

AUDIT COMMITTEE REPORT



Stephen Young
Chair of the Audit Committee

FOCUS AREAS IN 2019

- Ensure a smooth transition as John Waters becomes the new audit partner
- Approve the 2019 internal audit plan and review the outcome of the assurance reviews
- Review the significant judgements applied in the preparation of the Annual Report and Accounts
- Review our internal financial control procedures to ensure they continue to operate effectively

Dear Shareholder,

I am pleased to present our Audit Committee report for 2018 which describes our activities and areas of focus.

Financial reporting

Our review of the significant financial judgements made during the year and key financial reporting issues are described on page 105 of this report.

We were pleased to advise the Board that the 2018 Annual Report is fair, balanced and understandable and provides the necessary information for our shareholders to assess the Company's position, prospects, business model and strategy. Our review process is described in greater detail on page 108.

Audit quality

During the year, the FRC conducted an audit quality review (AQR) of our 2017 year end audit which had been performed by PwC. The Committee was delighted with the outcome of the AQR which confirmed there were no significant recommendations for further improvement (see page 107).

Internal audit

In conjunction with our review of the Group's internal financial controls, we consider on an annual basis whether Derwent London could benefit from an internal audit function. After detailed discussions with management in August 2018, it was agreed that an outsourced internal audit function would be established to improve the Group's procedures and to help achieve the highest standards for governance and compliance. Following a tender process, RSM have been appointed, initially for a three-year period. The 2019 internal audit plan will be approved by the Committee in May 2019.

Further information on the review of the internal financial controls and the establishment of an outsourced internal audit function can be found on pages 108 to 109.

Succession

After serving as a Non-Executive Director for nine years, and as chair of the Audit Committee since April 2011, I will be stepping down in May 2019 after a comprehensive handover to Lucinda Bell. Lucinda is a qualified accountant and has significant and recent financial experience, having been CFO of The British Land Company plc for seven years. I am confident she will make an excellent Audit Committee Chair.

Following the 2018 year-end audit, Craig Hughes will step down as our audit partner in accordance with the five-year rotation and will be succeeded by John Waters. After discussing the handover process in detail with Craig Hughes and our Finance Director, Damian Wisniewski, we are confident that the transition and handover period will be efficiently managed.

Further engagement

I welcome questions from shareholders on the Committee's activities. If you wish to discuss any aspect of this report, please contact me via our Company Secretary, David Lawler (telephone: +44 (0)20 7659 3000 or email: company.secretary@derwentlondon.com).

I will be attending the 2019 AGM, alongside my fellow Board members, and look forward to meeting you there.

Stephen Young
Chair of the Audit Committee
26 February 2019

Committee composition

During the year under review, the Committee was composed of four independent Non-Executive Directors with a wide range of experience, including real estate and finance. The Chair, Stephen Young, is a qualified accountant and has an appropriate level of recent and relevant financial experience to discharge his duties as chair of the Committee. Lucinda Bell, who joined the Committee on 1 January 2019, will become chair of the Committee following Stephen Young's retirement from the Board on 17 May 2019.

	Independent	Number of meetings	Attendance
Stephen Young, Chair	Yes	3	100%
Simon Fraser	Yes	3	100%
Richard Dakin	Yes	3	100%
Claudia Arney	Yes	3	100%

The Committee's role and responsibilities are set out in the terms of reference, which were last updated in August 2017 and are available on the Company's website at: www.derwentlondon.com/investors/governance/board-committees

Meetings of the Committee

During the year under review, the Committee met three times, in February, August and November (2017: four meetings). In addition to the Committee members, meetings are attended by the external Auditor and members of the Group's senior management team, at the request of the Committee Chair. Two additional meetings are held each year with the Group's external property valuers to consider the valuation of our property portfolio.

Significant financial judgements

Any key accounting issues or judgements made by management are monitored and discussed with the Committee throughout the year. The table below provides information on the key issues discussed with the Committee in 2018 and the judgements adopted.

