

**Royal Mail - Strictly Confidential**

**ARC(06)1<sup>ST</sup>**  
**01 - 18**

**ROYAL MAIL HOLDINGS plc**

(Company no. 4074919)

**AUDIT AND RISK COMMITTEE**

**Minutes of the meeting held at 148 Old Street on 14<sup>th</sup> March 2006**

**Members of the Committee Present:**

Bob Wigley	Non Executive Director, Chair of the Committee
John Neill	Non Executive Director
Margaret Prosser	Non Executive Director
Helen Weir	Non Executive Director

**In attendance:**

Adam Crozier	Chief Executive
Frank Schinella	Acting Group Finance Director
Jonathan Evans	Company Secretary
Mike Prince	Group Financial Controller, for ARC 06/01-05
Derek Foster	Internal Audit & Risk Management Director
Luke March	Compliance Director, for ARC 06/10
Andrew Wilson	Security Director for ARC 06/ 11
Neil Henderson	Service Integrity Director for ARC 06/ 11
Alison Duncan	Ernst & Young
Will Rainey	Ernst & Young
Maggie Mills	Ernst & Young
Andrew Poole	Deputy Company Secretary

**ARC06/01**

**MINUTES OF PREVIOUS MEETING**

The minutes of the meeting of the 15<sup>th</sup> November 2005 were considered and approved as an accurate record of the meeting subject to the following paragraphs being revised as follows:

(a) ARC05/47(m) - Going Concern: The Committee noted a paper providing an update on Going Concern since the Royal Mail Holdings plc Board had been updated on 1 November 2005. The Committee noted a number of events and information received since the Board on the 1 November 2005. The Directors should now be in a position to confirm its decision on Going Concern in accordance with the original Board paper. John Neill said that the business had a number of valuable assets that could be realised in the event of a potential breach of covenant, which had been highlighted in appendix 3 of the paper. Bob Wigley reminded the Committee that the directors had a duty to minimise the potential loss to all creditors. Allan Leighton added that, subject to the circumstances, it was often better to continue trading in order to achieve this objective. It was noted that the business cash flow analysis confirmed that the Group

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remained a Going Concern as at 25 September 2005 and that Management had Funding available to them sufficient to stay within the financial covenants during the forecast period;

- (b) ARC05/47(n) - The Committee noted an advice letter on solvency considerations dated the 11 November 2005 from Maggie Mills, partner at Ernst & Young. The Letter concluded that the Government was continuing to support the Company, both in terms of their current lending and in working towards a solution for the Balance Sheet solvency issues. Maggie Mills highlighted the issues, which the directors would need to consider in their review of continuing to trade. These gave the directors good reason to support them in coming to the conclusion to continue to trade. It was noted that this matter needed to be kept under continuous review. The support of Government was key to the going concern issue and needed to be kept under close review to enable the Board to react to changing circumstances;
- (c) ARC05/47(q) - the Committee noted that the External Auditors had reviewed the statements in the accounts and in the commentary.

**ARC06/02**

**STATUS REPORTS ARC(06)01**

The Committee noted the status of actions from the meeting held on the 15th November 2005.

**ARC06/03**

**2005 - 06 YEAR END ARC(06)02 – 08**

**ACTION  
All**

- (a) Year-end Timetable: The Committee noted the 2005-06 timetable. The Committee supported the timetable, particularly to deliver the front section of the accounts to the April 27 Board meeting. It was agreed that the A&R Committee must be in a position on the 8<sup>th</sup> May to give final approval;
- (b) IFRS: The Committee noted the proposed disclosures and format of the financial statements of the statutory accounts for the year ended 26 March 2006. These would be the first annual accounts prepared in line with International Financial Reporting Standards (IFRS);
- (c) IFRS in subsidiary accounts: the Committee supported the transition to IFRS in subsidiary accounts subject to the impact on the accounting restructure and further evaluation of the impact of any inter company transactions and any differences identified as part of the Group convergence exercise;
- (d) New OFR: The Committee noted the good work in this area. Bob Wigley asked that consideration be given to providing KPI's for Mail integrity and improving the KPI's for Social & Community. Frank Schinella highlighted the risk disclosures and asked for any comments to be fed back directly to him;

