**IN THE MATTER OF**

**EXECUTIVE COUNSEL TO THE**
**ACCOUNTANCY AND ACTUARIAL DISCIPLINE BOARD**

**-V-**

**ERNST & YOUNG LLP**
**and**
**ALAN FLITCROFT**

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# STATEMENT OF EXECUTIVE COUNSEL'S PARAGRAPH 6(9) FORMAL COMPLAINT

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## PART ONE - INTRODUCTION

### The AADB

1. The Accountancy and Actuarial Discipline Board ("the AADB") is the independent, investigative and disciplinary board for the accountancy and actuarial professions in the UK. The AADB's relevant rules and procedures are set out in the Accountancy Scheme ("the Scheme").

2. By paragraph 6(9) of the Scheme, if, having reviewed any representations received for the purposes of paragraph 6(8) of the Scheme, Executive Counsel to the AADB ("Executive Counsel") considers (i) that there is a realistic prospect that a Tribunal will make an Adverse Finding against a Member (or Former Member) or Member Firm and (ii) that a hearing is desirable in the public interest, Executive Counsel shall deliver a Formal Complaint against the Member or Member Firm to the Board.

3. This is Executive Counsel's paragraph 6(9) Formal Complaint in respect of Ernst & Young LLP ("EY") and Alan Flitcroft ("Mr Flitcroft").

## The Respondents

### Ernst & Young LLP

4. EY is and was at all material times a Member Firm of the ICAEW and thus a Member for the purposes of the Scheme.

5. EY was the auditor of European Home Retail plc ("EHR") and its subsidiaries, including Farepak Food & Gift Limited ("Farepak").

### Alan Flitcroft

6. Mr Flitcroft was at all material times a Member of the ICAEW. He has now left the ICAEW and thus is a Former Member for the purposes of the Scheme.

7. Mr Flitcroft was the engagement partner and Responsible Individual charged with carrying the audit of EHR and Farepak. The audit for the period ended 28th April 2005 ("FY05") was his first year as audit partner of EHR and the subsidiaries.

## Background

### Farepak

8. Farepak was a company which allowed customers to pay in advance through weekly instalments for the provision of hampers and high street vouchers for the Christmas period. Although the customers were not savers in the strict sense, they were often referred to as such.

9. Farepak was a subsidiary of a publicly listed company at all material times.

10. The Farepak business was established in the mid-1960s by Robert Johnson. The business grew into a nationwide network of agents who would collect

money from customers door to door. By the year 2000, the company's turnover had grown to £107 million.

11. In 1995, the company then known as Farepak plc purchased Kleeneze Homecare. Kleeneze Homecare operated a similar sales model to Farepak in that it operated a network of agents selling cleaning products door-to-door through catalogues. In 1999 Farepak plc changed its name to Kleeneze plc ("Kleeneze"). The newly named company operated two subsidiary businesses in Farepak and Kleeneze Homecare. Kleeneze and its successor incarnations[1] were at all material times publicly listed companies.

12. In 2000, Kleeneze purchased Dealerfield and Colour Library Direct and merged the acquisitions to form a new subsidiary, Direct Marketing Group ("DMG"). The acquisitions were made for a consideration of £31.5 million, funded through a credit facility of £45 million with the Bank of Scotland ("BoS").

13. A period of instability ensued for Kleeneze with the death of founder and chief executive Robert Johnson in 2001. Kleeneze's performance declined, with DMG sustaining heavy losses. Robert Johnson's replacement as chief executive, George Pollock, was replaced in turn by Mr Rollason in January 2003. Mr Rollason was appointed to restructure Kleeneze and dispose of DMG.

14. DMG was sold for £4.1 million in July 2003 at a considerable loss on the purchase price of £31.5 million. The losses caused by the acquisition and disposal of DMG led to a £12.8 million deficit in shareholders' funds as at 28th April 2004, this figure representing the excess of Kleeneze's liabilities over its assets.

15. Mr Rollason led a strategy to grow and modernise the business through acquisitions and the establishment of joint ventures. These acquisitions and

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[1] See paragraph 17.

joint ventures were predominantly funded through Kleeneze's overdraft facility with BoS. The companies acquired and established were:

(a) eeZee TV Limited, a joint venture with John Mills Limited ("JML"), a television station dedicated to selling Kleeneze and JML products through a satellite television station which was established in September 2004;
(b) I Want One Of Those, an online retailer of gadgets purchased in October 2004; and
(c) Kitbag Sports Limited, an online retailer of football shirts and related goods purchased in April 2005.

16. In Kleeneze's financial statements for FY05, Mr Rollason reported that the company had now been reorganised into a home shopping specialist selling through three channels:

(a) catalogue home shopping;
(b) internet retailing; and
(c) television shopping.

17. In September 2005, Kleeneze changed its name from Kleeneze plc to European Home Retail plc.

**The Farepak Trading Cycle**

18. Farepak's customers generated substantial positive cash flow from January to October through their weekly payments. By 2005 this was approximately £4 million per month. The cash taken by Farepak represented a liability that would be paid by Farepak in Christmas hampers or, more commonly, vouchers redeemable at high street retailers.

19. In FY05, 90% of Farepak's turnover was generated through voucher sales. The vouchers were principally provided by Choice Gift Vouchers Limited ("Choice").

20. Choice offered payment terms that only required Farepak to pay for the vouchers once they had been redeemed with a high street retailer. Most other suppliers in the market did not offer such generous terms and would require payment on supplying the vouchers.

21. The Choice model meant that Farepak paid for the majority of redeemed vouchers in December, January and February. When the payments to Choice were made in January and February, Farepak had already begun collecting payments from customers for the next Christmas.

