IN THE MATTER OF:

THE EXECUTIVE COUNSEL TO THE FINANCIAL REPORTING COUNCIL

and

(1) STEPHEN HARRISON

(2) PRICEWATERHOUSECOOPERS LLP

REPORT OF THE DISCIPLINARY TRIBUNAL

Javan Herberg QC, Nicholas Medcroft and **Elizabeth Houghton**, instructed by **Slater & Gordon (UK) LLP** for **the Executive Counsel to the Financial Reporting Council.**

Tom Adam QC and **Kyle Lawson,** instructed by **Taylor Wessing LLP**, for **the Respondents Stephen Harrison and PricewaterhouseCoopers LLP**

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Introduction

1. This is the report of the Disciplinary Tribunal, consisting of the Right Honourable Sir Stanley Burnton as chairman, Mr Anthony Cory-Wright (accountant) and Dr Pamela Ormerod (lay member), appointed pursuant to paragraph 9(2) of the Accountancy Scheme effective from 8 December 2014 ("the Scheme") of the Financial Reporting Council ("the FRC") by the Convenor of the FRC to hear the Formal Complaint of the Executive Counsel of the FRC against the above-named Respondents Stephen Harrison and PricewaterhouseCoopers LLP ("PwC").

2. The Tribunal reached unanimous agreement on the findings and conclusions made and the orders proposed in this Report.

3. The allegations under consideration relate to the audit of the financial statements of Connaught Plc ("Connaught") and its subsidiaries for the year ended 31 August 2009. Together, Connaught Plc and its subsidiaries comprised the Connaught Group ("the Group"). References below to 2009 are, unless the context requires otherwise, to the year ended 31 August 2009, and references to prior years are to be understood similarly.

4. References to "the Respondents" are to Mr Harrison and PwC. PwC were and are vicariously liable for any Misconduct on the part of its partners and employees. Mr Harrison would only be liable for his personal Misconduct. However, since he was a party to all of the auditing decisions we have to address, in general it is unnecessary to distinguish between them, but where necessary we do so.

The Connaught Group

5. Connaught was at all material times a FTSE 250 company operating in the social housing, public sector and compliance markets. Its subsidiaries included Connaught Partnerships Limited ("CPL") and Connaught Compliance Limited ("CCL").

6. CPL was Connaught's main subsidiary. CPL provided social housing landlords throughout the UK with a range of "planned" and "reactive" maintenance services. Planned maintenance involved providing programmed refurbishment work. This work often related to the Government's "Decent Homes" programme (which aimed to provide a minimum standard of housing conditions for those housed in the public sector). Reactive maintenance involved responsive repair work, which was provided generally in response to a breakdown or emergency.

7. CPL entered into contracts with social housing landlords, both local authorities and housing associations. These agreements were an important part of CPL's business and, in turn, had a significant impact on the financial statements of the Group. Of the amounts recoverable on contracts reported in Connaught's consolidated balance sheet at 31 August 2009, totalling £119 million, 87 per cent was attributable to CPL.

8. Until 2008, CPL's contracts were all, or mainly, planned maintenance contracts. From 2008, it entered increasingly into reactive maintenance contracts. These contracts were of varying durations and size. The term of these contracts was usually 5 years, and some included an option for extension. They did not normally provide for payment of a minimum or guaranteed fee or, in most cases, for planned maintenance or refurbishment works. In general, they did not confer exclusivity on CPL. Clause 15.24 of the contract with Bromford Carinthia Housing Association Ltd was typical:

> "15.24.1 [CPL] does not have the exclusive right to undertake all works and services to be performed and undertaken as part of the Term Program and the Client may, at its sole discretion, issue instructions to other service providers to carry out works and services and Tasks in or on properties which are in the Client's responsibility.
>
> 15.24.2 Given the nature of responsive repairs and maintenance, there is no minimum value for any works or services or Tasks to be undertaken pursuant to the Term Programme."

The term of this contract was 5 years from 1 April 2008, with the Housing Association having the option to extend it for a further 5 years. The contract was subject to earlier termination by the Housing Association under clause 13.3 by giving 39 weeks' notice.

9. These "new" contracts generally included priced schedules of repairs, and CPL would be paid according to the work, in the nature of repairs, it carried out. Most contracts included provision for termination during the nominal term of the contract, often on notice but without fault. Many provided for or envisaged the absorption of the client's workforce by the Group and the integration of the client's systems and procedures with those of CPL, for example arranging for tenants to be able to report a repair direct to CPL without the involvement of the landlord client. In the year to 31 August 2009 the greater part of the reported profit of CPL and the Group arose from reactive maintenance contracts.

10. CCL was part of the Group's Compliance Division. The Compliance Division provided safety, health and risk management services.

11. The Group's financial statements for the year ended 31 August 2009, approved on 28 October 2009, showed revenue of £660 million and profit before tax of £27 million.

12. CPL's financial statements for the year ended 31 August 2009, approved on 21 April 2010, showed turnover of £516 million and profit before tax of £38 million. The results

and performance of CPL for the year ended 31 August 2009 were highly material to the overall performance of the Group.

13. CCL's financial statements for the year ended 31 August 2009, approved in June 2010, showed turnover of £932,000 and loss before tax of £819,000.

14. The Group's unaudited interim results for the 6-month period ended 28 February 2010, approved on 27 April 2010, disclosed revenue of £354.6 million and profit before tax of £10.7 million.

15. On 8 September 2010, Connaught and a number of its subsidiaries were put into administration.

The Respondents

16. Stephen Harrison and PwC are respectively a Member and Member Firm of the Institute of Chartered Accountants in England and Wales and were so at all material times.

17. PwC had been retained as the auditor of Connaught and its subsidiaries, including CPL and CCL, since 2006.

18. For the year ended 31 August 2009, PwC audited the Group's financial statements, the financial statements of CPL and the financial statements of CCL.

19. As their auditor, PwC was required to form an opinion as to whether the financial statements of those companies showed a true and fair view and had been properly prepared in accordance with IFRS or UK GAAP (as applicable) and the Companies Act 2006.

20. Mr Harrison was the Senior Statutory Auditor at PwC for Connaught and its subsidiaries. He was the Engagement Partner responsible for the conduct of audits of Connaught, CPL and CCL. The Engagement Partner is the person in the firm who is responsible for the audit engagement and its performance and for the auditor's report that is issued on behalf of the firm.

21. Mr Harrison signed the three auditor's reports on the financial statements of Connaught, CPL and CCL on 29 October 2009, 21 April 2010 and 30 June 2010 respectively. He was assisted by, amongst others, Duncan Stratford and James Radway, senior managers employed by PwC and by Kevin Davies, a senior associate. Simon Chapman was the Quality Review Partner. The role of the Quality Review Partner is to provide an objective evaluation of the significant judgements made by the engagement team and the conclusions reached in formulating the auditor's report.

22. All three auditor's reports were unqualified.

23. On or around 18 March 2010, PwC agreed with the management of Connaught to perform certain limited scope procedures in relation to the half year position (namely, the 6-month period ended 28 February 2010) and to provide a private report to the Board summarising their observations. In relation to this engagement, Mr Harrison was the person in charge of providing the services, assisted by, amongst others, Duncan Stratford and James Radway. PwC provided a report, dated 21 April 2010, to the Board about the results of their limited scope procedures. None of the allegations before us relates to PwC's or Mr Harrison's conduct of those limited scope procedures.

The allegations

24. The allegations of Misconduct against the Respondents relate to the audit work in four areas:

    (1) Contract mobilisation costs.

    (2) Long-term contract adjustments.

    (3) Intangible assets.

    (4) Cash recognition: cut-off date.

25. We incorporate in our Report, as Annex 1, the terms of these allegations as set out in the Executive Counsel's Formal Complaint.

26. Paragraph 9(7) of the Scheme requires us to determine whether to make an Adverse Finding in respect of the Misconduct alleged by the Executive Counsel in the Formal Complaint or to dismiss the Complaint. An "Adverse Finding" is defined in paragraph 2(1) of the Scheme, so far as is relevant, as:

    > *"a finding by a Disciplinary Tribunal that a Member or Member Firm has committed Misconduct."*

27. "Misconduct" is defined in the same paragraph as:

    > *"an act or omission or series of acts or omissions, by a Member or Member Firm in the course of his or its professional activities (including as a partner, member, director, consultant, agent, or employee in or of any organisation or as an individual) or otherwise, which falls significantly short of the standards reasonably to be expected of a Member or Member Firm or has brought, or is likely to bring, discredit to the Member or the Member Firm or to the accountancy profession."*

28. In the *MG Rover* case (*FRC Executive Counsel v Deloitte and Einollahi* (Tribunal 2 September 2013, Appeal 2014/15) the Tribunal gave the following summary of the test:

> *"18. Before we can make a finding that the Respondents or either of them are guilty of misconduct and make a finding adverse to them we have to be satisfied not only that there has been a departure from the conduct reasonably to be expected of a member or member firm but that that departure has been significant. Whether that departure is significant is a matter for our judgment. A trivial departure will not suffice. We have to be satisfied before we reach a conclusion that there has been such a departure, that the Executive Counsel has proved that no reasonable accountant would have acted in the way that the Respondents have acted.*
>
> *24. We accept the Respondents' contention that for the Respondents to be guilty of misconduct and to have acted in a way that no reasonable professional would have acted the conduct has to amount to more than mere carelessness or negligence and has to cross the threshold of real seriousness. It is not sufficient for the Executive Counsel to prove that the Respondents failed to act in accordance with good or best practice or that most or many members of the profession would have acted differently. The conduct has to be more serious than that."*

29. We have applied this guidance.

The applicable Accounting Standards

30. The Group was required to prepare its financial statements in accordance with International Financial Reporting Standards ("IFRS") issued by the International Accounting Standards Board and adopted by the European Union. These standards include the International Accounting Standards ("IAS").

31. Connaught's subsidiaries, specifically CPL and CCL, prepared their financial statements in accordance with UK GAAP, comprising accounting standards issued by the Accounting Standards Board in the United Kingdom, the Companies Act and other guidance and statements of recommended practice.

32. It was common ground before us that there was no relevant difference between the requirements of IFRS and UK GAAP.

The Relevant Auditing Standards

33. The relevant auditing standards were the International Standards on Auditing (UK and Ireland) ("ISAs"). The purpose of ISAs, issued by the Auditing Practices Board, is to establish standards and general principles with which auditors are required to comply in the conduct of any audit of financial statements. Together they form a body of standards that should be applied before an auditor can express an opinion that financial statements give "a true and fair view" within the meaning of section 393 of the Companies Act 2006.

34. Of general and important relevance to the issues we have to decide is ISA 500. It requires that:

> "2. The auditor should obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the audit opinion.
>
> …
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> 7. Sufficiency is the measure of the quantity of audit evidence. Appropriateness is the measure of the quality of audit evidence; that is, its relevance and its reliability in providing support for, or detecting misstatements in, the classes of transactions, account balances, and disclosures and related assertions. The quantity of audit evidence needed is affected by the risk of misstatements (the greater the risk, the more audit evidence is likely to be required) and also by the quality of such audit evidence (the higher the quality, the less may be required). Accordingly, the sufficiency and appropriateness of audit evidence are interrelated. However, merely obtaining more audit evidence may not compensate for its poor quality."

35. In their final report dated 12 October 2009 on the 2009 audit to the Audit Committee of Connaught, the Respondents identified the key areas of judgment in preparing the financial statements as:

(1) Accounting for long-term contracts;

(2) Pre-contract and set-up costs (i.e., mobilisation costs); and

(3) Capitalisation of intangible assets.

Significantly, these were the three main areas that are the subject of the Executive Counsel's allegations and of our Report.

Contract mobilisation costs

36. Pre-contract costs and costs associated with setting up CPL's contracts with social housing landlords were referred to by CPL and the Group as "mobilisation costs". These costs were primarily staff costs (i.e., the time spent by management and other employees in concluding and implementing contracts to the point when they became operational).

37. CPL and the Group adopted the accounting policy of capitalising mobilisation costs, i.e., mobilisation costs were added to the balance sheet as an asset and then amortised (or written off) on a straight-line basis over the life of the contract. Had such costs not been capitalised, they would have been written off when incurred and recognised as an expense in the profit and loss account.

38. Mobilisation costs across the Group in relation to 251 contracts were carried in the Group's balance sheet at 31 August 2009 at £32.3 million. This amount was recognised in the Group's financial statements at 31 August 2009 as an asset (under "Amounts recoverable on contracts"). Of this £32.3 million, £30.4 million related to contracts entered into by CPL.

39. Until 2008, Connaught sought to determine actual costs incurred in relation to mobilising each contract that could be and were capitalised. PwC's report to the Audit Committee dated 24 October 2007 stated:

> "Management may wish to consider simplifying the approach to capitalising preliminary expenses. If a 'standard costing' approach were to be adopted (by establishing a standard percentage of contract value based on a representative sample) the level of administration would reduce."

40. In consequence, in 2008 CPL and the Group did not determine these costs by calculating actual costs incurred in relation to each contract. As an approximation of actual cost they developed a "standard cost" approach which was applied to all contracts. This standard cost was derived as a percentage of the projected order book value of the contract. The standard cost percentage for that year was 1 per cent of the projected order book value over the term of the contract.

41. In 2009, the Group and CPL applied a standard cost of 2.75 per cent to the projected contract order book value in respect of each contract secured in the 2009 accounting year and a small number of contracts that had started to be mobilised in the previous accounting year. 1.75 per cent of the contract order book value of the 9 contracts mobilisation of which had begun in 2008 was capitalised in addition to the 1 per cent capitalised in that year.

LTA Contracts

42. In 2009, 23 of CPL's contracts with social housing landlords ("the LTA Contracts") were accounted for using an accounting policy that the Group and CPL described as a "long term accounting adjustment". In accordance with this policy, the profitability of each contract was accounted for not by reference to profits actually earned or the loss actually incurred in the year to 31 August 2009 but by reference to the gross profit that CPL expected to earn over the life of each contract and the percentage of its completion. Thus, if the total projected gross profit of a 5-year contract was £5 million (i.e., £1 million a year overall) but the loss in the first year (assuming it to be the year to 31

August 2009) was £650,000, an adjustment of £1,650,000 would be made in the profit and loss account. The profit and loss account for the year ended 31 August 2009 as a result reflected a profit of £1 million on that contract.

43. In 2008 a modified form of this policy had been applied, under which an adjustment was made so as to eradicate the loss on a contract that was expected to be profitable over its term, but no further. In other words, the policy as applied in 2008 did not result in a profit being reported in respect of the contracts to which it was applied.

44. The 2009 policy was described in a PwC working paper, entitled "Consider key judgments in contract accounting" in the following terms:

> "**Long term accounting adjustment (judgmental area)**
>
> Management account using long term accounting for a selection of their contracts; these contracts are ones which meet the following criteria:
>
> - Have a life of 5 years or greater
> - Have high annual and lifetime turnover projections
> - Have a high degree of seasonality
>
> For these specific contracts management review the overall expected turnover and costs for the contract to estimate an average margin for the contract. Management then use this margin to calculate an adjusted turnover figure for the year to date and enter it into the accounts..."

45. This working paper also addressed a number of further matters in relation to this policy.

46. Most of the records retained by PwC relate to four particular contracts, namely CPL's contracts with Bromford Carinthia Housing Association Limited ("Bromford"), Paradigm Housing Group Limited ("Paradigm"), Raglan Housing Association ("Raglan") and South Essex Homes Limited (the management organisation arm of Southend-on-Sea Borough Council) ("South Essex").

47. These four contracts were the subject of a paper authored by Mr A, the Finance Operations Director of CPL, entitled “Long term accounting case studies”, which was requested by and provided to PwC on or around 25 September 2009 and which was considered by PwC as part of the audit. The LTA adjustments made in connection with these four contracts (prior to certain adjustments PwC proposed) are set out in the table below:

	Counterparty	**CPL’s LTA**
1	Bromford	£2,597,000
2	Paradigm	£1,195,000
3	Raglan	£1,264,000
4	South Essex	£1,556,000

48. The LTA adjustments made in respect of these four contracts totalling £6.612 million represented 51 per cent of CPL’s cumulative LTA adjustment at 31 August 2009 of £12.885 million.

49. The effect of this accounting treatment, in relation to CPL’s 2009 financial statements for the year ended 31 August 2009, was to increase turnover by £6,964 million and to increase assets in CPL’s balance sheet at 31 August 2009 by the same amount. This additional turnover increased profit by the same figure. This increased profit represented 18.4 per cent of CPL’s profit before tax for the year (CPL’s profit before tax for the year ended 31 August 2009 was £37.8 million).

50. The effect of this accounting treatment in relation to the Group's 2009 financial statements (after recognising £2 million of PwC’s proposed adjustments which appear not to have been booked in CPL) was to increase profit before tax by £4.964 million,

which represented 18.6 per cent of the Group's £26.7 million reported consolidated profit before tax for that year.

51. As stated above, in 2008 additional revenue was only recognised to the extent of each contract's cumulative costs (with the result that such contracts were accounted for as breaking even). At 31 August 2008, LTA adjustments totalled £5.921 million. The aggregate amount of LTA adjustments in CPL's balance sheet at 31 August 2009 was £12.885 million (being £5.921 million plus £6.964 million). In the Group's balance sheet it was £10.833 million at 31 August 2009.

Intangible Assets

52. In the year ended 31 August 2008, the Group capitalised as intangible assets £3.1 million of costs said to be attributable to internal development projects.

53. In the year ended 31 August 2009, an additional £7.7 million was capitalised in relation to such projects, leading to a total capitalised amount of £10.8 million being included in the Group's balance sheet at 31 August 2009.

54. The costs were referred to in the Group's financial statements as "assets under construction" and were included within "Computer Software". None had been amortised as at 31 August 2009.

55. The costs were similarly referred to in CCL's financial statements as "Computer Software".

56. The effect of this accounting policy was to increase the reported profit before tax by £7.7 million in the Group's financial statements for the year ended 31 August 2009 and

to reduce the reported loss before tax by £6.1 million in CCL's financial statements for the year ended 31 August 2009.

57. The costs were attributed to the various internal development projects as follows:

Connaught plc

Project	**Amount capitalised**
HR and payroll project	1.6m
The Connaught Way	0.7m
Others	0.3m
Subtotal Plc	*2.6*

CCL

Compliance Hub	2.6m
Sales Logix CRM System	1.4m
PDA Project	1.5m
National Britannia Project	1.6m
Other	1.1m
Subtotal CCL	*8.2*
Total costs capitalised	**8.2 + 2.6 = £10.8 million**

58. The majority of the costs capitalised comprised internal staff costs.

Cash Recognition

59. The Group's policy of recognising BACS transfers and cheques received from clients some time after the year end as cash on the balance sheet date had no impact on profitability: if the relevant assets had not been accounted for as cash, they would have been accounted for as trade debtors and would therefore have been recognised as assets in the balance sheet of the Group and CPL in any event. However, this accounting treatment did impact on the cash balances recognised in the financial statements.

60. In addition, the cash recognition policy affected the cash conversion ratio, which was a measure that was used by analysts and others assessing the Group's financial

performance. The cash conversion ratio was derived from operating cash flow and was of interest to analysts. [redacted], a member of the Connaught Audit Committee, said in her interview:

> "Q: And did you have any concerns as to the underlying reason why the cash cut-off may have been extended in this way?
>
> [redacted]: Well, one of the – one of the key – well, one of the things that people look at for business like this is cash conversion. So from your turnover line to your cash line, what percentage are you making? And Connaught had always said that it was going to make 70%. So, in order to hit 70%, this cash needed to come in. So it was very clear to me why it had been left open; it didn't make it okay."

61. In the Group's Financial Review of its 2009 results, published with its financial statements, it stated:

> "The Group has continued to focus on delivering sustainable cashflow at a rate reflective of the strong organic growth. …. We remain highly focused on cash conversion through the efficient management of the cash cycle."

62. Although the cash conversion ratio was not (and was not required to be) disclosed in the Group's 2009 financial statements, it is and was derived from operating profit and operating cash flow presented in the financial statements.

The evidence before the Tribunal

63. We were provided with no less than 29 ring binders of relevant documents. We commend those responsible for the preparation of the documents, and in particular for the cross-referencing to documents embedded in the Respondents' working papers, all of which was of great assistance.

64. Oral factual evidence was given by Mr Harrison, Mr Stratford, Mr Davies and Mr Chapman. Their witness statements stood as their evidence in chief, and they were cross-examined on behalf of the Executive Counsel. Mr Harrison was recalled, without

objection, because Mr Cory-Wright wished to question him further. He was then cross-examined and re-examined again by counsel. It was not suggested, and could not be suggested, that any of these witnesses give their evidence otherwise than to the best of their recollections. In assessing their evidence we have of course borne in mind the long time since the events they were asked to recall. Mr Harrison, in particular, had retired on 1 July 2010, over 6 years before the hearing. Mr Chapman had retired in September 2010. We were particularly impressed with Mr Harrison, who did not seek in any way to disclaim his responsibility for the audit judgments in question. Mr Davies was relatively inexperienced at the time, evidently nervous during his cross-examination, and we have taken that into account in assessing his evidence.

65. Both Mr Harrison and Mr Adam on behalf of the Respondents emphasised Mr Harrison's knowledge and experience of the Group at the time, its businesses and its officers and staff. It is clear that Mr Harrison placed considerable trust in management. However, his experience and knowledge, and his views of management, did not absolve him from the duty to consider material management information and proposals with an appropriate degree of professional care and scepticism. Moreover, the impression he gave in evidence contrasts with the experience of Mr Radway, set out in his email dated 7 January 2010 to Mr Stratford on the subject "Connaught – thoughts on year-end":

> "General
>
> - Difficult to obtain information. Simple information is often not available (e.g., loans breakdown).
>
> - Often provided piecemeal, with nothing volunteered. Initial information usually very high level with no thought as to suitability for audit.
>
> - Conflicting explanations, passed around from person to person. Often difficult to get direct access to individuals when needed.
>
> - No clear allocation of responsibilities.

- No Connaught person of sufficient seniority within ownership of the whole process

- Struggle to supply substantive evidence

- Number of times we needed to ask for the same thing multiple times (e.g., board reports: six weeks; Connaught Way since June; consol[idation]: months)

- Interim was a missed opportunity - this should be the key time to agree accounting treatments, prove changes in policy, etc.

- Lack of rigorous analysis from an accounting perspective, leading to simple errors that a modicum of thought and sense-checking would have avoided

- Fear factor when telling us things: won't give information that they know until they have passed it by group (e.g., obtaining management accounts)

Head office

- Acquisitions: File provided was very light. No clear evidence of consideration, FV [fair value] adjustments/costs not thought through or reviewed, opening balances not appropriately reconciled.

- Cost capitalisation: Very slow to provide business cases/investment appraisals. Did not volunteer details of other significant projects.

- Loan balances: difficult to obtain breakdown

Social Housing

- Long-term contract accounting adjustments - failed to take advantage of interim audit to put this to bed. Missed opportunity - provided COINS report late, hence sample could not be given far in advance, leading to delays in obtaining.

- Contracts should be there on arrival on day one. We did not receive COINS report until second day of the audit and had to pick sample in a rush in order to obtain something to work on. Subsequent delay in receipt of contract info, etc.

- P Numbers - similar to above.

- Divisions sometimes very removed as to what goes into the accounts - items adjusted on consolidation.

- Lack of urgency in Leeds

- Basic reconciliations from managers' report to COINS not thought about

Compliance

- P Numbers

….”

(P numbers were the Connaught abbreviation for mobilisation costs. COINS referred to Construction Industry Solutions, a third party provider of software systems for the construction industry. The COINS system was CPL’s core contract management system, used to record costs incurred and revenue received. It could produce detailed information on, for example, revenue, costs and margin information on a contract-by-contract basis. The Connaught Way was a project to standardise the way that Connaught operated through the use of operation manuals, shared services and new systems.)

66. Mr Radway was not called to give evidence, and we did not have a witness statement from him. We have no reason to treat his email report to Mr Stratford as biased or inaccurate, particularly given its specificity. It was produced, in part, to document difficulties to support PwC’s claim for overruns, and we have taken into account that Mr Radway may have painted a bleaker picture than the facts warranted. Nonetheless, the email suggests that there was a real need for PwC and Mr Harrison to examine management’s proposals assiduously and critically.

67. In addition to the factual witnesses, we were assisted by the expert evidence of Richard Kelly and Nick Gomer. Their qualifications as expert witnesses were unquestioned. Their reports (two in the case of Mr Kelly, one in the case of Mr Gomer) stood as their evidence in chief, and both were subject to lengthy cross-examination. We were very impressed with Mr Kelly. His answers in a difficult cross-examination were thoughtful and convincing. Mr Gomer was also authoritative initially, but we have to say that he became overly defensive of his views. When cross-examined he was willing to make assumptions on the audit work of the Respondents that were not borne out by the

working papers, as in the case of Mr Radway's work on intangible assets, to which we refer at paragraph 235 below. His evidence on cash cut-off, in particular, became contradictory.

