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HORIZON M REGO 01



Post Office Counters Ltd

FACSIMILE TRANSMISSION

URGENT

PLEASE DELIVER IMMEDIATELY UPON RECEIPT

TO Jeff Triggs
Slaughter & May

FROM Keith Baines
Horizon Commercial

FACSIMILE GRO

DATE 6 September 1999

NUMBER OF PAGES 6
(including header)

COMMENTS As promised in my e-mail, here is a copy of the auditors'
letter re A.I. 376

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HORIZON M REGO 02**ERNST & YOUNG**27 AUG 1999
- 1004Becket House
1 Lambeth Palace Road
London SE1 7EUPhone:
Telex:
Fax:
CTDF & ITDF Box 241**GRO**Mr D Miller
Post Office Counters Ltd
Gavrelle House
2 - 14 Bunhill Row
London
EC1Y 8HQ

1. Bruce McNamara
2. Keith Gurney

*Please ensure that these
issues are fully addressed
during the remaining
Acceptance process.
Keep me in touch.**all comments
re release to be kept
from*

23 August 1999

ICO/IMK/KLR

Direct Line

GRO

Direct Fax

GRO

Dear Mr Miller

DWM

24.8.99.

HORIZON ACCEPTANCE TESTING

As auditors of The Post Office we have been asked by Post Office Counters Ltd to provide you with our views in respect of certain accounting integrity issues arising from tests performed by POCL on Horizon data in the live trial.

We have not performed any validation of the issues or testing of the data. Our views expressed in this letter are based on information provided to us by POCL resulting from their tests. This letter is not intended to provide any assurance over any data in the live trial or over any results arising from tests of such data.

The live trial is limited to 323 outlets. We make our comments on the assumption that this sample of outlets will be representative of the full network of outlets.

The following issue, as described to us by POCL gives us concern as to the ability of POCL to produce statutory accounts to a suitable degree of integrity. We understand that POCL has attributed a severity rating of 'High' to this matter.

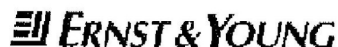
Incident 376. Data Integrity - In order to test the integrity of weekly polling of Horizon cash account transactions, POCL are reconstructing a weekly total by outlet from daily Horizon pollings. At present this control test is showing discrepancies in that certain transactions do not record the full set of attributes and this results in the whole transaction being lost from the daily polling.

We are informed that an incident has also occurred where transactional data committed at the counter has been lost by the Pathway system during the creation of the outlet cash account and has not therefore been passed to TIP in the weekly cash account sub files.

Both types of incident result in a lack of integrity on each of the two data streams used by POCL to populate its central accounting systems. We understand that the cash account data stream is the primary feed for POCL's main ledgers and client reconciliation processes.

A list of partners' names is available for inspection at the above address, the partnership's principal place of business. Authorised by The Institute of Chartered Accountants in England and Wales to carry on investment business.

The United Kingdom firm of Ernst & Young is a member of Ernst & Young International

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A major component of the current systems is the matching of the underlying transaction stream to summary totals on the cash account. In the new Pathway service there are currently logged incidents where both the underlying transaction stream is incomplete and where transactions are being "missed" when the service accumulates the summary cash account line. It would appear from these incidents that Pathway's service is not capable of detecting all types of these errors because of an underlying systems control deficiency.

It is a fundamental of any accounting system that it provides a complete and accurate record of all transactions. These discrepancies suggest that the ICL Pathway system is currently not supporting this fundamental.

POCL have informed us that these items have resulted in difficulties substantiating the cash account balances which form the basis of certain items in the balance sheet. We understand that the issues are not attributable to specific outlets or to specific products on a continuing basis. It is not therefore possible to quantify the likely impact on client balances, or the resulting implications for POCL's financial statements, as the incidents cannot be forecast.

The nature of the gaps in both the cash account and transaction data streams is such that POCL believe that they would not be able readily to explain them, and that significant balances might have to be written off to the profit and loss account.

We also understand that POCL have identified a number of other incidents which also impact on the accounts. These may also be relevant to us in reaching our audit opinion, as they may be indicative of further uncertainties.

