

**Royal Mail - Strictly Confidential
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RMH(04)84

ARC 04/1 TO ARC 04/13

ROYAL MAIL HOLDINGS plc

(Company no. 4074919)

AUDIT AND RISK COMMITTEE

Minutes of the meeting held at 148 Old Street on 18 March 2004

Members of the Committee Present:

Bob Wigley	Non Executive Director, Chair of the Committee
John Neill	Non Executive Director
Rosemary Thorne	Non Executive Director

In attendance:

Elmar Toime	Executive Deputy Chairman
Adam Crozier	Chief Executive, Royal Mail Holdings plc
Marisa Cassoni	Chief Financial Officer
Jonathan Evans	Company Secretary
Derek Foster	Internal Audit and Risk Management Director
Frank Schinella	Director, Financial Management & Control
David Lindsell	Ernst &Young
Rachel Harper	Ernst &Young
Alison Duncan	Ernst &Young
Andrew Poole	Notes

ARC04/01

CHAIR OF THE COMMITTEE

As approved by the Holdings Board on the 9 March 2004, Bob Wigley had been appointed as Chair of the Committee, taking over from Rosemary Thorne, whose tenure as non-executive director of the Company was scheduled to end on 25 March 2004. Bob Wigley thanked Rosemary Thorne for her hard work as Chair of the Audit & Risk Committee over several years, and expressed the wish that the Committee would continue to build on the high standards she had set.

ARC04/02

MINUTES OF PREVIOUS MEETING

The minutes of the meeting of the 11 November 2003 were considered and approved subject to the following amendments being recorded;

- (a) ARC03/37: Bob Wigley noted that some of the responses to the Committee's questionnaire on H&S issues had not been completed and in other cases, the responses indicated non-compliance with regulation. The non executive members of the Committee observed that non compliance with Audit Committee questionnaires on a timely and comprehensive basis was unacceptable and non-

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compliance with H&S regulation could not be tolerated. Bob Wigley asked if there were actions the committee could take to support management in effecting the required culture change. Elmar Toime said he had built measuring compliance with H&S regulation into his direct report review processes and he would need the completion of one appraisal cycle to see whether this effected the required changes. The Committee asked that they be kept in touch with progress. Adam Crozier said he and Elmar Toime would address the issue of non-compliance with Audit Committee questionnaires so that this was not repeated.

- (b) ARC03/41: In relation to the issue of when the current pay round increases would be consolidated into basic pay based on achievement of agreed productivity targets, John Neill said that he was concerned that leaving the judgment of the achievement of targets to local management left the process open to more risk. Bob Wigley asked how the Committee could be sure that pay increases would not be consolidated if targets were not genuinely achieved and also asked how we could be sure efficiency would not fall to below target levels again once the pay increase had been consolidated. Management assured the Committee that this could not happen. It was explained that to make the targets, walks had to be reorganised, and at this point heads would be gone or on the way out, thus ensuring targeted savings were permanently achieved.

ARC04/03**CORPORATE RISK MANAGEMENT COMMITTEE**

The minutes of a meeting of the Corporate Risk Management Committee held on 20 February 2004 were noted. The Committee further noted in response to questions raised by the Chairman:

- (a) CRMC action point 7 – the Committee received a note from Roger Durrant, Group Treasury Director setting out the comparative data relating to insurance premium spend, limits of cover and deductible levels. Bob Wigley asked for an explanation of the minute which noted that “RM retains a fairly large risk appetite in comparison to the other companies” Marisa Cassoni explained that whilst the conclusion drawn in the minutes was true it should be seen in the light of the Company having a captive Insurance company, which took the risk for losses of between £1million and £5 million. The Corporate Risk Management Committee had responsibility for reviewing the Insurance strategy annually as part of its remit. The Committee was satisfied that the trade off between premium charged and deductible level was optimal and taking into account the existence of the captive Insurance Company, in line with benchmark Companies;
- (b) Bob Wigley asked whether the Joint Venture with the Bank of Ireland would have an FSA Compliance Officer and if so who. The Secretary tabled a note setting out the Compliance

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Jonathan Evans

arrangements between Post Office Limited and the Bank of Ireland in relation to the provision of Financial Services. Bob Wigley asked that the Compliance Officer present to a future meeting of the Committee.

