Edited for publication

IN THE MATTER OF

THE EXECUTIVE COUNSEL OF THE FINANCIAL REPORTING COUNCIL

-and-

(1) ERNST & YOUNG LLP

(2) NEIL PARKER

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.

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**"), revised in June 2023. 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 defined terms are used, they appear in italics.

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

1.3.1. "**FY2017**" means the financial year ended 30 April 2017, "**FY2017 Financial Statements**" means the financial statements of London Capital & Finance PLC (**"LCF"**) for that period, and "**FY2017 Audit**" means the statutory audit of the FY2017 Financial Statements.

1.3.2. **“Respondents”** means:

1.3.2.1. Ernst & Young LLP (**“EY”**), which was the *Statutory Audit Firm* for the FY2017 Audit; and

1.3.2.2. Neil Parker, who was the *Statutory Auditor* for the FY2017 Audit, and signed the FY2017 Audit report on behalf of EY.

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

1.5. A *Proposed Settlement Decision Notice* was issued by Executive Counsel on 30 November 2023 pursuant to Rule 103 of the AEP in relation to the conduct of the Respondents in respect of the FY2017 Audit. The Respondents provided written agreement to the *Proposed Settlement Decision Notice* on 15 December 2023, pursuant to Rule 105 of the AEP. The *Convener* subsequently appointed an *Independent Reviewer* to consider the *Proposed Settlement Decision Notice*, pursuant to Rule 106 of the AEP.

1.6. On 29 December 2023 the *Independent Reviewer* approved the issuance of a *Final Settlement Decision Notice* pursuant to Rule 107(a) of the AEP.

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

1.7.1. the breaches of *Relevant Requirement(s)*, with reasons;

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

1.7.3. the amount payable in respect of Executive Counsel’s Costs.

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

1.8.1. Section 2: Executive Summary of the breaches of *Relevant Requirements*;

1.8.2. Section 3: Background;

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

1.8.4. Section 5: Detail of the breaches of *Relevant Requirements*;

1.8.5. Section 6: *Sanctions*;

1.8.6. Section 7: Costs.

2. EXECUTIVE SUMMARY OF THE BREACHES OF *RELEVANT REQUIREMENTS*

2.1. LCF’s business involved issuing private bonds to retail investors and lending the proceeds to a small number of commercial clients. LCF went into administration just under a year after the FY2017 Audit was concluded. By that stage, LCF had issued bonds with a total value of about £237m, to 11,625 individual investors.

2.2. LCF's borrowers were unable to repay their loans, leaving bondholders with significant losses. These have been partly reimbursed by compensation schemes funded by the financial services industry and the taxpayer. The Serious Fraud Office (the **"SFO"**) has begun a criminal investigation on the basis of suspicion that LCF's bondholders may have been defrauded, but no finding to that effect has been made by any court.

2.3. Against that background, this *Final Settlement Decision Notice* sets out breaches of *Relevant Requirements* in relation to the following matters:

2.3.1. Identifying and assessing the risk of material misstatement

2.3.1.1. The Respondents failed to gain an adequate understanding of the nature of LCF's business, including: (i) the small number and interconnectedness of its borrowers, (ii) the liquidity of the borrowers, (iii) the commercial implications of the terms under which funds were lent, (iv) the extent to which the maturity of the loans matched that of the bonds issued by LCF, and (v) the heightened risks arising from LCF's high debt ratio.

2.3.1.2. Further, the Respondents failed to evaluate the design and implementation of LCF's internal controls adequately, with particular regard to the controls in relation to: (i) the loan initiation process, (ii) loan set up fees and amortisations, (iii) bond issuance, (iv) bond redemption and rollover, and (v) cash receipts.

2.3.1.3. An adequate understanding of these matters is essential for an auditor to be able to identify and assess risks of material misstatement in the financial statements.

2.3.2. Exercise of professional skepticism and the risk of fraud

2.3.2.1. The Respondents failed to apply adequate professional skepticism in respect of: (i) the degree of control exercised by the managing director of LCF, and the reliance that could be placed on information provided by him, (ii) the commerciality of LCF's business model and operations, and (iii) LCF's cash flows and liquidity. All of these matters were relevant to the possibility of material misstatement due to fraud.

2.3.2.2. Further, the Respondents failed properly to execute the audit procedures that they had designed in response to the assessed risk of fraud, with particular regard to the recoverability of LCF's loans.

2.3.3. Loan debtors

The Respondents failed to design and perform audit procedures to obtain sufficient appropriate audit evidence in relation to LCF's borrowers, and particularly in relation to: (i) the existence and quantum of the loans, (ii) the interest payable, (iii) the nature and effect of the collateral by which the loans were secured, and (iv) the potential impairment of the loans.

2.3.4. Bond creditors

The Respondents failed to design and perform audit procedures to obtain sufficient appropriate audit evidence in relation to LCF's bondholders, and particularly in relation to whether the amounts recorded as owing to bondholders and as having been repaid to them were not materially misstated.

2.3.5. Going concern

The Respondents failed adequately to consider and document the appropriateness of LCF's preparation of the financial statements on the assumption that the company was able to continue as a going concern, and in particular the impact of the issues affecting the company's liquidity.

2.3.6. Related parties

The Respondents failed to remain alert to the existence of undisclosed transactions between LCF and related parties. As a result, the Respondents failed to identify two such related party transactions: (i) one of LCF's loans, which was made to a company of which LCF's managing director was a director, and (ii) LCF's purchase of information technology services from a company run by another of LCF's directors.

2.4. Section 5 of this *Final Settlement Decision Notice* sets out the detail of the breaches of *Relevant Requirements.*

2.5. This *Final Settlement Decision Notice* sets out the following *Sanctions* imposed on the Respondents.

Against EY:

2.5.1. A financial penalty of £7,000,000, adjusted for aggravating and mitigating factors (in particular reflecting an exceptional level of co-operation) by a reduction of 10%, and further discounted for admissions and early disposal by 30% so that the financial penalty payable is £4,410,000;

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

2.5.3. A declaration that the FY2017 Audit report did not satisfy the *Relevant Requirements*, as set out in this *Final Settlement Decision Notice*; and

2.5.4. An order requiring EY to take the following action which is designed to prevent the recurrence of the contravention:

2.5.4.1. Within 3 months of the date of the *Final Settlement Decision Notice*, provide a report to the FRC (the "**First Report**") which:

(a) identifies improvement measures taken by EY since the FY2017 Audit with regard to: (i) audit client acceptance, (ii) review of audit portfolios, and (iii) auditor training on professional scepticism and understanding the audited entity; and

(b) makes proposals for the assessment, by EY, of the extent to which those measures have addressed the specific shortcomings in the FY2017 Audit.

2.5.4.2. By such deadline as may be agreed by the FRC, which shall not be later than 18 months after the date of the *Final Settlement Decision Notice*:

(a) carry out the assessment of the improvement measures identified in the First Report, in a manner agreed by the FRC; and

(b) provide a further report (the "**Second Report**") which: (i) sets out the results of the assessment, and (ii) either identifies any further measures that EY intends to take to address the shortcomings, or explains why no such further measures are necessary.

