18. Audit Committee Report

Ruth Anderson
Audit Committee Chairman

> ***"During the year the Audit Committee oversaw the tender for the role of external auditors."***

Dear Shareholder,

I am pleased to present the report of the Audit Committee for the financial year ended 27 November 2016.

Our report provides information concerning our oversight of the Company's financial reporting, assurance framework and internal controls.

We considered the significant accounting matters and issues in relation to the financial statements and in this report we explain why the issues are considered significant, which provides context for understanding the Group's accounting policies and financial statements for the period.

A key responsibility of the Audit Committee during the year was overseeing the tender for the role of external auditors. The tender was completed in late 2016 and, based upon the Audit Committee's recommendation, the Board is proposing that shareholders approve that Deloitte LLP be appointed, effective from the 2017 Annual General Meeting. More detail about the external audit tender process can be found on pages 62 and 63.

The Audit Committee would like to thank each firm that participated in the tender and specifically to thank PwC on the Board's behalf, for their significant contribution to Ocado over the years.

During the year the Audit Committee reviewed the work being done to establish a control environment for the Ocado Smart Platform by Internal Audit and Risk. Internal Audit and Risk oversaw the design of the control model and the Audit Committee has received, and will continue to receive regular updates and reports.

These matters, as well as its other key responsibilities, are outlined in more detail below. I will be available at the AGM to answer any questions about our work.

Ruth Anderson
Audit Committee Chairman
31 January 2017

Membership and meetings

The membership and appointment dates of the Audit Committee members, together with details of each member's meeting attendance, are set out below.

As required under the terms of reference, the Audit Committee has three members, all of whom are independent Non-Executive Directors, and holds a minimum of three meetings a year.

Ruth Anderson
Chairman

Audit Committee member since 9 March 2010
Number of meetings: 4
Number attended: 4

Relevant sector experience: Retail

Alex Mahon

Audit Committee member since 1 June 2012
Number of meetings: 4
Number attended: 4

Relevant sector experience: Technology

Andrew Harrison

Audit Committee member since 1 March 2016
Number of meetings: 3
Number attended: 3

Relevant sector experience: Retail, Technology

At least one member of the Audit Committee (Ruth Anderson) is considered by the Board to have competence in accounting and all members have recent and relevant financial experience. Ruth Anderson is a chartered accountant with the Institute of Chartered Accountants in England and Wales. In line with the UK Corporate Governance Code 2016, the Audit Committee as a whole has competence relevant to the sectors in which the Company operates, notably the retail and technology sectors. Details of each Audit Committee member's relevant sector experience can be found in the diagram above. The biography of each member of the Audit Committee is set out in the Board of Directors section on pages 48 and 49.

During the year, the Audit Committee composition changed as a result of the retirement of David Grigson and the subsequent appointment of Andrew Harrison effective from 1 March 2016. David Grigson attended two meetings during the period, out of a possible two meetings, before his retirement from the Audit Committee on 4 May 2016.

Regular attendees at the Audit Committee meetings include the Chief Financial Officer, the Group General Counsel and Company Secretary, the Finance and Risk Director, the Head of Internal Audit and Risk and the external auditors. Other attendees who attend as required include the Chief Executive Officer, the Chairman, a number of senior members of the finance department and other advisers to the Company. The Deputy Company Secretary is the secretary to the Audit Committee.

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Key Areas of Focus for the Audit Committee

The responsibilities of the Audit Committee are set out in its terms of reference. The Audit Committee has an annual work plan, developed from its terms of reference, with standing items that the Audit Committee considers at each meeting, in addition to areas of risk identified for detailed review and any matters that arise during the year. The main matters that the Audit Committee considered during the year are described below.

Financial Statements and Reporting: The Audit Committee monitored the financial reporting processes for the Group, which included reviewing reports from, and discussing these with, the external auditors. As part of the year end reporting process the Audit Committee reviewed this Annual Report, a management report on accounting estimates and judgements, external auditors' reports on internal controls, accounting and reporting matters and management representation letters concerning accounting and reporting matters.

