



Financial Reporting Council

# ANNUAL ENFORCEMENT REVIEW 2019

JULY 2019

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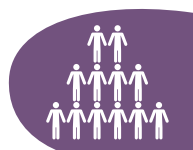
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The FRC's mission is to promote transparency and integrity in business. The FRC sets the UK Corporate Governance and Stewardship Codes and UK standards for accounting and actuarial work; monitors and takes action to promote the quality of corporate reporting; and operates independent enforcement arrangements for accountants and actuaries. As the Competent Authority for audit in the UK the FRC sets auditing and ethical standards and monitors and enforces audit quality.

The FRC does not accept any liability to any party for any loss, damage or costs howsoever arising, whether directly or indirectly, whether in contract, tort or otherwise from any action or decision taken (or not taken) as a result of any person relying on or otherwise using this document or arising from any omission from it.

## The year at a glance



25% growth in Enforcement Division



Proactive horizon scanning



16 cases resolved through Constructive Engagement



First AEP case concluded within 14 months



41 current investigations

15 new investigations into auditors and/or accountants opened in the year



Scepticism and independence of auditors key themes in concluded cases



Nearly three-fold increase in fines to £42.9m (before settlement discounts)



6 individuals excluded from membership of professional bodies



Increased use of non-financial sanctions to improve audit quality



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# 1 Overview by Executive Counsel

Successful and well-run companies, with clear and accurate financial statements, and an open and transparent approach, attract investment and create sustainable economic growth on which society depends.

The role of the FRC includes taking action to promote the accuracy and reliability of financial reporting so that investors, businesses and individuals can understand, and trust, what companies are telling us. Enforcement helps to drive improvement by taking robust and proportionate action to hold those responsible to account when behaviour falls short of what is required.

This is our first annual report on our enforcement activities, highlighting the progress we have made as well as areas, such as timeliness, where we can improve. It is intended to explain how we identify where we need to intervene, the steps we take and, importantly, the results we achieve.

The report summarises our remit and powers (and their limitations) and provides a baseline against which our future performance can be measured. This will be important as the FRC transitions into the new regulator, ARGA (the Audit, Reporting and Governance Authority), with its proposed strengthening of our enforcement regime.

We recognise the importance of improving the speed of our investigations and delivering consistently timely outcomes. To achieve this, we have already introduced significant changes and are further increasing resource (both human and technological); sharpening and streamlining our processes and approach; and embedding new practices.

Whilst timeliness of outcomes and magnitude of financial sanctions are metrics of effective enforcement, the true measure is improved behaviour. This requires cultural change by those we regulate. It requires recognition – and acceptance – that where errors or ethical failures occur, the root causes must be identified, effectively addressed and reported to us. Where such co-operation occurs, it will be credited; where it does not, consequences will be severe.

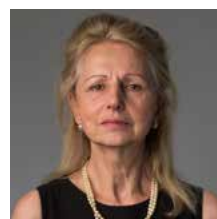
Transparency focusses minds on better behaviour. However, the size and complexity of our cases, the need for robust analysis and the requirements of fair dealing, mean that however efficiently conducted, there may be lengthy periods when we can say little about an investigation without risking prejudicing its outcome. That would not be in the public interest.

We have however improved the accessibility of our published outcomes over the year, details of which are included in this report. As a means of promoting improved behaviour, we have also highlighted underlying themes from concluded cases to increase understanding of behaviour to be avoided.

In summary, we have had a busy year with a significant overall increase in financial sanctions against firms and individuals, and wider use of non-financial sanctions designed to improve future audit quality.

We look forward to building on this bedrock and reporting again next year.

**Elizabeth Barrett**  
**Executive Counsel and Executive Director of Enforcement**



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## 2 Summary of remit and powers

### Who can the FRC investigate and act against?

The FRC's overarching mission is to promote transparency and integrity in business. Public confidence in business depends not just on regulators setting and monitoring standards but on those who fail to meet those standards being held to account where necessary.

The FRC is, among other things, the UK Competent Authority for statutory auditors and the independent disciplinary body for accountants and actuaries in public interest cases. It operates investigation and enforcement procedures (enforcement action) in relation to each of these groups, and is committed to taking firm, fair and timely enforcement action against those within its jurisdiction to protect the public, promote confidence in the profession, uphold standards and deter Misconduct.

#### *Auditors*

The FRC has responsibility for enforcement action in relation to audit firms and individual auditors.

#### *Accountants*

The FRC can also take enforcement action in respect of suspected Misconduct by individual accountants and firms of accountants, who are members of the professional accountancy bodies<sup>1</sup> in relation to non-audit work in public interest cases. These individuals are often working within businesses preparing financial statements and other financial information.

#### *Actuaries*

The FRC can take enforcement action in respect of suspected Misconduct by individual actuaries who are members of the Institute and Faculty of Actuaries (IFoA) in public interest cases. The FRC has no jurisdiction over firms employing actuaries.

The FRC currently has no power to investigate companies, or to take enforcement action or impose sanctions on individual directors who are not accountants (see discussion of the Independent Review of the FRC, led by Sir John Kingman in chapter 8).

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<sup>1</sup> The professional accountancy bodies referred to in this report, approved as Recognised Supervisory Bodies (RSBs), are the Institute of Chartered Accountants in England and Wales (ICAEW), the Institute of Chartered Accountants [ –Scotland (ICAS), Chartered Accountants Ireland (CAI), the Association of Chartered Certified Accountants (ACCA) and the Chartered Institute of Management Accountants (CIMA).

## The Enforcement Regimes

Subjects of inquiry and investigation	Auditors (firms and individuals)	Accountants	Actuaries
Powers pre 2016	Accountancy Scheme <sup>2</sup>	Accountancy Scheme	Actuarial Scheme <sup>3</sup>
Powers post 2016	Audit Enforcement Procedure <sup>4</sup>	Accountancy Scheme	Actuarial Scheme

Before June 2016, all audit and accountant investigations were conducted under the Accountancy Scheme. Following implementation of EU legislation<sup>5</sup> the FRC became the UK Competent Authority for audit and the Audit Enforcement Procedure (AEP) replaced the Accountancy Scheme for audit matters.<sup>6</sup> The Accountancy Scheme remains in place for audit investigations which began before June 2016 and all non-audit matters.

As of 1 April 2018, 11 out of 25 of our investigations into audit were under the Accountancy Scheme. As new investigations were opened and pre-2016 investigations were concluded during the year, the balance of cases shifted so that at 31 March 2019 three audit investigations are being conducted under the Accountancy Scheme and 25 under the AEP.

### *The Accountancy and Actuarial Schemes*

The Accountancy and Actuarial Schemes (the Schemes) are contractual arrangements between the FRC and the accountancy/actuarial professional bodies and provide for the FRC to take enforcement action against accountants and actuaries in cases which raise important issues affecting the public interest in the UK.<sup>7</sup>

The aim of the Schemes is to protect the public, maintain public confidence in the accountancy/actuarial professions and uphold proper standards of conduct.

Enforcement action can be taken against individual accountants and actuaries as well as accountancy firms.

<sup>2</sup> [The Accountancy Scheme](#)

<sup>3</sup> [The Actuarial Scheme](#)

<sup>4</sup> [Audit Enforcement Procedure](#)

<sup>5</sup> The revised EU Statutory Audit Directive 2014/56/EU and EU Audit Regulation (EU) 537/2014 (ARD), implemented by The Statutory Auditors and Third Country Auditors Regulations 2016 (SATCAR).

<sup>6</sup> The AEP lowered the test for taking enforcement action from Misconduct to Breach of a Relevant Requirement (see more at pages 8-9)

<sup>7</sup> Matters not affecting the public interest are dealt with by the professional bodies.

Enforcement action<sup>8</sup> can be taken when there is a realistic prospect that a Tribunal<sup>9</sup> will find that individuals and/or firms have engaged in Misconduct, i.e. conduct which falls significantly short of the standards reasonably to be expected of an accountant/accountancy firm/actuary, or which has brought, or is likely to bring discredit to the accountant/actuary or to their profession. The threshold for opening investigations is that, in the opinion of the Conduct Committee, the matter raises or appears to raise important issues affecting the public interest in the United Kingdom and there are “reasonable grounds to suspect that there may have been Misconduct”.

The FRC can require information from accountants, accountancy firms and actuaries under the Schemes, and a failure to co-operate on the part of an individual accountant, actuary or accountancy firm may itself amount to Misconduct.<sup>10</sup> However, there is no power under the Schemes to require information or co-operation from non-accountants, such as the audited entities and/or employers of the accountants/actuaries under investigation.

As at 31 March 2019, there were 13 open non-audit investigations into accountants, accountancy firms or actuaries under the Schemes.

#### *The Audit Enforcement Procedure (AEP)<sup>11</sup>*

Under the AEP, the FRC can investigate statutory auditors and audit firms in relation to audits of Public Interest Entities (PIEs)<sup>12</sup>, large AIM-listed companies<sup>13</sup> and Lloyd’s Syndicates<sup>14</sup>.

An investigation is opened where there is information which “raises a question as to whether there has been a breach of a relevant requirement” and the FRC’s Conduct Committee considers that there is a good reason to investigate. Enforcement Action (as defined in the AEP<sup>15</sup>) can only be taken if the investigation shows that there has been a breach of a Relevant Requirement under auditing or ethical standards. This is a lower test than ‘Misconduct’ under the Schemes.

The AEP contains powers to require information from auditors and audit firms and, in the case of PIEs, from the audited entity and others involved in or otherwise connected to an audit. A failure to comply with these requirements can lead to the FRC applying to the High Court for an order to ensure that the information is provided, as happened in the case of Sports Direct. It can also amount to a criminal offence<sup>16</sup>.

8 Enforcement action in the context of the Schemes means steps taken pursuant to paragraph 7(11) of the Accountancy Scheme or 7(11) of the Actuarial Scheme, i.e. the delivery of a Formal Complaint against the individual or firm by Executive Counsel to the Conduct Committee.

9 See description of the Tribunal at pages 17-18.

10 See paragraphs 14(1) and 14(2) of the Schemes.

11 The AEP sets out the procedure for investigations under SATCAR.

12 As defined in Regulation 2, SATCAR.

13 With a market capitalisation of over 200 million Euros.

14 Other audit-related matters are delegated by law to the professional accountancy bodies, although the FRC can investigate such matters where it considers that it is in the public interest to do so.

15 Enforcement Action in the context of the AEP means any steps taken pursuant to Rules 17, 18, 24, 25, 27 and 54 of these Rules i.e. rules relating to the issuing of a Decision Notice and Final Decision by Executive Counsel and the Enforcement Committee and a Decision by the Tribunal.

16 Paragraph 5, Schedule 2 SATCAR.



	Schemes	AEP
<b>Test for opening an investigation</b>	The matter raises or appears to raise important issues affecting the public interest and there are reasonable grounds to suspect Misconduct	Information which raises a question as to whether there has been a breach of a Relevant Requirement and there is good reason to investigate
<i>Decision maker</i>	<i>Conduct Committee</i>	<i>Conduct Committee</i>
<b>Test for enforcement action</b>	There is a realistic prospect that a Tribunal will make a finding of Misconduct; and a hearing is desirable in the public interest	Breach of a Relevant Requirement
<i>Decision maker</i>	<i>Executive Counsel</i>	<i>Executive Counsel or Enforcement Committee</i>

## Sanctions

The Schemes and the AEP each prescribe a range of sanctions that can be imposed following a finding of Misconduct or a breach of Relevant Requirements. These include:

- Unlimited fines;
- Reprimands or Severe Reprimands<sup>17</sup>
- Orders designed to prevent recurrence, such as placing restrictions on the nature of work undertaken or clients represented, and education and training programmes;
- Waiver/repayment of client fees;
- Prohibition from conducting statutory audits/withdrawal of registration or practising certificate;
- Exclusions as a member of a professional body.

Additional sanctions under the AEP include:

- Notice to cease or abstain from conduct giving rise to the breach of a Relevant Requirement (and publication of this);
- A declaration that the Statutory Audit Report does not satisfy the Relevant Requirements;
- Temporary prohibition from being a member of the management body of an audit firm or a director of a PIE.

<sup>17</sup> The decision as to whether a Reprimand or a Severe Reprimand is appropriate will depend on the facts of individual cases and the seriousness of the Misconduct/breaches.

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## 3 The team and processes

### The Team

The Enforcement Division has grown significantly in recent years reflecting the FRC's investment in what has become recognised as one of the organisation's key functions. A decade ago the team comprised just six members. By 31 March 2019 it had been expanded to 35; itself an increase of 25% over the previous year. Since 2014 the Division has also developed its own in-house forensic accounting investigation capability so that, save for investigations that are delegated to the professional bodies, forensic investigation work is now conducted by our own staff rather than outsourced to external firms. This has ensured that significant technical knowledge and expertise has built up within the Division and led to substantial cost savings.

The Enforcement Division is headed by the Executive Counsel, who must be a qualified lawyer. All investigations and enforcement proceedings are conducted in the name of Executive Counsel. Decisions about the opening of investigations, amending the scope of investigations or publication are made by the Conduct Committee (see page 13). The AEP and Schemes specify decisions to be taken by Executive Counsel, such as whether enforcement action should be commenced<sup>18</sup> and decisions as to settlement<sup>19</sup>.

As at 31 March 2019, the Enforcement Division comprised 13 further lawyers (qualified either as barristers or solicitors), 13 forensic accountants, 7 legal/accounting assistants, and an administrator. Despite its growth, the Division remains small by the standards of other regulators given the scale, complexity and importance of the cases handled and significant further expansion is planned.

### Case Examinations and Enquiries

The Enforcement Division includes the Case Examination and Enquiries team (CEE). The team gathers intelligence and conducts initial enquiries on cases arising under the AEP or the Schemes<sup>20</sup>. The head of CEE acts as a Case Examiner for AEP enquiries.

#### *Origin of CEE enquiries*

CEE enquiries originate from CEE horizon scanning activities, from complaints and whistleblowing disclosures and from referrals by other FRC teams, other regulators or the RSBs and accountancy bodies.

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<sup>18</sup> See rule 16 AEP and paragraph 7(11) Schemes.

<sup>19</sup> Settlements agreed by Executive Counsel under the Accountancy Scheme are subject to approval by a legal member of the Tribunal panel.

<sup>20</sup> CEE was set up when the AEP was introduced in June 2016. Prior to this, a Supervisory Enquiries team was responsible for intelligence gathering and assessing potential cases under the Schemes.

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### *Horizon scanning*

Most CEE enquiries are generated from our horizon scanning activities, which include searches of listed company Regulatory News Service (RNS) updates and the review of reports in the financial press. The types of issues of interest include:

- Material misstatements in a company's financial statements which may not have been detected through the statutory audit process (including errors in the audited financial statements themselves and in other parts of the annual report which an auditor has a duty to review);
- Indications of fraud which may not have been detected by the statutory audit process;
- Indications of Misconduct by qualified accountants or actuaries where it may be in the public interest for the FRC to make enquiries, primarily in relation to the preparation and approval of financial statements which may contain material errors.

Consideration is given to the nature of the issue before deciding to make further enquiries in order to ensure that our actions are proportionate and risk-based. In relation to errors in a set of financial statements, we focus on those which appear to be material and could reasonably be expected to influence the decisions of users of the financial statements.

### *Complaints and whistleblowing disclosures*

Complaints and whistleblowing disclosures are managed centrally by the FRC and are referred to CEE if they appear to relate to audit, accounting or actuarial matters within the FRC's enforcement remit.

### *Referrals*

Other FRC teams may refer matters to CEE if they become aware of matters indicative of auditing, accounting or actuarial irregularities. For example, the FRC's Corporate Reporting Review team (CRR) may identify a material error in a company's financial statements in terms of an incorrect accounting treatment or a disclosure failure, which may also suggest that there has been a failure in the audit process.

Until mid-2018 CEE received referrals arising from audit inspections conducted by the FRC's Audit Quality Review team (AQR). These referrals are now handled by a separate Case Examiner within the FRC's Audit and Actuarial Division but otherwise follow the same process as that conducted by CEE.

CEE liaises closely with other relevant regulators and prosecuting authorities to identify cases of public interest and determine which body may be best placed to act. CEE both receives and makes referrals, and information is received from and shared with other agencies as permitted through formal legal gateways.

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### *Outcomes of a CEE enquiry*

A CEE enquiry will end in one or more of the following outcomes:

- Referral to the Conduct Committee for a decision on whether an investigation should be opened;
- In AEP cases only, resolution through Constructive Engagement (more information on the Constructive Engagement process is set out below);
- Referral to CRR/AQR;
- Referral to an RSB or accountancy body where that body is better placed to investigate and/or if the matter does not fall within the FRC's remit;
- No further action by the FRC where the initial enquiry conducted by CEE identified no evidence of acts or omissions likely to amount to potential breaches or Misconduct.

CEE may also make a referral to another regulator or agency, whether or not the matter is also progressed within the FRC.

## **CONSTRUCTIVE ENGAGEMENT**

### *What is Constructive Engagement?*

Constructive Engagement is a process introduced by the AEP for resolving cases where the audit quality concerns can be appropriately and satisfactorily addressed without full enforcement action.

As set out in paragraphs 13 and 14 of the "Guidance for Case Examiner", the use of Constructive Engagement is entirely at the discretion of the Case Examiner. Examples given of cases for which it will or may be suitable include:

- cases where there has been a minor, technical breach, usually at the very lowest end of the spectrum of Allegations.
- cases where there is no real concern about harm to investor, market or public confidence in statutory audit process and where there is no evidence of financial detriment to anyone.

### *Who conducts Constructive Engagement?*

Constructive Engagement decisions are made by a Case Examiner. There are currently two Case Examiners at the FRC. The Case Examiner within CEE deals with all AEP-related matters except for those arising from inspections conducted by AQR which are dealt with by a Case Examiner within the FRC's Audit and Actuarial Division.