2.5.4.3. Provide any further information or report, in connection with or as a result of the Second Report, as required by the FRC.

<u>Against Neil Parker:</u>

2.5.5. A financial penalty of £75,000, adjusted for aggravating and mitigating factors (in particular reflecting an exceptional level of co-operation) by a reduction of 10%, and further discounted for admissions and early disposal by 30% so that the financial penalty payable is £47,250;

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

2.5.7. A declaration that the FY2017 Audit report did not satisfy the *Relevant Requirements*, as set out in this *Final Settlement Decision Notice*.

3. BACKGROUND

The Respondents

3.1. In 2017 EY was, and remains, the third largest audit firm in the UK by revenue. In 2021-22 its total fee income for audit work was about £595m, and its total fee income for all work was about £2,754m.

3.2. Mr Parker joined EY in September 2002 and became a Responsible Individual (**"RI"**) qualified to sign statutory audit opinions in November 2015. He was, and remains, an employee of EY rather than an equity partner in the firm. His job title at the time of the FY2017 Audit was Associate Partner (since changed to 'Partner', with no change to his status as an employee).

The FY2017 Audit

3.3. The FY2017 Audit was the first carried out for LCF by EY. The previous year's audit had been carried out by another of the "Big Four" largest UK accountancy firms. Before that, the only audit was of one month's financial statements, carried out by the accountants who had prepared the financial statements (and who continued to provide accountancy services to LCF, including preparing the FY2017 Financial Statements). These two previous audits by different firms are the subject of separate investigations by the FRC.

3.4. The FY2017 Financial Statements reported as follows, in respect of the nature and scale of LCF's business:

> *"The company's principal activities during the period continue to be raising funding through the issuance of medium term private bonds to retail investors and then lending the proceeds of the bonds to medium sized businesses on a fully secured basis. The company is regulated by the Financial Conduct Authority.*
>
> *During the year the company issued bonds with an aggregate par value of £53,397,157 (2016: £9,269,143) and redeemed bonds with a par value of £2,444,954 (2016: £664,463). During the year the company also issued loans with an aggregate value of £50,392,963 (2016: £8,731,220) and redeemed loans with a par value of £488,500 (2016: £688,960). At year end, the company had a total of 11 corporate borrowers (2016: 5). Loans issued have an average maturity profile of three years."*

3.5. The FY2017 Financial Statements reported both total assets and liabilities of just over £50m (2016: just over £10m), almost exclusively the bond debtors and loan creditors referred to above, with total equity of £298,827 (2016: £25,592). Revenue of £7,822,771 (2016: £948,202) and post-tax profits of £273,234 (2016: £166,916) were reported for the year. The financial statements were signed by LCF Director A, one of six directors of the company during FY2017, and the sole beneficial owner of the company's shares.

3.6. The Respondents issued an unqualified audit opinion on the financial statements on 14 February 2018. The fee for carrying out the audit, as disclosed in the FY2017 Financial Statements, was £85,000.

Events after the FY2017 Audit

3.7. LCF's promotion of its bonds was regulated by the Financial Conduct Authority (**"FCA"**). LCF went into administration on 30 January 2019, after the FCA imposed restrictions on LCF's ability to issue or approve further financial promotions, and subsequently called into question the viability of LCF's business. The FCA's intervention was prompted by serious concerns regarding LCF's conduct, including issues with the accuracy of the firm's financial promotions. This was just under a year after the FY2017 Audit was concluded. By the time it entered administration, LCF had issued bonds with a total value of about £237m, to 11,625 individual investors.

3.8. LCF's administrators reported that the company had limited immediately realisable assets, and its borrowers were unable to repay their loans. The administrators' latest estimate is that the total return to secured creditors (including bondholders) will be in the range of 10% to 18%, and it is not anticipated that there will be a surplus to enable a dividend to be paid to unsecured creditors. Total compensation of about £172m has been paid to LCF bondholders by the Financial Services Compensation Scheme (**"FSCS"**), either under the general statutory compensation scheme funded by the financial services industry or under a bespoke scheme set up by the Government specifically for LCF investors.

3.9. LCF's administrators also reported that large sums of bondholders' money ended up in the personal possession of a small group of individuals connected to each other and to LCF, as a result of a number of highly suspicious transactions. The administrators have begun legal proceedings to try to recover this money. The SFO has also begun a criminal investigation, in conjunction with the FCA, into individuals associated with LCF. The conduct relates to LCF investments offered between 2013 and 2018. It is suspected that actions relating to the sale of LCF bonds may have been fraudulent, but this question has not been decided by any court to date.

4. *RELEVANT REQUIREMENTS*

4.1. 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 ("**SATCAR**"). The *Relevant Requirements* applicable to the FY2017 Audit include, but are not limited to, the International Standards on Auditing (UK and Ireland) ("**ISAs**") issued by the FRC.

4.2. The ISAs 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 230 (Audit documentation);

4.2.3. ISA 240 (The auditor's responsibilities relating to fraud in an audit of financial statements);

4.2.4. ISA 315 (Identifying and assessing the risks of material misstatement through understanding the entity and its environment):

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

4.2.6. ISA 500 (Audit evidence);

4.2.7. ISA 550 (Related parties); and

4.2.8. ISA 570 (Going Concern).

4.3. The relevant versions of the ISAs are those effective for audits of financial statements for periods ending on or after 15 December 2010, except in the case of ISA 570, where the relevant version is that effective for audits of financial statements for periods commencing on or after 1 October 2014.

4.4. Those parts of the ISAs which are of particular relevance to the breaches of *Relevant Requirements* are set out as an **Appendix** to this *Final Settlement Decision Notice*.

4.5. As the Senior *Statutory Auditor* responsible for the Audit, Mr Parker was responsible for the overall quality of the Audit, and the direction, supervision, and performance of the Audit in compliance with professional standards and applicable legal and regulatory requirements.

4.6. As the *Statutory Audit Firm* responsible for the Audit, EY is responsible for any established breaches of Relevant Requirements on the part of its employees.

5. BREACHES OF *RELEVANT REQUIREMENTS*

<u>Breach 1 – Failure to identify risk of fraud or material misstatement</u>

<u>Understanding the entity and its environment</u>

5.1. Paragraph 11 of ISA 315 required the Respondents to gain an adequate understanding of the nature of LCF (including its operations, ownership, governance structures, investments and the way in which it was financed), and the business risks arising from LCF's objectives and strategies. The purpose was to provide a basis for the identification and assessment of risks of material misstatement in LCF's financial statements. During the audit planning stage, the audit team based its initial understanding of the LCF business on enquiries of management (in particular, LCF Director A as the individual with day-to-day operational responsibility) and a review of high-level documentation.

Number and interconnectedness of borrowers

5.2. The audit team failed to gain an understanding during the initial audit planning stage of the risks created by LCF's loan debtor balance being concentrated in a small number of borrowers, and the fact that those risks were heightened by the connections between LCF and its loan debtors.

