

Report of the Audit Committee

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 2017.

I succeeded Philip Scott as Chairman of the Committee on 1 January 2017. Philip chaired the Committee for some nine years and I would like to take this opportunity to thank him and to pay tribute to his leadership of the Committee during his outstanding tenure.

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.

The work of the Committee during the year gave attention to all elements of its remit. The Committee gave additional focus to the risk programme, beginning a series of review and training sessions covering each of its principal risks (as set out above in the Annual Report). It is the intention to continue this work, to cover each principal risk on a regular basis.

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 am 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.



Alan JH Stewart

Chairman of the Audit Committee

Report 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 once) 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.

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 2017 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 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 an appropriate rate used for the year ended 30 June 2017 for consolidation purposes, that represents the best estimation of the rate at which capital and dividend repatriations are expected to be realised (see note 1).
- Disclosure on taxation. The committee agreed that the separate presentation of the tax risk appropriately addresses the significant change in the international tax environment and sufficient and transparent disclosures are provided for the ongoing tax discussions (see page 21 and note 7).
- Review of legal cases. The committee agreed that adequate provision has been made for all material litigation and disputes, based on the currently most likely outcomes, including the litigation summarised in 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).
- Viability statement. The committee noted that severe but plausible risk scenarios had been identified; a robust risk assessment had been carried out; and the group's viability and going concern consideration proved with stress testing. Taking into account the company's balance sheet position, the committee expected the group to be able to meet its liabilities as they fell due over the three-year period ending 30 June 2020. The risk that the group would become insolvent during this timeframe was considered remote. The Committee recommended to the Board that the Viability statement above be approved.

As part of its review of the Annual Report, the committee considered whether the report is 'fair, balanced and understandable' (noting the Code's reference to 'position' as well as 'performance, business model and strategy'). 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. The work and reporting to the Committee of both GRC and GAR during the year focused on recent acquisitions, cyber security and change in the organisation. The Committee in turn were thus able to keep under review the operation of the controls and compliance framework in these areas. 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 and that there were no material failings identified and no significant failings identified which require disclosure in this Annual Report.

External auditor

Following a tender process carried out during the year ended 30 June 2015, PwC were appointed as external auditors with effect from the year ended 30 June 2016.

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 company has complied with the provisions of The Statutory Audit Services for Large Companies Market Investigation (Mandatory Use of Competitive Tender Processes and Audit Committee Responsibilities) Order 2014 ("CMA Order") for the financial year ended 30 June 2017.

The Audit Committee assesses 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 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 2017. 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. 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.

'Financial expert' and other attendees

For the purposes of the Code and the relevant rule under SOX, section 407, the Board has determined that Alan Stewart 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 reviews and training sessions, presented by senior executives, on Scotch whisky inventory management and political violence and terrorism. In addition members of the Committee had (at a Board meeting) a session on crisis management.