ARC04/04**STATUS REPORT**

The status of actions from the meeting held on 11 November 2003 was noted, in particular:

- (a) ARC03/31(d): Bob Wigley had requested confirmation from David Burden that he was satisfied with the IT security measures being undertaken with Prism, RM's outsourcing alliance. In response to a request for an update David Burden confirmed in a written reply that "The Company had a strong internal IT security group which sets policy and monitors IT security activities by all our suppliers and our own staff.

The PRISM (CSC) contract includes specific clauses stipulating that CSC will follow Royal Mail IT security policies and standards.

For certain major applications (and the infrastructure on which they run) we have achieved BS7799 certification. This covers all the Finance and Procurement systems.

We had to press CSC to perform against the contract but we are now satisfied with their response. We are in the process of introducing a higher level of security (involving smartcard authentication and full file encryption) to cover the senior executives and their secretaries. This includes vetting of the immediate technology support staff and those people with administrator privileges over critical file servers."

- (b) The DTI had raised the issue of the effectiveness of the continuity plans (see page 3 of the CRMC minutes) and a request from Bob Wigley to receive a short presentation at a future Committee meeting on these Plans and noting that TSI and Finance were noted on page 20 of the March 2004 Internal Audit & Risk Management report to be least compliant. The Chairman requested that a presentation to the Committee addressed these two areas in particular;
- (c) ARC03/37(d) – a paper had been circulated providing an update on the progress to communicate the key control activities within the business in an attempt to mitigate the majority of major risks. The Committee noted the process and structure with the idea that each Unit/function had a clear list of control activities that had impact at unit and corporate level. The effect of this revised structure was to ensure that the business addressed the key risks, and focused control at the local level which could transparently impact the management of high level risks and the achievement of objectives;
- (d) ARC03/40(g) Bob Wigley observed that contrary to the

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undertaking contained in the previous minutes that "action is being taken to fill the vacancies" in Internal Audit, the number of people employed by the Internal Audit function had reduced by 30% as part of the Company restructure. Bob Wigley observed that if RM could not prudently have a situation where Internal Audit was below the headcount contained in its own Internal Audit Plan, Internal Audit Plans were not being produced on time relative to that Plan and significant numbers of the reports contained limited or no assurance outcomes. Internal Audits latest plan noted that the department had reviewed ways of working to ensure that Royal Mail issues continued to be addressed. The department had a mix of new, externally recruited staff and internal staff and some departmental cost had been made variable by budgeting for co-sourced activity. Adam Crozier confirmed that the Company recognised the need to upgrade and recruit good quality staff into this area and to have an adequate level of resource in line with the Internal Audit Plan. John Neill said the Company should recruit full time staff as this would provide an excellent source of future finance people and that he preferred to see the Company at the top end of any benchmarking exercise, as it was important that the Company had adequate in-house resource. Bob Wigley said that ultimately the number of people employed in the audit function should be increased. Management agreed to take action prior to the next meeting and revert with details.

ARC04/05

**POSSIBLE CHANGES TO AUDIT COMMITTEE
PROCEDURES**

Bob Wigley introduced a note that he had circulated to the Committee on a number of issues relating to the operation of the Committee, as he was very keen to continue the high standards in the way in which the Committee had operated in the past and in order to comply with best practice. Bob Wigley believed that if the Audit Committee process was used properly it should be helpful to and support Management in achieving culture change within the organisation by reinforcing accountability and sanctions for non-compliance. In that regard, having received the paper for this meeting and having met with the Head of Internal Audit and John Neill, Bob Wigley had concluded that it would be appropriate in future to review in detail Management's proposed actions to deal with Internal audit reports which concluded with limited or no assurance. Other proposals included:

- (a) arrangements for the self-assessment of the effectiveness of the Committee annually. A template provided by the Audit Committee Institute would be utilised for this purpose and the Secretary would work with the Chairman in order to get these forms completed prior to the next full meeting. The Chairman would then organise a discussion on the output and consider any changes suggested as necessary by the assessment;

