

IN THE MATTER OF:

THE EXECUTIVE COUNSEL OF THE FINANCIAL REPORTING COUNCIL

-and-

(1) GRANT THORNTON UK LLP

(2) MR DAVID NEWSTEAD

EXECUTIVE COUNSEL'S FINAL DECISION NOTICE

Pursuant to Rule 18 of the Audit Enforcement Procedure

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

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1. INTRODUCTION

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

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

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

1.3.1. “**FY15**” means the financial year ended 30 September 2015, “**FY15 financial statements**” means Patisserie Holdings Plc’s financial statements for that period, and “**FY15 Audit**” means the statutory audit of the FY15 financial statements.

1.3.2. “**FY16**” means the financial year ended 30 September 2016, “**FY16 financial statements**” means Patisserie Holdings Plc’s financial statements for that period, and “**FY16 Audit**” means the statutory audit of the FY16 financial statements.

- 1.3.3. “**FY17**” means the financial year ended 30 September 2017, “**FY17 financial statements**” means Patisserie Holdings Plc’s financial statements for that period, and “**FY17 Audit**” means the statutory audit of the FY17 financial statements.
- 1.3.4. “**PH**” means Patisserie Holdings Plc.
- 1.4. Pursuant to Rule 16(b) of the AEP, Executive Counsel has decided that Grant Thornton UK LLP (“**GT**”) and Mr David Newstead are liable for Enforcement Action, having made Adverse Findings against each of them.
- 1.5. This Final Decision Notice is issued pursuant to Rule 18 of the AEP in respect of the conduct of:
- 1.5.1. GT in relation to the FY15 Audit, the FY16 Audit and the FY17 Audit. GT was the Statutory Audit Firm for these statutory audits; and
- 1.5.2. Mr David Newstead, at the relevant time, a partner of GT and audit engagement partner in relation to the FY15 Audit, the FY16 Audit and the FY17 Audit. In his capacity as Senior Statutory Auditor Mr Newstead signed off the Independent Auditor’s Report for the FY15 Audit, the FY16 Audit and the FY17 Audit on behalf of GT.
- 1.6. In this Final Decision Notice, GT and Mr David Newstead are together referred to as the “**Respondents**”.
- 1.7. In accordance with Rule 18 of the AEP this Final Decision Notice sets out Executive Counsel’s Adverse Findings and Sanctions, together with reasons.

2. EXECUTIVE SUMMARY OF THE ADVERSE FINDINGS

- 2.1. PH was at all material times the holding company for a group of companies engaged in the business of casual dining, predominantly under the brand “Patisserie Valerie” (“**the Group**”).
- 2.2. PH listed on the Alternative Investment Market (“**AIM**”) in May 2014. Prior to that listing the Group was headed by a company called Patisserie Acquisition Limited (“**PAL**”). PAL was incorporated on 26 January 2007. GT was PAL’s first statutory auditor and audited the financial statements of the Group over a ten-year period, from 2007 to FY17.

2.3. PH's public statements in October 2018 suggested that an alleged fraud had been perpetrated within PH. Consequently, it appears that misleading information may have been provided to GT during the course of their audits:

2.3.1. On 10 October 2018 PH issued a statement that the board had been notified of *"significant, and potentially fraudulent, accounting irregularities and therefore a potential misstatement of the Company's accounts."* It continued *"This has significantly impacted the Company's cash position and may lead to a material change in its overall financial position."*

2.3.2. On 16 October 2018 PH provided an update of the situation: *"The work carried out by the Company's forensic accountants ... has revealed that the misstatement of its accounts was extensive, involving very significant manipulation of the balance sheet and profit and loss accounts. Among other manipulations this involved thousands of false entries into the Company's ledgers."*

2.4. The Adverse Findings and this Final Decision Notice are concerned only with how the Respondents' acts and omissions failed to comply with the Relevant Requirements. This Final Decision Notice is not a finding of fraud and does not depend on any finding of fraud; the audit failings of GT and Mr Newstead would still deserve sanction whether or not a fraud had been committed at PH. Even if GT and Mr Newstead had been in receipt of misleading information from PH management, it would not be a defence to the Adverse Findings for the Respondents.

2.5. This Final Decision Notice and the Adverse Findings contained within concern the audit work of the Respondents in relation to the FY15 Audit, the FY16 Audit and the FY17 Audit. The Final Decision Notice sets out Adverse Findings in the following four categories in turn:

2.5.1. Revenue;

2.5.2. Cash;

2.5.3. Journals;

2.5.4. Fixed Asset Additions.

2.6. GT and Mr Newstead have accepted failures in their audit work.

Revenue

2.7. Revenue is an important performance measure for a company such as PH and it is a key metric for users of the financial statements. The reported revenue grew over the three years relevant to this Final Decision Notice. In the audit of revenue, the Respondents

failed in their audit planning by not requiring the testing of large receipts of revenue at year end. They also failed adequately to test disproportionately large receipts, failed to spot “red flags” in the FY17 supporting evidence, and failed to perform the audit with professional scepticism. The size of receipts at year end should have been questioned. The Respondents ought to have stepped back to consider the trading patterns of revenue that PH purportedly received from voucher sales, from third party companies. PH’s figures showed very large proportions of revenue being received at or around year end, for example 73% of the Group’s entire annual revenue from vouchers from a third party company in FY16 was purportedly received in one payment, on 28 September 2016. This was 11 times the average monthly receipts in preceding months. This called out for further investigation, but none was carried out. There is evidence of an audit team member raising concerns about the concentration of another third party company income receipts at the FY16 year end in emails to a more senior audit team member. It is unclear how these concerns were resolved. They were not reported to Mr Newstead, but should have been.

Cash

- 2.8. As regards cash and cash equivalents, the reported figure in PH’s financial statements increased from £6.1 million in FY15 to £13.3 million in FY16 and £21.5 million in FY17; cash growth each year was significantly larger (in percentage terms) than growth in revenue or profit before tax. GT audited cash at bank (i.e. bank balances) by seeking information from PH management, and from PH’s banks. There appeared to be repeated inconsistencies in this information, including GT learning from the banks that at least one dormant account had been reactivated and used, without PH management informing them. These should have led GT to challenge PH management, review the evidence and representations obtained with increased professional scepticism, and perform a more detailed review of PH’s bank account activity. It did not.
- 2.9. GT received numerous documents as evidence of cash transactions that should have, in the circumstances, given rise to concerns about their authenticity, for example third party invoices with missing company logos, typing errors, incorrect addresses and documents provided as evidence of cash receipts that in fact looked like purchase invoices and stated that PH was required to pay money. These issues were not acted upon. Other documents were misread (a bank letter stating PH had a £4 million overdraft facility (i.e. money available but not necessarily withdrawn) was misread as meaning a bank account was £4 million overdrawn).

2.10. GT did not query the apparently incorrect accounting treatment of lodgements recognised by PH as “reconciling items”. “Reconciling items” amounted to £3 million in FY15, £17.3 million in FY16 and £11.1 million in FY17. In FY16, for example, one bank account had a balance according to the bank letter of £543,261 while reconciling items on the account amounted to £10.6 million. “Reconciling items” may increase the reported cash balance compared to the bank letters. PH recognised in its year end cash balances hundreds of “reconciling items” that were cash receipts which had been recorded in the accounting ledger after year end and received at bank after year end. These should not have been accepted by GT as valid without further explanation. GT failed to investigate adequately both individual large entries and the gross quantum of the reconciling items.

Journals

2.11. Journals are the method by which an adjustment is entered into accounting records. A “journal entry” will identify the areas of the accounting records that need to be changed, by how much, the reasons for the changes and the effective date for those changes. Changes to the accounting records are made through journal entries, and they are therefore building blocks for producing information such as the entity’s financial statements. PH used journal entries to record some sales transactions, employee costs, costs of sales and overhead costs for individual stores on a weekly and/or monthly basis and, as a result, there were many thousands of journal entries in each year.

2.12. The Respondents did not properly test journals made at year ends, and used inappropriate criteria to select which journal entries to test. This resulted in an excessively large number of journals to test, in turn compromising the quality and depth of the testing as entries were left untested and inconsistencies arising from testing were left unexplained. In other instances the results of journal testing did not match GT’s recorded expectations, but this was not followed up. GT did not confirm adequately that journal entries were properly approved by members of the PH finance team.

Fixed Asset Additions

2.13. PH’s financial statements recorded the net book value of four categories of Property, plant and equipment (or “**fixed assets**”), and additions to those categories over the financial year. They included “Motor vehicles” and “Plant, equipment, fixtures and fittings”. The “Motor vehicles” category of additions was shown as nil, because PH wrongly categorised its motor vehicle additions in the years under investigation as plant and equipment. This was not challenged by GT, allowing £2 million of fixed asset additions (“**Fixed Asset Additions**”) to be wrongly categorised by management in the relevant years.

2.14. Other apparent mis-categorisations were not challenged; four additions which were supported by invoices from prior years, but not the relevant year, should have been investigated further, while others had no real detail, or appeared not to be fixed assets at all (e.g. revenue and salary costs). In this area of the audit, like the others identified above, there was a lack of professional scepticism across the three years and across the Group's Stonebeach and Flour Power City entities.

Overall

2.15. These were not isolated shortcomings or failures. Over three separate years, the Respondents committed serious breaches of multiple International Standards on Auditing (UK and Ireland) (“ISAs”), across four different audit areas. The failures were often repeated in each of the three years under consideration, and in relation to several legal entities in the Group. They relate to important audit procedures or important components of the financial statements. Many concerned matters fundamental to the proper conduct of an audit. Some breaches related to basic requirements, evidencing a serious lack of competence in conducting the audit work. They all had the potential to fail to detect a misstatement in PH’s financial statements, and many had the potential to result in material misstatements, which could call into question the truth and fairness of the financial statements. They reveal a pattern of serious lapses in professional judgement, failures to exercise professional scepticism, failures to obtain sufficient appropriate audit evidence and / or to prepare sufficient audit documentation, and failures of supervision and review on the part of the senior members of the GT audit team (including an instance of a junior team member raising certain concerns but it is not clear how those concerns were followed up).

2.16. Executive Counsel considers the following factors as relevant to the seriousness and gravity of the breaches of the Relevant Requirements:

2.16.1. The repeated failure to scrutinise documents and challenge management explanations, over an extended period.

2.16.2. The repetition of failures to scrutinise reconciling items, despite their value in comparison to income for the remainder of the year and despite the concerns raised by a junior member of the audit team about certain voucher sales in FY16.

2.16.3. The lack of scrutiny of adjusting journal entries around the year ends of FY15 and FY16, and the limited amount of that scrutiny in FY17, despite the materiality of those entries.

2.16.4. What appeared to be clear errors in the categorisation and capitalisation of certain fixed asset additions, which went unremarked by the Respondents and may have led to material misstatements in the financial statements.

2.16.5. Each of the FY15, FY16 and FY17 Audits failed in their principal objectives of providing reasonable assurance that the financial statements were free from material misstatement, whether caused by fraud or error. Had the Respondents complied with the Relevant Requirements regarding the proper exercise of professional scepticism and professional judgement, it should have been apparent to them that they were receiving what appeared to be inaccurate and incomplete information from management, and that there were numerous matters calling out for proper investigation. Had the Respondents conducted the Audits over the three years in accordance with the Relevant Requirements, exercising appropriate professional scepticism and judgement and properly investigating the matters identified in the Adverse Findings as calling out for investigation, they should have identified clear indicators of the risk of material misstatement due to fraud.

Sanctions

2.17. This Final Decision Notice imposes the following Sanctions in respect of the Respondents:

GT

2.17.1. A declaration that the Statutory Audit Report for each of the FY15, FY16 and FY17 Audits signed on behalf of GT did not satisfy the Relevant Requirements, as set out in this Final Decision Notice;

2.17.2. A published statement, in the form of a Severe Reprimand;

2.17.3. A financial sanction of £4 million adjusted for aggravating and mitigating factors (in particular reflecting an exceptional level of co-operation) by a reduction of 10%, and further discounted for admissions and early disposal by 35% so that the financial sanction payable is £2.34 million; and

2.17.4. Non-financial sanctions, in the form of an order pursuant to Rule 96(c) of the AEP, requiring GT to take remedial action to prevent the recurrence of the breaches:

2.17.4.1. GT to report to the FRC's Executive Counsel and Executive Director of Supervision annually for a period of three years on the remedial action taken as a result of these breaches, and the impact on audit quality. The report is to be in a format and to include key metrics agreed with the FRC. At the end of the reporting period, or at such other time to be agreed between the FRC and GT, GT to provide a Root Cause Analysis of the reasons for the breaches, why the firm's processes and controls did not prevent the breaches and whether the firm's current processes would lead to a different outcome, and any further remedial action proposed;

2.17.4.2. GT to undertake a review of the audit practice's culture relating to challenge and to provide a report and proposed actions to the FRC's Executive Counsel and Executive Director of Supervision. GT to report on the progress of the actions taken as a result of this review and the impact of those actions on audit quality, annually for three years. This report is in addition to, but may form part of, the annual reporting set out at paragraph 2.17.4.1;

2.17.4.3. GT to undertake additional monitoring in relation to bank and cash work, including the involvement of the Responsible Individual ("RI") and Engagement Quality Control Reviewer, on a selection of audits to include at least one audit per RI over a period of three years. GT to report to the FRC's Executive Counsel and Executive Director of Supervision a summary of the outcomes of the additional monitoring, and any proposed remedial action to address issues identified, annually for three years. This report is in addition to, but may form part of, the annual reporting set out at paragraph 2.17.4.1.

Mr Newstead

2.17.5. A declaration that the Statutory Audit Report for each of the FY15, FY16 and FY17 Audits signed by Mr Newstead did not satisfy the Relevant Requirements, as set out in this Final Decision Notice;

2.17.6. A published statement, in the form of a Severe Reprimand;

2.17.7. A financial sanction of £150,000 adjusted for aggravating and mitigating factors (in particular reflecting an exceptional level of co-operation) by a reduction of 10%, and further discounted for admissions and early disposal by 35% so that the financial sanction payable is £87,750; and

2.17.8. A temporary prohibition of three years banning Mr Newstead from carrying out Statutory Audits and signing Statutory Audit Reports.

2.18. In determining the Sanctions to be imposed on the Respondents, Executive Counsel has taken into account the remedial actions already taken by the Respondents in response to the identified failings in the FY15, FY16 and FY17 Audits. Executive Counsel highlights that the discounts given for co-operation and settlement reflect the exceptional level of co-operation provided by the Respondents during the investigation of the breaches by Executive Counsel.

