



## **Post Office Limited**

Audit results report for the 52 weeks ended **25 March 2012**

14 May 2012

Ernst & Young LLP

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Dear Members of the Audit Committee

**Audit results report**

We are pleased to attach our audit results report for the forthcoming meeting of the Audit Committee. This report summarises our preliminary audit conclusion in relation to Post Office Limited's financial position and results of operations for the 52 week period from 27 March 2011 to 25 March 2012 ("the period"). We plan to issue our final conclusion following the Audit Committee scheduled for 23 May 2012.

Our audit was designed to express an opinion on the financial statements for the period ended 25 March 2012 and address current statutory and regulatory requirements. This report contains our findings related to the areas of audit emphasis, our views on the company's accounting policies and judgements and material internal control findings.

This report also contains our final summary of audit differences, communications regarding our independence, a summary of communications we are required to make to you and a draft management representation letter.

This report is intended solely for the information and use of the Audit Committee, Board of Directors and management. It is not intended to be, and should not be, used by anyone other than these specified parties.

We welcome the opportunity to discuss the contents of this report with you at the audit committee meeting scheduled on 23 May 2012.

Yours faithfully  
For and on behalf of Ernst & Young LLP

Angus Grant  
Partner

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Overview

## 1. Overview

This has been an eventful and exciting year for Post Office Limited ('POL') given the attention and preparations for separation from the Royal Mail Group. Despite the challenges faced by the business as part of this process, the annual results close process of POL, including the P11 hard close, was well executed by the business and finance teams.

The coming year ahead poses additional challenges and opportunities with further separation-related activity and the beginning of network transformation projects across the business.

Despite the continued restructuring of the finance function during the year, with the POL finance team taking further steps to be able to help us prepare to deliver a standalone audit from Royal Mail, there was no impact on the quality or timeliness of the information provided for audit.

We have received full co-operation from both management and the Royal Mail teams with whom we work and are substantially complete, subject to a few outstanding matters as noted in section six.

In the following pages, we provide you with a summary of our audit scope and status, our areas of focus around significant audit and accounting issues, findings from our controls testing, our required independence communications and a draft management representation for your review.

## Significant audit and accounting issues

### Refer to section three

The following significant items were discussed and agreed with management:

- ▶ **Going Concern:** We have reviewed management's draft going concern paper to the Board, and agree with the conclusion with respect to the appropriateness of the going concern basis of preparation for the POL financial statements.
- ▶ **IT:** In conjunction with our IT specialists, we have assessed the manage change and logical access IT controls to be ineffective, which was the same conclusion we reached in the prior year. However, through additional compensating testing we have been able to rely on the IT systems supporting the POL financial statements.
- ▶ **Counterparty Risk:** Management continues to be proactive in its assessment of counterparty risk. One highlight of the year was that by settling ATM transactions with the Bank of Ireland a day earlier, management has reduced its exposure by up to £30m during weekends compared to the previous year.
- ▶ **Long Term Investment Plan (LTIPs):** Management has overstated the LTIP accrual by £1.9m as at the end of FY2011/12 as disclosed in the Summary of Audit Differences (SAD) section of this report (Section 7). Management has elected to leave this difference as an unrecorded adjustment.
- ▶ **Employee Benefits:** We concur with management that it is appropriate to accrue for NFSP payments totalling £5.75m, and £3.4m relating to Crown Transformation Payments in accordance with IAS19, Employee Benefits.
- ▶ **GRNI Accrual:** Based on our discussions with management and our detailed audit procedures, we conclude that the GRNI accrual at year end is reasonable and fairly stated.

Overview

- ▶ **WH Smith Income Guarantee – Onerous Contract:** We have assessed management's assumptions with regards to the WHS onerous provision (a legacy issue arising from the contract signed with WH Smith in 2006) noting them to be reasonable in the current circumstances.
- ▶ **Exceptional Charge - Fixed Asset Impairment:** Management continues to assess that they should fully impair fixed assets as they are purchased. We continue to agree that POL's accounting policy for impairment and disclosure of the charge as an exceptional item under FRS and IFRS is reasonable.

## Audit approach

Our risk based audit approach took into account the following key inputs:

- ▶ Business and financial risks relevant to the financial statements.
- ▶ Developments in financial reporting and auditing standards.
- ▶ The quality of systems and processes.
- ▶ Changes in the business and regulatory environment.
- ▶ Management's views on all of the above.

By considering these inputs, our audit was focused on the areas that matter, and our feedback is therefore more likely to be relevant to the business. For POL, our audit testing strategy is controls based with significant reliance placed on key systems and processes that we are able to test throughout the year. We have assessed the internal control environment for the purposes of our external audit and consider it to be effective for the period ended 25 March 2012.

## Control themes and observations

### Refer to section four

The key internal control findings arising from our audit work are:

- ▶ Key controls tested around revenue and payroll were deemed to be operating effectively. In particular, we noticed a continued improvement in the payroll process during the current year in response to our management letter comments raised in the prior year.
- ▶ Our audit continued to identify continuing IT control weaknesses, which in our view reflects the continued need for control improvements by the outsource provider Fujitsu, and for the POL governance and control approach to continue to evolve. However, we should note that there were improvements from the prior year, notably in the two highest risk areas identified. We ultimately obtained mitigating audit evidence to rely on the IT control environment.
- ▶ In light of the continued separation of POL from Royal Mail, with POL taking on more activities which Royal Mail had previously carried out on their behalf (such as the statutory financial statement preparation process), the finance team was resilient and well prepared for the year end. We noted no adverse impact on the quality of information produced.

Detailed control observations and recommendations are currently being discussed with management and will be reported in our forthcoming management letter.

## Scope update and status of the audit

### Refer to sections two and six

We undertook our audit in accordance with the scope set out in our engagement letter dated 24 February 2012, and attached as Appendix E to this report.

We have undertaken the majority of our audit procedures and the audit is substantially complete. Key procedures outstanding relate to review of detailed narrative disclosures in the statutory financial statements and obtaining a number of third party bank confirmations.

## Summary of audit differences

### Refer to section seven

- ▶ We report one factual difference in relation to LTIPs.
- ▶ The impact of unadjusted audit differences at 25 March 2012 would be to increase profit before tax for the year by £2.7m,
- ▶ The unadjusted amounts are not material to the presentation and disclosures of the financial statements for the period ended 25 March 2012.

## Our opinions and confirmations

- ▶ We anticipate issuing an unqualified audit opinion on the POL financial statements for the period ended 25 March 2012.
- ▶ We confirm our independence as your external auditor in this report in Appendix C.
- ▶ We confirm that our fees for non-audit services during 2011/12 have been reviewed in order to maintain our independence as your external auditor.

Finally, we would like to thank management for the assistance and cooperation we have received throughout the audit. We have appreciated the continued commitment to challenge and improve the overall control environment and the quality and timeliness of information provided for the audit.

Scope of the audit

## 2. Scope of the audit

We are required by the primary audit team of the Royal Mail Group Plc to perform a full scope audit of POL for the period ended 25 March 2012 in accordance with International Financial Reporting Standards (IFRS) and Clarified ISAs (UK and Ireland) as required in the engagement instructions received by us from them.

We are also engaged to provide a full scope audit on the stand-alone financial statements of POL to confirm with reasonable assurance that they are free of material misstatement.

The services above are set in the Royal Mail Group Plc engagement letter provided to the Royal Mail Group Plc Audit Committee dated 24 February 2012. A copy of the engagement letter is attached at Appendix E for your reference.

