THE FACTS SET OUT IN THIS DOCUMENT HAVE BEEN AGREED BETWEEN EXECUTIVE COUNSEL AND THE RESPONDENTS. NO FINDINGS HAVE BEEN MADE, NOR SHOULD BE TAKEN TO HAVE BEEN MADE, AGAINST ANY OTHER PERSONS.

IN THE MATTER OF:

THE EXECUTIVE COUNSEL TO THE FINANCIAL REPORTING COUNCIL

- and -

1. ERNST & YOUNG LLP
2. JULIAN GRAY

PARTICULARS OF FACT AND ACTS OF MISCONDUCT

INTRODUCTION

1. The Financial Reporting Council (the "**FRC**") is the independent disciplinary body for the accountancy and actuarial professions in the UK. The FRC's rules and procedures relating to accountants are set out in the Accountancy Scheme of 8 December 2014 (the "**Scheme**").

2. This is the Executive Counsel's Particulars of Fact and Acts of Misconduct ("**the Particulars**") in relation to the audit of the financial statements of Tech Data Limited ("**Tech Data**")[1] for the year ended 31 January 2012 ("**FY12**").

3. The Respondents to the Particulars are:

   (1) Mr Julian Gray ("**Mr Gray**"), a former partner of Ernst & Young LLP ("**EY**") and a member of the Institute of Chartered Accountants in England and Wales ("**ICAEW**"); and

   (2) EY, a member firm of the ICAEW;

   together the "**Respondents**".

[1] Until 4 October 2013, Tech Data was named Computer 2000 Distribution Limited. References to Tech Data also include any predecessor company.

4. As, respectively, a member and a member firm of the ICAEW, the Respondents are a Member and a Member Firm for the purpose of the Scheme[2].

EY and Mr Gray

5. According to its website (as at March 2017) and its UK Transparency Report 2016, worldwide, EY has 690 UK partners working in 20 offices and approximately 231,000 people spanning more than 150 countries. In 2015/6, the UK firm grew its revenue to £2,150 million of which 29% was assurance (including audit) revenue.

6. Mr Gray joined EY in 1994 and was admitted to membership of the ICAEW in 1998. He became a partner in EY in 2005, and was Senior Partner of EY Southampton for 7 years. In February 2015, he joined PricewaterhouseCoopers LLP as a partner and became Senior Partner of the Southampton office in April 2016. Mr Gray had been the engagement partner for the statutory audit of Tech Data since 2010. EY and Mr Gray gave an unqualified audit opinion in respect of Tech Data for FY12, which Mr Gray signed personally on behalf of the firm.

7. As engagement partner, Mr Gray was responsible for the audit engagement and its performance, and for the auditor's report that is issued on behalf of the firm. Pursuant to the International Standard on Auditing (UK and Ireland) ("**ISA**") 220:

   (1) "*The engagement partner shall take responsibility for the overall quality on each audit engagement to which that partner is assigned*" (paragraph 8)

   (2) "*The engagement partner shall take responsibility for: (a) The direction, supervision and performance of the audit engagement in compliance with professional standards and applicable legal and regulatory requirements; and (b) The auditor's report being appropriate in the circumstances*" (paragraph 15).

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[2] References to "Member Firm" and "Member" in this document correspond to the definition as set out in paragraph 2(1) of the Scheme. References to "member firm" and "member" denote their membership of the ICAEW.

Accordingly, where criticisms are accepted in relation to the performance of EY's audit in the Acts made below, Mr Gray bears responsibility for the audit shortcomings as the engagement partner.

THE RELEVANT STANDARDS & NATURE OF MISCONDUCT

The relevant standards of conduct

8. The standards of conduct reasonably to be expected of the Respondents included those set out in the Fundamental Principles contained in Part A of the Code of Ethics (the "**Code**") issued by the ICAEW. The Fundamental Principles contained in the Code are made in the public interest and they are designed to maintain a high standard of efficiency and professional conduct by all members of the ICAEW.

9. The Fundamental Principles set out in paragraph 100.5 of the Code required the Respondents, inter alia, to act with "Professional Competence and Due Care" and to:

   "*maintain professional knowledge and skill at the level required to ensure that a client or employer receives competent professional services based on current developments in practice, legislation and techniques and act diligently and in accordance with applicable technical and professional standards*."

10. The Fundamental Principles and the accompanying Conceptual Frameworks contained in Part A of the Code are supplemented by Part B of the Code in relation to professional accountants in public practice and Part C of the Code in relation to professional accountants in business.

