Further information on principal risks is on pages 94 to 104. The committee conducts an annual evaluation of its effectiveness, details of which are provided below.

Fair, balanced and understandable

Following a review, the committee confirmed that the annual report and financial statements for 2022/23 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. 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 appropriateness of the associated disclosures in the financial statements.</p> <p>In the current year an adjustment was applied for the difference between the market cost of borrowing and that allowed in the CP6 regulatory return. Previously, because of the stability in long-term borrowing rates it had been observed that the cost of debt was broadly unchanged from that determined at the start of CP6. However, rates had moved considerably, and this led to an adjustment to the valuation. The accounts include an adjustment for £1.7bn in relation to this.</p> <p>After this review, the committee confirmed the valuation derived from the estimates, key judgments and valuation methodology.</p>
Deferred tax	<p>It was considered whether it remains appropriate for Network Rail not to recognise a deferred tax asset in relation to its brought forward tax losses. 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>

Pension assumptions	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. 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. Finally, the committee considered the valuation of the scheme assets, noting the estimation uncertainty associated with Level 3 assets. 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.
Capital accruals	The estimate of cost of work done is a key judgement in Network Rail's accounts. 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 2023. 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. 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. 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.
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.

The committee is required to review any correspondence received from regulators in respect of financial reporting. There has been no correspondence from the Financial Reporting Council (FRC) or the ORR in relation to Network Rail's financial reporting during the 2022/23 financial year.

Committee effectiveness

The committee completed a self-evaluation effectiveness review in 2022/23, supported by more detailed interviews with committee members. The review has shown that the committee was functioning effectively, and no significant areas of concern were raised. A number of recommendations emerged from the review to further improve the work of the committee and these are being taken forward.

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 and AG also audits the individual accounts of Network Rail Infrastructure Finance PLC, Network Rail Infrastructure Limited, Network Rail (High Speed) Limited and Great British Railways Transition Team Limited.

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.

PricewaterhouseCoopers (PwC) acted as the independent auditors for the remaining subsidiaries in 2022/23.

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, the senior statutory auditor of the independent auditor is regularly rotated, along with other key audit principals within that firm.

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 2022/23 the fee for audit services was £0.674m (£0.615m in 2021/22). This includes the NAO's cost of auditing Network Rail Infrastructure Limited, Network Rail Infrastructure Finance plc, Network Rail (High Speed) Limited, Great British Railways Transition Team Limited, 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 PricewaterhouseCoopers for auditing the smaller subsidiaries was circa £252k in 2022/23 (£190k in 2021/22).

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 2022/23 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. Following two years of fully remote working due to Covid-19, the external audit has continued to be delivered with a significant remote element, with good communication retained between teams.

Evaluating the effectiveness of internal control and risk management systems

The committee regularly reviews the corporate risk profile, including the status of mitigating actions; complementing the SHEC Committee, which reviews the safety, health and environmental compliance risk profile and mitigating actions. The committee 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 Network Rail's risk appetite statements and 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 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 106.

Internal audit

The committee approved the annual internal audit plan and reviewed it through the year to check alignment with the group's strategic priorities and key risks (safety, health and environmental compliance elements of the audit plan

are approved and reviewed through the SHEC committee). At each committee meeting the director of risk and internal audit updated the committee on changes to the plan including notable audits, overdue actions, themes, and key issues arising from internal audit activity. The audit programme was periodically reviewed to assess the impact of changes in Network Rail's risk profile and updated to maintain an appropriate level of assurance.

In addition to delivering formal risk-based audits, independent advisory reviews have been undertaken to support key programmes and respond to emerging issues. These reviews have included GBRTT, control period 7, and how industry planning has been updated to support recovery from the pandemic.

Internal Audit continue to use a root cause framework to identify, analyse, and highlight common themes arising from audit activity for consideration by the committee. Over the last year, these included:

- **assurance and monitoring:** audits found control weaknesses in assurance and monitoring arrangements relating to, for example, station asset management, control centres and environmental sustainability strategy
- **governance:** audits identified cases of less mature governance, risk, and control frameworks both in design and operating effectiveness. Examples include audits of working with plant and machinery, and the Power Supply Upgrade 2 project on the East Coast Main Line
- **processes and procedures:** audits found evidence of gaps that meant the operation of controls could not be demonstrated. Improvements were identified in processes underpinning payroll, renewals, and IT programme delivery activities.

Where areas for improvement have been identified through audit activity, these are being actively managed, and the improvements closely monitored by the committee.

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

Quality assurance

An external quality assessment of the Internal Audit function was carried out last year and improvements have been made to address the minor areas highlighted for improvement. These include an update of audit methodology and refresh of the terms of reference for

each engagement. Each audit is subject to independent review by the head of internal audit for quality and consistency and a more detailed review of compliance with methodology is undertaken on a sample of audits through the year. Actions arising are actively monitored and tracked in the Internal Audit action plan.

Risk management and internal controls

The Board has ultimate responsibility for Network Rail's risk management and internal control systems, but delegates oversight to the committee, which then reports its findings and makes recommendations to the Board. This covers all material controls (financial, operational, and compliance) and the risk management framework. Risk management systems and internal controls are designed to manage rather than eliminate risk and 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 136.

The committee reviews the current status of existing risks and progress against agreed action plans to manage them. Detailed oversight of safety related risks, including physical security, is delegated from the Board to the safety, health and environmental compliance committee.

The Board and executive leadership continue to monitor emerging risks, such as winter power disruption and those identified in the horizon scanning workshop in January 2022, to consider their impact on Network Rail in the future.

Network Rail's approach to risk identification and management, its risk appetite, and an assessment of its principal and emerging risks is provided on pages 94 to 104.

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

- the risk of hostile or malicious acts exploiting vulnerabilities in Network Rail's cyber systems
- the risk of winter power disruption
- the opportunity for Network Rail provided by HS2 integration
- the risk of supply chain shortages and the impact of inflation

- the risk of the railway not meeting expected levels of train service delivery
- the financial risks associated with weather resilience and climate change.

Business ethics

The committee reviews and makes recommendations to the Board on the company's whistleblowing (Speak Out) 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 March 2023 the committee assured the Board that the required policy, processes, and systems were in place to manage whistleblowing reports effectively. The Code

of Business Ethics (CoBE), policies and ethical decision-making tool are accessible on all company mobile devices via 'EthicsApp'. Periodic dashboards are also produced to monitor ethical performance across the organisation, these cover: e-learning completion, gifts, hospitality and conflicts of interest declarations and Speak Out cases.

In the last year the ISO:37001 Anti-Bribery Management System accreditation was obtained which recognises the controls and systems that had been put in place to minimise the threat of bribery within Network Rail's highest risk areas.

The Speak Out policy, which clearly identifies the channels available for those wishing to raise concerns and how Network Rail endeavours to respond to investigating whistleblowing allegations, was also updated.

Planned activities for 2023/24

In the 2023/24 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 continue to adapt the structure and focus of meetings to reflect the current risk landscape, including the impact of industrial action, recovery of passenger numbers, progress of industry reform, the preparations for CP7 and other key challenges facing the organisation and wider industry. This will include: oversight of the risks specific to each region; continued monitoring of governance, risk, assurance and improvement activity; assurance of the capital delivery programme; and assurance of cyber security risk management.