22. Farepak had an idiosyncratic trading model that was clear and predictable. It collected cash throughout the year, generating significant cash balances in the period up to December, but was then liable to make three large payments to Choice in December, January and February.

**The Group Treasury Function and Banking Facility**

23. EHR operated a central treasury function whereby, at the close of business each day, the available cash resources from EHR's subsidiaries were pooled in EHR's bank account held by BoS. This included the funds received from Farepak's customers which were not held separately.

24. The nature of the Farepak business model meant that the company received large amounts of cash for periods of the year, in particular the late autumn. This cash would be swept up to EHR as an intercompany loan that would be repaid, as and when Farepak needed to pay liabilities.

25. Kleeneze had agreed a revolving bank credit facility with BoS of £45 million in October 2000. Due to the seasonal nature of Farepak's business, EHR was in a net credit position for much of the year. In July 2002, the BoS facility was revised and reduced to £40 million. In December 2005, the facility was

restructured to provide an overdraft of £30 million and a term loan of £10 million.

**EHR's Financial Performance**

26. Following the merger of Dealerfield and Colour Library Direct to form DMG in 2000, the group's (Kleeneze/EHR) financial performance suffered. This is illustrated by the fact that from 2003 onwards, Kleeneze and then EHR had net current liabilities, essentially meaning that it was balance sheet insolvent. As such, EHR was dependent on the continuing support provided by the BoS bank facility and the Farepak customers. While Kleeneze did make a profit of £3.2 million for FY05, in the prior four years it had accrued aggregated losses, before tax, of £25.9 million.

27. Throughout the financial year to 30th April 2006 ("FY06"), EHR's trading fell significantly behind budget and, by year end, turnover was £15.4 million short of target. As a result of this, EHR failed to achieve its budgeted profit.

**Overview of the Events of 2005 and 2006**

28. EHR was consistently in a position where it had net liabilities as the table below demonstrates:

| | *Audited* | *Audited* | *Audited* | *Audited* | *Draft* |
|---|---|---|---|---|---|
| *Year ended:* | *30-Apr-02* | *30-Apr-03* | *30-Apr-04* | *28-Apr-05* | *30-Apr-06*[2] |
| | *£000* | *£000* | *£000* | *£000* | *£000* |
| | | | | | |
| **Retained profit (loss)** | **75** | **(35,027)** | **(4,109)** | **3,222** | **(8,775)** |
| | | | | | |
| **Capital and reserves** | | | | | |
| Share capital and reserves | 4,394 | 4,394 | 4,398 | 4,475 | 4,035 |
| Profit and loss account | 21,894 | (13,065) | (17,226) | (11,986) | (21,584) |
| **Shareholders' funds** | **26,288** | **(8,671)** | **(12,828)** | **(7,511)** | **(17,549)** |

It was therefore reliant on the £40 million facility with BoS to continue trading.

29. As FY06 progressed EHR fell progressively behind budget in terms of trading and cash flow.

30. In April 2005 EHR issued a pre-close trading update in respect of the FY05 financial statements which warned the market that, *"...operating profit will be substantially below market expectations"*.

31. On 22nd July 2005 an EHR Financial Report estimated that borrowing would peak at £28.5 million in February 2006.

32. On 10th August 2005 an unqualified audit report in respect of the EHR Financial Statements for FY05 was signed by EY. Shortly thereafter the peak borrowing was reforecast as being £33 million in January 2006. However, this figure did not include pre-existing loan notes and guarantees, which should have been included, increasing the peak-borrowing requirement to £37.8

[2] Prepared under IFRS

million. This figure did not take account of a large payment due to Choice at the very end of January, but after the accounting month end, which would have increased the true peak forecast to well in excess of £40 million.

33. In October 2005 the EHR finance department, in reaction to the difficult trading and cash flow position, began preparing weekly cash flow forecasts for the first time. The forecast prepared in the week commencing 14th November 2005 forecast that in the week commencing 30th January 2006 borrowing would peak at £42.5 million, i.e. above the agreed £40 million limit with BoS. It was reported to the board on the 30th November 2005 that projections showed that for the last quarter EHR would be close to its borrowing limits.

34. On 7th December 2005, in a press release that accompanied the EHR Interim Report for the six months ended 31st October 2005, it was stated that revenue was below expectations. On 15th December 2005 the EHR overdraft position was discussed by the Farepak Board and it was recorded in the minutes that there was a need for cash planning and conservation. On 21st December 2005 the EHR Board approved the renewal of the £40 million facility with BoS. The minutes also recorded a requirement for a significant cash conservation exercise. On 23rd December 2005 the outgoing Finance Director of EHR, Chris Hulland ("Mr Hulland"), sent a handover email to William Rollason ("Mr Rollason"), the Chief Executive of EHR, within which he highlighted that borrowing would peak at £46.8 million in February 2006.

35. On 20th January 2006 Mr Rollason and the new Finance Director of EHR, Stevan Fowler ("Mr Fowler"), met with BoS to request an extension of £5 million to the £40 million facility. The need for the additional facilities was discussed at an EHR Board meeting on 25th January 2006. At the same meeting a new clearing system for any payments over £10,000 was introduced. On 31st January 2006 BoS refused the request for additional funds (save for a temporary increase to £41.2 million). As a result, that day, Farepak was only

able to pay £6.5 million of £12.1 million that was due to Choice, because EHR had insufficient funds to repay Farepak its intercompany debt to allow the full payment to be made. By way of an email dated 31st January 2006, EHR attempted to agree a payment schedule with Choice for the payment of the outstanding debt. Choice went into administration on 31st January 2006.