The relevant auditing standards

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

12. ISA 200, paragraph 11 requires an auditor to:

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

The applicable financial reporting framework in the case of the financial statements for Tech Data was UK Generally Accepted Accounting Practice ("**GAAP**"). GAAP refers to the standard framework for financial accounting used in any given jurisdiction. UK GAAP comprises applicable UK law and UK Accounting Standards as issued by the FRC. Tech Data's interim financial information, compiled for its parent company, was prepared under US GAAP.

At paragraphs 14 onwards of ISA 200, the requirements with which the auditor shall comply are set out as follows:

- Ethical Requirements Relating to an Audit of Financial Statements;
- Professional Scepticism;
- Professional Judgement;
- Sufficient Appropriate Audit Evidence and Audit Risk; and
- Conduct of an Audit in Accordance with ISAs (UK and Ireland).

The Respondents' Misconduct

13. Paragraph 2(1) of the Scheme defines "Misconduct" as:

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

14. As set out more particularly below, the Respondents accept that, in relation to the Admitted Acts of Misconduct, their conduct fell significantly short of the standards reasonably to be expected of a Member or Member Firm in the following respects:

    (1) Mr Gray's conduct fell significantly short of the standards reasonably to be expected of a Member in relation to the audit of the financial statements of Tech Data for FY12 in the following areas:

    a. drop shipment accruals;

    b. vendor rebates; and

    c. ageing and provisioning of inventory and receivables.

    (2) EY's conduct also fell significantly short of the standards reasonably to be expected of a Member Firm. In accordance with paragraph 5(11) of the Scheme, anything said, done or omitted by an employee of a Member Firm shall be taken as having been said, done or omitted by that Member Firm. Therefore, as the conduct of Mr Gray fell significantly short of the standards reasonably to be expected of a Member, then the conduct of EY also fell significantly short of the standards reasonably to be expected of a Member Firm.

BACKGROUND

The Tech Data Group

15. Tech Data is a wholly owned subsidiary of Tech Data Corporation ("**Tech Data Corp**"), which is one of the world's largest wholesale distributors of technology products and services. Tech Data Corp is headquartered in Clearwater, Florida, USA. It was ranked 108 in the 2016 Fortune 500 listing of US companies and 409 in the Fortune Global 500 and its group employs approximately 9,000 people. For the year ended 31 January 2016, Tech Data Corp had:

    (1) total net sales of US$26.4bn;

    (2) net income of US$266m; and

    (3) total assets of US$6,358m.

16. Within the wider Tech Data group, Tech Data carries on business as a trade-only distributor to the computer and mobile communications industry operating through a number of product divisions. Customers are exclusively dealers and value added resellers in the UK and Ireland.

Restatement of Financial Statements

17. On 21 March 2013, Tech Data Corp announced that it would be restating some or all of its quarterly and audited financial statements for FY11 and FY12 and some or all of the quarters of for the year ended 31 January 2013 ("**FY13**"). Tech Data Corp stated that it anticipated that the restatement would be made to correct improprieties primarily related to how Tech Data reflected vendor accounting.

18. On 5 February 2014, Tech Data Corp reported a restatement in its FY13 group financial report. The restatements resulted in a cumulative reduction in consolidated net income of US$61 million for FY09 to FY13 inclusive.

19. At the same time as the restatements were published, a press release was issued by Tech Data Corp confirming that an independent investigation, along with supplemental procedures performed by internal and external resources, had identified material weaknesses in internal control over financial reporting.

20. On 30 June 2014, Tech Data signed its financial statements in the UK for FY13 containing significant restatements to the financial statements for FY12. The directors' report in the financial statements for FY13 stated:

"*The preparation of this report and financial statements was delayed pending the completion of an internal investigation of the Company's accounting practices. This investigation was initiated after significant accounting irregularities were identified in March 2013. The Company has engaged substantial internal and external resources to perform supplemental procedures to assist in reviewing its financial statements and accounting practices.*

The Company has restated its financial statements to correct improper accounting. There were a number of instances where there was improper timing of recognition in the profit and loss account of certain vendor incentives, product discounts, price variances, promotions and other vendor credits. There were also errors related to accounting for accounts receivable, manual journal entries, cash cut-off, certain inventory transactions, improper recognition of foreign exchange gains and losses and certain other errors."