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(e) Regulatory Provisions: The Committee noted the position and agreed that the level of accrual proposed at £47m was reasonable. However, the Committee highlighted that they would like to review these in the context of total accruals and provisions at the year end. John Neill noted that Postcomm's position may be more punitive than on previous occasions when they had fined Royal Mail;

(f) Deferred tax: At March 2005 the Group had a UK potential deferred tax asset of £1.3bn, the bulk of which related to future tax relief in respect of the deficit correction payments with respect to the £4bn accounting pension deficit, which was disclosed in the notes to the accounts as required by UK reporting standards (FRS17). The Committee noted a paper providing an update on the extent to which this potential deferred tax asset was likely to be recognised in the March 2006 accounts where the pension deficit would be recorded on the face of the balance sheet under International Financial Reporting Standards (IAS19) and to explain a difference in view that existed between Deloittes, acting for Government, and RMG. RMG intended to use the 5-year strategic plan as the base for recognising deferred tax assets. The reason for not using a 10-year plan was that this was produced at the request of Government for their own "valuation" purposes. The Committee noted the move to a five-year horizon as a reasonable approach to recognising deferred tax assets in the statutory accounts. Ernst & Young supported the approach being proposed;

(g) Going Concern; the Committee noted the update on Going Concern, based on the 14 February 2006 five year strategic plan and latest understanding of the outcome of the price control, and funding negotiations with the shareholder and pension trustees. This was very much work in progress and more work would be undertaken but the Committee noted that for the base case ('transformation') including a financing package the Group and its subsidiaries were a going concern. The going concern issue revolved around the fact that HMG had not, as yet, confirmed the financing package and therefore a paper had been produced assuming, that by 27 April 2006, HMG had still not confirmed the package. The paper included headroom analysis for downside sensitivities within the Strategic Plan. Bob Wigley asked, on top of the analysis provided, for a summary of movement in assets, profitability, cash flow and debt. Will Rainey also asked for covenant calculations to be included. Specifically, the members wanted a separate briefing before the April Board meeting including Slaughter & May and E&Y's insolvency teams. E&Y asked whether it was intended to include an emphasis of matter in the accounts and it was confirmed that one might be included in the POL accounts but use a note disclosure in the Group accounts to highlight the POL funding issue. However, it was recognised that any disclosure must be relevant to the comfort that the directors would take with respect to the financing package.

**ACTION**  
**Frank Schinella**

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**ARC06/04**

**ACCOUNTING FOR PROVISIONS    ARC(06)09**

The Committee noted a paper asking the Audit and Risk Committee to endorse the Group policy on accounting for provisions that would be included in the Group internal policy manual, Royal Mail Generally Accepted Accounting Practice (RM GAAP).

(a) the Audit and Risk Committee endorsed the Group policy for accounting for provisions. John Neill thought the summary was excellent. Ernst & Young had reviewed the policy and agreed that it was appropriate for the Group and accorded with current Accounting Standards. However due to the subjective nature of restructuring provisions and the unique circumstances of Royal Mail, E&Y and the Group Financial Controller would consider the 'fact patterns' relevant to each restructuring programme before concluding on the appropriate treatment.

**ARC06/05**

**E&Y REPORT    ARC(06)10**

The Committee noted a paper on Audit Independence and non-audit fees dated 14 March 2006. E&Y were not aware of any other relationships between member firms of E&Y and RMH that might reasonably be thought to bear on their independence or the objectivity of the audit engagement team. E&Y concluded that the firm was independent within the meaning of professional and regulatory requirements and that the objectivity of the audit engagement partners and audit staff had not been impaired. The Chairman added that in his view the auditors, if judged by their behaviour, were clearly independent, and the Committee agreed.

