IN THE MATTER OF

THE EXECUTIVE COUNSEL OF THE FINANCIAL REPORTING COUNCIL

-and-

(1) KPMG AUDIT PLC

(2) ANTHONY JAMES SYKES

EXECUTIVE COUNSEL'S FINAL DECISION NOTICE

Pursuant to Rule 18 of the Audit Enforcement Procedure

This *Final Decision Notice* is a document prepared by Executive Counsel following an investigation relating to 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. Redactions have been applied to this *Final Decision Notice* on grounds of confidentiality and legal professional privilege, at the request of third parties.

1. INTRODUCTION

1.1. The Financial Reporting Council (the "**FRC**") is the competent authority for *Statutory Audit* in the UK and operates the Audit Enforcement Procedure (the "**AEP**"), effective 1 January 2021. The AEP sets out the rules and procedure for the investigation, prosecution and sanctioning of breaches of *Relevant Requirements*.

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

1.3. This *Final Decision Notice* also uses the following definitions: "**FY**" means financial year, "**FY2010**" means the financial year ended 31 December 2010, "**FY2010 financial statements**" means Rolls-Royce Group plc's ("**Rolls-Royce**") consolidated financial statements for that period, and "**FY2010 Audit**" means the *Statutory Audit* of the FY2010 financial statements.

1.4. Pursuant to Rule 16(b) of the AEP, Executive Counsel has decided that KPMG Audit PLC ("**KPMG**") and Anthony James Sykes ("**Mr Sykes**") are liable for *Enforcement Action*, having made *Adverse Findings* against each of them.

1.5. This *Final Decision Notice* is issued pursuant to Rule 18 of the AEP in respect of the conduct of:

1.5.1. KPMG in relation to the FY2010 Audit. KPMG was the *Statutory Audit Firm* for the FY2010 Audit; and

1.5.2. Mr Sykes, a partner of KPMG in relation to the FY2010 Audit. For FY2010, he was the *Statutory Auditor* of Rolls-Royce and signed the FY2010 Audit report on behalf of KPMG.

1.6. In this *Final Decision Notice*, KPMG and Mr Sykes are referred to together as the "**Respondents**".

1.6.1. In accordance with Rule 18 of the AEP this *Final Decision Notice* sets out Executive Counsel's *Adverse Findings* and *Sanctions*, together with reasons.

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

1.7.1. Section 2: Summary;

1.7.2. Section 3: *Relevant Requirements* to which the *Adverse Findings* relate;

1.7.3. Section 4: Factual matters on which Executive Counsel relies in support of the *Adverse Findings*;

1.7.4. Section 5: The Respondents' Audit failings;

1.7.5. Section 6: The *Adverse Findings*;

1.7.6. Section 7: *Sanctions*; and

1.7.7. Section 8: Costs.

1.8. Applicable *Relevant Requirements* are set out in Schedule 1.

2. SUMMARY

2.1. Rolls-Royce was a FTSE 100 company listed on the London Stock Exchange. At the time of the FY2010 Audit, Rolls-Royce was one of the 30 largest companies listed on the London Stock Exchange (by market capitalisation), with underlying revenue of £10.9 billion, underlying profit before tax of £955 million, average net cash balances of £960 million, and an order book of £59.2 billion. In the circumstances, the level of materiality applied to the FY2010 Audit of the Rolls-Royce group was £46 million. Rolls-Royce specialized in the manufacture and supply of gas turbine engine products and services in four sectors: civil aerospace, defence aerospace, marine and energy. (Soon after

FY2010, in early 2011, the group's assets were transferred from Rolls-Royce to a new company, Rolls-Royce Holdings plc.)

2.2. KPMG was in 2010 (and its successor KPMG LLP is today) one of the largest audit firms in the UK, with audit fee income of £431 million and 149 audit principals in the year to 30 September 2010. KPMG (or its predecessor firm or its successor KPMG LLP) audited the financial statements of Rolls-Royce (and/or its predecessor and successor holding companies) throughout the period from 1990 to 2017.

2.3. Mr Sykes was the *Statutory Auditor* for Rolls-Royce from 2008 to 2012 and signed the FY2010 Audit report, on behalf of KPMG.

2.4. Allegations of bribery and malpractice through the use of intermediaries and "advisers" by large multi-national companies in the defence field in particular were achieving a particular prominence in the years leading up to 2010. In particular, following malpractice allegations and UK and US investigations, [a FTSE 100 UK defence-sector company ("**Defence Company A**")] in August 2007 appointed a committee [redacted] (the "**Committee**") to review its compliance with anti-corruption legislation. The Committee reported in April 2008. Its report noted that "*The Company is not alone in having to focus on these issues*". KPMG (which also audited [Defence Company A]) [was] well aware of the report and its contents. KPMG [was] also aware that in March 2010 [Defence Company A] paid a fine of £0.5 million in the UK and a fine of $400 million in the US to settle criminal investigations resulting from the use of intermediaries.

2.5. In May 2010, Rolls-Royce's Ethics Committee met with [two partners at an External Law Firm] in attendance and considered reports of findings, actions and recommendations in relation to "**Project Arrow**", which encompassed an investigation into the use by Rolls-Royce of agents in India at a time when the use of intermediaries in connection with Indian Government defence contracts was restricted by the Indian authorities. [redacted] At a meeting on 2 June 2010, on the instructions of the Rolls-Royce Board, Rolls-Royce's General Counsel terminated the services of [an intermediary in India (the "**Intermediary**")][redacted]. At the meeting at which the General Counsel did so, [the Intermediary] referred to help he had given to Rolls-Royce in relation to a difficulty in India in 2006 and mentioned that he had paid out a lot more than received from Rolls-Royce to resolve the matter and that had he not done so, some Rolls-Royce employees would have gone to jail and Rolls-Royce would have been closed out of the Indian market for 25 years. By 11 June 2010, the Respondents were aware that there might be an issue with Rolls-Royce or a third party associated with Rolls-Royce having engaged in an activity which did not comply with legislation or regulations, and that this concerned an agent in India. By 5 July 2010, the Respondents were aware of two "**Indian Issues**", namely:

2.5.1. the payment of £3.32 million in previous years to the Indian agent who had been terminated on 2 June 2010 of commission ostensibly in respect of goods sourced from a warehouse in the Middle East whereas in fact he had continued to represent Rolls-Royce's interests in India at a time when the use of agents in India was restricted ("**Indian Issue 1**"); and

2.5.2. the payment in 2006 to the same agent of a sum (£1.85 million) to secure the return of a list of agents which had been taken from Rolls-Royce's Indian branch office ("**Indian Issue 2**").

2.6…..In their audit work on consideration of laws and regulations in the FY2010 Audit, the Respondents failed to comply with the *Relevant Requirements* that are identified at Section 3 below (and set out in Schedule 1), in that:

2.6.1. As the Respondents accept, they should have included a summary of the Indian Issues and the results of their discussions with management and others in the audit documentation, but failed to do so, in breach of ISA 250A.29.

2.6.2. The Respondents recognised that the payments gave rise to a suspected non-compliance with laws and regulations and had been made aware by [redacted] The advice provided to the Rolls-Royce board about these issues was confidential and privileged. Nevertheless, the Respondents:

a) failed to record on the audit file the meetings Mr Sykes had attended at which the payments had been discussed, the information that had been provided to him in relation to the payments, and the professional judgments he had made in light of that information;

b) wrongly decided (on their own, undocumented, subsequent account) that [redacted] Rolls-Royce could not have infringed laws or regulations, and the possible effect on the FY2010 financial statements could not be material. They thereby failed to obtain sufficient appropriate audit evidence on which they could be satisfied (as they say that they were by the time Mr Sykes and KPMG signed the FY2010 Audit report) that the initially suspected non-compliance with laws and regulations was by that time no longer even suspected to have been a non-compliance and even if it had been, could not have had a material effect on the FY2010 financial statements;

c) not only did not inform the Engagement Quality Control Reviewer of the Indian Issues, but Mr Sykes positively instructed a manager to remove a paragraph referring to them from the manager's draft of the Board minute review;

d) failed to exercise a sufficient degree of professional scepticism as to the information they were given by their client.

