

**Royal Mail – Strictly Confidential**

**ARC (08)1<sup>ST</sup>**  
**01 - 12**

**ROYAL MAIL HOLDINGS plc**

(Company no. 4074919)

**AUDIT AND RISK COMMITTEE**

**Minutes of the meeting held at 148 Old Street on 6<sup>th</sup> March 2008**

**Members of the Committee Present:**

Helen Weir	Non Executive Director, Chair of the Committee
Richard Handover	Non Executive Director
Margaret Prosser	Non Executive Director

**In attendance:**

Adam Crozier	Chief Executive
Ian Duncan	Group Finance Director
Jonathan Evans	Company Secretary
Doug Evans	General Counsel
Derek Foster	Internal Audit & Risk Management Director
Mike Moores	Financial Management & Control Director
Sarah Hall	Chief Accountant
Alison Duncan	Ernst & Young
Will Rainey	Ernst & Young
Anup Sodhi	Ernst & Young
Andrew Poole	Deputy Company Secretary
Robin Dargue	Group Chief Information Officer
Frank Schinella	Finance Director, Letters
Jane Morley	Director of Tax

**ARC08/01**

**MINUTES**

The minutes of the meeting of the 6<sup>th</sup> November 2007 were considered and approved as an accurate record of the meeting.

**ARC08/02**

**STATUS REPORT**

**ARC(08)01**

The Committee noted the status of actions from the previous meetings. In particular;

- (a) ARC07/45(e): Derek Foster confirmed that the Internal Auditor at GLS would have a dotted reporting line to the Internal Audit and Risk Management Director at Group.

**ARC08/03**

**2007-08 YEAR END**

**ARC(08)02-07**

- (a) The Committee noted a paper presenting the draft format for the 2007-08 Royal Mail Holdings plc Group Accounts for review and comment as appropriate and setting out the timetable. The proposed dates for the year end Report and

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Accounts and Regulatory Accounts production were noted. The proposed timetable would result in an announcement in 39 working days after the year end which was broadly in line with 2004-05 and 2005-06 and as planned for 2006-07;

- (b) the Committee noted the draft format of the Royal Mail Holdings plc Group Accounts for the year ended 30 March 2008 and approved the proposed year end timetable for recommendation to the Board;
- (c) ColleagueShares: the Committee noted a paper setting out the proposed accounting treatment for the Royal Mail ColleagueShare scheme. The Committee agreed that:-
- the costs of ColleagueShares (share costs and stakeholder dividend) charged to the income statement should be treated as an exceptional item throughout the life of the scheme and presented on the face of the Income Statement within the Operating Exceptional Items;
  - stakeholder dividends should be charged to the income statement in the financial year to which they relate;
  - the share costs of ColleagueShares should be spread throughout the life of the scheme;
  - the ColleagueShares would be valued at the latest plan forecast for the share value; and that the ColleagueShares share costs would be discounted.
- (d) Fines Compensation and Material Litigation: the Committee noted an update on fines, Quality of Service compensation and current material litigation. The Committee noted the amount for accruals for fines and compensation and provisions held for material litigation at Period 11; and noted the range of between £10.6m - £127.6m and agreed the approach to setting the accrual for 2007-08 bulk compensation at the year end;
- (e) New Subsidiaries: two new subsidiaries had started trading during the year – iRed Redefining Document Management Ltd (formerly known as DMS) and Royal Mail Courier Services Ltd (RMCS). The Audit and Risk Committee noted the establishment of the two new subsidiaries and the approach to accounting for them;
- (f) Audit Update and Independence Report: the Committee noted the 2007-08 audit update and in particular that a detailed report of any material audit findings would be presented to the May meeting. Further to a discussion at the September 2007 meeting E&Y confirmed that the planning materiality had been reset to £24 million (2006-07 £23 million). The main impacts on the audit approach resulting from the lowering of the planning materiality from £48m to £24m were noted;

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- (g) E&Y confirmed that they had considered the potential impact of the 'credit crunch' on the Group's financial position including key assumptions on which accounting valuations, including for example valuations for pension obligations and impairment reviews were based and made a number of observations which were noted;
- (h) the Financial Statements for 2007-08 would be prepared for the first time in accordance with IFRS 7 Financial Instruments Disclosure, which required greater disclosure in relation to the nature and extent of risks to which the Company was exposed;
- (i) Auditor independence: as part of the audit E&Y were required to review their independence and objectivity, and to confirm their ability to act as the Company's auditors. E&Y noted that they were not aware of any relationships between member firms of Ernst & Young International and Royal Mail that, in their professional judgment, would reasonably be thought to bear on their independence or the objectivity of the audit engagement team. Accordingly E&Y confirmed that the firm was independent and the objectivity of the audit engagement partner and staff had not been compromised;
- (j) there had been 3 breaches of the Royal Mail non-audit services policy during the year. The Committee agreed that E&Y could re-invoice the Company for £245,000 in respect of the work undertaken on Tele2 which had been previously invoiced and then credited as it exceeded the pre-approved amount of £100,000. The Committee noted that the fees for the remaining two breaches had been refunded to the Company. The Committee further agreed to pay £34,000 in respect of the additional work undertaken in relation to the 2006-07 accounts as this was considered to be a reasonable charge for the work done;
- (k) Auditors Remuneration for Non Audit Services: the Committee approved the schedule of proposed maximum fees set out in the paper for the 2008-09 year amounting to £1,370,000 and noted that the process would operate in line with the Audit & Risk Committee paper previously approved in May 2007. Helen Weir noted that the non audit fees were high in relation to the audit fees and the Committee agreed that E&Y would not be used in acquisition related work beyond the engagement in Spain;
- (l) GLS A&RC report: Ian Duncan reported on the recent GLS Audit & Risk Committee meeting held on the 4<sup>th</sup> March 2008, and the progress that had been made in establishing an Internal audit function at GLS with the recent appointment of a Group Internal Audit Manager. The Committee agreed that the minutes of the GLS Audit & Risk Committee would be presented to the Group A&RC on a regular basis;
- (m) Ian Duncan updated the Committee on the GLS risk

