

# AUDIT COMMITTEE REPORT

“ THE GROUP CONTINUES TO MAINTAIN A CULTURE OF ROBUST AND EFFECTIVE SYSTEMS OF INTERNAL CONTROL, OVERSEEN BY STRONG AND EXPERIENCED FINANCE DEPARTMENTS ”

Anne Thorburn, Chairman of the Audit Committee



Members of Committee	Attendance
Anne Thorburn (Chairman)	5/5
Charles Packshaw	5/5
Andy Smith	5/5

## DEAR SHAREHOLDER

The Committee welcomed Christopher Burns of PwC to the Company as the new auditor this year, following the formal appointment at the AGM of PwC as auditor to the Company after a competitive tender process last year. After attending last year's audit close meeting, alongside the retiring auditor, they worked diligently during the first half of the year to complete their audit transition process. At the close of this process PwC met with the Committee to confirm that they had completed their handover with the retiring auditor, had met with senior finance staff across the business and they had no significant concerns to bring to the Committee's attention.

In March this year, the Committee received a report from the Group finance team that set out a detailed evaluation of the potential impact that the new IFRS15 standard on Revenue may have on the Group's financial statements. The report was based on detailed discussions that the Group finance team had with each of the individual businesses. As expected, given the nature of the Group's business, this work confirmed that the impact on the financial statements from adopting IFRS15 was negligible. A similar exercise will be carried out in 2019 to assess the potential impact of adopting IFRS16 on Leases, and it is likely that the impact on the financial statements may be significant, as explained further on page 93 in the notes to the consolidated financial statements.

The Committee was pleased to welcome during the year the appointment of an experienced tax professional as Head of Group Tax & Treasury. The tax environment and tax demands on business have become increasingly more complex in recent years, particularly where the Group has significant operations based outside the UK. This appointment will ensure that the Group businesses both maintain compliance with local tax legislation and focus on good tax governance.

I also look forward to Neil Yazdani joining the Group in January 2019 as Group Financial Controller. Neil will replace Stuart Bell who has now moved to International Seals to support Darin Clause as Finance Director of those businesses.

As Chairman of the Committee, I continue to meet regularly with members of the Internal Audit team to discuss their reports, prepared following each of their visits to the businesses. This provides me with greater insight of the culture of the internal control environment in the Group and provides assurance that controls are both in place and are tested, which is particularly important given the Group's decentralised operating model.

I am pleased to report that again there have been no significant control deficiencies or accounting irregularities reported to the Committee this year. The Group continues to maintain a culture of robust and effective systems of internal control, overseen by strong and experienced finance departments.

I look forward to meeting shareholders at the AGM on 16 January 2019 and will be happy to respond to any questions relating to the activities of the Audit Committee.

**Anne Thorburn**  
19 November 2018

# AUDIT COMMITTEE REPORT CONTINUED

## KEY DUTIES AND FOCUS IN 2018

The Audit Committee is responsible for ensuring that the Company maintains a strong control environment. It provides effective governance over the Group's financial reporting, including oversight and review of the systems of internal control and risk management, the performance of internal and external audit functions, as well as the behaviours expected of Diploma PLC's employees through the whistleblowing policy and similar codes of conduct. The Committee's role and responsibilities are set out in its Terms of Reference, which are reviewed every two years and are approved by the Board.

The Terms of Reference are available at [www.diplomaplc.com/governance/constitutional-documents](http://www.diplomaplc.com/governance/constitutional-documents). The Committee's key responsibilities and focus during the year have been:

- Reviewed and agreed the scope of audit work to be undertaken by the external auditor and agreed the terms of engagement and fees to be paid for the external audit.
- Reviewed the Annual Report & Accounts and received reports from the Group Finance Director and the external auditor on the key accounting issues and areas of significant judgement.
- Reviewed the report on compliance with the UK corporate governance Code and reports on the provision of information to the auditor.
- Reviewed the report from the Group Finance Director on the controls in place to mitigate fraud risk.
- Reviewed the Half Year Announcement and received reports from the Group Finance Director and the external auditor on the key accounting issues and areas of significant judgement.
- Reviewed a report from the Group finance department setting out the impact of new IFRSs on the Group's financial statements, including in particular IFRS15 (revenue from contracts with customers).
- Reviewed and approved the classification and presentation of the costs incurred on the CEO transition.
- Reviewed the Trading Updates at meetings held in January, March and August.
- Reviewed the effectiveness of the Group's internal control and risk management procedures and, where appropriate, made recommendations to the Board on areas for improvement.
- Invited the Director of Internal Audit to attend meetings to review the results of the Internal Audit work for the current year and to agree the scope and focus of Internal Audit work to be carried out in the following year.
- Reviewed the transition to PwC following their appointment as the Group's external auditor.
- Approved the Committee work programme for 2018.
- Reviewed the scope of new sanctions issued by the European Union and the US and the procedures being followed by the Group's businesses to monitor compliance.
- Reviewed the whistleblowing arrangements and the use of a dedicated external independent and confidential telephone hotline service for all employees to raise concerns.

## AUDIT COMMITTEE

The Committee is chaired by Anne Thorburn and comprises three independent non-Executive Directors. The Chair of the Committee is a qualified accountant, who has recent and relevant financial experience.

The Audit Committee is satisfied that as a whole, the Committee has sufficient knowledge and competence of the business model and Sectors in which the Group operates in order to provide appropriate challenge to management.

The Group Company Secretary acts as Secretary to the Committee. The Executive Directors also attend Committee meetings and the Internal Audit Director also attended Committee meetings to present the Internal Audit plan for the following year and to report on progress against that plan. The Committee met with the external auditor during the year, without the Executive Directors being present.

The Audit Committee confirms that the Company has complied with the provisions of the Competition & Markets Authority Order throughout its financial year ended 30 September 2018 and up to the date of this report.

## AUDIT TRANSITION

The Audit Committee completed an audit tender process in 2017 (as described more fully in the Annual Report & Accounts 2017) and recommended to the Board the appointment of Christopher Burns, PricewaterhouseCoopers LLP ("PwC") as auditor. The Board accepted and endorsed this recommendation, which was approved by shareholders at the AGM held on 17 January 2018.

The Audit Committee agreed an audit transition plan with PwC which identified key milestones, beginning with PwC shadowing Deloitte LLP ("Deloitte"), the retiring auditor, at the 2017 Group audit close meeting with management and the Audit Committee meeting held on 14 November 2017. During the first half of this year, PwC met with both members of the Group finance department and senior finance personnel of the larger businesses in the Group. At these meetings, work was carried out by PwC to plan their audit approach and prepare their audit strategy for the 2018 audit. In May, PwC reported to the Audit Committee that they had completed their audit transition plan and that there were no substantive matters to report to the Committee.

### ENGAGEMENT OF THE EXTERNAL AUDITOR

The external auditor is engaged to express an opinion on the financial statements of the Group and of the Company. The audit includes the review and testing of the systems of internal financial control and the data contained in the financial statements, to the extent necessary for expressing an audit opinion on the truth and fairness of the financial statements.

As explained above, the Company's Annual Report & Accounts this year has been audited by PwC. In their first year as auditor, PwC has met with the Audit Chair and has agreed its audit strategy and audit fees with the Audit Committee. As part of its audit, PwC will continue to provide the Committee with relevant reports, reviews and advice throughout the coming year.

In accordance with UK regulations, PwC also assured the Committee that it adheres to a rotation policy based on best practice and the Group engagement partner will serve a period of no longer than five years.

During the year, the Committee carried out an assessment of the effectiveness of the external audit process for the previous year ended 30 September 2017, which was carried out by Deloitte. The assessment was led by the Chair of the Committee, assisted by the Group Finance Director and focused on certain criteria which the Committee considered to be important factors in demonstrating an effective audit process. These factors included the quality of audit staff, the planning and execution of the audit and the role of management in the audit process. Following this assessment, the Committee concluded that the external audit process remained effective and that it provides an appropriate independent challenge of the Group's senior management.

