Royal Mint: 2001-02 Accounts

Report by the Comptroller and Auditor General

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Introduction

1. The Royal Mint is an executive agency and has operated as a Trading Fund since 1 April 1975, in accordance with the Royal Mint Trading Fund Order 1975 (SI 501/1975). Her Majesty's Treasury makes payments to the Mint under a five-year contract for the manufacture and distribution to banks of UK circulating coins, and the Mint also competes with its overseas counterparts and private sector commercial organisations in the world-wide markets for collector coins and medals etc.

2. As a Trading Fund, the Royal Mint operates on commercial lines and is required under Section 4(1) of the Government Trading Funds Act 1973 to:

   "*manage the funded operations so that the revenue of the fund is not less than sufficient, taking one year with another, to meet outgoings which are properly chargeable to revenue*".

   In practice this statutory requirement is generally taken to mean that whilst the Royal Mint is permitted to record an operating loss in any one financial year, this loss should be made good in subsequent years so that financial 'break-even' is achieved. More formal Treasury guidance, set out in 'PES 13', penalises the sponsor departments of 'Self Financing Public Corporations (SFPCs)', a category that includes Trading Funds, whereby a failure by an SFPC to achieve its Corporate Plan targets for two consecutive years results in a reduction in the Departmental Expenditure Limit (DEL) of the parent department in the following year.

3. Given the magnitude of the losses reported by the Royal Mint for the 2001-02 financial year, I have decided to place this report on the accounts to set out the causes of the Royal Mint's deteriorating financial position and to describe the corrective action that the Royal Mint is taking. This report also examines the

circumstances that led to a theft from the Royal Mint during the 2001-02 financial year and reports the results of an investigation undertaken by the Deputy Master into allegations of improper payments made by the Mint in previous financial years.

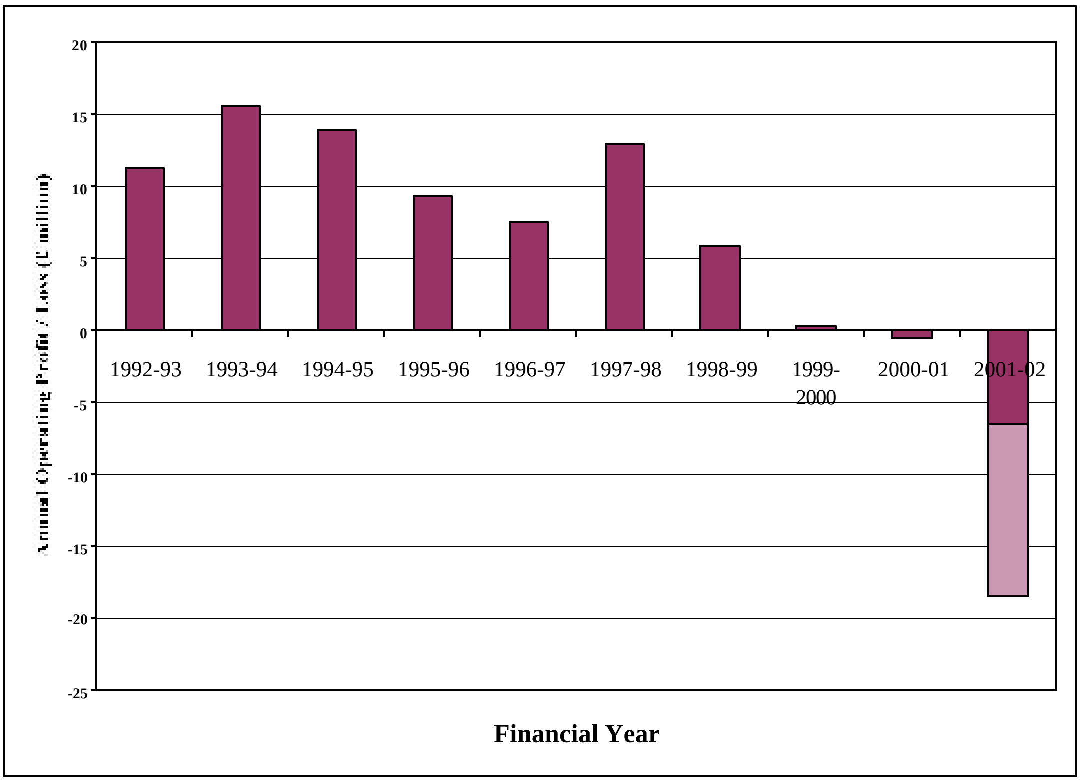
4. I am satisfied that none of these matters has had an impact on the truth and fairness of the financial statements or the regularity of the transactions contained therein. My audit opinion on the 2001-02 accounts of the Royal Mint is therefore unqualified.