Monitoring the integrity of the financial statements of the Company, the financial reporting process and reviewing the significant accounting issues are key roles of the Audit Committee. The Board ensures this Annual Report, taken as a whole, is fair, balanced and understandable and provides the information necessary for shareholders to assess the Company's position, performance, business model and strategy and the Audit Committee plays an important role in assisting the Board in reaching those conclusions, including an assessment that the narrative reporting in the front of the Annual Report accurately reflects the financial statements in the back. For information concerning the process followed by the Company in preparing this Annual Report see page 57 of the Statement of Corporate Governance. The Audit Committee also monitors the financial reporting processes for the Group's half year report, which is a similar role to the one it carries out for full year reporting.

Accounting Judgements and Issues: The Audit Committee has assessed whether suitable accounting policies have been adopted and whether management has made appropriate judgements and estimates.

The Audit Committee reviewed and discussed reports from management on accounting issues and estimates in relation to this Annual Report. The Audit Committee sought to assess the reasonableness of the assumptions and judgements underlying the accounting issues.

The table below summarises those significant issues which received particular focus from the Audit Committee in relation to the financial statements for the period and how these issues were addressed.

Area	Issue and Nature of Judgement	Factors and Reasons Considered and Conclusion	Impact on Financial Information and Disclosure in Financial Statements
Intangible Assets — Capitalisation of Internal Development Time and Costs	The capitalisation of internal development costs is material and involves management judgements as to whether the costs incurred meet the criteria in accounting standards for capitalisation, including the technical feasibility of the project and the likelihood of the project delivering sufficient future economic benefits. The key projects in 2016 have been the development of new technology used in Andover CFC and replatforming the non-CFC based software to a cloud-based solution.	Details of material technology projects which are being capitalised along with the rationale for capitalisation were presented to and reviewed by the Audit Committee. The criteria for identification of projects which may be treated as intangible assets and the process to capture the costs of these technology projects were discussed by the Audit Committee. The Audit Committee also discussed the need for any impairment of the existing carrying values of capitalised software and systems recognised as a result of the development of new software and systems and concluded an impairment was required.	The amount of £44.9 million of internal development costs has been capitalised within intangible non-current assets, as set out in note 3.1 to the consolidated financial statements on pages 141 and 142.
Cost of Sales - Supplier income (including commercial income, promotional allowances and volume rebates)	Commercial income is an area of focus due to the quantum of income recorded and its significance to the results of the period. Some parts of commercial income require management to apply judgement to ascertain the amounts and timings of income to be recognised where it relates to supplier transactions that span the period end. The amounts due from suppliers in relation to promotional activity and volume related sales targets are material.	The Audit Committee assessed management judgements regarding estimates of commercial income. This commercial income arises from a range of agreements with suppliers including annual agreements with many suppliers which include a financial reward for achieving pre-agreed sales volumes. The Audit Committee reviewed the basis of the judgements made by management and concluded these were appropriate.	See notes 2.1 and 3.8 to the consolidated financial statements on pages 134 and 148.
Revenue Recognition	New promotional initiatives impact on Revenue, Other Income and Cost of Sales.	Details of the nature of the new promotional activity were considered by the Audit Committee. They reviewed the management judgements and accounting treatment, which takes into account the method by which the customer is incentivised to shop and how the supplier reimburses some, or all, of the promotional cost of this incentive to Ocado. The Audit Committee concurred with conclusions reached.	The accounting treatment is included in the Consolidated Income Statement on page 125.

Area	Issue and Nature of Judgement	Factors and Reasons Considered and Conclusion	Impact on Financial Information and Disclosure in Financial Statements
Recognition of Deferred Tax Asset	The estimates used to support the future business profitability and recognised deferred tax asset require management judgement.	The basis of management estimates of future taxable profits of the Group and the process used to calculate the deferred tax asset recognised were reviewed by the Audit Committee. The Audit Committee assessed the reasonableness of the assumptions underlying the Group's future profits forecasts.	The amount of £14.2 million was recognised in the Consolidated Balance Sheet for the period. Details of the deferred tax asset are set out in note 2.8 to the consolidated financial statements on pages 138 to 140.
Exceptional Items Ⓐ	Whether the costs associated with the head office move to new buildings and material litigation costs should be treated as exceptional.	The Audit Committee assessed management judgements, took into account the views of the external auditors and concluded that the accounting treatment was appropriate given the one-off nature of these particular events.	Given the accounting treatment as exceptional, £2.4 million was included as an exceptional cost item in the Consolidated Income Statement. See note 2.7 of the consolidated financial statements on page 137.

The table above is not a complete list of all the Group's accounting issues, estimates and policies, but highlights the most significant ones for the period in the opinion of the Audit Committee.