### ***How does Constructive Engagement work?***

The Case Examiner seeks information from the audit firm about the audit work conducted and the root causes of the potential audit breach. The Case Examiner will review relevant audit working papers and seek explanations from the audit team. Sometimes, an audit firm will be asked to appoint an independent team to perform an in-depth review of the audit work, to an agreed scope. The Case Examiner will then agree appropriate remedial actions with the firm, for example, modifications to firm-wide audit procedures and/or staff training.

Constructive Engagement will only succeed with the full co-operation of an audit firm. If an enquiry is not or cannot be resolved to the Case Examiner's satisfaction, it may be referred to the Conduct Committee for a decision on opening an investigation. As part of its oversight role, the Conduct Committee is provided with information about all cases resolved via Constructive Engagement.

### ***How do we share learnings from Constructive Engagement activities?***

Learnings from Constructive Engagement activities are communicated. Although the FRC does not publish individual outcomes of Constructive Engagement, the Case Examiners communicate themes to audit firms, accountancy bodies (for circulation to their members), other regulators and other teams within the FRC, who feed the results into their work. More information on the cases dealt with via Constructive Engagement is set out on pages 20-22.

## **The Board**

The Board is responsible for and oversees the maintenance and operation of enforcement procedures with the assistance of the Conduct Committee and the Case Management Committee. The Board delegates enforcement decisions, for example to open and close investigations and take enforcement action, as set out in the FRC's published enforcement procedures.

## **Conduct Committee**

The Conduct Committee is a sub-committee of the FRC Board, to which its Chair reports on enforcement matters. It comprises Board members and others, such as lawyers and former auditors<sup>21</sup>, with a range of skills, experience and relevant technical expertise. It has a majority of lay members and excludes current practising auditors and any officers of the professional bodies it regulates. The Conduct Committee decides whether to open investigations under the Schemes and AEP and performs an oversight role in relation to the FRC's enforcement work, including the work of the Case Examiners. If it considers that an AEP case is suitable for Constructive Engagement, it can refer the matter back to one of the Case Examiners. If it considers that it does not have sufficient information to open an investigation under the Schemes, it can direct Executive Counsel to conduct preliminary enquiries.<sup>22</sup> The Conduct Committee is also responsible for making decisions about publication of certain case-related matters and for issuing Guidance<sup>23</sup>.

21 Who have not carried out statutory audits or worked for an audit firm for the previous three years.

22 Preliminary enquiries will usually be conducted by lawyers and forensic accountants within the Enforcement Division, but assistance from external specialists can also be sought (see paragraphs 6(10) and 7(7) of the Schemes).

23 All Guidance issued by the Conduct Committee is published on the FRC website.

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## Case Management Committee

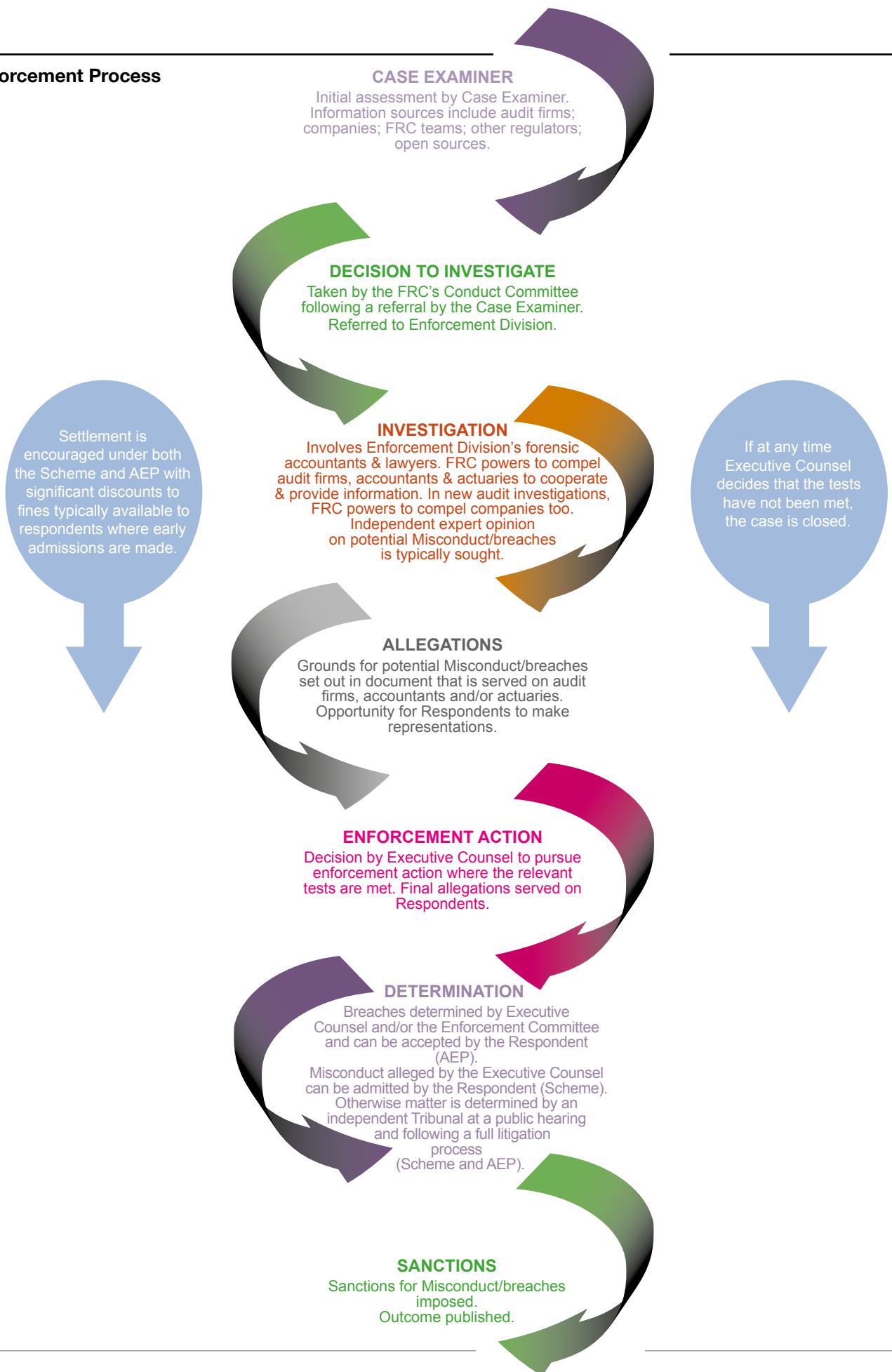
The Case Management Committee (CMC) supports the Conduct Committee and similarly comprises members with a range of skills and relevant experience: it includes former auditors, lawyers and lay members. Typically, a group of three or four members of the Committee (the Group of the CMC, or GCMC) will be assigned to each investigation<sup>24</sup> to provide oversight, support and challenge to the case team throughout the lifetime of a case. Under the Scheme, the CMC has certain specific functions over and above its monitoring role, such as advising Executive Counsel of any factors which should be taken into account when deciding whether to proceed with a Formal Complaint and advising on the appropriateness of settlement discussions. In practice, each case GCMC is updated on at least a monthly basis and will be fully consulted at certain key junctures such as when deciding whether to serve a Proposed Formal Complaint (PFC) under the Schemes or an Initial Investigation Report (IIR) under the AEP.

## Enforcement Process

A high-level overview of our enforcement process is set out in the flow chart on the next page.

<sup>24</sup> Typically, each such group will include an accountant/actuary, a lawyer and a lay member. The CMC's terms of reference can be found [here](#).

**Enforcement Process**



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## Overview of our investigation process

Following a decision by the Conduct Committee to open an investigation, the subjects are notified of the investigation by the FRC and a case team is assigned to the matter.

### *Obtaining evidence*

In the first phase of the investigation documentary material will be obtained from the subjects of the investigation. In a typical audit case, this is voluminous and will involve requests for the audit file/s, relevant emails between audit team members and between the audit firm and the audited entity, and other material which may be relevant to an assessment of the conduct under investigation.

As mentioned in chapter 2, while we have had powers under the Schemes to compel such information from accountants and auditors, we have not previously had such rights in relation to the audited entity – this gap has been addressed under SATCAR and the AEP such that we can now require PIEs and related parties to produce material relevant to our investigation.

Delays in the receipt of material arise as a result of various matters, including, for example, documents being withheld on grounds of legal professional privilege. Receipt of the audit files usually takes 1–2 months, but it can take significantly longer in cases where extensive privilege redaction exercises are conducted by the audit firm or the audited entity. Particular issues arise where the privilege belongs to, and is asserted by, the audited entity rather than the audit firm. The audit firms' review for privilege, the redaction process and explaining the basis on which this has occurred is becoming increasingly protracted. For investigations opened this year, the time taken to receive the audit files has ranged from 28 to 125 days.

### *Review of audit files*

The forensic accountants will review the audit files in their native format. In most cases, they will also work with audit firms to extract the audit files and recreate them within a search platform with enhanced electronic search and analysis capabilities.

### *Interviews and written requests*

Preliminary interviews may be conducted at an early stage, followed by substantive interviews after a detailed review of documentary material. We will typically conduct formal, recorded interviews with the subjects of the investigation and others whom we consider may have relevant evidence (such as audit team members and employees/directors within the audited entity). Interviews may be supplemented by written requests for information and follow-on questions.

### *Use of experts and preparation of an investigation report*

An investigation report is prepared setting out the factual matters relevant to the conduct in question and in most cases<sup>25</sup> an independent expert is instructed to provide their opinion as to whether the conduct meets the relevant threshold test for enforcement action. In order to ensure independence, expert evidence is obtained from those who are not employed by the FRC. The pool of potentially suitable and available experts in each case is limited, with a high risk of potential conflicts of interest. Identifying a suitable non-conflicted expert willing to assist

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<sup>25</sup> Independent experts are not typically engaged in cases involving only ethical breaches.



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can be a lengthy process necessitating inquiries with numerous potential experts/organisations before signing an engagement. We will also typically instruct external counsel to advise on the merits of the case and whether there is a sound evidential basis for enforcement action.

#### *Service of document setting out allegations*

Executive Counsel will consider the expert's and counsel's opinion before determining whether the relevant threshold tests are met. If so, a document will be served on the subjects setting out the draft allegations (under the AEP this is in the form of the IIR and under the Scheme, it is the PFC).

The subjects are then given the opportunity to make written representations on the allegations set out in the IIR/PFC. In practice this is a common time for settlement discussions to ensue.

Settlement is encouraged. It enables earlier delivery and publication of outcomes which are important in declaring proper standards of conduct, protecting the public, and deterring similar Misconduct/breaches. As explained at page 40, settlement can attract significant discounts on financial penalties and provide an opportunity for bespoke and targeted non-financial sanctions.

#### **Decision of Executive Counsel whether to take enforcement action**

If having considered their representations Executive Counsel decides that the Respondents are liable for enforcement action, a document will be issued setting out the findings (in a Decision Notice under the AEP) or allegations (in a Formal Complaint under the Scheme).

Under the AEP, if the Respondents do not confirm their agreement to the Decision Notice, the matter will be referred to the Enforcement Committee<sup>26</sup> which will decide if the Respondents are liable for enforcement action and, if so, issue a Decision Notice setting out its findings. The Enforcement Committee sits in private, although it may invite Executive Counsel and the Respondent to attend to make oral submissions.

If the Respondent rejects all or part of that Notice the matter is referred for hearing before a Tribunal. Thereafter, under both procedures, the matter follows a typical litigation process, including exchange of witness statements and expert reports. The procedures under the regimes are slightly different but an important safeguard in both is that the Respondents have the right to have the matter heard before an independent Tribunal if they do not accept the allegations advanced. The Tribunal hearing is held in public and chaired by a senior lawyer, typically a retired member of the judiciary or senior barrister.<sup>27</sup>

The Tribunal is convened on an *ad hoc* basis at the conclusion of an investigation, unless the case has been settled or otherwise resolved. The Convenor (a lawyer from outside the FRC) selects Tribunal members from a Tribunal Panel. There are restrictions on who can be Panel members: members of the FRC, officers of any of the RSBs or accountants who have carried out statutory audits during the previous three years are ineligible.

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<sup>26</sup> The Enforcement Committee comprises a legally qualified chair, an auditor and a non-legal or accountant member.

<sup>27</sup> The full list of Tribunal members is on the FRC website [here](#).

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In rare circumstances (for example in a joint audit and actuarial case) there will be five members of the Tribunal, but usually the number is three: a lawyer (who will act as chair), an accountant and a lay person.

The procedure at Tribunal hearings is similar to a court case: all parties including Executive Counsel are represented by barristers, who set out the facts of the case in opening and closing submissions; call and cross-examine witnesses; and advance any legal arguments. The Tribunal does not usually make its decision on the final day of the hearing but sets out its findings and reasoning in a report, which is circulated to the parties at a later stage.

As with civil court proceedings, the Tribunal decides the issues using the civil standard of proof, i.e. 'on the balance of probabilities'.

In some cases, the matters we are looking into may overlap with investigations by other regulatory authorities such as the Financial Conduct Authority, the Serious Fraud Office, the Insolvency Service and the Pensions Regulator. Our aim is always to work collaboratively with other agencies using information gateways to share relevant information to the extent permissible. In certain circumstances, however, it may be necessary for us to pause our process, or to delay publication of our outcomes or settlements, such as where a criminal trial is pending (see further discussion in chapter 7).

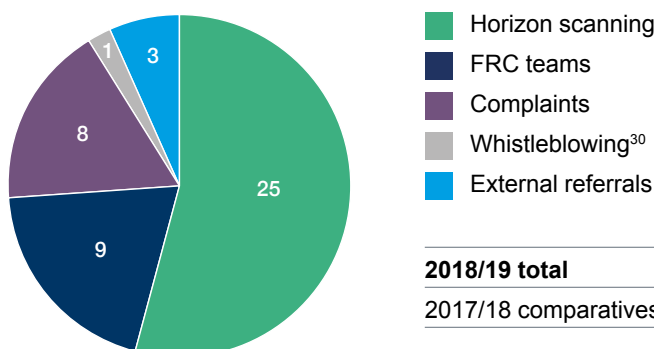
Our approach to enforcement action is informed by a clear understanding that we must be fair, rigorous and timely.

As investigations progress, it is not appropriate to publish detailed updates as this would risk jeopardising the integrity of the investigation and/or potentially causing unfairness to those under investigation. Given the exceptional public interest arising from the collapse of Carillion, the FRC has provided progress updates on the Carillion investigations. However, we are not able to provide details about the evidence obtained to date or future investigation plans.

## 4 Review of the year

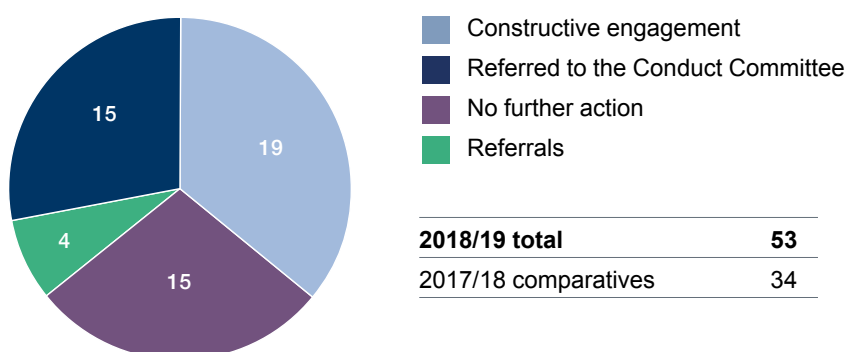
### Case Examination and Enquiries

#### Source of enquiries<sup>28,29</sup>



<b>2018/19 total</b>	<b>46</b>
2017/18 comparatives	52

#### Outcome of enquiries<sup>31</sup>



<b>2018/19 total</b>	<b>53</b>
2017/18 comparatives	34

2018/19 was the second full year since the AEP came into force and CEE was formed. The AEP brought a significant shift in audit enforcement, with an expansion of the FRC's remit (to all PIEs, large AIM companies and Lloyd's Syndicates) and a change to the threshold for examining potential statutory audit failures (to breaches of Relevant Requirements as opposed to Misconduct). It also introduced Constructive Engagement to deal with cases where the audit quality concerns can be appropriately and satisfactorily addressed and the risk of repetition mitigated without the time and expense of full enforcement action.

28 The enquires and outcomes data comprises cases dealt with by CEE and also cases dealt with by the Case Examiner in the Audit and Actuarial Division, arising from AQR inspections.

29 The source category refers to the method by which a matter first came to our attention. It may be that matters we identify through horizon scanning activities are subsequently the subject of complaints or referrals.

30 We use the term whistle-blower to include individuals who appear likely to have met at any relevant point in time, the definition in the Public Interest Disclosure Act 1998.

31 Enquiries are regarded as closed at the point of referral for investigation by the Conduct Committee or when the decision is taken that no further enquiry work needs to be undertaken by the Case Examiner's team.

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A primary focus for CEE during 2018/19 was improving the range and reach of our horizon scanning activities to identify issues within our remit potentially meriting action, in addition to those attracting significant press comment or complaints. In 2018/19, horizon scanning activities accounted for 25 (over 54%) of the enquiries opened (compared to 14 or 27% in 2017/18). Of the 25 cases identified in 2018/19, the majority (17 or 68%) were from RNS updates, largely in relation to the discovery of errors in prior year financial statements.

Another focus for CEE was improving the timeliness of its enquiries, in particular referrals to the Conduct Committee for a decision on whether to investigate. During the year, 15 cases referred to the Conduct Committee resulted in the opening of investigations (see discussion of investigations opened in chapter 4). In eight of these cases (including high profile matters such as Conviviality plc and Patisserie Holdings plc) CEE was able to complete its enquiries and refer the matter to the Conduct Committee within three months of the matter coming to CEE's attention. Those taking longer were cases where detailed enquiries with relevant parties were needed in order to gather sufficient information to enable the Conduct Committee to make an informed decision. One further case was referred to the Conduct Committee which decided not to open an investigation but to refer it back to the Case Examiner to seek resolution through Constructive Engagement<sup>32</sup>.

