Letter from the Chairman of the Audit Committee

Dear Shareholder

On behalf of the Audit Committee, I am pleased to present its report for the year ended 30 June 2015.

The purpose of this report is to describe how the Committee has carried out its responsibilities during the year.

In overview, the role of the Audit Committee is to monitor and review: the integrity of the company’s financial statements; internal control and risk management; audit and risk programmes; business conduct and ethics; ‘whistleblowing’; and the appointment of the external auditor.

A key project undertaken by the Committee during the year was the tender for the external audit, as flagged in my report last year. The tender has been completed and PricewaterhouseCoopers LLP (PwC) were selected. The appointment of PwC will take effect for Diageo’s financial year ending 30 June 2016, subject to approval at the company’s September 2015 AGM. KPMG has been the group’s auditor since 1997 and, on behalf of the Audit Committee, I take this opportunity to thank KPMG for their unstinting professionalism and for the insight that they have brought and the value that they have added to the business during their tenure.

The Committee took note of the publication in September 2014 of an updated version of the UK Corporate Governance Code (Code) and the requirement for a ‘viability statement’ contained therein. As stipulated, we propose to apply the requirements of the updated Code for Diageo’s year ending 30 June 2016 and we have begun the thought process and preparation to enable us to do so. Again in September 2014, the Financial Reporting Council published its ‘Guidance on Risk management, Internal Control and related Financial and Business Reporting’ (replacing the current ‘Turnbull’ and other guidance). This is also applicable to Diageo’s financial year ending in 2016 and the Committee will oversee the necessary compliance.

In discharging its duties, the Audit Committee seeks to balance independent oversight of the matters within its remit with providing support and guidance to management. I remain confident that the Committee, supported by members of senior management and the external auditors, has carried out its duties in the year under review, effectively and to a high standard.

Philip G Scott  
Chairman of the Audit Committee
Role of the Audit Committee
The formal role of the Audit Committee is set out in its terms of reference, which are available at www.diageo.com/en-row/ourbusiness/aboutus/corporategovernance. Key elements of the role of the committee and work carried out during the year are set out as follows.

Financial statements
During the year, the Audit Committee met four times (and a sub-committee met twice) and reviewed the annual reports and associated preliminary year end results announcement, focusing on key areas of judgement and complexity, critical accounting policies, provisioning and any changes required in these areas or policies. In addition, the Audit Committee reviewed the interim results announcement, which included the interim financial statements and the company’s interim management results and dealt with the tender for the external audit.

The company has in place internal control and risk management systems in relation to the company’s financial reporting process and the group’s process for preparation of consolidated accounts. A review of the consolidated financial statements is completed by management (through the work of its filings assurance committee (FAC)) to ensure that the financial position and results of the group are appropriately reflected therein. The Audit Committee reviewed the work of the FAC and a report on the conclusions of the FAC process was provided to the Audit Committee by the Chief Financial Officer.

Significant issues and judgements that were considered in respect of the 2015 financial statements were as follows. These include the matters relating to risks disclosed in the UK external auditor’s report.

- Disclosure on the quality of the earnings and one off items included in cash flow. The committee agreed that sufficient disclosure was made in the financial statements.
- The committee determined that exceptional items are appropriately classified considering their size and nature, and sufficient disclosure is provided in the financial statements (see note 4).
- Review of carrying value of assets – in particular intangible assets. The committee agreed that an impairment charge of £41 million be made against the group’s equity investment in Hanoi Liquor Joint Stock Company (a Vietnamese spirit company) but that, otherwise, the fair value of the company’s assets was in excess of their carrying value (see notes 6 and 10).
- Exchange rate used to translate operations in Venezuela. The committee determined that the appropriate rate used for the year ended 30 June 2015 was the SIMADI rate of $1 = VEF197.3 (£1 = VEF309.76) compared with $1 = VEF49.98 (£1 = VEF85.47) for the year ended 30 June 2014 (see note 1).
- Following the completion of the tender offer on 2 July 2014, United Spirits Limited (USL) is accounted for as a subsidiary with a 43.91% non-controlling interest. The fair valuation of assets and liabilities has been finalised during the year ended 30 June 2015. The committee agreed on the appropriateness of the acquisition fair values recognised (see note 9).
- Review of legal cases and contingent liabilities. The committee agreed that adequate provision and disclosure have been made for all material litigation and disputes, based on the currently most likely outcomes, including: litigation in Colombia; a customs dispute in Korea; the guarantee agreement with Standard Chartered in respect of Watson Limited; the USL internal inquiry and related matters; the SEC inquiry; and other legal, customs and tax proceedings (see note 18).
- Assumptions used in respect of post employment plans. Having considered advice from external actuaries and assumptions used by companies with comparator plans, the committee agreed that the assumptions used to calculate the income statement and balance sheet assets and liabilities for post employment plans were appropriate (see note 13).