2.7. The breaches are serious and therefore Executive Counsel has decided to impose financial sanctions of £4.5 million and £150,000 on KPMG and Mr Sykes respectively, taking into account any aggravating and mitigating factors, discounted for admissions and early disposal by 25% to £3,375,000 and £112,500 respectively, as well as deciding to publish a severe reprimand in relation to both.

2.8. Whilst this *Final Decision Notice* explains the failings in the Respondents' audit work, it is not alleged that the failings in question caused any misstatement in the FY2010 financial statements to go undetected: the Executive Counsel does not know what would have been discovered had the Respondents exercised a sufficient degree of professional scepticism. However, Rolls-Royce's conduct was subsequently (starting in 2012) the subject of investigation by the Serious Fraud Office (the "**SFO**"). As part of that investigation, Rolls-Royce (under partially different executive leadership) provided to the SFO a report which concerned a number of matters, including some conduct concerning India which Rolls-Royce had known about since 2010. In 2017, Rolls-Royce plc entered a Deferred Prosecution Agreement with the SFO, under which it paid £497.25 million (comprising disgorgement of profits and a financial penalty) plus interest, and a further £13 million in costs. The Deferred Prosecution Agreement contained twelve counts, two of which related to the Indian Issues: count 5, False Accounting between March 2005 and September 2009 (concerning Indian Issue 1), and count 6, Conspiracy to Corrupt between January 2006 and August 2007 (concerning Indian Issue 2). Of the £497.25 million paid by Rolls-Royce under the Deferred Prosecution Agreement, circa £21 million related to these two counts.

3. *RELEVANT REQUIREMENTS* TO WHICH THE *ADVERSE FINDINGS* RELATE

3.1. Rule 1 of the AEP states that *Relevant Requirements* has the meaning set out in regulation 5(11) of the Statutory Auditors and Third Country Auditors Regulations 2016. The *Relevant Requirements* include the International Standards on Auditing (UK and Ireland) (the "**ISA(s)**") issued by the Financial Reporting Council based on the International Standards on Auditing issued by the International Auditing and Assurance Standards Board.

3.2. The ISAs relevant to this *Final Decision Notice* are those effective for audits of financial statements for periods ending on or after 15 December 2010.

3.3. The *Relevant Requirements* referred to in this *Final Decision Notice* are the following:

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

3.3.2. ISA 220 (Quality control for an audit of financial statements);

3.3.3. ISA 230 (Audit documentation);

3.3.4. ISA 250 Section A ("**ISA 250A**") (Consideration of laws and regulations in an audit of financial statements);

3.3.5. ISA 330 (The auditor's responses to assessed risks); and

3.3.6. ISA 500 (Audit evidence).

3.4. Extracts from the ISAs setting out those parts which are of particular relevance to the *Adverse Findings* are set out in Schedule 1 hereto.

3.5. The *Relevant Requirements* identified above obliged the Respondents, amongst other things:

3.5.1. to include in the audit documentation suspected non-compliance with laws and regulations and the results of discussion with management and, where applicable, those charged with governance and other parties outside Rolls-Royce; and to prepare audit documentation sufficient to enable an experienced auditor having no previous connection with the audit to understand significant matters arising during the audit, the conclusions reached thereon and significant professional judgments made in reaching those conclusions;

3.5.2. once suspected non-compliance with laws and regulations had come to their attention, to obtain sufficient information that supported either (1) that Rolls-Royce was in compliance with laws and regulations or (2) the auditor's judgment that the effect of any actual or suspected non-compliance could not be material to the FY2010 financial statements; alternatively, in the absence of such information, to consider the need to obtain legal advice;

3.5.3. since Rolls-Royce was a listed entity, to discuss significant matters arising during the audit engagement with the Engagement Quality Control Reviewer ("**EQCR**"); and

3.5.4. to plan and perform their audit with professional scepticism.

3.6. The Respondents failed to comply with the *Relevant Requirements* as more particularly set out below.

4. FACTUAL MATTERS ON WHICH EXECUTIVE COUNSEL RELIES IN SUPPORT OF THE *ADVERSE FINDINGS*

The risk of substantial fines for non-compliance with laws and regulations

4.1. Allegations of bribery and malpractice through the use of intermediaries and "advisers" by large multi-national companies active in the defence field in particular were achieving a particular prominence in the years leading up to 2010.

4.2. Besides auditing Rolls-Royce, KPMG audited [Defence Company A] and Mr Sykes and KPMG's Rolls-Royce audit team were well aware of the difficulties which [Defence Company A] was having as regards adverse financial consequences from the use of intermediaries and "advisers". By way of example:

4.2.1. One of Mr Sykes' junior partners on the Rolls-Royce audit (the Group engagement partner) was described in interview by the [Senior Audit Partner 1] as "*very experienced through his work on* [Defence Company A] *as well as on Rolls[-Royce]*"

4.2.2. Another of Mr Sykes' junior partners on the Rolls-Royce audit, who had particular responsibility for the UK location in the Defence sector, was described in interview by the [Senior Audit Partner 1] as having co-ordinated a cross-industry accounting group around Aerospace.

4.2.3. The Group audit senior manager for FY2010 emailed the Group engagement partner and Mr Sykes on 16 January 2011 saying that he had discussed adviser payments extensively with the [Group Audit Partner for the audit of Defence Company A] and [Group Audit Senior Manager for the audit of Defence Company A].

4.3. Following allegations of malpractice and UK and US investigations into [Defence Company A], in August 2007 [Defence Company A] appointed a committee [redacted] (the "**Committee**") to review its compliance with anti-corruption legislation, including UK law, the US Foreign Corrupt Practices Act and relevant international treaty obligations. The Committee reported in April 2008. Its report noted in its Introduction that "*The Company is not alone in having to focus on these issues*". [Mr Sykes and KPMG were] well aware of the report and the actions being taken by Rolls-Royce in response to it.

4.4. Under the heading "The nature of defence contracts", the Committee's report commented as follows (emphasis added):

> "In many defence contracts the price, technical performance and delivery times of the equipment being procured are necessary, but far from sufficient factors when competing for the contract. Other important, and possibly determining, factors will

include the political commitment from the supplying nation, the political benefit to the recipient, credit and financing arrangements, offset packages and related technology transfer with the aim of supporting the development of indigenous defence capacity. These factors mean that most companies need to employ advisers (individuals or companies) to provide local knowledge of market specific procurement processes and practices. Some also act as an intermediary between the company and recipient government. **The use of such advisers, particularly when they are paid by a commission, carries significant risk for the companies.** The complexity and confidential nature of the contractual arrangements, and the significant financial stake an adviser may have in a successful contract, **increases the opportunities and temptations for non-transparent payments**."

4.5. One of a number of steps which Rolls-Royce took in response to the [Committee's] Report was to set up an Ethics Committee in September 2008. Rolls-Royce's Ethics Committee's terms of reference required the minutes to be circulated to KPMG. KPMG did review the minutes of Rolls-Royce Board meetings at which the chair of the Ethics Committee reported to the Rolls-Royce Board. The Respondents did not, however, review the Ethics Committee Minutes in the FY2010 Audit.

4.6. On 1 October 2009, the SFO announced that it intended to seek the Attorney-General's consent to prosecute [Defence Company A] for offences relating to overseas corruption following the SFO's investigation into the business activities of [Defence Company A] in Africa and Eastern Europe. The press reported that the SFO had wanted to strike a deal which would involve [Defence Company A] pleading guilty to charges of corruption and agreeing to pay between £500m and £1 billion in compensation, but no deal had been done.