**ACTION**  
**Ian Duncan**

**ACTION**  
**Secretary**

**Royal Mail – Strictly Confidential****ACTION**  
**Ian Duncan**

assessment report noting GLS Management's view of the top five key risks facing the Business. The Committee expressed surprise that the risks were all short term operational matters rather than longer term strategic issues such as the loss of senior management or a significant downturn in volumes. The risk assessment would be discussed at the next meeting of the GLS Supervisory Board;

- (n) the Committee was advised that in October 2007 Italian lawyers had been contacted by a whistleblower hinting at fraudulent activities by local management. Having received an indemnity, the whistleblower made his detailed allegations in December 2007. In January 2008 GLS appointed forensic accountants to commence investigations into the allegations made. In parallel GLS had commenced investigations into the value of the GLS head office in Milan; the alleged activities concerned the local GLS management having a significant interest in a company that owned the Milan Head office building which, it was claimed, was rented to GLS at an inflated rent. Other allegations related to the lease value of satellite navigation systems and the purchase price of acquired franchise businesses;
- (o) investigations were continuing with the focus on gaining evidence which would be used to restrict and if possible recover any losses, and to evaluate the case against the individuals involved;
- (p) the Committee was very concerned with the report, in particular at the apparent delay in dealing with the individuals - who were still in post - and in the non-reporting of the issue formally by GLS management until two days earlier. The Committee requested, as a matter of urgency, to know the details of the actions being taken to reduce exposure together with an explanation and timeframe of when all the issues became known to GLS and to RMG.

**ACTION**  
**Ian Duncan****ARC08/04****IT CONTROL ENVIRONMENT**

- (a) Robin Dargue was welcomed to the meeting. Derek Foster provided an update on the work that the Internal Audit & Risk Management (IA&RM) function had undertaken in relation to IT controls. Group Technology was currently undergoing significant change. The Group Chief Information Officer had recently presented to the Holdings Board an overview of the challenges facing IT in Royal Mail and this had concluded that the IT capabilities were inadequate for the current and future environment;
- (b) IA&RM reviews and the risk management process had consistently echoed many of the challenges set out in the IT Strategy. These included the need for a comprehensive IT strategy, concerns over data quality, weaknesses in management of IT projects, lack of accountability, non-compliance with policy and procedures, concerns over

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system access, over-reliance on, and lack of control over, end-user computing;

- (c) currently IT control activities focused on the priority areas of IT Strategy, Information Security, and Disaster Recovery. Following the reorganisation, a more wide-ranging IT control framework would be introduced;
- (d) the internal audit and IT audit qualifications and interrogation tools used in Royal Mail were consistent with those commonly used in other major organisations. IA&RM recognised that it needed to align its IT audit effort with the needs of the business and also to ensure it had the right IT technical capabilities going forward. IA&RM was working with a leading co-sourcing partner to augment its IT audit capability. The Audit & Risk Committee noted the update on the IT control environment and the assessment of IA& RM's IT audit resource capability and quantity;
- (e) the Committee asked that the IT control environment be considered as a regular item at future ARC meetings to enable the Committee to be updated on progress.

**ACTION**  
**Robin Dargue/**  
**Derek Foster**

**ARC08/05**

**ANNUAL REVIEW OF GROUP TREASURY POLICIES**  
**ARC (08)08**

- (a) Ian Duncan introduced a paper which enabled the Committee to conduct the annual review of Group Treasury policies on behalf of the Holdings Board. The Group Treasury policies were last reviewed and agreed by the Committee in March 2007 (ARC (07)06 refers. In the interests of good corporate governance over the Treasury area the Committee had previously agreed to review the policies on an annual basis;
- (b) the current, revised, policies were noted. Whilst there were some minor changes of substance, the main amendments were factual ones to reflect the renewed financing facilities for Mails and POL, agreed with Government in 2007, including the new Pension escrow arrangements;
- (c) the Audit & Risk Committee agreed the changes to the Group Treasury Policies and noted that they would be notified to the Holdings Board via the next Quarterly Group Treasury report.

