IN THE MATTER OF:

THE EXECUTIVE COUNSEL TO THE FINANCIAL REPORTING COUNCIL

- and -

(1) PRICEWATERHOUSECOOPERS LLP

(2) JONATHAN HOOK

EXECUTIVE COUNSEL'S FINAL SETTLEMENT DECISION NOTICE

Pursuant to Rules 107(a) and 108 of the Audit Enforcement Procedure

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

A. INTRODUCTION

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

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

3. This Final Settlement Decision Notice also uses the following additional definitions:

    3.1. The '**Company**' or '**Galliford Try**' means Galliford Try plc;
    3.2. '**FY2018**' means the financial year ended 30 June 2018;
    3.3. '**FY2019**' means the financial year ended 30 June 2019;
    3.4. '**FY2020**' means the financial year ended 30 June 2020;

3.5. ‘**FY2018 financial statements**’ means the consolidated financial statements for the Company for that period;

3.6. ‘**FY2019 financial statements**’ means the consolidated financial statements for the Company for that period;

3.7. ‘**FY2020 financial statements**’ means the consolidated financial statements for the Company for that period;

3.8. ‘**FY2018 Audit**’ means the Statutory Audit of the FY2018 financial statements; and

3.9. ‘**FY2019 Audit**’ means the Statutory Audit of the FY2019 financial statements.

4. Executive Counsel has decided that the Respondents (as defined below) are liable for Enforcement Action, having found breaches of Relevant Requirements. This Final Settlement Decision Notice is issued pursuant to Rule 108 of the AEP in respect of the conduct of:

4.1. PricewaterhouseCoopers LLP (“**PwC”**) in relation to the FY2018 Audit and the FY2019 Audit. PwC was the Statutory Audit Firm for the FY2018 Audit and FY2019 Audit; and

4.2. Mr Jonathan Hook, then a partner of PwC, in relation to the FY2018 Audit and the FY2019 Audit (“**Mr Hook**”). For FY2018 and FY2019, Mr Hook was the Statutory Auditor of the Company and signed the FY2018 and FY2019 Audit reports on behalf of PwC.

together, the ‘**Respondents**’.

5. On 18 March 2022 Executive Counsel issued a Proposed Settlement Decision Notice pursuant to Rule 103 of the AEP. On 21 March 2022 the Respondents provided written agreement to the Proposed Settlement Decision Notice. On 31 March 2022 the Independent Reviewer approved the Proposed Settlement Decision Notice.

6. Consequently, and in accordance with Rules 104 and 107 of the AEP, this Final Settlement Decision Notice:

6.1. outlines the breaches of Relevant Requirements with reasons;

6.2. outlines Sanctions with reasons; and

6.3. outlines an amount payable in respect of the Executive Counsel's costs of the matter.

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

7.1. Section A: Introduction;
7.2. Section B: Executive Summary of the breaches of Relevant Requirements and Sanctions;
7.3. Section C: Background;
7.4. Section D: Relevant Requirements to which the breaches relate;
7.5. Section E: Detail of the breaches of Relevant Requirements;
7.6. Section F: Sanctions; and
7.7. Section G: Costs.

B. EXECUTIVE SUMMARY OF THE BREACHES OF RELEVANT REQUIREMENTS AND SANCTIONS

8. This Final Settlement Decision Notice explains the failings in PwC's and Mr Hook's audit work in the FY2018 and FY2019 Audits. It also finds breaches of Relevant Requirements regarding PwC's and Mr Hook's audit work.

Breaches of Relevant Requirements

9. **Breach 1**: in relation to both the FY2018 Audit and the FY2019 Audit, the Respondents did not obtain sufficient appropriate audit evidence, did not sufficiently challenge or corroborate management representations, or adequately determine whether the Company had appropriately applied the requirements of the applicable financial reporting framework in relation to [Contract A].

10. **Breach 2**: in relation to the FY2018 Audit, the Respondents did not obtain sufficient appropriate audit evidence, did not sufficiently challenge or corroborate management representations, or adequately determine whether the Company had appropriately applied the requirements of the applicable financial reporting framework in relation to the [B Contracts].

11. **Breach 3**: in relation to the FY2018 Audit the Respondents did not prepare sufficient audit documentation in respect of the appropriateness of including transactions with joint ventures in operating cash flows.

12. **Breach 4**: in relation to the FY2018 Audit, the Respondents did not design and perform audit procedures appropriate in the circumstances and obtain sufficient appropriate audit evidence in relation to the selection and testing of Construction contracts.

13. **Breach 5**: in relation to the FY2018 Audit, the Respondents did not adequately document the design and test the controls over Construction contracts.

14. Section E of this Final Settlement Decision Notice sets out the detailed breaches of Relevant Requirements relating to the audit work on the matters set out above.

15. The FRC's Audit Quality Review ("**AQR**") team conducted an inspection of the FY2018 Audit in Spring 2019 and identified a number of audit deficiencies, which correlate with some of the breaches of Relevant Requirements in this Final Settlement Decision Notice. In response to the AQR's inspection, PwC (i) conducted a Root Cause Analysis to identify how the breaches of Relevant Requirements had occurred; and (ii) agreed with the AQR inspection team to take certain remedial steps in the FY2019 Audit to respond to the identified audit deficiencies. In addition, senior partners from PwC's Audit line of service followed up certain aspects of these matters in a meeting with the FRC AQR team shortly before the FY2019 Audit was completed.

16. Executive Counsel recognises that PwC and Mr Hook sought to address these deficiencies by performing additional procedures in the FY2019 Audit. Nevertheless, Executive Counsel considers that the steps taken by PwC and Mr Hook were not sufficient to prevent the recurrence of certain of the breaches of Relevant Requirements in relation to the [Contract A] in the FY2019 Audit.

<u>Sanctions</u>

17. This Final Settlement Decision Notice imposes the following sanctions in respect of the Respondents:

PwC

17.1. A financial sanction of £5,500,000 adjusted for aggravating and mitigating factors (in particular reflecting an exceptional level of cooperation) by a reduction of 15% and further discounted for admissions and early disposal by 35% so that the financial sanction payable is £3,038,750;

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

17.3. A declaration that the Statutory Audit Reports for FY2018 and FY2019 did not satisfy the Relevant Requirements, as set out in this Final Settlement Decision Notice.

Mr Hook

17.4. A financial sanction of £150,000 adjusted for aggravating and mitigating factors (in particular reflecting an exceptional level of cooperation) by a reduction of 15% and further discounted for admissions and early disposal by 35% so that the financial sanction payable is £82,875;

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

17.6. A declaration that the Statutory Audit Reports for FY2018 and FY2019 did not satisfy the Relevant Requirements, as set out in this Final Settlement Decision Notice.

C. <u>BACKGROUND</u>

The Respondents

18. PwC is one of the largest audit firms in the UK. It is a member firm of the Institute of Chartered Accountants in England and Wales ("**ICAEW**"). PwC was appointed as the Statutory Audit Firm for the Company for the financial years ended 30 June 2001 to 30 June 2019.

19. At the time of the FY2018 and FY2019 Audits, Mr Hook, a member of the ICAEW, was a partner of PwC and had over 30 years' auditing experience.

20. Mr Hook signed the FY2018 and FY2019 Audit reports, on behalf of PwC, in respect of the FY2018 and FY2019 financial statements.