5.3. The audit team did not understand fully the interconnections between LCF and its loan debtors:

5.3.1. LCF had eleven loan debtors during FY2017 – ten companies and one individual.

5.3.2. Four of those companies were wholly owned subsidiaries of a Limited Liability Partnership with a membership consisting of two individuals – Member A and Member B. Member A was a director of five of the other companies, and Member B was a director of four of the other companies, during FY2017.

5.3.3. LCF Director A was a director of one of the companies during FY2017 (which made it a related party) and had served as a director of two of the other companies prior to FY2017. All of LCF Director A's directorships overlapped with Member A's. Moreover, LCF Director A held a significant number of non-voting shares in the parent company of two of the loan debtors.

5.3.4. None of this was noted in the audit team's planning documents.

5.3.5. The audit team was told by LCF Director A that the loan portfolio consisted of a small number of high value loans sourced from his business associates. It was reasonable for the audit team to place a degree of reliance on representations from LCF Director A at the planning stage of the audit, but they should have done further work to understand the detail underlying the incomplete information provided.

5.3.6. The audit team gained a greater appreciation of the interconnections between LCF's loan debtors over the course of the audit, revisited their conclusions from the initial planning stage, and documented their findings. However, this did not prompt any reassessment of engagement risk or audit risks for the FY2017 Audit.

5.3.7. The audit team appear therefore not to have appreciated the risks posed by those interconnections, even when they had a better view of who LCF's loan debtors were.

Liquidity of borrowers

5.4. The audit team failed to gain an understanding of the liquidity of LCF's loan debtors and their ability to repay their loans, both of which were critical to LCF's ability to repay bond holders. In particular:

5.4.1. The audit team failed to gain an understanding of whether LCF monitored the liquidity of its loan debtors, as LCF Director A stated it did. While the audit team planned to obtain financial information on borrowers, it is not clear what, if any, information was obtained.

5.4.2. The fact that most of LCF's loans were repayable at 14 days' notice was essential to the company's ability to meet any maturing bond creditors, but the audit team did not make any assessment of the borrowers' ability to repay the loans on call.

Lending terms

5.5. The audit team failed to gain an understanding of the commercial implications of the terms on which loans were made by LCF. The loans made by the company had higher levels of interest that might tend to indicate that the borrowers were unable to raise finance by other means, and therefore suggest a higher risk of default inherent in those loans. Commission expenses reduced the funds available to make loans, and thereby increased the returns required from the portfolio of loans so that the company could meet its obligations to bondholders.

5.6. The audit team failed to consider whether loans were made on commercial terms. The costs of finance noted above amounted to 34.22% of the amounts advanced to borrowers. So, for example, a company that borrowed £100,000 from LCF would owe a principal sum of £134,220 once the £100,000 had been advanced. Interest was then to be charged on that principal sum. The audit team failed to gain an understanding of why borrowers were willing to borrow at such a high cost.

Liquidity of LCF

5.7. The audit team failed to take proper account of LCF's high debt ratio (the ratio of the company's debts to its assets). While a high debt ratio would be expected from a business model like LCF's (essentially, borrowing money from bondholders in order to lend it on to businesses at a higher rate), the audit team ought to have appreciated that it heightened the risks arising from the terms of LCF's lending, the nature of its debtors and their ability to service their debt, because the company was wholly reliant on those debtors meeting their obligations to it.

5.8. To the extent that this failure was based on the audit team's understanding that the maturity profile of LCF's loans was matched to that of its bonds, and that this was monitored by the company, the audit team failed to gain an adequate understanding of the extent to which maturity was actually matched and monitored in practice.

Conclusion

5.9. It follows that, in breach of paragraph 11 of ISA 315, the Respondents failed to obtain an adequate understanding of the nature of LCF, including its operations, how it was financed, and the business risks arising from its objectives and strategies which may have resulted in risks of material misstatement.

Internal control environment

5.10. The audit team did not place reliance on LCF's internal controls for audit purposes, and instead performed a fully substantive audit. However, paragraphs 12 and 13 of ISA 315 still required the Respondents to obtain an understanding of LCF's internal controls relevant to the audit, to evaluate the design of those controls, and to determine whether they had been implemented. The audit team predominantly obtained their understanding of internal controls from enquiries of management (including LCF Director A). While it was reasonable for the audit team to place a degree of reliance on statements made and information provided by LCF Director A, at least at the planning stage, the team placed undue weight on information provided by him, in particular in relation to aspects of the audit over which he was able to override existing controls or other procedures, and should have done further work to validate the representations LCF Director A had made.

Loan initiation process

5.11. While the audit team relied upon LCF's legal advisers to understand the process by which LCF checked the details of potential borrowers and the security offered for the loans, the team did not consider the role of the legal advisers in relation to loan initiation to be a relevant control for the purposes of paragraphs 12 and 13 of ISA 315. In fact the role of LCF's legal advisers was relevant to the audit, as there would be a heightened risk of management override and potential fraud in the absence of the involvement of the lawyers, and verifying that the borrowers had good title to assets which had purportedly been offered as security was fundamental to assessing the recoverability of the loans.

5.12. However, the written information provided by LCF's lawyer as to the checks that he conducted did not tally with what he had apparently told the audit team in an undocumented meeting. The lawyer was only willing to confirm in writing that he would do a "*quick check*" on the Companies House website to determine the existence of companies and confirm who the appointed directors were. He gave no written confirmation that he had checked the validity of the alleged security.

5.13. The audit team were also told that LCF Director A would review documentation for potential borrowers and request documentation as necessary. There is no record of the audit team having seen evidence that this process was in fact in place, or having assessed its efficacy. It follows that the audit team failed to understand how controls over loan initiation operated, and whether they had, in fact, been implemented.

Loan set up fee and amortisations

5.14. The audit team recorded that an employee of LCF ("LCF Employee A") would reconcile cash received for fees pertaining to loans with LCF's entitlement to the fees. That could not have happened, since loan set up fees were not paid by loan debtors to LCF in cash – they were added to the borrower's loan balance. Similarly, the control of having an employee calculate LCF's entitlement to a fee by reference to underlying loan documentation (as recorded by the audit team) could not have been in place. All of the loan agreements (save one) failed to specify the amount of the cost of borrowing fee. The audit team recorded that LCF's accountants would independently calculate interest and cost of borrowing fees, discuss their figures with LCF and resolve any differences. There is no record of the audit team having seen evidence that any such control was operated.

Bond issuance controls

5.15. The issuance of bonds was handled by two third-party suppliers. There is no record of the audit team having evaluated the design or implementation of controls put in place by those suppliers.

Bond redemption/rollover controls

5.16. There was no control in place at LCF to ensure that payment was made back to a bondholder's correct bank account. As a result, there was no adequate assurance that bonds were being correctly repaid. The audit team ought to have been alive to this omission.

Cash receipts controls

5.17. The audit team did not check that the controls it recorded as being in place in relation to cash receipts were, in fact, in place and effective.

