

Royal Mail – Strictly Confidential

**ARC (10)3RD
23 - 31**

ROYAL MAIL HOLDINGS plc

(Company no. 4074919)

AUDIT AND RISK COMMITTEE

**Minutes of the meeting held at 100 Victoria Embankment London on
13TH May 2010**

Members of the Committee Present:

Paul Murray	Non Executive Director, Chair of the Committee
David Currie	Non Executive Director
Richard Handover	Non Executive Director

In attendance:

Donald Brydon	Chairman
Ian Duncan	Group Finance Director
Doug Evans	General Counsel
Jonathan Evans	Company Secretary
Derek Foster	Internal Audit & Risk Management Director
Mick Jeavons	Financial Management & Control Director
Lindsay Leteve	Chief Accountant
Luke March	Group Compliance Director
Les Owen	Non-Executive Director
Matthew Rose	Director Group Treasury & Taxation
Richard Wilson	Ernst &Young
Alison Duncan	Ernst &Young
Ben Marles	Ernst &Young
Andrew Poole	Deputy Company Secretary

ARC10/23

MINUTES

- (a) The minutes of the meeting of 11th March 2010 were considered and approved as an accurate record of the meeting;
- (b) the Committee noted the minutes of the GLS Group Audit & Risk Committee dated 5th May 2010.

ARC10/24

MATTERS ARISING

ARC(10)19

- (a) The Committee noted the status of actions from the previous meetings, in particular:-
- (b) ARC10/07(e) POL FS Compliance: progress to agreed milestones was being made on the deliverables as detailed in the January presentation. A full update would be provided for the July meeting when the presentation would include details

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Dave Smith

of the plan to deliver a business wide compliance and risk framework covering all POL's business and operational risks;

ACTION
Robin Dargue

- (c)
- ARC10/18(d) PSP
- : A full update report on the PSP project will be made to the Holdings Board in June.

ARC10/25**YEAR END MATTERS ARC(10)20 (a-c)**

- (a) 2009/10 Report & Accounts: the Committee noted a draft of the 2009-10 Royal Mail Holdings plc Annual Report & Financial Statements for review and comment, together with a draft of the preliminary Statement;
- (b) on 28 April 2010, the Royal Mail Holdings plc Board delegated authority to a Board Accounts Sub-Committee comprising the Chairman, the Group Finance Director and the Chairman of the Audit and Risk Committee, to approve the final Annual Report and Financial Statements on behalf of the Board, following review by the Audit and Risk Committee;
- (c) the Committee:
- reviewed the Annual Report and Financial Statements for 2009-10 and approved them for signing by the Board Accounts Sub-Committee;
 - agreed the content of the Letters of Representation included in the Ernst & Young report for issue to the auditors on behalf of the Board and delegated authority to the Board Accounts Sub Committee to sign the letter; and
 - confirmed that the Preliminary Statement was consistent with the Annual Report and Financial Statements;
 - agreed to review the documentation and provide any feedback to Ian Duncan or the Finance team;
- (d) Going Concern: the Committee noted a paper summarising the key developments since the Holdings Board meeting on 28th April 2010. Ernst and Young had reviewed the available analyses in respect of Going Concern, and discussed their initial conclusions at a Professional Standards Panel on 28 April 2010. Subject to material new information arising before the date of signing that might require the Panel to reconsider its conclusion, and given the proposed comprehensive disclosure of Directors' assumptions in Note 2 of the financial statements, the Panel agreed that a Going Concern basis of accounts preparation is appropriate, with no requirement for an emphasis of matter paragraph in the audit report;
- (e) Group Finance had completed the review of forecast compliance with loan covenants. Latest projections show that the Loan To Value covenant on the senior debt facility may be breached in March 2012. This represents an improvement to the draft position presented to the Holdings

ACTION
All

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Board in April, when the breach looked likely in September 2011. This covenant could come under threat earlier than March 2012 if material risks crystallise, or if commercial property values are negatively impacted. Alternatively, the threat could be mitigated by increases in commercial property values;

- (f) further covenants may come under pressure in the event of deterioration in forecasts, in particular the Total indebtedness covenant on the £500m GLS loan, which is threatened by the additional lease finance now assumed in the plan. The April Board paper highlighted that this covenant might also be breached during 2012, however improvement in the opening cash position and mitigation of the assumed risks addresses the shortfall;
- (g) the Audit and Risk Committee:
 - i. noted the issues to be considered with respect to Going Concern for the 2010 year end and the progress to date;
 - ii. noted the draft financial analysis that currently underpinned the projections;
 - iii. noted the proposed approach to prioritisation and review of management actions;
 - iv. agreed the proposed Going Concern disclosure for Note 2 of the financial statements; and
 - v. recommended to the Royal Mail Holdings plc Board Accounts Sub Committee that the accounts were correctly prepared on a Going Concern basis;
- (h) Cash Management actions in RMG: the Committee noted a paper assessing the cash management actions being taken to improve funding headroom in RMG. In particular Business Units were to be issued with cash stretch targets within the 2010-11 incentive arrangements. The structure of the scheme had been to drive towards improving forecast headroom by c£200m over the next 24 months, £125m in the budget year. It was hoped this would provide the required focus on cash management and performance and, if successful, drive forecast funding headroom to a more appropriate level. Progress would be reported regularly to allow any necessary actions to be taken;
- (i) Accounts Disclosure: Royal Mail Group Ltd continued to face considerable cash requirements with respect to its investment in modernisation and funding its pension deficit at a time when the mails market had been opened up to full competition and there was ongoing volatility in mail volumes;
- (j) on 23 March 2007, a funding package totalling £1.2bn was completed with Government and for which State aid approval had been received in April 2009. The £900m senior debt facility expires in March 2014. It had been assumed that another facility would be negotiated to be available by this

