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Royal Mail Holdings plc Audit and Risk Committee

UPDATE ON POST OFFICE LIMITED HORIZON CONTROLS AND RELATIONSHIP WITH FUJITSU

Purpose of paper

1. This paper sets out the controls that operate around the Post Office Limited (POL) Horizon system, the relationship with Fujitsu and why the Post Office is able to rely on these controls in the light of:
    a. IT control issues identified at last year's audit; and
    b. possible challenges against the integrity of the Horizon platform.

Background

2. **IT controls and SAS70 assurance**
    a. There were a number of IT control issues identified during the 2010-11 year end Ernst & Young (EY) audit. These were largely centred on Fujitsu and a number of recommendations were included in the management letter following the audit. Unlike other RMG IT suppliers, Fujitsu does not have a SAS70 or equivalent report on its controls and the consequence of this is that EY needs to do full testing of all systems which are integral to the financial results.

3. **Horizon challenges**
    a. Post Office Ltd has, over the years, had to dismiss and prosecute a number of subpostmasters and Crown staff, following financial losses in branches. A small number of these have then made counter claims that they were not guilty of the charges made but that Horizon was faulty.

Historic relationship with Fujitsu

4. Fujitsu Services provides a fully managed service to support the Horizon Online system. This includes: help desk, support for the hardware installed in branch, support for the branch network, hosting the application and support and development for the Horizon Online application. Horizon Online is the application, which supports branch operations. It combines point of sale, mails, banking and front office of government functions. Post Office also has Supply Chain, Finance and Accounting and MI hosted in the Fujitsu Data Centres.

5. The initial Horizon 1994 contract was let as a Private Finance Initiative with the then DSS Benefits Agency. The first pilot branches went live in 1996 and full roll out was completed in 1999. The DWP withdrew from the contract, and there were a number of significant changes made to the contract and service, such as implementing Network Banking in 2004/5.

6. In 2006 the contract was renegotiated again to significantly reduce the cost of the service. This required migration from the original Horizon to Horizon Online, which was functionality equivalent, but with new systems architecture. This took £50m pa from costs and provided a strategic platform for the future. Horizon Online was implemented in 2010.

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7.   The original Horizon contract cost £150m pa, over the duration of the relationship with Fujitsu this has been reduced to an operational cost with Fujitsu of £55m pa which includes significantly increased scope. The contract has a provision for periodic independent benchmarking of the contract and charges. Such an exercise is in progress, with Gartner providing independent benchmark measures against a number of comparable organisations. This covers Applications Support Services, Branch Network Service, Service Desk and Data Centre. So far only the Data Centre exercise is complete. The finding of this is that the cost to Post Office of this service is 9.3% below market average.

Horizon system – process and controls

8.   Assurance about the accounting control environment may be taken in terms of the system, processes, training and support. This framework enables individual post offices to record and supervise their transactions and balances locally. It also enables oversight and intervention from central finance processing teams.