Conclusion

5.18. The Respondents' conduct thereby breached paragraphs 12 and 13 of ISA 315 by failing to obtain an adequate understanding of LCF's internal controls relevant to the audit, and failing adequately to evaluate those controls.

Breach 2 – Exercise of professional skepticism and risk of fraud

Professional skepticism

5.19. An auditor is required to plan and perform an audit with professional skepticism, recognising that circumstances may exist that cause the financial statements to be materially misstated.[1] Auditors are required to recognise the possibility that fraud could give rise to a material misstatement[2], notwithstanding the auditor's past experience of the honesty and integrity of an entity's management. As part of the planning of an audit, the discussion among the auditor's engagement team must place particular emphasis on how and where an entity's financial statements may be susceptible to material misstatement due to fraud, including how fraud may occur.[3]

Role of LCF Director A

5.20. LCF Director A had, in effect, sole control of LCF. He was also the only director of LCF with whom the audit team would regularly communicate. This gave rise to a clear risk of management override of internal controls. For example, LCF Director A had the ability

[1] Paragraph 15 of ISA 200.
[2] ISA 240, para 12, clarifying ISA 200.
[3] ISA 240, para 15,

to authorise loans to entities which might have had difficulties raising funds from another source. The ability of those entities to repay loans, and the uses to which they would put the loaned funds, were not subject to any further scrutiny from within LCF.

5.21. Given LCF Director A's role as a director of LCF and his level of involvement in the operations of the business, it was reasonable for the audit team to place a degree of reliance on statements made and information provided by him, at least at the planning stage. However, the audit team placed undue weight on information provided by LCF Director A, in particular in relation to aspects of the audit over which he was able to override existing controls or other procedures, and thereby failed to exercise an appropriate level of professional skepticism.

LCF business model

5.22. The commercial rationale of LCF's business model was not obvious. Some of the reasons for this have already been mentioned in the context of Breach 1 above. LCF paid exceptionally high costs to obtain debt finance and had minimal capital of its own. Those costs were then passed on to LCF's borrowers, on the basis of loan agreements which allowed LCF to add an unspecified amount in respect of the cost of borrowing to the loan balances. The charges applied were exceptionally high for loans that were supposed to have been fully secured, and the specific amounts do not appear to have been notified to, or agreed by, the borrowers. What is more, LCF lent funds to a small number of businesses with little or no financial track record in circumstances where all except one of those businesses was controlled by two individuals with whom LCF Director A had previously been a co-director and/or shareholder.

5.23. As noted above in relation to Breach 1, these interconnections were not initially appreciated by the audit team, and when they were, they did not prompt any reassessment of engagement risk or audit risks for the FY2017 Audit. The audit team accepted LCF Director A's representation that loan debtors had been sourced from LCF Director A's personal contacts.

5.24. The commercial rationale of the restructuring arrangement that took place one day before the end of LCF's accounting period was not clear. In that restructuring, LCF's largest debtor ("Company A") apparently assigned the entirety of its debt to a series of newly formed companies. There is no record that the audit team inspected any evidence in relation to the assignment of debt. It appears that the audit team relied solely on an explanation from LCF's management, several facility agreements with the companies which were said to have taken over the obligation, and related debentures (which the audit team failed adequately to consider, as set out under Breach 3 below).

5.25. It was unclear what, if any, due diligence enquiries were carried out in relation to security provided in relation to loans made by LCF. LCF Director A did not provide documentation to evidence the processes he said were in place to assess this. Moreover, LCF's lawyer declined to confirm in writing that he had verified that the assets allegedly charged to secure the loans made by LCF were actually owned by the borrowers, although according to the Respondents he had stated this in an earlier, unrecorded meeting with the audit team.

Cash flow and liquidity

5.26. A fundamental risk in LCF's business model was that bond cash outflows were not matched by cash inflows from the loan assets. Absent a clear understanding of how that risk would be met, an auditor considering the matter with an appropriate degree of professional skepticism would call into question the going concern assumption.

5.27. While management initially explained to the audit team that loans and bonds were matched by their maturity dates, as alluded to under Breach 1 above, it should have quickly become apparent that this was incorrect. LCF issued fixed term bonds. However, the loans LCF advanced were (mostly) repayable on the earlier of 14 days' notice from LCF or the third anniversary of the date of the agreement. It follows that the maturity profile of a loan was unlikely to match the maturity profile of any given bond.

5.28. An auditor applying an adequate degree of professional skepticism would therefore have raised questions about how, precisely, LCF managed its cash flow to address the mismatch in the maturity of mini-bonds and loan assets. Limited work was undertaken to address that issue. Notably, the audit team were content to conclude the FY2017 Audit without having seen a cashflow forecast. While the Relevant Requirements do not mandate the use of a cashflow forecast, LCF's business model made it next to impossible to assess the risk created by mismatched maturity profiles without one. Moreover, the audit team recorded in their working papers that "*bonds are matched to the loan on a one-to-one basis*". It appears that the audit team never fully worked through the issues pertaining to the matching of bonds to loans.

5.29. The Respondents' conduct thereby breached paragraph 15 of ISA 200 and paragraph 12 of ISA 240.

<u>Responding to assessed risk of fraud</u>

5.30. Having identified a risk of fraud, the auditor is required to design and execute audit procedures that are responsive to that risk. In this context, the audit team's proposed response to the risk of loan impairment comprised six points, namely to:

5.30.1. obtain management's understanding of the operations, financial performance, and behaviour of LCF's loan debtors;

5.30.2. assess whether there was any evidence that borrowers were unable to service their debts;

5.30.3. review credit and collateral agreements with a view to understanding the nature of collateral obtained and whether it could be enforced;

5.30.4. obtain third party valuations of collateral and recalculate loan-to-value ratio;

5.30.5. obtain the latest available financial information on loan debtors and analyse whether they had sufficient resources to generate income to pay principal and interest; and

5.30.6. prepare and complete a checklist of impairment indicators as set out in IAS 39.

5.31. These six actions relate to a number of aspects of the audit team's substantive procedures which are addressed in further detail elsewhere in this *Final Settlement Decision Notice*. In short, none of those actions was adequately completed. The Respondents' conduct thereby breached paragraph 26 of ISA 330, in that they incorrectly concluded that sufficient appropriate audit evidence had been obtained.

Breach 3 – Loan Debtors

5.32. LCF had eleven loan debtors during FY2017. The loan balances for five companies were created on 29 April 2017 as part of a restructuring process. As part of that process, the debts of three previous loan debtors were extinguished. The remaining debtors were an individual whose borrowing from LCF began in 2015 ("Individual A") and two companies which first borrowed money from LCF in 2013 and 2015 respectively ("Company B" and "Company C").

5.33. Auditors are required to design and perform audit procedures to obtain sufficient audit evidence in relation to loan debtors, and particularly in relation to: the existence and quantum of loans, the interest payable, the nature and effect of collateral by which loans are secured, and potential impairment of loans. The audit team performed substantive audit procedures over LCF's entire loan portfolio, but that work was deficient as set out below.

