RMG00000085
RMG00000085

Royal Mail Holdings plc

Report to the Audit and Risk Committee

2010-11 Audit Planning Report

19 October 2010

Royal Mail reference: ARC (10) 36

ERNST & YOUNG

RMG00000085

Page left intentionally blank

RMG00000085

ERNST & YOUNG

Ernst & Young LLP
1 More London Place
London SE1 2AF

Tel: GRO
Fax:
www.ey.com/uk

Private and confidential
Audit and Risk Committee
Royal Mail Holdings plc
100 Victoria Embankment
London EC4Y 0HQ

14 October 2010

Direct Line: GRO
e-mail: aduncan1 GRO

Members of the Audit and Risk Committee

2010-11 Audit Planning Report

We are pleased to attach our Audit Planning Report for the forthcoming meeting of the Audit and Risk Committee. The purpose of this report is to provide the Audit and Risk Committee with a basis to review and validate our proposed audit approach and scope for the 2010-11 audit, but also to align our audit with the Committee's service expectations. We also include the results from our P6 accelerated audit procedures.

Whilst the new organisational structure of the Group is being implemented, the planning and execution of our audit approach will be flexible in order to respond to changes that may arise in terms of risks, controls, audit process and timetable. This report summarises our assessment of the expected business and financial statement risks which drive the development of an effective audit for Royal Mail Holdings plc. We have aligned our audit approach and scope with these issues.

This report is intended solely for the information and use of the Audit and Risk Committee, Board of Directors and management, and is not intended to be, and should not be, used by anyone other than these specified parties.

We welcome the opportunity to discuss this report with you on 19 October 2010.

Yours sincerely

GRO

Alison Duncan
For and on behalf of Ernst & Young LLP

RMG00000085

Page left intentionally blank

RMG00000085

Contents

RMG00000085

Page left intentionally blank

RMG00000085

Introduction

Royal Mail is currently undergoing a period of significant change. Following a request from the Coalition Government, Richard Hooper updated his 2008 report on the future of the UK Postal Services, which was released in September 2010. His key findings reconfirmed:

- Private capital is required in order to complete the modernisation of the business
- The historical pension deficit should be taken over by the Government
- A new regulatory framework is required

Project New Future is underway, which we expect to have a significant impact on the structure of the business over the coming months. The transformation plan to modernise and automate the Letters business continues against a backdrop of a declining market and a reduced market share.

Whilst a new Group organisational structure is being implemented, the planning and execution of our audit approach will be flexible in order to respond to changes that may arise in terms of risks, controls, audit process and timetable. At the time of writing this report, there are still many unknowns in relation to the impact of the finance team restructure on the year end close and audit processes. Consequently, the approach that we have outlined in this report is based on the current structure of the business, as well as the changes that we have discussed with management to date. Any changes to the details set out in this report will be reported to the Audit and Risk Committee at its next meeting.

The areas that we expect to be of most significant audit focus in 2010-11 will be the ongoing transformation, including the current restructuring process:

- As the restructuring and transformation plans are executed, the funding arrangements of Royal Mail Group and Post Office Limited ('POL') will require continuous monitoring and the flexibility of operational, financing and strategic actions to be continuously reassessed.
- The restructuring and transformation processes also have accounting consequences, for example the accounting for the proposed headcount reductions, potential curtailment of ColleagueShares and the treatment of sale and leaseback transactions for mail centres.

During our audit, we will review the progress that has been made in the areas that required additional audit effort in 2009-10, such as the POL payroll control environment and the elements of the SAP IT general control environment that are outsourced to Fujitsu. We will support management as they reorganise the finance function and use our experience and knowledge of the business to highlight areas of potential risk as they arise.

Over the following pages, we have provided a Summary audit plan, as well as more detailed information on our audit strategy.

RMG00000085
RMG00000085

Summary audit plan

This Summary audit plan outlines the key areas of audit emphasis for our 2010-11 audit. Project New Future has a number of financial statement impacts and we have outlined how our audit approach will reflect this. We also highlight other key areas of audit emphasis.

Project New Future

Transformation

Financial statement impact	*Change to audit approach*
Carrying value of assets: ▸ Ongoing viability of capital projects ▸ Mail centre reduction ▸ Sale and leaseback arrangements ▸ Onerous leases	▸ Review of all capital projects and assessment of carrying values required ▸ Review of new lease agreements and agreement of accounting treatment for sale and leasebacks ▸ Understand the impact of the updated mail centre strategy on asset carrying values
Systems implementation: ▸ SAP HR PSP system ▸ VAT changes in February 2011	▸ Work with internal audit to give our view on the proposed SAP HR control framework and provide assurance on the implementation process ▸ Understand and test the process that management has established to implement the rate changes, with input from EY VAT and IT specialists
ColleagueShares ▸ Good leavers ▸ Employee decision on redemption	▸ Test the valuation and calculation of payment to employees who leave as part of the restructuring process ▸ The first potential payment date falls in the financial year, although it may be impacted by the proposed employee ownership plans on privatisation

Restructuring

Financial statement impact	*Change to audit approach*
The impact of restructuring on: ▸ Severance provisions ▸ Non-severance provisions	▸ Up front agreement that current provisioning accounting methodology is appropriate for New Future ▸ Challenge management assumptions reflect agreements in place
Restructured finance organisation: ▸ Impact on processes and controls ▸ Impact on reporting timetable	▸ Understand new structure of finance function and financial reporting timetable ▸ Continue collaborative approach with finance teams on information requirements ▸ Feedback areas of potential control risk
Going concern assumption: ▸ Revised business plans ▸ Capital expenditure ▸ Restructuring spend ▸ Flexibility of management actions	▸ A number of the transformation decisions/restructuring decisions have an initial cash consequence and may impact the flexibility of management actions

Pension reform

Financial statement impact	*Change to audit approach*
The impact of restructuring on: ▸ Pension fund valuation assumptions ▸ Impact of funding agreement on timing of cash flows	▸ Monitor Pension Regulator findings in relation to timings of cash flows ▸ Continue to use EY actuarial experts to assess key assumptions

Regulation

Financial statement impact	*Change to audit approach*
▸ Impact of proposed regulatory changes on cash flow forecasting and modelling ▸ Regulatory accounting principles scheduled for release in November 2010	▸ The proposed regulatory changes introduce an element of uncertainty to be considered as part of the cash flow forecasts ▸ Updated principles are not expected to impact the current year's Regulatory accounts, but we will work with management to understand the potential implications for 2011-12

RMG00000085

As management implements Project New Future, there are a number of factors that will need to be considered looking forward to potential privatisation. We have highlighted these below, as well as the insight that we will provide throughout the 2010-11 process:

Privatisation considerations

POL separation:
- Employee contracts
- Shared contracts
- Pension balances

Group structure:
- Tax structure
- VAT impact
- GLS ownership
- Dividend block
- Impact of takeover on contracts

Employee ownership:
- Structure of share plans
- Interaction with ColleagueShares

Privatisation process:
- Vendor due diligence
- IPO readiness
- Working capital
- FRP procedures

Insight from the audit

- Review of significant contracts required by ISAs
- Pension consideration as part of RMG/POL statutory accounts

- Tax structure reviewed as part of tax loss model
- Dividend block considered in plc investment testing

- Audit of ColleagueShare model and assumptions
- insight on structure of share plans

- Controls-based audit approach covers main FRP requirements
- Going concern review considers funding position, management forecasts and working capital to audit tolerance

Other areas of audit emphasis

In addition to Project New Future, we outline below the other key areas of audit emphasis from the underlying business. The areas of audit emphasis that are 'significant risks' in accordance with International Standards on Auditing have been highlighted in the 'Areas of audit emphasis' section:

Business risk	*Financial statement impact*	*Audit approach*
Taxation	▸ Deferred tax asset recognition ▸ GLS tax expense	▸ Review of deferred tax calculations and appropriateness of asset recognised ▸ Review of tax balances by EY tax experts in each of the key GLS locations
VAT	▸ Partial exemption methodology ▸ Changes in VAT rate	▸ Obtain an update on the progress of partial exemption methodology negotiations, vouching that changes have been appropriately reflected ▸ Use of EY IT analytical tools to test the rates applied to the relevant products
Revenue recognition	▸ Revenue is recognised appropriately	▸ Focus on deferred revenue balances, including SITHOP/MITHOP and international mail settlement provisions ▸ Test cut off of revenue around the year end date ▸ Review of contracts for new business eg in POL

RMG00000085

Our service commitments

Building on your assessment of our 2009-10 service quality

In order to assess our performance during the 2009-10 audit cycle, we have undertaken an assessment of our service quality to ensure that we provide Royal Mail with the highest level of assurance, and to ensure that we meet your particular service needs.