The approach of the Tribunal

68. The parties were agreed that our findings should be made on the balance of probability, but must take account of the seriousness of the allegations of Misconduct. In other words, we should not make a finding of Misconduct unless it is supported by clear and cogent evidence. In fact, there was little if any issue as to the primary facts before us. The most important issues concern the adequacy of the Respondents' audit work and the reasonableness of their judgments.

69. It was suggested on behalf of the Executive Counsel that the Tribunal should consider the Respondents' conduct as a whole. Paragraph 40 of his Opening Submissions was as follows:

> "40. But even were the Tribunal to find that PwC's work in relation [to] one or more of the four Allegations might not, when considered in isolation, amount to falling significantly short, the EC's position is that, in determining whether the Respondents have committed Misconduct, the Tribunal is also entitled to consider the cumulative failings of Mr Harrison and PwC in relation to the audit work, including that they fell short (but not significantly short) in respect of an area."

70. As we understand it, the submission is that if the Tribunal were to find that the Respondents' work in one area of the 2009 audit fell below the standard reasonably to be expected of them, and in a second area their work fell below, but not significantly below, that standard, the Tribunal might find Misconduct in relation to both areas.

71. We reject this submission. We can conceive of a case in which it having been expressly alleged that the work of auditors on a company audit viewed generally fell significantly

below the requisite standard, the Tribunal did indeed uphold that allegation. However, that is not this case. In the present case, four specific and separate Allegations have been made. Each of those Allegations must be considered on its own facts. It not having been alleged that the entirety of the Respondents' conduct in the audits was significantly below the standard reasonably to be expected of them, the Tribunal did not consider the Respondents' work in other areas of the audits and could not make a finding of general Misconduct that included areas of the audit that were not the subject of any Allegation.

72. There was considerable debate before us as to the application of the relevant accounting and auditing standards, and in particular whether each of the responsive repair contracts entered into by CPL could or should have been accounted for as a single transaction or project or whether each call for a repair to be carried out should have been accounted for as a separate transaction. We shall discuss these issues below, but there are certain preliminary observations we can make at this stage. A failure to apply a standard, the meaning of which is clear and undisputed, will be evidence of negligence on the part of an accountant and may be evidence of Misconduct. Where the requirements of a standard are controversial, we would expect the issue as to its application to be addressed in the auditor's working papers. Nonetheless, even without such evidence, it would require an exceptional case for Misconduct to be found on the part of an auditor who sought to apply a meaning of a standard that was generally accepted among a substantial body of professional opinion, even though we considered it to be incorrect.

73. It is a matter of great regret that our hearing took place over 7 years since the events in question. It is most unfortunate from the point of view of the individuals involved that the allegations should have been hanging over their heads for so long. Moreover, after such a long period of time, no one can be expected to have a clear recollection of what

he knew or considered at the time, other than is recorded in the contemporaneous working papers and other documents. In addition, it may be more difficult to be clear as to what was accepted professional practice 7 years ago.

74. Hindsight, and the forensic process, may provide an apparent clarity that was absent at the relevant time. We have sought to take this consideration into account in our deliberations and our findings.

75. In this connection, we have placed great weight on the contemporaneous documents, including the audit working papers, which are expected to be a record of the work done and judgments reached by the auditors.

76. The Group's management included a number of accountants. It is implicit in our findings that members of the Group's management share responsibility and might have been the subject of disciplinary proceedings. Two of them, Mr B and Mr C, were the subject of such proceedings, but the allegations against them did not relate to those made against PwC and Mr Harrison. In our view, the fact that the conduct of members of the Group's management could have been the subject of disciplinary proceedings is of no assistance to us in considering the evidence and determining the allegations before us.

77. PwC had audited the Group's financial statements for the years ended 31 August 2007 and 2008, and had carried out limited scope procedures on the Group's 2008 half-year results. Management's proposed changes to accounting practice in 2009 differed significantly from the practice followed in earlier years. They had a substantial impact on the Group's reported profit for 2009 and on the view presented on the sustainability of Connaught's and its subsidiaries' businesses. All four areas had rightly been identified by PwC as "critical matters". Capitalised mobilisation costs, LTA

adjustments and intangible assets amounted to £54 million at 31 August 2009. This sum was highly material to the Group's total equity shareholders' funds amounting to £167.5 million. Additional amounts capitalised in 2009 in respect of these assets amounted to £31 million, which was highly material to the Group's pre-tax profit for the year ended 31 August 2009 of £27 million.

78. Late adjustments are by no means unusual, and are not necessarily unjustified. However, a late adjustment, such as that in relation to capitalisation of mobilisation costs, particularly if material to the financial statements (as it was), requires particular vigilance on the part of the auditor, for two reasons. First, inevitably in the case of a listed company, there may be a concern that management are seeking to improve the company's results beyond what is justified. This concern will be enhanced if there is no good reason for the lateness of the proposal. We refer to this passage from the evidence of Mr Gomer, concerning management's proposal to increase the standard cost for the calculation of mobilisation costs from 1 per cent to 2.75 per cent:

> "THE CHAIRMAN: This having been raised late, would you consider the possibility that the paper was drafted to produce a particular result, rather than the particular result resulting from groundwork?
>
> MR GOMER: I think as a sceptical auditor you are always mindful of the motivation of anything that is highly judgmental and the timing of when it's raised, I think that's just inherent in the auditor's psyche.
>
> THE CHAIRMAN: Which has a material effect on the profits to be reported by a public listed company.
>
> MR GOMER: Particularly if it's that, but there may be other things that you would be sceptical of, or cause you to be sceptical."[1]

79. The appropriate degree of scepticism will be enhanced if the auditor is confronted with an adjustment proposed by management that is manifestly unsupportable.

[1] Day 9 page 187

Management's proposal in relation to cash cut-off was such a proposal. It should have given rise to the suspicion that it was an attempt at window dressing. The late increase in the standard cost percentage for mobilisation costs, put forward on the basis of the Mr A paper, should itself have raised concerns.

80. Furthermore, we accept the evidence of Mr Kelly and Mr Gomer that, where management's proposals constitute such a great proportion of profits, the reasonable auditor must consider them more critically than might otherwise be appropriate.

81. Lastly under this head, where the company is listed, and there is a timetable for the publication of its annual results for the Stock Exchange, the lateness of the proposal may place pressure on the auditor to reach its conclusion without carrying out the work that it would carry out if the proposal had been made at an earlier stage. In this connection, we note from the Interim Report to the Audit Committee that in 2009 there was an accelerated group reporting timetable which, with acquisitions, the reorganisation and the restructuring that had taken place, created time pressures for the completion of the audit.

The findings of the Tribunal

Contract mobilisation costs

82. In appropriate circumstances (which we discuss below), a company is required to capitalise costs incurred and to amortise them over an appropriate period of time. As mentioned above, in the year to 31 August 2008 the Group (and CPL) capitalised mobilisation costs based on 1 per cent of order book value (anticipated revenue) over the life of a contract. The possibility of an increase in this percentage was mentioned at an audit update conference call on 10 September 2009. At that date, PwC anticipated

signing off the CPL audit on 2 October 2009, that is, 3 weeks later. After discussion of a number of matters, Mr Stratford asked whether there was anything else of which he should be aware. Mr D, Financial Director of CPL, was noted as saying:

> "… since HY 2009, and in particular GHA [Glasgow Housing Association], we have been reviewing the P numbers and are coming to the conclusion that we are probably under-providing at the current 1% for these new and more complex contracts. [Mr D] said that he believed Mr B and Stephen Harrison had historically discussed this and are likely to pick this up again in their conversations."

As mentioned above, "P numbers" were used within the Group to refer to mobilisation costs. The "new and more complex contracts" to which Mr D referred were the reactive maintenance contracts.

83. On 17 September 2009, PwC received a paper produced (or at least presented) by Mr A, the Finance Operations Director of CPL, headed "Capitalising of Mobilisation Costs". It stated:

> "<u>Introduction</u>
>
> This paper refers to those costs that the business incurs from the point at which the Company has been awarded a contract through to the point at which the contract has successfully reached full operational status.
>
> Such costs will be of an internal and external nature, and will consist of but not be limited to the following items:
>
> <u>External</u>
>
> - Consultancy fees
> - Professional fees
> - Outsourcing Costs
>
> <u>Internal</u>
>
> - Management costs
> - Support teams
> - Discretionary Spend.

Method of Calculation

Based upon costs incurred in 'live' mobilisation cases over the past year within Connaught Partnerships, the detailed costings showing in appendices B & C have been arrived at, and broken down in to the following two areas:

- Staff Costs (see Appendix B)
- Non-Staff Costs (See Appendix C)

The sum of these two types of cost, have then been applied to the contracts that commenced in the year to August 2009 as shown in Appendix A. This is a consistent approach to the current method employed where a percentage of 1% is used against the projected orderbook values of each new contract secured.

Findings

Appendix A shows that the sum of the costs incurred in mobilising contracts amounts to, on average, 3% of the contract orderbook value and clearly demonstrates that the current rate of 1% is significantly below the actual run rates incurred.

To further sense check the calculations, appendix A also shows the impact of the mobilisation costs if they were only applied to the larger contracts of £5m or above. This calculates out at 2% of the orderbook, and therefore double the existing rate applied.

Conclusion

The clear conclusion arrived at is that the current practice of applying 1% to the new orderbook values is not a fair reflection of the true cost incurred in mobilising new contracts, particularly as we are continuously entering into more and more complex and innovative contractual operations.

Although the total average percentage arrived at is 3%, it is understood that the smaller contracts will not enjoy the level of mobilisation support as the much larger contracts, but they will without question still incur an amount considerably higher than the current 1% reflects.

It is felt that a fair and appropriate percentage to adopt for new business secured in the year to August 2009 and going forward would be one in the region of 2.5% to 2.75%."

84. Mr A's description of mobilisation costs at the beginning of the paper was misleading. Mobilisation costs incurred once it is probable the contract will be concluded (in the case of CPL, when the client informs the company that it is the preferred bidder or that

the client intends to enter into the contract with the company) and before the contract is concluded are referred to as pre-contract costs. Mobilisation costs incurred after the contract has been concluded are referred to as set-up costs. It seems that in 2008 CPL had used the 1 per cent calculation to determine both pre-contract and set-up costs, but the documentation is inconsistent. Mr A's paper apparently sought to justify the 2.75 per cent calculation to determine the total of set-up costs in 2009, but it is common ground that the calculation was used to determine both pre-contract and set-up costs.[2] The paper arrived at a percentage of 3 per cent of anticipated revenue, but the percentage figure of 2.75 was in fact used.

85. Appendix A to the Mr A paper was a list of 42 contracts, with an anticipated order book value over the term of the contract ranging from £611,000 (Runcorn) to £150 million (Raglan). Against each contract was the order book value (i.e., the anticipated revenue over the entire duration of the contract) and a figure of "Total costs" of £502,750, made up of staff costs of £330,440 and non-staff costs of £172,310. The penultimate column of the schedule contained the percentage that the total costs of £502,750 bore to the order book value. This percentage varied from 0.3 per cent for Raglan to 82.3 per cent for Runcorn. The product of 42 times £502,750 was 3 per cent of the total order book value of the 42 contracts.[3]

86. Appendix B to the paper, incorrectly headed "Mobilisation Costs Analysis – Non Salary Costs", was a list of the members of staff who were said to have worked in mobilisation, the number of weeks each of them worked on what was apparently perceived to be a

[2] See the PwC working paper "Pre Contract / Set up Costs" at F1/8/45.
[3] The paper gave the figure for the total costs as £21,115,483. This was incorrect: the correct figure would have been £21,115,500. The difference is immaterial.

typical contract and the salary costs of that work. Appendix C set out non-salary costs for such a contract.

87. The figure of 2.75 per cent thus arrived at was to be applied to a total of 69 contracts. In respect of 9 larger contracts in which mobilisation costs had first been recognised in 2008 (at 1 per cent of estimated revenue), a further 1.75 per cent of contract value was recognised, on the basis that mobilisation had begun in 2008 but continued into 2009.

88. The proposed increase in the capitalised mobilisation costs suggested by the Mr A paper was highly material to the financial statements of CPL and of the Group for the year to 31 August 2009. Mr Harrison and PwC realised that the paper was essentially unauditable. The Group's salaried staff did not keep time sheets, but even if they had done so, the time sheets would not have referred to the hypothetical typical contract. It would similarly be impossible to enquire of a member of the mobilisation team how much time he worked on an *ex hypothesi* non-existent "typical" contract. In any event, PwC made no enquiry of the members of the mobilisation teams.

89. Mr Harrison sought to obtain comfort from a substantive analytical review that involved comparing an *expectation* of CPL's non-contract overheads expensed for 2009 (derived from actual non-contract overheads expensed in 2008) with CPL's *actual* non-contract overheads expensed in 2009. This exercise has come to be referred to as "A minus B equals C", where A represents total overheads before allocation, B represents mobilisation costs capitalised and C represents overheads expensed. There was a fourth category, D, which represents overheads charged directly to contracts. The calculation is set out in the table in the Critical Matter working paper "Pre-Contract/Set-up costs" referred to below. We discuss it at paragraph 120 below. The result of this test was regarded by Mr Harrison as supporting Mr A's proposal.

90. Mr Davies prepared a Critical Matter working paper entitled "Pre-Contract/Set-up costs". It was reviewed by Mr Chapman and cleared by Mr Harrison. Its purpose was to "Obtain comfort over pre-contract costs (P Numbers)". It stated, among other things:

> "Connaught has previously established the standard cost of such pre-contract work to be 1%. (This is the rate applied for all contracts up to FY09).
>
> The changing nature of Connaught's work suggests that the pre-contract and initial set-up costs are increasing (see separate Critical matter on long-term contracts). In particular, the design and interface of systems with the customer becomes a significant investment in the operation of the contracts.
>
> Connaught has estimated, by calculating, the typical costs arising on setting up a contract to be c.2.75% of contract value. The standard cost is effectively an estimate of the time taken. The actual costs incurred and expensed (£1.4m) on the aborted Glasgow contract in the year were more than 2.3% of expected contract revenues which is broadly in line with the typical rate used.
>
> **Comments on the approach**
>
> The concept of pre-contract costs in contract accounting is specific to those costs incurred between the period of being certain of winning the contract and the award of the contract.
>
> The nature of the costs identified by management, in arriving at 2.75%, includes set-up costs. These set-up costs are therefore not pre-contract costs.
>
> The additional costs (additional 1.75% compared with prior years capitalisation rate of 1%) identified by management relates to "set-up costs" on the contract not pre-contract. However, it would be important to treat these costs as attracting future revenue as part of the treatment of long-term contract accounting (see separate CM where we have considered the impact of including these costs in specific long term contracts).
>
> …
>
> Confirmation of costs
>
> Management has identified the costs associated with setting up new contracts (from preferred tender basis to mobilisation). Costs of, on average, 2.75% have been identified.
>
> Our work on management's estimated capitalisation rate of 2.75% is included on the attached step.

However, in order to determine the extent to which social housing division costs (CPL) have been included in contracts, an overall proof has been prepared.

In principle, the activities undertaken by CPL comprise:

winning of the contracts;
general administration;
management of the contracts;
monitoring the contracts;
mobilisation and set-up costs.

The costs associated with (a) and (b) do not relate to the delivery of the contract, but are general administration and selling costs; these should be treated as overhead costs.

The activities ((c) to (e)) are those relating to contract management and these costs should be identified as part of the contract costs. Accordingly, the overheads relating to these cost should be apportioned to contracts and recognised as part of the contract costs.

Analysis of overheads

We have analysed overheads for CPL, as this is the significant proportion of the social housing business,

Set out below is an analysis of CPL's overhead costs (i.e. costs not directly charged to contracts). The apportionment of these costs to contracts is shown below:

	FY09	FY08
	£m	£m
Total overheads pre-allocation	65.5	48.6
Less:		
Directly charged	(33.9)	(22.2)
PC Value	(18.3)	(11.7)
Overheads charged	13.3	14.7

Source - trial balance analysis 2009 and 2008.

The increase in overheads is largly [sic] driven by an increase in staff costs in the year due to increased activity in the year. As a significant number of partnerships have been entered into, finance charges have also increased

> The remainder relates to establishement [sic] and other office costs,
>
> Our analysis of overheads is detailed further within [an embedded work paper].
>
> **Summary and conclusions**
>
> The above analysis demonstrates that overheads charged to income in 2009 have fallen by £1.4m. Management attributes this to efficiency savings in rationalising the business structure from three regions to one. On a group basis this is offset by an increase in overheads at the plc level of £7.8m, relating to personnel costs of shared services such as procurement and payroll where the related costs have been included in the plc entity in 2009. Overall the level of overheads remaining appears reasonable."

91. As mentioned above, the capitalisation of costs at 2.75 per cent of estimated revenue over the anticipated life of the contract was applied to some 69 contracts. The increase in the calculation of mobilisation costs in relation to contracts the mobilisation of which began in the year to 31 August 2009 was £6.9 million. In addition, the increased percentage was applied to 9 contracts mobilisation of which had begun in 2008. The resulting increase in assessed mobilisation costs for those contracts was £7.5 million. Thus the total increase as a result of the increase in the mobilisation costs percentage in mobilisation costs capitalised in 2009 was approximately £14.4 million.

92. The gross effect of the capitalisation of the assessed mobilisation costs (i.e., not merely the increase from 1 per cent to 2.75 per cent) was set out by Mr Kelly in his first report:

> "5.30 The effect of the accounting treatment for mobilisation costs on CPL's Financial Statement was to improve reported profits (by deferring the recognition of costs in the profit and loss account to later years rather than charging them all to the profit and loss in the year) by £11.3 million (some 29.8% of profit before tax) and to increase the reported balance of assets (i.e. AROC) by the same amount. The effect of CPL's balance sheet and cumulative profits to 31 August 2009 was £30.4 million. The effect on Connaught's balance sheet and cumulative profits to 31 August 2009 was £32.3 million."

There was no relevant difference between Mr Kelly and Mr Gomer as to the impact of the 2009 capitalisation on the financial statements of the Group and CPL.

Mobilisation costs: (1) The Allegations

93. In summary the allegations against PwC and Mr Harrison are:

(1) The applicable accounting standards did not permit the capitalisation of the mobilisation costs of reactive maintenance contracts.

(2) The Mr A paper was "fundamentally flawed" and should simply have been rejected.

(3) Mr Harrison's A-B = C calculation was itself flawed, and, in any event, was a wholly inadequate basis to accept that 2.75 per cent was a materially reliable calculation of mobilisation costs.

(4) In any event, the mobilisation costs and the method of their calculation were not disclosed in either CPL's or Connaught's financial statements. They should have been.

(5) PwC's and Mr Harrison's actions constituted Misconduct.

Mobilisation costs: (2) The relevant accounting standards

94. The relevant accounting standards were UITF 34 and SSAP 9 for UK GAAP, applicable to the financial statements of CPL, and IAS 18 and IAS 11 (referred to at paragraph 21 of IAS 18 as "generally applicable to the recognition of revenue and the associated expenses for a transaction involving the rendering of services") for the financial statements of the Group.

95. We do not find that the requirements of these standards were clear beyond peradventure, and it is not the function of this Tribunal to give an authoritative

pronouncement on these requirements to the extent that they may be unclear. We also consider that there may well have been a diversity of practice. What we have found clear are the relevant contents of PwC's own manual.

96. PwC's Manual of accounting IFRS for the UK 2009, stated as follows:

> "9.258 When considering costs in relation to a sales contract – be it for goods, services or a construction contract – it is important to firstly determine which standard is applicable.
>
> 9.259 IAS 11 is clear that, for construction contracts, direct costs of the contract can be deferred on balance sheet when certain criteria are satisfied. In contrast, no specific guidance exists in IAS 18 for recognising costs in relation to selling goods or rendering services. However, paragraph 21 of IAS 18 states that, for the rendering of services, the requirements of IAS 11 generally apply to recognising revenue and associated expenses. This cross-reference clarifies that the principles of percentage of completion accounting, as outlined in IAS 11, are applied to contracts for the rendering of services. On this basis, the requirements of IAS 11 as a whole are considered in relation to contracts for the rendering of services. However, IAS 11 would not override any of the IAS 18 guidance. Additionally, it would be inappropriate to delay recognising costs associated with service contracts in the income statement solely on the basis that paragraph 21 of IAS 18 states the requirements of IAS 11 are '*generally applicable'* to service contracts.
>
> 9.260 When considering a contract, other than a construction contract, the treatment of costs will be dependent on the nature of the costs and the relevant facts and circumstances. It may be appropriate to capitalise costs if the entity can recognise an asset under IAS 2, 'Inventories', IAS 16, 'Property, plant and equipment' or IAS 38, 'Intangible assets'. By extension, this principle also requires that the costs meet the definition of an asset under the Framework. The Framework states:
>
>> '*An asset is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity'.* [Framework para 49 a].
>
> 9.261 The application of this principle to contracts for the provision of a service is considered in the examples below.
>
>> **Example 1 – Contract for the performance of services to numerous customers**
>>
>> ….

Example 2 – Contract for the performance of a repetitive service to one customer

Entity C offers outsourced travel booking services to corporate clients. A five-year contract is put in place whereby entity C will undertake all travel bookings on behalf of one specific customer. Entity C allocates separate space within its premises for the provision of services to that customer. Therefore, it is possible to obtain all direct costs for the contract, for example, rent, staff costs, computer and telephone links. Over the period of the contract, entity C will make numerous individual bookings for this specific customer.

The revenue is on a transactional basis – that is, for each individual booking made a fee is charged. Often, transaction numbers are relatively low in the first year of the contract. In addition, certain non-recurring costs (such as training costs) are incurred in the early years of the contract. As such, income is expected to be below costs in the early years of the contract. However, the contract is very likely to be profitable overall as, in later years, the number of transactions will increase and fewer non-recurring costs will be incurred. The entity has good historical data when predicting future revenues and costs of the business under each contract based on experience with similar clients.

As above, costs incurred would be capitalised if they meet the definition of inventory, property, plant and equipment or intangible assets. For example, the cost of acquiring equipment such as desks and computers would be capitalised under IAS 16. Other costs would be expensed as incurred.

Revenue associated with each booking would be recognised as each booking is made. If it is not appropriate to capitalise costs and they are expensed as incurred, then based upon the transaction pattern above, this may result in losses being made in the early years of the contract and profits being made in the later years.

9.262 Service contracts may have initiation or pre-contract costs as well as costs incurred during the contract. For construction contracts, paragraph 21 of IAS 11 requires costs incurred to secure a contract to be included as part of contract costs provided they can be separately identified, reliably measured and it is probable that the contract will be obtained. If such costs are expensed in the period they were incurred, they cannot be capitalised and included in contract costs when the contract is obtained in a subsequent period. This guidance specifically applies to construction contracts, but the question arises as to whether the costs of securing a service contract or a contract to deliver goods can be deferred and recognised over the contract period in a similar way. For such contracts, we consider that the principle in paragraph 9.260 above applies. Consequently, **such costs may be capitalised only when they meet the definition of inventory, property, plant and equipment or intangible assets**."

The emphasis in the last sentence is ours.

97. It was common ground that the Group's and CPL's contracts that were the subject of the capitalisation of mobilisation costs were service contracts. In our view, the reactive maintenance contracts were relevantly indistinguishable from Example 2 above. Indeed, in one respect Example 2 presented a stronger case for capitalisation of mobilisation costs, since the travel agent had exclusivity under its contract, whereas CPL did not have an exclusive right to carry out repairs under its reactive maintenance contracts. If PwC had applied the guidance given in their own manual, they would not have accepted the capitalisation of the mobilisation costs, save in so far as they qualified under another head (inventory, property, plant and equipment or intangible assets). The contracts would not have been treated as a single transaction. The transactions in question were the individual orders for specified repairs or maintenance.

98. We find confirmation of our view that the PwC manual represented the prevailing professional view of the requirements of IAS 18 and 11 in Deloitte's draft letter dated 6 August 2010 to the Board of Directors of Connaught plc. Deloitte's draft letter set out its accounting advice in respect of contract mobilisation cost recognition. Deloitte summarised its advice as follows:

> "The requirements of IAS 18 and IAS 11 are complex and, whilst they do permit for mobilisation costs to be capitalised or spread in certain prescribed circumstances, the appropriate accounting treatment should be determined on a case-by-case basis.
>
> In our opinion, the Group's current 'mobilisation cost' approach, being to capitalise a fixed percentage of contract revenue in the first year of contract operation and to spread the costs over the contract period, is not compliant within the requirements of IAS 18 and IAS 11.
>
> Costs should be individually tracked, and compared to the guidance of both IAS 11 and IAS 18. Only costs specifically meeting the requirements of the standards should be held on balance sheet."