21. The purpose of an audit is to enhance the degree of confidence of intended users in the financial statements. This is achieved by the expression of an opinion by the auditor on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework. Mr Hook's and PwC's statutory responsibilities were to form an opinion as to whether the FY2018 and FY2019 financial statements showed a true and fair view and had been properly prepared in accordance with International Financial Reporting Standards as adopted by the EU ("**IFRS**") and the Companies Act 2006. An audit conducted in accordance with the International Standards on Auditing (UK) ("**ISAs**") and relevant ethical requirements enables the auditor to form that opinion.

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

23. Audit evidence is defined in ISA 500 as '*information used by the auditor in arriving at the conclusions on which the auditor's opinion is based*'. Audit evidence is primarily obtained from audit procedures performed during the course of the audit.

24. ISA 200 requires that an auditor shall plan and perform an audit with professional scepticism recognising that circumstances may exist that cause the financial statements to be materially misstated and shall exercise professional judgment.

25. As ISA 230 explains, it is important for documentation on the audit file to be clear so that an experienced auditor, with no previous connection with the audit, could understand the audit procedures that have been carried out, their results, the audit evidence obtained and the conclusions reached in respect of significant matters arising during the audit (including those involving professional judgment).

The Company

26. At the time of the FY2018 and FY2019 Audits, Galliford Try was one of the UK's leading housebuilding, regeneration and construction groups, operating through three principal business segments: Linden Homes, Partnerships & Regeneration and

Construction & Investments. The Construction & Investments business segment was split into Building, Infrastructure and PPP Investments sub-segments. It was (and remains) listed on the London Stock Exchange and as such was (and remains) a Public Interest Entity.

27. For FY2018 and FY2019, the Company reported the following key group results and balances:

	2018	**2019**
	£m	**£m**
Revenue	2,932	2,711
Profit after tax	118.3	86.9
Net assets	776.5	751.7

28. The Company's Construction & Investments business segment delivered large-scale infrastructure projects and construction work for both private and public sector clients, with contracts ranging in size from less than £1m to over £100m. These projects typically spanned several years, requiring total revenue to be estimated and apportioned across financial reporting periods. The relevant accounting standards for the recognition of such revenue were IAS 11 (in FY2018) and IFRS 15 (in FY2019). These contained specific requirements for uncertain or variable elements of revenue, such as claims or variations. IAS 11 also required that for any contracts forecast to make a loss, the full loss should be recognised in the accounts immediately. In FY2019 the requirement to immediately recognise the full forecast loss was covered by the onerous contract provisions within IAS 37, Provisions, Contingent Liabilities and Contingent Assets.

29. For both the FY2018 and FY2019 Audits, the valuation of Construction contracts was identified as a significant risk by PwC.

30. For the FY2019 Audit, PwC also identified the risk that the recognition, in contract revenue, of material variations and claims on contracts may not be appropriate, as a significant risk.

31. For the FY2018 Audit, overall materiality for the Company was £9.4m. For the FY2019 Audit, overall materiality for the Company was £7.8m. For both the FY2018 and FY2019 Audits performance materiality was set at 75% of overall materiality.

Contract Selection and Testing

32. PwC selected 58 contracts (17 in Infrastructure and 41 in Buildings) for substantive testing in the FY2018 Audit which met qualitative or quantitative targeted risk criteria. This resulted in revenue coverage of 39% and 28% of the Infrastructure and Buildings sub-segments respectively.

33. No contracts were tested other than those which met the risk criteria. This left an untested revenue balance of £353.9m in Infrastructure and £726.3m in Buildings.

34. ISA 500 specifies that selective examination of specific items from a class of transactions, such as through the application of the risk criteria identified by PwC, does not provide audit evidence concerning the remainder of the population.

35. The audit file states that additional procedures were planned to give comfort over the remaining balance. These were: (a) analytical reviews to identify any unusual movements, focused on large variances between tendered and forecast outturn margins, to determine whether any further contracts required testing; and (b) testing such as bank reconciliations, unrecorded liability, accounts payable and cost of sales testing.

36. However, the analytical reviews performed were not sufficiently detailed or substantive in nature, and the other procedures did not specifically address the significant risk within revenue.

37. Furthermore, the planned analytical procedures were not all undertaken and testing of contracts that fell outside the risk criteria was not undertaken. To that extent, the audit workpapers did not accurately describe the audit work the audit team had performed, as required by ISA 230.

[Contract A]

38. [Contract A] was a contract between a joint operation ("**JO**") (between the Company and two other main contractors) and the client (the "**Client**") to build a bypass around Aberdeen. The contract was for a fixed sum. It started in January 2015 and was expected to be completed in May 2018. The contract was therefore expected to extend across a number of the Company's financial reporting periods. In January

2018, one of the two other main contractors entered insolvency, leaving the Company and the remaining other contractor each with a 50% share.

FY2018 [Contract A] Testing

39. In FY2018, the Company accounted for [Contract A] under IFRS 11 (Joint Arrangements) whereby each party recognised its share of the assets, liabilities, revenue and expenses of the JO. PwC selected [Contract A] for targeted testing due to it meeting the risk criteria by virtue of its size.

40. At the end of FY2018, [Contract A] was forecast to make a loss. The Company's forecast of its share of this loss (the Company's End of Life Forecast, "**ELF**") included a number of material estimates:

    40.1. an amount of £80m was recognised in forecast revenue in relation to a claim against the Client (the "**Upstream Claim"**);

    40.2. an amount of £12.5m was recognised in forecast revenue in relation to claims against the designer and checker on the project (referred to as the **"[Contract A] Downstream Claim"**, as it related to a claim against subcontractors as opposed to the Client); and

    40.3. a decision not to provide for a potential exposure of £28.5m in penalties potentially payable to the Client for lane closures (referred to as Lane Occupancy Charges "**LOCs**"); and

    40.4. a deduction of £20m (£40m at JO level) from the forecast revenue for liquidated damages ("**LDs**").

41. The Auditor's report in the FY2018 financial statements explained that the Group's loss provisions for [Contract A] incorporated assumptions regarding claim recoveries against the Client and other parties where negotiations had yet to be concluded. The Auditor's report also included the following with regard to [Contract A]:

    > *"How our audit addressed the key audit matter ... In respect of management's assumptions regarding recovery of claims on* [Contract A] *we obtained evidence of adjudication decisions, reviewed the basis of the claim calculation and challenged the level or [sic] provisioning assumed based on discussions*

> *with Group's external quantum experts and legal counsel as to the assumed levels of recovery built into the loss provision calculation."*

42. No disclosures in the FY2018 financial statements were made regarding the quantum of uncertainty relating to the accounting estimates on [Contract A].

<u>The Upstream Claim</u>

43. The Upstream Claim related to multiple diversions of water and electricity services. The JO contended that the Client failed to give proper instruction to the utilities which caused delay and disruption to the project.

44. An adjudication in 2016 (the "**2016 Adjudication**") was convened by the Client. The dispute referred to in the 2016 Adjudication was whether the Client was entitled to strike out the JO's claims; it was not to determine whether the JO was positively entitled to the claims.

45. The adjudicator concluded that the Client was not entitled to strike out the JO's claims. The 2016 Adjudication therefore prevented the Client's attempt to block the JO from claiming compensation by determining that the Client had failed to demonstrate that the JO had no claim. However, it did not make any determination of the JO's claim itself.

46. The audit file documents the audit team's consideration of the outcome of the 2016 Adjudication; the audit team placed disproportionate weight on its ambit and significance in their assessment of the appropriateness of the cumulative revenue recognised.