We interviewed nine individuals, including the Chairman of the Audit and Risk Committee and seven senior management team members involved in Finance and Risk. The interviews were conducted in June 2010 by Richard Wilson and a senior member of our Service Quality team.

We asked each of the interviewees for an assessment of their overall satisfaction on a scale of 1-5, with 1 being extremely dissatisfied and 5 being extremely satisfied. The average score across all participants was 4.1.

The review identified key strengths in our relationships that we will maintain, together with areas for improvement. The following summarises the action plans we have developed:

	2010-11 commitments
Continuous communication	► In addition to the audit findings that we currently report, provide greater visibility and feedback on our point of view on how the GLS business is run to the Audit and Risk Committee. ► Our audit process and approach is well understood by the UK finance teams following the introduction of the joint planning day in 2008 and will continue.
Fair and transparent fees	► We will continue to provide management with a detailed breakdown of the proposed cost of our audit and where we spend the time. This is agreed each year with the respective finance teams and aggregated at the centre. No additional work is undertaken prior to agreement with Group Finance. ► Continue to strive for audit efficiency and challenge how we can get the most from working with others, such as internal audit, to minimise the cost base.
Relevant insight	► Continue to support management's desire to adopt a 'plc' culture. During our audit we will provide observations on the financial reporting process compared to FTSE peers. ► Provide benchmarking observations around the narrative reporting section of the Annual Report to compare Royal Mail reporting to FTSE100 companies.
Right team	► Feedback on the current structure of Alison Duncan as audit signatory, with Richard Wilson as Senior Advisory Partner is that it works well and will continue. ► Continuity in the audit teams is strong, particularly at senior levels, where there was strong feedback on the quality of individuals. Management commented on the knowledge and understanding of the business, technical abilities, as well as pragmatism. ► Following increased oversight of the GLS tax function from the centre, the audit of the GLS tax balances will be coordinated by the Group tax team in London, rather than the GLS audit team.
Technical interaction	► Ernst & Young has previously provided a tailored technical update training session as part of the joint planning day with the Group finance team. Management has requested that in 2010 we provide an all day technical update for key Royal Mail finance staff.
Industry focus	► We will provide industry insight and benchmarking against our other postal clients globally to share best practices on those items that matter most to you. We are currently working with management to benchmark the process for deferring SITHOP revenue balances against peer postal operators.

In light of the proposed finance reorganisation, we will tailor our audit service as required so that it responds to the finance team's most urgent needs. Through the process, we will provide management with flexibility in our approach and continuity in our audit teams. We will continue to offer our point of view on the areas of risk, controls and process as change is implemented.

RMG00000085

Developing our audit strategy

Objective and scope of our audit

Our audit service includes the provision of statutory audit opinions, together with audit-related services.

Our statutory audits include:

- The provision of statutory audit opinions under International Standards on Auditing (UK and Ireland) on the consolidated IFRS financial statements of Royal Mail Holdings plc ('Royal Mail') and on the UK GAAP parent company accounts for the year ending 27 March 2011.
- The provision of separate statutory audit opinions on Royal Mail's subsidiaries as required by local regulations (for details of UK statutory opinions see appendix B).

We leverage our knowledge and work performed on the statutory audit in delivering audit-related and assurance work required by the postal regulations and other related services.

Materiality

For the purposes of determining whether the accounts are free from material error, we define 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. Our evaluation of it requires professional judgement and necessarily takes into account qualitative as well as quantitative considerations implicit in the definition. We would be happy to discuss with you your expectations regarding our detection of misstatements in the financial statements.

The amount we consider material at the end of the audit may differ from our initial determination. At this stage, however, it is not feasible to anticipate all of the circumstances that may ultimately influence our judgement about materiality. At the end of the audit we will form our final opinion by reference to all matters that could be significant to users of the accounts, including the total effect of the audit misstatements we identify, and our evaluation of materiality at that date.

Reporting unit scoping

We set audit scopes for each reporting unit, based on size and risk factors, which when taken together, enable us to form an opinion on the group accounts as a whole.

The majority of the audit work is carried out by the Ernst & Young teams from London, except for:

- GLS: The audit of Royal Mail's European parcels business, GLS, is coordinated by our Ernst & Young Frankfurt team. In order for the GLS audit team to provide us with an opinion on the GLS group as a whole, the team set a separate scope for each of the GLS businesses, based on the same size and risk factors that we use to scope our audit. The GLS audit scope is approved by the GLS Audit and Risk Committee. The local EY team mirrors the GLS approach and performs a hard close audit on the P11 numbers, and review the roll forward to P12.

  In 2010-11, Ernst & Young teams will perform procedures in 15 of the 20 GLS countries, covering 95% of the business by revenue.

- FRES: Given the relative contribution of FRES to Group operating profit (£30m in 2009-10), we instruct PricewaterhouseCoopers (the statutory auditor of FRES) to report the results of their audit to us, in line with the Group reporting timetable.

Full details of the scope and locations of our procedures are detailed in Appendix B.

RMG00000085

Audit process overview

Our audit process has been designed in conjunction with management over a number of years to provide an efficient audit that meets the Group reporting timetable and addresses our assessment of audit risk.

A controls-based audit approach

Our audit approach is controls-based, which is the most efficient process for a business with a high volume of transactions. We will test controls around selected Revenue streams and Payroll processes to gain assurance that revenues, staff costs, trade debtors and payroll-related balance sheet and income statement balances are materially correctly stated.

In POL, payroll control improvements we had previously suggested have now been implemented, and we therefore expect to also be able to take a controls-based audit approach for payroll in POL.

IT controls

IT underpins a significant proportion of Royal Mail's transactions. Our audit plan is designed around reliance on certain IT applications and the use of electronic audit evidence. We will therefore evaluate the IT general control environment, test IT controls covering user access, programme changes and IT security.

Where it is more efficient, we plan to obtain a certificate of reliance (a "SAS70" report) from the Group's IT suppliers. This is the case for CSC. However, based on past experience, we do not expect to receive a SAS 70 from Fujitsu. The following IT applications are in scope across the Group:

Application in audit scope	Group	Letters	POL	Regulatory
SAP – Consolidation BCP	✓			✓
SAP Revenue Management BSP	✓	✓		✓
SAP Revenue Management BW	✓	✓		✓
SAP – ESFS	✓	✓		✓
SAP – ADS	✓		✓	✓
SAP – SDS	✓			✓
SAP – OBA	✓	✓		✓
SAP – HR	✓	✓		✓
SAP – POL FS			✓	
Credence			✓	
Horizon Next Generation			✓	
TDA		✓		
Infinium Payroll	Preliminary conclusion – control environment ineffective, no testing procedures			
E-pro	Preliminary conclusion – control environment ineffective, no testing procedures			
MDR/FRS	Preliminary conclusion – control environment ineffective, no testing procedures			

The last 3 applications listed are legacy systems that do not have a strong control environment in place. We have agreed with management to undertake alternative procedures over data from these systems.

RMG00000085

Leveraging technology

The benefit of a controls-based approach is that we can leverage technology and use EY's powerful IT analytical tools. This increases the efficiency of the process and is also valuable as it enables us to test entire populations of data, rather than using sampling techniques.

We will use these analytical tools in our audit of journal entry postings, payroll, debtors and creditors. The tools identify anomalies in the data such as employee payments before joining date or invoices that are paid without a purchase order, which we investigate further.

In the current year, we will extend our use of analytics in two areas to address specific risks:

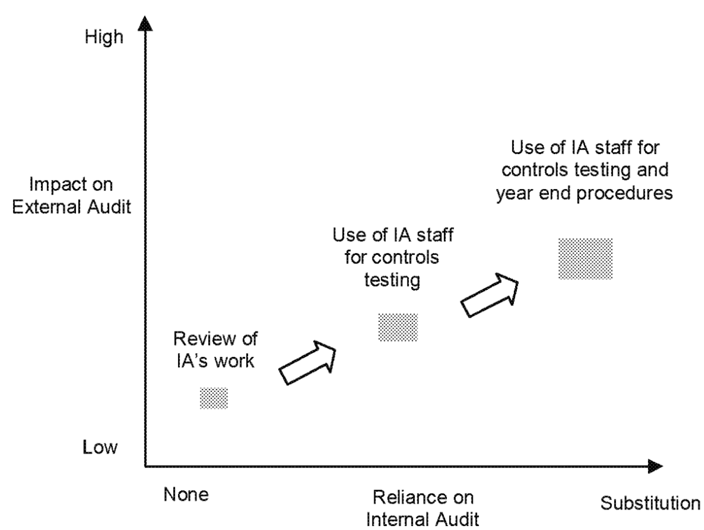
- Review the application of VAT rates for a population of transactions to vouch that the appropriate rate change has been implemented following the TNT VAT ruling.
- EY has a proprietary IT solution called SAP Explorer, which is non-invasive and allows us to test the control configuration of the SAP environment and identify control exceptions and anomalies with user access rights. Whilst Royal Mail's IT control environment is undergoing a period of change it is not efficient to use SAP Explorer across the Group. However, to highlight the value that it can bring, we are in discussion with management to run a pilot using one of the Group's SAP processes.