99. We would not find that the Respondents were guilty of Misconduct in failing to follow the guidance in their own manual or for accepting the eligibility of mobilisation costs for capitalisation. We take into account that the requirements of IAS 18 and IAS 11 are complex and less than pellucid. We also take into account that there were powerful reasons to consider some of the Group's contracts as long term, as a matter of economic reality, notwithstanding their notice provisions: see the internal email of [redacted], Connaught's Commercial Director, dated 30 September 2009. We accept Mr Gomer's evidence that some other companies with businesses of a similar nature capitalised mobilisation costs at the time.

100. However, we would have expected in the Respondents' working papers a fuller reference to the undoubted accounting issues and an explanation for and justification of the conclusion that capitalisation was appropriate. The issues included whether the reactive maintenance contracts were such that capitalisation of mobilisation costs was appropriate, having regard to the absence of any minimum or guaranteed revenue, the fact that the contracts could be terminated on notice without cause, and the lack of exclusivity; and whether there was any, and if so what, limitation on the nature of the costs that could be properly capitalised rather than written off as incurred. If there had been an appropriate full discussion of the issues in the working papers relating to the 2008 audit, we would have expected that a copy, or at the very least, a reference to the 2008 paper, would have appeared in the 2009 working papers. There was neither. It seems simply to have been assumed that capitalisation of all of the mobilisation costs of all the contracts in question was appropriate. This was despite the statement in IAS 11 that "the IFRIC …. noted that a great deal of care should be taken when determining

whether pre-contract costs should be capitalised”.[4] The working paper “Obtain comfort over pre contract costs (P Numbers)” listed as an item of work: “Summarise the accounting treatment & policies for P costs. Ensure that this is considered for compliance with accounting standards and GAAP.” However, the paper includes no such summary or consideration.

101. In failing to consider carefully the accounting issues, or, if there was such consideration, in failing to document it, the Respondents’ conduct fell short of the standards reasonably to be expected of them.

102. It was also common ground that the costs to be capitalised must be capable of being measured reliably: see, e.g., paragraph 89 of the Framework. This does not mean that estimates cannot be used; but they must be reasonable estimates. Paragraph 86 of the Framework states:

> “… In many cases, cost or value must be estimated; the use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability. When, however, a reasonable estimate cannot be made the item is not recognised in the balance sheet or income statement.”

103. Thus the question arises: were the estimates of mobilisation costs made for the purposes of the 2009 financial statements reliable?

104. We make it clear that the question for the Respondents, and now for us, was not whether the Group had incurred mobilisation costs. Furthermore, there were likely to have been mobilisation costs that might have been eligible for capitalisation, as being, for example, plant and equipment. The question is whether the sums arrived at were reasonable or reliable estimates.

[4] Footnote 1 to paragraph 21,

Mobilisation costs: (3) The estimates of mobilisation costs

105. Neither Mr Kelly nor Mr Gomer supported the Mr A paper. Mr Harrison regarded it as unauditable, but did not reject it out of hand. The same applies to Mr Davies and Mr Chapman.

106. In our view, the Respondents should have rejected it out of hand. They should have regarded it as manifestly flawed. It depended entirely on what purported to be an accurate mobilisation cost of a "typical" or average contract. Given the wide variety of contracts, varying as to duration, expected revenue, housing units involved and contractual terms, it was impossible to see how there could be a "typical" contract. Moreover, no information was provided as to how what was said to be a typical contract had been arrived at, or what were its relevant characteristics. The paper referred to the experience of "live mobilisation cases over the past year", but it did not identify them or explain how they had been used to arrive at the typical mobilisation cost. PwC did not identify those contracts and therefore could not see whether they justified Mr A's typical cost. The Mr A paper was in our view rightly regarded as unauditable. Mr Kelly did consider it to be auditable, by PwC interviewing staff to corroborate the estimates made in the paper. However, that would have had to be done by reference to actual contracts, which would be a very different exercise from Mr A's assumption of a typical contract.

107. Secondly, it was known that the numbers of weeks each member of the mobilisation team identified in Appendix A to the paper were taken to work on the typical contract were not derived from any time sheets. No information was given as to how those numbers had been determined. In addition, any scrutiny of the numbers would have raised concerns. In general, the descriptions of their work were vague in the extreme,

for example, "Conference calls, review meetings, client contact". The managing director of CPL was stated to work 0.3 weeks on a typical (or average) contract. That implied that on the 42 contracts in Appendix A he spent a total of 12 weeks, and on the entire population of 69 contracts mobilised in 2009 to which the calculation was applied implied that he spent 20.7 weeks on mobilisation – i.e., approaching one half of his time. The Business Development Manager was stated to work 8 weeks on mobilising the average contract. This assumes that he or she worked a total of 336 weeks on the 42 contracts and 552 weeks on the 69. Even if there were several Business Development Managers among whom the work would have been divided, the total is implausible.

108. Mr Gomer stated:

> "… in my experience, other contracting and outsourcing businesses take a very different approach and consider that it is entirely appropriate that where members of the senior management team have been <u>directly</u> involved in the mobilisation of contracts, a relevant proportion of the salary costs would be capitalised. For example, time spent by a senior member of the management team would typically be capitalised in respect of time spent directly attending detailed project management meetings with the mobilisation team for, say, half a day a week in order to get the contract mobilised. Conversely, time spent by senior members of the management team on general high-level discussions about contracts in a management meeting would not be capitalised, as this time would not be considered to be directly involved in the mobilisation of contracts."

109. The underlining is in the original. The difficulty here is that the descriptions in the Mr A paper were far too general and vague for any assurance that the members of the senior management team had in fact been directly involved in mobilisation, quite apart from the dubious quantification of their times.

110. Furthermore, the Mr A paper assumed that mobilisation costs were a fixed percentage of a contract's total expected revenue. This implied that for two contracts identical in all respects including expected annual revenue, apart from duration, with one having a

duration of 5 years and the other of 10 years, the mobilisation costs of the longer contract would be twice those of the shorter contract. That clearly would be an irrational result. Mobilisation costs had to be estimated for each contract since their amortisation depended on the contract length. We note that Deloitte in 2010 considered whether any other support services company used a percentage estimate of mobilisation costs. In their draft letter to the Board of Directors of Connaught dated 6 August 2010 they stated:

> "As part of our investigations, we have reviewed the statutory financial statements of the following competitors of Connaught plc, in order to ascertain whether any other company is using a similar methodology to that of the Group (being the capitalisation of a specified percentage of the total estimated contract revenue during the mobilisation phase of the contract).
>
> We note that no other company states this approach is used in their financial statements. The companies reviewed were as follows:
>
> - Capita Group plc
> - Serco Group plc
> - Interserve plc
> - MITIE plc
> - WS Atkins plc
> - Mouchel plc
> - G4S plc"

111. The Mr A calculation depended on a reliable estimate of the revenue of each contract over a period that could be as long as 10 years. No information was given as to how those estimates were arrived at. Estimates must have been made (and certainly should have been made) by the Group/CPL when preparing its tenders for these contracts. According to the Administrators' Report to the Insolvency Service of 6 June 2011, Connaught's internal policies dictated that contract bids had to be supported by detailed projections of contract performance. However, such tender estimates were not referred to by Mr A in his paper or by the Respondents in their audit work papers relating to the Mr A paper. It should have been obvious to the Respondents that developing reliable

estimates of revenue over the term of these contracts presented substantial challenges, and may not have been possible. Among other things (to some of which we refer at paragraph 172 below), revenue would depend, in the case of contracts with local authorities, on their budgets, which were set annually. Social landlords depended significantly on central government funding, which might vary from year to year and would be subject to political considerations. Mr D, the Finance Director of CPL, stated, in an internal email dated 29 September 2009:

> "Fundamentally I'm not sure that we have any contract documents for any contract that totally state the amount of revenue that we are entitled to. The nature of the business is such that there are always movements in client budget (up & down), work requirements, variations and the like – it is impossible for the clients to state at tender they don't know what their budget is going to be, but they know that the work will need to be carried out, and it is going to be within a value range – as stated in the OJEUs, contract awards, etc.."

He added: "… but I would say that to my knowledge we have never been vastly out in our forecast revenues", but this does not detract from the relevance of his comments to long term estimates of contract revenue.

112. The Mr A paper also assumed that general administrative costs, such as conference calls by management, qualified as costs that could be capitalised, irrespective of whether such costs created an asset. It is instructive to refer to Deloitte's advice in its draft letter dated 6 August 2010 to the Board of Directors of Connaught:

> "**5.3 Application of the accounting treatment to mobilisation costs**
>
> As detailed above, under IAS 18 costs and revenues for the provision of regular services are recognised as incurred.
>
> Mobilisation costs incurred at the outset of a contract are capitalised onto the balance sheet and amortised over the life of the contract. These costs represent *those which are absolutely necessary to enable management to meet their contractual obligations* and therefore meet

the definition of an asset under IAS 38 — by giving guaranteed access to future economic benefits.

Although contract revenues and costs are not governed by IAS 11, further guidance is given in that standard, and within IAS 38, on costs that can be capitalised as part of the mobilisation phase."

The italics are ours.

113. Deloitte referred to IAS 11 and gave the following summary:

"This guidance supports the conclusion that mobilisation costs should only relate to costs that are absolutely necessary to enable management to meet their contractual obligations (for example, transition of systems and data to the contractors network, or contractual requirements to re-livery equipment or vehicles). General administration costs, such as the costs of senior management time in the early stages/set-up of a contract, should not form part of mobilisation costs.

In support of this, IAS 38 provides further guidance about the types of costs which should be expensed rather than capitalised as an asset.

5.3.2 Capitalisation guidance within IAS 38

IAS 38 notes that in some cases, expenditure is incurred to provide future economic benefits to an entity, but no intangible asset or other asset is acquired or created that can be recognised.

In these cases, the expenditure should be recognised as an expense when it is incurred. For example, except when it forms part of the cost of a business combination, expenditure on research is recognised as an expense when it is incurred. Other examples (as included in IAS 38) of expenditure that is recognised as an expense when it is incurred include:

- expenditure on start-up activities (ie start-up costs), unless this expenditure is included in the cost of an item of property, plant and equipment in accordance with IAS 16 "Property, Plant and Equipment". Start-up costs· may consist of establishment costs such as legal and secretarial costs incurred in establishing a legal entity, expenditure to open a new facility or business (ie pre-opening costs) or expenditures for starting new operations or launching new products or processes (ie pre-operating costs);
- expenditure on training activities;
- expenditure on advertising and promotional activities;
- expenditure on relocating or reorganising part or all of an entity.

As described above (in either IAS 11 and/or IAS 38) general administrative costs, generic training costs (rather than technical training absolutely necessary to operate a contract), pre-opening type costs and various other "general" costs should be expensed rather than capitalised.

It should be noted that, in general, costs incurred in order to increase the future efficiency of a contract would not normally fall within the types of costs described in IAS 38 (set out above) and would therefore need to be expensed.

5.3.3 Costs to be included within "mobilisation costs"

Given the guidance above, during the mobilisation phase of a contract, Connaught should track costs incurred in order to commence services. Expenditure should be split between amounts relating to the provision of individual services remunerated via monthly or quarterly invoice, and those relating to contract mobilisation.

Mobilisation costs will include a number of the work streams noted in section 1 of this paper, including:

- Transition of systems;
- Transfer of property to the Group's control, together with associated maintenance; and
- Transfer of assets to the Group, together with associated re-livery.

On a contract by contract basis, management should then assess whether each of the costs incurred was necessary for mobilisation of the contract."

114. The Deloitte's advice in its draft letter is largely consistent with the opinion of Mr Kelly. We also note that KPMG, in their Administrators' report, commented:

"Mobilisation costs, being the costs of finalising contracts terms and setting up the contract infrastructure, were capitalised based on a percentage of total forecast revenue, not actual costs incurred. The capitalisation of costs on this basis appears to be inconsistent with the prevailing financial reporting standards, as highlighted by Deloitte in their letter dated 6 August 2010… "

115. An additional problem with a percentage calculation of mobilisation costs is what was referred to during the hearing as the "cut-off" problem. The problem can be illustrated by the following hypothetical example. CPL was informed on 31 May 2009 that the client intended to enter into a contract with it. CPL begins pre-contract work immediately, and that work continues beyond 31 August 2009. Applying the percentage, the entirety of the calculated mobilisation costs are treated as incurred in the year ended 31 August 2009, although in fact only part of those costs would have

been incurred as at that date. The result is an adjustment to the balance sheet and the profit and loss account that exceeds that which would have been justified if only those costs incurred in the year ended 31 August 2009 had been capitalised. Since most of the reactive maintenance contracts were entered into in the year ended 31 August 2009, the effect of the cut-off problem is likely to have been significant. The increase in 2009 of the mobilisation costs of the 9 contracts which had begun in 2008 also illustrates this problem.

116. Mr Gomer defended the use of a standard cost “but only in circumstances where the directors and management of the entity are satisfied, based on the individual facts and circumstances, that the standard cost approach applied is a reasonable proxy for the actual costs incurred for mobilising those contracts”. We take it that by “actual costs” Mr Gomer was referring to the actual costs of those *directly* involved in the mobilisation of contracts: see paragraph 108 above. We have seen nothing to show that the directors and management of the Group were, or could reasonably have been, satisfied that the standard cost was indeed a reasonable proxy for actual costs. For the reasons we have given above, we do not think that such a conclusion could sensibly have been open to them.

117. As we stated above, the Respondents should simply have rejected the Mr A paper and if no other information was provided by management they should have qualified their audit opinion. In any event, however, we consider that the work that was done to audit mobilisation costs was wholly inadequate.

118. It is common ground that the Respondents were required to comply with ISA 540, and specifically paragraphs 10 and 11:

> "10. The auditor should adopt one or a combination of the following approaches in the audits of an accounting estimate:
>
> (a) Review and test the process used by management to develop the estimate;
>
> (b) Use an independent estimate for comparison with that prepared by management; or
>
> (c) Review of subsequent events which provide audit evidence of the reasonableness of the estimate made.
>
> 11. The steps ordinarily involved in reviewing and testing of the process used by management are:
>
> (a) Evaluation of the data and consideration of assumptions on which the estimate is based;
>
> (b) Testing of the calculations involved in the estimate;
>
> (c) Comparison, when possible, of estimates made for prior periods with actual results of those periods; and
>
> (d) Consideration of management's approval procedures."

119. With regard to paragraph 10(a) and paragraph 11, in our view, already expressed, evaluation of the data and consideration of the assumptions in the Mr A paper should have led to its rejection. The calculations involved in the Mr A estimate could not be tested, and were not tested, other than arithmetically and by a check on rates of pay. No comparisons of prior periods were made. Management approval procedures were irrelevant.

120. The Respondents sought to make an independent estimate for comparison with that prepared by management. They reviewed remaining overheads expensed after capitalisation of mobilisation costs. This was referred to in the hearing as A = B + C, and sometimes as A = B + C + D. The calculation used by PwC can be seen in the table reproduced at paragraph 90 above from the Critical Matter work paper "Pre contract and set-up costs" and in PwC's report to the Audit Committee. A was total overheads; B mobilisation costs capitalised; C was "overheads expensed". D was amounts directly

charged to contracts. There was no detailed testing of C, and the exercise could not therefore lead to a reliable estimate of B. The result was the following table:

	2009	2008	Increase/ (decrease)	
	£m	£m	£m	
Total overheads pre-allocation	65.5	48.6	16.9	A
Overheads directly charged to contracts	(33.9)	(22.2)	(11.7)	D
P number additions (mobilisation costs capitalised)	(18.3)	(11.7)	(6.6)	B
	(52.2)	(33.9)	(18.3)	
Overheads charged	13.3	14.7	(1.4)	C

121. The difficulty with this work is that it relied on Mr Harrison's expectation that expensed overhead costs (C) remained the same in 2009 compared with 2008, "or a bit less". This was an untested assumption that could not form the basis for a reliable calculation of B. As Mr Kelly put it, the test implicitly assumes that any increase in costs related to mobilisation costs; but this was what was required to be proved.

122. Mr Gomer also thought that the overheads test was inadequate. His opinion was set out in paragraphs 4.95 and following of his Report:

> "4.95 The alternative approach [followed by PwC] effectively involved the auditors considering whether the total overhead costs as reported by Connaught in CPL's 2009 Financial Statements (i.e. after taking account of the 2.75% of mobilisation costs capitalised by Connaught) appeared to be in line with expectations compared with 2008 (Exhibit RK15). This was on the basis that, had Connaught effectively capitalised too many costs in respect of mobilisation costs in 2009 as a result of increasing the amount of mobilisation costs to 2.75%,

this would have led to too low an amount of overheads being reported in CPL's 2009 Financial Statements.

4.96 In my opinion, this was a proper and valid test for the auditors to consider and demonstrated that the auditors were clearly focussed on ensuring that the amount of mobilisation costs capitalised by Connaught in 2009 was reasonable and not excessive. As noted above, ISA 540 specifically envisages that an auditor may need to adopt an independent estimate of an accounting estimate to compare with the accounting estimate calculated by management.

4.97 I have reviewed the audit work carried out by the auditors as reflected in the audit work-papers, and also considered the detailed comments included in the witness statements of Mr Harrison, Mr Davies and Mr Stratford in connection with the additional work carried out by the auditors and the judgements they took when assessing the reasonableness of overheads in CPL in conjunction with the reasonableness of the 2.75% capitalised mobilisation costs.

4.98 In my opinion, the auditors were diligent in carrying out the additional work in order to assess whether the additional 1.75% of mobilisation costs capitalised was reasonable or not. In my view, the auditors applied their minds in trying to find an alternative approach of auditing mobilisation costs, particularly given the significant number of assumptions and judgements made by Connaught in order to calculate the 2.75% mobilisation costs rate included in Mr A's Mobilisation Paper.

4.99 However, for a business such as CPL's which in 2009 was experiencing a high amount of growth and change in the scale of its operations, in my opinion, it was possible but very difficult for a reasonable auditor to calculate an expectation of overhead costs for 2009 with a sufficient level of precision or accuracy to assess or detect whether a material error had been reflected in the calculation of overheads. In my view, any such analysis would have required more granularity than the auditors applied in this case when determining a reliable expectation of the 2009 overhead costs (although I would accept that the level of granularity required is a matter of judgement).

4.100 As noted above, I consider that this was a proper and valid test for the auditors to consider. However, in my view, for the test to provide sufficient assurance that no material error existed, the auditors would have needed to calculate a reliable expectation of the level of overhead expense on a more granular level (i.e. on a category by category of costs basis), considering each of the relevant drivers for each expense category (including headcount, number of offices and office space and actions taken during the year, for example, in connection with advertising and promotions etc.) to compare with the actual expense observed.

4.101 In the event, it appears to me that the auditors approached this by building an expectation of total overheads for CPL for 2009. For example, at paragraph 147 of his witness statement, Mr Harrison notes that "*We expected the overhead costs expensed in the business to remain broadly similar from 2008 to 2009, or indeed be slightly lower"*. I note that the auditors did carry out a more detailed analysis of the actual overhead costs incurred in 2009 for CPL by various categories (as shown in the work-paper at Exhibit RK15). Additional work was carried out on the overall reasonableness of such overhead costs elsewhere in the audit files, for example, in connection with payroll testing and overall analytical review. However, in my opinion, given the amount of growth and change in the scale of CPL's operations in 2009, an expectation based on total overheads (without a more granular analysis) would not be reliable enough to provide the level of assurance required (although I would accept that the extent of the additional level of granularity required in respect of that expectation is a matter of judgement, as noted above).

4.102 Accordingly, in respect of the additional 1.75% of mobilisation costs capitalised in 2009, in my opinion, the auditors' work fell short, <u>but not significantly short,</u> of the standard I would expect of a reasonable auditor."

The underlining is in the original.

123. In cross-examination Mr Gomer accepted that the overheads test could not constitute an independent estimate of mobilisation costs as required by ISA 540:

"Q. No, this is precisely the first point that I'm putting to you. You were right the first time: there was a general expectation of C, but there was not an estimate of C. So that's why I'm putting to you that it wasn't an independent estimate within 540 at all?

A. And that is one of the principal concerns that I have with the tests, is that the detail behind the expected C is less than I would have expected to see. So it was an overall expectation of C rather than, as you suggest, Mr Herberg, a more detailed buildup of C."[5]

124. Figure D did not feature in PwC's explanation of the Overheads test. Mr Kelly's evidence was as follows:

"Q. Mr Kelly, can you explain, if convenient by reference to page 35, what is that figure D and what the problem that you're saying there with figure D is?

A. Okay. So D is the amounts which have been directly charged to the contracts, but not through the time sheet system. So this is effectively

[5] Day 9/210

> salaried costs, of salary time, that were charged to contracts. Now, ordinarily, in order to looking at that, I wouldn't be overly concerned if it's just a reclassification between profit and loss account numbers, because it's either come into cost of sales --
>
> Q. Can I just ask you to pause before you go on in your explanation, just so we can see what is the number D on page 35 before you go on?
>
> A. So D is the directly charged 33.9 on page 35. …
>
> A. So D now becomes a important number, because it's effectively -- it's the biggest deduction from the 65.5 million of the total overheads. So what I can't find evidence of is how PwC checked that that directly charged number were correctly charged to contracts. They looked at the direct staff, so those were timesheets and how they were charged to contracts, but we can't see evidence of how they checked the directly charged going into contracts -- so the indirectly charged, sorry, so the salaried costs. So clearly that becomes an important part of the equation when you are considering the argument minus B minus C, because there's also D and that's my concern with D."[6]

125. Mr Gomer accepted that no audit work had been carried out on D specifically for the purpose of the overheads test. He said that it was an expense which was audited by the review of the controls around the allocation of that expense: Day 9 page 231. This was not adequate to arrive at a reliable figure to use in the estimation of mobilisation costs.

126. Paragraphs 51 and 52 of ISA 330 "The Auditor's Procedures in Response to Assessed Risks" were as follows:

> "51. When, in accordance with paragraph 108 of ISA 315, the auditor has determined that an assessed risk of material misstatement at the assertion level is a significant risk, the auditor should perform substantive procedures that are specifically responsive to that risk. ….
>
> 52. When the approach to significant risks consists only of substantive procedures, the audit procedures appropriate to address such significant risks consist of tests of details only, or a combination of tests of details and substantive analytical procedures The auditor considers the guidance in paragraphs 53 – 64 in designing the nature, timing, and extent of substantive procedures for significant risks. In order to obtain sufficient appropriate audit evidence, the substantive procedures related

[6] Day 9 page 45.

> to significant risks are most often designed to obtain audit evidence with high reliability."

127. There was clearly a significant risk of material misstatement in relation to the capitalisation of mobilisation costs. The standard was clear, and required a test or tests of details. The overheads test was not a test of details, as Mr Gomer accepted. He said, at Day 10 page 12:

> "Mr Gomer: I agree, obviously, that the standard is quite clear. It says you can't rely solely on a substantive analytical procedure. I'm suggesting that the procedure as was performed was purely a substantive analytical procedure but with the specific detail I'm describing you would still be able to do a test in total but there would be some additional tests to support it, which perhaps in Mr Herberg's description could be described as tests of detail to support that, but you get the same result, I would say.
>
> Mr Cory-Wright: But in relation to what was done, that clearly did not meet the standard?
>
> Mr Gomer: Which is what I said in my report: it was not sufficient on its own."

128. We take into account Mr Gomer's comments and his view set out in paragraph 4.102 of his Report. However, it is our clear view that the overheads test, as carried out by PwC, was fraught with a number of difficulties which meant that it could not conceivably result in an independent estimate of mobilisation costs to be capitalised for comparison with that prepared by management.

