

Audit Committee Report

The Purpose and Function of the Audit Committee (the Committee)

Purpose

The Committee's key role is to review and report to the Board on financial reporting, internal financial control effectiveness and to oversee the relationship with the external auditor. The main responsibilities are summarised on page 69 of the Corporate Governance Report.

Membership, Meetings and Attendance

The membership of the Committee, together with appointment dates and attendance at meetings, are detailed on page 68 of the Corporate Governance Report. The Committee is pleased to welcome Lawson Macartney as its most recent member. Tony Rice resigned from the Committee on his appointment as Chairman of the Company at the 2016 Annual General Meeting.

The Board considers that all members of the Committee are independent. Julian Heslop has recent and relevant financial experience as a result of his financial background and qualification. Ishbel Macpherson and Lawson Macartney provide different but relevant skills and experience which support the Committee in meeting its objectives. The biographies of all Committee members are detailed on pages 64 and 65.

The Company Secretary attends each meeting and acts as its secretary assisting the Chairman in ensuring that all Committee papers are provided prior to each meeting in a timely manner and providing advice to the Committee on all governance related matters.

Other members of the Board normally attend each meeting together with the PricewaterhouseCoopers LLP (PwC) Lead Audit Partner, the Group Financial Controller and the Head of Internal Audit and Risk Assurance.

The Committee has discussions at least twice a year with the external auditor without management being present, including the meetings where the annual and interim results are reviewed and endorsed.

Neither the Company nor its Directors have any relationships that impair the external auditor's independence.

Role and Responsibilities

The main role and responsibilities of the Committee are set out in the written terms of reference which are available on the Company website at www.dechra.com. The Board reviewed the Committee's terms of reference at the December 2016 meeting and amended them following recent legislative changes in relation to its membership and the qualifications required.

Major Activities of the Committee during the Year

The Committee met five times since the last Annual Report was issued. The meetings are generally timed to coincide with the financial reporting timetable of the Company. The Committee Chairman and the Company Secretary have developed an annual programme of business. This allows the Committee to ensure that standing items of business are appropriately considered alongside any exceptional matters that may arise during the course of the year.

The table below provides an overview of the main matters discussed at the meetings:

Meeting Date	Main Activities
1 December 2016	<ul style="list-style-type: none"> Review and approval of the annual internal audit plan Review of the internal audit progress and assurance report Review and approval of PwC Half-Yearly review plan Review of the Committee's terms of reference Review of Anti-Bribery and Anti-Corruption and Whistleblowing Policies Review of status of statutory audits, global tax management and compliance support Review of non-audit fees (including actual and projected spend)
19 December 2016	<ul style="list-style-type: none"> Review and approval of FRC response letter
22 February 2017	<ul style="list-style-type: none"> Review of the Group's Half-Yearly Report and supporting papers Consideration of the Half-Year Review Memorandum prepared by the external auditor Half year review of internal financial controls Half-Yearly Accounts and Report disclosure enhancement following FRC feedback Review of the internal audit progress and assurance report Review of the dividend policy and interim dividend proposal Meeting with the external auditor without management present Anti-Bribery and Anti-Corruption and Sanctions progress update
11 May 2017	<ul style="list-style-type: none"> Review and approval of the year end external audit strategy (including timetable, scope and fees) Discussion in relation to the Company's expectations of the external auditor and audit process Review of year end accounting treatment for acquisitions, accounting for associates and segmental analysis Review of the internal audit progress and assurance report Review of non-audit fees (including actual and projected spend) Review of tax strategy and policy framework Meeting with the external auditor without management present
29 August 2017	<ul style="list-style-type: none"> Review of the Group's preliminary statement, draft Annual Report (including the Audit Committee Report) for the year ended 30 June 2017 and supporting papers, and the proposed final dividend Consideration of the Audit Memorandum prepared by the external auditor, including: <ul style="list-style-type: none"> review of accounting treatment of non-underlying items assessment of acquired intangible assets and goodwill commentary on the general control environment across the Group Review and approval of the going concern and viability statements Review and approval of the internal control and risk management statements Review of the internal audit progress and assurance report Full year review of internal financial controls for the period ended 30 June 2017 Review of the external audit effectiveness, external auditor's independence and level of non-audit fees Meeting with the external auditor without management present Fair, balanced and understandable recommendation of the Annual Report

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During the year the Financial Reporting Council's (FRC) Corporate Reporting Review Team carried out a review of the Company's Annual Report for the year ended 30 June 2016. The Committee discussed the Company's response with the full involvement of the external auditors, PwC, and Tony Rice, Chairman, prior to responding to the FRC. The FRC have closed their enquiries with no requirement to restate any disclosures. However, undertakings were given to enhance certain disclosures in the future in response to the FRC review. The Committee is satisfied that the enhancements proposed to, and agreed with, the FRC have been appropriately incorporated in the 2017 Annual Report.

All significant matters under consideration by the Committee during the year were supported by relevant justification papers and fully discussed in order to ensure that due and appropriate consideration was given before any decision was approved. Further detail in relation to a number of the matters is provided below:

- **Financial Judgements**

The Committee reviewed both the half-year and the annual financial statements. This process included an analysis by management of key judgements made in determining the results. The Committee reviewed this in detail and endorsed management's judgements.

