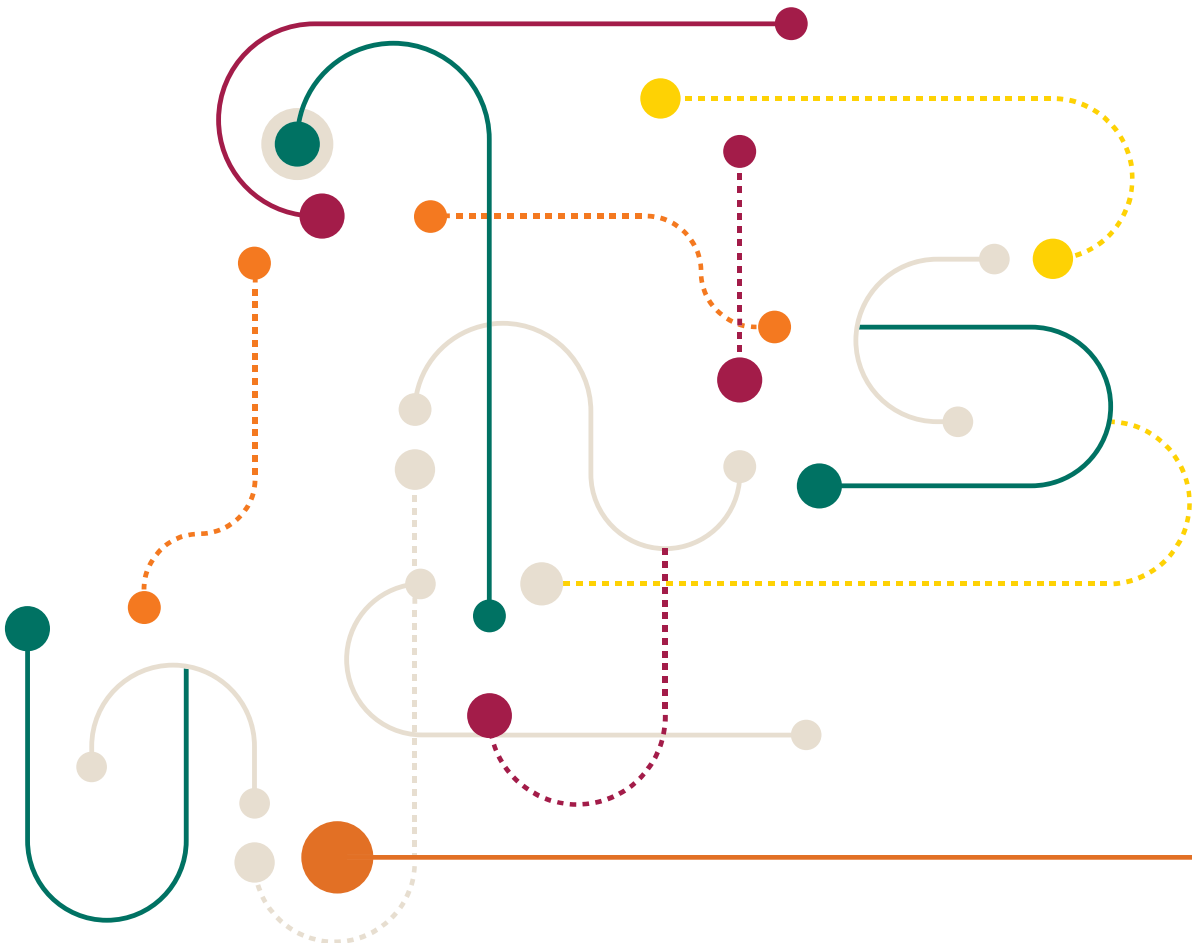


Accounting Integrity and Conduct – Review of 2016

March 2017



Our Accounting Integrity and Conduct team specialises in investigating or providing expert opinion in relation to allegations of accounting irregularities, professional negligence and misconduct.

In this review we look back over the past year and comment on key themes, and in particular the regulatory landscape for professional accountants in the UK.

Overview

Much of the activity in the public domain in the last year has been in relation to regulatory oversight, rather than civil actions

The outcome of the Aero Inventory complaint, which related to the value of stock and was heard at tribunal in 2016, set a new benchmark for the quantum of fines for auditors at £4 million plus costs. The FD was fined £170,000 and excluded from the ICAEW for 3 years.

