

IN THE MATTER OF:

THE EXECUTIVE COUNSEL TO THE FINANCIAL REPORTING COUNCIL

and

(1) KPMG AUDIT PLC
(2) ANDREW WALKER

PARTICULARS OF FACT
AND ACTS OF MISCONDUCT

8 February 2019

The Settlement Agreement (which includes the Particulars of Fact and Acts of Misconduct) is a document agreed between KPMG and Mr Walker (the Respondents) and the Executive Counsel. 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 since they are not parties to the proceedings.

I. 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 document contains the Particulars of Fact and Acts of Misconduct admitted by the Respondents in relation to their audit (“**the 2009 Audit**”) of the financial statements of The Co-operative Bank plc (“**the Co-op Bank**”) for the year ending 31 December 2009 (“**the 2009 Financial Statements**”). This document forms part of the Proposed Settlement Agreement, as defined in paragraph 2(1) of the Scheme.
3. Sections II to IV introduce the parties and the relevant standards of conduct; Section V summarises the background to the audit and the Misconduct and sections VI and VII contain the admitted allegations of Misconduct.

II. THE RESPONDENTS

4. KPMG and Mr Walker are respectively a member firm and a member of the Institute of Chartered Accountants in England and Wales (“**ICAEW**”).

5. KPMG, or its predecessor firms, was the Co-op Bank's auditor from the Co-op Bank's incorporation in 1970 up to and including the financial year ending 31 December 2013.
6. Mr Walker qualified as a Chartered Accountant on 1 August 1993. In 2009 he was an audit and transactions services partner based in KPMG's Manchester and Leeds offices. Mr Walker was KPMG's 'Engagement Partner' for the 2009 Audit. The Engagement Partner is the person in the firm who is responsible for the audit engagement and its performance, and for the auditor's report that is issued on behalf of the firm.
7. An audit involves obtaining "audit evidence" about the amounts and disclosures in financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. Audit evidence is "*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. For the purposes of the 2009 Audit, KPMG calculated the level at which a misstatement in the financial statements would be material as £7.2 million.
8. The Respondents' statutory responsibility in performing the 2009 Audit was to form an opinion as to whether the Co-op Bank's financial statements showed a true and fair view and had been properly prepared in accordance with the applicable accounting standards and the Companies Act 2006.
9. The 2009 Financial Statements and KPMG's audit opinion were signed on 17 March 2010.

III. THE RELEVANT STANDARDS OF CONDUCT

10. "Misconduct" is defined by paragraph 2(1) of the Scheme as conduct "*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.*"
11. The standards of conduct reasonably to be expected of KPMG and Mr Walker include those set out in the Fundamental Principles contained in the Code of Ethics issued by the ICAEW ("**Code**"). The Fundamental Principles apply to all members and member firms of the ICAEW. They are framed in broad and general terms and are designed to maintain a high standard of professional conduct by all members and member firms of the ICAEW.
12. The relevant auditing standards, issued by the Auditing Practices Board, were the International Standards on Auditing (UK & Ireland) ("**ISAs**"). The purpose of the ISAs is to establish standards and general principles with which auditors are required to

comply. Together 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.

13. As a listed company preparing consolidated group financial statements, the Co-op Bank was required to report under International Financial Reporting Standards (“**IFRS**”), which incorporated International Accounting Standards (“**IASs**”). For the Co-op Bank, this included compliance with IFRS 3, in particular concerning recording assets and liabilities at fair value, and IAS 39, in particular concerning the amortisation of fair value adjustments.
14. The relevant extracts from the Code and the ISAs are set out at Annex A. The relevant extracts from IFRS 3 and IAS 39 are set out at Annex B.

IV. THE CO-OP BANK

15. The Co-op Bank is a full-service bank which was incorporated on 5 October 1970. On 1 August 2009, it merged with the Britannia Building Society (“**Britannia**”).
16. Until 2013, the Co-op Bank was a wholly owned subsidiary of Co-operative Financial Services Limited (which was renamed Co-operative Banking Group Limited in September 2011) and part of a group of companies known as the Co-operative Financial Services Group (“**CFS Group**”, or from September 2011, “**Co-operative Banking Group**”). That group was itself wholly owned by Co-operative Group Limited (the “**Co-op Group**”), one of the UK’s largest mutual businesses, owned by millions of UK consumers.
17. At the time of its merger with Britannia in August 2009, the Co-op Bank was a small retail bank which operated through 90 branches and served 500,000 retail customers. Its retail side had assets of £5.7 billion and offered current accounts, savings accounts, credit cards, personal loans and mortgages. It also had a substantial business lending to corporate customers, with lending across a range of industry sectors, and assets of £4.2 billion. The Co-op Bank had £15 billion in total assets.
18. By contrast, Britannia was the second largest building society in the UK, operating through 254 branches and serving 2.8 million customers. It had total assets of £35 billion, comprised of two main components:
 - (a) A low-risk member business with assets of £11.3 billion, which offered mortgages and savings products to its members – its loans were high quality with an average loan-to-value ratio at the end of 2008 of below 40%; and
 - (b) A higher-risk specialist business, Britannia Capital Investment Group, with assets of £10 billion, which invested in sub-prime assets, intermediary

residential lending, intermediary purchased residential mortgage portfolios and commercial lending.

19. In July 2008, formal negotiations concerning a merger of the Co-op Bank and Britannia began. From August 2008 to January 2009, the Co-op Bank conducted a first phase of due diligence of Britannia. In January 2009, the merger agreement was signed by the Co-op Bank and Britannia. In April 2009, Britannia members approved the merger and it was completed on 1 August 2009.