Direct assistance from Internal Audit

Internal audit staff provide assistance in testing the controls over revenue and payroll, using their experience and knowledge of the business. They essentially work under the direction of Ernst & Young, while key decisions, such as sample selections and the application of judgement remain within the Ernst & Young team.

This practice is now increasingly being used on our other large and FTSE audits to keep costs down. Internal audit personnel gain a different experience from working with Ernst & Young and there is two-way feedback as part of our team and internal audit's annual performance appraisal.

The following chart highlights how our ability to rely on internal audit impacts our audit:



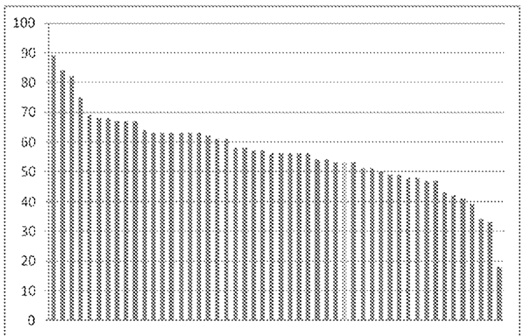
We are currently working with management to confirm the extent of our use of internal audit resource for the current year.

RMG00000085

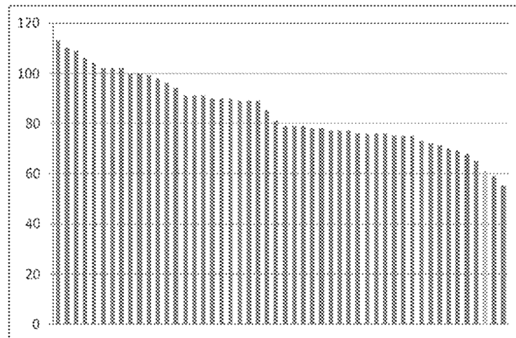
Period 11 hard close

Royal Mail has historically adhered to a strict reporting timetable as part of its commitment to best practice. In the prior year, Royal Mail issued a preliminary announcement 53 days after the year end, with signed accounts published 61 days after the year end. The graphs below show how this reporting compares to companies in the FTSE50-100:

Days to file preliminary announcement:



Days to publish Annual Report:



These charts show that Royal Mail reports on a very timely basis and would be in second quartile of this FTSE group in respect of the preliminary announcement and the first quartile for the annual report.

The ability to report in such a timely manner has been supported by the controls-based approach, as well as our P11 hard close. We will perform our substantive audit procedures on P11 ‘hard close’ balances, with the exception of balances which are only recorded at P12 such as pensions and tax. At P12 we will audit these remaining balances and update our P11 procedures.

The benchmarking above shows that there is flexibility in the reporting timetable and the year end timeline will be finalised once the structure of the finance function is known. Whatever timeline is agreed, the hard close approach will reduce the peak of work that is required post year end and will assist in identifying and resolving issues prior to our final audit visit.

Quality Assurance

We have the following processes in place to support our team in delivering an audit opinion that is both robust and technically compliant:

- Independent review: A partner, independent of the audit team, to provide guidance and challenge on the key judgemental areas of the audit. This partner reviews the Report and Accounts, as well as key audit deliverables, including all reports to the Audit and Risk Committee.

- Technical review of Report and Accounts: Richard Crisp from our Financial Reporting Group will review the Report and Accounts to check that the disclosures are appropriate and that any new reporting requirements are met. Richard has provided support to the Royal Mail team for a number of years. We will continue to adopt the approach that has worked in previous years with Richard reviewing a ‘skeleton’ set of accounts in advance of the year end, as well as in the close process, to maximise efficiency and avoid surprises.

- Every Partner is subject to an internal ‘Audit Quality Review’ every three years by a team independent of the Audit team and the Partner’s location. This is to ensure that the Partner’s audits have been conducted in accordance with Ernst & Young’s audit methodology.

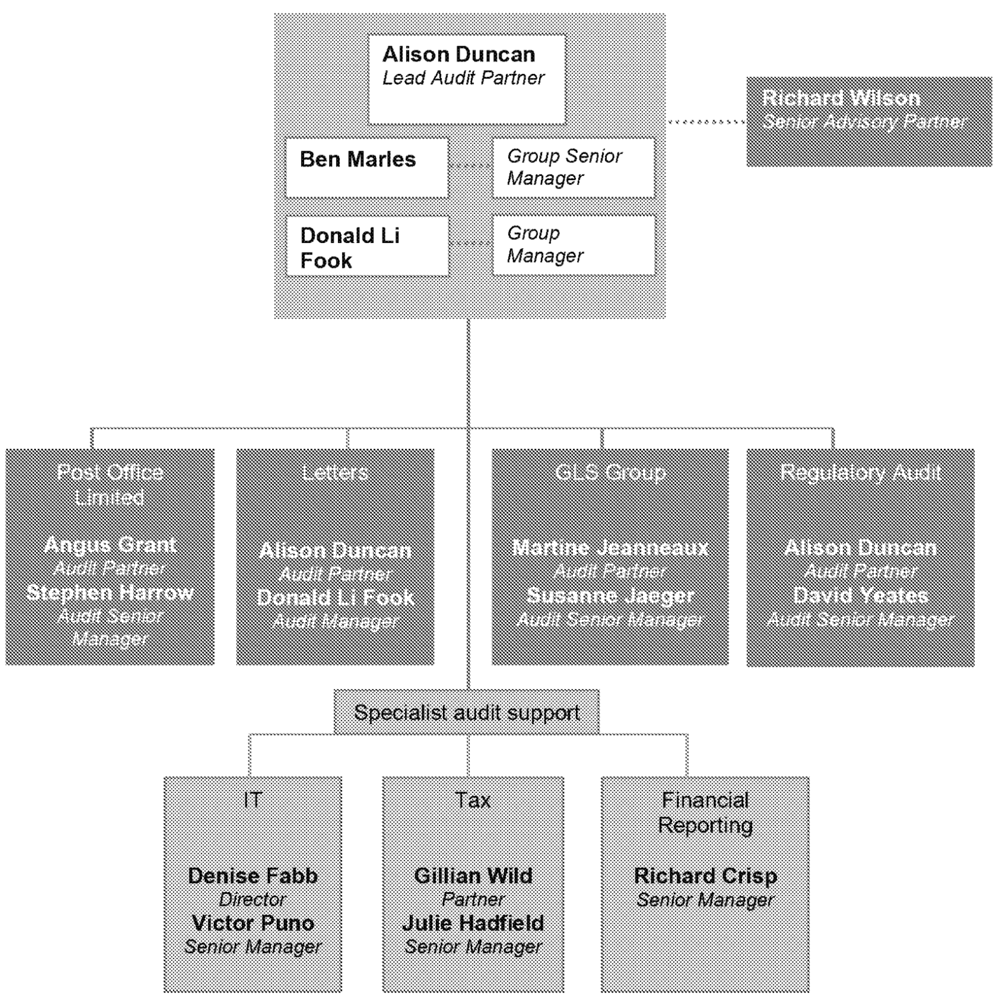
We are confident that these procedures, which are consistent with those that we would perform on a listed audit client, will provide you with the highest quality technical input.

RMG00000085

Your audit team

Your audit team is lead by Alison Duncan, supported by Richard Wilson, the Senior Advisory Partner.

- We have maintained significant continuity in our teams at senior levels. This was reflected in the strong positive feedback that we received as part of our Assessment of Service Quality for our 2009-10 audit.
- The main change in the team is in IT, where we have introduced Denise Fabb and Victor Puno to leverage their SAP experience for the audit of the core IT applications, as well as their views on the current SAP-HR project.
- We are currently working with the Board in relation to Audit Partner rotation. Alison Duncan is due to rotate off the Royal Mail audit after March 2011 as she will have served the maximum 7 years. However, in light of the significant change in management and across the business, there is the potential to invoke an exception in the Ethical Standards that allows an Audit Engagement Partner to remain on the audit longer.