**ARC06/06**

**INTERNAL AUDIT & RISK MANAGEMENT QUARTERLY REPORT    ARC(06)11**

Derek Foster introduced a report summarising the activity of IA&RM for the period November to February 2006. The Committee noted:-

(a) fourteen reports had been issued in the period and 13 assurance risk ratings had been applied, of these 2 were rated as satisfactory, 8 were rated as low risk, 1 was not satisfactory and 2 were critical or high risk. These were the Costing model and the HR Infinium system;

(b) Costing System: this system provided both costing and product profitability information. The IA&RM review had identified a number of significant weaknesses in the control environment with respect to a key data input into the costing system; this included ownership and accountabilities, training and awareness, a lack of performance management and issues around the reconciliation of authorised Working Duties to those recorded in RCS. The Committee was concerned to

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ensure that there was no way in which Postcomm could be inadvertently given misleading information on which to base its decisions. Frank Schinella confirmed that the Regulator was aware of data input issues and accepted that Royal Mail provided information on a 'best endeavours' basis, but agreed that the controls around the costing system needed to be more accurate both from a commercial and regulatory perspective;

**ACTION**  
**Frank Schinella**

(c) an update on the immediate actions and longer-term solution being taken to resolve the data input issues and how this information had been disclosed to Postcomm would be presented to the next meeting of the Committee;

(d) HR Infinium: was a business critical system and approximately £4 billion of costs had been processed through the application in 2004/05. The control environment surrounding the core application was generally robust; however there was a high risk that Infinium would not effectively meet future business needs. A business case was currently being prepared to replace HR Infinium with an enterprise-wide HR system. An update on progress was being provided to the next meeting of the Holdings Board;

(e) Credit policy: was owned by Group Treasury and deployed by Finance Operations. The deployment of the credit policy at the time of the review was not satisfactory. It was a requirement of condition 7 of RM's Licence that the credit policy was published on the website and that no contractual arrangements be offered other than those published. It was agreed that the operation of the Credit Policy Forum would be formally documented and the membership would be reviewed. John Neill wanted to see some evidence of accountability for instances of non-compliance. Frank Schinella would raise the issue of inconsistent pricing at the next meeting of the Credit Policy Forum;

**ACTION**  
**Frank Schinella**

(f) in response to a comment from Bob Wigley, Adam Crozier agreed to consider the level of staffing dedicated to the deployment of Agency Staffing procedures and on Revenue Protection Measures;

**ACTION**  
**Adam Crozier**

(g) John Neill reminded the Committee that it had been due to receive a presentation on compliance with Employment Law. This item would be included on the agenda for the next meeting.

**ACTION**  
**Jonathan Evans**

**ARC06/07**

**UPDATE ON OVERDUE RECOMMENDATIONS ARC(06)12**

(a) Derek Foster introduced a paper outlining progress on overdue audit recommendations as at 3 February 2006. Over the past year, 312 separate agreed actions had been completed out of a total of 354 due for completion. 42 actions were overdue for completion compared to the agreed timescales;

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**ACTION**  
**Derek Foster**

- (b) Helen Weir said that it was unacceptable that management were not closing agreed action points on time. Bob Wigley reminded the Committee that the Group Executive Team had agreed to review all overdue audit recommendations on a regular basis. The Committee was also concerned at the number of actions being presented and requested a method be devised to prioritise Audit recommendations. Adam Crozier undertook to ensure that the Group Executive Team followed up these issues. A further update on the overdue audit actions would be given to the Committee following consideration by the Group Executive Team;
- (c) the RFID business case was currently being reviewed and would be brought back to the Holdings Board for approval as necessary.

**ARC06/08**

**INTERNAL AUDIT & RISK MANAGEMENT CHARTER**  
**ARC(06)13**

The Committee considered a revised Charter for Royal Mail's Internal Audit & Risk Management department. The Charter had been compiled having regard to standards and models set out by Internal Audit professional standards.

- (a) the Charter was substantially unchanged from the prior year. The only amendment had been to specify already established practice with regard to the liaison with external audit, specifically that Terms of Reference for audit assignments, and copies of audit reports on issue, were shared with the external auditors;
- (b) the Committee approved the proposed IA&RM Charter.

**ARC06/09**

**GROUP TREASURY POLICIES** **ARC(06)14**

The Committee noted the paper, which had been prepared to enable the Committee to conduct an annual review of Group Treasury Policies. The Group Treasury Policies had been reviewed by the Committee in March 2005. In order to maintain tight corporate governance over this sensitive area it was agreed that the policies would be reviewed on an annual basis.