CEE also focused on developing the Constructive Engagement process in order to provide an effective and efficient alternative to referring qualifying cases<sup>33</sup> for investigation. Nineteen cases, involving a wide range of issues, were dealt with through Constructive Engagement during the year. Over 80% of the 19 cases were closed or resolved within nine months.

Most of the cases resolved by Constructive Engagement involved errors in financial statements which led to subsequent restatements. Many of these were in areas of the financial statements which were not of fundamental importance to the measurement of the underlying financial performance of the entity or where the underlying accounting issues were highly technical.

In 16 of the 19 cases, remedial actions to ensure that the risk of repetition was adequately addressed were agreed with the relevant firms. In three cases, having made enquiries with the firms and reviewed the audit work, CEE found no evidence of breaches of Relevant Requirements and concluded that no remedial actions were necessary. CEE continues to monitor restatements and will take further action if similar matters are identified in financial statements audited by the same audit firms.

One important element of Constructive Engagement is to identify the underlying causes of the issues so that bespoke remedial measures, on a firm-wide basis where appropriate, can be developed and implemented. The most common issues identified this year include:

- Insufficiently granular audit procedures in areas typically regarded as lower risk. These matters have largely been resolved through firms adopting more detailed and effective audit procedures and the introduction of additional reviews.
- Insufficient understanding by junior audit staff of technical accounting requirements. These matters have largely been resolved through the delivery of additional firm-wide training, circulation of revised guidance, and improved review procedures by technical specialists within the firms.

Three anonymized case examples are set out below:

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<sup>32</sup> This case remains open at 31 March 2019.

<sup>33</sup> See paragraphs 13-15 of the Guidance for Case Examiner which can be found [here](#)

### Case A

A company restated its 2017 balance sheet to correct undetected errors in the accounting for share option schemes. The errors did not have a material impact on the income statement (and therefore on the financial performance reporting of the company).

The matter raised some particularly challenging technical matters and CEE's enquiries with the audit firm identified that the key underlying cause was insufficient technical expertise within the audit team and a lack of technical review.

As part of Constructive Engagement, the firm provided immediate training on the technical issue to auditors within the relevant office and implemented a firm-wide training programme. An additional technical review was also added to future audits of the company.

The Case Examiner was satisfied that these steps appropriately addressed the risk of repetition.

### Case B

During the current year audit, the audit team identified errors in previous years in the accounting for revenue and cost of sales in relation to a complex revenue sharing agreement with a supplier. This resulted in a restatement of the prior year revenue and cost of sales which had no impact on reported gross profit.

CEE's enquiries with the audit firm identified that the errors had not been picked up in the previous years because insufficiently detailed revenue testing procedures had been performed.

The firm had introduced significant firm-wide improvements to revenue testing procedures prior to the matter coming to CEE's attention. CEE was satisfied that these new procedures had been effective in detecting the errors and would prove similarly effective in other audits.

Therefore, no additional remedial action was required.

### Case C

An immaterial error in a company's financial statements had been identified by the FRC's CRR team. The error did not have a material impact on the income statement or balance sheet and arose in relation to a highly complex accounting standard.

CEE's enquiries with the audit firm identified that the audit team had consulted with the firm's technical experts but that a lack of clarity in those communications had led to the guidance being misinterpreted by the audit team.

As part of Constructive Engagement, the audit firm introduced practical guidance to all audit teams and the technical consultation function on framing questions and interpreting answers when consulting on complex technical accounting issues. The firm also allocated a technical quality review partner to the particular audit for the following year.

The Case Examiner was satisfied that these steps appropriately addressed the risk of repetition.

Another important element of constructive engagement is that a firm engages with CEE throughout the process. CEE was generally satisfied with the level of engagement demonstrated by Audit firms during the year.

CEE has also considered restatements arising from a change of accounting treatment by a company, sometimes arising from different judgements being reached by a new finance director. These cases have not always resulted in potential breaches by the auditors being identified and remedial actions being required as there may be more than one approach which is considered reasonable. Auditors are, however, reminded of the need to demonstrate that appropriate levels of professional judgement and scepticism have been applied.

The Case Examiner shares the themes with the audit firms, as well as the accountancy bodies, other regulators and other FRC teams. The Case Examiner also provides regular reports on cases resolved by Constructive Engagement to the Conduct Committee, who carry out an oversight role.

## Investigations and Enforcement

### Investigations opened

	2016/17	2017/18	2018/19
<b>Investigations opened in Year</b>	11	14	15

The Conduct Committee opened 15 new investigations in the 12 months to 31 March 2019: 12 audit investigations under the AEP and three investigations into accountants under the Accountancy Scheme.

No investigations were opened during this period under the Actuarial Scheme.

#### *The AEP investigations*

The 12 investigations concern a wide range of audit issues including revenue recognition; oversight of component auditors; the audit of cash, supplier rebates, provisions and pensions; and compliance with laws and regulations. Three of the investigations opened by the Conduct Committee followed referrals to the Case Examiner from the FRC's AQR team, following audit inspections (see more on page 24).

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In accordance with the FRC's publication policies<sup>34</sup>, not all investigations are announced at the outset, although if the case leads to enforcement action and the imposition of sanctions, this will be published.

Decisions on publication of the opening of investigations are made by the Conduct Committee on a case by case basis in accordance with the FRC's publication policies.

Decisions about publishing the opening of investigations take into account:

- (a) the level of public interest in publishing or not publishing an announcement in relation to the matter under consideration;
- (b) public confidence in audit regulation;
- (c) whether it is right in all the circumstances to publish a discretionary announcement;
- (d) fairness to all concerned in relation to the enforcement action in question and the publication or otherwise of a discretionary announcement;
- (e) what legitimate purpose is served by making such a discretionary announcement;
- (f) requirements under the Freedom of Information Act 2000 and/or the Environmental Information Regulations 2004 to publish such information or to release such information into the public domain upon request.

The four new AEP investigations, which have been announced are:

- **Deloitte's** audit of the financial statements of **SIG plc** for the years ended 31 December 2015 and 2016.<sup>35</sup>
- **KPMG's** audit of the financial statements of **Conviviality plc** for the 52 weeks ended 30 April 2017, following the company entering administration in April 2018.
- **Grant Thornton's** audit of the financial statements of **Patisserie Holdings plc** for the years ended 30 September 2015, 2016 and 2017.
- **Grant Thornton's** audit of the financial statements of **Interserve plc** for the years ended 31 December 2015, 2016 and 2017.

In addition, the investigation into **KPMG's** audit of the financial statements of **Carillion plc** was extended to include certain transactions entered into between Carillion plc and Wipro Ltd in the year ended 31 December 2013.

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<sup>34</sup> Links to the publication policies are here: [Accountancy and Actuarial Schemes](#); [AEP](#). These policies are currently being amended. Revised versions are due to be published in the Autumn.

<sup>35</sup> The FRC has delegated the investigation to the ICAEW, which is Deloitte's RSB. See further information on delegation of cases at page 24.

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### *Investigations following referral from AQR*

Prior to the introduction of the AEP (which has a lower threshold for opening investigations and for taking enforcement action than under the Accountancy Scheme), it was relatively rare for the FRC's AQR team to refer cases to the Case Examiner to be considered for investigation. Since June 2016, 12 investigations were opened following such referrals; three during the current year.

Investigations opened following a referral from the AQR team will usually initially focus on the areas of the audit which have been identified as needing improvement by AQR. However, the whole audit file will be requested from the firm, so that the investigation team can look at other areas where necessary.

The investigation team will conduct its own investigation. This will also usually include obtaining emails from the audit firm and holding interviews with the audit partner/audit team.

If, early in an investigation, firms and audit partners accept that there were breaches and share their root cause analysis or any internal review conducted into the audit, it is highly likely that this will be treated as exceptional co-operation, which would be reflected in the discount in any proposed sanctions<sup>36</sup>.

### *Delegation of investigations*

Three of the AEP investigations opened were delegated to the ICAEW, as the RSB of the relevant audit firms. Decisions whether to delegate investigations are made by the Conduct Committee, which can take into account amongst other things: the seriousness and complexity of the Allegation; the capacity and capability of the RSB; the capacity within the FRC to conduct the investigation and/or the likely resources required for the investigation (including costs).

In these three cases, the ICAEW is responsible for carrying out the investigations, using the powers under Rule 9 of the AEP.<sup>37</sup> The cases will be returned to the FRC on completion of the investigations, at which point Executive Counsel will be responsible for deciding if enforcement action is appropriate, and if so, will take over the case.

### *The Accountancy Scheme investigations*

Three new investigations under the Accountancy Scheme were opened and publicly announced:

The preparation and approval of **Conviviality plc's** financial statements and other financial information by a member of the ICAEW.

The preparation and approval of **Patisserie Holdings plc's** financial statements and other financial information by the former Chief Financial Officer, a member of the ICAEW.

The provision of materials to the FRC by **KPMG** in connection with the FRC's Audit Quality Review into aspects of the audit of **Carillion plc** for the year ended 2016.<sup>38</sup>

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36 See section on settlement at page 40.

37 In delegated investigations, there is regular communication with the ICAEW to monitor case progress and ensure the quality of the investigation.

38 The decision to open this investigation followed matters self-reported to the FRC by KPMG.



## Concluded cases

### *Outcome of investigations*

	Closed with no further action	Closed with findings of misconduct and sanctions		Total
		Settlement Agreement	Tribunal	
2016/17	1	7	1	9
2017/18	3	5	1	9
2018/19	1	8	4	13

During 2018/19, 13 cases were concluded, a significant increase on previous years. In a further case, which remains open, final sanctions were imposed during the year against the audit firm and an audit partner.

### *Concluded audit cases*

The FRC has published outcomes of nine audit investigations which have resulted in sanctions being imposed on audit firms and partners. Two of these were legacy cases, which involved lengthy investigations and culminated in contested proceedings before the independent Tribunal (Baker Tilly/Tanfield; KPMG/ESML).

In seven cases, liability was admitted by the audit firms and partners, and sanctions were agreed as part of a settlement process. This includes the first concluded case under the AEP.

Details of the nine cases are set out below. Additional case summaries are included in Appendix A.

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#### **KPMG LLP/Quindell plc/Accountancy Scheme**

In May 2018, a settlement agreement was approved after KPMG LLP and the Audit Partner admitted Misconduct in relation to the 2013 audit of Quindell plc.

Quindell was a professional services provider which dealt with a large number of legal claims for industrial diseases.

The Misconduct related to two areas of the audit: revenue recognition for legal services; and a series of transactions relating to the sale and purchase of software licenses, related services and investments.

KPMG was fined £4.5 million (discounted to £3.15 million for settlement) and received a Reprimand, and the audit partner was fined £120,000 (discounted to £84,000 for settlement) and received a Reprimand.

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### **PwC LLP/BHS Ltd/Accountancy Scheme**

In June 2018 a settlement agreement was approved after PwC and the audit partner admitted Misconduct in relation to the 2014 audit of the Taveta Group, including BHS Ltd.

The Misconduct related to the audit of BHS and two Taveta companies and concerned multiple areas of the audit including: planning, going concern, income statement and impairment.

PwC was fined £10 million (discounted to £6.5 million for settlement), received a Severe Reprimand and was subjected to non-financial penalties including:

- A condition to monitor and support the Leeds PwC audit practice for three years and provide a detailed report to the FRC each year.
- An undertaking to review (and if necessary, amend) its policies and procedures to ensure that high risk or high-profile private companies are subjected to an engagement quality control review.

The audit partner was fined £500,000 (discounted to £325,000 for settlement), received a Severe Reprimand and was prohibited from performing any audit for 15 years.

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### **KPMG LLP**

In July 2018 a settlement agreement was approved after KPMG and the audit partner admitted Misconduct in relation to the 2013 and 2014 audits of Ted Baker plc.

The Misconduct concerned breaches of the FRC's Ethical Standards<sup>39</sup> in providing litigation services to a client while acting as its auditor.

KPMG was fined £3 million (discounted to £2.1 million for settlement) and received a Severe Reprimand. The audit partner was fined £80,000 (discounted to £46,800 for mitigation and settlement) and received a Reprimand.

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### **Grant Thornton LLP/Nichols plc, University of Salford/Accountancy Scheme**

In July 2018 a settlement was approved after Grant Thornton and three partners admitted Misconduct in respect of Grant Thornton's audits of Nichols Plc and the University of Salford's financial statements for the years ending 2010-2013 inclusive.

The Misconduct related to breaches of the FRC's Ethical Standards and concerned a former audit partner taking on key non-executive positions at existing audit clients of Grant Thornton while continuing to provide paid services to the firm through a consultancy agreement.

Grant Thornton was fined £4 million (discounted to £3 million for settlement) and received a Severe Reprimand. The three audit partners were fined between £60,000 – £100,000 (discounted to £45,000 - £75,000 for settlement) and received Reprimands (including one Severe Reprimand).

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<sup>39</sup> These standards were consolidated into one Ethical Standard with effect from June 2016. The standards applicable in the relevant cases referred to in this report were those in force prior to June 2016 and accordingly the plural is adopted throughout.

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### **Deloitte LLP/Serco Geographix Limited**

In January 2019 a settlement agreement was approved after Deloitte LLP admitted Misconduct in relation to the audit of Serco Geographix Limited's 2011 and 2012 audits and an audit partner admitted Misconduct in relation to 2011.

Deloitte and the audit partner failed to act in accordance with the Fundamental Principle of Professional Competence and Due Care. (No further details have been published at this stage.)

Deloitte was fined £6.5 million (discounted to £4.225 million for settlement) and received a Severe Reprimand. In addition, Deloitte has arranged for all its audit staff to undergo a training programme (designed to the satisfaction of the FRC) aimed at improving the behaviour that is the subject of the Misconduct.

The audit partner was fined £150,000 (discounted for settlement to £97,500) and received a Severe Reprimand.

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### **Baker Tilly UK Audit LLP (now RSM UK Audit LLP)/Tanfield Group plc/Accountancy Scheme**

In January 2019 the Tribunal signed its final report setting out findings of Misconduct and sanctions imposed against Baker Tilly and two audit partners, following a two-week Tribunal hearing in 2017 and a sanctions hearing in October 2018.

The findings of Misconduct relate to Baker Tilly's audit of Tanfield Group plc and two of its subsidiaries for the year ended 31 December 2007 and concern the audit of inventories and trade receivables, the most significant items on Tanfield's balance sheet.

Baker Tilly was fined £750,000 and received a Reprimand. The partners were fined £30,000 and £35,000 and received a Reprimand.

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### **KPMG Audit plc/Equity Syndicate Management Limited/Accountancy Scheme**

In February 2019 the Tribunal signed its final report regarding the findings of Misconduct and sanctions against KPMG and two audit partners, following a four-week Tribunal hearing in 2017 and a sanctions hearing in October 2018.

The findings of Misconduct concern KPMG's 2008 and 2009 audit of Lloyd's Syndicate 218 (Equity Red Star) and involve a failure to make sufficient enquiries regarding a claims review process conducted by the Syndicate's Finance Director and not acting on warning signs of deterioration in the Syndicate's claims reserves.

KPMG was fined £6 million, received a Severe Reprimand and agreed to undertake an additional internal review and report to the FRC on certain aspects of its 2018 audits of insurance undertakings. The audit partners were both fined £100,000 and received Severe Reprimands. In addition, the more senior partner has agreed to the imposition of a requirement to have a second partner review of his audits until the end of 2020.

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### **KPMG Audit plc/The Co-operative Bank plc/Accountancy Scheme**

In February 2019 a settlement agreement was approved after KPMG and an audit partner admitted Misconduct in relation to the 2009 audit of The Co-operative Bank plc.

The Misconduct concerned the bank's 2009 audit, which took place shortly after the bank's merger with the Britannia Building Society and included: (1) failures to obtain sufficient appropriate audit evidence; (2) failures to exercise sufficient professional scepticism and (3) a failure to inform the bank that the disclosure in the financial statements was not adequate.

KPMG was fined £5 million (discounted to £4 million for settlement) and received a Severe Reprimand. In addition, it agreed that all audit engagements with credit institutions for audits with 2019, 2020 and 2021 year ends be subjected to an additional review by a separate KPMG Audit Quality team, who will provide reports to the FRC.

The audit partner was fined £125,000 (discounted for settlement to £100,000) and received a Severe Reprimand.

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### **MSR PARTNERS LLP (formerly known as Moore Stephens LLP)/Laura Ashley plc/AEP**

In March 2019 a final Decision Notice was served on MSR Partners LLP (MSR) following admissions of breaches of Relevant Requirements by the audit firm and the audit partner in relation to the 2016 audit of Laura Ashley plc.

The breaches concern failures in three areas of audit work: materiality; revenue; and going concern.

MSR received a fine of £825,000 (reduced for mitigation, in particular reflecting an exceptional level of co-operation, and for early disposal, to £455,813), a Severe Reprimand and a declaration that the 2016 audit did not satisfy Relevant Requirements.

The audit partner received a fine of £110,000 (reduced for mitigation, in particular reflecting an exceptional level of co-operation, and for early disposal, to £60,775), a declaration (as above), a prohibition on acting as statutory auditor for a PIE for 18 months and a requirement for additional training.

#### *Closed cases*

The investigation into Grant Thornton's audit of the consolidated financial statements of Globo plc for the years ended 31 December 2013 and 31 December 2014, conducted under the Accountancy Scheme, was closed without enforcement action, following a decision of Executive Counsel that there was insufficient evidence of Misconduct.

#### *Concluded investigations into accountants*

Four investigations into accountants were concluded with sanctions.

