Audit Committee report

PHILIP BROADLEY
Chair of the Audit Committee

The composition of the Committee

The Committee is composed entirely of independent non-executive directors. The table below sets out its membership during the year.

Members:
Philip Broadley (Chair)
Lesley Knox
Richard Meddings until 25 May 2017
Toby Strauss
Julia Wilson

Other regular attendees at Committee meetings include the following:

Group Chairman; Group Chief Executive; Group Chief Financial Officer; Group Chief Risk Officer; Director of Group Finance; Group Chief Internal Auditor; Legal & General Retirement Finance Director; LGIM Finance Director; Group Actuary; Chief Tax Officer; Representatives of the external auditor, PricewaterhouseCoopers LLP (PwC).

"The Committee's remit covers accounting and financial reporting, internal controls and the external audit. A particular focus during the year was our review of the estimates for future improvement of an annuitant's life expectancy."

Letter from the Chair

Dear Shareholder

I am pleased to present the Audit Committee (Committee) report for the year ended 31 December 2017. The report explains the work of the Committee during the year.

The report meets the disclosure requirements set out in the 2016 UK Corporate Governance Code (the 'Code'). The significant accounting issues considered by the Committee are set out on page 72.

The Code requires that the Committee must operate effectively and efficiently and that its members have a balance of skills and experience to deliver its responsibilities. Members of the Committee have varied experience including as executives in the financial services and other sectors, as non-executive directors in other sectors and as board members responsible for financial reporting. The Board consider that I meet the requirements of the Code in having recent and relevant financial experience, as other members of the Committee have too.

Three members of the Committee are also members of the Group Risk Committee, and two members of the Committee are also members of the Remuneration Committee, ensuring the appropriate identification and management of any issues that are relevant to both committees.

The Committee meets regularly and privately with each of the external auditor and the Chief Internal Auditor. These meetings allow for regular and open dialogue of any issues relevant to the Committee's work. Committee members also meet regularly with management outside formal Committee meetings to discuss topical issues and maintain their understanding of the group's businesses.

During 2017, the Committee met seven times in accordance with its annual plan. The Committee's terms of reference are reviewed on an annual basis and the current terms of reference, reviewed in December 2017, are available on our website. The Committee's time over the course of the year was spent principally in consideration of:

- half-year and year-end financial reporting
- asset valuations and actuarial reserving matters
- monitoring and reviewing internal controls
- Solvency II matters
- the effectiveness and work of both the internal and external audit functions
- tax strategy

I set out in my report last year the results of the tender for the future provision of external audit services. KPMG LLP has been shadowing this year's audit by PwC for 2017 and has completed a review of PwC's working papers from the 2016 full year results as well as the 2017 interim results and, in due course, will review the 2017 papers in anticipation of its appointment by shareholders to serve as the group's external auditor in 2018.

The information on the following pages sets out in detail the activities of the Committee during the year. I hope that you will find this report useful in understanding our work and I welcome any comments from shareholders on my report.

Philip Broadley
Chair of the Audit Committee

Accounting and financial reporting

The Committee reviews the appropriateness of the half-year and annual financial statements, which it carries out with both management and the external auditors. This review includes ensuring that the annual report and accounts, taken as a whole, are fair, balanced and understandable (FBU) in compliance with disclosure requirements and the material areas in which significant judgements had been applied.

In collaboration with the Group Risk Committee, the Committee also reviews the disclosures to be made in relation to internal control and risk management, and principal risks and uncertainties.

In assessing whether the annual report was fair, balanced and understandable and provides the information necessary for shareholders to assess the company's position and performance, business model and strategy, the Committee evaluated whether:

Robust year-end governance processes are in place to support the Committee's considerations which include:

- ensuring that all of those involved in the preparation of our annual report have been appropriately trained and fully briefed on the FBU requirements;
- internal legal verification of all factual statements, together with legal verification of descriptions used within the narrative;
- regular engagement with and feedback from senior management on proposed content and changes;
- feedback from external advisers (corporate reporting specialists, remuneration and strategic reporting advisers, external auditor) to enhance the quality of our reporting; and
- early opportunity for review and feedback on our annual report by Committee members.

The Committee, having completed its review, recommended to the Board that, when taken as a whole, the 2017 annual report is fair, balanced and understandable, and provides the information necessary for shareholders to assess the company's position and performance, business model and strategy. The Committee, together with the Group Risk Committee, reviewed the key assumptions and methodologies of the risk-based capital model as well as related Solvency II disclosures and the proposed disclosures pertaining to the group's economic capital disclosure position.

During the year, the Committee has continued to keep abreast of significant and emerging accounting developments, in particular changes to IFRS relating to insurance accounting.

