

Royal Mail – Strictly Confidential

ARC(06)4TH

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ROYAL MAIL HOLDINGS plc

(Company no. 4074919)

AUDIT AND RISK COMMITTEE

Minutes of the meeting held at 148 Old Street on 22th September 2006

Members of the Committee Present:

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

Apologies:

Bob Wigley	Non Executive Director
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In attendance:

Ian Duncan	Group Finance Director
Frank Schinella	Letters Finance Director
Jonathan Evans	Company Secretary
Doug Evans	General Counsel
Mike Moores	Financial Management & Control Director
Derek Foster	Internal Audit & Risk Management Director
Alison Duncan	Ernst &Young
Will Rainey	Ernst &Young
Andrew Poole	Deputy Company Secretary
Neil Henderson	Service Integrity Director, RML for ARC06/38(a)
Jon Allen	Head of Employee Relations for ARC06/38(g).
Keith Woollard	Head of Compliance, POL for ARC06/43

ARC06/37

MINUTES OF PREVIOUS MEETING

- (a) The minutes of the meeting of the 8th May 2006 were considered and approved as an accurate record of the meeting;
- (b) the minutes of the meeting of the 6th June 2006 were considered and approved as an accurate record of the meeting subject to the second sentence of minute ARC(06)32(e) being deleted in its entirety and replaced with the following wording:-

E&Y had initially been concerned by the quality of data in the costing system but were now comfortable with the current position given the disclosure in respect of the inherent limitations of key resource drivers and discussion and agreement with the Regulator in relation to the actions being taken by the Company and the treatment in the 2005-06 Regulatory accounts.

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STATUS REPORT ARC(06)40

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

- (a) ARC06/11(k) Mail Integrity: in March, the Audit Committee commented that establishing a mail integrity benchmark with other postal administrations, especially those in Europe, would serve a number of purposes. The benchmark itself would prompt improvements if clearly required, any existing good or best practice within Royal Mail would become apparent and, finally, the Business' leading role in benchmarking activity would demonstrate a willingness to be pro-active in identifying improvements. However attempts to enlist the support of other administrators had proved largely fruitless, and a major benchmarking exercise as proposed by CSG was not considered practical. The Committee accepted this, but asked for Andrew Wilson to continue to pursue the issue on a bilateral basis with those countries who are showing an interest;
- (b) ARC06/20(a) POL Losses: the business was continuing to make steady progress in controlling cash losses, mainly through improvements in the ability to focus on the areas of highest risk assisted by better management information. This was partly due to the completion of the Impact programme;
- (c) ARC06/20(e) Revenue protection: there were currently 900 people directed at Mails verification and Revenue Protection within Operations. Mails verification resource levels had been maintained despite falling volumes. This was because mails verification was not directly linked to traffic volumes but was driven by the number of postings. Falling volumes had not significantly affected the number of postings. A higher percentage of checks were being carried out. The level of resource was a balance that took into account the potential to sample more customers against the finite time window available to check mail before Quality of Service was jeopardised, and space constraints within the buildings to handle more mail;
- (d) ARC06/20(f) Delegated Authorities: current devolved authorities within Treasury for placing investment were unlimited up to the extent of liquidity forecasts. Devolved authority was thus limited only by reference to length of maturity. A review of the following value and maturity delegations had been done. No changes were proposed to the borrowing authorities, which must continue to be limited, by liquidity need and maturity. The new limits were introduced from 9 August 2006 and would be further reviewed in conjunction with the general review of delegated authorities;
- (e) ARC06/20(h) Mail Integrity: measures had been set up and were now live, as per the action, apart from quarterly loss

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ACTION
Neil Henderson

estimates where the Compliance Director had some questions over the robustness and risk of potential Postcomm misinterpretation and misuse. The next step would be to distil the detailed KPI's for reporting to the Holdings Board. The Committee agreed to provide input as to what the KPI's would look like. A clear picture of how the distilled KPI's would look would be given at the next Audit & Risk Committee meeting;

