ARC (11)5TH
44 - 50

ROYAL MAIL HOLDINGS plc

(Company no. 4074919)

AUDIT AND RISK COMMITTEE

Minutes of the meeting held at 100 Victoria Embankment London on 17th November 2011

Members of the Committee Present:

Paul Murray	Non Executive Director, Chair of the Committee
Donald Brydon	Chairman
Nick Horler	Non Executive Director
Cath Keers	Non Executive Director – by Telephone

Apologies:

David Currie	Non Executive Director
Orna Ni Chionna	Non Executive Director
Les Owen	Non Executive Director

In attendance:

Derek Foster	Internal Audit & Risk Management Director
Moya Greene	Group CEO for ARC(11) 44-48
Matthew Lester	Chief Finance Officer for ARC(11)44-48
Jon Millidge	Company Secretary
Mike Prince	Financial Management & Control Director
Andrew Poole	Deputy Company Secretary
Alex Smith	Director, Business Development and Technology for ARC(11)/44
Richard Wilson	Ernst &Young
Kath Barrow	Ernst &Young
Ben Marle	Ernst &Young

The Chairman welcomed everyone to the meeting.

ARC11/44 **MINUTES**

(a) The minutes of the meeting of the 7th July 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 30th September 2011 and the minutes of the GLS Group Audit & Risk Committee held on the 3rd October 2011. Paul Murray commented on the excellent report from the Risk Management Committee which he had found particularly helpful especially in describing how the risk issues were being thought about by management.

(c) Derek Foster explained how the risk workshops operated in facilitating discussion on risk and the areas of the business that had been covered to date;

(d) Matthew Lester noted that the GLS Audit & Risk Committee would modify its approach to follow the Group and would consequently focus less on operational matters. He felt that the audit approach in GLS was effective and noted that management was given an opportunity to interview the auditor and raise any concerns.

ARC11/45 **STATUS REPORT** **ARC(11)44**

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

ACTION: Derek Foster

(b) AC11/31(f) Group Risk Profile: It was noted that this would be considered as an agenda item at the July ARC.

ACTION Matthew Lester

(c) Paul Murray noted that the recent Modernisation day had proved useful and asked management to consider ways in which the board could be introduced to risk in a more dynamic way. Matthew Lester agreed to consider the request.

ARC11/46 **iRED UPDATE** **ARC(11)45**

(a) Alex Smith was welcomed to the meeting. Moya Greene introduced a paper outlining issues arising from the investigation into iRed activities. It provided some background to the investigation, the main conclusions of the investigations and the closure plan arising from those conclusions;

(b) iRed had been established as a separate business unit in 2007 (initially called Royal Mail Document Services), reporting to the Strategy Director (Alex Smith) and with its own Board. From its inception, the business was managed by Ray Huntzinger and was created to provide new innovative products that looked at the interface of digital and physical communications. It had been explicitly agreed that iRed would operate outside of the normal policies /procedures of the Royal Mail - the belief was that these would stifle the entrepreneurial culture that iRed would need to grow its business;

(c) iRed had not made a profit since it was created (total losses £32m). For a number of years it had managed only one external contract, with Nationwide, but it had also managed the print function for Royal Mail Group over recent years. In March 2011 Ray Huntzinger claimed major contract wins with Sainsbury and Weight Watchers, and confirmed its budget for 2011-12 was to grow top line revenue by over £30m. The iRed management team were aware that if this could not be achieved then the business model would be re-appraised;

(d) In September 2011, the Company Secretary had had a discussion with a supplier of iRed that triggered some concerns regarding the controls within the organisation and that precipitated an enquiry by Royal Mail Internal Audit which was followed by investigations by Royal Mail Security. As a result of those investigations, Ray Huntzinger was suspended on 29th September 2011and Declan Salter, a turnaround specialist, was appointed to manage the company in the interim;

(e) The initial recommendations from Declan Salter were as follows:-

(f)
i. close iRed and transfer existing work into the Royal Mail;
ii. investigations into the conduct with iRed suppliers would continue;
iii. ensure that similar errors are not occurring elsewhere (and similar reviews would include Specialist Services, Parcelforce, Stamps & Collectables and China office initially);
iv. consider a programme for external review of divisions/companies, perhaps one organisation per quarter;
v. review the senior management structures in all divisions/subsidiaries such that there are appropriate internal management structures that are not controlled by one individual and where the majority of members must be full-time employees (not contractors);
vi. review the Corporate Governance for all divisions/subsidiaries; and
vii. review the processes for allowing concerns to be raised (and perhaps its 'whistle-blowing' policies).

(g) The Committee noted the main learning points, in particular the lack of formal business reviews by the iRed Board. Paul Murray asked Derek Foster to include details of any business areas not covered by the annual audit plan to help the Audit & Risk Committee understand any residual risk.

ACTION
Derek Foster

ARC11/47 **INTERIM REPORT & ACCOUNTS ARC(11) 46- 48**

(a) Sign Off Process ARC (11)46b: The Committee noted a paper setting out the formal sign off procedure that management had followed for the interim financial statements 2011-12. For the half year a formal compliance statement was not required. However the paper outlined a number of actions that had been undertaken to assure the Audit & Risk Committee that the financial position at 25 September 2011 and the financial performance in the first half of 2011-12 were fairly presented in the Interim Financial Statements;

(b) The Committee noted the balance sheet review performed as at September 2011;

(c) Matthew Lester asked the Committee to note that management had selected a set of long term pension assumptions which were not 'middle of the pack' but remained within the normal distribution used by other corporates. This resulted in a pension deficit of £4.6bn compared to £3.7bn had the mid-range assumption been selected. These assumptions had been approved at the Pension Committee and given these were interim results and the long-term trend assumption for cpi still had to settle down, proposed that a more conservative position, consistent with the year end, be adopted.