Significant accounting issues considered by the Committee

Issue	Committee's response
Valuation of non-participating insurance contract liabilities – retirement: The non-participating insurance liabilities for retirement products are significant in size and their estimation is inherently judgemental.	The Committee evaluated the significant judgements that have an impact on the valuation of non-participating insurance liabilities for retirement products. This included considering: Valuation interest rates – which are used to discount the liabilities. These are sensitive to judgements made, for example, on credit default of the backing assets, as well as the investment data used to calculate the yield on these assets and the methodology used to model the asset cash flows to calculate the internal rate of return. The Committee focused on management's proposed changes to reserving assumptions, other modelling changes, and the determination of the credit default assumption. This included analysis of internal historic data and external market experience. Longevity assumptions – which estimate how long policyholders receiving annuity payments will live. The Committee considered the effectiveness of the controls over the accuracy and completeness of the data used in determining the longevity assumptions and the validity of independent industry data supporting those assumptions. The Committee also reviewed available data illustrating recent trends in mortality experience in the UK population and the mortality experience on different blocks of our business. The Committee concluded that the retirement insurance contract liabilities are appropriate for inclusion in the financial statements, reflecting the asset risks and the available data on policyholder longevity.
Valuation of complex investments: Mark to model investments can involve significant judgement and can produce valuation challenges for investments in new asset classes. Mark to model valuations inherently include assumptions that lead to the existence of a range of plausible valuations for financial instruments (known as valuation uncertainty). Certain assets are subject to a higher degree of valuation uncertainty particularly where valuations are modelled using non-market inputs or the valuations are affected by other factors such as illiquidity of the asset.	The valuation of property assets, lifetime mortgages, private credit, new asset classes and new transactions require the use of complex models and management judgement. The Committee seeks to ensure that the valuation process for these investments is robust. The Committee reviewed the processes and controls over investments valuations. In particular, the Committee reviewed the valuation uncertainty policies and governance including management's assessment of valuation uncertainty by asset type. The Committee concluded that there are appropriate controls surrounding the valuation of complex assets and that they are valued appropriately for inclusion in the financial statements.
Valuation of non-participating insurance liabilities – insurance: The non-participating insurance liabilities for protection contracts are an important driver of the profitability for this line of business and require judgements to be made regarding the assumed rates of mortality and persistency. The company makes extensive use of reassurance to reduce mortality risk.	The Committee has reviewed the methodology for calculating reserves including the allowance made for payments to and from reassurance counterparties. The assumptions for the rate of future mortality and morbidity (how many customers will die or become ill during the policy term) and persistency (how many customers will discontinue cover) are based on the company's internal experience and use judgement about how experience may vary in future. The Committee reviewed the assumptions and the expected level of prudence taking into account market benchmarking, internal experience studies and the reinsurance structure. The Committee also considered the internal control environment in place to control the valuation models. The Committee concluded that the insurance liabilities of the Insurance division are appropriate for inclusion in the financial statements.

Internal control
The Board has delegated responsibility for reviewing the effectiveness of the group's systems of internal control to the Committee.

The Committee has the primary responsibility for the oversight of the group's system of internal controls including financial control and the work of the Internal Audit function. The Committee, in collaboration with the Group Risk Committee, seeks to ensure that the group operates within a framework of prudent and effective controls that allow risk to be identified, assessed and managed.

The Committee has completed its review of the effectiveness of the group's system of internal control policies and procedures, during the year and up to the date this report was approved, in accordance with the requirements of the Guidance on Risk Management, Internal Control and related Financial and Business Reporting published by the FRC. During this review, the Committee did not identify any weaknesses which were determined to be significant to the preparation of the financial statements. The Committee also noted that while the location of significant numbers of the finance teams relocated to our offices in London, Cardiff and Hove, there were no significant changes to the control environment noted in the current year, significant to the preparation of the financial statements. Where areas for improvement were identified, processes are in place to ensure that the necessary actions are taken and progress is monitored by the Committee.

The Committee monitored and reviewed the scope, extent and effectiveness of the activity of the group Internal Audit department. In particular, the Committee evaluates the alignment of the Internal Audit Plan with the group's key risks and strategy.

Internal Audit is an agenda item at each Committee meeting and the Group Chief Internal Auditor updates the Committee on audit activities, progress of the audit plans, the results of any unsatisfactory audits and the action plans to address these areas. In 2017, 106 audits were completed in line with the Internal Audit Plan approved by the Committee.

The Internal Audit function acts in accordance with the Global Institute of Internal Auditors' International standards. In the year, the Committee engaged Ernst & Young LLP to perform an independent review of the effectiveness of the group's internal audit department. The outcomes were reported to the Committee which concluded that progress had been achieved with the strengthening of the leadership team and that the function was meeting its key objectives. The recommendations from the review will be implemented to evolve and strengthen the function's effectiveness.

The Committee received and considered reports from the external auditor on its assessment of the control environment as well as reports from senior management on its response to internal control recommendations made by internal audit and the external auditor. The internal control and risk management systems cover the group's financial reporting process and the group's process for preparation of consolidated financial statements.

The Committee has concluded that the systems of internal controls and risk management within the group are effective. No significant control failings or weaknesses were identified during the period under review.