The accounting treatment of all significant issues and judgements was subject to review by the external auditors. For a discussion of the areas of particular audit focus by the external auditors, refer to pages 118 to 121 of the Independent Auditors' Report.

The Audit Committee considers that the Company has adopted appropriate accounting policies and made appropriate estimates and judgements.

Share-based payments: Accounting for share-based payments is a recurring issue, but did not require a significant estimate or judgement during the period, unlike previous periods. Although there were no material new share schemes in the year requiring assessment, the Audit Committee remain aware of their assessments in the prior years and their accounting impact. The judgements historically mainly relate to vesting criteria, share price volatility and leaver assumptions for each of the schemes.

Segmental Reporting: The Audit Committee considered the Group's approach to segmental reporting and concluded that the approach of reporting as one operating segment remains appropriate given the Group continues to be managed as one segment.

Going Concern and Viability Assessments: The Audit Committee and the Board reviewed the Group's going concern and viability statements (as set out on page 35) and the assessment reports prepared by management in support of such statements. The external auditors reviewed management's assessment and discussed this review with the Audit Committee.

Tax Review: The Audit Committee also considered the Company's tax policy, and concluded that management's low risk approach to tax management remained appropriate. The Audit Committee discussed the various means by which the Group could provide or access the necessary tax expertise to cater for the growth of the business in the future and the impending rule changes regarding tax disclosures and reporting of effective tax rates.

Internal Audit and Risk: Part of the assurance provided to the Audit Committee when reviewing the effectiveness of the Group's systems of internal control comes from Internal Audit and Risk. The Internal Audit and Risk plan, which was approved by the Audit Committee in January 2016, set out a number of activities for the period and the 2017 financial year, including assurance programmes for key strategic projects such as the new CFCs and the Ocado Smart Platform technology. These assessments of key programmes focus on several areas including programme management processes and governance for the project. The Internal Audit and Risk function recruited a new team member during the period to focus on technology assurance work.

In carrying out operational audits that test key controls designed to manage key risks to achieving the Group's strategic objectives, Internal Audit and Risk agrees recommendations with the relevant business area for implementation of appropriate actions. Management actions are tracked and the status of these actions are reported to the Audit Committee alongside progress against the Internal Audit and Risk plan. This helps mitigate the Group's risks.

As well as reporting at each Audit Committee meeting on the results of their work, Internal Audit and Risk reports on any cases of whistleblowing, fraud and bribery.

Internal Audit and Risk effectiveness review: A review of the effectiveness of the Internal Audit and Risk function was carried out during the period by way of questionnaire completed by members of management and business operations, the Audit Committee members and the external auditors, as well as a self-assessment by the Head of Internal Audit and Risk. The assessment questionnaire asked questions to assess performance in a range of areas including planning and work programme, communication, reporting and performance. Having considered the results of this review and informal feedback from management and the external auditors provided during the period, the Audit Committee concluded that the Internal Audit and Risk function was effective. During the period, the Audit Committee met with the Head of Internal Audit and Risk, without management present.

Risk Review: The Board has ultimate responsibility for effective management of risk for the Group including determining its risk appetite, identifying key strategic and emerging risks, and reviewing the risk management framework. The Audit Committee, in supporting the Board to assess the effectiveness of risk management and internal control processes, relies on a number of different sources to carry out its work including an assessment report provided by management, Internal Audit and Risk assurance reports and the assurance provided by the external auditors and other third parties in specific risk areas. No significant failings or

A See Alternative Performance Measures on page 194

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weaknesses were identified for the period. As the Group's risk management framework evolves with the growth of the business new controls and processes are identified and actions are put in place to implement them. The Board discussed and reviewed the Group's risk appetite when reviewing the principal risks for the Group. Regular review of the risk appetite ensures that the Company's risk exposure remains appropriate and acceptable in enabling the Group to achieve its strategic objectives. The Audit Committee also reviews risk appetite and principal risks when considering the effectiveness of risk management system. Every year the Audit Committee focuses on particular risk areas identified in the Group risk register. During the period, management reported on the progress of the Group's business continuity plans and the Ocado Smart Platform control environment. The Audit Committee will continue to receive reports on these areas in future years. Further details of the risk review and the Group's risk management and internal control systems, including financial controls, are set out in the "How We Manage Our Risks" section on pages 34 to 37.