On 17 June 2016 the FRC became the 'competent authority' for audit under the EU Audit Regulation and Directive. This impacts the process by which it progresses cases and reduces the threshold for enforcement action from 'misconduct' (falling significantly below the standard reasonably to be expected of a member) to 'breach of a relevant requirement'. Four cases have so far been brought under the new regime. It remains to be seen how the new rules will shape the outcomes and future flow of cases.

New investigations include a number of high profile incidents occurring during the year including BHS Limited and the re-opening of the HBOS case. The cases opened during the year include professional judgment around disclosure as well as accounting issues.

In respect of civil claims in the UK, the major cases included PwC's settlement of the £1.6bn claim brought in respect of their audit of sub-prime lender Cattles, and property developer Harlequin was awarded £9 million in respect of its claim against its advisers Wilkins Kennedy. We know from experience however, that the majority of matters settle behind closed doors, and that where there is a regulatory inquiry, there is often a civil suit running in tandem in connection with the same facts. The regulatory inquiries in the public domain thus provide a guide to the issues arising and the risk landscape for auditors and accounting professionals from a negligence perspective.

The UK Regulatory Regime

Disciplinary financial penalties arising from the FRC Enforcement division¹ investigations

The FRC Enforcement division is the independent disciplinary body for accountants, accounting firms and actuaries in the UK, with a focus on cases that raise important issues affecting the public interest. In doing so they investigate relevant cases and can bring forward complaints to be considered by an Independent Tribunal. The penalties available to the Independent Tribunal include the levying of fines on accountants and accounting firms.

From 17 June 2016 the FRC uses the Audit Enforcement Procedures (AEP) to investigate allegations into statutory audit matters principally Public Interest Entities² and AIM companies with a capitalisation of more than €200m.

FRC case update

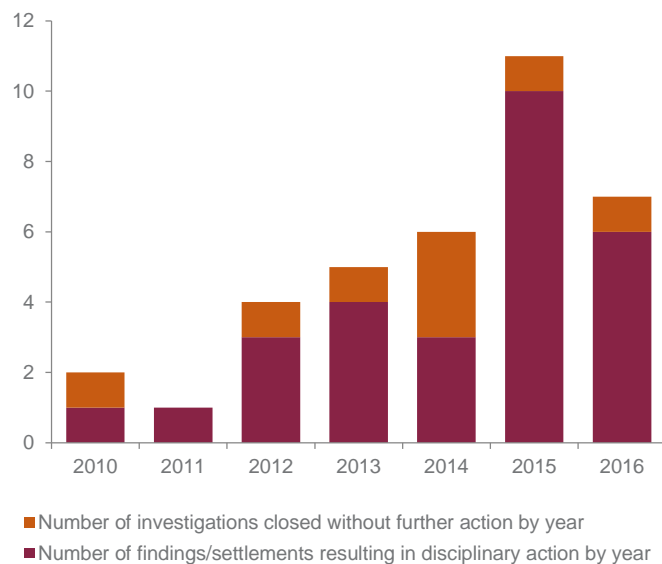
The FRC commenced six investigations in 2016 (compared to four in the prior year). The number of cases³ concluded fell from a record ten in 2015 to six in 2016 (the lowest number since 2011). This halts the trend, as can be seen in Figure 1 below, of an increase in investigations being concluded or closed year on year since 2011.

¹ Previously the FRC Professional Discipline Division

² including entities with securities listed on a regulated market, credit institutions and insurers

³ Cases against either an accounting member or member firm in practice and/or an accountant in business

Figure 1: Cases concluded by the FRC and their outcome



The six cases concluded and resulting in disciplinary action in 2016 were long running cases that commenced in or before 2012. The FRC has 23 open professional discipline cases at 3 January 2017, listed in Figure 2. The FRC has stated its aim is to commence and conclude investigations within two years. There is still a significant backlog of old investigations to be cleared by the FRC before this aim can be achieved, with the majority of the FRC open cases having commenced prior to 1 January 2015.

Several investigations commenced by the FRC in 2016 concern aspects of matters that already had a high public profile - BHS, HBOS and Sports Direct.