In addition to the key areas of audit emphasis discussed later in this report, we performed other procedures as required by auditing, ethical and independence standards, company law and other regulations as outlined below:

***Mandatory procedures required by auditing standards on***

- ▶ Addressing the risk of fraud and error.
- ▶ Significant disclosures included in the financial statements.
- ▶ Entity-wide controls.
- ▶ Reading other information contained in the financial statements and reporting whether it is inconsistent with our understanding and the financial statements.
- ▶ Auditor independence.

***Procedures required by company law***

- ▶ Opining on whether the information contained in the directors' report is consistent with the financial statements.
- ▶ Auditing the disclosures that unquoted companies are required to make with respect to directors' remuneration.

***Regulatory audit and other assurance related requirements***

In addition to the statutory audit requirements we are required, as auditors of the Company, to perform procedures on a number of reports required by postal regulation and related matters, including:

- ▶ Procedures in connection with the Post Office Limited credit facilities from BIS, DVLA motor vehicle license transactions and the Bank of England note circulation scheme.

Where appropriate, we design the above procedures together with our statutory audit procedures to maximise the efficiency and leverage the work already performed.

***Materiality***

For the purposes of determining whether the accounts are free from material error, we define materiality as the magnitude of an omission or misstatement that, individually or in the aggregate, in light of the surrounding circumstances, could reasonably be expected to influence the economic decisions of the users of the financial statements. Our evaluation of it requires professional judgement and necessarily takes into account qualitative as well as quantitative considerations implicit in the definition. We would be happy to discuss with you your expectations regarding our detection of misstatements in the financial statements.

Significant findings from the audit

### 3. Significant findings from the audit

The following outlines the basis for our assessment of the level of subjectivity and level of risk involved in accounting matters reported to you. In addition, our assessment of where judgments and estimates fall in a range of possible outcome is also highlighted below.

#### Level of subjectivity

This rating applies only to significant estimates and indicates the level of subjectivity in the estimate as well as the reliability of the underlying data used to develop the estimate.

Subjectivity rating	Description
High	Estimate involves significant judgment and is made with little verifiable historical experience, current trend information or market and industry comparative information.
Medium	Estimate still involves some judgment and is made with verifiable historical experience, current trend information, or market industry comparative information.
Low	Estimate involves limited judgment and is made with verifiable historical experience, current trend information, or market industry comparative information.

#### Assessment of management's judgments and accounting treatment

This measure provides an indication of where in the range of possible acceptable outcomes the estimate has been recorded. The evaluation of any estimate or treatment being in the upper (more conservative) or lower range (less conservative) of acceptable outcomes does not imply the estimate/treatment is not in accordance with GAAP, or the preferred accounting treatment has not been applied to the estimate.

Measure	Description	Range
Low	The estimate/treatment is within the lower range of acceptable outcomes resulting in a less conservative treatment.	L M H
Medium	The estimate is within the mid range of acceptable outcomes.	L M H
High	The estimate/treatment is within the upper range of acceptable outcomes resulting in a more conservative treatment.	L M H

#### 3.1 Issues dashboard

The following 'dashboard' summarises the significant accounting matters outlined in this report. It seeks to provide the Audit Committee with an overview of the subjectivity involved and our assessment of where the accounting treatment falls within a range of acceptable outcomes. The detail of each accounting matter is set out after the dashboard.

Significant findings from the audit

Items included in this report:

Accounting and audit matters that have come to our attention during the audit:	Level of subjectivity	Ernst & Young assessment		
Going Concern	Medium	L	M	H
IT Controls	Medium	L	M	H
Long Term Incentive Plan (LTIPs)	Medium	L	M	H
Counterparty Risk	Medium	L	M	H
Employee Benefits	Medium	L	M	H
GRNI Accrual	Medium	L	M	H
WHS Income Guarantee – Onerous Contract	High	L	M	H
Project Gamma	High	L	M	H
Exceptional Charge: Fixed Asset Impairment	High	L	M	H
POSS Provision	Medium	L	M	H
POCA	Low	L	M	H
Vendor Creditor - IPS Reconciliation	Medium	L	M	H
Former Agents Debt	Low	L	M	H
WHS TUPE Provision – CWU Litigation	Low	L	M	H

## Going Concern

Level of subjectivity	Medium
Ernst & Young assessment	L M H
Description and conclusion	

POL has historically operated in net liability position and has generally had a net cash outflow (excluding government State Aid funding) in prior years. The Company has been reliant on State Aid to remain a going concern which has historically been provided for only one year at a time and extended by one year towards the end of each financial year. As a result, management's going concern assessment in prior years was dependant on funding being extended. In light of these factors, we have continued to consider management's assessment of going concern and whether the company would be able to meet its liabilities for the ensuing twelve-month period.

For the current period assessment, on 28 March 2012, POL management received confirmation that their application for State Aid had been successfully approved, including approval for the funding of its £1.55b working capital facility for 2012/13 to 2014/15, along with the Network Subsidy Payment for the following year amounting to £210m.

We have reviewed POL's draft going concern assessment and reviewed management's forecasts to demonstrate that the business is a going concern. Based on the forecasts in the going concern paper, as a result of the working capital facility being approved, there is expected to be borrowing headroom over the next three years, enabling POL to meet its liabilities as they fall due.

In light of the above, and our review of management's assumptions and forecasts underlying its going concern assessment, we concur with management's assessment that POL can continue as a going concern.

Significant findings from the audit

**IT Controls**

Level of subjectivity	Medium
Ernst & Young assessment	<b>L M H</b>
Description and conclusion	

IT underpins a significant proportion of Post Office's transactions, including all over the counter transactions at all branch locations. Our audit process is designed around reliance on certain IT applications and reliance on electronic audit evidence. We have therefore evaluated the IT general control environment, tested IT controls regarding user access, program changes and IT security to gain assurance that the systems supporting the data produced by the IT systems are subject to a robust control environment.

We have completed all of our required procedures and concluded that the IT systems can support our audit conclusions.

From our review we have noted that action has been taken by Post Office resulting in remediation of some of the observations raised in the prior year audit, including our area of greatest concern from 2010/11, change management. However, improvement is still to be made to the IT control environment, including POLSAP and HNGX. One important area is control over privileged users; in particular, for POLSAP management should ensure access is strictly controlled and monitored. As in previous years, we have been able to perform additional procedures to mitigate the risk associated with this observation in addition to additional procedures required to mitigate other findings from our audit.

Given that this is a continued area of focus for improvement, we will issue a detailed letter to management highlighting our recommendations to fully embed and continue to improve the IT control environment. We anticipate issuing this at the conclusion of the statutory audit in June 2012.

**Long Term Investment Plan (LTIPs)**

Level of subjectivity	Medium
Ernst & Young assessment	<b>L M H</b>
Description and conclusion	

To incentivise current employees, POL utilises a long-term incentive plan to reward employees for meeting certain targets and expectations. Currently, POL has two outstanding reward schemes - the first, the '2010/11 award' will be paid based on the level of operating profit and network transformation targets met in FY 2012/13, and the second, the '2011/12 award' will be paid based on the level of operating profit and network transformation targets met in FY2013/14. Under the terms of the LTIP scheme, the bonus to be paid will vary based on the level of profit achieved. At a high level, both awards set out a maximum pay-out of 140% of salary should the stretch targets for operating profit and network transformation be achieved.

In the current year, Management has accrued on the basis that whilst it is likely that POL will meet their targets to trigger a bonus, it is unlikely that stretch targets will be achieved. Per discussion with management, and review of FY2012/13 budget and strategic plan with both assuming that the stretch targets will not be achieved, we concur with management's basis for calculating the bonus accrual.