3. BACKGROUND

PH structure and business

3.1. The principal trading entity of the Group was Stonebeach Limited (“**Stonebeach**”), but trading was also conducted through Patisserie Valerie Ireland Limited (a company incorporated in 2017), Philpotts Limited (“**Philpotts**”) and Flour Power City Limited (“**Flour Power City**”). These companies traded the Group’s five brands, which were described in the FY17 financial statements as follows:

- 3.1.1. Patisserie Valerie: “*an iconic brand established in Soho in 1926 offering fine continental patisserie*” as well as cakes and pastries, teas and coffees, continental breakfasts and light meals. “*Formats include cafes, concessions, brasseries, kiosks and an online channel. Patisserie Valerie’s 152 stores are located predominantly in London and across England, with a developing Scottish presence*”;
- 3.1.2. Druckers – Vienna Patisserie: a Viennese cake shop and continental coffee lounge. It operated 20 stores in England;
- 3.1.3. Baker & Spice: a high-end deli with four stores, all in Central London;
- 3.1.4. Flour Power City bakery: an organic artisan bakery and wholesaler based in Lewisham and supplying stores in London and the Home Counties; and
- 3.1.5. Philpotts: a premium sandwich and salad retailer with 22 stores across England and Scotland.

3.2. The first three of these brands were traded by Stonebeach.

3.3. The Group’s trading was described in the FY17 financial statements as being monitored in line with four Key Performance Indicators: (i) Turnover growth, (ii) margin, (iii) Earnings Before Interest, Taxes, Depreciation and Amortisation and (iv) new sites. GT understood that in order to increase revenues the Group targeted opening 20 new stores each year. It was these openings (not like-for-like sales at existing stores) that were relied upon to increase Group revenues in the period relevant to this investigation. As discussed in more detail below, the Group also made increasing use of voucher sales, through third party companies that would charge a commission for selling discounted vouchers for certain Patisserie Valerie products or experiences such as afternoon teas. These third party companies are referred to in this Final Decision Notice as Company A, Company B, etc.

3.4. The Group had banking facilities with three banks, referred to in this Final Decision Notice as Bank A, Bank B and Bank C.

Chronology of GT's Role

- 3.5. GT acted as statutory auditor for the Group from 2007 (when the Group was headed by Patisserie Acquisition Limited) to 20 December 2018 (by which point, the Group was headed by PH). PH was incorporated in May 2014 and replaced PAL as the Group's holding company. PH also listed on AIM in May 2014.
- 3.6. The Respondents' statutory responsibility as auditor in relation to PH's FY15, FY16 and FY17 financial statements was to form an opinion as to whether the financial statements (i) showed a true and fair view and (ii) had been properly prepared in accordance with IFRS and the Companies Act 2006.
- 3.7. An audit involves obtaining sufficient appropriate "audit evidence" about the amounts and disclosures in the financial statements in order to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. Audit evidence is defined in ISA 500 as "*Information used by the auditor in arriving at the conclusions on which the auditor's opinion is based*". Audit evidence is primarily obtained from audit procedures performed during the course of the audit.
- 3.8. GT signed off on PH's FY17 financial statements on 24 November 2017. It opined that those financial statements "*give a true and fair view of the state of the Group's and of the parent company's affairs as at 30 September 2017 and of the Group's profit for the year then ended*". GT also signed off on PH's FY16 and FY15 financial statements and gave the same opinion in relation to those financial years.
- 3.9. When PH made its announcement to the market on 10 October 2018 that its board had been notified of potentially fraudulent accounting irregularities and therefore a potential material misstatement of PH's accounts, GT had begun preparation for the audit of the 2018 financial statements, however no substantive audit work had been carried out by that time in respect of the financial year ended 30 September 2018 ("**FY18**").
- 3.10. The announcement of 10 October 2018 followed the presentation of a winding-up petition by HMRC against the principal trading subsidiary of PH, Stonebeach. The petition claimed £1.1 million, which was paid and subsequently the petition was withdrawn.

3.11. Although a PH shareholder made funding of £20 million available to the Group in October 2018, PH and four other Group companies entered into administration on 22 January 2019.

3.12. GT formally resigned as auditor on 20 December 2018.

GT's team

3.13. The GT team on the audits for FY15, FY16 and FY17 comprised a total of 174 individuals across the three years, with between around 60 and 90 individuals in any one audit year. The majority of this number had limited involvement in the audit, undertaking site visits across the stores. A smaller core team, including a senior manager and assistant manager/in-charge accountant in each year, undertook most of the substantial work on the audit.

3.14. Mr David Newstead was the audit engagement partner, Senior Statutory Auditor and RI for each of these three financial years. He is a member of the Institute of Chartered Accountants in England and Wales ("ICAEW"). He became involved in the audit of PH in 2012, taking on a role of presenting GT's audit findings to the Audit Committee of PH. In 2014, once PH had listed on AIM he took over as RI. He remained as RI for each of the three audits under consideration in this Final Decision Notice, and signed off the audit of the financial statements for FY15, FY16 and FY17 on behalf of GT.

4. RELEVANT REQUIREMENTS TO WHICH THE ADVERSE FINDINGS RELATE

4.1. Rule 1 of the AEP states that Relevant Requirements has the meaning set out in regulation 5(11) of the Statutory Auditors and Third Country Auditors Regulations 2016 ("SATCAR"). The Relevant Requirements include, but are not limited to, the ISAs issued by the International Auditing and Assurance Standards Board.

4.2. The ISAs relevant to Executive Counsel's Final Decision Notice are those effective for audits of financial statements for periods ending on or after 30 September 2015, 30 September 2016 and 30 September 2017. Where this results in the application of more than one version of an ISA, as revised versions of a number of ISAs were published in June 2016, Executive Counsel has had regard to each version, as was applicable at the time of the particular audit.

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

- 4.3.1. ISA 200 (Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing, including requirements for professional judgment and professional scepticism);
 - 4.3.2. ISA 220 (Quality Control for an Audit of Financial Statements);
 - 4.3.3. ISA 230 (Audit Documentation);
 - 4.3.4. ISA 240 (Auditor’s Responsibilities relating to Fraud);
 - 4.3.5. ISA 265 (Communicating Deficiencies in Internal Control to Those Charged with Governance and Management);
 - 4.3.6. ISA 315 (Identifying and Assessing the Risks of Material Misstatement Through Understanding of the Entity and Its Environment);
 - 4.3.7. ISA 330 (Responses to Assessed Risks);
 - 4.3.8. ISA 500 (Audit Evidence); and
 - 4.3.9. ICAEW Code of Ethics 130.1(b), imposing an obligation “to act diligently in accordance with technical and professional standards”.
- 4.4. Relevant extracts of the above are set out in Appendix 1.

5. ADVERSE FINDINGS

- 5.1. The Adverse Findings relate to four areas of the audit: (1) Revenue, (2) Cash, (3) Journals, and (4) Fixed Asset Additions. They are considered in turn below. There is some unavoidable overlap between the subject matter of the categories, meaning that certain Adverse Findings relate to more than one category. Executive Counsel has addressed the Adverse Findings in the most appropriate category and has not taken account of an Adverse Finding twice in the assessment of the failures of the Respondents, or the assessment of appropriate sanctions.

CATEGORY 1: REVENUE

Introduction to Revenue

- 5.2. In each of FY15, FY16 and FY17 PH reported revenue as one identifiable line item in its financial statements. The revenue figure was made up of (a) “retail revenue”, which came from restaurant, takeaway and online sales, and (b) “wholesale sales” or “voucher sales”, which were the result of arrangements with third party companies.

5.3. The accuracy of the Group’s revenue figure was clearly important, to PH and to investors and other users of the financial statements. The Group’s revenue was reported as one of four financial “highlights” in each year. Sales growth was reported in the financial statements as one of PH’s Key Performance Indicators. The total revenue reported in the financial statements consisted of:

	FY15 £'000	FY16 £'000	FY17 £'000
Retail revenue	88,677	96,635	103,295
Wholesale revenue	3,257	7,517	10,916
Other	(9)	(11)	(14)
Total	91,925	104,141	114,197

5.4. A requirement of ISA 240 is that there is a rebuttable presumed risk that revenue may be misstated due to improper revenue recognition. The auditor is to presume that there are risks of fraud in revenue recognition when identifying and assessing the risks of material misstatement. The auditor must therefore evaluate what types of revenue, revenue transactions or assertions give rise to such risks. Where the auditor concludes that the presumption is not applicable in the circumstances, they are required to document the reasons for that conclusion.

5.5. ISA 240 includes paragraphs setting out application and other explanatory material. These provide examples of specific circumstances where the risks of fraud in revenue recognition may be greater, including “*for example there may be pressures or incentives on management to commit fraudulent financial reporting through inappropriate revenue recognition in the case of listed entities when, for example, performance is measured in terms of year-over-year revenue growth or profit*” (paragraph A29). As noted above, the Group’s revenue was reported as one of four financial “highlights” in each year and its sales growth was reported in the financial statements as a Key Performance Indicator.

5.6. In conducting an audit of revenue figures shown on financial statements, the overall objectives of the auditor include obtaining reasonable assurance about whether those figures are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial framework (ISA 200, paragraph 11). “Reasonable assurance” is a high level of assurance and is achieved when the auditor has obtained sufficient appropriate audit evidence to reduce audit risk (that is, the risk that the auditor expresses an inappropriate opinion when the financial statements are materially misstated) to an acceptably low level (ISA 200, paragraph 5).

5.7. GT rightly identified that there was a significant risk of material misstatement as regards PH's revenue. Despite this, the Respondents failed to plan or perform the audit of PH's revenue in accordance with the ISAs. The following paragraphs take those failures in turn.

Revenue: Failures in audit planning

Adverse Finding 1: In each of the FY15, FY16 and FY17 Audits, as regards Philpotts, and in each of the FY16 and FY17 Audits as regards Stonebeach, the Respondents failed to include in the relevant audit programmes a work step requiring the testing of large amounts recorded at or near year end. These were breaches of the obligation (i) to obtain sufficient appropriate audit evidence (paragraph 6 of ISA 500), and (ii) to perform substantive procedures specifically responsive to the risk which was assessed as significant (paragraph 21 of ISA 330).

5.8. The audit plan for FY15, FY16 and FY17 listed revenue as an area of "significant" risk of material misstatement applicable for Stonebeach, Philpotts and Flour Power City. The "*Description of risk*" stated that there was a "*Presumed risk that revenue contains fraudulent transactions*".

5.9. The planned audit procedures in response to this identified risk included "*we will perform an analytical review on material revenue streams and corroborate management's explanations for any unexpected movements*".

5.10. However, the audit programmes for all entities in the Group, save Stonebeach in FY15, contained an omission in the proposed testing. The programme for Stonebeach in FY15 recorded a step of testing "*Large amounts recorded at or near period end*", and "*Large volume of transactions at or near period end*". This was an appropriate step, as the risk of improper revenue recognition is particularly prevalent in transactions approaching an entity's period end. However, this step was not included in the programme for Stonebeach in FY16 or FY17, nor other audit programmes for PH in any of the three years under consideration.

5.11. This inconsistency was not explained in the audit papers, and the omission is significant because the Group did record large items of revenue near its year end in each of FY15, FY16 and FY17. The remainder of this section describes these items, and the steps that the Respondents failed to take in respect of them. Whilst GT documented that certain year end amounts were tested to supporting documents, there is no evidence of focus

on large entries at or near period end. The omission of this step of testing led, in each year and for each individual audit, to a breach of the obligation to obtain sufficient appropriate audit evidence (paragraph 6 of ISA 500), and to perform substantive procedures specifically responsive to the risk (paragraph 21 of ISA 330).

Revenue: Failures in revenue testing

5.12. The PH audit plans described above applied to retail revenue and wholesale revenue. The recognition in the plans that revenue posed a high audit risk applied equally to wholesale revenues. In addition, for the FY16 and FY17 Audits, discounts and income from voucher sales were specifically identified as an “Other area of focus” in the audit plan. GT planned to perform testing on PH’s third party arrangements and planned to agree a sample of revenue transactions to corroborating evidence. The audit plans showed a planned procedure to “*perform other substantive testing on other material revenue streams as required (such as agreeing voucher sales to statements).*”

5.13. The Group’s wholesale revenues were significantly larger at the accounting year end than in the course of the year itself in each of PH’s financial years under review. The sums listed as received at the end of September of FY15, FY16 and FY17 comprise a substantial proportion of PH’s wholesale sales: 41% in 2015; 67% in 2016; and 49% in 2017. This is shown in the following table¹:

	2015			2016			2017	
	Company B	Company C	Company D	Company E	Company A	Company B	Company A	Company C
October	41,332.94	111,075.50					177,011.22	49,977.08
November	69,930.42	43,447.93					317,426.16	59,293.33
December	54,131.26	29,927.08		34.20			67,077.12	62,987.50
January	49,530.90	29,137.08		24,172.56			339,779.18	66,157.08
February	37,137.80	31,671.25		36,717.36			114,042.94	65,060.83
March	36,095.58	35,563.00	18,368.90	96,870.12			244,850.36	64,091.25
April	33,291.18	63,909.17	19,938.62	108,803.12			557,167.99	70,380.00
May	113,081.77	50,525.00	12,534.08	77,890.12			692,541.56	68,879.17
June	124,661.81	45,024.17	26,097.16	98,537.88	26,127.66		486,818.43	72,297.50
July	109,297.63	43,218.75	945.91	36,205.68	97,839.74		299,003.57	67,525.00
August	152,546.73	44,857.08	9,148.48	44,046.40	175,057.64		48,976.59	71,112.50
September	147,212.60	45,837.50	10,539.98	150,840.62			421,898.06	80,304.17
End September	679,872.98	190,144.17	370,873.33	802,056.00	1,218,002.43	770,173.00	4,118,932.00	
	1,648,123.60	764,337.68	468,446.46	1,325,333.44	1,667,868.09	770,173.00	7,885,525.18	798,065.41
	<u>1,648,123.60</u>					<u>4,996,158.67</u>		<u>8,683,590.59</u>

5.14. Despite this, the Respondents did not stand back and consider the trading patterns of wholesale revenues. This unusual pattern should have been investigated by the Respondents, so that they understood why very large sums (both in absolute terms, and by comparison with the other receipts in the year) were being received at year end.

¹ This table was prepared during the course of the Executive Counsel's investigation and was not available to the Respondents during the Audits.

Adverse Finding 2: In the FY15 Audit, the Respondents failed adequately to carry out testing of large amounts recorded at or near year end, even where it had been included in an audit programme, in breach of the obligation (i) to obtain sufficient appropriate audit evidence (paragraph 6 of ISA 500), (ii) to perform substantive procedures specifically responsive to the risk which was assessed as significant (paragraph 21 of ISA 330), and (iii) for audit documentation to include the results of procedures (paragraph 28(c) of ISA 330).