Issue	Judgement
Valuation of the Group's property portfolio	
The Committee considers this to be a major area of judgement in determining the accuracy of the financial statements as it is the principal component of the Group's net asset value	The valuation is performed by CBRE Limited and Savills (UK) Limited (the 'external valuers') and, due to its significance, is also reviewed by the external Auditor. The valuation is determined without management being present (see page 106). The Committee reviewed the underlying assumptions used in the valuation and the external valuers' independence and methodology. These procedures enabled the Committee to be satisfied with the assumptions and judgements used in the valuation of the Group's property portfolio.
Taxation and REIT compliance	
Should the Group not comply with the REIT regulations, it could incur tax penalties or ultimately be expelled from the REIT regime, which would have a significant effect on the financial statements	The Group employs a qualified and experienced Head of Tax whom the Committee meets at least annually. The Committee noted the frequency with which compliance with the regulations was reported to the Board and considered the margin by which the Group complied. Based on this and the level of headroom shown in the latest Group forecasts the Committee agreed that, once again, no further action was required for the current year.
Borrowings and derivatives	
Calculation of the fair values of the Group's financial instruments, such as the 2019 convertible bonds and interest rate swaps	The Committee noted that the valuations were carried out by an independent third party which had valued the instruments in previous years and that the external Auditor used its own treasury specialists to re-perform the valuation and to assess the reasonableness thereof. The external Auditor subsequently confirmed that no issues had arisen relating to the valuation. The Committee was satisfied with the level of assurance gained from these procedures.

Financial reporting

One of the Committee's principal responsibilities is to review and report to the Board on the clarity and accuracy of the Group's financial statements, including the Annual Report and interim statement. When conducting its reviews, the Committee considers the overall requirement that the financial statements present a 'true and fair view' and the following:

- the accounting policies and practices applied (see page 109 of this report for further details on internal financial controls);
- material accounting judgements and assumptions made by management;
- significant judgements or key audit matters identified by the external Auditor (see pages 105 and 140); and
- compliance with relevant accounting standards and other regulatory financial reporting requirements including the UK Corporate Governance Code.

In order to assess the financial statements, the Committee regularly reviews reports from members of the finance team and external Auditors who are invited to attend the Committee's meetings. Through face-to-face discussions and detailed written reports, the Committee are able to understand the business rationale for transactions and how they are being recorded and disclosed in the financial statements.

AUDIT COMMITTEE REPORT CONTINUED

Valuation

Our property portfolio is valued by the external valuers for our interim and year end results. As at 31 December 2018, it was valued at £5.2 billion (2017: £4.9 billion) and principally consists of 86 properties in 13 'villages' across London.

The valuation of the portfolio underlies the net asset value. Movements in that valuation are a significant part of how we measure our progress and a key determinate of the Group's total return (a KPI and a performance measure for our Executive Directors' variable remuneration – see pages 40 and 125). Due to its significance, the Committee monitors the objectivity and independence of the external valuers' work and hosts the valuation meetings without management being present.

The valuation meetings typically occur in February and July prior to Audit Committee meetings. Due to his position as Managing Director of Capital Advisors Limited (a wholly-owned subsidiary of CBRE Limited), Richard Dakin does not take part in discussions regarding the valuation of the Group's property portfolio (see page 97).

Key matters discussed during the meetings include the assumptions underlying the valuation, any valuation which required a greater level of judgement than normal, for example development properties, and any valuation movements that were not broadly in line with that of the MSCI Investment Property Databank (IPD) benchmark. The assumptions are discussed with the external Auditor and an update on the matters discussed at the meetings is provided to the Board.

External Auditor

The Committee has primary responsibility for overseeing the relationship with the external Auditor, including assessing their performance, effectiveness and independence annually and recommending to the Board their reappointment or removal.