IMPACT ON THE AUDITORS' OPINION ON THE STATUTORY ACCOUNTS

Horizon rollout will cause POCL to become dependent on Horizon data for the compilation of certain balances feeding into its financial statements. In light of the uncertainties raised, and dependent on the scale of incidents, we may have to consider certain alternatives in developing our audit opinion.

Given the above background, if these matters remained unresolved at the accounting year end we would need to consider whether an unqualified opinion were appropriate. Under the present circumstances there appear to be a number of uncertainties whose financial impact cannot be quantified and which make an unqualified opinion unlikely to be available to us.

Should this be the case, we would have to decide between including a fundamental uncertainty paragraph in our opinion or issuing a qualified audit opinion.

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Fundamental Uncertainty

A fundamental uncertainty is given in circumstances where we are unable to agree or to disagree with the company on a specific issue. It is usually confined to a specific area of the accounts without affecting those areas of the accounts where we are able to give a true and fair view.

We set out below the likely wording of a fundamental uncertainty paragraph based on the unpredictable differences between streams of data from the same originating system at the counter:

"Fundamental Uncertainty"

In forming our opinion, we have considered the adequacy of the disclosures made in the accounts concerning the uncertainties in respect of client balances. Certain differences have arisen between streams of data from the same originating source within the client transaction processing system, and these have caused uncertainty as to the balances due to or from clients arising from counter transactions. There is also uncertainty in respect of the client fee income and subpostmasters remuneration arising from such transactions. Details of the circumstances relating to this fundamental uncertainty are described in note [x]. Our opinion is not qualified in this respect."

*Extracts from Accounts:***1. FUNDAMENTAL ACCOUNTING CONCEPT**

POCL acts as an agent for several clients. Accounting for the transactions performed on behalf of these clients is fundamental to the integrity of POCL's accounts. Certain differences have arisen between streams of data from the same originating source within the client transaction processing system, and these have caused uncertainty as to the balances due to or from clients arising from counter transactions. There is also uncertainty in respect of the client fee income and subpostmasters remuneration arising from such transactions.

The directors have adopted the data which they deem to have the most reliable supporting evidence in the circumstances. Where unreconciled credit balances arose then these have been retained as liabilities in the balance sheet. Unreconciled debit balances have been written off to the Profit and Loss Account.

The accounts do not include any adjustments that would result if the adopted data streams were subsequently found to have been inappropriate."

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Qualification of the Accounts

If we disagreed with the treatments and/or balances in respect of counter transactions, because we were able to substantiate alternative figures or if the impact on the accounts was so pervasive as to impact on the integrity of the full financial statements, then we would issue a qualified opinion.

We recognise that ICL Pathway may offer fixes to the issues raised by POCL. Given POCL's dependence on the individual transaction data streams, in respect of incident 376, we suggest that in order for the fix to justify downgrading the severity from the current "High" rating attributed by POCL, it is essential that data obtained from further testing in the live trial area be provided, demonstrating the effectiveness of the fixes. This will require the inclusion of reliable controls within the Horizon system to demonstrate non-recurrence of the issues. Evidence of the effectiveness of these controls over a reasonable period will be required.

This letter is intended for the use of Post Office Counters Ltd in respect of the Business Impact Analysis of Proposed High Acceptance Incidents. We do not assume responsibility in respect of its contents to any person other than Post Office Counters Ltd.


We are aware that you may wish to make this letter available to the Independent Arbitrator in the Horizon dispute resolution process. We are prepared to allow this, although any use the Independent Arbitrator makes of this information is at their own risk.

This letter has been prepared for your private use. Subject to the foregoing, it should not be disclosed to any third party without our written consent.

Yours sincerely

A rectangular box with a dashed border containing the text 'GRO' in a large, bold, sans-serif font.

Ernst & Young

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HORIZON M REGO 008 **ERNST & YOUNG**

Mr D Miller
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23 August 1998

ICO INK-KLR

Direct Line

GRO

Direct Fax

GRO

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