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To: Baroness Neville-Rolfe
From: Justin Manson (GRO), Richard Callard (GRO)
Date: 11th December 2015



Subject: Post Office Limited update

Purpose: To update on issues related to accounting restatement and to IT transformation programme.

Timing: Routine.

Recommendation: That you note the issues.

A. Background

1. We set out below our views on the proposed accounting restatement and on the delays in implementation of the IT transformation at POL. These views are based on discussions in the last few days with the Chairman, the CEO, the CFO and the original Financial Controller. They represent our best current understanding of the company's position as well as a cautious view of what the company may face in the next twelve months.

B. Context

2. In the first half of 2015, the CEO of POL, working with the Board, moved to strengthen the executive team to ensure that the business, which is still going through its full operational separation from Royal Mail, has the right processes and controls. Three appointments were made to the executive: a CFO, a General Counsel and a Transformation Director. As the business is transformed, issues are being identified and resolved: this process is expected to continue for some time, at least through fiscal year 2016/17.

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C. Understatement of provision for sub-postmaster exit costs

What is the issue?

3. The POL Finance team identified that the provision for making future payments of compensation to sub-postmasters under the Network Transformation (NT) programme had been understated. As at 29th March, 2015 (POL's fiscal year end) the understatement is estimated at c£86mm. The data sources are complex and the work to ensure that the number is correct, and fully audited, is nearing completion. The final figure may vary but the CFO is increasingly confident that it is substantially correct. The work to date suggests that there has been no cash impact, no funding impact and that the cost of the Network Transformation (NT) programme remains as planned. There has been no suggestion of improper payments, missing payments to sub-postmasters, or any loss to the business.

What is the restatement and what is the impact on BIS and POL accounts?

4. POL's 2014/5 accounts were signed and published in the summer and will now have to be restated in the 2015/16 accounts (and interims).
5. HMG, through the Secretary of State for BIS, owns 100% of the shares in the Postal Services Holding Company, the company that owns 100% of POL. PoSH's 2014/5 accounts will not need to be restated because they have not yet been published but might need to be delayed beyond the last filing date of 23rd December.
6. POL's net assets appear in the BIS Departmental Group accounts (which have been published for 2014/15), because PoSH is consolidated by BIS. POL's prior period error of around £86m is not material to the BIS Departmental Group position and so BIS's 2014/15 position would not need to be restated. The 2015/16 accounts will instead recognise a fair value movement to reflect the understatement. A narrative explanation for that movement would not need to be disclosed as it is below the disclosure threshold.

When will the provision be finalised?

7. The CFO expects to finalise the number in the next few days and is attending this Friday's board meeting of POL's parent company (Postal Services Holding Company Ltd (PoSH)) to provide an update. In addition to the calculation and

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auditing of the number, POL is looking to demonstrate and state in its interim results that there has been no impact on payments to sub-postmasters or on the overall cost of the programme.

8. The accounting teams are also focussed on the six month period ending 30th September, 2015 which will be reported in the interim statements in the next couple of weeks. Applications to the NT programme, by which sub-postmasters sign up to leave the network, or amend their contracts, will end on 31st December, 2015 (possibly with a short grace period thereafter for any late applicants). After that date, payments to exiting (or modernising) sub-postmasters will continue to be made as they actually leave the network or refresh their branches. The provision will reach its peak and the final amounts to be paid over the remainder of the programme will then become increasingly certain.

How did the need for restatement of POL accounts arise?

9. The need for restatement of the provisioning of payments to sub-postmasters exiting the transformation programme arose for two reasons. Some data from the Network Transformation programme did not flow through to the spreadsheets used as the basis for the financial provisioning. Secondly, some of the data that was included in the spreadsheets was not being picked up in the calculations used for the financial reports. Financial reports were therefore based on incomplete data although the underlying documentation and payments appears to be sound. POL has sought to confirm the value of the provision by reviewing payments and agreements either side of the period end and these processes are being tested by EY. To date, no missing payments or overpayments have been identified. Provisions were under-recorded from the perspective of the accounts but no sub-postmasters have suffered financial losses.

