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ARC 04/32 TO ARC 04/43

ROYAL MAIL HOLDINGS plc

(Company no. 4074919)

AUDIT AND RISK COMMITTEE

Minutes of the meeting held at 148 Old Street on 7 September 2004

Members of the Committee Present:

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

In attendance:

Elmar Toime	Executive Deputy Chairman
Adam Crozier	Chief Executive
Marisa Cassoni	Group Finance Director
Jonathan Evans	Company Secretary from item ARC04/35(i)
Derek Foster	Internal Audit and Risk Management Director
Frank Schinella	Director, Financial Management & Control, for ARC 04/25
Martin Gafsen	Group Investment Director
David Lindsell	Ernst &Young
Earl Sibley	Ernst &Young
Graham Halliday	Director of Banking & Financial Services for ARC 04/39
Keith Woollard	Head of Compliance for ARC 04/39
Andrew Poole	Notes

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MINUTES OF THE PREVIOUS MEETING

The Minutes of the meetings of the 24 May 2004 and 9 July 2004 were considered and approved as an accurate record of the meetings. The minutes of the Corporate Risk Management Committee meetings held on 13 May and 17 August 2004 were noted. In order to enable the Audit and Risk Committee to stay informed as to how the CSR Committee is fulfilling its responsibilities to oversee compliance with Health and Safety and other associated legislation minutes of the CSR Governance Committee dated 12 May 2004 and 5 August 2004 were tabled at the Committee. The Committee noted that RMG's mail safety policy had been approved by the Management Board and was being prepared for launch. The Committee also noted the proposed oversight role to be undertaken by Internal Audit in reviewing HS&E functions.

- (a) Adam Crozier referred to the minutes of the CSR Governance Committee dated 5 August and in particular paragraph 14.3. He reported that two recent failures of the safety concurrence process, coupled with a lack of consultation, had been of concern. A note was being issued

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to all operational managers reinforcing compliance with the process.

ACTION
Derek Foster

(b) It had been agreed that any overdue Internal Audit recommendations would be reviewed at the Executive Board with the intention of reverting to the Audit & Risk Committee with proposals to catch up with implementation. This action was currently outstanding and would be addressed at the next meeting.

(c) Bob Wigley referred to the CRMC minutes of the 17 August where it was noted a risk on the CRS 'non-compliance with FSA/ anti money laundering regulations – fines and loss of banking customers' had been removed from the Corporate Risk Scorecard. Bob Wigley asked who had to authorise this and who ultimately approves the Corporate Risk Scorecard. This was in light of the control environment being put in place and also Management's view that the impact of any non-compliance would not exceed £3 million – the highest level of penalty previously levied by the FSA. Marisa Cassoni confirmed that an appropriate risk assessment process was in place to evaluate risks for inclusion in the Scorecard, ~~however the~~ The Committee were concerned- stressed that the reputational risk associated with any such breach should also be included in the risk assessment process. ~~The Risk-Assessment process would be reviewed and a presentation-given- The updated summary of Corporate risks and rationale will be presented~~ to a future Holdings Board meeting.

ACTION
Derek Foster

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STATUS REPORT

The Audit & Risk Committee noted the status of actions from the meeting held on the 9 July 2004.

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AUDIT & RISK COMMITTEE -TERMS OF REFERENCE AND SELF ASSESSMENT

Committee members had recently completed a questionnaire, in a format provided by KPMG' Audit Committee Institute, giving their views on the effectiveness of the Committee against a range of criteria. These criteria were the recommendations of the Smith review of Audit Committees, which had subsequently been adopted within the Combined Code on Corporate governance as good practice. The Committee noted that the procedures of the Committee (when taken together with changes in procedures already agreed) were broadly compliant with Code requirements except in the following respects:-

- (a) a more rigorous and systematic approach to the review of Internal audit will be implemented;
- (b) terms of reference for the Committee as approved by the Board in February 2003 to be amended in response to item 5.19 – the Committee will now agree the audit fee;

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- (c) further NED being recruited to have significant, recent and relevant financial experience;
- (d) a report on the Committee's work to be included in the next Annual Report and Accounts;
- (e) Committee remuneration to be reviewed by the Remuneration Committee in the light of the increased workload;
- (f) Induction programs for the NED's to be tailor made to suit their experience;
- (g) Committee members to report to the Committee once a year on the training activity they have undertaken to maintain their currency;
- (h) whistleblowing procedures to be relaunched;
- (i) a more informed review of external auditor independence in future years;
- (j) the Company's policy for the employment of former employees of the external auditor and the provision of non-audit services would be formally documented.
- (k) future Report & Accounts would show how RMG's policies ensured external auditor independence.

