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ARC 04/15 TO ARC 04/24

ROYAL MAIL HOLDINGS plc

(Company no. 4074919)

AUDIT AND RISK COMMITTEE

Minutes of the meeting held at 148 Old Street on 24 May 2004

Members of the Committee Present:

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

In attendance:

Allan Leighton	Chairman
Elmar Toime	Executive Deputy Chairman
Adam Crozier	Chief Executive
Marisa Cassoni	Chief Financial Officer
*Jonathan Evans	Company Secretary
Derek Foster	Internal Audit and Risk Management Director
Frank Schinella	Director, Financial Management & Control
Andrew Wilson	Director, Security for ARC04/20
*David Lindsell	Ernst & Young
*Rachel Harper	Ernst & Young
Andrew Poole	Notes

PRE- MEETING WITH EXTERNAL AUDITORS

* In attendance: The Committee met the external auditors in private before the start of the main meeting.

ARC04/15

MINUTES OF PREVIOUS MEETING

The minutes of the meeting of the 11 November 2003 were considered and approved subject to typographical error on page 7 being corrected to read SDD and not 500.

ARC04/16

STATUS REPORT

The status of actions from the meeting held on 18 March 2004 was noted, in particular:

- (a) ARC04/05(a) a review of the terms of reference of the Audit Committee would now be undertaken as part of the Board effectiveness review, which was also considering the terms of reference for all Board Committees. Bob Wigley said that this review would clarify that Health and Safety would be the sole responsibility of the CSR Committee going forward and the Audit Committee would satisfy itself by reference to minutes of that Committee;

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ACTION
Derek Foster

- (b) ARC04/05(i) Management were now attending special meetings of the Committee for 'limited' or 'no assurance' related audit reports. At the meeting on 6 April 04, action plan updates were presented in respect of Single Daily Delivery (Roger Baynes), Payroll fraud (Dermot Toberty) and PAYE (Jonathan Evans). Bob Wigley requested that Audit recommendations (as detailed and agreed in past individual audit reports) that were overdue for completion of agreed action would be included for review at the next meeting of the Committee;

ACTION
Derek Foster

- (c) ARC03/05(j) – Adam Crozier had suggested that it would be helpful to incorporate the views of management into future audit reports. Derek Foster confirmed that this is being done, and is achieved by detailed discussion and review of the report with management and by agreement of actions arising;

- (d) ARC03/11(b) the Whistle blowing policy had been given widespread communication across the business in March. The taking of illegal substances on duty was already a disciplinary offence in the Company, leading to dismissal. Bob Wigley and John Neill requested that notwithstanding the March communication exercise, the Whistle blowing policy be reviewed in the light of the Dispatches programme, and relaunched. The Committee discussed the way in which the current whistleblowing procedures worked, noting that not many calls are received. There were also questions about employee perception of how effectively the organisation protected the anonymity of callers. As a result, the committee requested that Andrew Wilson produce a note of recent calls to the whistleblowing number, which should now be produced at each regular audit committee meeting together with a note on how the call had been followed up, and that management also undertake a review to establish how the protection of anonymity could be improved (including the possible use of an external call agency) and bring forward proposals to the next full audit committee meeting;

- (e) the self-assessment forms on the Committee's effectiveness had been completed and would be summarised by Company Secretariat for review by the Audit Committee at the next meeting.

ARC04/17

YEAR END ACCOUNTS 2003/04

Marisa Cassoni introduced a paper presenting the Group Accounts for Royal Mail Holdings plc together with the Preliminary Announcement for the Committee's review and recommendation to the main Board's delegated Sub Committee, for approval and signing. The Committee noted:

- (a) a full set of the Royal Mail Holdings Plc Group Accounts together with a draft of the Preliminary Announcement, the Audit and Risk Committee briefing book, which provided an

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analysis of performance against prior year and the balance sheet together with a draft Letter of Representation addressed to the external auditors for review and approval. The Committee noted that comments that had previously been raised, particularly in respect to the consistency of the reviews at the front of the Accounts with the formal financial statements had been satisfactorily addressed in the final version of the accounts that were being presented for review and approval;

