

AUDIT COMMITTEE REPORT



Lucinda Bell
Chair of the Audit Committee

2020 FOCUS AREAS

- Ensure a smooth transition as Sandra Dowling becomes the new audit partner
- Review our internal financial control procedures to ensure they continue to operate effectively
- Monitor changes to legislation and the UK Corporate Governance Code following the publication of The Brydon Report
- Review the external valuers' appointment policy
- Conduct a review of RSM's effectiveness and assess their compliance with the Internal Audit Code of Practice

Dear Shareholder,

This is my first report to you as Chair of the Audit Committee after Stephen Young stepped down from the Board at the 2019 AGM. I am pleased to provide you with an overview of the Committee's main activities and areas of focus during the year.

Portfolio valuation

The Committee considers the valuation of the Group's property portfolio to be a major area of judgement in determining the accuracy of the financial statements. A subcommittee of the Audit Committee meets twice yearly to review the underlying assumptions and estimates made during the valuation process (see page 124).

During the year under review, the Committee:

- performed a detailed effectiveness review of our external valuers;
- reviewed and approved the proposed new lead valuer signatories at CBRE Limited; and
- agreed that a detailed review of our valuers' appointment policy would be conducted during 2020.

External Auditor

Following the 2019 year-end audit, John Waters will step down as our audit partner and will be succeeded by Sandra Dowling. After discussing the handover process in detail with our Chief Financial Officer, Damian Wisniewski, we are confident that the transition and handover period will be efficiently managed.

Internal audit

The Committee appointed RSM to act as the Group's outsourced internal audit function in December 2018 and approved the 2019 audit plan at a joint meeting with the Risk Committee in May 2019. An overview of the reviews performed is provided on page 126 of this report.

Overall, the Committee has been pleased with the work performed by RSM and with the additional assurance received from their reviews. Management have actively embraced any recommendations raised and have acted swiftly to implement the limited number of recommendations identified. We intend to perform a formal review of RSM's effectiveness during 2020.

Financial reporting

We were pleased to advise the Board that the 2019 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 127.

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 2020 AGM alongside my fellow Board members and look forward to meeting you there.

Lucinda Bell
Chair of the Audit Committee
25 February 2020

Committee composition

During the year under review, the Committee was composed of independent Non-Executive Directors with a wide range of experience, including real estate and finance (biographies are available on pages 98 to 99). The Chair, Lucinda Bell, is a Chartered Accountant and has an appropriate level of recent and relevant financial experience to discharge her duties as Chair of the Committee.

	Independent	Number of meetings	Attendance
Lucinda Bell, Chair	Yes	4	100%
Simon Fraser	Yes	4	100%
Richard Dakin	Yes	4	100%
Claudia Arney	Yes	4	100%
Stephen Young ⁽ⁱ⁾	Yes	2	100%

⁽ⁱ⁾ Stephen Young attended all meetings until he stepped down from the Board on 17 May 2019.

The Committee's role and responsibilities are set out in the terms of reference, which were last updated in November 2019 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 four times, in February, May, August and November (2018: three meetings). In addition to the Committee members, meetings are attended by the internal and external auditors and members of the Group's senior management team, at the request of the Committee Chair. Two additional subcommittee meetings are held each year with the Group's external property valuers to consider the valuation of our property portfolio.

Significant financial judgements, key assumptions and estimates

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 2019 and the judgements adopted.

Issue	Assumptions or estimates	Judgement
Valuation of the Group's property portfolio		
Due to its size and nature and the direct impact upon the Group's net asset value, the Committee considers this to be the primary area of judgement in determining the accuracy of the financial statements	The valuation considers a range of assumptions including future rental income, investment yields, anticipated outgoings and maintenance costs, future development expenditure and appropriate discount rates. The external valuers also make reference to market evidence of transaction prices for similar properties (see note 16 on pages 195 to 198).	The valuation is performed twice yearly by CBRE Limited and Savills (UK) Limited (the 'external valuers') and, due to its significance, is also reviewed by the external Auditor. 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 estimates used in the valuation of the Group's property portfolio.
Taxation and REIT compliance		
Should the Group not comply with UK 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	As a REIT, the Group benefits from tax advantages. Income and chargeable gains on the qualifying property rental business are exempt from corporation tax. Income that does not qualify as property income within the REIT rules is subject to corporation tax in the normal way. There are a number of tests that are applied annually, and in relation to forecasts, to ensure the Group remains well within the limits allowed within those tests.	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 tests and 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.
Borrowings and derivatives		
The calculation of fair values for the Group's financial instruments, such as the USPP notes, 2025 convertible bonds and interest rate swaps, is a technical and complex area and the amounts involved are significant	The fair values of the Group's borrowings and interest rate swaps are provided by an independent third party based on information provided to them by the Group. This includes the terms of each of the financial instruments and data available in the financial markets (see note 24 on page 203).	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 valuations. The Committee was satisfied with the level of assurance gained from these procedures.