However, upon our review of the accounting we noted that management had fully accrued for the 2010/11 award and 2011/12 award as at the end of FY2011/12, resulting in an accrual of £3.5m in the balance sheet at 25 March 2012. According to IAS19, Employee Benefits, we note that bonuses of this nature should be accrued on a straight-line basis, as the benefits earned by employees would be attributable to their services between the grant of the award and the payment date (the 'vesting period'). Therefore, in POL's situation, the LTIP obligation

## Significant findings from the audit

should be accrued on a straight-line basis from the grant date (FY2010/11 and FY 2011/12) to the date it's fully vested (FY 2012/13 and 2013/14, respectively). Therefore, we have raised an adjustment to reduce the current year accrual by £1.9m as at 25 March 2012. Please see the SAD section of this report (Section 7) for further details.

### Counterparty Risk

Level of subjectivity	Medium
Ernst & Young assessment	L M H
Description and conclusion	

In light of the current economic environment, POL undertakes a review of all counterparties to assess their exposure and relative risk of their trading partners. In particular, given the concentration of risk associated with the Bank of Ireland (BoI), POL has performed a more detailed assessment to determine if steps should be taken to mitigate any perceived risk.

As part of their assessment, management undertakes steps to assess the level of risk and ensure that they are aware of POL's exposures and have appropriate detailed contingency plans in place, in particular focusing on Instant Saver and general banking areas. This contingency plan was prepared in October 2010 at the height of the banking crisis and management continues to believe this to be relevant in the current year. Management noted that the first stages of the contingency plan were deployed successfully when the Irish banking crisis was widely reported in the media. This plan takes into account all similar types of banking and how they would cope with customer related issues (e.g. all deposits taken in one day) and/or counterparty related issues such as liquidation of a third party.

It is noted that the counterparty risks associated with the BoI mainly relate to the daily trading balance which is owed from BoI to POL with the most significant exposure in respect to the ATM debtor. On any given weekday the exposure is approximately £20-30m; however on a Sunday, the exposure could be approximately £80m, as it would include the full weekend's transactions. This represents a reduced exposure of £20m-£30m to the BoI compared to what we noted in the prior year as BoI now settles transactions one day earlier as compared to the prior year.

Therefore, based on our discussions with management, we are satisfied that management continues to assess and respond to counter party risk appropriately.

### Employee Benefits

Level of subjectivity	Medium
Ernst & Young assessment	L M H
Description and conclusion	

In the current year financial statements, three employee/agent related accruals have been made in respect of NFSP (National Federation of Sub Postmasters) and Crown Transformation payments. We have considered the aspects of each accrual individually, assessing whether its accounting treatment was reasonable, and summarised as follows:

Firstly, on 23 March 2012, POL made an offer by letter to pay two lump sum payments to agents totalling £5.75m to be paid at the end of April or May 2012. The payments are detailed as follows:

- A payment of £3m (plus National Insurance at 10%) to the agency network as a remuneration settlement for sub-postmasters in order to support network stability and alleviate hardship.

Significant findings from the audit

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- An additional payment of approximately £2.75m (plus National Insurance at 10%) to commercial agency branches. This is also made to support network stability and alleviate hardships.

Secondly, POL agreed to make a Business Transformation Payment to Crown staff on the basis of sign up and delivery of transformational change in working practices, and made the offer to Crown staff in post on 23 March 2012. These business transformation payments totalled £3.4m.

In respect of the above payments, we concluded that they met the criteria of short term employee benefits as per the requirements of IAS 19 – Employee Benefits and FRS 20 – Other Employee Benefits, and have therefore been appropriately accrued at 25 March 2012.

Additionally, with regards to the £3.4m payment to Crown staff, we have also assessed and concurred with management's decision to present this as an exceptional item given that it relates to the business transformation related programme.

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#### GRNI Accrual

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Level of subjectivity	Medium
Ernst & Young assessment	L M H
Description and conclusion	

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POL operates a manual two-way matching purchasing system whereby purchase orders are input along with an expected delivery date and automatically classified as "Goods Received Not Invoiced" (GRNI) accruals as soon as the expected delivery date is reached. When the subsequent invoice is received and recorded, the GRNI accrual is closed and the amount is posted in the creditors ledger.

The risk underlying the current system is that if goods are not received, and a manual adjustment amending the expected delivery date is not made, the GRNI accrual risks being overstated. As a result, the process involves a high degree of manual adjustment and overview. In prior years, with high volumes of capital activity, the GRNI balance was significant and we noted than an ageing of the accrual highlighted a number of old balances. However, in the past two years, management has addressed this risk by regularly monitoring its GRNI balances across the business to ensure that the GRNI balance is not overstated.

We noted that the GRNI balance increased significantly during the current year by £15.2m, to a closing balance of £43.3m at year end.

The increase in GRNI was mainly due to an increase in marketing efforts by POL towards year-end, particularly in regards to market flagging products such as insurance and telephony, increased project spend on developing revenue lines such as ATMs and AEI through the purchase of new equipment and commencement of the network transformation project.

However, whilst there was a large increase in GRNI balances, we noted that the ageing of the GRNI accrual has improved from prior year with 99.8% of the accrual relating to items less than six months old (compared to 93.5% in the prior year).

Based on our discussions with management and detailed audit of the accrual, we concluded that the movement and ageing of the GRNI accrual is reasonable at 25 March 2012.

#### WH Smith Income Guarantee – Onerous Contract

Level of subjectivity	High
Ernst & Young assessment	<input checked="" type="checkbox"/> M
Description and conclusion	

In 2006, POL entered into an agreement with WH Smith, which saw it transfer 85 existing branches to WHS shops (as franchises) between 2006 and 2008. As part of the franchise contract, POL guaranteed a certain level of gross contribution in return for WHS meeting certain service and performance standards. This guarantee was intended to limit WHS' financial exposure in the event WHS was not able to achieve 90% of forecast gross contribution at a portfolio level.

However, since the inception of the contract, the required income thresholds have not been met by the WHS shops and has meant that POL has been liable to pay WHS the forecast contribution guarantee and leading to a provision being made for the WH Smith contribution guarantee. The contract has been treated as onerous for the previous three years, and it does not appear likely that income thresholds will be achieved until the anticipated end of all contracts by FY2017/18.

The current year saw, for the first time, branches under the agreement closed, which required POL to revisit the original contracts and agreements in place. Upon revisiting the

## Significant findings from the audit

agreements with its solicitors, Lovells, POL management noted that the individual branch agreements, which ended at various different dates, override the overall franchise agreement which ends in 2014/15. As a result of this review, a true-up to the provision of £3.5m was made in the current year to extend POL's obligation to mirror the end dates in the individual branch agreements.

Another key assumption in the calculation of the onerous provision is the amount of forecast mails revenue (commission received from Royal Mail Group for the sale of stamps over POL counters). Through the inter-business agreement with Royal Mail Group, POL earns commission based on a percentage of product prices. Given the April 2012 rise in stamp prices, POL expects revenues to increase, thereby reducing the level of provision that is required. As a result, POL released £5.8m of the contract provision.

The overall provision has decreased by £4.0m, from £12.9m to £8.9m at 25 March 2012, mainly due to the net decrease of £2.3m as discussed above coupled with the net decrease of £1.7m related to utilisation and unwinding of the discount on the provision.

We have considered all assumption changes in relation to the provision and deem the forecasts to be reasonable and the onerous provision at 25 March 2012 to be fairly stated.