5.15. As noted above, the audit programme for Stonebeach in FY15 included the step of testing "*Large amounts recorded at or near period end.*" In FY15 PH recorded large amounts of revenue from voucher sales at and around year end, and two receipts of £568,175 and £211,454 respectively from a processor of credit card payments. PH explained these receipts by telling GT that the processor had delayed these payments due to an issue with their receipts. GT did not question this explanation further but should have undertaken further investigations in respect of these two items and of the large voucher sales at year end in order to confirm their validity.

5.16. The result of this is a failure not only to obtain sufficient appropriate audit evidence (paragraph 6 of ISA 500) but also to perform substantive procedures specifically responsive to risk (paragraph 21 of ISA 330), and for audit documentation to include the results of procedures (paragraph 28(c) of ISA 330).

Adverse Finding 3: In the FY15 Audit, the Respondents failed sufficiently to investigate a Company B receipt shortly before year end that represented 42% of all of the Company B income that year, in breach of the obligation to obtain sufficient appropriate audit evidence (paragraph 6 of ISA 500).

5.17. In FY15 wholesale revenue was relatively low, but 41% of it was recorded as received at the end of September. This comprised a single receipt from Company B, in the sum of £622,656. Company B was a legitimate source of revenue for the Group, as it sold vouchers to Company B customers for Group products such as afternoon teas. However, this one receipt represented 42% of all of the Company B revenue received by Stonebeach in FY15. There is no evidence on the audit file that GT questioned this receipt, or the rationale for such a large amount of income being received at year end (other than as detailed in the paragraphs below).

5.18. The receipt is recorded in the audit workpapers as having been agreed to a paper copy of a Company B statement in the CAF – a reference to the hardcopy audit file. No Company B statement has been retained on the audit file that reconciled to this receipt; accordingly

it has not been seen during this investigation. There was an annotation on the spreadsheet provided to GT by PH management that stated “End of offer re Afternoon Tea” against the £622,656 receipt on 20 September 2015. There is no evidence that this annotation was considered at the time of the audit or investigated.

- 5.19. There is an entry in a separate GT workpaper that appears to record GT’s understanding of this revenue, which noted that: “*It would appear that circa £300k was generated from expired vouchers.*” However, this entry would only explain half of the £622,256 payment.
- 5.20. GT accepts that there is no documentation on the audit file to evidence why there should be large year end payments relating to expired Company B vouchers (or for another reason).

Adverse Finding 4: In the FY16 Audit, the Respondents failed to investigate sales receipts which were unusual by virtue of their size and timing, in breach of the obligation to perform an audit with professional scepticism (paragraph 15 of ISA 200 and paragraph 12 of ISA 240), and failed adequately to follow up concerns of a team member regarding concentration of Company B voucher income at year end, in breach of the engagement partner’s quality control obligations (paragraph 8 of ISA 220; paragraphs 15(a) and A15.3 of ISA 220; and paragraphs 16 and A17.2 of ISA 220).

5.21. The pattern of unusually large receipts at year end continued in FY16. In that year Stonebeach apparently received large payments from each third party arrangement at year end. These are unusual in their amounts, but were not investigated by the Respondents despite the presumed risk of misstatement of revenue due to incorrect revenue recognition (ISA 240):

- 5.21.1. £1.2 million was received on 28 September 2016 in relation to Company A. This was 73% of the total voucher revenue from Company A in the year, and almost 11 times the average monthly receipt from Company A in the year. The receipt is recorded in the audit workpapers as having been traced to a bank statement and the statement from the voucher provider. No copies of Company A statements were retained on the audit file;
- 5.21.2. £190,144.17 was received on 28 September 2016 in relation to Company C, which also had third party arrangements with PH. This was 25% of the total wholesale revenue from Company C in the year, and 4 times the average monthly receipt from Company C in the year. The receipt is recorded in the audit workpapers as having been traced to a bank statement and the statement from the voucher provider. No copies of Company C statements were retained on the audit file;

- 5.21.3. £370,873.33 was received on 30 September 2016 in relation to Company D. This was 79% of the total voucher revenue from Company D in the year, and 27 times the average monthly receipt from Company D in the year. The receipt is recorded in the audit workpapers as having been traced to a bank statement. The file does not say this receipt was traced to a voucher statement. No copies of Company D statements were retained on the audit file; and
- 5.21.4. £802,056.00 was received on 29 September 2016 in relation to Company E. This was 61% of the total voucher revenue from Company E in the year, and 12 times the average monthly receipt from Company E in the year. This is recorded as traced to a bank statement and a statement from the voucher provider. No copy of the voucher statement was kept on the audit file.
- 5.22. Whilst amounts were checked to bank and voucher statements as detailed above, there is no evidence of the Respondents investigating why these receipts were so large, or why they were arriving at year end. This failure to investigate further displays a lack of professional scepticism, in breach of paragraph 15 of ISA 200 and paragraph 12 of ISA 240. The first of those paragraphs requires the auditor to perform the audit with professional scepticism, recognising that circumstances may exist that cause the financial statements to be materially misstated. Professional scepticism is defined in that ISA as including “a critical assessment of audit evidence”.
- 5.23. In FY16 there is evidence of an audit team member raising concerns about the concentration of Company B income receipts at year end in internal emails to a more senior member of the audit team. It is unclear how these team members satisfied themselves in relation to these concerns. There is no evidence that management was asked about this issue, nor that these issues were followed up within GT or reported to Mr Newstead, as they should have been.

Adverse Finding 5: In the FY17 Audit, the Respondents failed to investigate receipts and supporting documentation, despite “red flags”, in breach of the obligation to perform the audit with professional scepticism (paragraph 15 of ISA 200 and paragraph 12 of ISA 240).

- 5.24. In FY17 the Group’s wholesale sales (i.e. those from vouchers or other third party arrangements) increased further. Numerous issues with documentation should have prompted investigation by GT of specific wholesale sales, in order to comply with the obligation to perform the audit with professional scepticism (paragraph 15 of ISA 200 and paragraph 12 of ISA 240):

- 5.24.1. 128 items of revenue from Company A are listed on GT's audit spreadsheet for FY17. There were numerous "red flags" including the fact that they cover 13 months when they should cover only 12 and that for the final five items listed, the invoices are dated 2 October 2017, indicating that they might have related to FY18. Another "red flag" was that these five receipts comprise 54% of all revenue apparently received from Company A in FY17. These receipts are over 14 times higher than the average monthly receipts from Company A. Further, they are for 217,788 afternoon teas, which ought to have prompted investigation as there were only 124,779 afternoon teas sold through Company A in the rest of FY17, and they are all shown as being for afternoon tea, whereas all earlier Company A receipts had been for a range of different offers.
- 5.24.2. The documents retained by PH in relation to these payments were for large amounts but contain little or no detail. There is no evidence that GT queried this lack of detail. No documents to support each of the final five receipts were retained on the audit file.
- 5.24.3. One copy Company A invoice dated 2 October 2017 relied on by GT had various errors in the invoice and inconsistencies with other Company A documents, which (given other red flags) should have cast doubt on the provenance of the document and ought to have prompted investigation:
- 5.24.3.1. The Company A logo is missing from the top of the invoice, and the Company A website address is missing from the bottom of the invoices. These details are present on other Company A invoices;
 - 5.24.3.2. The word "quantity" is spelt incorrectly as "quantiiy";
 - 5.24.3.3. The postcode for Stonebeach is written as "828 8DT" compared to B28 8DT in other Company A invoices; and
 - 5.24.3.4. The font and format are different to other Company A invoices.

CATEGORY 2: CASH

Introduction to Cash

5.25. PH's financial statements reported consolidated "cash and cash equivalents" balances as follows:

5.25.1. FY15: £6,095,000

5.25.2. FY16: £13,273,000

5.25.3. FY17: £21,525,000

The Group held actual cash at year end (for example shop cash floats and petty cash), but these balances were immaterial.

- 5.26. This was an important category in PH's financial statements. The Strategic Report in the FY17 financial statements stated that "*the group remains solely funded from operating cash flow*" (where "operating cash flow" refers to the cash that PH generated from its business activities, rather than from any other sources such as investments).
- 5.27. The Financial Highlights in the FY17 financial statements included "*Net cash at year end of £21.5m (2016: £13.3m) with operating cash inflows of £24.4m (2016: £22.0m)*". The Operational Highlights included the statement that 20 new stores had been opened in the year, all "*funded from operational cash flows*" and that a further 20 new stores were targeted for 2018. The number of new sites was reported as one of PH's Key Performance Indicators in the FY17 financial statements.
- 5.28. Further, the Directors' Report in the FY17 financial statements noted that the Group's principal financial assets were "*mainly cash and trade debtors*", and that the Group used cash and overdraft facilities to manage financial risk and ensure sufficient liquidity.
- 5.29. It was therefore particularly important for the Respondents to ensure that an audit which complied with the relevant ISAs was undertaken in relation to the Group's cash balances at each year end, so that the financial statements showed a true and fair view to any reader.

Cash: Obtaining audit evidence

Adverse Finding 6: In each of the FY15, FY16 and FY17 Audits, the Respondents relied on management to advise the full list of bank accounts, but then failed to challenge management about information received from PH's banks that suggested that information about bank accounts held by the audit team may have been incomplete. In each year this was a failure to perform the audit with professional scepticism relating to unusual items, in breach of paragraph 15 of ISA 200 and paragraph 8 of ISA 240, and a failure to obtain sufficient appropriate audit evidence in breach of paragraph 6 of ISA 500.

- 5.30. In order to audit cash at bank, in each year GT requested details from PH of the bank accounts that the Group held. GT then sought confirmation letters from the banks based on this information. It was essential that GT obtained independent and accurate corroboration of the Group's bank account balances, and it was therefore also essential

that GT had a complete list of accounts that the Group held, and any inconsistencies in the information from PH and its banks were investigated.

5.31. The GT cash audit programme listed audit procedures that were intended to identify all bank accounts “*maintained and closed*” in the year. The listing of accounts was confirmed by PH finance staff. As an example, for Flour Power City in FY15, the write up against this step included “*Email Sent to [PH Finance Team] (23/10/15) to confirm these accounts are active. Confirmation received, listing is deemed to be complete*”. This procedure, without any further steps, deemed the listing to be complete.

5.32. GT then wrote to PH’s banks requesting confirmation of the accounts that the Group held, and their balances. The responses from the banks revealed issues requiring investigation:

5.32.1. Across the FY15, FY16 and FY17 Audits, there were 19 separate instances of bank accounts being included in bank confirmation letters but not listed in the audit lead schedules that GT used to audit bank account balances. Each of these 19 accounts had nil or less than trivial balances at year end, however there was a risk that there could have been material transactions on these accounts during the year. There were 11 occasions (nine of which were part of the 19 above) where accounts were listed in the confirmation letters but had not been mentioned in GT’s request letters to the banks. Therefore, there were inconsistencies between the accounts recorded on the lead schedules, those in respect of which GT sought confirmations from the banks, and the responses received from the banks.

5.32.2. In the circumstances of this case, the Respondents should have gone on to consider the consequences of this, including whether there might be additional bank accounts (which may have had balances of any amount) which had not been disclosed by management. Their failure to do so was a failure to perform the audit with professional scepticism and gave rise to the risk of not identifying undisclosed bank accounts or the potential consequent misstatement of cash and borrowings.

5.33. These inconsistencies ought to have been resolved by the Respondents. They were not. In each year this was a failure to perform the audit with professional scepticism relating to unusual items, in breach of paragraph 15 of ISA 200 and paragraph 8 of ISA 240.

Adverse Finding 7: In each of the FY15, FY16 and FY17 Audits, the Respondents received letters from Bank B that gave details of PH’s bank accounts. The Respondents

failed to ensure that their audit documentation recorded all of these accounts, with the result that four bank accounts in each of FY15, FY16 and FY17 and an additional three bank accounts in FY15, all with nil or less than trivial balances at year end, are not referred to in that documentation at all. In each year this was a failure in relation to audit documentation under paragraph 8 of ISA 230.

5.34. Under paragraph 8 of ISA 230, the Respondents were obliged to prepare audit documentation that was sufficient to enable an experienced auditor, having no previous connection with the audit, to understand the audit procedures that had been performed, the results of those procedures, and any significant matters arising during the audit.

5.35. This obligation is important to enable a sufficient and appropriate record of the basis for the auditor's report, and to ensure that there is evidence that the audit was performed in accordance with ISAs (ISA 230, paragraph 5).

5.36. The Respondents in this case failed to meet that obligation. In each of FY15, FY16 and FY17, GT received bank confirmation letters from Bank B that gave details of bank accounts held by PH as at the relevant year end. GT did not save all of these letters to the audit file, nor did they ensure that all of the bank accounts referred to in those letters were referred to in the audit file or any other audit documentation.

5.37. This meant that bank accounts held by PH were not referred to at all in the audit documentation, and their existence would have been unknown to any other auditor seeking to understand the audit or reperform it. The Respondents should have recognised that apparent inconsistencies in the information they held as to which bank accounts the Group was using meant it was all the more important for GT's audit documentation to be thorough, accurate and complete on the issue of bank accounts. Although the accounts in question had nil or trivial balances at year end, there was a risk that there could have been material transactions on these accounts during the year.

Cash: Obtaining bank reconciliations

Adverse Finding 8: In the FY17 Audit, the Respondents failed to obtain reconciliations for bank accounts with nil or less than trivial balances in circumstances where the audit team had received what appeared to be incomplete information from management regarding those bank accounts and at least one previously dormant account had been reactivated. Although independent bank confirmations had been received for these balances, this was a failure to perform the audit with professional scepticism, in breach

of paragraph 8 of ISA 240, and a failure to obtain sufficient appropriate audit evidence, in breach of paragraph 6 of ISA 500.

5.38. ISA 200 states at paragraph A22: *“Professional skepticism is necessary to the critical assessment of audit evidence. This includes questioning contradictory audit evidence and the reliability of documents and responses to inquiries and other information obtained from management and those charged with governance. It also includes consideration of the sufficiency and appropriateness of audit evidence obtained in the light of the circumstances, for example in the case where fraud risk factors exist and a single document, of a nature that is susceptible to fraud, is the sole supporting evidence for a material financial statement amount.”*

5.39. As set out above, in each of FY15, FY16 and FY17 the audit programme required that management was asked for details of all Group bank accounts maintained or closed in the year. In FY17 there appear to have been five bank accounts (from the 11 referred to in paragraph 5.32.1 above) listed on the bank confirmations which had not been included in the confirmation requests sent to banks by GT.

5.40. The five “missing” accounts were held in the names of three different entities. Four of the accounts had nil balances and one had a credit balance of £0.04. Notwithstanding the balances, the fact there were missing bank accounts should have led GT to make further enquiries of PH management as to which bank accounts were in use by the Group at any time. The Respondents should have obtained reconciliations for all bank accounts held by the Group, but did not. Indeed, this was a specific requirement of GT’s audit programmes for PH in FY16 and FY17, which contained the work step “obtain reconciliations for all bank accounts”.