47. IAS 11 'Construction Contracts' prescribed the accounting treatment for revenue and costs associated with construction contracts for the purposes of the FY2018 Audit. IAS 11 provides that claims regarding disputed construction contracts should only be included in contract revenue when two conditions are met:

    47.1. '*negotiations have reached an advanced stage such that it is probable that the customer will accept the claim*'; and

    47.2. '*the amount that it is probable will be accepted by the customer can be measured reliably*'.

48. In relation to whether the negotiations regarding the Upstream Claim were at an advanced stage, the audit file recorded that:

48.1. At a meeting between the Client and the JO in July 2018, the JO had presented its valuation of the Upstream Claim. The Client had made an oral without prejudice settlement offer which was not accepted and the JO had stated a proposed settlement amount that it would accept as a "walk away" position to avoid formal legal action. There was a difference of over £100m between the "walk away" position and the Client's oral offer.

48.2. In September 2018, facilitated negotiations between the Client and the JO had commenced although they were at an early stage. At a meeting on 6 September 2018, the JO had been asked by the Client to re-configure its claim to show a clear linkage to the non-performance by utilities and the impact of weather.

48.3. The audit team summarised the position at the FY2018 year end as follows:

'[...]The JV [Joint Venture] currently expect [sic] progress in agreeing an end value settlement with [the Client] in the first week of September. The [Client's oral] offer has narrowed the gap but there is no indication from [the Client] of what it's] offer is made up of and whether LOCs ... are included'.

48.4. No settlement had been reached by 12 September 2018, the date the Auditor's report was signed.

49. In relation to whether the amount regarding the Upstream Claim could be measured reliably:

49.1. The JO valuation of the Upstream Claim had been prepared with the help of an external consultant and included an adjustment to accept an element of fault.

49.2. The audit team held meetings with management and the external consultant to understand this calculation and obtained documentation supporting the JOs presentation at the July 2018 meeting. However, the valuation and key inputs were not otherwise corroborated.

49.3. The audit team documented a call with the external consultant on 10 September 2018. The audit team obtained an analysis of the components of the JO's valuation of the Upstream claim and discussed the JO's "walk away" position presented at the July 2018 meeting with the Client.

49.4. The audit team documented that they challenged the external consultant on why the full amount at which the JO had valued the Upstream Claim was not being claimed in the JO's "walk away" position. The external consultant indicated that this reflected that the JO was responsible for some element of the cost overrun.

49.5. Although it was also recorded that the external consultant had advised that it was better to seek a mediated settlement rather than take the risk of pursuing adjudication or legal proceedings, no further explanation was provided as to how the "walk-away" figure was derived from the amount at which the JO had valued the Upstream Claim.

49.6. The audit team recorded that the external consultant was '*very optimistic*' that the claim would settle at approximately the "walk away" figure.

49.7. The call with the external expert on 10 September 2018 was stated by the audit team to be evidence of the recoverability of the "walk away" figure. The audit file did not record how the Company's share of the "walk away" offer was then reduced by a material amount to the £80m recognised in the Company's ELF.

49.8. The audit team stated that they believed that the LOCs would be settled within the overall Upstream Claim. However, it is not clear what allowance for LOCs had been included with the £80m in the Company's ELF. The Company's share of the potential charge in respect of LOCs was £29m at the FY2018 year end (addressed further below).

49.9. The audit team noted that:

> "*In light of the without prejudice offer, the successful adjudication, external consultant view we accept there is significant merit to the recovery from [the Client]. While quantum remains unagreed, we accept the portion being assumed by the* [JO] i*s significantly below amounts actually* [being] *presented to [the Client].*"

[Contract A] Downstream Claims

50. In FY2018, an amount of £12.5m at Company level was included in the Company's ELF revenue in relation to the [Contract A] Downstream Claims.

51. As stated in paragraph 47 above, IAS 11 provides that a claim can only be included in revenue when negotiations have reached an advanced stage such that it is probable that the customer will accept the claim, and when that amount can be measured reliably.

52. The [Contract A] Downstream Claims were valued at £39.1m (JO level) on the valuation schedule management provided to the audit team. The audit team did not test this figure and no reconciliation between this figure and the £12.5m recognised in the FY2018 financial statements was included in the audit file.

53. The audit team recorded that:

53.1. Each of the [Contract A] Downstream Claims had a liability cap of £20m.

53.2. No formal submission of the [Contract A] Downstream Claims had been made and therefore "*there is no further detail obtained at this stage*", although the parties had been put on notice.

53.3. The Company had informed the audit team that its intention was to progress the [Contract A] Downstream Claims only once the main Upstream Claim had progressed.

53.4. The audit team had challenged the external consultant on the recoverability of the [Contract A] Downstream Claims during their conversation on 10 September 2018 (referred to in paragraph 49 above). The audit file notes: "*He confirmed that the [Design Joint Venture, (the "DJV")] has been notified of the claims. He also explained that the detailed claim would not be submitted to the DJV until the road is completed and the upstream position with [the Client] is resolved. He also reaffirmed that the value of the claims would be well in excess of the capped amount in the* [DJV] *contracts and that in his view a level of recovery up to the capped position was likely to be achieved*".

54. No further testing was carried out.

55. On transition to IFRS15 in FY2019, the [Contract A] Downstream Claims were de-recognised. This was disclosed in the FY2019 financial statements as an adjustment to opening reserves in FY2019 on transition to IFRS15.

<u>LOCs</u>

56. IAS 11 provides that the revenue of a contract may decrease due to '*penalties arising from delays caused by the contractor in the completion of the contract*'.

57. LOCs were contractual amounts payable by the JO to the Client in relation to road closures arising from delays to the project timeline. In FY2018, the audit file records that £57m (at JO level) of LOCs was calculated representing a defined number of days at a defined rate per day. The rate was said on the audit file to have been agreed to [Contract A], however, the components of the calculation and how they corresponded with the details in the Contract are not documented in the audit file.

58. In FY2018 no allowance, separate to that recognised in the Upstream Claim as referred to in paragraph 49.8 above, was made for LOCs. The audit file records that the reasons for this were as follows:

    58.1. The Client had not historically charged LOCs or suggested that they would charge them in future.

    58.2. The taxpayers did not actually incur any expense due to the roads being closed and therefore there was less reason for the Client to charge LOCs.

    58.3. The LOCs were likely to be settled as part of the overall Upstream Claim settlement. However, the audit team reported to the Audit Committee that they had not ascertained whether the Client's oral without prejudice settlement offer included any allowance for LOCs.

59. A possible legal challenge to LOCs had been discussed with management's legal advisors although at the time of the FY2018 financial statements the audit team had not obtained a copy of any written legal advice.

60. The audit team provided no further challenge to the Company's judgement that the LOCs did not need to be recognised.

LDs

61. The FY2018 ELF included a deduction of £40m at JO level (£20m at Company level) from forecast revenue for estimated LDs. LDs are pre-agreed amounts of compensation which are to be paid on breach of contract to the contracting party not in breach. Under [Contract A], the LDs were being levied on the JO by the Client in relation to delays in achieving project completion.

62. There is no evidence on the audit file that that audit team re-calculated the level of provision for LDs by reference to the provisions of [Contract A] and the delays to practical completion. Further the calculation of the LDs should have been £43.4m.