**ACTION**  
**Frank Schinella**

- (a) Bob Wigley requested clarification on the specific delegations made by the Group Treasurer. Frank Schinella agreed to obtain details of delegations within the Treasury function and revert to the Committee;
- (b) the Committee agreed the changes to the Group Treasury Policies and noted that the review would be notified to the Holdings Board via the next quarterly Group Treasury Report.

**ARC06/10**

**COMPLIANCE REPORT** **ARC(06)15**

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Luke March updated the Committee on the progress on Postcomm's investigations into Royal Mail activity, and on other developments within the remit of the Compliance Unit since the last compliance report to the Audit Committee in November 2005. A similar update had been given to the Holdings Board in February 2006.

- (a) the last few months had been disappointing with regards to the outcome of Postcomm's recent decisions. However the compliance unit continued to make positive progress with business units with regards to establishing a framework and way of working on compliance issues and it was clear from recent experience that compliance awareness was starting to grow throughout the commercial side of the business. The challenge for 06/07 was to ensure it permeated through the wider organisation;
- (b) however Postcomm's recently expressed objectives for 06/07 indicated intense scrutiny of any commercial initiative launched by Royal Mail, and the business must expect significant levels of Postcomm information requests and investigations, either on their own initiative or generated by competitor complaints;
- (c) the Committee noted that a large number of information requests had been received by the Company each month. Bob Wigley asked what progress had been made on his suggestion to formalise the process and policies for transmission of information to Postcomm – to include appropriate sign off from legal, finance and the business. Bob Wigley referred to his email of 14 November 2005 requesting detailed recommendations on this and observed that notwithstanding that three months had passed, no such recommendations had been presented. This was unacceptable. Bob Wigley reiterated the substantial risks RMG could run if incomplete or inaccurate information was provided to Postcomm, even if inadvertently, and how this could be exacerbated in the absence of formal policies and processes rigorously applied. Bob Wigley reminded the Committee of the issues recently raised at Severn Trent. suggested that it might be appropriate to have one point of contact for these requests. Bob Wigley suggested that it might be appropriate to have one point of contact for these requests. Adam Crozier agreed that a formal process was required and Luke March would return to the Committee with detailed proposals on how information would be managed for the next meeting.

**ACTION**  
**Luke March**

**ARC06/11**

**MAIL INTEGRITY UPDATE**

**ARC(06)16**

The Committee noted the progress made in developing and deploying an integrated, business-wide Mail Integrity (MI) plan.

- (a) significant progress had been made over the last few

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months, and a comprehensive action plan was in place which responded to the areas for improvement identified in the Postcomm report and draft enforcement order, as well as encompassing actions required from the implementation of the new MI Code of Practice, which now formed an integral element of condition 8 of the Postcomm Licence. All policies and procedures had been reviewed and were in force, and compliant contracts with Reed and Manpower had been signed. The focus of the plan was now moving away from reviewing and deploying policies and procedures to ensuring compliance down the line;

- (b) in August 2005, the Audit and Risk Committee had commissioned the Control Risks Group (CRG) to conduct an independent and high-level review to assess Royal Mail's mail integrity procedures against its obligations as set out in its Operating Licence. The Committee noted a status report against each of the report's recommendations;
- (c) CRG found that Royal Mail's security policies and procedures mainly reflected best practice and that there was visible commitment by management to continuous improvement. In addition, the Business dedicated considerable resources to protecting the mail and had in place many good improvement initiatives. However there were areas where improvements could be made. In particular, there should have been greater visibility between "processes and action groups for initiatives". In other words there should have been clearer evidence of an effective process connecting policies and standards to improvement activities identified through effective mail integrity performance management. This observation echoes the Postcomm general finding that the Business "failed properly to co-ordinate loss prevention management activities";
- (d) the business had been working to establish a framework (policies, procedures and processes) to ensure compliance with a new version of Licence Condition 8 (Mail Integrity).
- (e) Helen Weir asked who was responsible for compliance on Mail Integrity. In response it was made clear that Luke March was responsible for the process i.e. checking that the business was compliant whilst Tom Melvin, Operations Director was responsible for Mail Integrity. Luke March confirmed that he was content with the level of resource available to Internal Audit to meet the proposed work plan. Derek Foster stressed that while he had ensured that the Internal Audit Plan had a very significant focus on Licence issues, this Plan was not part of the regular ongoing monitoring and would vary year on year. Work was continuing to complete the exercise within Licence Compliance to map out the Licence conditions, equivalent processes, and related sources of monitoring and assurance;
- (f) Bob Wigley questioned why CRG had concluded security

