IN THE MATTER OF

THE EXECUTIVE COUNSEL OF THE FINANCIAL REPORTING COUNCIL

-and-

(1) PRICEWATERHOUSE COOPERS LLP

(2) MR PHILIP STORER

EXECUTIVE COUNSEL'S FINAL SETTLEMENT DECISION NOTICE

Pursuant to Rule 108 of the Audit Enforcement Procedure

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

1. INTRODUCTION

1.1. The Financial Reporting Council (the "**FRC**") is the competent authority for statutory audit in the UK and operates the Audit Enforcement Procedure (the "**AEP**"), effective 5 January 2022. The AEP sets out the rules and procedure for the investigation, prosecution and sanctioning of breaches of *Relevant Requirements*.

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

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

1.3.1. "**FY2018**" means the financial year ended 30 November 2018, "**FY2018 financial statements**" means Eddie Stobart Logistics plc's ("**ESL**" or "**the Group**") consolidated financial statements for that period, and "**FY2018 Audit**" means the statutory audit of the FY2018 financial statements.

1.4. Pursuant to Rule 19(b) of the AEP, Executive Counsel has decided that

PriceWaterhouseCoopers LLP ("**PwC**") and Mr Philip Storer ("**Mr Storer**") are liable for Enforcement Action, having found breaches of *Relevant Requirements*.

1.5. A *Proposed Settlement Decision Notice* was issued by Executive Counsel on 13 March 2023 pursuant to Rule 103 of the AEP in respect of the conduct of:

1.5.1. PwC in relation to the FY2018 Audit. PwC was the *Statutory Audit Firm* for the FY2018 Audit.

1.5.2. Mr Storer, a partner of PwC in relation to the FY2018 Audit. For FY2018, he was the *Statutory Auditor* of ESL and signed off the FY2018 audit report on behalf of PwC.

1.6. PwC and Mr Storer provided written agreement to the *Proposed Settlement Decision Notice*, pursuant to Rule 105 of the AEP, on 17 and 21 March 2023 respectively. The *Convener* subsequently appointed an *Independent Reviewer*, pursuant to Rule 106 of the AEP, to consider the *Proposed Settlement Decision Notice.*

1.7. On 28 March 2023, the *Independent Reviewer* approved the issuance of a *Final Settlement Decision Notice* pursuant to Rule 107(a) of the AEP.

1.8. In this *Final Settlement Decision Notice*, PwC and Mr Storer are referred to as the "**Respondents**".

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

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

1.9.2. the *Sanctions* imposed on the Respondents with reasons; and

1.9.3. the amount payable by the Respondents in respect of Executive Counsel's *Costs*.

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

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

1.10.2. Section 3: Background;

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

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

1.10.5. Section 6 and 7: *Sanctions*;

1.10.6. Section 8: *Costs.*

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

2.1. The breaches of *Relevant Requirements* in this *Final Settlement Decision Notice* relate to six areas of the audit:

First year audit procedures

2.1.1. Given that the FY2018 Audit was an "initial audit engagement" as defined in the auditing standards, PwC were required to consider how to address the reasons given by their predecessor KPMG LLP ("**KPMG**") for their resignation given that

they gave rise to potentially difficult or contentious matters. This should have resulted in a formal consultation with PwC Audit Risk and Quality. However, Mr Storer failed to initiate any such formal consultation.

Property transactions

2.1.2. PwC understood that the accounting for certain property and consultancy transactions entered into by ESL was an important judgement, and that the difficulties experienced by KPMG in the course of their audit of the property transactions was one of the reasons for their resignation. However, PwC and Mr Storer failed to identify revenue recognition on these transactions as a significant risk of material misstatement.

2.1.3. PwC and Mr Storer should have initiated a formal consultation on the technical aspects of accounting for these transactions, but failed to do so.

2.1.4. PwC and Mr Storer failed to challenge the selection of management's accounting policy. They did not obtain sufficient evidence of the services ESL had provided in the transactions. They accordingly failed to obtain a proper understanding of these transactions.

2.1.5. Furthermore, they wrongly reported (i) to the Audit Committee; (ii) in the audit report on ESL's FY2018 financial statements, that they had challenged management's selected accounting policy, and so failed to provide an accurate summary of their response to this matter and carry out procedures they deemed to be necessary.

Disclosure in the FY2018 Financial Statements concerning the property transactions

2.1.6. ESL, a transport and logistics company, had been entering into certain property transactions since 2016. Without the profit generated from the property transactions, ESL would have been in a loss making position. However, this was not made clear by the disclosures set out in the FY2018 financial statements. The disclosures in the FY2018 financial statements did not adequately reflect the requirements of the accounting standard IAS 1 (Presentation of Financial Statements) ("**IAS 1**"). They did not make it clear that the revenue earned by ESL was akin to profit, because there were virtually no costs incurred beyond the expenditure of management time. The disclosures did not adequately explain the impact of the property transactions on ESL's financial performance.

2.1.7. PwC and Mr Storer failed to properly evaluate whether the disclosures about the property transactions were adequate to enable users of the FY2018 financial statements to understand the impact of the transactions on profit.

Property lease accruals

2.1.8. ESL entered into various property leases, and where the lease agreements included planned rental increases, an accrual should have been calculated.

PwC and Mr Storer failed to design audit procedures that would identify historical leases where no accrual had previously been made. They also failed to document any consideration of whether the audit strategy needed to be updated when evidence that had been sought was unavailable.

Dilapidations provision

2.1.9. PwC and Mr Storer failed to design audit procedures that would identify historical leases which may have reached a point where a dilapidations provision should be considered.

The consolidation of investment in a company

2.1.10. In July 2017 ESL acquired 50% of the shares in a company ("**the investee company**"). PwC concluded that the investee company should be accounted for as a subsidiary, and not as an associate. However, in reaching that conclusion Mr Storer failed to appropriately consider the available information. He also failed to record the basis for the conclusion that ESL exercised control over the investee company. Accordingly, PwC and Mr Storer failed to properly evaluate whether ESL controlled the investee company.

2.2. As is set out in this *Final Settlement Decision Notice*, there were numerous and pervasive failures by the Respondents in the manner in which the FY2018 Audit was conducted. The audit failed in its principal objective: that of providing reasonable assurance that the FY2018 financial statements were free from material misstatement.

2.3. As referred to at paragraph 2.1 above, the breaches of *Relevant Requirements* in this *Final Settlement Decision Notice* relate to six areas of the audit:

2.3.1. First year audit procedures;

2.3.2. Property transactions;

2.3.3. Disclosure in the FY2018 financial statements concerning the property transactions;

2.3.4. Property lease accruals;

2.3.5. Dilapidations provision; and

2.3.6. The consolidation of an investment in a company.

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

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

<u>PwC</u>

2.5.1. A financial sanction of £3.5 million adjusted for aggravating and mitigating factors (in particular reflecting an exceptional level of co-operation) by a reduction of 12.5%, and further discounted for admissions and early disposal by 35%, so that the financial sanction payable is £1,990,625;

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

2.5.3. a declaration that the FY2018 audit report signed on behalf of PwC did not satisfy the *Relevant Requirements*, as set out in this *Final Settlement Decision Notice*; and

2.5.4. a non-financial sanction requiring PwC to report to the FRC on (i) its monitoring of its audit teams' compliance with its policies regarding consultations; and (ii) its training in this area of new audit partners.

<u>Mr Storer</u>

2.5.5. A financial sanction of £90,000 adjusted for aggravating and mitigating factors (in particular reflecting an exceptional level of co-operation) by a reduction of 12.5%, and further discounted for admissions and early disposal by 35%, so that the financial sanction payable is £51,187.50;

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

2.5.7. a declaration that the FY2018 audit report signed by Mr Storer did not satisfy the *Relevant Requirements*, as set out in this *Final Settlement Decision Notice.*

2.6. Executive Counsel highlights that the discounts given for exceptional co-operation and settlement reflect that the Respondents admitted the breaches of *Relevant Requirements,* offering admissions at a relatively early stage in the investigation, including admissions relating to matters which were not in the communicated scope of the investigation; they have shown insight into their failings; and prior to this *Final Settlement Decision Notice*, PwC imposed remedial actions to prevent recurrence of the breaches.

3. BACKGROUND

3.1. In 2018, PwC was ranked as the largest audit firm in the UK, with revenues of £3,764m and 915 audit principals. FY2018 was PwC's first year as the *Statutory Audit Firm* for ESL.