4.7. In February 2010:

4.7.1. it was reported that [Defence Company A] was going to plead guilty to two criminal charges and pay fines of £286m to settle US and UK criminal investigations resulting from the use of intermediaries.

4.7.2. the Accountancy and Actuarial Discipline Board began examining KPMG's work for [Defence Company A], relating to commissions paid to third-party agents and outside companies in big deals (albeit that that investigation was subsequently closed in 2013 without any adverse finding being made);

4.7.3. Mr Sykes was present at part of the Board meeting of Rolls-Royce (at which the Annual Report for 2009 was approved), including the part of the meeting at which the [Chair of the Ethics Committee] reported that:

> "The Anti-Bribery Compliance programme was getting underway and would be a major piece of work this year. The Company's policy on the use of advisers would be reviewed as part of that programme."

Mr Sykes also met regularly with the Risk and Compliance function during 2009 and 2010. At these meetings, Mr Sykes received updates as to the progress of this Anti-Bribery Compliance programme, as well as in relation to other matters.

4.7.4. Rolls-Royce's 2009 Annual Report was published, including under the heading "Market Outlook" and the subheading "Defence aerospace":

> "The Group forecasts that demand for military engines will be worth US$170 billion over the next 20 years. The largest single market is expected to be the US, followed by Europe and the Far East. Within Asia, demand will be dominated by Japan, South Korea and India. Trends are driven by the scale of defence budgets and geopolitical developments around the world."

4.8. On 1 March 2010, [Defence Company A] formally pleaded guilty in the USA (as anticipated in the press in February 2010, as noted above). [Redacted]

Project Arrow

4.9. On 26 May 2010 there was an unscheduled meeting of Rolls-Royce's Ethics Committee (the previous meeting on 8 February 2010 having concluded by noting that the next meeting would be on 26 July 2010). The meeting was attended by [two partners at an External Law Firm] [redacted] who were among the most senior individuals at the firm in the corporate and investigations specialist fields. As explained to Executive Counsel by Rolls-Royce's solicitors, the minutes (which have been fully redacted by Rolls-Royce on grounds of legal professional privilege) contain "*Reports of findings, actions and recommendations following an investigation into anti-bribery issues in India*". That investigation into the Indian Issues was part of Project Arrow. The meeting led to a decision by Rolls-Royce that Rolls-Royce's General Counsel (the "**General Counsel**") should terminate its relationship with [the Intermediary], which the General Counsel did in a meeting on 2 June 2010. [redacted]

[redacted]

4.10. At the meeting between the General Counsel and [the Intermediary] on 2 June 2010, according to the Statement of Facts in Rolls-Royce's subsequent Deferred Prosecution Agreement:

> "[the Intermediary] mentioned the help [he] had given to RR in resolving the tax difficulty in the RR India office in 2006, that [he] had paid out a lot more than received from RR to resolve the matter and that, had [he] not done so, some RR employees, including one based in India, would have gone to jail, and RR would have been closed out of the Indian market for 25 years."

4.11. That reference to a "tax difficulty" is a reference to what is described in earlier paragraphs of the Deferred Prosecution Agreement Statement of Facts: in January 2006 an Indian tax inspector had removed some documents from Rolls-Royce's Delhi office in the course of a tax survey; the following month he had produced to a Rolls-Royce employee a May 2002 list of Rolls-Royce advisers which included a number of entries for a company connected to [the Intermediary], and he had requested that Rolls-Royce provide complete names and addresses of those listed, the amounts paid to them, and the purposes of their engagement; that had caused concerns to be expressed within Rolls-Royce that if the list were passed to the Indian Ministry of Defence there would probably be an investigation and that if it were found that a breach had occurred, the outcome could be that any Rolls-Royce company would be debarred from contracting with any Indian government agency for 5 years or more; a decision had thus been taken (by 20 March 2006) to pay [the Intermediary] to retrieve the adviser list. These specific facts were not known by the Respondents in full contemporaneously.

4.12. As the Deferred Prosecution Agreement Statement of Facts put it:

4.12.1. (at paragraph 160)

> "Whilst it has not been established that a payment was made to a tax inspector or any other official, there is an inference that this decision was made in the expectation that the list could only be retrieved and the attendant investigations prevented if a payment was made to a third party".

4.12.2. (at paragraphs 161 to 163) by May 2006, eight new contracts were signed as a mechanism by which Rolls-Royce paid £1.85m to entities connected to [the Intermediary] between April 2006 and August 2007 in connection with the adviser list. None of the proposal forms, Side Letters or Commercial Consultancy Agreements revealed any link to the adviser list issue. Within Rolls-Royce's accounting system some payments were set up as "non-project Sales Related non R&D costs"; others were settled to a cost centre within "Commercial and Administrative Costs" (i.e. not linked to sales).

4.13. On 4 June 2010 there was an unscheduled meeting of Rolls-Royce's Board (the previous meeting on 27 April 2010 having concluded by noting that the next meeting would be on 28 July 2010). The same [two partners at an External Law Firm] referred to in paragraph 4.9 above [redacted] were in attendance, as was [Member 2 of Rolls-Royce Senior Management] [redacted]. [Member 2 of Rolls-Royce Senior Management] described this meeting in interview with Executive Counsel:

> "the Indian matter became such a big issue, that actually, it merited attention, not just from a Board Subcommittee, but actually the Board itself ... I went and made a presentation to the full Board ... Together with [an External Law Firm] ... I don't think [KPMG] did attend that one; because in that particular meeting, there was the senior partner from [an External Law Firm] ; there was ... the Lead Partner that worked with me on the investigation, and the compliance programme staff; and then there was me. And the three of us trotted in together."

4.14. On 22 July 2010 another unscheduled meeting of Rolls-Royce's Ethics Committee took place (the meeting on 8 February 2010 having concluded by noting that the next meeting would be on 26 July 2010), again with the [two partners at an External law Firm] in attendance. As explained to Executive Counsel by Rolls-Royce's solicitors, the minutes (which have been extensively redacted by Rolls-Royce on grounds of legal professional privilege) again referred to Project Arrow.

4.15. On 26 July 2010, the meeting of Rolls-Royce's Ethics Committee which had been scheduled at the meeting on 8 February 2010 took place, again with the [two partners at an External Law Firm] in attendance. As explained to Executive Counsel by Rolls-Royce's solicitors, the minutes (which have been extensively redacted by Rolls-Royce on grounds of legal professional privilege) again referred to Project Arrow. The meeting concluded by noting that the next scheduled meeting would take place on 10 November 2010.

4.16. On 28 July 2010, Rolls-Royce's Board approved the half-yearly accounts (in a part of the meeting at which Mr Sykes was in attendance) and then (later in the meeting, after Mr Sykes had ceased to be in attendance) was joined by the [two partners at an External Law Firm]. As explained to Executive Counsel by Rolls-Royce's solicitors, the minutes (which, on production to the Executive Counsel, have been extensively redacted by Rolls-Royce, on grounds of legal professional privilege) again referred to Project Arrow. In early 2011, as part of the yearend audit, the passage of the minutes that referred to Project Arrow was noted in a paragraph of the draft workpaper by the Group Audit senior manager, but Mr Sykes instructed him to remove that paragraph of the workpaper (as noted below). KPMG has advised that Rolls-Royce has agreed that KPMG can inform Executive Counsel that the minute records that the conclusion reached was a resolution not to make a report under the Proceeds of Crime Act, but to keep the decision under review.

4.17. On 23 September 2010, another unscheduled meeting of Rolls-Royce's Ethics Committee took place (the meeting on 26 July 2010 having concluded, as noted above, by noting that the next scheduled meeting would be on 10 November 2010). As explained to Executive Counsel by Rolls-Royce's solicitors, the minutes (which have been extensively redacted by Rolls-Royce on grounds of legal professional privilege) again referred to Project Arrow. The unredacted part of the minutes records that

> "The Committee agreed that the decision whether or not to make a notification under the Proceeds of Crime Act should be kept under review."