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ACCOUNTING AND AUDIT

- (a) Chairman's Letter: The Committee had received a copy of a letter dated 23 July from Ernst & Young to the Chairman setting out the report to Management for 2003-04. The letter drew attention to a number of matters, which had been identified during the performance of the audit work and previously reported to the Audit & Risk Committee as part of the normal year-end process. The Committee noted:
- (b) a number of points had been raised with Management across all areas however overall nothing had come to the auditors' attention that brought into question the ability to issue an unqualified audit opinion, and many points raised were considered to be of a housekeeping nature;
- (c) previously the letter had been submitted to the shareholder, but that the relationship had changed and this was now considered to be a matter solely for Management;
- (d) there had been a number of low-level instances of non-compliance in minor areas, for example, bank reconciliations not correctly performed, which had been signed off as reviewed. John Neill said that if managers signed off work as complete then they should be accountable for the accuracy of

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ACTION
Derek Foster

the information provided. Derek Foster would review this area of non-compliance. actions taken to address these items and confirm if the issues had been resolved.

- (e) Statutory Audit Hours/Fees 2003-04: the final audit hours and net fees for 2003-04 together with the 64% recovery rate and highlighted variances to budget were noted. The Audit fees for 2004-05 would be agreed with E&Y and presented to the November Audit Committee for approval;
- (f) 2004-05 Interim Timetable: The Committee noted the proposed timetable for the production of the Interim Report for the 2004-05 half year. The Committee agreed the form of the Ernst & Young Statutory and Regulatory Engagement Letters and authorised Marisa Cassoni to finalise and sign the letters;
- (g) Accounting Updates for half Year: The Committee noted the update on provisions, restructuring creditors and other significant one-off accruals with particular focus on the proposed £40 million increase in redundancy provision and potential adjustment to the 'bags accrual';
- (h) 2004-05 Interim Audit Plan: David Lindsell introduced a report setting out the Audit cycle and Half Year review approach for 2004-05. The Committee noted that the intention would be to integrate the statutory and regulatory audits to the maximum extent possible having regard to the different bases of accounting involved;
- (h) IFRS transitional Balance Sheet: The Committee noted the third paper presented to it on IFRS over the past 9 months and confirmed the status of Royal Mail's IFRS conversion work, reviewing a draft transitional Balance Sheet and Profit & Loss as at March 2004. The Committee noted the current status of this work and that IFRS was still evolving and that therefore work in this area would continue. In the meantime Bob Wigley would have a detailed session for his own benefit with Frank Schinella;
- (i) Group Investment Policy and Delegated Authorities: two papers were circulated. The first covered the reserved powers and delegated authority framework for Royal Mail; the second addressed a proposed new Group Investment Policy. The first report was discussed and the Committee noted several areas where it did not consider the proposals tight enough. In particular, contract negotiation, fines per case, staff entertainment per event, corporate hospitality per event, debt write off's, company credit and levels per customer were all considered too high. Contract negotiation subsequent to authority, management consultancy per item, impairment provisions, debt write off's, Company credit levels, redundancy payments and recruitment limits were also considered too high at the top end where it seemed appropriate for most if not all items to go to the Board. Derek

Action
Derek Foster

ACTION
Marisa Cassoni

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Foster agreed to amend as discussed and reissue to the Committee. The second paper (Group Investment Policy) had been produced to address weaknesses identified in a paper presented to the Committee's meeting on 9th July. ~~a summary of the new investment policy and delegated authorities was considered. The~~ The Committee asked to see an analysis of previous projects sizes in order that it could confirm that the requested approval limits were appropriate. There was extensive discussion of the proposed approval process and the Committee felt that it fell well short of meeting the recommendations previously made by Martin Gafsen, Group Investment Director. In particular, Bob Wigley mentioned that on the basis of internal audit reports it was clear that the Company had a history of being too optimistic when quantifying potential program benefits and did not appear to challenge sufficiently the assumptions made in Investment proposals before they were approved. Furthermore the Company had a weak record of project accountability. These issues had not been addressed in the revised Investment policy put forward for approval: they needed to be addressed before the matter could be considered further by the Committee. The Investment policy and delegations would be reviewed in the light of the Committee's comments and re-submitted to the Committee for further consideration;

- (j) Bob Wigley suggested that given the number of on-going regulatory investigations and potential investigations facing the Company, that an on-going tracker report should be provided covering all on-going Regulatory processes. It was suggested that this could be incorporated into the Company Secretary's report.

