AUDIT COMMITTEE REPORT

Ruth Anderson
Audit Committee Chairman

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DEAR SHAREHOLDER,

This Audit Committee report provides an overview of the work we carried out during the period, including the significant issues considered in relation to the financial statements and how we have assessed the effectiveness of the external auditors.

We have a responsibility to oversee the Group's internal control and risk management systems. A significant change in the Group's internal control framework during the year was the appointment to the newly created role of Head of Internal Audit & Risk to provide additional assurance for the Group. Overseeing the appointment and establishment of this function, including reviewing its charter, strategy and work areas, was a key achievement for us this year. We will continue to monitor and review the effectiveness of the Group's internal control and risk management systems with the support of this new function.

This report also outlines the significant accounting matters which received our particular focus during the year. It seeks to explain why the issues are considered significant and together with the external auditors' report provides additional context for understanding the Group's accounting policies and financial statements for the period.

I will be available at the AGM to answer any questions about our work.

Ruth Anderson
Audit Committee Chairman
3 February 2015

MEMBERSHIP AND MEETINGS

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

	Ruth Anderson (Chairman)	David Grigson	Alex Mahon
Audit Committee member since	9 March 2010	9 March 2010	1 June 2012
Number of meetings	4	4	4
Number attended	4	3	4

Two members of the Audit Committee (Ruth Anderson and David Grigson) are considered by the Board to have competence in accounting and/or auditing and recent and relevant financial experience. Both have professional qualifications with the Institute of Chartered Accountants of England and Wales. The biography of each member of the Audit Committee is set out in the Board of Directors section on pages 62 to 63.

Regular attendees at the Audit Committee meetings include the Chief Financial Officer, the Legal & Business Affairs Director and Company Secretary, the Director of Finance and Risk, the Deputy Company Secretary, the Head of Internal Audit & 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.

KEY AREAS OF FOCUS FOR THE AUDIT COMMITTEE

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 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, PwC. The Board and the Audit Committee have reviewed this Annual Report, as well as the half-year report and accounts. As part of the year-end reporting process the Audit Committee reviewed a management report on accounting estimates and judgements, external auditors' reports on internal controls, accounting and reporting matters and a management representation letter concerning accounting and reporting matters.

Monitoring the integrity of the financial statements of the Company and the financial reporting process and reviewing the significant accounting issues are key roles of the Audit Committee in assisting the Board to ensure 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. For information concerning the process followed by the Company in preparing this Annual Report see page 73 of the Statement of corporate governance.

Accounting judgements and issues: The Audit Committee reviewed and discussed reports from management on significant accounting issues and estimates in relation to this Annual Report, which also included the external auditors' views. The Audit Committee sought to assess the reasonableness of the assumptions and judgements underlying the significant accounting issues.

The Audit Committee considers that the Company has adopted appropriate accounting policies and made appropriate estimates and judgements. The table overleaf summarises those significant accounting issues which received particular focus from the Audit Committee in the period and how the issues were addressed.

AUDIT COMMITTEE REPORT continued

Area	Issue and nature of judgement	Factors and reasons considered and conclusion	Impact on financial information
Commercial income	Accounting for the quantum and timing of amounts due from suppliers in relation to promotional activity and volume related sales targets is material and involves an element of judgement in determining the amounts and timing of income to be recognised.	See detailed explanation below.	See detailed explanation below. See notes to the consolidated financial statements on page 147.
Capitalisation of internally generated costs	The capitalisation of internally generated costs is material and involves management judgements as to whether the costs meet the criteria in accounting standards for capitalisation.	The criteria for identification of projects which may be treated as intangible assets and the process to capture the costs of these projects were discussed. Details of material projects which are being capitalised along with the basis for capitalisation were presented to and reviewed by the Audit Committee.	The value of intangible non-current assets created during 2014 is included in notes to the consolidated financial statements on page 155.
Accounting for share-based payments	Multiple share schemes with differing methods of settlement and vesting criteria require management judgement, including transfer restrictions, share price volatility and leaver numbers.	Details of the accounting treatments for new share-based payment arrangements were considered. The methodology and key assumptions for each arrangement were discussed and agreed.	Charges for share-based payments are included in operating expenses. The methodology and key assumptions are set out in notes to the consolidated financial statements on pages 174 to 183.
Deferred tax asset	Estimates used to support the amount of future profitability and recognised deferred tax asset require management judgement.	The basis of estimates of future taxable profits of the Group and the process used to calculate the deferred tax asset were reviewed.	Details of the deferred tax asset are included in notes to the consolidated financial statements on page 152.

