



Audit and risk committee report

I am pleased to report on the key activities and focus of the audit and risk committee during 2017/18. The committee monitors the integrity of the group’s reporting process and financial management. It ensures that risks are carefully identified and assessed, and that sound systems of risk management and internal control are in place. It scrutinises the full and half-yearly financial statements before proposing them to the Board for approval. The committee also reviews in detail the work of the external independent auditor and any significant financial judgements made by management.

Throughout the year, the committee received executive deep dives from within the business on various risks, financial, audit and governance matters. These executive deep dives are essential in enabling the committee to better understand any key issues and areas of concern. They also inform the committee how different risks are managed and mitigated throughout the business, and assist the committee to understand the progress made towards the strategic plan.

The May 2018 timetable revision and the operational issues experienced following its introduction were reviewed by the committee. This topic continues to receive close attention.

This was my first full year chairing the audit and risk committee. I would like to thank the other committee members, together with management and the NAO, for their support.

Sharon Flood,
 Chair, audit and risk committee
 27 June 2018

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

The committee members collectively have a broad range of financial, commercial, aviation/transport and rail sector expertise that enables them to provide oversight of financial, operational and risk matters and to advise the Board accordingly.

All members of the audit and risk committee are independent. The chair of the committee has recent and relevant financial experience.

Committee attendees

The chair of the board, the chief executive, chief financial officer, director of risk and internal audit, 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 internal audit meets with the committee without executive management present.

Role and responsibilities of the committee

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

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

Financial reporting

- Monitoring the integrity of the annual report and financial statements of the company, major subsidiary undertakings and the group as a whole.
- Reviewing significant accounting judgements and policies and compliance with accounting standards.
- Considering whether the annual report and financial statements as a whole are fair, balanced and understandable.
- 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.
- Internal controls and risk management.
- Reviewing Network Rail’s risk management processes, risk

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identification and reporting any issues arising from such reviews to the Board.

- Making recommendations to the Board on the level of risk appetite acceptable to Network Rail.
- Reviewing the company's overall risk assessment processes that inform the Board's decision making.
- Reviewing the process undertaken and the associated work required to complete the viability statement.
- Keeping under review the adequacy and effectiveness of the group's financial reporting and internal control procedures (including financial, operations and compliance controls and risk management) prior to endorsement of such procedures by the Board.
- Monitoring and overseeing the group's compliance with accounting and regulatory requirements.

Internal audit

- Agreeing internal audit plans and reviewing internal audit reports on the effectiveness of systems for internal financial control, financial reporting and risk management.
- Reviewing the progress of the internal audit plans.
- Monitoring the status of audit actions, including any that are overdue.

Independent auditor

- Overseeing the relationships with the Comptroller and Auditor General as the independent auditor and with the NAO.
- Approving the company's independent auditor's appointment, terms of engagement and fees and reviewing the management letter and management's response.
- Considering the results of external audit work and resolution of identified weaknesses; enquiring about and considering the independent auditor's planned audit approach.
- Assessing annually, and reporting to the Board on, the independence, objectivity, qualification, expertise and resources of the Company's independent auditor.

Whistleblowing and fraud

- Reviewing the policy and procedures whereby employees can raise, in confidence, concerns about possible improprieties.
- Assuring that such arrangements allow proportionate and independent investigation and appropriate follow-up action on such matters.

Principal activities during the year

The committee works to a structured programme of activities and meetings to coincide with key events around the company's financial calendar.

The committee received detailed updates from the business at each meeting. Business updates are planned on a 12-month basis and if any matter is identified by internal audit as in need of discussion sooner than 12 months, it is added to the agenda of a future meeting.

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

Some of the key topics discussed during 2017/18 were:

Accounting standards and policies

The committee assessed whether suitable accounting policies had been adopted and whether management had made appropriate judgements and estimates.

The committee received an overview of the changes introduced by the new International Financial Reporting Standard 16 (IFRS 16) with regards to leases; International Financial Reporting Standard 9 (IFRS 9) with regards to financial instruments and International Financial Reporting Standard 15 (IFRS 15) with regards to revenue recognition, and their impact on the company.

Following discussion, the committee was satisfied that based on current activities, no significant impact on NR's group accounts was expected from IFRS 9 and IFRS 15.

The changes in IFRS 16 were not expected to have a material effect on NR's profitability although they would increase net debt and non-current assets. Further details can be found in note 2 to the accounts on page 100.

Group tax strategy

Under the Finance Act 2016, large entities are obliged to publish their tax strategy online.

The audit and risk committee reviewed Network Rail's approach to conducting its tax affairs and managing tax risks. Upon reviewing the proposals, the committee was satisfied that the proposed strategy was in line with Network Rail's current practice rather than a change of direction.

The Board approved the group tax strategy. The document can be found on Network Rail's website: <https://www.networkrail.co.uk/wp-content/uploads/2018/03/Tax-strategy-and-tax-risk-management.pdf>

The document will be reviewed periodically.

Viability Statement

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.

Four severe but plausible scenarios had been selected and stress tested: 'Train accident', 'Exiting CP5 within financial and delivery boundaries', 'Suitable CP6 settlement' and 'Significant loss of personal or operational information'.