Loan existence

5.34. The audit working papers stated that loans were to be agreed to drawdown notices, and Mr Parker's recollection is that the audit team performed these procedures. However, the results of this testing were not recorded, and the work recorded on individual items tested indicates that drawdowns in relation to the pre-restructuring loans were only agreed to bank statements. Bank statements do not provide adequate evidence that the figures listed on those statements constitute loans to the payee, rather than payments for some other purpose. While the audit team had been provided with signed loan facility agreements for all the loans, without having recorded their work in relation to the drawdown notices, or confirming the loans with the borrowers, the audit team did not retain sufficient audit evidence that the loans existed.

5.35. The loan balances post-restructuring were said to have been the result of the assignment of pre-existing loans. Consequently, it would not have been possible to confirm the post-restructuring loan balances by reference to drawdown notices. Instead, the audit team ought to have assured itself that the loans existed by confirming that an assignment had taken place. However, beyond the explanations for the restructuring provided by LCF Director A, the audit team saw no documentation supporting the assignment of the loans. The circumstances of the restructuring ought to have raised questions about how and why the balances were assigned:

5.35.1. It was unclear which pre-restructuring debtor's loan balance had been assigned to each new loan debtor – the figures did not map straightforwardly.

5.35.2. There was a shortfall of approximately £418,000. Although this balance was recorded as having been written off in the accounting records provided to the audit team, no reason was given for the waiver.

5.35.3. There was no clear commercial logic for assigning the loans.

5.36. In the circumstances, and absent seeing any documentary evidence of assignment or receiving confirmation from debtors about the existence of the new loans, the audit team had no evidential basis on which to conclude that the post-restructuring loan balances existed.

5.37. Therefore, in breach of paragraph 6 of ISA 500, the Respondents failed to design and perform appropriate audit procedures in such a way as to enable the audit team to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions as to whether the loans made by LCF existed.

Loan quantum

5.38. The audit team were unable to obtain direct confirmation of the loan balances from borrowers, due to LCF Director A's reluctance to allow the audit team to send enquiries to the borrowers.

5.39. In relation to pre-restructuring loan debtors, the precise amounts repayable to LCF were not clear on the face of the various loan facility agreements. This was because repayments comprised the amount drawn down, an unspecified cost of borrowing fee, and interest (addressed separately below).

5.40. The audit team accepted LCF's explanation that the cost of borrowing fee comprised commission fees paid to two third-party companies for advertising and management services in relation to the bonds. Those costs were a fixed percentage of the bonds bought by investors, amounting to 25.5% of the value of the bonds bought. They were consistent with signed contracts between LCF and the two third-party companies that the audit team had obtained, although there was no record that the level of costs had been disclosed to the borrowers.

5.41. The mechanism by which the cost of borrowing fee was charged was, in effect, to add the fee to the principal owed whenever an amount was drawn down by a borrower from LCF. However, the audit team did not confirm with loan debtors that they had accepted these fees.

5.42. Although the audit team performed 'cut off and completeness' testing using loan interest invoices for May 2017 to calculate the notional balance of the new loans as at the end of FY2017, there were nevertheless several further areas of uncertainty in relation to the quantum of the loans:

5.42.1. First, as has already been noted in respect of loan existence, it was not clear which of the original three debtor's debts had been assigned to each of the five new debtors. As has been noted under Breach 2, the audit team did not see any deeds of assignment to support the figures provided by LCF. Instead, the audit team checked the loan figures against the loan facility agreements between LCF and the five new loan debtors. There is no evidence recorded, save for an assertion by LCF's management, that those facility agreements were part of transactions which assigned previous debts owed to LCF.

5.42.2. Secondly, the largest of the new loan debtors ("Company D") was shown in the audit working papers as having a loan balance of £17.5 million. However, Company D agreed in the relevant facility agreement that it had received the sum of £16.4 million. No information is recorded in the audit working papers that accounts for the discrepancy.

5.42.3. Thirdly, the facility agreements for the other four new debtors stated the limit of the facility but did not state what amount, if any, had been drawn down. For three out of the four, the loan figure in the working papers was recorded as the limit of the facility. For the other loan debtor ("Company E"), the debt was recorded as £6.5 million from a £7 million facility.

5.42.4. Fourthly, as noted above, although Mr Parker recalls that such analysis was undertaken, there is no record that the audit team checked the drawdown notices which ought to have been submitted in relation to each drawdown on the loans, to verify the amount advanced.

5.42.5. Fifthly, while certain loan drawdowns were tested by reference to bank statement entries, it has already been noted that this was not a reliable method of testing that the amounts had been drawn down as loans, as opposed to having been paid for some other purpose.

5.43. It follows that the Respondents were not in a position to verify the quantum of the loan debtor balance because, in breach of paragraph 6 of ISA 500, they failed to design and perform appropriate audit procedures in such a way as to enable the audit team to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions as to the amounts owed by LCF's loan debtors.

<u>Loan interest</u>

5.44. The interest rate charged to borrowers was not clear. LCF's facility agreements would typically include a term to the effect that the interest rate would be a fixed rate plus the interest rate agreed between LCF and its funders (i.e. bondholders) who provided the monies to be lent pursuant to the facility. However, bondholders did not all receive the same rate of return.[4] Moreover, bonds were not adequately matched to loans, and it is not clear that it would even have been possible to do so given the maturity mismatch between bond creditors and loan debtors which has already been mentioned. That is all the more apparent after the restructuring of loan debtors.

5.45. In the face of that uncertainty, the audit team calculated a weighted average of interest payable on all bonds (7.1%). The interest due from Company A (LCF's largest pre-restructuring loan debtor) was tested against the weighted average, with immaterial differences being explained by the fact that interest was paid in relation to matched bonds rather than the weighted average. The problem with that approach was that it did not resolve the question of precisely what rate of interest loan debtors were due to pay.

5.46. Moreover, Company A was shown to have paid materially less interest than was due (on the weighted average calculation) by a margin of £387,323. A possible explanation

[4] Between September 2013 and 30 April 2017, LCF issued bonds with fixed interest rates of between 3.9% and 11% and maturity dates ranging from one to five years from the date of issue.

for the discrepancy that should have been considered by the audit team was that the calculated rate of interest was incorrect

5.47. In the face of these uncertainties the audit team ought to have sought to confirm the applicable interest rates with the loan debtors, but did not do so.

5.48. Therefore, in breach of paragraph 6 of ISA 500, the Respondents failed to design and perform appropriate audit procedures to obtain sufficient appropriate audit evidence to ascertain the interest rates being charged to LCF's loan debtors.

<u>Loan collateral</u>

5.49. Each of the contracts by which debts were assigned as part of the restructuring contained similar provisions regarding collateral. The loan from LCF was secured by a deed of debenture which granted LCF a charge over the debtor's assets. The debtor's assets were, effectively, loans made (or loan facilities granted) by the debtor to a third party. Those loans were, in turn, secured or guaranteed.