ACTION
Bob Wigley/
Jonathan Evans

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Jonathan Evans**

- (b) a review of the Committee's terms of reference would be undertaken against the specimen provided by the Audit Committee Institute and to identify any necessary amendments;
- (c) noted that papers circulated to the Committee would continue to be reviewed by the Finance Director and Company Secretary prior to circulation. In addition the papers would be notated as having been reviewed by the Finance Director and Company Secretary. It was understood that internal audit papers in particular would not be "approved" by Finance Director and Company Secretary, to ensure any perception of compromise of independence was avoided;
- (d) a review of the agenda items of the Committee had been undertaken against the Audit Committee Institute guidelines and items had been added to future meetings covering inter alia self assessment, whistleblowing, policy on non-audit services, financial personnel succession planning, directors expenses and related party transactions, internal audit performance and legal/compliance developments;
- (e) the Committee would meet privately with the External Auditors at the beginning of the Audit Committee meeting. At the meeting the auditors would be asked, inter alia, the 'Warren Buffet' questions;
- (f) a contract be established setting out the respective responsibilities of and relationship between the internal and external auditors;
- (g) implementation of personal compliance reports from the CEO and CFO together with upward reports from line personnel;
- (h) Senior Management demonstrate to the Committee that when Business Unit managers prepare business plans, there is adequate identification and discussion of business risks and that these are aggregated and tracked during the Risk Management review process;
- (i) where the Audit department had given a 'limited' or 'no assurance' rating following the audit then Management would be required to attend and present their proposed action plan to the Committee;

**ACTION
Derek Foster****ACTION
Derek Foster**

- (j) Adam Crozier suggested that it would be helpful to incorporate the views of the Management into future audit reports to the Committee whilst recognising the imperative of maintaining audit independence. Derek Foster confirmed that management comments and views were reflected as part of the audit sign off process, and this would continue.

ARC04/06**FORWARD PLANNER 2004**The Committee noted a revised forward planner of business

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for the rest of the year.

ARC04/07

YEAR END 2003/4 UPDATE

- (a) Statutory Audit/Close process- Marisa Cassoni introduce a paper on the year end process and proposed timetable of events leading to the publication of the Annual Report and Accounts. The Audit Committee had requested a minimum of one to two days' clearance between the Audit Committee meeting to review the accounts together with the auditor's findings and the final date on which the accounts were approved by the Board Accounts Sub Committee. To meet this request the timetable had been reviewed. Bob Wigley said that it was important to have sufficient time between the Audit Committee meeting and publication of the accounts such that if the Audit Committee wished to change anything presented to it, there was time for this to be practically possible without changing the proposed publication timetable. The Committee noted;

**ACTION
Frank Schinella**

- a proposed year-end close timetable leading to publication on or around the 26/27 May 2004. The exact publication date for this years accounts would be confirmed;
 - the potential to accelerate the Audit Committee meeting currently scheduled for 24 May 2004;
 - the potential to reduce the year end close by some two weeks next year;
- (b) Statutory Audit Hours – the Committee had requested further details of the hours that Ernst & Young had budgeted for this year's statutory audit. The total hours were budgeted at 7,328. The agreed fees of £864,000 provided for a recovery rate of 70% after allowing for estimated cost savings of £100,000. John Neill said that it was helpful to have details of the hours as the purpose was to improve quality and to reduce costs. Rosemary Thorne said that the information would allow for the possibility of transferring work from the External auditors to the Internal Audit function;
- (c) Regulatory Accounts Year-End process – the Committee noted a paper seeking approval for the approval and publication of the Regulatory Financial Statements. It was noted that discussion had taken place with Postcomm to simplify the Financial Statements. The Committee agreed the proposed timetable and agreed that the accounts could be authorised by the directors of Royal Mail Group plc;
- (d) Regulatory Accounts Audit Fees - the Committee noted the proposed fee and analysis of hours and that they had been agreed with Management and approved the proposed audit fee for this work of £482,000;

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- (e) Provision of non-audit services by Ernst & Young – the Committee approved a proposal for a policy and approval process for the provision of non-audit services by the external Auditor. This was designed to ensure that best practice is followed and that the independence of Ernst & Young with respect to their audit services and sign off was preserved;
- (f) International Financial Reporting Standards- the Committee noted a paper providing an update on the progress made towards the adoption of International Financial Reporting Standards (IFRS) as the basis for producing and reporting the Royal Mail Holdings group statutory and management accounts;
- (g) E&Y Early Warning Report – David Lindsell introduced the report dated 18 March 2004. In particular he emphasised the importance of providing key messages on business performance, and for the need to clearly state these in the Report and Accounts. It would be critical that misleading statements were avoided. The Auditors expressed a wish to see more disclosure on LTIP along with evidence to support Provisions. A good understanding between Management and the Auditors had been developed on these issues. Rosemary Thorne sought and received assurance from Management that the Provisions at year end would be fully supported by Management.