3.2. Mr Storer was a partner of PwC, with 24 years auditing experience. He signed the FY2018 audit report, on behalf of PwC, in respect of the FY2018 financial statements.

3.3. The Respondents' statutory responsibility was to form an opinion as to whether the FY2018 financial statements showed a true and fair view and had been properly prepared in accordance with IFRS and the Companies Act 2006.

3.4. ESL was first listed on the Alternative Investment Market ("**AIM**") on 25 April 2017, having previously been privately held. ESL was previously named Greenwhitestar UK Plc. It operated in the supply chain, transport and logistics business.

3.5. As a listed entity ESL was required to prepare financial statements in accordance with International Financial Reporting Standards ("**IFRS**").

3.6. KPMG had performed the audit of the FY2017 Financial Statements.

3.7. KPMG later resigned as auditor to ESL. The letter of resignation dated 27 November 2018 explained that there had been a breakdown in KPMG's relationship with management following difficulties in obtaining sufficient appropriate audit evidence during the FY2017 Audit.

3.8. PwC were subsequently appointed as auditors for the FY2018 Audit.

3.9. An audit involves obtaining sufficient appropriate "audit evidence" about the amounts and disclosures in financial statements in order to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error.

3.10. Audit evidence is defined in International Standard on Auditing (UK) ("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.

3.11. In July 2019 ESL announced that a review had been conducted into the Group's prior year financial statements and that a number of matters would be addressed by means of Prior Year Adjustments ("**PYAs**"). The interim results for the 6 months ended 31 May 2019 ("**the 2019 interims**") were published on 26 February 2020 and included a number of PYAs, as detailed below. Some of these PYAs related to FY2018.

3.12. The background to the breaches of *Relevant Requirements* can be briefly summarised as follows:

<u>Breach 1: First year audit procedures</u>

3.13. The FY2018 Audit was an "initial audit engagement" as defined in the auditing standards. PwC reviewed the prior year work papers prepared by KPMG and identified a number of points to be followed up in the FY2018 Audit.

3.14. There was some communication with KPMG concerning the reasons for their resignation, which was described in a letter from the relevant audit partner at KPMG to ESL (a copy of which was provided to Mr Storer) as arising from "…*a breakdown in our relationship with management which followed difficulties in obtaining sufficient appropriate audit evidence during our audit of the Company and its subsidiaries for the year ended 30 November 2017, although that information was ultimately obtained"*.

<u>Breaches 2 and 3: Property transactions</u>

3.15. The FY2018 financial statements disclosed a total of £19.2 million property-related revenue and an additional £15.0m from property-related consultancy services. This accounted for 4.1% of the Group's total revenue but 91% of operating profit (before exceptional items) and 144% of total profit before tax, because there were almost no direct costs associated with this revenue (the only costs being management time).

3.16. The £19.2m property-related revenue was principally derived from transactions where a third party ("the Third Party") conducted the initial purchase and onward sale of warehouse properties where ESL subsequently took out a lease ("the Third Party transactions"). Under a profit-sharing agreement, ESL received between 90% and 100% of the profit from the sale of each property, and the Third Party received the remainder of the profit. The relevant Third Party transactions were referred to as [Property Transaction A, Property Transaction B, and Property Transaction C]. The consultancy services transaction was referred to as [Property Transaction D] and there was a further transaction included in the £19.2m of property related revenue referred to as [Property Transaction E].

3.17. The FY2018 financial statements included disclosure of the accounting policy for "Sales of Services – Property" and "Sales of services – Consultancy" as follows:

"(e) Sales of services – Property

At certain sites where the Group has entered into leases, arrangements have been entered into with a third party, under which the Company received fees for property-related advisory services. Revenue earned from providing property associated services is recognised in the Consolidated Income Statement at fair value of the consideration received or receivable, net of professional fees, associated costs and VAT.

The Group continues to be successful in providing property-related services including to third party investors as part of its core strategy and the growth of its warehousing estate. It has earned fees of £19.2m (2017 £10.4m) with a strong pipeline of further projects and work going into 2019. The Directors have made the judgement that the fees are payments for the provision of property services to a third party investor that may be recorded as revenue at the time of the transactions.
In forming that judgement the Company has considered whether the leases it has entered into are operating leases and whether the future rentals are at market value and accordingly, whether fees received can be attributed to delivered property services.

(f) Sale of services – Consultancy

In line with the stated strategy of consulting-led logistics, the Group offers a range of consultancy services including property, logistics, IT consulting and integration services. In the year to 30 November 2018 revenue from these services totalled £15.0m (2017: £6.7m)".

3.18. The accounting treatment of these transactions was a very important judgement. If the revenue was allocated solely to services, this resulted in the amounts being recognised in full as revenue up front, whereas if they were allocated solely to the lease that was subsequently taken on the property, then the revenue would be spread over the term of

the lease as a lease incentive. If they were considered to relate in part to services and in part to lease incentives, then the profit would be apportioned between the respective elements and accounted for accordingly.

3.19. Paragraph 1 of SIC-15 (*Operating Leases – incentives*) provides:

> *1.1.1 "In negotiating a new or renewed operating lease, the lessor may provide incentives for the lessee to enter into the agreement. Examples of such incentives are an up-front cash payment to the lessee or the reimbursement or assumption by the lessor of costs of the lessee (such as relocation costs, leasehold improvements and costs associated with a pre-existing lease commitment of the lessee). Alternatively, initial periods of the lease term may be agreed to be rent-free or at a reduced rent."*

3.20. Mr Storer consulted a member of PwC's technical accounting team who advised that the key consideration was whether the related leases were at or below market rate. However, no formal technical consultation was conducted.

3.21. In the FY2018 financial statements, the property-related revenue was recognised in full as revenue up-front.

3.22. The 2019 interims explained that the Group had determined that the more appropriate way to account for these property and consultancy transactions was to treat all the consideration as a lease incentive and allocate no revenue to consultancy services. PYAs were made, and the FY2018 revenue for the property and consultancy transactions was reversed and restated, with the amount recognised over the life of the lease.

<u>Breach 4: Property lease accrual</u>

3.23. ESL entered into various operating leases for property. Where these agreements included planned rental increases, an accrual should have been calculated and included.

3.24. PwC's audit work focussed on the liability recorded in the FY2018 financial statements, including an assessment of opening balances and a recalculation of closing balances. However, no audit procedures were designed to test the completeness of the accrual by identifying historical leases where no accrual had previously been made.

3.25. The 2019 interims identified that there had been an under-accrual in prior years. Lease accounting adjustments relating to FY2018 totalled £1.8m.

<u>Breach 5: Dilapidations provision</u>

3.26. Dilapidations clauses are commonly included in lease agreements, and refer to the work a tenant is required to carry out, including repairs and maintenance, in order to preserve the property.

3.27. ESL had long-term leases in its property portfolio which were subject to dilapidations

clauses. However, it was understood by PwC that management had determined that related provisions were not required.

3.28. The 2019 interims stated:

"Historically, the Group has determined that dilapidations provisions were not required as there is a policy to ensure warehouses are maintained to a very high standard.

Given the expansion of the warehouse portfolio….that are subject to dilapidation clauses, that determination has been reviewed and the financial statements have been restated to reflect a dilapidation provision This has resulted in an increased income statement charge of £0.7m in 2018, and £5.7m in respect of previous periods".

<u>Breach 6: Consolidation of investment in a company</u>

3.29. In July 2017 ESL acquired 50% of the shares in the investee company which was described in the FY2018 financial statements as a company which *"specialises in urgent, same or next day deliveries of urgent cargos for commercial and domestic customers across the UK and Europe"*. Management determined that ESL exercised control over the investee company and so consolidated the results of the investee company within the Group accounts. The circumstances in which an investor controls an investee are governed by IFRS 10.

3.30. The FY2018 financial statements record the position as follows:

"The Group has effective control over the operating activities of [the investee company]*, a franchise delivery model business incorporated in the United Kingdom and therefore consolidates* [the investee company] *in its financial statements in accordance with IFRS 10".*

3.31. Had the acquisition been accounted for as an associate, the equity method of accounting would have been appropriate, and would have resulted in only ESL's 50% share of the profit or loss of the investee company being recognised in the FY2018 financial statements.