ACTION E&Y

The Committee agreed these assumptions. The Committee noted that the actuarial deficit was some £11bn and recognised that it was almost impossible to explain why accounting deficits and actuarial deficits moved in different ways to stakeholders. Donald Brydon asked the external auditors to work with the actuaries to produce a presentation which explained this in simple terms;

(d) Matthew Lester introduced the Half -Year results presentation, a pro-forma results presentation pack which provided a summary of the interim results versus last year. He highlighted the key messages around revenue growth, cost control and cash generation.

(e) The Committee noted the full draft interim report for the half year ended 25th September 2011;

(f) Summary Briefing Book: The Committee noted the summary briefing book for the half year ended 25th September 2011.

(g) Fines Compensation & Material Litigation: The Committee noted a paper providing an update on accruals and provisions covering potential fines, quality of service compensation and current material litigation and environmental issues and agreed they were reasonable in light of the risks and factors that had emerged since March 2011; and

(h) agreed that the Horizon claims were a contingent liability which was considered remote at this stage which meant no accrual would be booked and no disclosure made.

(i) Cash & Going Concern: The Committee noted the update on cash headroom management in RMG ex POL and its status as a going concern based on October 2011 actuals, together with an indicative forecast for 2011-12 and 2012-13 obtained via the Quarterly Business Review process. The range of forecasts included a "realistic but pessimistic downside case" which assumed no pension deficit relief and a recession in 2012 similar to that of 2008. In this downside case headroom ran out in August 2012;

(j) at period 7, the actual headroom was £516m higher than budget. This was better than expected;

(k) the Audit and Risk Committee noted the year to date actual position and the forecast cash ranges for 2011-12 and 2012-13;

(l) and agreed that RMG ex POL remained a going concern at September 2011 and that the two material uncertainties with respect to this position that existed at the year end still remained (as disclosed in the interim accounts).

ARC11/48 **E&Y REPORT ON INTERIM REPORT & ACCOUNTS ARC(11)49**

(a) The Committee noted a report from E&Y setting out their summary of the review findings and conclusion in relation to the Royal Mail's financial position and results for the 6 months ended 25 September 2011;

(b) E&Y concurred with the Going Concern basis of preparation for the Group accounts and had reviewed the draft basis of the preparation note. The report would include an emphasis of matter paragraph which would draw attention to fundamental uncertainties and key assumptions highlighted by management in the basis of preparation paragraph in the notes to the accounts;

(c) Subject to receiving outstanding documentation and completing the audit review E&Y anticipated issuing an unqualified review conclusion for the six months ended 25th September 2011;

(d) Letter of Representation: The Committee noted the proposed letter of representation.

ARC11/49 **AUDIT APPROACH 2011-12 AND PROPOSED FEES ARC(11)50**

(a) Kath Burrows introduced the 2011-2012 Audit planning report. The purpose of the report was to provide the committee with a basis to review and validate the proposed approach and scope for the 2011-12 audit, but also to align the audit with the Committee's service expectations;

(b) Paul Murray said that E&Y should be able to demonstrate that the audit approach was robust, effective and sceptical, as E&Y were by now very familiar with the business and its processes. The Committee noted that E&Y were seen to be playing a critical role in helping non-executives understand how the business was performing during a significant transformation and regulatory change. Donald Brydon confirmed that he believed there was an emerging risk around the setting of prices in a de-regulated mail market;

(c) Donald Brydon also enquired as to the audit activity

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ACTION E&Y

undertaken in relation to Procurement. E&Y confirmed that they took a 'controls & process' view of the activity, by undertaking a walk through test. E&Y would consider this area further and revert back to the Committee but felt that the process was fit for purpose in terms of the accuracy of the numbers;

ACTION Jon Millidge

(d) Jon Millidge was asked to review the Separation Agreement with POL to see if the requirements around a SAS 70 report with respect to the POL Horizon system were adequate;

(e) The Committee discussed the level of audit materiality, noting that for the purpose of determining whether the accounts were free from material error, E&Y defined materiality as the magnitude of an omission or misstatement that, individually or in the aggregate, in light of the surrounding circumstances, could reasonably be expected to influence the economic decisions of the users of the financial statements.

(f) E&Y reported that the raising of their materiality limit back to normal practice would still provide assurance on key routine controls but would allow them to re-invest time saved into higher risk areas;

(g) The Committee were interested to understand which risks were reviewed by Ernst & Young. Mike Prince provided one example of a risk that not covered by the audit: revenue protection. It was Managements responsibility to prepare the accounts and E&Y audit the revenues that are shown in the books: the revenue protection risk was that Royal Mail should be paid more than it records. The Committee asked E&Y to prepare a summary of the areas that are and are not covered as part of the year end audit;

ACTION E&Y

(h) Fees: The Committee noted the audit fee for the UK statutory and regulatory audit had been agreed at £1,395,000 consistent with the fee for the last two years. A further fee of £303,000 had been agreed to perform a one-off procedure to mitigate the risks from the PSP system migration and to gain comfort that adequate controls were in place in the new system.

(i) The Committee noted the summary of the non-audit services provided and billed by E&Y for the period 28th March 2011 through to 25th September 2011;

(j) The Committee noted the report.

ARC11/50 **DATE OF NEXT MEETING**

8th December 2011.

GRO