Revenue Recognised

63. The audit workpapers do not include details of how the cumulative or YTD revenue recognised to the end of FY2018 by the Company reconciled to the amounts recognised at the JO level and the Company's ELF.

Costs

64. The audit workpapers also do not provide an explanation of how the costs recognised at the Company level reconciled with those recognised at the JO level.

FY2019 [Contract A] Testing

65. By the end of FY2019, [Contract A] was substantially complete. However, the Upstream Claim had not been settled and an amount of £80m continued to be included in the Company's ELF for the purposes of the FY2019 financial statements. Further, there was a potential £80.9m exposure for LOCs (at the JO level) for which an allowance of £20m had been deducted by management in the calculation of the amount recognised for the Upstream Claim (at the JO level).

66. The relevant accounting standard in FY2019 had changed to IFRS 15 which required that claims could be recognised, '*only to the extent that it is highly probable that a significant reversal in the amount of cumulative revenue recognised will not occur.*'

The Upstream Claim

67. Whilst substantial additional audit procedures had been performed on the Upstream Claim in FY2019 (when compared with FY2018), nevertheless there were still shortcomings in the audit judgements.

68. At the time of the FY2019 Audit, discussions had been ongoing between the JO and the Client, through a facilitator, since September 2018 and the audit workpapers document that the Client had instructed its advisers to "*work through the detail and build their view of this [reconfigured claim] (joint effort)".* However, there was limited evidence that a settlement was close despite the many months of discussions, and it was unknown if legal proceedings would be commenced and, if so, how long they would take to conclude.

68.1. Despite the request made of the JO (at the meeting on 6 September 2018 referred to in para 48.2 above) to reconfigure its claim to show a clear linkage to the non-performance by utilities and the impact of weather, whilst there had been some further analysis undertaken, by September 2019 a formal reconfigured claim had not been submitted.

68.2. The audit team recorded that a meeting had been arranged with the Client on 31 October 2019 at which management expected an offer to be made by the Client. In the event that an acceptable offer was not received, it was noted that the JO would escalate the matter by commencing legal proceedings.

68.3. The audit team held discussions with the Company's management and the JO's representatives; including management from the other JO party and the JO's experts, both of whom were in dialogue with the Client. These discussions included the status of negotiations between the JO and the Client. Despite the audit team's attempts to further corroborate the status of negotiations (including contact with the facilitator of negotiations between the JO and the Client) the audit team had not been able to obtain any further evidence.

68.4. The audit workpapers noted that the likely quantum of any settlement was unlikely to be higher than the "walk away" which had been put forward by the JO in July 2018. The audit team also referred to the oral offer which had been made by the Client in 2018 but this offer had not been confirmed in writing and it was still unclear to what extent this took account of LOCs.

69. IFRS 15 paragraph 57 addresses constraints on estimates of variable consideration. It requires that preparers of financial statements should assess whether it is highly probable that a significant reversal in the amount of cumulative revenue recognised will not occur once the uncertainty related to the variable consideration is subsequently resolved. It then provides that in making that assessment an entity shall consider both the likelihood and the magnitude of the revenue reversal and provides examples of relevant factors to consider. The audit team considered these requirements and factors and concluded that "*the amounts assumed [i.e. recognised in revenue] are highly probable of not reversing and thereby satisfy the requirements of IFRS 15."*

70. However, Executive Counsel considers that the following factors indicated that it was not '*highly probable that a significant reversal in the amount of cumulative revenue recognised will not occur once the uncertainty related to the variable consideration is subsequently resolved'*:

70.1. The quantum of any settlement was highly susceptible to the judgements or actions of third parties including the Client and the Company's JO partner.

70.2. Past settlements on claims could not provide an indication of the likely settlement level given the unique circumstances applying to each claim.

70.3. There was a large number and broad range of possible settlement amounts. The range between the Company's share implied by the oral offer previously made by the Client and the JO's "walk away" counter-offer was many multiples of audit materiality.

71. The audit team documented management's rationale as to why a settlement in excess of the amount implied by the Company's recognition of its share, £80m, could be achieved but the audit workpapers document limited consideration of the counter arguments that might be presented by the Client. Further, the audit team

acknowledged that there was no written evidence from the Client to support the Client's oral offer and the audit team continued to place disproportionate weight on the 2016 Adjudication's ambit and significance.

<u>LOCs</u>

72. The issue of LOCs remained unresolved at the time of the FY2019 Audit. However, the potential charge for LOCs had risen to £80.9m (at the JO level). The approach to LOCs was the same as in FY2018, with management recognising nil costs in respect of LOCs in the Company's ELF. However, further work had been performed by the audit team and they had ascertained that an adjustment of £20m for LOCs had been made in arriving at the Upstream Claim amount at the JO level.

73. IAS 37 paragraph 14 requires that a provision be recognised where an entity has a present obligation as a result of a past event, it is probable that an outflow of resources will be required to settle the obligation and a reliable estimate of the obligation can be made. The audit team did not document an evaluation of the LOCs against the criteria in IAS 37.

74. The audit team did document:

    74.1. arguments as to why there was no obligation as a result of a past event, referencing a QC opinion obtained by the Company (the "QC Opinion"). However, the audit team did not document their consideration of the counter arguments presented in the legal opinion obtained by the Client (a copy of which the audit team had obtained), which disagreed with the conclusions reached in the QC Opinion.

    74.2. a view that an outflow of resources was not likely, based on the QC Opinion, the Client not having levied LOCs to date and the belief that LOCs would be settled with any settlement of the Upstream Claim. However, there was uncertainty as to the timing and quantum of any such settlement. If the JO had to institute legal proceedings, it was possible that it may have to pay the LOC liability with no certainty on the timing or quantum of any recovery. The audit file does not document the audit team's consideration of this possibility.

74.3. consideration of the quantum of the potential obligation, being £80.9m gross and £38.4m net of ELOs[1] (both at the JO level), with the implication that any obligation could be reliably estimated. However, there is no evidence that these amounts were verified or corroborated other than by agreement to the LOC master schedule, and the audit team did not obtain audit evidence in respect of the accuracy or completeness of the LOC master schedule. Further, the Upstream Claim of £80m recognised by the Company made an allowance for LOCs based on the potential exposure in 2017. There was no consideration on the audit file as to why this deduction had not increased at 30 June 2019, given the increase in the gross exposure.

[B Contracts]

75. The Company contracted (the "[**B Contracts]**") with three separate Special Purpose Vehicles ("**SPVs**") set up by a client of the Company

76. The [B Contracts] commenced in September /November 2015 They had been scheduled to complete in September/October 2017, but at the date of the FY2018 Audit, it was expected that they would complete in September/October 2018.

77. The [B Contracts] were the second largest contract judgement exposure in FY2018 (after [Contract A]),

78. As part of their audit work, the audit team reviewed two adjudications that had been decided in the Company's favour by the time of the FY2018 Audit.

79. The two adjudications were both in respect of one of the [B Contracts] (although the principle of the second adjudication was capable of applying to the other two [B Contracts] under which similar disputes had arisen). Both adjudications concerned the Company's entitlement to additional revenue because of contract variations:

1 Exempt Lane Occupations which would avoid the LOC charges

2 Work in Progress

79.1. The first adjudication agreed 80% of the £912,000 contract variations put forward by the Company

79.2. The second adjudication related to a client advised change in the specification The adjudicator concluded that the changes were variations as defined in the [B Contracts]. He also concluded that the variations should be valued on the basis of cost plus profit but noted that quantum would be difficult to establish as it would be difficult to establish the linkage between any change in the specification and the associated increase in the Company's costs.