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### **Finance Director/RSM Tenon Group plc/Accountancy Scheme**

In May 2018 a settlement agreement was approved after the Finance Director of RSM Tenon Group plc admitted Misconduct in relation to the preparation and approval of the 2011 financial statements of RSM Tenon. He admitted nine allegations that his conduct fell significantly short of the standards reasonably to be expected of a member of the ICAEW including being reckless as to whether certain information within the financial statements had been fairly and accurately stated.

He was fined £60,000 (discounted to £57,000 for settlement) and was excluded from the accountancy profession for a recommended period of five years.

PwC (and the audit partner) and the former Chief Executive Officer of RSM Tenon had admitted Misconduct and had been sanctioned, pursuant to settlement agreements, in previous years.

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### **Former senior partner/Grant Thornton/Accountancy Scheme**

In July 2018 a settlement was approved after a former senior partner of Grant Thornton admitted Misconduct in respect of Grant Thornton's audits of Nichols Plc and the University of Salford's financial statements for the years ending 2010-2013 inclusive.

The admitted Misconduct included a breach of the Fundamental Principle of Objectivity as a result of taking on key non-executive positions at former audit clients while continuing to provide paid services to Grant Thornton through a consultancy agreement.

He was fined £200,000 (discounted to £150,000 for settlement) and was excluded from the accountancy profession for a recommended period of five years.

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### **Chief Executive Officer, Chief Finance Officer, Financial Controller/AssetCo plc/Accountancy Scheme**

In August 2018, the Tribunal signed its final report regarding the findings of Misconduct and sanctions against the former Chief Executive, Chief Finance Officer, and Financial Controller (all professional accountants) in relation to the preparation of AssetCo plc's 2009 and 2010 financial statements.

The Tribunal made findings of Misconduct in all 27 allegations that had been brought by Executive Counsel. These included findings of dishonesty and failing to act in accordance with core standards of integrity, objectivity and competence, which related to dealing with company funds, the preparation of financial statements, and the recognition of fictitious assets and revenue. The Tribunal also found that they had each misled the auditors, Grant Thornton.

All three were excluded from the accountancy profession (16, 14 and 12 years respectively) and fined (£250,000, £150,000 and £100,000 respectively).

Grant Thornton (and the audit partner) had admitted Misconduct and been sanctioned, pursuant to a settlement agreement, in previous years.

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## Finance Director/Equity Syndicate Management Limited (ESML)/Accountancy Scheme

In February 2019 the Tribunal signed its final report regarding the findings of Misconduct and sanctions against the former Finance Director (FD) of ESML in relation to the preparation and audit of Lloyd's Syndicate 218 (Equity Red Star) Report and Accounts 2007, 2008 and 2009.

The Misconduct arose from claims file reviews carried out within the business, and under the FD's direction, and which involved claims reserves held by the Syndicate being reduced to meet a pre-determined target. The Tribunal found that the reviews were 'wholly improper' and further that the FD had failed to ensure that proper records were made, or that the reviews were properly disclosed to the Board, the Syndicate's external Actuary or the auditors.

The FD was excluded from membership of CIMA for two years.

## Ongoing cases as at 31 March 2019

As at 31 March 2019, there were 41 open cases<sup>40</sup>: 28 investigations into individuals and firms for audit work<sup>41</sup>; two investigations into individuals and firms for non-audit work and 11 investigations into actuaries or accountants working within business.

Of the 28 audit investigations, three are being investigated under the Accountancy Scheme and the remaining 25 are under the AEP. Four of the AEP investigations have been delegated to the ICAEW.

Of the 25 audit investigations under the AEP, nine have been announced<sup>42</sup>:

- **Grant Thornton's** audit of the financial statements of **Sports Direct International plc** for the 52-week period ended 24 April 2016.
- **PwC's** audit of the financial statements of **Redcentric plc** for the years ended 31 March 2015 and 31 March 2016.
- **KPMG Audit Plc's** audit of the financial statements of **Rolls-Royce Group plc** for the year ended 31 December 2010 and of **Rolls-Royce Holdings plc** for the years ended 31 December 2011 to 31 December 2013.
- **PwC's** audit of the consolidated financial statements of **BT Group plc** for the years ended 31 March 2015 to 31 March 2017.
- **Deloitte's** audits of the consolidated financial statements of **Mitie Group plc** for the years ended 31 March 2015 and 31 March 2016.

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40 A case will comprise one of the below: i) an audit investigation into an audit firm and audit partner(s) (under the Accountancy Scheme or the AEP); ii) an investigation into qualified accountant(s) working in business (under the Accountancy Scheme); iii) a non-audit investigation into qualified accountant(s) and accountancy firms (under the Accountancy Scheme); iv) an investigation into actuaries (under the Actuarial Scheme). Each case may include multiple subjects, and a case is not deemed to be closed until concluded against all subjects.

41 Audit work includes audit of Client Assets Reports.

42 See explanation of the FRC's policy on announcing investigation on page 23.

- **KPMG’s** audit of the financial statements of **Carillion plc** for the years ended 31 December 2014, 2015 and 2016, and additional audit work carried out during 2017.
- **KPMG’s** audit of **Conviviality plc** for the 52 weeks ended 30 April 2017.
- **Grant Thornton’s** audit of **Patisserie Holdings plc** for the years ended 30 September 2015, 2016 and 2017.
- **Grant Thornton’s** audit of the financial statements of **Interserve plc** for the years ended 31 December 2015, 2016 and 2017.

The 25 investigations concern a wide range of issues, including:



The open investigations into accountants working in business concern many of the same accounting issues.

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### *Preliminary enquiries*

As at 31 March 2019, we also had ongoing preliminary enquiries in relation to one accountant.

### *Service of Formal Complaints in three cases*

In the 12 months to 31 March 2019, Formal Complaints (under the Accountancy Scheme) were served in three cases, leading to the matters being listed for hearings before the independent Tribunal.

### *Deloitte LLP/Autonomy Corporation plc/Accountancy Scheme*

Following the completion of its investigation Formal Complaints in connection with the conduct of Deloitte and two audit partners, as well as Autonomy's former Chief Financial Officer and former Vice President of Finance were served in May 2018. The Complaints against the two individuals have been temporarily paused by the independent Tribunal pending the resolution of criminal proceedings in the USA. In the meantime, both individuals have consented to orders suspending them from membership of the ICAEW. The Complaint against Deloitte and the audit partners is due to be heard by the Tribunal later in the year.

### *KPMG Audit plc/BNY Mellon/Accountancy Scheme*

KPMG Audit plc and the audit director admitted Misconduct in relation to their Client Assets Reports to the FCA on compliance by The Bank of New York Mellon (International) Limited and The Bank of New York Mellon London Branch with the FCA's Client Assets Sourcebook (CASS) for the year ended 31 December 2011.

Accordingly, a Formal Complaint was delivered by the FRC's Executive Counsel in September 2018. A three-day hearing took place before the Tribunal in May 2019 to determine appropriate sanctions.

### *KPMG LLP/Silentnight/Accountancy Scheme*

In November 2018, Formal Complaints were served on KPMG LLP and one of its insolvency partners. The Misconduct alleged in the Formal Complaints relates to an engagement carried out by the Respondents between January 2011 and April 2011 relating to companies trading under the name "Silentnight". A Tribunal has been convened to hear the Complaints next year.

## **High Court litigation**

### *Sports Direct International plc*

In September 2018, Mr Justice Arnold gave judgment in **FRC v Sports Direct International plc**<sup>43</sup>. The case was the first to consider the FRC's powers pursuant to SATCAR. It concerned the FRC's first application to the High Court for an order against an audit client in respect of the client's failure to comply with a statutory notice requiring the production of documents, pursuant to SATCAR and the AEP. The judge held, among other things, that the production of documents to a regulator by a regulated person, solely for the purposes of a confidential investigation by the regulator into the conduct of the regulated person, was not an infringement of the legal professional privilege of a client of the regulated person in respect of those documents. The judge also held that the same was true of the production of documents to the regulator by a client of the regulated person.

Sports Direct appealed the decision. The appeal is expected to be heard in November 2019.

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43 [2018] EWHC 2284 (Ch).



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### *Taveta Investments Limited*

In June 2018, Taveta Investments Limited (Taveta) sought an application for Judicial Review and an interim injunction to prevent the FRC's publication of certain parts of the settlement agreement entered into by PwC and one of its partners, Mr Stephen Denison relating to PwC's audit of BHS and Taveta. The settlement agreement contained the facts agreed between the FRC, PwC and Mr Denison and set out the nature and seriousness of the admitted Misconduct and the basis on which the sanctions had been determined.

Taveta was not a subject of the FRC's investigation.

Taveta argued that the settlement documents contained criticisms of its personnel and that the FRC's decision to publish the settlement agreement without first giving Taveta a fair opportunity to answer any criticisms breached the duty of fairness. The FRC argued that the Scheme makes no provision for the involvement of third parties in the processes of investigating, settling or adjudicating upon alleged disciplinary breaches by members of its regulated community and such third-party participation would be impractical. Further, and in any event, any duty of fairness that the FRC was under as regards Taveta was satisfied by the publication of a disclaimer with the sanction documents.

In **Taveta Investments Ltd v FRC**<sup>44</sup>, Mr Justice Nicklin held that Taveta had not satisfied the high bar required to restrain publication of a report produced by a regulator and did not grant the injunction. Nevertheless, he found (a) the settlement documents contained implied criticisms of Taveta personnel which were capable of defaming them and as such there was a serious issue to be tried as to whether the FRC owed a duty of fairness to Taveta and (b) there was a serious issue to be tried whether the FRC's consideration of Taveta's representations satisfied the duty of fairness.

Following the judgment, some changes were made to the text of the settlement documents to enable publication in a timely manner.

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44 [2018] EWHC 1662 (Admin).

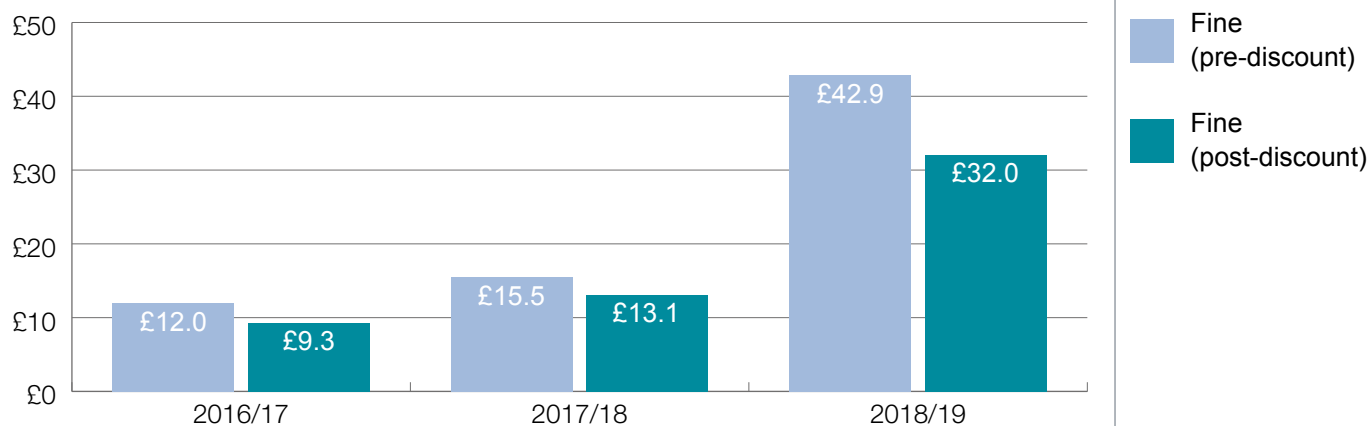
## 5 Sanctions

During 2018/2019, the FRC imposed a significantly higher number of sanctions than in previous years, with an increase in financial sanctions, periods of exclusion and a range of non-financial sanctions. Details of sanctions in nine audit cases and four non-audit cases have been published.

### Financial Sanctions

	2016/17 £m	2017/18 £m	2018/19 £m
Total financial sanctions imposed <sup>45</sup> :			
- Pre-discount	£12.0	£15.5	£42.9
- Post-discount	£9.3	£13.1	£32.0
Number of financial sanctions imposed	13	11	27
Number of non-financial sanctions imposed	16	11	38
<i>Of which:</i>			
Exclusions	7	2	6
Conditions and Undertakings	-	-	9

### Total financial sanctions



<sup>45</sup> Total financial sanctions in all enforcement cases including firms and individuals (audit and non-audit) between 1 April 2018 and 31 March 2019. Previously published figures may differ if sanctions were issued but not published at the date of the earlier publication.

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## The Clarke Review

In 2017, the FRC commissioned an independent review chaired by Sir Christopher Clarke (the Clarke Review) to consider the FRC's sanctions (under both the Schemes and the AEP) and to determine whether the level of financial sanctions was adequate. The review panel sought representations from a wide range of stakeholders and looked at the experience of fellow regulators in the UK and internationally. The final report (the Clarke report) was published in November 2017.

The Clarke report made no recommendation for a general increase in the quantum of financial sanctions, noting that they had increased in recent years. Neither did the report recommend the introduction of a tariff approach to the calculation of fines. It did, however, suggest that an appropriate sanction for "a Big Four audit firm guilty of seriously bad incompetence, in respect of an audit of a major public company, where the errors were measured in nine figures or more and there had in consequence been either widespread actual loss or the risk thereof" would be a financial penalty of £10 million or more (before any discount).

The report also recommended that greater attention be given to the use of non-financial sanctions, in order to achieve the objectives of maintaining and enhancing the quality and reliability of audit and accounting work. Where an individual is found to have been dishonest, the recommendation was that any exclusion from membership of a professional accountancy body should be for at least 10 years.

Another key recommendation was the adjustment of settlement discount provisions to encourage timely settlement.

## Revised sanctions policy and guidance

Following the Clarke report and taking into account the recommendations, in April 2018 the FRC issued revised Sanctions Guidance (for use by Executive Counsel, Tribunals and any other relevant decision maker) in relation to the Schemes and the AEP. The guidance came into force in June 2018<sup>46</sup>.

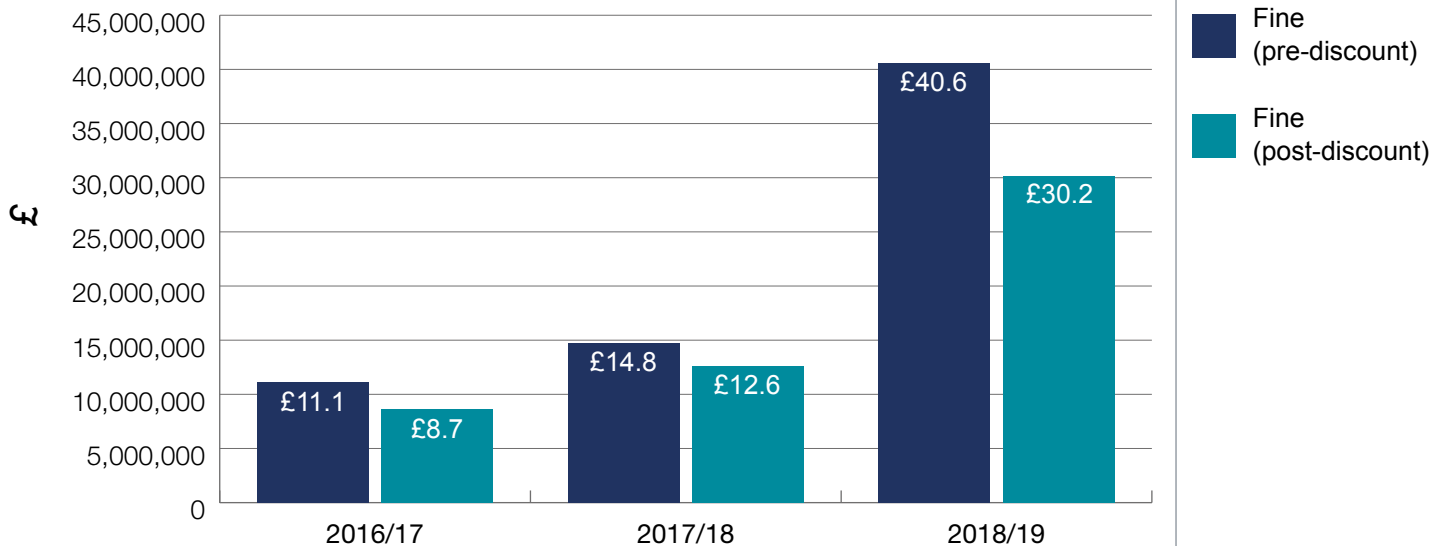
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<sup>46</sup> [Sanctions Policy \(Audit Enforcement Procedure\); Accountancy Scheme Sanctions Guidance ; Actuarial Scheme Sanctions Guidance](#)

## Financial Sanctions against audit firms

The FRC has published financial sanctions in relation to nine audit investigations during the year. The total amount of financial sanctions on audit firms (pre-discount for settlement) was £40.6 million, almost treble that of the previous year.

### Financial sanctions - Audit Firms



The increase in total financial sanctions is partly due to an increased number of cases being concluded (either following Tribunal proceedings or firms agreeing to settle cases prior to a Tribunal hearing).