V. SUMMARY OF THE MISCONDUCT

V.1 Background

20. At the relevant times, the Financial Services Authority (“**FSA**”) (renamed as the Financial Conduct Authority on 1 April 2013), required that all entities authorised to carry on ‘regulated activities’ maintained a level of regulatory capital. These capital requirements were put into place to make sure that institutions hold enough capital to ensure continuation of a safe and efficient market and are able to withstand foreseeable problems.
21. As an entity ultimately wholly owned by a mutual, the Co-op Bank had limited options for raising capital. It could retain profits or receive funds from the Co-op Group, but, unlike publicly-listed banks, it could not issue equity shares to the public from which it could raise capital without diluting the Co-op Group’s stake in the Co-op Bank. The Co-op Group was itself financially stretched, having taken on a substantial amount of debt for its acquisition of the food retailer Somerfield for approximately £1.5 billion in 2008.
22. The financial crisis of 2008 meant that it was widely anticipated there would be regulatory demands for financial institutions to hold more capital. In 2009, the Co-op Bank faced some difficulty in ensuring its reported capital position would remain within the requirements imposed by the FSA. This pressure was increased by the merger with Britannia.
23. Britannia was unusual among building societies in the extent to which it had moved into non-traditional forms of lending. In particular:
 - (a) Britannia Capital Investment Group accounted for around half of Britannia’s loan book and over 90 per cent of its risk-weighted assets;
 - (b) KPMG had concluded in their March 2009 limited scope due diligence report for the Co-op Bank (in which attention had been focused on the residential mortgage lending) that Britannia’s overall loan impairment and arrears profile was one of the worst in the sector. (A loan’s value is impaired by a lender when

the lender believes the loan may not be repaid in full because, for example, the debtor has defaulted on payments or the value of the collateral has reduced.)

- (c) Britannia's commercial portfolio was highly concentrated so that it involved a high counterparty and credit risk.
24. Britannia's profits fell significantly during the financial crisis in 2008, which had led to falling interest rates, severe liquidity and solvency problems in the banking sector and substantial falls in the value of commercial real estate. While Britannia had recorded profits of £130 million in 2006 and £115 million in 2007, its profits decreased to £24 million in 2008. Further, Britannia's loan impairments increased from £14 million in 2007 to £58 million in 2008.
25. In early 2009, the FSA wrote to Britannia expressing concerns about the long-term sustainability of its high-risk business model. Without informing Britannia, the FSA also placed it on a watchlist.

V.2 Fair Value Adjustments

26. For accounting purposes, where two entities combine, one entity is treated as "acquiring" the other. For the purposes of the Co-op Bank merger with Britannia, the Co-op Bank was treated as the acquirer of Britannia. At the date of the merger, the acquiring entity (here, the Co-op Bank) is required to take on the assets and liabilities of the acquired entity (here, Britannia) at their "fair value" at the date on which the two combine. "Fair value" is the price that would be received to sell an asset or paid to transfer a liability in an orderly, arms-length transaction between willing parties. As accounting standards may have required items to be held on the balance sheet of the acquired entity (Britannia) on a non-fair-value valuation basis, there may be a need to "adjust" the value of those items to fair value so that they can be correctly recorded in the balance sheet of the combined entity. Thus Britannia's assets and liabilities had to be adjusted to fair value at the date of the merger (i.e. they were the subject of Fair Value Adjustments ("**FVA**")).
27. The effect of a negative FVA on an asset was to reduce its value and therefore reduce the Co-op Bank's capital position. By contrast, a negative FVA for a liability increased the Co-op Bank's capital position. Any increase or decrease in the capital position was only temporary and had to be "unwound": where a liability or asset in issue is taken on to the balance sheet at a fair value which represents a discount or increase to its face (or redemption) value, that difference will be recognised through the profit and loss account (with such recognition being spread over the remaining life of the liability before redemption) to reflect the fact that the liability or asset is expected to be repaid at par. This process is explained further below.

28. The Respondents' Misconduct is related to the audit of the FVAs and their subsequent unwind in relation to (a) loans within the commercial loan book acquired from Britannia and (b) liabilities under a series of loan notes, called the "**Leek Notes**", which were also acquired from Britannia.

V.3 Loans

29. After the merger, the Co-op Bank divided the loans it owned into two broad 'books' of loans, namely those previously owned by the Co-op Bank ("**the Blue Book**") and those previously owned by Britannia ("**the Red Book**"). The Red Book was then divided into further books to reflect the different types of loan Britannia had made. One such book was the 'Commercial Book', which consisted primarily of sub-prime, commercial real estate loans. At the date of merger, the Red Commercial Book was valued at £3.69 billion and contained 250 loans. The total value of the Co-op Bank's loan book at year end was £34 billion.
30. In addition, as is standard accounting practice, the Co-op Bank also divided its loans into those that were performing, i.e. those which were being repaid according to their terms, from those that were not. There were 61 non-performing, or distressed, loans in the Red Commercial Book (the "**Distressed Loans**").
31. The Co-op Bank's review of all loans in the Red Commercial Book was on-going throughout 2009 and up to the time of signing the 2009 Financial Statements. In particular, in relation to the Red Commercial Book, the Bank applied a total of £333 million in (negative) FVAs, including £257 million in FVAs for incurred losses to the Distressed Loans.
32. KPMG audited the FVAs applied to the Red Commercial Book. It did so by collecting evidence in relation to each of the 61 Distressed Loans. However:
- (a) by relying primarily on substantive testing of the pool of Distressed Loans, with limited testing of the relevant controls, KPMG failed to obtain sufficient appropriate audit evidence that the pool of Distressed Loans was complete.
 - (b) KPMG failed to demonstrate sufficient professional scepticism in response to evidence collected during the substantive testing of the pool of Distressed Loans. In particular, in relation to certain loans, KPMG did not demonstrate sufficient professional scepticism in response to (i) the Co-op Bank's assertions about the loans and the associated risks and (ii) the valuations the Bank had obtained of the collateral held in relation to the loans.
 - (c) As a result of this, the audit evidence which KPMG obtained in respect of some of the loans in the distressed pool did not amount to sufficient appropriate audit

evidence to support the FVA which the Co-op Bank had made in respect of them.

33. As a result, the FVAs for the Red Commercial Book may have been materially understated.

V.4 Leek Notes

34. Unlike other building societies, Britannia relied heavily on wholesale funding, that is, funding obtained from financial institutions rather than customer deposits. In particular, commencing in 1996, it had issued a series of loan notes ("**the Leek Notes**") to the wholesale funding market. Between 1996 and April 2007, Britannia had issued a total of 18 Leek Notes (Leek Notes 1 – 19, with no Leek Note 13) with a combined value of over £9 billion.

