

Audit Committee report

Committee focus during 2018

I am pleased to present the Audit Committee's report for the year ended 31 December 2018.

2018 has been a year of continued political and business turbulence as uncertainty around Brexit continued to impact financial markets and business planning. Against this background, the Committee has continued to focus on the fundamentals of financial reporting, our system of internal controls and the performance of the internal and external auditors. The potential impact of a number of new International Financial Reporting Standards (IFRS), including the new insurance accounting standard (IFRS 17) on the Company's financial operations and financial reporting has remained under close review by the Committee.

The Committee continued to provide oversight on behalf of the Board of all the Major Control Improvement Topics (MCITs) on Cyber Security, Compliance Effectiveness, Data Governance, Disaster Recovery, Outsourcing and Fraud Management. The Committee has specific accountability for the Fraud Management MCIT. Four MCITs were closed during 2017 and are now monitored as part of our business as usual processes. The remaining Cyber Security and Disaster Recovery MCITs remain in operation and will continue to be overseen by the Risk Committee. The MCIT programme was designed to assist management in providing even greater focus on enhancing our control environment around the six thematic areas identified.

Committee membership

The members of the Committee are shown in the table below. Details of their experience, qualifications and attendance at Committee meetings, together with the number of Committee meetings held, during the year are shown in the Directors' Biographies and Directors' and Corporate Governance report. There were no changes of the composition of the Committee during 2018.

Name	Member Since	Years on the Committee
Keith Williams ¹	01/08/2016	2
Glyn Barker	08/08/2012	6
Patricia Cross	01/12/2013	5
Michael Hawker ²	01/09/2011	7

¹ Chair

² Michael Hawker will retire from the Committee with effect from 31 March 2019.

Committee member requirements

The Committee annually reviews how its members meet the expertise criteria set out in the 2016 UK Corporate Governance Code (the 2016 Code) and the Disclosure Guidance and Transparency Rules (DTRs). Following the review undertaken for 2018, a recommendation was made to the Board that I, as Committee Chair, continued to fulfil the Code requirement for recent and relevant financial experience and the DTR requirement for competence in accounting and auditing, as did Glyn Barker. Patricia Cross and Michael Hawker confirmed that they meet the Code requirement for recent and relevant financial experience. The Committee as a whole has competence relevant to both the insurance and financial services industry.

Committee purpose

The main purpose of the Committee is to assist the Board in discharging its responsibilities for monitoring the:

- integrity of the Company's financial statements;
- adequacy and effectiveness of our systems of internal control including whistleblowing provisions; and,
- monitoring the effectiveness, performance and objectivity of our internal and external auditors.

The Committee acts independently of management and works closely with the Governance, Remuneration and Risk Committees. There is cross-membership between these Committees to ensure a good understanding and efficient communication of the work of each.

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Significant issues

The significant issues that the Committee considered during the year are set out in the table below.

