IN THE MATTER OF

THE EXECUTIVE COUNSEL OF THE FINANCIAL REPORTING COUNCIL

-and-

(1) UHY HACKER YOUNG LLP

(2) MARTIN JONES

FINAL SETTLEMENT DECISION NOTICE

Pursuant to Rule 108 of the Audit Enforcement Procedure

This Final Settlement Decision Notice is a document prepared by Executive Counsel following an investigation relating to, and admissions made by, the Respondents. It does not make findings against any persons other than the Respondents and it would not be fair to treat any part of this document as constituting or evidencing findings against any other persons or entities since they are not parties to the proceedings.

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1 INTRODUCTION

1.1. This *Final Settlement Decision Notice* is divided into the following sections:

1.1.1. Section 1: Introduction;

1.1.2. Section 2: Background;

1.1.3. Section 3: Executive Summary;

1.1.4. Section 4: *Relevant Requirements* to which the breaches relate;

1.1.5. Sections 5 and 6: Detail of the breaches of *Relevant Requirements*;

1.1.6. Sections 7 and 8: *Sanctions*; and

1.1.7. Section 9: Costs.

1.2. The Financial Reporting Council (the "**FRC**") is the competent authority for statutory audit in the UK and operates the Audit Enforcement Procedure[1] (the "**AEP**"). The AEP sets out the rules and procedure for the investigation, prosecution and sanctioning of breaches of *Relevant Requirements*.

1.3. The AEP contains a number of defined terms and, for convenience, those defined terms are also used within this document. Where defined terms are used, they appear in italics.

1.4. This *Final Settlement Decision Notice* also uses the following definitions:

1.4.1. "**FY2018**" means the financial year ended 30 June 2018[2], "**FY2018 financial**

[1] Version with effect from 5 January 2022.

[2] In this *Final Settlement Decision Notice* other financial years are styled "FY[year]".

statements” means the consolidated financial statements of Laura Ashley Holdings plc (“**LAH**”) for that period, and “**FY2018 Audit**” means the statutory audit of the FY2018 financial statements.

1.4.2. “**FY2019**” means the financial year ended 30 June 2019, “**FY2019 financial statements**” means LAH’s consolidated financial statements for that period, and “**FY2019 Audit**” means the statutory audit of the FY2019 financial statements.

1.4.3. “**Group”** means LAH and its subsidiaries as at the relevant time.

1.4.4. “**Public Interest Entity”** has the meaning given in paragraph 1 of the January 2022 edition of the AEP.

1.4.5. **“Respondents”** means:

1.4.5.1. UHY Hacker Young LLP[3] (referred to herein as **“UHY**”), which was the *Statutory Audit Firm* for the FY2018 Audit and the FY2019 Audit.

1.4.5.2. Martin Jones, a partner of UHY, who was the *Statutory Auditor* of LAH for the FY2018 Audit and the FY2019 Audit and signed off the FY2018 and FY2019 Audit reports on behalf of UHY.

1.5. In accordance with Rule 102 of the AEP, Executive Counsel entered into settlement discussions with the Respondents.

1.6. A *Proposed Settlement Decision Notice* was issued by Executive Counsel on 11 May 2022, pursuant to Rule 103 of the AEP, in relation to the conduct of the Respondents in respect of the FY2018 Audit and the FY2019 Audit. The Respondents provided written agreement to the *Proposed Settlement Decision Notice*, pursuant to Rule 105 of the AEP, on 11 May 2022. The *Convener* subsequently appointed an *Independent Reviewer*, pursuant to Rule 106 of the AEP, to consider the *Proposed Settlement Decision Notice*.

1.7. On 30 May 2022, the *Independent Reviewer* approved the issuance of a *Final Settlement Decision Notice* pursuant to Rule 107(a) of the AEP.

1.8. In accordance with Rule 108 of the AEP this *Final Settlement Decision Notice* sets out:

1.8.1. the breaches of *Relevant Requirements*, with reasons;

1.8.2. the *Sanctions* imposed on the Respondents, with reasons; and

[3] UHY is a member of a network of 12 independent firms (LLPs or Limited companies) which use the common branding of “UHY Hacker Young”. However, this *Final Settlement Decision Notice* relates only to UHY Hacker Young LLP, and no other members of the network.

1.8.3. the amount payable by the Respondents in respect of Executive Counsel's costs.

2 BACKGROUND

2.1. The Group was a well-known high-street retail group and, as at 30 June 2019, it had 155 high-street stores in the UK and international operations in 25 countries worldwide, employing over 2,700 people. LAH's shares were listed on the main market of the London Stock Exchange, and as such the company was a *Public Interest Entity*.

2.2. The Group's revenue, operating profit, profit before tax ("**PBT**") and profit after tax declined between FY2015 and FY2018 (with the Group in fact making a loss after tax of £1.4m in FY2018):

£m	**2015 (53 wks)**	**2016 (74 wks)**	**2017 (52 wks)**	**2018 (52 wks)**
Revenue	303.1	400.9	277.0	257.2
Operating profit	21.9	27.9	11.0	6.4
Profit / (Loss) before tax	21.6	22.8	6.3	0.1
Profit / (Loss) after tax	16.4	15.9	4.0	(1.4)

2.3. During this period, the Group changed its statutory auditors twice; once in 2017 and once in 2018. UHY was appointed as *Statutory Audit Firm* in May 2018.

2.4. The Group announced three profit warnings shortly before the Respondents carried out the FY2018 Audit (on 16 February 2017, 15 August 2017 and 15 February 2018).

2.5. Against this backdrop of declining performance, LAH's management made ambitious forecasts around the time of the FY2018 Audit, which anticipated significantly improved performance over the next two years. In this regard:

2.5.1. for FY2019: revenue growth of 2.9% and operating profit growth of 54.5%.

2.5.2. for FY2020: revenue growth of 4.2% and operating profit growth of 46.4%.

2.6. Mr Jones signed the audit opinion for FY2018 on behalf of UHY on 21 September 2018. The auditor's report was unmodified and noted no material uncertainty related to the use of the going concern assumption. The FY2018 financial statements were published on

21 November 2018.

2.7. On 9 May 2019, the FRC published its *Decision Notice* against the *Statutory Audit Firm* and *Statutory Auditor* (respectively) for the FY2016 Audit of LAH.

2.8. Further, on 6 August 2019 the FRC's Audit Quality Review team ("**AQR**") issued their review of UHY's work on the FY2018 Audit. AQR assessed the work within the scope of their review at the worst available grading - "*Significant Improvements Required*".

2.9. The management forecasts mentioned in paragraph 2.5 above were not met – in fact, the financial performance of the Group continued to deteriorate in FY2019.

2.10. The results of the Group for FY2019, as compared with FY2018, were as follows:

£m	**2018 (52 wks)**	**2019 (52 wks)**
Revenue	257.2	232.5
Operating profit/ (loss)	6.4	(0.9)
Profit / (Loss) before tax	0.1	(14.3)
Profit / (Loss) after tax	(1.4)	(14)

2.11. Revenue thus fell by almost 10% as compared with FY2018 and the Group made an operating loss of £0.9m, as compared with an operating profit of £6.4m in FY2018.

2.12. The Group's loss after tax increased ten-fold from £1.4m in FY2018 to £14m in FY2019.

2.13. The Group announced further profit warnings shortly before the Respondents carried out the FY2019 Audit (on 20 February 2019 and 25 April 2019).

2.14. In addition, LAH's share price had also declined sharply in the period 2015 to 2019 as follows:

Date	Share price (pence)
30 June 2015	30.5000p
26 October 2017	8.0700p
21 November 2018	3.6800p
15 October 2019	1.6275p

2.15. Mr Jones also signed the audit opinion for FY2019 on behalf of UHY. The auditor's report was unmodified and noted no material uncertainty related to going concern. The FY2019 financial statements were published on 15 October 2019.

2.16. On 23 March 2020, administrators were appointed to LAH and various subsidiary companies in the Group. LAH cited the impact of the COVID-19 pandemic on the Group's business as the reason for the administration. The administrators' progress report dated 16 December 2020 estimated that unsecured creditors of LAH's subsidiary companies would receive a return of between 1% and 20% on their claims.

2.17. Notwithstanding that the Respondents' audit work regarding the assessment of going concern breached *Relevant Requirements*, Executive Counsel does not suggest that such breaches caused the insolvent administration of LAH.

3 EXECUTIVE SUMMARY

3.1. As noted above, the *Statutory Audit Firm* and *Statutory Auditor* responsible for the FY2018 Audit and FY2019 Audit were UHY and Mr Jones respectively. In this regard:

3.1.1. For the year ended 2018, UHY was approximately the 40th largest audit firm in the UK, with total fee income (audit and non-audit) of £18m and 17 audit principals. For the year ended 2020, UHY had a total fee income of approximately £19.8m (of which audit fee income accounted for £7 million), with 18 audit principals.

3.1.2. Mr Jones is a partner of UHY, with over 30 years' statutory audit experience.

3.1.3. As a firm, UHY has over 20 years' experience in carrying out *Statutory Audits* of *Public Interest Entities*, albeit the majority of UHY's other *Public Interest Entity* clients have been Venture Capital Trusts or companies with listed debt, rather than corporate groups of the size and complexity of LAH and the Group.

3.1.4. The FY2018 Audit was the first audit for which UHY and Mr Jones were the *Statutory Audit Firm* and *Statutory Auditor* of LAH.

3.2. Fundamentally, the Respondents' responsibilities were to form an opinion as to whether the FY2018 and FY2019 financial statements showed a true and fair view and had been properly prepared in accordance with the Companies Act 2006 and International Financial Reporting Standards. The *Relevant Requirements* applicable to *Statutory Audits* include (among other things) the International Standards on Auditing ("**ISAs**").

3.3. The applicable *Relevant Requirements* and the Respondents' breaches of *Relevant Requirements* in relation to the FY2018 and FY2019 Audits are described in more detail in section 4 and in sections 5 and 6 of this *Final Settlement Decision Notice* respectively. However, of particular note:

3.3.1. An audit requires the auditor to obtain sufficient appropriate audit evidence about the amounts and disclosures in the financial statements in order to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. Audit evidence is defined in ISA 500 as "*information used by the auditor in arriving at the conclusions on which the auditor's opinion is based*". Audit evidence is primarily obtained from audit procedures performed by the auditor during the course of the audit.

3.3.2. The auditor is also required by ISA 200.15 to "*plan and perform an audit with professional skepticism recognizing that circumstances may exist that cause the financial statements to be materially misstated…the auditor shall maintain professional skepticism throughout the audit, recognising the possibility of a material misstatement due to facts or behaviour indicating irregularities, including fraud, or error, notwithstanding the auditor's past experience of the honesty and integrity of the entity's management and of those charged with governance.*" Furthermore, ISA 200.A22 explains that, "*Professional skepticism is necessary to the critical assessment of audit evidence. This includes questioning contradictory audit evidence and the reliability of documents and responses to inquiries and other information obtained from management and those charged with governance.*"

3.4. Further, as the *Statutory Auditor* responsible for the FY2018 and FY2019 Audits, Mr Jones was responsible for the overall quality of the audits (ISA 220.8) and for the direction, supervision and performance of the audits in compliance with professional standards and applicable legal and regulatory requirements (ISA 220.15(a)).

3.5. Mr Jones was also required to comply with any *Relevant Requirements* that were applicable to any work for which he was or ought to have been personally responsible.

3.6. Further, as the *Statutory Audit Firm* responsible for the FY2018 and FY2019 Audits, UHY is responsible for any breaches of *Relevant Requirements* by its audit team.

3.7. As set out in this *Final Settlement Decision Notice*, the failings by the Respondents in respect of the FY2018 and FY2019 Audits were both serious and widespread across nine separate areas of the FY2018 Audit and six separate areas of the FY2019 Audit (including areas which were correctly identified by the Respondents as significant risk).

3.8. Sections 5 and 6 of this *Final Settlement Decision Notice* detail the Respondents' breaches of *Relevant Requirements* in the following areas of the FY2018 and FY2019 Audits:

3.8.1. Materiality (FY2018 only);

3.8.2. Going Concern Assessment;

3.8.3. Revenue;

3.8.4. Inventory;

3.8.5. Journal Entry Testing and Fraud Risk Assessment;

3.8.6. Property, Plant and Equipment Adjustments / Other Comprehensive Income;

3.8.7. Pension Scheme Assets and Liabilities;

3.8.8. Carrying Value of Investment in Subsidiaries (FY2018 only); and

3.8.9. Long-Standing Debtors (FY2018 only).

3.9. The failings were most numerous in the FY2018 Audit. However, the FY2019 Audit nevertheless also demonstrated a large number of significant failings including in relation to most of the same areas as the FY2018 Audit, even though the FY2019 Audit was carried out after aspects of the Respondents' audit work for the FY2018 Audit had been heavily criticised by the AQR. In light of AQR's criticisms of the FY2018 Audit, Executive Counsel would have expected the Respondents' audit work for the FY2019 Audit to have been of a much higher quality.

3.10. The Respondents' breaches of *Relevant Requirements* related to audit procedures of fundamental importance and many concerned matters crucial to the proper conduct of an audit including (for example) the determination of materiality and the assessment of going concern. In a number of cases, basic audit requirements were not followed, evidencing a significant lack of competence and basic challenge in conducting the audit work. The Respondents failed to challenge management appropriately, to exercise professional skepticism and/or to seek or obtain sufficient appropriate audit evidence.

3.11. Ultimately, as a result of the Respondents' breaches of *Relevant Requirements*, the audits failed in their principal objectives: that of providing reasonable assurance that the FY2018 and FY2019 financial statements were free from material misstatement.

3.12. Sections 7 and 8 of this *Final Settlement Decision Notice* also set out the *Sanctions* imposed in respect of the Respondents' breaches of *Relevant Requirements*.

3.13. The *Sanctions* imposed reflect that UHY and Mr Jones have voluntarily decided to withdraw temporarily from undertaking *Statutory Audits* of *Public Interest Entities* and are resigning from relevant statutory audit engagements. In conjunction with that approach, they have voluntarily offered an undertaking to the FRC not to conduct *Statutory Audits* of *Public Interest Entities* for a period of at least two years from the date of the *Proposed Settlement Decision Notice* and until such point in the future as the prevailing registration body for *Public Interest Entity Statutory Audit* registration is satisfied that they have the necessary competence to conduct high quality *Statutory Audits* of *Public Interest Entities* in compliance with *Relevant Requirements.* This undertaking is reflected in the *Sanctions* imposed at paragraphs 3.14 and 3.19 below.