35. The Leek Notes were secured against mortgage loans which Britannia had made to its customers. Creditors who purchased the notes were paid interest until the Leek Notes were repaid. Under the terms of the Leek Notes:

- (a) The interest due on the notes increased or 'stepped up' 5 years after they had been issued ("**the step-up date**");
- (b) However, Britannia had the option to buy back (or "call") the notes at their step-up date at their "face value", i.e. the amount which had been lent; and
- (c) Britannia also had an option to call the notes when the outstanding value of the underlying mortgages had reduced to approximately 10% of their original value ("**the clean-up date**").

36. Prior to the merger, Britannia had called Leek Notes 1-12. In September 2003, Leek Note 1 had been called 9 months after its step-up date, but Leek Notes 2 to 12 had all been called at or before their step-up dates.

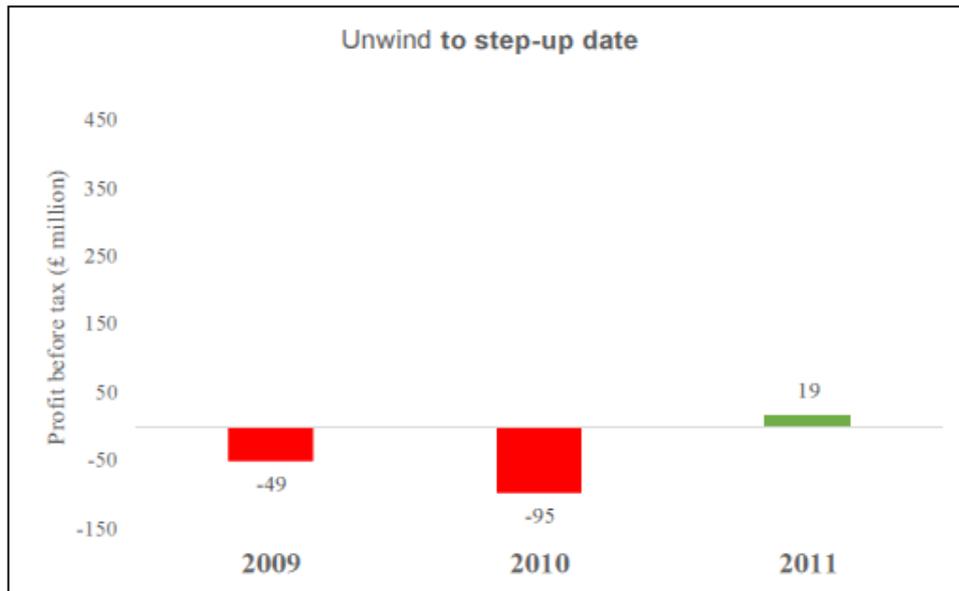
37. Since the Co-op Bank acquired the outstanding Leek Notes (i.e. Leek Notes 14-19) as liabilities in the merger, it was required to record them at their 'fair', or market, value and so make FVAs as appropriate. The Co-op Bank made very substantial negative FVAs to Leek Notes 14-19 on the basis that the Leek Notes were trading in the wholesale funding market at a lower price than that at which they were held in Britannia's books. The FVAs totalled approximately £1.2 billion, as set out below:

	Issue date	Issue amount	Step-up date	Fair Value Adjustment at merger
Leek Note 14	Oct-04	£1,046 million	Dec-09	£54 million
Leek Note 15	Apr-05	£1,080 million	Jun-10	£136 million
Leek Note 16	Oct-05	£961 million	Dec-10	£163 million
Leek Note 17	Apr-06	£1,168 million	Jun-11	£225 million
Leek Note 18	Oct-06	£1,048 million	Dec-11	£298 million
Leek Note 19	Apr-07	<u>£833 million</u>	Jun-12	<u>£345 million</u>
		<u>£6,136m</u>		<u>£1,221m</u>

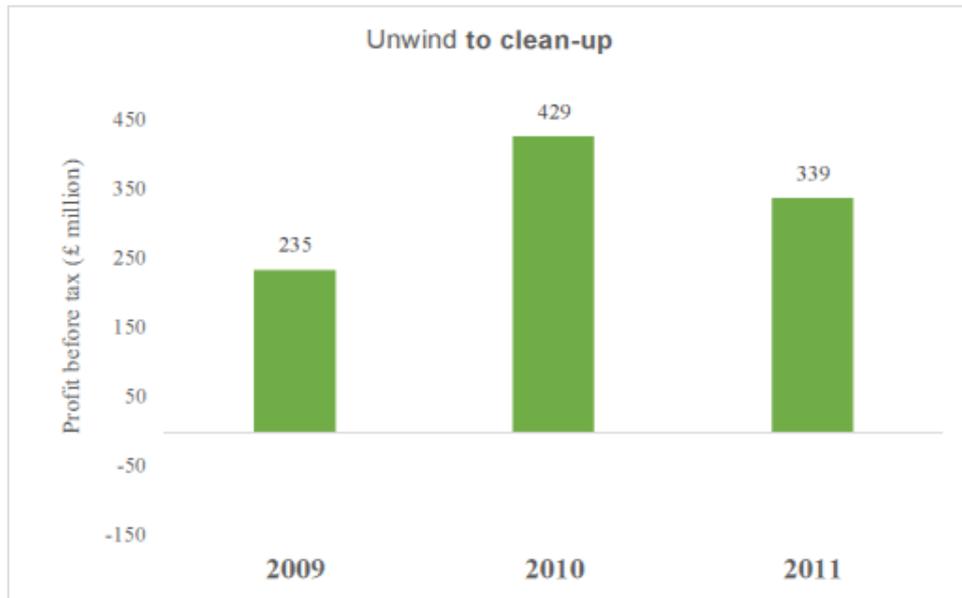
38. These large FVAs represent the difference between the “face value” of the loan notes, which is the amount which the Co-op Bank would ultimately have to repay to the purchasers of the notes, and the value at which they were recorded in the Co-op Bank’s accounts (based on the price at which they were trading at the time). IAS 39 required the FVAs to be recorded as a reduction in the liabilities in the financial statements. The reduction for each Leek Note was then to be unwound, or “amortised”, as an annual charge in the profit and loss account each year until the relevant Leek Note was called or expected to be called by the Co-op Bank. In order to calculate the amount of the annual charge in each subsequent year, the Co-op Bank had to estimate when the Leek Notes would be called so that it could calculate the number of years over which the charge had to be spread. To take Leek Note 19 as an example, if at the time of the finalisation of the 2009 Financial Statements it was estimated that the note would be called at its step-up date in June 2012, the Co-op Bank was required to spread the £345 million FVA from August 2009 (the date of merger) to June 2012, and record an appropriate charge in the profit and loss account for 2009 based on spreading the £345 million over that (relatively short) period.
39. If a Leek Note was called, any unamortised FVA had to be unwound at that point, with an immediate negative impact on the Co-op Bank’s profits and capital (which was an incentive not to call it for as long as possible). Accordingly, the charge recorded in the accounts of a given year depended on whether the Co-op Bank had called particular Leek Notes, and on its estimate of when it would call any outstanding Leek Notes: the later the estimate of when the outstanding Leek Notes would be called, the more years over which the FVA on them would be spread and the lower the charge recorded in each year. The timing of the call date, and the estimate of the life of the Leek Notes, could have a material impact on the financial statements. In particular, extending the