The Committee gave particular attention to significant matters where judgement was involved, which were complex in nature, or where additional performance measures (APMs) were provided to enhance investors' understanding of the underlying performance. The Group uses various non-GAAP APMs within internal management reporting, the Half-Yearly Report and the Annual Report. The objective of these APMs is to isolate the impact of exceptional, one-off or non-trading related items to allow the Board and investors to understand better the underlying performance of the business. The Group also uses constant exchange rate growth percentages to eliminate the impact of exchange rate fluctuations and show the underlying business growth.

These matters were well supported by briefing papers provided by management and were specifically reviewed and agreed by the external auditor in their reports to the Committee and in related discussions.

The key matters reviewed are shown in the table below:

Significant risks considered by the Committee in relation to the financial statements	Corresponding actions taken by the Committee to address the issues
Review of the carrying value of acquired intangible assets and goodwill of £377.8 million, which represents 125.0% of Group net assets.	The Committee reviewed management's process for reviewing and testing goodwill and other intangible assets for potential impairment.
Valuation of the acquired intangible assets and goodwill acquired during business combinations in the year, which total £31.3 million.	The Committee reviewed the calculations and assumptions provided by management and third party experts which support the valuation of these acquired assets and these valuations were assessed for completeness. The Committee reviewed the useful economic lives of the identifiable intangible assets and the future growth rate assumptions applied in the valuations.
Valuation and accounting for the acquired commercial licensing agreement intangible with Animal Ethics Pty Ltd of £30.1 million together with the related deferred consideration	
Significant judgements considered by the Committee in relation to the financial statements	Corresponding actions taken by the Committee to address the issues
Review of the corporate tax rate for the year of 8.6% (21.9% on underlying operations).	The Committee discussed the key risks in respect of corporate tax and reviewed that appropriate controls were in place to ensure that taxation calculations are not materially misstated. Areas where significant judgements such as uncertain tax positions have been applied are reviewed and challenged and external audit work and conclusions are considered.
Review the accounting treatment of related disclosures for associates acquired in the period of £10.9 million.	The Committee reviewed the basis for accounting for the associate company and the related disclosures.
In order to assist investors with a better understanding of the underlying performance of the business, management present within the financial statements figures for underlying profit and earnings.	The Committee reviewed the basis for calculating the underlying figures and its consistency with previous year's figures. It also sought confirmation from the external auditor, PwC, that they were satisfied that the application of the accounting policy was appropriate.
This is reconciled to the figures provided in the financial statements and excludes matters such as impairment and amortisation of acquired intangible assets and related deferred consideration, acquisition cost, restructuring costs, and the fair value uplift on inventory acquired through business combinations.	The Committee also reviewed material one-off income and costs within the underlying results, if any, and ensured these were clearly disclosed within the financial statements and notes.

- **Going Concern and Viability Statements**

The Committee reviewed the Group's going concern and viability statements set out on pages 72 and 73 of the Corporate Governance Report. In considering the viability statement the Committee paid particular attention to the robustness of the stress testing scenarios. The external auditor reviewed management's assessment and discussed this review with the Committee.

- **Fair, Balanced and Understandable Assessment of the Annual Report**

At the request of the Board, the Committee considered whether the 2017 Annual Report was fair, balanced and understandable and whether it provided the necessary information for shareholders to assess the Company's performance (pages 21 to 27), business model (page 8) and strategy (pages 13 to 15).

The Committee based its assessment on a review of the processes and controls put in place by management. This included the relevant senior management providing information on their own business units and their confirmation that it was fair, balanced and understandable. In addition, the final draft document was reviewed by all members of the Senior Executive Team (SET) who also concluded that it met the fair, balanced and understandable test.

An integral part of the process was the Committee's final review; other Board members and the external auditor were invited to comment so that issues could be debated and a final assessment made.

The external auditor confirmed that in their opinion the Annual Report 2017 was fair, balanced and understandable, which can be found on pages 108 to 114.

This assessment was carried out by the Committee on 29 August 2017, following which the Committee reported to the Board that it was satisfied that, taken as a whole, the Annual Report 2017 is fair, balanced and understandable.

- **Review of Policies and Procedures**

During the year the Committee reviewed the following policies:

- **Accounting Policies**
The Committee undertook the annual review of the tax policy.
- **Anti-Bribery and Anti-Corruption and Whistleblowing Policies**
The Head of Internal Audit and Risk Assurance provides regular updates on the third party due diligence procedures and their implementation throughout the organisation.
- **Dividend**
The dividend policy was reviewed by the Committee and amended to take account of the underlying financial position of the organisation. The amended dividend policy was recommended to the Board for approval.

Internal Controls and Risk Management

The Board retains overall responsibility for the management of the Group's risk management and internal control framework. The Committee monitors and reviews the effectiveness of the Group's internal financial controls.

