

Royal Mail – Strictly Confidential

ARC (11)3RD
26 - 34

ROYAL MAIL HOLDINGS plc

(Company no. 4074919)

AUDIT AND RISK COMMITTEE

Minutes of the meeting held at 100 Victoria Embankment London on
20th May 2011

Members of the Committee Present:

Paul Murray	Non Executive Director, Chair of the Committee
David Currie	Non Executive Director
Nick Horler	Non Executive Director
Cath Keers	Non Executive Director
Orna Ni Chionna	Non Executive Director
Les Owen	Non Executive Director

Apologies:

Donald Brydon

In attendance:

Moya Greene	Group CEO
Matthew Lester	Chief Finance Officer
Jon Millidge	Company Secretary
Derek Foster	Internal Audit & Risk Management Director
Shane O'Riordain	Director, Group Communications for ARC11/28 (b-t)
Mike Prince	Financial Management & Control Director
Jeff Triggs	General Counsel
Richard Wilson	Ernst &Young
Alison Duncan	Ernst &Young
Ben Marles	Ernst &Young
Andrew Poole	Deputy Company Secretary
Mike Young	POL for item ARC11/28(t-u)
Lesley Sewell	POL for item ARC11/28(t-u)
Anne Fletcher	Group Compliance Director for ARC11/32

The Chairman welcomed everyone to the meeting.

ARC11/26

MINUTES

- (a) The minutes of the meeting of the 10th March 2011 were considered and approved as an accurate record of the meetings;
- (b) the Committee noted the minutes of the Risk Management Committee held on 3rd May 2011.

ARC11/27

STATUS REPORT

ARC(11)25

- (a) The Committee noted the status of actions from the previous meetings, in particular:-

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ACTION
Derek Foster

- (b) AC11/19(b) IA&RM Annual Plan: At the last ARC, the proposed assignment plan for IA&RM for 2011/12 was approved. IA&RM was tasked with preparing an analysis of the plan that showed the alignment to the priorities of the business. The ARC was invited to note the progress and action in articulating the alignment of the audit plan to business priorities and that the final version of the document would be available at the July ARC.

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YEAR END ARC(10)26-31

ACTION
Mike Prince

- (a) Letter from BIS: Jon Millidge tabled a letter received that morning from Department for Business Innovation & Skills dated 19th May 2011 addressed to the Chairman of Royal Mail Holdings. The letter was deemed by the Committee to be sufficient to support the Going Concern assessment and the associated disclosure in the Annual Report & Accounts 2010/11. Mike Prince was asked to reflect the contents of the letter in the Going Concern note to the accounts.

- (b) Draft Annual Report & Accounts: the Committee received the latest draft of the Annual Report & Accounts. Shane O’Riordain explained that one of the objectives this year was to begin the process of moving the Annual Report and Accounts closer, where possible, to the standards of a listed PLC company. The draft had moved towards this goal, but there was more to do in this area for next year’s report;

- (c) the chapters had been arranged thematically to include modernisation, people, customers etc. They reviewed progress in these key areas in the last 12 months and detailed some of the businesses main plans for the future. Also, for the first time, a Regulation and a Transparency report had been included. The idea was to convey a sense of a company that was on a journey of change on many fronts and that we were attempting to be more open. Matthew Lester noted that there was a process in place to validate the disclosures being made. The Directors Remuneration Report was not in the draft presented to the Committee as it was still being drafted. Orna Ni Chionna noted that the Remuneration Committee would meet shortly to discuss and approve the Director’s Remuneration Report;

ACTION
Shane O’Riordain

- (d) Cath Keers noted the strong language being used in some respects and suggested that this could be toned down. Moya Greene said she would review the disclosure. The Committee further suggested that the document be passed to major stakeholders for review as this would help balance the tone of the document. This suggestion was agreed;

ACTION
Jon Millidge

- (e) the Committee reviewed the draft of the Annual Report & Accounts, and recommended to the Board that the statements made be adopted. A further draft of the Report & Accounts would be circulated to the full Board for formal

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approval.