Sanctions imposed against UHY

3.14. **An Order**, that UHY takes action to prevent the recurrence of the breach of the Relevant Requirements; namely that the firm shall not accept appointment as *Statutory Auditor* to any *Public Interest Entity* for which it is not currently acting as *Statutory Auditor*, until the later of: (i) 11 May 2024*;* and (ii) such time as the prevailing registration body for *Public Interest Entity Statutory Audit* registration is satisfied that UHY has the necessary competence to conduct high quality *Statutory Audits* of *Public Interest Entities* in compliance with *Relevant Requirements*. By agreement, a condition shall be applied to UHY's audit licence to that effect.

3.15. **A financial penalty** of £300,000 adjusted for aggravating and mitigating factors and discounted for admissions and early disposal by 27.5% so that the financial penalty payable is £217,500.

3.16. A published statement in the form of a **severe reprimand**.

3.17. **A declaration** that the FY2018 and FY2019 Audit reports signed on behalf of UHY did not satisfy the *Relevant Requirements*, as set out in this *Final Settlement Decision Notice*.

3.18. In determining the *Sanctions* to be imposed on UHY, Executive Counsel has noted that in response to the identified failings in the FY2018 Audit, UHY took the remedial steps set out at paragraph 7.20 below, and in those circumstances no further non-financial

sanctions will be required.

Sanctions imposed against Mr Jones

3.19. **An Order**, that he takes action to prevent the recurrence of the breach of the *Relevant Requirements*, namely that he does not sign any *Statutory Audit* report for a *Public Interest Entity* for a period of 2 years from 11 May 2022..

3.20. A **financial penalty** of £45,000 adjusted for aggravating and mitigating factors and discounted for admissions and early disposal by 27.5% so that the financial penalty payable is £32,625.

3.21. **An Order** that Mr Jones take action to prevent the recurrence of the breach of the *Relevant Requirements*, by undertaking training, in a form agreed with the FRC, in relation to the application of ISAs 220, 315 and 570.

3.22. A published statement in the form of a **severe reprimand.**

3.23. **A declaration** that the FY2018 and FY2019 Audit reports signed by Mr Jones did not satisfy the *Relevant Requirements*, as set out in this *Final Settlement Decision Notice.*

3.24. Additionally, UHY shall pay Executive Counsel's costs of the investigation being £418,885.91

4 *RELEVANT REQUIREMENTS* TO WHICH THE BREACHES RELATE

4.1. *Relevant Requirements* are defined in the AEP as having the meaning set out in Regulation 5(11) and Regulation 11(5)(b) of the Statutory Auditors and Third Country Auditors Regulations 2016 ("**SATCAR**"). *Relevant Requirements* include the requirement under regulation 4(1) of SATCAR to conduct a *Statutory Audit* in accordance with the relevant standards for the conduct of *Statutory Audits* (the "relevant standards" being defined in regulation 4(2) of SATCAR). The *Relevant Requirements* applicable to the FY2018 and FY2019 Audits therefore included the ISAs and the 2011 Code of Ethics of the Institute of Chartered Accountants in England and Wales ("**ICAEW**" and the "**ICAEW Code**").[4]

4.2. Save in limited respects, the ISAs relevant to this *Final Settlement Decision Notice* are those effective for audits of financial statements for periods ending on or after 17 June

[4] The requirement under paragraph 130.1(b) of the ICAEW Code to exercise 'Professional Competence and Due Care' is relevant to the breaches set out in this *Final Settlement Decision Notice.*

2016[5]. The *Relevant Requirements* referred to in this *Final Settlement Decision Notice* are the following:

4.2.1. ISA 200 (Overall objectives of the independent auditor and the conduct of an audit in accordance with international standards on auditing);

4.2.2. ISA 220 (Quality Control for an Audit of Financial Statements);

4.2.3. ISA 230 (Audit Documentation);

4.2.4. ISA 240 (The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements)

4.2.5. ISA 260 (Communication With Those Charged With Governance);

4.2.6. ISA 265 (Communicating Deficiencies in Internal Control to Those Charged with Governance and Management);

4.2.7. ISA 315 (Identifying and Assessing the Risks of Material Misstatement Through Understanding of the Entity and Its Environment);

4.2.8. ISA 320 (Materiality in Planning and Performing an Audit);

4.2.9. ISA 330 (The Auditor's Responses to Assessed Risks);

4.2.10. ISA 450 (Evaluation of Misstatements Identified During the Audit);

4.2.11. ISA 500 (Audit Evidence);

4.2.12. ISA 530 (Audit Sampling);

4.2.13. ISA 540 (Auditing Accounting Estimates and Related Disclosures);

4.2.14. ISA 570 (Going Concern);

4.2.15. ISA 620 (Using the Work of an Auditor's Expert); and

4.2.16. ISA 701 (Communicating Key Audit Matters in the Independent Auditor's Report).

4.3. Extracts from the ISAs and the ICAEW Code setting out those parts which are of particular relevance to the breaches of *Relevant Requirements* are set out in Appendix 1 hereto.

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[5] The applicable versions of ISA 500 and ISA 530 are those effective for audits of financial statements for periods commencing on or after 15 Dec 2010. The applicable version of ISA 300 is that effective for audits of financial statements for periods commencing on or after 15 Dec 2017.

5 BREACHES OF *RELEVANT REQUIREMENTS* - FY2018

Category 1 – Audit work in relation to materiality

Background

5.1. A *Statutory Auditor* must exercise professional judgment when determining the materiality threshold for the audit. The setting of materiality has a pervasive impact on the planning and performance of an audit, including the auditor's assessment of risks of material misstatement and the response to those risks. If materiality is set too high, there is the potential that unadjusted misstatements contained in the financial statements will not be treated as material and will not be corrected when they should have been.

5.2. ISA 320 requires the auditor, when establishing the overall audit strategy, to determine materiality for the financial statements as a whole. Paragraphs A1 and A3-A7 of ISA 320 provide relevant guidance on determining materiality. In particular, materiality should be determined with a view to obtaining reasonable assurance that the financial statements as a whole are free from material misstatement.

5.3. ISA 320 does not prescribe which benchmarks should be used to calculate materiality. ISA320.A5 provides an example of profit before tax being used to calculate materiality for profit-orientated entities. As LAH was a profit-oriented entity in the retail sector, an appropriate approach to materiality would have been to set the threshold for the FY2018 Audit at 5% of estimated PBT. That would have given a materiality threshold of c.£280,000. Whilst this is not the only approach that an auditor could have taken, such an approach would have been in accordance with the *Relevant Requirements* and common audit practice.

5.4. By contrast, it appears[6] that the Respondents calculated overall materiality for the FY2018 Audit by taking an average of 1% of turnover and 5% of PBT. This resulted in an overall materiality threshold for the FY2018 Audit of £1,417,365.

5.5. Overall materiality for the FY2018 Audit was therefore set at about five times the level that would have been calculated using the common approach of using 5% PBT.

5.6. In addition to setting overall materiality, ISA 320.11 requires the *Statutory Auditor* to determine a figure for "performance materiality[7]" for (among other things) the purposes

[6] It is unclear from the audit file and the auditor's judgment is insufficiently explained.

[7] ISA 320 defines "performance materiality" as, "*the amount…set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole…*"

of assessing the risks of material misstatement . It is set by the *Statutory Auditor* at a lower level than overall materiality, to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements in the financial statements exceeds materiality for the financial statements as a whole[8].

5.7. The determination of performance materiality is not a simple mechanical calculation and involves the exercise of professional judgment[9]. Normal audit industry practice is for the *Statutory Auditor* to calculate performance materiality at 75% of overall materiality where the risk of misstatement is low. The Respondents set performance materiality at 75% for the FY2018 Audit.

5.8. However, the amount of the reduction from overall materiality is dependent on factors such as risk of misstatements, the control environment, and the expectation of misstatements. If the risk of misstatement is greater, then performance materiality should be set lower. The audit team noted in their audit workpapers concerns that this was their first year auditing LAH and that they had *"limited knowledge"* of LAH's *"controls"*. Such matters should have led then to apply an amount for performance materiality which was lower than 75% of overall materiality.

5.9. As a consequence of the foregoing:

5.9.1. the Respondents failed to determine adequately or at all whether uncorrected misstatements were material, individually or in aggregate, and/or whether the overall audit strategy and audit plan therefore needed to be revised; and

5.9.2. the Respondents failed to report to those charged with governance during the FY2018 Audit that uncorrected misstatements were in fact material.

5.10. Specifically, unadjusted misstatements of £676,0000 (debit) on the income statement were not considered by the Respondents to be material and were not required by them to be corrected. Correcting that misstatement in the FY2018 financial statements would have led to LAH reporting a loss before tax for FY2018 rather than a £100,000 PBT.

<u>Breach</u>

5.11. In breach of ISA 320.10 and 320.11, the Respondents failed to select an appropriate benchmark and percentage to calculate overall materiality and / or performance materiality for the FY2018 Audit.

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[8] ISA320.A13.

[9] ISA320.A13.

Category 2 – Going Concern

Background

5.12. The going concern assumption is the assumption that a company will remain in business for the foreseeable future. In considering whether a company is a going concern, the key test is whether the company is able to pay its debts as they fall due. If the going concern assumption is not appropriate, an entity prepares its accounts on a break-up basis with assets valued on the basis of expected realisation from a forced sale.

5.13. The going concern assumption is therefore a fundamental principle in the preparation of financial statements and is a key consideration for any S*tatutory Auditor* to address (as the Respondents themselves correctly recognised in planning the FY2018 Audit).

5.14. As at the end of FY2018:

5.14.1. the Group had recently issued three profit warnings - in February and August 2017 and February 2018;

5.14.2. LAH's share price had fallen from circa 30 pence in late 2014 to circa 4 pence by the end of June 2018;

5.14.3. The fashion and soft furnishing retail sector in which the Group operated was generally under pressure from declining revenues – and the Group's revenue had fallen from £303m in FY2015 to £257m in FY2018 and, over the same period, PBT for the Group had fallen from £22m to break even; and

5.14.4. the Group had also experienced a recent decline in cashflow.

5.15. The Respondents identified going concern as a "significant risk" for the FY2018 Audit due to the state of the retail sector, the Group's profit warnings, and potential cash flow concerns for the Group. The workpapers for the FY2018 Audit identified that:

5.15.1. The retail sector was "*currently struggling somewhat*" and that this had had a "*significant impact*" on the Group's revenues and profits

5.15.2. There were also several other "*key factors*" affecting the Group, including:

1.1.1.1. Fluctuations in foreign exchange rates; and

1.1.1.2. UK employment costs.

5.16. LAH's management intended to alleviate the Group's cash flow constraints by (among other things) selling a building in Singapore. For the purposes of this potential transaction, a UHY working capital team (separate from the audit team, but also headed by Mr Jones) was engaged by the Group to review and report on management's cash flow projections ("**the UHY working capital team**"). The UHY working capital team

produced a report dated 20 August 2018 ("**the UHY working capital report**"). This report contained a number of caveats which limited its value and utility as audit evidence, including that:

5.16.1. The UHY working capital team had not sought to verify the accuracy of data or information and explanations provided by management; and

5.16.2. The forecasts were based on management's estimation of what would be prudent and did not necessarily reflect UHY's opinion of what constitutes prudence.

5.17. Notwithstanding these caveats, the Respondents placed heavy reliance on the UHY working capital report in their audit of the going concern assessment for the FY2018 Audit. However, there is no evidence on the FY2018 Audit file that the Respondents carried out adequate audit work to verify the contents of the UHY working capital report.

5.18. Furthermore, the Respondents also identified that management's assessment of going concern was based on a number of important assumptions, such as:

5.18.1. Completion of the Singapore property sale;

5.18.2. Improved gross profit margins;

5.18.3. Significant increases in online sales; and

5.18.4. Improved intake margin and lower costs of sales.

5.19. There is no evidence on the FY2018 Audit file of the nature or extent of any 'challenge' to these assumptions by the UHY working capital team or of any investigation or review by the audit team of the nature, extent and effectiveness of any such 'challenge'.

5.20. There is also no evidence on the FY2018 Audit file as to how the audit team satisfied itself that the forecasts for increased revenue and improved gross profit margins were management's best estimate of financial performance for FY2019 and FY2020. The forecasts indicated considerable performance improvements, as compared with recent results, and the Respondents should have sought more persuasive supporting evidence. The explanations in the UHY working capital report were high-level and non-specific.

5.21. As noted above, the workpapers for the FY2018 Audit recorded that movements in foreign exchange rates were of significance to LAH. The FY2018 financial statements prominently stated, in the Strategic Report, that approximately two-thirds of the products sold by LAH were paid for in US Dollars and Euros, and a 1% depreciation in Sterling against those currencies for a full 12 months could therefore reduce LAH's profit by approximately £1.1m. LAH was not hedged against foreign exchange movements nor

did it undertake forward-purchasing.

5.22. The effect of foreign exchange volatility was therefore a significant consideration for the Respondents to take into account for the audit of the going concern assessment, but there is no evidence on the FY2018 Audit file that they gave this adequate consideration.

5.23. The Respondents considered the effect of various sensitivities on management's forecasts, as set out in the UHY working capital report. The Respondents concluded that the Group would remain within its overdraft limit of £15m even after applying these sensitivities (which it described as "a '*worst case scenario'* situation"). However:

5.23.1. This was not a true "worst case scenario" because the Respondents' sensitivity analysis was carried out as an alternative, rather than in addition, to the sensitivities that were included in the UHY working capital report; and

5.23.2. In any event, the revenue sensitivity was carried out incorrectly because, although the Respondents reduced revenues by 10%, they did not make any reduction to gross profit commensurate with this reduction in revenue and the reduction in revenue did not flow through into the forecast cash position. There were no valid reasons for leaving the gross profit figure unchanged in the sensitised forecasts (and none is identified in the relevant workpapers).

5.24. A draft executive summary of a report contemporaneously produced, for LAH, by another accountancy firm was provided to the Respondents, which identified various matters which were of relevance to consider for the audit of the going concern assessment, including that:

5.24.1. the Group was forecast to exceed its existing overdraft limit by up to £2.5m between September and November 2018; and

5.24.2. the forecast intra-month cash spikes indicated that maximum daily borrowing could exceed the forecast month-end position by up to £6m.

5.25. There is no evidence in the FY2018 Audit file that the Respondents considered these matters in the context of their audit of the going concern assessment.

5.26. The Respondents' report to LAH's Audit Committee also did not mention the breaches of the overdraft limit that had been forecast. This referred to "possible changes in trading performance", but did not mention either the optimism in management's forecasts and the fact that the Group was already trading behind the forecast in FY2019 or the Group's exposure to factors which might impact on the likelihood of those forecasts being achieved. The report did not explain the assumptions underlying the forecasts.