Interaction with the Board: The Chairman of the Audit Committee reports at each Board meeting on the business conducted at the previous Audit Committee meeting and the recommendations made by the Audit Committee.

Annual Review: In addition to its annual performance evaluation, discussed in the Statement of Corporate Governance on page 54, the Audit Committee carried out a review of its terms of reference. A number of changes were made to the Audit Committee's terms of reference to reflect changes in Disclosure Guidance and Transparency Rules and The UK Corporate Governance Code 2016, including with regards to Audit Committee competence and audit tender requirements.

Auditor Tender and Appointment Overview

Assessing the Effectiveness of the External Audit Process and the External Auditors

The Audit Committee places great importance on ensuring that there are high standards of quality and effectiveness in the external audit carried out by PwC. Audit quality is reviewed by the Audit Committee throughout the year and includes reviewing and approving the annual audit plan to ensure that it is consistent with the scope of the audit engagement. In reviewing the audit plan, the Audit Committee discussed the significant and elevated risk areas identified by PwC most likely to give rise to a material financial reporting error or those that are perceived to be of higher risk and requiring additional audit emphasis (including those set out in the Independent Auditors' Report on pages 118 to 124). The Audit Committee also considered the audit scope and materiality threshold. The Audit Committee met with PwC at various stages during the period, including without management present, to discuss their remit and any issues arising from the work of the auditors.

The Audit Committee reviewed the performance of PwC based on a questionnaire that contained various criteria for judging their effectiveness and on feedback from management. The criteria for assessing the effectiveness of the audit included the robustness of the audit, the quality of the audit delivery and the quality of the people and service. The results of the questionnaire were reviewed by the Audit Committee. The Audit Committee also met with management, including without PwC present, to hear their views on the effectiveness of the external auditors. The Audit Committee concluded that the performance of PwC remained effective.

Independence and Objectivity: The Audit Committee considered the safeguards in place to protect the external auditors' independence. PwC reported to the Audit Committee that it had considered its independence in relation to the audit and confirmed to the Audit Committee that it complies with UK regulatory and professional requirements and that its objectivity is not compromised. The Audit Committee took this into account when considering the external auditors' independence and concluded that PwC remained independent and objective in relation to the audit.

Non-Audit Work Carried Out by the External Auditors: To help protect auditor objectivity and independence, the provision of any non-audit services provided by the external auditors requires prior approval, as set out in the table below.

Approval Thresholds for Non-Audit Work	Approver
Over £10,000 and up to £30,000 per engagement	Chief Financial Officer
Over £30,000 and up to £100,000 per engagement	Chief Financial Officer and Audit Committee Chairman
Greater than £100,000 per engagement, or if the value of non-audit fees to audit fees reaches a ratio of 1:2 as a result of a new engagement, regardless of value	Audit Committee

An additional protection is provided by way of a non-audit services fee cap. The Audit Committee (or the Company) may not approve an engagement of the external auditors if annual non-audit services fees would exceed 70% of the average audit fees (not including fees for audit related services) charged in the previous three years. Certain types of non-audit service are of sufficiently low risk as not to require the prior approval of the Audit Committee, such as "audit-related services" including the review of interim financial information. "Prohibited services" are those that have the potential to conflict directly with the auditors' role, such as the preparation of the Company's financial statements.

Non-Audit Work Undertaken During the Period: The total of non-audit fees, audit fees and audit-related services fees paid to PwC during the period is set out in Note 2.5 of the consolidated financial statements on page 136. The non-audit services fees of £50,000 (2015: £37,000) paid to PwC related to: (1) advice on the Company's Greenhouse Gas Assurance Report (further details of which can be found in the Corporate Responsibility section on page 39); (2) an engagement concerning Ocado Smart Platform controls assessment; and (3) advice covering the establishment of the Group's Spain office during the period. All non-audit work engagements were approved by the Chief Financial Officer as the fees concerned were well within the approval thresholds set under the policy. In the case of each engagement, management considered it appropriate to engage PwC for the work because of their existing knowledge and experience from prior Group engagements.

The Audit Committee received a regular report from management regarding the extent of non-audit services performed by PwC. PwC also provided a report to the Audit Committee on the specific safeguards put in place for each piece of non-audit work confirming that it was satisfied that neither the extent of the non-audit services provided nor the size of the fees (being 15.5% of the audit fees) charged had any impact on its independence as statutory auditors. The Audit Committee was satisfied this was the case and so concluded that the auditors' independence from the Group was not compromised.