ARC04/08

INTERNAL AUDIT AND RISK MANAGEMENT PLAN

Derek Foster introduced the Internal Audit and Risk Management Plan for 2004-05. A risk-based approach had been adopted in identifying the areas of coverage. Key inputs to the planning process included the Corporate Risk Scorecard, Risk & Control Self assessment returns, previous internal audit reviews and input from senior management. The Committee discussed the plan in some detail and approved the plan. In particular:

- (a) John Neil asked if operational management had been asked for their input on where they thought the risks might be. Derek Foster confirmed that the process followed did allow for input from operational managers;
- (b) Bob Wigley asked if Derek Foster felt sufficient provision had been made for the training of audit staff next year. He asked Derek Foster to produce a matrix showing the recommended level of training for each grade of audit staff and commentary on the degree to which current staff meet the recommended level of training. Derek Foster confirmed that a budget had been developed and undertook to provide these details for the next Audit Committee meeting;
- (c) Bob Wigley asked if in light of the findings of the 500 Internal Audit Report, Derek Foster was content that sufficient days

Action
Derek Foster

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were included in the Plan to adequately address risks in this area. Derek Foster confirmed that he was content with the 65 days allowed in the plan for audit work on Single Daily Delivery, noting that some contingency time could be made available if necessary.

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INTERNAL AUDIT AND RISK MANAGEMENT QUARTERLY REPORT

Derek Foster introduced the Internal Audit and Risk Management report for the period November 2003 to February 2004. The Committee noted the contents of the report and further noted:

- (a) the one page overview of key indicators of the state of Royal Mail control environment. Derek Foster explained the schedule and pointed out that the financial indicators showed financial controls appeared to be to a large degree in place or improving, but that the indicators for customer experience and successful business transformation remained at unacceptable levels.
- (b) that the gap between the reported workflows from operations and actual income received provided an indication of the effectiveness of the Revenue Management process. Current estimates were that a gap of some £90 million existed. Whilst this was not necessarily lost revenue it did highlight the potential inconsistency of the data. Derek Foster noted that the gap had reduced from some £400m here years ago. Elmar Toime noted that the current gap noted was consistent with or better than his experience of postal operations generally. Work was continuing to improve the Revenue Management process. Derek Foster noted that the audit & risk management department was working closely with the business on risk solution activity in the area of revenue management;
- (c) that the audit review of Single Daily Delivery had resulted in a 'no assurance' rating. The cumulative percentage of 'no assurance' in the year is now 12%. Of the 196 recommendations due for completion in the year to date, 25 were overdue for completion;
- (d) due to the importance and high risk of the SDD programme to the Renewal Plan (highlighted in the internal audit report at the last Audit Committee meeting in November 2003), Internal Audit had carried out a review of the implementation management of SDD, including deployment and processes for benefit target setting, equipment costs, voluntary redundancy, employee pay awards and unit post implementation reviews;
- (e) the review of findings had highlighted a number of significant potential weaknesses including:

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- robustness of targets
- consistency of communication
- errors in submission forms
- consolidation of payments for achievement of target in inadmissible weeks
- potential for manipulation of training to achieve targets
- inconsistent treatment / use of staff on VR
- inconsistent payment of increment to staff serving notice
- pressure on VR business plan forecast
- lack of implementation of budget control process for equipment

Adam Crozier reported on a whole series of actions he had taken since this issue had come to his attention. He had reviewed with senior line management why exceptions had been declared and how/why data had been incorrectly recorded. He confirmed that further checks were being made 'on the ground' to ensure that the necessary changes had been implemented. John Neill said that this was a serious issue for the business and that the issue needed to be addressed by the Committee in detail. This matter would be discussed further at the first special meeting of the Committee to be convened to examine audits with 'limited' or 'no assurance' completed in the preceding review period;