3.32. The 2019 interims stated that the control issue had been reconsidered and it was determined that it was more appropriate to account for the investee company as an associate, and therefore not to consolidate its results.

4. RELEVANT REQUIREMENTS

4.1. Rule 1 of the AEP states that *Relevant Requirements* has the meaning set out in regulation 5(11) of the Statutory Auditors and Third Country Auditors Regulations 2016 ("**SATCAR**"). The *Relevant Requirements* 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 Settlement Decision Notice* are those

effective for audits of financial statements for periods ending on or after 17 June 2016.

4.3. The *Relevant Requirements* referred to in this *Final Settlement Decision Notice*, listed in the order in which they first appear, are the following:

4.3.1. Paragraph 18 of ISA 220 (Quality Control for an Audit of Financial Statements);

4.3.2. Paragraph 27 of ISA 315 (Identifying and Assessing the Risks of Material Misstatement Through Understanding of the Entity and Its Environment);

4.3.3. Paragraphs 15, 16 and 17 of ISA 200 (Overall objectives of the independent auditor and the conduct of an audit in accordance with international standards on auditing);

4.3.4. Paragraphs 5 and 6 of ISA 330 (the Auditor's Responses to Assessed Risks);

4.3.5. Paragraph 16 of ISA 260 (Communication With Those Charged With Governance);

4.3.6. Paragraph 13(b) of ISA 701 (Communicating Key Audit Matters in the Independent Auditor's Report);

4.3.7. Paragraph 10 of ISA 300 (Planning an Audit of Financial Statements);

4.3.8. Paragraph 9 of ISA 500 (Audit Evidence); and

4.3.9. Paragraph 13(e) of ISA 700 (Forming an Opinion and Reporting on Financial Statements);

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

4.5. Under the AEP acts and omissions of PwC employees and partners within the scope of relevant audit engagements are to be attributed to PwC. Consequently the conduct of PwC's employees and partners described in this *Final Settlement Decision Notice* is to be treated as the conduct of PwC.

4.6. As the Senior *Statutory Auditor* responsible for the FY2018 Audit, Mr Storer was responsible for the overall quality of the FY2018 Audit and the direction, supervision, and performance of the FY2018 Audit in compliance with the professional standards and applicable legal and regulatory requirements. Accordingly, Mr Storer is responsible for all breaches of Relevant Requirements in relation to the FY2018 Audit.

5. BREACHES OF *RELEVANT REQUIREMENTS*

<u>Breach 1 – First year audit procedures</u>

5.1. In a presentation to the FRC in September 2020, PwC explained the following:

> *"PwC became aware of KPMG's resignation reasons in a meeting with* [the KPMG audit partner] *on 6 September 2019.*
>
> *It was explained that KPMG's reasons were due to the audit being "challenging" due, in part, to the structure of the company (e.g. lots of divisions and sub-ledgers) meaning*

that receipt of audit evidence was sometimes slow.

[The Audit Committee Chair at ESL] *explained to PwC that the company accepted that management could have nurtured a better/more transparent relationship with the auditor by being more timely and forthcoming with information.*

…

One specific matter raised by KPMG was in relation to property transactions that had been identified by KPMG late in the FY17 audit process. It was noted that KPMG had been frustrated that management had not drawn this to their attention sooner, although it was confirmed by KPMG that they were, in the end, able to obtain sufficient appropriate audit evidence to support their audit opinion".

5.2. The PwC work papers do not include any minutes of the meeting with the KPMG audit partner, or any record of how the issues raised at this meeting were considered by the PwC audit team.

5.3. On 27 September 2018 Mr Storer approved the *"Acceptance and Continuance"* checklist, stating:

"We have met with the AC Chair, Senior Management and the incumbent KPMG audit partner. Nothing has come to our attention to suggest it is not appropriate to take part in this audit tender".

5.4. Mr Storer ticked the box *"Communications with prior auditors are still underway"*, but did not tick the box *"Prior auditor resigned or declined to be reappointed for reasons that reflect adversely on the entity and/or indicate a lack of integrity on the part of management"*.

5.5. Later, on 8 November 2018, the KPMG audit partner sent an email to Mr Storer attaching a draft professional etiquette letter and *"the statement of circumstances to which it refers"*. The statement of reasons, provided under section 519 of the Companies Act 2006, stated:

"Our reason for resigning is due to a breakdown in our relationship with management which followed difficulties in obtaining sufficient appropriate audit evidence during our audit of the Company and its subsidiaries for the year ended 30 November 2017, although that information was ultimately obtained".

Failure to consult PwC Audit Risk and Quality

5.6. While the meetings Mr Storer had held with the company and KPMG provided him with an understanding of the circumstances surrounding KPMG's resignation, the PwC work papers do not include any record of how the issues raised by KPMG were considered by the audit team.

5.7. The reasons given by KPMG for their resignation gave rise to a difficult and contentious

matter for the purposes of ISA 220 cited below, which should have resulted in a formal consultation with Audit Risk and Quality at PwC. No such consultation was initiated by Mr Storer.

5.8. In light of the foregoing, Mr Storer breached paragraph 18 of ISA 220, which provides that:

"The engagement partner shall:

(a) Take responsibility for the engagement team undertaking appropriate consultation on difficult or contentious matters;

…"

<u>Breach 2 – Property transactions</u>

<u>Audit planning</u>

5.9. From an early stage in their work, the audit team were aware that difficulties arising from the audit of the property transactions were one of the reasons behind the resignation of KPMG, and that the accounting for property and consultancy revenue was an important judgement.

5.10. The note of the audit planning meeting on 29 October 2018 records that Mr Storer noted:

"…that we should remain particularly sceptical around potential related parties in connection with property transactions. We should therefore perform additional procedures in particular on [the Third Party] *and consultancy businesses in connection with property transactions.*

… there is a significantly material revenue impact from property transactions which needs to be considered whether appropriate to recognise during the year.

Manipulation is deemed to be the riskiest area in the business, particularly around management incentives that could result in pay outs based on performance e.g. extra credit to the P&L either through increasing revenue or reducing costs."

5.11. On 11 December 2018 Mr Storer sent an email to the PwC Engagement Senior Manager:

"…the absolute key to this is understanding exactly what ESL had to do to earn their 90% profit share – what is the commercial rationale?

…

So, what exactly did ESL do and what did [the Third Party] *do in this transaction> What was the "balance of effort/input"? Who found the site/conducted negotiations etc…*

…

As you say, risk is that ESL are earning their 90% profit share by agreeing to be the

tenant – that's why [the property purchaser in the transaction] *buy it – in which case could there be an argument for spreading the credit. That says; looks like ESL have absolutely nothing more to do in the purchase and subsequent sale transaction – ie they have discharged all their responsibilities?"*

5.12. The Audit Strategy Memorandum, presented to the Audit Committee on 25 January 2019, referred to the recognition of the property transactions under the heading *"Business Developments/key issues impacting the audit"*.

"Total profit of £33m has been recognised on the following property transactions during the year: [Property Transactions A – E] *(prior year: c£17m). Our work will focus on the recognition and disclosure of these transactions given the significant impact they have on the overall group result."*

5.13. The Audit Strategy Memorandum classified accounting for the property transactions as an 'elevated risk'. It stated:

"Certain individual transactions may have a material impact on the group's results and may be complex in nature…We will obtain supporting documentation for such transactions and obtain third party evidence as appropriate. We will ensure profit recognition and disclosures are appropriate".

5.14. The Engagement Team originally assessed the risk of material misstatement in property transactions to be a normal risk. Following discussions with the audit engagement quality review partner ("**EQCR**") the Engagement Team increased the risk to elevated.

5.15. The Engagement Team tested 100% of the revenue earned from the property transactions, discussed the disclosure of the transactions further with the EQCR and included them as a separate key audit matter in the Audit Opinion.

5.16. However, given the matters considered by the audit team during the audit planning, the Respondents should have identified revenue recognition on the property transactions as a significant risk of material misstatement which required special audit consideration. Had they done so, more extensive audit procedures and consultation would have been required. However, the Respondents failed to classify revenue recognition on the property transactions as a significant risk.

5.17. In light of the foregoing, PwC and Mr Storer breached paragraph 27 of ISA 315, which provides that:

"As part of the risk assessment as described in paragraph 25, the auditor shall determine whether any of the risks identified are, in the auditor's judgment, a significant risk…."