ACTION
Jonathan Evans

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WHISTLE BLOWING RELAUNCH

Andrew Wilson provided an oral update on the proposed re-launch of the Whistleblowing arrangements. The plan was to provide a secure and confidential facility for people in the organisation to report suspected crime. The initiative would be in partnership with Crimestoppers and operated by the Police. The telephone number for reporting would be well publicised throughout the business in a forthcoming campaign. The existing contact details for the Corporate Security helpdesk would remain available – giving whistleblowers a choice of routes, internal and external. Bob Wigley requested that the Audit & Risk Committee be updated at each meeting on the nature and resolution of calls made to the helplines. Andrew Wilson would provide an update for inclusion in the regular audit report and would also revert to the Committee, if necessary, if he felt any constraints were being placed on his ability to tackle crime effectively.

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INTERNAL AUDIT & RISK MANAGEMENT QUARTERLY REPORT

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Derek Foster introduced the Internal Audit & Risk Management quarterly report for the period June to August 2004. The Committee noted the report and: -

- (a) the challenge was to complete the business transformation, while maintaining control of business as usual processes (including assuring achievement of quality of service targets), controlling costs and protecting business reputation. There was considerable activity underway in the business to make this happen. The Committee noted:- the Royal Mail KPI and selected control indicator schedule. – the program risk log prepared by internal audit to ensure the organisation embedded learning from previous projects in new ones – the progress on implementing POL's new Impact program and Internal Audit conclusion that an effective management methodology is being tailored to minimise the risk of failure to deliver expected benefits – Internal Auditor plan to provide protection against excessive costs and other negative impacts from the Bulk Compensation Scheme - Internal Audit's conclusions relating to new controls to provide protection against excessive costs of deployment and loss of benefits due to headcount reductions - proposals to mitigate the payroll gap – proposals to enhance the process of people leaving the business – support from Internal Audit to ensure risks in the end to end revenue management system were effectively managed – the reduction in cash losses – proposed improvements in business planning – an action plan to deal with issues identified on a Times Newspaper contract – progress on business continuity planning;
- (b) while the level of financial control in the business remained stable the effectiveness of the broader business controls remained a concern IA&RM had completed 19 assignments in the period. Of the five assignments for which ratings had been issued, three were rated as 'limited' or 'no assurance';
- (c) the audit report highlighted issues with Single Daily Delivery, ~~and~~ Quality of Service, ~~and~~ purchasing. In addition to noting outstanding action on 6 of 23 agreed action plans, in relation to Single Daily Delivery – the report concluded that it was possible for an office to achieve a consolidated bonus without delivering all of its targeted cost savings. On Quality of Service, issues were noted with the adequacy and appropriateness of process and guidelines, the suitability of structures and resource constraints, the effective use of MIS and the consistency of data. In purchasing, there was potential for non-compliance with PPL and competition law in addition to a series of weaknesses in adherence to procedures. Bob Wigley and John Neill expressed disappointment and surprise that the SDD action plan previously agreed and reviewed by the Committee with Management at an earlier special meeting had not been fully implemented. They observed that Quality of Service was a top priority for Senior Management. They commented on purchasing, that non-compliance with the law could not be

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tolerated.

- (d) the report also recommended that the business prepare a comprehensive action plan to address the action items highlighted in section 4.2 of the report in connection with compliance with the licence conditions. Bob Wigley observed that non-compliance with the Licence and the Law generally was not tolerable and it was unacceptable that a plan put in place to address issues previously identified did not comprehensively address those issues. Bob Wigley requested that this recommended action plan should be reviewed at the next special meeting of the Audit & Risk Committee;
- (e) Bob Wigley asked that a special meeting of the Audit & Risk Committee be arranged to receive presentations from Operational Management on Single Daily Delivery, Quality of Service, Purchasing processes and the Licence compliance action plan preferably before the next Board meeting.