21. In respect of Tech Data, the restatement resulted in:

(1) a decrease of £8,701,000 in the profit before tax (and £5,931,000 in the profit after tax) for FY12;

(2) a reduction in net assets of £21,961,000, meaning that £16,030,000 of the cumulative net asset restatement related to accounting periods prior to FY12.

22. The main captions before and after the restatement were as follows:

Profit and loss account (£m)	**FY12 before restatement**	**Restatement**	**FY12 after restatement**
Sales	1,431	(3)	1,428
Cost of sales	(1,352)	(2)	(1,354)
Gross profit	79	(5)	74
Operating costs	65	(4)	(69)
Tax and interest	(5)	3	(2)
Retained profit	9	(6)	3

Balance sheet (£m)	FY12 before restatement	Restatement	FY12 after restatement
Intangible assets	7	-	7
Tangible assets and investments	2	-	2
Stock	72	(8)	64
Debtors	191	(5)	186
Cash	66	(8)	58
Creditors and provisions	(252)	(1)	(253)
Share capital and share premium	(10)	-	(10)
Profit and loss account	(76)	22	(54)

23. Note 23 to Tech Data's FY13 financial statements included the following narrative explanations to support the main adjustments summarised in the table in paragraph 22 above:

(1) Cost of sales adjustments primarily reflected the impact of correcting vendor accounting errors such as the incorrect recording of rebates, discounts, price variances and other credits, and the presentation of sales of vendor warranty services on an agency basis. This is related to acts 1 – 3 below.

(2) Operating costs adjustments consisted of various errors including the incorrect recording of bad debts and payroll costs. This is related to act 3 below.

(3) Stock included adjustments to amend the value for estimated sales returns, correct the impact of various cut-off errors, correct goods in transit accounting and various other errors. This is related to act 3 below.

(4) Debtors had been adjusted primarily to reduce the balance for cash at bank cut-off errors and to adjust for irrecoverable balances. This is related to acts 1 – 3 below.

24. For the avoidance of doubt, not all of the matters in respect of which restatements were made in the Tech Data financial statements were attributable to areas in respect of which criticisms have been made of and accepted by EY and Mr Gray. Nor is it the case that, absent the Admitted Acts of Misconduct, the FY12 audit of Tech Data

would have necessarily detected or prevented the misstatements. In addition, the restatements of the Tech Data Corp. financial statements included matters which were unrelated to Tech Data in the UK and wholly outside the scope of the FY12 audit of Tech Data.

EY's Work

25. The EY team responsible for the statutory audit of the financial statements of Tech Data also performed specific scope group reporting under the direct instructions issued by the EY Corp group audit team ("**group audit team**") based in Florida. The specific scope instructions required the EY team in the UK to perform procedures set out by the group audit team on specific accounts and disclosures. These were then reported to the group audit team which supported its opinion on the Tech Data Corp financial statements. EY used its work performed for the group audit team to support its performance of the statutory audit of the financial statements of Tech Data, and performed many statutory audit procedures at the same time as the group audit procedures.

26. The audit of the financial statements of Tech Data was conducted in two separate phases. The first phase was referred to as the 'hard close', which covered the first nine months of the financial year, up to 31 October 2011. At hard close, reporting to the group audit team was also completed. The year-end procedures would then focus on the three-month period to 31 January 2012.

27. EY commenced its audit work for FY12 in September 2011 by meeting with the group audit team engagement partner, with the team planning meeting taking place in November 2011. The final reporting to the group audit team took place in March 2012. The completion of the remaining statutory audit procedures took place between May and October 2012.

28. For the audit of the financial statements of Tech Data for FY12, EY set overall planning materiality at £1,330k, which was 10% of profit before tax. Tolerable error was set at 75% (£997k) of planning materiality. Summary of Audit Differences was set at 3% of Planning Materiality. EY reassessed materiality based on the full year actual results; this was slightly higher than planning materiality, however it was not amended and the lower figure retained so as to maintain consistency between year-end procedures and those performed at planning and interim stages of the audit.

29. EY's audit methodology follows a software template called GAMx which contains the electronic audit file. Procedures are grouped within four headings based on EY's global audit methodology:

(1) Planning and risk identification;
(2) Strategy and risk assessment;
(3) Execution; and
(4) Conclusion and reporting.