Property Transactions A, B and C: the Third Party property transactions

5.18. PwC's work on the property transactions was recorded in the work paper *"Test property transactions"* and was summarised in the file note *"ESL property final for file"*. The file

note states that in each of Property Transaction A, Property Transaction B and Property Transaction C, ESL and the Third Party worked together to identify the property and negotiate the purchase price. The Third Party then acquired the property and negotiated the forward sale, generating a profit. ESL subsequently took a lease on the property at below market rate.

5.19. Despite the matters identified by the Respondents concerning the accounting treatment for property transactions at the planning stage, the file note does not set out any consideration of the appropriate accounting treatment for the Property Transactions B and C leases, except to test in both cases that the rental was at below market rate. In respect of Property Transaction A, the file note states:

> *"It is therefore reasonable to conclude that one of the reasons* [the property purchaser in the transaction] *was prepared to pay a premium to acquire the property is because ESL would be their tenant.*
>
> *As above, we therefore considered whether the 2 transactions (i.e. the receipt of the £4.2m and the lease of the warehouse) needed to be considered together.*
>
> *We have concluded that it is appropriate to recognise the £4.2m for the following reasons:*
>
> - *£4.2m cash has been received on 25/05/18;*
> - *ESL has earned its share of the profit through working with* [the Third Party] *to identify the property as well as agreeing to be the tenant;*
> - *ESL are paying a below market rent to occupy the warehouse, it would therefore seem illogical to consider spreading any of the profit earned over the term of the lease with* [the property purchaser in the transaction]*".*

<u>Property Transaction D: the consultancy property transaction</u>

5.20. In respect of Property Transaction D, PwC's work papers recorded that:

- ESL identified the site as a suitable location for a warehouse.
- The company party to the transaction offered ESL the opportunity to assist with the development of the site, for a fee of £15 million.
- The deal was negotiated and brokered by the Third Party.
- The agreement dated 30 May 2018 states that the services to be provided by ESL were *"providing the consultancy services in respect of* [land relating to Property Transaction D]*"* and *"Enhancing the overall value of* [land relating to Property Transaction D] *by virtue of its position as a cornerstone occupier"*.
- ESL secured a 20 year lease at below market rate for 850,000 sq feet of warehousing at the site post-development.
- Management considered it was appropriate to recognise the £15 million in FY 2018.

5.21. Management's accounting paper stated:

"Services that are being provided to [the company party to the transaction] *can be summarised as follows:*

- ***Planning Support****: provide support in relation to* [land relating to Property Transaction D] *to secure detailed consent for phase 1 of the development site. Provide advice around HGV movements, employment numbers and other logistics requirements.*
- ***Design and Masterplan****: ensure the distribution park is designed and configured to attract future occupiers.*
- ***Project Management support****: Introduce professional advisors/suppliers/contractors to [the company party to the transaction] who have previously developed ES distribution warehouses.*
- ***Introduction of potential tenants to*** [land relating to Property Transaction D]*: ES to attract other occupiers to* [land relating to Property Transaction D]*: exploiting its industry network.*
- ***Future Funding****: ESL have an extensive network of institutional investors. These relationships have been leveraged to attract well priced capital."*

5.22. The PwC file note *"ESL property final for file"* recorded the commercial rationale as follows:

"We have written confirmation from [company party to the transaction] *that ESL had completed all its obligations under the Agreement by the year end;*

The £15m will have been invoiced and received by the time we sign the accounts;

ESL's lease of the new facility will be at below market rent…it would therefore be illogical to consider spreading any of the profit earned by completing the services for [company party to the transaction] *over the term of the lease with another party.*

The overall commercial rationale for the Agreement is as follows:

- *ESL earns its £15m by advising* [company party to the transaction] *by utilising its contacts and expertise of developing such sites;*
- [company party to the transaction] *benefits by realising a profit for the sale to the third party – having ESL as a "cornerstone occupier" clearly enhances the value, however, ESL's input into the development of the site also does so."*

Property Transaction E: the sale and leaseback property transaction

5.23. PwC's work paper explained that ESL had taken out the Property Transaction E lease in 2017. ESL subsequently granted a sublease to a sublessee. At the time of the sublease, ESL had purchased a further 1.2 acres of land to create a separate entrance to a landlocked parcel of land. As at November 2018, the net book value of the land was

£350,000 and it was sold to a purchaser (the landlord to the head lease) for £2.1m, generating a profit of £1.7 million. The existing head lease was modified to increase ESL's annual rental payment by £110,000, and an additional lease between the landlord and ESL was signed in respect of the transport yard (the landlocked parcel of land) for £30,000 per annum.

5.24. The PwC file note *"ESL property final for file"* does not set out any consideration of the appropriate accounting treatment for the Property Transaction E lease, other than a reference to the leaseback being at below market rate.

Failure to conduct a formal technical consultation

5.25. The audit team consulted a partner in PwC's Accounting Consulting Services team ("**the ACS Partner**"). On 28 January 2019 Mr Storer emailed the ACS Partner concerning whether it was appropriate to recognise the profits from these transactions:

"There are 2 things we wanted to run by you:

1) That its appropriate to recognise the profits;

2) Disclosure

1) Subject to being provided with all the necessary evidence we are happy with all of them – [Property Transaction D] *should be fine but only assuming the invoice and receive the cash before we sign off. Main reasons we get there are:*

- *Cash will have been received;*
- *Other parties are 3P/not related;*
- *Subsequent lease rentals are below market rate, alleviating concerns over need to spread the credits;*
- *Landlords are blue chip".*

5.26. A note of a subsequent telephone conversation states:

"[Mr Storer] explained the general rationale/commercial substance of the transactions and noted that ESL have a proven track record of working with a third party (usually [the Third Party]*) to identify undervalued properties.* [The Third Party] *acquire the property and back-to-back sell it to an institutional investor (several in the year being* [anonymised]*) with ESL agreeing to be the tenant going forward. Having ESL as the tenant enhances the value of the property to the new owner and, given their position in the market/reputation, gives them a reliable tenant. Properties are only looked for where ESL has an ongoing/future business need for the additional warehousing space (ie they are not speculative property deals).*

Discussed the general principles of the treatment adopted by the client with [the ACS Partner]*, specifically the basis on which they believed it was appropriate to recognise the revenue. The main drivers to recognise revenue are the fact that (1) ESL has done*

everything it needs to do as part of the transaction; (2) ESL are paying a below market rent for their subsequent lease of the premises. This is absolutely critical as if the rent were not below market rent there could be an argument to spread the credit over the term of the lease. [Mr Storer] *noted to* [the ACS Partner] *that we had engaged our property team … to review ESL's statements regarding market rents etc (o/s at the time of the call).* [The ACS Partner] *agreed that this was the key consideration and it was important for us to get comfortable with the rentals being below market rent.* [The ACS Partner] *also suggested we check our property team were comfortable that these transactions did not seem unusual given their knowledge of the market – ie was it reasonable for such large profits to be generated ?* [Mr Storer] *confirmed we would ensure they had specifically addressed that point."*

5.27. PwC have confirmed that there are no other records of the technical consultation beyond the note of the telephone call between Mr Storer and the ACS Partner.

5.28. The discussion with the ACS Partner took place after the relevant audit procedures had been planned, but before all substantive work had been completed, and so the advice provided by the ACS Partner was not founded on a complete understanding of the transactions. The Respondents should have conducted a formal technical consultation (which PwC methodology termed an "IGLO") on the technical aspects of accounting for the property transactions. An adequately performed formal technical consultation would have, for example, included a fuller analysis of the property transactions and the appropriate treatment of the property related revenue; and consideration of the relevant accounting standards.

5.29. In light of the foregoing, PwC and Mr Storer breached paragraph 18 of ISA 220, which provides that:

"The engagement partner shall:

(a) Take responsibility for the engagement team undertaking appropriate consultation on difficult or contentious matters;
(b) Be satisfied that members of the engagement team have undertaken appropriate consultation during the course of the engagement, both within the engagement team and between the engagement team and others at the appropriate level within or outside the firm;

(c) Be satisfied that the nature and scope of, and conclusions resulting from, such consultations are agreed with the party consulted; and
(d) Determine that conclusions resulting from such consultations have been implemented."