5.50. In each case, the audit team misinterpreted the contracts and recorded that the security provided for the debtor/third-party loan was, in fact, security for the LCF/debtor loan. In each case, the audit team recorded wrongly that LCF's exposure was sufficiently covered by collateral. In each case, the actual collateral was not ascertained, as the audit team did not have any evidence about the value or existence of the assets in the new companies to which the loans had been assigned and to which the security actually related.

5.51. A similar error occurred in relation to the loan to Company C (one of the companies not affected by the restructuring). The audit team recorded excess collateral of £400m on a loan from LCF of approximately £12m. In fact, from the information available from Companies House at the time, the collateral appeared to be worth £5.5m, considerably less than the value of the loan.

5.52. When considering the value of properties which were (wrongly) thought to be collateral for the loans made by LCF, the audit team placed undue weight on the value of the purported collateral, giving insufficient weight to the liquidity of that collateral, the subjectivity in the valuation of those collateral assets, or other claims on the collateral.

5.53. In relation to the loan to Individual A, the audit team recorded some general information provided by LCF's management about Individual A's ownership of land and other assets, noted that "*LCF has right to call all assets in case default is made*", and concluded that "*collateral sufficiently covers the outstanding exposure*". However, the audit team did not obtain sufficient audit evidence in relation to that collateral.

5.54. The audit team relied on a valuation of a particular category of assets owned by Individual A. No audit procedures were recorded in relation to: i) whether the assets listed were, in fact, owned by Individual A; ii) who carried out the valuation; iii) whether the valuer was independent; iv) whether the approach to valuation reflected realisable value in a forced sale situation; or v) whether a valid charge had been created over the assets, as the audit team appear to have assumed. Mr Parker's recollection is that the audit team confirmed ownership on a sample basis by reference to third party websites, but this testing was not recorded, and it is therefore impossible to assess the extent to which it provided reliable evidence of ownership. The audit team did not check the land registry to establish if LCF (or anyone else) held any charge over Individual A's real property.

5.55. As a result of its errors in understanding the nature of the collateral, the audit team concluded that LCF's post-restructuring lending was adequately secured when there was insufficient evidence upon which to base that conclusion and, in some cases, there was reason to believe that purportedly secured loans were not secured at all. This was a result of: i) relying on the valuation of assets which were not, in fact, collateral for the loans being considered, and ii) not obtaining sufficient appropriate audit evidence in relation to assets which were, in fact, collateral for the loans being considered.

5.56. Therefore, in breach of paragraph 6 of ISA 500, the Respondents failed to design and perform appropriate audit procedures to obtain sufficient appropriate audit evidence to ascertain the nature, value and effect of collateral supporting loans made by LCF; and in breach of paragraph 7 of ISA 500, the Respondents failed to consider the relevance and reliability of the information used as audit evidence in relation to collateral.

Loan impairment

5.57. The points made above in relation to collateral are also relevant to impairment. In circumstance where loans were (or might have been) unsecured, there was a clear impairment risk.

5.58. There is no record that the audit team saw or requested any due diligence enquiries made by LCF to assess the ability of the five new (i.e. post-restructuring) loan debtors to service repayment of their loans.

5.59. There was evidence that the loan to Individual A was £62,210 in arrears. While that figure was not material, it was indicative of a potential impairment issue and ought to have been treated as such.

5.60. There was evidence that the largest pre-restructuring loan debtor was over £380,000 in arrears before the restructuring took place.

5.61. Audit procedures that might be completed for higher risk loans were not planned or executed. The audit team considered that because interest payments were being met there was a lower risk of impairment of the loans. More extensive audit procedures may have led to a better understanding of the businesses to which the company had made loans, and consequently the ability of those businesses to meet their loan obligations, including capital repayments.

5.62. Consequently, the audit team had insufficient audit evidence to conclude, in relation to any of the loan debtors, that there were no impairment triggers. Therefore, in breach of paragraph 6 of ISA 500, the Respondents failed to design and perform appropriate audit procedures to obtain sufficient appropriate audit evidence to ascertain whether the loans made by LCF could have been impaired.

Breach 4 – Bond Creditors

5.63. Auditors are required to design and perform audit procedures to obtain sufficient appropriate audit evidence in relation to creditors (in LCF's case those were largely bond creditors), and particular in relation to whether a company's liabilities are correctly stated, monies paid by creditors have been accounted for, and amounts recorded as having been repaid to creditors were, in fact, repaid.

5.64. In relation to the completeness of LCF's bond creditor liability (i.e. whether the figure recorded as owing to bondholders was correct), the audit team did not carry out any substantive testing to determine whether the stated bond creditor liability was complete. The audit team relied, in effect, on the controls and processes in place at the third-party service providers employed by LCF to market and manage the issuance of bonds to ensure that all monies from investors were properly accounted for. The audit team, therefore, did not have sufficient audit evidence to conclude that LCF's bond creditor liabilities were correctly stated or that monies paid by bond creditors had been accounted for.

5.65. The redemption of bonds required a bondholder to email LCF Employee A with their bank details, so that LCF Employee A could process the repayment of the bond amount to the bondholder. As has already been noted, this was a weakness in LCF's control over the bond redemption process. There is no record of checks being carried out by the senior management of LCF to ensure that amounts recorded by LCF Employee A as paid were actually paid to the bondholders. Moreover, the audit team obtained insufficient audit evidence to provide assurance that these amounts were paid to the relevant bondholders.

5.66. Therefore, in breach of paragraph 6 of ISA 500, the Respondents failed to design and perform appropriate audit procedures to obtain sufficient appropriate audit evidence in relation to bond creditors. That is a breach of the Relevant Requirements, regardless of whether or not bond creditor liabilities were correctly stated in the FY2017 financial statements.

Breach 5 – Going Concern

5.67. Under the going concern basis of accounting, the financial statements are prepared on the assumption that an entity is a going concern and will continue its operations for the foreseeable future. Financial statements are prepared on a going concern basis of accounting unless an entity's management intends to liquidate the entity or to cease trading or has no realistic alternative to liquidation or cessation of operations. An entity's ability to continue as a going concern will therefore determine whether or not it is appropriate for an entity to adopt the going concern basis of accounting.

5.68. Paragraph 10 ISA 570 requires that auditors consider whether there are events or conditions that may cast significant doubt on the entity's ability to continue as a going concern.

5.69. In that respect, the audit team failed adequately to consider LCF's potential liquidity issues which could arise from maturity mismatching (as explained above). They initially understood, wrongly, that the terms of LCF's bonds allowed the company to defer repayment to bondholders. While the audit team later appreciated the true position on this important point, they did not record this. Moreover, the audit team relied, wrongly, on assessments of the collateral supporting loans to borrowers when the key issue was whether borrowers could service their interest and repayment obligations without defaulting on their debts (as explained above). Those issues, properly considered, would have cast significant doubt on LCF's ability to continue as a going concern.