Royal Mail – Strictly Confidential

time. The remaining £300m subordinated loan was fully drawn in March 2009 and would not be repaid until the later of the unconditional release of the monies held in escrow for the Pension Trustee or 19 March 2016;

- (k) in making an assessment on Royal Mail Group Ltd's ability to continue as a going concern, the Directors had assumed the successful execution of the modernisation plan, which was reflected in detailed plans and supported by financial forecasts, assumed that an affordable payment profile would be agreed with the Royal Mail Pension Plan Trustee and considered the ongoing volatility in the mails market, along with the risk of greater market decline than forecast, which creates uncertainties around the financial projections and, consequently, the funding and headroom requirements of Royal Mail Group Ltd;
- (l) on the basis of careful consideration of the cash flow projections and the above considerations the Directors have concluded that it was appropriate that the financial statements be prepared on a going concern basis;
- (m) Alison Duncan noted that she had met with the Trustee during the audit and felt that the Trustee clearly understood the headroom issues. E&Y confirmed that the directors assumptions were reasonable given the stated intention of the Trustee and the flexibility in relation to GLS disposal and transformation spend, and on that basis were comfortable with the proposed disclosure. Paul Murray also confirmed, on behalf of the Committee, that he too was content with the disclosures which he thought were both appropriate and adequate;
- (n) a short paper would be produced for the Board accounts Sub Committee providing assurance that the statement included in the Annual report & Accounts on Internal controls was appropriate;
- (o) the Committee noted the Directors Remuneration Report and the KPIs included in incentive schemes. As the future of the LTIP was currently under review by the Remuneration Committee, the Committee agreed that it would be useful for the two committee chairmen to discuss future options for KPIs;
- (p) the Committee noted the Royal Mail Holdings plc Briefing book providing an analysis of performance against prior year and the balance sheet movements year-on-year. The analysis was provided to facilitate a greater understanding of the disclosures made in the financial statements.

ACTION
Derek Foster

ACTION
Paul Murray

ARC10/26

E&Y REPORT ARC(10)21

- (a) Alison Duncan and Ben Marles introduced the E&Y Audit update and Independence report dated 13th May 2010;

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- (b) the annual results close process, including the period 11 hard close, was well executed by the business units and Group finance teams;
- (c) a summary of control observations were set out in the report together with recommendations of a housekeeping nature that would be discussed with management and reported in the management letter;
- (d) subject to on-going discussions with the Board and on-going review up until the signing of the accounts, E&Y were satisfied that there were no material uncertainties that could cast doubt on RMG's ability to continue as a going concern. E&Y further confirmed that on the basis of the audit work undertaken to date E&Y had not identified anything that would lead them to believe that they would not be able to issue an unqualified audit report. However some matters were still outstanding and until E&Y had completed their procedures, it was possible that further matters requiring amendment might arise;
- (e) E&Y noted that in April 2010 the IASB had issued an exposure draft of proposed changes to the pensions accounting standard, IAS19. The draft was open to public comment until September 2010, with final amendments to be made in mid 2011. The proposed changes if fully implemented as suggested in the draft could have a material impact on the income statement charge;
- (f) the Committee confirmed, in response to a question from Alison Duncan, that there were no instances of fraud to report and noted the report from E&Y.

ARC10/27**INTERNAL AUDIT & RISK MANAGEMENT QUARTERLY REPORT AND GROUP RISK PROFILE ARC(10)22 AND 22(a)**

- (a) Derek Foster introduced the Quarterly report for February to March 2010. The Committee noted in particular that sixteen IA&RM reports had been issued in the period with the most significant report being the Review of Financial Services Compliance. The report outlined the key findings and the actions being taken to address the issues identified in the report;
- (b) in August 2008, Post Office Limited had engaged the consulting firm Deloitte to review its arrangements for ensuring compliance with Financial Services Authority (FSA) and HM Revenue & Customs (HMRC) regulations in relation to the sale of its Financial Services products. Deloitte's report noted that compliance was consistently and significantly below expected levels, and had identified a number of areas for improvement relating to the overall control environment and allocation of regulatory responsibilities. In

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February/March 2009 the Bank of Ireland also undertook a review of the effectiveness of processes and controls by which POL manages the training, competency and development of people in selling Financial Services products and concluded that there were significant issues that required remedial action;

**ACTION
Derek Foster**

- (c) the POL Compliance Team developed a Financial Services Delivery Plan (FSDP) for 2009/10 to address issues raised in these reports and in late 2009 POL established a Network Financial Services Compliance Programme (“the Compliance Programme”) to provide greater impetus;
- (d) the Committee noted the quarterly IA&RM report and in particular the work currently in hand in relation to POL compliance. For future Quarterly reports, Derek Foster was asked to show, alongside the summary of assignment ratings on reports for the year, an equivalent summary for prior years to help provide a comparison;
- (e) Group risk profile: the Committee noted the Group Risk profile dated May 2010;
- (f) Paul Murray said that in order to improve oversight of the risk management process a member of the Committee would on a rolling basis attend the Corporate Risk Management Committee and that he would attend the next meeting.