Areas of focus	Actions taken by the Committee
IFRS and Solvency II (SII) key issues and judgements	Challenged estimates and judgements for IFRS and SII reporting bases. IFRS judgements included goodwill and intangible asset impairment reviews, valuation for hard to value investments, reserving for insurance contracts and the additional liability arising in the UK defined benefit pension schemes for Guaranteed Minimum Pensions (GMPs), following the High Court judgement in October 2018. The Committee also reviewed the product governance provision in respect of historical advised sales by Friends Provident.
Longer Term Viability Statement (the Statement)	Reviewed and challenged the principles underpinning the Statement for 2018, and concluded that the Company and its subsidiaries will be able to continue in operation and meet their liabilities as they become due over the period covered by the Statement. The Committee continues to consider it appropriate that the Statement covers a three year period.
New IFRS	Prepared for the implementation of new IFRS, including IFRS 17, the new insurance accounting standard, IFRS 15, in respect of revenue from contracts, IFRS 9 on financial instruments, and IFRS 16 on leases. The Committee assessed the impact of each on the Group's financial position, processes, systems and data. While the impact of adopting IFRS 17 has yet to be fully assessed it is expected that it will have a significant impact on the measurement and disclosure of insurance contracts. It is not yet possible to assess the effect of adopting IFRS 9 as the Group has elected to apply the deferral approach permitted by IFRS 4 (with the result that the Standard will be considered alongside IFRS 17). The adoption of IFRS 15 in 2018 and IFRS 16 in 2019 does not have a significant impact on the Group.
IFRS and SII Life technical provisions and reserves	Challenged the assumptions used in the calculation of the Best Estimate Liability component of the technical provisions and the reserves required under SII. Reviewed and challenged the longevity, expense and credit default assumptions used for the 2018 half and full year. The challenge around the setting of longevity assumptions was a particularly significant area for review. During 2018, a detailed analysis was conducted, and reviewed by the Committee, to validate changes observed in recent mortality experience and the resulting impact on our existing longevity assumptions. In particular, the Committee reviewed the rate of annuitant mortality improvement reflecting recent experience in the UK market. The Committee met with the Chair of the UK Life Audit Committee, which had conducted its own 'deep dive' on longevity assumptions, together with the UK Life Chief Financial Officer. Following assessment of the proposed assumption changes the Committee considered the associated release of margins and the timing of recognition of changes in longevity experience in the financial statements. During the year the Committee considered, reviewed and approved the adoption of the relevant industry tables for the Bulk Purchase Annuity business in the UK. The Committee also reviewed proposals for adoption of CMI 2017 model for mortality improvement including the selection of parameters within the CMI model. The Committee also reviewed the implementation of a new actuarial modelling system in the UK. During 2018, annuities and certain protection products were transferred onto the new model. In addition, the Committee continued to review the allowance for the possible adverse impact of the decision for the UK to leave the European Union.
IFRS and SII GI reserving issues and judgements	Reviewed and challenged the principal assumptions in the calculation of the GI reserves, in particular the continued appropriateness of maintaining the provision for bodily injury claims, which was first made in the 2016 financial statements. The Committee continued to monitor progress in the changes in Ogden rate, noting the passing of the Civil Liability bill, and the range of estimates for the change in the rate.
Global Finance for The Future	The Committee reviewed and challenged management's plans for the creation of a 'Global Finance for the Future' (GFF) model for the Group's internal finance functions. The primary objective of GFF is to simplify and consolidate finance systems and operations to a single model and underlying IT systems, driving simplicity and lower cost.
Internal controls	The Committee continued to challenge and drive the ongoing implementation of the Operational Risk and Control Management framework (ORCM) to ensure ORCM is adopted across the Group and to further support a risk aware culture.
Preference shares	The Committee received and reviewed the disclosures relating to our ability to cancel our preference shares following a shareholder and court approved reduction of capital.

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External auditor

PricewaterhouseCoopers LLP (PwC) was appointed as the Group's External Auditor (Auditor) in 2012 following a formal tender process. In line with the Company's policy for the external audit contract to be put out to tender at least every ten years, and in conformance with European rules on mandatory audit rotation, the Committee propose that a competitive tender process will next be completed no later than for the 2022 year end. While there is no requirement to rotate audit firms until the current auditor has served a maximum of 20 years, in determining the timing of a tender process the Committee is mindful that it is necessary to allow the selected auditor appropriate time to become independent should the Committee propose that an auditor other than PwC be selected to serve shareholders going forwards. For this reason, it is currently proposed that a tender process be completed in the 2020 financial year for the 2022 year end. The Committee will continue to monitor the effectiveness and independence of PwC, as well as considering whether this proposed timing remains appropriate in light of business developments.

The external audit is currently led by the PwC audit partner, Marcus Hine who has held the role for four years. The role of audit partner will be rotated after completion of the 2018 year end reporting process. The incoming PwC audit partner for the year ending 31 December 2019 has been agreed and a transition plan is in place.

An annual review of the Auditor was undertaken through completion of a questionnaire by the Committee, senior management, and members of the Group's finance community. The Committee concluded that PwC continued to perform effectively and is recommended to shareholders for reappointment at the 2019 AGM.

The Company has complied with the Statutory Audit Services for Large Companies Market Investigation (Mandatory Use of Competitive Tender Processes and Audit Committee Responsibilities) Order 2014 for the year ended 31 December 2018.

The Company has an External Auditor Business Standard (Standard) in place which is aimed at safeguarding and supporting the independence and objectivity of the Auditor. The Standard is compliant with all UK and International Federation of Accountants rules and takes into account the FRC's Revised Ethical Standard 2016 and the EU Audit Directive (2014/56/EU).

Non-audit fees

In 2018 the Group paid PwC £20.4 million (2017: £22.3 million) for audit and audit-related assurance services, a saving of £1.9 million following completion of the Friends Life Part VII transfer in 2017. In addition, PwC were paid £1.9 million (2017: £3.0 million) for other services, including £0.9 million (2017: £2.2 million) for other assurance services, giving a total fee to PwC of £22.3 million (2017: £25.3 million).

In line with the Standard, our Committee satisfied itself that for all non-audit engagements, robust controls were in place through a quarterly review process for audit related and non-audit services provided, to ensure that PwC's objectivity and independence was safeguarded, and concluded that it was in the interests of the Company to purchase these services from PwC due to their specific expertise. Further details are provided in note 13 of the financial statements.

Internal control

The Committee is responsible for supporting the Board in ensuring a robust system of internal control and risk management in the Group. The Committee receives regular reports on the status of the control environment, reports on our remaining Group MCIT, and updates on the management of operational risks and controls under ORCM. More information about our system of internal control

and risk management can be found in the Directors' and Corporate Governance report.