5.70. Therefore, in breach of paragraph 10 of ISA 570, the Respondents failed to consider adequately the appropriateness of management's use of the going concern assumption in the preparation of the FY2017 financial statements. To the extent that the Respondents failed to record their developing understanding of matters underlying the use of the going concern assumption, they also breached the requirement in paragraph 8 of ISA 230 to prepare audit documentation sufficient to enable an understanding of the audit evidence obtained.

Breach 6 – Related Parties

5.71. ISA 550 addresses the risks associated with related party transactions. Although many related party transactions are in the normal course of business, in some instances the nature of related party relationships and transactions may give rise to higher risks of material misstatement of the financial statements than transactions with unrelated parties. The reasons for this include the fact that related parties are not independent of each other, and related party transactions may not be conducted under normal market terms and conditions.

5.72. Paragraph 15 of ISA 550 requires that an auditor "*shall remain alert, when inspecting records or documents, for arrangements or other information that may indicate the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor*".

5.73. The audit team failed to detect two related party transactions which had not been disclosed by management. While a failure to detect related party transactions is not itself a breach of the Relevant Requirements, in those two instances the omission was caused by the audit team's failure to remain alert to such transactions in the course of its audit work.

5.74. First, the FY2017 financial statements did not disclose that the loan from LCF to one of its borrowers ("Company F") was a related party transaction. Company F was a related party by virtue of the fact that LCF Director A was one of its directors during FY2017, having resigned on 16 November 2016.

5.75. The question of whether Company F was a related party had arisen in the previous year's audit, conducted by LCF's previous auditor (another major audit firm). The audit team noted that the previous auditor concluded that, although LCF Director A had not made an adequate disclosure about his connection with Company F (which he attributed to a misunderstanding on his part of the related party requirements), it was ultimately not necessary to disclose the Company F loan as a related party transaction because LCF Director A had resigned as a director of Company F, even though the resignation had "*not been enacted*" by the company. The audit team understood, in light of the matters in the previous auditor's papers, that LCF Director A was now aware of his disclosure obligations, and so chose to follow the approach of the previous auditors and not disclose the loan as a related party transaction.

5.76. That was the wrong approach. The previous auditor's records ought to have alerted the audit team to a potential issue, not reassured it that there was not one. The audit team ought to have made inquiries to reach its own conclusions regarding whether Company

F was a related party. Company F's loan balance at the beginning of FY2017 was material to the financial statements (although there were no material transactions such as drawdowns or repayments against the loan facility during FY2017).

5.77. Secondly, the financial statements failed to disclose as related party transactions the purchase by LCF of information technology services from a company ("Company G") of which LCF Director B was a director and controlling shareholder. There were 37 transactions with Company G in all, with a total value of £61,119.15 (i.e. the transactions, both individually and in aggregate, fell short of the audit's materiality threshold). While a document that might have alerted the audit team to the connection between Company G and LCF Director B was provided to a member of the audit team during the early stages of the audit, due to human error this document was not shared more widely within the audit team and acted upon.

5.78. Further, the financial statements did not disclose the required details in respect of the financial relationship between LCF and LCF Director A. It was disclosed that LCF owed LCF Director A £7,474 at the year end, but no disclosure was made in respect of a total of £300,894 (a material amount) which was advanced to LCF Director A by LCF during the year and repaid. This was a contravention of section 413(3) of the Companies Act 2006, which required LCF's financial statements to disclose details of the total amounts drawn and repaid by directors, and the maximum balance owed to LCF at any time during the year. The audit team's failure to recognise that the required disclosures had not been made is indicative of a lack of alertness to arrangements or information that may indicate the existence of related party relationships or transactions with LCF Director A.

5.79. For the reasons set out above, the Respondents, in breach of paragraph 15 of ISA 550, failed to remain alert, when inspecting records or documents, for arrangements or other information that may have indicated the existence of related party relationships or transactions that management had not previously identified or disclosed to the auditor.

6. *SANCTIONS*

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

6.1.1. 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;

6.1.2. 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 of the accountancy profession;

6.1.3. to protect the public from *Statutory Auditors* and *Statutory Audit Firms* whose conduct has fallen short of the *Relevant Requirements*; and

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

6.2. Paragraph 12 of the 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.

6.3. In deciding on *Sanctions*, Executive Counsel has, in summary, considered the following matters in accordance with the Policy.

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

6.4. The breaches were very serious. They included multiple contraventions of requirements which are fundamental to the role of the independent auditor, and they affected the auditing of several areas of the financial statements which were fundamental to LCF's business (although many of them arose from common root issues).

6.5. Executive Counsel is unable to determine whether the Respondents would necessarily have identified that: i) LCF was potentially a fraudulent entity, or ii) the financial statements may have been materially misstated, if the breaches had not occurred.

6.6. Executive Counsel does not, therefore, hold the Respondents directly responsible for the losses resulting from LCF's collapse. However, by failing to gain a proper understanding of LCF and to exercise adequate professional skepticism, in particular, the Respondents were not in a position to detect such matters, and failed to provide the reasonable assurance that is the objective of any statutory audit.

6.7. That failure is made more serious by the fact that the Respondents were aware that LCF was engaged in issuing bonds to retail investors, and that its business was growing rapidly. It should have been obvious to the Respondents that a clean audit opinion issued by one of the top audit firms in the UK might be relied upon by future investors, and could be exploited by LCF to promote its business. On that basis, the breaches risked the loss of significant sums of money and had the potential to adversely impact significant numbers of people. These risks did in fact materialise when LCF collapsed, at least with regard to investors who had bought bonds after the FY2017 Audit. The breaches also had the potential to significantly undermine public confidence in the standard of UK auditing, and the truth and fairness of financial statements generally.

6.8. Conversely, the breaches were not deliberate, reckless or dishonest and were not committed with a view to financial gain. It is also right to acknowledge that EY has proactively taken significant steps to establish the causes of the failings and to prevent them occurring in other audits. However, Executive Counsel requires further evidence to be satisfied that these steps appropriately mitigate the risk of repetition.

6.9. In respect of Mr Parker, he is no longer designated by EY to act on the firm's behalf as an RI. Any application by any firm to designate him as an RI in the future would require the approval of the firm's professional body.

6.10. The financial strength of the Respondents is a relevant consideration when determining the appropriate *Sanctions.* As has been noted, EY is the third largest audit firm in the UK, with total revenue across all of its business of about £2,754m in 2021-22. Conversely, with respect to the appropriate *Sanctions* against Mr Parker, it has also been noted that Mr Parker is an employee of the firm rather than an equity partner, and the level of any financial penalty against him should be proportionate to his level of remuneration. EY have indicated that they will pay any financial penalty imposed on Mr Parker, but his level of remuneration should still be taken into account in ensuring that any such financial penalty is proportionate.