Financial impacts of each scenario were quantitatively assessed both pre-mitigation (a hypothetical condition that no controls were in place) and post-mitigation (taking into account the current controls that were in place).

It had been concluded that none of the four scenarios would result in a financial impact that would require NR to request additional funding.

The committee, and subsequently the Board, agreed that there was a reasonable expectation that NR would be able to continue in operation and meet its liabilities as they fall over the period to March 2021.

Fair, balanced and understandable

At the request of the Board, the committee considered whether, in its opinion, the annual report and financial statements 2017/18 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 2017/18 and a

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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. Following its review, the audit and risk committee stated that the annual report and financial

statements 2017/18 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.

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 2017/18 financial year.

The committee has considered whether the annual report and accounts for 2017/18 is fair, balanced and understandable and provides the information necessary for an informed reader to assess Network Rail's performance, business model and strategy.

The committee considered the following questions:

Is the annual report fair?

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

Is the annual report balanced?

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

Is the annual report understandable?

- Is the document designed to suit the needs of the Department for Transport in its capacity as a member?
- Is the report understandable to a reasonably informed reader?
- Are new messages and themes clearly articulated?

The committee considers that the annual report for 2017/18 is fair, balanced and understandable and allows assessment of the group's performance and prospects.

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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 the remainder of CP5. • The appropriate level of disclosures in the annual report and accounts around the valuation process and the related assumptions and judgements.
<p>Risk of management override of internal controls</p>	<p>Reports on management's approach to implementing, operating and monitoring the system of internal control are considered by the committee on a regular basis. The committee considered a letter of responsibility from the chief executive regarding the standard of internal controls and integrity that has prevailed in the business during the financial year.</p> <p>The independent auditors have also focused attention on this area and provided satisfactory reporting to the committee on this matter.</p>
<p>Deferred tax</p> <p>It was considered 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>Valuation of investment properties</p> <p>Investment properties are stated at fair value. The valuations are based on assumptions and estimates that require judgement.</p>	<p>The committee agreed the appropriate methodology had been used. The methodology was consistent with prior years and included valuations and additional assistance from external valuation specialists. The valuations were reviewed by management and the external valuation specialists.</p>
<p>Hedge accounting and derivatives</p> <p>Forward starting interest rate swaps are accounted for as cash flow hedges where it is believed that future sterling issuances are highly probable.</p>	<p>The committee agreed with the assessment that it is highly probable that Network Rail will borrow more than required to utilise all the forward starting interest swaps. The borrowing agreement in place with the DfT is greater than the value of the interest rate swaps. Network Rail's CP5 capital investment programmes will use substantially all of the borrowing facility.</p>
<p>Pension assumptions</p> <p>The group operates defined benefit and defined contribution pension schemes. Valuation of these schemes is dependent on certain key assumptions and complex calculations. External actuaries are engaged to assist in advising on key assumptions and determining the value of the pension obligations.</p>	<p>The committee discussed the key assumptions, including the degree to which these were supported by professional advice from the actuaries. The independent auditors also focused attention on this area and provided reporting to the committee on this matter.</p>

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Risk management and internal controls

The Board assumes ultimate responsibility for the effective management of risk across the group, determining its risk appetite and implementation of appropriate internal controls across all departments/business units. The Board has delegated responsibility for reviewing the effectiveness of the risk management framework and internal controls to the committee. 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 risk landscape has evolved during the year; the committee therefore reviewed a number of existing and emerging significant risks affecting the group. These were:

- project and programme cost/schedule slippage.
- Gospel Oak to Barking electrification.
- the destabilising effect of change.
- the CP6 Strategic Business Plan.
- the deployment of digital railway at the start of CP6.
- the asset divestment portfolio.
- cyber security.
- the opportunities presented by HS2.
- train service reliability.

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.

Some of the key topics discussed during 2017/18 were:

Cyber security

The committee was updated on the current status of the cyber security risk to Network Rail and the mitigation strategies. The committee noted that attacks against or affecting rail infrastructures had occurred in the last six months and a broader increase in threats had been consistently reported by UK security services and other intelligence feeds available to Network Rail. Network Rail's defences against these threats had been effective, and substantial progress had been made in bringing the risk under control. The team continued to review vulnerability of the systems and any likely exposure; further work was being undertaken to strengthen the governance and assurance systems.

Project and programme cost/schedule slippage

The committee reviewed the general enhancement portfolio 'landscape' within which Network Rail Infrastructure Projects (IP) had operated, and identified a number of issues. A series of remedial actions had been implemented, which were strengthening the planning and delivery of IP projects. The portfolio of projects had remained within the 'Hendy cap' for CP5, albeit with financial constraints.

Further information on Network Rail's approach to risk management and on the analysis/ scenario testing for the viability statement can be found on page 46.

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Internal audit

The committee approves the annual Internal Audit plan (plan), which is structured to align with the group's strategic priorities and key risks. At each meeting the director of Risk and Internal Audit updates 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 audits. Reports on major findings of internal investigations (and management's response to them) are also discussed on a regular basis. Our assurance processes have identified areas for improvement in our internal controls. Plans are in place to address these and are being monitored closely by the audit and risk committee.