- (f) Going Concern & Licence Condition 16 Letter: The Committee noted a paper including the latest draft going concern note for RMG ex POL and the draft LC16 letter that was required to be sent to Postcomm by the end of June 2011. There was a licence requirement to confirm to Postcomm by June each year, that Royal Mail had the “necessary resources” (human, financial) for the next twelve months from the date of the letter to provide the Universal Postal Service. The draft letter confirmed that RMG did have the necessary resources, but drew the reader to two specific matters: the potential for Industrial Action in London and the Going Concern status of Royal Mail;
- (g) The Committee noted both the Going Concern and LC16 draft disclosures and delegated authority to the Chief Financial Officer to sign and send the LC16 letter, at a suitable time before June 2011, to Postcomm.
- (h) Summary Briefing Book y/e 27 March 2011: the Committee noted the summary Briefing book. Mike Prince introduced the overview to the year end highlighting that both the Group re-organisation and VAT implementation had not impacted the year end. He confirmed that although there was a lot in the detail, the main issues related to going concern and the reduction in the pension deficit by over £3bn. The Briefing Book also confirmed in detail the sign off and assurance process that the ARC could rely on when reviewing the results. It also provided a high level review of the Income Statement and focussing on major movements in the Balance Sheet particularly the pension deficit and other material balances which required judgement and which were not mechanically calculated or systems driven;
- (i) The Committee agreed that the fact that the business was highly regulated was a key risk, and noted that this was addressed in the Government, Regulation and Legislation segment of the Risk Management and Control section in the draft Report & Accounts;
- (j) the net pension liability was both the most material and volatile item on the balance sheet and was driven by a number of long term assumptions, small changes in which could drive significant movements in the balance sheet. The pension deficit at March 2011 was £4.5 bn compared to £8.0 bn in March 2010 mainly due to the change in inflation assumption from RPi to CPI;
- (k) Les Owen enquired about the statistical validity of the Stamp and meter revenue SITHOP/MITHOP values as disclosed in the accounts. Mike Prince confirmed that the methodology used to calculate the value had been applied consistently over a number of years and was commonly used by other Postal Operators. The Committee agreed that the approach

ACTION
Mike Prince

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being taken by the company in this respect was reasonable.

- (l) Carrying Values of Investments and Goodwill: the Committee noted a paper providing information on the carrying values of investments and goodwill in respect of Subsidiaries, Joint Ventures and Associates referred to in the 2010-11 Financial Statements. In particular the Committee noted the there was no goodwill recognised in the carrying values of Associates or Joint Ventures at March 2011. Under IAS 27, the investment in Royal Mail Group Ltd (RMG) held by Royal Mail Holdings plc was held at cost (£4.2bn) and then assessed for impairment under IAS 39. The net carrying value at March 2010 was £3.8bn. In assessing for impairment, the carrying value of RMG at March 2011 was tested using a standard NPV calculation of forecast cash flows for Years 1 to 5 of the business plan plus a terminal value for Year 6 onwards, adjusted for the net debt / cash position at the valuation date. With the more pessimistic forecast cash flows included in the latest Strategic Plan, the value of RMG was reduced to £0.5bn, requiring a significant impairment of £3.3bn at the year end.
- (m) the impairment of £3.3bn of the carrying value of Royal Mail Group Limited in Royal Mail Holdings company financial statements had been largely brought about by the revised business plan and alignment with the Colleague Share valuation. The Audit and Risk Committee further noted the impairment of £2m of goodwill relating to the Spring associate;
- (n) the carrying value of associates and joint ventures was supported by their underlying assets and liabilities in accordance with accounting standards; and
- (o) Goodwill of £197m in the consolidated Financial Statements related to the GLS acquisition and was supported by GLS's profits and forecast cash flows. Alison Duncan confirmed that subject to confirmation of the WACC used, E&Y agreed with Management's assessment of the carrying value of assets.
- (p) Fines Compensation & Material Litigation: The Committee noted the amount for accruals for fines and compensation and provisions held for material litigation at 27th March 2011. In particular, the Committee noted the need to identify a specific industrial diseases provision that had arisen through BT seeking clarification from the Court as to the liabilities transferred to BT following the split of the old Post Office Corporation in 1981.
- (q) E&Y Report - Audit Results Report for the year end 27 March 2011: Alison Duncan introduced the Audit Results Report for the Year ended 27 March 2011. The annual results close process including the period 11 hard close was well executed by the business unit and Group Finance teams with the exception of the POL IT work with Fujitsu. Despite the

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finance team restructuring during the year, there was no impact on the quality or timeliness of the information provided to the auditors;