Commercial income remains a key area of focus for the Audit Committee and is an area where, this year, users of the financial statements may expect to receive more detailed information. This income comes from three major sources which, in diminishing order of size, are promotional support; media income; and volume rebates.

- Promotional support — This represents over half of all commercial income. The Group negotiates funding with many of its suppliers to support specific promotions on selected items. The funding is typically based on an agreed sum per item sold on promotion for a period. There is limited judgement or estimation involved in recording the income received, which is collected in a timely manner throughout the period. This is included within cost of sales.
- Media income — Income is received from suppliers and other third parties for advertising services provided on the Webshop. The income received is recognised in other income over the period that the services are provided so limited judgement is required.
- Volume rebates — the smallest proportion of commercial income comes from annual agreements with many suppliers for volume rebates based on agreed targets for the Ocado and Waitrose businesses. The majority of these agreements are negotiated on behalf of the Group by its supply partner, Waitrose, and the contract period typically spans across the financial year end. Where Waitrose negotiates the agreement it provides the Group with an estimate of the expected funds due to Ocado. Final confirmation of any amounts due is usually received three to six months after the period end. The Audit Committee reviewed the judgements made by management based on the estimates provided by Waitrose. This is included within cost of sales.

The accounting treatment of all significant issues and judgements was subject to review by the external auditors. The above list is not a complete list of all accounting issues and estimates but highlights the most significant ones in the opinion of the Audit Committee. For further information on the Company's critical accounting estimates and assumptions refer to the notes to the consolidated financial statements on page 146. For a discussion of the areas of particular audit focus by the external auditors, refer to pages 132 to 136 of the Independent Auditors' report.

Governance review: During the period, KPMG LLP, an external consultant, completed a broad-ranging review of the effectiveness of the Group's governance and risk management framework. The purpose of the review was to assess the Group's governance framework against market practice for listed companies in the context of a business that is growing rapidly and that has plans for future expansion. The Company has taken steps to implement the recommendations from KPMG and has a timetable for completing them, including formalising the Company's approach to risk management and formalising the Group-wide policy framework. It has also embedded a form of independent assurance, via the newly established internal audit and risk function (noted below).

Internal audit: The Group established an internal audit function during the period, with the appointment of a Head of Internal Audit & Risk in July 2014. Internal audit provides independent and objective assurance and advisory services designed to add value and improve the operations of the Group. Its scope encompasses, but is not limited to, the examination and evaluation of the adequacy and effectiveness of the Group's governance, risk management and internal control processes in relation to the Group's defined goals and objectives. The Audit Committee approved the internal audit function's charter, which sets out its role, scope, accountability and authority.

Risk review: An annual review of the effectiveness of risk management and internal control processes was carried out by the Audit Committee. The Audit Committee focused its review on the Company's risk mitigation and controls and the strategic and organisation-wide risks facing the Group.

The Audit Committee also oversaw an information technology risk review during the period, focusing on the key risks in connection with the Group's technology and the processes used to identify those risks. The Audit Committee reviewed reports from management on key risk programmes concerning key technology projects including its new technology platform.

The Group's risk management and internal control systems, including financial controls, are described in more detail in the How We Manage Our Risks section on page 33, where the Audit Committee's work in this area is highlighted.

Going concern assessment: The Audit Committee and the Board reviewed the going concern basis for preparing the Group's consolidated financial statements, including in particular the assumptions underlying the going concern statement and the period of assessment. The Audit Committee's assessment was based on reports by management and the external auditors and took note of the principal risks and uncertainties, the improved financial performance of the Group, the existing financial position, the Group's financial resources including the new unutilised revolving credit facility, and the expectations for future performance and capital expenditure. For further information concerning going concern see the notes to the consolidated financial statements on page 146, the Independent Auditors' report on page 137 and the Directors' report on page 87. Although not applicable to the going concern assessment for the period, the Audit Committee discussed the new 2014 Code requirements for reporting on the Group's longer-term viability. Management will report to the Audit Committee in 2015 on its review under the expanded going concern assessment.