As part of its review of the Annual Report, the Committee considered whether the report is ‘fair, balanced and understandable’. On the basis of this work, the Audit Committee recommended to the Board that it could make the required statement that the Annual Report is ‘fair, balanced and understandable’.

Internal control and risk management; audit and risk programme; business conduct and ethics (including ‘whistleblowing’)
At each of its meetings, the Audit Committee reviewed detailed reports from the heads of the Global Risk & Compliance (GRC) and Global Audit & Risk (GAR) teams (including coverage of the areas mentioned in the title of this section) and had sight of the minutes of meetings of management’s Audit & Risk Committee. A key focus for the work of both GRC and GAR during the year and their reporting to the committee, continued to be a review of recent acquisitions. The Committee in turn were thus able to keep under review the development of the controls and compliance framework in acquired companies, bearing in mind the appropriate level for those that were associates during the year rather than wholly owned subsidiaries. The committee also received regular updates from the group general counsel on significant litigation and from the head of tax on the group’s tax profile and key issues.

The GRC reporting included a consideration of key risks and related mitigations, including those set out in the section of this Annual Report dealing with principal risks. Based on this activity during the year, the Audit Committee made a recommendation to the Board covering the nature and extent of the risks it was willing to take to achieve its strategic goals and its internal statement of risk appetite (this was considered also by the Audit & Risk Committee). The Board agreed this recommendation.

Through the activities of the Audit Committee described in this report and its related recommendations to the Board, the Board confirms that it has reviewed the effectiveness of the company’s systems of internal control and risk management.

External auditor
During the year, the Audit Committee reviewed the external audit strategy and the findings of the external auditor from its review of the interim results and its audit of the consolidated financial statements. The Audit Committee reviews annually the appointment of the auditor (taking into account the auditor’s effectiveness and independence and all appropriate guidelines) and makes a recommendation to the Board accordingly. Any decision to open the external audit to tender is taken on the recommendation of the Audit Committee. There are no contractual obligations that restrict the company’s current choice of external auditor.
The Audit Committee assessed the ongoing effectiveness and quality of the external auditor and audit process on the basis of meetings and a questionnaire-based internal review with the finance team and other senior executives. The outcome of the assessment was positive.

The group has a policy on auditor independence and on the use of the external auditor for non-audit services, which is reviewed annually, most recently in July 2015. The review took into consideration the new regulations on non-audit services. Under this policy, the provision of any non-audit service must be approved by the Audit Committee, unless the proposed service is both expected to cost less than £250,000 and also falls within one of a number of service categories which the Audit Committee has pre-approved. All services relevant to taxation requires Audit Committee approval. Fees paid to the auditor for audit, audit related and other services are analysed in the notes to the consolidated financial statements. The nature and level of all services provided by the external auditor is a factor taken into account by the Audit Committee when it reviews annually the independence of the external auditor.

During the year, in light of the requirements of the Code and other recent changes to the regulatory framework, the Committee undertook a tender for the external audit (KPMG having been the Group’s auditor since 1997). The result of the tender was that, on the recommendation of the Committee, the Board selected PwC. Subject to approval at the company’s September 2015 AGM, the appointment of PwC as auditor will take effect for Diageo’s financial year ending 30 June 2016.

‘Financial expert’ and other attendees
For the purposes of the Code and the relevant rule under SOX, section 407, the Board has determined that Philip Scott is independent and may be regarded as an Audit Committee financial expert.

The Chairman, the Chief Financial Officer, the group general counsel, the group financial controller, the head of GAR, the GRC director, the group chief accountant and the external auditor regularly attend meetings of the committee.

The Audit Committee met privately with the external auditor and with the head of global audit and risk as appropriate.

Training and deep dives
During the year, the Audit Committee had risk review and training sessions, presented by senior executives, on: brand assurance; Eurozone risk; catastrophic risk; and an update on cyber risk. In addition, as part of a Board meeting, committee members had a training session on the group’s new Risk Management Standard. The Committee concluded at the time that it was satisfied with the company’s position on these matters but they would be kept under review.