129. The following extract from Mr Harrison's evidence is illuminating:

> "Mr Harrison: … So, therefore, what I expected in Connaught was the fact that those selling and admin expenses would remain fairly constant with the prior year, (a) because they tend to be fixed costs, they don't vary with contract activity because of their nature, and also the selling activities in Connaught were actually lower in the current year that we are dealing with because they were spending so much time on dealing with the contracts they'd already won and implementing.
>
> So I actually expected it to actually, you know – I actually expected it to remain the same rather than fall. I also thought that because we'd under

> – I think that the client had – the 1% was under estimate of the previous year, that we'd over expensed in the prior year and that would come through in the current year. I thought the element that we had undercharged had actually come through in the current, that's how I arrived at my estimate.
>
> Mr Cory-Wright: You've touched on several things here, but even in circumstances where little has changed from one year to the next it's quite difficult to do this type of analysis and proof in total, as you describe it, to any degree of precision. But in the case of Connaught we have a number – quite a number of things that make that even more difficult. One is it is growing rapidly. The nature of the business is changing very significantly and the nature of the contracts is changing. There is an internal reorganisation and, if I understand the critical matters work paper properly, it appears that there is a difference between 2008 and 2009, so far as CPL is concerned, in that certain costs which were born by CPL –
>
> Mr Harrison: That's gone into –
>
> Mr Cory-Wright: – have been borne centrally and no adjustment seems to have been made for that within the CPL reconciliation. So there are a number of things that make what is anyway quite a difficult exercise to do very, very difficult. Would you agree with that?
>
> Mr Harrison: Yes, and it was then down to degree of materiality, as far as I was concerned, given the nature of the test.
>
> Mr Cory-Wright: Of course this test, this overhead proof in total, as you describe it, it is effectively the one and only substantive test that was performed.
>
> Mr Harrison: To confirm management's estimate, yes."[7]

130. PwC also took into account the costs written off on the Glasgow Housing Association ("GHA") matter. The Group was informed that GHA would enter into a contract with CPL, but the contract fell through over difficulties with pension liabilities, after substantial mobilisation costs had been incurred. Costs of £1.5 million were written off in 2009, representing 2.3 per cent of the expected revenue over the term of the contract. These mobilisation costs were not audited, and it was not known what their nature was.

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[7] Day 3 page 129.

131. We do not think that the Respondents themselves considered the overheads test as an independent estimate of mobilisation costs. In the Critical Matter work paper entitled "Pre-Contract/Set-up costs" they stated only:

> "Based on our proof in total of overheads in the CPL business the level of pre-contract costs capitalisation appears reasonable …."

In the Critical Matter work paper entitled "Reports to the Audit Committee 2009 – 6 October 2009 interim report and final conclusions report (and associated minutes)" Mr Harrison is reported as having said to the Audit Committee:

> "Pre contract costs – SWH noted increasing costs and way PwC had done an overall proof to *sense check* what costs left in P & L.… "

The italics are ours.

132. Having criticised the use of a standard percentage to determine mobilisation costs, it is relevant to refer to PwC's recommendation to the Audit Committee, in their final report dated 12 October 2009:

> "The change in the group's business to more long-term outsource contracts has resulted in the group having to incur greater costs in setting up contracts that may run from 5 to 15 years.
>
> At present, these set-up costs are accounted for as a "standard cost" percentage attributable to the long-term contracts. Given the increasing significance of the "set-up costs" on major contracts, we recommend that the cost should be determined on an "actual basis" for each contract, including the related overheads.
>
> We also recommend that the analysis of overheads for social housing should identify separately:
>
> a) proposal and tendering costs
> b) general administration
> c) mobilisation of contracts
> d) management and monitoring of the contracts
>
> Those overhead costs relating to (c) and (d) above should be charged to the individual contracts to the extent of the actual cost incurred. The extent of any over/under recovery of the total overhead costs (ie the extent to which it is not

> charged to individual contracts) should be investigated on a monthly basis as it arises."

133. In considering the Respondents' audit work, we have necessarily taken into account the materiality, indeed the importance, of the amounts involved to the financial statements of the companies. We have come to the clear conclusion that the Respondents' audit work on mobilisation costs was not merely significantly, but was substantially short of the standard reasonably to be expected of them.

Mobilisation costs: (4) Disclosure

134. The policy of capitalising and amortising mobilisation costs was not disclosed or referred to in CPL's financial statements. Given the great materiality of the amounts in question, which transformed the results of CPL in terms of its profits, in our view the absence of any mention of the policy gave the reader of the financial statements a misleading view of the results of the company and of its financial position at year end.

135. The Respondents contend that it was sufficient that reference to the capitalisation policy was made in the financial statements of Connaught plc. The intelligent and informed reader of Connaught plc's accounts would realise that the policy must have been applied in its subsidiaries, and specifically CPL. The financial statements of CPL made it clear that it was a subsidiary of Connaught, and there was express disclosure in the Group financial statements of the capitalisation policy.

136. In our view, the 2009 financial statements of CPL did not give a true and fair view. Whether they did so must be determined on the basis of the financial statements standing alone, subject to any express or clear cross reference made in them. The disclosed accounting policies of CPL did not include any express reference to the Group's financial statements, and standing alone they gave a misleading view of the

profits and assets of CPL. An intelligent reader would not realise that the reported profits had been arrived at substantially by reason of the capitalisation of mobilisation costs incurred in the year. The Respondents should have insisted on a clear description of the capitalisation and amortisation policy for mobilisation costs, which would have been improved by a statement of the relative size of the effect of the application of the policy. In the unlikely event that management objected to the inclusion of appropriate disclosures, the Respondents should not have signed off without qualification.

137. CPL was a contracting company, and its financial statements were relevant to its clients and potential clients. However, its financial statements were primarily intended for its sole shareholder, Connaught itself, which was of course well aware of its accounting policies and their application. In these circumstances, while we regard the conduct of the Respondents in relation to disclosure to have been below the standard reasonably to be expected of them, we do not consider it to have been significantly so.

138. The Group's 2009 financial statements did refer to the capitalisation of mobilisation costs:

> "Pre-contract costs are expensed as incurred, except where there is a reasonable certainty that the contract will be awarded, in which case they are recognised as an asset (within amounts recoverable on contracts) which is amortised to the income statement over the period in which they are reimbursed, generally equivalent to the term of the contract."

139. This statement was at best incomplete. It made no reference to start-up costs or to the method used to determining the amount of mobilisation costs capitalised. It gave no impression of the importance of the capitalisation of mobilisation costs to the Group's financial results. The reference to costs being "reimbursed" was inapt: it should have referred to their being recovered. The disclosure did not approach the clarity and content of that of Babcock plc, put into evidence by the Respondents, and was

imperfect. However, we do not consider that the Respondents' conduct in relation to the disclosure in the financial statements of the Group to have been significantly below the standard reasonably to be expected of them.

Mobilisation costs: (5) Conclusion on capitalisation of mobilisation costs

140. For the above reasons, we find that the conduct of the Respondents fell substantially below the standard reasonably to be expected of them. We find the first allegation of Misconduct to be proved.

Allegation 2: Long Term Accounting Adjustments

Long Term Accounting Adjustment: (1) The preliminary issue

141. There were, at least originally, two aspects of the Executive Counsel's allegations under this head. First, it was alleged that the Respondents should have concluded that the contracts to which management applied the policy of long-term accounting adjustments were, under the applicable accounting standards, ineligible for such adjustments. The resolution of this issue depended on the interpretation and application of the relevant standards, the terms and the practical effect (sometimes referred to as the economic reality) of the contracts in question, and the work done by the Respondents in order to conclude that the adjustments might be appropriate.

142. The second aspect of this allegation was that the Respondents failed adequately to audit management's application of the policy, i.e., they failed to obtain adequate audit evidence that the forecasts made by management were sufficiently reliable, as required by the applicable standards.

143. In his closing submissions, Mr Adam QC for the Respondents made a powerful submission that it was not open to the Executive Counsel to seek a finding of Misconduct in relation to the second aspect of the allegation, viewed in isolation from the first aspect, and that the Tribunal could not fairly, and should not, make a finding of Misconduct in that respect.

144. In the Executive Counsel's Formal Complaint, Particulars 5 and 6 of Allegation 2 were as follows:

> "5. [The Respondents] failed adequately to consider whether the outcome of the contracts could be estimated reliably in accordance with paragraphs 20 and 23 of IAS 18 and paragraph 22 of IAS 11 (in relation to Connaught) and in accordance with paragraphs 9 to 10 and 29 of SSAP 9 (in relation to CPL) notwithstanding (i) the facts and matters set out in paragraphs [45] and [47] above and (ii) the weakness on the part of management (acknowledged by the Respondents no later than 15 April 2010, prior to Mr Harrison signing the auditor's report in relation of CPL's financial statements) to forecast margins reliably.
>
> 6. [The Respondents] failed to approach management's representations in relation to contract performance with sufficient professional scepticism."

145. In Mr Kelly's first expert report, served at the same time as the Formal Complaint, he stated that the Respondents' work in auditing management's forecasts was deficient, below the standard that reasonably could be expected of them, but not significantly so. As a result, in the Respondents' solicitors letter dated 14 December 2015 to the Executive Counsel's solicitors the following request was made:

> "2.2 At paragraph 2.68 of his report, Mr Kelly concludes that "PwC and Mr Harrison's work on the accuracy of forecasting of long term contracts fell short, but not significantly short, the standards reasonably to be expected of a Member Firm and Member of the ICAEW." Mr Kelly's opinion in this respect would appear to contradict Allegation 2 of the Formal Complaint: in particular Allegations 2 (5) and 2 (6) which relate directly to the work performed by our clients in connection with the forecasts supporting the long-term contract accounting adjustments.
>
> 2.3 We should be grateful for your explanation as to:

> (a) whether the Executive Counsel intends to pursue Allegation 2 is presently formulated in the Formal Complaint given the conclusions reached by Mr Kelly; and
>
> (b) if the Executive Counsel does intend to pursue the allegations of misconduct currently set out in Allegation 2 of the Formal Complaint, how the Executive Counsel proposes to address the issues raised by the conclusions in Mr Kelly's report."

146. The solicitors to the Executive Counsel replied by letter dated 17 December 2015:

> "The Executive Counsel intends to pursue Allegation 2 as formulated. Whilst Mr Harrison and PwC's work in relation to forecasting might not, when considered in isolation, amount to Misconduct (on the basis of Mr Kelly's view that the conduct fell short, but not significantly short, of the standards reasonably to be expected), it is the Executive Counsel's case that it does amount to Misconduct when considered in the context of the Respondents' other failures in relation to the 23 LTA Contracts and more generally on the audit. Executive Counsel's case will be that the Tribunal should be concerned, in relation to whether Misconduct has been committed, with the cumulative failings of Mr Harrison and PwC in relation to the audit."

147. In the course of the hearing, it became clear that the Executive Counsel and his legal team, Mr Kelly, and indeed the Respondents' legal team, had not fully understood what was referred to as the P10/P12 test. We shall describe and discuss that test below, but for the present it is sufficient to note that it had mistakenly been thought by the lawyers and Mr Kelly that the figures used in that test were unadjusted figures. Mr Gomer said that he was aware that the long-term adjustments were included, but he could not remember whether it was when he prepared his report or subsequently. His report is inconsistent with his having been aware of this when he prepared it. At paragraph 6.23 he said:

> "One of the key work-steps carried out by the auditors at the interim stage (P10) and year end stage (P12) of the audit to assess management's ability to forecast reliably was in respect of work on margin reviews. The auditors selected a large number of contracts (including most but not all of the 23 LTA Contracts) and compared *actual margins* on a contract by contract basis with budgeted margins at P10 and P12, …"

The italics have been added.

148. During the course of Mr Adam QC's opening, Mr Harrison corrected him and pointed out that the figures in question had been adjusted under the LTA policy. This led Mr Kelly to change his opinion, and to conclude that the Respondents' work in relation to forecasting had been significantly below the standard reasonably to be expected, and the Executive Counsel to submit that even viewed in isolation, the Tribunal should find that it constituted Misconduct.

149. In essence, Mr Adam submitted that Mr Kelly's first report, read with the Formal Complaint, together with the exchange of correspondence to which we have referred, led the Respondents to consider that they did not face an allegation that their work on forecasting, at least viewed in isolation, was contended to constitute Misconduct, that as a result the work involved in P10/P12 had not been fully investigated by the Respondents as it would have if the Executive Counsel's case had been that it of itself constituted Misconduct. In these circumstances it would be unfair for a finding of Misconduct to be made on the basis of the criticisms now made in relation to the P10/P12. It was not therefore open to the Executive Counsel to seek a finding of Misconduct on that basis, or to the Tribunal to make such a finding.

150. We do not accept this submission. It is clear to us that the Respondents defended the criticisms of the P10/P12 test. In their Defence dated 14 April 2016, served after their receipt of Mr Kelly's first report and after the above exchange of correspondence, they stated:

> "29. When read in conjunction with the Kelly Report (see in particular sections 6 and 7), it seems that the allegations in the Formal Complaint in respect of the Long-term Contract Accounting Policy are intended to address two separate issues:
>
> (1) whether it was appropriate for Connaught to have accounted for each of the 23 LTA Contracts to which it applied the Long-term Contract

Accounting Policy as if they were *"one transaction"* for revenue recognition purposes (***"the One Transaction Issue"***); and

(2) whether Connaught was able to estimate the outcome of the 23 LTA Contracts to which it applied the Long-term Contract Accounting Policy with sufficient reliability (***"the Forecasting Issue"***)."

We shall similarly use these convenient expressions, i.e., the One Transaction Issue and the Forecasting Issue.

151. In paragraph 39 of the Defence, it was contended that in the light of Mr Kelly's First Report, Allegations 2(5) and (6) were unsustainable, but the Respondents then pleaded to those allegations. Paragraphs 40 to 43 of the Defence are the Respondents' response to Allegations 2(5) and 2(6). P10/P12 was the subject of paragraph 42(4):

"(4) PwC selected a large number of contracts and compared actual margins with budgeted margins on the contract-by-contract basis at the P10 and P12 stage. PwC then discussed the results of their analysis with management and obtained explanations for any large or unusual variances. This review did not raise any significant issues or concerns about management's ability to reliably forecast contract outcomes."

152. In his witness statement, Mr Harrison dealt at length with the Forecasting Issue at paragraphs 221 to 274 and described the audit work carried out on it. He said, at paragraph 225:

"Our approach, therefore, was to focus on the following:

(a) an assessment of the control environment around management's forecasting;

(b) actual performance against forecast by comparing P 10 to P 12 figures;

(c) a consideration of historic margins;

(d) checking of management's calculations for the LTCA adjustments to ensure that they were substantially correct and that they tied into the underlying financial records; and

(e) a sensitivity analysis to obtain comfort that the long-term contract accounting adjustment was not likely to lead to a misstatement material

> to the truth and fairness of the accounts (including validating the tenure of a number of contracts)."

153. He concluded, so far as is relevant, at paragraph 274 (e):

> "(e) I have also set out above how we concluded that the outcome of the long-term contracts could be estimated reliably and in accordance with accounting standards.…"

154. Mr Stratford addressed the Forecasting Issue in his witness statement:

> "115. A key part of our assessment of the Long-term Contract Accounting Policy related to the extent to which we were satisfied that management's estimation of future contract revenues and margins were sufficiently reliable. During our audit work we obtained management's explanations and noted that, as far as revenues were concerned, they were typically within the range of total revenues that the customers had publicly released in the cases where we sample checked this. During our audit work we also compared forecast margins to the historic margins which the business had achieved and we found these to be in the same range or slightly lower. Management had also explained to us that not all of the efficiencies expected to be made had been built into their cost forecasts, for instance many of the bids had been made prior to the financial crisis and there were now opportunities to make savings on labour costs, as increased unemployment would be likely to minimise wage rate increases."

155. Mr Stratford then set out the work in which he had been involved in relation to long-term contract adjustments. He concluded:

> "180. I believe that during our audit work we gave proper consideration to the nature of the contracts in relation to which Connaught wanted to use long-term contract accounting and took reasonable steps to satisfy ourselves that these were the sorts of contracts for which long-term contract accounting was permissible. We properly considered management's track record of providing contractual estimates and were satisfied that management were able to make reliable estimates in relation to the performance of their contracts. We undertook detailed work in relation to Connaught's proposed a long-term contract adjustment and made adjustments in order to satisfy ourselves that it appeared to be reasonable and free from material error. We also highlighted this issue clearly with the Audit Committee and discussed it with them."

156. In his witness statement, Mr Davies dealt at length with his work on the long-term contract adjustment, including his work on the Forecasting Issue. He entitled his

Workstep "Review the accuracy of estimating procedures and forecasting in the light of past experience". He referred to his work on P10 and on P12 at, among other places, paragraphs 82 and 88(b).

157. Mr Gomer addressed the Forecasting Issue in his Report. He summarised the audit work carried out and concluded:

> "6.46 In my opinion, based on the audit work carried out by the audit team combined with the cumulative knowledge and experience of the audit team (as explained in more detail above), I consider that it was reasonable for the auditors to reach their conclusion that the client could make reliable estimates as to total contract revenues and contract margins and therefore that the likely outcome of the transactions involving the rendering of services under Connaught's outsourcing agreements and partnership contracts could be reliably estimated."

158. Mr Gomer addressed the particulars of the Allegations in the Formal Complaint at paragraph 6.156 of his Report. In relation to the Forecasting Issue, he stated:

> "I consider that the auditors obtained sufficient audit evidence to indicate that Connaught was able to forecast contract revenues and contract out-turns reliably, as required under IFRS and UK GAAP for long term contract accounting adjustments to be made.…"

159. Mr Harrison and Mr Davies, in particular, were cross-examined on the Forecasting Issue, and both Mr Kelly and Mr Gomer addressed it in cross-examination. Mr Kelly changed his opinion on the basis of the Respondents' factual evidence that emerged in the hearing. He was both entitled and bound to do so.

160. It was clear to the Tribunal throughout the hearing that the Forecasting Issue was a live issue. Both parties were aware that the Tribunal was not bound by either expert's opinion as to whether the audit work carried out was, in any particular respect, below or significantly below the standard reasonably to be expected of the auditor.

161. Mr Adam gave no specific example of further work that might have been carried out by the Respondents to present their case on the Forecasting Issue. Ultimately, the Forecasting Issue is relatively straightforward and uncomplicated. We are satisfied that the Forecasting Issue was fully and properly investigated during the hearing.

162. We take into account that in the Workstep paper "Roll forward margin analysis from period 10 to year end – P12", the comments against a number of the contracts, such as Bromford and Matrix, included references to long term contract adjustments. It may be that this element of the test could have been identified earlier.

163. However, what in our view is important is that the issue was identified and fully investigated before us.

164. We do not accept that the Respondents have suffered any unfair prejudice.

Long Term Accounting Adjustments: (2) The One Transaction Issue

165. We could lengthen this Report with a long discussion of the applicable accounting standards. Ultimately, however, we accept that their requirements and contemporary practice were not so clear and unambiguous as to justify a finding of Misconduct on the part of the Respondents in accepting the eligibility for adjustment of CPL's long-term contracts to which the long-term contract adjustment policy was applied.

Long Term Accounting Adjustments: (3) The Forecasting Issue

(a) The requirements under the standards

166. By contrast, the requirements of the applicable accounting and auditing standards in relation to the Forecasting Issue were common ground. Paragraph 20 of IAS 18 was as follows:

> "When the outcome of a transaction involving the rendering of services can be **estimated reliably**, revenue associated with the transaction shall be recognised by reference to the stage of completion of the transaction at the end of the reporting period. The outcome of a transaction can be **estimated reliably** when all of the following conditions are satisfied:
>
> (a) The amount of revenue can be **measured reliably**;
>
> (b) It is probable that the economic benefits associated with the transaction will flow to the entity;
>
> (c) The stage of completion of the transaction at the end of the reporting period can be **measured reliably**; and
>
> (d) The **costs incurred** for the transaction and the costs to complete the transaction can be **measured reliably**."

(Emphasis added.)

167. It was common ground that in substance the requirement of reliable estimation in IAS 18 is in substance the same as the requirement in UK GAAP, in SSAP 9 paragraphs 9 and 10, of "reasonable certainty".

168. Thus long-term contract adjustments may only be made if the entity in question can reliably estimate the outcome of the transactions in question. As Mr Gomer said in his Report:

> "6.10 As explained in Section 5 of my report, in order for an entity to be in a position to apply longer term contract accounting, an entity must be able to make 'reliable' estimates as to total contract costs and revenues (and therefore contract margins), and accordingly, it is also usually necessary for the entity to have an effective internal financial budgeting and reporting system."

169. See too the Respondents' Defence at paragraph 40:

> "PwC properly understood that, in accordance with the relevant accounting standards, Connaught's ability to account for its long-term contracts under the Long-term Contract Accounting Policy was dependent on whether it could estimate the outcome of those contracts reliably. …"

170. The question for us, therefore, is whether the Respondents' audit work in respect of the forecasts made by the Group's management in relation to the long-term contracts in question was below the standard reasonably to be expected of them, and if so whether their work was significantly below that standard.

The Forecasting Issue (b): Management's Estimates

171. On 18 August 2009 Mr A provided a paper entitled "Long Term Accounting". It stated that the current contract portfolio had been reviewed to identify those contracts with high annual and lifetime turnover projections and contract tenure of 5 years or greater and/or impacts of seasonality. The paper then listed 14 contracts with an estimated lifetime value varying from £12 million £249 million and with a tenure of 5 or 10 years. It was not and is not evident in the paper that seasonality played any part in their selection.

The Forecasting Issue (c) The Respondents' audit work

172. There were a number of obvious difficulties inherent in the forecasting of the outcomes of the 23 contracts to which long-term adjustments were applied (to which we shall refer as "the 23 contracts"). We commented on the difficulties of such forecasting above when discussing the Mr A mobilisation costs paper. Relevant factors include the terms of the contracts relied upon by the Executive Counsel as excluding the eligibility of the 23 contracts from long term adjustments: that they were primarily reactive contracts; that they did not confer exclusivity on CPL; that in the main they included no provision for a minimum or guaranteed revenue; that the client might serve notice to terminate the contract before the expiration of its term. To these there was added the obvious difficulty of estimating the outcome of a contract 5 or even 10 years into the future. Furthermore, in so far as the contracts were with local authorities, they were with bodies

that budgeted on an annual basis, and their budgets (and therefore their calls on the services of CPL) would be liable to political policies and pressures; and that both local authorities and housing associations were partly dependent on central government funding, which too would be affected by political change (and it was known that there would be a general election in 2010, which might result in a government that would wish to restrain public expenditure).

173. In addition, there was the fact that the Group had very limited experience of reactive maintenance contracts. As a result, management of the Group/CPL could not demonstrate any significant established experience of reliable long-term forecasting in relation to such contracts.

174. Furthermore, it was necessary to distinguish between effective management control of costs and forecasting of outcomes. It was also necessary to bear in mind the difference between short-term budgeting and forecasting and long-term forecasting.

175. Some of these difficulties were referred to by the Respondents during the audit. The Workstep "Evaluate accounting policy for contracts and consider any changes during the year – P10 and P12" was completed by Mr Davies and reviewed by Mr Harrison. It stated, among other things:

> "Fundamental to the contract accounting calculation is the value of forecast costs/contract margins. For the majority of contracts no independent confirmation can be sought with regard to forecasts contract costs/margins and as such we are reliant on management estimates.
>
> …
>
> We note that it is not possible to verify these estimates to external sources so we have evaluated and validated management's own controls over the processes driving the forecasts and consider them to be robust.

> … Margins vary on a year-on-year basis due to the varying nature of the partnerships. Work can speed up and slow down due to a number of reasons including, customer budget shortfalls, staffing issues and learning curves in addition to changes in the mix of work. As costs remain relatively consistent (staff are still paid regardless of the amount of work they do), margins can therefore fluctuate on the same contract year-on-year. We can therefore expect some variation in the margins year-on-year."

176. There were some forecasts, the reliability of which might have been tested. Management must have produced estimates of contract outcomes when preparing tenders for the contracts in question, which could have been compared with the actual experience of the contracts. This is confirmed by the Respondents' Defence, at paragraph 42(1):

> "(a) significant detailed work was undertaken in bidding for the relevant contracts (the group employed qualified quantity surveyors to prepare its costings and to monitor progress of the contracts);
>
> (b) contract tenders were based on expected revenues which were specifically discussed and negotiated with the customers;
>
> … "

177. They were not considered by the Respondents. There would appear to have been other estimates, as appears from this extract from Mr Harrison's evidence:

> "Q. We know from the list of contract extensions that out of the 23 you had three contracts from 2004, you had Paradigm 2005, you had more, six, seven, you had quite a lot of contract where you could have tested several years' worth of forecasts and actuals if you'd gone back to look at earlier estimates?
>
> A. Yes.
>
> Q. Shouldn't you have done some testing on that longer term forecasting ability?
>
> A. I didn't at the time come to that view. I was --
>
> THE CHAIRMAN: Were there in fact such estimates available to you?
>
> A. I could have done it.
>
> THE CHAIRMAN: You could have done what?
>
> A. Looked back and seen how the forecasts compared going forward.

MR HERBERG: Because there were --

THE CHAIRMAN: Were there forecasts in previous years?

A. Yes, there were continual forecasts, that's how they operated.

THE CHAIRMAN: That's what I wanted to know -- whether the material was there for you to look at.

A. Yes, it was continual forecasts that were continually being updated**.**

MR HERBERG: Do you agree now that that would have been a sensible thing to do?