Figure 2:

List of current FRC investigations		Year investigation commenced
1	Tanfield Group and the audit by Baker Tilly UK Audit LLP	2010
2	Connaught plc and the audit by PwC LLP	2011
3	Equity Syndicate Management Limited (Actuarial)	2012
4	Equity Syndicate Management Limited (Accountancy)	2012
5	RSM Tenon and the audit by PwC LLP	2012
6	Autonomy Corporation plc	2013
7	Grant Thornton UK LLP and Nichols plc	2013
8	The Cup Trust and the audit by Hillier Hopkins LLP	2013
9	The Co-operative Bank plc and the audit by KPMG Audit plc	2014
10	Computer 2000 Distribution Limited and the audit by EY LLP	2014
11	AssetCo plc and the audit by Grant Thornton UK LLP	2014
12	PricewaterhouseCoopers LLP in connection with Barclays Bank PLC	2014
13	Tesco plc	2014
14	Globo plc and the audit by Grant Thornton UK LLP	2015
15	KPMG Audit plc and BNY Mellon	2015
16	RSA Insurance Ireland Limited	2015
17	Quindell plc	2015
18	BHS Limited and the audit by PwC LLP	2016
19	Coats Group plc	2016
20	HBOS plc and the audit by KPMG Audit PLC	2016
21	KPMG Audit plc and Ted Baker plc	2016
22	Serco Group and the audit by Deloitte LLP	2016
23	Sports Direct International plc	2016

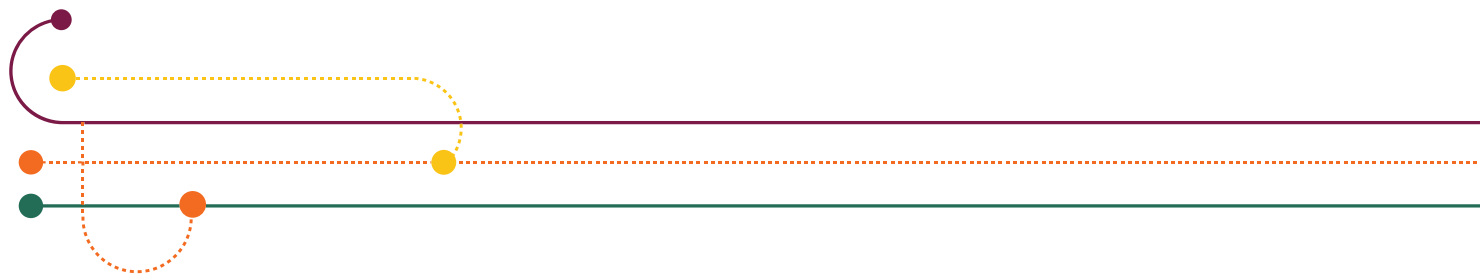
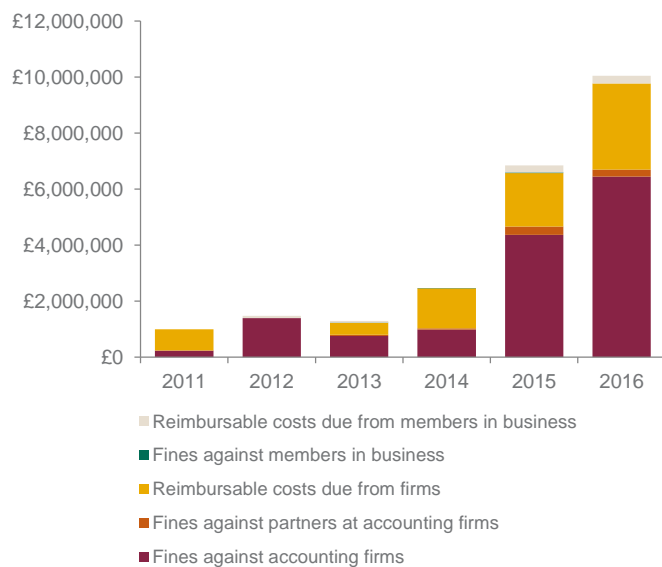


Figure 3: Monetary sanctions from FRC Professional Discipline division cases by type between 2010 and 2016



Total fines and reimbursable costs exceeded £10 million in 2016. There was a record fine of £3 million in 2015 for misconduct relating to MG Rover. This was topped in 2016 with a fine of £4 million fine against Deloitte in relation to the audits of AIM listed Aero Inventory PLC, for the financial years ended 30 June 2006, 2007 and 2008.

The brunt of fines and reimbursable FRC costs continues to fall on accounting firms and their partners.