The Committee has also reviewed the effectiveness of the Group's risk management and internal control processes. This includes:

- confirmation that the rolling programme of risk and control reviews by the Board has been completed;
- a review of the SET's assessment of material internal control effectiveness; and
- a review of the going concern and viability statements together with the financial stress testing conducted to support these statements.

Further details in respect of the Group's risk management and internal control processes are provided on pages 56 and 57 of the Strategic Report and the Board's statements on the effectiveness of these processes are provided on page 73 of the Corporate Governance Report.

Internal Audit

The Head of Internal Audit and Risk Assurance provides objective assurance and advice on the management of the Group's risks and its systems of internal control. Internal Audit is supported by a co-sourcing arrangement with KPMG LLP (KPMG) to provide a flexible resource model and access to specialist expertise and language skills in geographies.

Internal Audit has a three year plan which seeks to provide balanced assurance coverage of the Group's material financial, operational and compliance control processes. It sets out a rolling programme of core assurance activities together with a significant focus on the implementation of the Oracle ERP system. The annual delivery plan, which defines the specific assurance projects to be delivered each calendar year, is developed from the three year plan. The annual plan for the year to December 2017 was approved by the Committee in December 2016.

Internal Audit recommendations are communicated to relevant business leaders and appropriate control improvements are agreed with them. Audit reports are provided to the Audit Committee together with regular progress reports on management's implementation of control improvements.

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External Auditor

Following a competitive tender in 2015, PwC were appointed as the Company's external auditor for the 2016 audit.

The Company complies with the Competition and Market Authority Order 2014 relating to audit tendering and the provision of non-audit services.

Audit Plan

PwC agreed their audit plan with the Committee, which included their audit scope, key audit risk areas and materiality. The Committee discussed the audit plan with PwC and approved it, together with the fees proposed.

Independence, Effectiveness and Objectivity of the Audit Process

The Committee conducted a review of the external auditor's independence, effectiveness and objectivity based on:

- the Committee's own assessment of the quality of the audit plan, the rigour of the audit findings and conclusions, the extent to which the Lead Audit Partner understands the business and constructively challenges management and the quality and clarity of the technical and governance advice provided;
- the results of a questionnaire on external auditor effectiveness and efficiency (further detail on which is provided below);
- a report prepared by PwC setting out its processes to ensure independence and its confirmation of compliance with them; and
- the level of non-audit fees as a percentage of the audit and half-yearly review fees paid to the external auditor, which were 8.5% (2016: 3.9% in relation to services rendered by PwC).

Responses to the questionnaire have been received from all finance directors across the Group who provided information and assistance to the external auditor. The questionnaire covered a number of areas, including:

- quality of the audit team;
- knowledge and understanding of the Group;
- appropriateness of the areas of audit focus;
- interaction with audit specialists; and
- timeliness and adequacy of communication by the external auditor.

The results of the questionnaire were reported to the Committee at the meeting on 29 August 2017.

Based on the review set out above, the Committee is satisfied with the external auditor's independence, effectiveness and objectivity.

Re-Appointment of External Auditor

At the forthcoming Annual General Meeting, a resolution to re-appoint PwC as the external auditor and to authorise the Audit Committee to set their remuneration will be proposed.

There are no contractual obligations that restrict the Committee's capacity to recommend a particular firm as external auditor and the Company does not provide an indemnity to the external auditor.

External Audit Engagement Partner Rotation

In line with the ethical standards of the Audit Practices Board, the Lead Audit Partner will be rotated every five years. The current Lead Audit partner was appointed during the 2016 financial year and consequently will stand down at the latest after the completion of the audit of the 2020 financial year.

Non-Audit Assignments

With respect to non-audit assignments undertaken by the external auditor, the Company has a policy of ensuring that the provision of such services does not impair their independence or objectivity.

Prior approval of the Committee, or the Committee Chairman for smaller pieces of work, is required before the external auditor is appointed to carry out non-audit work and the rationale for doing so is provided to the Committee, who assess the qualification, expertise, independence and objectivity of the external auditor prior to granting approval. As such, non-audit fee spend is a standing item on the agenda for every Committee meeting.

The Committee firmly believes that there are certain non-audit services where it is appropriate for the Group to engage the external auditor. In such cases safeguards are in place to ensure continued external auditor independence, including the use of separate teams to undertake the non-audit work separately from the audit work. The external auditor assisted with the preparation of the FRC letter. The Committee did not consider that the performance of this non-audit work affected or impaired the external auditor's integrity. This is consistent with the ethical standard published by the Accounting Practices Board.

The results of this policy are that:

- Deloitte undertake global tax compliance work;
- KPMG support internal audit; and
- during the course of the year Deloitte, Ernst & Young LLP, KPMG, Smith & Williamson LLP and Grant Thornton UK LLP have provided advice on global mobility matters, related tax advice, company reorganisation, acquisition valuation support and due diligence.

A summary of audit and non-audit fees in relation to the year is provided in note 7 to the Group's financial statements. This shows that non-audit work carried out by the external auditor represented 8.5% (2016: 3.9%) of the annual audit fee and half-yearly review fee, and reflects the policy set out above.

Julian Heslop

Audit Committee Chairman
4 September 2017