36. The administration of Choice forced Farepak to find an alternative supplier of shopping vouchers. They were unable to find a supplier on the same generous terms as those that had been offered by Choice, with the alternative suppliers either requiring payment to be made upon the supply of the vouchers to Farepak or on a limited deferred basis, rather than when they were redeemed by the customers. The payment terms offered by Choice had been an important part of Farepak's business model and the new arrangements were to have a significant negative effect on the cash flow of both Farepak and EHR, with payments to suppliers having to be made earlier than had previously been the case. This had the effect of breaking the Farepak payment cycle that had allowed Farepak to fund the voucher payments, made to Choice, with the money they received from their customers in respect of goods and vouchers due to be supplied the following Christmas.

37. On 13th February 2006 EY signed the audit report contained within the Farepak FY05 Financial Statements, which had been signed by William Rollason and Stephen Hicks, two directors of Farepak, on 8th February 2006. Included within the Financial Statements was a statement that EHR would continue to support Farepak to enable it to meet its liabilities as they fell due and that accordingly the going concern basis had been adopted.

38. On 23rd March 2006 EHR issued a press release that reported that operating profit for the year as a whole would be disappointing.

39. In the summer of 2006 a working capital review indicated that raising an additional £20 million by way of a rights issue would provide sufficient

funding for EHR. The EHR Board continued to seek additional funds, but none were forthcoming. On 23rd August 2006 EHR's shares were suspended.

40. On 13th October 2006 EHR and Farepak entered administration. As a result Farepak's customers did not receive the vouchers or hampers, in relation to Christmas 2006, that they had already paid for.

**Overview of the EY Audits of EHR and Farepak**

41. Mr Flitcroft was the audit engagement partner for both the EHR and Farepak FY05 audits. Mr Alan Soo ("Mr Soo") was Audit Manager.

42. EY's planning and substantive audit procedures in relation to both the EHR and Farepak FY05 audits were conducted concurrently between May-August 2005. The auditors' report on the EHR Financial Statements was signed by EY on 10th August 2005 and that relating to Farepak on 13th February 2006.

43. EY's audit planning is summarised in a document called the Audit Strategies Memorandum ("ASM"). The EHR ASM was initialed by Mr Flitcroft on 2nd August 2005 and included separate headings for significant audit and accounting issues in relation to each of the subsidiaries, including Farepak, for which there was no separate ASM.

44. In the six month period between signing the FY05 Financial Statements for EHR and those for Farepak, EY and, in particular, Mr Flitcroft carried out work on two further matters relating to EHR:

i. In August and September 2005 a Covenant Review, in relation to and as a requirement of the £40 million BoS facility. EHR had in fact breached one of the covenants earlier in the year, but BoS had granted a waiver; and
ii. In November and December 2005 an Interim Review for the 6 months ended 31st October 2005.

45. Many of the audit papers relating to EHR, Farepak and other subsidiaries are incomplete. Amongst the incomplete documents are a number of the Summary Review Memorandums ("SRM"), including the one for Farepak. These are important documents setting out key issues arising and the audit conclusions. The Farepak SRM records that the Choice vouchers were only invoiced to Farepak when they were redeemed by customers. The section relating to going concern is blank.

46. A document entitled "Farepak Business Overview" was included within the Farepak audit file. It provides an overall description of EY's understanding of Farepak and comments on various aspects of the business including the annual cycle, deferred income and prepayments. This document does not detail that Farepak's largest payments were in relation to gift vouchers or that it did not have to pay Choice for these vouchers until after they were redeemed. Neither does it identify that, as Farepak collected cash from customers, these funds were immediately swept up by EHR and used to fund other parts of the business, thereby creating an inter-company debt, nor that Farepak relied on EHR repaying this inter-company debt, which was Farepak's largest asset by far, to enable it to meet its liabilities as they fell due.

47. In interview Mr Flitcroft recognised that cash would be swept up from Farepak to EHR and later repaid. As a result of the cash sweeping and subsequent inter-company debt, the affairs and audit of Farepak were inextricably linked to those of the parent company, EHR.

## PART TWO – MISCONDUCT, CODE OF ETHICS & AUDITING STANDARDS

**Meaning of Misconduct**

48. Paragraph 2(1) of the Scheme defines an act of misconduct as: *"…any Member's or Member Firm's conduct in the course of his or its professional business or financial activities (including as partner, member, director or employee in or of any organization or as an individual), which falls short of the standards reasonably to be expected of a Member or Member Firm."*

**Code of Ethics in force at the relevant date**

*ICAEW Code of Ethics*

49. The ICAEW Ethical Code Fundamental Principle 4 'Performance' states that; *"A member should carry out his professional work with due skill, care, diligence and expedition and with proper regard for the technical and professional standards expected of him as a member."*

**The Relevant Auditing Standards**

50. In relation to the audit of the Financial Statements for the year ending 28th April 2005 the relevant professional guidance for auditors was contained within the Statements of Auditing Standards ("SAS"). The SAS relevant to this complaint are:

 i. SAS 150 – Subsequent Events;
 ii. SAS 400 – Audit Evidence;
 iii. SAS 130 – The going concern basis in financial statements;
 iv. SAS 440 - Management Representations;
 v. SAS 230 – Working Papers.

## POST BALANCE SHEET EVENTS[3]

**Relevant Standards**

**SAS 150 – Subsequent Events**

51. The requirement for a company to adjust for or disclose material relating to post balance sheet events is set out in Statement of Standard Accounting Practice 17 ("SSAP 17"). It states:

*"Events arising after the balance sheet date need to be reflected in financial statements if they provide additional evidence of conditions that existed at the balance sheet date and materially affect the amounts to be included.*

...