Breaches

5.27. In breach of ISA 570.12D-1 (and ISA 200.15), the Respondents failed to maintain sufficient professional skepticism by failing to challenge or investigate adequately or at all the assumptions underlying management's working capital forecast. The forecasts indicated considerable performance improvements, as compared with recent results, and UHY should therefore have sought more persuasive supporting evidence.

5.28. By reason of the same facts and matters, in breach of ISA 500.6, the Respondents failed to obtain sufficient appropriate audit evidence to support their conclusion as to the appropriateness of management's use of the going concern basis of accounting in the preparation of the FY2018 financial statements and/or as to whether a material uncertainty existed about the Group's ability to continue as a going concern.

5.29. Further, in breach of ISA 500.6, the Respondents failed to obtain sufficient appropriate audit evidence by failing to obtain and document a clear explanation in respect of foreign exchange rates used in management's forecasts and/or to apply appropriate sensitivities to the forecasts to reflect potential fluctuations in the relevant foreign exchange rates. Foreign exchange was an important variable contributing to the Group's performance (as UHY recognised in its workpapers), which could have a very material impact on the cash flow forecast, and over which LA did not exercise control.

5.30. In breach of the ICAEW Code of Ethics paragraph 130.1(b), the Respondents failed to act diligently and/or in accordance with applicable technical and/or professional standards in that they failed to recognise the need to adjust the gross profit figures when applying a sensitivity of a 10% reduction in revenue to management's forecasts. There were no valid reasons for leaving the gross profit figure unchanged in the sensitised forecasts (and none is identified in the relevant workpapers): in particular, any suggestion that costs savings on this scale were achievable is wholly unrealistic.

5.31. In breach of ISA 500.6, the Respondents failed adequately or at all to obtain sufficient appropriate audit evidence to verify the work carried out by the UHY working capital team. In particular, but without limitation, the Respondents failed to identify that the gross margin sensitivity applied to management's forecasts had been incorrectly described in the UHY working capital report and, as a result, the gross margin sensitivity was inadequate.

5.32. In breach of ISA 500.6, the Respondents also failed adequately or at all to investigate or consider the issues raised by the draft executive summary of the report referred to in

paragraph 5.22 above, including in particular, but without limitation:

5.32.1. The differences between the scenarios on which the Respondents and the other accountancy firm had relied and the reasons for the differences between the cash flow forecasts in each scenario (and what this meant for the achievability of the cash flow forecasts on which the Respondents had relied for the audit);

5.32.2. The forecast breaches of LAH's overdraft limit referred to in the report; and

5.32.3. The intra-month cash spikes referred to in the report.

5.33. The Respondents breached ISA 260.9(c) by providing a report to the Audit Committee which indicated that there were no matters of concern regarding LAH's borrowing requirements and its trading results and by failing to provide the Audit Committee with relevant and significant information about the following matters related to going concern:

5.33.1. The forecast breaches of LAH's overdraft limit of which it was aware;

5.33.2. The fact that the "budget" provided for borrowing in excess of the forecast; and/or

5.33.3. The fact that the Group's trading to date for FY2019 was below the forecast.

<u>Category 3 – Revenue</u>

<u>Background</u>

5.34. Revenue is an important performance measure for a retail group, such as the Group, and it is a key metric for users of the financial statements.

5.35. The Respondents identified revenue recognition as one of eight "significant risks" and identified "the key elements" of the audit testing for revenue as follows:

- *Sample testing around the period end;*
- *Test interfaces between merchandising and PoS*[10] *systems;*
- *Sample test deposits to ensure they are properly deferred;*
- *Review and test controls around the reconciliation of cash and card takings with the revenue recognition;*

[10] "Point of Sale"

- *Review and test the controls and reconciliations around the interface between JDA and JDE* [which were two internal LAH systems*]; and*
- *Test a sample of franchisees and licensee sales reports to royalty invoices.*

5.36. Whilst the FY2018 Audit file explains that the Respondents intended to rely on the Group's controls when auditing revenue, it does not contain any evidence of an adequate assessment, testing and/or evaluation of the effectiveness of the Group's controls in relation to revenue recognition for the purposes of planning the FY2018 Audit.

5.37. Furthermore, the Respondents' proposed audit work programme for revenue did not identify any proposed testing that would address the risk of false inclusion of sales (as opposed to addressing the incorrect omission of sales). False inclusion testing would have involved tracing back from entries in the general ledger to store or till sales.

5.38. The Respondents undertook testing to ensure that revenue items recorded close to the financial year end were recognised by LAH in the correct financial year (commonly known as 'cut off' testing). The Respondents tested ten invoices (five pre-year end and five post-year end) to confirm whether revenue had been recorded in the correct financial year. The Respondents identified that the revenue for one invoice had been recorded in FY2019 when it should have been recorded in FY2018. The FY2018 Audit file stated the Respondents' conclusion that this was a "one-off issue", but it does not contain any explanation as to why this was so or what work was done to determine whether it was indicative of possible shortcomings in the Group's procedures. The 'cut off' testing undertaken by the Respondents was also only tracked through from invoices to postings into revenue; there was no 'cut off' testing the other way from revenue back to invoices.

5.39. The workpapers on the FY2018 Audit file identify up to four "key controls" for revenue, but different controls appear to be identified as "key controls" in different workpapers. The audit workpapers suggest that two of the "key controls" were not in fact tested.

<u>Breaches</u>

5.40. In breach of ISA 330.6, 330.7 and/or 330.8, the Respondents failed:

5.40.1. To carry out, or to document on the FY2018 Audit file, an adequate preliminary assessment of the strength of sales-related controls, based on the design and nature of those controls, in order to appropriately plan the audit;

5.40.2. To carry out, or to document on the FY2018 Audit file, any adequate testing or

evaluation of the operational effectiveness of sales-related controls for the purposes of planning the audit and, accordingly, how those controls would affect the nature and amount of substantive audit work to be carried out;

5.40.3. To identify, or to document on the FY2018 Audit file, clearly and consistently which sales-related controls were regarded as “key controls” and why; and/or

5.40.4. To perform any audit procedures to test two controls which were identified as “key controls” in the revenue audit work programme.

5.41. In breach of ISA 500.6, the Respondents failed:

5.41.1. To design and/or perform any audit procedures to test whether sales recorded by entries on the general ledger were reflected in transaction records either generally or in relation to sales cut-off testing; and/or

5.41.2. To investigate the underlying reasons for the exception that was recorded in relation to the sales cut-off testing, so as to obtain sufficient appropriate evidence that the exception was not indicative of wider issues.

Category 4 – Inventory (counts, controls and provisions)

Background - Inventory Counts and Inventory Controls

5.42. The FY2018 Audit file also does not contain any evidence of the assessment, evaluation or testing by UHY of the design or nature, nor of the operational effectiveness, of any relevant controls over the stock recording system for the purposes of planning the audit.

5.43. The Respondents identified three audit work steps that they planned to carry out in relation to the perpetual inventory system. However, there is no evidence on the FY2018 Audit file that any of these three steps were in fact completed for the audit of inventory.

5.44. The FY2018 Audit file also set out a fourth audit work step that the Respondents planned to carry out in relation to the perpetual inventory system, namely attendance at one stock count to verify adherence to controls, but it did not contain any explanation or justification of why attendance at one perpetual count would provide sufficient audit evidence.

5.45. The FY2018 Audit file also recorded that stock counts would be performed at two distribution centres and at one retail store “*selected haphazardly*”. Save for asserting that “*due to the vast number of stock locations, it is not possible to obtain substantive coverage by testing stores*”, the workpaper did not provide any explanation or justification of the proposed sample size in relation to the audit of stock counts.

Breaches

5.46. In breach of ISA 330.6, ISA 330.7 and ISA 330.8, the Respondents failed to carry out, or to document on the FY2018 Audit file:

5.46.1. any or any adequate preliminary assessment of the strength of relevant controls over the stock recording system, based on the design and nature of those controls, in order to appropriately plan the audit; and/or

5.46.2. any or any adequate testing or evaluation of the operational effectiveness of those controls for the purposes of planning the audit and, accordingly, failed to consider or explain how those controls would affect the nature and amount of substantive audit work to be carried out.

5.47. In breach of ISA 500.6, the Respondents failed to perform three planned audit work steps in relation to the perpetual inventory system and thereby failed to obtain sufficient appropriate audit evidence.

5.48. In breach of ISA 200.16, the Respondents failed to exercise, or to document on the FY2018 Audit file, their professional judgment (if any) as to the appropriate sample sizes for the audit of the perpetual inventory system and/or for the audit of depot and store stock counts.

Background - Inventory Provisions

5.49. The Respondents identified stock valuation as a “key risk” for the FY2018 Audit because the provision for slow-moving, damaged or obsolete stock might be misstated.

5.50. The audit report in the FY2018 financial statements also recorded that inventory valuation was a “key audit matter” and that "significant judgment" was required to estimate the net realisable value of old and slow-moving stock lines.

5.51. The Respondents planned to test inventory provisions by: (a) testing a sample of items to check that the classification and ageing of stock was an appropriate basis for the inventory provisions ; (b) reviewing the outcome of the inventory provisioning process in the prior year; and (c) challenging the inventory provision for old and slow-moving stock.

5.52. However, there is no evidence on the FY2018 Audit file that the Respondents carried out any assessment of the appropriateness of the Group’s obsolescence formula (as opposed to the accuracy of its application). Furthermore, there is no evidence on the FY2018 Audit file that they assessed the accuracy of the prior year provisions.

5.53. The Respondents also reviewed the calculation of and assumptions underlying the stock

loss provision. However, the workpapers on the FY2018 Audit file do not explain:

5.53.1. the calculations relating to garments and home furnishings; or

5.53.2. the sources of data or how the data had been verified.

5.54. There is also no evidence on the FY2018 Audit file that the Respondents assessed the appropriateness of the percentages used for the accrual of stock loss provisions.

5.55. Despite the inadequacies in the Respondents' audit work in relation to inventory provisions for the FY2018 Audit, the audit report for the FY2018 financial statements stated (incorrectly) that:

> *"We tested the inputs to the provision calculation, including the classification of inventory.*
>
> *We considered and challenged the basis and methodology for inventory provisions with a particular focus on the areas for which no provision had been made. We examined the sales history of previously unprovided inventory to assess whether the methodology adopted was reasonable.*
>
> *The results of our testing was satisfactory.*
>
> *We assessed the appropriateness of the related disclosures in note 17 of the Group financial statements, and consider them to be reasonable."*

5.56. The Respondents' report to the Audit Committee contained the same inaccuracies.

<u>Breaches</u>

5.57. In breach of ISA 500.6, the Respondents failed:

5.57.1. To carry out any review of the accuracy of the obsolescence provisioning in FY2017;

5.57.2. To identify the source of the data used in the provisioning calculation or to verify the accuracy and completeness of that data; and

5.57.3. To review and compare recent stock loss results to determine the appropriateness of the percentages used to calculate stock loss provisions. (This was also a breach of ISA 200.16 as explained by ISA 200 A29: i.e. a failure by the Respondents to record or document professional judgment in relation to this issue.)

5.58. In breach of ISA 701.13, the Respondents incorrectly described their audit work in relation to stock valuation in the audit report in a manner which overstated the depth and detail of their work. In particular, contrary to the audit report:

5.58.1. They failed to identify or test the source data used to calculate the stock provisions (so did not "test the inputs to the provision calculation");

5.58.2. They failed to assess whether the methods applied to calculate the obsolescence provisions produced an accurate result (so did not "consider and challenge the basis and methodology for inventory provisions"); and

5.58.3. They did not carry out any "examination of the sales history of previously unprovided for inventory to assess whether the methodology adopted was reasonable".

5.59. In breach of ISA 260.9(c), the Respondents therefore also incorrectly described their audit work in relation to stock valuation in the report to the Audit Committee in a manner which overstated the depth and detail of their work.

Category 5 – Journals and Fraud Risk Assessment

Background

5.60. An auditor is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error. The risk of fraud can arise from sources internal or external to the audited entity. However, when conducting audit planning, the Respondents:

5.60.1. did not record any discussion of potential pressure from external parties which might be relevant to the risk of fraud; and/or

5.60.2. in the context of fraud risk relating to revenue recognition, did not consider the risk arising from the possibility of under-recording of liabilities, inflating inventory valuations, or accelerated recognition of supplier incentives.

5.61. Journal entry testing was the only audit procedure undertaken by the Respondents which was directed at addressing fraud risk.

5.62. Journals are the method by which an adjustment is entered into accounting records. A "journal entry" will identify the areas of the accounting records that need to be changed, by how much, the reasons for the changes and the effective date for those changes. Journal entries are therefore building blocks for producing the information which goes into the entity's financial statements. The Respondents recorded that, for LAH, up to between 10,000 and 20,000 journal entries might be entered each day.

5.63. The Respondents explained that the purpose of the audit work on journals was to

"*ensure that all journals are reasonable and to test the risks of management override and to ensure they do not cover any misappropriation of assets.*"

5.64. However, this work had serious limitations. In particular, the FY2018 Audit file did not adequately explain or record:

5.64.1. what data had been obtained from the LAH accounting system and how it was presented;

5.64.2. how the data was confirmed to be representative and complete;

5.64.3. LAH's explanation for those entries which were identified as requiring investigation and whether management's explanations had been challenged; and

5.64.4. what evidence (if any) had been sought or obtained from LAH to corroborate management's explanations for the entries requiring further investigation.

5.65. Furthermore, the comments recorded by the Respondents on the audit workpapers were not always responsive to management's explanation for the relevant journal entry.

5.66. Recognising the risk of fraud that can arise from the creation of journal entries, ISA 240.32(a)(ii), specifically states, "*In designing and performing audit procedures for such tests…the auditor shall… select journal entries and other adjustments made at the end of a reporting period.*" There is no evidence that the Respondents undertook this step.

5.67. Furthermore, the FY2018 Audit file records that the Respondents were aware of certain significant control weaknesses in relation to journal entries, but there is no evidence on the FY2018 Audit file that the Respondents tested or evaluated the effectiveness (or not) of controls on journal posting and/or that they considered the impact of any weaknesses in these controls on the risk of fraud or error. There is also no evidence on the FY2018 Audit file that the Respondents discussed journal entry control weaknesses with management or reported them to the Audit Committee.

<u>Breaches</u>

5.68. In breach of ISA 240.15, the Respondents failed to hold, or to document on the FY2018 Audit file, adequate discussion concerning the risk of fraud which might result from external pressures.

5.69. The Respondents failed to exercise, or to document on the FY2018 Audit file, their professional judgment (if any) as to: (i) the effectiveness of controls in relation to journal posting; (ii) and the impact of the control weaknesses on the risk of fraud or error; and

(iii) the impact of the control weaknesses on the audit scope and approach (in breach of ISA 200.16 as explained by ISA 200.A29). Furthermore, they also failed in this regard to design and perform tests of the relevant controls (in breach of ISA 330.8).