80.

81. The FY2018 audit file does not document the linkage between these adjudication decisions and the revenue recognised in the FY2018 financial statements as a result of contract variations.

81.1. The audit workpapers include the minutes of a meeting with the Company's external solicitors There is limited evidence of the auditor's evaluation of the adjudications in the audit workpapers; the audit team compared the quantum of additional revenue recognised to costs incurred, without documenting their consideration as to whether all of the additional costs could be reasonably attributed to the variations, and therefore their conclusions as to the appropriateness of the accounting treatment adopted by the Company.

81.2.

82. The audit workpapers do not document consideration by the audit team of the requirements of IAS 11 and how they applied to the circumstances of the [B Contracts].

82.1. Variations to contracts were accounted for in accordance with IAS 11 paragraph 13, which required that a variation be included in contract revenue when it is probable that the customer will approve the variation and the amount of revenue arising from the variation; and the amount of revenue could be reliably measured.

82.2. On the other hand, disputed variations fell within the ambit of IAS 11 paragraph 14, which contained the provisions applying to claims. Such disputed variations could only be recognised in contract revenue when negotiations have reached an advanced stage such that it was probable that the customer would accept the claim (or disputed variation) and the amount that it was probable would be accepted by the customer could be measured reliably. In this case, negotiations with the Company's client, operating through the three SPVs, were not at an advanced stage.

82.3. Executive Counsel considers that, this was nevertheless a very fine judgement. Therefore, this important judgement should have been, but was not, documented and evaluated in the audit workpapers. Further, there is no evidence in the audit workpapers that the revenue associated with the variations could be reliably measured.

83. There is no evidence in the audit workpapers that the audit team considered whether a provision should be made against the contract asset as at 30 June 2018 on account of the risk that the SPVs may not have sufficient resources to meet the Company's claim.

83.1. The FY2016 financial statements of the SPVs were filed at Companies House in October/November 2017 and were therefore available at the time of the FY2018 Audit. All of these contained qualified audit opinions on the basis that there remained "*a number of uncertainties including the achievement of certain construction and related milestones regarding the expected qualification for particular forecast revenue streams…*'"

83.2. The FY2016 financial statements of the SPVs show that there were limited facilities available to the SPVs for completion of the projects.

83.3. By the time of the FY2018 Audit, it was known that the Company had won the two adjudications referred to above

83.4. Given that the SPVs had limited facilities available, the audit team should have considered the risk that the SPVs may not have had sufficient resources to meet the Company's claims in full and whether provision should have been made under IAS 39, paragraph 59. No such consideration was documented in the audit workpapers.

84.

Controls over Construction Contracts

85. ISA 315 requires, amongst other things, where an auditor has determined that a significant risk exists the auditor is to obtain an understanding of internal controls relevant to the risk and the audit, to evaluate the design of those controls and determine whether they have been implemented and to design further audit procedures responsive to assessed risks of material misstatement.

86. The valuation of construction contracts was identified as a significant risk in FY2018. However, in the FY2018 Audit, with the exception of controls over subcontractor and supplier payments, the audit team did not document or walk through the controls over measurement of contract revenue, costs, receivables and payables.

87. Further, controls over estimating, tendering and monitoring of contracts were also not documented or walked through in the FY2018 Audit.

Statement of Cash Flows

88. IAS 7, paragraph 16 required cash flows arising from loans to other parties (including joint ventures ("**JVs**")) to be classified within the Company's financial statements as investing activities.

89. The Company used JVs with third parties to deliver projects across its segments, sub-segments and divisions. The Company had treated cash flows from JVs (except for dividends received) as 'operating activities' since at least 2015, during which time the Company's investment in JVs had increased from £9.2m to £49.9m in FY2018.

90. The Company's accounting treatment was based on its assessment of the underlying substance of the transactions and relied on IAS 7, paragraph 11 which states that: 'a*n entity presents its cash flows from operating, investing and financing activities in a manner which is most appropriate to its business*'. However, no specific disclosures were included in the FY2018 financial statements explaining the departure from the requirements of IAS 7, paragraph 16.

91. Further, the FY2018 Audit file did not document the audit team's consideration of the treatment of the above cash flows (including how the Company had applied, and complied with, IAS 7, or any challenge to the Company's approach) or the adequacy of the disclosures included in the FY2018 financial statements.

92. In the FY2019 financial statements, a restatement to the FY2018 cash flow statement was made to report £53.2m of cash flows from loans and advances to JVs within investing activities (rather than operating activities). In the Notes to the FY2019 financial statements, it was explained that:

> '*Whilst the Group regards joint ventures as extensions of our core operations and previously presented loans and advances to and from joint ventures*

within operating cash flows, to be consistent with other working capital movements, the Directors acknowledge the specific requirements of IAS 7 paragraph 16(e) to present such movements within investing activities. Consequently, and as agreed in discussion with the FRC, we have restated the prior year consolidated cash flow statement with £53.2m of net costs used in operating activities reclassified as net cash used in investing activities'.

FY 2020 Restatements

93. The Company's condensed consolidated half year financial statements for the 6 months ended 31 December 2019 (published on 12 March 2020) disclosed:

"(i) [Contract A]

As at 30 June 2018, 31 December 2018 and 30 June 2019, the Group had recognised an asset (within 'Trade and Other Receivables') in relation to [Contract A]*, in respect of the amount assessed to be recoverable from claims against the [Client],. The Group had previously considered that this balance was assessed in accordance with the appropriate accounting standard (IAS 11 Construction Contracts) as at 30 June 2018. Reference to these expected recoveries was included in the Annual Report at 30 June 2018 and 30 June 2019.*

As disclosed in the Group's 30 June 2019 financial statements, the CRRT undertook a review of the Group's 30 June 2018 financial statements. Following this review and discussions held between the CRRT and the Group, the Group has revised its assessment as to whether negotiations with [the Client] had reached a sufficiently advanced stage to allow the Directors to reliably assess the amount of revenue expected to be recovered and concluded that it was incorrect to recognise revenue and the associated contract asset in respect of the claim under IAS 11 as at 30 June 2018, or under IFRS 15 as at 31 December 2018 and 30 June 2019.

The Group has therefore undertaken a prior year adjustment to reverse the recognition of the Trade and Other Receivables balance of £80.0m (and the associated tax liability), reducing those items to nil and to restate retained earnings by £64.8m as at 30 June 2018, 31 December 2018 and 30 June 2019. This adjustment would have reduced revenue and profit before tax in the years to 30 June 2017 and 30 June 2018 by £62.5m and £17.5m respectively.

As a result of the above adjustments, following settlement with the client, the Group has recognised exceptional income of £32.0m (net of final cost estimates of £4.0m) in the period to 31 December 2019 (note 5)

(ii) Downstream claims

On adoption of IFRS 15 from 1 July 2018, as disclosed in the 30 June 2019 financial statements, the Group concluded that the recognition of expected reimbursements resulting from certain third–party claims (previously accounted for under IAS 11 Construction Contracts) would now be accounted

for under IAS 37 Provisions, Contingent Liabilities and Contingent Assets. The requirements of IAS 37 are more stringent than IAS 11, requiring recovery to be 'virtually certain' before an asset can be recognised. Accordingly, in the 30 June 2019 financial statements, the Group included £28.7m as a net IFRS 15 transition adjustment. At 31 December 2018, as part of its initial IFRS 15 implementation, the Group had not considered the changes required above and the impact of this is to reduce trade and other receivables by £35.4m, deferred tax by £6.7m and retained earnings by £28.7m at 31 December 2018.