*To prevent financial statements from being misleading, disclosure needs to be made by way of notes of other material events arising after the balance sheet date which provide evidence of conditions not existing at the balance sheet date. Disclosure is required where this information is necessary for a proper understanding of the financial position."*

52. Some relevant extracts of SAS 150, the relevant auditing standard, state:

*(1) The purpose of this SAS is to establish standards and provide guidance on auditors' responsibility regarding 'subsequent events' occurring:*

*(a) Between the period end and the date of the auditors' report;*

*(b) Between the date of the auditors' report and the issue of the financial statements; and*

*(c) After the financial statements have been issued, but before they are laid before the members, or equivalent.*

...

[3] The accounting standard, SSAP 17, refers to "post balance sheet events". The auditing standard, SAS 150, refers to "subsequent events". The expressions are interchangeable.

***(2) Auditors should consider the effect of subsequent events on the financial statements and on their report. (SAS 150.1)***

*(3) 'Subsequent events' means both those relevant events (favourable and unfavourable) which occur and those facts which are discovered between the period end and the laying of the financial statements before the members, or equivalent. 'Relevant events' are those which:*

- *Provide additional evidence relating to conditions existing at the balance sheet date; or*
- *Concern conditions which did not exist at the balance sheet date, but which may be of such materiality that their disclosure is required to ensure that the financial statements are not misleading.*

*Discovery of facts is relevant in the context if the discovery reveals material misstatements in the financial statements.*

...

***(5) Auditors should perform procedures designed to obtain sufficient appropriate audit evidence that all material subsequent events up to the date of their report which require adjustment of, or disclosure in, the financial statements have been identified and properly reflected therein. (SAS 150.2)***

*(6) Auditors focus these procedures on any matters they may have become aware of during the course of the audit which may be susceptible to change after the period end. Such procedures are in addition to those which may be applied to specific transactions occurring after period end to obtain audit evidence as to account balances as at the period end, for example the testing of cutoffs of sales and stocks and payments to creditors.*

*(7) The procedures to identify subsequent events which may require adjustment of, or disclosure in, the financial statements are performed as near as practicable to the date of the auditors' report and generally include some or all of the following:*

- *Enquiring into, and considering the effectiveness of, the procedures management has established to ensure that subsequent events are identified;*
- *Reading minutes of the meetings of members, the board of directors and audit and executive committees held after the period end and enquiring about matters discussed at meetings for which minutes are not yet available;*
- *Reviewing relevant accounting records and reading the entity's latest available financial information, such as interim financial statements, budgets, cash flow forecasts and other related management reports; and*
- *Making enquiries of management as to whether any subsequent events have occurred which might affect the financial statements.*

*The extent to which the results of these procedures require reviewing and updating immediately before the date of the auditors' report depends on the length of time which has elapsed between when these procedures were initially performed and the date of their report and the susceptibility of items to change over time."*

*(8) Examples of specific enquiries which may be made of management are:*

...

- *Whether any events have occurred or are likely to occur which might bring into question the appropriateness of accounting polices used in financial statements as would be the case, for example, if such events might call into question the validity of the going concern basis.*

**SAS 400 – Audit Evidence**

53. SAS 400 establishes the standards and provides guidance on the quantity and quality of evidence to be obtained by auditors, and the procedures for obtaining that evidence. Some relevant extracts state:-

***(2) Auditors should obtain sufficient appropriate evidence to be able to draw reasonable conclusions on which to base the audit opinion. (SAS 400.1).***

*Sufficient Appropriate Evidence*

*(4) Sufficiency and appropriateness are interrelated and apply to audit evidence obtained from both tests of control and substantive procedures. Sufficiency is the measure of the quantity of audit evidence; appropriateness is the measure of the quality or reliability of audit evidence and its relevance to a particular assertion. Usually, audit evidence is persuasive rather than conclusive, and auditors therefore often seek audit evidence from different sources or of a different nature to support the same assertion.*

*Substantive procedures*

*(10)* ***In seeking to obtain audit evidence from substantive procedures, auditors should consider the extent to which that evidence together with any evidence from tests of controls supports the relevant financial statement assertions. (SAS 400.3)***

**SAS 440 – Management Representations**

54. It may be necessary for auditors to consider management representations as part of the audit evidence. SAS 440 sets out guidance in relation to such management representations. Paragraphs 14-15 state:

*(14) When representations to the auditors relate to matters which are material to the financial statements, they:*

*(a) Seek corroborative evidence;*

*(b) Evaluate whether the representations made by the management appear reasonable and are consistent with the other audit evidence obtained, including other representations; and*

*(c) Consider whether the individuals making the representations can be expected to be well-informed on the particular matters.*

*(15) Representations by management cannot be a substitute for other audit evidence that auditors expect to be available. If auditors are unable to obtain sufficient appropriate audit evidence regarding a matter which has, or may have, a material effect on the financial statements and such audit evidence is expected to be available, this constitutes a limitation on the scope of the audit, even if representation from management has been received on the matter. In these circumstances it may be necessary for them to consider the implications for their report."*

**Overview of relevant facts**

55. The key dates can be summarised as follows:

| | EHR Audit | Farepak Audit |
|---|---|---|
| Year end | 28 April 05 | 28 April 05 |
| Sign off of audit test re going concern | 20 July 05 | 22 July 05 |
| Sign off of audit test re subsequent events | 20 July 05 | 26 July 05 |
| Half year review | November 05 | N/A |
| Date of audit report in financial statements | 10 Aug 05 | 13 Feb 06 |

56. EY carried out its audit work in relation to post balance sheet events for both EHR and Farepak in July 2005, though no separate working papers exist in relation to work performed solely for the purpose of assessing EHR's post balance sheet events. The EY audit programme for subsequent events includes just one paragraph on the work to be carried out and refers to the EY form 'Review of Events after the Balance Sheet date".