30. As part of its planning and risk identification, EY identified the following risks of material misstatement due to fraud, all of which were considered significant:

- Improper Revenue Recognition;
- Improper Sales Cut Off;
- Incorrect recognition of vendor receivables income; and
- Manipulation of inventory and accounts receivable reserves.

In addition, the following significant risk was recorded:

- Failure to properly execute vendor incentive agreements.

At the EY Corp group level, the following fraud risks were identified by the group audit team and communicated to the EY team in the UK:

- Risk of management manipulation of vendor incentive recognition;
- Risk of management manipulation of accounts receivable and inventory reserves; and
- Revenue recognition: Risk of recording revenue without relieving the related inventory.

In addition, the following significant risk was recorded by the group audit team:

- Risk of failure to properly execute vendor incentive arrangements.

31. As part of the strategy and risk assessment stage of the audit, EY identified significant accounts and significant classes of transaction, in relation to which they performed controls and substantive testing, along with journal entry testing, analytical review and representations from management.

32. Mr Gray, as engagement partner on behalf of EY, signed the auditor's report containing an unqualified opinion on Tech Data's FY12 financial statements on 31 October 2012.

33. In June 2013, following the uncovering of the accounting irregularities, a new engagement partner was appointed to replace Mr Gray for the audit of the restated accounts for FY12, as presented in the FY13 accounts.

THE ADMITTED ACTS OF MISCONDUCT

ACT 1 – DROP SHIPMENT ACCRUALS

In relation to the audit of Tech Data's financial statements for FY12, the conduct of Mr Gray and EY fell significantly short of the standards reasonably to be expected of, respectively, a Member and a Member Firm in that, in respect of drop shipment accruals:

- **(i)** **the Respondents failed to obtain reasonable assurance about whether the financial statements as a whole were free from material misstatement; and/or**
- **(ii)** **the Respondents failed to obtain sufficient appropriate audit evidence from which to draw a reasonable conclusion; and/or**
- **(iii)** **the Respondents failed to demonstrate sufficient professional scepticism,**

and thereby the Respondents failed to comply with the requirements of ISA 200, ISA 220, ISA 240 and ISA 500 and/or failed to act in accordance with the Fundamental Principle of Professional Competence and Due Care contained in the Code.

Particulars of Act 1

34. Drop shipment accruals ("**DSAs**") were created when inventory was shipped directly from the vendor to the customer, without going through Tech Data's warehousing and inventory systems.

35. As a result of the inventory being shipped directly to the customer, sales invoices would sometimes be raised by Tech Data before corresponding vendor invoices had been received. When this happened, purchase orders ("**POs**") were raised to record the liabilities where vendor invoices had not yet been received. When those vendor invoices were later received, duplicate POs were raised to match the vendor invoice.

36. DSA-related accounting entries had a potential impact on accounts receivable and accounts payable in the balance sheet, and sales and cost of sales in the profit and loss account. These were large and highly material areas of both the balance sheet and the profit and loss account. There were prior year restatements to all of these areas for FY12, £5 million, £1 million, £3 million and £2 million respectively. As set out at paragraph 28 above, materiality was £1.33 million. The total restatements to the financial restatements for FY12 resulted in a reduction of approximately £9 million to profit before tax, from £14 million to £5 million, amounting to over 60% of the total

figure. The effect on profit after tax was a £6 million adjustment, from £9 million to £3 million, and net assets were reduced by £22 million. The failures in relation to the audit of DSAs involved a failure to obtain reasonable assurance over material balances, and therefore about whether the financial statements as a whole were free from material misstatement. For the avoidance of doubt, it is not the case that if EY had not committed the failures admitted in relation to the audit of DSAs, the audit work would have necessarily detected or prevented these misstatements.

37. DSAs were identified as a "significant audit & accounting matter" in planning the FY12 audit, however it was not identified as a significant risk or a fraud risk. EY's summary of the DSA process in the audit working papers included the following:

> *"Occasionally an error is made in raising the original PO. Technically the procurement team member should close the PO with the error and re-raise a new one to match against the invoice. Quite often however the PO with the error on it is not closed off, and a second PO is raised anyway."*
>
> "[Tech Data] *have completed a significant amount of work and time into identifying historic open POs and getting them closed off, to the extent that the accrual for open POs is much lower than it has been in the past.*
>
> *The greatest control, and the thing that gives management the greatest comfort over the balances, is that they perform a monthly margin review of all profit centres, to ensure that there are no material errors in the reporting of sales and front end margin. Due to the company's small margins it is evident when they become skewed. If they were accruing duplicated POs then our margins would fluctuate significantly and be able to spot immediately any material errors that have occurred as a result. The process of identifying such errors is initially identified by running an exceptions report: this details all transactions that have occurred in the day."*
>
> *"As mentioned in above discussions, sometimes a PO is raised in error and is not closed off. Or if they haven't received the vendor invoice but believe the 'goods' have been delivered due to the lead time on deliveries the team will push through a customer invoice. The system will continue to accrue against the PO. This is not correct as they are not now expecting any invoice against the original POs. The finance team have done a lot of work in investigating where they have open POs and have adjusted the balances accordingly in anticipation of getting these closed off."*

38. During the course of the audit, a junior member of the audit team raised queries in an email dated 1 March 2012 with the Tech Data Financial Management Controller in relation to what had driven the fall in the 31 January 2012 DSA accrual balance, and if this fall was due to duplicate POs, what would be the margin impact.

39. EY conducted no controls testing specifically relating to DSAs. EY performed a substantive test of a sample of five duplicate POs. The test for integrity of duplicate status revealed no exceptions.

40. Given that the accounting for these arrangements appeared to bypass normal processes and controls and in view of the risk of fraud and error arising from that accounting, EY should have, but failed to perform audit testing to corroborate management's assertion in relation to the *"greatest control"* described at paragraph 37 above. Instead, EY relied on an internal audit *"walkthrough of management review of sales and margins"* which consisted of a high-level discussion between Tech Data's internal audit team and the Tech Data finance team; there was no testing by internal audit or EY on this control. EY's basis for not testing the "control" in question was that it was not relied upon in support of its audit work or conclusions. EY did not cite any alternative control, the implication being that they accepted management's assertion without any further challenge or testing and without sufficient professional scepticism.

41. ISA 200, paragraph 5 provides that, *"ISAs (UK and Ireland) require the auditor to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error"*.

42. Further, ISA 500, paragraph 6 provides that, *"the auditor shall design and perform audit procedures that are appropriate in the circumstances for the purpose of obtaining sufficient appropriate audit evidence"*.

43. ISA 220, paragraph 17 provides that, *"the engagement partner shall, through a review of the audit documentation and discussion with the engagement team, be satisfied that sufficient appropriate audit evidence has been obtained to support the conclusions reached and for the auditor's report to be issued"*.

44. The audit evidence that EY obtained in relation to DSAs was not sufficient to comply with ISA 200 and ISA 500, and did not amount to obtaining reasonable assurance

that the financial statements as a whole were free from material misstatement. EY should have designed and performed more extensive testing on DSAs, in particular the controls and the duplicate POs. In accordance with ISA 220, Mr Gray was ultimately responsible for ensuring the sufficiency and appropriateness of the audit evidence to support the conclusions reached.

45. ISA 240, paragraph 12 provides that, *"In accordance with ISA (UK and Ireland) 200, the auditor shall maintain professional scepticism throughout the audit, recognising the possibility that a material misstatement due to fraud could exist, notwithstanding the auditor's past experience of the honesty and integrity of the entity's management and those charged with governance"*.

46. EY failed to exercise sufficient professional scepticism in relation to DSAs by omitting to challenge management's assertions in relation to their cited "greatest control". If EY had shown sufficient professional scepticism in this regard, it might have exposed the shortcomings in management's margin review, or led to the discovery of the misstatements within DSAs.

<u>ACT 2 – VENDOR REBATES</u>

In relation to the audit of Tech Data's financial statements for FY12, the conduct of <u>Mr Gray and EY</u> fell significantly short of the standards reasonably to be expected of, respectively, a Member and a Member Firm in that, in respect of vendor rebates:

(i) the Respondents failed to obtain reasonable assurance about whether the financial statements as a whole were free from material misstatement; and/or

(ii) the Respondents failed to obtain sufficient appropriate audit evidence from which to draw a reasonable conclusion; and/or

(iii) the Respondents failed to sufficiently identify and assess and respond to the risks of material misstatement; and/or

(iv) the Respondents failed to demonstrate sufficient professional scepticism,

and thereby the Respondents failed to comply with the requirements of ISA 200, ISA 220, ISA 240, ISA 315, ISA 330 and ISA 500 and/or failed to act in accordance with the Fundamental Principle of Professional Competence and Due Care contained in the Code.