Our audit team also includes a number of other specialists to assist us with our procedures, including specialists in pensions, real estate, VAT, modelling and corporate restructuring. In addition, we are able to draw from knowledge and experience of all our EMEIA practice which operates as one firm.

RMG00000085

Areas of audit emphasis

Our audit plan is developed, with input from management, to provide assurance over the Group's reported financial results as well as providing insights and recommendations in relation to the Group's financial processes, accounting compliance and financial statement disclosures. This allows the potential impact of issues on the Group's financial reputation to be assessed by the Board and management. We outline below the key areas of audit focus based on our assessment of the key business risks, key financial statement risks and significant accounts and disclosure requirements.

We summarised the areas of audit emphasis, including those resulting from Project New Future in our Summary audit plan on pages 2 and 3 and these are described in more detail below. We also include commentary on additional areas of audit emphasis, such as tax and VAT. Our audit will also include the mandatory procedures that we are required to perform in accordance with applicable laws, regulations and auditing standards.

These key areas of focus are from a Group perspective. Our GLS team separately provides the GLS ARC with detail of the significant financial statement risks for the GLS group. These traditionally include the collectability of accounts receivable, deferred tax balances and LTIP.

Restructuring	
Description of risk and financial statement impact	*Our audit approach*
Management is current implementing Project New Future. The restructuring will lead to a reduction in head count, with a significant increase in severance provisions and spend. There will also be an impact on the ColleagueShares provision, as "good leavers" are entitled to sell their shares on departure. Royal Mail has a structured process in place for managing its severance provisions. Business cases are approved by appropriate management, with predefined approval limits. The provision is calculated based on known salaries or, when the individuals are not known, on an average salary for the role and geographical location.	► Review management's process to assess that it continues to operate effectively. ► Review provisions that have been established to meet the IAS 37 criteria and vouch amounts provided to salary information. ► Compare exceptional costs to Royal Mail accounting policies. ► ColleagueShares impact discussed in more detail later in this section.

Carrying value of assets	
Description of risk and financial statement impact	*Our audit approach*
IAS 36 Impairment of Assets requires that indefinite-lived assets are tested for impairment and that other assets are reviewed at each reporting date for indicators of impairment. The most significant indefinite-lived asset relates to the goodwill recognised on acquisition of GLS. Royal Mail performs an annual impairment exercise to support the carrying value of the goodwill in relation to GLS. The most significant long-lived assets that are held at cost less accumulated depreciation/impairment are Royal Mail Holdings plc's investments in subsidiaries of £3.8bn and Royal Mail's property assets and the plant and equipment of the Letters business. As part of the transformation plan, management continues to review the mail centre strategy, which has led to a number of sale and leaseback transactions and is also currently reviewing ongoing capital projects, given the current funding position. At March 2010, following a decline in property values, an impairment exercise was performed to support the carrying value of the properties assets. At year end, management will consider whether there are any further indicators of impairment.	► Review of GLS goodwill impairment exercise to support the carrying value of the goodwill and challenge the significant assumptions made. ► At year end, discuss with management their assessment of the presence of any impairment indicators. Where an impairment exercise is required, we will review management's calculations to assess amounts recognised in the balance sheet are appropriate. ► Discuss mail centre strategy with management and understand any assets that are at risk of impairment or leases that become onerous. ► For sale and leaseback transactions, review these with management during the year to assess the appropriate accounting treatment and determine that the lease liability has been recognised. ► Review capital projects to assess the carrying value of capitalised spend.

RMG00000085

Restructured finance organisation

Description of risk and financial statement impact	*Our audit approach*
The current restructuring will lead to a finance function that is different in terms of size and structure. This could potentially impact: ► The existing control framework ► The financial reporting timetable.	► Continue our collaborative approach with management and work with the new team to determine an audit process and timetable that is appropriate during this period of change and provide detailed information requirements to meet the timeline established. ► Provide feedback on the finance structure, key areas of risk and the control environment adopted.

Systems implementation

Description of risk and financial statement impact	*Our audit approach*
HR PSP The new HR PSP system due to be implemented from April 2011 is a business critical system for Letters. If correctly designed and implemented, the system has the potential to streamline the payroll processes and provide greater clarity of costs along the reporting lines within Letters. However, the implementation of the new system also gives rise to a number of risks. These include the transfer of sensitive data, establishing appropriate controls within, and around, the new system and training system users.	► Prior to implementation, we will review design of IT controls around user access, segregation of duties. ► Perform control review procedures around the data migration from the legacy system to the new SAP system. ► Aim of our procedures is to assess reliance on the payroll system from implementation date and early identification of issues.
VAT Following a European Court decision, HMRC will require VAT to be accounted for on non-price controlled products from 31 January 2011. Royal Mail has established a project team, which includes members from Group Tax, the Letters, POL and Parcelforce business units, Group IT and the outsourced IT providers and is in the process of identifying the appropriate VAT treatment for each product and how this will be tracked by the IT systems.	► Understand and test process that the project team has established in respect of the rate changes. ► Seek input from our VAT and IT experts where appropriate and provide management with feedback prior to the introduction date. ► Review the partial exemption calculation and the test the VAT balances that are recorded at balance sheet date.

ColleagueShares

Description of risk and financial statement impact	*Our audit approach*
ColleagueShares At March 2010 a provision of £108.6m was recorded in relation to the ColleagueShare phantom share incentive scheme that was introduced during 2008. This provision reflected management's best estimate of the current value of the obligation to buy back the ColleagueShares from employees in 2011 and 2012. The estimation of the provision will continue to be refined as more accurate information is obtained. The key assumptions remain: ► The number of ColleagueShares to be paid out in 2011 and 2012 (employees' discretion) ► The rate of leavers ► The discount rate ► The multiple of different assumptions supporting the value of each ColleagueShare at the date of payment.	► Review updated ColleagueShare model and challenge any changes in assumptions made. ► Assess whether assumptions remain valid in light of changes in the business during the year. ► Test payments made to "good leavers" as part of the current restructuring process. ► Understand management's intention regarding employee ownership as part of the privatisation process and the impact that this may have on the ColleagueShares liability.
Stakeholder dividends At each year end of the ColleagueShare scheme, Royal Mail accrues for the stakeholder dividend payable. At March 2011, the Group will make an accrual based on the Group's results compared to profit targets. In previous years, the profit targets have not been approved by the Government and we have obtained specific representation from management on their intention to pay out the full £400 (2009 and 2010) or £800 (2008) per employee.	► Test management's calculations for the level of Stakeholder dividends accrued. If necessary, we will continue to seek specific representation from management on the amount accrued. ► Review changes to the ColleagueShare scheme agreed as part of the latest pay deal

RMG00000085

Going concern - Funding and covenants*

Description of risk and financial statement impact	*Our audit approach*
Royal Mail Group and Post Office funding *RMG* Key factors in our 2009-10 going concern conclusion were: ▸ Business plan forecasts and sensitivities ▸ Credibility of management's operational and financial actions ▸ The funding plan for pension deficit repair ▸ Flexibility on transformation The 2010-11 funding analysis will need to reflect the impacts of Project New Future, including any proposed changes to capital expenditure, planned restructuring spend and revised business plans.	▸ Review of updated management actions each month to establish the impact that changes in the business have on the flexibility of management actions. ▸ Review the funding analysis prepared by management and ensure that it supports the going concern basis. We will challenge significant assumptions, accuracy of forecasts, areas of judgement and flexibility of cash flows as well as performing sensitivity analysis on key drivers.
POL Post Office's current funding agreements expire in 2016, subject to State Aid approval, with a Social Network Payment agreed to 2012.	We will discuss the progress of the POL application for State Ai approval and review the disclosures in the Annual Report to ensure that they are appropriate.
Covenant compliance Management will also prepare covenant calculations for the year ended 27 March 2011 for the Senior debt facility and the GLS facility, as well as projected covenant calculations using the latest strategic plan to ensure covenant compliance for the foreseeable future. The 2009-10 covenant projections highlighted a potential Loan to Value ('LTV') covenant breach in March 2012 if property values do not recover significantly. This was disclosed in the 2009-10 Report and Accounts, together with management's intention to seek a waiver from Government if property values do not recover.	▸ Review and reperform management's covenant compliance calculations to ensure compliance with facility terms. ▸ We will track this matter prior to year end and participate in the assessment of options including agreement of a waiver, to ensure we are satisfied that any solutions are appropriat for audit sign off.