57. In respect of the EHR financial statements a period of 15 days had elapsed from the date of the subsequent events review on 26th July 2005 and the 10th August 2005 when EY signed the audit report.

58. In the case of Farepak a period of 6.5 months had elapsed between the date of the subsequent events review on 26th July 2005 and the 13th February 2006 when EY signed the audit report. This was a considerable period of time and should have led to a full and proper subsequent events review. There is no evidence that any subsequent events work was carried out between these dates by EY or, in particular, Mr Flitcroft. There is no evidence to suggest that on 13th February 2006, when EY and, in particular, Mr Flitcroft signed the Farepak FY05 Financial Statements that they were aware of:

i. The cash flow difficulties being experienced by EHR;
ii. The effect that this would have on Farepak;
iii. The failure to make payment in full to Choice on 31st January 2006, due to lack of funds;
iv. The administration of Choice; and
v. The effect that this was likely to have on Farepak's cash flow.

**<u>Subsequent Events in Detail</u>**

59. EY's audit methodology categorised audit work relating to subsequent events as a general audit procedure. For Farepak this was collated on a document entitled "Programme for General Audit Procedures" ("PGAP").

60. The front sheet of the PGAP contains a declaration to be signed by the engagement review partner. It states "*I have reviewed the Programme for General Audit Procedures and the results of the procedures for this engagement and am satisfied that all applicable general audit procedures have been completed, the conclusions are reasonable and consistent with the professional standards, and the financial statements and/or the auditor's report properly reflect the issues addressed.*" This was signed by Mr Flitcroft, on 13th February 2006, the same day the audit report was signed. The document was initialed by Mr Soo on 29th December 2005.

61. The PGAP details a number of procedures and then records the work that was performed in relation to each (work completed recorded below in italics). At page 10 of the PGAP under the heading "Subsequent events" it states:

> Perform a review of post balance sheet events to obtain sufficient appropriate audit evidence that all material subsequent events up to the date of the auditors' report that may require adjustment of, or disclosure in, the financial statements have been identified and properly reflected therein.
>
> Use form 'Review of Events after the Balance Sheet date', held in EY/GAM [General Audit Manual], to complete this step.
> *Reviewed minutes, cash book and interim financial position for Fairpak (sic) Food & Gifts. Refer A4/2"*

This was the only entry on the PGAP relating to a subsequent events review.

62. The Farepak audit file includes a document marked A4/2 entitled "Fairpak (sic) Food and Gifts Subsequent Events Review". The document records that it was prepared by Muzzammil Sabir on 26th July 2005. It records three procedures said to have been carried out as at that date:

i. Review of subsequent cash book for unusual cash receipts and payments (Apr 29 2005 to July 25 2005);
ii. Review of minutes of board meetings (May 17, June 22, July 14); and
iii. Review of latest financial position.

63. The A4/2 document was initialed by Mr Soo on 2nd December 2005, but does not record that any additional subsequent events review or procedures had been carried out after 26th July 2005. There is no evidence on the audit file, aside from the management letter of representation (dealt with below), that

any additional work was carried out by EY and, in particular, Mr Flitcroft in relation to subsequent events between 26th July 2005 and 13th February 2006, when the audit report was signed.

64. A management letter of representation, dated 8th February 2006, signed by Farepak's Finance Director, was provided to EY in relation to Farepak. Item (d) in that letter refers to events after the balance sheet date and states:

*"There have been no events since the balance sheet date which necessitate revision of the figures included in the financial statements or the inclusion of a note thereto. Should any such material events occur before the date of the AGM, we will advise you accordingly."*

These management representations were not true. No audit work was carried out by EY or, in particular, Mr Flitcroft to review or substantiate these management representations.

65. The representations were inaccurate and did not reflect:

(a) That there had been concerns within EHR, discussed at board level, about cash flow and liquidity for some months;
(b) That on 20th January 2006 an application had been made to BoS to extend the credit facilities;
(c) That this application had, in substance, been refused on 31st January 2006;
(d) That on the same day Farepak had been unable to meet its commitments to its main supplier, Choice, due to EHR's inability to repay its inter-company debt;
(e) That on 31st January 2006 Choice had gone into administration; and
(f) The potential effect that the loss of Choice as a supplier would have on the cash flow of Farepak, and by extension, EHR.

66. There is no evidence that EY or, in particular, Mr Flitcroft made any enquiries of the management as to their procedures for identifying subsequent events as required by SAS 150 and SAS 440 or that they made any enquires of management as to the status of substantial payments due to Choice at the end of January 2006. Such enquiries would have revealed the payment and the size of the payment that was due and the fact that it had not been made in full.

67. No EHR Board minutes for meetings held after May 2005 were found in EY's audit files. The minutes for the meetings held from November 2005 onwards record the substantial cash flow pressures that EHR was facing in the lead up to the signing of the Farepak Financial Statements on 13th February 2006. Further, from week commencing 14th November 2005 EHR's cash flow forecasts consistently projected that it would exceed its available borrowing facilities in the week commencing 30th January 2006. EY and, in particular, Mr Flitcroft, should have reviewed this material, but failed to do so.

68. Due to the way cash was swept into the central account the cash position of EHR was directly relevant to Farepak and its ability to trade. Farepak relied on EHR to settle the inter-company debt to enable it to pay its suppliers. As at 31st January 2006 EHR was unable to meet its commitments to Farepak.

69. Financial Reports were presented to the EHR Board between July 2005 and February 2006. These showed EHR's results deteriorating over that period, particularly over the critical Christmas trading period. EY and, in particular, Mr Flitcroft should have reviewed this material, but failed to do so.