	2016/17	2017/18	2018/19
<b>No of financial sanctions against firms</b>	4	4	9

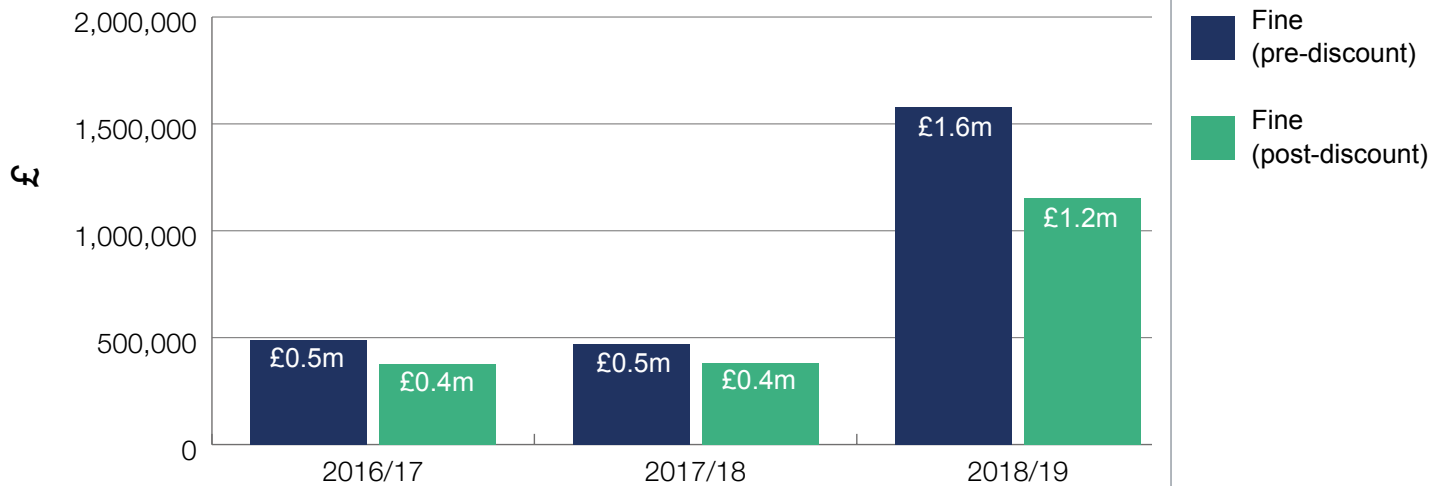
The increase also reflects the serious nature of the Misconduct and the size of the audit firms. A key issue in determining the level of financial sanctions is the seriousness of the Misconduct/breaches. Factors which go towards seriousness include the nature of the audit failings; the number of people potentially adversely affected by the Misconduct/breaches and the impact of the Misconduct/breaches on the public's confidence in financial reporting and the professional generally. There were a number of large financial sanctions imposed this year to reflect serious Misconduct/breaches.

Financial sanctions also take into account the size and financial resources of the audit firms. Of the nine sanctions imposed on audit firms, six related to Big Four firms. Whilst there is no set mathematical formula (which was rejected by the Clarke report) the turnover of the firm, its revenue and profit per partner are all measures which may be taken into account in determining a proportionate financial sanction.

## Financial sanctions against audit partners

The total amount of financial sanctions on audit partners (pre-discount for settlement) was £1.6 million.

### Financial sanctions - Audit Partners



The three-fold increase in financial sanctions imposed on audit partners reflects the same issues as above. The fines will take account of the seriousness of the Misconduct/breaches as well as the financial resources of the partner.

## Sanctions against Accountants

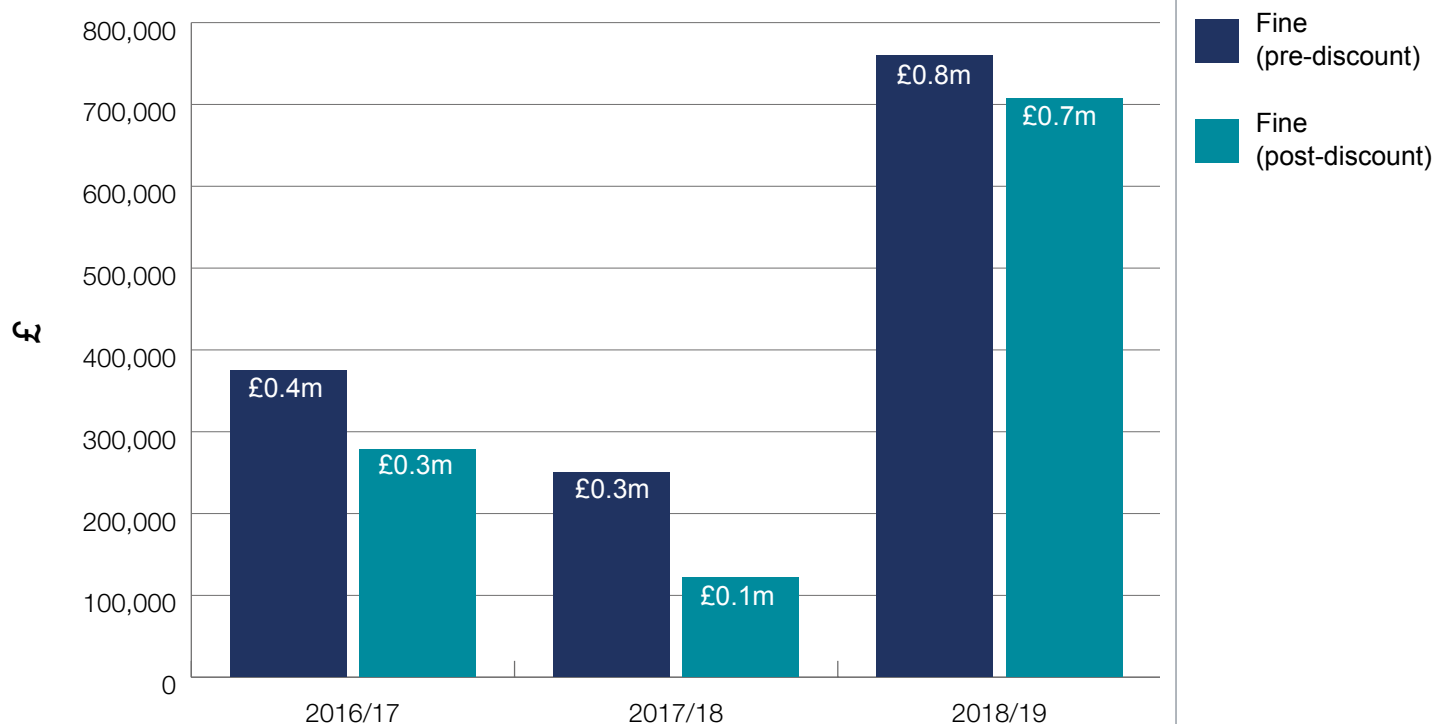
During the year, six accountants in business have been sanctioned for Misconduct<sup>47</sup>.

Audit Firm/ Audit Partner/ Members	Company	Outcome	Date	Sanction
<b>Russell McBurnie</b>	RSM Tenon Group plc	Sanction agreed as part of a settlement	May 2018	Fine of £60,000 (discounted to £57,000). An exclusion of 5 years.
<b>Eric Healey</b>	Nichols plc	Sanction agreed as part of a settlement	July 2018	Fine of £200,000 (discounted to £150,000). An exclusion of 5 years.
<b>John Shannon</b>	AssetCo plc	Sanctions imposed by the Tribunal	July 2018	A fine of £250,000 and an exclusion of 16 years.
<b>Raymond Flynn</b>				A fine of £150,000 and an exclusion of 14 years.
<b>Matthew Boyle</b>				A fine of £100,000 and an exclusion of 12 years.
<b>Douglas Morgan</b>	ESML	Sanction imposed by the Tribunal	February 2019	An exclusion of 2 years.

<sup>47</sup> In each of these cases, enforcement action has also been taken against the audit firms.

Financial sanctions were imposed on five of the individuals. In relation to the three accountants who worked at AssetCo plc, the financial sanctions were imposed by the Tribunal, following a full hearing. There was no discount for settlement, therefore.

### Financial sanctions – Accountants



All six of the individuals were excluded from membership of their professional bodies. The length of exclusion ranged from 2 years to 16 years.

### Non-financial sanctions

Following the Clarke Review, the FRC has expanded the use of non-financial sanctions, as a means of maintaining and enhancing the quality and reliability of future audits. This is an important and developing initiative and has involved working across the FRC and with the audit firms to ensure the sanctions are workable, effective and have a meaningful impact. Whereas in previous years non-financial sanctions such as reprimands (for firms and individuals) were used, the current year has seen sanctions directed to improving the quality of work in particular areas.

As well as the imposition of Reprimands, Severe Reprimands and exclusions from the accountancy professional bodies, non-financial sanctions which have been published this year have included:

- PwC to monitor and support its Leeds audit practice and to report to the FRC for three years;
- PwC to review, and if necessary, amend its policies and procedures with a view to ensuring that all audits of high risk or high-profile entities that are not listed companies are subjected to an engagement quality control review;

- All Deloitte audit staff, including partners, to undergo training on the audit of subsidiary companies as part of group audits, including identification of areas of significant risk, the importance of stakeholder relationships of the wider group and the risk of fraud in that context;
- KPMG to undertake a review of its 2018 audits of insurance undertakings and to report to the FRC;
- KPMG to conduct additional quality reviews on all audits with credit institutions (banks and building societies) over the next three years and to report to the FRC;
- The prohibition on audit partners performing any audit work or acting as a statutory auditor in relation to public interest companies;
- The introduction of second review partners on audits of particular partners.

Careful consideration is given to proposing bespoke non-financial sanctions, which will address some of the underlying causes of the Misconduct/breaches. The above-mentioned policies and procedures sanction imposed against PwC, for example, sought to redress the lack of a requirement for an engagement quality control review in respect of audits of private companies. As a result of the sanction, PwC reviewed and amended its policies and procedures regarding audits of private companies with significant numbers of UK employees. Such audits conducted by PwC are now required to have additional procedures, including audits being subjected to an engagement quality control review.

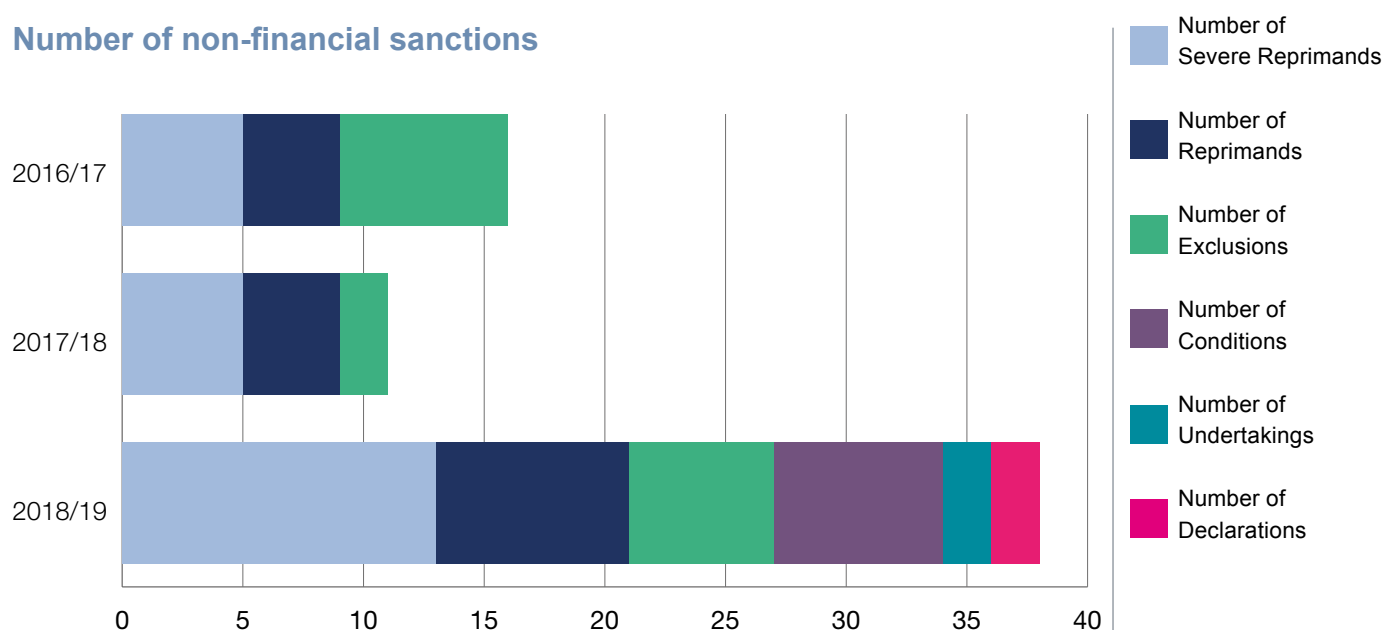
Non-financial sanctions available are not limited to the examples above. Under the Schemes and the AEP, it is possible for the FRC to impose far reaching measures, including, in the most serious cases of systemic failures, prohibiting a firm from conducting statutory audits or taking on new clients.

Where an audit firm has already taken appropriate remedial steps to prevent audit failures reoccurring (as was the case with Moore Stephens in relation to its investigation into its audit of Laura Ashley plc), additional non-financial sanctions may not be required.

#### *Number of non-financial sanctions*

	2016/17	2017/18	2018/19
Number of Reprimands	4	4	8
Number of Severe Reprimands	5	5	13
Number of Exclusions	7	2	6
Number of Declarations	-	-	2
Number of Conditions	-	-	7
Number of Undertakings	-	-	2
	16	11	38

## Number of non-financial sanctions



## Settlement

The Clarke Review also recommended the encouragement of early settlement by continuing with a staged discount on the fines imposed as well as additional mitigation for exceptional co-operation.

Settlement is encouraged. It involves understanding and recognition by the Respondents of their breaches/Misconduct which is a first step in taking improving action. It enables cases to be resolved faster and the full details of the Misconduct/breaches and the outcomes, including sanctions, to be communicated to the public and the profession more quickly – which is important for driving behavioural change. It also achieves significant savings in time and costs by avoiding (often lengthy) Tribunal proceedings.

The FRC also encourages an exceptional level of co-operation, above and beyond that which is required under the enforcement procedures. Examples of exceptional co-operation, set out in the sanctions guidance, which may amount to a mitigating factor and result in a further reduction to any financial sanction are:

- Self-reporting and/or bringing to the attention of the FRC potential Misconduct or breaches;

- Volunteering information which may assist the investigation, but which has not specifically been requested.

The revised sanctions guidance provides for discounts of up to 35% for early admissions and settlement.

In the first AEP case which was settled, MSR Partners LLP (formerly known as Moore Stephens LLP) and the audit partner also benefitted from an additional 15% reduction in the financial sanctions, due to exceptional co-operation which included undertaking their own investigation into their failures, sharing the results with those conducting the investigation and making comprehensive early admissions.



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## 6 Issues identified from Enforcement cases concluded in 2018/19

All professional accountants are expected to conduct themselves in accordance with their professional body's code of conduct and Fundamental Principles, as well as comply with the requirements of applicable accounting or auditing standards.

The following issues, amongst others, arose in the Enforcement cases concluded in the year, summaries of which are included in Appendix A.

The Fundamental Principles required of all professional accountants and auditors are integrity, objectivity, professional competence and due care, confidentiality and professional behaviour.

Acting with professional competence and due care, and in a professional manner, includes complying with technical and professional standards, e.g. the accounting and auditing standards, and relevant laws and regulations. The FRC's Ethical Standards also require auditors to act with integrity, objectivity and independence. Our concluded cases this year resulted in sanctions being imposed for both technical and ethical failings of auditors and accountants in business.

### Integrity

This overarching principle of the FRC's Ethical Standards applicable to audit engagements requires that auditors are trustworthy, straightforward, honest, fair and candid and comply with the spirit as well as the letter of applicable ethical principles, laws and regulations. In this way the public's trust in the auditing profession should be maintained.

While findings of a lack of integrity in relation to auditors are rare in our cases, where suspicions of dishonesty or a lack of integrity arise, they are thoroughly investigated and where proven, we will seek severe sanctions.

In cases concluded in 2018/19, the following findings were made regarding breaches of the standard of integrity expected of an auditor:

- Back-dating of the date of signing an audit report; and
- False statements regarding the timing of completion of audit work made on the audit file.

Accountants in business must also comply with their profession's Fundamental Principle of Integrity. In cases concluded in 2018/19, the following findings were made regarding breaches by accountants in business of the Fundamental Principle of Integrity:

- 
- Misleading and/or incorrect entries in financial statements having the effect of falsely improving the financial position of a company, including:
    - Recognition of fictitious revenue;
    - Incorrect recognition of work in progress and amounts recoverable on contracts;
    - Understatement of expenses and accruals;
    - Failure to impair goodwill and carrying value of subsidiaries.
  - Falsification of documents and provision of false information to auditors;
  - Improper claims' file reviews involving reserves being reduced to meet a pre-determined target.

In addition to financial sanctions, these cases have led to five exclusions from membership of the profession averaging 10 years and a ban on one audit partner from performing audit work for a period of 15 years.

## Objectivity and Independence

The FRC's Ethical Standards are designed to ensure the independence, objectivity and integrity of audit. The need for objectivity is critical given that many of the questions involved in the preparation of financial statements are matters of judgement and involve the application of discretion. If directors make biased or otherwise inappropriate decisions, the financial statements may be misstated or misleading. The auditor therefore needs to be in a position to make impartial judgements in light of all available evidence and adopt a robust approach, challenging management where necessary. Because in most cases the users of financial statements do not have all the information to judge whether the auditor is in fact objective, it is critically important that auditors are independent i.e. free from situations and relationships that are capable of threatening independence.

In cases concluded in 2018/19, findings were made of a lack or compromise of auditor objectivity in respect of the following matters:

- Provision of litigation services to a client whilst also acting as auditor which resulted in the firm having to review and evaluate its own work, when auditing the disclosures in the financial statements relating to ongoing litigation;
- Provision of audit services to clients where a former partner had joined the Audit Committees of those clients, whilst also providing consultancy services to the audit firm;
- Failure to identify and consider the risk of threats to objectivity and independence posed by fees for non-audit services which were many times the audit fee, combined with a long or close business association between the audit partner and client.

In addition to financial sanctions and exclusions, the above cases have resulted in the audit firms involved taking measures designed to prevent a reoccurrence of the breaches, including:

- 
- prohibiting the provision of any expert witness services to audit clients of a UK firm;
  - prohibiting former partners from entering or continuing consultancy agreements with their former audit firm if they join an audit client;
  - amending policies and procedures with regard to the engagement quality control review of private companies;
  - providing support for a period of three years to the office involved in the Misconduct.