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### Project Gamma

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Level of subjectivity	High
Ernst & Young assessment	L M H
Description and conclusion	

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'Project Gamma' relates to an agreement with the Bank of Ireland (Bol) whereby POL is paid to maintain and upgrade Crown branches for the provision of financial services. We noted that £6.1m of 'Gamma' revenue has been recognised in the period in accordance with the schedule agreed between the Bank of Ireland and POL at the end of FY2010/11.

However, as a result of renegotiations between the Bol & POL during the current period, there has been a change in the expected revenues to be received under the agreement. Under the revised terms of the agreement, POL will now receive £76m in total revenue over the period between 2008/09 to 2019/20, which is an increase from the £65m agreed in FY2010/11.

POL has accounted for this change by recalculating the revenue (£76m less revenue recognised to date) to be recognised over the remaining length of the contract going forward, while still aligning to the phasing of costs to be incurred. The impact on the current year has been an additional £2.0m in revenues earned through the agreement.

We have reviewed management's assessment noting that treatment and recalculation of revenue recognised in the current period is consistent with the amended agreement. We note that management continues to recognise revenue in line with the services provided and accordingly we concur with the revenue recognised in the current period and forecasted revenues remaining to be earned under the agreement.

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### Exceptional Charge: Fixed Asset Impairment

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Level of subjectivity	High
Ernst & Young assessment	L M H
Description and conclusion	

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## Significant findings from the audit

In FY2002/03, POL adopted a policy of fully impairing all fixed asset additions made during the year in which they are purchased, except for freehold land & buildings and building shells. Management's justification for adopting the above policy is mainly due to the fact that the company has historically, and continues to be, a loss making entity absent the Network Subsidy Payment it receives from the Government. Further, as all fixed assets (except for freehold land & buildings and building shells) are bespoke to the company's activities, their recoverable amounts are deemed to be below carrying value and thus impaired accordingly. The policy to impair the above assets is in line with the requirements of IFRS and UK GAAP (IAS 36 'Impairment of Assets' and FRS 11 'Impairment').

The fixed asset impairment charge for the year amounted to £36.2m (PY: £33.6m). The year on year increase is mainly due to the procurement of hardware to implement new Pin-Pad systems at POL branches and software development costs. P12 also saw the beginning of the implementation of some network transformation projects, for which plans were finalised in the second-half of the year.

As an additional factor in the decision to impair, POL is embarking on a major programme of network change costing £500m over the next three years, which is included within the £1.55bn State Aid funding package. Investment of this scale will lead to significant cash outflows for the immediate years. The degree of transformational change and the impact on cash flow would impact the future profits of the Company and accordingly management believes that POL will continue to be a loss making entity in future years. As such, management continues to assess that they should fully impair their fixed assets.

We note that the above treatment is consistent with prior periods and continues to be appropriate given the Company's forecasted loss making position in future years, net cash outflow and reliance on State Aid funding. Additionally, we continue to assert that disclosure of the charge as an exceptional item under FRS 3 and IAS 36 is reasonable.

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### POSS Provision

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Level of subjectivity	Medium
Ernst & Young assessment	
Description and conclusion	

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In May 2010, POL announced that they would no longer be issuing savings stamps and told the public to redeem savings stamps in their possession. POL also announced to the public that there would be no expiry period for the savings stamps in issue and guaranteed that they would redeem all savings stamps upon presentation.

At 25 March 2012, the total Post Office savings stamps liability was £1.3m, representing a decrease of £2.5m from the prior year liability of £3.8m. The movement during the year is due to utilisation for presented stamps and the release of £1.7m of the provision, as management's review of the redemptions in the current year and revised forecast of redemptions in the next few years indicated that a lower provision was required. We obtained the clients forecasts for future savings stamps provision and performed sensitivity testing on the assumptions used by management.

Overall, we conclude that the decrease in the provision is in line with our expectation based on declining redemption rates which are expected to continue. Accordingly, we believe that the assumptions used by management are reasonable and the provision at period end is

## Significant findings from the audit

appropriate.

**POCA**

Level of subjectivity	Low
Ernst & Young assessment	L M H
Description and conclusion	

In 2009, Post Office Limited signed a contract for the Post Office Card Account ("POCA") with the Department of Work & Pensions ("DWP") for six years up to March 2015. As part of this contract, the DWP agreed to make one-off payments relating to the "regulatory changes" (an upfront payment to cover any changes to POCA accounts due to changes in regulation) and the "migration of accounts" (a payment to cover costs associated to migration of 700,000 POCA accounts). Both one-off payments were received in the 2009/10 and 2010/11 financial years, respectively and are being recognised evenly across the life of the contract in accordance with IAS18.

In the current year, revenue recognised under POCA was £3.9m.

There have been no changes in the treatment of POCA revenue from the prior year, which is consistent with our expectations as there have been no changes to the agreement or accounting principles applied by management.

**Vendor Creditor - IPS Reconciliation**

Level of subjectivity	Medium
Ernst & Young assessment	L M H
Description and conclusion	

POL has an agreement to supply passport services to the public on behalf of the government department Identity & Passport Services (IPS). POL is liable to IPS to return the proceeds of the IPS services sales after deducting its commission.

In the current year, we noted that POL overprovided for the IPS creditor balance by £0.8m. There has been an ongoing system fault on IPS's side, which has resulted in issues in maintaining accurate data for the amount receivable from POL. This has lead to POL being under-invoiced in the year. However, POL maintains a record of the amounts owed to IPS by recording each transaction in Horizon as it occurs at a POL branch. POL have provided IPS with a record of settlement differences ("the difference between the amount invoiced by IPS and the actual amount owed") and have settled these in addition to the invoices.

At year end, the last three weeks' "settlement differences" are estimated (which total £4.7m and are the source for the £0.8m difference), with the actual figures available six weeks after year end (mid-May). As per management's best estimate, the IPS Vendor creditor liability is

## Significant findings from the audit

£13.9m at year end, which is £0.8m lower than the amount stated in the accounts of £14.7m.

Whilst this difference is currently immaterial for Group reporting purposes and is only a material adjustment for the purposes of our statutory audit, we note that the above difference may change as there is an element of unpredictability on the above "settlement differences" estimate. As such, we continue to follow up with management to obtain the final "actual" amounts, which are expected to be finalised in the w/c 14 May. We have included the £0.8m overstatement as an unrecorded difference in our SAD schedule. We will accordingly update the overstatement difference to reflect the final difference that management should be adjusting for when they receive the actual data. We plan on providing an update to the Audit Committee on this matter.

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### Former Agents Debt

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Level of subjectivity	Low
Ernst & Young assessment	L M H
Description and conclusion	

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Former Agents Debt is 100% provided for as the recoverability associated with this debt is unpredictable and often requires a large expense to take agents to court in the event of default. Although it is POL's policy to chase all agents with debt, given the level of uncertainty attached to this debt, management fully provides against it.

Provision for payments to former agents at year end was £7.2m, representing a £1.4m (or 5%) decrease from prior year end. Former Agents Debt has decreased due to fewer agents leaving during the period or having their positions terminated as a result of fraudulent or negligent behaviour.

We have reviewed management's calculation of debt and have concluded that the policy to provide 100% remains reasonable given the continued low level of recoverability of old debts and uncertainty of recoverability of current debts (3% of former agents debt was recovered in the current year, amounting to £230,000).

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### WH Smith TUPE Provision – CWU Litigation

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Level of subjectivity	Low
Ernst & Young assessment	L M H
Description and conclusion	

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In FY2009/10, management recognised a £2.4m liability regarding a claim involving the Communication Workers Union (CWU). The claim related to the extent of redundancy costs arising from the consultation period held with POL employees when POL committed to the WH Smith contract (which led to WH Smith taking over 70 main Post Offices). The provision remained unchanged in FY2010/11.