70. On 13th February 2006, the same day that the Farepak audit report was signed, Mr Flitcroft signed the 'Programme for General Audit Procedures' for Farepak. In doing so he was asserting that he was satisfied with the level of post balance sheet work carried out by EY up to the date of the signing of the audit report. In reality, aside from obtaining the letter of management

representation, which was not verified, little if any subsequent events review work was undertaken by EY and, in particular, Mr Flitcroft after 26th July 2005.

**Allegation 1**

71. In relation to Farepak's FY05 Financial statements, EY and, in particular, Mr Flitcroft failed properly, or at all, to:-

    i. Perform adequate procedures designed to obtain sufficient appropriate audit evidence that all material subsequent events up to the date of their audit report which required adjustment of, or disclosure in, the financial statements had been identified and properly reflected therein;

    ii. Obtain sufficient appropriate audit evidence, in relation to subsequent events, to enable them to draw reasonable conclusions on which to base their audit opinion;

    iii. Consider the effect of subsequent events on the financial statements and on their audit report.

72. In particular they failed properly, or at all, to:

    i. Obtain and consider the minutes of the board meetings of EHR and Farepak held between August 2005 and January 2006, and the material supplied to the board at those meetings which was relevant to the concerns about cash flow that began to be expressed towards the end of the year;

    ii. Conduct proper discussions with management in respect of subsequent events in order to identify if any events had or were likely to occur which might bring into question the appropriateness of the accounting policies and if such events might call into question the validity of the going concern basis;

    iii. Consider the effectiveness of the procedures which the management of Farepak had established to ensure that subsequent events were identified;

    iv. Carry out an up-dating review of the position in February 2006;

v. Obtain and consider cash flow projections for EHR and Farepak;

vi. Identify the cash flow difficulties being encountered by EHR at the end of 2005 and beginning of 2006 and consider the effect this had on Farepak;

vii. Identify that a significant payment was due to Choice at the end of January 2006 and that this payment had not been made due to a lack of available bank facilities;

viii. To identify that the entry of Choice into administration was likely to have a negative effect of Farepak's cash flow profile.

As such they failed to comply with SAS 150 and 400, were in breach of ICAEW Fundamental Principle 4: Performance, and their conduct fell below the standard reasonably to be expected of them.

**Allegation 2**

73. In relation to the Letter of Representation, dated 8th February 2006, regarding post balance sheet events, EY and, in particular, Mr Flitcroft failed properly, or at all, to:

i. Seek or obtain corroborative evidence for the assertions made in the letter;

ii. Evaluate whether the representations made in the letter appeared reasonable and consistent with the other audit evidence obtained, including other representations;

iii. Consider the implications of the lack of evidence for their audit report.

As such they failed to comply with the requirements of SAS 440, were in breach of ICAEW Fundamental Principle 4: Performance and their conduct fell below the standard reasonably to be expected of them.

## GOING CONCERN

### Relevant Standards

**SAS 130 – the going concern basis in financial statements**

74. Relevant extracts from SAS 130 state:

***(2) When forming an opinion as to whether financial statements give a true and fair view, the auditors should consider the entity's ability to continue as a going concern, and any relevant disclosures in the financial statements. (SAS 130.1)***

*(7) Accordingly the auditors' procedures in complying with this SAS are intended to provide them with assurance that:*

*(a) The going concern basis used in the preparation of the financial statements as a whole is appropriate; and*
*(b) There are adequate disclosures regarding that basis in the financial statements in order that they give a true and fair view.*

*(8) The auditors' procedures necessarily involve a consideration of the entity's ability to continue in operational existence for the foreseeable future. In turn, that necessitates consideration of both of the current and the possible future circumstances of the business and the environment in which it operates.*

...

***(21) The auditors should assess the adequacy of the means by which the directors have satisfied themselves that:***

***(a) It is appropriate for them to adopt going concern basis in preparing the financial statements; and***
***(b) The financial statements include such disclosures, if any, relating to going concern as necessary for them to give a true and fair view.***

*For this purpose:*

***(i)*** ***The auditors should make enquiries of the directors and examine the appropriate available financial information; and***

***(ii)*** ***Having regard to the future period to which the directors have paid particular attention in assessing the going concern, the auditors should plan and perform procedures specifically designed to identify and material matters which could indicate concern about the entity's ability to continue as a going concern. (SAS 130.2).***

*(23) The auditors may need to consider some or all of the following matters* (not all listed below)*:*

- *Budget and/or forecast information (cash flow information in particular) produced by the entity…*
- *Whether the key assumptions underlying the budgets and/or forecasts appear appropriate in the circumstances;*
- *The sensitivity of budgets and/or forecasts to variable factors both within the control of the directors and outside their control;*
- *The existence, adequacy and terms of borrowing facilities and supplier credit,*
- *The directors' plans for resolving and matters giving rise to concern (if any) about the appropriateness of the going concern basis.*

*(24) In many entities the headroom between the financial resources required in the foreseeable future and the facilities available is large. In others it will often be marginal. The nature and scope of the auditors' procedures depends on the circumstances. The extent of the procedures is influenced primarily by the excess of the financial resources available to the entity over the financial resources that it requires.*

*Determining and documenting the auditors' concerns*

***(29) The auditors should determine and document the extent of their concern (if any) about the entity's ability to continue as a going concern. In***

***determining the extent of their concern, the auditors should take account of all the relevant information of which they have become aware during their audit. (SAS 130.3)***

*(31) The auditors might be more likely to conclude that there is a significant level of concern about the entity's ability to continue as a going concern if, for example, indications such as the following are present* (not all listed below)*:*