- (f) ARC06/20(j) Whistleblowing: since January 2005, there had been thirteen reports received (twelve directly to the Corporate Security Helpdesk and one via the Crime Stoppers organisation) concerning suspected immigration/identity offences and drugs offences. Five of these reports were about immigration/identity and eight were about drugs. These numbers do appear to be on the low side, but there were several reasons for this, with the big reduction in casual staff a significant reason. However, over the last three years, P&OD had introduced a range of enhanced recruitment checks for all staff and this would undoubtedly have weeded out a number of illegals or those with suspect identities and discouraged others from following through with their job applications. For these reasons the number of people in the Business that might prompt a whistleblowing report was probably much reduced. We cannot do a direct before and after comparison because we did not keep separate whistleblowing reports per se prior to Jan 2005; before this date, the reports were embedded within criminal investigation case files. So far as drug abuse is concerned, it was less clear whether the incidence of whistleblowing reflected the true position in the Business. Andrew Wilson would be asked to carry out further benchmarking to determine what levels of whistleblowing could be expected;

ACTION
Jonathan Evans

- (g) ARC06/25(b) & (c) Compliance with HR policies: Jon Allen joined the meeting and provided an assessment of the exposure, in comparison to anticipated levels, from the risk that Royal Mail Group did not comply with its statutory or regulatory obligations and provide tools to support the business in the ongoing assessment, monitoring and management of the risk of non compliance with Employment legislation. He confirmed that a lot of work had been done to ensure compliance in this area and that monitoring was due to be put in place by December 2006. He did consider that the Company was vulnerable on disability in relation to a failure to make reasonable adjustments, however this issue was being addressed. He further reported that there was a risk around the Company's ability to fulfil its obligations in respect of notifying employees of changes to terms of employment as the Gazette had previously been used for this purpose and therefore an alternative method was now sought. Helen Weir said that the actions outlined seemed sensible but asked what KPI's were being reported. Jon Allen said that KPI's were being developed. Helen Weir also asked if Jon could give the Committee any data to illustrate outcomes, such as number of tribunals, cost in £ of tribunal

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decisions, etc – Jon confirmed that he did not have this to hand;

ACTION
Jon Allen

- (h) John Neill said that he found the executive summary confusing and that it lacked a clear plan of action necessary to address the issues, and a line of sight from the issues raised to the actions proposed. He added that proposed actions should be supported by appropriate metrics to confirm that the actions being taken had been effective in addressing the issues. Jon Allen agreed to re draft the report taking into account the views expressed by the Committee.

ARC06/39

SELF ASSESSMENT OF A&R COMMITTEE & TERMS OF REFERENCE
ARC(06)41

The Committee's policy, in line with good standards of corporate governance, was to review its effectiveness each year. As with last year's review, an assessment had been made of the Committee's proceedings against the recommendations of the Smith Review, which formed the basis of the relevant section of the Combined Code;

- (a) overall, the procedures of the Committee were judged to be compliant with the Code requirements;
- (b) the Committee noted and endorsed the conclusions of the paper.

ARC06/40

ACCOUNTING UPDATE
ARC(06)42- 45

- (a) Fines and Compensation update: the Committee noted the proposed amount for regulatory accruals for fines and compensation at the half year assuming that no further facts emerged or progress made in respect of the appeals. The Committee agreed that the provision of £45 million for fines and judicial review was appropriate;
- (b) UK GAAP accounting policies: the Audit and Risk Committee (ARC) had agreed in May to the continued application of UKGAAP in the preparation of the ultimate parent and UK subsidiary accounts. The impact of International Financial Reporting Standards (IFRS) on the relevant accounts had now been reviewed for compatibility with UKGAAP. The Committee noted changes to the Group's UKGAAP accounting policies and estimates to provide alignment with IFRS where permitted, for the purposes of production of the ultimate parent company accounts and the accounts of the UK subsidiaries;
- (c) UKGAAP net assets and profit for the parent & UK subsidiaries were now closely aligned to IFRS and the more onerous IFRS disclosures had been avoided;
- (d) Interim Report: the Audit & Risk Committee noted the proposed format for the half-year accounts for the period