5.41. Further, the Respondents received evidence in FY17 that one dormant account (separate to the five accounts mentioned at paragraph 5.40 above) had been reactivated in conflict with the Group’s records and revealed only by the bank’s letter, without management informing GT.

5.42. These matters should have made clear to the Respondents that they needed to exercise increased professional scepticism in relation to the information they held regarding bank accounts. That professional scepticism should have caused the Respondents to obtain reconciliations for smaller and less-used bank accounts of the Group, as well as for those with significant balances at year end. Even if a bank account shows a trivial balance at

year end, or is little used, it can still include unrecorded material reconciling items² which may lead to significant bank balances (positive or negative). Unless the accounting records, the bank statements, and the reconciliations for these accounts were examined, the Respondents could not have obtained reasonable assurance, in the circumstances, that cash balances, and indeed the financial statements, were not materially misstated.

5.43. Further, bank accounts that are little used can be poorly controlled and may contain incorrect reconciling items.

5.44. What is “sufficient” and “appropriate” audit evidence for the purposes of ISA 500, is fact specific. That ISA states, at paragraph 6 *“The auditor shall design and perform audit procedures that are appropriate **in the circumstances** for the purpose of obtaining sufficient appropriate audit evidence”* (emphasis added). ISA 500 paragraph 5(e) defines sufficiency of audit evidence as: *“The measure of the quantity of audit evidence. The quantity of the audit evidence needed is affected by the auditor’s assessment of the risks of material misstatement and also by the quality of such audit evidence”*, and appropriateness of audit evidence as: *“The measure of the quality of audit evidence; that is, its relevance and its reliability in providing support for the conclusions on which the auditor’s opinion is based.”*

5.45. It should have been clear to the Respondents, if they had exercised appropriate professional scepticism in performing this part of the audit, that the information they had received regarding bank accounts contained numerous inconsistencies calling for investigation, and that further investigation was required to establish its reliability. That meant that more audit evidence was required in order to comply with ISA 500. In the circumstances of this audit, such evidence included the reconciliations for smaller and less used bank accounts. It was not sufficient to rely on the year end balances as shown in bank confirmation letters; these alone would not reveal any unrecorded reconciling items.

Cash: Reviewing bank account activity

Adverse Finding 9: In FY17, the Respondents failed to review bank statements or transaction listings for bank accounts with nil or less than trivial balances to confirm that they were dormant or infrequently used in circumstances where the audit team had received what appeared to be incomplete information from management about those

² “Reconciling items” are the individual entries on a “bank reconciliation”, which is a document that compares the cash balances recorded by management in the cash book against the cash balances in bank statements as at the same date. Where they are different, the bank reconciliation identifies the “reconciling items” which are causing the difference.

bank accounts. Although independent bank confirmations had been received for these balances, this was a failure to perform the audit with professional scepticism, in breach of paragraph 8 of ISA 240, and to obtain sufficient appropriate audit evidence, in breach of paragraph 6 of ISA 500.

5.46. The inconsistencies in the information held by the audit team about bank accounts with nil or less than trivial balances and the fact that one dormant account had been reactivated in conflict with the Group's records and without management informing GT should have caused the Respondents to have exercised increased professional scepticism when performing the audit of these accounts.

5.47. It should have been clear to the audit team that they needed to review activity on bank accounts over the course of the year to obtain audit evidence that these accounts were, in fact, dormant or infrequently used. The audit team did not review the activity on any of these five bank accounts, nor on the account which had been reactivated by management.

5.48. For the FY17 audit of Flour Power City, GT's audit papers record the existence of a Flour Power City bank account which appeared unused and had a balance of £39.45. The Respondents ought to have reviewed transaction activity on bank statements in relation this bank account but did not.

5.49. During the FY17 Audit of Philpotts, the Respondents failed to review any transaction activity on the Philpotts Bank C account. It appears this was because the difference between the balances shown on the bank letter and lead schedule was only £3,704 and thus deemed trivial.

5.50. These failures to review account activity were failures to perform the audit with professional scepticism, in breach of paragraph 15 of ISA 200 and paragraph 8 of ISA 240. The Respondents ought to have exercised professional scepticism when performing the audit of these accounts, particularly in FY17, because by then management had repeatedly supplied the Respondents with what appeared to be inaccurate bank account information and it was apparent that at least one account thought to be dormant had been reactivated.

5.51. Had they performed this part of the audit with professional scepticism, it would have been clear that they needed to review activity on apparently unused or infrequently used bank accounts referred to above in order to confirm that these accounts were in fact unused or

infrequently used, and to obtain sufficient appropriate audit evidence (in these circumstances) within the meaning of ISA 500, paragraph 6. The bank confirmation letters alone were not sufficient appropriate audit evidence of bank account activity as they did not disclose activity during the year (just the year end balance) and would not reveal any unrecorded reconciling items.

Cash: Failures to investigate dubious provenance of documents

5.52. As part of the audit of cash at bank, the Respondents obtained several documents from management that sought to explain or justify particular reconciling items. Examples include documents purportedly from a well-known UK department store, showing payments made to PH in FY15, and documents purporting to be remittance advices from local authorities apparently showing PH receiving refunds of business rates in respect of particular store locations.

5.53. ISA 240, at paragraphs 12-13, provides as follows:

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

Unless the auditor has reason to believe the contrary, the auditor may accept records and documents as genuine. If conditions identified during the audit cause the auditor to believe that a document may not be authentic or that terms in a document have been modified but not disclosed to the auditor, the auditor shall investigate further.”

5.54. Further, ISA 200 makes clear that the auditor is obliged to obtain “sufficient appropriate audit evidence” in order to provide “reasonable assurance” about whether the financial statements as a whole are free from material misstatement (paragraph 5). The definition of “audit evidence” (paragraph 13 (b)(ii)) states that the *“Appropriateness of audit evidence is the measure of the quality of audit evidence; that is, its relevance and its reliability in providing support for the conclusions on which the auditor’s opinion is based.”*

5.55. The importance of audit evidence being reliable is thus clear, and the auditor is obliged to maintain professional scepticism in relation to the audit evidence presented. The Respondents failed to meet that obligation in the ways identified in the following Adverse Findings.

Adverse Finding 10: During the FY15 Audit of Stonebeach and Philpotts, the Respondents failed to take proper account of indicators of dubious provenance of documents provided by management, or to raise any concern with PH management about them. This was a failure to perform the audit with professional scepticism, in breach of paragraph 15 of ISA 200 and paragraph 12 of ISA 240.

5.56. In connection with the FY15 Audit, GT accepted PH management's assertion that £499,401 should be added to a figure for cash in Stonebeach as at 30 September 2015 because customers had processed payments in that sum on 29 and 30 September 2015 but amounts had not been received at year end. The PH finance team purported to provide "supporting evidence" for part of this sum.

5.57. This "supporting evidence" included two remittance documents which purported to originate from a well-known UK department store, apparently showing total remittances of some £148,000. However, the heading was presented differently in each document and there are several typing errors and formatting inconsistencies. One of the documents was not addressed to PH, but rather to a third party company. It used the registered office address of that company. There is no evidence of the Respondents noticing these indicators of the dubious provenance of the documents, or raising any concerns with PH management about them. This was a serious failure to perform the audit with professional scepticism, in breach of paragraph 15 of ISA 200 and paragraph 12 of ISA 240.

5.58. Three other remittance advices were also provided by management as "supporting evidence" on the same date. They all appeared to be from local authorities. They purported to show refunds of business rates, but, taken together, had a number of unusual features:

5.58.1. one did not refer to the period to which the refund related;

5.58.2. another looked like an invoice (including attaching a bank payment slip, and wording "*This notice requires you to pay business rates for the above property*"); and

5.58.3. the amounts were relatively large (ranging from £42.5k to £68k, amounting to large portions of the year's rates for the relevant properties).

5.59. At the very least, the Respondents should have queried the timing and size of these apparent rates refunds, together with the provenance of the documents. Their failure to do so was a serious failure to perform the audit with professional scepticism in breach of paragraph 15 of ISA 200 and paragraph 12 of ISA 240.

5.60. GT's audit of Stonebeach cash in FY15 relied on a spreadsheet entitled "*xK1b Stonebeach bank statement*". However this document does not look like a bank statement, but instead displays all the characteristics and functionality of an Excel spreadsheet, and the source of the data on it is unclear. The same occurred in relation to another spreadsheet in the Stonebeach cash workpaper for FY15, also described as a "Bank statement" but this time for Patisserie Valerie Holdings' Bank B account. GT's audit working papers did not explain the source of the data on these sheets, nor indicate any concerns over the provenance of them, or the data.

5.61. In auditing Philpotts' cash at bank in FY15 GT relied on a spreadsheet tab that was named "[Bank A] Statement". It was headed with a blue Bank A logo, and contained similar information to a typical bank statement, such as the bank address, the IBAN code, and currency. However, there were signs that it originated with or had been edited by management, as it contained only reconciling items (not a continuous run of transactions) and it was embedded within an Excel spreadsheet, and contained annotations. There is no evidence that the provenance of this spreadsheet was investigated.

5.62. This was a failure to perform the audit with professional scepticism, in breach of paragraph 15 of ISA 200 and paragraph 12 of ISA 240.

Adverse Finding 11: During the FY17 Audit of Stonebeach, the Respondents failed to take proper account of indicators of dubious provenance of documents provided by management, or to raise any concern with PH management about them. This was a failure to perform the audit with professional scepticism, in breach of paragraph 15 of ISA 200 and paragraph 12 of ISA 240.

5.63. As in FY15, in FY17 GT relied on documents named "bank statement extract" in order to reconcile cash balances. Those documents were not retained on the audit file, but have been provided separately to Executive Counsel by GT. They contain several indications that they originated with management and are not extracts from bank statements (such as entries stating "balance per nominal" and the fact they only list reconciling items, not all transactions in a particular period).

5.64. Despite this, no concerns appear to have been raised about the provenance of these documents, which amounts to a failure to perform the audit with professional scepticism in breach of paragraph 15 of ISA 200 and paragraph 12 of ISA 240.

Cash: Testing

Adverse Finding 12: In each of the FY15, FY16 and FY17 Audits, the Respondents did not carry out testing of transfers between accounts. In each year, in the circumstances, this was a failure of professional judgement, in breach of paragraph 16 of ISA 200.

5.65. Testing of transfers between Group accounts needed to be considered given, in particular, that the Group, made frequent bank transfers between different bank accounts that were large in size when compared with the size of the Group's companies, and particularly occurred around the year end in FY17. Further, bank transfers around the year end can lead to material misstatements of cash if the accounting for the payment and for the receipt is inconsistent.

5.66. In these circumstances, as part of the audit in each of FY15, FY16 and FY17 the Respondents should have undertaken testing of the transfers that the Group made between its bank accounts. Alternatively, the Respondents ought to have reached and recorded an appropriate professional judgement which explained why such testing was not required.

5.67. This was not done, save in two minor instances, because GT considered such testing was not necessary. This was on the basis that the risk that bank transfer testing was designed to address would have been covered by the bank reconciliation work. This was a failure of professional judgement, in breach of paragraph 16 of ISA 200.

5.68. In this regard, a more junior member of the team sent an instant message to a more senior member of the audit team on 22 November 2016 describing bank transfer testing as "*pointless*". This description did not appear to be challenged by the more senior team member at the time (for the reason set out above).

Adverse Finding 13: During the FY17 Audit, the Respondents misread a bank letter as showing a £4 million overdrawn balance instead of a nil balance, in breach of the obligation to act diligently in accordance with applicable technical and professional standards, pursuant to the ICAEW Code of Ethics para 130.1 (b).

5.69. While auditing cash in Stonebeach in FY17, GT reviewed an account named "[Bank A] ref". This was described in the audit papers as having an overdrawn balance of £4 million, which was said in the lead schedule to be "*per bank letter*".

5.70. In fact, the bank confirmation letter that Bank A sent to GT to confirm the balance on this account showed a balance of nil. The Bank A letter referred to a Group overdraft facility of £4 million, rather than a drawn down overdraft of £4 million.

There was therefore a £4 million difference between the actual account balance, and GT's understanding of it, due to GT's misreading of the bank letter. This was a serious and material mistake, and the misreading of the bank letter was a failure to act diligently in accordance with applicable technical and professional standards in breach of the ICAEW Code of Ethics paragraph 130.1 (b).

Adverse Finding 14: During the FY17 Audits of Stonebeach and Philpotts, the Respondents introduced an inappropriately high testing threshold of half tolerable error without explanation or apparent justification. This was a failure to design and perform substantive procedures for each material class of transactions, in breach of paragraph 18 of ISA 330, and a breach of the obligation to obtain sufficient appropriate audit evidence pursuant to paragraph 6 of ISA 500.

5.71. In each year and for each entity the Respondents determined a testing threshold in order to determine which reconciling items were of a sufficiently low value that they need not be individually tested. In FY17 the testing threshold used for Stonebeach and Philpotts was half "tolerable error", which was inappropriately high³. No justification for this was included in the workpapers, and previous years' thresholds had been far lower. This new threshold significantly reduced the number of items for GT to test and the extent of the audit work on the bank reconciliations. Adopting this threshold without apparent justification or explanation, breached the obligation to obtain sufficient appropriate audit evidence contained in paragraph 6 of ISA 500, and was also a failure to design and perform substantive procedures for each material class of transactions, in breach of paragraph 18 of ISA 330.

Cash: Accounting treatment of lodgements

5.72. A payment into a bank account is often called a "lodgement" in audit papers, and GT used this term in all three years relevant to this investigation.

5.73. A lodgement has a "posting date", which is the date that the money was paid into a bank account. This is sometimes referred to simply as the date in the audit papers. A

³ "Tolerable error" is a term for a testing threshold, akin to tolerable misstatement or "performance materiality". Performance materiality is an adjustment of materiality that takes into account misstatements that might arise but are not corrected and misstatements that may exist but are not detected by audit procedures.

lodgement also has a “clearance date”, which is the date when the payment is credited on the relevant bank statement.

5.74. PH recorded a large number of lodgements at or around year end as “reconciling items”. Reconciling items are part of the process of comparing (i) an entity’s cash balance at year end according to its cash book to (ii) the cash balance at year end per the entity’s bank statements. Reconciling items explain the difference between (i) and (ii); for example a lodgement with a posting date before year end but a clearance date after year end will appear in (i) but not (ii) and thus lead to different cash balances in each⁴.

5.75. For a lodgement to be a valid reconciling item, its posting date will ordinarily be on or before the year end even if its clearance date is within a reasonable period thereafter.