<u>Failure to understand the property transactions</u>

5.30. The file note *"ESL property final for file"* contains no reference to the requirements of accounting standards. The note of the discussion between Mr Storer and the ACS

Partner does not refer to the requirements of IFRS, despite Mr Storer raising the issue that *"if the rent were not below market rent there could be an argument to spread the credit over the term of the lease".* In an update to the file note (27 March 2019), Mr Storer wrote:

- *"We have now received the report from our property team. This concludes that ESL's view that they are paying below market rents is reasonable, albeit, the report notes that the discount may well be less than they state. The report also notes that there is no evidence to suggest that* [the Third Party] *is a related party to ESL.*
- **Based on the report received we have not identified anything to suggest the accounting treatment is unreasonable.** [emphasis added]
- *We have also confirmed the cash from* [Property Transaction D] *has been received.*
- [Property Transaction C] *completion did not take place until post year end. We have been provided with 3 party confirmation that exchange was unconditional at the year end.* [Philip Storer] *also discussed the appropriateness of taking exchange as the trigger for revenue recognition with both* [PwC Partner] *and* [another PwC Partner] *(based on their significant experience of auditing property companies). Both agreed that, whilst completion was the normal trigger point, so long as the exchange was unconditional at the year end, it was reasonable to recognise the revenue."*

5.31. The extent of the challenge made by the audit team was limited to the assessment that rentals were below market rate. This was therefore a challenge only of the application of management's selected accounting policy, rather than the selection of the accounting policy itself. The file note referred to above contains no record of any discussion with management concerning alternative accounting treatments. PwC have confirmed that there are no other audit file documents recording challenge of management concerning the accounting treatment, although there are documents in which it is asserted that management had been challenged. There are no audit file documents referring to the application of IAS 18 (Revenue) ("**IAS 18**") and IAS 17 (Leases) ("**IAS 17**").

5.32. The audit team did not give sufficient consideration to the commercial substance of these transactions. For example, they did not obtain sufficient evidence identifying what services ESL had provided in each of the Third Party property transactions, and so did not properly identify what their share of the profit on each transaction represented.

5.33. As a result, the audit team did not properly consider the principal alternative to management's view, which was that the substance of ESL's role in the transactions was to take on the liability of a longer lease, and so failed to properly evaluate whether the profits generated by the property transactions reflected services provided by ESL or lease incentives.

5.34. The audit team accordingly failed to obtain a proper understanding of the property

transactions.

5.35. In light of the foregoing, PwC and Mr Storer breached paragraphs 15, 16 and 17 of ISA 200, which provide that:

"15. 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.

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

17. To obtain reasonable assurance, the auditor shall obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion."

Reporting to those charged with governance

5.36. The Report prepared for the Audit Committee meeting on 25 March 2019 set out the procedures that the audit team had designed and purportedly performed in respect of the property transactions. It states:

"We challenged management as to whether the revenue earned should be treated as a lease incentive and spread over the term of the lease".

However, there is no evidence that the audit team challenged management concerning the accounting treatment of the property transactions (which could have been achieved by, for example, the request, review and challenge of a technical analysis prepared by management). It follows that the audit team did not perform all the procedures which they had concluded were necessary.

5.37. In light of the foregoing, PwC and Mr Storer breached paragraphs 5 and 6 of ISA 330, which provide that:

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

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

5.38. Furthermore, the inconsistency between the information provided to the Audit Committee, and the procedures which had in fact been performed by the audit team in relation to the property transactions, reflected a failure by the Respondents to properly communicate the significant findings from the audit.

5.39. PwC and Mr Storer breached paragraph 16 of ISA 260, which provides that:

"The auditor shall communicate with those charged with governance:

(a) The auditor's views about significant qualitative aspects of the entity's

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

…

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

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

(ii) Written representations the auditor is requesting;"

<u>The audit report</u>

5.40. The audit report on ESL's FY2018 financial statements specified *"Accounting for consultancy and property services"* as a key audit matter. Under the heading *"How our audit addressed the key audit matter"*, it stated:

"We challenged management as to whether any of the revenue earned should be spread over the term of the associated commitment or recognised in the current year. It was concluded that the latter was the appropriate treatment."

5.41. Again, the inconsistency between the information provided in the audit report, and the procedures which had in fact been performed by the audit team in relation to the property transactions, reflected a failure by the Respondents to provide an accurate summary of its response to this key audit matter.

5.42. PwC and Mr Storer therefore breached paragraph 13(b) of ISA 701, which provides that:

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

…

(b) How the matter was addressed in the audit, including significant judgments made by the engagement team with respect to the matter".

<u>Breach 3 – Property transactions: disclosure</u>

5.43. Mr Storer was aware that management were sensitive about the extent of disclosure concerning the property transactions. In a note of a call with the chief financial officer of ESL on 16 October 2018, Mr Storer wrote:

"He wanted our views on their accounts and specifically disclosures. So I referred to the discussions we'd had with KPMG, [the Audit Committee chair] *and their team regarding property sales and consulting costs. In summary I told him that so long as*

the Chief Operating Decision Maker (the Board) didn't receive management info that presented this as a separate segment on which they based their decisions then they would be compliant. Anything that undermined that would be a problem. Then had a wider discussion about their journey and "growing up" (as [ESL officer] *put it when we met) as a plc - in particular how transparent they wanted to be/the direction of travel for Aim businesses, fair/balanced/understandable (ie the profits from these streams make up a big % of the total) and finally the potential for future FRC attention. He got it."*

5.44. On 28 January 2019 Mr Storer sent an email to members of the audit team:

"Spoken to [Audit Committee Chair]*…*

I did say I was surprised at the level of property profits, hadn't expected the figure to be so high. I asked about whether they had progressed their discussions re "the journey" regarding disclosure -he said they hadn't. He said the AC would be keen to know whether we were happy with the actual taking of profits and was fully expecting a full discussion around disclosure. I told him we still had some work to do but would be able to update the AC on Wednesday.

I am speaking to [the ACS Partner] *tomorrow late morning (he's in the US too !) and will send him the paper this evening."*

5.45. PwC's work paper includes the text of an email from Mr Storer to the ACS Partner on 29 January 2019, which states:

"Revenue and profit from the property transactions is included in the contract logistics & warehousing segment.

We have seen internal board reports and this is consistent - ie property sales/profits are not shown separately - the other segments disclosed have their own p&l accounts in the monthly pack. So, on the one hand, the segmental analysis complies with the standard in so far as, on face value, it's at the level the [chief operating decision maker] *looks at, however, in the current year the property profit is £33m and the group PBT is only £24m so it has a huge impact. There is a bit of a mis-match as they have not generated much revenue/profit from the new warehousing in the year, these deals are part of longer term strategy as they need more space.*

We did discuss this with them as part of the proposal (no views given) and that they needed to consider transparency and the "journey" they are on in respect of this - we said even if they were deemed to be compliant with the standard then they needed to consider whether they were being open enough. So what we really need to understand is how this sits with us. It could be that we can agree a journey with them whereby this year they enhance disclosure by stating at the foot of the segmental note that revenue and profits from property sales sit within the warehousing segment - it's a case of how far we need to push them."

5.46. The email indicates that Mr Storer and [the ACS Partner] were to speak the next day, but a *"Note of telecon"* does not record any discussion concerning the adequacy of the disclosures.

5.47. The minutes of the Audit Committee meeting held on 30 January 2019 state:

> *"Disclosure of property related profits. Philip Storer acknowledged that including property related profits within transport and warehousing profits in the financial statements is not inconsistent with the technical accounting requirements which require presentation of profits in accordance with the method of reporting to the Board (referred to in the regulations as the chief decision maker). However he noted the possibility of criticism of the Directors if the overall annual report is not 'fair, balanced and understandable' taking into account the level of profits derived from property related transactions (although the requirement for Directors to make this statement does not technically apply to an AIM listed company). The non-executive Directors commented that they are mindful of this point and also recognise the importance of protecting the business from potential damage from over disclosure of sensitive information."*

5.48. The Report to the Audit Committee for the Audit Committee meeting on 25 March 2019 states, under the heading *"Conclusions"*:

> *"We continue to recommend that the Board considers providing additional disclosure on the amounts such transactions contribute to the group's results, in particular profits, as it is our understanding that revenue is akin to profits.*
>
> *The disclosures in the financial statements have not changed significantly from the prior year. In particular we recommend more transparency over the amounts contributed to the group's profitability from property related transactions and clarity over which operating segments these are included in."*

5.49. Under the heading *"Presentation of property transactions"*, it states:

> *"We have held a number of discussions with management in relation to the adequacy of the presentation of property transactions in particular when considering the fair and balanced presentation of the front end of the accounts and the transparency over the interpretation of results.*
>
> *We acknowledge that there is reference to the property transactions within the revenue accounting policies which states that the Group has earned revenues of £17.9m (2017: £10.4m) in relation to provision of property associated services and £15.0m (2017: £6.7m) in relation to the provision of consultancy services during the year.*
>
> *We recognise that management has extended references to the development of warehousing portfolio within the CEO statement and strategy, however we remain of the strong view that due to the significant contribution to the underlying profits (which*

is not disclosed) that more explicit narrative is included in relation to these transactions."