4.18. On 10 November 2010, the meeting of Rolls-Royce's Ethics Committee which had been scheduled at the meeting on 26 July 2010 took place. As explained to Executive Counsel by Rolls-Royce's solicitors, the minutes (which have been extensively redacted by Rolls-Royce on grounds of legal professional privilege) again referred to Project Arrow.

4.19. On 11 November 2010, a Rolls-Royce Board meeting took place, and as explained to Executive Counsel by Rolls-Royce's solicitors, the minutes (which have been redacted by Rolls-Royce on grounds of legal professional privilege) again referred to Project Arrow. The sole reference to Project Arrow or either of the Indian Issues in the FY2010 Audit workpapers (following Mr Sykes's instruction to the Group Audit senior manager to remove from the Board minute review the paragraph relating to the discussion at the Board meeting on 28 July 2010) is a sentence in the Board minute review that at this meeting on 11 November 2010 *the General Counsel "gave a briefin* [sic] *on Project Arrow*."

Mr Sykes' knowledge of the Indian Issues

4.20. By 11 June 2010, Mr Sykes was aware that there might be issues concerning non-compliance with laws and regulations by reason of payments made to [the Intermediary], as is apparent from his emails of that date. On that date, he had an exchange of emails within KPMG with [Senior Audit Partner 2] following an undocumented discussion with him.

4.20.1. Mr Sykes sent an email to the [Senior Audit Partner 2] at 10.29 with the subject line "Ethics and Independence guideline", reading as follows:

> "Our Ethics and Independence policies state that:
>
> *'If you become aware that a client or third party associated with a client is, or may be, engaging in an activity that does not comply with relevant legislation, regulations or professional standards (including fraud, bribery or insider dealing), you should bring it to the attention of the engagement partner who will then notify the [UK Risk Department].'*
>
> There are strict reporting requirements where one

suspects that money laundering is involved.

Tony"

4.20.2. [Senior Audit Partner 2] responded at 12.56, saying, "*Tony, thanks. Let's pick up later this pm to agree what I say to [Member 1 of Rolls-Royce Senior Management].*
[i.e. [Member 1 of Rolls-Royce Senior Management] [redacted]].".

4.20.3. Despite having expressly quoted to [Senior Audit Partner 2] that the KPMG policy said that if the engagement partner became aware that a client or third party associated with a client may be engaging in an activity that does not comply with relevant legislation, the engagement partner "*will*" (not "*may*") notify the [UK Risk Department], Mr Sykes never informed the [UK Risk Department], who remained uninformed.

4.20.4. At 14.05, Mr Sykes sent a further email to [Senior Audit Partner 2]. The email indicates that he was aware of Indian Issue 1. It read:

> We understand that what was done pre 2002 was legal. The agent has not been paid directly in India since but has been rewarded for other activities he has conducted elsewhere. The company does not intend to pay him anything further. We have an obligation to report matters which we believe may involve criminal activity. Bribery would constitute criminal activity. We do not have sufficient information to have a legitimate basis for any such suspicion and would not have any reason to make any further enquiries unless further payments were made in the current year.
>
> Tony"

4.21. On 5 July 2010, Mr Sykes attended a meeting with [Member 1 and Member 2 of Rolls-Royce Senior Management]. [Member 2 of Rolls-Royce Senior Management] informed Executive Counsel in interview that he thought that Mr Sykes must have been aware that [Member 2 of Rolls-Royce Senior Management] had made a presentation to the Board (the presentation he made with [an External Law Firm] on 4 June 2010), and that [redacted] Those two paragraphs read as follows:

"Count 5

False Accounting between 24 March 2005 and 30 September 2009

In Summary

129. In summary, during this period the use of intermediaries in connection with Indian Government defence contracts was restricted by the Indian authorities. The terms of some RR defence contracts contained undertakings that intermediaries had not been used. Breach of the undertaking entitled the Indian authorities to cancel agreements and prevent bidding for future contracts. However RR continued to use one of its key intermediaries ("Intermediary 4") in relation to relevant defence contracts. RR created contractual documents in respect of the payments thereby due to Intermediary 4 which recorded the payments as being due for general consultancy services, rather than as commissions due in respect of those relevant defence contracts. The contractual documents therefore did not correctly record the real reasons for these payments to Intermediary 4.

Count 6

Conspiracy to Corrupt between 1 January 2006 and 31 August 2007

In Summary

130. In 2006 the Indian tax authorities came into possession of a RR list of its Indian intermediaries dated May 2002. RR paid Intermediary 4 to retrieve the list and prevent further investigations. There is an inference that this involved payment to a tax inspector. These payments to Intermediary 4 were also made through contractual documentation which did not correctly record the real reason for the payments."

4.22. [redacted]

[redacted]

[redacted]

4.23. As to Indian Issue 1, Executive Counsel infers from the information that Mr Sykes says he was given [redacted] that Mr Sykes was aware or suspected that the commission payment had been disguised as a payment for a different purpose so as to seek to get around the fact that the use of agents in India was restricted by the Indian Authorities.

4.24. As to Indian Issue 2, Mr Sykes explained in interview that Rolls-Royce "*obviously knew who was on that list and they were concerned that those details would get into the authorities' hands. So they wanted to get the list back*". Executive Counsel infers from this evidence that Mr Sykes was aware or suspected that the payment to the Indian agent for the list of agents' names had been made, or might have been made, so as to prevent the authorities from investigating Rolls-Royce for the use of agents.

4.25. It is noted in this regard that the Respondents admit that the Indian Issues were initially suspected to be non-compliance with laws and regulations and as such should have been (but in breach of ISA 250A.29 were not) included in the audit documentation. Executive Counsel finds that by 5 July 2010, Mr Sykes had information upon which to form the view that the Indian Issues were suspected non-compliance with laws and regulations.

4.26. On 6 July 2010, Mr Sykes discussed the Indian Issues with KPMG's money laundering reporting officer (the "**MLRO**"). In interview, the MLRO has explained that although he does not remember this meeting, his role was to explore with Mr Sykes "*whether, from a narrow perspective, as the MLRO, this was a matter that was potentially reportable under the money laundering legislation*". It was not part of his remit to discuss further action that might be necessary from an audit perspective.

4.27. Mr Sykes has told Executive Counsel in interview that he and the MLRO agreed to speak again once they knew what the legal advice from [an External Law Firm] was.

4.28. Mr Sykes did not record, for the purpose of the FY2010 Audit, (i) the fact that he had discussed the Indian Issues with the MLRO; (ii) the content of the discussion; (iii) any advice he received; or (iv) the conclusion arrived at (i.e. the need to consider the matter further following receipt of information about the advice from [an External Law Firm]).

4.29. On Tuesday 20 July 2010, Mr Sykes met the General Counsel and [Member 2 of Rolls-Royce Senior Management] to obtain further information about the Indian Issues. During this meeting (of which there is no record on the audit file):

4.29.1. according to the account which Mr Sykes has given to Executive Counsel, [redacted] and

4.29.2. according to KPMG's representations to Executive Counsel, in the course of this and/or the meeting on 5 July 2010 Mr Sykes was also told [redacted]

4.30. Also on 20 July 2010, Mr Sykes again discussed the Indian Issues internally with the MLRO and the [Senior Audit Partner 2], with specific reference to whether KPMG was required to make a money-laundering report under the Proceeds of Crime Act. In an email from Mr Sykes to the Group engagement partner the following day, 21 July 2010, Mr Sykes informed him that he met with the [Senior Audit Partner 2] and the MLRO on 20 July 2010 and that "*We concluded that there was nothing to report based on what we know now*".

4.31. Mr Sykes did not record on the FY2010 Audit File (i) the fact that he had attended this meeting; (ii) the discussion which took place during the meeting; or (iii) the conclusion reached.