The new investigations opened in the year continue to focus on the areas where significant judgement is required in determining the appropriate accounting treatment and disclosure within the financial statements. The cases opened during 2016 include those involving revenue recognition, the preparation of the financial statements on a going concern basis and disclosure of related party transactions. These are areas that have been subject to a number of FRC cases over recent years. We expect to continue to see future FRC cases deriving from such areas of accounting and financial reporting, in which the appropriate treatment is a matter of applying accounting judgement to a specific set of facts.

FRC Thematic reports and reviews

A number of thematic reports and reviews were released by the FRC during 2016. We highlight the following reviews of particular relevance to audit disputes and investigations:

- **Extended auditor's reports: A further review of experience⁵:** According to the report, auditors continued to develop high quality, accessible reports in the second year of extended auditor reporting. Investors were noted to have welcomed extended auditor reporting and the additional information it provides about the companies being audited. The extended audit report requirements are now applicable to AIM listed entities, credit institutions and insurance undertakings for 2017/18 year ends.

We set out how we consider extended audit reports are having, and will have, a significant impact on Dispute cases in our article 'The impact on disputes of enhanced audit reporting published in December 2016⁶.

- **AQRT annual reports 2015/16⁷:** The FRC published its principal findings arising from the 2015/16 reviews of BDO, Deloitte, EY, Grant Thornton, KPMG and PwC. Melanie McLaren, FRC's Executive Director for Audit, commented:

"This year's reports on our reviews of individual audit firms reflect the FRC's focus on promoting continuous improvement in audit quality. For the first time, we asked the firms to carry out a root cause analysis into each of our key findings before developing proposed actions and discussing these with us. The firms responded positively to this request and engaged in a constructive dialogue with us on the outcome of their work and how this had informed the actions they intend to take."

⁵ <https://www.frc.org.uk/Our-Work/Publications/Audit-and-Assurance-Team/Report-on-the-Second-Year-Experience-of-Extended-A.pdf>

⁶ <http://www.grantthornton.co.uk/insights/the-impact-on-disputes-of-enhanced-audit-reporting/>

⁷ <https://www.frc.org.uk/News-and-Events/FRC-Press/Press/2016/May/Audit-quality-review-reports-published-by-FRC.aspx>

As a significant number of audits inspected are judged by the AQR to require some sort of improvement, it is easy to see how a significant number of audits could 'breach a "relevant requirement" and lead to an Adverse Finding against a firm under the new regime. With the lower bar set for action by the FRC against auditors, the level of enforcement action seems likely to continue to increase.

Further thematic reviews were published by the FRC during 2016 as follows:

- **Audit Quality Thematic Review⁸**: Firms' audit quality monitoring, which considers the monitoring performed by nine audit firms over both the quality of completed audit engagements and the effectiveness of their overall quality control systems. The Review seeks to share good practice and improve overall effectiveness and notes key areas for improvement.
- **The FRC's thematic review into 'Engagement Quality Control Reviewers'⁹** considers the use of the Quality Control Reviewer by audit firms and areas for improvement in the review process for audit files.
- **Developments in Corporate Governance and Stewardship 2015¹⁰**: The most recent edition of the UK's Corporate Governance Code was issued in April 2016, to take account of the EU Audit Directive and Regulation, which became law on 17 June 2016, effective for Public Interest Entities' financial reporting years starting on or after that date.

Grant Thornton published its 15th annual FTSE 350 **Corporate Governance Review¹¹** in November 2016, which provided the encouraging news that full compliance with the Code has improved and 62% of companies in the survey (and 72% of the FTSE 100 companies) complied fully - the highest proportion ever measured.

In July 2016 the FRC published its paper **Corporate Culture and the role of Boards** following its 'Culture Coalition' initiative, market-led exploration into corporate culture. The UK Corporate Governance Code says¹²:

"One of the key roles for the Board includes establishing the culture, values and ethics of the company. It is important that the board sets the correct tone from the top. The directors should lead by example and ensure that good standards of behaviour permeate throughout all levels of the organisation. This will help prevent misconduct, unethical practices and support the delivery of long-term success".

Of all companies in the Grant Thornton survey, 86% mentioned culture, but only 20% of companies provide any meaningful or detailed discussion on their organisational culture and 48% do not clearly communicate their organisational values.