5.50. The FY2018 financial statements set out the accounting policies adopted for property-related revenue. Under the heading *"Sales of services – Property"* is stated:

"At certain sites where the Group has entered into leases, arrangements have been entered into with a third party, under which the Company receives fees for property-related advisory services. Revenue earned from providing property associated services is recognised in the Consolidated Income Statement at the fair value of the consideration received or payable, net of professional fees, associated costs and VAT.

The Group continues to be successful in providing property-related services including to third party investors as part of its core strategy and the growth of its warehousing estate. It has earned fees of £19.2 million (2017 £10.4m) with a strong pipeline of future projects and work going into 2019. The Directors have made the judgement that the fees are payments for the provision of property services to a third party investor that may be recorded as revenue at the time of the transactions."

5.51. Under the heading *"Sale of Services – Consultancy"* is stated:

"…the Group offers a range of consultancy services including property, logistics, IT consulting and integration services. In the year to 30 November 2018 revenue from these services totalled £15.0m (2017: £6.5m)."

5.52. Additional disclosure was added to the FY2018 financial statements to give clarity over which operating segments the revenue was included in:

"For the purpose of allocating revenues to operating segments (note 3) £12.3m of fees relating to property services and £15.0m of consulting revenues form part of Transport revenues (2017: £10.4m and £6.7m respectively). Contract and logistics revenue relating to property services is £5.6m (2017: £nil)".

5.53. Property-related revenue accounted for only 5.1% of total Road Transport revenue, but the related profit accounted for 50.7% of Road Transport underlying EBITDA.

5.54. The Group's operating profit before exceptional items was £37.4 million in 2018. Revenue from property transactions and consultancy services totalled £34.2 million. As there were no associated costs for this revenue, it accounted for 91% of this profit.

5.55. Given that the reported profit before tax was £23.6 million, and the profit from the property transactions was £34.2 million, in the absence of the profit from the property transactions, ESL would have been in a loss making position.

5.56. IAS 1 provides as follows:

"9. Financial statements are a structured representation of the financial position and financial performance of an entity. The objective of financial statements is to provide

information about the financial position, financial performance and cash flows of an entity that is useful to a wide range of users in making economic decisions…"

"15, Financial statements shall present fairly the financial position, financial performance and cash flows of an entity. Fair presentation requires the faithful representation of the effects of transactions, other events and conditions in accordance with the definitions and recognition criteria for assets, liabilities, income and expenses set out in the Framework…"

"17. In virtually all circumstances, an entity achieves a fair presentation by compliance with applicable IFRSs. A fair presentation also requires an entity:

(a)…

(b) to present information, including accounting policies, in a manner that provides relevant, reliable, comparable and understandable information;

(c) to provide additional disclosures when compliance with the specific requirements in IFRSs is insufficient to enable users to understand the impact of particular transactions, other events and conditions on the entity's financial position and financial performance".

5.57. The disclosures did not adequately reflect the fair presentation requirements in IAS 1 cited above and should not have been approved by the audit team. The Notes to the Consolidated FY2018 Financial Statements contained an indefinite description of the nature of the property and consultancy transactions. The disclosures did set out the revenue earned from the transactions, stated to be *"net of professional fees, associated costs and VAT"*, but they did not make clear that the revenue earned from the transactions was ESL's share of the profit, or that the costs incurred by ESL to generate the revenue were minimal.

5.58. The term *"net of…associated costs"* is opaque and would not drive a user of the FY2018 financial statements to conclude that the revenue figure was stated net of <u>all</u> costs. On the contrary, an informed user of the financial statements would appreciate that revenue is not and should not be reported net of costs and so would not interpret the disclosure as meaning that revenue was equivalent to profit.

5.59. The disclosure should, at the very least, have described what the costs were, and explained that the costs were essentially limited to management time, making it plain that for these transactions revenue was akin to profit. The overall effect of the disclosures was to obscure the fact that should have been made easily visible, namely that the relatively small percentage of revenue generated by the property transactions had a very significant impact on the profitability of the Road Transport division and the Group as a whole. An informed user of the FY2018 financial statements would therefore not be able to understand the impact of the property transactions on ESL's financial position and financial performance as required under IAS 1.

5.60. These deficiencies were compounded by the fact that the Strategic Report contained no clear description of the nature of the property and consultancy transactions and the effect that they had on the performance of ESL and its profit.

5.61. PwC and Mr Storer accordingly failed to properly evaluate whether the FY2018 financial statements provided adequate disclosure to enable the intended users to understand the impact of the property transactions on profit, and so breached paragraph 13(e) of ISA 700, which provides that:

"…the auditor shall evaluate whether, in view of the requirements of the applicable financial reporting framework:

…

(e) The financial statements provide adequate disclosures to enable the intended users to understand the effect of material transactions and events on the information conveyed in the financial statements".

<u>Breach 4 – Property lease accruals</u>

5.62. PwC's work on property lease accruals was recorded in the work paper *"Obtain detailed listings and test accruals and other liabilities"*. Lease accruals above performance materiality were selected for testing, and audit sampling resulted in two further leases being tested.

<u>Failure to test completeness of property lease accrual</u>

5.63. PwC did not design or perform any audit procedures to test the completeness of the property lease accrual. No work was undertaken to identify if there were any historical leases where an accrual had not previously been made, but should have been. Such work should have been planned and performed, especially given the size of ESL's property lease portfolio.

5.64. PwC and Mr Storer therefore breached paragraph 6 of ISA 330, which provides that:
"The auditor shall design and perform further audit procedures whose nature, timing and extent are based on and are responsive to the assessed risks of material misstatement at the assertion level."

<u>Work on one lease agreement</u>

5.65. In respect of one particular lease, PwC obtained the original lease agreement from 1997 which did not set out the rental amounts. The work paper states:

"The original lease agreement obtained dated 1997, did not stipulate the rental amounts. Separate agreements that stated amounts could not be obtained. Management did have record of invoice history, which showed a 5 year compounded increase of 3%. Which we have worked back with for our sense check of the accrual b/f".

5.66. PwC did not document any consideration of whether it needed to update or amend its audit strategy given the unavailability of the evidence it had sought.

5.67. PwC and Mr Storer therefore breached paragraph 10 of ISA 300, which provides that:

"The auditor shall update and change the overall audit strategy and the audit plan as necessary during the course of the audit".

5.68. PwC and Mr Storer did not evaluate whether the *"record of invoice history"* was sufficiently precise and detailed to be relied upon as audit evidence, and therefore breached paragraph 9 of ISA 500, which provides that:

"When using information produced by the entity, the auditor shall evaluate whether the information is sufficiently reliable for the auditor's purposes, including, as necessary in the circumstances:

(a) Obtaining audit evidence about the accuracy and completeness of the information; and (Ref: Para. A49–A50)

(b) Evaluating whether the information is sufficiently precise and detailed for the auditor's purposes."

Breach 5 – Dilapidations provision

5.69. PwC's work relevant to dilapidations provision was recorded in the work paper *"Obtain movement schedule and test provisions"*. This states:

"As per discussion with [ESL employee] *on 27/02/19, we have found no suggestions of any unprovided amounts. As per the unrecorded liabilities results revealing no concerns and given there are no employees and this is not a trading entity, we are comfortable that the client has told us there are no other provisions that should be in place here…"*

5.70. The work paper does not document any planned or performed work in respect of the terms of any historical leases which may have reached a point where provision would need to be considered. Such work should have been planned and performed, especially given the size of ESL's property lease portfolio.