Following a comprehensive tender in 2014, PricewaterhouseCoopers LLP (PwC) were appointed as the Group's Auditor. Prior to this appointment, BDO had been the Group's Auditor since 1985. The Committee anticipates that the next competitive tender will be conducted no later than 2024 in accordance with current regulation that requires a tender every 10 years. There are no contractual obligations which restrict the Committee's choice of Auditor or a minimum appointment period.

The Company has complied with the provisions of the Competition and Markets Authority's Order for the financial year under review in respect to audit tendering and the provision of non-audit services.

Change in audit partner

Craig Hughes will reach the end of his term as audit partner following the 2018 year end audit. The Committee met with the new audit partner, John Waters, during the year. The transitional arrangements were discussed in detail with PwC and our Finance Director to ensure a smooth handover and induction process. The first audit under the supervision of John Waters will be the 2019 year end audit.

Working with the Auditor

The external Auditor (the lead audit partner and his team) attends the Committee's meetings to provide insight and challenge and to present their reports on the review of the half-year results and audit of the year end financial statements. To further facilitate open dialogue and assurance, the Committee holds private sessions with the Auditor without members of management being present.

Annual review of the external Auditor

Following the year end audit, the Committee assessed the effectiveness of the external Auditor. The assessment took into account the views of senior management and was supported by a questionnaire which covered the Auditor's resources, objectivity, character, knowledge, organisation, judgements and quality of reporting.

As part of their review, the Committee reviewed the audit plan, which was focused on risk and materiality, and considered the quality of their planning, whether the agreed plan had been met, the extent to which it was tailored to our business and its ability to respond to any changes in the business.

An important aspect of managing the external Auditor relationship is ensuring there are adequate safeguards to protect Auditor objectivity and independence. In assessing this matter, the Committee considered the following:

- the Auditor's independence letter which annually confirms their independence and compliance with the Financial Reporting Council's (FRC) Ethical Standard;
- the operation, and compliance with, the Group's policy on non-audit work being performed by the Auditor;
- the tenure of the external Auditor and the lead audit partner;
- how the Auditor identified risks to audit quality and how these were addressed, including the network level controls the Auditor relied upon; and
- the outcome of the FRC's inspection of PwC's audit quality (further information is provided below).

After taking all of these matters into account, the Committee concluded that PwC had performed their audit effectively, efficiently and to a high quality. Accordingly, the Committee has recommended to the Board that PwC be reappointed as Auditor to the Group for the year ending 31 December 2019. Any feedback arising from the annual assessment will be discussed with the external Auditor for implementation into the audit plan for the next year end audit.

FRC's Audit quality review

The FRC's Audit Quality Review team (AQR) carried out a review of the audit of our financial reporting for the 31 December 2017 financial year as part of their routine process. The chair of the Committee was involved in the planning for the review which included a preparatory call with the FRC. Following completion of the AQR, the Committee was provided with a report from the FRC's AQR Team and received a verbal update on the outcome from PwC. The Committee were pleased to note that there were no significant recommendations made by the FRC for further improvement.

Non-audit services

The objective of maintaining the Non-Audit Services Policy is to ensure that the provision of such services do not impair the external Auditor's independence or objectivity. During 2018, PwC provided non-audit services which totalled £45,095, including the review of our half-year results (2017: £43,715).

£'000	2018	2017
Audit of Derwent London plc and subsidiaries	350	340
Review of interim results	41	40
Other non-audit services	4	4
Total fees	395	384

Overview of our Non-Audit Services Policy

Under the policy, all services provided by the external Auditor (other than the audit itself) are regarded as non-audit services. Our policy draws a distinction between permissible services (which could be provided subject to conditions set by the Committee) and prohibited services (which may not be provided by the external Auditor except in exceptional circumstances when the Auditor has been provided with approval by the Financial Conduct Authority). The type of non-audit services deemed to be permissible include: review of the half-year results, assurance work on non-financial data, tax services, including tax advisory, and reporting best practice.