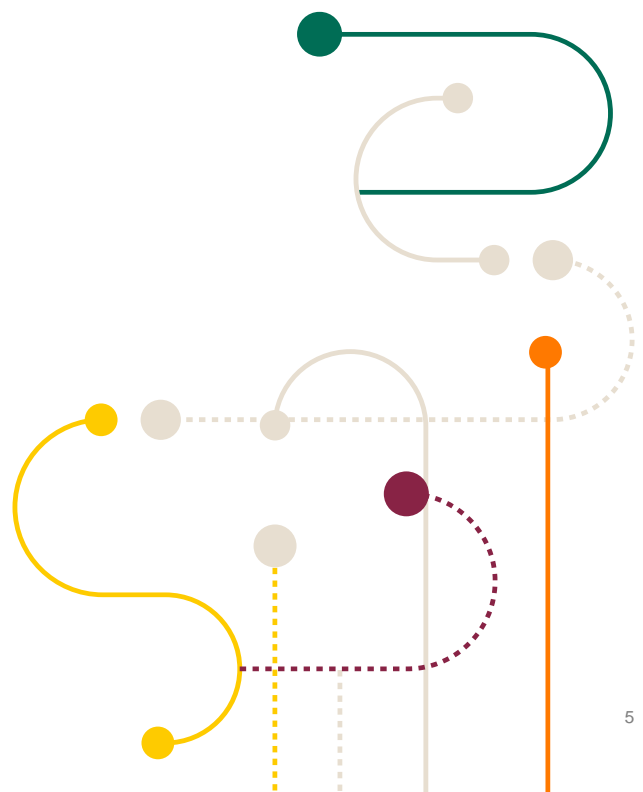
⁸ <https://frc.org.uk/Our-Work/Publications/Audit-Quality-Review/Audit-Quality-Thematic-Review-Firms-audit-qualit.pdf>

⁹ <https://www.frc.org.uk/Our-Work/Publications/Audit-Quality-Review/Audit-Quality-Thematic-Review-Engagement-Quality.pdf>

¹⁰ [https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/Developments-in-Corporate-Governance-and-Stewa-\(1\).pdf](https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/Developments-in-Corporate-Governance-and-Stewa-(1).pdf)

¹¹ <http://www.grantthornton.co.uk/insights/uk-corporate-governance-review-2016-highlights/>

¹² para 4 of the Preface



UK audit developments in 2016

A new ethical standard

During the year a new Ethical Standard was introduced governing the work of audit engagements and other public interest assurance engagements. The most significant changes are in relation to the audit of Public Interest Entities where revised requirements on the provision of non-audit services by an auditor have been issued. These requirements include the types of services that are prohibited or *may* be prohibited, and a fee cap of 70% on non-audit services provided.

This standard adds complexity to the requirements surrounding the provision of non-audit services. Provision of non-audit services and similar ethical issues have been the subject of a number of FRC cases, including MG Rover (2013), EY (which was closed in 2014), and the KPMG Ted Baker case opened in June 2016. We expect further such cases to arise in due course under this new standard.

Cross-border regulatory audit enforcement makes headlines in 2016

Regulators have been looking abroad to consider instances of misconduct that occur across an international accountancy network. Global accountancy firms are typically structured as networks of independent entities subject to their own local laws and regulations.

A recent cross-border case concluded in early December 2016 was Deloitte Brazil, which resulted in a fine of US\$8 million being levied by the US regulator, the Public Company Accounting Oversight Board (PCAOB), which could inspect the Brazilian firm because that firm audited a US issuer and was a member of an international network registered with the PCAOB. Deloitte Brazil's misconduct included falsifying reports, altering documents and providing false testimony in relation to the investigation into the audits of low cost airline Gol Linhas Aéreas Inteligentes. The Enforcement Director of the PCAOB described it as 'the most serious misconduct we've uncovered'.

In a separate instance, the PCAOB fined Deloitte Mexico US\$750k for poor quality control policies.

The challenge of maintaining global standards across global networks is one that accounting firms take seriously, as they strive to serve global clients to the same level of quality of service and uphold the same values across the world.

More than 50 national accounting regulators are now members of the International Forum of Independent Audit Regulators, which sets global standards and coordinates cross-border investigations¹³.

The SEC filed 868 enforcement actions exposing financial reporting-related misconduct and accounting abuse in fiscal year 2016, an all-time high for the US regulator.