- (b) John Neill said that whilst the business might be achieving acceptable margins it needed to improve on Quality of Service. The aim should be to achieve adequate returns on all resources utilised in the business. Adam Crozier added that this was a good reason for returning to profit in order that investment can be made in the business and in its people. The Government had waived its right to a dividend for a period of five years;
- (c) Jonathan Evans reported that the Remuneration Committee had met to consider the achievement of annual bonus targets. The Remuneration Committee considered that an 80% award was appropriate: 60% for the achievement of financial targets and 20% for the achievement of exit rates. No award would be made for quality of service (20%). The Remuneration Committee, as required, had taken input from the DTI on the matter, who had initially considered, based on the partial information available to them, that the Company had failed the exit rate target. Following further deliberations the DTI had agreed that the exit rate had been achieved;
- (d) John Neill asked about the bonus payable to Jerry Cope. Allan Leighton confirmed that the Remuneration Committee had handled this matter, but essentially this payment had been made in order to honour his contract;
- (e) The Committee reviewed carefully the note disclosing the LTIP. Whilst the proposed disclosure of the LTIP was technically correct, the Committee were keen to ensure that the disclosure was full having regard to the deferred element of the LTIP scheme which would fall to be disclosed in the subsequent year. Allan Leighton confirmed that he would review with management the current treatment and disclosure of Director' remuneration and that the final approval would be both technically correct and full. Any change from the agreed approach would be reported back to the Committee;
- (f) David Lindsell confirmed that the report to the Audit & Risk Committee represented a 'fair view' of the business and that whilst there was some sensitivity around specific provisions they were in the opinion of the Auditors fairly stated;
- (g) David Lindsell reported an improvement in the financial control environment whilst expressing some concern at the

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effect that VR might have on this area, as the Finance function would be losing some 280 people. Marisa Cassoni acknowledged that losing this number of people would result in an increased risk, but explained that a strategy was in place to mitigate the overall effect of the headcount reduction. Frank Schinella confirmed that there was no practical risk of any significant issues getting through the current financial controls undetected;

- (h) Bob Wigley said that some Audit Committees liked to see the Management letter before approving the accounts. David Lindsell confirmed that there were no major issues to draw to the attention of the Audit & Risk Committee but said that given the reporting timetable it would be impractical to achieve a review prior to signing the accounts;
- (i) each Finance director and the Heads of Legal and Regulation had signed off Annual Letters of Assurance. Marisa Cassoni confirmed that there were no further issues known that would require alterations to the letter of representation to the auditors;

The Committee;

- (j) reviewed the Accounts and Preliminary Announcement for 2003-04;
- (k) agreed the content of the Letter of Representation for issue to the auditors on behalf of the Board;
- (l) endorsed the Accounts and Preliminary Announcement for approval by the Board Sub-Committee subject to any material changes being brought to the attention of the members in respect to the Directors Remuneration Report;
- (m) noted the items of non-audit work carried out by Ernst & Young.

ARC04/18

INTERNATIONAL FINANCIAL REPORTINGS STANDARDS IMPLEMENTATION

A paper had been circulated providing a quarterly update to the Audit Committee on progress toward the adoption of International Financial Reporting Standards. The Committee noted the progress that had been made in implementing the Standard.

ARC04/19

INTERNAL AUDIT & RISK MANAGEMENT DEPARTMENT PERSPECTIVE

Derek Foster introduced a paper setting out the Internal Audit & Risk Managements Department's perspective on the risk management and control system within the business, as it pertained to the financial statements disclosure. The Committee noted the paper and in particular:

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- (a) that the data contained in the report, along with the on-going communication throughout the year (including updates of the Corporate Risk Scorecard allow the board to discharge its duty for timely review of the effectiveness of the risk management and control system;
- (b) that from a statutory reporting perspective, the risk and control system had appropriate components to satisfy governance requirements. In particular the Financial controls were set up to allow timely and accurate reporting of results and the safeguarding of assets;
- (c) a requirement of the Combined Code for a proper process of Corporate Governance for the directors to carry out timely reviews of the effectiveness of the system and to report this annually in the Annual Report. The specific disclosures in the 2003/04 Annual Report were summarised in the paper along with an illustration of Royal Mail's practice to support the statement;
- (d) that due to the pace of changes in the business the broader business controls remained vulnerable. David Lindsell gave assurance that the financial controls were adequate and effective the issue now was 'non-financial' control resulting in poor Quality of Service and compensation payments;
- (e) Adam Crozier confirmed that the Headcount reduction process had been put under severe pressure with the volume of people being processed. Lessons had been learnt and the process was being redesigned.

