Edited for publication

THE EXECUTIVE COUNSEL TO THE FINANCIAL REPORTING COUNCIL

- a n d -

(1) KPMG LLP

(2) WILLIAM SMITH

EXPLANATORY MEMORANDUM TO THE SETTLEMENT AGREEMENT AND PARTICULARS OF FACT AND MISCONDUCT

The FRC has published the Settlement Agreement and Particulars of Fact and Misconduct agreed between the Executive Counsel to the FRC and (1) KPMG LLP and (2) William Smith ("the Respondents").

The Settlement Agreement reflects the terms of settlement agreed between the Executive Counsel and the Respondents, and has been approved by an independent person. In reaching the Settlement Agreement, it was not necessary for the Executive Counsel to receive or consider any evidence or representations from any parties other than the Respondents.

Accordingly this Settlement Agreement and Particulars of Fact and Misconduct has not made, and should not be taken to have made, any finding against any individual or entity other than the Respondents (including Quindell plc, any of its subsidiaries or any individual who was a director, member of management or employee at Quindell plc or any of its subsidiaries).

It would not be fair to treat any part of this Settlement Agreement and Particulars of Fact and Misconduct as constituting or evidencing findings against anyone other than the Respondents.

The published Settlement Agreement and Particulars of Fact and Misconduct anonymises several third parties, who are instead identified by ciphers. To assist readers with the intelligibility of these documents, and in order to understand the nature of the Misconduct found, the relationship between the cipher and the nature of the third party is set out below.

Cipher	Third party
A Solicitor’s Firm	a legal services business
A Costs Drafting Company	a legal costs drafting company
A Legal Firm	a legal services business
A Healthcare Company	a provider of healthcare services
Legal Services Company	a legal services company
Company 1	a purchaser of software and related services from Quindell plc
Company 2	a purchaser of software and related services from Quindell plc
Company 3	a purchaser of software and related services from Quindell plc
TP1	a company

IN THE MATTER OF

THE EXECUTIVE COUNSEL TO THE FINANCIAL REPORTING COUNCIL

-and-

(1) KPMG LLP

(2) WILLIAM SMITH

SETTLEMENT AGREEMENT

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1. This Settlement Agreement **("Agreement")** is made on 3 2ot tbetween Claudia Mortimore as the Interim Executive Counsel of the Financial Reporting Council **("the Executive Counsel")** and KPMG LLP **("KPMG")** and William Smith **("Mr Smith").** The Executive Counsel, KPMG and Mr Smith together are described as **"the Parties".** The Agreement is evidenced by the signatures of the Executive Counsel on her own behalf, by Jeremy Barton on behalf of KPMG and by Mr Smith on his own behalf.

2. The Particulars of Fact and Acts of Misconduct concerning KPMG and Mr Smith **("the Particulars")** were prepared by the Executive Counsel in accordance with the Accountancy Scheme **("the Scheme)** and are annexed. The Particulars relate to the conduct of each of KPMG and Mr Smith in relation to the audit of the financial statements of Quindell plc for the period ended **31** December 2013. KPMG and Mr Smith admit the Acts of Misconduct set out in the Particulars,

3. The Parties recognise that the determination to be made in this case is a matter for the Tribunal member in accordance with paragraph 8(4)(ii) of the Scheme.

Sanction

4. The Parties have agreed the following terms of settlement:

   a. That KPMG and Mr Smith each receive a Reprimand;

   b. That KPMG pay a Fine of £4,500,000 (discounted for settlement by 30% to £3,150,000).

   c. That Mr Smith pay a Fine of £120,000 (discounted for settlement by 30% to £84,000).

   d. The Fines shall be paid not later than 28 days after the date when this Agreement takes effect.

5, In determining the appropriate sanctions the Executive Counsel adopted the approach set out in paragraph 16 of the Sanctions Guidance, as follows:

Nature and Seriousness of the Misconduct

6. The Executive Counsel considers that the factors relevant to assessing the nature and seriousness of the Misconduct are:

    a. The Misconduct arose in connection with the audit of a listed company and in respect of financial statements that were subsequently re-stated, The restatement of the company's accounts and significant fall in the share price caused or risked the loss of significant sums of money and adversely affected a significant number of people in the United Kingdom,

    b. The Misconduct involved failing to comply with important auditing standards and included failings in relation to the exercise of professionbi scepticism. In those circumstances the Misconduct could undermine confidence in the standards of conduct in general of Members and/or in financial reporting and/or in the profession generally:

    c. As the engagement partner, Mr Smith was the senior member of the audit team with overall responsibility for the conduct of the audit.

    d. The Misconduct was not dishonest, deliberate or reckless and did not involve a failure to act with integrity.

    e. The Misconduct related to a single audit year and was the first year that KPMG or Mr Smith had audited the relevant entity.

    f. No financial benefit was derived or intended to be derived from the Misconduct, in that the fees received were unconnected with and not dependent on the failings identified.

Identification of Sanction

7. Having assessed the seriousness of the Misconduct and considered the range of available sanctions, the Executive Counsel considers that a Reprimand and a Fine is an appropriate sanction for each of the Respondents.

8. The Executive Counsel has taken into account aggravating and mitigating factors set out below, to the extent that they have not already been taken Into account in considering the nature and seriousness of the Misconduct. The Executive Counsel has also considered whether any adjustment to sanction for deterrence is required in this case, The conclusion reached is that the sanctions set out in paragraph 4 above are appropriate, having regard to the purpose of the Scheme.

Aggravating Factors

9, No aggravating factors have been identified.