Pensions*

Description of risk and financial statement impact	*Our audit approach*
At March 2010, Royal Mail recognised a net pension liability of £8.0bn. During the year, the Royal mail pension trustees have finalised their triennial pension funding valuation, and agreed a new pension deficit funding payment profile with the Group, although we note that The Pension Regulator is currently reviewing the agreement. The deficit, together with its public profile following the revised Hooper report mean that the liability recognised on the balance sheet, and the disclosures included in the annual report, attract significant focus. The size of the scheme's assets and liabilities means that the valuation process adopted by the Group's actuaries is extremely sensitive to small changes in actuarial assumptions, such as the discount rate and mortality assumptions.	▸ Review key financial assumptions supporting the valuation, with input from Ernst & Young pension specialists, where appropriate and ensure that the methodology is consistent with 2009-10. ▸ Benchmarking Royal Mail assumptions against peers we will assess and provide insight into the relevant position of the treatment adopted. ▸ Review the results of the triennial funding valuation and discuss it with the Group's actuaries. We will ensure that any updates to the scheme information, such as mortality assumptions, are reflected in the IAS 19 valuation of the March 2011 obligation.

RMG00000085

Regulation

Description of risk and financial statement impact	Our audit approach
The updated Hooper report has recommended that a new regulatory framework is required and Postcomm has conducted a consultation over the summer of 2010. A change in the regulatory framework is likely to have a significant impact on the future of the business, with impacts on: ▸ Price control ▸ Pricing flexibility ▸ Competition This will impact on future cash flow forecasts and feed into the Group's business plan.	▸ Consider the potential impact on the future cashflows as part of our funding review, ensuring that appropriate sensitivities are included to reflect potential changes.

Taxation*

Description of risk and financial statement impact	Our audit approach
Income tax At March 2010, a deferred tax asset of £94m was recorded in the Group financial statements. This principally related to the tax benefit of pension funding that is expected to be realised over the next five years. A complex recognition model is used to establish the amount of tax benefit expected. Royal Mail's basis of UK deferred tax asset recognition is restricted to the amount of tax benefit which is expected to be realised in the next five years, with unrecognised potential deferred tax assets of £2,847m at March 2009. Management is currently reviewing the methodology in relation to the deferred tax asset recognised to ensure that it remains consistent with the approach taken by other corporates.	▸ Discuss deferred tax methodology with management and will review the deferred tax calculations, together with the updated forecast for accuracy and consistency with previous periods. ▸ Assess the appropriateness of the deferred tax asset recognised in light of the Group's forecast profitability, together with the unrecognised potential deferred tax assets.

VAT*

Description of risk and financial statement impact	Our audit approach
Royal Mail has agreed a new partial exemption methodology with HMRC that applies from the beginning of the 2009-10 financial year. Management is currently finalising the calculations and the impact that the revised methodology will have on the financial statements.	▸ Discuss new methodology with management and review and reperform the calculations that they have made and provide insights on how the methodology has been implemented.

Revenue recognition*

Description of risk and financial statement impact	Our audit approach
The majority of Royal Mail's revenue transactions are routine in nature, with minimal judgement required. An area that is more complex is the deferred SITHOP/MITHOP revenue balances, which require judgement and estimation. An adjustment is made to the system-generated revenue figure at the end of the year for stamps and meters that have been sold to customers but not yet used. The deferred revenue is estimated based on surveys of retailers, businesses and of the general public.	▸ Review management's approach and the survey results and calculations used to estimate the deferred revenue, focussing on consistency of assumptions and methodology. ▸ For new products or revenue streams, we will review the accounting treatment in line with the revenue recognition accounting standard.

* Significant risks as defined by International Standards on Auditing

RMG00000085

Other required procedures

In addition to the audit impact of financial statement risks outlined earlier in this section, we have to perform other procedures as required by auditing, ethical and independence standards, company law and other regulations. We outline the procedures we will undertake during the course of our audit.

Mandatory procedures required by auditing standards on:

- Addressing the risk of fraud and error
- Auditing the significant disclosures included in the financial statements
- Reviewing entity-wide controls
- Reading other information contained in the financial statements and reporting whether it is inconsistent with our understanding and the financial statements
- Confirming auditor independence.

Procedures required by company law:

- Opining on whether the information contained in the directors' report is consistent with the financial statements.
- Auditing the disclosures contained in the auditable part of the directors' remuneration report to ensure it is in agreement with accounting records and returns.

Procedures we perform as required by the listing rules

Given the Group's stated aim to adopt a 'plc' culture and its historical approach to financial reporting, we also perform the following procedures that are required by listing rules:

- Review of the company's disclosures relating to corporate governance, going concern and directors' remuneration.
- Review of the preliminary announcement to ensure that financial information is correctly extracted from the financial statements and that commentary is consistent with the information we have audited.

We have included in Appendix B a list of matters that we are required to communicate to you under professional standards.

RMG00000085

Regulatory audit and other assurance related requirements

In addition to the statutory audit requirements, we are required, as auditors of the Group to perform procedures on a number of reports required by postal regulation and related matters, including:

- The audit of the regulatory accounts as required by Royal Mail's licence and the EC Directive. This is the most significant element and is discussed in more detail below.
- Procedures in connection with the Directors' Statement of Covenant Compliance for the Royal Mail and Post Office Limited credit facilities from BERR.
- Procedures in relation to Licence Condition 16 on the adequacy of resources and Licence Condition 21 in relation to the application of the price setting process.
- Procedures in relation to DVLA motor vehicle licence transactions and the Bank of England note circularisation scheme.
- Procedures on fuel rebates submissions to the Department of Transport.

Where appropriate, we design the above procedures together with our statutory audit procedures to maximise the efficiency and leverage the work already performed.

Regulatory accounts

As is the case in other regulated industries, Royal Mail is required by paragraph 4(a) of Condition 15 of the Licence to prepare regulatory financial statements. We are required to issue an opinion that the financial statements have been properly prepared, in all material respects, in accordance with the regulatory accounting principles and basis of preparation and with the requirements of the licence.

We review regulatory financial information on a quarterly basis, to confirm our understanding of the costing model and the systems environment. This involves an analysis of the integrity of the system, ensuring system or costing allocations are reasonable and have been correctly implemented and applied consistently.

Changes in Regulatory accounts

The principles underlying the regulatory accounts of Royal Mail in previous years have been developed over time in conjunction with PostComm. However, PostComm is expected to issue new Regulatory Accounting Guidelines ("RAGs") in December 2010. Royal Mail management has been consulted on these changes, and based on discussion with management we expect that the RAGs will have a number of potential implications:

- The change in methodology is likely to lead to different profitability of USO products. This may have an impact on the price setting of USO products and the perception of the business by potential investors.
- Reporting burden on Royal Mail is likely to increase in terms of complexity and reporting requirements.

We will review the new RAGs to be issued in December and work in conjunction with the Regulatory Reporting team to assess the impact. While we do not expect that the 2010-11 Regulatory accounts will be impacted by the new RAGs, the changes in reported costs and profits may have real implications on pricing and future cash flows and therefore impact on the going concern assessment at the year end.

RMG00000085

Regulatory and accounting developments

Following the issuance of new auditing standards in October 2009 by the International Auditing and Assurance Board (IAASB), the Auditing Practices Board (APB) has issued in the UK and Ireland a revised suite of auditing standards which will be applicable for the current year's audit.

This has resulted in the revision of twelve auditing standards, and the introduction of two new standards, addressing communication of deficiencies in internal control, and the evaluation of misstatements. Our audit approach has been amended as necessary in order to ensure compliance with the new standards. The primary areas of change will be with respect to:

Area of change	Detail of change and impact on the audit	Impact on Royal Mail
Related party relationships and transactions (RPTs)	Clarified ISA 550 (UK and Ireland) requires the auditor to apply increased rigour and scepticism to the audit of RPTs. There is an increased focus on the identification and assessment of risks of material misstatements associated with RPTs coupled with a requirement to perform additional procedures to respond to such risks. Such procedures include: ► Obtaining an understanding of the controls that management has established to a) identify, account for and disclose RPTs and b) authorise and approve significant RPTs and arrangements outside the normal course of business. ► Obtaining sufficient evidence where management assert that a RPT was conducted on terms equivalent to an arm's length transaction. ► Performing specified procedures on significant RPTs outside the normal course of business.	We have discussed the impact with management who have agreed to ► Document the names of RPTs, the terms of the relationships and arrangements, and their business rationale. ► Document any controls that management have to a) identify, account for and disclose RPTs and b) authorise and approve significant RPTs and arrangements outside the normal course of business. This requirement will encourage management to strengthen the controls around the identification and reporting of related party transactions.
Estimates (including fair value estimates)	Similar to the changes in the audit of RPTs, ISA 540 requires the auditor to exercise increased rigour and scepticism in the audit of estimates, including a consideration of indicators of management bias. New requirements of the ISA include: ► More in depth understanding of how management identifies those transactions, events that give rise to the need for accounting estimates, and how management makes accounting estimates ► Reviewing the outcome of accounting estimates included in prior period financial statements or, where applicable, their subsequent re-estimation for the purpose of the current period ► Requiring substantive procedures to respond to significant risks ► Reviewing management's judgments and decisions to identify whether there are indicators of possible management bias	Similar to the changes in the audit of RPT, we have discussed with management who have agreed to prepared a summary of: ► The key accounting estimates including pension valuation, restructuring and non-restructuring provisions, and QoS provisions. ► The process used in arriving at these. ► The outcome of accounting estimates included in prior period financial statement. This will allow both auditors and management to more easily assess accounting estimates at the year end, and judge retrospectively the accuracy of previous estimates.
Other changes	There are a number of other changes in auditing standard requiring analytical reviews of out of scope locations in audits of group financial statements and communication of control deficiencies in writing to those charged with governance.	EY audit methodology, which is based on the highest common denominator of requirements and best practice across a number of countries, already complied with these requirements. As such, there will be no additional impact on the Group.