ACTION

~~Derek Foster~~
Jonathan Evans

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SUMMARY OF KEY ASSURANCE ACTIVITY RESULTS

A report was presented which was designed to assist the Audit & Risk Committee in its objective of understanding the key control issues and sources of assurance in the business. Within the 'business as usual' the Company had specialist Assurance Providers to protect assets and revenue streams and to help ensure compliance with operational standards. The summary of key assurance activity results for September 2004 was noted.

- (a) Adam Crozier said that Revenue Collection, Billing and Docket management were real issues for the business and had impacted adversely on Quality of Service. A project was now in place to identify and resolve all of these issues.

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FINANCIAL SERVICES REGULATION

Graham Halliday and Keith Woollard introduced papers on Anti-Money Laundering and Regulation of the Distribution of General Insurance Products by Post Office Limited. The Committee noted:-

- (a) the improvements generated following a formal warning from Her Majesty's Customs and Excise (HMCE) about failure by Post Office Limited to comply with statutory anti-money laundering regulations;
- (b) negotiations continued with the Bank of Ireland on the terms for inclusion of the travel insurance business within the Appointed Representative agreement. The Bank of Ireland had suggested that the administration of the product be transferred from the present provider to the Bank of Ireland

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with value being given up in recognition of the regulatory risk involved. Post Office Limited had rejected the proposal and agreement on reward for risk was being sought;

- (c) Bob Wigley asked whether online compliance training for staff had been considered. Graham Halliday said that it had been examined but discounted because the branch network did not have access to the technology and consequently other methods were being considered e.g. telephone training which incorporated many of the track and cost benefits of online training;
- (d) The Committee sought assurance that sufficient consideration had been given to protecting the business from the potential adverse publicity of mis-selling of financial products. Graham Halliday confirmed that whilst the FSA regulatory requirements would be met, for example by the inclusion of appropriate wording in sales literature, there was detailed work ongoing with the objective of brand protection;
- (e) that an on-going Financial Services compliance report would be produced for the Committee covering all products and activity for each meeting.

ACTION
Graham Halliday

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DIRECTOR EXPENSES & RELATED PARTY TRANSACTIONS

A paper had been circulated setting out the process for the approval of directors' expenses. Royal Mail Group had recently been subject to an audit by the Inland Revenue to establish compliance with the PAYE taxation legislation, which had not yet reported.

- (a) The Audit & Risk Committee noted the expense policy, the summary of personal expenditure form, the Corporate HSBC account summary form and the summary of Audit Recommendations;
- (b) In response to a question from Bob Wigley, Jonathan Evans confirmed that car use was compliant with the Company policy and that the policy was under review by the Remuneration Committee. Bob Wigley requested a summary of expenses by category by director.

ACTION
Jonathan Evans

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IA&RM RESOURCING AND PLAN FULFILMENT

In line with the Smith guidance on best Audit Committee practice, a note was tabled addressing the status of resourcing in IA&RM, its implications for plan fulfilment, and the adequacy of the training budget to meet the standards expected of a professional department.

- (a) Derek Foster confirmed that recruitment effort was underway with the objective of restoring the department to budgeted head count and no impediments including pay levels were

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preventing him making progress. In the meanwhile, steps had been taken to ensure that the audit plan would be delivered in full using contract and temporary staff to top up where necessary;

- (b) the budget allocation was adequate to meet the training requirements of the department.
- (c) Bob Wigley questioned the need for specialist skills training e.g. IT and Treasury and received satisfactory responses from Derek Foster.

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REVIEW FINANCIAL PERSONNEL SUCCESSION PLANNING

Marisa Cassoni tabled a paper setting out the proposed succession plan for the Finance department. David Lindsell remarked that there had been a clear improvement in the ability of staff over the last couple of years. Marisa Cassoni confirmed in response to a question from John Neill that she was comfortable with the level of skill in the Finance function while retaining some concerns about the quality of staff lower down the organisation especially in the area of 'decision support'. Marisa Cassoni said that there would be need to bring in some skills into this area in order to fill the gap.

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DATE OF NEXT MEETING

The Audit & Risk Committee noted that the date of the next scheduled meeting of the Audit & Risk Committee was Tuesday 16 November 2004.