The Committee has provided pre-approval which allows management to appoint the external Auditor to conduct permissible non-audit services if they fall below a set fee level. The Committee review the pre-approval limit on an annual basis and it is currently set at £25,000. Permissible services which are above the pre-approval limit require approval from at least two members of the Audit Committee (including the Committee Chair). When considering if the services should be approved, the Committee will ensure that the Auditor's objectivity and independence are not threatened. Any non-audit service provided by the external Auditor is reported to the Board. In the unlikely event that the provision of non-audit services would exceed £100,000, the Committee would request Board approval.

AUDIT COMMITTEE REPORT CONTINUED

Internal audit

On an annual basis, the Committee considers whether Derwent London would benefit from the establishment of an internal audit function. Although historically this was not deemed necessary – due to the relatively small scale and level of complexity of the organisation, the focused nature of the Group's business and the close involvement of Directors in day-to-day operations – it was agreed in August 2018 that an outsourced internal audit function would be established to provide additional assurance and suggestions for best practice improvements.

In November, four internal audit firms presented to the Committee Chair and executive team. It was agreed that RSM would be appointed to provide an outsourced internal audit function, initially for a three-year period, to conduct a series of risk-based internal audits and projects. RSM perform no other work for the Group and are considered by the Committee to be independent.

The Committee will approve the internal audit plan for 2019 in May 2019 in liaison with the Risk Committee. RSM will attend each Committee meeting to present their findings and progress against the internal audit plan. The other Board Committees will be kept updated on the outcome of any reviews which fall within their areas of responsibility.

Viability statement

We have reviewed the process and assessment of the Company's prospects and viability made by management for the next five years which formed the basis for the viability statement (see page 44).

Whistleblowing

As a business, we seek to conduct ourselves with honesty and integrity and believe that it is our duty to take appropriate measures to identify and remedy any malpractice within or affecting the Company. Our employees embrace our high standards of conduct and are encouraged to speak out if they witness any wrongdoing which falls short of those standards.

Our whistleblowing procedures are included within our staff handbook, on our Group intranet and staff noticeboards. In addition to an independent reporting line for anonymous reporting of concerns, the Senior Independent Director acts as an independent point of contact for whistleblowing concerns.

Our whistleblowing policy ensures that any significant issues relating to potential fraud are escalated to the chair of the Committee immediately. The Committee receives updates from the Company Secretary on the operation of the whistleblowing system. During the year under review, we did not receive any whistleblowing messages (2017: no messages).

Review of the 2018 Annual Report

At the request of the Board, the Committee was asked to review the Group's Annual Report and to consider whether, taken as a whole, it was fair, balanced and understandable. In carrying out its review, the Committee had regard to the following:

Fairness and balance

- Is the report open and honest, are we reporting on our weaknesses, difficulties and challenges alongside our successes and opportunities?
- Do we provide clear explanations of our KPIs and is there strong linkage between our KPIs and our strategy?
- Do we show our progress over time and is there consistency in our metrics and measurements?

Understandable

- Do we explain our business model, strategy and accounting policies simply using precise and clear language?
- Do we break up lengthy narrative with quotes, tables, case studies and graphics?
- Do we have a consistent tone across the Annual Report?
- Are we clearly 'signposting' to where additional information can be found?

Specific considerations for the 2018 Annual Report

Are we providing clear and detailed explanations in respect of:

- Our Board succession plans and how we intend to mitigate against any governance issues?
- Brexit risk and opportunities?
- The remuneration paid to Executive Directors and senior managers in respect to Board succession changes?

Structural changes to the 2018 Annual Report included:

- the introduction of a dedicated stakeholder section within the Strategic report (see pages 18 to 19);
- restructuring the Responsibility report to provide clearer explanation and linkage (see pages 74 to 81);
- expanded disclosures on our viability assessment (see pages 44 to 45); and
- the introduction of 'Governance at a glance' and 'Remuneration at a glance' to improve readability (see pages 86 and 118).

The Committee paid particular attention to these changes to ensure they did not impact on the balance and clarity of the Annual Report.