estimate of the life of the Leek Notes, increased short-term profits and the short-term capital position.

40. The Co-op Bank's estimate of when the Leek Notes would be called materially affected its 2009 Financial Statements. As the Co-op Bank's auditor, it was KPMG's responsibility to obtain sufficient appropriate audit evidence as to whether the estimate was reasonable in the circumstances and appropriately disclosed in the Co-op Bank's financial statements. KPMG failed in its discharge of these responsibilities.
41. At the time of the merger, the step-up dates for Leek Notes 14-19 were earlier than their clean-up dates. KPMG was aware that, leading up to the merger, the Co-op Bank assumed that the Leek Notes would be called at their step-up dates and that, partly because of Britannia's deteriorating financial position, the Co-op Bank was expected to record losses in 2009 and 2010, and only a small profit in 2011, as set out in the following table:



42. Shortly before merger, the Co-op Bank changed its estimate of when the Leek Notes would be called, changing it from being on their step-up dates to being on their clean-up dates. This had a substantial positive effect on the Co-op Bank's projected profits, as set out below:



43. This change in assumption did not accord with Britannia's past practice of calling the Leek Notes at or before their step-up dates. Moreover, the Co-op Bank and KPMG were aware that the wholesale funding market expected the Leek Notes to be called at or before their step-up dates and that if the Co-op Bank disappointed that expectation it would undermine its ability to access funding from the wholesale market. Given the Co-op Bank had limited alternative means to obtain funding, this was an unpalatable option for it. For that reason, and because the Co-op Bank could afford to do so, Leek Note 14 was called at its step-up date in December 2009.
44. Nevertheless, the Co-op Bank produced its 2009 Financial Statements on the assumption that the remainder of the Leek Notes would not be called until their clean-up dates. While that was the assumption behind the financial statements (and could perhaps have been inferred from the absence of any adjustment in the liquidity table in the Risk Management section of the financial statement), the statements did not in fact expressly state this assumption and it appears that readers of those statements, including those in the wholesale funding market, did not understand that that assumption (or estimate) had been made.
45. KPMG audited the Co-op Bank's estimate of the call dates for Leek Notes 15-19. The audit team fully understood the tension between the Co-op Bank's need to, on the one hand, preserve capital by accounting for the Leek Notes on the basis that they would be called at clean-up and, on the other hand, preserve access to the wholesale markets which might be undermined if the Co-op Bank did not call the Leek Notes at step-up. KPMG was also aware that the Co-op Bank had called Leek Note 14 on 21 December 2009. However, KPMG failed adequately to challenge the Co-op Bank's management's statements of intention to call Leek Notes 15-19 at their clean-up dates and accepted that this was an appropriate estimate of their expected lives.

46. In the circumstances KPMG and Mr Walker:
- (a) failed adequately to challenge the Co-op Bank's management's stated intention to call Leek Notes 15-19 at their clean-up dates and therefore failed to exercise sufficient professional scepticism in relation to the estimate; and
 - (b) failed to obtain sufficient appropriate audit evidence to support the Bank's estimate of when the Leek Notes would be called.
47. KPMG also failed to inform the Bank's management that the estimate of when the Leek Notes would be called was not adequately disclosed in the financial statements and that further disclosure was required.

VI. ALLEGATION 1: RED COMMERCIAL BOOK FAIR VALUE ADJUSTMENTS

In relation to the audit of the Co-op Bank's financial statements for the financial year ending 31 December 2009, and in particular their audit of the Co-op Bank's Fair Value Adjustments for the Red Commercial Loan Book, KPMG and Mr Walker failed to comply with ISA 200 and ISA 500 and failed to act in accordance with Fundamental Principle C 'Professional Competence and Due Care' in the Code of Ethics 2006. As a result of these failings KPMG and Mr Walker fell significantly short of the standards reasonably to be expected of a Member Firm and Member.