9.   The accounting data flows and controls at each stage are summarised in the diagram and table below.

Key control points →
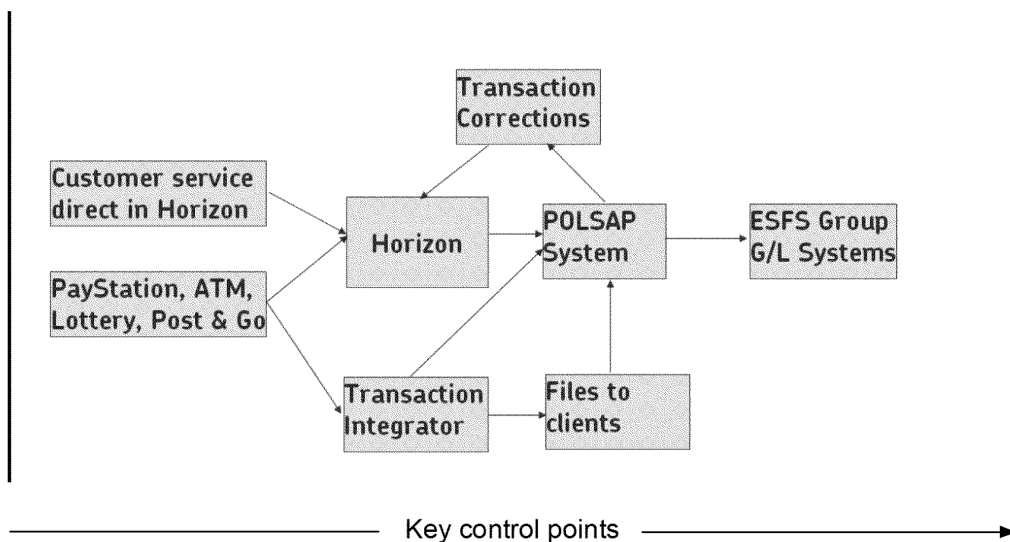
| Access to Horizon	Customer transactions	Control routines in branch	Central finance controls	Intervention processes
User creation	Card driven	Trial balances	Data matching	Cash supply
Secure IDs	Barcodes	Cash counts	Reconciliations	Helpline calls
Passwords	System pricing	Batch cut offs	Range checks	Trainers
Physical access	Screen prompts	Period ends	Trend analysis	Surprise audit
Tagged txns	Sequentials refs			Investigations
	Read only file			Suspension

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	Receipting			Appeals

10. At the branch level, the key controls centre on:
    a. System access and audit trails of user activity
    b. Automation to minimise manual entries when recording transactions
    c. Training given to staff and help available from guides and helplines
    d. Cash balancing routines, end of day routines and supervisory checks
    e. Double entry system aligning cash and stock with payment flows

11. At the central oversight level the key controls include:
    a. Branch cashflow targetry and variances against reported levels
    b. Range checks and trends in client creditors, cash and stock
    c. Reconciliation and matching of client data against Horizon data

12. Horizon, and its users, are supported by robustly planned training material, helpline contact centres, operational instruction manuals, induction training and critically the ability to "call for help" if a branch is unsure about its situation. Post Office has a demonstrable record of supportive interventions to help branches who have positively appealed for help upon identifying an issue with how they recorded transactions or with the existence of the expected amounts of cash.

13. Horizon is a double entry based accounting system which is supported by training and helplines to enable colleagues in branches to maintain complete, accurate and timely accounting records. There are well communicated processes for recording transactions directly in Horizon and for updating it with summaries of transactions performed in other customer facing technology in branches such as ATMs. Branches are able to run trial balances at any time and are required to do daily routines which enable them to detect keying errors locally and which enable central accounting support teams to detect issues and intervene.

14. Central teams in Finance and in Supply Chain monitor levels, trends and variances of sensitive balances such as cash and cheques and can initiative intervention ranging from advice and training through to audit, security visits and staff suspensions.

15. The nature of the online business and clients' requirements for daily transaction reports mean that there are multiple data streams originating from post office branches. These also are monitored by central teams and provide batch and variance controls to prevent and detect issues in branch. Transaction corrections are sent to branches where a keying error arises which the branch cannot correct themselves. These can also have the effect of "invoicing" branches when there are cash shortages which are not considered fraudulent.

16. There is also a constant feedback loop, such that issues identified by front line users and back office support teams can be fed into updated training and helpline support.

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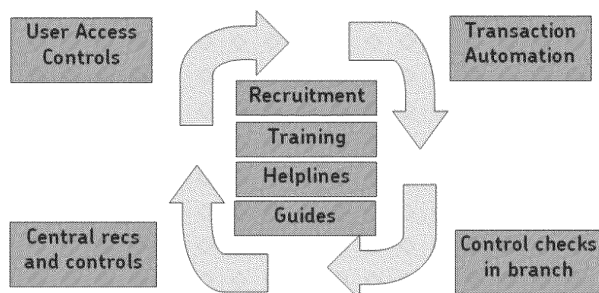
17. The Horizon system is a secure application with demonstrable integrity. In the old Horizon system this was achieved by:

   a. keeping copies of all transactions in multiple locations, both in the branch and the data centre.
   b. Every transaction has a unique sequential number and a 'checksum' value, which protects against any missing transactions, data corruption or tampering.
   c. Double entry accounting is applied to all financial transactions, recording sales against methods of payment.
   d. The integrity of transaction accounting is ensured by checking that all file updates have completed successfully before a message that the transaction is complete is presented to the counter clerk. If any update fails, an error message is issued to the counter clerk and logged, and all of the transaction is backed out.
   e. An audit trail of all transactions is kept for seven years in a tamper proof database.
   f. A control log of records written and deleted from the audit trail is maintained.