5.70. In breach of ISA 200.15 and/or 240.12, the Respondents failed to maintain sufficient professional skepticism by not challenging and/or seeking or obtaining any or sufficient audit evidence to corroborate management's responses in relation to journal entries.

5.71. In breach of ISA 500.6, the Respondents failed to obtain, or to document on the FY2018 Audit file, sufficient appropriate audit evidence in relation to some of the journal entries that were selected for testing when either no explanation from management was obtained or recorded on the FY2018 Audit file or the Respondents' comment did not correspond to management's explanation. Executive Counsel infers that the Respondents did not investigate these entries adequately or at all.

5.72. In breach of ISA 240.32(a)(ii), the Respondents failed to select (and did not plan to select) journal entries made at or around the end of FY 2018 for testing.

5.73. In breach of ISA 265.9, the Respondents failed to communicate, on a timely basis or at all, the significant deficiencies in the internal controls relating to the posting of journals to the Audit Committee.

Category 6 – Property, Plant and Equipment Adjustments

Background

5.74. Other Comprehensive Income ("**OCI**") is a category used in financial statements for certain items which IFRS requires to be separately disclosed, and to be excluded from the computation of reported income in the income statement.[11] The use of the OCI category reduces the volatility of reported income, by segregating items that are not directly related to business performance, such as unrealised gains and losses on investments held for sale; gains and losses on defined benefit pension plans; and foreign currency translation adjustments (e.g. on converting overseas subsidiaries to group reporting currency).

5.75. In the FY2018 financial statements:

5.75.1. £1.3m was debited to increase fixed assets; and

[11] OCI is defined in IAS 1 as "items of income and expense (including reclassification adjustments) that are not recognised in profit and loss as required or permitted by other [IFRS] …".

5.75.2. The balancing £1.3m credit entry was made to OCI.

5.76. This adjustment was explained as the elimination of a recurring consolidation journal entry. The Group's finance team was unable to explain this recurring entry.

5.77. The Respondents requested that management investigate when the entry was first made. However, management were unable to confirm when the entry was first made, although they did confirm that the journal entry went back at least three years.

5.78. The Respondents concluded that the fixed asset registers ("**FARs**") were a reliable record of the actual assets held by the Group and that the FARs agreed to the subsidiaries' accounts. This was despite the fact that the Respondents observed that the fixed asset register did not detail all assets on a line-by-line basis. This observation cast doubt on the accuracy and reliability of the fixed asset registers; however, it was not taken into account by the Respondents when considering the appropriateness of the adjustment that was made by LAH to the value of fixed assets through the credit entry to OCI.

Breaches

5.79. In breach of ICAEW Code of Ethics paragraph 130.1(b) and/or ISA 200.15, the Respondents failed to maintain sufficient professional skepticism and failed to act diligently and/or in accordance with applicable technical and/or professional standards in that they did not take into account and/or adequately investigate the concerns expressed over the reliability of the fixed asset registers which ought to have called into question the appropriateness of the £1.3m adjustment to the value of fixed assets and the corresponding credit to OCI (and this would have been a material amount if the Respondents had determined materiality correctly – see Category 1 above).

5.80. Further, in breach of ICAEW Code of Ethics paragraph 130.1(b), the Respondents failed to act diligently and/or in accordance with applicable technical and/or professional standards in that they incorrectly accepted the classification of this adjustment as a component of OCI, even though they ought reasonably to have concluded that this was not appropriate and that any such adjustment should instead have been treated as a prior year adjustment in accordance with the requirements set out in IAS 8 (including as to disclosure) because:

5.80.1. It was intended to be the correction of an error in LAH's financial statements for previous years; and, in any event;

5.80.2. It was not an item of either income or expense; and

5.80.3. It did not fall within any of the recognised categories of OCI.

5.81. Further, in breach of ISA 450.12, the Respondents failed to explain in their report to the Audit Committee that this adjustment was based on a difference between the fixed asset register and the general ledger and/or the basis for accounting for this adjustment within OCI rather than as a prior year adjustment. If these circumstances had been reported to the Audit Committee, this may have led the Audit Committee to question the appropriateness of this adjustment or to request further information regarding the accuracy of the fixed asset register which was the basis for making this adjustment.

Category 7 – Carrying Value of Investments

Background

5.82. IAS 36.66 requires each cash generating unit ("**CGU**")[12] to be separately identified, and valued, where possible. Each subsidiary of LAH was a CGU. Accordingly, each subsidiary needed to be considered separately for the purpose of assessing whether LAH was required to recognise an impairment of its investment in that subsidiary.

5.83. The value of LAH's net investment in subsidiaries (as per the FY2018 financial statements) was £124.3m.[13] This was 98% of the net assets on the LAH parent company balance sheet (£126.2m). As addressed further at paragraph 5.86.1 below, the net assets on the Group's consolidated balance sheet were only £36.4m.

5.84. The Respondents identified that the valuation of LAH's investments in subsidiaries was a "significant risk" for the FY2018 Audit, principally because management's estimate of the recoverable amounts of CGUs involved a number of assumptions and significant judgments. Sufficient challenge of management's calculations was therefore crucial.

5.85. In this regard, IAS 36.59 requires an impairment loss to be recognised if the carrying amount of an asset is less than its recoverable amount. The calculation of the recoverable amount is highly sensitive to the estimates made as to future cash flows and as to the appropriate discount rate to determine the present value of the asset.

5.86. However, the Respondents failed adequately to challenge or to obtain evidence to

[12] A CGU is the smallest identifiable group of assets that generates cash inflows which are largely independent of the cash flows generated by other assets: see IAS 36.68.

[13] This comprised the value of LAH's equity investment (£99.7m – cost of £147.8m less a provision of £48.1m) plus the net liabilities due from subsidiaries to LAH (£24.6m).

support the optimistic cash flow forecasts on which management's calculations of recoverable amounts were based. The need to do so was underlined by the fact that:

5.86.1. The carrying value of LAH's investments (£99.7m) was in excess of the Group's market capitalisation (£40.0m) and net assets (£36.4m); and

5.86.2. Revenue and PBT for FY2018 was lower than for FY2017, yet management's forecasts projected significant increases in cash flows for the Group, including from FY2020 for which no explanation was recorded on the FY2018 Audit file.

5.87. Furthermore, a surplus in the recoverable amount over the carrying amount of one CGU cannot be set off against a deficit in the recoverable amount compared with the carrying amount of another CGU so as to avoid recognising an impairment loss on the latter.

5.88. Management's discounted cash flow ("**DCF**") valuation of LAH's investments in subsidiaries gave a total value of £151.8m of which £36.3m was for Laura Ashley Ltd ("**LA Ltd**"). The FY2018 Audit file records that the carrying amount of LAH's investment in LA Ltd (£90.7m) plus a receivable due from LA Ltd to LAH (£12.8m) (total £103.5m) was in excess of the DCF valuation of LA Ltd (i.e. £36.3m). LAH should therefore have recognised an impairment loss of £67.2m (including its exposure to the receivable due from LA Ltd) or £54.4m (excluding that receivable) in the FY2018 financial statements.

5.89. However, the FY2018 Audit file also recorded, in relation to this exposure, that: "*Covered by inter-company receivable of £94,885,391, of which £90,354,332 is supported by DCF calculations (See intercompany impairment analysis for LA Limited 30 June 2018)*." On this basis, the Respondents concluded (incorrectly) that no impairment was required.

5.90. This inter-company receivable was from Laura Ashley Investments Limited ("**LA Investments**") to LA Ltd. However, no reciprocal impairment was recognised for LA Investments on the basis that its carrying value (£0.3m) was immaterial.

5.91. The FY2019 financial statements included a restatement of the FY2018 carrying value of LAH's investments in subsidiaries to reflect an additional impairment of £25.9m.

5.92. This restatement was approximately 18 times the level of materiality calculated for the FY2018 Audit (even on the basis of the Respondents' incorrect determination of materiality – using a more appropriate level of materiality it would have been circa 90 times materiality). This impairment related entirely to LAH's investment in LA Ltd.[14]

[14] A further impairment of £25.5m was recognised in FY 2019 itself on LAH's investment in LA Ltd.

Breaches

5.93. In breach of ICAEW Code of Ethics paragraph 130.1(b), the Respondents failed to act diligently and/or in accordance with applicable technical and/or professional standards by failing to conclude that a highly material impairment loss (of £67.2m including LAH's exposure to a receivable due from LA Ltd or £54m excluding that receivable) should have been recognised under IAS 36.59 in the FY2018 financial statements in respect of the valuation of its investment in LA Ltd. It was not correct, as a matter of principle, that LAH's exposure to LA Ltd could simply be "covered" by an inter-company balance owed by LA Investments to LA Ltd to avoid an impairment loss.

5.94. The Respondents failed to challenge adequately or at all management's cash flow forecasts for FY2019 through to FY2023 and thereby failed:

5.94.1. To comply with ISA 540.6 by failing to obtain sufficient appropriate audit evidence to support management's forecasts;

5.94.2. To evaluate whether the significant assumptions used by management in their forecasts were reasonable in breach of ISA 540.15; and/or

5.94.3. To maintain sufficient professional skepticism in relation to the realism and achievability of management's forecasts and/or their conclusion that no impairment of LAH's investments in subsidiaries was required in breach of ISA 540.21-D1 (particularly, in view of the external indicators of impairment, such as the large discrepancy between the DCF valuation (£151.8m) and the Group's market capitalisation (c.£40m) and the Group's deteriorating trading performance).

Category 8 – Pension Scheme Liabilities

Background

5.95. The Group operated both a defined benefit ("**DB**") and a defined contribution ("**DC**") pension scheme. The DB scheme was closed to new members from 1 September 2005. Members of the DB scheme ceased to accrue benefits, but those benefits remained linked to their final salary at retirement and their length of service up to 1 September 2005. The liabilities of the DB scheme exceeded its assets as at the end of FY2018 by c.£11.1m (as compared with c.£13.8m in FY2017 and c.£16.1m in FY2016).

5.96. At the time of the FY2018 financial statements, the last full actuarial valuation of the DB scheme had been issued as at 1 September 2014. Management had engaged an

actuarial firm to carry out a new valuation as at 31 August 2017.

5.97. The audit report in the FY2018 financial statements recorded that the pension scheme was a "key audit matter". In the FY2018 Audit file, the "Pension Asset / Liability valuation" was identified as a significant risk for the FY2018 Audit.

5.98. There is no evidence on the FY2018 Audit file that the Respondents:

5.98.1. sought or obtained confirmation of the existence of pension scheme assets directly from the custodians holding the assets;

5.98.2. verified the valuations of the assets by reference to market prices; and/or

5.98.3. sought or obtained any supporting documentation for a balance of £1,714k in respect of what was described as "Insured Annuities" / "Insured Assets".

5.99. The audit work programme included a step to challenge the accuracy and completeness of records of the members of the pension scheme by (among other things) testing the number of members. However, the Respondents observed that it would be difficult or impractical to gain specific information about members in order to conduct substantive testing due to data protection rules under GDPR. Nevertheless, the Respondents concluded, in light of "*clear channels of communication*" between LAH, the pension scheme administrators and the scheme actuary, that there were reasonable controls in place to ensure that the records of member numbers for the pension scheme were accurate and complete.

5.100. The audit work papers relating to "*Using the work of management's expert*" set out an assessment of the competence and independence of the actuarial firm as an expert. One of the steps required by the workpaper was: "*Ensure you have obtained sufficient understanding of the field of expertise to be able to evaluate the adequacy of the work performed by the expert.*" The Respondents' purported response to this step was: "*Valuation has been discussed with the client.*" This workpaper gave no further indication as to how sufficient understanding of pension scheme valuation was obtained by the audit team to enable them to evaluate the adequacy of the actuary's valuation work.

5.101. The Respondents prepared a sensitivity analysis (using sensitivities set out by the actuary in its valuation report), to estimate the impact of changes in variables on the DB scheme liabilities. However, instead of applying the sensitivities to the DB scheme liabilities as at 30 June 2018 (£57,051k), the Respondents (incorrectly) applied them to the DB scheme deficit (£11,051k). The cumulative impact of the sensitivities calculated by the Respondents in this manner was £917k. Had they applied the sensitivities correctly to the liabilities they would have calculated a cumulative effect of £4,736,000.

5.102. Applying the (incorrect) results of the above analysis, the audit team remarked that, "*no individual sensitivity is material nor are they material in aggregate*." This conclusion was based on group performance materiality being £967k. As explained in relation to Category 1 above, the Respondents' calculation of materiality was incorrect. However, even on the basis of this materiality figure, the impact of these sensitivities, had they been calculated on the basis of the DB scheme liabilities instead of the DB scheme deficit (as they should have been), would have been material in the aggregate (c.5 times performance materiality) and also, for the discount rate and mortality rate, individually (c.2.5 times and c.2 times performance materiality respectively).

<u>Breaches</u>

5.103. In breach of ISA 500.6, the Respondents failed to obtain sufficient appropriate audit evidence in respect of:

5.103.1. the DB scheme's assets; and

5.103.2. the accuracy and completeness of data regarding of members of the DB scheme notwithstanding that testing of this was a required work step.

5.104. In breach of ISA 620.7, the Respondents failed to give, or to document on the FY2018 Audit file, any or adequate consideration as to whether an auditor's expert was needed to obtain sufficient appropriate audit evidence to effectively challenge or corroborate the methodology and assumptions used by the actuarial firm in its valuation work. The Respondents should have used an auditor's expert because the audit team lacked specialist knowledge and expertise in relation to actuarial valuations of pension scheme liabilities. This also meant that the Respondents failed to obtain sufficient appropriate audit evidence in respect of the valuation of the DB scheme's liabilities in breach of ISA 500.6.

5.105. In breach of ICAEW Code of Ethics paragraph 130.1(b), the Respondents failed to act diligently and/or in accordance with applicable technical and/or professional standards by incorrectly applying sensitivities to the DB scheme deficit instead of the scheme liabilities. Mr Jones also breached ISA 220.14 since it is to be inferred from this error that member(s) of the audit team did not have appropriate competence and capabilities to perform this work in accordance with technical and professional standards.

Category 9 – Long-Standing Debtors

Background

5.106. The Respondents assessed the risk of error or misstatement in relation to trade debtors as "low" and that the risk of irrecoverability of trade debtors was "extremely low". This assessment was premised on debtors relating primarily to store and internet purchases which involved immediate payment. However, the Respondents' assessment overlooked the fact that by far the majority of trade debtors for the Group were franchise and royalty debtors and these debtors did present concerns over recoverability.