Particulars

48. As noted above, the Red Commercial Book consisted primarily of sub-prime, commercial real-estate loans. These loans were relatively high-risk, especially given the weakness in the commercial real-estate market in 2009 and the high loan-to-value ratios of the loans. Moreover, the Red Commercial Book had a value between £3 and £4 billion by year end, in a loan book with a total value of approximately £34 billion.
49. The FVAs made in respect of loans and advances were important to the 2009 Financial Statements.
50. KPMG's audit work over the Red Commercial Book was carried out for the dual purpose of auditing the Bank's FVAs and auditing any post-merger impairments to the loans.
51. The following factors gave KPMG and Mr Walker some comfort as to the level of impairments Britannia had recorded in relation to the Red Commercial Book:
- (a) Britannia's cessation accounts as at 1 August 2009 (i.e. the accounts prepared at the time of the Britannia merger) were audited by another audit firm and subsequently reviewed by KPMG. The FVA as at 1 August 2009, as recorded in the 2009 Financial Statements for the Red Commercial Book was significantly higher than the impairment provision included in the cessation accounts, providing some indication (although the two figures were prepared for different purposes and, in some respects, to different accounting standards)

that the Co-op Bank was not unrealistically positive in its approach to the FVA;
and

- (b) the fair value exercise, in particular the Co-op Bank's review of all loans in the Red Commercial Book, was on-going at the time of signing the 2009 Financial statements. This was permitted by IFRS 3, which allowed an entity up to one year within which to finalise FVAs following an acquisition.
52. Nevertheless, as explained below, the testing performed by KPMG and Mr Walker in relation to the Red Commercial Book was inadequate.
53. The testing performed was a mixture of controls testing and substantive testing. Controls testing involves the auditor testing the effectiveness of the control mechanisms used by the client entity to ensure its financial statements are free from error. Substantive testing involves the auditor directly testing balances recorded in the financial statements for material misstatements, by reference to the supporting documents.
54. KPMG's testing of the controls operating in respect of the Distressed Loans pool was inadequate: KPMG relied on the Co-op Bank's own identification of the loans at risk of default, without conducting its own testing of other loans to determine whether the Distressed Loans pool was complete. This failing meant that further FVAs for other loans may not have been identified.
55. The substantive testing performed by KPMG on the Distressed Loans was also inadequate. It consisted of an individual review of the 61 Distressed Loans identified by the Co-op Bank. The testing performed was deficient for a number of reasons:
- (a) KPMG failed to demonstrate sufficient professional scepticism in response to evidence collected during the substantive testing of the pool of Distressed Loans. For some loans, KPMG did not demonstrate sufficient professional scepticism in response to (i) the Co-op Bank's assertions about the loans and the associated risks and (ii) the valuations the Bank had obtained of the collateral held in relation to the loans. In relation to the collateral valuations:
 - (i) KPMG did not review all the valuations that were provided to determine they were reliable and up-to-date;
 - (ii) A number of loans did not have reliable, external valuations and in some instances KPMG did not require such valuations to be obtained;
 - (iii) While KPMG engaged a valuation specialist in relation to some loans, they did not adequately follow up valuations which the specialist considered to be either unreliable or on which he had insufficient information to be able to comment.

- (b) As a result, the audit evidence which KPMG obtained in respect of some of the loans in the distressed pool did not amount to sufficient appropriate audit evidence to support the FVA which the Co-op Bank had made in respect of them and / or KPMG failed to obtain sufficient appropriate audit evidence to explain clearly the rationale for the conclusions reached by the audit team in respect of the FVAs on some of the distressed pool loans.

56. In the circumstances:

- (a) In breach of ISA 500 and Fundamental Principle C 'Professional Competence and Due Care' (as explained at section 130 in the Code of Ethics 2006, paragraphs 130.1(b) and 130.4), KPMG and Mr Walker did not obtain sufficient appropriate audit evidence:
 - (i) to support the completeness of the Distressed Loan Book in the Red Commercial Book; and
 - (ii) to support the FVA for the Distressed Loan Book in the Red Commercial Book.
- (b) In breach of ISA 200 and Fundamental Principle C 'Professional Competence and Due Care' (as explained at section 130 in the Code of Ethics 2006, paragraphs 130.1(b) and 130.4), KPMG and Mr Walker did not demonstrate sufficient professional scepticism in relation to the above matters and in particular in relation to:
 - (i) the collateral valuations for some of the Distressed Loans in the Red Commercial Book; and
 - (ii) the Co-op Bank's management's assertions about some of the loans in the Red Commercial Book.

VII. ALLEGATION 2: THE LEEK NOTES

In relation to the audit of the Co-op Bank's financial statements for the financial year ending 31 December 2009, and in particular their audit of the Co-op Bank's estimate of the expected lives of Leek Notes 15-19, KPMG and Mr Walker failed to comply with ISA 200, ISA 500 and ISA 540 and failed to act in accordance with Fundamental Principle C 'Professional Competence and Due Care' in the Code of Ethics 2006. As a result of these failings KPMG and Mr Walker fell significantly short of the standards reasonably to be expected of a Member Firm and Member.

Particulars

- 57. As noted above, in the 2009 Financial Statements the Co-op Bank assumed that Leek Notes 15-19 would not be called until their clean-up dates. KPMG accepted this

estimate was appropriate on the basis that, on a number of occasions, the Co-op Bank internally stated an intention not to call the notes at their step-up dates.

58. KPMG and Mr Walker were aware that there was some support for the Bank's estimate:

- (a) The Co-op Bank could not afford from a capital perspective to redeem all of the outstanding Leek Notes at step-up. This was ultimately addressed through the restructuring of the Leek Notes that took place the following year.
- (b) The Co-op Bank's 2010-2012 Corporate Plan and the 2010-2012 Funding Plan, which were formally approved by the Co-op Bank, implied an intention to redeem the outstanding Leek Notes at maturity.
- (c) A "Merger Accounting Update" dated 2 November 2009 and received and noted on that date by the CFS Group Audit & Regulatory Compliance Committee ("**ARCC**") (which Mr Walker attended) stated that an assumption made in the projected unwind of FVAs was "*that Leek notes, apart from Leek 14 (redeemed after 31 July), are held to maturity and are not redeemed at call dates. This is consistent with the current 3-year strategic plan and with the intention that there will be no future redemptions prior to maturity.*"
- (d) A CFS Group board meeting minute of 12 November 2009 recorded in an update on the CFS Group ARCC meeting of 2 November 2009 (noted above) that "*The unwind of the FVAs had been discussed. It had been recognised that if the notes within the Leek programme were called early, this could affect the pace of the unwind, but there were no plans to take such a course of action, currently.*"

59. However, there were a number of factors known to KPMG and Mr Walker which meant that the Co-op Bank's internally stated intention needed to be treated with acute professional scepticism.