5.71. PwC and Mr Storer therefore breached paragraphs 15, 16 and 17 of ISA 200 (set out above).

Breach 6 – Consolidation of investment in a company

5.72. PwC's work paper *"Obtain movement schedule and test provisions"* documents the procedures performed in respect of the investee company. It records the results of consultation with PwC's ACS accounting team regarding the assessment as to whether ESL controlled the investee company. Such assessment was relevant to whether the investee company was accounted for as an associate or a subsidiary. The consultation was recorded as follows:

"1) There is a Chairman appointed by ESL but as the Chairman does not have a vote the fact that ES appoints the Chairman does not influence the control conclusion.

2)The fact that for meetings to go ahead there only needs to be 5 directors present does not influence the control conclusion. All 6 directors have a right to attend and decisions are made based on a 50% majority. In addition there are matters that require shareholder consent…

3) ESL have the ability to dismiss a nominated … Director [of the investee company] *but…only…for gross misconduct…This does not influence the control conclusion as they cannot be dismissed at ESL's will…*

…

From the agreements it is clear that ESL do not have a majority of voting rights. Therefore it is necessary to consider whether there is power without the majority of voting rights…"

5.73. The analysis concludes:

"…the judgement to support the control conclusion should be based around whether ESL has defacto control because the other shareholders do not act together / voting patterns at board meetings indicate that they do not necessarily vote in the same way".

5.74. A side note in the work paper states:

"Engagement Leader, Phil Storer, had a conversation with [the ACS Partner]*…on 25/03/19, to further discuss the control point.*

As a result of the conversation, Phil has satisfied himself that the Eddie Stobart do [sic] *control."*

5.75. Emails exchanged between members of the audit team and PwC technical consultants, over the period 21 – 25 March 2019, demonstrate that the issue of control was still unresolved. On 21 March 2019 [a Senior Manager in ACS] emailed Mr Storer stating *"I am still not convinced ESL has control…we are struggling to see how ESL has control, looks more like an associate…"*. Mr Storer replied on 22 March 2019:

"As discussed, following a significant amount of consideration and discussion with our client, I have concluded that, on balance, ESL do have control of [the investee company]*. That said, I acknowledge that this is subjective and is not black and white".*

5.76. The Senior Manager in ACS replied later that day:

"…I have discussed your note with [the ACS Partner].

…

We don't think the commercial points raised in your email are sufficient to support the control conclusion. The judgement would have to be based around whether ESL has defacto control because the other shareholders do not act together / voting patterns at

board meetings indicate that they do not necessarily vote in the same way. We leave this for you to ponder on, and whether you would be comfortable making this judgement as this would be the line of argument you would have to use to be able to support the control conclusion if you can get there".

5.77. A *"FILE NOTE OF TELECON CONVERSATION BETWEEN* [Mr Storer] *AND* [the ACS Partner] *(25/03/19)"* records the discussion between Mr Storer and [the ACS Partner]:

"[Mr Storer]…*noted that we had not consulted over the concept of control, we had done a considerable amount of work on it and had reached our conclusion. The consultation was over the treatment of the flowering shares/recording of the acquisition of the remaining minority interest as an addition to cost of investment;*

…

[The ACS Partner] *noted that the key consideration was whether ESL had "de facto" control over* [the investee company]. *This is key given the equal rights each side has, ie what actually happens in reality, does ESL exert control over* [the investee company].

…

[The ACS Partner's] *view was as follows:*

- *agreed that ESL probably does control* [the investee company]*, however, the challenge is how to record and be comfortable with this;*
- *from a technical/legal/"black & white" perspective ESL would need 1 of* [investee company] *shareholders/directors to vote with it. From a purely technical perspective, could be argued that, because ESL could not guarantee the vote of one of the other shareholders, they may not actually be in control;*
- *so, as noted above this becomes a question of whether ESL has de facto control and how this can be "justified".*
- *noted that taking all the "commercial factors" noted in* [Mr Storer] *email (and above), then "in the round" it would not seem unreasonable to conclude that ESL does have control. In particular* [the ACS Partner] *referred to the fact that ESL do set the budget for* [the investee company] - *if the other shareholders did not agree then there would be a discussion, however, ultimately it would be ESL that had the final say on the budget.*
- *so overall* [the ACS Partner] *agreed with* [Mr Storer] *view that, in the round, we can get to control given the points noted above do point to de facto control."*

5.78. On 26 March 2019 a Senior Manager in ACS sent an email to Mr Storer and an audit team member attaching a *"note of the points we have discussed for the consultation"*. The note stated:

"In this fact pattern the other shareholders would have to act together to stop ESL having control. Therefore, the judgement to support the control conclusion should be

based around whether ESL has defacto control because the other shareholders do not act together / voting patterns at board meetings indicate that they do not necessarily vote in the same way".

5.79. Mr Storer responded to the audit team member as follows:

> *"Re the fact pattern from* [the Senior Manager in ACS] *and specifically the control point, the note is factually accurate and the penultimate para does refer to de facto control and that this is the judgement. This is of course the discussion I had with* [the ACS Partner] *so, as long as the email I wrote post that discussion is included on the file, then the note is fine as that email/conversation supersedes it and our conclusion (ie that there is control) is based on that conversation".*

5.80. However, the analysis recorded in the note of the discussion between [the ACS Partner] and Mr Storer does not record any consideration of the voting pattern at board meetings or shareholder behaviour, which were the two areas specifically identified in the formal IGLO consultation as relevant to the existence of de facto control.

5.81. The *"Consultation Memo"*, which was signed off by Mr Storer and [the ACS Partner] on 28 March 2019, does not refer to their discussion on 25 March 2019, and repeats that:

> *"…the judgement to support the control conclusion should be based around whether ESL has defacto control because the other shareholders do not act together / voting patterns at board meetings indicate that they do not necessarily vote in the same way".*

5.82. Mr Storer accordingly (i) failed to obtain and consider the further evidence required by the IGLO consultation, (ii) failed to record the basis for the conclusion that ESL did exercise control and (iii) failed to record the basis for the conclusion that the further evidence required by the IGLO consultation would not be obtained, and so breached paragraph 18 of ISA 220 (set out above).

5.83. PwC and Mr Storer failed to properly evaluate whether ESL exercised control over the investee company, and failed to obtain further evidence of voting patterns at board meetings and shareholder behaviour, and so breached paragraphs 16 and 17 of ISA 200 (set out above).

6. SANCTIONS – PwC

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* against PwC:

6.3.1. a financial sanction of £3.5 million adjusted for aggravating and mitigating factors (in particular reflecting an exceptional level of co-operation) by a reduction of 12.5%, and further discounted for admissions and early disposal by 35% so that the financial sanction payable is £1,990,625. The financial sanction shall be paid no later than 28 days after the date of the *Final Settlement Decision Notice*;

6.3.2. a published statement in the form of a severe reprimand;

6.3.3. a declaration that the FY2018 audit report signed on behalf of PwC did not satisfy the *Relevant Requirements*, as set out in this *Final Settlement Decision Notice*; and

6.3.4. a non-financial sanction requiring PwC to report to its FRC supervisor for a period of one year on (i) the results of its monitoring of its audit teams' compliance with its policies regarding consultations; and (ii) its training of new audit partners on its policies regarding consultations. PwC's supervisor may extend the reporting period for up to three years if the results of PwC's monitoring suggest that there may have been failings by audit teams in the area of consultations, or if there are concerns about the monitoring carried out.

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

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

6.5. As a result of the breaches of *Relevant Requirements*, the FY2018 Audit failed in its principal objective namely to obtain reasonable assurance about whether the FY2018 financial statements as a whole were free from material misstatement.

6.6. The audit of the property transactions was a highly significant part of the audit. The property transactions had a significant impact on revenue and profit recognised in the financial year due to the accounting treatment adopted by management. The property transactions formed 91% of the operating profit of ESL. Without the profit from the property transactions, ESL would have reported a pre-tax loss in FY18.

6.7. Fair presentation is a fundamental part of financial reporting. The disclosure regarding the property transactions was inadequate and did not achieve fair presentation given the impact of transactions on the reported profit for the ESL group as a whole and for the operating segments.

6.8. The breaches of *Relevant Requirements*:

6.8.1. were serious (in particular relating to the property transactions and the disclosures concerning the same), and numerous;

6.8.2. were mainly centred around the work on the property transactions, but there were further breaches which related to other areas of the audit; and

6.8.3. relate only to one audit year.