5.107. The FY2018 financial statements recorded trade receivables at £7.9m.

5.108. Note 21 to the FY2018 financial statements stated that trade receivables were recorded net of bad debt provision which was said to have been estimated by management following a review of individual receivable accounts. This note added that the provision made for debts that were overdue was based on prior default experience and known factors at the statement of financial position date and that receivables were written off against the bad debt provision when management considered that the debt is no longer recoverable. The note explained that £3.7m of trade receivables were overdue as at the date of the FY2018 financial statements and not provided for of which £3.3m were more than 60 days overdue. However, it was said that there was no indication that these debtors would not meet their payment obligations in respect of these receivables.

5.109. The Respondents selected a sample of the largest trade debtors for LA Ltd and LA Investments. However, there is no evidence on the FY2018 Audit file that the Respondents challenged the inadequate explanations given by management for concluding that these debts were recoverable and did not need to be provided for.

5.110. The auditor's report to the Audit Committee did not mention the recoverability of trade debtors.

Breaches

5.111. In breach of ISA 315.11, the Respondents failed to identify, or to document on the FY2018 Audit file adequately or at all, that the trade debtors balance was likely to include franchise and royalty debtors. This was a significant omission which most likely would have affected the assessment of risk of misstatement.

5.112. The Respondents failed to challenge adequately or at all management's position regarding the recoverability of trade debtor balances and accordingly:

5.112.1. They failed to maintain sufficient professional skepticism in breach of ISA 200.15; and/or

5.112.2. They failed to obtain sufficient appropriate audit evidence as to recoverability in breach of ISA 500.6.

5.113. In breach of ISA 260.9(c), the Respondents failed to provide significant and relevant information to the Audit Committee in that their report omitted to include a summary of management's assertions regarding the recoverability of overdue receivables against which no provision had been made and/or their views as to the reasonableness of management's position.

6 BREACHES OF *RELEVANT REQUIREMENTS* - FY2019

Category 1 – Going Concern Assessment

Background

6.1. The Respondents identified going concern as a significant risk for the FY2019 Audit.

6.2. The financial performance of LAH continued to deteriorate in FY2019. Revenue declined by approximately 10% in FY2019 despite having been forecast by LAH to increase.

6.3. LAH's forecasts still projected significant increases in revenue and profit in both FY2020 and FY2021. The Respondents failed adequately to challenge these forecasts, including in light of LAH's failure to meet forecasts that had been made the previous year and the fact that post FY2019 year-end LAH was already trading significantly behind the forecasts.

6.4. The Respondents applied a downside revenue sensitivity of 5% to the forecasts.

6.5. The Respondents also purported to apply a downside gross margin sensitivity of 3%. However, this sensitivity was applied incorrectly so that it was not an effective test.

6.6. Despite this error in the gross margin sensitivity, the sensitised forecast still indicated that LAH would run out of available funds (including its borrowing facility with ABC Bank[15] very soon after the 12 month period over which going concern was assessed and would incur a sustained cash deficit from February 2021 onwards.

6.7. The Respondents also did not apply sensitivities which would have reflected a

[15] Name anonymised for the purposes of this *Final Settlement Decision Notice*.

continuation of the trend of deteriorating financial performance for LAH or which would have reflected LAH's exposure to fluctuations in foreign exchange rates.

6.8. The Respondents did not give adequate consideration to the terms of the ABC Bank borrowing facility by (a) re-computing headroom in light of the Group's inventory against which the facility was secured, and (b) testing compliance with the 'Trading Cashflow' covenant.

6.9. The Respondents failed adequately to investigate the reasons for discrepancies between actual and forecast cash balances; and between management's cash flow model and management's daily cash flow forecasts.

6.10. The Respondent's accepted LAH's assertion without adequate investigation that the annual pension deficit payment of £950k did not need to be reflected in the forecasts.

6.11. The Respondents' report to the Audit Committee did not mention the extent of the turnaround in performance which was forecast and raised no concerns regarding the achievability of the forecasts; the assumptions underlying that forecast; and/or that on the basis of sensitised forecasts LAH would run out of cash very soon after the 12 month period over which going concern was assessed. The Respondents' report to the Audit Committee was also dated two weeks after the date of the FY2019 financial statements.

Breaches

6.12. The Respondents failed to maintain sufficient professional skepticism (in breach of ISA 570.12D-1, in accordance with ISA 200.15) in concluding, incorrectly, that there was no material uncertainty related to going concern despite the presence of numerous warning signs at the time of the FY2019 Audit, including, amongst other things:

6.12.1. the sustained pattern of decline in the Group's financial performance since FY2015;

6.12.2. that a significant improvement in financial performance would have been required in FY2020 and FY2021 to achieve management's forecasts;

6.12.3. the minimal headroom (of £0.1m) that would exist in September 2020 (i.e. within approximately 12 months of signing the accounts) once only modest sensitivities had been applied to management's forecasts;

6.12.4. the sustained cash deficit that the Group would encounter from February 2021 on the basis of management's sensitised forecasts, which was apparent from information available to the audit team and which should have been taken into account pursuant to ISA 570.15 and ISA 570.A-14;

6.12.5. the fact that actual cash balances were consistently less than forecast cash balances, by material amounts, and there were unexplained discrepancies between management's cash flow model and management's daily cash flow forecasts; and

6.12.6. subsequent to the financial year end on 30 June 2019, the Group had already made a £0.4m loss in July 2019 in contrast to the £0.2m profit that had been forecast by management. Notwithstanding, the auditor did not obtain or consider any more up-to-date information concerning the Group's trading performance prior to signing their audit opinion on 26 September 2019.

6.13. The Respondents failed to maintain sufficient professional skepticism (in breach of ISA 570.12D-1, in accordance with ISA 200.15) and/or failed to obtain sufficient appropriate audit evidence (in breach of ISA 500.6) in relation to management's overly optimistic forecasts for revenue growth in FY2020 and FY2021 (despite the fact that revenue had declined by 7% in FY2018 and almost 10% in FY2019, continuing a trend since FY2015).

6.14. In breach of ISA 330.6 and/or ISA 330.28, the Respondents failed to design and perform appropriate audit procedures because they failed to give adequate consideration to the significance of inaccuracies in management's previous forecasts for the reliability of the forecasts on which they relied for the going concern assessment. This was despite: (i) having planned to review the accuracy of recent forecasts as part of their work on the going concern assessment; and (ii) having identified in their work on investments in subsidiaries during the FY2019 Audit that management's previous forecasts had been fundamentally inaccurate.

6.15. The Respondents failed to act diligently and/or in accordance with applicable technical and/or professional standards in breach of ICAEW Code of Ethics paragraph 130(1)(b) by failing to detect an error in the application of the gross margin sensitivity to management's forecasts. The Respondents had requested that the forecasts be sensitised by reducing gross margin by 3%, but (in error) the sensitivity applied (by management) only in fact reduced gross margin by 0.1% in FY2020 and 0.9% in FY2021.

6.16. In breach of ISA 330.28(c), the Respondents failed adequately to document the conclusions that they had drawn from the sensitivity analysis that was applied to management's forecasts and, in particular, from the fact that headroom would be only £0.1m in September 2020 on the basis of the sensitivities that were applied. The observations recorded on the FY2019 Audit file in this regard were not consistent.

6.17. The Respondents failed to give any or adequate consideration to or explanation of

foreign exchange rates used in management's forecasts and/or the impact of foreign exchange fluctuations on management's forecasts and/or they failed to apply any foreign exchange sensitivities to management's forecasts. They thereby failed to obtain sufficient appropriate audit evidence in relation to going concern in breach of ISA 500.6.

6.18. The Respondents failed to maintain sufficient professional skepticism (in breach of ISA 570.12D-1, in accordance with ISA 200.15) in relation to management's explanations for discrepancies between actual cash balances and management's forecasts in relation to the cash position.

6.19. The Respondents failed to obtain sufficient appropriate audit evidence (in breach of ISA 500.6) by failing to compare the cash balances that were forecast in the cash flow modelling workpaper and the daily cash flow forecast workpaper and to identify and obtain evidence to explain the material differences between them.

6.20. The Respondents failed to obtain sufficient appropriate audit evidence (in breach of ISA 500.6) by failing to give adequate consideration to the terms of the Group's borrowing facility with ABC Bank including, in particular, by:

6.20.1. Failing to re-compute the level of headroom in light of the impact of applying the revenue and gross margin sensitivities on the Group's inventory against which its borrowing under the ABC Bank facility was secured; and/or

6.20.2. Failing to consider whether the Group would comply with the "Trading Cashflow" covenant in the ABC Bank facility on either the base case or sensitised forecasts.

6.21. The Respondents failed to maintain sufficient professional skepticism (in breach of ISA 200.15) by accepting management's assertion that an agreed contribution of £950k per year in respect of the Group's defined benefit pension scheme could be omitted from cash flow forecasts on the basis that the trustees of the scheme would accept a charge over the Group's brand as sufficient security for this liability of the Group without adequate challenge or obtaining sufficient appropriate audit evidence.

6.22. The Respondents failed to meet the objective of ISA 260.9(c) and breached ISA 260.16 and ISA 260.21 in that they failed to provide the Audit Committee with timely observations arising from the audit that were significant and relevant to their responsibility to oversee the financial reporting process including, in particular, that they did not inform the Audit Committee in their report of:

6.22.1. The extent of the turnaround in financial performance that would be required to meet the forecasts on which the assessment of going concern was based;

6.22.2. The assumptions underlying the achievability of that turnaround including in relation to revenue growth and improvements in gross margin; and/or

6.22.3. The fact that the Group would run out of cash on the sensitised forecasts very soon after the 12-month period from the date of the FY2019 financial statements over which going concern assessment was based.

6.23. Further, the Respondents failed to meet the objective of ISA 260.9(c) and breached ISA 260.21R-1 in that they failed to provide their final report (dated 7 October 2019) to the Audit Committee on a timely basis in advance of the approval of the FY2019 financial statements (signed on 26 September 2019).

Category 2 - Revenue

Background

6.24. The Respondents' work on revenue for the FY2019 Audit failed adequately to consider the interaction between controls testing and substantive testing – in particular, it is unclear how the results of their evaluation of controls, and the operational effectiveness of those controls, affected the scope of, and reliance upon, substantive testing.

6.25. The Respondents also failed to obtain sufficient appropriate audit evidence as to the operating effectiveness of two controls that they had identified to be "key controls".

6.26. The Respondents engaged an external IT consultant, but they failed to explain the scope of his work and approach on the FY2019 Audit file. There was also no evidence on the FY2019 Audit file of the extent to which the Respondents reviewed his work.

6.27. The Respondents' testing for the existence of revenue was flawed because it used a sample drawn from randomly chosen stores and sales, rather than directly from the general ledger revenue account. The Respondents also failed to carry out any test for full inclusion of sales, as was required by their audit programme for revenue, and did not explain any professional judgment as to why they considered this to be appropriate.

6.28. The FY2019 Audit file also contains no record of any work done by the Respondents to support the segmental disclosures for revenue in the FY2019 financial statements.

Breaches

6.29. The Respondents failed to give any or adequate consideration to the interaction between controls testing and substantive testing for revenue when designing the audit approach and carrying out audit procedures (in breach of ISA 330.5, ISA 330.6 and/or ISA 330.7).

6.30. The Respondents failed to exercise, or document on the 2019 Audit file, their professional judgment (if any) as to the extent to which reliance could properly be placed on the work carried out by an external IT expert to understand and evaluate the IT environment and general IT controls for the purposes of their audit of revenue (in breach of ISA 200.16, as explained by ISA 200.A29).

6.31. The Respondents failed to obtain sufficient appropriate audit evidence as to the operating effectiveness of two of the controls stated by the audit team to be "key controls" in relation to revenue recognition (in breach of ISA 500.6).

6.32. The Respondents failed (in breach of ISA 500.6) to properly design audit procedures in relation to revenue recognition that were appropriate for the purpose of obtaining sufficient audit evidence, in that their substantive test for no false inclusion (or existence) of revenue started from a sample from selected stores and weeks (rather than entries taken from the general ledger).

6.33. The Respondents failed (in breach of ISA 200.16, as explained by ISA 200.A29) to exercise or document any professional judgment as to why it was acceptable not to carry out any substantive testing for full inclusion of revenue for the FY2019 Audit.

6.34. The Respondents failed to obtain sufficient appropriate audit evidence to support the segmental disclosures in the FY2019 financial statements (in breach of ISA 500.6); and/or they failed to record any professional judgment in relation to these disclosures on the FY2019 Audit file (in breach of ISA 200.16, as supplemented by ISA 200.A29).

Category 3 – Inventory (counts, controls and provisions)

Background

6.35. The Respondents stated in their audit workpapers that their approach to inventory in the FY2019 Audit was controls-based. However, there is no evidence that the Respondents undertook identification, evaluation and testing of key controls in the inventory system.

6.36. The Respondents also failed to carry out three planned audit steps in relation to perpetual stock counts, which was an important component of LAH's controls over stock existence.

6.37. The Respondents' audit work in relation to stock valuation failed:

6.37.1. to assess the accuracy of the inventory provision for FY2018 against the actual position, despite having planned to do so; and

6.37.2. to explain and confirm the source data and calculations supporting the inventory provisions.

6.38. The Respondents' assessment of the stock loss accrual percentages also used an incorrect benchmark.

6.39. The Respondents overstated the depth and detail of their work in relation to inventory provisions in their report to the Audit Committee and the audit report in the FY2019 financial statements.

Breaches

6.40. The Respondents failed to design and perform adequate audit procedures to test inventory controls on which they stated they had placed "medium" reliance (in breach of ISA 330.6).

6.41. The Respondents failed to carry out three planned work steps in relation to perpetual stock counts and accordingly they did not obtain sufficient appropriate audit evidence in relation to inventory existence (in breach of ISA 500.6).

6.42. The Respondents failed to perform a planned review of the outcome of the inventory provisioning process from FY2018 by reference to the actual sales price of inventory held as at 30 June 2018 and accordingly they did not obtain sufficient appropriate audit evidence in relation to the appropriateness of the methodology and/or the assumptions underlying the level of inventory provisions (in breach of ISA 500.6).

6.43. In breach of ISA 500.6, the Respondents failed to obtain sufficient appropriate audit evidence in that they did not:

6.43.1. confirm the origin, accuracy and completeness of the source data used in the calculation of the obsolescence provision and stock loss accrual;

6.43.2. reconcile the gross stock data used in the calculation of the obsolescence provision to the gross stock data on the lead schedule F.10; and

6.43.3. set out any adequate explanation of the calculation of the obsolescence provision.

6.44. The Respondents failed to act diligently and/or in accordance with applicable technical and/or professional standards in that they sought to benchmark the stock loss accrual percentages by comparing actual shrinkage against gross stock rather than costs of sales, (since this was the figure against which the stock loss accrual percentage was applied) (in breach of ICAEW Code of Ethics paragraph 130.1(b)).