- (a) Britannia had previously called Leek Notes 2-12 at or before their step-up dates.
- (b) In early 2009 the Co-op Bank's original business case for the merger assumed the Leek Notes would continue to be called at their step-up dates. This assumption was changed shortly before the merger and only after Britannia's financial position had deteriorated significantly. The change in assumption had the effect of extending the period over which the FVAs would have to be unwound and thus of improving the profitability and capital position in the near-term. KPMG were aware that a consideration of the effect of the assumption on profit and capital was part of the motivation for the declared change of intention. For example, on 13 July 2009, the Co-op Bank's [REDACTED]

██████ telephoned Mr Walker to discuss the proposed change in estimate. In a hand-written note of that call Mr Walker recorded that, when discussing the reason for the change, he commented that *“in examining 3 ‘pillars’ profit, liquidity, capital, business plan combined was looking weaker on profit and capital”*. The change in assumption was legitimate if management really did have the intention of not calling the Leek Notes at step-up. But KPMG were aware of the helpful short-term effect which the change in assumption had, which called for scepticism as to the robustness of management’s intention.

(c) The Co-op Bank and KPMG recognised that the wholesale funding market expected the Leek Notes to be called at or before their step-up dates and that if the Bank disappointed that expectation it would likely be locked out of the wholesale funding market for a substantial period of time. For example:

(i) In a paper dated 20 August 2009 seeking approval from the Asset and Liability Committee (“ALCO”) for the buy-back of Leek Note 14, the Capital Markets team warned that *“the decision not to call [at step-up] will hamper the Bank’s ability to utilise public wholesale debt capital markets in the future (Capital Markets & ████████ & ████████ view). Indeed, evidence indicates that Leek paper is priced in the secondary RMBS markets assuming the respective deal’s call options are exercised. A decision not to call LFL14 will adversely affect the Bank’s reputation in wholesale debt capital markets.”*

(ii) The Co-op Bank’s 2010-2012 Funding Plan for ALCO dated 25 January 2010 stated that *“The market will expect the notes to be called [at step-up] and if they are not, the secured and potentially the unsecured market will effectively be closed to the Bank for a significant period of time.”* The plan also noted that not calling the notes at step-up *“would result in severely restricted access to the capital markets.”*

(d) The Co-op Bank redeemed Leek Note 14 at its step-up date in December 2009. The Bank’s rationale for calling Leek Note 14 was that not doing so would *“hamper the Bank’s ability to utilise public wholesale debt capital markets in the future”* and *“adversely affect the Bank’s reputation in wholesale debt capital markets”*.

The Co-op Bank’s key planning document, the 2010-2012 Corporate Plan as presented to the board, did not clearly state that the Leek Notes would not be called until their clean-up dates. As presented to the Board (and as seen and reviewed by Mr Walker) the Corporate Plan included a “base case”, and two alternative scenarios: (1) a “stress scenario” of *“Continued depression”*; and (2) a *“Stronger, faster economic recovery”* scenario which assumed that

recovery was one year faster than base case. The “base case” contained no express statement that the Leek Notes would not be called until their clean-up dates. While the “stress scenario” included as the third of the potential “Business Mitigation” steps “*Leek notes not redeemed until maturity*”, the “Stronger, faster economic recovery” scenario noted that in this scenario “*Buybacks of Leek Notes more likely, which would consume capital (and unwinds some of FVA)*”.

60. In these circumstances, a reasonable auditor would have further challenged the Co-op Bank’s management about the realism of the estimate that Leek Notes 15-19 would not be called until their clean-up dates; and sought further appropriate audit evidence to support the estimate, such as a board minute expressly confirming an intention not to call Leek Notes 15-19 until their clean-up dates. KPMG did not do this.
61. In addition, the disclosure of the Co-op Bank’s estimate of the expected lives of the Leek Notes in the 2009 Financial Statements was also inadequate. The relevant accounting standards include paragraph 125 of IAS 1, which requires an entity to “*disclose information about the assumptions it makes about the future, and other major sources of estimation uncertainty at the end of the reporting period, that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next financial year.*” The 2009 Financial Statements were prepared on the assumption that the Leek Notes would not be called until their clean-up dates. The assumption should have been explicitly disclosed in accordance with IAS 1 paragraph 125, but it was not.
62. In the circumstances:
 - (a) In breach of ISA 200 and Fundamental Principle C ‘Professional Competence and Due Care’ (as explained at section 130 in the Code of Ethics 2006, paragraphs 130.1(b) and 130.4), KPMG and Mr Walker failed to exercise sufficient professional scepticism in relation to the Bank’s estimate of the expected lives of Leek Notes 15-19.
 - (b) In breach of ISA 500, ISA 540, and Fundamental Principle C ‘Professional Competence and Due Care’ (as explained at section 130 in the Code of Ethics 2006, paragraphs 130.1(b) and 130.4), KPMG and Mr Walker failed to obtain sufficient appropriate audit evidence to support that estimate.
 - (c) In breach of ISA 200 and Fundamental Principle C ‘Professional Competence and Due Care’ (as explained at section 130 in the Code of Ethics 2006, paragraphs 130.1(b) and 130.4), KPMG and Mr Walker failed to inform the Bank’s management that the assumption as to the expected lives of Leek

Notes 15-19 was not adequately disclosed and that further disclosure was required.

Annex A

Relevant Extracts from the Applicable Auditing Standards

Code of Ethics

Fundamental Principle (c) Professional Competence and Due Care.

... Professional accountants should act diligently and in accordance with applicable technical and professional standards when providing professional services.

Section 130 Professional competence and due care

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

...

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

...

130.4 Diligence encompasses the responsibility to act in accordance with the requirements of an assignment, carefully, thoroughly and on a timely basis.

ISAs

ISA 200 – Objective and general principles governing an audit of financial statements

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

8 An audit in accordance with ISAs (UK and Ireland) is designed to provide reasonable assurance that the financial statements taken as a whole are free from material misstatement.

15 The auditor should plan and perform the audit to reduce audit risk to an acceptably low level that is consistent with the objective of an audit. The auditor reduces audit risk by designing and performing audit procedures to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base an audit opinion. Reasonable assurance is obtained when the auditor has reduced audit risk to an acceptably low level.