A. It would have been a sensible test, yes."[8]

178. The evidence of Mr Stratford and Mr Davies was less clear as to the availability of past estimates. Mr Stratford was initially clear that there were available forecasts:

> "MR STRATFORD: There were forecasts available for each of the long term contracts and it was, that was what was used for the sensitivity analysis, which was talked about last week around flexing the revenue. So you could see for each of the contracts the forecast revenue for each year.
>
> THE CHAIRMAN: How many years back could you go, or did you go?
>
> MR STRATFORD: You could go back into the previous year. If you – if it had been running for a number of previous years, like the Paradigm contract, you could go back and look at those.
>
> THE CHAIRMAN: An estimate for each year?
>
> MR STRATFORD: Well, going backwards, it would be the actual figure, yes."[9]

179. In re-examination Mr Stratford stated that historic forecasts were over-written on the COINS system, but did not contradict his earlier evidence that forecasts were available, presumably elsewhere. Neither he nor any other witness suggested that the forecasts made for the purpose of tendering could not have been used. Mr Davies's evidence was confusing: he stated that he did not ask management for historical forecasts because they could have been concocted for him. We prefer to think that this evidence was the

[8] Transcript Day 4 (23 November 2016) page 156.
[9] Transcript Day 6 page 11.

result of Mr Davies's nervousness rather than an indication of his view of the dishonesty of management.

180. The only substantive test carried out by the Respondents on management's ability to forecast contract outcomes was what was referred to in the hearing as the P10/P12 test. This was described by Mr Gomer as "[a comparison of] actual margins on a contract by contract basis with budgeted margins at P10 and P12". The workstep entitled "Roll forward margin analysis from period 10 to year end – P12" described the work as follows:

> "As at P10 we picked a sample of contracts and reviewed their expected margins for P12 … therefore as at P12, we have picked the same contracts and reviewed how the margins performed against the forecasts and we will investigate any significant differences further, a significant difference is deemed as a movement greater than 1% of gross margin, as we would expect management's forecasting to be reasonably accurate over a 2 month period."

181. The Tribunal had understood that the Respondents sought to compare the outcomes budgeted at P10 (30 June 2009) for the remainder of the financial year with the actual outcomes at 31 August 2009: testing for accuracy over the 2-month period. In opening Mr Herberg on behalf of the Executive Counsel opined that the P10 to P12 forecast test was a test over a 2 month period (i.e., a test of forecasts at P10 of revenue and costs for selected contracts compared to actual results at P12), rather than over a 12 month period (i.e., a test of forecasts made at the start of the financial year compared to actual results at P12). That it was a test over a 12-month period is inconsistent with the above extract from the workpaper and the explanations provided in the hearing.

182. The fundamental problem with this test, if indeed it was a test of forecasts over a period of 2 months, is that it was confined to a very short period. Even if the test had supported management's forecasts for a period of 2 months, it would have given very little, and

in our view manifestly insufficient, comfort as to their ability reliably to forecast contract outcomes over a period of 5 or 10 years, particularly having regard to the factors to which we have referred above. However, the same applies, with less force, if the test was of forecasts made at the beginning of the year, given the features of the contracts to which we have referred.

183. The second problem with the test is that the results did not justify the conclusion. The results did not demonstrate accurate forecasting. There were substantial differences between forecasts and results, which were explained (we might say explained away). For example, in respect of Bromford, the expected margin was 5.1 per cent, and actual was 3.2 per cent for the year, i.e. a difference nearly twice the "significant difference". PwC stated: "This contract has had some old materials costs in the period which were not sufficiently included in previous accruals, further to this, this contract has an (sic) long term contracting adjustment (LTA), which we have reviewed at the year-end, which sets the margin on this contract over its life … ". In respect of Matrix, the expected margin was 13.6% and the actual margin was 9.2%, i.e. a difference over 4 times the significant difference. PwC stated "Management carried out a detailed long term accounting review and provided an LTA Adjsutment [sic] on this contract in P12, which concluded that the original forecast margin by management was slightly overstated. Accept as reasonable." On Cannock, the difference between the expected and the actual was 2.2 per cent. On A2D, the difference was 2.4 per cent, and explained:

> "the margin decrease is due to Margin improvements in Voids having been offset by losses in reactive maintenance and the call centre, and y/e expectations were not achieved as a result. Accept as consistent with our understanding of this contract which has been discussed with commercial management."

This does not justify a finding that management's forecast was reliable.

184. On Amber, the difference was 2.5%. The explanation recorded was:

> "Review of the contract by management in P12 highlighted some trading issues (cost accruals and allocations) which management have now reflected in P12, however this had an impact on year-end margin. This contract has a £48K margin so differences trivial."

However, this explanation suggests that even on small contracts there were difficulties in accurate forecasting.

185. On Newham, there was a difference of 2 per cent. The explanation given was:

> "The margin on this contract has suffered due to further delays on the start of specific projects which has prevented the expected recovery."

186. Again, this did not support management's accurate forecasting.

187. North Somerset Council is also relevant. The difference was 5.6 per cent, between the expected margin of 8.7 per cent and an actual margin of 3.1 per cent. The explanation was:

> "This decrease is due to adjustments to reduce the level of seasonality. WIP adjustments made in the month resulted in the loss for the month. (£100k) Now carrying £150k of seasonality WIP. (seasonality impacts environmental/grounds keeping business as it depends on weather etc.)."

This comment demonstrates the difficulties of accurate forecasting rather than supporting the ability of management to forecast accurately.

188. Only 11 of the 23 LTA contracts were tested in this test. This alone restricted its utility. In addition, seven of the 11 had variances over the "significant" figure. All of these were negative variances, indicating the contracts were performing worse than expected.

189. Moreover, the problems with this test do not stop there. As mentioned above, it had been assumed by the Executive Counsel and his legal team, and Mr Kelly, and by the Respondents' legal team, that the test used actual figures as against estimates of actual

figures. That the Respondents' lawyers shared this misapprehension can be seen from paragraph 42(4) of the Defence:

> "PwC selected a large number of contracts and compared *actual* margins with budgeted margins on the contract-by-contract basis at the P10 and P12 stage. …"

The italics are ours. It appears that Mr Stratford shared this misapprehension. In his witness statement he said, at paragraph 110:

> "The [audit] team also undertook audit work which considered the reasonableness of Connaught's contract estimations by looking at the estimates for margins which Connaught had made at P10 (30 June 2009) *with those which it had actually achieved at the year-end* (31 August 2009)."

Again, the italics have been added.

190. Mr Davies's witness statement contributed to this impression. He said, at paragraph 82:

> "The Workstep (which I completed and Stephen and Duncan reviewed) compared the year-end margins anticipated at P10 *with actual year-end margins*."

191. During the course of the hearing it emerged that the figures used in the test themselves included LTA adjustments. Thus the test was not a test of estimated outcomes against actual outcomes. Mr Harrison and Mr Davies explained that the test included the contract managers' expected LTA adjustments (within the "expected P12 results") and Mr A's LTA adjustments (within the "actual P12 results").[10] It therefore emerged that the P10 to P12 test was "contaminated" by the inclusion of significant changes to LTA adjustments between P10 and P12 and it was, therefore, not purely a comparison of actual results against forecasts. In our view, this deprived the test of any significant

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[10] Mr Stratford also explained that those results included LTA adjustments, but explained that Mr Davies, who had performed the test, would be better able to explain it: Transcript Day 6/25/20 and Day 6/79/19.

value. It was the emergence of this fact that led Mr Kelly to conclude that the Respondents' audit work was significantly short of the standard reasonably to be expected of them.

192. The value of the P10/P12 test would have been greater if the LTA adjustments had been taken out of the figures, or if both the actual and adjusted figures had been analysed in detail. However, if it was possible to take out the LTA adjustments, the working papers contain no such comparison, and it is not clear that the information to carry it out was available. Mr Harrison was unable to explain the figures relating to Paradigm.[11]

193. Mr Harrison also carried out sensitivity testing. Mr Harrison said that he found that a reduction of 25 per cent in management's estimated future revenue from LTA contracts would have reduced CPL's pre-tax profit for 2009 by £500,000, which amount was taken to the summary of unadjusted audit differences. His test could not remedy the failures to comply with accounting and auditing standards.

194. Mr Harrison gave evidence in his witness statement that he had undertaken an analysis of LTA contracts and the results were tabulated in a schedule to his statement. The schedule was described in the heading to paragraphs 203 to 205 of the closing submission as Mr Harrison's "run rate" schedule. This was said to reflect the results of a "run rate" test which uses current financial information to check a forecast, although Mr Harrison does not use this term in paragraphs 245 to 262 of his witness statement. However, the only differences between PwC's and CPL's forecast revenue in the schedule arise as a result of differences between PwC's and CPL's forecasts of remaining tenure for certain contracts. In his closing submission, Mr Adam conceded

[11] Transcript 23 November 2016 (day 4), page 150.

(Transcript Day 12 page 151) that the schedule did not, in fact, reflect the results of the run rate test that Mr Harrison said he performed:

> "MR CORY-WRIGHT: So this doesn't really have anything to do with run rate, I think.
>
> MR ADAM: What it has to do with run rate is Mr Harrison's evidence. You're right this document doesn't prove it."

195. The Tribunal was unable to take into account the run rate work that Mr Harrison said he had performed because no details of the work or its results could be made available.

196. Finally, we come to the difficult question raised by the 2010 Half Year Review. The Review is relevant because the audit report on CPL's 2009 financial statements was not signed by PwC until 21 April 2010, i.e., after PwC had the results of that Review. It appears that serious questions were raised as to management's ability to forecast.

197. In a Clearance Meeting with Connaught management on 15 April 2010, PwC's minutes record:

> "SWH [i.e., Mr Harrison] commented that forecasting seems to be an area of weakness given the tables presented indicating prior year forecasts have not been met on the majority of contracts."

198. In an Audit Committee meeting on 21 April 2010 (the same day CPL's financial statements were signed off), PwC's minutes state:

> "SWH highlighted the key judgements that had been made as summarised in the report. In particular it was noted that contracts identified as more long term and outsourced in nature have had long term accounting principles applied.
>
> SWH highlighted that this approach [LTA adjustments] depends on forecasting and estimating and that some of these contracts as identified in the report had been loss making to date but no loss provisions for future losses made as management expect to turn the contracts around."

> "SWH noted that over time the track record will show whether management have the ability to estimate costs and profits with reasonable accuracy which is the cornerstone of a long-term contract approach.
> The approach adopted meant that if contracts went wrong the group would be exposed to a big P & L hit and that the big contract [sic] were at an early stage. If the trend on page 17 continued the challenge would be that estimating is not good enough to justify the accounting."[12]

199. Mr Harrison referred to this in his evidence:

> "What I was trying to do, and I know this sounds -- I was leaving; right? And what I was trying to do was actually put it in very blank terms. And you can see in a sense the way in which this is set up. I was trying to get across to them that they had a problem that they needed to address. And what I was genuinely trying to achieve was to protect my partner coming in, right? So it was absolutely clear, if you like, that I was taking a line, which was quite a hard line at this point, given it was only six months in and it had been a very bad winter. So I didn't offer that explanation at all in this meeting. And you can see all I am doing in this meeting -- and the style of my meeting and how I did this meeting was different from how I would normally address these meetings, in that I was actually just raising the point and letting the executive management explain it."[13]

200. It followed from Mr Harrison's view that "forecasting seems to be an area of weakness" that long term adjustments were not justified, since the forecasts of results were not sufficiently reliable. In April 2010 he may well have expressed himself more strongly than he would have done if he had been continuing as audit partner, but his view was clear. It should have led him and PwC to qualify its opinion on CPL's financial statements. This would have been most unfortunate, given that CPL's financial statements had already been incorporated in the Group's audited and published financial statements, and embarrassing, but it was inherently possible in the situation in which a subsidiary's financial statements are signed off significantly after those of the Group. However, in arriving at our conclusion on Allegation 2, we have not taken this failure into account.

[12] Minutes contained within PwC's Critical Matter "Private report issued to the board" at F1/16/80.
[13] Transcript Day 4 page 164.

Conclusion on Allegation 2

201. Our conclusion is that the Respondents' audit work on the long-term adjustments fell significantly short of the standard reasonably to be expected of them. We find Allegation 2 to have been established.

Allegation 3: Intangible Assets

202. As mentioned above, in the year ending 31 August 2008, the Group capitalised as an intangible asset £3.1 million of development costs (divided between Connaught and CCL). In the year ended 31 August 2009, an additional £7.7 million was capitalised, leading to a total of £10.8 million being included in the Group balance sheet at 31 August 2009. In large part, these were internal staff costs. None of this sum was amortised. In CCL's 2009 financial statements, £8.2 million was capitalised as computer software.

203. Capitalising these amounts had the effect of increasing the reported consolidated profit before tax in the Group's 2009 financial statements by £7.7 million, represented by £1.6 million in the Group's financial statements and decreasing by £6.1 million the reported loss before tax in CCL's 2009 financial statements.

204. The questions for us are, first, whether, as alleged by the Executive Counsel, the Respondents' audit work on assessing whether Connaught and CCL had measured the costs in question sufficiently reliably was significantly deficient; and secondly whether the Companies' policy was sufficiently disclosed.

Intangible Assets: (1) The accounting standards

205. Under paragraph 8 of IAS 38, an intangible asset is defined as "an identifiable non-monetary asset without physical substance". Under IFRS, the recognition criteria are those set out in paragraphs 21, and 52 – 67 of IAS 38. Under UK GAAP, the criteria are those set out in paragraph 25 of SSAP 13 "Accounting for research and development" and paragraphs 5.16 and 5.17 of the Statement of Principles for Financial Reporting. Mr Kelly and Mr Gomer agreed that, so far as relevant, the provisions under UK GAAP largely mirror those under IAS 38.

206. The criteria under IAS 38 were described by Mr Kelly as "necessarily stringent". Internally generated assets are usually an area of enhanced consideration on an audit because there is an increased requirement for judgment compared to other assets and the applicable accounting rules are relatively complex. In addition, such costs are vulnerable to manipulation by management by overstating costs and thereby enhancing profits or reducing reported losses.

207. One of the particular difficulties with internally generated intangibles is distinguishing between the cost of generating an intangible asset and the costs of maintaining or enhancing the entity's internally generated goodwill or of running day-to-day operations. This was expressly acknowledged in IAS 38. Para 51 of IAS 38 states:

> "It is sometimes difficult to assess whether an internally generated intangible asset qualifies for recognition because of problems in:
>
> (a) identifying whether and when there is an identifiable asset that will generate expected future economic benefits; and
>
> (b) determining the costs of an asset reliably. In some cases, the cost of generating an intangible asset internally cannot be distinguished from the cost of maintaining or enhancing the entity's internally generated goodwill or of running day-to-day operations.

> Therefore, in addition to complying with the general requirements for the recognition and initial measurement of an intangible asset, an entity applies the requirements and guidance in paragraphs 52 – 67 to all internally generated intangible assets."

208. Paragraph 57 of IAS 38 set out the applicable test:

> "An intangible asset arising from development (or from the development phase of an internal project) shall be recognised if, and only if, an entity can demonstrate all of the following:
>
> (a) the technical feasibility of completing the intangible asset so that it will be available for use or sale.
>
> (b) its intention to complete the intangible asset and use or sell it.
>
> (c) its ability to use or sell the intangible asset.
>
> (d) how the intangible asset will generate probable future economic benefits. Among other things, the entity can demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset.
>
> (e) the availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset.
>
> (f) its ability to measure reliably the expenditure attributable to the intangible asset during its development."

Intangible Assets: (2) The applicable auditing standards

209. There were no auditing standards specific to internally generated intangible assets. The provisions of ISA 500, to which we have already referred, are obviously pertinent.

Intangible Assets: (3) PwC's audit work

210. For present purposes, we assume that the projects in respect of which costs were capitalised satisfied the requirements of IAS 38 paragraph 57 other than paragraph (f). The crucial questions for us are whether Connaught plc and CCL were able to measure reliably the expenditure attributed by management to those projects, and whether the

Respondents obtained sufficient appropriate evidence that the Companies were able and did measure that expenditure reliably.

211. As mentioned above, the majority of the costs capitalised were internal staff costs: salaries and the costs of benefits. The fundamental problem facing the Companies and the Respondents was that the Companies' salaried staff did not record time spent on any project on any time sheets or otherwise. As a result the Respondents were compelled to rely on evidence that was not contemporaneous with the work said to have been carried out. Furthermore, the evidence they did rely upon was, in general, second hand, i.e. not provided by those who had carried out the work in question.

212. Intangible assets were referred to in PwC's report to the Board for the half year ended 28 February 2009, when the amount capitalised was considered to be immaterial to the half year results. There was a brief reference to them in the minutes of the audit planning meeting held with the Group finance team on 17 June 2009:

> "Continuing with Hub, still developing. Indications that capitablised [sic] costs will be less than prior year and less than £1m. PwC stress that any assets being capitalised will need to be specific, measurable and supportable and will need to be recoverable. These will comprise the Hub, Connaught Way and HR/Payroll. Management agreed to supply supporting papers and rationale for any items to be capitalised."

Mr Harrison's evidence is that the capitalised costs referred to were those relating to one project only, the Hub.

213. The next record of discussion of intangible assets was at an audit status meeting on 17 September 2009.

> "**Costs capitalisation 2009 (hub, centre (ca £2.5m) and others**)
>
> SWH noted that PwC need a paper to identify and support all costs…….Total investment expected ca £8 – 10 million."

214. Mr Harrison confirmed in evidence that the expectation then was that the costs capitalised would be around £8 million to £10 million. The sum was now material, particularly to the financial statements of CCL.

215. On 6 October 2009 there was an Audit Committee meeting. As late as the previous day, Mr Radway was receiving information concerning the intangible asset costs. The draft interim report to the Committee circulated the previous afternoon still marked the comment that PwC were satisfied that the intangible assets were not materially mis-stated "TBC". The interim report for the meeting of 6 October 2009 stated:

> "An area of concern is the lack of timesheet recording relating to the projects which is a control weakness. Of the total amounts capitalised approximately £5.9m relates to incremental internal labour costs. However, as the payroll costs appear reasonable, the overall amount is unlikely to be materially misstated."

216. The audit work was described in the Critical Matter work paper entitled "Intangible assets – cost capitalisation on new systems/processes". It was completed by Mr Radway, who was primarily responsible for the audit work on intangible assets, reviewed by Mr Chapman and cleared by Mr Harrison:

> "Audit work
>
> We have reviewed the nature of the developments undertaken and made enquiries of management. See [the workpaper "Examine documentation supporting assets under construction"].
>
> Based on our work, we are satisfied that a major investment has been made in new processes and developments. The new suite of products and offerings to customers was launched on 1 October 2008 and new work during the period has essentially been to integrate the more recently acquired businesses such as Water and Electrical into the Hub, as well as the development of systems to work alongside the Hub (e.g., CRM and the PDA project).
>
> The developments are integral to the Group's compliance strategy and are an essential enabler for the implementation of that strategy. As a result, management is confident that the developments of the business (which are dependent upon the new systems and processes) will provide

economic benefit. This is reflected in the aggressive growth budgets for the compliance division.

We have agreed the details of costs to schedules setting out the cost of those individuals involved in the developments and tested a sample of items back to underlying payroll records. The client has identified the individuals, but the costs are not supported by time-sheets as the client does not operate a time recording system. However, we are satisfied on the basis of the following:

The amount involved does not look unreasonable in relation to the systems and process development involved and our understanding of the work completed during the year.

The fair value of the software acquired at the time of the acquisition of [National Britannia] has been estimated to be £4.3 million. In addition, Connaught incurred expenditure in developing its own software systems of £3 million. Although not directly relevant, it does demonstrate the extent to which these businesses are dependent upon systems and processes to derive value.

The management has identified the individuals involved in the development of the systems and processes - *we have scanned the lists of individuals involved and consider that it is reasonable that individuals with their job roles would be involved in such projects*.

The costs are limited to the direct costs of employment, which we have tested to underlying records.

…

Final conclusions

We are satisfied with the carrying value as not being materially misstated in the financial statements. Our final report to the audit committee will emphasise that the amount is acceptable on the grounds that the amount is unlikely to be materially misstated, given our understanding of the work involved in these projects and testing of the accuracy of the underlying costs capitalised.

As reported to the audit committee last year, there is no time-recording system being used to capture costs on these projects, which makes it more difficult to accurately identify the exact amount of time spent on projects by the individuals in question. We strongly recommend that such a system is introduced in order to more robustly support such capitalisation in the future."

(The italics have been added.)

217. In their Final Report to the Audit Committee, PwC stated:

> “**Intangibles**
>
> The group is continuing to invest in database systems to improve the quality of technology support for the group's activities. In addition, common systems and methods of working are being introduced across the group.
>
> The development costs associated with these new systems are being capitalised. Currently, the group's procedures are fairly rudimentary. We recommend that the controls should be improved as follows:
>
> For every project, a specification should be prepared describing the project and the economic benefits which are expected from the project, together with the budgeted costs of development.
>
> Time sheets should be maintained for individual employees identifying the time spent on each project.
>
> Explanations should be provided for variances between budget and actual expenditure.”

Our findings on the Respondents’ audit work on intangible assets

218. As appears from the foregoing, the only audit work to test the accuracy of the figures provided by management for the amounts of time spent on the projects in question was to scan the lists of individuals involved. Assessing whether it was reasonable that individuals with their job roles would be involved in such projects could not test these figures. Given the materiality of the figures attributed to intangible assets, simply to assess the reasonableness of management’s figures was manifestly insufficient. The need for further audit work was enhanced by the lateness in which the issue had arisen and the lateness of management’s provision of information to PwC and the substantial increase in the sums compared with the previous year.

219. Mr Harrison asked Mr Radway to speak to project managers in order to obtain comfort as to the amounts of time attributed to staff said to have worked on the projects. He stated in his witness statement:

> "The team had detailed discussions with some project managers relating to the projects with which they were involved, obtaining comfort about the extent of their own time allocated in their projects.…"

220. The project managers to whom Mr Harrison referred are not identified. If there had been such discussions, they should, and in our view would, have been recorded or referred to in a work paper. Only one discussion was recorded, that with [redacted]. We comment further below.

221. Mr Harrison said in evidence:

> "What I wanted James to do was go through all the major projects with the team leaders on each of those projects ... I have looked at the file now again after the event. It doesn't mention them, but I am -- that's what he was asked to do in order to make sure he understood the projects ... I wanted him to go through with the project leaders, so he fully understood it and see evidence of what he was seeing to see if it looked sensible and reasonable. So I believed, right, that he had looked at the HR and payroll, the Connaught Way, the compliance hub, the sales logic, PDA. National Britannia was looked at by the team in Cardiff who did National Britannia, because National Britannia is based in Caerphilly."
>
> "I actually -- what I asked him to, do as I said at the beginning, was look at the major ones, all the major ones, and talk through them with their team leaders. Now I thought he had done that."
>
> "As I said, James talked to the leaders on it. That's what – that's what happened as far as I'm aware."[14]

222. However, the only evidence that Mr Radway in fact spoke to project leaders relates to [redacted]. She was involved in the HR and Payroll Project. The information on this Project in the Workstep "Examine documentation supporting assets under construction" was:

> "Per discussion with [redacted] (project manager – payroll/HR), the basic software package was purchased and a project team set up to work on building the system – this comprises scheme calculations, configurations, data migration and cleansing.

[14] Transcript Day 4 page 201.

> The project team consists of [redacted] (IT project manager), [redacted] (Payroll system administrator), [redacted] (HR system administrator) and an external consultant. Their time was 100% concentrated on working on the project – from Dec 08 the Payroll manager left and [redacted] had to oversee the payroll department as well as working on the project."

223. Mr Radway also met [redacted], the programme director for the Connaught Way, presumably to satisfy himself that it was a project that qualified for treatment as an intangible asset: see the Critical Matter "Intangible assets – cost capitalisation on new systems/processes".

224. If Mr Radway had spoken to other project managers in order to check on the times said to have been worked on the projects in question, we should have expected their input to have been evidenced in the working papers, and in particular in Mr Radway's Critical Matter work paper. To the contrary, the italicised passage in that work paper cited above at paragraph 216 from the content is inconsistent with there having been relevant discussions.

225. In this connection, the Respondents also rely on the Workstep "Agree comparative totals to the general ledger – Intangible assets". It states the work to be performed as "We will understand the status of the projects, assess their eligibility for capitalisation against IAS 38 and perform substantive procedures to test the intangible asset additions in the year." The Workstep does refer to "discussion with management" but only in connection with the description of the projects in question, rather than the quantification of the sums capitalised. Under the heading "Substantive testing", the only testing performed is stated to be "Agreed to Payroll Reports". The Respondents' reliance on this Workstep is misplaced.