The external auditor

The Committee has the primary responsibility for overseeing the relationship with, and performance of the external auditor. This includes making recommendations for their appointment, re-appointment or their removal. In addition, the Committee assesses the effectiveness of the external auditor against some of the following criteria:

- provision of timely and accurate industry specific and technical knowledge
- maintaining a professional and open dialogue with the Committee Chair and members at all times
- delivery of an efficient audit and the ability to meet objectives within the agreed timeframes
- the quality of its audit findings, management's response and stakeholder feedback

The Committee receives regular reports from the external auditor on audit findings and significant accounting issues. In 2017, the Committee continued to focus on the external auditor's assurance work on Solvency II.

The Committee Chair regularly meets the external auditor throughout the course of the year. The Committee also meets the external auditor in private throughout the year.

The Committee reviewed the quality of the external audit throughout the year and considered the performance of PwC, taking into account the Committee's own assessment and feedback.

The Committee concluded that there had been appropriate focus and challenge by PwC on primary areas of the audit and had applied robust challenge throughout the audit.

The Committee reviews and approves the terms of engagement of the external auditor and monitors its independence. This includes overseeing, and in certain circumstances approving, the engagement of the external auditors for non-audit work. The non-audit services policy prohibits the auditor from providing the following services:

- tax advice and compliance
- management or decision-making
- book-keeping and preparing accounting records or statements
- design or implementation of internal controls
- valuation
- legal, internal audit or human resources
- those linked to financing capital structure or allocation or investment strategy
- promoting, dealing in or underwriting share issues
- payroll services

The Committee is cognisant of the requirements governing the appointment of an external auditor, notably the requirements of the Competition and Markets Authority (CMA) in relation to the mandatory re-tendering of audit services every ten years, together with the European Union's requirements for mandatory audit firm rotation. The company confirms that it has complied with the provisions of the CMA's Order for the financial year under review.

As advised last year, PwC has been the group's external auditor for a number of years. The audit was last tendered in full in 2006 with a partial re-tender process in 2009. During 2016, the Committee undertook a full tender process in respect of external audit services in compliance with legislation and FRC guidance on best practice, in particular ensuring independence in respect of potential audit firms.

The existing external audit firm, PwC, was not invited to re-tender. We approached a range of firms including the 'big four' (other than the incumbent) and mid-tier firms to express their interest. Interested firms were subsequently requested to complete a detailed Request For Proposal (RFP). Following this, a full tender process of firms shortlisted based on the responses to the RFP was undertaken. During the tender process, each firm was given access to members of the group's senior management and a data room. The tendering firms were judged against objective criteria determined in advance of the process, together with the findings and conclusions of published inspection reports on the audit firms. Whilst the Committee appreciated the quality of the proposals presented by all the tendering firms, it considered that the submission and team from KPMG LLP (KPMG) best met the predefined criteria it had set.

As reported in the 2016 annual report and subject to shareholder approval, KPMG will be appointed as the Company's auditor with effect from the audit for the financial year ending 31 December 2018 at the 2018 AGM. To ensure a smooth transition from PwC, KPMG is shadowing PwC on the audit for the financial year ending 31 December 2017 and will then take responsibility for the audit in 2018.

In 2017, the group spent £2.2 million on non-audit services provided by PwC. It spent a further £0.8 million on audit-related services required by legislation, which is excluded from any calculation of the ratio of non-audit to audit fees in accordance with the UK FRC Ethical Standard for Auditors (June 2016). Further details can be found in note 34 to the consolidated financial statements. The non-audit fee represents 35% of the total audit fee for 2017.

Analysis of current and prior year spend on audit, other assurance and non-assurance services (£m)

	2017	2016	2015
Audit	**6.1**	5.7	4.9
Audit-related required by legislation	**0.8**	1.0	1.1
Other audit-related	**1.0**	1.0	1.6
Other assurance	**0.4**	0.4	0.4
Non-assurance	**0.8**	1.1	1.3
Total	**9.1**	**9.2**	**9.3**

Following the audit tender process, the policy was updated and approved by the Committee to address the requirements as set out in the EU Audit regulation.

Our policy is to approach other firms for significant non-audit work unless the audit firm offers a materially better combination of value, quality and timeliness compared with the non-audit firm whilst not impairing the audit firm's integrity, objectivity and independence. In these circumstances, the group's policy requires that all services with an anticipated cost in excess of a specified amount are subject to a full competitive tender involving at least one other alternative party in addition to the external auditor. If the external auditor is selected following the tender process, the Committee is responsible for approving the external auditors' fees on the engagement. The Committee has pre-approved the engagement of the auditor for non-prohibited services where the anticipated cost is trivial, but authority is still required from the Group Chief Financial Officer to approve any such engagement. The external auditor is required to report regularly to the Committee on the nature and fees relating to non-audit services provided under this authority.

The Committee supports the five-year rotation of audit engagement partners to maintain the objectivity of the group external audit. The current audit partner commenced his engagement in 2013. PwC will end their tenure as external auditor at the 2018 AGM.

The Committee remains satisfied that PwC continued to be independent. In addition, PwC annually reports on whether and why it deems itself to be independent.

Update on auditor transition progress

Since May 2017, the Committee has received a report from KPMG at each meeting describing its preparatory work during the transition period.