Particulars of Act 2

47. Within Tech Data, vendor rebates could be earned through a number of different arrangements. Tech Data would negotiate rebate arrangements with vendors, whereby discounts were agreed which Tech Data would pass onto its customers, or Tech Data could fund discounts itself on certain goods. There were three key types of vendor rebate:

(1) Vendor-funded ship and debits – this arrangement was applied to goods already held in stock. Tech Data would negotiate with the vendor an arrangement whereby the vendor would reimburse it should products be sold to a customer at a discounted price;

(2) Buy-ups (also referred to as "ZBUP") – this term referred to goods not yet purchased by Tech Data but which would, in due course, pass through its warehouse when sold to a customer. Discount would be negotiated with the vendor to be applied to the cost of the goods at the point of purchase by Tech Data, which would then be passed on to the customer; and

(3) Self-funded ship and debits – this arrangement was applied to goods already in stock however the discount was funded by Tech Data. Although there was no rebate from a vendor, it was accounted for in a similar way, and considered within the audit of vendor rebates.

48. Vendor rebate related accounting entries had a potential impact on accounts payable and accounts receivable in the balance sheet and cost of sales in the profit and loss account. These are large and highly material areas of both the balance sheet and the profit and loss account. Prior year adjustments were made to both accounts payable (£1 million) and cost of sales (£2 million) in FY12. As set out at paragraph 28 above, materiality was £1.33 million. The total restatements to the financial restatements for FY12 resulted in a reduction of approximately £9 million to profit before tax, from £14 million to £5 million, amounting to over 60% of the total figure. The effect on profit after tax was a £6 million adjustment, from £ 9 million to £3 million, and net assets were reduced by £22 million. The failures in relation to the audit of vendor rebates amounted to a failure to obtain reasonable assurance over material balances, and therefore about whether the financial statements as a whole were free from material misstatement. For the avoidance of doubt, it is not the case that if EY had not committed the failures admitted in relation to the audit of vendor rebates the audit work would have necessarily detected or prevented these misstatements.

49. As part of its audit planning documentation, EY listed "Incorrect recognition of vendor receivables income" as one of five fraud risks and "Failure to properly execute vendor incentive agreements" as a significant risk. The financial statement and control implications noted as associated to each of these risks was "*Vendor claims made outside of agreements, resulting in incorrect recognition of discounts/incorrect valuation of inventory*". The audit response to both was to "*test the management controls in the VR process… We will also test a sample of VR rebate claims around year end*".

50. The Fraud Considerations Form prepared by the audit team made the following observation in relation to "Incorrect recognition of vendor receivables income": "*This is an inherently risky account as sometimes the vendors dispute the debit notes that C2k* [Tech Data] *have raised outside of agreements in order to claim a credit*". A similar form was prepared by the group audit team and provided to the audit team in the UK which included the following observation: "*Amounts due from vendors for*

vendor incentives may be manipulated with the intent of increasing earnings or saving the incentives for recognition at a future date".

51. Testing of controls was carried out at both the hard close and the year end, and concluded as to whether they were effective or ineffective. This testing was performed either by EY or Tech Data's Internal Audit. At the hard close, three controls, out of 19 tested relating to vendor rebates, were deemed to be ineffective. EY's response was "*extra consideration will be given to testing these in Phase 2*" and "[w]*hen we identify control exceptions in the interim period, our update tests of controls may be more extensive depending on the importance of the control to the relevant assertion, including the risks associated with the control, the nature of the control and causes of the exceptions …*". There is no commentary on the impact of ineffective controls or the planned scope of retesting for control test failures, and no evidence of any extra consideration or more extensive testing.

52. At year end, either EY or Tech Data internal audit carried out testing on the same controls. EY's summary of the results of controls testing at year end (phase 2) showed different phase 1 results from those recorded at phase 1. In the EY phase 2 summary, two controls previously shown as ineffective at phase 1 were recorded as effective. However, two more controls, previously shown as effective at phase 1, were recorded as ineffective. For all these four controls, there was no explanation of these inconsistencies, nor was there any evaluation of the impact of the ineffective conclusions.

53. One further vendor accounting control (in respect of self-funded ship and debit transactions) remained ineffective at year end, in respect of one of two attributes. This test showed that four out of a sample of five tested self-funded ship and debits, although properly accounted for, did not have the required authorisation. EY's response was documented as "*the process will be put in place from today (25/01/2012) and going forwards all self funded S&D approvals will be approved in accordance with the DoA* [Designation of Authority]. *The existing issue will remain on retest status at year end and be retested at the end of Q1 FY13 when a suitable population is available*". There is no evidence of any retest subsequent to the year end on the audit file.