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

6.11. Having assessed the nature, seriousness, gravity and duration of the breaches, Executive Counsel identified the following combination of *Sanctions* as appropriate in the case of each Respondent:

6.11.1. A financial penalty of £7,000,000 in the case of EY and £75,000 in the case of Mr Parker;

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

6.11.3. A declaration that the FY2017 Audit report signed on behalf of EY did not satisfy the *Relevant Requirements*; and

6.11.4. In the case of EY only, an order requiring specified steps to prevent a recurrence of the breaches.

Aggravating and mitigating factors

6.12. Executive Counsel then took 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).

6.13. There are no aggravating factors that have not already been considered in the context of the seriousness of the breaches. While EY has been the subject of two previous FRC enforcement outcomes within the last six years, these do not amount to such a poor disciplinary history as to merit any increase in the *Sanctions* against the firm.

6.14. With regard to mitigating factors, Mr Parker has a clean disciplinary record, but this is not regarded as meriting any further reduction in the *Sanctions* against him, in the circumstances. The fact that he is an employee rather than an equity partner in EY has already been taken into account.

6.15. The only relevant mitigating factor is that the Respondents provided an exceptional level of co-operation during Executive Counsel's investigation. In particular, they volunteered a copy of the report of the Root Cause Analysis carried out by EY in respect of the issues affecting the FY2017 Audit. The report identified a number (but not all) of the breaches eventually admitted by the Respondents, and the Respondents' voluntary action in sharing it is deserving of recognition. Accordingly, Executive Counsel considers that a discount of 10% to the financial penalty imposed on each Respondent is appropriate.

Deterrence

6.16. 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

6.17. Full admissions were made by the Respondents at an early point in Stage 1 of the case, in accordance with paragraph 84 of the Policy. On that basis, Executive Counsel considers that a further reduction of 30% to the financial penalty imposed against each Respondent is appropriate.

Sanctions

6.18. For the reasons set out above Executive Counsel imposes the following *Sanctions*.

Against EY:

6.18.1. A financial penalty of £7,000,000, adjusted for aggravating and mitigating factors (in particular reflecting an exceptional level of co-operation) by a reduction of 10%, and further discounted for admissions and early disposal by 30% so that the financial penalty payable is £4,410,000;

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

6.18.3. A declaration that the FY2017 Audit report did not satisfy the *Relevant Requirements*, as set out in this *Final Settlement Decision Notice*; and

6.18.4. An order requiring EY to take the following action which is designed to prevent the recurrence of the contravention:

6.18.4.1. Within 3 months of the date of the *Final Settlement Decision Notice*, provide a report to the FRC (the "**First Report**") which:

(a) identifies improvement measures taken by EY since the FY2017 Audit with regard to: (i) audit client acceptance, (ii) review of audit portfolios, and (iii) auditor training on professional scepticism and understanding the audited entity; and

(b) makes proposals for the assessment, by EY, of the extent to which those measures have addressed the specific shortcomings in the FY2017 Audit.

6.18.4.2. By such deadline as may be agreed by the FRC, which shall not be later than 18 months after the date of the *Final Settlement Decision Notice*:

(a) carry out the assessment of the improvement measures identified in the First Report, in a manner agreed by the FRC; and

(b) provide a further report (the "Second Report") which: (i) sets out the results of the assessment, and (ii) either identifies any further measures that EY intends to take to address the shortcomings, or explains why no such further measures are necessary.

6.18.4.3. Provide any further information or report, in connection with or as a result of the Second Report, as required by the FRC.

Against Neil Parker:

6.18.5. A financial penalty of £75,000, adjusted for aggravating and mitigating factors (in particular reflecting an exceptional level of co-operation) by a reduction of

10%, and further discounted for admissions and early disposal by 30% so that the financial penalty payable is £47,250;

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

6.18.7. A declaration that the FY2017 Audit report did not satisfy the *Relevant Requirements*, as set out in this *Final Settlement Decision Notice*.

7. **COSTS**

7.1. Executive Counsel requires that the Respondents pay her costs in full in this matter, being £239,639. Such costs shall be paid no later than 28 days after the date of this *Final Settlement Decision Notice*.

Signed:

[Redacted.]

Jamie Symington
DEPUTY EXECUTIVE COUNSEL

Date: 9 January 2024

APPENDIX – EXTRACTS FROM RELEVANT ISAS

ISA 200: Overall objectives of the independent auditor and the conduct of an audit in accordance with international standards on auditing

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.*"

ISA 230: Audit Documentation

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 Ireland) 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*."

ISA 240: The auditor's responsibilities relating to fraud in an audit of financial statements

Paragraph 12 states as follows:

> *"In accordance with ISA (UK and Ireland) 200, 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."*

Paragraph 15 states as follows:

> *"ISA (UK and Ireland) 315 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.5*

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."

ISA 315: Identifying and assessing the risks of material misstatement through understanding the entity and its environment

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."

Paragraph 12 states as follows:

"The auditor shall obtain an understanding of internal control relevant to the audit. Although most controls relevant to the audit are likely to relate to financial reporting, not all controls that relate to financial reporting are relevant to the

audit. It is a matter of the auditor's professional judgment whether a control, individually or in combination with others, is relevant to the audit."

Paragraph 13 states as follows:

"When obtaining an understanding of controls that are relevant to the audit, the auditor shall evaluate the design of those controls and determine whether they have been implemented, by performing procedures in addition to inquiry of the entity's personnel."

ISA 330: The auditor's responses to assessed risks

Paragraph 26 states as follows:

"The auditor shall conclude whether sufficient appropriate audit evidence has been obtained. In forming an opinion, the auditor shall consider all relevant audit evidence, regardless of whether it appears to corroborate or to contradict the assertions in the financial statements."

ISA 500: Audit Evidence

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.*"

Paragraph 7 states as follows:

"When designing and performing audit procedures, the auditor shall consider the relevance and reliability of the information to be used as audit evidence."

ISA 550: Related parties

Paragraph 15 states as follows:

"During the audit, the auditor shall remain alert, when inspecting records or documents, for arrangements or other information that may indicate the

existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor.

In particular, the auditor shall inspect the following for indications of the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor:

(a) Bank and legal confirmations obtained as part of the auditor's procedures;

(b) Minutes of meetings of shareholders and of those charged with governance; and

(c) Such other records or documents as the auditor considers necessary in the circumstances of the entity."

ISA 570: Going Concern

Paragraph 10 states as follows:

"When performing risk assessment procedures as required by ISA (UK and Ireland) 315 (Revised June 2013),[3] the auditor shall consider whether there are events or conditions that may cast significant doubt on the entity's ability to continue as a going concern. In so doing, the auditor shall determine whether management[1a] has already performed a preliminary assessment of the entity's ability to continue as a going concern, and:

(a) If such an assessment has been performed, the auditor shall discuss the assessment with management and determine whether management has identified events or conditions that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern and, if so, management's plans to address them; or

(b) If such an assessment has not yet been performed, the auditor shall discuss with management the basis for the intended use of the going concern assumption, and inquire of management whether events or conditions exist that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern.

[1a] In the UK and Ireland those charged with governance are responsible for the preparation of the financial statements and the assessment of the entity's ability to continue as a going concern.

[3] ISA (UK and Ireland) 315 (Revised June 2013), "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment," paragraph 5."