226. Mr Harrison reviewed both of the work papers to which we have referred. He should have drawn the conclusions that we have done as to the work performed by Mr Radway.

227. Furthermore, there was information casting doubt on management's figures. The schedules provided by management attributed the entirety of [redacted]'s time to her project. However, as noted above, PwC ascertained that this was an overstatement, since she also oversaw the payroll department. This may have been an isolated error, but it may not have been. It was the more concerning because the project managers were the source of the estimates of time incurred on projects which formed the basis of the capitalisation of intangible assets. The conclusion in the Workstep "Examine documentation supporting assets under construction" was:

> "The salary element of the project appears reasonable – the salaries and costs of the IT project manager and system administrators from HR and Payroll have been fully coded to the project as all their time spent working on this (it is incremental) – there is the part exception of [redacted] who since Dec 2008 has had to oversee the payroll department but no costs have been taken out for this – appears reasonable as would be highly immaterial. …"

228. However, the significance of the capitalisation of the entirety of [redacted]'s costs was not their materiality, but the question it raised as to the accuracy and reliability of management's figures.

229. Because the project managers had been responsible for providing the estimates of the times of staff devoted to their projects, they would not have been an appropriate audit source to check on the accuracy of those times: this would not have provided independent comfort as to those figures.

230. Possibly of greater concern was that Connaught capitalised 100 per cent of the salary costs of [redacted], CPL's Finance Controller as part of the Connaught Way Project. She had other operational duties (including her involvement in producing financial analysis, assisting the auditors, preparing the mobilisation paper and attending contract meetings). In addition, in the supporting documents to Mr A's mobilisation paper, [redacted]

[redacted] was an "example name" who spent four weeks on the mobilisation of a typical contract. It is difficult to see why Mr A would have given her name as an example if in fact she took no part in the mobilisation of any contract. The inference that PwC should have drawn is that in the absence of any explanation, Ms [redacted] had been involved in the mobilisation of at least one contract, and possibly more. Mr Kelly stated:

> "Had PwC exercised an appropriate level of scepticism, they may have questioned why a significant amount of [redacted]'s time was being capitalised across two distinct activities (mobilising contracts and the Connaught Way project) particularly as they would have been aware that she had other operational responsibilities."

231. However, we have no evidence that anyone in the PwC audit team had sufficient knowledge of both the Mr A mobilisation paper and the intangible assets schedules to make the connection. Mr Kelly accepted, in cross-examination, the following:

> "Mr Kelly: … No, but you're right, in terms of, if a junior member of staff had seen that and wasn't aware that [redacted] was also involved in other projects.
>
> Q. And you wouldn't suggest, would you, that any reasonable auditor who'd have been given the list of staff names and staff times for intangible would have thought I must check this against the Mr A schedule?
>
> Mr Kelly: No, I agree."[15]

232. As mentioned above, Mr Radway considered the schedules provided by management and concluded that "it is reasonable that individuals with their job roles would be involved in such projects". This was not a justified conclusion. In the embedded document "Finalised Intangibles (NB with sample)" no job titles or job descriptions were provided for the individuals working on the National Britannia projects. The total amount of £1,593,061 was capitalised in relation to the costs of individuals who had no job title. Similarly no job titles or descriptions were given for the individuals associated

[15] Transcript Day 9 page 2.

with '8 dot' project in the bottom left hand corner of the embedded document "Hub Cost Analysis – PwC (sample selected)".

233. In addition, 100 per cent of the costs of staff who had other management, operational or administrative responsibilities were capitalised, although one would not have expected them to be working exclusively on the internal projects. For example:

(1) [redacted], Customer Services Manager (salary costs of £34,275 attributed to internal projects);

(2) [redacted], Operations Director (salary costs of £147,770 attributed to internal projects);

(3) [redacted], Finance Director (salary costs of £60,504 attributed to internal projects);

(4) [redacted], BUL (salary costs of £72,624 attributed to internal projects);

(5) [redacted], Ops director (salary costs of £57,204 attributed to internal projects); and

(6) [redacted], Business Development (salary costs of £104,488 attributed to internal projects).

234. Mr Gomer said that the Respondents' audit work on intangible assets had been sufficient. He said, in cross-examination:

> "… the documentation is lighter than I would have expected, but everything I have read suggests that that was a reasonable approach. I think if you step back and say 'Should they have gone beyond the project managers and spoken to other people?' I think if that exercise in talking to the project managers was sufficiently robust, as I have described, with somebody with Mr Radway's experience, then I don't think they needed to go beyond that exercise."

235. We have difficulties with this evidence. Most importantly, as we have stated, not only is there no evidence that Mr Radway (or anyone else) spoke to the project managers

other than in relation to Ms [redacted], but the terms of the Critical Matter work paper entitled "Intangible assets – cost capitalisation on new systems/processes" are inconsistent with his having done so. There is certainly no evidence that if any inquiries were made of any project managers other than in relation to Ms [redacted] they were sufficiently "robust". Secondly, if the project managers were the source of the schedules provided to PwC, questioning them would not have provided any independent audit evidence. Thirdly, Mr Gomer's opinion does not take into account the matters referred to above at paragraphs 230 to 233.

236. Some staff costs had been coded to the projects on which they were working. Workpapers entitled "Contract Recharges – Staff costs Coded to the Project" show that, for the Connaught Way and the HR and Payroll projects, costs related to time incurred by staff members on these projects was captured, at least in part, via the payroll system. Although there is evidence that salary costs were checked to rates of pay, it is not clear how such time charges were captured or what relevant controls were in place over them, and there is no evidence that the time for which charges were made was checked to supporting documentation or otherwise corroborated.

237. The Group's reported pre-tax profit for the year ended 31 August 2009 was £27 million. Additions to intangible assets during the year ended 31 August 2009 of £7.7 million, of which internal staff costs made up £5.9 million (D4/1400), were unquestionably material to pre-tax profit. Although the Group may well have been incurring significant costs on intangible projects, any attempt to estimate the likelihood of intangible assets being misstated by a given percentage can only be speculative.

238. Our conclusion is that PwC's audit of intangible assets fell significantly below the standard reasonably to be expected of them.

239. Mr Harrison instructed Mr Radway, supervised him and cleared his workpapers, which showed that his audit work had been seriously deficient. Mr Harrison's conduct was significantly below the standard reasonably to be expected of him.

240. It follows that we find Allegation 3 to have been established in relation to both PwC and Mr Harrison.

Intangible Assets: (4) Disclosure

241. The Executive Counsel does not contend that the disclosure in respect of intangible assets in the Group's financial statements was inadequate. He does, however, contend that the disclosure in the financial statements of CCL was seriously deficient.

242. SSAP 13 "Accounting for research and development" required:

> "30. The accounting policy on research and development expenditure should be stated and explained.
>
> 31. The total amount of research and development expenditure charged in the profit and loss account should be disclosed, analysed between the current year's expenditure and amounts amortised from deferred expenditure.
>
> 32. Movements on deferred development expenditure and the amounts carried forward at the beginning and the end of the period should be disclosed. Deferred development expenditure should be disclosed under intangible fixed assets in the balance sheet."

243. In addition, paragraph 40 of SSAP 13 referred to the applicable statutory requirement:

> "Paragraph 20 (2) of Schedule 4 [of the Companies Act 1985] requires that if any amount is included in a company's balance sheet in respect of development costs the following information shall be given in a note to the accounts:
>
> (a) the period over which the amount of those costs originally capitalised is being or is to be written off; and
>
> (b) the reasons for capitalising the development costs in question."

244. Note 7 to the financial statements of CCL, under the heading "Intangible Assets", net book value of computer software of nil at 31 August 2008, additions in the year ended 31 August 2009 of £8,194,000 and net book value at year end of the same amount. The accounting policy was not stated or explained, the period over which the development costs were to be written off was not stated, and the basis for capitalising the development costs in question was not given.

245. Mr Gomer's view was that disclosure was sufficient on the basis that an intelligent reader of CCL's financial statements would refer to the Group's financial statements and gain sufficient information from them. As we have already stated, a company's financial statements must themselves give a true and fair view. They must comply with accounting standards and legislative requirements. Those of CCL did not. It follows that the disclosure was deficient.

246. Mr Kelly and Mr Gomer agreed that the deficiency of disclosure was not a significant failing. In these circumstances, we find that the Respondents' failure to address the deficiency in disclosure resulted in their conduct being below the standard to be expected of them, but not significantly so.

Cash cut off

(1) The applicable accounting test

247. There is no accounting standard specific to the recognition of cash in the financial statements of a company. However, in our view it is clear that the applicable criterion for the recognition of cash is the entity's control of the asset. This follows from the definitions of an asset in the IFRS Framework and the Statement of Principles for

Financial Reporting published by the Accounting Standards Board, which is relevant to UK GAAP. The IFRS Framework defines an asset at paragraph 49(a):

> "An asset is a resource *controlled by the entity* as a result of past events and from which future economic benefits are expected to flow to the entity."

Similarly, paragraph 4.6 of the Statement of Principles defines an asset as follows:

> "Assets are rights or other access to future economic benefits *controlled by an entity* as a result of past transactions or events".

The italics on both these definitions are ours.

248. The experts' joint memorandum stated:

> "206. The fundamental difference between Mr Kelly's and Mr Gomer's opinion is whether it was acceptable for Connaught to treat BACS payments received after the year end as cash. In Mr Kelly's opinion, BACS payments received after the year end could not be recorded as cash in transit. Mr Gomer's opinion is that BACS payments received after the year end could be recorded as cash in transit provided they were executed by the customer and notified to Connaught before the year end."

249. Our view is that Mr Kelly is right and Mr Gomer incorrect. The requirement is that the entity has control of the asset in question. That occurs when it receives a cheque, which is itself an asset, or when a BACS payment is received into its bank account.

250. Mr Gomer's view, as expressed in the joint memorandum, was as follows:

> "218. … Mr Gomer's view is that there are different approaches in relation to whether cheques received shortly after the year end are treated as cash… Following the discussions at the Experts' meeting on 6 October 2016, Mr Gomer would like to clarify that he considers that it is better practice not to recognise as cash those cheques which have not been received until after the year end (although in his experience, this was not uncommon practice with audit clients). Mr Gomer's view is that a more appropriate period within which to recognise cheques cleared after the year end (as a proxy for cash in transit) would be about 3 to 5 days. It may, in Mr Gomer's view, be reasonable for the auditors to

> accept a longer period however if the difference is unlikely to have a material impact on the truth and fairness of the balance sheet."

251. In his oral evidence, Mr Gomer was less clear. At one point he seemed to accept that loss of control by the client debtor could be an appropriate test. In evidence he said:

> "This goes back to the matter of whether or not [the test] is control lost by the customer or gained by Connaught. So there is a significant proportion of people would argue that they would record cash that is received immediately after the year end, where it was clear that the customer had released it before the year end, and that is – so we were taken through previously the fact that the Connaught audit work papers describes loss of control by the customer as the measure, which was certainly a practice applied by a number of people."

252. On the basis that the test is loss of control by the debtor, if the client posts a cheque on the last day of the entity's financial period, which is not received until some days later, the entity is entitled to include the amount of the cheque in cash at year end. However, paragraphs 203 and 204 of the joint memorandum of Mr Kelly and Mr Gomer, recording matters agreed by them, were as follows:

> "203. It would be appropriate for cheques received by Connaught from customers on or before 31 August 2009 which cleared through Connaught's bank statements after 31 August 2009 to be treated as cash in transit and reflected in the cash balance as at 31 August 2009. This would be the case whether Connaught physically paid in the cheques to the bank either before or after 31 August 2009, albeit Mr Kelly would require strong evidence in this situation to be satisfied that they had received a cheque but not banked it before the year end.
>
> 204. It would not be appropriate for material amounts of cheques received by Connaught from customers after 31 August 2009 to be treated as cash in transit and reflected in the cash balance as at 31 August 2009."

253. These propositions are consistent with our view. However, in the joint memorandum Mr Gomer also recorded his view as follows:

> "BACS transfers which had been executed by customers and notified to Connaught on or before 31 August 2009 but which cleared after 31 August 2009

> Mr Gomer considers that such payments could reasonably be classified as cash at the year end."

254. On this basis, the test would appear to be loss of control by the customer that has been made known to the entity. It is in our view not consistent with the definitions of an asset. Moreover, it is difficult to see the relevance of the requirement of notification to Connaught. This was taken up with Mr Gomer in his evidence:

> "MR CORY-WRIGHT: How does the notification give you control?
>
> A. Well, it is not the same legal form, which I know is the point that has been made in previous commentary on this. But in practice you have received notification that it is actually in the banking system somewhere and will be in your account as cleared funds within a few days. So as the company receiving that notification, you can then start to plan payments based on that. You could even write a cheque and send it out to your supplier, knowing that that money -- in fact it is more certain that it is going to be going into your bank account than the cheque which you have got to – because the bank -- the point I think you made yesterday, the bank has not even had an instruction yet to start the process with a cheque. So from a practical point of view it seems quite clear that you can operate as having those funds available to you, knowing you can start using them within the business."

255. We do not accept this. We are reminded that "There is a cheque in the post" is said to be one of the great lies. An assurance that a payment has been made, or will be made, is not the same as, and is certainly not as reliable as, actual receipt of a cheque or a payment into a bank account. Moreover, a bank manager might be unwilling to treat his client's assurance that a customer's payment is on its way as the equivalent of cash in the account on which his client is permitted to draw. Put more succinctly, an expectation of control is not the same as control. In any event, there is no evidence that the Group (or CPL) recorded or systematically received notifications that payments had been, or were to be, made.

256. Mr Kelly's evidence as to practice is consistent with our and his opinion. He stated:

> "2.76. … The established accounting practice is to recognise as cash those cheques received prior to the year end which had not yet cleared the bank. However, in my experience, I have never seen a business adopt a practice of including within period end cash those cheques and bank transfers actually received after the period end. The standard practice is to include only those cheques received prior to the period end, notwithstanding the fact that they may not have cleared the bank account until the following period."

257. In his evidence, Mr Gomer seemed to accept that the correct test was indeed control:

> "Q. Indeed. So you are effectively agreeing that the reason why control is important is because a test derived from the IFRS framework is where the cash is an asset controlled by the entity, so you have to look at Connaught in this case and see whether it controls the cash at the year end. That is right is it not?
>
> A. That is the basis.
>
> Q. That is the technical basis?
>
> A. The technical basis on which that is reached."

258. We accept that where a company does not record its receipt of cheques, it may be appropriate to include in cash credits to its bank account entered within 2 or possibly 3 working days after the year end, on the basis that it may be inferred that the cheques in question were received before the year end. We do not see that BACS payments received after the year end could properly be included in cash at year end: the company does not have control of the money until it reaches its bank account.

259. We add that in our view, Mr Gomer, in the last sentence of paragraph 218 of the Joint Memorandum set out above, confused the accounting requirement with the responsibility of the auditor. An auditor might accept a longer period than 2 or 3 working days if, as a result, the truth and fairness of the financial statements (or of other amounts derived from the financial statements, such as the cash conversion ratio) were not materially affected. In doing so, however, the auditor would not be accepting that cheques received after the end of the year were assets of the entity at the year end.

260. Lastly under this head, we point out that the references by Mr Kelly and Mr Gomer to cash in transit were not relevant to the Group's and CPL's 2009 balance sheets. The Group's balance sheet referred to "Cash and cash equivalents" and Note 27 disclosed that "Cash and cash equivalents" comprised "Cash in hand and at bank." The balance sheet of CPL gave a figure for "Cash at bank and in hand." A cheque of a solvent client may fairly be included within "cash equivalents", but a cheque that has not been received, and a BACS payment that has not be credited to the entity's bank account, cannot be brought within those words. Even more clearly, a cheque that has not been received and a BACS payment not yet credited cannot be accurately described as "cash .. in hand" or truthfully or fairly included within that expression. On the other hand, moneys over which the entity has control (e.g., cheques actually received and BACS payments credited to its bank account) are fairly within these expressions.

Cash Cut off: (2) Connaught's accounting for cash in 2008

261. In our view it is unclear whether in 2008 the Group included in cash at year end BACS payments received and cheques credited to their bank accounts 5 working days or 7 working days after the year end. Both Mr Harrison and Mr Stratford said that in 2008 the period of 5 working days had been used. Mr Harrison said, in evidence:

> "I believe, as best I can remember, but going back a long time, that [Connaught's policy in relation to the cash cut-off in 2008] was 5 days, because in my mind 5 days was the acceptable period, which is basically why the – I think the critical matter has been written in this way."

262. On the other hand, paragraph 212 of the Joint Experts' Memorandum sets out Mr Gomer's understanding of the Group's and CPL's accounting practice:

> "212. It was Connaught's past accounting practice to treat amounts clearing through the bank statements in the first 7 working days after the financial year end as cash as a proxy for actual cheques received from customers in connection with the financial year end (i.e. cheques

> physically received by Connaught or mailed by the customer to Connaught on or before the year end) and BACS payments executed by customers for Connaught's account (and notified to Connaught) before the financial year end but which cleared through the bank statement shortly after the financial year end. The use of the 7 working day period was understood by the audit team to represent the typical length of time experienced by Connaught in practical terms for cheques to be presented to the bank and cleared through the bank statement, and for bank transfers to be cleared through the bank statement…"

263. In our view, if the period of 7 working days was used by the Group in 2008, it was an excessive period for cheques, which even in 2008 to 2009 did not take that long to clear; and no BACS payments credited to the bank account after the year end should have been included in cash at the year end. In this connection, we note that Mr Stratford's recollection was that the normal period between a customer instructing his bank to make a payment and the credit to the recipient's bank account was 3 or 4 working days. Even 5 working days was an excessive period, particularly for BACS payments, but also for cheques.

264. Our view is supported by the comments of David Charles, PwC's new Quality Review Partner, on the draft Report to the Board for the half year ended 28 February 2010. It was proposed that cash cut-off be shortened back to 5 working days. Mr Charles commented:

> "What is the rationale for 5 days – shouldn't it be less than this?"

He added:

"What work do they do internally to ensure that all cash received post year end related to pre-year end? I don't think that they should simply assume that it does…"

Cash cut off: (3) The conduct of the 2009 audit

265. According to the Critical Matter "Cut off approach – consideration following discussion of audit plan as July 2009 audit committee meeting" at the Audit Committee

meeting on 15 July 2009, the Chair of the Audit Committee asked PwC to confirm that cut-off procedures and testing would form part of the year-end testing plan.

266. PwC approached the 2009 audit by considering when control of a cash asset had been lost by the customer rather than when control had been gained by the Group. Thus the Critical Matter referred to at paragraph 265 above stated:

> "We sample tested the cash receipts for the CPL and Compliance cash in transit to identify the timing of receipts and assess whether the cash receipts were likely to have been outside of the control of the customer (typically local authorities and housing associations) at year end.
>
> The approach to cash in transit was discussed with Senior Management including the finance director who confirmed that consistent with prior years cash in transit has been booked where customers had confirmed that payments had been made but had not been processed into the bank account. Cash in transit is common for the business often because cheques had been sent for payments took at least 4 to 5 working days to clear."

See too the notes to the update telephone call with the Audit Committee on 8 October 2009:

> "… [Mr Harrison] noted that in order to justify cash recognition there should be evidence that the customer had lost control of the cash and that in PwC view the ca £4m of cash receipts books relating to CPL was an error and should be adjusted (being the total of cash receipts for after working day 7).… "

267. In their evidence, Mr Harrison and Mr Stratford accepted that the focus at the time of the 2009 audit was on loss of control by the customer. Thus Mr Harrison said in evidence:

> "Mr Herberg: …. It is clear, from all the audit papers, that you are taking as your start point not when the company received the cheques but when the customer lost control of the cheques. In other words, you were taking it as a proxy from the date when the customer sent the cheque not from when the company received the cheque. Would you accept that?
>
> Mr Harrison: Yes, I would accept that. So if it came in – if it came in on the first morning, let's say it came in on the first –

The Chairman: Of September

Mr Harrison: September, I would treat that as –

The Chairman: As cash at year-end.

Mr Harrison: -- the customer having left it.

The Chairman: you would include it as cash at year-end?

Mr Harrison: I would include that."[16]

268. Mr Chapman explained that his understanding was that the 2009 policy was a proxy for cheques and BACS received by the accounting entity. Mr Chapman's understanding does not accord with the audit file or with Mr Harrison's and Mr Stratford's evidence.

269. A further problem with the accounting treatment of cash receipts in 2009 is that the great majority (in 2009 some 80 per cent in the case of social housing division) of payments to the Group were made by BACS transfers. Mr Kelly noted at paragraph 8.60 of his first Report that PwC's bank reconciliation work indicated that the vast majority of receipts clearing into the bank account after the year end were bank transfers rather than cheques. It was one thing to infer from a payment by cheque recorded in a bank account at a date shortly after the year end that the cheque had been received by the year end: in such circumstances the cheque was within the recipient's control by the year end. It was a different thing, and unjustifiable, to include BACS payments received after the year end, since in this case the recipient had no control over the money until after the year end.

270. It seems that the 2009 audit was begun on the assumption that the Group was following its previous practice of including in cash at year end payments into its bank accounts within 5 or 7 working days following the year end, and, if the period was 5 working

[16] Transcript Day 5 page 18.

days, that this was permissible. Furthermore, it seems that neither the Group nor the Respondents was or were distinguishing between cheques and BACS payments. Thus in Mr Harrison's witness statement he stated:

> "297. The Cash Recognition Policy relates to the accounting policy adopted by the Group for treatment of cheques and transfers, received up to 7 working days after the year-end, as cash assets as at the balance sheet date.
>
> 298. The basis for such a policy was that transfers would be made, or cheques sent, before the year-end, but that it would take a few days for such payments to clear. …"

271. For the reasons we have given, this accounting practice was incorrect, clearly so in relation to the BACS payments, but also, if less clearly, in relation to payments by cheque.

272. PwC's assumption that management were using the period of 5 or that of 7 working days after year end continued until 7 October 2009. Accordingly, PwC's interim findings report to the Audit Committee on 6 October 2009 noted:

> "Cut off
>
> At the last Audit Committee we were asked to look at cash cut-off. We have reviewed our approach in this area to ensure that it was regarded as an area of risk. Nothing has arisen from a work which would require reporting to the audit committee."

273. Mr Harrison's and Mr Stratford's evidence that loss of control by the client was the test applied is consistent with the working papers. The Workstep "Cash in Transit" completed by Mr Radway stated:

> "The client use [sic] 7 working days as a proxy for money that has been sent by customers before year end, and therefore should be recognised as cash in FY09 by Connaught Compliance."

274. However, on 7 October 2009 Mr Stratford discovered that management were including moneys received in the period up to 10 working days after the year end as cash at the year end. He emailed Mr Harrison that day:

> "I may have overstated the cash cut off potential error – need to discuss with client tomorrow as when I looked at the analysis given to our team today and it looks to me like they have kept books open for 10 working days and days 6 – 10 represents nearly £7m cash. I will ask about this in the morning to see if I am correct in my interpretation."

275. The implication of this email is that Mr Stratford had been working to a cash cut-off of 5 working days after the year end (rather than the 7 working days referred to by Mr Gomer). The Audit Committee Update dated 8 October 2009 included a section on Cash in transit drafted by Mr Stratford:

> "Management analysis of cash receipts indicates that more than £7m of cash receipts relate to working days 6 – 10. [Conclusion pending further support for this treatment as we would typically expect outstanding lodgements to clear the bank within 5 working days]."

276. It is also relevant to mention that Mr Radway's understanding, set out in the Step paper "Cash in Transit" completed by him on 14 October 2009 (i.e., after Mr Stratford's discovery), cited at paragraph 273 above, was that the Group were including credits to the bank accounts entered in the period of 7 working days after the year end.

277. In fact, Mr Radway's understanding was incorrect: as Mr Stratford had discovered, the Group was using a period of 10 working days, and was doing so without informing the Respondents. We do not know the source of Mr Radway's misunderstanding, but it may have been management.

278. The inclusion by management of working days 6 to 10 (and certainly the inclusion of days 8, 9 and 10) should have alerted the Respondents to real doubts as to management's reliability. Management had substantially extended the period

previously used (whether it was 5 or 7 working days) without informing PwC. As Mr Harrison knew, it was significant given the relevance of cash at year end to the cash flow statement and the importance of the cash conversion ratio to investors. The cash conversion ratio was also of significance to the bonuses of senior management, but we do not know whether the Respondents were aware of this.