   Horizon Online uses the same techniques, other than that no business data is stored in the branch and it is all stored in the Data Centre.

18. As a result of the process and controls in place, POL is fully confident in the Horizon computer system operating in its branches. This accounting system, and the processes around it, enable our branches to maintain accurate and reliable accounts.

IT audit of Horizon system

19. Horizon is audited annually by EY as part of the financial year end audit of Royal Mail Group and POL. The audit work identified weaknesses relating to the IT control environment but, after additional control testing, was able to place reliance on the systems controls. There were ten key findings raised in the 2010-11 Ernst and Young Audit of the new Horizon Online, four high, three medium, and three low priorities, which Fujitsu and Post Office have addressed.

20. Post Office requested that a separate audit by Royal Mail Group internal audit validate that Fujitsu has satisfactorily resolved all of the issues identified by EY. A report will be issued from the RMG audit by 5th

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December 2011. Pre-release indications are that there are no significant issues / findings.

21.   Next year's EY audit will commence towards the end of January 2012, although a number of preliminary meetings have already been held to plan and scope the audit. The target date for the delivery of the final audit report is end March 2012.

22.   Fujitsu Services have committed to covering the cost to implement a SAS70 approach for Post Office for 2012-13 with EY carrying out this work so we expect a reduction in audit costs for 2012-13. The activities completed during the 2011-12 audit will provide the foundations for a SAS70. EY has ratified the approach we have taken for this year's audit and the planning is underway for the 2012-13 audits. A proposal is to be presented to the Post Office Ltd Board in December for agreement to this approach.

23.   It should also be possible to extend the scope of the SAS70 to cover the other audits that are carried out (i.e. PCI, VocaLink, ISO270001 etc) similarly reducing the effort and cost required to support these audits.

Former sub-postmasters – challenges to Horizon

24.   Post Office Ltd has, over the years, had to dismiss and prosecute a number of sub-postmasters and Crown staff, following financial losses in branches. A small number of these have then made counter claims that they were not guilty of the charges made but that Horizon was faulty.

25.   Various lobby groups have been set up by former sub-postmasters and these have at times received national media coverage and in some cases been taken up by local MPs. Most recently, the BBC has proposed a news article about this area.

26.   The allegations to which POL is responding follow on from cases where thousands of pounds were missing at audit. POL remains satisfied that this money was missing due to theft in the branch. Due to the controls set out above, POL does not believe the account balances against which the audits were conducted were corrupt.

27.   There are 4 broad strands of challenge. They are being dealt with as follows:
a. Prosecutions by POL where the defence claim Horizon is flawed – these have consistently been won on the facts of the Horizon transaction logs. Defendants have pleaded guilty or been found guilty. Judges have spoken supportively of Horizon.
b. Threatened class action by former sub-postmasters including individuals who have pleaded guilty or been found guilty – but a year on, only 4 have been received – of those, one is now time barred and two are rebutted as previously found guilty. POL will vigorously defend the final one if it proceeds.
c. Freedom of Information Act requests, written parliamentary questions and Flag Cases – POL has responded consistently and positively, including some meetings with MPs. Nevertheless, certain former sub-postmasters find new routes for the same allegations.

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    d. Media (Private Eye, The Grocer and regional TV) – whilst robust and successful in court, POL has to date adopted a firm but low key response to the media. Where detailed responses have been made, the media have lifted soundbites whilst giving lengthy interviews to those making the allegations. Media interest reflects "the popular underdog versus the public sector IT system".

Summary

28.   The Audit and Risk Committee is asked to:

    a. <u>Note</u> the contents of this paper.

Chris Day
December 2011