Audit Fees: The Audit Committee was satisfied that the level of audit fees payable in respect of the audit services provided (excluding audit-related services) (being £322,000 (2015: £287,000)) was appropriate and that an effective audit could be conducted for such a fee. The existing authority for the Audit Committee to determine the current remuneration of the external auditors is derived from the shareholder approval granted at the Company's annual general meeting in 2016. At the annual general meeting in 2016, all votes cast by shareholders were in favour of granting the Directors this authority.

External Audit Tender

As reported in last year's annual report, the Audit Committee decided to undertake a tender of the external auditor role in 2016. PwC has audited the Group's accounts since 2001 and the current audit engagement partner's five year term was due to end in mid-2017. A formal tender of the external audit contract had not been carried out since PwC was first engaged in 2001. Although the Board and the Audit Committee have remained satisfied with both PwC's quality of service and their independence and objectivity, the Audit Committee recommended to the Board that a competitive tender process take place in 2016, with the outcome to be put to shareholders for approval at the 2017 Annual General Meeting. The Audit Committee believed that this timing was in the best interests of the Company's shareholders as it coincided with the timing of the rotation of PwC's audit engagement partner under professional standards and because a tender had not been conducted since 2001.

The Audit Committee approved and oversaw the tender process, including agreeing the timetable and tender document, which were prepared in accordance with the relevant requirements. A description of the process undertaken during the audit tender is below.

Audit tender process – Timeline and key activities
Stage One
Audit Committee recommended the audit tender to the Board in April 2015, for the tender to take place in 2016.
The Audit Committee agreed the timetable for the tender, the tender document, the tender shortlist and the key decision criteria it would use in deciding to make a recommendation to the Board.
Stage Two
Ruth Anderson and Duncan Tatton-Brown met separately with the audit partner of each shortlisted firm in advance of issuing the invitation to tender for audit. This provided the ability to assess each audit partner from an experience and cultural fit perspective.
Four firms were invited to tender for the audit of Ocado. Each firm was sent a list of proposal requirements and evaluation criterion. The criteria included, but was not limited to, the auditor's application of technical knowledge, commercial insight and ability to deliver high quality audits. Each firm was invited to: • A tour of the CFC in Hatfield; • A meeting with management and finance team members; and • Access a secure data room with information to help them gain an understanding of Ocado as a business.
Each firm submitted an extensive written proposal to the Company in September 2016.
Stage Three
Each proposal was reviewed and a shortlist was agreed.
Three of the firms were invited to present to the Audit Committee.
Stage Four
Each firm presented to the Audit Committee in October 2016. It was an interactive session with questions and answers.
The Audit Committee met to evaluate each firm using the agreed key decision criteria and to reach its recommendation to the Board.
Stage Five
Board approved the recommendation of the Audit Committee. Feedback was provided to all four firms.

At the conclusion of the process, the Audit Committee (having consulted with management) recommended to the Board that Deloitte LLP be appointed as external auditors with effect for the 2017 financial year. The Audit Committee believed that both Deloitte LLP and one other firm, KPMG LLP, could be recommended, but had a reasoned preference for Deloitte LLP, based on the selection criteria as above.

Recommendation to Appoint: The Board accepted the Audit Committee's recommendation to appoint Deloitte LLP as external auditors and a resolution for the appointment of Deloitte LLP will be put to shareholders at the 2017 AGM. The Audit Committee confirms this recommendation is free from influence by a third party and that no contractual term has been imposed on the Company limiting the choice of auditor.

Transition to New Auditors: The Audit Committee has reviewed plans for the transition to the new auditors during 2017 and will receive regular reports on the transition at Audit Committee meetings.

Resignation of auditors: PwC will cease to hold office effective at the conclusion of the Annual General Meeting on 3 May 2017, having completed the audit of the Company's financial statements for the period.

Statement of Compliance with the Competition and Markets Authority (CMA) Order

The Company confirms that it has complied with The Statutory Audit Services for Large Companies Market Investigation (Mandatory Use of Competitive Processes and Audit Committee Responsibilities) Order 2014 (Article 7.1), published by the CMA on 26 September 2014, including with respect to the Audit Committee's responsibilities for agreeing the audit scope and fees and supervising the audit tender process.