Summary

Similar to 2015, against a backdrop of increasing activity by the regulatory bodies and with a number of new high profile cases, accounting firms in the UK face an increasing level of scrutiny, together with increasing monetary sanctions for findings of misconduct. 2016 is notable for the record level of fines levied internationally against accounting firms and their partners by regulators operating across borders. Public and political scrutiny has intensified and the appetite for redress following corporate scandals continues. This trend of increased regulatory focus and greater penalties seems likely to continue.

Contact us

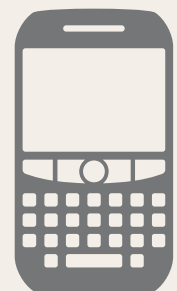
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¹³Brooke Masters, 'Big Four Auditors can no longer hide behind their local models', Financial Times, 9 December 2016: <https://www.ft.com/content/75cd40f2-bd3e-11e6-8b45-b8b81dd5d080>

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Phil, a partner in Grant Thornton's forensic practice, has over 30 years' experience in accounting, auditing and investigations. Phil was UK Head of Audit from July 2006 until 30 June 2012 and a member of the Grant Thornton International Assurance Advisory Board. He continues to be a Responsible Individual with involvement in audit work and is a non-executive director and chairman of the audit committee of an AIM-listed company. Phil has extensive audit and advisory experience having worked with a wide range of listed and private international companies. This includes addressing financial reporting and accounting issues under IFRS and UK GAAP. He also has significant due diligence, accounts reconstruction and transactions-related experience.

Phil is an experienced expert witness, in a consulting/advisory capacity or as a testifying expert. He has given evidence at trial.



Philippa Hill

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Philippa Hill is a director in Grant Thornton's forensics practice. She has specialised in accounting disputes and investigations since 2001, prior to which she was an auditor. Philippa has particular experience investigating suspected accounting irregularities including fraud and financial misstatement, and the role of directors and advisers in this context. She also has significant experience in regulatory and corporate investigations and has given oral testimony in both criminal and regulatory matters. Philippa has significant experience of professional accountants disciplinary inquiries, having advised in relation to four FRC cases including the conduct of advisers to MG Rover/the Phoenix Four, its first tribunal case, in which she gave evidence in 2013.

Philippa has a wide range of commercial disputes experience in the context of litigation, arbitration, expert determination, including professional negligence, loss of profits claims, M&A disputes, misrepresentation and insurance claims. She has acted as an accounting expert witness in international arbitration.



Fred Brown

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Fred has specialised in forensic and investigation work since 1990. He has acted as an expert witness in hundreds of matters and given evidence on ten occasions.

He leads the insurance practice within forensic. He has acted in professional negligence claims involving accountants including investigating the trading of a business in an audit negligence case that ran to trial and acting as the expert in a negligence claim involving business valuation.

Fred is regularly instructed as the expert in professional negligence claims involving other advisers, contractors and brokers. He gave evidence on the loss of profits arising in [2014] EWHC 3352 (Comm) Sugar Hut Group and others v A J Insurance, a broker negligence claim involving a fire at the Sugar Hut night club. He has also given evidence on behalf of a bank in a mis-selling claim. In addition to expert reports, Fred frequently prepares initial reviews, including for disclosure at mediation.

Speakers (continued)



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Adrian, a director in the Firm's technical team, has ten years' experience as a financial reporting specialist. He is consulted about IFRS and UK GAAP financial reporting issues affecting our audit and advisory clients, particularly in the technology, media and financial services sectors.

Adrian advises both clients and Grant Thornton on professional negligence and accounting misstatement matters as part of our Accounting integrity and conduct team. His experience as a financial reporting specialist who works in these areas enables him to provide unique insight on complex accounting issues that often form the backdrop to allegations of accounting misstatement and fraud, and audit negligence and related regulatory enquiries. Much of this work involves accounting for transactions, predominantly business combinations, revenue recognition and complex financial instruments.



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Jonathan, an associate director in Grant Thornton's forensic practice, has over 12 years' experience in accounting, auditing and investigations, including spending over three years experience working on forensic assignments and over six years experience managing audit assignments. He continues his involvement in audit work.

Jonathan has significant experience of financial reporting and accounting issues under IFRS and UK GAAP and extensive experience on international audit and advisory assignments.

Jonathan specialises in projects involving misconduct, accounting irregularities and associated professional negligence matters, advising both claimants and defendants as well as regulators on the professional liability and conduct of accountants and firms.

He also advises clients in the context of commercial litigation on matters including breach of contract and alleged fraud.



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