- (f) Bob Wigley noted that agencies providing staff to RM had clearly not been complying with RM vetting policies. This was a serious issue since it could involve a breach of RM licence. Bob Wigley requested details of what contractors were requested to do on vetting in RM contracts with them, whether Royal Mail checks that they comply with the contract and what financial or other penalty was imposed if they did not comply. A note from David Burden on Contractor vetting (attached) confirmed that the contracts with Manpower and Reed included, as Schedule 4, a requirement for security and vetting. This stipulated:-

- a fully documented career or education history over the past 2 years
- a personal declaration concerning criminal convictions
- a personal declaration that the information supplied is accurate
- a minimum of two referees, with one preferably an employment referee or someone of standing within the community
- a National Insurance number
- proof of home address

In addition, agency casual employees were to be screened through the Corporate Security Personal Identification Bureau for any previous debarment notice and through the Inland Revenue for N.I. checks.

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The terms and conditions of this vetting process had recently changed to take account of new legislation, which came into force from 1st April 2004.

Management could not comment at this stage on any specific penalties, which may be available to us, should the labour supplier fail in these areas. The contracts are being looked at in more detail.

It was worth commenting that it was likely that one of the reasons why we had failed to take fully vetted people was because of the pressure we put the supplier under to supply labour at short notice, with the promise that vetting will be carried out subsequently.

The Chairman had personally reviewed the contracts with both Manpower and Reed and noted that they contained warranties given by the Contractors which they could be in breach of. He suggested that senior management take up the issue with senior management at each contractor and asked for an update at the special audit committee meeting to be held on the 6 April 2004.

ARC04/10**SECURITY REPORT**

The Security report for March 2004 was received which highlighted any emerging security risks and the actions taken to mitigate them and in particular the following was noted:

- (a) probity checks performed by the P&OS payroll centre in Sheffield identified a number of advance payments that could not be traced and did not have supporting documentation. Further investigation had highlighted that 11 fraudulent payments had been made, with a total value of £249,000. A number of improvements had been implemented intended to eliminate the risk of similar occurrence;
- (b) Adam Crozier reported that the Company was reviewing the way in which the Company undertook prosecutions and in particular potentially reducing the staff in the Corporate Security department by increasing Police involvement. John Neill said that it was good to review these processes but that it was important to have our own people carrying out this work, as the Police would only investigate and prosecute in extreme cases. Jonathan Evans reported that three constabularies had already been approached and had indicated that they would prioritise out work for Royal Mail. Bob Wigley asked that the Committee be informed if there was any intention to reduce headcount in Security.

ARC04/11**WHISTLEBLOWING PROCEDURES**

At the Audit Committee meeting on the 11 November 2003 the Chairman had asked if the Company had adequate

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whistle blowing procedures in place. The Committee:

- (a) noted the current arrangements contained within the Code of Business Standards document. Bob Wigley reported that he had requested a log of calls to the helpline from the Head of Corporate Security and also said that a concern had been expressed to him that the organisation did not appear to have been particularly effective at protecting the anonymity of the employees who had come forward with information. He observed that this was clearly critical to the efficiency of the system and asked Management to consider how this could be improved;
- (b) agreed that the policy should include wording on raising concerns about possible improprieties in matters of financial reporting or other matters. The inclusion of a policy statement on illegal substances would also be reviewed;
- (c) endorsed the need to refresh the communication of the procedure generally.

ACTION
Jonathan Evans

ARC04/12

ANY OTHER BUSINESS

Bob Wigley said that he would like the minutes in to be circulated promptly after the meeting and for them to reflect the dialogue of the meeting. The Chairman thanked Derek Foster for the quality of the Audit papers.

ARC04/13

DATE OF NEXT MEETING

The Committee noted that the date of the next scheduled meeting of the Committee was Monday 24 May 2004 and that a special meeting would be convened in advance of the next full board meeting to receive and review Management's proposals to deal with the recommendations contained in the Internal Audit Report on Single Daily Delivery implementation, Management processes (Feb 2004) The assessment of Policies and Processes to support PAYE payments for Management Board and Holdings Board directors (Feb 2004), the follow up review of People and Organisational Development, review Vital Few Controls, receive Managements proposals to increase Internal Audit resource and receive an update on discussions with Manpower and Reed about their performance on vetting agency staff .