16 Audit risk is a function of the risk of material misstatement of the financial statements (or simply, the “risk of material misstatement”) (i.e., the risk that the financial statements are materially misstated prior to audit) and the risk that the auditor will not detect such misstatement (“detection risk”). The auditor performs audit procedures to assess the risk of material misstatement and seeks to limit detection risk by performing further audit procedures based on that assessment (see ISA (UK and Ireland) 315, “Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement” and ISA (UK and Ireland) 330, “The Auditor’s Procedures in Response to Assessed Risks”). The audit process involves the exercise of professional judgment

in designing the audit approach, through focusing on what can go wrong (i.e., what are the potential misstatements that may arise) at the assertion level (see ISA (UK and Ireland) 500, “Audit Evidence”) and performing audit procedures in response to the assessed risks in order to obtain sufficient appropriate audit evidence.

ISA 500 – Audit evidence 2

- 2 The auditor should obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the audit opinion.
- 11 When information produced by the entity is used by the auditor to perform audit procedures, the auditor should obtain audit evidence about the accuracy and completeness of the information. In order for the auditor to obtain reliable audit evidence, the information upon which the audit procedures are based needs to be sufficiently complete and accurate. For example, in auditing revenue by applying standard prices to records of sales volume, the auditor considers the accuracy of the price information and the completeness and accuracy of sales volume data. Obtaining audit evidence about the completeness and accuracy of the information produced by the entity’s information system may be performed concurrently with the actual audit procedure applied to the information when obtaining such audit evidence is an integral part of the audit procedure itself. In other situations, the auditor may have obtained audit evidence of the accuracy and completeness of such information by testing controls over the production and maintenance of the information. However, in some situations the auditor may determine that additional audit procedures are needed.
- 14 In forming the audit opinion the auditor does not examine all the information available because conclusions ordinarily can be reached by using sampling approaches and other means of selecting items for testing. Also the auditor ordinarily finds it necessary to rely on audit evidence that is persuasive rather than conclusive; however to obtain reasonable assurance the auditor is not satisfied with audit evidence that is less than persuasive. The auditor uses professional judgment and exercises professional scepticism in evaluating the quantity and quality of audit evidence and thus its sufficiency and appropriateness, to support the audit opinion.

ISA 540 – Audit of accounting estimates

- 2 The auditor should obtain sufficient appropriate audit evidence regarding accounting estimates.
- 8 The auditor should design and perform further audit procedures to obtain sufficient appropriate audit evidence as to whether the entity’s accounting estimates are reasonable in the circumstances and, when required, appropriately disclosed.
- 16 In evaluating the assumptions on which the estimate is based, the auditor would consider, among other things, whether they are:
- Reasonable in light of actual results in prior periods.
 - Consistent with those used for other accounting estimates.
 - Consistent with management’s plans which appear appropriate.

The auditor would need to pay particular attention to assumptions which are sensitive to variation, subjective or susceptible to material misstatement.

Annex B

Relevant Extracts from the Applicable Accounting Standards

IFRS 3

- 4 A business combination is the bringing together of separate entities or businesses into one reporting entity. The result of nearly all business combinations is that one entity, the acquirer, obtains control of one or more other businesses, the acquiree. If an entity obtains control of one or more other entities that are not businesses, the bringing together of those entities is not a business combination. When an entity acquires a group of assets or net assets that does not constitute a business, it shall allocate the cost of the group between the individual identifiable assets and liabilities in the group based on their relative fair values at the date of acquisition.
- 14 All business combinations shall be accounted for by applying the purchase method.
- 15 The purchase method views a business combination from the perspective of the combining entity that is identified as the acquirer. The acquirer purchases net assets and recognises the assets acquired and liabilities and contingent liabilities assumed, including those not previously recognised by the acquiree. The measurement of the acquirer's assets and liabilities is not affected by the transaction, nor are any additional assets or liabilities of the acquirer recognised as a result of the transaction, because they are not the subjects of the transaction.
- 36 The acquirer shall, at the acquisition date, allocate the cost of a business combination by recognising the acquiree's identifiable assets, liabilities and contingent liabilities that satisfy the recognition criteria in paragraph 37 at their fair values at that date, except for non-current assets (or disposal groups) that are classified as held for sale in accordance with IFRS 5 Non-current Assets Held for Sale and Discontinued Operations, which shall be recognised at fair value less costs to sell. Any difference between the cost of the business combination and the acquirer's interest in the net fair value of the identifiable assets, liabilities and contingent liabilities so recognised shall be accounted for in accordance with paragraphs 51-57.
- 61 The initial accounting for a business combination involves identifying and determining the fair values to be assigned to the acquiree's identifiable assets, liabilities and contingent liabilities and the cost of the combination.
- 62 If the initial accounting for a business combination can be determined only provisionally by the end of the period in which the combination is effected because either the fair values to be assigned to the acquiree's identifiable assets, liabilities or contingent liabilities or the cost of the combination can be determined only provisionally, the acquirer shall account for the combination using those provisional values. The acquirer shall recognise any adjustments to those provisional values as a result of completing the initial accounting:
- (a) within twelve months of the acquisition date; and
 - (b) from the acquisition date. Therefore:
 - (i) the carrying amount of an identifiable asset, liability or contingent liability that recognised or adjusted as a result of completing the initial

accounting shall be calculated as if its fair value at the acquisition date had been recognised from that date.

- (ii) goodwill or any gain recognised in accordance with paragraph 56 shall be adjusted from the acquisition date by an amount equal to the adjustment to the fair value at the acquisition date of the identifiable asset, liability or contingent liability being recognised or adjusted.
- (iii) comparative information presented for the periods before the initial accounting for the combination is complete shall be presented as if the initial accounting had been completed from the acquisition date. This includes any additional depreciation, amortisation or other profit or loss effect recognised as a result of completing the initial accounting

IFRS 7

- 1 The objective of this IFRS is to require entities to provide disclosures in their financial statements that enable users to evaluate:
- (a) the significance of financial instruments for the entity's financial position and performance; and
 - (b) the nature and extent of risks arising from financial instruments to which the entity is exposed during the period and at the end of the reporting period, and how the entity manages those risks.
- 31 An entity shall disclose information that enables users of its financial statements to evaluate the nature and extent of risks arising from financial instruments to which the entity is exposed at the end of the reporting period.