What is being done to address the accounting and internal control issues?

10. The weaknesses of the internal accounting controls which gave rise to the under-provisioning, were identified by the relatively new CFO and are being addressed. He has replaced the Financial Controller, and has created Finance Director functions for each of the four business lines. A programme of work is underway to agree accountabilities. Previously these lines were much less clear. The internal audit function is being rebuilt from first principles by an external recruit reporting to the new General Counsel Jane MacLeod. The redesign of

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the internal reporting controls will be substantially finished in 2015/16 but their refinement, implementation and improvement will continue through 2016/17.

11. The external audit function continues to be performed by EY and a new audit partner has been assigned. The fee for EY will be reviewed once the work to correct the sub-postmaster provisioning is completed.
12. POL is putting in place significant changes to the accounting and controls environment. POL should also benefit from having a new Chairman, a new CFO, a new external audit partner, new lines of internal accounting responsibility, and a new Chair of the Audit Committee. As the improved governance and controls take effect over a full new audit cycle, and as the company continues to actively manage significant change in its business environment and its operating model, we expect that issues such as the understated provision will be addressed fully and openly. By the same token, we expect that any residual accounting and control issues, if there are any, will become apparent over the next audit cycle. ShEx will have visibility of these issues through Richard Callard's membership of the board and future membership of the audit committee, and will encourage POL to continue to identify and address these issues in an early and open manner.

D. IT Transformation

Why the delay and cost overrun of implementation of the IT transformation plan?

13. POL's IT network suffers from significant underinvestment. The Horizon front office system has been in place for over a decade, POL resorts to having to recycle kit from old post offices to find replacements, and its back office systems suffer operational issues most days. The £280m IT transformation programme aims to address these issues and POL has been running a series of IT procurements over the last two years.
14. POL had originally wanted to use its existing front office software provider Fujitsu, which would have reduced the operational risk (and cost) of the replacement software significantly. Despite being pressed by POL, Fujitsu refused to participate in the public procurement process. POL therefore had to use a different supplier, which has involved added complexity and cost. The current IT transformation plan involves four suppliers to cover front office software,

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hardware, network, and back office, plus a fifth supplier co-ordinating their integration. This is a challenging task, particularly in rolling out the front office software and hardware in all 11,600 post offices whilst ensuring that all financial ledgers are reconciled during the changeover.

15. The new Director of Transformation (David Hussey), who was appointed six months ago, has recently conducted a detailed review of POL's wider transformation programme which encompasses IT, the Post Office network, separation from Royal Mail, and other projects such as cost reduction plans. He has found that there is now likely to be a delay of eleven months and an additional cost estimated, on a preliminary basis and if unmitigated, at c£60m. The CFO does not expect to seek additional funds in the current spending period (through to 2018). Detailed funding discussions for post-2018 are scheduled to begin next year.

An alternative solution to the current IT transformation plan?

16. In an effort to mitigate the time and cost challenges, POL has confidentially re-engaged with Fujitsu, who with new management seem more inclined to consider supporting POL. Fujitsu's involvement would make the upgrade of the software much simpler from the perspectives of the front office and upgrades to the network and hardware. However, simply re-appointing Fujitsu presents challenges, primarily from a procurement law perspective. POL is working through these issues and will update the Board on 17th December.

E. Next steps

17. ShEx will have weekly calls with the CFO and ad hoc calls with the Chairman and CEO as necessary. ShEx will continue attend board meetings and audit committee meetings as a member.
18. We will also hold discussions with the Chair, and incoming Chair of the Remuneration Committee, Ken McCall, about any further actions that need to be taken by the Board and/or the shareholder.
19. ShEx will continue to keep the Minister updated.

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Copied to: Minister's office; Mark Russell, ShEx

Advice received from:

Finance	SpAds	Press	Legal	Analysts
N/A	N/A	N/A	N/A	N/A
Devolution Issues			Post Office is not a devolved matter.	
Equality Analysis			N/A	