Committee performance evaluation

As part of the externally facilitated Board evaluation performed by The Effective Board LLP during Q4 2019, the Committee's effectiveness was subject to review. The Committee was concluded to work effectively and no recommendations were raised. The evaluator did highlight two areas of the Committee's work for being particularly robust (its viability processes and review of internal financial controls), further information on page 113.

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 note 42 on pages 230 to 233);
- the effectiveness and application of internal financial controls (see page 126);
- material accounting assumptions and estimates made by management (see note 3 on page 185);
- significant judgements or key audit matters identified by the external Auditor (see pages 175 and 176); 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 members 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

Portfolio valuation

Our property portfolio is valued by the external valuers for our interim and year-end results. As at 31 December 2019, it was valued at £5.475bn (2018: £5.2bn) and principally consists of 82 properties in 13 'villages' across London.

p.16 Our property portfolio

The valuation of the portfolio is a major component of net asset value. Movements in that valuation are a significant part of how we measure our progress and a key determinant of the Group's total return (a KPI and a performance measure for our Executive Directors' variable remuneration – see pages 40 and 156). Due to its significance, the Committee monitors the objectivity and independence of the external valuers' work and hosts the valuation meetings.

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 110).

Key matters discussed during the meetings include:

- the assumptions underlying the valuation and the quality of data;
- any valuation which required a greater level of judgement than normal, for example development properties;
- any valuation movements that were not broadly in line with that of the MSCI Investment Property Databank (IPD) benchmark;
- the London commercial property market and the potential impact of Brexit on the valuation; and
- the quality of the Derwent London team.

The assumptions underlying the valuation are discussed with the external Auditor and an update on the matters discussed at the meetings is provided to the Board.

During the year, the Committee also reviewed and approved the proposed new lead valuer and signatories at CBRE Limited. As part of this review, the Committee were assured that the changes were compliant with the Red Book¹ and in accordance with CBRE's internal policies which require lead valuer rotation every five years.

Effectiveness of the Group's valuers

In February 2020, the valuation meeting reviewed the effectiveness of the external valuers with assistance from Nigel George. The review considered the following:

- experience and qualification of the valuation team;
- independence and objectivity;
- quality of reporting; and
- robustness of the valuation.

The meeting concluded that the external valuers continue to perform effectively and are compliant with the Red Book¹.

The Audit Committee agreed to review its valuer appointment policy in August 2020, to ensure it reflects the most recent RICS proposals and best corporate governance practice. One aspect of the review will include considering the RICS 2020 Futures Report which is due to be published in the first half of 2020.

External Auditor

The Committee has primary responsibility for managing 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's current intention is to conduct its next competitive tender for the 2024 year-end audit, in accordance with current regulation that requires a tender every 10 years. This timetable is subject to annual assessment of the Auditor's effectiveness and independence (see page 125).

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.

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.

¹ 'RICS Valuation – Global Standards 2017' (the Red Book).

Annual review of the external Auditor

Following the year-end audit, the Committee assessed the effectiveness of the external Auditor. This effectiveness review is performed on an annual basis and aims to ensure a robust audit is performed, auditor performance is optimised and encourages candid feedback and communication between the Auditor and the Committee.

The assessment took into account the views of the Chief Financial Officer, finance team and senior management and was supported by a questionnaire. The questionnaire allowed the Committee to track progress and improvements from prior years. The areas covered by the review are detailed in Chart 1 below.

Chart 1: Annual effectiveness review of the external Auditor



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 the Group’s business and its ability to respond to any changes in the business.

The Committee also considered the outcome of the review by the Financial Reporting Council, published in July 2019, containing the conclusions from 26 audit file inspections at PwC. The Committee noted that six of the 26 audit files reviewed required improvements. The Committee received confirmation from PwC that they were committed to further investment to support audit quality, including additional funding for recruitment, training and technical support. The Committee also took into account the Audit Quality Review by the FRC in respect of the Derwent London 31 December 2017 audit which had no recommendations for improvement.

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 2020, subject to reappointment at the 2020 AGM. 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.

Non-audit services

The Group’s pre-approval policy for the provision of non-audit services by the external Auditor is described on page 126.

The objective of maintaining the Non-Audit Services Policy is to ensure the independence of the external Auditor is not compromised and that the provision of such services do not impair the external Auditor’s objectivity. During 2019, the only significant non-audit services provided by PwC was in respect of the interim results review. The Committee intends to review its Non-Audit Services Policy during 2020.