During 2011/12, POL received a favourable ruling in respect of this claim and was cleared of any future liability and accordingly released the provision held for this matter in this period's results.

We have reviewed correspondence with CMS Cameron McKenna LLP confirming that the time period for the CWU to appeal expired on 22 September 2011. Given this ruling and the fact that the CWU has exhausted all appeals, the release of the provision in the current period is appropriate.

Significant findings from the audit

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## 4. Control themes and observations

As part of our audit of the financial statements, we obtained an understanding of internal control sufficient to plan our audit and determine the nature, timing and extent of testing performed. Although our audit was not designed to express an opinion on the effectiveness of internal control we are required to communicate to you any significant deficiencies in internal control.

We can confirm that on the basis of our audit work performed, we did not identify any significant deficiencies in internal controls other than the control deficiencies reported below. However, we anticipate providing a detailed letter incorporating certain recommendations for process improvements noted by us in the performance of our procedures at the conclusion of this year's audit cycle.

### 4.1 Current year observations

#### IT Control observations

##### Background

During the 2010/11 audit, we identified significant control weaknesses in POL's IT environment which, in our view, reflected a need for improvement on the part of service provider Fujitsu and also a change in approach on the part of POL in terms of the governance, risk and control framework over its business critical systems. These weaknesses in the IT control environment, together with the lack of an ISAE 3402 (formerly SAS70) report on Fujitsu's control environment contributed to a lengthy and inefficient audit process. In addition, Fujitsu's shared service delivery model, lack of key audit contacts' knowledge of POL's end-to-end processes and lack of availability of documentation together made it time consuming for either POL or EY to gain assurance that effective controls were in place and were operating as expected. The complexity of the audit process was further compounded by the significant changes made to the key financial systems environment during the audit period, including the progressive replacement of Horizon with Horizon Next Generation (HNGX) across the branch estate and the consolidation of the POLFS and SAPADS system into a single SAP system (POLSAP).

During the process we received great support from Lesley Sewell and her team, which included securing from Fujitsu an audit liaison contact and the sponsorship of the Fujitsu account leader. At the completion of the audit, POL and Fujitsu accepted that control improvements were required and high-level action plans were agreed by Fujitsu, POL and ourselves to initiate remediation activity and improve the audit process for 2011/12.

##### 2011/12 IT audit

At an early stage in this audit cycle, the three parties took part in a workshop to consider the control framework for POL and to agree planning milestones and protocols. As a result of this, the continuing sponsorship from Lesley and her team, and the commitment of Fujitsu, the audit process for 2011/12 has improved significantly over the previous year. Whilst there were minor delays in providing some documentation, the IT audit was largely delivered and completed within the agreed timeframe. During the year, we understand Fujitsu initiated discussions to commission an ISAE 3402 report for FY2012/13.

We noted that the IT general control environment for POLSAP and HNGX has improved in comparison with 2010-11. However we observed that some of the control improvements had not been fully implemented or embedded at the time of the audit and that there were some remediation efforts that were not completely aligned with our expectations. There were also some findings from the previous audit which require further work to close.

#### Control themes and observations

Since the completion of the IT audit, we have discussed our control observations with POL and Fujitsu management, and are currently finalising our management letter which will provide details of our findings, observations and agreed management actions.

#### **Looking forward – ISAE 3402 report**

We understand that planning for the provision of the ISAE 3402 report for the Fujitsu services supporting the POL account is in progress. We welcome this, and intend to place reliance on the report to reduce the extent of our testing. We should point out that the reliance we will be able to place on the report will be dependent on the opinion expressed in it. In the event that control exceptions are identified in the report, we will need to perform additional procedures to address the remaining risks.

#### **Other Control observations**

We continue to utilise a controls based approach in respect of the identified significant processes of revenue, purchasing, cash settlements and payroll. Our controls testing approach focuses on the controls implemented across the entire POL business, including the London head office, Bolton (payroll), Chesterfield (shared services), branches and cash centres. Whilst we test controls in London, Bolton and Chesterfield annually, we rotate our cash centre and branch visits each year.

#### **Financial statement close process**

Management continues to employ a robust system of internal controls around its financial reporting and financial statement close process. We note that there is appropriate rigor over both the P11 hard close and P12 year-end processes with all key balances reconciled in a timely manner and supported by appropriate documentation.

#### **Payroll process**

The POL payroll process is independent of the payroll process and systems that support the rest of Royal Mail Group Plc. It covers approximately 20,000 employees and agents, which primarily include front line workers and agents working at Post Offices around the country. The system supporting this process is a SAP-HR module.

During past audits, we took a fully substantive audit approach to payroll due to a number of control deficiencies over the review of joiners and leavers and a lack of documentation of a number of review controls. Following efforts in the prior year to improve the process, the payroll process has received a high level of management focus and attention. As such, our work in this area was completed with no significant findings identified and we are therefore able to rely on controls in this area. Whilst we did not find any exceptions which inhibit us from relying on the payroll controls, we did identify an exception relating to the review of quarterly bonus calculations at the London head office. As this was an area of focus for us at P11 and P12, this finding did not impact our audit strategy in respect of payroll.

#### **Transactional, branch and cash centre process and controls**

For the revenue, purchasing and cash settlements processes, we note that the controls framework remains consistent with the prior year with no significant findings from our testing. We have completed our walkthroughs and the results of our testing indicate that we will continue to be able to rely on controls.

Additionally, our controls testing in respect of branches and cash centres was completed with no findings to communicate to you.

Considerations for the coming year

## 5. Considerations for the coming year

### **Looking forward – considering the impact of separation**

There were two key post balance sheet events at the end of the current financial year:

- (1) Post Office Limited was transferred from under the ownership of Royal Mail Group Limited to Royal Mail Holdings plc (as part of the wider restructuring that is expected to leave Post Office under HM Government ownership); and
- (2) Certain assets and liabilities of the Royal Mail Pension Plan (RMPP) were transferred to HM Government, leaving RMPP fully funded.

These two events are expected to have the following audit and IT implications, which is not meant to be exhaustive but provided to illustrate that the audit may 'look and feel' differently next year:

#### **Impact on substantive and non-IT related testing**

Our understanding of the POL business indicates that management should continue to consider the effects of separation on the following areas:

- ▶ With POL no longer being a subsidiary of Royal Mail Group, management may elect to consolidate the results of POFS and FRES in the POL annual report and accounts for the first time;
- ▶ Possible requirement for POL to produce IFRS consolidated accounts and no longer exempt from producing cash flow statements and other disclosure requirements, should Royal Mail Holdings plc only produce stand-alone financial statements;
- ▶ Assessment of tax implications of carve-out for POL once Royal Mail Group not part of same group, for example, use of tax losses and implications for charging VAT on transactions with Royal Mail Group;
- ▶ Consideration of separate tax and VAT teams for POL and need to acquire knowledge in these specialist areas;
- ▶ Accounting for lease, property and other asset transfers into POL books and records;
- ▶ Development of pension accounting facilities at POL level;
- ▶ Appointment of actuary to value go-forward defined benefit plan; and
- ▶ Development of a governance structure and strategy with regards to treasury and cash management.