4.32. Mr Sykes was aware, from his review in February 2011 of the draft which the Group Audit senior manager prepared of the Board minute review, that at the 28 July 2010 Board meeting after he had ceased to be in attendance, there had been a discussion of the Indian Issues: Mr Sykes instructed the Group Audit senior manager to remove that paragraph of the Board minute review, and he did so.

Audit documents recognising the significance of advisor payments and the need for professional scepticism

4.33. KPMG has explained to Executive Counsel that (following consultation with the designated [Forensics Department] for the Rolls-Royce audit team) it carried forward from the FY2009 audit onto the FY2010 Audit file, on the grounds that there was no change in the risk environment, the four specific risk factors identified in the FY2009 audit's Fraud Risks kick-off meeting. Under the heading "*Specific risk factors*", the audit team recorded:

> "The audit team identified a number of specific risk factors that are to be specific areas of audit focus:

- Profit to cash reconciliation and year end cash management
- Headline to underlying presentation
- Material judgmental and subjective accounting issues
- Advisors and other intermediaries" 4.34.

The Rolls-Royce Group Audit Instructions for 2010 set out:

4.34.1. what Mr Sykes's covering letter to the KPMG audit teams described as "*the key areas of audit focus*" (albeit the risk of non-compliance with laws and regulations was not identified as one of the 13 significant risks in the audit), one of which was "*Claims and litigation*", in relation to which the Instructions said:

> "Breaches of security conventions or laws or contraventions of export controls could result in lost orders, fines and potentially even cessation of operations in an area."

4.34.2. what was described as "*a summary of E[ntity] L[evel] C[ontrols] work performed at Group level*" which stated that the controls tested by the Group audit team included "*Review of Ethics Committee minutes*"

4.34.3. an "*analysis ... to aid local teams when planning their work*" which said under the heading "Laws and Regulations" that the tasks of "*Reviewing legal papers held by RR with Legal Counsel*" and "*Review Group Board Minutes*" would be performed at Group level;

4.34.4. work to be performed in relation to "Advisor payments", as to which it noted that payments to advisors were material by nature due to the potential for non-compliance with laws and regulations:

> "Rolls-Royce employs advisors (often termed 'agents') to assist with sales campaigns across the globe. These advisors are typically paid a percentage of the sales contract following contract signature.
>
> These payments are material by nature due to the potential for actual or perceived non-compliance with laws and regulations. These include, but are not limited to, the US Foreign Corrupt Practices Act and the UK's money laundering and anti-terrorist regulations."

4.35. At the year-end audit kick-off meeting on 3 November 2010, to which Mr Sykes sent his apologies, the Group Audit senior manager "*stressed the need to be vigilant in regards to fraud and maintain high professional scepticism throughout the audit*" and, according to the minutes:

"highlighted the key fraud risks regarding Rolls-Royce and the potential enabling mechanisms

…

- Defence contracts dealing with governments open to bribery/corruption
  - In response we carry out work on advisor payments
  - Rolls-Royce compliance with new law passed regarding bribery and corruption."

5. THE RESPONDENTS' AUDIT FAILINGS

The failure to document the Indian Issues

5.1. As the Respondents accept, they should have included a summary of the Indian Issues and the results of their discussions with management and others in the audit documentation, but failed to do so, in breach of ISA 250A.29.

5.2. The FY2010 Audit file did not contain, and the Respondents failed, contrary to the requirements of ISA 230.8, 230.9, 230.10 and 250A.29, to document:

5.2.1. any reference to the existence of the Indian Issues, save for an isolated reference to the General Counsel having given the Board "*a briefin* [sic] *on Project Arrow*" (which was unaccompanied by any explanation of what Project Arrow was), as noted at paragraph 4.19 above;

5.2.2. any reference to the facts that (as the Respondents accept), at least at the time the Indian Issues were identified, [redacted]

5.2.3. any reference to the basis on which the Respondents satisfied themselves that the Indian Issues were (as they have said in correspondence with the Executive Counsel) "*of little or no significance to the audit*" such that they did not think it was appropriate to have any reference to them in the audit documentation, or of the basis on which (as the Respondents have said was the case) the suspicions that existed initially had been addressed and it had been determined that the Indian Issues did not constitute suspected non-compliance with laws and regulations which could have a material effect on the FY2010 financial statements.

5.3. Executive Counsel finds that the Indian Issues were not of "*little or no significance to the audit*", as the Respondents have contended that they concluded, but on the contrary were, in all of the circumstances of this particular case, "*significant matters*" pursuant to ISA 230.8(c), and should have been recognised as such by the Respondents. Accordingly, the details of the Indian Issues and the conclusions reached thereon should have been recorded on the audit file. The significance of the Indian Issues to the audit should have been obvious to the Respondents in the light of the matters set out at (a) paragraphs 4.1 to 4.8, (b) paragraphs 4.13, 4.16 and 4.19 (all of which the Respondents knew, and even disregarding the contents of the minutes of the Ethics Committee which the Respondents should have read, but did not) and (c) Mr Sykes's knowledge as set out at paragraphs 4.20 to 4.32.

The failure to obtain sufficient appropriate audit evidence in respect of the Indian Issues

5.4. The Respondents also failed to obtain sufficient appropriate audit evidence and failed to obtain an adequate understanding of the nature of the Indian Issues, the circumstances in which they occurred and any further information that would have enabled them adequately to evaluate the possible effects on the FY2010 financial statements, contrary to ISAs 250A.18 and 500.6.

5.5. In particular, the Respondents accepted without question, apparently as being audit evidence that the Indian Issues were not suspected to be instances of non-compliance with laws and regulations, information from Rolls-Royce to the effect that [an External Law Firm] had [redacted] and further concluded following that advice that the Indian Issues could not have a material effect on the FY2010 financial statements. Mr Sykes did not attempt, as he should have done, to obtain more details as to the underlying basis for this conclusion. The test for reporting under the Proceeds of Crime Act is narrower than the test for whether a crime or non-compliance with laws and regulations has taken place. In all the circumstances, the Respondents should not have accepted that advice that the Indian Issues [redacted] meant that there was no suspected non-compliance with laws or regulations which could have had a material effect on the FY2010 financial statements.

5.6. Furthermore, in the circumstances, the Respondents should have reviewed the minutes of the Ethics Committee (as KPMG had planned to do, as noted at paragraph 4.34.2 above).

The failure to inform the EQCR of the Indian Issues

5.7. At no time did Mr Sykes discuss the Indian Issues with the EQCR, contrary to ISA 220.19(b). Further, there was nothing on the Audit File for the FY2010 Audit (or the interim review file) which would have enabled the EQCR to identify for himself that the Indian Issues came to light in or around June 2010 or that any judgments had been made as to how they would be treated in the context of the audit.

5.8. When the EQCR signed off the Engagement Quality Control Reviewer Checklist for the Rolls-Royce FY2010 Audit he was unable to carry out an objective evaluation of the judgment made by Mr Sykes that the Indian Issues no longer amounted to a suspected non-compliance with laws and regulations which could have had a material effect on the FY2010 financial statements, because he was unaware that any such judgment had been made.