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INTERNAL AUDIT AND RISK MANAGEMENT QUARTERLY REPORT

Derek Foster introduced the Internal Audit and Risk Management report for the period March 2004 to May 2004. The Committee noted the contents of the report and:

- (b) the level and pace of business transformation had continued and increased in the period. The number and scope of changes in the space of these few years was greater than at any time in Royal Mail's past, and arguably is greater than changes in comparable postal companies or UK business generally, this inevitably puts strain on the control environment;
- (c) IARM had completed 27 audit assignments in the period. Of the 13 assignments for which ratings were issued, two assignments, (Managing Headcount reduction and Safety management) were rated as 'no assurance'. Two further assignments, Transport Review and the use of agency staff were also noted due to the significance of the issues identified. These reports (other than the Safety Management report) would be considered further at the special meeting of the Audit & Risk Committee scheduled for July;

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- (d) John Neill asked what was being done to ensure that health and safety issues were being addressed. Elmar Toime confirmed that the CSR Committee had now reviewed the framework for managing Safety issues in the business and a detailed action plan was being implemented under the Committee's supervision.
- (e) Bob Wigley noted that the Secretariats review of Board Committee terms of reference would clarify that the CSR Committee would have total responsibility for Health & Safety issues;
- (f) the Committee discussed the Company's relationship with the H&SE and how the business might engage with the Executive to deliver improvements in identifying Safety issues. Further consideration would be given to this matter.

ACTION
Derek Foster

ARC04/21

PROTECTING ROYAL MAIL ASSETS

Andrew Wilson, Director of Security, attended for this item. The Committee noted that Royal Mail was inherently vulnerable as a business to attacks on its assets, whether through fraud or other events. This is due to the scale of the business, nature of the core handling process and liquidity of assets. The Committee noted:

- (a) the key activity of the business in protecting Royal Mail's assets and pipeline, including increased focus on fraud investigations, protection of information and the level of prosecutions. Separate discussions had taken place and action plans had been developed to address the issues highlighted recently in the Dispatches programme;
- (b) The Company had made 299 prosecutions last year. John Neill asked if the policy on prosecutions was clear and what level of resources would be required to improve the prosecution rate. Andrew Wilson did not feel that an increase in resource was necessary or likely to be effective. Andrew Wilson mentioned that the Company had identified a problem in recruiting people in cities where criminal activity was at higher levels. In addition security was not always treated as high priority matter for all managers. John Neill asked whether custom and practice could restrict investigations. Andrew Wilson confirmed that he had not encountered active obstruction however there was a cultural issue to address;
- (c) John Neill said that the impression was that there were no restrictions on Andrew Wilson being able to pursue investigations, on the other hand there seemed to be an impression that the culture did not embrace security issues as it might. There was still a need to deal with the issue of non-compliance across the business. There was a clear need to consider a programme of re-education in order that people were comfortable reporting security issues and this issue

ACTION
Derek Foster

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would be considered further at a future Board meeting.

ACTION
Derek Foster

- (d) The Whistle blowing policy would be reviewed and relaunched with a confidential helpline number.

ARC04/22

REVIEW OF EXTERNAL AUDITOR PERFORMANCE/FEEES

A paper was tabled setting out the Budgeted Audit fee for the year ended 28 March 2004. The Committee noted:

- (a) the total audit hours were budgeted at 7,328 hours with a gross audit cost before any discount of £1,345,000. The agreed fees of £864,000 provided a recovery rate of some 64%. The reduction in hours vs. last year was almost absorbed by increases to rates which was driven by increases in absolute rates and changes in the mix of staff;
- (b) John Neill asked how audit costs could be reduced. The business should review the process to consider those elements the business could perform for itself. Derek Foster confirmed that this work was in hand.

ARC04/23

ANY OTHER BUSINESS

ACTION
Derek Foster

Bob Wigley said that he had recently met both the POL compliance officer and BOI Compliance Officer who seemed well qualified and to have an adequate plan to install necessary controls and ensure compliance with relevant legislation. They would produce a note covering activity for each Audit Committee meeting. Derek Foster would consider if it would be helpful for the Auditors to meet the Compliance teams.

ARC04/24

DATE OF NEXT MEETING

The Committee noted that the date of the next scheduled meeting of the Committee was Monday 7 September 2004 and that a special meeting would be convened to consider the regulatory accounts and receive and review Management's proposals to deal with audit reports with 'limited' or 'no-assurance'.

GRO