#### **Impact on IT**

Our experience indicates the following as key areas requiring significant management focus during the separation process:

- ▶ Development of a transition plan and transitional services agreements with Royal Mail Group to maintain and monitor the third party contractual obligations during the period of separation including ensuring service levels are met;
- ▶ Review of the contracts and service level agreements that Royal Mail Group has with its third party service providers, in particular, CSC, to help ensure they meet POL's business requirements;

Considerations for the coming year

- ▶ Maintenance of restricted access to sensitive data such as payroll information during the transition period;
- ▶ Implementation of measures to gain assurance regarding completeness and accuracy of data as a result of data migration activities where services are transferred from Royal Mail Group to POL;
- ▶ Assessment of the impact on existing enterprise software licence arrangements and associated re-negotiation with vendors; and
- ▶ Segregation/separation of networks and email systems.

We understand that POL is working closely with Royal Mail Group to agree the separation plan, and aims to complete the process over the coming two years, where appropriate. However, in light of POL's transformation plans and the associated reshaping of its IT strategy, which may entail the implementation of significant new systems, we understand POL anticipates that some use of Royal Mail Group services will continue for approximately three years.

#### ***Impact on the financial statement audit***

There are currently two key systems that support POL's financially significant processes that are operated by Royal Mail Group and reviewed as part of the Royal Mail Group IT audit. These systems are SAP ESFS, which supports the processing of branch returns, fixed assets, purchasing and general ledger transactions, and SAP HR – HRP, which supports the payroll for POL employees. The existing audit approach adopted for these two systems is based on the audit efficiencies gained from assessing the controls managed by third party provider, CSC, which are common across Royal Mail Group's key financial systems. Whilst Royal Mail Group continues to provide these services, we would anticipate requesting comfort over these systems from the Royal Mail Group audit team. To the extent that POL migrates relevant data and applications to itself or implements new systems to cover these requirements over time, they will fall within the scope of the POL IT audit.

## Status of the audit

## 6. Status of the audit

Our audit work in respect of the opinion on the Company's financial statements is substantially complete. The following items relating to the completion of our audit procedures were outstanding at the date of drafting this report.

Item	Actions to resolve	Responsibility
Letter of representation	To be signed/ dated contemporaneous to our audit opinion, which will coincide with the date of the Royal Mail Group opinion.	Management Audit Committee
Subsequent events procedures	To be completed through the date of our audit opinion, per the timing above (matters to be updated include: management inquiries, review of latest management accounts).	Management Ernst & Young
Confirmations	Awaiting receipt of all bank confirmations, anticipated to be received by 23 May 2012.	Management Ernst & Young
Annual report and accounts	<ul style="list-style-type: none"> <li>▶ Finalisation of unrecorded IPS adjustment, which will be compared to actuals in w/c 14 May 2012;</li> <li>▶ Incorporation of Ernst &amp; Young review comments on disclosure notes;</li> <li>▶ Finalisation by management of disclosures related to tax and pensions; and</li> <li>▶ Audit report to be signed by Ernst &amp; Young and financial statements to be approved by management to coincide with the date of the Royal Mail Group financial statements and opinion.</li> </ul>	Management Ernst & Young
Tax	The review is in process and no adjustments have been noted to date.	Management Ernst & Young

On the basis of our work performed to date, we anticipate issuing an unqualified auditor's report in respect of the POL financial statements for the period ended 25 March 2012. However, until we have completed our outstanding procedures, it is possible that further matters requiring amendment may arise.

## Summary of audit differences

## 7. Summary of audit differences

In the normal course of any audit, we identify misstatements between amounts we believe should be recorded in the financial statements and amounts actually recorded. These differences are classified as 'known' or 'judgemental'. Known differences represent items that can be accurately quantified and relate to a definite set of facts or circumstances. Judgemental differences generally involve estimation and relate to facts or circumstances that are uncertain or open to interpretation.

We highlight the following misstatements identified during the course of our audit. These have been corrected by management:

- ▶ £1.3m reclassification from customer prepayments to trade creditors in relation to the DVLA creditor at period end.

In addition we highlight the following misstatements which have not been corrected by management (all figures in £m):

Uncorrected misstatements	Assets current (£m)	Assets non-current	Liabilities current	Liabilities non-current	Income/ expenses
	Debit/ (Credit)	Debit/ (Credit)	Debit/ (Credit)	Debit/ (Credit)	Debit/(Credit) Current period
<b>Errors:</b>					
▶ LTIP Bonus Creditor			1.9		(1.9) <sup>1</sup>
▶ IPS Creditor			0.8		(0.8) <sup>2</sup>
<b>Income statement total</b>					<b>(37)</b>
<b>Balance sheet totals</b>	<b>1,052</b>	<b>16</b>	<b>(964)</b>	<b>(228)</b>	
Income effect of uncorrected misstatements (before tax)					(2.7)
Less: tax effect at current year marginal rate					0.7
Cumulative effect of uncorrected misstatements before turnaround effect					(2.0)
Turnaround effect <sup>3</sup> .					0
Cumulative effect of uncorrected misstatements, after turnaround effect					(2.0)

There are no amounts that we identified that are individually or in aggregate material to the presentation and disclosures of the consolidated financial statements for the period ended 25 March 2012.

Note 1: This error is an overstatement of the LTIP Bonus accrual for the current year. The LTIP Bonus creditor was overstated by £1.9m as management accrued for the full LTIP expense of the 2010/11 award and 2011/12 award by the end of the current period. This is assessed by EY to be not in compliance with IAS19 which requires that the award for such benefits be spread evenly over the lifetime of the bonus award until vested/paid.

Note 2: This error is an overstatement of the IPS Creditor for the current year, which has been discussed in detail in Section 3 of this report.

Note 3: turnaround effect is the post-tax impact of uncorrected misstatements identified in the prior period, on results of the current period.

## Appendix A Required communications with the Audit Committee

There are certain communications that we must provide to the audit committee of UK clients. These are detailed here:

Required communication	Reference
<b>Terms of engagement</b> Confirmation by the audit committee of acceptance of terms of engagement. Ernst & Young to provide a copy of the engagement letter.	Engagement Letter was signed on 24 February 2012 and is attached as Appendix E
<b>Planning and audit approach</b> Communication of the planned scope and timing of the audit including any limitations.	Presented at Group level and discussed herein
<b>Significant findings from the audit</b> <ul style="list-style-type: none"> <li>► Our view about the significant qualitative aspects of accounting practices including accounting policies, accounting estimates and financial statement disclosures</li> <li>► Significant difficulties, if any, encountered during the audit</li> <li>► Significant matters, if any, arising from the audit that were discussed with management</li> <li>► Written representations that we are seeking</li> <li>► Expected modifications to the audit report</li> <li>► Other matters if any, significant to the oversight of the financial reporting process</li> </ul>	Discussed herein
<b>Misstatements</b> <ul style="list-style-type: none"> <li>► Uncorrected misstatements and their effect on our audit opinion</li> <li>► The effect of uncorrected misstatements related to prior periods</li> <li>► A request that any uncorrected misstatement be corrected</li> <li>► In writing, corrected misstatements that are significant</li> </ul>	Discussed herein
<b>Fraud</b> <ul style="list-style-type: none"> <li>► Enquiries of the audit committee to determine whether they have knowledge of any actual, suspected or alleged fraud affecting the entity</li> <li>► Any fraud that we have identified or information we have obtained that indicates that a fraud may exist</li> <li>► A discussion of any other matters related to fraud</li> </ul>	Enquiries to be performed with Audit Committee
<b>Related parties</b> Significant matters arising during the audit in connection with the entity's related parties including, when applicable: <ul style="list-style-type: none"> <li>► Non-disclosure by management</li> <li>► Inappropriate authorisation and approval of transactions</li> <li>► Disagreement over disclosures</li> <li>► Non-compliance with laws and regulations</li> <li>► Difficulty in identifying the party that ultimately controls the entity</li> </ul>	No such significant matters noted
<b>External confirmations</b> <ul style="list-style-type: none"> <li>► Management's refusal for us to request confirmations</li> <li>► Inability to obtain relevant and reliable audit evidence from other procedures</li> </ul>	None noted
<b>Consideration of laws and regulations</b> <ul style="list-style-type: none"> <li>► Audit findings regarding non-compliance where the non-compliance is material and believed to be intentional. This communication is subject to compliance with legislation on tipping off</li> <li>► Enquiry of the audit committee into possible instances of non-compliance with laws and regulations that may have a material effect on the financial statements and that the audit committee may be aware of</li> </ul>	None noted that would have a material effect on the financial statements as per our discussions with management and legal counsel Enquiries to be performed with Audit Committee
<b>Independence</b> Communication of all significant facts and matters that bear on Ernst & Young's objectivity and independence Communication of key elements of the audit engagement partner's consideration of independence and objectivity such as: <ul style="list-style-type: none"> <li>► The principal threats</li> <li>► Safeguards adopted and their effectiveness</li> <li>► An overall assessment of threats and safeguards</li> <li>► Information about the general policies and process within the firm to maintain objectivity and independence</li> </ul>	Independence report in Appendix C of this report
Other communications as detailed in the ethical standards:	Independence report in