54. In addition to this testing, Tech Data's Internal Audit performed walkthroughs of the various vendor rebate processes. These walkthroughs were reviewed by EY and this review was documented on the audit file.

55. Other testing performed by EY in relation to vendor rebates included testing samples from general ledger accounts making up the vendor rebate related balance. EY selected the four largest accounts and tested samples from each for specified attributes. Credit balances were excluded from the samples chosen; in one account, credit balances amounted to 148% and one item alone in an account represented 68% of the total balance. Given the nature of these accounts and the transactions therein, they would typically contain debit balances rather than credit balances. Credit balances were not considered or explained on the audit file. The approach to testing, excluding credit balances, was followed at both hard close and year end.

56. In its audit work in relation to vendor rebates, given it was recognised as a fraud and significant risk and subject to management manipulation or override of controls, EY should have, but failed to:

(1) consider the impact of ineffective controls at the hard close described at paragraph 52, and plan and perform further audit testing on those controls to understand whether these controls were operating effectively throughout the entire financial year. Where a control was ineffective at hard close, it may not have been operating effectively for a substantial part of FY12; this risk was potentially amplified where a control remained ineffective at year end. Yet EY failed to explain the potential impact of the control deficiencies and failed to perform the required follow-up on the ineffective controls, by consideration of compensating controls and undertaking further audit testing. Furthermore, there was a failure to appreciate and remedy inconsistencies on the audit file; and

(2) design and perform audit procedures to ensure coverage of major components and credit balances on the vendor rebate related accounts, described at paragraph 55. EY ignored large and unexplained credit balances, and failed to understand the principal components of a material balance sheet caption.

57. EY failed to design and perform audit procedures that were appropriate in the circumstances for the purpose of obtaining sufficient appropriate audit evidence in relation to vendor rebates, and thereby the audit evidence obtained was not sufficient to comply with the requirements of ISA 200 and ISA 500.

58. ISA 240, paragraph 8 provides that, *“the auditor is responsible for maintaining professional scepticism throughout the audit, considering the potential for management override of controls”*. EY failed to exercise sufficient appropriate professional scepticism in relation to the audit of vendor rebates.

59. ISA 315, paragraph 25 requires the auditor to “*identify and assess the risks of material misstatement… to provide a basis for designing and performing further audit procedures*”. Further, ISA 330, paragraph 6 requires the auditor to “*design and perform further audit procedures whose nature timing, and extent are based on and responsive to the assessed risk of material misstatement…*”. The absence of EY’s follow up for all “ineffective” conclusions contravenes these requirements.

<u>ACT 3 – AGEING AND PROVISIONING OF INVENTORY AND RECEIVABLES</u>

In relation to the preparation of Tech Data's financial statements for FY12, the conduct of <u>Mr Gray and EY</u> fell significantly short of the standards reasonably to be expected of, respectively a Member and a Member Firm in that, in respect of ageing and provisioning of inventory and receivables:

- **(i)** **the Respondents failed to obtain reasonable assurance about whether the financial statements as a whole were free from material misstatement; and/or**
- **(ii)** **the Respondents failed to obtain sufficient appropriate audit evidence from which to draw a reasonable conclusion,**

and thereby the Respondents failed to comply with the requirements of ISA 200, ISA 220, and ISA 500 and/or failed to act in accordance with the Fundamental Principle of Professional Competence and Due Care contained in the Code.

Particulars of Act 3

60. The audit of ageing and provisioning of inventory and receivables includes the work done by EY to check the accuracy of the ageing of inventory (which may be used, for example, in assessing obsolescence), and to assess the appropriateness of any provisions where net realisable value of inventory was estimated to be less than the amounts recorded in the accounting records. It also covers the work done to check the accuracy of the ageing of debts, and the appropriateness of any provisions against estimated non-recovery.