Financial Performance of the Royal Mint

Operating Results

5. Over the past decade, the trading performance of the Royal Mint has gradually declined, as shown in **Table 1**. The Mint's annual operating profits peaked in 1993-94 at £15.6 million, but fell in all but one of the subsequent financial years to reach £345,000 in 1999-2000. (The rise in operating profits recorded in 1997-98 was mainly generated by increased collector coin sales in that year.)

Table 1: Royal Mint annual operating results, 1992-93 to 2001-02



Note: The total reported operating loss of £18.5 million for 2001-02 includes a £12 million exceptional item (shown as shaded bar), which comprises a provision for restructuring costs.

Source: Royal Mint annual accounts, 1992-93 to 2001-02

6. In 2000-01, the Royal Mint reported an operating loss of £493,000 - the first year that a loss had been recorded. In the Mint's 2000-01 Annual Report and Accounts, the then Deputy Master stated in his Report that "*although the bottom-line performance for the full year was disappointing, the decline in the Mint's overall financial performance during the previous two years was arrested and reversed in the second half of 2000-01*".

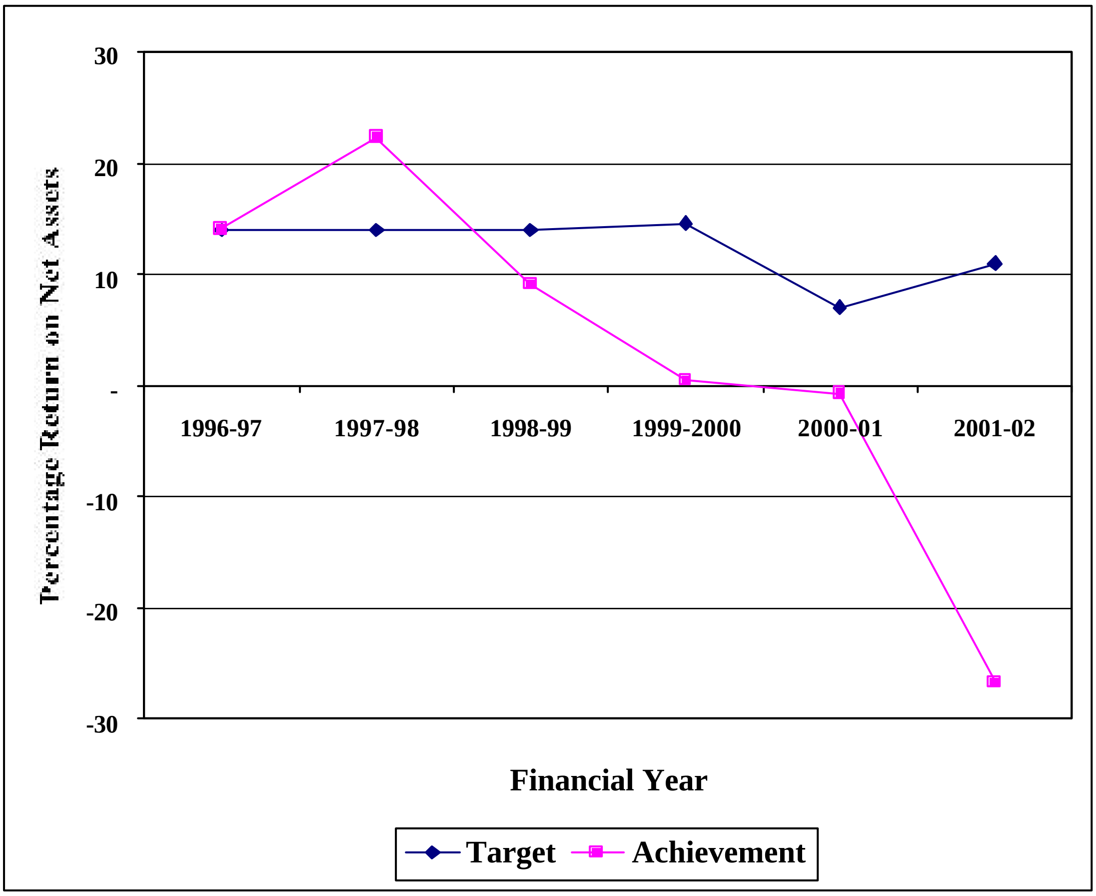
7. However, the Mint's financial performance has worsened considerably in 2001-02 and this year's accounts show a further operating loss (before the £12 million exceptional charge for restructuring costs) of £6.473 million. Whilst overall reserves remain at a healthy level, the downward trend in profitability is not sustainable in the medium term under the Mint's current statutory financial regime.