RMG00000085

As part of the convergence project, the IASB and the FASB are working on a number of high profile projects that may have significant impacts on users of IFRS and US GAAP. We highlight below those exposure drafts issued during the year which might impact the Group in the future.

Area of change	Detail of change and impact on the audit	Impact on Royal Mail
Leases Exposure Draft	► The IASB issued an exposure draft (ED) on accounting for leases in August 2010. The ED is part of the convergence project with the US FASB. ► The ED requires lessees to recognise a liability for the obligation to pay rentals, with a corresponding right of use asset. This will see operating leases, as well as the current finance lease commitments, come onto the balance sheet. ► This could have potential commercial implications with credit ratings and certain banking covenant measures. ► The lessee will recognise the obligation to pay rentals for the longest possible lease term that is more likely than not to occur and measure it at the present value of lease payments discounted using the incremental borrowing rate. ► A worked example:	► Royal Mail will need to review all leases, including those for property and office machinery and make judgements around lease options, contingent rentals, as well as the discount rate that would be appropriate for the Group. ► It is not possible at this stage to estimate impact of the changes on the fixed charge cover, leverage multiple or loan to value calculations. However, given the small headroom available, we will work with management to assess the likely impact.

Assumptions

Annual Lease Payment (assumes no contingent rentals, residual value guarantee or term option penalties):	CU6,0000
Term of lease:	3 years
PV of lease payments based on incremental borrowing rate:	CU15,000

Balance sheet analysis

A 'right-of-use asset' of CU15,000 and a corresponding 'lease liability' would be recognised on lease commencement.

Expense analysis

	Year 1 CU	Year 2 CU	Year 3 CU	Total CU
Amortisation of right-of-use asset (PV/3)	5,000	5,000	5,000	15,000
Interest expense	1,500	900	600	3,000
Proposed expense	6,500	5,900	5,600	18,000
Current IFRS expense	6,000	6,000	6,000	18,000

RMG00000085

Area of change	Detail of change and impact on the audit	Impact on Royal Mail
Employee Benefits Exposure Draft	► The Employee benefits ED was issued in April 2010, with the aim of simplifying accounting for defined benefits plans by reducing the level of judgement available. The key elements are: ► Removal of the 'corridor mechanism' where actuarial gains and losses could remain unrecognised if they are within a range ('corridor') of the recognised value. ► Adopts a 'net interest' approach, which replaces the current expected return on assets assumption with the AA corporate bond rate. ► Proposes improved disclosures, including sensitivity analysis of changes in demographics	► Royal Mail doesn't adopt the 'corridor mechanism' so will not be impacted by this proposed amendment. ► The proposed move to the 'net interest' approach will impact the Group. Based on March 2010 data, the 6.7% expected return on assets assumption would be replaced by the 5.6% discount rate. We estimate this would have increased the income statement charge by approximately £280m ► The Group will have to adopt any changes to disclosure requirements.
Revenue Recognition Exposure Draft	No implementation date has been set but we do not believe that any new standard would be effective before 2014. The key elements of the proposed model are: ► Transaction price is allocated to separate performance obligations based on their relative selling prices, and revenue is recognised when those obligations are satisfied. ► Performance obligations are satisfied when the customer has the ability to direct the use of and receive the benefit from the good or service (control). ► A net contract asset or liability is recognised pending completion of performance obligations by both parties. ► Revenue is deferred for the value of a warranty included in a contract, and recognised as the warranty services are performed. ► Revenue is adjusted for certain estimable items, eg. Refunds and collectability. ► Increased disclosure around the component parts of revenue and any contract asset or liability.	► No significant impact expected on covenants. ► The main revenue streams of the Letters division and over the counter products of POL are routine in nature. Presentational changes would lead to customer refunds being accounted for as a reduction of revenue rather an expense. ► However, as both POL and Letters continue to issue new products to offset the decline in their traditional revenue it is important to assess the terms of these products in light of the proposed standard to avoid any surprises. ► Potential impact on revenues of subsidiaries and joint ventures within the Group, eg. In Romec service contracts or in accounting for building and sale of mail centres in the books of Royal Mail Estates Ltd.

RMG00000085

The IASB issued the IFRS for SMEs accounting standard in July 2009. In August 2009, the UK ASB issued a consultation on "the future of UKGAAP", proposing that IFRS for SMEs replaced UK GAAP. When the consultation period ended in February 2010, the ASB had received over 150 replies and is currently considering the responses.

Area of change	Detail of change and impact on the audit	Impact on Royal Mail
IFRS for SMEs	► The IFRS for SMEs is a standalone standard that contains 35 chapters addressing all of the recognition, presentation and disclosure requirements for SMEs. ► The requirements of IFRS have been simplified and significantly reduced, with a reduction in text of at least 85%. This will give differences between IFRS and IFRS for SMEs, where full IFRS gives a range of options and IFRS for SMEs mandates one of these options, to eliminate the level of choice. ► The ASB is also considering the option for listed groups, where subsidiaries who currently adopt UKGAAP could adopt full IFRS, with reduced disclosures requirements, although there is not yet any guidance on these reduced disclosures. ► Despite the name of the standard, there is no size restriction for its adoption. Instead, it is available for entities that publish general purpose financial statements and do not have public accountability (defined as having listed instruments in a public market or holds assets in a fiduciary capacity for a broad group of outsiders as one of its primary businesses).	► In the absence of any listing of debt or equity as part of Project New Future by March 2013, the Group and its subsidiaries will have the option to adopt either full IFRS with reduced disclosures or IFRS for SMEs. ► Any decision on the standard to adopt should consider the need to maintain the Group's compliance with 'Listed PLC' best practice and user and tax requirements. Listed companies will continue to adopt full IFRS. ► An opening balance sheet under IFRS for SMEs will be required in the subsidiaries at March 2011.
Combined Code	► The FRC issued the UK Corporate Governance Code in June 2010 and it applies to Royal Mail from the year ended March 2012. ► The focus is on the spirit of the code rather than compliance with the individual provisions of the code. ► All directors of FTSE 350 companies should be subject to annual election by shareholders, rather than every three years. ► Chairmen are encouraged to report personally in their annual statements how the principles relating to the role and effectiveness of the Board have been applied. ► The comply or explain provision remains ► The board and its committees should have the appropriate balance of skills, experience, independence and knowledge of the company to enable them to discharge their respective duties and responsibilities effectively. ► Evaluation of the board of FTSE 350 companies should be externally facilitated at least every three years. ► The board is responsible for determining the nature and extent of the significant risks it is willing to take in achieving its strategic objectives. ► The board should maintain sound risk management and internal control systems.	► Whilst Royal Mail is not required to adopt the UK Corporate Governance code, it has previously adopted the Combined Code insofar as they apply to a public company with a single shareholder and included disclosures in the Annual Report. ► Royal Mail will need to consider which of the amendments are appropriate and how to apply them.

RMG00000085

Appendix A RESULTS OF ACCELERATED P6 AUDIT PROCEDURES

Introduction

Royal Mail intends to issue a half year trading statement for the period ended 26 September 2010. Whilst there is no formal requirement for Royal Mail to issue financial information for the first half of the year, the Group has a track record of publishing a trading statement with selected disclosure information.

The Group do not issue full IAS34 Interim financial statements and the trading statement is not in compliance with IAS 34. We are therefore not required to perform a review under ISRE 2410, the standard that covers interim reporting procedures.