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ending on 24 September 2006. The accounts followed International Financial Reporting Standards (IFRS) as used in preparing the Royal Mail Holdings accounts in the year to 26 March 2006. In addition, the Committee further noted various financial accounting developments and issues relating to the first half of the financial year;

**ACTION
Jonathan Evans**

- (e) the Audit & Risk Committee approved the format and timetable for the Interim Report and the re-scheduling of the ARC to post agreement with Government. Will Rainey observed that if agreement had been reached with Government on funding that the business may wish to report on the POL position at the half-year. He also asked what the fall back position would be if no agreement had been reached. Frank Schinella said that the business was reviewing the manage for cash case and preparing all options. The Committee agreed to meet before the Board on the 5th December;

- (f) noted the accounting treatment for Share in Success payments, redundancy and Romec Services Limited; and

- (g) noted the developments in accounting standards and the likely impact on the Royal Mail financial statements in future years;

- (h) E&Y Audit Report & Fees 2007: Will Rainey introduced a report dated 22 September 2006 providing information regarding the overall audit approach for the year ending 25 March 2007. The Committee noted that E&Y would be taking a risk-based approach in accordance with the E&Y global audit methodology and international standards on auditing (UK and Ireland). This approach would be tailored to each business unit/reporting subsidiary allowing E&Y to adopt the most efficient approach for each business. The methodology, as far as it could, would also be used as the framework to plan and execute the Regulation audit;

**ACTION
E&Y**

- (i) initial 2006-07 cost budgets had been discussed with business unit management and Group Finance and specific areas for target efficiencies agreed. The detail underlying cost budgets had not yet been discussed with Ian Duncan and it was anticipated that this exercise would be completed over the next few weeks and the final agreed audit cost and fee position would be presented to the Audit & Risk Committee in November 2006;

- (j) Alison Duncan confirmed that E&Y would assess how the Company complied with the Licence. John Neill said that the Committee would be unable to rely on E&Y in this respect and that it would look to the Company to provide the necessary assurances;

- (k) John Neil said that he was encouraged by the work undertaken on fraud. He asked E&Y if they had any

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E&Y**

techniques which allowed them to come to a logical conclusion. Will Rainey said that the approach was to talk to team members in the business to obtain an informed view of the softer aspects of the environment. Alison Duncan added that E&Y were introducing more unpredictability into the audit process. John Neill asked for a short paper outlining the approach being taken to tackle fraud;

John Neill also asked if there were ways to help determine the ethical “health” of the Company. Derek Foster confirmed that an ethical audit was included in the IA&RM plan for the year and that IA&RM had benchmarked with Australia Post to help understand ways of approaching such a review;

- (l) Helen Weir said that she had been surprised that the audit fees had been higher than that approved by the Committee and said that any increase in fees should have been referred to the Committee for approval;
- (m) the Committee noted the additional requirement for companies that have a statutory audit for periods commencing on or after 1 April 2005, and specify that the directors report must contain a statement regarding disclosure of information to auditors. Will Rainey agreed to provide the Company with some recent legal advice on this issue. John Neill expressed his concern at the onerous nature of the requirement. The changes impact both executive and non-executive directors. Directors and the Company will need to exercise judgement when assessing the potential impact of this new guidance. In particular the directors will need to consider whether the Company's current processes are sufficient to meet the new requirements and whether sufficient evidence exists to support the explicit statement required in the directors report. Ian Duncan said that the best approach would be to agree a number of steps with the Auditors and agreed to develop a proposal for the next meeting. E&Y were asked to propose the necessary steps to ensure that the requirement was met;

**ACTION
Ian Duncan/
E&Y**

- (n) E&Y had been contacted by the National Audit Office in connection with the audit of the Whole of Government Accounts for the 2005/06 year. Helen Weir said that it would be helpful to have an update on this activity at some point.