Performance against financial objectives

8. As a Trading Fund, the Mint is also required under the 1973 Act to "*achieve such further financial objectives as…the responsible Minister [may determine]*". However, the Mint's decline in profitability has also been reflected in the difficulties that it has increasingly experienced in meeting the financial target set by the Chancellor of the Exchequer.

9. For the three financial years 1996-97 to 1998-99, the Mint was set a target expected annual rate of return on net assets of 14 per cent over the period. This target was raised to 14.6 per cent for 1999-2000 but, because of the Mint's worsening financial position, was then reduced to 7 per cent for the 2000-01 financial year. For the period 1 April 2001 to 31 March 2006, the Mint is required to achieve a rate of return of 11 per cent in at least one of these five financial years. The performance of the Mint against these targets for each of the six years from 1996-97 to 2001-02 is shown in **Table 2**.

Table 2: The Mint's performance against its financial target, 1996-97 to 2001-02



Note: The achievement for 2001-02 before the exceptional charge for restructuring costs was a negative return of 9.6%

Source: Royal Mint annual accounts, 1996-97 to 2001-02

Causes of the Royal Mint's financial difficulties

Financial Results: 1992-93 to 1996-97

10. During the mid-1990's, the Mint recorded declining levels of annual turnover, which fell from £104 million in 1992-93 to £92 million in 1996-97. This was due to a variety of factors, including:

- A change in the terms of the Royal Mint's contract with the Treasury for the production of UK coinage, which resulted in lower profit margins;
- declining overseas market demand for production of circulating coin, coupled with world-wide overcapacity amongst coin producers; and

- much of the production machinery originally installed when the Mint moved to Llantrisant 30 years previously was coming to the end of its useful life.

11. In response to these factors, in 1997-98 the Mint embarked upon a three-year programme of major change. This £25 million modernisation plan aimed to increase the Mint's productivity and profitability through the restructuring of working practices, shift patterns and remuneration of employees, coupled with significant capital investment and improved staff training.

12. The overall effect of these changes was to increase the Mint's manufacturing capacity to produce circulating coins and blanks from around 18,000 tonnes in 1996-97 to some 27,000 tonnes each year by 1999-2000. The investment programme was also successful in increasing the productivity of the Mint's employees, which rose by some 27 per cent between 1996-97 and 2000-01.

13. One important consequence of the investment programme was to increase the cost base of the Royal Mint. Coin manufacture is a technological, capital intensive industry that tends to carry a high proportion of fixed and semi-fixed costs, which vary little with customer demand. In order to arrest the decline in profitability, the Mint also needed to increase its turnover by improving sales volumes and / or increasing its prices.

Financial results: 1996-97 to 2000-01

14. Despite the benefits of the investment programme, over the period 1996-97 to 2000-01 the Mint's turnover rose by only 5.1 per cent, whilst its cost base rose by 15.2 per cent, as shown in **Table 3**.