Other matters considered by the Audit Committee: The Audit Committee also considered the Company's tax strategy 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 the necessary tax expertise to cater for the growth of the business in the future. 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.

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 71, the Audit Committee carried out a review of its terms of reference. The terms were updated to reflect the Audit Committee's changed responsibilities as a result of amendments to the 2014 Code.

AUDIT COMMITTEE REPORT continued

ASSESSING THE EFFECTIVENESS OF THE EXTERNAL AUDIT PROCESS

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 132 to 136). The Audit Committee also considered the audit scope and materiality threshold.

The Audit Committee met with PwC at various stages during the audit process, including without management present, to discuss their remit and any issues arising from the audit. The Audit Committee concluded that the effectiveness of the external audit process remains strong.

AUDITOR REAPPOINTMENT OVERVIEW

The Audit Committee considered the reappointment of PwC. This review took into account the factors below.

Auditor effectiveness: The Audit Committee reviewed the performance of PwC based on a survey 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 Audit Committee also met with management, including without the auditors 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 follows the Auditing Practices Board's standards and its own ethical guidelines, and 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 auditor's 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

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. The 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 significant non-audit work undertaken by PwC during the period included assurance work on the Group's carbon disclosures. The total of non-audit fees and audit fees paid to PwC during the period is set out in Note 2.5 of the consolidated financial statements on page 149.

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 charged had any impact on its independence as statutory auditors. The Audit Committee was satisfied that the quantum of the non-audit fees relative to the audit fees (being 14.3%) of the audit fees together with the other measures taken by the Company and the auditors meant that the auditors' independence from the Group was not compromised.

The Audit Committee continues to monitor the proposed audit reform regulations including tighter restrictions on non-audit services provided by an auditor to an audit client and an overall non-audit fee size limit, as well as mandated audit committee duties regarding auditor selection and audit process. As noted below, the Audit Committee will review its auditor appointment policy in 2015 with these proposed requirements in mind.

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 £244,000 (2013: £183,000)) was appropriate and that an effective audit could be conducted for such a fee. The Audit Committee compared the proposed fees with the prior year's fees in drawing this conclusion, noting that the 33% increase in fees was mostly attributable to the increased complexity of the Group following the Morrisons agreement and Group reorganisation. The existing authority for the Directors (including 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 2014. At the annual general meeting in 2014, 98.07% of votes cast by shareholders were in favour of granting the Directors this authority.

Tendering external audit contract: The Company must put the external audit contract out to tender at least every ten years, under the 2012 Code. As PwC has audited the Group's accounts since 2001 and has not re-tendered for the contract since then, the Audit Committee considered whether the audit should be put out to tender. Given that the Company became a listed company in 2010, that the audit engagement partner had rotated in 2012, and that the Audit Committee remained satisfied with the independence and effectiveness of PwC, the Audit Committee decided not to recommend a re-tender at this time.

The Audit Committee is cognisant of the current and emerging requirements governing the appointment of external auditors, notably the re-tendering requirements of the 2012 Code and the Competition and Markets Authority, together with the mandatory firm rotation regulations from the European Commission. The regulatory guidance includes transitional arrangements which, among other matters, address the length of time for which an auditor has been incumbent at the date the rules come into force. In the case of the Company, as a listed company since 2010, it is not entirely clear how the rules in rotation will apply, but it is understood the proposed rules would require a tender process by 2020 and mandatory audit firm rotation by 2023. The Audit Committee will review its auditor appointment policy in 2015 with these proposed re-tendering and rotation requirements in mind and will make a decision on audit re-tender in due course.

Recommendation to reappoint: Following its consideration, the Audit Committee recommended to the Board the reappointment of PwC as external auditors. The Board has accepted this recommendation and a resolution for its reappointment for a further year will be put to the shareholders at the AGM. At the annual general meeting in 2014, 98.10% of votes cast by shareholders were in favour of reappointing PwC as external auditors.