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activity was not sufficiently targeted. Neil Henderson confirmed that a risk based approach was being taken on Mail Integrity and that he was working closely with the security team to identify gaps. The Mail Integrity Working Group draws on information related to Mail Integrity from across the business and develops a risk register to identify areas of significant risk. The Mail Integrity Working Group then develops and deploys action plans to mitigate these risks. All of these Plans are reviewed and endorsed by The Mail Integrity Working Group;

(g) the code of practice policies and procedures had been implemented and focus was now being given to demonstrating compliance before Postcomm resumed close scrutiny. Internal Audit would undertake an independent review of Mail Integrity during 2006-07;

(h) Neil Henderson said that overall there had been some very encouraging signs with all areas in Operations responding positively to the changes however there was a long way to go. John Neill said that it was encouraging but that a lot depended on culture and willingness and asked if the culture had changed. Andrew Wilson replied that following the introduction of Single Daily Delivery everyone was aware that things were being done differently and that change throughout the organisation was happening but that this would need to be sustained. Bob Wigley asked for Management to consider which statistics on Mail Integrity would be presented to the Committee at its next and subsequent meetings to enable it to demonstrate and monitor progress;

(i) Bob Wigley turned to the findings of the Control Risks Group and in particular CRG 5 – and agreed that Andrew Wilson and Derek Foster would discuss options for the design and introduction of a tool for assessing cost per equivalent saving for security investment;

(j) CRG9 – opportunities for RM to invest in mail reception facilities for high risk customers delivery locations would be taken forward as part of the Delivery Review;

(k) CRG10 – a benchmark for mail protection measures with other Postal Operators would be developed, as this would help the business to understand differences in operating procedures and facilitate the acquisition of comparison loss figures with other operators.

**ARC06/12** **INTERNAL AUDIT & RISK MANAGEMENT**  
**DEPARTMENTAL PLAN** **ARC(06)17**

The Committee noted a paper setting out the proposed Internal Audit & Risk Management Departmental Plan for 2006/07. John Neill asked if the plan included a focus on Licence compliance matters and was assured that the Plan

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did.

**ARC06/13**

**WHISTLE BLOWING REPORT**

**ARC(06)18**

The Committee noted a statistical breakdown of reports by crime category for the whole of the calendar year 2005. It also showed the breakdown of reports received as between the in-house Corporate Security Helpdesk and the external Crimestoppers organisation. The same information was provided for the first two months of 2006 and included brief details of investigations and their outcomes for each listed incident.

**ACTION**  
**Andrew Wilson**

(a) the Committee asked for further work to be undertaken to identify themes or patterns from the data held and for regular reports to be made to the Committee, perhaps in a more summarised form but that all Whistleblowing activity to be reported to the Committee regularly.

**ARC06/14**

**2006 SCHEDULE OF BUSINESS**

**ARC(06)19**

The Committee noted the schedule of business for 2006.

**ARC06/15**

**CRMC MINUTES**

**ARC(06)20**

The Committee noted the Corporate Risk Management Committee minutes for 2 February 2006.

**ARC06/16**

**POL IMPACT PROJECT UPDATE**

**ARC(06)21**

The Committee noted the paper updating the Audit & Risk Committee on the status of the Impact Programme as it neared completion, and to highlight the actions being taken to clear out legacy issues and satisfy the external auditors that the new Post Office Ltd Finance System (POLFS) would robustly support the year end balance sheet.

(a) the Audit & Risk Committee noted the current status and the actions being taken to resolve open issues in time for the year-end close.

**ARC06/17**

**FINANCIAL SERVICES COMPLIANCE REPORT**

**ARC(06)22**

The Committee noted the Financial Services Compliance report for March 2006.

**ACTION**  
**Keith Woollard**

(a) a note would be provided on the action being taken to address the regulatory risk of operating as an 'arranger' rather than as a mere 'introducer'.

**ARC06/18**

**DATE OF NEXT MEETING**

The Committee noted that the date of the next meeting of the Committee was Monday 8<sup>th</sup> May 2006.

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