- *An excess of liabilities over assets;*
- *Net current liabilities;*
- *Necessary borrowing facilities have not been agreed;*
- *Significant liquidity or cash flow problems;*
- *Major losses or cash flow problems which have arisen since the balance sheet date and which threaten the entity's continued existence;*
- *Inability to pay debts as they fall due;*

***(36) The auditors should consider whether the financial statements are required to include disclosures relating to going concern in order to give a true and fair view. (SAS 130.5)***

***(42) Where the auditors consider that there is a significant level of concern about the entity's ability to continue as a going concern, but do not disagree with the preparation of the financial statements on the going concern basis, they should include an explanatory paragraph setting out the basis of their opinion. They should not qualify their opinion on these grounds alone, provided the disclosures in the financial statements of the matters giving rise to the concern are adequate for the financial statements to give a true and fair value (SAS 130.6)***

***Where the auditors disagree with the preparation of the financial statements on the going concern basis, they should issue an adverse audit opinion (SAS 130.8).***

**SAS 440 – Management Representations**

75. The relevant material is set out at paragraph 75 above.

## Overview of relevant facts re Going Concern

76. As at 13th February 2006, when the audit report on the Farepak Financial Statements was signed, both Farepak and their parent company EHR had significant financial difficulties and they were unable to meet their debts in full as they fell due. As set out above, within the previous two weeks EHR's request for an extension of their loan facilities had, in substance, been refused by BoS, Farepak had been able to pay only £6.5million of £12.1 million due to Choice at the end of January 2006 because they and EHR had insufficient funds, and Choice had then gone into administration denying Farepak the generous payment terms that Choice had extended to them. None of these issues were identified by EY or, in particular, Mr Flitcroft prior to signing the Financial Statements. Each of these occurrences should have given rise to a significant level of concern as to Farepak's ability to continue as a going concern.

## Farepak - Going Concern

77. EY's audit methodology categorised audit work relating to going concern as a general audit procedure, or "PGAP". The PGAP for Farepak was collated on the "PGAP programme".

78. Pages 10-12 of the PGAP deal with going concern. The PGAP details a number of procedures and then records the work that was performed in relation to each (work completed recorded below in italics):-
    i. Assess the adequacy of the means by which the directors have satisfied themselves that the going concern basis of preparation of the financial statements is appropriate and that the financial statements include any disclosures relating to going concern which are necessary for them to give true and fair view (SAS 130.2).
        - Make inquiries of the directors – *07/05 AS/AF*

- Examine appropriate available financial information – *See BoS covenant audit 22/07/05;*
- Plan and perform procedures to identify any material matters which could indicate concern about the entity's ability to continue as a going concern. – *We critically reviewed the Management Accounts of June and the Board Minutes and discussed with the Directors in the Audit Committee. The group will extend their borrowing facility by BoS. See BoS covenant report as well. 22/07/05.*

(d) Determine and document the extent of concern (even if none) about the entity's ability to continue as a going concern. Take account of all relevant evidence obtained during the audit. (SAS 130.3) – *If you look at the current group financial statements you can identify that the group cannot cover their current creditors with current debtors. But they have a borrowing facility with the BoS which they will extent (sic). So we have no risk of illiquidity in the future.*

79. The work recorded in this section is in identical terms to that recorded on the equivalent EHR PGAP programme, only the dates of completion are different. The contents appear to have been cut and pasted between the two documents.

80. The Farepak PGAP does not indicate or record that any procedures were carried out in relation to Going Concern after July 2005.

81. The July 2005 audit work in relation to going concern was itself of a poor standard in that EY and, in particular, Mr Flitcroft failed properly, or at all, to:-
    a. Assess the adequacy of the means by which the directors had satisfied themselves it was appropriate for them to adopt the going concern basis in preparing the financial statements;
    b. Make enquiries of the directors and examine appropriate financial information;

c. Plan and perform procedures specifically designed to identify matters which could indicate concern about Farepak's ability to continue as a going concern.

For the avoidance of doubt, it is not alleged that a reasonable auditor should have concluded in July 2005 that Farepak could not continue as a going concern, or that there were grounds for significant concern as to that issue. There is no separate head of complaint in relation to the work carried out in July 2005 on going concern. The fact that EY had failed to carry out sufficiently extensive work on going concern was a relevant part of the background, when in January/February 2006 they came to sign the financial statements which stated that the accounts were prepared on the going concern basis without any explanatory paragraph of the type contemplated by SAS 130 para 42.

82. The PGAP was initialed by Mr Soo on 29th December 2005, though there is no indication what the purpose of this was and there is no evidence that any additional work had been carried out. It was signed by Mr Flitcroft on 13th February 2006.

83. There is no evidence on the EY audit files to indicate that they and, in particular, Mr Flitcroft carried out an assessment in February 2006, as to whether Farepak was able to continue as a going concern for the next 12 months. It is to be inferred that they did not do so.

84. EY obtained a Letter of Representation dated 8th February 2006 and signed by Stephen Hicks, Farepak's Finance Director. This appears to be the only additional procedure carried out in relation to Farepak, after July 2005. The letter states:

*"(e) Going Concern*

*The Financial Statements have been prepared on a going concern basis…in assessing the appropriateness of the going concern basis, we have taken account of all relevant* *information covering a period of at least 12 months from the date of approval of the financial statements."*

85. There is no evidence that the Farepak directors carried out any assessment as to the appropriateness of the going concern basis, to support the assertion made in their letter of 8th February 2006. The EHR and Farepak Board minutes for January and February 2006 do not refer to the Farepak FY05 Financial Statements or the Farepak Letter of Representation. It is to be inferred that no such assessment was carried out.

86. There is no evidence that EY or, in particular, Mr Flitcroft carried out any procedures to identify whether the Farepak Directors conducted an assessment as to whether the going concern basis was appropriate for the FY05 Financial Statements. Further, there is no evidence that EY or, in particular, Mr Flitcroft obtained or audited the information underlying the Directors' assessment. It is to be inferred that no such procedures or work was carried out.