6.9. In aggregate the breaches:

6.9.1. had the *potential* to adversely affect a significant number of people in the United Kingdom (such as the public, investors or other market users), and could have harmed investor, market and public confidence in the truth and fairness of the FY2018 financial statements published by *Statutory Auditors* or *Statutory Audit Firms*. ESL's shares were AIM listed. For the avoidance of doubt, the Executive Counsel has not alleged or found that there was in fact such harm or that such people were in fact adversely affected.

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

6.10. The breaches were not intentional, dishonest, deliberate or reckless.

6.11. It is not asserted that the Respondents derived or intended to derive any specific financial benefit from the breaches of *Relevant Requirements,* aside from the audit fee.

6.12. PwC has implemented a number of remedial measures and the firm has conducted an audit improvement programme. A Root Cause Analysis was conducted by PwC, which was subsequently provided to Executive Counsel on a voluntary basis. In light of the remedial action taken by PwC, Executive Counsel considers the likelihood of the breaches recurring to be low, although it is determined that one aspect of the remedial work is monitored pursuant to a non-financial sanction, for which see further below.

6.13. Certain breaches of *Relevant Requirements* applicable to this *Final Settlement Decision Notice* were identified by AQR in the course of their inspection cycle which preceded the audit. There have been five FRC Enforcement decisions made under the AEP against PwC since 2019, some of which contain breaches of the same standards to the breaches contained within this *Final Settlement Decision Notice.*

6.14. PwC is the largest audit firm in the UK. Its UK fee income in 2021 was approximately £3,557 million and its audit fee income was £790 million. It has 914 partners. The audit fee for the audit was £548,000.

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

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

6.15.1. a financial sanction of £3.5 million;

6.15.2. a published statement in the form of a severe reprimand;

6.15.3. a declaration that the FY2018 audit report signed on behalf of PwC did not satisfy the *Relevant Requirements*, as set out in this *Final Settlement Decision Notice*; and

6.15.4. a non-financial sanction requiring PwC to report to its supervisor at the FRC on its (i) monitoring of its audit teams' compliance with its policies regarding consultations; and (ii) training in this area of new audit partners.

6.16. 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).

<u>Aggravating factors</u>

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

<u>Mitigating factors</u>

6.17.1. As paragraph 69 of the Policy explains:

"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…"

6.18. PwC provided an exceptional level of cooperation during the investigation of the breaches by Executive Counsel in particular by:

6.18.1. providing full admissions of breaches of *Relevant Requirements* at a relatively early stage in the investigation (including admissions relating to matters which were not in the communicated scope of the investigation); and

6.18.2. conducting a Root Cause Analysis as to how the breaches of Relevant Requirements had occurred and providing a copy of the same to Executive Counsel.

6.18.3. dealing timeously, properly and fully with all requests for information made on behalf of Executive Counsel.

6.19. In light of the mitigating factors, Executive Counsel considers that a discount to the financial sanction of 12.5% is appropriate.

<u>Deterrence</u>

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

Discount for Admissions and Settlement

6.21. Having taken into account the admissions by PwC and the stage at which those admissions were made (at an early point within Stage 1 of the case for the purposes of paragraph 84 of the Policy), Executive Counsel determined that a further reduction of 35% to the financial sanction for early disposal is appropriate, such that a financial sanction of £1,990,625 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 PwC and the effect of a financial sanction on its business and whether any financial sanction would be covered by insurance.

7. SANCTIONS – MR STORER

7.1. Executive Counsel imposes the following *Sanctions* against Mr Storer:

7.1.1. A financial sanction of £90,000 adjusted for aggravating and mitigating factors (in particular reflecting an exceptional level of co-operation) by a reduction of 12.5% and further discounted for admissions and early disposal by 35% so that the financial sanction payable is £51,187.50. The financial sanction shall be paid no later than 28 days after the date of the *Final Settlement Decision Notice*;

7.1.2. a declaration that the FY2018 audit report signed by Mr Storer did not satisfy the *Relevant Requirements*, as set out in this *Final Settlement Decision Notice*;

7.1.3. a published statement in the form of a severe reprimand.

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 factors cited at paragraphs 6.5 – 6.11 above are repeated and in particular it is noted that Executive Counsel does not assert that Mr Storer purposely failed to prevent the users of the FY2018 financial statements from potentially being misled.

Identification of *Sanction*

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

7.4.1. a financial sanction of £90,000;

7.4.2. a declaration that the FY2018 audit report signed by Mr Storer did not satisfy the *Relevant Requirements*, as set out in this *Final Settlement Decision Notice*;

and

7.4.3. a published statement in the form of a severe reprimand.

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.

Mitigating factors

7.7. Mr Storer has no previous adverse compliance or disciplinary record.

7.8. Mr Storer provided an exceptional level of cooperation during the investigation of the breaches by Executive Counsel by:

7.8.1. providing full admissions of breaches of *Relevant Requirements* at a relatively early stage in the investigation (including admissions relating to matters which were not in the communicated scope of the investigation); and

7.8.2. responding to all requests for information made on behalf of Executive Counsel timeously, properly and fully.

7.9. In light of the mitigating factors, Executive Counsel considers that a discount to the financial sanction of 12.5% is appropriate.

Deterrence

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

Discount for Admissions and Settlement

7.11. Having taken into account the admissions by Mr Storer and the point at which those admissions were made (at an early point within 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 for early disposal is appropriate, such that a financial sanction of £51,187.50 is payable.

8. COSTS

8.1. The Respondents shall pay the costs in full in this matter, being £266,000. Such costs shall be paid no later than 28 days after the date of the *Final Settlement Decision Notice.*

Signed:

[Redacted.]

DEPUTY EXECUTIVE COUNSEL

Date: 30 March 2023

APPENDIX 1 – EXTRACTS OF RELEVANT REQUIREMENTS

Extracts from ISAs

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

    1.1. Paragraph 15 states as follows:

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

    1.2. Paragraph 16 states as follows:

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

    1.3. Paragraph 17 states as follows:

    "To obtain reasonable assurance, the auditor shall obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion."

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

    2.1. Paragraph 18 states as follows:

    ""The engagement partner shall:

    (a) Take responsibility for the engagement team undertaking appropriate consultation on difficult or contentious matters;

    (b) Be satisfied that members of the engagement team have undertaken appropriate consultation during the course of the engagement, both within the engagement team and between the engagement team and others at the appropriate level within or outside the firm;

    (c) Be satisfied that the nature and scope of, and conclusions resulting from, such consultations are agreed with the party consulted; and

    (d) Determine that conclusions resulting from such consultations have been implemented."

3. ISA 260: Communication With Those Charged With Governance

3.1. Paragraph 16 states as follows:

"The auditor shall communicate with those charged with governance:

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

…

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

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

(ii) Written representations the auditor is requesting;"

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

4.1. Paragraph 27 states as follows:

"As part of the risk assessment as described in paragraph 25, the auditor shall determine whether any of the risks identified are, in the auditor's judgment, a significant risk. In exercising this judgment, the auditor shall exclude the effects of identified controls related to the risk."

5. ISA 330: the Auditor's Responses to Assessed Risks

5.1. Paragraph 5 states as follows:

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

5.2. Paragraph 6 states as follows:

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

6. ISA 300: Planning an Audit of Financial Statements

6.1. Paragraph 10 states as follows:

"The auditor shall update and change the overall audit strategy and the audit plan as necessary during the course of the audit".

7. ISA 500: Audit Evidence

7.1. Paragraph 9 states as follows:

"When using information produced by the entity, the auditor shall evaluate whether the information is sufficiently reliable for the auditor's purposes, including, as necessary in the circumstances:
(a) Obtaining audit evidence about the accuracy and completeness of the information; and
(b) Evaluating whether the information is sufficiently precise and detailed for the auditor's purposes."

8. ISA 700: Forming an Opinion and Reporting on Financial Statements

8.1. Paragraph 13(e) states as follows:

"…the auditor shall evaluate whether, in view of the requirements of the applicable financial reporting framework:
…
(e) The financial statements provide adequate disclosures to enable the intended users to understand the effect of material transactions and events on the information conveyed in the financial statements".

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

9.1. Paragraph 13(b) states as follows:

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

…

(b) How the matter was addressed in the audit, including significant judgments made by the engagement team with respect to the matter".