6.45. The Respondents overstated the extent of the audit work that they carried out by stating

in their auditors' report that they had "*assessed discounting of products following the year end to check the reasonableness of the provisions applied at year end*" when no such work had been performed (in breach of ISA 701.13).

6.46. The Respondents breached ISA 260.16 in that they overstated the extent of the audit work that they carried out by stating in their report to the Audit Committee that:

6.46.1. They had "*reviewed the outcome of the provisioning process in the year*" when no such work had been performed; and

6.46.2. They had "*considered and challenged the basis and methodology for inventory provisions*" when, in relation to the obsolescence provision, they had failed to perform any work to assess whether the provision percentages and the (very broad) categories of inventory to which they were applied produced an overall result which was appropriate.

Category 4 - Journal Entry Testing and Fraud Risk Assessment

Background

6.47. The Respondents identified that AQR's review of the FY2018 Audit concluded that the journals testing did not have enough focus on completeness of revenue.

6.48. Management review of journal entries was an important control. The Respondents also identified management override of controls as a key risk for the FY2019 Audit.

6.49. However, the Respondents failed to design and perform tests of the effectiveness of management review of journal entries as a control.

6.50. The FY2019 Audit file identified a large sample of journal entries for testing. However, save for some of the selections made for revenue adjustments, the Respondents did not corroborate or challenge management's explanations for these journal entries.

Breaches

6.51. The Respondents failed to design and perform tests of a relevant control in relation to journal entries, namely management review (in breach of ISA 330.8).

6.52. The Respondents failed adequately either to challenge or to seek and obtain evidence to corroborate management's explanations for journal entries that were selected for testing and/or as to whether the general ledger accounts affected by these journal entries were appropriate and accordingly:

6.52.1. They failed to maintain sufficient professional skepticism, recognising the

possibility that a material misstatement due to fraud could exist (in breach of ISA 240.12 and ISA 200.15); and/or

6.52.2. They failed to obtain sufficient appropriate audit evidence (in breach of ISA 500.6).

Category 5 - Other Comprehensive Income

Background

6.53. As set out at paragraph 5.75 above, the Respondents failed to identify in their work on the FY2018 Audit that £1.3m had been incorrectly credited to OCI.

6.54. This credit entry was reversed in the FY2019 financial statements. The £1.3m credit adjustment was applied instead to the opening balance of retained earnings for FY2017.

6.55. However, the FY2019 Audit file does not document any consideration of the basis for this credit adjustment.

Breach

6.56. The Respondents failed to document the basis for a credit adjustment of £1.3m to the opening balance of retained earnings as at 1 July 2017 following removal of the credit of £1.3m to OCI in the FY2018 financial statements (in breach of ISA 230.8).

Category 6 - Pension Scheme Assets and Liabilities

Background

6.57. The DB pension scheme was included as a key audit matter in the audit report in the FY2019 financial statements. However, the Respondents' audit work in this area failed:

6.57.1. to carry out certain calculations, to draw appropriate conclusions from the calculations that were carried out, and/or to apply sensitivities correctly;

6.57.2. to obtain independent confirmation of pension assets (despite this being required by additional procedures introduced for the FY2019 Audit in light of the failings identified by AQR in this area of the FY2018 Audit);

6.57.3. to explain the basis for the sample sizes for testing the accuracy and completeness of the records of DB scheme members; and

6.57.4. to use an auditor's expert when this was needed to enable them to adequately

challenge or to obtain sufficient appropriate audit evidence to corroborate the methodology and assumptions of the actuary engaged by LAH to value the liabilities of the DB scheme.

6.58. The Respondents' report to the Audit Committee also overstated the extent of their work in this area and omitted to include any statement of the main assumptions used in the valuation of the DB pension scheme or of the effect of applying example sensitivities to those assumptions.

Breaches

6.59. In breach of ISA 500.6, the Respondents failed to obtain sufficient appropriate audit evidence as to the existence or valuation of the DB pension scheme assets, despite the fact that their audit programme and the additional procedures introduced for the FY2019 Audit as a result of failings identified by AQR in relation to the FY2018 Audit required them to obtain independent confirmation of assets.

6.60. In breach of ISA 620.7 and ISA 500.6, the Respondents failed to use an auditor's expert and were therefore unable to effectively challenge and/or to obtain sufficient appropriate audit evidence to corroborate the methodology and assumptions used by the actuary engaged by LAH to value the defined benefit pension scheme liabilities.

6.61. The Respondents failed to act diligently and/or in accordance with applicable technical and/or professional standards (in breach of ICAEW Code of Ethics, paragraph 130.1(b)) in that:

6.61.1. They failed to delete incorrect calculations of interest income and interest expense from workpaper T.30;

6.61.2. They reached unsupportable conclusions that their calculations of interest income and interest expense for the defined benefit pension scheme were "*reasonable*", even though the implied interest rates they had calculated were far in excess of rates which could be regarded as reasonable;

6.61.3. They failed to give proper recognition in workpaper T.30 to "*return on plan assets*" and thereby mis-categorised this asset movement; and/or

6.61.4. They incorrectly applied sensitivities to the defined benefit pension scheme deficit instead of the scheme liabilities.

6.62. In addition, by reason of these failings Mr Jones breached ISA 220.15-17 because he failed to properly discharge his responsibility to ensure adequate supervision of, and proper review of the audit work carried out by, the audit team.

6.63. In breach of ISA 530.6 and/or ISA 530.7, the Respondents failed to explain the basis for the sample sizes for testing the accuracy and completeness of the membership records for the defined benefit pension scheme and/or how those sample sizes related to the population from which the samples were drawn and/or the characteristics of and/or the sampling risk associated with the relevant population.

6.64. The Respondents breached ISA 260.16 and failed to meet the objective of 260.9(c) in that their report to the Audit Committee:

6.64.1. overstated the extent of the audit work that they had carried out in relation to:

(a) assessing the competence of the actuary engaged by LAH;

(b) challenging the assumptions used by the actuary by comparison with the assumptions used by other schemes and other external data; and/or

(c) testing the underlying value of pension scheme assets.

6.64.2. omitted to include any statement of the main assumptions used in the valuation of the defined benefit pension scheme or of the effect of applying example sensitivities to those assumptions, despite the fact that this was specifically recommended by the FRC as an improvement that should be made by audit firms in relation to the audit of pension schemes in a paper entitled "*The Audit of Defined Benefit Pension Obligations – Findings from 2017/18 Audit Quality Reviews*" which had been published in July 2018.

7 *SANCTIONS* – UHY

7.1. Paragraph 10 of the FRC's Sanctions Policy (Audit Enforcement Procedure) (January 2022 edition) (the "**Sanctions Policy**") provides that *Sanctions* are intended to be effective, proportionate and dissuasive. The reasons for imposing *Sanctions* are identified in paragraph 11 of the Sanctions Policy as the following:

7.1.1. to declare and uphold proper standards of conduct amongst *Statutory Auditors* and *Statutory Audit Firms* and to maintain and enhance the quality and reliability of future audits;

7.1.2. to maintain and promote public and market confidence in *Statutory Auditors* and *Statutory Audit Firms* and the quality of their audits and in the regulation or the accountancy profession;

7.1.3. to protect the public from *Statutory Auditors* and *Statutory Audit Firms* whose

conduct has fallen short of the *Relevant Requirements*; and

7.1.4. to deter *Statutory Auditors* and *Statutory Audit Firms* from breaching the *Relevant Requirements* relating to *Statutory Audit.*

7.2. Paragraph 12 of the Sanctions Policy provides that the primary purpose of imposing *Sanctions* for breaches of the *Relevant Requirements* is not to punish, but to protect the public and the wider public interest.

7.3. Executive Counsel imposes the following *Sanctions* against UHY:

7.3.1. **An Order**, that UHY takes action to prevent the recurrence of the breach of the *Relevant Requirements*; namely that the firm shall not accept appointment as *Statutory Auditor* to any *Public Interest Entity* for which it is not currently acting as *Statutory Auditor*, until the later of: (i) 11 May 2024*;* and (ii) such time as the prevailing registration body for *Public Interest Entity Statutory Audit* registration is satisfied that UHY has the necessary competence to conduct high quality *Statutory Audits of Public Interest Entities* in compliance with *Relevant Requirements*. By agreement, a condition shall be applied to UHY's audit licence to that effect.

7.3.2. **A financial penalty** of £300,000 adjusted for aggravating and mitigating factors and discounted for admissions and early disposal by 27.5% so that the financial penalty payable is £217,500.

7.3.3. A published statement in the form of a **severe reprimand**.

7.3.4. **A declaration** that the FY2018 and FY2019 Audit reports signed on behalf of UHY did not satisfy the *Relevant Requirements*, as set out in this *Final Settlement Decision Notice*.

7.4. Executive Counsel's considers that, in light of UHY's remedial measures described at paragraph 7.20 below, and the package of *Sanctions* set out in this *Final Settlement Decision Notice,* no non-financial sanctions relating to audit quality are presently required.

7.5. In making her determination, Executive Counsel has also, in summary, considered the following matters in accordance with the Sanctions Policy.

<u>Factors in paragraph 24 of the Sanctions Policy, including nature, seriousness, gravity and duration of the breaches</u>

7.6. As a result of the breaches of *Relevant Requirements*, the FY2018 and FY2019 Audits failed in their principal objective namely to obtain reasonable assurance about whether

the financial statements as a whole were free from material misstatement.

7.7. Many of the audit areas relevant to the breaches (in particular revenue, materiality and going concern) are fundamental to the proper conduct of *Statutory Audits* and it is of the utmost importance that they are audited in accordance with *Relevant Requirements.*

7.8. The breaches of *Relevant Requirements*:

7.8.1. were serious, affected nine areas of the FY2018 Audit and were repeated in six of the same areas of the FY2019 Audit;

7.8.2. in some instances, were pervasive throughout the audit;

7.8.3. in some instances, involved failures to report important matters accurately on a timely basis, or at all, to those charged with governance and involved overstating the depth and detail of the audit work conducted. This served to undermine the corporate governance of the audited entity;

7.8.4. were fundamental to the proper conduct of an audit and include failures:

7.8.4.1. to maintain professional skepticism;

7.8.4.2. to obtain sufficient appropriate audit evidence;

7.8.4.3. to exercise or document professional judgment;

7.8.4.4. to design and/or perform certain audit procedures; and

7.8.4.5. to act diligently and/or in accordance with applicable technical and/or professional standards to meet the overall objectives of an audit.

7.9. The FY2018 Financial Statements were restated in FY2019 following enquiries from FRC's Corporate Reporting Review team, to reflect additional impairment to investments in subsidiaries. It is likely that, had the Respondents performed the audits competently and in accordance with the *Relevant Requirements,* they would have detected a number of material misstatements in the FY2018 financial statements. These would have had to have been corrected in order for an unqualified audit opinion to be signed.

7.10. In aggregate the breaches:

7.10.1. potentially adversely affected, a significant number of people in the United Kingdom (such as the public, investors or other market users), and potentially harmed investor, market and public confidence in the truth and fairness of the financial statements audited by *Statutory Auditors* or *Statutory Audit Firms*.

7.10.2. undermined confidence in the standards of conduct in general of *Statutory Auditors* and *Statutory Audit Firms*, and/or in S*tatutory Audit*.

7.11. The fact that a number of the breaches of R*elevant Requirements* which occurred in the FY2018 Audit re-occurred in FY2019 is a cause for concern and is an aggravating factor. This is particularly the case given that prior to signing the audit report, the FRC's AQR team had reviewed the FY2018 Audit work and given it the worst possible grading. This should have, at the very least, prompted a significant improvement in the care with which the audit was undertaken, the quality of professional skepticism displayed by the Respondents, and the sufficiency of audit evidence obtained by the Respondent for the FY2019. In particular:

7.11.1. AQR raised specific concerns regarding the FY2018 Audit work in respect of going concern. Failings in relation to professional skepticism, obtaining sufficient appropriate audit evidence, and acting diligently were repeated in FY2019;

7.11.2. in relation to pension scheme assets and liabilities in FY2019, the Respondents failed to obtain sufficient appropriate audit evidence as to the existence or valuation of the defined benefit pension scheme assets, despite additional procedures being introduced for the FY2019 Audit in light of the failings identified by the AQR in this area of the FY2018 Audit; and

7.11.3. in respect of journals testing, in FY2019 the Respondents failed to design appropriate tests, exercise professional skepticism or obtain sufficient appropriate audit evidence notwithstanding AQR's review of the FY2018 Audit concluded that the journals testing did not have enough focus on completeness of revenue.

7.12. The breaches were neither intentional, dishonest, deliberate nor reckless.

7.13. The breaches of *Relevant Requirements* indicate that the internal review and quality procedures applied at UHY were ineffective.

7.14. Paragraph 24 t) of the Sanctions Policy relates to the response of the *Statutory Audit Firm's* senior management after they became aware of the breach of *Relevant* Requirements. On 6 August 2019 the FRC's AQR team issued their review of UHY's work on the FY2018 Audit. As stated above, AQR gave the worst available grading. The 2019 Audit report was signed on 26 September 2019 and Executive Counsel's investigation was opened in October 2019. The AQR findings should have prompted UHY to reflect upon their work and ultimately approach Executive Counsel to seek early disposal on at least the areas AQR had considered. This did not happen.

7.15. As regards the "Financial Strength"[16] of the *Statutory Audit Firm*: UHY is among the smaller audit firms in the market. Its UK fee income for 2020 / 21 was c.£20 million and its audit fee income was £7million. It has 28 partners, and profit per partner was £165,000 in 2020 / 21. In total, the firm earned fees of c.£315,000 in respect of the FY2018 and FY2019 Audits. The firm is still suffering from the Covid-19 instability and the prevailing economic uncertainty. It is noted that the departure of the firm from the *Public Interest Entity* audit market will further impact its potential revenue and profit.

Identification of *Sanction*

7.16. Having assessed the nature, seriousness, gravity and duration of the breaches, Executive Counsel has identified the following combination of *Sanctions* as appropriate:

7.16.1. **An Order**, that UHY takes action to prevent the recurrence of the breach of the Relevant Requirements; namely that the firm shall not accept appointment as *Statutory Auditor* to any *Public Interest Entity* for which it is not currently acting as *Statutory Auditor*, until the later of: (i) 11 May 2024*;* and (ii) such time as the prevailing registration body for *Public Interest Entity Statutory Audit* registration is satisfied that UHY has the necessary competence to conduct high quality *Statutory Audits of Public Interest Entities* in compliance with *Relevant Requirements*. By agreement, a condition shall be applied to UHY's audit licence to that effect.