<ul style="list-style-type: none"><li>▶ Relationships between Ernst &amp; Young, the company and senior management</li><li>▶ Services provided by Ernst &amp; Young that may reasonably bear on the auditors' objectivity and independence</li><li>▶ Related safeguards</li><li>▶ Fees charged by Ernst &amp; Young analysed into appropriate categories such as statutory audit fees, tax advisory fees, other non-audit service fees</li><li>▶ A statement of compliance with the ethical standards</li><li>▶ The audit committee should also be provided an opportunity to discuss matters affecting auditor independence</li></ul>	Appendix C of this report
<p><b>Going concern</b></p> <p>Events or conditions identified that may cast significant doubt on the entity's ability to continue as a going concern, including:</p> <ul style="list-style-type: none"><li>▶ Whether the events or conditions constitute a material uncertainty</li><li>▶ Whether the use of the going concern assumption is appropriate in the preparation and presentation of the financial statements</li><li>▶ The adequacy of related disclosures in the financial statements</li></ul>	No such conditions noted and further discussed herein
<p><b>Significant deficiencies in internal controls identified during the audit</b></p>	Discussed herein, and in management letter to be provided to Board at later date

## Appendix B Management representation letter for statutory reporting

xx June 2012

Ernst & Young

1 More London Place

London SE1 2AF

Dear Sirs,

This representation letter is provided in connection with your audit of the financial statements of Post Office Limited ("the Company") for the 52 weeks ended from 27 March 2011 to 25 March 2012 ("the period"). We recognise that obtaining representations from us concerning the information contained in this letter is a significant procedure in enabling you to form an opinion as to whether the financial statements give a true and fair view of the financial position of Post Office Limited as of 25 March 2012 and of its financial performance (or operations) and its cash flows for the period then ended in accordance with UK GAAP.

We understand that the purpose of your audit of our financial statements is to express an opinion thereon and that your audit was conducted in accordance with International Standards on Auditing (UK and Ireland), which involves an examination of the accounting system, internal control and related data to the extent you considered necessary in the circumstances, and is not designed to identify - nor necessarily be expected to disclose – all fraud, shortages, errors and other irregularities, should any exist.

Accordingly, we make the following representations, which are true to the best of our knowledge and belief, having made such inquiries as we considered necessary for the purpose of appropriately informing ourselves:

### **A. Financial Statements and Financial Records**

1. We have fulfilled our responsibilities, as set out in the terms of the audit engagement letter dated 24 February 2012, for the preparation of the financial statements in accordance with UK GAAP.
2. We acknowledge, as members of management of the Company, our responsibility for the fair presentation of the financial statements. We believe the financial statements referred to above give a true and fair view of (or 'present fairly, in all material respects') the financial position, financial performance (or results of operations) and cash flows of the Company in accordance with UK GAAP, and are free of material misstatements, including omissions. We have approved the financial statements.
3. The significant accounting policies adopted in the preparation of the financial statements are appropriately described in the financial statements.
4. As members of management of the Company, we believe that the Company has a system of internal controls adequate to enable the preparation of accurate financial statements in accordance with UK GAAP that are free from material misstatement, whether due to fraud or error.
5. We believe that the effects of any unadjusted audit differences, summarised in the accompanying schedule, accumulated by you during the current audit and pertaining to the latest period presented are immaterial, both individually and in the aggregate, to the

financial statements taken as a whole. We have not corrected these differences identified by and brought to the attention from the auditor because we do not believe that they are material to the reader's understanding of the financial statements.

**B. Fraud**

1. We acknowledge that we are responsible for the design, implementation and maintenance of internal controls to prevent and detect fraud.
2. We have disclosed to you the results of our assessment of the risk that the financial statements may be materially misstated as a result of fraud.
3. We have disclosed to you all significant facts relating to any frauds, suspected frauds or allegations of fraud known to us that may have affected the Company (regardless of the source or form and including, without limitation, allegations by "whistle-blowers"), whether involving management or employees who have significant roles in internal control. Similarly, we have disclosed to you our knowledge of frauds or suspected frauds affecting the entity involving others where the fraud could have a material effect on the financial statements. We have also disclosed to you all information in relation to any allegations of fraud or suspected fraud communicated by employees, former employees, analysts, regulators or others, that could affect the financial statements.

**C. Compliance with Laws and Regulations**

1. We have disclosed to you all known actual or suspected noncompliance with laws and regulations whose effects should be considered when preparing the financial statements.

**D. Information Provided and Completeness of Information and Transactions**

1. We have provided you with:
  - Access to all information of which we are aware that is relevant to the preparation of the financial statements such as records, documentation and other matters as agreed in terms of the audit engagement.
  - Additional information that you have requested from us for the purpose of the audit and
  - Unrestricted access to persons within the entity from whom you determined it necessary to obtain audit evidence.
2. All material transactions have been recorded in the accounting records and are reflected in the financial statements.
3. We have made available to you all minutes of the meetings of shareholders, directors and committees of directors (or summaries of actions of recent meetings for which minutes have not yet been prepared) held through to the most recent meeting on 18 April 2012.
4. We confirm the completeness of information provided regarding the identification of related parties. We have disclosed to you the identity of the Company's related parties and all related party relationships and transactions of which we are aware, including sales, purchases, loans, transfers of assets, liabilities and services, leasing arrangements, guarantees, non-monetary transactions and transactions for no consideration for the period ended, as well as related balances due to or from such parties at the year end. These transactions have been appropriately accounted for and disclosed in the financial statements.

5. We have disclosed to you, and the Company has complied with, all aspects of contractual agreements that could have a material effect on the financial statements in the event of non-compliance, including all covenants, conditions or other requirements of all outstanding debt.

#### **E. Liabilities and Contingencies**

1. All liabilities and contingencies, including those associated with guarantees, whether written or oral, have been disclosed to you and are appropriately reflected in the financial statements.
2. We have informed you of all outstanding and possible litigation and claims, whether or not they have been discussed with legal counsel.
- We have recorded and/or disclosed, as appropriate, all liabilities related litigation and claims, both actual and contingent, and have disclosed in Note *[X]* to the financial statements all guarantees that we have given to third parties.<sup>2</sup>

#### **F. Subsequent Events**

1. Other than those disclosed, there have been no events subsequent to period end which require adjustment of or disclosure in the financial statements or notes thereto.