IAS 1 Presentation of Financial Statements

- 125 An entity shall disclose information about the assumptions it makes about the future, and other major sources of estimation uncertainty at the end of the reporting period, that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next financial year. In respect of those assets and liabilities, the notes shall include details of:
- (a) their nature, and
 - (b) their carrying amount as at the end of the reporting period.
- 129 An entity presents the disclosures in paragraph 125 in a manner that helps users of financial statements to understand the judgements that management makes about the future and about other sources of estimation uncertainty. The nature and extent of the information provided vary according to the nature of the assumption and other circumstances. Examples of the types of disclosures an entity makes are:
- (a) the nature of the assumption or other estimation uncertainty;
 - (b) the sensitivity of carrying amounts to the methods, assumptions and estimates underlying their calculation, including the reasons for the sensitivity;

- (c) the expected resolution of an uncertainty and the range of reasonably possible outcomes within the next financial year in respect of the carrying amounts of the assets and liabilities affected; and
- (d) an explanation of changes made to past assumptions concerning those assets and liabilities, if the uncertainty remains unresolved.

IAS 39 - Financial Instruments: Recognition and Measurement

9 Definitions relating to recognition and measurement

The *amortised cost of a financial asset or financial liability* is the amount at which the financial asset or financial liability is measured at initial recognition minus principal repayments, plus or minus the cumulative amortisation using the effective interest method of any difference between that initial amount and the maturity amount, and minus any reduction (directly or through the use of an allowance account) for impairment or uncollectibility.

The *effective interest method* is a method of calculating the amortised cost of a financial asset or a financial liability (or group of financial assets or financial liabilities) and of allocating the interest income or interest expense over the relevant period. The *effective interest rate* is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument or, when appropriate, a shorter period to the net carrying amount of the financial asset or financial liability. When calculating the effective interest rate, an entity shall estimate cash flows considering all contractual terms of the financial instrument (for example, prepayment, call and similar options) but shall not consider future credit losses. The calculation includes all fees and points paid or received between parties to the contract that are an integral part of the effective interest rate (see IAS 18 *Revenue*), transaction costs, and all other premiums or discounts. There is a presumption that the cash flows and the expected life of a group of similar financial instruments can be estimated reliably. However, in those rare cases when it is not possible to estimate reliably the cash flows or the expected life of a financial instrument (or group of financial instruments), the entity shall use the contractual cash flows over the full contractual term of the financial instrument (or group of financial instruments).

Derecognition is the removal of a previously recognised financial asset or financial liability from an entity's statement of financial position.

Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

A *regular way purchase or sale* is a purchase or sale of a financial asset under a contract whose terms require delivery of the asset within the time frame established generally by regulation or convention in the marketplace concerned.

Transaction costs are incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or financial liability (see Appendix A paragraph AG13). An incremental cost is one that would not have been incurred if the entity had not acquired, issued or disposed of the financial instrument.

- 14 An entity shall recognise a financial asset or a financial liability in its statement of financial position when, and only when, the entity becomes a party to the contractual

provisions of the instrument. (See paragraph 38 with respect to regular way purchases of financial assets.)

47 **After initial recognition, an entity shall measure all financial liabilities at amortised cost using the effective interest method...**

58 **An entity shall assess at the end of each reporting period whether there is any objective evidence that a financial asset or group of financial assets measured at amortised cost is impaired. If any such evidence exists, the entity shall apply paragraph 63 to determine the amount of any impairment loss.**

59 A financial asset or a group of financial assets is impaired and impairment losses are incurred if, and only if, there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the asset (a 'loss event') and that loss event (or events) has an impact on the estimated future cash flows of the financial asset or group of financial assets that can be reliably estimated...

AG5 In some cases, financial assets are acquired at a deep discount that reflects incurred credit losses. Entities include such incurred credit losses in the estimated cash flows when computing the effective interest rate.

AG6 When applying the effective interest method, an entity generally amortises any fees, points paid or received, transaction costs and other premiums or discounts included in the calculation of the effective interest rate over the expected life of the instrument. However, a shorter period is used if this is the period to which the fees, points paid or received, transaction costs, premiums or discounts relate. This will be the case when the variable to which the fees, points paid or received, transaction costs, premiums or discounts relate is repriced to market rates before the expected maturity of the instrument. In such a case, the appropriate amortisation period is the period to the next such repricing date. For example, if a premium or discount on a floating rate instrument reflects interest that has accrued on the instrument since interest was last paid, or changes in market rates since the floating interest rate was reset to market rates, it will be amortised to the next date when the floating interest is reset to market rates. This is because the premium or discount relates to the period to the next interest reset date because, at that date, the variable to which the premium or discount relates (i.e. interest rates) is reset to market rates. If, however, the premium or discount results from a change in the credit spread over the floating rate specified in the instrument, or other variables that are not reset to market rates, it is amortised over the expected life of the instrument.

AG8 If an entity revises its estimates of payments or receipts, the entity shall adjust the carrying amount of the financial asset or financial liability (or group of financial instruments) to reflect actual and revised estimated cash flows. The entity recalculates the carrying amount by computing the present value of estimated future cash flows at the financial instrument's original effective interest rate or, when applicable, the revised effective interest rate calculated in accordance with paragraph 92. The adjustment is recognised in profit or loss as income or expense. If a financial asset is reclassified in accordance with paragraph 50B, 50D or 50E, and the entity subsequently increases its estimates of future cash receipts as a result of increased recoverability of those cash receipts, the effect of that increase shall be recognised as an adjustment to the effective

interest rate from the date of the change in estimate rather than as an adjustment to the carrying amount of the asset at the date of the change in estimate.

AG57 A financial liability (or part of it) is extinguished when the debtor either:

- (a) discharges the liability (or part of it) by paying the creditor, normally with cash, other financial assets, goods or services; or
- (b) is legally released from primary responsibility for the liability (or part of it) either by process of law or by the creditor. (If the debtor has given a guarantee this condition may still be met.)