However, at the request of management, we have accelerated certain elements of our 2010-11 year end audit work. This is designed to provide some level of comfort to Royal Mail management and the Audit and Risk Committee on the statement and are broadly similar to those procedures we would have performed on specific balances for a half year review. Procedures are performed only on those balances identified by management, who acknowledge that these procedures represent neither a half year review nor a full audit.

We include below the procedures that we have performed and the findings:

Procedure	Findings
Review of primary statements numbers and support	
Review support for the current year financial numbers included in the two P&L summary tables (Group and by Business Unit) and the cash flow summary table from the BCS trial balance and/or extracts from the ledgers.	At the time of writing this report, the Trading statement has not been finalised. We will provide an update at the Audit and Risk Committee on 19 October 2010.
Review support for all other numbers (financial and non-financial) in the trading statement.	
Review support for selected numbers (financial and non-financial) in the trading statement to ensure consistency with the financial statements and our understanding of the business.	

RMG00000085

Procedure	Findings
Current material litigation and regulatory fines, compensation and accruals	
Review papers containing an update on (i) the current material litigation and (ii) regulatory fines, compensation and accruals. Review a schedule of amounts provided at the current half year end, including movements since the prior year end. Obtain explanations for any movements greater than £10m and ensure these are consistent with the papers. Hold a meeting with Doug Evans to enquire of: ► Any changes in the position since the date of the above papers; ► Any issues with a potential exposure greater than £10m that have not been included in the above papers; ► Update on Project Q resolutions; and ► Update on the Quality of Service accrual	We have reviewed the Fines, Compensation and Material Litigation Report to be presented to the October 2010 Audit and Risk Committee, and have met with Doug Evans. We note that the total provision has decreased from £12m to £nil. The main movements relate to: ► The release of an accrual of £2m in relation to Project Q, following Postcomms's investigation ► The release of an accrual of £10m in relation to the impact of industrial action on Quality of Service targets following Postcomm's investigation. We agree that these amounts are no longer required and should be released.
Non-exceptional provisions (including non-exceptional vacant leasehold provision)	
Review the breakdown of non-exceptional provisions as at the current half year end, including movements since the prior year. For movements greater than £10m obtain explanations from management. Hold a meeting with management and ensure that the assumptions used are appropriate and consistent with the prior year end. Where assumptions differ from those at the prior year end, understand management's reasons for changing.	We have met with management and have reviewed the breakdown of non-exceptional provisions at September 2010. No movements greater than £10m were noted. The assumptions used at the half year are consistent with those used at the year end and we agree that they remain appropriate.
Sale and Leaseback transactions to date	
Audit the sale and leaseback transactions entered into by half year and confirm that accounting treatment adopted (sale and finance/operating leaseback) is appropriate.	At the time of writing this report, we are finalising our procedures in relation to leases and we will provide an update at the Audit and Risk Committee on 19 October 2010.

RMG00000085

Procedure	Findings
Consolidation Journals	
Select and audit a sample of group consolidation journals.	We have obtained appropriate support for all of the material journals identified.
General Logistics Systems accounts receivable	
Review the schedule showing the bad and doubtful debt provision as at the current half year end, including movements since the prior year end. For movements greater than £10m obtain explanations from management. Obtain an ageing profile of the trade accounts receivable balances as at the current half year end, the prior year end. For significant changes in the ageing profile obtain (i) an explanation from management and (ii) an explanation from management on the related impact on the bad and doubtful debt provision.	There are no movements in trade accounts receivable greater than £10m. The decrease in trade debtors from €225m to €217m is in line with the seasonal fluctuations, with March reflecting higher level of activity over the Easter period. The slight worsening of the ageing of debtors reflects the difficult economic climate, and the provision for bad debts has been increased by €1m to reflect this. We note that a provision of €2m held centrally remains to be allocated to specific debtors that are deemed to be at risk. This type of general provision is not permitted by IFRS and management will allocate it to specific debts as part of their statutory audit.
Letters accounts receivable	
For accounts receivable review the schedule showing the breakdown to the ES/FS code level (together with any reconciling items) as at the current half year end, including movements since the prior year end. For movements greater than £10m obtain explanations from management.	The decrease in accounts receivable from £419m at the year end to £317m at the half year reflects seasonality of sales, settlement of international mail balances in July, and timing of capital expenditure in the prior year.
Letters SITHOP and MITHOP accrual	
Review the schedule of SITHOP and MITHOP accruals as at the current half year, including movements since the prior year end. For items greater than £10m obtain explanations from management. Review the SITHOP and MITHOP calculations which support the above schedule and the assumptions used. Discuss with client any changes in assumptions since the year end and agree the accounting treatment. Where assumptions differ from those at the prior year end, understand management's reasons for changing.	SITHOP/MITHOP deferred revenue has decreased from £197m to £176m despite the impact of price increases, reflecting the higher level of sales volumes and advance stamp purchases in March compared with September. This is consistent with our expectations and previous years. The calculations, methodology and assumptions used at the half year remain consistent with the prior year end. In the case of the SITHOP balance, management has again used the lower end of the survey results, and is still in the process of reviewing the scope and quality of the surveys. We will work with management on this process and will obtain insights from other EY audit teams on how other postal operators address this issue.

RMG00000085

Procedure	Findings
Letters terminal dues balances and REIMS exit accrual	
Review the schedule for each balance as at the current half year end, including movements since the prior year end. For movements greater than £10m obtain explanations from management. Ensure that the assumptions used for these accruals are consistent with previous periods. Discuss with the client any changes in assumptions since the year end. Where assumptions differ from those at the prior year end, understand management's reasons for changing.	*Terminal dues* The net terminal dues creditor has decreased from £117m at the year end to £103m at the half year, reflecting both seasonality and the timing of settlements during the year. *REIMS exit accrual* The REIMS accrual has decreased from £28m to £14.9m reflecting settlement in Denmark, Switzerland, Ireland, Norway and Austria, offset by an increase in provision for Greece given the difficult negotiations and economic conditions. There are no other significant changes in assumptions from year end.
Letters and POL GRNI accruals	
Review the GRNI accruals analysis and provide an update on issues reported at the year end.	*Letters* The GRNI account includes balances over 6 months old of £16m, compared with £18m at the year end. We have enquired about key items included in the over 6 months balance and obtained satisfactory explanations. We confirmed with management that all aged items were reviewed at September 2010. *POL* There is no significant movement from the prior year end. The slightly increase in the total GRNI balance is due to an increase in the level of activity, and we note that the regular review controls implemented by management are operating well.
Letters Transformation	
Obtain from management an update on progress of any existing and future restructuring or transformation plan, focusing on progress compared to the timetable and benefits realised.	From discussion with management, we understand that transformation investment is progressing with most machines now in place, and the closure of 5 mail centres in the half year. However, the expected changes in work practices and the exit rates are behind schedule due to the agreement with trade unions being agreed slightly later than planned, and the consultation meetings with front line staff taking longer. However, now that these meetings have taken place, management is confident that rate of progress should increase.

RMG00000085

Procedure	Findings
POL Alliance and Leicester reconciliation	
Review the Alliance and Leicester reconciliation throughout the period and provide an update on the robustness of the control.	Management has continued to focus on the Alliance and Leicester reconciliation. The unsupported balance at the end of P6, is less than £0.1m and is now deemed to be immaterial.
POL Project Gamma, POCA and WH Smith update	
Obtain updates on Project Gamma, POCA and WH Smith.	From discussion with management we understand that these contracts are progressing in all material respects as had been expected, with no change in accounting treatment from the year end.
VAT Review application of VAT treatment agreed with the tax authorities	
Review through discussion with Royal Mail, the treatment and procedures put in place by Royal Mail following agreement in principle with the tax authorities for the computation of VAT amounts.	*Partial exemption* The partial exemption methodology applied to the previous tax year has been agreed with HMRC and the cash received and benefit recognised. We have held initial discussions with management with regards the implementation of the partial exemption methodology in the current year. We understand that whilst HMRC have accepted the use of the PESM for the period 2010-11, they have indicated that in respect to future periods they would expect the method to be amended to take into consideration supplies that RM buys in and sells on without material alteration/value add as these are seen to be distortive to the PESM calculation. *TNT ruling* Management has performed a bottom up review of the various USO and non-USO items of revenue, and are in the process of making the relevant changes to the systems to correctly invoice VAT and capture the transactions from February 2011. We have agreed with management that we will audit the changes that have been made late in 2010.