87. EY and, in particular, Mr Flitcroft did not obtain updated cash flow forecasts regarding EHR's financial position or assess their ability to support Farepak. Given the cash sweeping arrangements and Farepak's reliance on EHR to repay inter-company debt to allow them to meet their own liabilities, this was of particular importance.

88. In the foregoing premises it is to be inferred that EY or, in particular, Mr Flitcroft failed to carry out any assessment of Farepak's ability to continue as a going concern in February 2006 or in the period immediately preceding February 2006.

**Allegation 3**

89. In relation to Farepak's FY05 Financial Statements, EY and, in particular, Mr Flitcroft failed to properly consider Farepak's ability to continue as a going

concern. In particular, in February 2006, prior to signing the financial statements, they failed properly, or at all, to:

i. Consider Farepak's ability to continue as a going concern;
ii. Consider whether any relevant disclosures were required in the financial statements;
iii. Assess the adequacy of the means by which the Farepak Directors had satisfied themselves that it was appropriate for them to adopt the going concern basis in the preparation of the FY05 Financial Statements and whether the FY05 Financial Statements should include disclosures relating to going concern for them to give a true and fair view;
iv. Make proper enquiries of the directors and examine the appropriate financial information;
v. Plan and perform procedures specifically designed to identify any material matters which would indicate concern about the entity's ability to continue as a going concern.

90. In particular EY and Mr Flitcroft failed properly, or at all, to:

i. Obtain and consider updated cash flow forecasts regarding EHR's financial position or assesses their ability to support Farepak;
ii. Obtain and consider the minutes of recent board meetings of EHR and Farepak;
iii. Consider the sensitivity of the budgets and forecasts to variable factors both within and outside the control of the directors;
iv. Consider the existence, adequacy and terms or borrowing facilities and supplier credit;
v. Identify the significant liquidity and cash flow problems facing EHR and by extension Farepak, that had arisen since the balance sheet date, in particular the absence of headroom in January and February 2006;
vi. Identify the failure of Farepak to meet its debts as they fell due, in relation to the inability to pay Choice £5.6 million on 31st January 2006.

vii. Identify the potential consequences for Farepak of the entry of Choice into administration.

As such they failed to comply with the requirements of SAS 130, were in breach of ICAEW Fundamental Principle 4: Performance and their conduct fell below the standard reasonably to be expected of them.

**Allegation 4**

91. In relation to the Letter of Representation, dated 8th February 2006, regarding going concern, EY and, in particular, Mr Flitcroft failed to properly, or at all:

i. Seek or obtain corroborative evidence for the assertions made in the letter;
ii. Evaluate whether the representations made in the letter appeared reasonable and consistent with the other audit evidence obtained, including other representations;
iii. Consider the implications of the lack of evidence for their audit report.

As such they failed to comply with the requirements of SAS 440, were in breach of ICAEW Fundamental Principle 4: Performance and their conduct fell below the standard reasonably to be expected of them.

## WORKING PAPERS

### Relevant Standards

### SAS 230 – Working papers

92. SAS 230 establishes standards and provides guidance regarding working papers in the context of the audit of financial statements. Relevant extracts state:-

***Auditors should document in their working papers matters which are important in supporting their report.***

*Working papers are the material that auditors prepare or obtain, and retain in connection with the performance of the audit…Working papers support, amongst other things, the statement in the auditors' report as to the auditors' compliance or otherwise with Auditing Standards to the extent that this is important in supporting their report.*

*Working papers are the record of:*

*(a) The planning and performance of the audit;*

*(b) The supervision and review of the audit work; and*

*(c) The audit evidence resulting from the audit work performed which the auditors consider necessary and on which they have relied to support their report.*

*Form and content of working papers*

***Working papers should record the auditors' planning, the nature, timing and extent of the audit procedures performed, and the conclusions drawn from the audit evidence obtained. (SAS 230.2)***

***Auditors should record in their working papers their reasoning on all significant matters which require the exercise of judgment, and their conclusions thereon.* (SAS230.3)**

*The extent of working papers is a matter of professional judgment since it is neither necessary nor practical to document every matter auditors consider. Auditors base their judgment as to the extent of the working papers upon what would be necessary to provide an experienced auditor, with no previous experience with the audit, with an understanding of the work performed and the basis of the decisions taken. However, even then, that experienced auditor may only be able to obtain a comprehensive understanding of all aspects of the audit by discussing them with the auditors who prepared them.*

*It is in those areas of the audit that involve difficult questions of principle or judgment that auditors' judgment may be questioned subsequently, particularly by a third party who has the benefit of hindsight. In such circumstances it is important to be able to demonstrate the relevant facts that were known at the time the auditors reached their conclusion.*

**Allegation 5**

93. If EY and Mr Flitcroft seek to meet the allegations herein by reference to audit work of significance which was not documented in the relevant working papers, then in relation to the conduct of the audit of Farepak's FY 05 Financial Statements EY and, in particular, Mr Flitcroft failed to properly, or at all:-

   i. Document in their working papers matters which were important in supporting their report;
   ii. Record the nature, timing and extent of the audit procedures performed and the conclusions drawn from the audit evidence obtained;
   iii. Record in their working papers their reasoning on all significant matters requiring the exercise of judgment and their conclusions thereon.

94. As such they failed to comply with the requirements of SAS 230, were in breach of ICAEW Fundamental Principle 4: Performance and their conduct fell below the standard reasonably to be expected of them.

Gareth Rees QC

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**Executive Counsel**

26.9.2012
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**Date**