ARC10/28**IA&RM ANNUAL PLAN****ARC(10)23**

- (a) The Committee noted a paper setting out details of the Internal Audit & Risk Management Departmental Plan for 2010/11;
- (b) the plan recognised the continued critical importance of the Letters business to Royal Mail overall. The Plan for the last few years had had a significant focus on the Letters business, due to its scale in the Group, and this focus continued in the 2010/11 plan. As well as Business Transformation assignments noted in Appendix B, business as usual process reviews included manpower planning, procurement contract management, revenue protection, and aviation security;
- (c) a significant allocation of activity to POL recognised the importance of continued risks facing this business, including FSA compliance, agents remuneration, the Horizon payment system, and cash logistics security;
- (d) Group activity included the assurance work around the People System Programme, which was a critical change programme for payroll processing and people management, and also reviews of specific Licence Conditions;
- (e) GLS: as in 2009/10, GLS Group Internal Audit compiled a

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Derek Foster

proposed audit plan for the year, and this had been approved at the May GLS Audit & Risk Committee (attended by the Royal Mail Group Finance Director and the IA&RM Director). The plan contains 96 depot audits (2009/10 actual: 75) and 21 head office audits (2009/10 actual: 16). In addition, GLS will continue its programme of national quality, international quality, and security audits. IA&RM would continue to report progress against this plan on a quarterly basis to the Group ARC. GLS would be invited to attend the September ARC meeting to provide an update on Internal Controls.

(f) the Committee approved the Plan for 2010/11;

ACTION
Donald Brydon

(g) Donald Brydon agreed to consider what steps the Board needed to take to understand how the assessment of risk played into the strategic planning process;

(h) Paul Murray referred to the Bribery Act 2010 which reformed the criminal law to provide a new, modern and comprehensive scheme of Bribery offences that would enable courts to respond more effectively to bribery at home and abroad. Doug Evans reminded the Committee of the various activities underway in the business, such as improved whistle blowing that would provide some assurance, however the Committee acknowledged that from a Group perspective there were areas where control improvements could be made and asked for a full update at the next meeting.

ACTION
Doug Evans**ARC10/29****GROUP COMPLIANCE UPDATE ARC(10)24-26**

- (a) Group Annual Compliance Report: the Committee noted the Group Compliance Report providing an overview of compliance activity in 2009/10;
- (b) Licence Compliance - Risk Identification and Assurance: the key changes proposed by Royal Mail in the response to the report in relation to risk identification and assurance were: increased focus on training and awareness, particularly in Operations; a review of accountability for each Licence condition and any necessary improvement required in being able to demonstrate compliance; improved 'bottom-up' risk identification and increased means for reporting and assessing incidents or concerns raised. Annex 4 to the paper provided the full list of remediation measures resulting from Project Q;
- (c) the Committee noted the issues raised in this paper and noted the proposed framework being deployed across the business;
- (d) Improving Whistleblowing post Project Q: the Committee noted a paper recommending an external provider of a Whistleblowing helpline as part of the response to Postcomm's *Minded to Decision* document (The Report) on its investigation into Quality of Service Performance

Royal Mail – Strictly Confidential

Measurement (Project Q). The paper also recommended a broader review of the policy and procedures for reporting incidents and the governance arrangements in place for management and board oversight of helplines;

- (e) subject to the necessary purchasing processes and policies, it was recommended that InTouch be selected to provide the external whistleblowing helpline which would replace the current Employee Disclosure (Whistleblowing) Policy operated by IA&RM. A review would be undertaken and a paper presented to the GET of existing helplines to assess their efficacy and a re-launch be undertaken to promote awareness of the portfolio of helplines available. Revised policy and procedures would be established on escalation of reported incidents of 'wrong doing' to ensure incidents were reported to the appropriate level in a timely manner and quarterly summary reports would be prepared for the GET and Audit & Risk Committee;
- (f) the Committee supported the proposals as outlined in the paper to improve the Whistleblowing arrangements throughout the Group;
- (g) the Committee thanked Luke March for his report noting that this would be his last meeting as he was leaving the business. A successor had been appointed.

ARC10/30

ANY OTHER BUSINESS

- (a) Paul Murray reported that he would be undertaking a formal review of the effectiveness of the Committee during the summer aided by external advisers. This would then be followed by a review of audit processes.

ARC10/31

DATE OF NEXT MEETING

8th July 2010 at 2pm.