5.76. In each of FY15, FY16 and FY17 PH's bank reconciliations contained many hundreds of lodgements, with posting dates after the year end, or no posting dates shown at all, and which cleared the bank after year end. The audit workpapers contain no explanation of why these lodgements were valid reconciling items, rather than simply being payments into Group bank accounts that should have been accounted for in the following financial year. On their face, these are amounts banked in a current year but recognised as cash in the previous year. This is obviously an important distinction as an incorrect accounting treatment would directly and immediately inflate an entity’s cash balance for the period prior to the year end. The following Adverse Findings arise from the Respondents’ repeated failure to investigate what was, on the face of the audit papers, apparently an incorrect accounting treatment that would lead to incorrect reporting of cash balances.

Adverse Finding 15: During the FY15 Audits of Stonebeach and Philpotts, the Respondents failed to investigate the apparently incorrect accounting treatment of lodgements, as the vast majority of outstanding lodgements recorded by PH had posting dates after the year end and cleared the bank after the year end. If there was no evidence to support their recognition before the year end, these lodgements should not have been accounted for in FY15. Despite this, the Respondents raised no concerns about them, nor explained them. This is a failure to act diligently in accordance with applicable technical and professional standards, pursuant to the ICAEW Code of Ethics paragraph 130.1 (b), and a breach of the obligation to obtain sufficient appropriate audit evidence pursuant to ISA 500, paragraph 6.

⁴ Accounting adjustments could also be made to the reported cash balance to reflect payments paid in and cleared after the year end date but which, because the transfer of “risk and reward” took place before the year end, could be accounted for as occurring before year end. As a result, the payment could validly be reported as cash in the year end financial statements. This is a separate process to bank reconciliations.

- 5.77. The failure to investigate lodgements after year end occurred in respect of 589 lodgements on a Bank B account that were recorded by PH as reconciling items in Stonebeach for FY15, 109 lodgements on Patisserie Valerie Holdings' Bank B account that were also recorded as reconciling items in Stonebeach for FY15, and 39 lodgements on a Bank A account that were recorded as reconciling items in Philpotts for FY15.
- 5.78. All of these had posting dates that were after the year end date (30 September 2015). GT's audit workpapers do not explain this. This failure to query an apparently incorrect accounting treatment of the payments was a serious failure to act "*diligently in accordance with applicable technical and professional standards...*", in breach of the ICAEW Code of Ethics para 130.1 (b).

Adverse Finding 16: During the FY16 Audits of Stonebeach, Flour Power City and Philpotts, the Respondents failed to investigate the apparently incorrect accounting treatment of lodgements, as the vast majority of outstanding lodgements recorded by PH had posting dates after the year end and cleared the bank after year end. If there was no evidence to support their recognition before the year end, these lodgements should not have been accounted for in FY16. Despite this, the Respondents raised no concerns about them, nor explained them. This is a failure to act diligently in accordance with applicable technical and professional standards, in breach of the ICAEW Code of Ethics paragraph 130.1 (b), and a breach of the obligation to obtain sufficient appropriate audit evidence pursuant to ISA 500, paragraph 6.

- 5.79. Exactly the same failure occurred in the following year's audit, in respect of three entities rather than two (Stonebeach, Flour Power City and Philpotts):
- 5.79.1. 310 lodgements that were recorded as reconciling items for Stonebeach's Bank A current account had a posting date of 3 October 2016, i.e. after the year end. The column "Date cleared bank" was blank for all but one lodgement.
- 5.79.2. all three lodgements in the Patisserie Valerie Holdings' Bank B account that were recorded by PH as reconciling items in Stonebeach for FY16 had a posting date of 3 October 2016. The "Date cleared bank" was blank for each of these lodgements.
- 5.79.3. 592 lodgements relied on as reconciling items in the Stonebeach Bank B account had posting dates of 3 October 2016 and 12 had later posting dates (in one case as late as 14 October 2016). The "Date cleared bank" was blank for 125 of these lodgements.

- 5.79.4. All five lodgements recorded as reconciling items in the Patisserie Valerie Holdings' Bank A account had posting dates of 4 October 2016. These were for large sums, each between £445,000 and £831,994.
- 5.79.5. All five lodgements recorded as reconciling items in Flour Power City's Bank A account, and the one lodgement recorded as a reconciling item in in Flour Power City's Bank B account, had posting dates of 4 October 2016. One lodgement had no "Date cleared bank"; the others were recorded as 4 October 2016.
- 5.79.6. Finally, all six lodgements recorded as reconciling items in Philpott's Bank B account had posting dates of 3 or 4 October 2016 and all 32 lodgements recorded as reconciling items in Philpott's Bank A account had posting dates of 3 October 2016. 25 of the lodgements in the Bank A account did not have an entry for "Date cleared bank"; the others cleared on 3 October 2016.

5.80. GT's audit workpapers do not explain any of these occasions when posting dates were after year end. This failure to query an apparently incorrect accounting treatment of the payments was a serious failure to act "*diligently in accordance with applicable technical and professional standards...*", in breach of the ICAEW Code of Ethics para 130.1 (b).

Adverse Finding 17: During the FY17 Audits of Stonebeach, Flour Power City and Philpotts, the Respondents failed to investigate the apparently incorrect accounting treatment of lodgements, as the outstanding lodgements recorded by PH had no posting date shown. If there was no evidence to support their recognition before the year end, these lodgements should not have been accounted for in FY17. Despite this, the Respondents raised no concerns about them, nor explained them. This is a failure to act diligently in accordance with applicable technical and professional standards, in breach of the ICAEW Code of Ethics paragraph 130.1 (b), and a breach of the obligation to obtain sufficient appropriate audit evidence pursuant to ISA 500, paragraph 6.

5.81. In the FY17 audit the outstanding lodgements recorded as reconciling items were listed without any posting dates at all. This occurred in respect of Stonebeach, Flour Power City and Philpotts, and should have led GT to investigate whether these were valid reconciling items:

- 5.81.1. 615 lodgements were recorded as reconciling items for Stonebeach's Bank B account. None had posting dates shown on the bank reconciliation spreadsheet, and only 14 had a clearance date shown (all were on or after 2 October 2017). These were below the testing threshold.
- 5.81.2. 366 lodgements were recorded as reconciling items for Stonebeach's Bank A account. None had posting dates shown on the bank reconciliation spreadsheet,

and only seven had a clearance date shown (all were on 2 or 3 October 2017). The remainder were below the testing threshold.

- 5.81.3. Two lodgements were recorded as reconciling items for Patisserie Valerie Holdings' Bank B account. Neither had posting or clearance dates shown on the bank reconciliation spreadsheet. Both were below the testing threshold.
- 5.81.4. Only one Flour Power City account was recorded as having reconciling items in FY17. This was a Bank A account, with two outstanding lodgements. Neither had a posting date shown and they had clearance dates of 2 and 3 October 2017.
- 5.81.5. The audit of Philpotts cash at bank in FY17 involved consideration of reconciling items on two bank accounts, a Bank B and a Bank A account. The reconciliation spreadsheet showed three outstanding lodgements for the former and 32 for the latter. Information for several of these was redacted, including clearance date information. These were below the testing threshold. No posting dates were recorded.
- 5.82. GT's audit workpapers do not explain any of these occasions when posting dates were not shown, but the relevant outstanding lodgement was nevertheless relied on as a reconciling item. This failure to investigate was a serious failure to act *"diligently in accordance with applicable technical and professional standards..."*, in breach of the ICAEW Code of Ethics para 130.1 (b).
- 5.83. In these circumstances it should have been apparent to the Respondents that necessary information was missing before they could conclude that these outstanding lodgements were valid reconciling items. GT did not obtain this information, in breach of their obligation under paragraph 6 of ISA 500 to obtain sufficient appropriate audit evidence.

Adverse Finding 18: During the FY15, FY16 and FY17 Audits of Philpotts the Respondents failed to check posting dates for outstanding lodgements in breach of paragraph 6 of ISA 500.

- 5.84. GT's workpapers for the audit of Philpotts' cash at bank described the audit "Method", including *"Ensure any outstanding lodgement/payments are genuine by seeing date they cleared bank"*. However, there was no instruction or audit step for the auditor to check when the lodgement originated in the accounting records, i.e. its "posting date" when the payment into the bank account in question actually occurred.
- 5.85. This is a significant omission, and a breach of the obligation to obtain sufficient appropriate audit evidence, contrary to paragraph 6 of ISA 500. A proper check on the accuracy and integrity of a bank reconciliation can only be achieved if the posting dates

of outstanding items are tested, as only then can the auditor see that the item is properly a cash balance for the accounting period in question and should not be accounted for in the following period. Mistakes in this area can lead to material misstatements of cash balances.

Cash: Investigating reconciling items

5.86. In order to audit the Group’s cash at bank, GT obtained PH’s “bank reconciliations”. These were prepared by management by comparing the cash balances recorded by management in the cash book against the cash balances in bank statements for 30 September, and where they are different, identifying the reconciling items which are causing the difference.

5.87. The total size of the reconciling items on these audits was extremely large:

Total reconciling items (£’000)	2015	2016	2017
Flour Power City	-	709	190
Stonebeach	2,940	15,567	9,862
Philpotts	78	1,036	1,058
Total reconciling items	3,018	17,312	11,110
Total year end cash balance	6,094	13,273	21,526

5.88. The Respondents described (in the course of this investigation) their process of identifying and investigating reconciling items as follows:

“[T]he audit team obtained the bank reconciliations prepared by management reconciling their nominal ledger bank balances to bank statements for each account. The audit team then identified large reconciling items which were investigated. The purpose of this was twofold: (i) to establish that the item had been correctly recorded prior to the year-end; and (ii) that the amounts had subsequently been paid and received as cash post year end.

The audit team further sought explanations from management in respect of certain large reconciling items (above tolerable error) as to why amounts were recorded prior to year-end.

The audit team also sought evidence to corroborate the explanations for the large reconciling items provided by management. Members of the audit team then agreed the material reconciling items to certain documentation.”

5.89. The evidence shows several serious failures and breaches of the ISAs in this part of the audit. In each of FY15, FY16 and FY17, the Respondents failed adequately to:

5.89.1. Understand the basis of preparation and sources of certain data used by management, including investigating the dates of certain transactions and whether they validly represented cash reconciling items or should have been reclassified as debtors in the financial statements and subsequent year end cash receipts. If they should have been reclassified, it follows that PH's cash was overstated and its debtors were understated by the same amount; and

5.89.2. Obtain sufficient appropriate audit evidence to support a vast number of material reconciling items on bank reconciliations, or to challenge certain of management's explanations (which did not appear to be plausible or where the provenance of documentation provided by management was dubious). As such, the audit team failed to show adequate professional scepticism in their work.

5.90. As shown above, in FY15 and FY17 almost half of the total year end cash balance comprised reconciling items, and in FY16 there were over £17.3 million of reconciling items for a total year end cash balance of £13.2 million. Despite the size of the reconciling items, and despite them persisting over a three-year period, the GT audit team did not make Mr Newstead or those charged with governance aware of the scale of the reconciling items that were being recognized in the year end cash balances. In interviews, the GT team had no recollection of raising with Mr Newstead the total number or value of the reconciling items.

5.91. In the following paragraphs Executive Counsel sets out the specific Adverse Findings that relate to this section of the audit.

Adverse Finding 19: During the FY15, FY16 & FY17 Audit of Stonebeach's cash balances, the Respondents failed to obtain or refer to sufficient evidence in support of management's reconciliations or explanations of reconciliations. They also failed to investigate unusual reconciling items. This was a failure to perform the audit with professional scepticism, in breach of paragraph 15 of ISA 200 and paragraph 12 of ISA 240 and a breach of their obligations to obtain sufficient appropriate audit evidence pursuant to paragraph 6 of ISA 500.

5.92. For the FY15 Audit, the Respondents considered three bank accounts used by Stonebeach. These included one account which had £2.7 million of reconciling items. A number of these were marked in GT's workpaper as "checked to invoices and remittance" including ten reconciling items, for sums between £622,655 and £57,216. The Respondents accepted management's explanations for these items, without

corroboration or further investigation. The items in question included £568,175 and £211,454 from a processor of credit card payments. Six payments received from this processor, totalling £3.8 million, were dated as received after 30 September 2015. Management informed GT that the processor had an issue in June, July and August with receipts not coming through daily, hence the delay in making payment to Stonebeach. However, in a serious breach of their obligations to obtain sufficient appropriate audit evidence pursuant to paragraph 6 of ISA 500, the Respondents failed to obtain or refer to evidence to corroborate this explanation.

5.93. In FY16, Executive Counsel notes the following failures to obtain sufficient appropriate audit evidence in support of reconciling items:

5.93.1. The total size of the reconciling items called for explanation. In FY16 the bank letter for Stonebeach's Bank A account recorded a balance of £291,286 while the 310 reconciling items totalled £1.5 million. In the same year Stonebeach's Bank B account had a balance according to the bank letter of £543,261 while reconciling items amounted to £10.6 million.

5.93.2. The largest reconciling item for Stonebeach's Bank A account in that year was a payment of £1.2 million, dated 3 October 2016, and described as "[Company A]". The only annotation against this entry stated "[Company A] voucher income". Company A is a company that sold vouchers for PH products, so whilst payments from Company A would not be unexpected, the size of this payment and its timing called for an explanation beyond the agreement to bank and voucher statements documented on the audit workpaper. There is no evidence of the Respondents making any enquiries or requests for supporting evidence in relation to this reconciling item, despite the huge disparity in value between this and other reconciling items (the other reconciling items for that year have an aggregate value of only £289,309 and an average value of £1,000) and despite GT's audit papers stating that "unusual reconciling items" should be agreed to evidence;

5.93.3. Reconciling items for Stonebeach's Bank B account were also not properly investigated, including receipts for £225,120 and £409,018, which were neither annotated nor checked to supporting documentation. A further receipt for £228,173 was annotated with a description, but not checked to supporting documentation. Three other receipts are recorded as dated 3 October 2016 but without any narrative, nor reference to supporting evidence. One posting date was as late as 14 October 2016. GT has confirmed that nine different council rebates recorded by management as reconciling items in FY16, totalling over £900,000, were agreed to bank, but that there is no evidence on the audit file of separate statements confirming these payments;

5.93.4. GT audited a Bank A account in the name of PVH Limited whose bank statement showed a negative balance of -£3.5 million at year end, but where management relied on five reconciling items totalling £3.4 million. These were significant value items, ranging from £445,048 to £831,994. All are dated 4 October 2016, with the “Date cleared bank” also shown as 4 October 2016. None was agreed to supporting documentation and none had a sufficient explanation of the nature of the transaction, or why they were valid reconciling items.