7.16.2. Executive Counsel has taken into account the matters set out in paragraphs 46 to 49 of the Sanctions Policy, in particular the aims that any financial penalty should: be proportionate to the breaches of *Relevant Requirements* in this case; act as an effective deterrent; and promote public confidence in the regulation of statutory audit. She has also considered the size and financial resources of UHY and the fact that there are no arrangements in place that would result in part or all of any financial penalty being paid or indemnified by insurers, and the effect of a fine of this magnitude on its business. Executive Counsel has determined that a starting point **financial penalty** of £300,000 is appropriate in all the circumstances.

7.16.3. a published statement in the form of a **severe reprimand**.

7.16.4. a **declaration** that the FY2018 and FY2019 Audit reports signed on behalf of

[16] Paragraph 24 e) of the Sanctions Policy.

UHY did not satisfy the *Relevant Requirements*, as set out in this *Final Settlement Decision Notice*.

7.17. Executive Counsel has then taken into account any aggravating and mitigating factors that exist (to the extent that they have not already been taken into account in relation to the nature, seriousness, gravity and duration of the breaches).

Aggravating factors

7.18. Before the FY2019 Audit report was signed, UHY were aware that:

7.18.1. The *Statutory Audit Firm* for FY2016 resigned because the LAH board did not accept their fee proposal;

7.18.2. The S*tatutory Audit Firm* for FY2017 resigned for the same reason;

7.18.3. The S*tatutory Audit Firm* and *Statutory Auditor* for FY2016 were sanctioned by Executive Counsel in May 2019 for breaches of *Relevant Requirements* in respect of their conduct of the audit; and

7.18.4. On 6 August 2019, almost two months before completion of the FY2019 Audit, AQR graded UHY's FY2018 Audit as "*significant improvements required*" (the worst possible grade). The FY2019 Audit report was signed on 26 September 2019.

It was reasonable to expect as a minimum that the *Statutory Auditor* would approach the FY2019 Audit with appropriate care, skepticism and seek sufficient audit evidence on which to base his judgments in light of this background.

7.19. UHY has a poor recent disciplinary / regulatory history:

7.19.1. In March 2021, Executive Counsel issued a *Decision Notice* against UHY, and imposed *Sanctions*, for breaches of *Relevant Requirements* in respect of a statutory audit for the year ended 31 December 2016.

7.19.2. Between December 2020 and September 2021, UHY have agreed three Consent Orders (which imposed sanctions) with the ICAEW, in respect of *Statutory Audits*.

Mitigating factors

7.20. The *Decision Notice* issued against UHY in 2021, and the outcome in this case, has prompted significant reflection by the firm's senior management. They have undertaken a substantial number of remediation measures in recent years, including:

7.20.1. The instruction of an audit methodology provider to review UHY's audit control

procedures and its audit compliance and quality systems. This was conducted in early 2020 (after the date of signing the FY2019 Audit);

7.20.2. Recruiting a dedicated Technical and Training Team ("**T&T**) specialist;

7.20.3. Implementation of a T&T training programme and issuance of T&T guidance directed at the breaches of *Relevant Requirements* identified in the LAH investigation;

7.20.4. introduction of a new Quality Policy in June 2020; and

7.20.5. Changes to personnel policies linking individual bonuses to audit file review grade and imposition of a new Competency Framework for staff, including an audit quality objective.

7.21. UHY did not stand to gain any profit or benefit, beyond the fees chargeable for the FY2018 and FY2019 Audits (£315,000 in total), from the breach of the *Relevant Requirements*.

7.22. UHY have expressed contrition and regret for both the failings identified and the time and resource expended by Executive Counsel in conducting her investigation.

7.23. Executive Counsel considers the aggravating and mitigating factors are balanced by so that no adjustment is required overall.

<u>Deterrence</u>

7.24. Having considered the matters set out at paragraphs 72 and 73 of the Sanctions Policy, Executive Counsel considers that no adjustment for deterrence is required in this case.

<u>Cooperation</u>

7.25. The co-operation provided by the Respondents has met the required level such that no adjustment to any sanction is required.

<u>Discount for Admissions and Settlement</u>

7.26. Having taken into account the full admissions by UHY and the stage at which those admissions were made (towards the end of Stage 1 of the case in accordance with paragraph 84 of the Sanctions Policy), UHY is entitled to a reduction to the financial penalty of between 20% and 35%.

7.27. In determining the level of reduction which is appropriate, Executive Counsel has had particular regard to the following:

7.27.1. The FRC's AQR team gave the worst available grading - "*Significant Improvements Required*" – to the Respondents' FY2018 Audit. That should have

prompted thoughtful reflection by the firm, leading to the identification by the firm of many (if not all) of the breaches, which would have enabled the Respondents to approach Executive Counsel and make admissions. Despite encouragement by Executive Counsel's team at an early stage, the Respondents did not take such an approach.

7.27.2. Executive Counsel identified to the firm in June 2021 that she considered they had breached *Relevant Requirements* in relation to the FY2018 Audit. Admissions were not forthcoming and Executive Counsel was required to prepare and formally serve an Initial Investigation Report[17] for the FY2018 Audit ("**IIR**"). In response to the IIR, the Respondents admitted many of the breaches of *Relevant Requirements* identified in the IIR. However, in respect of some other significant breaches, the firm put forward explanations or justifications for deficient work which were without merit and which they ultimately recanted.

7.28. Executive Counsel has determined that a reduction of 27.5% as to the financial penalty is appropriate, such that a financial penalty of £217,500 is payable.

Other considerations

7.29. In accordance with paragraph 47(d) of the Sanctions Policy, Executive Counsel has taken into account the financial resources of UHY, the effect of a financial penalty and other *Sanctions* on their business, and whether they are insured as to any financial penalty.

8 *SANCTIONS* – MR JONES

8.1. Executive Counsel imposes the following *Sanctions* against Mr Jones:

8.1.1. **An Order,** that he takes action to prevent the recurrence of the breach of the *Relevant Requirements*, namely that he does not sign any statutory audit report for a *Public Interest Entity* for a period of 2 years from 11 May 2022.

8.1.2. A **financial penalty** of £45,000 adjusted for aggravating and mitigating factors and discounted for admissions and early disposal by 27.5% so that the financial penalty payable is £32,625.

8.1.3. **An order** that Mr Jones take action to prevent the recurrence of the breach of the *Relevant Requirements*, by undertaking training, in a form agreed with the

[17] This document has been subsequently renamed "Investigation Report" in the January 2022 edition of the AEP.

FRC, in relation to the application of ISAs 220, 315 and 570.

8.1.4. A published statement, in the form of a **severe reprimand**.

8.1.5. **A declaration** that the FY2018 and FY2019 Audit reports signed by Mr Jones did not satisfy the *Relevant Requirements*, as set out in this Final Settlement Decision Notice.

8.2. Executive Counsel's determination as to *Sanctions* reflects that during settlement discussions, UHY and Mr Jones voluntarily, and proactively, offered an undertaking to the FRC not to conduct further *Statutory Audits* of *Public Interest Entities*, for at least two years and until such point in the future as the prevailing registration body for *Public Interest Entity Statutory Audit* registration is satisfied that they have the necessary competence to conduct high quality *Statutory Audits* of *Public Interest Entities* in compliance with *Relevant Requirements.*

8.3. In reaching this decision, Executive Counsel has, in summary, considered the following stages and taken account of the following factors in accordance with the Sanctions Policy.

<u>Nature, seriousness, gravity and duration of the breaches</u>

8.4. The factors set out in paragraphs 7.6 to 7.12 (inclusive) are also relevant to Mr Jones and are repeated.

8.5. Mr Jones had over 30 years' statutory audit experience at the time of the FY2018 Audit.

<u>Identification of *Sanction*</u>

8.6. Having assessed the nature, seriousness, gravity and duration of the breaches, Executive Counsel has identified the following combination of *Sanctions* as appropriate:

8.6.1. **An Order,** that he takes action to prevent the recurrence of the breach of the *Relevant Requirements*, namely that he does not sign any statutory audit report for a *Public Interest Entity* for a period of 2 years from 11 May 2022.

8.6.2. A **financial penalty** of £45,000.

8.6.3. **An Order** that Mr Jones take action to prevent the recurrence of the breach of the *Relevant Requirements*, by undertaking training, in a form agreed with the FRC, in relation to the application of ISAs 220, 315 and 570.

8.6.4. a published statement, in the form of a **severe reprimand**.

8.6.5. **a declaration** that the FY2018 and FY2019 Audit reports signed by Mr Jones did not satisfy the *Relevant Requirements*, as set out in this Final Settlement

Decision Notice.

8.7. Executive Counsel has then taken into account any aggravating and mitigating factors that exist (to the extent that they have not already been taken into account in relation to the seriousness of the breaches).

Aggravating factors

8.8. The matter identified at paragraph 7.18 applies equally to Mr Jones.

8.9. There are no other aggravating factors that have not already been considered in the context of the seriousness of the breaches.

Mitigating factors

8.10. Save for the AQR grading for the FY2018 Audit, Mr Jones has a good compliance and regulatory history, save in respect of the FY2018 and FY2019 Audits[18]. He has not previously received any adverse audit review grade through UHY's internal review system, nor from the ICAEW's QAD reviews.

8.11. Mr Jones has expressed contrition and regret for his failings. He has conveyed to Executive Counsel that he has learned a salutary lesson from the adverse AQR outcome and the resultant enforcement proceedings.

8.12. Mr Jones has taken action to identify and addresses his developmental and training needs. Since 2019, Mr Jones has undertaken 29 UHY iwebinars; 6 ICAEW webinars; 17 external training sessions; and 14 UHY Lunch & Learn Sessions.

8.13. Mr Jones did not stand to gain any profit or benefit from the breaches of the *Relevant Requirements* (save to the extent that he had an interest in UHY being paid engagement fees for the FY2018 and FY2019 Audits).

8.14. Executive Counsel considers that the aggravating and mitigating factors are balanced such that no increase or reduction to any financial penalty is warranted.

Deterrence

8.15. Having considered the matters set out at paragraphs 72 and 73 of the Sanctions Policy, Executive Counsel considers that no adjustment for deterrence is required in this case.

Discount for Admissions and Settlement

8.16. The circumstances identified at paragraphs 7.26 and 7.27 apply equally to Mr Jones.

8.17. Having taken into account the full admissions by Mr Jones and the stage at which those

[18] Paragraph 68(i) of the Sanctions Policy.

admissions were made (within Stage 1 of the case in accordance with paragraph 84 of the Sanctions Policy), Executive Counsel determined that a reduction of 27.5% as to the financial penalty is appropriate, such that a financial penalty of £32,625 is payable.

Cooperation and other considerations

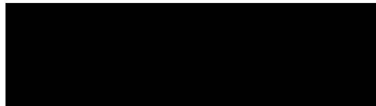
8.18. Paragraph 7.25 above applies equally to Mr Jones.

8.19. In accordance with paragraph 47(d) of the Sanctions Policy, Executive Counsel has taken into account the financial resources and annual income of Mr Jones, the effect of a financial penalty on him and his future employment, and whether he is insured as to any financial penalty.

9 COSTS

9.1. Executive Counsel requires that UHY pay her costs in full in this matter, being £418,885.91

Signed:



JAMIE SYMINGTON
DEPUTY EXECUTIVE COUNSEL

Date: 06 June 2022

APPENDIX 1 – EXTRACTS OF RELEVANT REQUIREMENTS

Extracts from ISAs

1. ISA 200 Overall Objectives for the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing

1.1. Paragraph 15 states as follows:

> "*The auditor shall plan and perform an audit with professional skepticism recognizing that circumstances may exist that cause the financial statements to be materially misstated.*
>
> *In the UK, the auditor shall maintain professional skepticism throughout the audit, recognising the possibility of a material misstatement due to facts or behaviour indicating irregularities, including fraud, or error, notwithstanding the auditor's past experience of the honesty and integrity of the entity's management and of those charged with governance.*"

1.2. Paragraph 16 states as follows:

> "*The auditor shall exercise professional judgment in planning and performing an audit of financial statements.*"

1.3. Paragraph A22 states as follows:

> *"Professional skepticism is necessary to the critical assessment of audit evidence. This includes questioning contradictory audit evidence and the reliability of documents and responses to inquiries and other information obtained from management and those charged with governance. It also includes consideration of the sufficiency and appropriateness of audit evidence obtained in the light of the circumstances, for example in the case where fraud risk factors exist and a single document, of a nature that is susceptible to fraud, is the sole supporting evidence for a material financial statement amount.*"

1.4. Paragraph A29 states as follows:

> "*Professional judgment needs to be exercised throughout the audit. It also needs to be appropriately documented. In this regard, the auditor is required to prepare audit documentation sufficient to enable an experienced auditor, having no previous connection with the audit, to understand the significant professional judgments made in reaching conclusions on significant matters arising during the audit.*[19] *Professional*

[19] ISA (UK) 230 (Revised June 2016), paragraph 8.

judgment is not to be used as the justification for decisions that are not otherwise supported by the facts and circumstances of the engagement or sufficient appropriate audit evidence."

2. ISA 220 Quality Control for an Audit of Financial Statements

2.1. Paragraph 8 states as follows:

"*The engagement partner shall take responsibility for the overall quality on each audit engagement to which that partner is assigned.*"

2.2. Paragraph 14 states as follows:

"*The engagement partner shall be satisfied that the engagement team, and any auditor's experts who are not part of the engagement team, collectively have the appropriate competence and capabilities to:*

(a) Perform the audit engagement in accordance with professional standards and applicable legal and regulatory requirements; and

(b) Enable an auditor's report that is appropriate in the circumstances to be issued."

2.3. Paragraph 15 states as follows:

"*The engagement partner shall take responsibility for:*

(a) The direction, supervision and performance of the audit engagement in compliance with professional standards and applicable legal and regulatory requirements; and

(b) The auditor's report being appropriate in the circumstances."

2.4. Paragraph 16 states as follows:

"*The engagement partner shall take responsibility for reviews being performed in accordance with the firm's review policies and procedures.*"

2.5. Paragraph 17 states as follows:

"*On or before the date of the auditor's report, the engagement partner shall, through a review of the audit documentation and discussion with the engagement team, be satisfied that sufficient appropriate audit evidence has been obtained to support the conclusions reached and for the auditor's report to be issued.*"

3. ISA 230 Audit Documentation

3.1. Paragraph 8 states as follows:

"*The auditor shall prepare audit documentation that is sufficient to enable an experienced auditor, having no previous connection with the audit, to understand:*

(a) The nature, timing and extent of the audit procedures performed to comply with the ISAs (UK) and applicable legal and regulatory requirements;

(b) The results of the audit procedures performed, and the audit evidence obtained; and

(c) Significant matters arising during the audit, the conclusions reached thereon, and significant professional judgments made in reaching those conclusions."