The Committee was satisfied that the Deloitte audit of the Company and Group had provided a robust and effective audit and supported the work of the Committee through clear and objective communication on developments in financial reporting and governance.

### NON-AUDIT SERVICES

The Committee has reviewed the Company's internal guidelines covering the type of non-audit work that can be carried out by the external auditor of the Company, in light of the regulation set out in the EU Audit Directive and Audit Regulation 2014 ("the Regulations").

The Regulations substantially curtail those non-audit services that can be provided by the auditor to the Company and in particular, prohibits all tax related services, including compliance services as well as general advice and all consultancy and advisory services. The Regulations require that Board approval is required if eligible non-audit services, such as due diligence and similar assurance services exceed 30% of the prior year Group audit fee and the Company may not allow eligible non-audit services to exceed 70% of the Group audit fee, calculated on a rolling three-year basis.

The Group Finance Director does not have delegated authority to engage the auditor to carry out any non-audit work, but must seek approval from the Chair of the Audit Committee.

Taxation services are not provided by the Group's current audit firm; a separate firm is retained to provide tax advice and any assistance with tax compliance matters generally. In addition, due diligence exercises on acquisitions and similar transactions are not provided by the auditor, but are placed with other firms.

The Group auditor is retained to carry out assurance services to the Committee in connection with "agreed upon procedures" on the Group's Half Year consolidated financial statements. With the exception of this work, PwC has not provided any non-audit services to the Company or its subsidiaries and has confirmed their independence to the Audit Committee. The fees for carrying out this work comprises the total non-audit fees of £15,000 set out in note 27 to the consolidated financial statements.

The Committee assures itself of the auditor's independence by receiving regular reports from the external auditor which provide details of any assignments and related fees carried out by the auditor in addition to their normal audit work and these are reviewed against the above guidelines. PwC has reconfirmed its independence for the current financial year.

### FINANCIAL REPORTING AND SIGNIFICANT FINANCIAL JUDGEMENTS

As part of its monitoring of the integrity of the financial statements, the Committee reviews whether suitable accounting policies have been adopted and whether management has made appropriate estimates and judgements and seeks support from the external auditor to assess them.

The Committee considered the matters set out below as being significant in the context of the consolidated financial statements for the year ended 30 September 2018. These were discussed and reviewed with management and the external auditor and the Committee challenged judgements and sought clarification where necessary. The Committee received a report from the external auditor on the work they had performed to arrive at their conclusions and discussed in detail all material findings contained within the report.

#### Provisions for excess and slow moving inventory

The Committee reviewed the Report of the Group Finance Director that set out the gross balances by business, together with any related provision against the carrying value. The Committee reviewed the bases used to value and confirm existence of inventory held across the Group; they also considered the appropriateness of provisions held against the carrying value of inventory, having regard to the age and volumes of inventory, relative to expected usage. Following their review, which also included consideration of the external audit findings, the Committee concluded that the provision for excess and slow moving inventory is appropriate.

#### Impairment of goodwill

The Committee considered the carrying value of goodwill and the assumptions underlying the impairment review. The judgements in relation to goodwill impairment largely relate to the assumptions underlying the calculations of the value in use of the Cash Generating Unit ("CGU") being tested for impairment. These judgements are primarily the calculation of the discount rate, the achievability of management's forecasts in the medium term and the use of the long term growth rate. Following their review which also included consideration of the external audit findings, the Committee concurred with the conclusion that no impairment of goodwill is required.

## AUDIT COMMITTEE REPORT CONTINUED

In addition to the above the Committee also seeks confirmation from the auditor that the Group's businesses follow appropriate policies to recognise material streams of revenue and their audit work carried out more generally has assessed any instances where management may be able to override key internal controls designed to guard against fraud or material misstatement. The auditor also reported to the Committee on other less material matters in relation to the recoverability of trade receivables, acquisition accounting, the valuation of the Group's defined benefit schemes and the classification and presentation of the CEO transition costs.