Table 3: Percentage changes in the Mint's Turnover and Costs, 1996-2001

	1996-97 (£'000)	2000-01 (£'000)	Increase (%)
Turnover	**91,566**	**96,241**	**5.1**
Staff Costs	23,858	30,594	28.2
Raw Materials & Consumables	42,135	46,014	9.2
Other Costs	17,971	20,126	12.0
Total Costs	**83,964**	**96,734**	**15.2**

Source: National Audit Office analysis

15. A key factor in the lower than anticipated increase in turnover between 1996-97 and 2000-01 was the extent to which the Mint was able to win and retain contracts for the production of euro coin 'blanks' for the twelve nation states which participated in the launch of euro notes and coins on 1 January 2002.

16. This project represented the largest re-coinage ever attempted, as some 50,000 million new coins would be required in total. It also represented a significant commercial opportunity for the Mint as, although the United Kingdom was not itself participating in the first wave of the euro, under European Union procurement rules the Mint was able to bid for the contracts for producing blank coins for other European governments. The Mint is a full member of the 'Working Group of European Mints' and participated in developing the detailed plans and technical specifications for the euro coinage. (In accordance with the Government's policy of 'Prepare and Decide', the Mint is required to ensure that robust plans are in place in the event that the euro is adopted by the UK.)

17. The Mint quickly appreciated that approximately 50 per cent of the total number of coins required would be for the three lowest denominations of the euro coinage (1, 2 and 5 cents), which would be produced in copper-plated steel. The Mint had extensive experience of copper plating and geared its investment programme to create an extra 10,000 tonnes per year of copper plating capacity to serve the

needs of the first-wave euro entrants. This also ensured that the Mint would be better prepared to respond rapidly to any UK government decision to adopt the euro.

18. The Mint aimed to supply blanks for the 10, 20 and 50 cent coins and outer rings for the bi-colour 1 euro and 2 euro coins (similar to the UK £2 coins already produced by the Mint). The Mint's ambitious target was to win around 20 per cent of the total contracts for euro blanks.

19. In the event, the Mint's original business plan assumptions for the euro proved over-optimistic. Whilst euro blanks were shipped to nine countries and outer rings for the bi-colour euro coins to three countries, only five per cent of the contracts for euro blanks were awarded to the Mint.

20. The above factors, coupled with losses made on other overseas circulating coin contracts, contributed to the Mint's operating loss of £493,000 reported in 2000-01. Mint officials informed my staff that the effects of these losses cancelled out the profits generated by the collector coin and other commercial operations of the Mint for that year.

2001-02 financial results

21. For 2001-02, the Mint has recorded a further operating loss of £6.473 million, before the £12 million exceptional charge for restructuring costs (paragraphs 23 to 28 refer). As explained in the Annual Report, turnover for the year fell by £16.6 million (over 17 per cent), due primarily to a £20.9 million (46 per cent) fall in the value of overseas circulating coin and blank sales. Operating costs excluding the exceptional charge fell by £10.6 million (nearly 11 per cent), partly because the decline in sales reduced the quantities of raw materials needed for production, but also because of a range of measures taken by the Mint's management to control and reduce costs. These included a reduction in average employee numbers from 1,136 in 2000-01 to 1,051 in 2001-02 and a change from seven to five-day working during the year. However, these measures were insufficient to offset the fall in sales and maintain profitability, as shown in **Table 4**.

Table 4: Percentage changes in the Mint's Turnover and Operating Costs, 2000-01 v 2001-02

	2000-01 (£'000)	2001-02 (£'000)	Increase / (Decrease) (%)
Turnover	**96,241**	**79,672**	**(17.2)**
Staff Costs	30,594	28,255	(7.6)
Raw Materials & Consumables	46,014	36,986	(19.6)
Other Costs	20,126	20,904	3.9
Total Costs	**96,734**	**86,145[1]**	**(10.9)**

[1] Excludes £12 million restructuring costs charged as exceptional item in 2001-02

Source: National Audit Office analysis

22. Mint officials informed my staff that productivity per employee in the circulating coin area had fallen by some 16 per cent between 2000-01 and 2001-02, and that the average cost per employee has risen by three per cent each year since 1998. The fall in demand has meant that the Mint has been operating well below capacity, although this has provided an opportunity to build up the Mint's stockpile of UK circulating coins, which has increased by some 240 million pieces (34 per cent) during 2001-02.