#### **G. Accounting Estimates**

1. We believe that the significant assumptions we used in making accounting estimates, including those measured at fair value, are reasonable.
2. Accounting estimates recognised or disclosed in the financial statements:
  - We believe the measurement processes, including related assumptions and models, we used in determining accounting estimates is appropriate and the application of these processes is consistent.
  - The disclosures relating to accounting estimates are complete and appropriate in accordance with the applicable financial reporting framework.
  - The assumptions we used in making accounting estimates appropriately reflects our intent and ability to carry out specific courses of action on behalf of the entity, where relevant to the accounting estimates and disclosures.
  - No subsequent event requires an adjustment to the accounting estimates and disclosures included in the financial statements.

#### **Going Concern**

1. Note 1 to the financial statements discloses all of the matters of which we are aware that are relevant to the Company's ability to continue as a going concern, including significant conditions and events, our plans for future action, and the feasibility of those plans.

#### **Contingent Liabilities**

1. We are unaware of any violations or possible violations of laws or regulations the effects of which should be considered for disclosure in the financial statements or as the basis of recording a contingent loss (other than those disclosed or accrued in the financial statements).

2. We are unaware of any known or probable instances of non-compliance with the requirements of regulatory or governmental authorities, including their financial reporting requirements, and there have been no communications from regulatory agencies or government representatives concerning investigations or allegations of non-compliance.

*Yours Faithfully,*

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Finance Director

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Chief Executive Officer

## Appendix C Independence report

The APB Ethical Standards and ISA (UK and Ireland) 260 "Communication of audit matters with those charged with governance", requires us to communicate with you on a timely basis on all significant facts and matters that bear upon our independence and objectivity. The Ethical Standards, as revised in December 2010, require that we communicate formally both at the planning stage and at the conclusion of the audit, as well as during the course of the audit if appropriate. The aim of these communications is to ensure full and fair disclosure by the auditor to those charged with governance of the audit client on matters in which they have an interest.

Matters to be communicated at the planning stage include:

- ▶ the principal threats, if any, to objectivity and independence identified by the audit, including consideration of all relationships between the company (including its affiliates, directors and senior management) and us, including all services provided to the company (including its affiliates, directors and senior management), by Ernst & Young LLP and its network firms ("Ernst & Young"), that we consider may reasonably bear on our independence and objectivity;
- ▶ the safeguards adopted and the reasons why they are considered to be effective, including any Engagement Quality Reviewer review;
- ▶ the overall assessment of threats and safeguards;
- ▶ information about the general policies and process within the firm to maintain objectivity and independence.

Matters to be communicated at the conclusion of the audit include:

- ▶ a written disclosure of relationships (including the provision of non-audit services) that bear on the auditor's objectivity and independence, the threats to auditor independence that these create, any safeguards that have been put in place and why they address such threats, together with any other information necessary to enable the auditor's objectivity and independence to be assessed;
- ▶ the total amount of fees that Ernst & Young have charged the company and its affiliates for the provision of services during the period ended 25 March 2012 analysed into the appropriate categories.
- ▶ where there are contingent fee arrangements for non audit services provided by Ernst & Young, we are required to disclose these arrangements, as well as the amounts of any future services that have been contracted, and details of any written proposal to provide non-audit services that has been submitted;
- ▶ any inconsistencies between APB Ethical Standards and the company's policy<sup>3</sup> for the supply of non-audit services by Ernst & Young and any apparent breach of that policy;
- ▶ a confirmation that we are independent;
- ▶ a statement that the engagement team, others within Ernst & Young as appropriate, Ernst & Young and our network firms have complied with relevant ethical requirements regarding independence.

We are also required to provide you with an opportunity to discuss any matters affecting our independence.

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<sup>3</sup> The Combined Code on Corporate Governance (provision C3.2) requires audit committees to develop the company's policy on the engagement of the external auditors to supply non-audit services.

## Relationships, services and related safeguards

We highlight the following significant facts and matters that may be reasonably considered to bear upon our objectivity and independence, including the principal threats, if any. However we have adopted the safeguards noted below to mitigate these threats along with the reasons why they are considered to be effective.

Description of relationship or service and related independence threat	Period provided/duration	Safeguards adopted and reasons considered to be effective
<b>Service 1:</b> AAF Report- AAF 01/06 report on POL Note Circulation Scheme related services to the Bank of England for the year ended 31 December 2011 and to be performed in April 2012.	Performed on continued annual basis	Not a prohibited service These are standard agreed-upon-procedures, where management instructs us on exactly the procedures to be performed and we conclude by issuing a factual findings report only.
<b>Service 2:</b> Agreed-upon procedures performed which relate to testing of covenants relating to the loan from the Department of Business, Innovation and Skills (BIS). This is a standard Agreed-Upon Procedures service which has been performed for the past four years and is in the process of being performed in May 2012.	Performed on continued annual basis	Not a prohibited service These are standard agreed-upon-procedures, where management instructs us on exactly the procedures to be performed and we conclude by issuing a factual findings report only.
<b>Service 3:</b> Agreed-upon procedures performed to ensure that the amount which is collected by Post Office Limited on behalf of the DVLA for road tax is subsequently paid over to the DVLA. This is a standard agreed-upon procedures service which has been performed for the past five years, and is in the process of being performed in May 2012	Performed on continued annual basis	Not a prohibited service These are standard agreed-upon-procedures, where management instructs us on exactly the procedures to be performed and we conclude by issuing a factual findings report only.
<b>Service 4:</b> Advisory- Review of saving commissions within the proposed distribution agreement between POL and Bank of Ireland	March 2012	Not prohibited service for EY Separate teams used Standard ring-fencing between audit and advisory teams Conflict of interest with Bank of Ireland was also managed via standard ring fencing procedures Went through complete review exercise to ensure in line with EY independence rules Advisory engagement not advocating anything with regards to financial systems, more related to performance improvement and benchmarking which has no link to our audit

Overall, we consider that the safeguards that have been adopted appropriately mitigate the principal threats identified and we therefore confirm that Ernst & Young is independent and the objectivity and independence of the audit engagement partner and the audit engagement team have not been compromised.

## Other required communications

Ernst & Young LLP (E&Y) has policies and procedures that instil professional values as part of firm culture and ensure that the highest standards of objectivity, independence and integrity are maintained.

Details of the key policies and processes in place within E&Y for maintaining objectivity and independence can be found in our annual Ernst & Young LLP Transparency Report which the Firm is required to publish by law. The most recent version of this Report is for the year ended 30 June 2011 and can be found here: <http://www.ey.com/UK/en/About-us/About-EY---Transparency-Report>.

We are not aware of any inconsistencies between the company's policy for the supply of non audit services and APB Ethical Standards. We are not aware of any apparent breach of that policy.

We confirm that in our professional judgment, the firm is independent.

We confirm that the engagement team and others within the firm, the firm and network forms have complied with relevant ethical requirements regarding independence.

## Appendix D Fair & transparent fees

	FY2012 Fees (excluding VAT)
Financial statement audit	195,000
<b>Total 2012 audit fees</b>	<b>£195,000</b>
BIS covenants agreed-Upon procedures	12,500
DVLA statement agreed-upon procedures	14,200
Bank of England AAF report	80,000
<b>Total recurring non-audit related fees</b>	<b>106,700</b>
Advisory project	4,708
<b>Non-recurring non-audit fees</b>	<b>4,708</b>
<b>Total 2012 Non-audit fees</b>	<b>£111,408</b>
<b>Total Ernst &amp; Young Fees</b>	<b>£306,408</b>

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