External audit

Independent auditor

The Comptroller & 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 accounts of the main trading subsidiaries of Network Rail. PricewaterhouseCoopers (PwC), the previous independent auditors, continued as the independent auditors for the remaining subsidiaries in 2017/18.

The obligation to appoint the C&AG as NR's independent auditor is a direct impact of the reclassification of Network Rail as a central government body and is in line with standard arrangements for central government bodies. The company is, therefore, unable to comply with the Competition and Markets Authority's Order and the Code that require listed companies to undertake a competitive tender process prior to the appointment of the auditor. This will remain the company's position for the foreseeable future.

Objectivity and independence of the independent auditor

The committee has put in place safeguards to maintain the independent auditor's objectivity and independence. To enhance independence and in line with established auditing standards, a new senior statutory auditor of the independent auditor is appointed every five years, with other key audit principals within that firm rotated every seven years.

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

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

In 2017/18 the fee for audit services was £0.51m (£0.5m in 2016/17). 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 performed by PwC.

The fee to PwC for auditing the smaller subsidiaries was £113k.

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A Value for Money report on the Thameslink programme

During the year, the committee considered the NAO's report on Thameslink in respect of the Department for Transport's and Network Rail's management of the remaining elements of the programme as it nears completion.

The committee noted the contents of the report including its key findings that:

- Network Rail had delivered the infrastructure works to schedule in a challenging environment, although there had been planned and unplanned disruption to passengers.
- Since the budget re-forecast in May 2015, Network Rail had kept its infrastructure budget stable and had improved its financial control over the programme.
- The wider rail network could not yet reliably support the Thameslink programme's new services.
- The Department for Transport was deferring the full introduction of the new services by up to a year, in order to improve the management of the risks of each service change.

Overall the Thameslink programme was found to be delivering benefits to passengers through station improvements and more spacious trains. The infrastructure work in central London was nearing completion and costs were stable.

A number of lessons learnt were now business as usual, e.g. the introduction of measures to improve the way Network Rail managed design changes or the use of more sophisticated cash forecasting techniques. The committee would continue to monitor this group's significant risk.

Committee performance effectiveness

During the year, an internally facilitated evaluation of the effectiveness of the committee was undertaken. Feedback was initially obtained through an anonymous questionnaire to members and other regular attendees of the committee. There then followed a series of interviews which elicited further detailed views. The outcome of the evaluation was a finding that there were no significant concerns about the effectiveness of the functioning of the committee. Several areas were identified that would contribute to the overall improvement to the committee and steps have been taken to implement these.

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 each reporting cycle/financial year, the auditing process was assessed. The independent auditor was invited to comment on what worked well and where improvements could be made. The committee reviewed the review's findings and decided that the independent auditor was fully effective and performed as expected in discharging its duties and obligations.

Speak Out

Network Rail's confidential reporting service and 'Speak Out' whistleblowing policy has been in place since 2012. Our Speak Out line is run by an external company on behalf of Network Rail, and all reports are investigated by our independent Business Integrity team.

Our Speak Out policy has been amended this year to add clarity on maintaining the confidentiality of those who raise a concern covered by the policy, and to include bullying and harassment.

Mandatory company-wide ethics training, which includes whistleblowing, has been fundamental in raising awareness of the Speak Out line. Over 35,000 employees and contractors completed our first ethics training course 'Doing the Right Thing' (launched in 2015). In January 2018 we launched new mandatory ethics training to the business, designed to consolidate our employee's knowledge and understanding of business ethics at Network Rail. This second course (covering fraud, conflicts of interest, corporate hospitality, bribery and modern slavery) includes a reminder of our whistleblowing policy and how to report concerns about suspected wrongdoing taking place within Network Rail. Four months after launch, the new training has been completed by almost 14,000 employees and contractors.

In 2017/18, a total of 296 reports were made to our Speak Out line, broadly consistent with the 345 reports made in 2016/17. We are confident that our employees – and those working on our behalf – now have a greater level of awareness of business ethics, and our responsibilities as a public sector organisation. With this comes a change in culture, and as a result the number of reports made to Speak Out was expected to stabilise. Of the 296 reports made, 54% were substantiated and action taken.

In 2018/19, we will continue to raise awareness of Speak Out by closely monitoring completion rates of our new ethics training, using targeted follow up communications in any function or route where these are lower than we would expect. This will complement our planned communications to further promote the Speak Out line.

Planned activities for the coming year

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

Particular areas of focus for 2018/19 will include:

- Internal Audit and other assurance plans.
- Integrity of internal controls and effectiveness of risk management across the group.
- Oversight of the most significant risks within the group.
- Review of the key risks and internal controls associated with devolution, and how those risks and controls will evolve to provide assurances to the board.
- Scrutiny of the issues surrounding the introduction of the May 2018 timetable, and the adequacy and effectiveness of the associated internal controls.
- Monitoring and oversight of new accounting and regulatory developments.