Actions now proposed

23. The Mint's latest Corporate Plan, for the period 1 April 2002 to 31 March 2005, has been approved by the Treasury and sets out a strategy designed to enable the Mint to "*reduce cost in order to compete in a fiercely competitive international market and to lay the foundations for sustained profitability*".

24. The Corporate Plan addresses key factors such as reduced demand in the circulating coin and blank markets now that the euro has been launched, consequent world-wide over-capacity amongst producers and inevitable falls in contract price levels as a result. The strategy is therefore based upon a revised,

lower estimate of the level of expected future demand for coins and blanks, both in the UK and in overseas markets. As a result, the Plan calls for a substantial reduction in the production capacity of the Mint.

25. This reduction in production capacity is being implemented through a wide-ranging restructuring programme in order to reduce its cost base and improve efficiency. The restructuring, which was announced by the Mint in March 2002, involves the loss of between 200 and 220 staff through voluntary and, if necessary, compulsory redundancies, and changes to the working practices of the remaining employees. A benchmarking exercise has also been undertaken to identify areas in which further efficiency improvements can be made.

26. In the Collector Coin area, the Mint aims to capitalise on the potential demand for Golden Jubilee products, to improve marketing and customer service and to ensure that the Mint's strong existing 'brand values' such as quality and craftsmanship are not diluted.

27. The Mint anticipates that the likely total cost of the restructuring programme will be £12 million, and has established a provision for this amount in its 2001-02 accounts. As explained in the Mint's Annual Report, the provision comprises anticipated redundancy and early retirement costs.

28. Mint officials informed my staff that they do not expect the Mint to return to operating profitability until 2003-04, as the impact of the various changes set out in the Corporate Plan will only start to take effect during the current financial year.

29. I intend to monitor closely the Mint's financial performance and recovery progress as part of my future audits of the annual accounts.

Theft of banknotes

30. The Royal Mint's plant at Llantrisant in South Wales is a high-security installation guarded by Ministry of Defence (MOD) Police. Robust controls are in place, including the use of metal detectors and random searches of staff and visitors, and these are rigorously enforced to ensure that coins are not taken into or out of the

premises without authorisation. (Within the plant, plastic tokens are used as currency.)

31. On 25 October 2000, the Mint took delivery of a consignment of 2,000 brand new £20 banknotes from the Bank of England. This consignment was intended by the Mint to be used in the production of special presentation packs - each containing one £20 note surrounded by decimal coins.

32. The banknotes were placed in a safe located in the Collector Coin Division's 'Gold Store', which is subject to particularly stringent security precautions within the Llantrisant site. However, on 13 December 2001 a stock check of the contents of this safe prior to the commencement of the production run for the presentation packs revealed that 1,284 notes were missing and only £14,320 of the original £40,000 consignment remained.

33. On the discovery of the loss, the section manager informed his senior management and the MOD Police. The MOD Police conducted an investigation into the incident and reported their interim findings to the Mint's Director of Collector Coins in April 2002. The section manager also submitted a report to the Finance Director outlining the circumstances of the loss.

34. The Mint's Director of Finance brought the loss to the attention of the National Audit Office, and in accordance with prescribed procedures formally notified the loss of £25,680 to the Treasury on 17 April 2002.

35. The Mint and MOD Police investigations noted that between April and October 2001 the 'Packing and Despatch' and the 'Collector Coin' areas of the Llantrisant plant underwent a large physical re-organisation. These changes required the removal and re-installation of various storage areas, which included the removal and subsequent return of the items held in each. Mint officials informed my staff that it was found necessary during this period to allow unrestricted access to both areas by internal and external contractors working on the site. Although a supervisory presence was maintained at all times, the normal access and stock controls were not adhered to during this period.

36. The identification of the loss was only made at the first full physical stock check after the restructuring had been completed, and it is therefore not possible to identify precisely when the theft occurred in the period from April to 13 December 2001. In May 2002, the MOD Police notified the Mint that their investigation had been concluded because of insufficient evidence, but that the matter remained unresolved. As a result, the case would remain on file and would be re-opened in the event that fresh evidence emerged.