5.94. The failure to obtain sufficient appropriate audit evidence in support of reconciling items was repeated in FY17. Further, several reconciling items relied on by management had unusual features. The Respondents’ obligation to perform the audit with professional scepticism meant that these features should have been investigated, but they were not:

5.94.1. In FY17 in relation to the Stonebeach Bank B account, there were 615 outstanding lodgements listed, amounting to £10.2 million. Several reconciling items relied on by management for the Stonebeach Bank B current account were shown on audit papers as corroborated, but there is no explanation of what evidence was used for this, or how the items were verified (either with copies of extracts of the evidence used, or a sufficient audit trail so that an experienced auditor could retrace the steps that had been taken to verify the items). This was a failure to obtain sufficient appropriate audit evidence contrary to paragraph 6 of ISA 500.

5.94.2. In FY17 in the Stonebeach Bank A account, GT accepted 366 reconciling items, amounting to £3.4 million, that have no dates shown on audit papers showing when these transactions took place. This is a fundamental missing component of this part of the FY17 Audit; no reconciliation can be audited properly without checking the transaction date to see that it was before year end. The failure to obtain these dates, or query with management why they were missing, is a serious failure to perform the audit with professional scepticism in breach of paragraph 15 of ISA 200 and paragraph 12 of ISA 240. There were reconciling items suggesting very significant receipts from certain counterparties, accumulating over time before 30 September 2017 and all paid at around year end. These include some £3.4 million that a processor of credit card payments transferred at around year end. This is almost a third of the total reconciling items for one bank account. Another third is made up of payments from Company A or its associates. Other examples are a £1.1 million reconciling item dated 2 October 2017 described only as “BACS refund due to duplicate payment”, £578,726 dated 2 October 2017, and £567,812 dated 3 October 2017.

Adverse Finding 20: During the FY16 Audit of Flour Power City, the Respondents failed to obtain or refer to evidence in support of management’s reconciliations and explanations of reconciliations. The Respondents also failed to require agreement of reconciling items to evidence. These are each breaches of the obligation to obtain sufficient appropriate audit evidence pursuant to paragraph 6 of ISA 500.

5.95. The workpaper for Flour Power City’s cash audit in FY16 recorded the “Method” for auditing reconciling items on the Bank A and Bank B current accounts used by Flour Power City. This makes clear that, unlike the method for other entities, this cash audit did not require the items to be agreed to evidence in order to support their recognition as reconciling items. This was a failure to plan the audit so as to obtain sufficient appropriate audit evidence, contrary to paragraph 6 of ISA 500.

5.96. Certain reconciling items in this audit also called for further investigation and appropriate audit evidence to support them. Examples are items described as “*cash received in relation to sales*” from traders described as “Market Pete” (a payment of £145,700 is shown as paid on 4 October 2016) and “Browm [sic] Bread” (a payment of £155,200, also on 4 October 2016) which represented a disproportionately large proportion of FPC’s external sales. The failure to raise any concern about these payments constitutes a failure to perform the audit with professional scepticism in breach of paragraph 15 of ISA 200 and paragraph 12 of ISA 240. It led to a failure to obtain sufficient appropriate audit evidence.

Adverse Finding 21: During the FY16 Audit of Philpotts the Respondents failed to query the large amount of an Company B receipt, in breach of the obligation to perform the audit with professional scepticism under paragraph 15 of ISA 200 and paragraph 12 of ISA 240.

5.97. The audit of Philpotts cash at bank in FY16 involved GT considering three bank accounts. Each had payments that PH management claimed were reconciling items. One account had two reconciling items, of £21,763 and £12,214. The next account had 32 reconciling items, with a total value of £401,983. The third had six reconciling items, totalling £600,773. Of these 40 reconciling items one called out for further investigation. It was an invoice from Company B in the sum of £402,658, i.e. higher than the value of 32 of the other 39 reconciling items put together. It represented 38% of the total annual income from Company B. Its size was thus disproportionate, but it also was recorded on the workpapers to have been paid into the bank the day after it cleared. This was obviously inconsistent, but no explanation was provided for on the audit file, GT therefore failed to

perform the audit with appropriate professional scepticism by accepting the reasonableness of this purported receipt.

CATEGORY 3: JOURNALS

Introduction to Journals

5.98. In accounting, a “journal” is the method by which an adjustment is entered into the accounting records. A “journal entry” will identify the areas of the accounting records that need to be changed, by how much, and the effective date for those changes. Changes to the accounting records are made through journal entries, and they are therefore a building block for information such as the entity’s financial statements (which are generated from the accounting records).

5.99. Auditors are required to design and perform audit procedures to, among other things, “test the appropriateness of journal entries recorded in the general ledger and other adjustments made in the preparation of the financial statements” (ISA 240, paragraph 32(a)). Those entries are made by the business, usually by management, and the ISAs recognise that *“management is in a unique position to perpetrate fraud because of management’s ability to manipulate accounting records and prepare fraudulent financial statements by overriding controls that otherwise appear to be operating effectively”* (ISA 240, paragraph 31). This means that although a business should have controls in place restricting who may make journal entries and seeking to ensure their accuracy, there is always the risk of management overriding those controls.

5.100. GT recognised the risk of management override of controls as a “significant risk” in the audit plans for PH for FY15, FY16 and FY17. GT chose to audit PH’s journals by testing particular journal entries rather than by relying on controls.

5.101. The audit plans show the following audit procedures were planned for journal testing:

“We will extract the transaction listings from Sage using our IDEA software and verify the completeness of the accounting system records

From these listings we will select a sample of journal entries and trace them to corroborating evidence, focusing on significant or unusual items

We will confirm our understanding of the control environment in place for the posting and reviewing of journal entries

We will undertake a review of key accounting estimates, judgements and decisions made by management where they relate to material balances or transactions

We will perform a detailed review of material transactions outside of the course of ordinary operations”.

5.102. GT’s approach meant that it was particularly important to test an appropriate sample of journal entries, using appropriate selection criteria and investigating unusual or particularly significant entries (such as those at year end). This should have meant focusing on areas of potential concern, which in turn should have been identified by considering the areas where journal controls were weak and the likely characteristics of potentially fraudulent journals. However in each year, the audit team failed adequately to do so. In particular GT failed to:

5.102.1. design and perform audit procedures to test the appropriateness of journal entries at the year end; and

5.102.2. exercise appropriate professional judgement in preparing to perform the audit by deciding to use inappropriate selection criteria, and not considering the feasibility of properly testing all those entries that met those criteria.

5.103. The following paragraphs set out the failures in detail.

Journals: Failures in preparing to test

Adverse Finding 22: In each of the FY15, FY16 and FY17 Audits, the Respondents failed properly to prepare to test journal entries and adjustments made at the year ends in breach of paragraph 32(a)(ii) of ISA 240.

5.104. Paragraph 32(a)(ii) of ISA 240 states that journal entries made at the end of a reporting period should be selected for testing. The Respondents ought to have selected a sample of these journal entries to be tested. This was not done at all for FY15 and FY16. In FY17 “cut off” journals (i.e. journal entries made near year end) were added as one of the criteria for selecting journals to test. However, in FY17 the testing of those “cut off” journals was minimal (12 journal entries were tested out of some 5,600 entries). The Respondents therefore breached paragraph 32(a)(ii) of ISA 240.

Adverse Finding 23: In each of the FY15, FY16 and FY17 Audits, the Respondents failed to exercise professional judgement in planning and performing the audit by deciding to use inappropriate selection criteria, and not considering the feasibility of properly testing all those entries that met the criteria. This led GT to test an excessively large number of entries in breach of paragraphs 16 and A29 of ISA 200.

5.105. The Respondents ought to have made and recorded a professional judgement at the planning stage, deciding which entries to test and taking account of the volumes and amounts of journals. This would have resulted in more refined criteria for selection and more detailed testing for some journals. The actual number of journals selected for testing by GT was excessively large, in each of FY15, FY16 and FY17. Some of these items were not tested, others were not properly tested, and in other cases there were unresolved matters and unexplained inconsistencies. This was in breach of paragraph 16 and A29 of ISA 200. These provide:

5.105.1. ISA 200, paragraph 16: *“The auditor shall exercise professional judgment in planning and performing an audit of financial statements”*; and

5.105.2. ISA 200 paragraph A29: *“Professional judgment needs to be exercised throughout the audit. It also needs to be appropriately documented. In this regard, the auditor is required to prepare audit documentation sufficient to enable an experienced auditor, having no previous connection with the audit, to understand the significant professional judgments made in reaching conclusions on significant matters arising during the audit. Professional judgment is not to be used as the justification for decisions that are not otherwise supported by the facts and circumstances of the engagement or sufficient appropriate audit evidence”*.

Journals: Failures in testing

Adverse Finding 24: In each of the FY15, FY16 and FY17 Audits, and in relation to each Group entity, the Respondents failed to perform appropriate audit procedures, as required by paragraphs 13, 18(f) and 29 of ISA 315, so as to be able to evaluate whether any significant control deficiencies existed which required reporting to those charged with governance in accordance with paragraph 9 of ISA 265.

5.106. GT’s assessment of journal entry controls resulted in several potential control weaknesses being identified and recorded, but not investigated further. These comprised:

5.106.1. Journals being uploaded in Excel, without restricted access and with no audit trail for review and authorisation;

5.106.2. Some journals having no journal description; and

5.106.3. Some journals lacked posting dates and user identities. This was because, as GT noted in the audit workpapers, PH’s system did not allow for this data to be reported.

5.107. ISA 265 imposes the following requirements (among others) on auditors:

- 5.107.1. *“The auditor shall determine whether, on the basis of the audit work performed, the auditor has identified one or more deficiencies in internal control”.*
- 5.107.2. *“If the auditor has identified one or more deficiencies in internal control, the auditor shall determine, on the basis of the audit work performed, whether, individually or in combination, they constitute significant deficiencies.”*
- 5.107.3. *“The auditor shall communicate in writing significant deficiencies in internal control identified during the audit to those charged with governance on a timely basis.”*
- 5.108. ISA 315 imposes other obligations regarding obtaining an understanding of controls:
- 5.108.1. *“When obtaining an understanding of controls that are relevant to the audit, the auditor shall evaluate the design of those controls and determine whether they have been implemented, by performing procedures in addition to inquiry of the entity’s personnel.”*
- 5.108.2. *“The auditor shall obtain an understanding of the information system, including the related business processes, relevant to financial reporting, including the following areas: ... (f) Controls surrounding journal entries, including non-standard journal entries used to record non-recurring, unusual transactions or adjustments.*
- 5.108.3. *“If the auditor has determined that a significant risk exists, the auditor shall obtain an understanding of the entity’s controls, including control activities, relevant to that risk.”*
- 5.109. In the case of PH, the Respondents identified potential weaknesses that could have amounted to control deficiencies. They ought to have investigated these potential weaknesses further in order to obtain an understanding of, and then assess, the controls that were in place over journal entries. That would have enabled them to evaluate whether significant control deficiencies existed which required reporting to those charged with governance. Their failures to do so, in each of the three years under consideration and in relation to each Group entity, was a breach of the paragraphs of ISA 315 quoted above.

Adverse Finding 25: In each of the FY15, FY16 and FY17 Audits, the Respondents failed to obtain sufficient appropriate audit evidence (paragraph 6 of ISA 500) and failed to design and perform audit procedures to test the appropriateness of journal entries (paragraph 32(a)(ii) of ISA 240) in relation to “cut off journals”.

- 5.110. “Cut off journals” were not tested in any proper detail in FY17, and were not tested at all in FY15 and FY16. This breached the obligation to obtain sufficient appropriate audit

evidence (paragraph 6 of ISA 500) and the obligation to design and perform audit procedures to test the appropriateness of journal entries, including by selecting journal entries and other adjustments made at the end of a reporting period (ISA 240, paragraph 32(a)(ii)).

5.111. In carrying out the testing, there were further failures by the Respondents to obtain sufficient appropriate audit evidence (in breach of paragraph 6 of ISA 500):

5.111.1. Not all journals identified as unusual and selected for testing were in fact tested;

5.111.2. GT did not document whether they had checked that the journals had been appropriately authorised, because some journals carried no descriptions and many would be aggregated into a combined posting which would have made it impossible to check individual journals had been appropriately authorised. This check of authorisation was an audit procedure specifically identified in the audit programmes; and

5.111.3. Where journal entries identified follow up enquiries, there was sometimes no evidence these follow-ups were carried out.

Adverse Finding 26: In each of the FY15, FY16 and FY17 Audits, the Respondents failed to obtain sufficient appropriate audit evidence (paragraph 6 of ISA 500) in relation to the approval of, and support for, journals.

5.112. According to GT's audit testing programmes, journal entries should have been tested for proper and appropriate approval (i.e. by a member of the PH finance team). For many journals there is no record of any such approval or authorisation being verified by GT. This was a breach of the obligation to obtain sufficient appropriate audit evidence (paragraph 6 of ISA 500).

5.113. Similarly, the Respondents failed to ensure that the explanations that were recorded for the tested journals were supported by evidence, despite the entries recording that such evidence was available. This was a further breach of paragraph 6 of ISA 500.

Adverse Finding 27: During the FY17 Audit, the Respondents failed to explain departure from expectations in relation to Stonebeach, in breach of paragraph 11 of ISA 500.

5.114. In FY17 GT recorded its expectation that cash transfers between Group accounts would usually be in round sums as they do not relate to particular transactions. The Stonebeach audit spreadsheet included an annotation stating "*Large cash transfers are often made between accounts in order to ensure cashflow meets the requirements of the business.*"

These usually will be round sum amounts as they do not usually refer to a specific payment /transaction.”

5.115. Despite this, most of the cash journal entries reflecting transfers between Group accounts that were recorded in Stonebeach’s FY17 audit papers did not in fact comprise round sum amounts. Of 44 transfers recorded in those papers, totalling £24.8 million, only nine entries were in round sums, totalling £966,520.

5.116. The Respondents failed to explain this departure from GT’s expectation, in breach of paragraph 11 of ISA 500, which requires: *“If: (a) audit evidence obtained from one source is inconsistent with that obtained from another; or (b) the auditor has doubts over the reliability of information to be used as audit evidence, the auditor shall determine what modifications or additions to audit procedures are necessary to resolve the matter, and shall consider the effect of the matter, if any, on other aspects of the audit”.*

Adverse Finding 28: During the FY17 Audit, the Respondents failed to investigate Stonebeach’s listing of cash journals, in breach of the Respondents’ responsibilities relating to fraud in accordance with paragraph 32(a)(ii) of ISA 240.

5.117. In FY17, as in other years, cash journals were heavily concentrated around year end. Stonebeach’s FY17 listing of cut off journals shows a total relating to cash of around £47.7 million that is dated 30 September 2017, compared to £18.1 million for the rest of September 2017. This was not investigated, in breach of paragraph 32(a)(ii) of ISA 240.