- (r) E&Y had received full cooperation from the Royal Mail teams and subject to a few outstanding matters as noted in the report to the best of their knowledge had received all information necessary to enable them to complete the audit.
- (s) The Committee confirmed that it was not aware of any fraud or suspected fraud involving management or other employees who had a significant role in the Group and Parent Company's internal controls over financial reporting;
- (t) Alison Duncan confirmed that subject to completion of procedures E&Y anticipated that they would concur with the going concern basis of preparation for the Group accounts. The unqualified audit report would include an emphasis of matter paragraph which would draw attention to the fundamental uncertainties and key assumptions highlighted by Management in the basis of preparation paragraph in the notes to the accounts;
- (u) Mike Young and Lesley Sewell joined the meeting. Alison Duncan explained that the Audit process had identified significant control weaknesses, which in Ernst & Young's view, reflected a need for improvement by the outsource provider Fujitsu but also a change in approach on the part of POL in relation to the management of the Fujitsu contract. The approach by Fujitsu in delivering audit requirements to POL and E&Y had resulted in an unduly lengthy, unpredictable and inefficient audit in respect of this aspect of the IT audit. Mike Young noted that the recent re-negotiation of the contract had offered POL significant cost savings and huge operational benefits in terms of efficiency savings, but accepted that POL had not been demanding SAS70 audit evidence from the supplier. POL had established an IT Audit & Control Board to manage contract governance going forward. An update on this matter would be given to the Audit & Risk Committee at the October meeting.

ACTION
Mike Young

Les Owen noted that the Post Office Board were not aware of this project and asked that in future that the Board be kept fully up to date on all such projects. The POL board would be updated on this matter at its next meeting.

ACTION
Mike Young

Nick Horler commented that contract management in the business was a particular risk in cases of incremental contract renewal. Paul Murray asked that this issue be considered for inclusion on the Group Risk register.

ACTION
Derek Foster

ARC11/29

YEAR END RISK MANAGEMENT & CONTROL DISCLOSURE **ARC(11)32**

- (a) Derek Foster introduced a paper to introduce the Risk

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Management and Control section of the draft 2010/11 Annual Report and Accounts, to explain context, and to summarise main changes from prior year;

- (b) the drive to provide a more comprehensive summary of risk management and control in Royal Mail had been driven by a) developments in reporting and accounting generally, and specifically where the Financial Reporting Council had set out increased expectations for more and better disclosure in this area, and b) the desire, in anticipation of reporting in a formal “plc” environment, to provide disclosure that was comprehensive and reflected best practice;
- (c) In the draft Report and Accounts for 2010/11, comments on risk management and control of the business had been gathered together to give a more coherent picture of the overall risk management and control environment. The key differences from prior year were:
 - clear articulation of overall risk environment
 - specific delineation of roles of Board, ARC, and RMC in this area
 - more focussed summary of key risks, and more detailed analysis of the main components of internal control in the business;
- (d) the Committee reviewed and endorsed the disclosure in respect of Risk Management and Control in the draft 2010/11 Report and Accounts.

ARC11/30

INTERNAL AUDIT & RISK MANAGEMENT QUARTERLY REPORT ARC(11)33

ACTION
Derek Foster

- (a) Derek Foster introduced a report summarising the activity of IA&RM for the period February to March 2011. The report assisted the Committee in discharging its responsibility for monitoring and reviewing the Group's risk management and internal control systems. The Committee noted:-
- (b) IA&RM had completed four assignments in the period, three of which had rated the subject either 'not satisfactory' or 'some improvement required' The two 'not satisfactory' reports covered Software Licence environment and Manager Bonus Scheme while the report rated as requiring improvement related to the Organisational restructure: Leavers process in POL. Paul Murray asked that the report clearly identify who was responsible for the improvement actions on these assignments;
- (c) Orna Ni-Chionna said she was shocked by the audit findings in respect of Managers Bonus arrangements. Moya Greene confirmed that the clear intention was to have one bonus scheme in future and that it would be backed up by robust data;

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ACTION
Derek Foster

- (d) the number of agreed actions overdue for completion is 21% at March 2011. This was an improvement on the 23% (Jan 2011) as reported to the last meeting. The report provided details of the number of issues raised (priority 1 and 2 combined) and of the trend in percentage of overdue actions. Details of the number of issues completed and overdue in the rolling year April 2010 - March 2011 were also shown, including the breakdown of overdue actions by priority. Paul Murray asked for a trend analysis of overdue actions be included in future reports and that those accountable for actions be identified in the report;