37. As a result of the investigations into the theft undertaken by the Mint and MOD Police, the following control breakdowns and weaknesses were identified as contributing to the loss:

- Neither of the two keys to the safe containing the banknotes was held securely;

- The safe was poorly located within the gold store, being located away from the supervisor;

- Although within a secure area, the safe was generally opened at the start of the day and left open and unattended until the end of the day;

- As well as Mint employees, certain contractors working on the site had access to the area where the safe was located;

- No periodic stock checks of the contents of the safe were made between February and December 2001;

- The decision to order and store the total expected production run at the outset, rather than drawing down smaller consignments from the Bank of England as required during production exposed the Mint to higher risk and greater potential loss; and

- Whilst the Mint is highly vigilant in addressing the risk of coin theft from the Llantrisant site, its control procedures (such as metal detectors) were not designed to combat the risk of thefts of other items such as banknotes.

38. As a result of the MOD Police and Mint investigations, a number of improvements to physical security arrangements and working practices have been

made at the Llantrisant site. Improvements in documentary procedures to record the receipt and issue of keys and banknotes have also been introduced and, since May 2002, regular stock checks have been made of the contents of the safe. Revised ordering arrangements have also been adopted to ensure that stock levels need only be sufficient to meet immediate business demands.

Improper payments

Claim by The Birmingham Mint Ltd.

39. On 12 June 2002, The Birmingham Mint Ltd issued a Claim in the High Court against the Treasury, claiming in excess of £5.4 million in damages for breach of contract. This claim is to be contested, and has been noted as a post balance sheet event in the Mint's 2001-02 trading fund accounts.

Allegations of improper payments

40. On 16 May 2002 the Chairman of The Birmingham Mint Ltd met with Gerald Sheehan, the Mint's newly appointed Deputy Master (equivalent to Chief Executive). At that meeting, The Birmingham Mint Ltd produced copies of letters from the Royal Mint and other papers for Mr Sheehan to read. The documents purported to show that over several years up to April 1999 the Royal Mint had been involved in the making of improper payments.

41. The Birmingham Mint Ltd refused the Deputy Master's request for copies of these letters and papers (as it was entitled to do), and so he immediately conducted a limited investigation of the Mint's own records to establish whether there was *prima facie* substance to these allegations. He then wrote to Treasury Ministers on 30 May 2002 to alert them and to seek agreement to his proposal that, as the allegations predated his time at the Mint, he was sufficiently independent to perform a full investigation. The Treasury agreed to this course of action and asked the Deputy Master to provide a full report to Ministers on the outcome of his investigation by 21 June 2002.

Results of the Royal Mint's internal investigation

42. The Deputy Master reviewed relevant Mint files and personal expense claims for the last six years and interviewed several current Mint employees. He took advice from the Mint's solicitors on the conduct of his investigation and structured his interviews with Mint staff so that any potential legal or disciplinary action would not be prejudiced. He did not contact ex-employees or non-Mint staff, other than to request The Birmingham Mint Ltd to supply copies of the papers held by them which supported the allegations. This request was refused in writing by The Birmingham Mint Ltd in light of the litigation it had commenced against the Royal Mint. He was also unable to extend his review prior to 1996 as the relevant Royal Mint papers had been routinely destroyed.

43. From his investigation, the Deputy Master concluded that all payments appeared to have ceased by September 1999 and that the payments he had identified had all been authorised in accordance with the Mint's internal financial procedures. He submitted his report to the Financial Secretary on 25 June 2002.

Treasury response

44. On receipt of the report, it was agreed with Treasury Ministers that the Serious Fraud Office (SFO) should be contacted by the Deputy Master and provided with a copy. The SFO announced on 26 September 2002 that it is now carrying out an investigation in conjunction with the Ministry of Defence Police.

45. On 1 July 2002, the Financial Secretary to the Treasury wrote to the Chairman of the Committee of Public Accounts and the Comptroller and Auditor General to notify them formally of the decision to call in the SFO. On the same day, the Treasury released a short public statement about this matter, having obtained confirmation from the Director of the SFO that this would not prejudice their investigation.