As part of its review of the financial statements for the year ended 30 June 2018, the CRRT challenged the Group as to whether or not it was in sufficiently advanced negotiations with third parties over certain downstream claims to warrant recognising an asset under the previous IAS 11 accounting standard. The Group has reviewed its accounting at 30 June 2018 and concluded that it had incorrectly recognised net assets of £21.9m at 30 June 2018 relating to these downstream claims under IAS 11. Therefore, the Group is now of the opinion that £21.9m of the total net balance of £28.7m that was derecognised on transition to IFRS 15 on 1 July 2018 should have been presented as the correction of an error under IAS 11 at 30 June 2018. This adjustment would have increased cost of sales and reduced profit before tax in the years to 30 June 2016 and earlier, 30 June 2017 and 30 June 2018 by £13.8m, £8.7m and £4.6m respectively."

The ████ exceptional income recognised by the Company in FY2020 in respect of [Contract A] represented the Company's share of the net final settlement with the Client of both the Upstream Claim and the potential counterclaim on LOCs.

94. These condensed consolidated half year financial statements for the six months ended 31 December 2019 (and the FY2020 financial statements) also disclosed a further prior year adjustment relating to the removal of £9.4m in other contract assets and the reduction of corporate tax liabilities of £1.8m in both FY2018 and FY2019 resulting from an adverse adjudication award.

95. The combined impact of the restatements, net of associated tax liabilities, was a £94.3m reduction in retained earnings as at 30 June 2018, and £72.4m as at 30 June 2019. The adjustments represented a 22% reduction in the total reported profit and a 12% reduction in net assets for the year for FY2018. The adjustments had no impact on the total reported profit for FY2019, but represented a 10% reduction in net assets for FY2019.

D. RELEVANT REQUIREMENTS

96. Rule 1 of the AEP states that Relevant Requirements has the meaning set out in regulation 5(11) of the Statutory Auditors and Third Country Auditors Regulations

2016 ("**SATCAR**"). The Relevant Requirements include, but are not limited to, the ISAs, issued by the FRC.

97. The ISAs relevant to Executive Counsel's Final Settlement Decision Notice are those effective for audits of financial statements for periods commencing on or after 17 June 2016.[3]

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

    98.1. ISA (UK) 200 (Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing (UK));
    98.2. ISA (UK) 230 (Audit documentation);
    98.3. ISA (UK) 315 (Identifying and Assessing the Risks of Material Misstatement);
    98.4. ISA (UK) 330 (the Auditor's Responses to Assessed Risks);
    98.5. ISA (UK) 500 (Audit evidence); and
    98.6. ISA (UK) 540 (Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures).

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

100. As the Statutory Auditor responsible for the FY2018 and FY2019 Audits, Mr Hook was responsible for the overall quality of the FY2018 and FY2019 Audits[4] and the direction, supervision and performance of the FY2018 and FY2019 Audits in compliance with professional standards and applicable legal and regulatory requirements[5]. Accordingly, Mr Hook is responsible for any established breaches of Relevant Requirements in relation to the FY2018 and FY2019 Audits.

[3] ISA 330 was further updated for periods commencing on or after 17 December 2017 - this updated standard applies to FY2019 and the 2016 version applies to FY 2018.
[4] ISA 220.8
[5] ISA 220.15(a)

101. As the Statutory Audit Firm responsible for the FY2018 and FY2019 Audits, PwC is responsible for any established breaches of Relevant Requirements on the part of any of its partners or employees.

E. BREACHES OF RELEVANT REQUIREMENTS

Breach 1 – [Contract A]

102. In breach of paragraphs 15 and 17 of ISA 200, paragraphs 6, 7(b), 21 and 26 of ISA 330, paragraphs 6, 9 and 11 of ISA 500, and paragraphs 12, 13(b), 17(a) and 19 of ISA 540, the Respondents failed adequately to determine whether the Company had appropriately applied the requirements of the applicable financial reporting framework, failed to obtain sufficient evidence in response to the assessed risks in respect of the [Contract A] judgements, failed to obtain sufficient appropriate audit evidence or corroboration in relation to the audit of contract judgements or information produced by the Company and failed to carry out the audit of [Contract A] with sufficient professional scepticism in that they:

    102.1. did not sufficiently challenge and/or corroborate management's assertions in FY2018 in respect of the [Contract A] forecast revenues and costs, LOC exposure and allowance for LDs;

    102.2. did not obtain sufficient audit evidence that the negotiations in respect of the Downstream Claims and Upstream Claim receivable had reached an advanced stage such that it was 'probable' (in accordance with the requirements of IAS 11) that revenue would be received, and whether the quantum could be measured reliably. As a result, the Downstream Claims and Upstream Claim receivable should not have been recognised as at 30 June 2018;

    102.3. did not sufficiently challenge and/or corroborate the assertions made by management in respect of the non-provision of LOCs in FY2018;

    102.4. did not document in the FY2018 Audit file how the cumulative revenue and costs had been calculated and how the JO level revenue and costs reconciled to the amounts recognised by the Company;

102.5. did not obtain sufficient appropriate audit evidence that it was 'highly probable' (in accordance with the requirements of IFRS 15) that a significant reversal in the amount of cumulative revenue recognised in respect of the Upstream Claim receivable would not occur. As a result, the Upstream Claim receivable should not have been recognised at 30 June 2019; and

102.6. did not obtain sufficient appropriate audit evidence to support the non-provision of LOCs in accordance with the criteria set out in IAS 37, placed reliance on the QC Opinion without sufficient consideration of the counter arguments and did not obtain audit evidence as to the accuracy and completeness of the LOC master schedule in FY2019.

Breach 2 – [B Contracts]

103. In breach of paragraphs 15 and 17 of ISA 200, paragraph 8 of ISA 230, paragraphs 6, 7(b), 21 and 26 of ISA 330, paragraph 6 of ISA 500, and paragraphs 12, 13(b), 15 and 17(a) of ISA 540, the Respondents failed adequately to determine whether the Company had appropriately applied the requirements of the applicable financial reporting framework, failed to obtain sufficient evidence in response to the assessed risks in respect of the [B Contracts], failed to obtain sufficient appropriate audit evidence or corroboration in relation to the audit of contract judgements or information produced by the Company and failed to carry out the FY2018 Audit of the [B Contracts] with sufficient professional scepticism in that they:

103.1. did not obtain sufficient appropriate audit evidence to support the aggregate contract variations recognised in the Company's revenue for the [B Contracts];

103.2. did not document consideration of the requirements of IAS 11 and how they applied to the facts and circumstances of the [B Contracts];

103.3. did not document the audit team's consideration of the risk that the SPVs may not have sufficient resources to meet the Company's claim; and

103.4. did not adequately document the audit team's conclusions as to why no provision for an exposure to LADs was appropriate.

Breach 3 – Statement of Cash Flows

104. In breach of paragraph 16 of ISA 200 and paragraph 8 of ISA 230, the Respondents failed to prepare sufficient audit documentation in respect of their conclusion that it was appropriate for the Company to include transactions with JVs in operating cash flows in FY2018, in particular the Respondents:

104.1. did not document how the Company had applied IAS 7, how this treatment had been challenged by the Respondents and the rationale for how this treatment complied with the standard; and

104.2. did not ensure that appropriate disclosures were made and failed to exercise sufficient professional judgment.