**ACTION
E&Y****ARC06/41****DELEGATED AUTHORITIES**

Ian Duncan confirmed that the item on Delegated Authorities would be deferred to a later date.

ARC06/42**INTERNAL AUDIT & RISK MANAGEMENT QUARTERLY
REPORT ARC(06)46**

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

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- (a) twenty reports had been issued in the period and 13 assurance risk ratings had been applied, of these only one was rated as satisfactory, seven were rated as low risk, and three were not satisfactory. Of the two follow up reviews one was rated as partially implemented and one was rated as fully implemented;
- (b) overall, the Group's risk profile was showing an increasing risk in certain areas. This reflected the scale of change required under the transformation programme, the increasing competition, and increased uncertainty following the Government's deferral of a decision regarding share scheme proposals that underpin the financial restructuring package;
- (c) the Audit & Risk Committee noted the Internal Audit & Risk Management report dated September 2006, and requested that management be asked to attend the next meeting of the Committee to address concerns on the deployment of manpower tools, Operational controls, compliance with regulation & competition law and USO compliance.

ACTION
Derek Foster

ARC06/43

POL FINANCIAL SERVICES COMPLIANCE REPORT
ARC(06)47

The Committee noted the POL Financial Services Compliance report dated September 2006.

- (a) previous reports had covered only financial services and anti-money laundering regulation, but to ensure that the Committee was given a fuller picture of the regulatory risks, we will now also report on risks and issues arising from Ofcom's regulation of the Post Office® HomePhone service;
- (b) Ofcom had conducted an enquiry into whether or not they should undertake a formal investigation into allegations of mis-selling of the HomePhone service in Post Office branches. This followed media coverage of mis-selling complaints, a complaint to Ofcom from BT and a sharp increase in the number of consumer complaints received direct by Ofcom. Many complainants alleged that they only agreed to have information concerning the service sent to them, but that they had then been notified that their phone service was to be transferred; or they said that they had had no contact at all with the Post Office before receiving such a notification. Our own monitoring had shown a significant increase in cancellations alleging mis-selling in May, June and July;
- (c) Helen Weir referred to the compliance, monitoring and enforcement activity and in particular the audit results for branch anti money laundering and financial services compliance. The Committee felt that targets of less than 100% could send the wrong message. John Neill said that the impact on Regulation and on brand values could be

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ACTION
Keith Woollard

significant, however the Committee noted that for areas of concern the consequence was that products were not sold. Keith Woollard was asked to provide some benchmarking data on compliance targets;

ACTION
Ian Duncan

- (d) Helen Weir noted the position on sales compliance but was concerned that the business appeared to be moving to a position of 'arranger' and questioned whether the business had obtained a mandate for this. Ian Duncan agreed to follow this up with Allan Cook and clarify the strategy.

ARC06/44

**DIRECTOR EXPENSES AND RELATED PARTY
TRANSACTIONS** **ARC(06)48**

The Committee noted schedules providing a summary of the executive directors expenses incurred during 2005-06 and the current year to date. In line with the Committee's request, the schedules provided details of individual expenses of £500 or higher.

ARC06/45

AUDIT & RISK COMMITTEE DATES 2007 **ARC(06)49**

The Committee noted a schedule of Committee meeting dates for 2007.

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ANY OTHER BUSINESS

ACTION
Jonathan Evans

- (a) Helen Weir asked for an update on how effective the new Postcomm information policy had been. Mike Prince would be asked to report back at the next meeting of the Committee.

- (b) Helen Weir thanked Alison Duncan GRO
GRO

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DATE OF NEXT MEETING

The Committee noted that the date of the next meeting of the Committee was Tuesday 1st November 2006.