CATEGORY 4: FIXED ASSET ADDITIONS

Introduction to fixed asset additions

5.118. PH’s financial statements recorded the net book value of four categories of fixed assets (which are all described under the heading of “Property, plant and equipment”). The Notes to the financial statements also recorded the additions to those categories during the financial year, as follows for FY15, FY16 and FY17:

Category	NBV FY15 (£’000)	Additions FY15 (£’000)	NBV FY16 (£’000)	Additions FY16 (£’000)	NBV FY17 (£’000)	Additions FY17 (£’000)
Freeholds	1,543	-	1,517	-	1,491	-

Leasehold property improvements (all in Stonebeach)	9,186	739	8,612	363	8,837	1,267
Plant, equipment, fixtures and fittings	21,931	7,273	26,364	8,363	29,346	7,455
Motor vehicles	19	-	5	-	-	-
Totals	32,679	8,012	36,498	8,726	39,674	8,722

5.119. GT's Auditor's Report in the FY17 Accounts recorded "*The Group carries property, plant and equipment at a net book value of £39,674,000 (2016: £36,498,000) which comprises a significant proportion of the Group's total assets.*" The Auditor's Report also recorded that GT identified the impairment of property, plant and equipment as a "*one of the most significant assessed risks of material misstatement.*"

5.120. Despite this, in FY15, FY16 and FY17 GT failed adequately in the circumstances to investigate additions to the fixed asset categories as questionable, including additions with no real detail and four additions that were supported only by invoices dated in the prior year. The Respondents accordingly failed to show adequate professional scepticism and to diligently apply technical and professional standards.

Fixed Asset Additions: Adverse Findings

Adverse Finding 29: In each of the FY15, FY16 and FY17 Audits the Respondents failed to correct PH's incorrect categorisation of certain motor vehicle additions as "Plant, equipment, fixtures and fittings" rather than as "Motor Vehicles", and certain costs as "Leasehold Property Improvements" rather than as "Plant, equipment, fixtures and fittings". This was in breach of the obligation to diligently apply technical and professional standards (Code of Ethics 130.1 (b)).

5.121. The notes to PH's financial statements describe the categories of fixed assets as described above. There was a separate category for motor vehicles, with additions shown as nil in each relevant year.

5.122. This was incorrect and misleading, as motor vehicles were acquired by the Group in these years, according to the fixed asset additions schedules provided by management. However, these additions were wrongly categorised by PH as additions to "Plant, equipment, fixtures and fittings", and GT failed to ensure it was corrected. In FY15

Stonebeach acquired motor vehicles at a cost of £362,762. In FY16 it acquired motor vehicles at a cost of £81,190 and in FY17 it acquired motor vehicles at a cost of £1.6 million. None of these was included in the “motor vehicles” category in PH’s filed accounts.

5.123. This was an obvious mistake, repeated in FY15, FY16 and FY17 in relation to Stonebeach and Flour Power City. It was obvious because PH’s financial statements only reported four categories of fixed asset additions. Two of these concerned property, and the other two were “motor vehicles” and “plant, equipment, fixtures and fittings”. This was therefore not a situation of several categories into which a fixed asset addition might reasonably be placed; on the contrary, the addition of a motor vehicle could only be categorised into “motor vehicles” or “plant, equipment, fixtures and fittings”. Despite that, the incorrect category was repeatedly used, and not corrected.

5.124. This error was compounded by the fact that the category of “motor vehicles” in the financial statements was used to show some motor vehicles, apparently acquired before FY15 and disposed of in FY15 and FY16. The reasonable reader of PH’s filed accounts would conclude that PH owned £56,000 of motor vehicles at the start of FY15, but due to disposals it owned none by the end of FY17.

5.125. This resulted in the potential for misstatement of in the financial statements in both FY15 and FY16, and also FY17 (since the incorrectly categorised additions depleted the carry-forward balance of net book value). These were repeated breaches of the obligations to diligently apply technical and professional standards.

5.126. Similar failures occurred when GT considered the fixed asset additions that PH had categorised as leasehold property improvements. These were shown on the additions schedules as including a number of additions that appear, on their face, to be shop fittings, salary, or to have no real detail at all. For example:

5.126.1. in FY15 three entries totalling £97,210, with reference “*shop fitting 50%*”, were categorised by PH as leasehold legal costs when they appear to belong in “fixtures and fittings”. GT ought to have investigated this.

5.126.2. FY16 leasehold additions included £154,605 for “*design costs*”. This was recorded as payroll costs and other expenses of individuals “*who are involved in the work of new leasehold additions*”. The Respondents failed to (i) challenge management’s assertion that these costs concerned leasehold additions, or (ii) categorise this as shop fitting, rather than leasehold costs.

5.126.3. FY17 leasehold additions also included items calling for further enquiry, for example £480,000 dated 25 September 2017.

Adverse Finding 30: In the FY15 Audit, the Respondents failed sufficiently to investigate seven motor vehicle additions with no real detail; in the FY16 Audit, the Respondents failed sufficiently to investigate the use of four invoices from prior years, and in the FY17 Audit, the Respondents also failed sufficiently to investigate four large motor vehicle additions with no real detail. These were in breach of the obligation to perform the audit with professional scepticism (paragraph 15 of ISA 200 and paragraph 8 of ISA 240).

5.127. Individual motor vehicle additions should have been investigated. For example:

5.127.1. The FY17 motor vehicle additions included an item for £339,600 dated 31/3/17.

It was annotated on the schedule provided to GT by PH as “*motor vehicles*” but no “*Site name*” or “*Narrative*” was recorded. Further, there were three September 2017 items, all annotated “*Source*”, again with no “*Site name*” or “*Narrative*”. These amounts were £334,250, £338,800 and £329,700 (total c.£1 million). The Respondents should have investigated these items, as their amounts were significantly larger than other amounts listed and very limited detail was given about them.

5.127.2. The motor vehicle additions recorded in Flour Power City in FY16 were supported by four invoices from the prior year, dated 1 June 2015. These were selected for testing by GT, but the use of invoices from the prior accounting year was not questioned. Nor was the fact that the invoices lacked the level of detail to be expected from vehicle invoices (for example vehicle identification numbers and specifications). They totalled £752,000, for 19 vehicles.

5.127.3. In FY15, seven motor vehicle additions were recorded in FY15, totalling £658,218 for 17 vehicles. The seven additions appear to have lacked real detail and there is no evidence of the Respondents investigating these further.

Adverse Finding 31: In the FY17 Audit, the Respondents failed to investigate an apparent £1m difference between a general ledger balance recorded by management on the schedule of motor vehicle additions and the final general ledger balance for motor vehicle additions listed in the trial balance, notwithstanding that the final general ledger balance agreed to the list of motor vehicle additions, in breach of the obligation to perform the audit with professional scepticism (paragraph 15 of ISA 200 and paragraph 8 of ISA 240).

5.128. In the Stonebeach additions workpaper for FY17, the “MOTORVEH” tab shows a balance of £577,975 (described as a “Sage balance”, and apparently recorded as such

by PH management). However the Stonebeach fixed asset lead schedule and detailed fixed asset summary showed the balance of £1.6 million for motor vehicle additions in that year. The failure to investigate this large discrepancy was a failure to perform the audit with professional scepticism.

Adverse Finding 32: In each of the FY15, FY16 and FY17 Audits, the Respondents failed adequately to challenge the capitalisation of certain internal costs capitalised as “Leasehold Property Improvements” or to investigate certain additions as questionable in “Leasehold Property Improvements” and in “Plant, Equipment, Fixtures and Fittings” in breach of the obligation to perform the audit with professional scepticism (paragraph 15 of ISA 200 and paragraph 8 of ISA 240).

5.129. In order to audit the category of fixed asset additions, the audit plans for each of FY15, FY16 and FY17 stated:

“We will review the Group’s capitalisation policies for consistency with the prior period and consider the appropriateness of any alterations

We will vouch a sample of additions...to supporting documentation to verify that transactions are being accurately recorded and capitalisation policies are being consistently applied...”

5.130. This was important as the audit team recognised a “reasonably possible risk” in each financial year of property, plant and equipment activity not being valid. The audit plans also recognised that *“Fixed assets may include items of a revenue nature which have been inappropriately capitalised”*.

5.131. Certain fixed asset additions do appear to be *“items of a revenue nature which have been inappropriately capitalised”*, but were not adequately challenged. Examples are two entries in FY17 Stonebeach leasehold additions for £290,425 and £23,107 that were annotated as “capitalized shop project salaries Oct16-Jun-17” with further narrative of “DVP Manager Oct16 to Jun17” against them. No “Site name” was annotated for either.

5.132. The Respondents also failed to investigate sufficiently certain additions as questionable in the fixed asset categories of “Leasehold Property Improvements” and in “Plant, Equipment, Fixtures and Fittings”. A number of entries in each of FY15, FY16 and FY17 called out for investigation because they were supported by no real detail, were for large amounts, and / or had entries that suggested they had been wrongly categorised. As noted above, certain apparent shop fitting costs were in fact categorised as leasehold property improvements. Conversely, the “shop fittings” category in FY17 included six

additions which called for investigation. In FY15, four fixed asset additions with the same reference were categorised as “Kitchen” rather than “shop fittings”. They totalled over £500,000. They all required investigation as questionable in order to comply with the Respondents’ obligation to perform the audit with professional scepticism.

6. SANCTIONS AGAINST GT

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

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

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

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

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

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

6.3. Executive Counsel imposes the following Sanctions on GT:

6.3.1. A declaration that the Statutory Audit Report for each of the FY15, FY16 and FY17 Audits signed on behalf of GT did not satisfy the Relevant Requirements, as set out in this Final Decision Notice;

6.3.2. A published statement, in the form of a Severe Reprimand;

6.3.3. A financial sanction of £4 million adjusted for aggravating and mitigating factors (in particular reflecting an exceptional level of co-operation) by a reduction of 10%, and further discounted for admissions and early disposal by 35% so that the financial sanction payable is £2.34 million; and

6.3.4. Non-financial sanctions, in the form of an order pursuant to Rule 96(c) of the AEP, requiring GT to take remedial action to prevent the recurrence of the breaches:

- 6.3.4.1. GT to report to the FRC's Executive Counsel and Executive Director of Supervision annually for a period of three years on the remedial action taken as a result of these breaches, and the impact on audit quality. The report is to be in a format and to include key metrics agreed with the FRC. At the end of the reporting period, or at such other time to be agreed between the FRC and GT, GT to provide a Root Cause Analysis of the reasons for the breaches, why the firm's processes and controls did not prevent the breaches and whether the firm's current processes would lead to a different outcome, and any further remedial action proposed;
- 6.3.4.2. GT to undertake a review of the audit practice's culture relating to challenge and to provide a report and proposed actions to the FRC's Executive Counsel and Executive Director of Supervision. GT to report on the progress of the actions taken as a result of this review and the impact of those actions on audit quality, annually for three years. This report is in addition to, but may form part of, the annual reporting set out at paragraph 6.3.4.1.
- 6.3.4.3. GT to undertake additional monitoring in relation to bank and cash work, including the involvement of the RI and Engagement Quality Control Reviewer, on a selection of audits to include at least one audit per RI over a period of three years. GT to report to the FRC's Executive Counsel and Executive Director of Supervision a summary of the outcomes of the additional monitoring, and any proposed remedial action to address issues identified, annually for three years. This report is in addition to, but may form part of, the annual reporting set out at paragraph 6.3.4.1.

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

Nature, seriousness, gravity and duration of the breaches

- 6.5. As a result of the breaches of Relevant Requirements, each of the FY15, FY16 and FY17 Audits failed in their principal objectives, namely to obtain reasonable assurance about whether the financial statements as a whole were free from material misstatement, whether caused by fraud or error.
- 6.6. The breaches of the Relevant Requirements:
 - 6.6.1. were serious and numerous;
 - 6.6.2. were pervasive and extensive throughout numerous important areas of the Audits, and across several legal entities in the Group;

6.6.3. were of a basic and fundamental nature, evidencing a serious lack of competence in conducting the Audits; and

6.6.4. were repeated over three audit years.

6.7. The audit areas relevant to the breaches (including Cash, Revenue and Journals), and the Relevant Requirements breached, are fundamental to statutory audits and it is of the utmost importance that the Relevant Requirements are complied with. The breaches reveal a pattern of serious failures to conduct the Audits over a three year period with appropriate professional scepticism and demonstrate appropriate professional judgement. The breaches include repeated failures to scrutinise documents and information and challenge management or properly investigate numerous matters calling out for investigation. Had the Respondents conducted the Audits over the three years in accordance with the Relevant Requirements, they should have identified clear indicators of the risk of material misstatement due to fraud.

6.8. The breaches all had the potential to fail to detect a misstatement in PH's financial statements, and many had the potential to result in material misstatements, which could call into question the truth and fairness of the financial statements.

6.9. The breaches adversely affected, or potentially adversely affected, a significant number of people in the United Kingdom, including investors, suppliers, employees, pensioners and creditors. PH was an AIM listed company, prior to its suspension following the announcement in October 2018 of the accounting issues. The Group had a large high street presence, in FY17 the financial statements reported 199 trading stores and over 2,500 employees. In 2019, it was announced that, as a result of the administration, 70 stores would close leading to more than 900 job losses.

6.10. The breaches undermine confidence in the truth and fairness of the financial statements published by Statutory Auditors and Statutory Audit, and in standards of conduct in general of Statutory Auditors and Statutory Audit Firms, and in Statutory Audit.

6.11. The breaches were not dishonest, deliberate or reckless.

Identification of Sanction

6.12. Having assessed the nature, seriousness, gravity and duration of the breaches, Executive Counsel has identified the combination of Sanctions specified above as appropriate.

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

Aggravating factors

6.14. GT's disciplinary history:

6.14.1. In 2020, GT was fined £3 million (discounted to £1.95 million for admissions and early disposal) and issued with a Severe Reprimand in relation to firm-wide failures to ensure compliance with ethical standards and requirements between 2014 and 2017 and the loss of independence in relation to its statutory audit of Conviviality Retail Plc for the year ending 30 April 2014, and subject to a declaration that the audit report did not satisfy the Relevant Requirements;

6.14.2. In 2019, GT was fined £650,000 (discounted for admissions and early disposal to £422,500) in relation to its statutory audit of a publicly listed company and subject to a declaration that the firm's 2016 audit report did not satisfy certain Relevant Requirements;

6.14.3. In 2018, GT was fined £4 million (reduced to £3 million for early settlement) and issued with a Severe Reprimand for Misconduct in relation to the loss of independence of its statutory audits of Nichols Plc and the University of Salford for the years ended 2010-2013 inclusive and for related serious and widespread inadequacies in its Manchester Office's control environment and deficiencies in certain of its firmwide policies relating to retiring partners; and

6.14.4. In 2017, GT was fined £3.5 million (reduced to £2.275 million for early settlement) and issued with a Severe Reprimand for Misconduct in relation to its statutory audit of AssetCo plc for the years ended 31 March 2009 and 31 March 2010.