Breach 4 – Contract selection and testing

105. In breach of paragraph 17 of ISA 200, paragraph 8 of ISA 230 and paragraph 6 of ISA 500 the Respondents did not design and perform audit procedures which were appropriate in the circumstances for the purpose of obtaining sufficient appropriate audit evidence on contracts (revenues, costs, assets and liabilities), in particular the Respondents:

105.1. did not perform additional substantive testing beyond those contracts selected on risk-based criteria, and therefore did not test the “tail” of contracts; and

105.2. did not undertake planned analytical procedures and accurately describe the work performed by the audit team in relation to the “risk of management override of controls” and the “risk of fraud in revenue recognition”.

Breach 5 – Controls over Construction Contracts

106. In breach of paragraphs 12, 13 and 20 of ISA 315 in relation to the 2018 Audit the Respondents did not document the design and test the implementation of controls operating over estimating, tendering and monitoring of contracts, and failed adequately or at all, to document and walk through the controls over measurement

of contract revenue, costs, receivables and payables (with the exception of controls over subcontractor/supplier payments).

F. SANCTIONS

107. Paragraph 10 of the FRC's Sanctions Policy (Audit Enforcement Procedure) ("the **Sanctions Policy**") provides that sanctions are intended to be effective, proportionate and dissuasive. The reasons for imposing sanctions are identified in paragraph 11 of the Sanctions Policy as follows:

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

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

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

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

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

109. Executive Counsel has considered the Sanctions Policy in relation to each of the Respondents individually and imposes the following sanctions:

In respect of PwC

    109.1. A financial sanction of £5,500,000 adjusted for aggravating and mitigating factors (in particular reflecting an exceptional level of cooperation) by a reduction of 15% and further discounted for admissions and early disposal by 35% so that the financial sanction payable is £3,038,750. The financial

sanction shall be paid no later than 28 days after the date of the Final Settlement Decision Notice;

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

109.3. A declaration that the Statutory Audit Reports for FY2018 and FY2019 did not satisfy the Relevant Requirements, as set out in this Final Settlement Decision Notice.

In respect of Mr Hook

109.4. A financial sanction of £150,000 adjusted for aggravating and mitigating factors (in particular reflecting an exceptional level of cooperation) by a reduction of 15% and further discounted for admissions and early disposal by 35% so that the financial sanction payable is £82,875. The financial sanction shall be paid no later than 28 days after the date of the Final Settlement Decision Notice;

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

109.6. A declaration that the Statutory Audit Reports for FY2018 and FY2019 did not satisfy the Relevant Requirements, as set out in this Final Settlement Decision Notice.

110. In reaching this decision Executive Counsel has, in summary, considered the following matters in accordance with the Sanctions Policy. Where a consideration is specific to one Respondent alone this has been specified. Otherwise, the considerations apply to each Respondent equally.

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

111. The breaches of Relevant Requirements in this case concern the recognition of exposures relating to contract judgements on long term construction contracts and concern breaches of a number of important Relevant Requirements which are designed to ensure the quality and effectiveness of an audit. As a result, the FY2018 and FY2019 Audits failed to obtain reasonable assurance about whether the FY2018 and FY2019 financial statements as a whole were free from material misstatement.

112. Galliford Try is a large high-profile company operating in the construction and housebuilding industry. The Company delivered large-scale infrastructure projects and construction work with a significant number of public sector clients, with the value of some contracts in excess of £100 million. There was an obvious public interest in the proper audit of such an entity as the users of financial statements expect auditors to adopt a mindset of professional scepticism in conducting audits and place reliance on an auditor's statement that a company's financial statements are free from material misstatement.

113. The valuation of construction contracts was identified as a significant risk in both the FY2018 and FY2019 Audits and an additional risk was added in FY2019 that the recognition of material variations and claims on contracts may not be appropriate. Failures to adequately challenge management and apply sufficient professional scepticism in an area of the audit of significant risk are more serious than such failures in an audit area of lower risk.

114. Breaches of Relevant Requirements were identified in several areas of the FY2018 Audit demonstrating that the breaches were not isolated incidents. It is accepted that the breaches in FY2019 were solely in relation to [Contract A].

115. The total audit fee for the parent company for the FY2018 and FY2019 Audits was £400,000. The total audit fee for the Group including subsidiaries for both years was £1.3m. In the year to 30 June 2021, PwC's audit fee income was approximately £790m and its total fee income was approximately £3,557m. Aside from the audit fees, the Respondents did not derive or intend to derive any specific financial benefit from the breaches.

116. When issuing its results for the half-year to 31 December 2019 and in its FY2020 financial statements for the year ended 30 June 2020, the Company made a number of restatements in relation to claims that had been recognised on construction contracts, the largest of which was the Upstream Claim on [Contract A]. The combined impact of the restatements, net of associated tax liabilities, was a £94.3 million reduction in net assets and retained earnings as at 30 June 2018, and £72.4 million as at 30 June 2019. The adjustments represented a 22% reduction in the reported profit before tax and a 12% reduction in net assets for FY2018. The adjustments had no impact on the reported profit before tax for FY2019 but represented a 10% reduction in net assets for FY2019. The restatement of the Upstream Claim reduced FY2018 profit before tax by £17.5m. The restatement for all

downstream claims, including the [Contract A] Downstream Claims, reduced profit before tax by £4.6m. Together, the restatement for the Upstream Claim and all downstream claims reduced the FY2018 profit before tax by £22.1m, representing 15% of the £143.7m of the FY2018 profit before tax as originally reported. The restatements had no impact on the FY2019 profit before tax.

117. The restatements to retained earnings and net assets were at a level many times the Group audit materiality level. Group materiality for FY2018 and FY2019 was £9.4m and £7.4m respectively.

118. The breaches caused or risked investors and other stakeholders to be exposed to financial loss. When the restatements were announced in March 2020 the share price dropped by approximately 18%.

119. It is accepted that the breaches were not intentional, dishonest, deliberate or reckless.

120. PwC has been sanctioned three times since 2018:

120.1. In May 2018 PwC received a sanction of £10 million (reduced to £6.5 million on settlement) and a severe reprimand were agreed for Misconduct in relation to PwC's audit of Taveta / BHS for FY2014.

120.2. In May 2019 a sanction of £6.5 million (reduced to £4.55m on settlement) and a severe reprimand were agreed for breaches of Relevant Requirements in relation to PwC's audit of Redcentric plc for FY2015 and FY2016.

120.3. In December 2021 a sanction of £3.35m (reduced to £1,959,750 on settlement) and a severe reprimand were agreed for breaches of Relevant Requirements in relation to PwC's audit of Kier Group plc for FY2017.

121. In addition to the points set out at 111 to 119 above Executive Counsel has also taken into account the following in relation to Mr Hook:

121.1. Mr Hook's seniority, in that he became a partner in 1995 and at the time of the FY2019 Audit, had 24 years' experience in an audit partner role and

supervisory responsibilities as PwC's Global Engineering and Construction Leader.

121.2. Mr Hook has been sanctioned by Executive Counsel on a separate but concurrent matter relating to PwC's audit of Kier Group plc for FY2017, in which he received a sanction of £90,000 (reduced to £52,650 on settlement) and a severe reprimand.