**ARC08/06**

**CREDIT MANAGEMENT CONTROLS**

- (a) Frank Schinella introduced a presentation updating the Committee on a review of Royal Mail's approach to credit management following implementation of the new Online Business Account (OBA) Sales Order System. The Committee noted;
- (b) the objective of the review was to assess how automated credit controls could be introduced on OBA or an associated system, to provide a greater level of protection to the



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business whilst not discouraging customers from using the service. RM incurred a relatively controlled level of bad debt write off per annum considering its diverse customer base, manual processes and the size of the business;

- (c) that detailed specifications including feasibility options and a cost benefit analysis would be produced by the end of Quarter 1 and that the business was committed to introducing automated credit checks to improve debt management controls;

**ACTION**  
**Frank Schinella**

- (d) Frank Schinella would provide an update on progress and timeframes at the end of the first quarter.

**ARC08/07**

**TAX ISSUES**

**ARC (08)09 - 10**

- (a) VAT: the Audit & Risk Committee noted Jane Morley's report that the VAT compliance failure which had occurred related to the annual calculation of the extent to which the VAT which RMG incur on expenditure was recoverable. The Committee noted the potential liability of £30 million, the explanation of the compliance failure and the actions being taken to prevent a similar control failure in future. In particular the Committee noted the Tax Director's conclusions:

- that the actions that were underway would ensure there was no repeat of the non EU revenue VAT compliance failure;
- that Internal Audit had reviewed tax department controls generally;
- that a specific control risk existed in respect of poor VAT management information, and that, when good information systems were built, this may possibly reveal further material VAT underpayments;
- that if VAT was to be managed effectively, using good quality information systems, and with the level of control recommended in this paper, the size of the VAT team needed to increase from one to at least four, two of whom should be accountants with considerable experience of Royal Mail's accounting system;

- (b) E&Y provided an overview of the audit work they had performed and an outline of the support that E&Y had provided to management in its review of previous tax returns and the exercise to quantify the potential VAT exposure;

- (c) Tax Audit Executive Summary: the Committee noted the review of the Tax Department Control Environment carried out by IA&RM and endorsed the actions being taken to improve the control environment. The Committee asked for an update report to be given at a future meeting.

**ACTION**  
**Derek Foster**

**Royal Mail – Strictly Confidential****ARC08/08****INTERNAL AUDIT & RISK MANAGEMENT QUARTERLY  
REPORT                      ARC (08)11**

- (a) Derek Foster introduced a report summarising the activity of IA&RM for the period November 2007 to February 2008. The Committee noted:-
- (b) twenty-seven reports had been issued in the period with 6 rated as not satisfactory. The number of agreed recommendations overdue for completion had increased from 4% at September 2007 to 10% in January 2008;
- (c) during the period IA&RM had carried out a number of reviews including a review of the Smartstamp & Online Postage Control environment, to provide assurance on the control environment supporting delivery of the Smartstamp and Online Postage payment channels. The conclusion reached was that the channel design and controls were not sufficient to prevent RMG being exposed to an unsatisfactory level of fraud or revenue loss. A number of activities were now underway to help reduce any such losses. Richard Handover was surprised that a new product could be launched without such risks being properly managed;
- (d) the Committee discussed the merits of the IA&RM function being closely involved at an early stage in product and process design;
- (e) Adam Crozier logically linked the extent of the transformation and the valuable role that IA&RM could play and confirmed that it would make sense to bolster the IA&RM team;
- (f) the Committee recognised the issues and endorsed a greater role for IA&RM but would want to ensure that Internal Audit independence was not jeopardised;
- (g) the Committee noted the quarterly IA&RM report dated March 2008.

**ARC08/09****2008 SCHEDULE OF BUSINESS    ARC(08)12**

- (a) The Audit & Risk Committee noted the schedule of business for 2008.

**ARC08/10****CRMC MINUTES**

- (a) The Audit & Risk Committee noted the CRMC minutes of the meetings held on the 31 October 2007 and 5<sup>th</sup> February 2008.

**ARC08/11****INTERNAL AUDIT & RISK MANAGEMENT CHARTER &  
EFFECTIVENESS QUESTIONNAIRE    ARC(08)13**

- (a) The Audit & Risk Committee noted the IA&RM charter providing a framework for the conduct of corporate risk

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management and audit activity within Royal Mail. The Charter set out the role, responsibilities, authority and positioning of Internal Audit & Risk Management (IA&RM);

- (b) as part of the annual Internal Quality Assessment performed by IA&RM (in accordance with International Standard for the Professional Practice of Internal Auditing Standard 1311), IA&RM were seeking the views of the Audit & Risk Committee on the various aspects of the department's work. The responses from the questionnaire provided would be used to update the rolling IA&RM annual plan to ensure appropriate coverage of areas of particular concern to members of the Committee. IA&RM would also use the responses when considering amendments to the departmental policies and procedures. Responses were requested from Committee members by 31st March 2008.

**ACTION  
Committee  
Members**

**ARC08/12**

**DATE OF NEXT MEETING**

The date of the next meeting of the Committee was Monday 12<sup>th</sup> May 2008.