	2019		2018	
	£'000	%	£'000	%
Audit of Derwent London plc and subsidiaries	387	90%	350	89%
Review of interim results	42	10%	41	10%
Other non-audit services	-	-	4	1%
Total fees	429	100%	395	100%

AUDIT COMMITTEE REPORT CONTINUED

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.

Internal audit

RSM were appointed as the Group's outsourced internal audit function in December 2018 following a competitive tender process and are considered by the Committee to be independent. In addition to performing an internal audit function, RSM also review our year-end tax returns.

The Internal Audit Plan for 2019 was approved jointly by the Risk and Audit Committees in May and includes a combination of risk-based audits and projects. During 2019, RSM performed six audits:

- budgeting and reforecasting;
- risk management and assurance mapping;
- procurement – major developments;
- cyber security;
- know your client/anti-money laundering; and
- cash and treasury management.

The outcome of these audits has been presented to the Risk and Audit Committees. The Committees were pleased with the level of assurance received from the audits and that no high priority actions were raised.

The Committee receives a report on internal audit activity at each meeting and monitors the status of internal audit recommendations and management's responsiveness to their implementation. The other Board Committees are kept updated on the outcome of any reviews which fall within their areas of responsibility.

During 2020, the Committee will receive an update on RSM's compliance with The Institute of Internal Auditors' Internal Audit Code of Practice.

The Committee has agreed to review the performance and effectiveness of the outsourced internal audit function (RSM) after they have been in their position for one year. The effectiveness review is therefore a focus area for 2020. The Internal Audit Plan for 2020 has been approved by the Audit and Risk Committees and will include audits on the following:

- due diligence on acquisition of property;
- charity and sponsorship;
- compliance management – building regulations;
- service charge management; and
- core financial controls.

Internal financial controls

On an ongoing basis, the Audit Committee reviews the adequacy and effectiveness of the Group's system of internal financial controls which are described briefly in table 1 on page 127.

The Committee received detailed reports on the operation and effectiveness of the internal financial 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.

During 2019, the following changes were made to our system of internal financial controls:

- updated our 'new supplier set-up form', which now includes a questionnaire for completion by the new supplier which obtains information to reduce risk in areas including tax (VAT, CIS, PAYE), health and safety, insurance arrangements and their supply chain, as well as providing key data such as bank account details. This process must be completed prior to work being instructed;
- as cyber risk has grown and systems have become more complex, these areas have been given much greater focus. This includes annual security awareness training, which is mandatory for all employees (further information on page 134); and
- updated our Expenses Policy, which provides guidance to employees on what they can claim and the details that need to be provided for a claim to be valid.

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) and our internal control procedures and policies are well established, reviewed annually and subject to external verification.

The Committee remains satisfied that the review of internal financial controls did not reveal any significant weaknesses or failures and they continue to operate effectively. Information on the Risk Committee's review of non-financial internal controls and risk management is available on pages 128 to 135.

Table 1 – Overview of Internal Financial Controls

Governance framework	Our governance framework (see page 97) 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.
Treasury and tax procedures	Treasury is controlled by the Chief Financial Officer and Treasurer. All transactions are checked and monitored. All complex or large transactions are discussed in advance with the Board and Executive Directors and are externally reviewed by our advisers. Taxation is a complex area and is subject to frequent external review. Corporate tax returns are prepared by the Tax Assistant and reviewed by the Group Head of Tax and, on a sample basis, by RSM. Other higher risk areas like PAYE and CIS (the Construction Industry Scheme which requires us to deduct tax at source from the labour element of a subcontractor’s invoice unless they are properly authorised by HMRC) is subject to thorough examination and testing. We maintain an open relationship with HMRC and have a ‘low risk’ tax status. Further information on tax risk and tax governance is on pages 48 and 91.
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 128 to 135.
Training and staff awareness	Staff compliance with internal policies is 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 (see page 109).
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. Each year, at renewal, a comprehensive review of the Group’s insurance cover is prepared by its independent insurance adviser.

Review of the 2019 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 Financial Reporting Council (FRC) letter to Audit Committee chairs dated 30 October 2019 which outlined the key developments for 2019/20 annual reports, in addition 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?

Structural changes to the 2019 Annual Report included:

- Improved navigation of the Responsibility section through an ‘ESG’ overview (see page 76);
- Revised structure of the Responsibility section, including additional disclosures on environmental, community and ESG governance;
- Inclusion of the new Remuneration Policy for Executive Directors (see pages 143 to 149); and
- The first report of the Responsible Business Committee (see pages 136 to 139).

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 2019 Annual Report is fair, balanced and provides sufficient clarity for shareholders to understand our business model, strategy, position and performance.

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. Further information on this assessment is contained on page 44.

 Viability statement