ACTION
Derek Foster

- (e) GLS audit function had completed its plan for the year. Since December 2010, the function had completed 48 depot audits, 2 of which were rated as "Unsatisfactory". For the full year, 108 depot audits were completed (09/10: 75), of which 5 were rated "Unsatisfactory" (09/10: 4), 33 were rated "Requires Improvement" (09/10: 29) and 70 were rated "Satisfactory" (09/10: 42). In addition 17 Head Office audits were completed in 2010/11 (09/10: 16), with none rated 'Unsatisfactory' (09/10: one rated 'Unsatisfactory');
- (f) the business operated as rolling 12 month control self assessment process to provide assurance that critical controls designed to mitigate significant business risks were working correctly. Derek Foster agreed to include tests of a sample of specific controls covered by the self-assessment exercise in the annual audit plan;

ARC11/31

- (g) The Audit & Risk Committee noted the report.

GROUP RISK PROFILE ARC(11)34

- (a) Derek Foster introduced a paper presenting the new, updated Group Risk Profile, to set the review of the profile in the context of risk management activities and responsibilities (including Board responsibilities) more generally, to highlight the enhancements to the risk management process we have introduced since the last ARC, and to note action required of the Committee;
- (b) the overall responsibility for risk management in Royal Mail rests with the Board, which will provide high level direction on the appropriate balance between risk and regard to be struck in the strategic plan, set the "tone" for managing risk, and ensure the most significant risks facing the organisation are properly managed. In particular, the Board strategy session scheduled for June will consider the overall level of risk in the strategic plan and the plans for management of specific critical risks. Within that overall framework, ARC has specific responsibilities, including monitoring the effectiveness of risk management processes and the control environment, reviewing the work of IA&RM, and reviewing the Group Risk Profile;

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**ACTION
Derek Foster**

- (c) the Committee approved the updated Terms of Reference for the Risk Management Committee, Appendix A to the paper, including membership;
- (d) the review of the Group Risk profile by the Audit & Risk Committee represented a sub-set of the overall Board responsibility for the setting and monitoring of the level of risk in the organisation. Therefore this review by the Committee was about the assessment and management of risks that had been identified;
- (e) the Committee considered and endorsed the overall profile, and discussed the rating for the Transformation Benefit risk. Cath Keers suggested that the business should consider if this risk be given higher profile in the Group Risk Profile;

**ACTION
Paul Murray**

- (f) the Committee expressed the view that the Board overall needed to give higher and specific attention to the subject of risk analysis and management. The Committee felt that risk analysis should be more closely integrated into the board process and that more time should be allowed to discuss the risks to the business in a more systematic manner. Paul Murray would discuss this with the Chairman.

ARC11/32

GROUP ANNUAL COMPLIANCE REPORT ARC(11)35

- (a) Anne Fletcher introduced the report providing an overview of compliance activity in 2010/2011. It had been another busy year with significant RFI activity, challenges around Q of S (resulting from volcanic ash, severe weather and the impact of the transformation activity), restructure activity and significant training deployment;
- (b) Postcomm had closed their investigation into E-2-E Q of S measurement (Q) and concluded that Royal Mail was in breach of parts of condition 4.8 and that it would not return to a compliant position until the assurances made by Royal Mail had been fully deployed. The assurances had now been fully deployed;
- (c) the Compliance Director confirmed that she was satisfied - on a risk basis - with the adequacy of independent assurance provided on procedures and controls relied upon to ensure compliance, including assurance activity within business units/functions and audits undertaken by the Group Internal Audit function;
- (d) the Committee noted that the Company would have its Anti-Bribery policy in place by the 1st July 2011; and that
- (e) 2010/2011 had been another challenging year and it remained essential to ensure continued focus and professionalism in all regulatory relationships;
- (f) the Committee noted the key activity during 2010/2011 and

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the focus of activity for 2011/2012 and the revised compliance framework, the assessment of compliance risk and the reporting and information provision set out in the paper.

ARC11/33

ANY OTHER BUSINESS

- (a) Paul Murray reported that the timing of Audit & Risk Committee meetings was being reviewed with the intention that future meetings would be more closely aligned to the Board meeting dates.

ARC11/34

DATE OF NEXT MEETING

7th July 2011.