Following its review, the Committee confirmed to the Board that the 2018 Annual Report is fair, balanced and provides sufficient clarity for shareholders to understand our business model, strategy, position and performance.

Internal control

On an ongoing basis, the Committee reviews the adequacy and effectiveness of the Group's system of internal financial controls which are described briefly in the table below.

While Derwent London is a large business in terms of the size of its balance sheet and market capitalisation, we are relatively small when considering the number of people working directly in the business. Almost all of our staff work in the same building and are in close proximity to our Executive Committee members, making for close supervision and easy monitoring. Our Group structure is organised to be simple and transparent (i.e. relatively few subsidiaries, no offshore structure, very few joint ventures) and our internal control procedures and policies are well established, reviewed annually and subject to external verification.

The Committee received detailed reports on the operation and effectiveness of the internal controls from members of the senior management team. The outcome of the external audit at year end and the half year review are considered in respect to our internal controls. The Committee also receives updates on the policies and procedures in place and how these are being communicated to and complied with by our staff.

The Committee remains satisfied that the review of internal controls did not reveal any significant weaknesses or failures and they continue to operate effectively.

During 2018, the following changes were made to our system of internal controls:

- **Payroll:** After the Head of HR has approved the payroll, an analytical review is performed by the Group Financial Controller of each employee's pay and changes are investigated. A summary sheet explaining the movements from one month to the next is also now given to the approver and authoriser of the salary BACS.
- **'Know your client' procedures:** These have been subject to in-depth review and have been further strengthened to minimise risk exposure. The Committee reviewed a flowchart of processes at its November meeting, and the forms which require completion for all property acquisitions, disposals and residential lettings. Further information on tenant covenants is available on page 114.
- **Anti-bribery and corruption:** Our procedures have been reviewed and strengthened during the year with a revised anti-bribery policy and Hospitality & Gift Return (see page 113). **Whistleblowing:** The Committee reviewed the whistleblowing procedures and recommended the introduction of an anonymous reporting line for concerns via an independent third party. The new system will be operational in Q2 2019. Further information on whistleblowing is available on page 108.

Overview of internal controls	
Governance framework	Our governance framework (see page 87) supports effective internal control through an approved schedule of matters reserved for decision by the Board and the Executive Committee, supported by defined responsibilities, levels of authority and supporting committees.
Financial reviews and internal procedures	Comprehensive systems of financial reporting and forecasting which are conducted frequently and include both sensitivity and variance analysis. An annual budgeting exercise is carried out with three rolling forecasts prepared. A five-year strategic review is prepared annually. Break-even and sensitivity analyses are included in both the five-year strategic review and the rolling forecasts.
Risk identification and monitoring	The Risk Committee regularly reviews the Group's risk register, the schedule of key controls and key risk indicators. The schedule of key controls provides evidence of how the controls are being operated and their effectiveness. Our risk management procedures are robust and include initiatives such as a 'tenant at risk' register and a back-up IT facility. The Risk Committee's report is on pages 110 to 115.
Training and staff awareness	Staff compliance with internal policies are routinely confirmed to the Committee. Staff are aware of the delegated authority limits set by the Board and confirm their understanding of our internal policies which are contained on our Group intranet and in our employee handbook. Staff have six-monthly performance reviews with any training requirements identified and fulfilled within six months. The Group operates a whistleblowing policy which includes access to an independent helpline for anonymous reporting of concerns.
External verification	During the year, no significant deficiencies had been raised by PwC as a result of their controls testing undertaken as part of the annual audit. The Group's VAT procedures are subject to ongoing periodic review by external advisers. Comprehensive reviews of the Group's financial controls have also been undertaken with assistance from external advisers. Regular annual credit ratings, including risk assessments, are conducted. In 2018, we appointed Fitch to provide our corporate credit rating. Each year, at renewal, a comprehensive review of the Group's insurance cover is prepared by its independent insurance adviser.