279. Mr Stratford appears to have been duly alarmed. On the day following his discovery, he emailed, at 7.19 am, Mr C, the Group Deputy Finance Director, Treasurer of Connaught and a director of CPL and CCL:

> "Please can we discuss the attached *first thing*.
>
> The £1.8m of cash receipts post 7 Sept I mentioned last night was based on our testing as at end of play yesterday.
>
> When I looked at the analysis given to our team yesterday it looks to me like this is suggesting that the kept books were open for 10 working days and days 6 – 10 represents nearly £7 million cash (see net debt rec tab of the spreadsheet below).
>
> Can we discuss as I we (sic) have not seen the adjustment in the accounts so I must be missing something as this shows adjustment of £23.2m whereas we only see £10m in the work we have done to date."

The italics are ours. The attached spreadsheet showed a total of £7.5 million posted on working days 1 to 5, and a total of £6.4 million posted on working days 6 to 10.

280. Cash cut-off was discussed at the Audit Committee meeting on 8 October 2009. Mr Stratford attended the meeting in person; Mr Harrison telephoned in. According to Mr Harrison, it was a difficult meeting. The minutes record:

> "Audit testing had identified that cash in transit included some late entries. Mr B [the Group Finance Director] reported that the majority of the balance related to two customers who had confirmed payment before the year-end, but whose cash was received later than expected. The Committee expressed its disappointment that cash cut off had not been raised for discussion by the auditors at the time of the initial meeting.

> After a lengthy discussion it was agreed that the cash cut off be brought forward by two days and net debt increased from £85m to £89m."

281. Bringing the cash cut-off forward by 2 working days from 10 working days would mean a cut-off of 8 working days after the year end. However, Mr Harrison was of the impression that what was agreed was a cut-off of 7 working days after year end. In his witness statement he said:

> "317. The Critical Matter [Cut off approach – consideration following discussion of audit plan at July 2009 audit committee meeting] records that the £4 million downwards adjustment agreed by management and the Audit Committee at the meeting had been taken to the summary of unadjusted differences and adjusted within the financial statements. …
>
> 318. The Critical Matter also notes that we considered that no further adjustments were required as the amount of cash received on working days 6 and 7 after the balance sheet date was only £2.4 million across CPL and the compliance businesses. While I was of the view that procedures on cash cut-off should be improved in future (I would have preferred the cut-off to have been no later than 5 workings days – hence we raised that point in our discussions referred to below at the 2010 half-year), we were satisfied that any further adjustment would not have had a material impact on the truth and fairness of the accounts. We also noted our discussion with the board and Audit Committee and that the proposed adjustment did not appear unreasonable given that the business billed around £65 million a month, with average cash receipts of about £2.5 million a day.
>
> 319. I emailed the final report to the Audit Committee on 12 October 2009. The controls and procedures section of the report included a recommendation that the cash cut-off procedures should be clarified and tightened in future."

282. Consistently, the Respondents' representations in response to the Executive Counsel's proposed Formal Complaint stated:

> "Connaught's accounting policy for cash-in-transit in the 2009 year was to treat as cash-in transit at the balance sheet date any cash received up to 7 days after the balance sheet date …"

283. In fact, the Consolidated Balance Sheet of the Group included moneys received into the bank accounts on working days 1 to 8 after year end in "Cash and cash equivalents" at year end. Note 27 to the financial statements was an "Analysis of cash equivalents" and

gave the amount of "Cash in hand and at bank" as £56.4 million. The Statement of Consolidated Accounting policies included the following:

> "Cash and cash equivalents
>
> Cash and cash equivalents comprise cash in hand and balances with bank and similar institutions … This definition is also used for the consolidated cash flow statement."

284. These were clear misstatements. As we stated above, moneys credited to the bank account after the year end as a result of BACS payments were neither "in hand" nor "at bank". Only cheques received by year end could properly be included in "Cash and cash equivalents" at year end.

Cash Cut off (4) Materiality

285. A finding that an accounting or auditing error was material to the financial statements in question is not an essential condition for a finding of Misconduct. To take an obvious case, an error that was due to deliberate and dishonest conduct by an accountant will always constitute Misconduct, even if the error turned out to be immaterial to the financial statements in question.

286. Materiality may none the less be relevant in two respects. First, the audit work that is appropriate will depend on the materiality of the item under consideration. Secondly, an auditor is not required to qualify his audit report for errors that individually or cumulatively are not material.

287. In this connection, auditing cash cut-off does not normally involve significant judgment, and is largely a matter of checking entries in the cash book and bank statements.

288. Paragraph 67 of the Formal Complaint states that, as a consequence of the Group's accounting policy for cash, the Group's and CPL's cash balances were overstated (and trade debtors correspondingly understated) by up to £18.9 million and £14.9 million, respectively, at 31 August 2009. The Group's and CPL's current assets, which largely consist of trade and other receivables, totalled £219.7 million and £186.8 million, respectively, at 31 August 2009. In our view, even if the overstatements are as stated in the Formal Complaint, the misclassifications between components of current assets in the Group's and CPL's financial statements are not sufficiently material for us to find that PwC should have qualified its audit opinions in relation to this matter. The misclassification would also have impacted the cash flow statement; however, the Formal Complaint did not allege that the Group's cash flow statement for the year ended 31 August 2009 was materially misstated. In addition, the extent to which it was misstated would depend on the amount of the overstatement in the Group's balance sheet at 31 August 2008, which was not addressed either by factual or expert evidence. CPL took advantage of the exemption in FRS 1 (Revised 1996) "Cash Flow Statements" not to present its own cash flow statement.

Cash cut off (5) The Tribunal's findings

289. In assessing the Respondents' conduct, we take into account that, as indicated in the preceding paragraph of our Report, if in 2008 the cash cut-off date was 5 working days after the year end, taking a similar period in 2009 would likely result in a materially correct figure for cash received during the year, assuming that receipts in working days 1-5 in 2008 were approximately the same as in working days 1-5 in 2009. If in 2008 the period was 7 working days, the effect of including day 8 in 2009 may have been

even less. However, this would still leave an over-statement in the balance sheet of cash in hand and at bank at the 2009 year end.

290. For the reasons set out above, while we find that the Respondent's work on cash cut off was below the standard reasonably to be expected of them, we do not find that their work was significantly so. Accordingly, we find that Allegation 4 has not been established.

Conclusions on Allegations 1 to 4

291. For the above reasons, we find that Allegations 1, 2 and 3 are established against both PwC and Mr Harrison. We find that Allegation 4 has not been established.

SANCTIONS

(a) Procedure

292. Our Adverse Findings on Misconduct required us to consider the sanctions to be imposed on the Respondents, as well as issues as to costs.

293. Paragraph 9(11) of the Scheme requires the Tribunal to make a report setting out its decision and reasons. Both "report" and "decision" are singular. It follows that the Scheme requires the Tribunal to make a single report on substantive issues, i.e., whether it makes a finding of Misconduct (referred to in the Scheme as an "Adverse Finding") or not. Paragraph 46 of the Accountancy Regulations is to the same effect. The result is that the Tribunal is unable to make a separate report on Misconduct that could be published and enable the parties to focus their submissions on sanctions (if an Adverse Finding has been made) and costs. For the parties to have to make submissions on these matters without knowing whether there was an Adverse Finding, and if there was one

or more on what allegations, in what terms and for what reasons, would be at best inefficient, would be liable to lead to a waste of work, time and costs, and to submissions that do not address the findings of the Tribunal. This result would be inconsistent with the purpose of paragraphs 34 and 35 of the Regulations, which do not sit well with paragraph 9(11) of the Scheme. Those paragraphs of the Regulations also do not sit comfortably with paragraph 46 of the Regulations.

294. In order to avoid these consequences, our report on the substantive issues of Misconduct was distributed to the parties as a confidential draft, to enable them to identify factual and typographical errors and, more importantly, to present submissions on sanctions and costs that took our findings into account. We held a separate hearing on 16 March 2017 when the parties presented their respective cases on the appropriate sanctions to be ordered by the Tribunal and on costs. This hearing enabled the Tribunal to comply with paragraphs 34 and 35 of the Regulations.

295. This procedure, in reality a work-around of the difficulties created by the requirement of a single report, is unsatisfactory. Until a report is signed by the chairman, it remains a draft and any Adverse Finding could be amended or even deleted. It must remain confidential: see paragraph 46(b) of the Regulations. However, the Tribunal is required to hold its hearings in public unless "in the opinion of the Tribunal, the circumstances are such that publicity would prejudice the interests of justice". Our hearing on 16 March was attended by reporters, and we declined the application that we should sit in private, because we did not consider that the interests of justice would be prejudiced by publicity. Despite the formal confidentiality attached to our draft report, it was obvious to the reporters that we had issued a draft report that made Adverse Findings, but they could not know in what terms or for what reasons. The Respondents' application had

been made after it had become apparent that there had been improper disclosure to the press by the FRC of details of our confidential draft report. The application was addressed in our separate ruling dated 16 March 2017. At our request, the FRC agreed that it would report back to us on the results of its investigation into the improper disclosure of our confidential draft report.

296. We urge the FRC to amend the Scheme as soon as possible to authorise Disciplinary Tribunals to make such reports (which should save in special circumstances be published) on the Formal Complaint as they consider appropriate, and to make consequential amendments to the Regulations.

The contentions of the Executive Counsel and of the Respondents

297. The Executive Counsel submitted that the appropriate sanctions for PwC are a severe reprimand and a fine of at least £6 million, and for Mr Harrison a severe reprimand and a fine of at least £200,000. Given that Mr Harrison has retired as an audit partner, the Executive Counsel did not seek his exclusion.

298. The Respondents accepted that a Severe Reprimand is appropriate for PwC, but submitted that a Reprimand is appropriate for Mr Harrison. They submitted that for PwC a fine of £2-2.5 million was appropriate and for Mr Harrison a fine of in the region of £50,000.

Additional evidence

299. The Respondents submitted two witness statements. The witness statement of Andrew Howell, one of the partners of Taylor Wessing having conduct of the Respondents' case, provided evidence of the revenues and profits of PwC and of the changes to their working practices since the events that are the subject of our Report. He confirmed that

any fine or costs order imposed on Mr Harrison would be met by PwC, but that is not a matter to be taken into account by us in deciding on the appropriate sanction or sanctions.

Sanctions: (b) Considerations

300. In considering whether to impose sanctions, and if so what sanctions, we are required to have regard to the Sanctions Guidance provided by the Conduct Committee of the FRC. The object of the Guidance is to "promote proportionality, clarity, consistency and transparency in decision-making; and ensure that all parties are aware from the outset of the approach likely to be taken by a Tribunal when determining what sanction to impose."

301. The Guidance states that in determining the appropriate sanction, a Tribunal should have regard to the reasons for imposing sanctions for Misconduct in the context of professional discipline.

> "9. … Sanctions are imposed to achieve a number of objectives, namely:
>
> - to deter members of the accountancy profession from committing 'Misconduct';
> - to protect the public from Members and Member Firms whose conduct has fallen significantly short of the standards reasonably to be expected of that Member or Member Firm;
> - to maintain and promote public and market confidence in the accountancy profession and the quality of corporate reporting; and
> - to declare and uphold proper standards of conduct amongst Members and Member Firms.
>
> The primary purpose of imposing sanctions for acts of Misconduct is not to punish, but to protect the public and the wider public interest. Therefore a Tribunal's objective should be to impose the sanction or combination of sanctions necessary to achieve the objectives of the Scheme."

302. Paragraph 10 of the Guidance prescribes that the sanctions should be such as to:

- improve the behaviour of the Member or Member Firm concerned;
- are tailored to the facts of the particular case and take into account the nature of the Misconduct and the circumstances of the Member or Member Firm concerned;
- are proportionate to the nature of the Misconduct and the harm or potential harm caused;
- eliminate any financial gain or benefit derived as a result of the Misconduct; and
- deter Misconduct by the Member, Member Firm or others.

303. We have had regard to the Guidance in deciding on the sanctions to be imposed on the Respondents.

304. We are also required to consider "precedents emerging from cases decided by previous Disciplinary Tribunals and Appeal Tribunals". This instruction, like the objective of consistency, is not straightforward, since necessarily previous decisions relate to different facts, and may in any event be affected by societal and commercial developments.

305. In the following paragraphs of our Report, references to Misconduct are to the Misconduct of the Respondents that we have found.

Sanctions: (c) the Factors set out in the Guidance

306. Paragraph 18 of the Guidance lists 17 factors that the Tribunal may take into account. The parties addressed most of these factors in their submissions, and we address them in the following paragraphs.

Financial benefit.

307. The Respondents derived no financial benefit from the Misconduct.

Financial loss: whether the Misconduct caused or risked the loss of significant sums of money.

308. The parties differed on this factor. The Respondents submitted that there is no evidence that anyone lost any money as a result of the Misconduct. The Executive Counsel submitted that it is to be inferred from the fact that Connaught was a public company, the shares of which were traded on The Stock Exchange, that investors who bought shares after the publication of the 2009 results would have lost money.

309. Curiously, the only specific evidence before us is that a fund manager made profits by shorting Connaught stock. Significantly, however, he did so because he found "lots of costs relating to contracts which had not gone through the P&L": see the article in the Financial Times of 1 August 2010 "Connaught failed to heed signs at ground level". Such costs would have been or included those that were accounted for as mobilisation costs and costs capitalised as intangible assets: in other words, the subjects of findings of Misconduct. Of course, for every gain made by shorting the shares, an existing shareholder lost as a result of the reduction in the share price.

310. In our view, we must take into account that investors, including professional investors acting for pension funds and others, retained or purchased shares in Connaught in reliance on the 2009 financial statements providing a true and fair view and on the unqualified audit report for which the Respondents were responsible. Creditors may have extended credit on the faith of the audited financial statements. The financial statements or the audit report (or both) would have been very different if the Respondents had exercised the degree of scepticism that was absent from their work and carried out their audit work in the areas we have considered with due care and professionalism. The audited 2009 financial statements enabled management to place in our view unjustified emphasis in the Annual Report on the Group's "sustainable business" and the delivery of "sustainable growth". The sums involved are likely to

have been significant, but cannot be quantified, since there can be no certainty as to what would have happened to the share price if the audit and audit report had been free from Misconduct.

Whether the Misconduct was intentional or unintentional.

311. The Misconduct was unintentional.

The nature, extent and importance of the standards breached.

312. The nature and extent of the standards breached appear from our Report. The financial importance of the breaches of the standards also so appears. They were not confined to a single area of the audit and were fundamental to the audit report. The importance of the standards themselves arises from the importance of audit in the economy and the financial system.

Whether the Misconduct involved a failure to act or to conduct business with integrity.

313. There was no such failure on the part of the Respondents.

Whether the Misconduct was dishonest, deliberate or reckless.

314. It was not.

Whether the Member or Member Firm has been convicted of a related criminal offence in the United Kingdom or elsewhere.

315. It is clear that the Misconduct on the part of the Respondents did not constitute a criminal offence and neither PwC nor Mr Harrison has been convicted of any such offence.

Whether any potential financial crime was facilitated as a result of deficiencies in the governance or management of the entity affected or the Misconduct.

316. It is not suggested that any such financial crime was committed.

Whether the Misconduct adversely affected, or potentially adversely affected, a significant number of people in the United Kingdom (such as the public, investors or other market users, consumers, clients, employees, pensioners or creditors).

317. For the reasons set out at paragraph 310 above, we consider that this factor is applicable.

Whether the Misconduct undermines the purpose or effectiveness of the disciplinary arrangements.

318. It does not.

Whether the Misconduct could undermine confidence in the standards of conduct in general of Members and Member Firms, and/or in financial reporting and/or corporate governance in the United Kingdom and/or in the profession generally.

319. This is not an easy factor to address. Any Misconduct in connection with an audit, particularly by a major Firm such as PwC of a quoted public company, is liable to undermine confidence in financial reporting. The extent to which the Misconduct we have found undermines such confidence is mitigated by the fact that it occurred over 7 years ago.

In the case of a Member Firm, the effectiveness of its relevant procedures systems or internal controls.

320. We have not found that there were wide or systemic failings on the part of PwC. However, in relation to the audit of the Connaught companies, internal procedures and internal controls were ineffective. Specifically, although there was a Quality Review Partner, he (i.e., Mr Chapman) wholly failed effectively to consider the work done or to question the judgments made in the key areas of audit judgment that had been identified by the audit team: see paragraph 35 above.

Whether the senior management of PwC became aware of the Misconduct.

321. This factor has no application.

Whether the Member (that is, Mr Harrison) caused or encouraged other individuals to commit Misconduct.

322. He did not.

Whether Mr Harrison held a senior position and/or supervisory responsibilities.

323. He did.

Whether Mr Harrison was solely responsible for the Misconduct.

324. He was not, but as the Engagement Partner he bears the principal responsibility for the audit.

The seriousness of the Misconduct: generally

325. We regard the Misconduct we have found to be very serious indeed. It has to be considered in the context of the audit of the financial statements of a public quoted company. Investors and creditors rely on those financial statements, and the auditor's report, in making their financial decisions. The responsibility of an auditor is in our view to be measured less by the amount of the audit fee than by the scales of the balance sheet and profit and loss account that it audits and on which it reports. Management may have every reason to overstate the profits shown by the profit and loss account, or to understate losses, to overstate assets and to understate liabilities. They may seek to do so beyond what is objectively justifiable. It is crucial that the auditor reasonably satisfies itself that this has not happened.

326. We take into account the fact that PwC's audit fee was only £300,000. The fact that the Respondents accept that a fine for PwC of £2-2.5 million is appropriate in this case confirms that the amount of the audit fee is no more than a consideration in determining the appropriate sanction.

327. We do not propose to repeat, or to summarise, our findings of Misconduct. It is sufficient to state that the principal failures on the part of the Respondents were their almost complete failure to stand back, to heed the warning signs (such as the manifestly unsustainable Mr A paper on mobilisation costs and the unjustifiable cash cut-off proposed) and to exercise any appropriate degree of scepticism in relation to management's proposed adjustments. In the areas we have considered, the audit function failed.

328. In paragraphs 11 to 14 of their submissions on sanctions, the Respondents point out that the scale of the misstatements in the financial statements of Connaught plc, CPL and CCL cannot be measured by the gross amounts of the adjustments that are the subject of our findings. To some extent we accept their submission. The Companies would have been entitled to capitalise significant sums as intangible assets and mobilisation costs. Whether any sum could have been included in respect of long-term accounting adjustments is more difficult, since these adjustments depended on reliable estimates of future revenue, of which we have seen no evidence. The amount of mobilisation costs that could properly have been capitalised was not determined. In reality, a careful audit would have resulted in either heavily qualified or disclaimed audit reports or substantially restated financial statements produced after the date expected by The Stock Exchange. The consequences for the Connaught Group and its shareholders and creditors would have been very different.

329. The Respondents contend that the PwC audit team was misled by certain members of Connaught's management who made efforts to withhold important information from them. We accept that the unjustified extension of the cash cut-off should have been disclosed by management, but was not. Mr A's paper on mobilisation costs, produced

very late in the day, had all the hallmarks of an unjustified attempt to improve the financial statements. However, the purpose of an audit is to ensure, so far as the auditor reasonably can, that the audited financial statements are free from error resulting from such conduct on the part of management. It is the key areas of judgment, identified by the Respondents, that are particularly vulnerable to misstatement. The Respondents correctly identified those areas, but did not then properly exercise their audit responsibility in relation to them.

Previous decisions

330. As we have already indicated, to search for consistency with previous decisions involves the difficulty that they necessarily were concerned with different facts and were decided at different times. In *Law Society v Emeana and ors* [2013] EWHC 2130 (Admin) Moses LJ said:

> *"*24. This appeal took a familiar course. The respondents were able to show cases of at least as great a gravity where fines were imposed and the appellant authority was able to refer to cases where it appeared the failures were no more severe but at least suspension was ordered.
>
> 25. I did not find this process of assistance. Of course, the disciplinary tribunal must strive for consistency. But uniformity is not possible**.** The sentences imposed are not designed as precedents. *..."*

331. It was for this reason that the Criminal Division of the Court of Appeal frowned on the citation of previous individual sentencing decisions, and adopted the practice of giving judgments that were intended and expressed to give guidance on appropriate sentences. A recent example was *R v Kahar and ors* [2016] EWCA Crim 568. *R v Millberry and ors* [2002] EWCA Crim 2891 [2003] 1 WLR 546 is an older example. The judgment in such cases would consider relevant factors bearing upon the sentencing decision and give guidance as to appropriate sentences in future cases. We do not have the benefit

of such a practice. Generally, reports of Disciplinary Tribunals and Disciplinary Appeal Tribunals are not expressed, and are not intended, to lay down sentencing guidelines. The Report in the *JPMorgan Securities* case does purport to lay down guidelines for future decisions, but there is no indication in the Report that the Disciplinary Tribunal had any special authority or that it had the benefit of submissions and evidence going beyond the case before it. We respectfully agree with what was said by Sharp LJ in *Scott v Solicitors' Regulation Authority* [2016] EWHC 1256 (Admin):

> "…I should add that decisions in this jurisdiction are of course fact sensitive, and I have not found the reference to the facts of other cases where lesser or different penalties were imposed to be of any assistance. As was observed in *Law Society (SRA) v Emeana and ors,* [2013] EWHC 2130 (Admin) sentences imposed in this jurisdiction are not designed as precedents: see paras 24 to 25.

The jurisdiction to which Sharp LJ referred was materially similar to the present jurisdiction.

332. Moreover, care is required when considering previous decisions. The decision of the Appeal Tribunal in the *MG Rover* case[17] is a case in point. The Appeal Tribunal imposed a fine of £3 million on Deloitte & Touche. The Respondents point to this fine and contend that a fine of £6 million, the amount suggested by the Executive Counsel in these proceedings, would be record-breaking and unjustified by reference to the fine in *MG Rover.* However, the Appeal Tribunal in that case explained its starting point in paragraphs 16 and 17 of its Report on Sanctions and Costs:

> 16. There is one matter we must mention at the outset. The fine imposed on Deloitte by the Disciplinary Tribunal was of £14 million; on Mr Einollahi it was £250,000. These fines reflected the findings of misconduct made by that Tribunal, summarised in our substantive decision. In contrast, we have allowed the appeal against all of the findings on Project Aircraft; we have allowed the appeal against what was regarded by the Disciplinary Tribunal as the most serious misconduct of

[17] *Deloitte & Touche and Maghsoud Einollahi v the Executive Counsel of the FRC*

> the Appellants, namely the alleged failure to have regard to the public interest; and we have quashed the finding of deliberate misconduct.
>
> 17. Whether or not we would have reached a different conclusion if we were a first instance tribunal, unaffected by a first instance decision, in our view fairness requires that the very substantial difference between our findings and those of the Disciplinary Tribunal is reflected in a substantial reduction in the fines imposed on Deloitte. …"

333. Thus the level of sanctions in the *MG Rover* case can be of limited, if any, assistance as a precedent. The report of the Appeal Tribunal in that case was explicit about the special facts of the decision, but this may not always be so.

334. For the above reasons we do not think it necessary or helpful to consider each of the decisions of Disciplinary Tribunals that has been cited to us, and to comment on the differences and similarities to the present case. We select two: the *JP Morgan Securities* Case and the *Aero* case.

335. *JP Morgan Securities* was not an audit case. The auditor's failure to detect and to report that client money was being mingled with firm moneys overnight, and not kept segregated, occurred over several years. Client moneys had been exposed to risk, but no loss had resulted. The Misconduct was admitted. A fine of £1.4 million was imposed. We note the very considerable difference between that fine and the fine of £33.32 million imposed on JP Morgan Securities Ltd itself.

336. The Tribunal's report on the *Aero* case has not been published, and the available information on the case is incomplete. Aero Industry Plc was a company listed on AIM. Its assets, liabilities and financial results are likely to have been less than those of Connaught. The information as to the nature and consequences of the Misconduct is minimal. It concerned stocks and sales in 3 years' audits and a single transaction. The failure to perform an adequate audit led to misleading information about profits and turnover being given to the market. The fine was £4 million.

The sanctions in the present case

Reprimands

337. The Respondents realistically accepted that a severe reprimand is appropriate for PwC, having regard to the seriousness of the Misconduct, and we need say no more about it.

338. With regard to Mr Harrison, we take into account his long, distinguished and unblemished career as an accountant. We have borne in mind that these proceedings have been pending, and hanging over him, for some considerable time. In addition to the unavoidable stress and worry, they have affected his activities in his retirement, as set out in paragraphs 10 to 14 of his second witness statement. We have taken into account the positive reference by Mr Justice Roth to his membership of the Competition Appeal Tribunal. Mr Harrison co-operated with the investigation, and we have commented favourably above on his conduct in these disciplinary proceedings.

339. Nonetheless, in our view it would be inappropriate to impose a severe reprimand on PwC but only a reprimand on Mr Harrison, the engagement partner who bore ultimate responsibility for the Misconduct we have found. In our judgment, a severe reprimand is appropriate for Mr Harrison also, and we so decide.