### CHANGES IN ACCOUNTING STANDARDS

The Audit Committee reviewed the likely impact of adopting IFRS15 (revenue from contracts with customers) ahead of the implementation across the Group, which will be applicable for the year ending 30 September 2019. A report prepared by the Group Finance department on the potential impact of this standard on the Group's consolidated financial statements was submitted to the Committee during the year. This report was based on a detailed review carried out in conjunction with the Heads of Finance of the major businesses. This report identified that the new standard may affect some contracts for bundled goods and services in relation to reagent rental agreements in Diploma Healthcare Group, as well as preventive maintenance service and CEMS revenues in a1-CBISS. The amounts relating to these revenue streams were in aggregate less than 1% of total Group revenues. The bases applied to revenue recognition across the Group will continue to be monitored to ensure compliance with IFRS15.

The Audit Committee also noted initial project work being carried out by the Group Finance department on the impact of IFRS16 (leases) on the Group's consolidated financial statements, which will be applicable for the year ending 30 September 2020. This standard will affect Diploma in that all material operating leases (including properties) will be capitalised on the Balance Sheet and depreciated. The Group Finance department will again report formally in 2019 to the Committee on the potential implications on the consolidated financial statements from adopting this standard.

Further information on the impact of IFRS15 and IFRS16 is set out on pages 92 and 93.

### TAX STRATEGY

The Committee noted that during the year, the Group tax strategy, including detailed tax policies, had been updated by the Head of Tax and Treasury and has been reviewed and approved by the Board.

### RISK MANAGEMENT AND INTERNAL CONTROL

The principal risks and uncertainties that are currently judged to have the most significant impact on the Group's long term performance are set out in a separate section of the Strategic Report on Internal Control and Risk Management on pages 30 to 33.

The Committee is responsible for reviewing the effectiveness of the Group's system of internal control. The system of internal control is designed to manage rather than eliminate the risk of failure to achieve business objectives and can only provide reasonable and not absolute assurance against material misstatement or loss. The Group has the necessary procedures in place to ensure that there is an ongoing process for identifying, evaluating and managing the principal risks to the Group. These procedures are in line with the Financial Reporting Council's guidance.

The Board has established a clear organisational structure with defined authority levels. The day-to-day running of the Group's business is delegated to the Executive Directors of the Company who are supported by members of the Executive Management Committee ("EMC") comprising of the heads of each business Sector and functional heads of Group FP&S and Group Finance. The EMC and Executive Directors visit each operating unit on a regular basis and meet with both operational and finance management and staff.

Key financial and operational measures relating to revenue, cash and receivables are reported on a weekly basis. Detailed management accounts and KPIs are prepared monthly using a robust proprietary reporting system to collect and analyse financial data in a consistent format. Monthly results are measured against both budget and half year reforecasts which have been approved and reviewed by the Board. All capital expenditure above predefined amounts must be supported by a paper prepared by management.

All financial data is taken directly from the trial balance of each business held in their local ERP systems and reanalysed and formatted in a separate Group management reporting system, operated by the Group finance department. There is no rekeying of financial data and very limited use is made of spreadsheets by the Group businesses to report monthly financial results. The Group finance department continues to develop the functionality of this management reporting system to provide greater insights into the activities of the Group's businesses, both financial and operational. The Group's Internal Auditor regularly audits the base data at each business to ensure it is properly reported through to the Group management reporting system.

As part of the year end close process each business is required to complete a self-assessment that evaluates their financial control environment in their business, which is designed to identify weaknesses in controls. These assessments are critically reviewed by the Group's Director of Internal Audit and a summary for each business is prepared for the Audit Committee. In addition, senior management of each business are required to confirm their adherence with Group accounting policies, processes and systems of internal control by means of a representation letter addressed to the Audit Committee.

The Committee has reviewed the effectiveness of the Group's risk management and internal control systems for the period from 1 October 2017 to the date of this Report. Taking into account the matters set out on pages 30 to 33 relating to principal risks and uncertainties and the reports from the Director of Internal Audit, the Board, with the advice of the Committee, is satisfied that the Group has in place effective risk management and internal control systems.