5.9. The FY2010 Audit papers contain a number of statements to the effect that there is nothing of potential concern to report in relation to bribery and anti-corruption. By way of examples:

5.9.1. Workpaper 2.12.4.0010 "Forensics approach" recorded the basis for concluding that "*KPMG Forensic involvement is not required in the 2010 audit*". It set out what procedures occurred in 2009, then said:

> "In 2010 the above fraud risk factors have been re-assessed and no changes noted with the following exceptions:
>
> - Profits to cash reconciliation and year-end cash management is no longer noted as a specific risk factor. In 2009 Rolls-Royce were very close to the cash target [which] is a significant factor in the bonus calculation. In 2010 this is not the case.
>
> It's also noted that in 2010 Rolls-Royce have taken further action to satisfy the new anti-bribery and corruption (ABC) legislation which has become effective in 2010. This involves setting new ABC policy which has been designed based on expert advice from [Advisor 1]. This is relevant to the advisors fraud risk discussed in the prior year. If anything this reduces the risk of fraud in this area due to enhanced processes and controls.
>
> As part of our fraud work no material frauds or issues with the controls/processes over fraud have been identified.
>
> For the 2009 audit it was agreed between the engagement partner and KPMG forensics that forensic involvement was not required through forensics attending the fraud risk meeting and reviewing the three fraud risk papers discussed above. In 2010 no significant changes had occurred to the risk of fraud and therefore a detailed discussion with KPMG forensics, and their review of the key fraud risk work

papers is not considered necessary."

No one reading that would have appreciated from it or anything else in the audit file that there had been a number of unscheduled meetings of the Board and the Ethics Committee, attended by [an External Law Firm], to report on an investigation which at one stage at least had led to Mr Sykes being told [redacted]

5.9.2. The EQCR reviewed workpaper 3.4.4, "*Suspected or actual noncompliance – illegal acts and fraud*", as he was required to do by KPMG's checklist. It did not put him in a proper position to perform an evaluation of the significant judgment which Mr Sykes has told the Executive Counsel that he had made that the Indian Issues were no longer a suspected non-compliance with laws and regulations which could have a material effect on the FY2010 financial statements.

a) In answer to the question:

"Have all instances that indicate that suspected or actual non-compliance with laws and regulations, including illegal acts or fraud may have occurred been documented in the Tracker and are included in the table above? If no, document such items in the Tracker"

the answer given was "*Not applicable*.", i.e. there have not been any instances which even indicate that suspected noncompliance may have occurred.

b) The attached workpaper 3.4.4.0020 "Adviser payments" (which was reviewed by Mr Sykes on 25 March 2011) explained under the heading "Overview":

"Payments made to advisers during 2010 amounted to £33.9m. In addition we consider it unlikely that payments made would be accounted for incorrectly",

then proceeded to state as follows under the heading "*Historical experience of failure to comply with laws and regulations*":

"There has been no recent experience of failures to comply with laws

> and regulations in this area. On acquisition of the Vickers business in 2004 a number of issues were highlighted and followed up and [Rolls-Royce Marketing Services] are aware that
> acquisitions increase the risk in this area. There have been no significant acquisitions during 2009 [sic]"

and concluded with a Summary which ended:

> "Nothing has come to our attention to suggest that there has been any material non-compliance with laws and regulations."

For a reviewer of the document to be able to perform an objective evaluation whether, as stated, it was "*unlikely that payments made would be accounted for incorrectly*", the reviewer needed to know, at least, [redacted] [what Mr Sykes had been told about the matters described in paragraph 129 of Count 5 set out at paragraph 4.21 above], and that the adviser had been "terminated" in the course of 2010, and that [an External Law Firm], the Ethics Committee and the Board had been considering this extensively and repeatedly. The EQCR was not told any of those things.

5.9.3. Workpaper 4.2.1.0020 "Group audit engagement partner meeting minutes" was prepared by Mr Sykes. It said that "*The purpose of this file note is to record details of meetings attended by* [Mr Sykes as the lead partner] *and* [Mr Sykes's junior partner, the Group engagement partner] *as part of the 2010 audit process at which they was* [sic] *not accompanied by another member of the audit team*."

a) The note covered meetings with [Member 1 of Rolls-Royce Senior Management] but omitted entirely the meeting of 5 July 2010. It said:

> "*Various meetings in 2010*
>
> We have held monthly meetings with [Member 1 of Rolls-Royce Senior Management] throughout 2010 in order to keep abreast of developments as they arise. The resolution of these issues is summarised in the audit committee paper to the extent that they are material to the group financial statements."

It then covered a meeting on 28 January 2011, and then, in a final paragraph, said (emphasis added):

> "We also considered fraud risk and [Member 1 of Rolls-Royce Senior Management] **confirmed that he was not aware of any new issues in 2010** and that the matters arising in 2009 had been dealt with appropriately as discussed previously."

That would give the EQCR not an inkling of the engagement of [an External Law Firm] to advise on Project Arrow.

b) The note recorded only one meeting (but not the one said to have taken place on 22 July at 17.30, according to the Interim Review workpaper 2.5.3.0070) with [Rolls-Royce Board Director]on 24 January 2011. Once again, it gave the impression that nothing had occurred in the year which had raised any concerns (emphasis added):

> "I met [the Rolls-Royce Board Director] on 24th January 2011. I explained to him the status of the audit and we discussed the key audit and accounting judgements which would feature in our audit committee paper. **We discussed the culture generally within RR which [the Rolls-Royce Board Director] said he found transparent and honest.**"

c) The note also recorded meetings with [the Chair of Ethics Committee] [redacted]. Once again, it would have given the EQCR no idea of what the Ethics Committee had repeatedly considered in both scheduled and unscheduled meetings over the course of the year, saying (emphasis added):

> "[The Group engagement partner] and I met [the Chair of Ethics Committee] on 3rd February 2011. ...
>
> We considered the control environment and concluded that it was sound overall.[redacted]. We discussed progress on the Group's anti bribery and corruption programme which [the Chair of Ethics Committee] described as being at an advanced stage (the group is being advised by [Advisor 1]). **[The Chair of the Ethics Committee] confirmed that there were no significant issues arising from the work of the Ethics Committee during 2010 that he believed should be brought to our attention**."

5.9.4. In or around February 2011, the Group Audit senior manager reviewed Rolls-Royce's Board minutes from May 2010 to the end of December 2010 and prepared a draft of audit working paper 2.5.1.0010 summarising those minutes.

a) In his summary of the Board meeting on 28 July 2010 the Group Audit senior manager's draft included 6 or 7 lines, which summarised the part of the Board minute which concerned Project Arrow and the conclusion not to make a report under the Proceeds of Crime Act but to keep the decision under review, as noted at paragraph 4.16.

b) The Group Audit senior manager told Executive Counsel in interview that he expressly drew Mr Sykes's attention to the reference in his draft working paper to the Board's decision not to make a report under the Proceeds of Crime Act because "*it appeared to me a significant enough point in the Board minutes to ensure that the engagement partner was aware.*"

c) Mr Sykes asked the Group Audit senior manager to remove that part of the Board minute review and he did so. The Group Audit senior manager said in interview that he remembered Mr Sykes asking him to remove an item from the Board minute review, that he did not believe Mr Sykes explained why, and that he did not recall any other occasion on which the audit engagement partner asked him to remove a section from a Board minute review.

d) As noted at paragraph 4.19 above, the workpaper (both in draft and as finalised) contained a note that at the Board meeting on 11 November 2010 "*[the General Counsel] gave a briefin* [sic] *on Project Arrow*" but did not explain what Project Arrow was.

The failure to apply sufficient professional scepticism in dealing with the Indian Issues

5.10. As referred to at paragraphs 4.34.4 and 4.35 above, the Group Audit Instructions for 2010 described payments to advisers as "*material by nature*" and, in its planning for the audit, KPMG had recognised the need to apply professional scepticism in respect of potential fraud.

5.11. However, in breach of ISA 200.15, the Respondents failed to perform the audit with sufficient professional scepticism in respect of their approach to the Indian Issues. The Respondents:

5.11.1. Failed to obtain sufficient appropriate audit evidence in respect of the Indian Issues, as more particularly set out in paragraphs 5.4 to 5.6 above. In particular, they failed to review the minutes of the Ethics Committee despite noting in the workpaper on adviser payments that:

> "The area of Adviser payments is the responsibility of the Ethics committee ... Essentially, the committee has two roles:
>
> ? …
>
> ? To review the process and contracts for adherence with the law."