## Professional competence and due care – audit evidence and professional scepticism

Two of the auditing standards which are frequently found to have been breached are International Standards on Auditing (ISAs) 200<sup>48</sup> and 500<sup>49</sup>. In particular, many of our findings are as a result of a failure by auditors to obtain sufficient appropriate audit evidence to draw reasonable conclusions on which to base the audit opinion. Sufficiency requires an assessment of the risks of material misstatement and the quality of the evidence. Appropriateness relates to the relevance and reliability of the evidence which might include consideration of, for example, whether it is from an independent third party, whether it came directly to the auditor or via the company itself, and the purpose for which it was obtained. A number of cases concluded in 2018/19 found that this requirement was not met.

In addition to obtaining sufficient appropriate audit evidence, ISA 200 also requires auditors to plan and perform audits with professional scepticism, recognising circumstances may exist that cause the financial statements to be materially misstated. Professional scepticism is defined as an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence. In a number of cases concluded in 2018/19, we have found that the auditor has failed to act with sufficient professional scepticism when undertaking the audit.

For cases concluded in 2018/19, the following findings were made with regard to failures to obtain sufficient appropriate audit evidence and failures to act with professional scepticism:

- Failure to complete statistical sample tests;
- Inadequate partner review of evidence;
- Delegation of responsibility to insufficiently experienced staff, and a general over-reliance by audit engagement partners on the work of junior staff, including failures to identify errors and discrepancies in audit work and evidence;
- Failure to obtain sufficient appropriate evidence of existence of work in progress and finished goods;
- Insufficient enquiries regarding internal processes;

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48 Overall objectives of the independent auditor.

49 Audit Evidence.

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- Failure to act upon warning signs, including profit warnings, pension deficits and deterioration in reserves.
  - Failure to consider and test the going concern basis of preparation of financial statements;
  - Over-reliance on management statements and failure to challenge management;
  - Inadequate testing of management's assumptions and estimates;
  - Failure to obtain independent, or external, corroborating audit evidence.

In addition to fines, the above cases have resulted in the audit firms involved taking the following measures to limit recurrence of the issues identified:

- Additional internal review;
- Reports to the FRC on reviews and planned actions;
- Requirement for second partner review of audits;
- Compulsory training;
- Engaging consultants to implement training and new audit methodology;
- Reviewing procedures and revising documentation.

To the extent that through our enforcement activities we discern any patterns in audit failings, we feed this information back to the audit firms so that they can act to ensure that the same breaches do not occur in their audits. We also share this information within the FRC, to inform standards setting and future monitoring and inspection activities.

## 7 Timeliness

### Key Performance Indicator

We recognise the critical importance of timely investigations and enforcement action and monitoring and improving the speed of our investigations continues to be a key priority for the Enforcement Division. For cases commenced on or after April 2016 we introduced a Key Performance Indicator (KPI) of a period of two years between commencement of an investigation and service of either the PFC or IIR.

As at 31 March 2019, 13 enforcement cases fell to be measured against the KPI (i.e. those which were opened between 1 April 2016 and 31 March 2017) and the table below sets out performance against this measure.

	Number of cases
PFC/IIR served (or case concluded without PFC/IIR) within two years	4
PFC/IIR not served/case not otherwise concluded within two years due to:	
Parallel regulatory or criminal proceedings	3
Satellite FRC legal proceedings	2
Finalisation of settlement process	2
Internal resource	2
<b>Total</b>	<b>13</b>

The target has been met in four cases, including complex and high-profile cases such as PwC/BHS in which very serious Misconduct was identified and significant sanctions imposed. In two cases insufficient internal resourcing at certain points in the investigations was a key reason for missing the KPI. We continue to increase resourcing of cases and to sharpen and streamline our processes, approach and monitoring tools.

However, in seven cases extraneous factors beyond our control have impacted significantly upon the speed at which we can act.

In three cases we were held up due to parallel action by other regulatory authorities. It is important to emphasise that where other proceedings are ongoing, we will only pause our process for compelling reasons – such as potential prejudice to a criminal process – and after the most careful consideration. Such was the case in these three matters.

In the investigations under the Accountancy Scheme and AEP in respect of the financial statements of Sports Direct International plc for the period ending April 2016, it was necessary to pause the substantive process pending the conclusion of satellite legal proceedings. This was the widely reported *Sports Direct* matter where an important point of legal principle relating to privilege was heard and determined by the High Court and is now subject to an appeal<sup>50</sup>.

In two other matters we were deep into the process of finalising settlement with the Respondents at the two-year mark and service of a PFC/IIR at that time would have jeopardised the prospects of achieving a timely resolution. These cases were concluded in just under 26 months and 28 months respectively<sup>51</sup> with significant sanctions imposed.

We shall continue to review our performance against our KPI and the extent to which extraneous factors impact on that performance with a view to separating and addressing that we which can, and will, improve, from that which is beyond our control.

#### *Average time taken to complete a case*

The table below sets out average case lengths of those matters which concluded this year and in the previous two years.

	2016/17	2017/18	2018/19
<b>Average length of cases referred to Tribunal (months)</b> (Number of cases)	69 (1)	77 (1)	82 (4)
<b>Average length of cases concluded as a result of settlement or service of undisputed Decision Notice (months)</b> (Number of cases)	42 (7)	46 (5)	42 (8)
<b>Average length of cases closed with no further action (months)</b> (Number of cases)	20 (1)	26 (3)	31 (1)

This reveals an increase in the length of cases referred to a Tribunal and those closed with no further action. It is important to note that the relatively small number of cases from which these averages are derived means that any outliers can have a significant impact on the figures. For example, the Baker Tilly/Tanfield legacy matter which was referred to a Tribunal and concluded in 2018/2019 commenced in 2010. The delay in this case included an unsuccessful judicial review challenge by the Respondents, followed by their unsuccessful appeal to the Court of Appeal, which, in total, took some three years to resolve. In a similar vein, the figure for the average length of cases closed with no further action is derived from just one case, GT/ Globo plc. This case related to a group audit with overseas components and involved, *inter alia*, liaison with another regulator in order to obtain information held in other jurisdictions and this had consequences for the speed with which we were able to progress the investigation.

<sup>50</sup> An appeal is due to be heard by the Court of Appeal in November 2019.

<sup>51</sup> KPMG/Ted Baker plc and PwC/Redcentric plc. NB: the PwC/Redcentric case was concluded with settlements and sanctions being agreed with PwC and two audit partners in May 2019. As this was after the year end, the details and statistics will be included in next year's report.

#### *Average time to service of PFC, IIR or settlement (if earlier)*

The Enforcement Division's KPI focuses on the investigation stage of our process. This is because if a matter proceeds to a contested hearing before an independent Tribunal, the directions for the stages leading to the hearing (such as service of witness statements and expert reports) will be set by the Tribunal Chair and accordingly the timetable is not within the control of Executive Counsel.<sup>52</sup> For similar reasons, in considering Enforcement performance it is instructive to consider the length of time to service of PFC/IIR (or settlement, if earlier). The relevant figures are set out below and show a clear downward trend.

Year to 31 March	2016/17	2017/18	2018/19
Number of cases for which PFC/IIR issued (or settled/closed if earlier)	8	9	6
Average length of time to issuance of PFC/IIR (or settlement/closure if earlier) in months	33	31	24

#### *Cases opened and closed*

We have also made significant progress in dealing with the backlog of "legacy" cases. The following table shows that, whereas at the beginning of the year we had ten open investigations which were opened between 2010 and 2015, by the end of the year, this had been reduced to two<sup>53</sup>.

Year investigation opened (to 31 March)	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	Total
Cases open at 1 Apr 2018	1	0	2	3	2	2	5	10	14	0	39
Cases closed in year	1	0	2	1	2	2	2	2	1	0	13
Cases open at 31 Mar 2019	0	0	0	2	0	0	3	8	13	15	41

The data above reveals some improvements and reflects the focussed and ongoing efforts of the Enforcement Division to deliver more timely results. This is also reflected in the table below, which shows a downward trend in the average age of cases open at each of the last three year-ends.

<sup>52</sup> It should be noted that guidance has been issued to Tribunals that matters should progress as expeditiously as possible.

<sup>53</sup> Relating to the investigation into the conduct of both the auditors and accountants in business in relation to the published financial reporting of Autonomy for the period between 1 January 2009 and 30 June 2011.

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*Average age of cases open at year end*

	2016/17	2017/18	2018/19
Number of cases open at year end	34	39	41
Number of cases opened in year	11	14	15
Average age of cases open at year end	30.4	27.2	20.9

In 2016/17 a review of the Enforcement Division was undertaken by the team to identify both the causes of delay and suitable measures to address them. In broad terms the causes were categorised as internal (e.g. resourcing) or external (such as delayed production of material from subjects). A number of recommendations for improvement resulted from this analysis which have subsequently been implemented. These include significant additional resources and a recalibrated relationship with subjects: one where we are clearer in our expectations and communicate more effectively from the beginning of a case and throughout and where we take a more robust approach where those expectations are not met.

This approach includes the careful monitoring and recording of the level of co-operation provided throughout the lifetime of a case and making it clear to subjects when it has fallen below the high level expected. This may result in non-co-operation being considered as an aggravating factor at the point of determining sanction.

Although our cases are now on average progressing more speedily than in the past, improvements in timeliness remain a key priority. We have identified above two cases where resourcing has been a material factor in missing the two-year KPI and we have taken further steps to address this issue, both by further increasing the size of the permanent team and making more use of temporary solutions such as fixed term contracts and secondments. We have, additionally, developed more sophisticated tools for monitoring the progress of cases internally. This has assisted case teams and the oversight function in more clearly identifying obstacles to progress and steps which can be taken to overcome them.



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## 8 Future developments

### A changing landscape

Recent corporate collapses have brought corporate reporting, governance and the role of audit under intense scrutiny with fundamental questions raised from many quarters as to the function of audit and whether it is meeting society's needs and expectations.

The Competition and Markets Authority (CMA) has carried out a study on the audit market<sup>54</sup>, the Department for Business, Energy and Industrial Strategy (BEIS) Select Committee has completed its inquiry into the Future of Audit<sup>55</sup> and Sir Donald Brydon is reviewing the quality and effectiveness of audit<sup>56</sup>. Sir John Kingman has concluded an independent review of the FRC and reported his findings in December 2018 (the Kingman Review).<sup>57</sup>

The full impact of these reviews has yet to be felt, but once implemented financial reporting and its regulation will undergo significant transformation. This will have major implications for the enforcement function of the FRC as it transitions into the new regulator, ARGA (the Audit, Reporting and Governance Authority), with the proposed strengthening of its enforcement regime. While continuing to prioritise the timely and effective investigation and resolution of our cases, we are already looking to the future and taking steps to assist in laying the groundwork for change and effective reform.

#### *Powers*

The Kingman Review made over 80 recommendations and the Government has endorsed and accepted the case for the major set of reforms they represent. The Review considered Enforcement specifically and recognised that many Respondents had noted a significant and positive shift in the FRC's approach since the introduction of the AEP and recorded that the Review was heartened by Enforcement's change in approach.<sup>58</sup> A number of the recommendations specific to Enforcement have already been implemented but others are for the longer term. In particular, the Review has recommended that ARGA be given greater powers to hold non-accountant directors to account for their duties to prepare and approve true and fair accounts and compliant corporate reports and to deal openly and honestly with auditors.

The FRC has welcomed these recommendations given the serious gaps in the regulatory framework in this area. As has been widely recognised, the granting of such powers would represent a significant shift in the regulatory landscape requiring primary legislation and careful consideration of how any such powers would interact with the existing enforcement framework. We are using our experience and knowledge to work with BEIS as they formulate proposals for consultation in this area.

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<sup>54</sup> CMA: Statutory audit services market study Final Report dated 18 April 2019.

<sup>55</sup> BEIS Committee: The Future of Audit dated 2 April 2019.

<sup>56</sup> Independent Review into the quality and effectiveness of audit: terms of reference dated 14 February 2019.

<sup>57</sup> Independent Review of the Financial Reporting Council dated 18 December 2018

<sup>58</sup> *ibid.* p.39.

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### *Cultural Change*

Improved behaviour and outcomes require recognition and acceptance at a senior level at those we regulate that where errors or ethical failings occur, it is necessary that their root causes are identified, effectively addressed and reported to us. Where this happens appropriate credit is given.

### *Non-financial sanctions*

As noted in chapter 5 we have adopted the Clarke report's recommendations that greater attention should be given to the quality of audit when considering sanctions and, in particular, the use of non-financial sanctions focused on future audit improvements. The imposition of such sanctions is however only part of the story; in order to achieve the intended results, there must be assurance that the measures have been fully and properly implemented. We will therefore focus in the coming year on the effective monitoring of these sanctions, working collaboratively with AQR where appropriate.

### *Themes*

We provide feedback on the issues and themes that we encounter in our investigations to our AQR team to help inform its monitoring, selection and inspection methodology. We also use past experience to guide our own work. We have, for instance, identified that in many cases evidence of the quality control review partner's involvement is concerningly light. We will be looking very carefully at whether this critically important role has been properly performed in investigations referred to us in the coming year. We will also pay particular attention to the quality of audit work in firms' regional offices given that we have come across a number of instances where work in the regions has not met the required standards and has compared unfavourably with those maintained in the central office. We shall report on these and other issues identified in ongoing work in future Annual Enforcement Reviews.

## 9 Glossary

Term	Meaning
ACCA	The Association of Chartered Certified Accountants.
Accountancy Scheme	a contractual arrangement between the FRC and the accountancy professional bodies which provides for the FRC to investigate (and take enforcement action against) accountants in cases which raise important issues affecting the public interest in the UK.
Actuarial Scheme	a contractual arrangement between the FRC and the actuarial professional bodies which provide for the FRC to investigate (and take enforcement action against) actuaries in cases which raise important issues affecting the public interest in the UK.
AEP	Audit Enforcement Procedure, which is the process under which the FRC can investigate statutory auditors and audit firms in relation to audits of PIEs, large AIM-listed companies and Lloyd's Syndicates for breach of a Relevant Requirement.
AQR	the FRC's Audit Quality Review team. This team is responsible for monitoring the quality of the audit work of statutory auditors and audit firms in the UK that audit Public Interest Entities (PIEs) and certain other entities within the scope retained by the FRC.
ARGA	Audit, Reporting and Governance Authority.
BEIS	Department for Business, Energy and Industrial Strategy.
Big Four	the four largest accounting firms i.e. Deloitte, Ernst & Young, KPMG and PricewaterhouseCoopers.
CAI	Chartered Accountants Ireland.
Case Management Committee	the FRC's Case Management Committee is comprised of former auditors, lawyers and lay members. It provides oversight, support and challenge to the case team throughout the lifetime of a case.
CEE	the FRC's Case Examination and Enquiries team. This team is responsible for gathering intelligence and conducting initial enquiries on cases arising under the AEP, the Accountancy Scheme or the Actuarial Scheme.
CIMA	The Chartered Institute of Management Accountants.
CMA	Competition and Markets Authority.

<b>Conduct Committee</b>	the Conduct Committee is a sub-committee of the FRC which decides whether to open investigations under the enforcement schemes and performs an oversight role in relation to the FRC's enforcement work. It is also the body responsible for making decisions about publication of certain case-related matters and issuing guidance.
<b>Constructive Engagement</b>	a process introduced by the AEP for resolving cases with an audit firm where the audit quality concerns do not necessarily warrant a full enforcement investigation.
<b>CRR</b>	the FRC's Corporate Reporting Review team reviews directors' reports and accounts of public and large private companies for compliance with the law. It also keeps under review interim reports of all listed issuers and annual reports of certain other non-corporate listed entities.
<b>Decision Notice</b>	a document issued at the end of an AEP investigation which sets out the allegations against the Respondent, as well as a recommended sanction.
<b>Ethical Standards</b>	a set of overarching principles and supporting provisions issued by the FRC which applies to audits of financial statements and other public interest assurance engagements in both the private and the public sectors.
<b>Formal Complaint</b>	a document issued at the end of an Accountancy Scheme investigation which sets out the alleged Misconduct.
<b>FRC</b>	Financial Reporting Council.
<b>ICAEW</b>	The Institute of Chartered Accountants in England and Wales.
<b>ICAS</b>	The Institute of Chartered Accountants in Scotland.
<b>IFoA</b>	The Institute and Faculty of Actuaries.
<b>IIR</b>	Initial Investigation Report. Under the AEP, this report is served on the Respondent at the end of an investigation and sets out the allegations against the Respondent, the Relevant Requirements which appear to have been breached and summarises the evidence and documents obtained over the course of the investigation.
<b>ISAs</b>	International Standards on Auditing (UK and Ireland), which are based on standards issued by the International Auditing and Assurance Standards Board. These form part of the Relevant Requirements which apply to statutory audit work.
<b>Kingman Review</b>	an independent review of the FRC led by Sir John Kingman which was published in December 2018.
<b>KPI</b>	Key Performance Indicator.
<b>Member Firms</b>	a firm which is subject to the systems of discipline, professional conduct, and regulation of any of the bodies which participates in the contractual arrangement of the Accountancy or Actuarial Scheme.