Mitigating factors

6.15. GT has demonstrated contrition and apologised for the breaches.

6.16. GT has undertaken remedial action following its review of the audit work and in response to the breaches of Relevant Requirements identified in the FY15, FY16 and FY17 Audits. Executive Counsel has taken this remedial action into account in determining the appropriate combination of Sanctions. In particular, GT has taken a range of remedial actions in relation to the following areas: professional scepticism, communication between the audit team, fraud, direction, supervision and review, the involvement of the RI, consideration of the entity's control environment and the audit of bank and cash. The

remedial action undertaken in these areas includes training, mandatory standardised working paper templates, the appointment of a Head of Audit Culture, introduction of stand back meetings, review and ongoing monitoring and roadshows to reflect on learning opportunities from the findings in these Audits.

6.17. GT provided an exceptional level of co-operation during the investigation of the breaches by Executive Counsel, responding timeously and thoroughly to requests for documents and information. In particular, at their request they provided a detailed presentation on the findings of their internal review into the FY15, FY16 and FY17 Audits which was helpful and frank, volunteered information and documentation not specifically requested and included certain voluntary admissions on an open basis. They have been willing to waive legal privilege, on a limited basis, in relation to certain aspects of their internal review. Paragraph 69 of the Sanctions Policy provides:

“It is a requirement that Statutory Auditors and Statutory Audit Firms will cooperate with an investigation conducted under the Audit Enforcement Procedure. In order for cooperation to be considered as a mitigating factor at the point of determining appropriate sanction it will therefore be necessary for the Statutory Auditors and Statutory Audit Firms to have provided an exceptional level of cooperation. Non-exhaustive examples of conduct which may constitute such cooperation include:

(a) self-reporting to the FRC and/or bringing to the attention of the FRC any facts and/or matters which may constitute an allegation of a breach of the Relevant Requirements; and

(b) volunteering information or documentation not specifically requested but which the Statutory Auditor / Audit Firm nevertheless considers may assist the investigation.”

6.18. GT did not stand to gain any profit or benefit, beyond the audit fees for each of the Audits, from the breaches of the Relevant Requirements.

6.19. In light of the factors set out above, Executive Counsel considers that a discount to the financial sanction of 10% is appropriate.

Deterrence

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

Discount for Admissions and Settlement

6.21. Having taken into account the admissions made by GT and the stage at which those admissions were made (in Stage 1 of the case in accordance with paragraph 84 of the Policy), Executive Counsel determined that a reduction of 35% as to the financial sanction is appropriate, such that a financial sanction of £2.34 million is payable.

Other considerations

6.22. In accordance with paragraph 47(c) of the Policy, Executive Counsel has taken into account the size / financial resources and financial strength of GT and the effect of a financial sanction on its business.

7. SANCTIONS AGAINST MR NEWSTEAD

7.1. Executive Counsel imposes the following Sanctions on Mr Newstead:

7.1.1. A declaration that the Statutory Audit Report for each of the FY15, FY16 and FY17 Audits signed by Mr Newstead did not satisfy the Relevant Requirements, as set out in this Final Decision Notice;

7.1.2. A published statement, in the form of a Severe Reprimand;

7.1.3. A financial sanction of £150,000 adjusted for aggravating and mitigating factors (in particular reflecting an exceptional level of co-operation) by a reduction of 10%, and further discounted for admissions and early disposal by 35% so that the financial sanction payable is £87,750; and

7.1.4. A temporary prohibition of three years banning Mr Newstead from carrying out Statutory Audits and signing Statutory Audit Reports.

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

Nature, seriousness, gravity and duration of the breaches

7.3. The features of the case set out in relation to GT above equally apply to Mr Newstead.

Identification of Sanction

7.4. Having assessed the nature, seriousness, gravity and duration of the breaches, Executive Counsel has identified the combination of Sanctions specified above as appropriate.

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

Aggravating factors

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

Mitigating factors

7.7. Mr Newstead did not stand to gain any profit or benefit from the breaches of the Relevant Requirements.

7.8. Mr Newstead has a good compliance history and disciplinary record with no prior Sanctions under the AEP or Accountancy Scheme.

7.9. Mr Newstead has demonstrated contrition and apologised for the breaches. Mr Newstead voluntarily surrendered his status as an RI on 1 October 2020, ahead of the Executive Counsel's findings, and has not signed off any audits conducted by GT since 31 July 2020.

7.10. Mr Newstead, through GT, provided an exceptional level of co-operation during the investigation of the breaches by Executive Counsel.

7.11. In light of the factors set out above, Executive Counsel considers that a discount to the financial sanction of 10% is appropriate.

Deterrence

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

Discount for Admissions and Settlement

7.13. Having taken into account the admissions made by GT and the stage at which those admissions were made (in Stage 1 of the case in accordance with paragraph 84 of the Policy), Executive Counsel determined that a reduction of 35% as to the financial sanction is appropriate, such that a financial sanction of £87,750 is payable.

8. COSTS

8.1. Executive Counsel requires that GT pay her costs in the matter, amounting to £651,472.
Such costs shall be paid no later than 28 days after the date of this Final Decision Notice.

Signed:



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CLAUDIA MORTIMORE
DEPUTY EXECUTIVE COUNSEL
Date: 29 July 2021

9. APPENDIX 1 – EXTRACTS OF RELEVANT REQUIREMENTS

International Standards on Auditing (UK and Ireland) (“ISA”)

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

1.1. Paragraph 5 of ISA 200 states as follows:

“As the basis for the auditor’s opinion, ISAs (UK and Ireland⁵) require the auditor to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error. Reasonable assurance is a high level of assurance. It is obtained when the auditor has obtained sufficient appropriate audit evidence to reduce audit risk (that is, the risk that the auditor expresses an inappropriate opinion when the financial statements are materially misstated) to an acceptably low level. However, reasonable assurance is not an absolute level of assurance, because there are inherent limitations of an audit which result in most of the audit evidence on which the auditor draws conclusions and bases the auditor’s opinion being persuasive rather than conclusive”.

1.2. Paragraph 11 of ISA 200 states as follows:

“In conducting an audit of financial statements, the overall objectives of the auditor are:

(a) To obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework; and

(b) To report on the financial statements, and communicate as required by the ISAs, in accordance with the auditor’s findings”.

1.3. Paragraph 13(b)(ii) of ISA 200 states as follows:

“Appropriateness of audit evidence is the measure of the quality of audit evidence; that is, its relevant and its reliability in providing support for the conclusions on which the auditor’s opinion is based”.

1.4. Paragraph 15 of ISA 200 states as follows:

⁵ The revised June 2016 version refers to UK only.

“The auditor shall plan and perform an audit with professional skepticism recognizing that circumstances may exist that cause the financial statements to be materially misstated”.

“In the UK, the auditor shall maintain professional skepticism throughout the audit, recognising the possibility of a material misstatement due to facts or behaviour indicating irregularities, including fraud, or error, notwithstanding the auditor's past experience of the honesty and integrity of the entity's management and of those charged with governance”⁶.

1.5. Paragraph 16 of ISA 200 states as follows:

“The auditor shall exercise professional judgment in planning and performing an audit of financial statements”.

1.6. Paragraph A22 of ISA 200 states as follows:

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

1.7. Paragraph A29 of ISA 200 states as follows:

“The sufficiency and appropriateness of audit evidence are interrelated. Sufficiency is the measure of the quantity of audit evidence. The quantity of audit evidence needed is affected by the auditor's assessment of the risks of misstatement (the higher the assessed risks, 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). Obtaining more audit evidence, however, may not compensate for its poor quality”⁷.

“Professional judgment needs to be exercised throughout the audit. It also needs to be appropriately documented. In this regard, the auditor is required to prepare audit documentation sufficient to enable an experienced auditor, having no previous connection with the audit, to understand the significant professional judgments made in

⁶ Text in grey appears in the revised June 2016 version only.

⁷ This paragraph appears in the October 2009 version only.

*reaching conclusions on significant matters arising during the audit. Professional judgment is not to be used as the justification for decisions that are not otherwise supported by the facts and circumstances of the engagement or sufficient appropriate audit evidence*⁸.

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

2.1. Paragraph 8 of ISA 220 states as follows:

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

2.2. Paragraph 15(a) of ISA 220 states as follows:

“The engagement partner shall take responsibility for:

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

2.3. Paragraph 16 of ISA 220 states as follows:

“The engagement partner shall take responsibility for reviews being performed in accordance with the firm’s review policies and procedures”.

2.4. Paragraph A15.3 of ISA 220 states as follows:

“Supervision includes matters such as:

- *Addressing significant matters arising during the audit engagement, considering their significance and modifying the planned approach appropriately”*

2.5. Paragraph A17.2 of ISA 220 states as follows:

“A review consists of consideration whether, for example:

- *Significant matters have been raised for further consideration;”*

3. ISA 230 – Audit Documentation

3.1. Paragraph 5 of ISA 230 states as follows:

“The objective of the auditor is to prepare documentation that provides:

- (a) A sufficient and appropriate record of the basis for the auditor’s report; and*

⁸ This paragraph appears in the revised June 2016 version only.

(b) Evidence that the audit was planned and performed in accordance with ISAs (UK and Ireland⁹) and applicable legal and regulatory requirements”.

3.2. Paragraph 8 of ISA 230 states as follows:

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

(a) The nature, timing and extent of the audit procedures performed to comply with the ISAs (UK and Ireland¹⁰) and applicable legal and regulatory requirements;

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

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

8D-1 The auditor shall retain any other data and documents that are important in supporting the auditor’s report as part of the audit documentation”¹¹.

4. ISA 240 - Auditor’s Responsibilities relating to Fraud

4.1. Paragraph 8 of ISA 240 states as follows:

“When obtaining reasonable assurance, the auditor is responsible for maintaining professional skepticism throughout the audit, considering the potential for management override of controls and recognizing the fact that audit procedures that are effective for detecting error may not be effective in detecting fraud. The requirements in this ISA (UK and Ireland¹²) are designed to assist the auditor in identifying and assessing the risks of material misstatement due to fraud and in designing procedures to detect such misstatement”.

4.2. Paragraph 12 of ISA 240 states as follows:

“In accordance with ISA (UK and Ireland¹³) 200, the auditor shall maintain professional skepticism throughout the audit, recognizing the possibility that a material misstatement due to fraud could exist, notwithstanding the auditor’s past experience of the honesty and integrity of the entity’s management and those charged with governance”.

4.3. Paragraph 13 of ISA 240 states as follows:

⁹ The revised June 2016 version refers to UK only.

¹⁰ The revised June 2016 version refers to UK only.

¹¹ Text in grey appears in the revised June 2016 version only.

¹² The revised June 2016 version refers to UK only.

¹³ The revised June 2016 version refers to UK only.

“Unless the auditor has reason to believe the contrary, the auditor may accept records and documents as genuine. If conditions identified during the audit cause the auditor to believe that a document may not be authentic or that terms in a document have been modified but not disclosed to the auditor, the auditor shall investigate further”.

4.4. Paragraph 31 of ISA 240 states as follows:

“Management is in a unique position to perpetrate fraud because of management’s ability to manipulate accounting records and prepare fraudulent financial statements by overriding controls that otherwise appear to be operating effectively. Although the level of risk of management override of controls will vary from entity to entity, the risk is nevertheless present in all entities. Due to the unpredictable way in which such override could occur, it is a risk of material misstatement due to fraud and thus a significant risk”.

4.5. Paragraph 32(a) of ISA 240 states as follows:

“Irrespective of the auditor’s assessment of the risks of management override of controls, the auditor shall design and perform audit procedures to:

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

(i) Make inquiries of individuals involved in the financial reporting process about inappropriate or unusual activity relating to the processing of journal entries and other adjustments;

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

(iii) Consider the need to test journal entries and other adjustments throughout the period”.

4.6. Paragraph A29 of ISA 240 states as follows:

“The risks of fraud in revenue recognition may be greater in some entities than others. For example, there may be pressures or incentives on management to commit fraudulent financial reporting through inappropriate revenue recognition in the case of listed entities when, for example, performance is measured in terms of year-over-year revenue growth or profit. Similarly, for example, there may be greater risks of fraud in revenue recognition in the case of entities that generate a substantial portion of revenues through cash sales”.

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

5.1. Paragraph 9 of ISA 265 states as follows:

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

6. ISA 315 – Identifying and Assessing the Risks of Material Misstatement through understanding the Entity and its Environment

6.1. Paragraph 13 of ISA 315 states as follows:

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

6.2. Paragraph 18(f) of ISA 315 states as follows:

“The auditor shall obtain an understanding of the information system, including the related business processes, relevant to financial reporting, including the following areas:

(f) Controls surrounding journal entries, including non-standard journal entries used to record non-recurring, unusual transactions or adjustments”.

6.3. Paragraph 29 of ISA 315 states as follows:

“If the auditor has determined that a significant risk exists, the auditor shall obtain an understanding of the entity’s controls, including control activities, relevant to that risk”.

7. ISA 330 - Responses to Assessed Risks

7.1. Paragraph 18 of ISA 330 states as follows:

“Irrespective of the assessed risks of material misstatement, the auditor shall design and perform substantive procedures for each material class of transactions, account balance, and disclosure”.

7.2. Paragraph 21 of ISA 330 states as follows:

“If the auditor has determined that an assessed risk of material misstatement at the assertion level is a significant risk, the auditor shall perform substantive procedures that are specifically responsive to that risk. When the approach to a significant risk consists only of substantive procedures, those procedures shall include tests of details”.

7.3. Paragraph 28(c) of ISA 330 states as follows:

“The auditor shall include in the audit documentation:

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

8. ISA 500 – Audit Evidence

8.1. Paragraph 5(e) of ISA 500 states as follows:

“For purposes of the ISAs (UK and Ireland¹⁴), the following terms have the meanings attributed below:

(e) Sufficiency (of audit evidence) – The measure of the quantity of audit evidence. The quantity of the audit evidence needed is affected by the auditor’s assessment of the risks of material misstatement and also by the quality of such audit evidence.”

8.2. Paragraph 6 of ISA 500 states as follows:

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

8.3. Paragraph 11 of ISA 500 states as follows:

“If:

(a) audit evidence obtained from one source is inconsistent with that obtained from another; or

(b) the auditor has doubts over the reliability of information to be used as audit evidence, the auditor shall determine what modifications or additions to audit procedures are necessary to resolve the matter, and shall consider the effect of the matter, if any, on other aspects of the audit.”

ICAEW Code of Ethics

9. Section 130 – Professional Competence and Due Care

9.1. Paragraph 130.1(b) of the ICAEW Code of Ethics states as follows:

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

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

¹⁴ The revised June 2016 version refers to UK only.