The Committee also receives quarterly control reports from the Internal Audit function and reviews and challenges management on the actions being taken to improve the quality of the overall control environment and the risk control culture across the Group.

The Committee reviews and approves the bi-annual Internal Audit Plan. It also conducts an annual review of the Internal Audit Function to assess its effectiveness and to satisfy itself that the quality, experience and expertise of the Internal Audit function is appropriate for the business. This is carried out by reviewing reports issued by Internal Audit and the output of an annual stakeholder effectiveness survey. This formal process is supplemented by regular private discussions with executive management, the Internal Auditor, and the External Auditor. In 2018, the Internal Audit function also undertook an external quality assurance review, and the Committee assessed the outcome of this review. The Committee concluded that for 2018 the function performed well and remained effective.

For the financial year under review, the Company met the relevant provisions of the 2016 Code relating to internal controls, and the FRC's 2014 'Guidance on Risk Management, Internal Control and Related Financial and Business Reporting'.

The Committee is also supported in its work by the Audit Committees that operate in the Group's regulated subsidiary entities. These subsidiary Audit Committees review the operation of internal controls, and actively challenge judgement made by management, strengthening the overall governance and control framework for the Group. The Committee Chair has engaged with subsidiary company entity chairs during the year on Group matters.

Whistleblowing

The Committee Chair is the whistleblowers' champion for the Group and has responsibility to oversee the integrity, independence and effectiveness of the Group's policies. The Committee as a whole is responsible for establishing and overseeing the effectiveness of controls put in place in accordance with regulatory requirements in respect of whistleblowing. The Board annually receives a formal report in respect of whistleblowing activity and compliance in line with our regulatory requirements.

Committee effectiveness review

The Committee undertakes a rigorous review of its effectiveness annually. More information can be found in the 'Directors' and Corporate Governance report' in this report.

2019 priorities

In 2019, in addition to carrying out its principal function, the Committee will continue to monitor the implementation of the new IFRS, with particular focus on IFRS 17, regarding the accounting treatment of insurance contracts, ahead of its expected effective date of 1 January 2022. The Committee will also closely monitor the developments related to the impact of Brexit, changes in the Ogden rate and will continue to support the development of the ORCM framework.

Keith Williams

Chair of the Audit Committee
6 March 2019

Committee activities during 2018**Financial Statements and accounting policies**

- Recommended to the Board for approval the 2018 half and full year results
- Approved the IFRS and SII technical provisions with the 2018 half and full year results
- Recommended to the Board for approval the SII Solvency and Financial Condition Report
- Reviewed and challenged the reserve positions relating to our UK Life and GI operations
- Reviewed and challenged the treatment and recoverability of goodwill and other intangible assets
- Reviewed the Chief Financial Officer's reports which included: IFRS and SII key issues and judgements; accounting developments with particular regard to the new IFRSs; and overview of internal control and risk management over financial reporting
- Reviewed and challenged the going concern assumptions for 2018 and the principles underpinning our Longer Term Viability Statement
- Reviewed and prepared for changes in the Ogden rate
- Reviewed the Group Risk Actuary's report on significant issues related to the technical provisions of SII and IFRS
- Assessed that the Annual Report was considered fair, balanced and understandable

External audit, auditor engagement and policy

- Reviewed the effectiveness of the External Auditor and was satisfied that the services it provided remained effective, objective and fit for purpose
- Reviewed the External Auditor's compliance with the independence criteria set out in the Code
- Monitored compliance with our External Auditor Business Standard on a quarterly basis
- Refreshed our External Auditor Business Standard to reflect new regulatory requirements
- Held private meetings with the External Auditor without management present to provide an appropriate forum for issues to be raised
- Approved auditor terms of engagement and remuneration
- Reviewed reports from the External Auditor with regard to: the 2018 Audit Plan and progress against plan and reports on the audit of the 2018 half and full year results including key assumptions used and outcomes of the audit

Internal audit

- Reviewed reports from the Chief Audit Officer (CAO)
- Reviewed and approved changes to our Internal Audit Charter and Business Standard
- Reviewed and approved our Internal Audit Plan
- Assessed the independence of the CAO
- Held private meetings with the CAO without management present
- Reviewed the objectives of the CAO

Internal controls, including financial reporting control framework and financial reporting developments

- Received quarterly updates on the effectiveness of our FRCF framework and rectification of controls
- Reviewed management's assessment of the effectiveness of our risk management and control environment
- Oversaw the MCIT programme
- Reviewed the Internal Audit function report to ensure adequacy of our systems of internal control and risk management
- Ensured an appropriate whistleblowing framework was in place