<b>Members</b>	a member of any of the bodies which participates in the contractual arrangement of the Accountancy or Actuarial Scheme, or a person who is subject to the systems of discipline, professional conduct, and regulation of any such body.
<b>Misconduct</b>	an act or omission or series of acts or omissions, by a Member or Member Firm in the course of his or its professional activities (including as a partner, member, director, consultant, agent, or employee in or of any organisation or as an individual) or otherwise, which falls significantly short of the standards reasonably to be expected of a Member or Member Firm or has brought, or is likely to bring, discredit to the Member or the Member Firm or to the accountancy profession.
<b>PFC</b>	a Proposed Formal Complaint, which is a draft of a Formal Complaint setting out the alleged Misconduct following an Accountancy Scheme investigation. Under the Accountancy Scheme, a Respondent has eight weeks to make representations in response to the Proposed Formal Complaint. After considering these representations, the FRC may finalise the Formal Complaint.
<b>PIEs</b>	<p>Public Interest Entities. These are:</p> <ul style="list-style-type: none"> <li>(a) an issuer whose transferable securities are admitted to trading on a regulated market;</li> <li>(b) a credit institution within the meaning of Article 4(1)(1) of Regulation (EU) No 575/2013 of the European Parliament and of the Council, other than those listed in Article 2 of Directive 2013/36/EU of the European Parliament and of the Council on access to the activity of credit institutions and investment firms; or</li> <li>(c) an insurance undertaking within the meaning given by Article 2(1) of Council Directive 1991/674/EEC of the European Parliament and of the Council on the annual accounts and consolidated accounts of insurance undertaking.</li> </ul> <p>No other entities have been specifically designated in law in the UK as 'public interest entities'.</p>
<b>Relevant Requirement</b>	<p>a requirement with which a statutory auditor must comply. The Relevant Requirements include those set out in:</p> <ul style="list-style-type: none"> <li>(a) SATCAR;</li> <li>(b) the Audit Regulation (537/2014/EU);</li> <li>(c) the ISAs; and</li> <li>(d) the FRC's Ethical Standard.</li> </ul>
<b>RNS</b>	Regulatory News Service: a regulatory and financial communications channel managed by the London Stock Exchange for companies to communicate with the professional investor.
<b>RSB/RQB</b>	Recognised Supervisory Body or Recognised Qualifying Bodies. These are professional bodies to which the FRC may delegate certain of its statutory functions under SATCAR.

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<b>SATCAR</b>	the Statutory Auditors and Third Country Auditors Regulations 2016/649.
<b>Statutory Audit</b>	an audit of annual financial statements or consolidated financial statements required by the Companies Act 2006 (as amended).
<b>Statutory Auditor</b>	a person appointed as an auditor under the Companies Act 2006 that is approved by or on behalf of the FRC to carry out Statutory Audits.
<b>Tribunal</b>	the panel appointed in order to conduct hearings where Executive Counsel has decided to take enforcement action against the subject of an investigation. Tribunals are formed of former auditors, lawyers and lay persons.

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## Appendix A

### Summary of cases concluded with sanctions in 2018/19

#### Investigations into Audit

##### KPMG LLP/Quindell plc

In June 2018 we announced a settlement with KPMG and William Smith in respect of Misconduct arising from the audit of Quindell plc's 2013 financial statements.

#### *Points to note*

- CRR reviewed Quindell's 2011 and 2012 financial statements. In the 2014 financial statements the company made substantial restatements of prior year revenues, profits and net assets, including corrections and adjustments in response to the issues raised by the CRR.
- The SFO opened an investigation into Quindell in August 2015, which is still in progress.

#### *The Facts*

KPMG was first appointed as Quindell's auditor in 2013 and provided an unqualified audit opinion on the 2013 financial statements. As noted above, Quindell's 2014 financial statements included substantial prior year adjustments, including in relation to the audit areas where Misconduct was admitted.

#### *The Issues*

KPMG and Mr Smith admitted that, as a consequence of the Misconduct, they failed to obtain reasonable assurance that the financial statements were free from material misstatement, failed to obtain sufficient appropriate audit evidence and failed to exercise sufficient professional scepticism.

The audit areas were:

- Revenue recognition for legal services; and
- A series of transactions relating to the sale and purchase of software licenses, related services and investments.

#### *The Outcome*

KPMG was fined £4.5 million (discounted to £3.15 million for early settlement) and received a Reprimand and Mr Smith was fined £120,000 (discounted to £84,000 for early settlement) and received a Reprimand.

## PwC LLP/BHS Ltd

In August 2018 we published a settlement in respect of PwC's 2014 audit of the Taveta Group, including BHS Ltd.

### *Points to note*

- The Misconduct covered multiple areas of the audit;
- The settlement agreement included novel non-financial penalties;
- The investigation was completed in under two years.

### *The Facts*

PwC had audited the Taveta Group for a number of years. Mr Denison was the audit engagement partner for the Group. Due to the likely sale of BHS in March 2015, the completion of the BHS audit was brought forward.

### *The Issues*

**Supervision:** Mr Denison, as audit engagement partner, was responsible for the overall quality of the audit, supervising the audit and issuing the auditor's report. However, he recorded just two hours' work on the audit during the completion stage and delegated responsibility to a junior team member with only one year of post-qualification experience. This failure was particularly notable as the audit was signed days before BHS Group was sold to Retail Acquisitions Group (RAL) for £1.

**Objectivity and independence:** PwC's fees for non-audit work outstripped audit fees by an 8:1 ratio and Mr Denison had a close business relationship with the client. Mr Denison and PwC failed to consider or identify the risk of threats to their objectivity and independence. They should have identified these threats and applied safeguards, such as (a) consultation with an ethics partner and/or (b) the appointment of an independent partner on the audit. They should also have considered separation of teams.

**Going concern:** At the time the audit was being finalised, there were several events or conditions that should have appeared to the auditors to cast significant doubt over BHS's ability to continue as a going concern and therefore to require further investigation. Amongst other things, BHS had significant liabilities, it was making substantial losses and it had large deficits in its pension schemes.

The auditors, however, failed to consider or gather any evidence to test whether BHS was a going concern. Instead, they signed off BHS's financial statements on a going concern basis, relying on a letter of support provided by the ultimate parent company, Taveta Investments no 2 Ltd (Taveta 2). However, the sale of BHS meant, in all likelihood, that Taveta 2's support would fall away. As to the existence of other facilities or financing arrangements in place to support the business in the event of a sale, there was no audit evidence.



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*Impairment:* When auditing impairment of BHS's fixed assets, Mr Denison and PwC failed adequately to understand and to test many of management's assumptions and estimates, which were unsupported by evidence. They failed to apply professional scepticism and failed to obtain sufficient appropriate audit evidence. Modest adjustments to management's assumptions would have substantially reduced the 'value in use' figure, resulting in a material impairment. Nonetheless the auditors concluded "[management] said they would be happy to take on board impairment in the next year if nothing improved with the brand in the coming year. Ultimately, we were happy they had proved to us no impairment required this year." There was no sufficient audit evidence for this conclusion.

*Income statement:* Mr Denison and PwC considered BHS's income statement from the perspective of the Taveta Group, rather than at the BHS level. They failed to obtain sufficient appropriate audit evidence about BHS specific revenue, cost of sales and operating expenses to be able to confirm whether BHS had made a profit or a loss. This was a particularly serious failing because Mr Denison and PwC knew that BHS was likely to be sold out of the group very soon.

*Taveta Investments (No. 2) financial statements:* BHS's immediate parent before the sale was Taveta 2. Taveta 2 held investments in BHS Group valued at around £201 million. Taveta 2's 2014 financial statements and Mr Denison's audit report were signed on 21 May 2015, just over two months after the sale of BHS. However, they made no reference to the sale for £1, Taveta 2's investment being written off, or the effect of the sale on the assessment of the value of that investment. The auditors failed to identify that the sale for £1 on 11 March 2015 suggested that the investment may not have been worth £201 million on 30 August 2014. This failure gave rise to a material misstatement in Taveta 2's financial statements.

*Arcadia Group Limited's financial statements:* BHS owed Arcadia Group Limited (AGL) £236.5 million at 30 August 2014. As part of the sale to RAL on 11 March 2015, £216.8 million of this debt was written off. Therefore, by the time the audit report for AGL was signed on 21 May 2015, it was known that the debt would not be repaid. There was, however, no reference in AGL's 2014 financial statements to the sale nor to the debt being written off. Despite knowing that the debt had largely been written off, the auditors failed to ensure that this was reflected in AGL's financial statements. This resulted in a material misstatement.

*Back-dating audit report:* Steve Denison signed the audit report on 9 March 2015, but back-dated his signature to 6 March 2015. He also attempted to conceal or obfuscate the truth about when the audit was completed by making a false statement on the electronic audit file.

### *The outcome*

PwC was fined £10 million and Mr Denison was fined £500,000. The fines were reduced by 35% because both admitted the Misconduct at an early stage, saving the significant additional time and costs of a Tribunal hearing.

The settlement agreement included non-financial penalties, including a condition that PwC monitor and support the Leeds Audit Practice for three years, and an undertaking to review (and if necessary) amend its policies and procedures with a view to ensuring that high profile private companies are subjected to an engagement quality control review. Mr Denison was also banned from performing any audit work for 15 years.

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## KPMG LLP/Ted Baker plc

In August 2018 we published a settlement in respect of KPMG's audits of Ted Baker's 2013 and 2014 financial statements relating to breaches of the FRC's Ethical Standards in providing litigation services to a client while acting as its auditor.

### *Points to note*

- There was no obvious financial detriment or misreporting (e.g. restatements, loss of shareholder value), however the case emphasises the intrinsic importance of independence in ensuring that the users of financial statements can have justified confidence in audit.
- The settlement agreement was approved just over two years after the opening of the investigation at a total cost of just under £115,000.
- Following the events that took place, KPMG implemented a policy in July 2017 prohibiting the provision of any expert witness services to audit clients of the UK firm.

### *The Facts*

In 2012, KPMG agreed, while acting as Ted Baker's auditors, to put forward a partner in its forensic team to act as an expert for Ted Baker in a Commercial Court claim against its insurers relating to losses caused by employee stock theft and a partner duly gave evidence relating to quantum at the trial in 2014. Having initially estimated that costs for its expert services would amount to approximately £50,000, KPMG's final bill for those services came in at nearly £1,000,000.

### *The Issues*

The FRC's Ethical Standards stipulate that some engagements pose such threats to the independence of an audit that no adequate safeguards can be put in place and therefore that they should not be undertaken by the auditor. One of these is the provision of litigation support services to a listed audit client when this would involve estimating the likely outcome of a legal matter that could be material to the disclosures in the client's financial statements. The engagement was prohibited by the Ethical Standards and should not have been accepted by KPMG.

A key threat the standards address is one of self-review - during the course of auditing the disclosures relating to the ongoing litigation in the financial statements, it may be necessary to review, and rely on, the expert's work. KPMG admitted that in acting as Ted Baker's auditors as well as providing it with expert services there was such a risk and that it had in fact transpired such that KPMG was re-evaluating its own work.

Another threat to the independence of audit is self-interest. This can occur when non-audit fees become significant as there may be a perception that the audit firm might be reluctant to challenge management's judgements in such a situation. The level of non-audit fees in both 2013 and 2014 were at such a level as to give rise to a self-interest threat.

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The standards therefore prescribe that the audit engagement partner of a listed company must consult with the firm's ethics partner when non-audit fees are expected to exceed a certain level. KPMG admitted that it failed to consult the ethics partner in good time for two years running in this case.

### *The Outcome*

In relation to the 2013 and 2014 audits KPMG admitted that it should have concluded that it was not independent and that the threats to independence could not be addressed, rather than going ahead and giving an audit opinion confirming compliance with the Ethical Standards.

KPMG was fined £3 million (discounted to £2.1 million for early settlement) and received a Severe Reprimand and the audit engagement partner was fined £80,000 (discounted to £46,800 for mitigation and early settlement) and received a Reprimand.

## Grant Thornton LLP/Nichols plc, University of Salford

In August 2018 we published a settlement in respect of Grant Thornton's audits of Nichols Plc and the University of Salford's financial statements for the years ended 2010-2013 inclusive relating to breaches of the FRC's Ethical Standards.

### *Points to Note:*

- As well as accepting that independence was compromised in respect of eight audits, Grant Thornton admitted that the case revealed widespread and serious inadequacies in the control environment in Grant Thornton's Manchester office over the period, in addition to firm-wide deficiencies in policies and procedures relating to retiring partners.
- Grant Thornton has since amended its policies to ensure that former partners can no longer enter into or continue consultancy agreements with the firm if they join an audit client.
- The only FRC case to date where settlement with the audit firm, the audit engagement partners, and a Member in Business was achieved in one global settlement.

### *The Facts*

Grant Thornton continued to act as the auditor of Nichols and the University after a former senior partner had joined those entities' Audit Committees and while he was also engaged to provide various paid services to Grant Thornton pursuant to the terms of a consultancy agreement. The services included the provision of advice relating to the strategic direction of the Manchester office.

### *The Issues*

The FRC's Ethical Standards proscribe certain situations which may threaten the auditor's independence and objectivity. This includes former partners' continued participation in an audit firm's business while also performing a role at an audited entity. In this case the former partner joined the Audit Committee of the University of Salford in May 2010 (and Nichols' Audit Committee in January 2011) and yet Grant Thornton did not terminate the consultancy until

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June 2012. The Audit Committee is the body responsible for assessing the independence and objectivity of the audit making the threats particularly stark in this case. The nature of the threat is well illustrated by an email from the former partner to a senior risk partner within Grant Thornton upon learning of his appointment at the University expressing his intention to “spread the GT gospel”.

The standards also seek to guard against certain familiarity threats. In this case, the former partner who joined the Audit Committees enjoyed a close relationship with both Nichols audit engagement partners (and he had acted as mentor to one of them) raising a serious question as to the degree of challenge they may have been prepared to exert.

Ultimately, Grant Thornton should have concluded, in relation to each of the audits, that there was a threat to objectivity and independence which had not been properly addressed, and therefore it should have refused to report, and it should have resigned as auditor.

#### *The Outcome*

Grant Thornton was fined £4 million (discounted to £3 million for settlement) and received a Severe Reprimand and the three audit engagement partners were fined between £60,000 – £100,000 (discounted to £45,000 - £75,000 for settlement) and received Reprimands.

### **Deloitte LLP/Serco Geographix Limited**

No further details can be provided at this stage as the settlement documents have yet to be published.

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## Baker Tilly UK Audit LLP (now RSM UK Audit LLP)/Tanfield Group plc

In January 2019 the Tribunal issued its report in relation to Baker Tilly's audit of the financial statements of Tanfield Group plc and two of its subsidiaries for the year ended 31 December 2007. The Tribunal found that there had been Misconduct by Baker Tilly and two of the firm's partners.

### *Points to note*

- The investigation was commenced in September 2009, and Tribunal proceedings started in May 2014, but the final resolution of the case was delayed while Baker Tilly challenged the FRC's decision to bring the case by judicial review. That challenge was ultimately determined in the FRC's favour by the Court of Appeal in 2017.
- A Tribunal hearing took place in October 2017 to determine whether there had been Misconduct by Baker Tilly and its partners. Having decided that there had been Misconduct, a further hearing to decide on the appropriate sanctions took place in November 2018. The Tribunal's report was published by the FRC in April 2019.

### *The Facts*

Tanfield is an AIM listed group which, during the relevant period, was primarily involved in manufacturing powered access platforms and zero emission vehicles. The business was carried out through a number of trading subsidiaries, including Tanfield Engineering Systems (TES) and SEV Group (SEV). Baker Tilly was the auditor for the group and its main subsidiaries from 2005 onwards. In 2007 the audit engagement partners were Richard King, responsible for the group financial statements, and Steven Railton, responsible for subsidiaries, including TES and SEV. The FRC's investigation was opened following a profit warning issued by the group in July 2008, resulting in a very significant fall in the share price.

### *The Issues*

The Formal Complaint alleged that the auditors had failed to obtain sufficient audit evidence over the largest balance sheet items in Tanfield's financial statements, namely inventories and trade receivables. This arose from deficiencies in a series of audit procedures carried out by Baker Tilly, and the failure to identify and remedy those deficiencies. It was further alleged that, in relation to the subsidiaries' financial statements, more work should have been done by the auditors to consider the profits warning as a post-balance sheet event, where the audit opinion was not provided until after the profits warning had been issued. Baker Tilly maintained in the Tribunal that the audit was carried out properly, and any deficiencies were minor and did not amount to Misconduct.

### *The Outcome*

The Tribunal found that, in each of the areas identified, the deficiencies in the audit were serious enough to amount to Misconduct, and imposed the following sanctions:

- Baker Tilly received a reprimand and a fine of £750,000.
- Mr King received a reprimand and a fine of £30,000;
- Mr Railton received a reprimand and a fine of £35,000.

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## KPMG Audit plc/Equity Syndicate Management Limited

In February 2019 the Tribunal issued its report in relation to KPMG's 2008 and 2009 audits of the financial statements of Syndicate 218. The Tribunal found that there had been Misconduct by KPMG, one of the firm's partners and one of its former partners.

### *Points to note*

- A Tribunal hearing took place in November-December 2017 to determine whether there had been Misconduct by KPMG and its partners. Having decided that there had been Misconduct, a further hearing to decide on the appropriate sanctions took place in September 2018. The Tribunal's report was published by the FRC in May 2019.
- The Tribunal also considered allegations of Misconduct concerning Mr Douglas Morgan, the former Finance Director of ESML. ESML was the managing agent of Syndicate 218.
- The FRC also investigated the conduct of James Rakow, the Syndicate Actuary for Syndicate 218 during the relevant period, and an associate partner of Deloitte. Mr Rakow admitted Misconduct and received a fine and a Severe Reprimand. The FRC published the outcome of that investigation in August 2017.
- Events surrounding the management of Syndicate 218 also gave rise to disciplinary action by Lloyd's of London, addressed to the managing agent and a number of its senior executives.

### *The Facts*

Syndicate 218 is a Lloyds Syndicate, underwriting a range of insurance businesses, but focusing on motor insurance. During the period 2007-2009 KPMG was the auditor for both the Syndicate and IAG UK, a group of companies that provided approximately 65% of the Syndicate's underwriting capacity. In 2008 and 2009 the audit engagement partners were Mark Taylor, responsible for the Syndicate financial statements, and Anthony Hulse, responsible for IAG UK. The FRC's investigation was opened following an announcement by IAG in 2010 indicating that the Syndicate's claims reserves required significant strengthening, and the ordering by the FSA of a section 166 report into reserving practices by ESML.