46. The Treasury agreed with the Deputy Master that in the light of his findings, and also the circumstances of the banknote theft referred to in paragraphs 30 to 38 of this report, an independent review of the Mint's internal financial control systems should be commissioned. After a competitive tender exercise for this work, Grant Thornton was appointed to conduct this review in July 2002.

Grant Thornton review

47. The terms of reference issued to Grant Thornton required the firm to:

> "*establish the effectiveness of the Royal Mint's internal financial systems, and make recommendations on improvements to ensure that improper payments cannot be made by the Royal Mint, or third parties on behalf of the Royal Mint, to their customers and agents.*"

48. Grant Thornton was required to report its findings to Treasury Ministers and to the Deputy Master. The firm conducted a review of the Mint's key financial controls and procedures, and worked closely with PricewaterhouseCoopers (who provide certain elements of the Mint's internal audit service), KPMG (contracted since 2000-01 to perform the external audit of the Mint for the Comptroller and Auditor General) and the National Audit Office. With the approval of Treasury Ministers, Grant Thornton scoped its work to ensure that it did not overlap with the ongoing SFO investigation. The firm was not required to examine the non-financial or operational controls of the Mint.

49. Grant Thornton submitted its report to the Financial Secretary to the Treasury on 24 September 2002. The report was agreed for factual accuracy with the Mint's management and with PricewaterhouseCoopers, and addressed two main areas. The first of these was the Mint's **overall corporate governance arrangements**, where the firm focussed in particular on:

    - The respective roles of the Mint's Audit Committee and Accounting Officer;
    - The adequacy of the Mint's internal audit arrangements; and
    - The Mint's risk management framework.

50. Grant Thornton identified several areas in which the Mint's corporate governance arrangements fell short of best public sector practice. These included:

    - The absence of formal terms of reference for the Mint's Audit Committee;
    - A lack of procedures to enable the Audit Committee to ensure that all internal audit recommendations had been implemented by management;

- That no formal 'Fraud Policy' or 'Public Interest Disclosure Policy' were in place within the Mint;
- A failure by management to ensure that the internal audit function was subject to competitive tendering on a regular basis; and
- The absence of an up to date and detailed specification for the provision of internal audit services.

51. The report then looked in detail at the **design and operation of the Mint's internal financial controls**, with particular regard to the controls within:

    - Purchasing and payables;
    - Sales;
    - Cash and bank;
    - Payroll;
    - Travel and subsistence;
    - The 'Collector Coin Club' operated by the Mint for its customers; and
    - Information technology systems.

52. Grant Thornton identified a range of control weaknesses within each of these systems, such as:

    - An inadequate separation of duties within the Mint's purchase ledger, whereby staff were permitted to amend supplier standing information and also post invoices to the system;
    - That the Finance Department safe containing items such as blank cheques, un-banked receipts and the BACS system password, was left open during working hours; and
    - That there were as many as 14 authorised signatories on the Bank of England bank mandate, although only two signatures were actually needed for payment authorisations.

Grant Thornton also identified a general absence of operating desk instructions. This restricts the ability of the Mint's management to rotate existing staff between functions to cover for absences and hampers the training of new employees.

53. The Grant Thornton report contained a total of 70 specific recommendations, presented in the form of an 'Action Plan' which incorporated the responses of the Mint's management to each point and also set deadlines for the implementation of each recommendation by the Mint.

54. Grant Thornton concluded that:

> "*We are satisfied with the responses received from the Mint to our recommendations included in the Action Plan. Further, we believe that the timescales for the implementation of the Action Plan are appropriate.*
>
> *There is much to be done. However the proper implementation of the Action Plan will provide a solid foundation from which to go forward.*"

55. Treasury officials informed my staff that they had received a copy of the Grant Thornton report and noted its recommendations, and that they looked to the Mint to implement these at the earliest opportunity. Mint officials informed my staff that the Grant Thornton report had been a valuable exercise and that a programme to implement the various recommendations contained in the Action Plan was underway. The Deputy Master intended to ensure that all 70 points would be addressed by 31 December 2002 at the latest.

John Bourn
Comptroller & Auditor General
14 October 2002

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