61. Ageing and provisioning of inventory and receivables had a potential impact on inventory and accounts receivable in the balance sheet, and cost of sales and operating expenses in the profit and loss account. These were large and highly material areas of both the balance sheet and profit and loss account, for example inventory amounted to £72 million in FY12. There were material prior year adjustments to each of these areas as follows: inventory £8 million, accounts receivable £5 million, cost of sales £2 million and operating expenses £4 million. As set out at paragraph 28 above, materiality was £1.33 million. The total restatements to the financial restatements for FY12 resulted in a reduction of approximately £9 million to profit before tax, from £14 million to £5 million, amounting to over 60% of the total figure. The effect on profit after tax was a £6 million adjustment, from £9 million to £3 million, and net assets were reduced by £22 million. Therefore, the

failures in relation to the audit of this area involved a failure to obtain reasonable assurance over material areas, and about whether the financial statements as a whole were free from material misstatement. For the avoidance of doubt, it is not the case that if EY had not committed the failures admitted in relation to the audit of ageing and provisioning of inventory and receivables the audit work would have necessarily detected or prevented these misstatements.

62. The EY audit planning documentation, and the instructions from the group audit team, record ageing and provisioning of inventory and receivables as an audit risk. “Risk of manipulation of accounts receivable and inventory reserves” was included as a group fraud risk. “Provisions for bad debt and inventory” was listed as a significant audit and accounting matter. “Allowance for doubtful accounts and allowance for inventory obsolescence” was included as a key estimate in which the partner was required to have direct participation.

63. EY documented the fraud risk described at paragraph 62 above as follows:

> *“Due to the judgement involved in the reserve process, management may manipulate these reserves with the intent of increasing earnings or saving the reserves for release at a future date.”*
>
> *“The AR reserve & inventory reserve could be manipulated by management at Tech Data HQ. Historically Tech Data provides the provision percentages to be applied to all the entities around the group, however these have been historically prudent and there is a risk that these large provisions could be released at some point in the future.”*

64. In its testing of the inventory provision, EY noted that the percentage for calculating the provision had been altered during FY12 as the prior year provision was deemed by management, and agreed by EY, to be too generous. EY documented management’s explanation as follows:

> *“Management explained that a higher level of write offs were required as a result of the overstocking issue in the prior year and also noted that stock control has improved in the current year and therefore write offs required going forward will not be as significant thereby justifying the reduction in provision.”*

However, EY also noted that write offs made during the year were significantly higher than expected and that the provision balance had increased. EY ultimately concluded "[e]*xplanation, and… balance deemed reasonable*".

65. In relation to EY's audit of accounts receivable ageing and provisioning:

(1) EY planned to re-compute ageing for a sample of debtors, but failed to do so. Rather it relied on a summary of controls testing by EY Germany, with no substantive audit work;

(2) the instructions from the group audit team contained the requirement that EY *"examine subsequent cash receipts, proof of vendor credit, and/or other evidence to verify validity of accounts receivable for which replies to confirm requested are unsatisfactory or not obtained"*. In the audit work paper, 83 balances are originally selected, however 14 were eliminated. Of the 69 remaining balances, 14 were confirmed and 55 were subjected to alternative procedures, which amounted to taking the largest invoice and testing that it was subsequently settled. There is no explanation as to how this gives comfort over the entire balance.

66. In its audit work in relation to ageing and provisioning of inventory and receivables, given it was recognised as an audit risk, EY should have, but failed to:

(1) challenge analytically management's assertions in relation to its approach to stock provision described at paragraph 64. EY re-performed provision calculations, but did not properly analyse the comparison of the stock provision at the start of the year with stock written off during the year, nor test management's argument that its approach was prudent. EY accepted this assertion with insufficient challenge or corroboration to underlying evidence. Provisioning of inventory was recognised by EY as an area that may be subject to management manipulation. The work performed by EY did not amount to sufficient appropriate audit evidence in an area where management judgement determined the provision.

(2) undertake sufficient audit procedures in relation to the ageing of debtors and debtors' confirmation. In particular EY failed to undertake any substantive audit testing on the ageing of debtors, despite its plan to re-compute the

ageing of a sample of debtors. EY failed to explain how its testing in relation to the debtors' confirmation provided sufficient comfort over the entirety of the balance or calculation. This amounted to a failure to obtain sufficient appropriate audit evidence from which to be able to draw a reasonable conclusion.

68. In light of the failings set out at paragraph 66 above, the audit work performed by EY in relation to ageing and provisioning of inventory and receivables did not amount to sufficient appropriate audit evidence to reduce audit risk to an acceptably low level and thereby enable the auditor to draw reasonable conclusions as to whether the financial statements as a whole were free from material misstatement. Thereby, EY and Mr Gray failed to comply with the requirements of ISA 200, ISA 220 and ISA 500.