### *The Issues*

The Formal Complaint alleged that in both 2008 and 2009 the auditors had failed to obtain sufficient audit evidence over the Syndicate's claims provisions. This arose from a failure to gain a proper understanding of the case file reviews carried out by the Syndicate, and the impact that those reviews had on the process for estimating the final provisions. It was also alleged that the auditors had failed to obtain proper assurance in relation to a number of matters, including key assumptions adopted by ESML management, that similarly had a significant impact on the level of provisions set. KPMG maintained in the Tribunal that the audit was carried out properly, and in particular that it was appropriate for the auditors to rely on the work of actuaries, both retained by ESML or employed within the audit team.

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### *The Outcome*

The Tribunal found that the audit work in both years was seriously deficient and amounted to Misconduct by KPMG. The Tribunal found that insufficient scepticism had been brought to bear, particularly in relation to the file reviews, which presented an obvious risk of manipulation. The Tribunal further found that there were numerous warning signs that the Syndicate's claims experience was deteriorating, but that KPMG did not respond appropriately to these, but continued to rely on the actuarial work. Mr Taylor, as engagement partner, was held responsible for these failures. Misconduct on Mr Hulse's part was found in 2009, when the Tribunal determined that he had taken ultimate responsibility for the conclusion of the audit and the opinion that was given. The Tribunal imposed sanctions as follows:

- KPMG was fined £6 million, severely reprimanded and ordered to undertake an additional internal review and report to the FRC on certain aspects of its 2018 audits of insurance undertakings
- Mark Taylor was fined £100,000, severely reprimanded and required to have a second partner review of his audits until the end of 2020;
- Anthony Hulse was fined £100,000 and received a Severe Reprimand.

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## KPMG Audit plc/The Co-operative Bank plc

In May 2018 we published a settlement in respect of KPMG's 2009 audit of the Co-operative Bank. The FRC also separately considered the conduct of the Chief Financial Officer of the Co-op Bank, who previously admitted Misconduct in a settlement in 2016.

### *Points to note*

- The Misconduct occurred shortly after the Co-op bank's merger with the Britannia Building Society (Britannia).
- There were parallel FCA/PRA investigations and various other enquiries.
- The sanctions include a condition in relation to all KPMG audits of banks.

### *The Facts*

KPMG, or its predecessor firms, were the Co-op Bank's auditors from the Co-op Bank's incorporation in 1970 up to and including the financial year ending 31 December 2013. On 1 August 2009, Co-op Bank merged with Britannia. At the time of the merger, the Co-op bank was a small retail bank, and Britannia was the second largest building society in the UK with a significantly larger business and a different risk profile. The Misconduct related to the audit of loans and liabilities acquired from Britannia as part of the merger.

### *The Issues*

KPMG and Mr Walker both admitted that their conduct fell significantly short of standards reasonably to be expected of an audit firm and an auditor in two areas:

- the audit of Fair Value Adjustments (FVAs) in relation to loans within the commercial book acquired from Britannia; and
- the audit of FVAs and liabilities under a series of loan notes (Leek Notes) which were acquired from Britannia.

The Misconduct in respect of these two areas included: failures to obtain sufficient appropriate audit evidence; failures to exercise sufficient professional scepticism and a failure to inform Co-op Bank that the disclosure of the expected lives of the Leek Notes in the financial statements was not adequate.

### *The Outcome*

KPMG was fined £5 million (discounted to £4 million for early settlement) and received a Severe Reprimand. A condition was imposed that all KPMG's audit engagements with credit institutions for three years will be subjected to an additional review by a separate KPMG Audit Quality team. At the end of each of the three years, KPMG will report to the FRC on the themes arising from the reviews; the planned actions; and the progress to address them.

The audit engagement partner was fined £125,000 (discounted to £100,000 for early settlement) and received a Severe Reprimand.



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## MSR Partners LLP (formerly Moore Stephens LLP)/Laura Ashley plc

In March 2019 Executive Counsel issued a Final Decision Notice, pursuant to Rule 18 of the Audit Enforcement Procedure, in respect of Moore Stephens's 2016 audit of Laura Ashley.

### *Points to note*

- This was the first case to be concluded under the Audit Enforcement Procedure.
- The case was concluded within 14 months of referral from the Conduct Committee.
- The discounts given for co-operation and settlement reflect that: the Respondents self-reported the breaches of Relevant Requirements; they had shown insight into their failings; and they had already imposed remedial actions to prevent recurrence of the breaches prior to the Final Decision Notice.

### *The Facts*

Moore Stephens conducted the 2016 audit of Laura Ashley for the financial year ended 30 June 2016. Stephen Corral was the audit engagement partner. 2016 was Moore Stephens' first year as Statutory Audit Firm for Laura Ashley.

### *The Issues*

There were numerous and pervasive failures by the Respondents in the 2016 audit. As a result, the audit failed in its principal objective: that of providing reasonable assurance that the 2016 financial statements were free from material misstatement. The breaches related to three fundamental areas of audit work: Materiality, Revenue and Going Concern.

**Materiality:** Auditors usually choose their materiality threshold using a benchmark, typically profit before tax (PBT). For example, the percentage applied to PBT for a PIE, such as Laura Ashley, may be 5% as set out in ISA 320 para A7. However, the audit team calculated the materiality threshold using an average of PBT and revenue which meant that, in practice, the impact of the PBT benchmark was substantially reduced. The materiality threshold was 18% of PBT, more than three times the threshold of 5% of PBT typical for a profit-orientated PIE.

This choice of materiality threshold determines the scope and coverage of the audit work. A lower materiality threshold would necessitate more audit work so that the auditor can fulfil his responsibility to provide reasonable assurance that the financial statements are free from material misstatement.

**Revenue:** The audit team for the 2016 audit planned to check Laura Ashley's sales using Computer Assisted Audit Techniques. Their plan was to trace sales from the till records in stores, and other primary records such as internet sales, through to the accounting system and the 2016 financial statements. However, the audit team did not follow their plan. Instead of tracing sales from the primary records, they checked two internal systems. This meant that they failed to adequately check that the sales recorded in the accounting system, and the 2016 financial statements, were correct. It is not alleged that Laura Ashley's revenue was misstated, only that the audit team failed to audit it in an appropriate manner.

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*Going Concern:* In considering whether a company is a going concern, the key test is whether the company is able to pay its debts as they fall due. The going concern assumption is a fundamental principle in the preparation of financial statements. The audit team did not gather enough appropriate audit evidence during the 2016 audit on which to base their conclusions. There were a number of aspects to the auditor's failings regarding this work, including failure to assess how much cash the group would need to pay for Christmas stock and failure to consider the group's cash needs throughout the year.

#### *The Outcome*

Due to a merger effective 1 February 2019, the Moore Stephens legacy entity MSR Partners LLP was the Respondent to the Final Decision Notice, together with Mr Corrall.

MSR Partners were fined £825,000, adjusted for aggravating and mitigating factors (in particular reflecting an exceptional level of co-operation) by a reduction of 15%, and further discounted for admissions and early disposal by 35%. Two non-financial sanctions were also implemented: a published statement in the form of a Severe Reprimand, and a declaration that the 2016 audit report did not satisfy the Relevant Requirements.

Mr Corrall was fined £110,000, adjusted for aggravating and mitigating factors (in particular reflecting an exceptional level of co-operation) by a reduction of 15%, and further discounted for admissions and early disposal by 35%. A number of non-financial sanctions were also implemented, comprising: a declaration that the 2016 audit report did not satisfy the Relevant Requirements and a condition that Mr Corrall shall not act as a Statutory Auditor of a PIE for 18 months, and only following approval by the firm Audit Compliance Principal and once certain training has been completed.

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## Investigations into Accountants in Business

### RSM Tenon Group plc

In June 2018 we published a settlement agreement reached with Mr McBurnie, former Finance Director of RSM Tenon Group plc in relation to the preparation and approval of the financial statements for RSM Tenon for the year ended 30 June 2011. The publication of the settlement also included information relating to a settlement reached with Mr Andrew Raynor, former CEO of RSM Tenon, in 2016 and a settlement reached with PwC and Mr Boden, audit engagement partner, in 2017.

#### *Points to note*

- Mr McBurnie admitted extensive Misconduct involving nine allegations, including breaches of the Fundamental Principle of Integrity, which required him to be straightforward and honest in all professional and business relationships, in that he was reckless as to whether certain information within the financial statements had been fairly and accurately stated.
- Mr McBurnie admitted extensive Misconduct some 18 months after the delivery of the Formal Complaint, and therefore received a low discount for settlement. He was ordered to pay £825,000 towards the costs of the investigation.

#### *The Facts*

RSM Tenon was an accounting firm which grew rapidly through a series of acquisitions. It was admitted to the London Stock Exchange in May 2010. Throughout the period from 2008 onwards RSM Tenon's net debt position increased each year as funding was utilised for acquisitions. In May 2011 RSM Tenon issued a profit warning that underlying profit would be below market expectations and thereafter several material accounting errors were discovered in the financial statements, which, together with changes in accounting policy, necessitated a restatement of the 2010 and 2011 financial statements. In addition, the interim results for the six months ended 31 December 2011 reflected a write-down in goodwill of £60.7 million. In August 2013, RSM Tenon's parent company entered administration.

#### *The Issues*

Mr McBurnie included within the financial statements of RSM Tenon a number of misleading and/or incorrect entries all of which had the effect of improving RSM Tenon's financial position at a time when the business was struggling. The specific areas in which Mr McBurnie's conduct fell significantly short of the standards reasonably to be expected of a Member are the following:

- (a) the accrual of bonus payments;
- (b) the recognition of work in progress and amounts recoverable on contracts;
- (c) the recognition of prepaid fees for the purpose of obtaining IVA appointments;
- (d) the classification as operating leases of two leases;

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(e) the assessment of the impairment of goodwill;

(f) the preparation of the financial statements on a going concern basis.

Mr McBurnie's accounting treatment of these matters had the effect of promoting a significantly more positive impression of RSM Tenon's financial position than was the case. In relation to certain of these matters, Mr McBurnie was reckless as to whether the financial statements of RSM Tenon for FY11 would give a misleading picture of RSM Tenon's underlying performance,

#### *The Outcome*

Mr McBurnie was excluded from the accountancy profession for a recommended period of five years. In addition, he was fined £60,000 (reduced to £57,000 for settlement).

## AssetCo plc

In August 2018 we published the outcome of the hearing of a Formal Complaint against three former executives of AssetCo plc, which related principally to their conduct in relation to the preparation and approval of the financial statements for the years ended 31 March 2009 and 31 March 2010. In 2017, we published a settlement in respect of Grant Thornton's audits of AssetCo for the same financial years.

### *Points to note*

- Executive Counsel brought a total of 27 allegations of Misconduct against Mr Shannon, Mr Flynn and Mr Boyle. The Tribunal made findings of Misconduct in relation to all of them. These included findings of dishonesty and lack of integrity.
- The individuals were excluded from membership of Chartered Accountants Ireland (CAI) for lengthy periods – 16, 14 and 12 years respectively. Financial penalties of £500,000 in aggregate were also imposed.
- The Tribunal made a finding of Misconduct in respect of a Member giving false answers to the FRC during an investigation.

### *The Facts*

AssetCo was an AIM-listed fire and rescue services business that provided fire engines to the London Fire Brigade (amongst others). As a result of the Misconduct, AssetCo's financial statements were materially overstated. When the financial statements were substantially restated in 2011 (£146 million reduction in assets, £25 million reduction in profit) there was a significant loss caused by the collapse in share price from 60p to 1.75p.

Mr Shannon was the CEO, Mr Flynn the CFO and Mr Boyle the Group Financial Controller. They were each involved, to varying degrees, with preparing misleading financial statements and misleading the auditors (Grant Thornton) of those financial statements. They also assisted in the payment of £1.5 million of company monies to Mr Shannon, and the subsequent misdescription of this payment in the financial statements.

### *The Issues*

In summary, the main findings of Misconduct were in respect of the following:

- (a) The payment by AssetCo of £1.5 million to a company associated with Mr Shannon, in December 2009, and the subsequent mis-description of this payment in the 2010 Financial Statements.
- (b) The acquisition by AssetCo of a company from Mr Shannon and the dishonest forgiveness of a debt due to AssetCo Municipal Limited in relation to the 2010 Financial Statements.
- (c) The incorrect goodwill value recorded for that company in the 2010 Financial Statements.

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- (d) The deliberately misleading accounting treatment of a preference share issue in respect of AssetCo's Abu Dhabi business and the consequent understatement of liabilities.
  - (e) Mr Flynn's provision of false explanations to AssetCo's auditors in respect of a management agreement relating to that preference share issue.
  - (f) Mr Shannon's failure to be involved in or properly oversee the preparation and approval of the 2009 and 2010 Financial Statements.
  - (g) The deliberate recognition, in the 2009 and 2010 Financial Statements, of revenue and debtors which did not exist, and the creation of false documents to support such recognition, in relation to assets and services provided to London Fire.
  - (h) The preparation and approval of the 2009 and 2010 Financial Statements which should have included substantial impairments in the assessments of goodwill and of the carrying values of subsidiaries, but did not do so, resulting in a substantial overstatement.
  - (i) Mr Shannon's provision of false and/or misleading information to the FRC and its Irish counter-part.
  - (j) Mr Boyle's provision of false information to AssetCo's auditors.

#### *The Outcome*

The Tribunal found each of the 27 allegations proven. Mr Shannon was excluded from the CAI for 16 years, Mr Flynn for 14 years and Mr Boyle for 12 years. Additionally, fines of £250,000, £150,000 and £100,000 respectively were imposed.

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## Nichols plc and the University of Salford

In August 2018 we published a settlement in respect of Mr Eric Healey in relation to his continued participation in Grant Thornton's business and professional activities through a consultancy agreement despite his appointment to the Audit Committees of the University of Salford and Nichols Plc. It formed part of the settlement referred to above at pages 59-60.

### *Points to note*

- Although he had previously been an auditor at Grant Thornton, Mr Healey's Misconduct was committed when he was a Member in Business and his conduct fell to be assessed by reference to the ICAEW's Code of Ethics rather than the FRC's Ethical Standards.
- Mr Healey admitted to a breach of the Fundamental Principle of Objectivity and that his conduct was in certain respects reckless.

### *The Facts*

Grant Thornton continued to act as the auditor of Nichols and the University after Mr Healey, a former senior partner at Grant Thornton, had joined those entities' Audit Committees and while he was also engaged to provide various paid services to Grant Thornton pursuant to the terms of a consultancy agreement. The services included the provision of advice relating to the strategic direction of the Manchester office.

### *The Issues*

Mr Healey joined the Audit Committee of both Nichols Plc and the University of Salford while (i) he continued to be engaged by Grant Thornton pursuant to the term of a consultancy agreement; and (ii) enjoyed a close relationship with both Nichols's audit engagement partners. He did not resign from the University until February 2015 or Nichols until March 2015. Mr Healey admitted that in performing those roles he was knowingly engaged in a business, occupation or activity that impaired, or might impair, objectivity.

### *The Outcome*

Mr Healey was excluded from the ICAEW for a recommended period of five years and received a fine of £200,000 (reduced to £150,000 for settlement).

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## Equity Syndicate Management Limited

In February 2019 the Tribunal issued its report in relation to Douglas Morgan, the former Finance Director of ESML. ESML was the managing agent of Syndicate 218. The Tribunal found that there had been Misconduct by Mr Morgan in each of the years 2007 - 2009.

### *Points to note*

- A Tribunal hearing took place in November-December 2017 to determine whether there had been Misconduct by Mr Morgan. Having decided that there had been Misconduct, a further hearing to decide on the appropriate sanctions took place in September 2018. The Tribunal's report was published by the FRC in May 2019.
- The Tribunal also considered allegations of Misconduct concerning KPMG, Mark Taylor and Anthony Hulse. KPMG was the auditor of Syndicate 218, Mr Taylor was the engagement partner in 2008 and 2009, and Mr Hulse was the engagement partner for the audit of IAG UK, a group of companies that provided approximately 65% of the Syndicate's underwriting capacity.
- The FRC also investigated the conduct of James Rakow, the Syndicate Actuary for Syndicate 218 during the relevant period, and an associate partner of Deloitte. Mr Rakow admitted Misconduct and received a fine and a severe reprimand. The FRC published the outcome of that investigation in August 2017.
- Events surrounding the management of Syndicate 218 also gave rise to disciplinary action by Lloyd's of London, addressed to the managing agent and a number of its senior executives, including Mr Morgan.

### *The Facts*

Syndicate 218 is a Lloyds Syndicate, underwriting a range of insurance business, but focusing on motor insurance. Mr Morgan worked at ESML, the Syndicate's managing agent for a number of years, becoming Finance Director in 2006. The FRC's investigation was opened following an announcement by IAG in 2010 indicating that the Syndicate's claims reserves required significant strengthening, and the ordering by the FSA of a s.166 report into reserving practices by ESML.

### *The Issues*

The Formal Complaint against Mr Morgan alleged that during the period 2007 – 2009 he had implemented a process of case file reviews within ESML that breached a number of rules and standards that applied to the reserving practices of Lloyd's syndicates, and served to undermine the reliability of the data on which reserving estimates were based. It was further alleged that Mr Morgan had failed to ensure that proper records were made, or that the reviews were properly disclosed to the Board, the Syndicate's external Actuary or the auditors.



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### *The Outcome*

The Tribunal found that Mr Morgan had committed Misconduct, both as to the implementation of file reviews and the recording and reporting of them. The Tribunal found that the reviews were 'wholly improper' and had a number of objectionable features. These included the setting of target amounts for the reduction in booked reserves, without any proper process for arriving at the amounts. The setting of targets also inevitably put pressure on claims handlers, which risked reserves being reduced below a level sufficient to meet the ultimate liabilities.

Mr Morgan was excluded from membership of the Chartered Institute of Management Accountants for two years.

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