RMG00000085

Procedure	Findings
Letters	**Other matters**
Discussion of new transactions or changes in accounting treatment during the period	*Re-life of transformation assets and software* Management has revised the useful economic lives of some new assets, such as walk sequence machines, based on new expectations of how long these will be in operation. They have also reflected the latest plans to replace existing software. This has lead to a £3m reduction in depreciation charge in the period, with a £6m reduction expected for the full year. We understand that there are no further revisions of useful economic lives expected. *Core Transformation Programme* The Core Transformation Programme, due to replace the current IT revenue system has been placed on hold due to cash constraints. The cost incurred to date of £6m is held on the balance sheet pending a decision of whether to proceed with the investment. We understand that a decision will be reached by the year end.

Note: References to Letters in the above refer to Letters excluding Wholesale and ParcelForce

RMG00000085

Appendix B AUDIT SCOPING

We set audit scopes for each reporting unit which, when taken together, enable us to form an opinion on the group accounts.

The scope definitions are as follows:

- Full scope: locations deemed significant based on size and those with significant risk factors are subject to a full scope audit, covering all significant accounts and processes using materiality levels assigned by the EY London audit team for purposes of the consolidated audit.
- Specific scope: locations where specific procedures are performed by the local audit team for Group reporting purposes, based upon procedures and accounts identified by the EY London audit team.
- Limited scope: limited scope procedures primarily consist of enquiries of management and analytical review. On-site or desk top reviews may be performed, according to our assessment of risk.

The preliminary audit scopes we have adopted to enable us to report on the Group financial statements are set out below:

Business unit	Audit Scope 2010-11	Audit Scope 2009-10	EY Office Responsible
Royal Mail Letters (including logistics and UK management)	Full	Full	London – Letters team
UK Wholesale	Specific	Specific	London – Group team
Post Office Limited	Full	Full	London – POL team
GLS (consolidated)	Full	Full	Frankfurt*
FRES	Full	Full	London**
RM Holdings plc	Full	Full	London – Group team
Treasury	Specific	Specific	London – Group team
RM Enterprises Ltd	Limited***	Limited	London – Group team
Romec Ltd	Limited***	Limited	London – Group team
Group Services (included within Letters)	Limited	Limited	London – Group team
Property Holdings	Specific	Specific	London – Group team
Royal Mail Estates Ltd	Specific***	Specific	London – Group team
Parcelforce Worldwide	Limited	Limited	London – Group team
Consignia Customer Management Ltd	Limited***	Limited	London – Group team
Post Cap Guernsey	Limited***	Limited	Guernsey
RM Pension Trustees Ltd	Limited***	Limited	London – Group team
Royal Mail Courier Services Ltd	Limited***	Limited	London – Group team
iRed Redefining Document Management Ltd	Limited***	Limited	London – Group team

* The GLS consolidated audit will be performed by EY Frankfurt. In order to complete their audit, EY Frankfurt will instruct other EY countries to perform full, specific and limited scope audits, depending on the size and risk of the locations. Audit scopes by individual location are discussed and approved at the GLS ARC. We also provide a statutory audit opinion for a number of local GLS entities throughout Europe.

** FRES is audited by PwC, who report to us as a full scope operation

*** These entities file audited financial statements. Whilst they receive specific or limited scope work for Group audit purposes, they receive a full statutory audit to entity materiality.

RMG00000085

Appendix C NON-AUDIT SERVICES

Royal Mail and Ernst & Young have agreed a process for the pre-approval of non-audit services, levels of approval required dependent on the value of the work. At each meeting of the Audit & Risk Committee, we provide an update on the amounts that have been billed and pre-approved in relation to non-audit services.

2010-11 non-audit fees billed

Set out below is a summary of the non-audit services provided and billed by Ernst & Young for the period 29 March 2010 to 26 September 2010:

	Notes	Apr 10-Sep 10 £'000	Total YTD 2010-11 £'000	Total 2009-10 £'000
United Kingdom				
Other services supplied pursuant to legislation	*Note 1*	54	**54**	28
Taxation services		-	**-**	24
Litigation services		-	**-**	-
Corporate finance services		-	**-**	-
Other		-	**-**	46
Total United Kingdom		**54**	**54**	**98**
Overseas				
Taxation services		-	**-**	97
Corporate finance services		-	**-**	-
Total Overseas		**-**	**-**	**97**
Total		**54**	**54**	195

Note 1: This relates to work on covenant calculations, Licence Condition 21 and Whole of Government Accounts

RMG00000085

2010-11 non-audit fees pre-approved

Set out below is a summary of the non-audit services pre-approved by Royal Mail for the period 29 March 2010 to 26 September 2010:

	Audit related				Tax Services		Other Services	Approval		
	GLS		Other		GLS	Other		EY	RM	ARC
	Accounting advice	Third party reporting	Accounting advice	Third party reporting						
Pre-approval limit (k)	**€170**	**€30**	**£250**	**£250**	**€400**	**£200**	**£250**			
Pre approvals since 29 March (k)										
China tax	-	-	-	-	-	6	-	✓	✓	Note 1
DVLA assurance	-	-	-	17	-	-	-	✓	✓	Note 1
POL Covenants	-	-	-	13	-	-	-	✓	✓	Note 1
GLS Germany tax	-	-	-	-	48	-	-	✓	✓	Note 1
GLS Netherlands	-	-	-	-	69	-	-	✓	✓	Note 1
Royal Mail Group Covenants	-	-	-	3	-	-	-	✓	✓	Note 1
GLS Belgium	-	-	-	-	6	-	-	✓	✓	Note 1
Royal Mail Group Fuel Rebate	-	-	-	10	-	-	-	✓	✓	Note 1
Whole of Government accounts	-	-	-	26	-	-	-	✓	✓	Note 1
Total pre-approvals to 26 September (k)	-	-	-	**69**	**123**	**6**	-			

Note 1: As noted in the 'Approval of Auditors' Remuneration' paper submitted to the Audit and Risk Committee in May 2007, these amounts are below the Audit and Risk Committee pre-approval limits and have therefore, in accordance with the process, been approved by the Group Finance Director. They are presented here for final approval by the Audit and Risk Committee.

RMG00000085

Appendix D UK REQUIRED COMMUNICATIONS WITH THE AUDIT COMMITTEE

There are certain communications that we are required by International Standards on Auditing ('ISA's) to provide to the audit committee of UK clients. These are detailed below:

Required communication	ISA Reference	Proposed EY reporting
Terms of engagement Confirmation by the audit committee of acceptance of terms of engagement Ernst & Young to provide a copy of the engagement letter	ISA 260 ISA 210	Engagement Letters will be presented to the October 2010 ARC.
Planning and audit approach Communication of the nature and scope of the audit including any limitations. This should include: ► Principal ways in which risks of material misstatement are to be addressed, with particular reference to areas of higher risk ► Audit team structure and succession planning	ISA 260 ISA 300	Included within this report.
Audit findings Our view about the qualitative aspects of accounting practices and financial reporting. Final draft of the representation letter that will be signed by management and the audit committee. Uncorrected misstatements. Expected modifications to the audit report. Material weakness in internal controls identified during the audit.	ISA 260	This will be included within our report to be presented to the May 2011 ARC.
Fraud Any fraud that we have identified or information we have obtained that indicates that a fraud may exist. Material weaknesses in the design or operation of internal control to prevent or detect fraud identified during the audit. A discussion of any other matters related to fraud.	ISA 260 ISA 240	If applicable, this will be included within our reports to the October 2010 ARC, March 2011 ARC and May 2011 ARC.
Consideration of laws and regulations Audit findings regarding non-compliance where the non-compliance is material and believed to be intentional. This communication is subject to compliance with legislation on tipping off. Enquiry by Ernst & Young into possible instances of non-compliance with laws and regulations that the audit committee may be aware of.	ISA 260 ISA 250	If applicable, this will be included within our reports to the October 2010 ARC, March 2011 ARC and May 2011 ARC.
Independence Communication of all significant facts and matters that bear on Ernst & Young's objectivity and independence. Communication of key elements of the audit engagement partner's consideration of independence and objectivity such as: ► the principal threats ► safeguards adopted and their effectiveness ► an overall assessment of threats and safeguards ► information about the general policies and process within the firm to maintain objectivity and independence For listed companies, communication of minimum requirements as detailed in the ethical standards: ► Relationships between Ernst & Young, the company and senior management ► Services provided by Ernst & Young that may reasonably bear on the auditors' objectivity and independence ► Related safeguards ► Fees charged by Ernst & Young analysed into appropriate categories such as statutory audit fees, tax advisory fees, other non-audit service fees ► A statement of compliance with the ethical standards.	ISA 260 APB Ethical Standard 1	This will be included within our reports to the March 2011 ARC.