4. ISA 240 The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements

4.1. Paragraph 12 states as follows:

"*In accordance with ISA (UK) 200 (Revised June 2016),*[20] *the auditor shall maintain professional skepticism throughout the audit, recognizing the possibility that a material misstatement due to fraud could exist, notwithstanding the auditor's past experience of the honesty and integrity of the entity's management and those charged with governance."*

4.2. Paragraph 15 states as follows:

"*ISA (UK) 315 (Revised June 2016) requires a discussion among the engagement team members and a determination by the engagement partner of which matters are to be communicated to those team members not involved in the discussion.*[21] *This discussion shall place particular emphasis on how and where the entity's financial statements may be susceptible to material misstatement due to fraud, including how fraud might occur. The discussion shall occur setting aside beliefs that the engagement team members may have that management and those charged with governance are honest and have integrity."*

4.3. Paragraph 32(a)(ii) states as follows:

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[20] ISA (UK) 200 (Revised June 2016), paragraph 15.
[21] ISA (UK) 315 (Revised June 2016), paragraph 10.

"*Irrespective of the auditor's assessment of the risks of management override of controls, the auditor shall design and perform audit procedures to:*

(a) Test the appropriateness of journal entries recorded in the general ledger and other adjustments made in the preparation of the financial statements. In designing and performing audit procedures for such tests, the auditor shall:

(ii) Select journal entries and other adjustments made at the end of a reporting period"

5. ISA 260 Communication with Those Charged with Governance

5.1. Paragraph 9(c) states as follows:

"*The objectives of the auditor are:*

(c) To provide those charged with governance with timely observations arising from the audit that are significant and relevant to their responsibility to oversee the financial reporting process."

5.2. Paragraph 16 states as follows:

"*The auditor shall communicate with those charged with governance:*

(a) The auditor's views about significant qualitative aspects of the entity's accounting practices, including accounting policies, accounting estimates and financial statement disclosures. When applicable, the auditor shall explain to those charged with governance why the auditor considers a significant accounting practice, that is acceptable under the applicable financial reporting framework, not to be most appropriate to the particular circumstances of the entity;

(b) Significant difficulties, if any, encountered during the audit;

(c) Unless all of those charged with governance are involved in managing the entity:

i. Significant matters arising during the audit that were discussed, or subject to correspondence, with management; and

ii. Written representations the auditor is requesting;

(d) Circumstances that affect the form and content of the auditor's report, if any; and

(e) *Any other significant matters arising during the audit that, in the auditor's professional judgment, are relevant to the oversight of the financial reporting process.*"

5.3. Paragraph 21 states as follows:

"*The auditor shall communicate with those charged with governance on a timely basis.*"

5.4. Paragraph 21R-1 states as follows:

"For audits of financial statements of public interest entities, the auditor shall submit the additional report to the audit committee not later than the date of submission of the auditor's report."

6. ISA 265 Communicating Deficiencies in Internal Control to Those Charged with Governance and Management

6.1. Paragraph 9 states as follows:

"*The auditor shall communicate in writing significant deficiencies in internal control identified during the audit to those charged with governance on a timely basis."*

7. ISA 315 Identifying and Assessing the Risks of Material Misstatement Through Understanding of the Entity and Its Environment

7.1. Paragraph 11 states as follows:

"*The auditor shall obtain an understanding of the following:*

(a) *Relevant industry, regulatory, and other external factors including the applicable financial reporting framework.*

(b) *The nature of the entity, including:*

i. *its operations;*

ii. *its ownership and governance structures;*

iii. *the types of investments that the entity is making and plans to make, including investments in special-purpose entities; and*

iv. *the way that the entity is structured and how it is financed to enable the auditor to understand the classes of transactions, account balances, and disclosures to be expected in the financial statements.*

(c) *The entity's selection and application of accounting policies, including the reasons for changes thereto. The auditor shall evaluate whether the entity's accounting policies are appropriate for its business and consistent with the applicable financial reporting framework and accounting policies used in the relevant industry.*

(d) *The entity's objectives and strategies, and those related business risks that may result in risks of material misstatement.*

(e) *The measurement and review of the entity's financial performance*."

8. ISA 320 Materiality in Planning and Performing an Audit

8.1. Paragraph 10 states as follows:

"*When establishing the overall audit strategy, the auditor shall determine materiality for the financial statements as a whole. If, in the specific circumstances of the entity, there is one or more particular classes of transactions, account balances or disclosures for which misstatements of lesser amounts than materiality for the financial statements as a whole could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements, the auditor shall also determine the materiality level or levels to be applied to those particular classes of transactions, account balances or disclosures.*"

8.2. Paragraph 11 states as follows:

"*The auditor shall determine performance materiality for purposes of assessing the risks of material misstatement and determining the nature, timing and extent of further audit procedures.*"

8.3. Paragraph A1 states as follows:

"*In conducting an audit of financial statements, the overall objectives of the auditor are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework; and to report on the financial statements, and communicate as required by the ISAs (UK), in accordance with the auditor's findings. The auditor obtains reasonable assurance by obtaining sufficient appropriate audit evidence to reduce audit risk to an acceptably low level. Audit risk is the risk that the auditor expresses an inappropriate audit opinion*

when the financial statements are materially misstated. Audit risk is a function of the risks of material misstatement and detection risk. Materiality and audit risk are considered throughout the audit, in particular, when:

(a) Identifying and assessing the risks of material misstatement;

(b) Determining the nature, timing and extent of further audit procedures;

(c) Evaluating the effect of uncorrected misstatements, if any, on the financial statements and in forming the opinion in the auditor's report."

8.4. Paragraph A3 states as follows:

"*In the case of a public sector entity, legislators and regulators are often the primary users of its financial statements. Furthermore, the financial statements may be used to make decisions other than economic decisions. The determination of materiality for the financial statements as a whole (and, if applicable, materiality level or levels for particular classes of transactions, account balances or disclosures) in an audit of the financial statements of a public sector entity is therefore influenced by law, regulation or other authority, and by the financial information needs of legislators and the public in relation to public sector programs.*"

8.5. Paragraph A4 states as follows:

"*Determining materiality involves the exercise of professional judgment. A percentage is often applied to a chosen benchmark as a starting point in determining materiality for the financial statements as a whole. Factors that may affect the identification of an appropriate benchmark include the following:*

- *The elements of the financial statements (for example, assets, liabilities, equity, revenue, expenses);*
- *Whether there are items on which the attention of the users of the particular entity's financial statements tends to be focused (for example, for the purpose*

of evaluating financial performance users may tend to focus on profit, revenue or net assets);

- *The nature of the entity, where the entity is in its life cycle, and the industry and economic environment in which the entity operates;*
- *The entity's ownership structure and the way it is financed (for example, if an entity is financed solely by debt rather than equity, users may put more emphasis on assets, and claims on them, than on the entity's earnings); and*
- *The relative volatility of the benchmark.*"

8.6. Paragraph A5 states as follows:

"*Examples of benchmarks that may be appropriate, depending on the circumstances of the entity, include categories of reported income such as profit before tax, total revenue, gross profit and total expenses, total equity or net asset value. Profit before tax from continuing operations is often used for profit-oriented entities. When profit before tax from continuing operations is volatile, other benchmarks may be more appropriate, such as gross profit or total revenues.*"

8.7. Paragraph A6 states as follows:

"*In relation to the chosen benchmark, relevant financial data ordinarily includes prior periods' financial results and financial positions, the period-to-date financial results and financial position, and budgets or forecasts for the current period, adjusted for significant changes in the circumstances of the entity (for example, a significant business acquisition) and relevant changes of conditions in the industry or economic environment in which the entity operates. For example, when, as a starting point, materiality for the financial statements as a whole is determined for a particular entity based on a percentage of profit before tax from continuing operations, circumstances that give rise to an exceptional decrease or increase in such profit may lead the auditor to conclude that materiality for the financial statements as a whole is more appropriately determined using a normalized profit before tax from continuing operations figure based on past results.*"

8.8. Paragraph A7 states as follows:

"*Materiality relates to the financial statements on which the auditor is reporting. Where the financial statements are prepared for a financial reporting period of more or less than twelve months, such as may be the case for a new entity or a change in the financial reporting period, materiality relates to the financial statements prepared for that financial reporting period.*"

9. ISA 330 The Auditor's Responses to Assessed Risks

9.1. Paragraph 5 states as follows:

> "*The auditor shall design and implement overall responses to address the assessed risks of material misstatement at the financial statement level.*"

9.2. Paragraph 6 states as follows:

> "*The auditor shall design and perform further audit procedures whose nature, timing, and extent are based on and are responsive to the assessed risks of material misstatement at the assertion level.*"

9.3. Paragraph 7 states as follows:

> "*In designing the further audit procedures to be performed, the auditor shall:*
>
> *(a) Consider the reasons for the assessment given to the risk of material misstatement at the assertion level for each class of transactions, account balance, and disclosure, including:*
>
> *i. The likelihood of material misstatement due to the particular characteristics of the relevant class of transactions, account balance, or disclosure (that is, the inherent risk); and*
>
> *ii. Whether the risk assessment takes account of relevant controls (that is, the control risk), thereby requiring the auditor to obtain audit evidence to determine whether the controls are operating effectively (that is, the auditor intends to rely on the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures); and*
>
> *(b) Obtain more persuasive audit evidence the higher the auditor's assessment of risk.*

9.4. Paragraph 8 states as follows:

> "*The auditor shall design and perform tests of controls to obtain sufficient appropriate audit evidence as to the operating effectiveness of relevant controls if:*
>
> *(a) The auditor's assessment of risks of material misstatement at the assertion level includes an expectation that the controls are operating effectively (that is, the auditor intends to rely on the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures); or*

(b) Substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level."

9.5. Paragraph 28 states as follows:

"*The auditor shall include in the audit documentation:*

(a) The overall responses to address the assessed risks of material misstatement at the financial statement level, and the nature, timing, and extent of the further audit procedures performed;

(b) The linkage of those procedures with the assessed risks at the assertion level; and

(c) The results of the audit procedures, including the conclusions where these are not otherwise clear."

10. ISA 450 Evaluation of Misstatements Identified During the Audit

10.1. Paragraph 12 states as follows:

"*The auditor shall communicate with those charged with governance uncorrected misstatements and the effect that they, individually or in aggregate, may have on the opinion in the auditor's report, unless prohibited by law or regulation.*[22] *The auditor's communication shall identify material uncorrected misstatements individually. The auditor shall request that uncorrected misstatements be corrected.*"

11. ISA 500 Audit Evidence

11.1. Paragraph 6 states as follows:

"*The auditor shall design and perform audit procedures that are appropriate in the circumstances for the purpose of obtaining sufficient appropriate audit evidence.*"

12. ISA 530

12.1. Paragraph 6 states as follows:

[22] ISA (UK) 260 (Revised June 2016), Communication with Those Charged with Governance, paragraph 7

"*When designing an audit sample, the auditor shall consider the purpose of the audit procedure and the characteristics of the population from which the sample will be drawn.*"

12.2. Paragraph 7 states as follows:

"*The auditor shall determine a sample size sufficient to reduce sampling risk to an acceptably low level.*"

13. ISA 540 Auditing Accounting Estimates and Related Disclosures

13.1. Paragraph 6 states as follows:

"*The objective of the auditor is to obtain sufficient appropriate audit evidence about whether:*

(a) accounting estimates, including fair value accounting estimates, in the financial statements, whether recognized or disclosed, are reasonable; and

(b) related disclosures in the financial statements are adequate,

in the context of the applicable financial reporting framework."

13.2. Paragraph 15 states as follows:

"*For accounting estimates that give rise to significant risks, in addition to other substantive procedures performed to meet the requirements of ISA (UK) 330 (Revised July 2017),*[23] *the auditor shall evaluate the following:*

(a) How management has considered alternative assumptions or outcomes, and why it has rejected them, or how management has otherwise addressed estimation uncertainty in making the accounting estimate.

(b) Whether the significant assumptions used by management are reasonable.

(c) Where relevant to the reasonableness of the significant assumptions used by management or the appropriate application of the applicable financial reporting framework, management's intent to carry out specific courses of action and its ability to do so.

13.3. Paragraph 21-D1 states as follows:

[23] ISA (UK) 330 (Revised July 2017), paragraph 18.

"*In accordance with ISA (UK) 200 (Revised June 2016),[24] the auditor shall maintain professional skepticism throughout the audit and in particular when reviewing management estimates relating to fair values, the impairment of assets and provisions.*"

14. ISA 570 Going Concern

14.1. Paragraph 12D-1 states as follows:

"*In accordance with ISA (UK) 200 (Revised June 2016),[25] the auditor shall maintain professional skepticism throughout the audit and in particular when reviewing future cash flow relevant to the entity's ability to continue as a going concern.*"

14.2. Paragraph 15 states as follows:

"*The auditor shall inquire of management as to its knowledge of events or conditions beyond the period of management's assessment that may cast significant doubt on the entity's ability to continue as a going concern.*"

14.3. Paragraph A14 states as follows:

"*As required by paragraph 11, the auditor remains alert to the possibility that there may be known events, scheduled or otherwise, or conditions that will occur beyond the period of assessment used by management that may bring into question the appropriateness of management's use of the going concern basis of accounting in preparing the financial statements. Since the degree of uncertainty associated with the outcome of an event or condition increases as the event or condition is further into the future, in considering events or conditions further in the future, the indications of going concern issues need to be significant before the auditor needs to consider taking further action. If such events or conditions are identified, the auditor may need to request management to evaluate the potential significance of the event or condition on its assessment of the entity's ability to continue as a going concern. In these circumstances the procedures in paragraph 16 apply.*"

15. ISA 620 Using the Work of an Auditor's Expert

15.1. Paragraph 7 states as follows:

[24] ISA (UK) 200 (Revised June 2016), Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing (UK), paragraph 15.
[25] ISA (UK) 200 (Revised June 2016), paragraph 15.

"*If expertise in a field other than accounting or auditing is necessary to obtain sufficient appropriate audit evidence, the auditor shall determine whether to use the work of an auditor's expert.*"

16. ISA 701 Communicating Key Audit Matters in the Independent Auditor's Report

16.1. Paragraph 13 states as follows:

"*The description of each key audit matter in the Key Audit Matters section of the auditor's report shall include a reference to the related disclosure(s), if any, in the financial statements and shall address:*

(a) Why the matter was considered to be one of most significance in the audit and therefore determined to be a key audit matter; and

(b) How the matter was addressed in the audit."

Extract from the ICAEW Code of Ethics (1 January 2011 – 21 December 2019)

17. Paragraph 130.1(b) states as follows:

"*The principle of professional competence and due care imposes the following obligations on all professional accountants:*

(b) To act diligently in accordance with applicable technical and professional standards when providing professional services."