And copying for the audit file the Terms of Reference of the Ethics Committee which made it clear that those minutes should have been sent to the Respondents in any event – the Terms of Reference said that the minutes of meetings would be circulated to the external auditors.

5.11.2. Having been told in the course of the meetings on 5 and 20 July 2010 (a) that Rolls-Royce [redacted] and (b) that Rolls-Royce was [redacted] as referred to at paragraph 4. [29.2] above, failed to ask:

a) what the basis was for the advice that [redacted] and/or

b) whether the reason why it was not reasonable to assume that there would be a claim or investigation was because it had been established that there was no claim to be made/no infringement to be investigated, or simply because, [redacted], any potential claim/infringement would be kept hidden. This was in circumstances where [redacted]

5.11.3. Relied on advice from [an External Law Firm] about which they were informed but which they did not see, where the question which they were told [an External Law Firm] was addressing [redacted] was different from the question which the Respondents needed to consider in the context of the audit (whether there was a suspected noncompliance with laws and regulations which could have a material effect on the FY2010 financial statements).

6. THE *ADVERSE FINDINGS*

Adverse Finding 1: Failure to document the Indian Issues

The Respondents failed to document the Indian Issues in the FY2010 Audit file contrary to ISA 230.8, 230.9, 230.10 and 250A.29

6.1. In light of the matters set out above, the Respondents breached the following requirements:

6.1.1. ISA 230.8(c) and 250A.29, in failing to record on the audit file the existence of the Indian Issues, which were a suspected noncompliance with laws and regulations and a significant matter arising during the audit;

6.1.2. ISA 230.8(a), 230.9, 230.10 and 250A.29, in failing to record on the audit file the discussions between Mr Sykes and Rolls-Royce regarding the Indian Issues, including disclosures of information relating to the Indian Issues which Rolls-Royce made to Mr Sykes in July 2010, namely the meetings between Mr Sykes and representatives of Rolls-Royce on 5 and 20 July 2010 referred to above; and

6.1.3. ISA 230.8(b) and 230.9, in failing to record on the audit file the

Respondents' conclusions in respect of the Indian Issues and the judgements they employed when reaching those conclusions, or the basis for those conclusions.

Adverse Finding 2: Failure to obtain sufficient appropriate audit evidence in relation to the Indian Issues

In relation to the Indian Issues, the Respondents failed to obtain sufficient appropriate audit evidence and to obtain an understanding of the nature of the acts in question and the circumstances in which they occurred and failed to obtain further information to evaluate the possible effect of the Indian Issues on Rolls-Royce's financial statements, contrary to ISA 500.6, 500.8 and 250A.18

6.2. In light of the matters set out above, the Respondents breached the following requirements:

6.2.1. ISA 500.6, in failing to perform audit procedures that were appropriate in the circumstances for the purposes of obtaining sufficient appropriate audit evidence in respect of the Indian Issues, including in failing to perform the review of the Ethics Committee meeting minutes which had been planned as part of the controls testing.

6.2.2. ISA 500.8, in that, while purporting to rely on the advice [an External Law Firm] allegedly provided to Rolls-Royce (as reported to them), they failed to obtain an understanding of the scope of work undertaken by [an External Law Firm], they failed to evaluate the appropriateness of [an External Law Firm's] work as audit evidence to support a conclusion that the Indian Issues were not a suspected non-compliance with laws and regulations, and they failed to explore the question whether [an External Law Firm's] advice (or part of it) might be made available to them notwithstanding that it was said to be privileged. Without taking these steps, the Respondents were not in a position to determine whether the advice of [an External Law Firm] constituted sufficient appropriate audit evidence in respect of a suspected noncompliance with laws and regulations.

6.2.3. ISA 250A.18 in respect of the Indian Issues, in failing to obtain an understanding of the nature of the acts that were suspected to be a non-compliance with laws and regulations and the circumstances in which those acts occurred.

Adverse Finding 3: Failure to discuss the Indian Issues with the EQCR

The Respondents failed to discuss the Indian Issues with the EQCR, contrary to ISA 220.19(b)

6.3. In light of the matters set out above, the Respondents breached ISA 220.19(b) by failing to discuss the Indian Issues, which were a "significant matter" within

the meaning of ISA 220, with the EQCR.

Adverse Finding 4: Failure to exercise professional scepticism

The Respondents failed to exercise professional scepticism, contrary to ISA 200.15

6.4. In light of the matters set out above, the Respondents breached ISA 200.15 by failing to exercise professional scepticism during the FY2010 Audit.

6.5. Had the Respondents exercised sufficient professional scepticism then they would have considered further whether to carry out substantive procedures under ISA 330.18, in light of the Indian Issues and evaluated further what, if any, impact the Indian Issues might have had on the FY2010 financial statements.

7. *SANCTIONS*

7.1. The FRC Sanctions Policy (Audit Enforcement Procedure) (the "**Policy**") summarises the approach to determining sanctions, which involves the following steps:

7.1.1. Assess the nature and seriousness, gravity and duration of the breach found by the Decision Maker and the degree of responsibility of the Respondent(s) for the breach;

7.1.2. Identify the sanction or combination of sanctions that the Decision Maker considers potentially appropriate having regard to the breach identified in (a) above;

7.1.3. Consider any relevant aggravating or mitigating circumstances and how those circumstances affect the level, nature or combination of sanctions under consideration;

7.1.4. Consider any further adjustment necessary to achieve the appropriate deterrent effect;

7.1.5. Consider whether a discount for admissions or early disposal is appropriate; and

7.1.6. Decide which sanction(s) to order and the level/duration of the sanction(s) where appropriate.

7.2. Paragraph 11 provides that:

"In determining the appropriate sanction, a Decision Maker should have regard to the reasons for imposing sanctions for a breach of the Relevant Requirements in the context of the Audit Enforcement Procedure. Sanctions are imposed to achieve a number of purposes, namely:

a) 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;

b) 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 of the accountancy profession;

c) to protect the public from Statutory Auditors and Statutory Audit Firms whose conduct has fallen short of the Relevant Requirements; and

d) to deter Statutory Auditors and Statutory Audit Firms from breaching the Relevant Requirements relating to statutory audit."

7.3. Paragraph 12 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.

KPMG

7.4. Executive Counsel imposes the following *Sanctions* against KPMG:

7.4.1. A declaration that the FY2010 Audit report signed on behalf of KPMG did not satisfy the Relevant Requirements, as set out in this *Final Decision Notice*;

7.4.2. A published statement in the form of a severe reprimand;

7.4.3. A financial sanction of £4.5 million discounted for admissions and early disposal by 25% so that the financial sanction payable is £3,375,000. The financial sanction shall be paid no later than 28 days after the date of this *Final Decision Notice*; and

7.4.4. A requirement that KPMG shall commission a review, to be completed within the period of one year from the date of this *Final Decision Notice*, carried out by an external independent person, being a senior specialist

expert in the field of professional compliance with laws and regulations, of the effectiveness of the firm's policies, guidance and procedures for audit work in the area of an audited entity's compliance with laws and regulations. The evidence for that review shall include quality performance reviews of five Statutory Audits completed after the end of 2019, to include two Statutory Audits in which non-compliance with laws and regulations was identified at the audit planning stage as a significant risk and three other Statutory Audits in which non-compliance with laws and regulations was addressed by the auditors. The scope and methodology of the review shall otherwise be agreed with the FRC.

7.5. In reaching this decision, Executive Counsel has, in summary, considered the following matters in accordance with the Policy.

Nature, seriousness, gravity and duration of the breaches

7.6. The area of audit work relevant to the breaches set out in this *Final Decision Notice*, namely non-compliance with laws and regulations, is fundamental to *Statutory Audits* and it is of the utmost importance that it is audited in accordance with *Relevant Requirements*. As noted in this *Final Decision Notice*, allegations of bribery and malpractice through the use of intermediaries and 'advisers' in the defence field were prominent, including that in March 2010 [Defence Company A] paid large fines to settle US and UK criminal investigations resulting from the use of intermediaries. KPMG were well aware of these matters having also been auditors of [Defence Company A].