Fines: (a) PwC

340. It is not disputed that a fine should be imposed in addition to a severe reprimand.

341. PwC is a very large and successful organisation. In the year to 30 June 2016, its total revenue was £3,437 million and profit was £829 million. Revenue from statutory audits and directly related services was £659 million, and in addition the revenue from other services to audit clients was £1,427 million. Distributable profit after tax was £323

million. Average profit per partner was estimated at £706,000. Clearly, PwC's ability to pay a fine of any sensible size would be unaffected by any lack of financial resources.

342. We have set out above most of the matters we have considered in determining the appropriate fine. There are additional matters that fall to be taken into account: PwC's previous findings of Misconduct, the steps it has taken to prevent a recurrence of the Misconduct in the present case and the Respondents' cooperation with the investigation.

343. In January 2012, PwC was fined £1.4 million over its Assurance Report to the FSA on Client Money Rules (for the year ends 2002-2008) of JP Morgan Securities. We have referred to this decision above.

344. In August 2016, PwC was fined £3.5 million (reduced to £2.3 million after mitigation and a settlement discount) in connection with its audits for financial year 2007 of Cattles Plc and Welcome Financial Services. The Chairman of the present Disciplinary Tribunal was the person appointed under the Scheme to determine whether or not it would be appropriate for the Proposed Settlement Agreement between the Executive Counsel and PwC and Mr Simon Bradburn, the engagement partner. PwC had issued unqualified audit opinions in respect of the 2007 Cattles financial statements and the 2007 WFS financial statements. Executive directors and senior management of Cattle and WFS, including qualified accountants, had colluded to conceal from PwC the fact that loans made by the companies that were accounted for at nominal value were non-performing. The principal Misconduct was the complete failure to identify that impaired loans were being treated as non-impaired for the purposes of the financial statements. As a result the companies' financial statements very greatly overstated profits and net assets. That case differed from the present in that:

(1) the Misconduct related to one area of the audit; it was, however, the major area to be audited.

(2) Management deliberately misled PwC.

345. The Respondents made the fair point that the Misconduct that was the subject of these cases preceded that in the present case. It is sufficient for us to remark that PwC does not have the advantage of an unblemished disciplinary record.

346. Secondly, and to our mind importantly, PwC has taken steps to emphasise the need for scepticism in relation to management's accounting and representations. Its audit processes now require the audit team to complete a separate work paper which records the actions which have been taken to demonstrate professional scepticism during the course of an audit. The relevant wording in the Audit Guide is as follows:

> "A significant matter shall be created to document how the engagement team has challenged management and applied its professional scepticism throughout the audit. The significant matter shall be attached to the engagement leader and team manager completion sign-off EGA. Where the audit is also a group audit, this policy shall apply to the audit of all significant components within the group (as defined in ISA (UK&I) 600). In such cases the group team shall require the component auditors of those significant components to prepare a significant matter and include it in their reporting to the group engagement team."

347. We have read, and taken into account, paragraphs 12 and 13 of Mr Howell's witness statement. We also take account of the improvement in the results of the Audit Quality Reviews of PwC's audit work.

348. Thirdly, we take into account the Respondents' cooperation with the investigation. This is not a substantial factor: it is what we would expect of a firm and a Member of the Respondents' standing.

349. As we have already indicated, a fine that would materially diminish PwC's financial resources would be unreasonably large. It remains the case that a substantial fine is required. The fine must be such as to mark the seriousness of the Misconduct, to have sufficient impact on PwC and be sufficient to "promote public confidence in the regulation of the accountancy profession and in the way in which Misconduct is addressed". If so, it will satisfy the requirement of deterrence.

350. Having taken account of all the matters to which we have referred, we have determined that the appropriate fine to be imposed on PwC is a fine of £5 million. There are no aggravating factors to be taken into account; we have taken into account the mitigating factors to which we have referred.

Fines (b): Mr Harrison

351. In determining the amount of the fine to be imposed on Mr Harrison, we do take into account the matters referred to at paragraph 338 above. But for those matters, the fine would be substantially greater. There are no aggravating factors. We consider that the appropriate fine in the circumstances is a fine of £150,000.

Costs

Costs: (a) The applicable principles

352. The Tribunal's power to make costs orders is conferred by paragraphs 9(8) to (10) of the Scheme:

> 9(8) Where the Disciplinary Tribunal makes an Adverse Finding in relation to a Member or Member Firm then:-
>
> > (i) it may order such sanctions against the Member or Member Firm as are contained within the schedule of sanctions at Appendix 1 to this Scheme as it considers appropriate; …

> (ii) in addition to the sanctions at Appendix 1 to this Scheme, any order made pursuant to paragraph (i) above may include an order that the Member or Member Firm be required to pay, in the manner set out in paragraph 13, the whole or part of the costs of, and incidental to, the investigation and the hearing of the Formal Complaint before the Disciplinary Tribunal. The amount to be paid by the Member or Member Firm shall be determined by the Disciplinary Tribunal. In considering any such application the Disciplinary Tribunal shall have no regard to any settlement discussions or proposals or offers; and
>
> (iii) the Tribunal may make no order against the Member or Member Firm, or no order except for the payment of costs, if it considers that to be appropriate in all the circumstances.
>
> 9(9) Where the Disciplinary Tribunal dismisses the Formal Complaint it may, on the application of a Member or Member Firm concerned, order that the FRC pay a specified sum in respect of legal costs that were reasonably incurred by the Member or Member Firm subsequent to the Formal Complaint being served on the Member or Member Firm.
>
> 9(10) The Disciplinary Tribunal's discretion to award costs to a Member or Member Firm concerned pursuant to paragraph 9(9) shall be restricted to circumstances where the Tribunal finds that no reasonable person would have delivered or pursued all or a substantial part of a Formal Complaint under the terms of this Scheme. In considering any such application the Disciplinary Tribunal shall have no regard to any settlement discussions or proposals or offers.

Costs: (b) The parties' contentions

353. The Executive Counsel contends that the Respondents should pay all his costs of the investigation into the affairs of Connaught and of these disciplinary proceedings.

354. The Respondents accept that the Executive Counsel is entitled to recover his reasonable costs, but they contend:

(1) The Executive Counsel should not have pursued his allegations as to the technical requirements of the applicable accounting standards. He was unreasonable in doing so. The Executive Counsel should pay the Respondents' costs of defending this part of the Executive Counsel's Formal Complaint.

(2) The Executive Counsel should not have his costs of his unsuccessful allegation of Misconduct in relation to cash cut-off.

(3) The Executive Counsel should recover none of the costs of the investigating accountants, amounting to some £193,000.

(4) There should be a substantial reduction in respect of the costs recovered by the Executive Counsel on account of the unjustifiable delay in prosecuting this case.

355. It was submitted on behalf of the Executive Counsel that by reason of the introductory words of paragraph 9(9) ("Where the Disciplinary Tribunal dismisses the Formal Complaint"), the Tribunal does not have any power to make an order that he pay any part of the Respondents' costs.

356. The parties have sensibly agreed that notwithstanding the provisions of paragraph 9 of the Scheme, we should not in our Report seek to quantify costs. Rather, we should determine the parties' entitlement and liability for costs in principle, and leave it to them hopefully to agree quantum, or in default of agreement to bring their quantification before the Tribunal at a future date.

Costs: (c) Discussion

357. We entirely accept the Respondents' submission that the Executive Counsel's interpretation of paragraph 9(9) of the Scheme is capable of leading to unjust and irrational results. One can imagine a case in which 90 per cent of the time and costs related to allegations that were unreasonably pursued, but one minor allegation succeeded. On the Executive Counsel's interpretation, in such a case the Tribunal would have no power to make any award of costs in favour of a respondent.

358. Nonetheless, the words of paragraph 9(9) are clear and unambiguous. It follows that it is only if the Formal Complaint is dismissed that a Tribunal may make an order that the Executive Counsel pay all or some of the respondent's costs. We urge the FRC to reconsider this provision, which is capable of working injustice.

359. We would not in any event have made an order against the Executive Counsel. We do not consider that he acted unreasonably in pursuing his case that the applicable accounting standards did not permit the treatment of mobilisation costs and the long-term accounting adjustments made by management and accepted by the Respondents. His case was cogently supported by Mr Kelly, and in the case of mobilisation costs supported by PwC's own manual: see paragraph 96 above. Furthermore, it was in any event necessary to educate the Chairman and lay member as to the requirements of the applicable standards. Lastly, we consider that the time and therefore costs involved in the avoidable issues as to the technical requirements of the applicable accounting standards were insubstantial. We propose to make a reduction in the costs the Respondents are ordered to pay which we consider will take into account the avoidable costs under this head.

360. The Executive Counsel's Allegation in relation to cash cut-off was reasonably pursued. As we have held, the accounting proposed by management and accepted in part by the Respondents was manifestly incorrect, leading to obvious misclassifications in the balance sheets. The Respondents' defence of the inclusion of credits to the bank accounts made 7 (in fact 8) days after year end in "Cash and cash equivalents" and "Cash at bank and in hand" was unsustainable. We consider that the Executive Counsel should have his costs of this Allegation.

361. The Executive Counsel's allegations in relation to disclosure involved little time or costs (as shown by Table 1 in the Respondents' Written Submissions on Sanctions and Consequentials) and we do not think it appropriate to make a separate order for costs in relation to them.

362. Paragraph 9(8) of the Scheme confers power on the Tribunal to order the Respondents to pay the costs of, and incidental to, the investigation leading to the making of the Formal Complaint. The Executive Counsel asks us to make an order in relation to the costs of the investigation attributable to the Formal Complaint against the Respondent, i.e., excluding those costs listed in paragraph 4 of his Further Submissions on Costs, such as costs attributable to the investigation of the Members in business. So limited we are informed that the costs of the investigating accountants, Ballamy Woodhouse, were £193,000.

363. The Respondents' case in relation to the investigating accountants' fees is set out in paragraph 76 of their Written Submissions:

> "… large portions of the interviews consisted of inconsequential questioning about points which in the event formed no part of the Allegations pursued by the EC. Conversely, the Allegations contained numerous matters about which the Respondents were never questioned in any depth (or even at all). For example, intangible assets and cash cut-off did not feature at all in any of the interviews with Mr Chapman, Mr Harrison, Mr Stratford or Mr Radway. The capitalisation of mobilisation costs was only touched on briefly and, in the case of Mr Harrison, this was only in the final moments of his interview."

364. Cash cut-off was referred to, albeit briefly, in the interview of [redacted], the Financial Services Director of CPL[18]. The Respondents themselves drew our attention

[18] File G5/30F/91.

to the remarks of Sid Harding of the investigating accountants in relation to long-term contract accounting.[19]

365. Mr Herberg QC informed us that the sum of £193,000 represents only 62 per cent of the total costs of the investigating accountants, which the Executive Counsel contends fairly relates to those allegations of Misconduct that the Tribunal has found proven. He also pointed out that necessarily an investigation is begun when there may be little hard information as to whether there has been any Misconduct. It is, he said, to some extent a voyage of discovery. We accept this.

366. It is significant that the Preliminary Report of the investigating accountants focused on, among other matters, the question whether the Group's management were able to forecast contract revenues over the long term: see paragraphs 1.22 to 1.24 and paragraphs 1.31 to 1.35 of the Executive Summary. This question was central to our findings in respect of long-term accounting adjustments. The Interim Report considered CPL's accounting for long-term contracts (paragraphs 1.25 to 1.30 of the Executive Summary) and the accounting treatment applied to mobilisation costs (paragraph 1.36 to 1.38).

367. We consider that the Executive Counsel is entitled to recover the costs of the investigation in so far as it relates to our findings of Misconduct.

368. Where we do sympathise with the Respondents' submissions on costs is in their complaint of the delay in the prosecution of this case. They have set out a helpful timetable in their Written Submissions:

[19] File G6/34/35.

(1) The AADB (as the FRC was then known) commenced its investigation into the collapse of Connaught on 29 November 2010 (over 6 years ago).

(2) The members of the PwC audit team were interviewed in September 2011.

(3) The AADB informed the Respondents in October 2012 that it had delivered its investigative findings to an expert who had been instructed to deliver a report on whether in his opinion, there was evidence of misconduct.

(4) The Proposed Formal Complaint was not issued until June 2014.

(5) The Respondents served their Written Representations in October 2014.

(6) There was then a delay of the best part of a further year before the Formal Complaint was finally issued in late September 2015.

(7) The hearing of the Formal Complaint did not take place until November 2016.

369. The period between Sept 2015 and the hearing was not unreasonable. Important interlocutory steps had to be taken, including the Respondents' service of their Defence and the service of witness statements and the Respondents' expert reports. It is the period between November 2010 and the service of the Formal Complaint that we regard as excessive and avoidable.

370. We accept the Respondents' submission that the delay must have added to the Executive Counsel's costs. We would in any event wish to mark our dissatisfaction with the delay, which meant that these proceedings were hanging over Mr Harrison for much longer than was necessary, by reducing the costs that would otherwise be ordered to be paid by the Respondents.

Costs: (d) our decisions

371. As mentioned above, having regard to the matters to which we have referred, we consider that the Executive Counsel should recover from PwC the costs of the investigation in so far as it relates to our findings of Misconduct.

372. We consider that PwC should pay the Executive Counsel 85 per cent of his other reasonable costs of and incidental to these proceedings. We have deprived him of 15 per cent of his costs on account of what we consider to have been excessive delay and also such of the costs of his unsuccessful pursuit of the technical accounting allegations that we think could have been avoided.

373. PwC must pay the costs of the Tribunal within 28 days of notification by the Executive Counsel of their amount.

374. We do not consider it necessary or appropriate to make a costs order against Mr Harrison personally.

375. We shall give separately directions for the determination of the sum to be paid by PwC in respect of costs. It is unnecessary for a procedural order to be included in this Report.

376. The parties agree that the Tribunal has power to make an order for an interim payment on account of the Executive Counsel's costs. We order PwC to pay the sum of £1,500,000 within 28 days after the date that our Report is sent to it by the Conduct Committee pursuant to paragraph 9(11)(ii) of the Scheme.

General comments

377. We express our appreciation of the very considerable work on the part of both the Executive Counsel and the Respondents and the very able representation of the parties

before us. We also thank the Secretary to the Tribunal, Rosemary Rollason, for her unfailingly efficient support.

12 April 2017

The Right Hon. Sir Stanley Burnton
Chairman of the Disciplinary Tribunal

IN THE MATTER OF:

THE EXECUTIVE COUNSEL TO THE FINANCIAL REPORTING COUNCIL

and

(3) STEPHEN HARRISON

(4) PRICEWATERHOUSECOOPERS LLP

ANNEX 1 to the REPORT OF THE DISCIPLINARY TRIBUNAL

ALLEGATION 1 - CONTRACT MOBILISATION COSTS

In relation to their engagement as auditor of the financial statements of Connaught and CPL for the year ending 31 August 2009 and in relation to the accounting treatment of "mobilisation costs" (described in paragraphs [27] to [39] above), Stephen Harrison and PricewaterhouseCoopers failed to act with professional competence and due care and in accordance with applicable technical and professional standards, paragraphs 28 and 29 of ISA 315, paragraph 2 of ISA 500 and paragraph 10 of ISA 540.

Particulars

1. They failed adequately to obtain an understanding of the policy and its application. More particularly, they failed adequately to consider whether (i) the costs incurred in mobilising contracts were capable of being capitalised in accordance with IFRS and UK GAAP and (ii) the method of calculating mobilisation costs was reliable and appropriate. As set out above at paragraph [35] the method was flawed, unreliable and inappropriate and the figure representing "typical" mobilisation costs included costs which could not properly be recognised as an asset.

2. They failed to obtain sufficient appropriate evidence in support of management's assertions that the typical costs incurred in mobilising contracts amounted to £502,750 and that mobilisation costs comprised, on average, 2.75% of the contract value. They should have: (i) tested management's assumption that there existed a relationship

between the order book value and mobilisation costs; (ii) identified and considered the basis on which the figure said to represent "typical" mobilisation costs (£502,750) was calculated; (iii) established whether that figure was based on a representative sample of contracts; (iii) obtained evidence of actual mobilisation costs; and (iv) verified estimates of employee time spent 'mobilising contracts'. They failed to do any of these things.

3. They failed to obtain sufficient appropriate evidence that the costs were contract costs and met the definition of an asset and were capable of being capitalised accordance with IFRS and UK GAAP.

4. They failed adequately to test the accuracy of management's contention that the costs involved in mobilising the Glasgow contract amounted to £1.4 million. They failed to carry out any, or any adequate, analysis of the costs in relation to this contract. In the premises, the Glasgow contract provided little support for the proposition that the typical costs incurred in mobilising contracts amounted to 2.75% of the contract value.

5. They failed to approach Mr A's mobilisation paper and the estimates of staff and other costs contained therein with sufficient professional scepticism.

6. By reasons of the facts and matters at (1) — (5) above, they failed adequately to review and test the process used by management to arrive at the estimate of mobilisation costs.

7. They failed to appreciate that, in relation to the 23 LTA contracts (as set out above at [53]) the costs did not relate to "long-term contracts" and were not therefore contract costs capable of being capitalised.

8. They concluded, erroneously, and in the absence of sufficient, appropriate, audit evidence that the accounting policy was appropriate and that the financial statements of the Group showed a true and fair view and had been properly prepared in accordance with IFRS and UK GAAP. By reason of the facts and matters set out above at paragraph [35] the policy was inappropriate and not in accordance with applicable accounting standards. Further, as a consequence, and as set out in paragraph [37] — [38] above, the financial statements contained material errors.

9. They failed to require management to correct the errors and/or to qualify their audit report to state that the financial statements of the Group and CPL had not been prepared in accordance with IFRS or UK GAAP and did not give a true and fair view.

10. They failed to ensure there was sufficient transparency in relation to the selection and application of this policy. The policy was not disclosed in CPL's financial statements (as required by paragraphs 55 and 56 of FRS 18) nor was it adequately disclosed in the Group's financial statements (as required by paragraphs 8(e), 15(b), and 108 and 110 of IAS 1).

ALLEGATION 2 — 23 LTA CONTRACTS

In relation to their engagement as auditor of the financial statements of Connaught and CPL for the year ending 31 August 2009 and in relation to Connaught and CPL's policy of "long term accounting adjustments" (described in paragraph [40] to [54] above) <u>Stephen Harrison</u> and <u>PricewaterhouseCoopers</u> failed to act with professional competence and due care and in accordance with applicable technical and professional standards, namely paragraph 6 of ISA 200, paragraph 28 of ISA 315 and paragraph 2 of ISA 500 and paragraph 4 of ISA 560.

<u>Particulars</u>

1. The Respondents failed adequately to obtain an understanding of Connaught's and CPL's selection and application of the policy of "long term accounting adjustments" and whether it was consistent with IFRS and UK GAAP and appropriate for the businesses. More particularly, they failed:

    a. to consider whether or not the 4 LTA contracts which were the subject of Mr A's paper long-term accounting case studies' were a representative sample;

    b. to obtain and review sufficient contractual material in order to understand the relevant contractual terms and the nature of the services being performed under the 23 LTA Contracts, …;

    c. to obtain from management, or carry out themselves, an analysis of the nature of the services being performed under the 23 LTA Contracts sufficient to identify the appropriate transaction and/or the separately identifiable components of the transaction, for revenue recognition purposes in accordance with (i) IFRS (IAS 18 paragraphs 9, 10 and 13) and UK GAAP (FRS 5, 'Application Note G: Revenue Recognition' (paragraphs G4 and G6), SSAP 9 (paragraph 22) and UITF abstract 40 (paragraphs 10 to 13).

2. By reasons of the facts and matter set out in 1 (a) — (c) above, they failed to obtain sufficient appropriate audit evidence in support of their conclusion that the accounting policy was appropriate.

3. They attached too much weight to a 'review and comparison' of policies adopted by Serco and Mears. The review of the policies adopted by Serco and Mears was superficial, based only on disclosed accounting policies. Further, they compared neither the contractual terms nor the services performed under long term contracts.

4. They failed adequately to consider whether the criteria adopted by management for the application of long term accounting adjustments (viz. duration of 5 years or greater,

high annual or lifetime turnover projections and high degree of seasonality) were appropriate and had any basis in IFRS and UK GAAP. In fact, they were not.

5. They failed adequately to consider whether the outcome of the contracts could be estimated reliably in accordance with paragraphs 20 and 23 of IAS 18 and paragraph 22 of IAS 11 (in relation to Connaught) and in accordance with paragraphs 9 to 10 and 29 of SSAP 9 (in relation to CPL) notwithstanding (i) the facts and matters set out at paragraphs [45] and [47] above and (ii) the weakness on the part of management (acknowledged by the Respondents no later than 15 April 2010, prior to Mr Harrison signing the auditor's report in respect of CPL's financial statements) to forecast margins reliably.

6. They failed to approach management's representations in relation to contract performance with sufficient professional scepticism.

7. They concluded, erroneously, and in the absence of sufficient, appropriate, audit evidence that the accounting policy was appropriate and that the financial statements of the Group showed a true and fair view and had been properly prepared in accordance with IFRS and UK GAAP. … the policy was inappropriate and not in accordance with applicable accounting standards. Further, … the financial statements contained material errors.

8. They failed to require management to correct the errors or to qualify their audit report to state that the said financial statements had not been prepared in accordance with IFRS or UK GAAP and did not give a true and fair view.

ALLEGATION 3 - INTANGIBLE ASSETS

In relation to their engagement as auditor of the financial statements of Connaught and CCL for the year ending 31 August 2009 and in relation to Connaught and CCL's policy of recognising certain internal projects as intangible assets and capitalising costs associated with them (described in paragraphs [55] to [58] above), <u>Stephen Harrison</u>

and PricewaterhouseCoopers failed to act with professional competence and due care and in accordance with applicable technical and professional standards, namely paragraph 28 of ISA 315 and paragraph 2 of ISA 500.

Particulars

1. The Respondents failed adequately to consider whether Connaught and CCL had measured reliably (or at all) the staff costs attributable to the internal projects in accordance with (i) paragraphs 5.16 and 5.17 of the Statement of Principles for financial reporting and (ii) the recognition requirements for internally generated intangible assets contained in paragraphs 21, and 52 —67 of IAS 38.

2. They failed to obtain sufficient appropriate audit evidence of the staff costs associated with the internal projects. … their audit work was confined to 'scanning the lists of individuals involved'. They failed to test and assess the accuracy or veracity of representations contained within the detailed schedules provided by management. They should have: (i) reviewed a sample of diary records and/or (ii) spoken to individual staff members to understand the nature of their work and the amount of time they were spending on the internal projects.

3. In the absence of the audit evidence referred to in (2) above the Respondents had insufficient evidence on which to conclude that the policy was appropriate and that the Group's and CCL's financial statements did not contain material errors.

4. They failed to ensure there was sufficient transparency in CCL's financial statements in relation to the selection and application of this policy. In accordance with the Companies Act 2006 and paragraphs 30 and 40 of SSAP 13, the following matters were required to be (but were not) set out in CCL's financial statements: the accounting policy, the reasons for capitalising development costs and the amortisation period. Given that the costs capitalised during the year to 31 August 2009 were £8.2 million, the amount was highly material to the financial statements and the disclosures should have been given in order to provide a true and fair view.

ALLEGATION 4 - CASH RECOGNITION

In relation to their engagement as auditor of the financial statements of Connaught and CPL for the year ending 31 August 2009, and in relation to Connaught and CPL's 'cash recognition' policy (described in paragraphs [64] [67] above), Stephen Harrison and PricewaterhouseCoopers failed to act with professional competence and due care and in accordance with applicable technical and professional standards, namely paragraph 28 of ISA 315 and paragraph 2 of ISA 500.

Particulars

1. The Respondents failed adequately to consider whether the cash recognition policy was consistent with applicable financial reporting framework and industry practice. As set out below, it was not.

2. The Respondents concluded, erroneously, that the cash recognition policy was appropriate. It was flawed and inappropriate. Bank transfers and cheques received up after the balance sheet date were not 'assets' within the meaning of the term in IFRS (paragraph 49 of the Framework) and/or in UK GAAP (Statement of principles for financial reporting, Chapter 4, paragraph 4.4) since CPL and Connaught had not acquired control of the cash.

3. They concluded, erroneously, that the financial statements of the Group and CPL showed a true and fair view and had been properly prepared in accordance with IFRS and UK GAAP. As set out above, the policy was not appropriate and, as a consequence the Group and CPL's financial statements did not give a true and fair view. Cash balances in the Group's financial statements were overstated by up to £18.9 and trade debtors understated by the same amount. Cash balances in CPL's financial statements were overstated by up to £14.9 million and trade debtors understated by the same amount.

4. They failed to require management to correct the errors and/or to qualify their audit report to state that the financial statements had not been prepared in accordance with IFRS or UK GAAP and did not give a true and fair view.