### INTERNAL AUDIT

The Group maintains a small Internal Audit department which reports directly to both the Group Finance Director and Chair of the Audit Committee. The department comprises a Group Director of Internal Audit, based at one of the Group's businesses in Minneapolis, US and a Group Senior Internal Auditor based at the Group's offices in London.

A full programme of Internal Audit visits has been completed during the year. The scope of work carried out by Internal Audit generally focuses on the internal financial controls and risk management procedures operating within each business, but was expanded this year to include regulatory & compliance reviews and business process improvement. In January, the

Group Director of Internal Audit presented his audit plan for the year to the Committee for their approval. Formal written reports are prepared on the results of each Internal Audit visit that set out internal control weaknesses/risks identified during their work, together with recommendations to improve the internal control environment and mitigate these weaknesses/risks. These reports are discussed with management of the business visited and are reviewed by the appropriate member of the Executive Management Committee.

At the end of the financial year, the Group Director of Internal Audit formally reports to the Committee on the results of the Internal Audit work carried out by his department during the year. The Committee reviews management's responses to matters raised, including the time taken to resolve such matters. The Audit Chair also meets separately with the Group Director of Internal Audit at least twice a year to review some of the department's reports and discuss their findings.

There were no significant or high risk matters identified in the internal audits undertaken during the current financial year. Several recommendations were made to the businesses in regards to implementing adequate and effective internal controls and procedures within the key processes related to their general IT and cybersecurity framework. The Group Director of Internal Audit also reported that good progress has been made with addressing those recommendations made in 2017 in connection with establishing and maintaining adequate segregation of duties within key process areas and more detailed employee expense reporting. It was also identified that further work is still required at some businesses to formalise and improve their inventory cycle count procedures.

The work of the Internal Audit department was also extended this year to review and report on progress made by Group businesses in ensuring that their internal control environment was sufficiently robust to resist cyber-attacks and that businesses have obtained or are seeking to obtain the Cyber-Essentials Basic certification. This work identified a number of instances where systems need to be upgraded and strengthened and these results were reported to the member of the EMC who has been given responsibility for managing and reporting to the Board on the Group's cybersecurity status.

The Internal Audit department also continues to monitor the businesses compliance with Group policies on anti-bribery/corruption and sanctions.

The Committee conducted the annual review of the effectiveness of the Internal Audit department, including its terms of reference, audit plan, general performance and relationship with the external auditors. Based on its review the Committee was satisfied with the effectiveness of the Group's Internal Audit function, specifically the Committee is satisfied that the Internal Audit department is sufficiently independent of Executive management and has sufficient resources and scope that is appropriate for the size and nature of Diploma PLC.

#### **SANCTIONS**

The Audit Committee continued to work with senior management of the Company, in conjunction with local management of Kentek's Russian operations, to ensure ongoing compliance with EU and US led sanctions. The Committee has received reports on compliance with these sanctions and will continue to monitor developments until the sanctions are suspended or revoked.

#### **ANTI-BRIBERY AND CORRUPTION**

Diploma PLC maintains a Group-wide policy on anti-bribery/corruption that addresses the requirements of the Bribery Act 2010. The Committee periodically reviews this policy and the procedures to ensure continued and effective compliance in its businesses around the world. During the year, the Group rolled out a refresher using an E-learning training programme to all its business. This training has been undertaken by all senior management and employees in customer or supplier facing roles and in particular by management and employees from companies that have recently joined the Group.

#### **WHISTLEBLOWING**

The Committee also monitors the Group's whistleblowing policy, which provides the framework to encourage and give employees confidence to "blow the whistle" and report irregularities. The policy, together with hotline posters are placed on site noticeboards across the Group. Employees are encouraged to raise concerns via the confidential multilingual hotline, which is managed by an independent external company and is available 24/7, 365 days a year. Reports to the hotline are investigated and reported to the Committee, together with details of corrective action taken. The Group received three such whistleblowing reports during the year, which on further investigation were found to be personal grievance matters. On further review and investigation, the Committee concluded that two of these reports related to grievance issues in the workplace and the third report comprised concerns that on investigation were not substantiated. All three cases reported to the Committee were satisfactorily resolved.