7.7. The breaches of *Relevant Requirements* that are set out in this *Final Decision Notice* (the "**breaches**") were serious, taking account, in particular, of the finding of a failure to exercise appropriate professional scepticism and to obtain and document evidence concerning an instance of suspected bribery and corruption. The breaches included failing to hold any discussion of key issues with the EQCR partner or to put information on the audit file which would have enabled the EQCR to identify for himself that the issues had arisen or that any judgments had been made as to how the issues would be treated in the context of the audit.

7.8. The Respondents' failure to conduct this aspect of the FY2010 Audit in accordance with *Relevant Requirements* could harm investor, market and public confidence in the truth and fairness of the financial statements published by *Statutory Audit*ors or *Statutory Audit Firms*. The fact that the Respondents failed to conduct this aspect of the audit of a Public Interest Entity in accordance with *Relevant Requirements* could harm confidence in the conduct of those who conduct *Statutory Audits* more generally.

7.9. However, the breaches relate only to one audit year; the *Decision Notice* does not make a finding that the FY2010 financial statements were in fact misstated; none of the breaches was dishonest, deliberate or reckless; and the Respondents did not derive any financial benefit from the breaches, aside from the audit fees.

7.10. Executive Counsel considers that remedial action is necessary to address the risk that failures of the same kind as the breaches will occur in future.

Identification of *Sanction*

7.11. Having assessed the nature, seriousness, gravity and duration of the breaches, Executive Counsel has identified the combination of *Sanctions* set out at paragraph 7.4 above as appropriate.

7.12. 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

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

Mitigating factors

7.14. There are no mitigating factors that have not already been considered in the context of the seriousness of the breaches. KPMG has provided the level of co-operation required by the AEP, but not the exceptional level that would warrant a discount to the financial sanction.

Deterrence

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

Discount for Admissions and Settlement

7.16. Having taken into account the full admissions by KPMG and the stage at which those admissions were made (within Stage 1 of the case in accordance with paragraph 84 of the Policy), Executive Counsel determined that a reduction of 25% as to the financial sanction is appropriate, such that a financial sanction of £3,375,000 is payable.

Other considerations

7.17. In accordance with paragraph 47(c) of the Policy, Executive Counsel has taken into account the size / financial resources and financial strength of KPMG and the effect of a financial sanction on its business. and whether any financial sanction would be covered by insurance.

MR SYKES

7.18. Executive Counsel imposes the following *Sanctions* against Mr Sykes:

7.18.1. A declaration that the audit report signed by Mr Sykes on behalf of KPMG in respect of the Audit did not satisfy the *Relevant Requirements* as set out in the *Decision Notice*;

7.18.2. A published statement, in the form of a severe reprimand, to the effect that Mr Sykes contravened *Relevant Requirements* in the Audit; and

7.18.3. A financial *sanction* of £150,000, adjusted for admissions and early disposal by 25%, resulting in a financial *sanction* to be paid of £112,500.

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

Nature, seriousness, gravity and duration of the breaches

7.20. The considerations set out in paragraphs 7.6 to 7.10 above apply to both Respondents. Furthermore, Mr Sykes bore a high degree of personal responsibility for the commission of the breaches.

Identification of *Sanction*

7.21. Having assessed the nature, seriousness, gravity and duration of the breaches, Executive Counsel has identified the combination of *Sanctions* aet out at paragraph 7.18 above as appropriate.

7.22. 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

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

Mitigating factors

7.24. There are no mitigating factors that have not already been considered in the context of the seriousness of the breaches. Mr Sykes has provided the level of co-operation required by the AEP, but not the exceptional level that would warrant a discount to the financial sanction.

Deterrence

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

Discount for Admissions and Settlement

7.26. Having taken into account the full admissions by Mr Sykes and the stage at which those admissions were made (within Stage 1 of the case in accordance with paragraph 84 of the Policy), Executive Counsel determined that a reduction of 25% as to the financial sanction is appropriate, such that a financial sanction of £112,500 is payable.

Other considerations

7.27. In accordance with paragraph 47(d) of the Policy, Executive Counsel has taken into account the financial resources and annual income of Mr Sykes, the effect

of a financial sanction on Mr Sykes and his future employment, and whether he is insured as to any financial sanction.

8. COSTS

8.1. Executive Counsel requires the Respondents to pay her costs of £726,000. Such costs shall be paid no later than 28 days after the date of this *Final Decision Notice*.

Signed:

Claudia Mortimore

DEPUTY EXECUTIVE COUNSEL

Date: 24 December 2021

Schedule 1 – Applicable Relevant Requirements

Extracts from ISAs

1. ISA 200: Overall Objectives of 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. (Ref: Para. A18-A22)"

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

2.1. Paragraph 19 states as follows:

"For audits of financial statements of listed entities, and those other audit engagements, if any, for which the firm has determined that an engagement quality control review is required, the engagement partner shall:

(a) Determine that an engagement quality control reviewer has been appointed;

(b) Discuss significant matters arising during the audit engagement, including those identified during the engagement quality control review, with the engagement quality control reviewer; and

(c) Not date the auditor's report until the completion of the engagement quality control review. (Ref: Para. A23-A25)"

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: (Ref: Para. A2-A5, A16-A17)

(a) The nature, timing and extent of the audit procedures performed to comply with the ISAs (UK and Ireland) and applicable legal and regulatory requirements; (Ref: Para. A6-A7)

(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.0 (Ref: Para. A8-A11)"

3.2. Paragraph 9 states as follows:

"In documenting the nature, timing and extent of audit procedures performed, the auditor shall record:

(a) The identifying characteristics of the specific items or matters tested; (Ref: Para.A12)

(b) Who performed the audit work and the date such work was completed; and

(c) Who reviewed the audit work performed and the date and extent of such review. (Ref: Para. A13)"

3.3. Paragraph 10 states as follows:

"The auditor shall document discussions of significant matters with management, those charged with governance, and others, including the nature of the significant matters discussed and when and with whom the discussions took place. (Ref: Para.A14)"

4. ISA 250A: Consideration of Laws and Regulations in an Audit of Financial Statements

4.1. Paragraph 18 states as follows:

"If the auditor becomes aware of information concerning an instance of noncompliance or suspected non-compliance with laws and regulations, the auditor shall obtain: (Ref: Para.A13)

(a) An understanding of the nature of the act and the circumstances in which it has occurred; and

(b) Further information to evaluate the possible effect on the financial statements. (Ref: Para. A14)"

4.2. Paragraph 29 states as follows:

"The auditor shall include in the audit documentation identified or suspected noncompliance with laws and regulations and the results of discussion with management and, where applicable, those charged with governance and other parties outside the entity. (Ref: Para. A21)"

5. ISA 330: The Auditor's Responses to Assessed Risk

5.1. Paragraph 18 states as follows:

"Irrespective of the assessed risks of material misstatement, the auditor shall design and perform substantive procedures for each

material class of transactions, account balance, and disclosure. (Ref: Para. A42-A47)"

6. ISA 500: Audit Evidence

6.1. 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. (Ref: Para. A1-A25)"

6.2. Paragraph 8 states as follows:

"If information to be used as audit evidence has been prepared using the work of a management's expert, the auditor shall, to the extent necessary, having regard to the significance of that expert's work for the auditor's purposes,: (Ref: Para. A34-A36)

(a) Evaluate the competence, capabilities and objectivity of that expert; (Ref: Para.A37-A43)

(b) Obtain an understanding of the work of that expert; and (Ref: Para. A44-A47)

(c) Evaluate the appropriateness of that expert's work as audit evidence for the relevant assertion. (Ref: Para. A48)