121.3. Mr Hook did not cause or encourage other individuals to breach the Relevant Requirements and has retired from PwC, in the normal course, in June 2021.

122. Having assessed the nature, seriousness, gravity and duration of the breaches, Executive Counsel is satisfied that the combination of sanctions set out in paragraph 109 above is appropriate.

Aggravating and Mitigating factors

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

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

125. In relation to mitigating factors, the Respondents have provided an exceptional level of cooperation during the investigation of the breaches by Executive Counsel in that the Respondents dealt properly, timeously and fully with all requests. In particular, insight was shown as to what went wrong, remedial measures were implemented and liability was agreed at an early stage.

126. In light of the mitigating factors, Executive Counsel considers that a discount to the Respondents' financial sanction of 15% is appropriate.

Deterrence

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

Discount for Admissions and Settlement

128. Having taken into account the full admissions by the Respondents and the stage at which those admissions were made, (at an early point within Stage 1 of the case in accordance with paragraph 84 of the Sanctions Policy) Executive Counsel has determined that a reduction of 35% to the financial penalties is appropriate in relation to both Respondents.

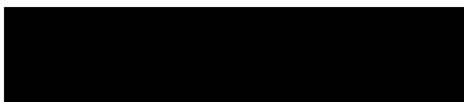
Other considerations

129. In accordance with paragraph 47(c) and (d) of the Sanctions Policy, Executive Counsel has taken into account the size of PwC and the financial resources and strength of the Respondents, the effect of a financial sanction and whether the financial sanction is likely to be covered by insurance.

G. COSTS

130. Executive Counsel requires the Respondents to pay her costs in full in this matter being £316,495. Such costs shall be paid no later than 28 days after the date of the Final Settlement Decision Notice.

Signed:



CLAUDIA MORTIMORE
DEPUTY EXECUTIVE COUNSEL
Date: 31 March 2022

APPENDIX 1 – EXTRACTS OF RELEVANT REQUIREMENTS

ISA	Paragraph	Relevant Requirement
ISA 200 (Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing)	15	The auditor shall plan and perform an audit with professional skepticism recognizing that circumstances may exist that cause the financial statements to be materially misstated.
	16	The auditor shall exercise professional judgment in planning and performing an audit of financial statements.
	17	To obtain reasonable assurance, the auditor shall obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion.
ISA 230 (Audit documentation)	8	The auditor shall prepare audit documentation that is sufficient to enable an experienced auditor, having no previous connection with the audit, to understand: (a) The nature, timing and extent of the audit procedures performed to comply with the ISAs (UK) and applicable legal and regulatory requirements; (b) The results of the audit procedures performed, and the audit evidence obtained; and (c) Significant matters arising during the audit, the conclusions reached thereon, and significant professional judgments made in reaching those conclusions.
ISA 315 (Identifying and Assessing the Risks of Material Misstatement)[6]	12	The auditor shall obtain an understanding of internal control relevant to the audit. Although most controls relevant to the audit are likely to relate to financial reporting, not all controls that relate to financial reporting are relevant to the audit. It is a matter of the auditor's professional judgment whether a control, individually or in combination with others, is relevant to the audit.
	13	When obtaining an understanding of controls that are relevant to the audit, the auditor shall evaluate the design of those controls and determine whether they have been implemented, by performing procedures in addition to inquiry of the entity's personnel.
	20	The auditor shall obtain an understanding of control activities relevant to the audit, being those the auditor judges it necessary to

[6] Revised June 2016

		understand in order to assess the risks of material misstatement at the assertion level and design further audit procedures responsive to assessed risks. An audit does not require an understanding of all the control activities related to each significant class of transactions, account balance, and disclosure in the financial statements or to every assertion relevant to them.
ISA 330 (the Auditor's Responses to Assessed Risks)	6	The auditor shall design and perform further audit procedures whose nature, timing, and extent are based on and are responsive to the assessed risks of material misstatement at the assertion level.
	7(b)	In designing the further audit procedures to be performed, the auditor shall:…. Obtain more persuasive audit evidence the higher the auditor's assessment of risk.
	21	If the auditor has determined that an assessed risk of material misstatement at the assertion level is a significant risk, the auditor shall perform substantive procedures that are specifically responsive to that risk. When the approach to a significant risk consists only of substantive procedures, those procedures shall include tests of details.
	26	The auditor shall conclude whether sufficient appropriate audit evidence has been obtained. In forming an opinion, the auditor shall consider all relevant audit evidence, regardless of whether it appears to corroborate or to contradict the assertions in the financial statements.
ISA 500 (Audit evidence)	6	The auditor shall design and perform audit procedures that are appropriate in the circumstances for the purpose of obtaining sufficient appropriate audit evidence.
	9	When using information produced by the entity, the auditor shall evaluate whether the information is sufficiently reliable for the auditor's purposes, including as necessary in the circumstances: (a) Obtaining audit evidence about the accuracy and completeness of the information; and (b) Evaluating whether the information is sufficiently precise and detailed for the auditor's purposes.
	11	If: (a) audit evidence obtained from one source is inconsistent with that obtained from another; or (b) the auditor has doubts over the reliability of information to be used as audit evidence, the auditor shall determine what

		modifications or additions to audit procedures are necessary to resolve the matter, and shall consider the effect of the matter, if any, on other aspects of the audit.
ISA 540 (Auditing Accounting Estimates, Including Fair Value Accounting Estimates and Related Disclosures)[7]	12	Based on the assessed risks of material misstatement, the auditor shall determine: (a) Whether management has appropriately applied the requirements of the applicable financial reporting framework relevant to the accounting estimate; and (b) Whether the methods for making the accounting estimates are appropriate and have been applied consistently, and whether changes, if any, in accounting estimates or in the method for making them from the prior period are appropriate in the circumstances.
	13(b)	In responding to the assessed risks of material misstatement, as required by ISA (UK) 330 (Revised July 2017), the auditor shall undertake one or more of the following, taking account of the nature of the accounting estimate: (a) Determine whether events occurring up to the date of the auditor's report provide audit evidence regarding the accounting estimate. (b) Test how management made the accounting estimate and the data on which it is based. In doing so, the auditor shall evaluate whether: (i) The method of measurement used is appropriate in the circumstances; and (ii) The assumptions used by management are reasonable in light of the measurement objectives of the applicable financial reporting framework.
	15	For accounting estimates that give rise to significant risks, in addition to other substantive procedures performed to meet the requirements of ISA (UK) 330 (Revised July 2017), the auditor shall evaluate the following: (a) How management has considered alternative assumptions or outcomes, and why it has rejected them, or how management has otherwise addressed estimation uncertainty in making the accounting estimate. (b) Whether the significant assumptions used by management are reasonable. (c) Where relevant to the reasonableness of the significant assumptions used by management or the appropriate application of

[7] Revised June 2016

		the applicable financial reporting framework, management's intent to carry out specific courses of action and its ability to do so.
	17(a)	For accounting estimates that give rise to significant risks, the auditor shall obtain sufficient appropriate audit evidence about whether: (a) management's decision to recognize, or to not recognize, the accounting estimates in the financial statements; and (b) the selected measurement basis for the accounting estimates, are in accordance with the requirements of the applicable financial reporting framework.
	19	The auditor shall obtain sufficient appropriate audit evidence about whether the disclosures in the financial statements related to accounting estimates are in accordance with the requirements of the applicable financial reporting framework.