Mitigating Factors

10. The following mitigating factors were identified:

a. Mr Smith has a good compliance history and disciplinary record.

b. [redacted]

. *Discount for Settlement*

11. Having taken into account the admissions made by KPMG and Mr Smith and the stage at which those admissions were made (in Stage 1 of the case in accordance with paragraph 59 of the Sanctions Guidance), the Executive Counsel has determined that a reduction of 30% as to the pine as a settlement factor is appropriate,

Amount of fine

12. The Executive Counsel considers that, having had regard to the circumstances of this case and the Parties, and previous relevant outcomes of cases under the Scheme, fines of £4,500,000 and £120,000 for KPMG and Mr Smith respectively are proportionate to the Misconduct and will act as an effective deterrent. In accordance with paragraph 32(iii) of the Sanctions Guidance, the Executive Counsel has taken into account the financial resources of KPMG and Mr Smith and whether there are arrangements that would result in part or all of the Fine being paid or indemnified by Insurers.

Costs

13. The Parties have agreed the following terms of settlement for costs:

a. That the sum of £146,000 be paid by KPMG as an appropriate contribution to the costs of, and incidental to, the investigation in respect of KPMG and Mr Smith.

b. The costs shall be paid no later than 28 days after the date when this Agreement takes effect, In accordance with paragraph 62 of the Sanctions' Guidance, in reaching the agreement as to costs the Executive Counsel has taken into account the financial position of KPMG and the impact of the Fine above; and whether there are arrangements that would result in part or all of any award of costs being paid or indemnified by insurers.

14. If the decision Is to approve the Settlement Agreement, including the sanctions set out above, then the Settlement Agreement shall take effect from the next working day after the date on which the notice of the decision is sent to KPMG and Mr Smith in accordance with paragraph 8(4)(iv) of the Scheme.

[redacted]

Claudia Mortimore

Interim Executive Counsel

9 May 2018

Date

[redacted]

Jeremy Barton

On behalf of KPMG LLP

8th May 2018

Date

[redacted]

William Smith

8th May 2018

Date

Edited for publication

IN THE MATTER OF:

THE EXECUTIVE COUNSEL TO THE FINANCIAL REPORTING COUNCIL

-and-

(1) KPMG LLP
(2) WILLIAM SMITH

PARTICULARS OF FACT AND ACTS OF MISCONDUCT

INTRODUCTION

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

2. On 14 July 2015 the Conduct Committee of the FRC directed the Executive Counsel to investigate the conduct of the Respondents (and others) in relation to:

   "the preparation, approval and audit of the financial statements of Quindell Plc for the period ended 31 December 2011 to the year ended 31 December 2013 and for the preparation and review of the company's interim results for the half year ended 30 June 2014."

3. This is the Executive Counsel's Particulars of Fact and Acts of Misconduct ("**the Particulars**") in respect of KPMG LLP ("**KPMG**") and William Smith ("**Mr Smith**", together "**the Respondents**") as regards their conduct in relation to the audit of the financial statements of Quindell plc ("**Quindell**")[1] for the period ended 31 December 2013 (**"the Financial Statements"**).

[1] In 2011, Quindell Ltd was acquired by Mission Capital Plc in a reverse acquisition. Mission Capital Plc was renamed Quindell Portfolio Plc (QPP). In December 2013 QPP was renamed Quindell Plc.

THE RESPONDENTS

4. KPMG is a member firm of the Institute of Chartered Accountants in England and Wales ("**ICAEW**") and Mr Smith is a member of ICAEW; consequently KPMG is a Member Firm and Mr Smith is a Member for the purposes of the Accountancy Scheme.

5. KPMG was appointed auditor of Quindell and its subsidiaries in October 2013. Mr Smith was the audit engagement partner responsible for the conduct of the audits and providing the audit opinion on the Financial Statements.

STANDARDS

Misconduct

6. Paragraph 2(1) of the Accountancy Scheme defines an "Adverse Finding" (inter alia) as a "*finding by a Disciplinary Tribunal that a Member or Member Firm has committed Misconduct*." "Misconduct" is defined under Paragraph 2(1) of the Scheme as:-

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

The relevant standards of conduct

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

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

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

The applicable technical standards

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

ISA 200 (Overall objectives of the independent auditor and the conduct of an audit in accordance with International Standards on Auditing)

10. ISA 200 sets out the objectives and general principles governing an audit of financial statements.

11. ISA 200, Paragraph 11(a) requires an auditor to:

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

The applicable financial reporting framework in this case was the International Financial Reporting Standards ("IFRSs").

Paragraph 15 provides that:

"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."

Paragraph 17 further provides that:

"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 220 (Quality control for an audit of financial statements)

12. ISA 220 sets out the specific responsibilities of an auditor regarding quality control procedures for the audit of financial statements.

13. The Engagement Partner is defined in Paragraph 7(a) of ISA 220 as:

"The partner or other 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..."

ISA 220 further provides, at Paragraph 15:

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

ISA 500 (Audit evidence)

14. ISA 500 sets out the auditor's responsibility to design and perform audit procedures to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the audit opinion.

Paragraph 6 provides:

"The auditor shall design and perform audit procedures that are appropriate in the circumstances for the purpose of obtaining sufficient appropriate audit evidence."

Paragraph 7 provides:

"When designing and performing audit procedures, the auditor shall consider the relevance and reliability of the information to be used as audit evidence."

Paragraph 9 provides:

"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."

Paragraph 10 further provides:

"When designing tests of controls and tests of details, the auditor shall determine means of selecting items for testing that are effective in meeting the purpose of the audit procedure."

BACKGROUND- QUINDELL

15. Quindell Ltd was founded in 2000 [...]. In 2011, Quindell Ltd was acquired by Mission Capital Plc in a reverse acquisition, in order to gain an AIM listing. Quindell experienced significant growth in the following years, acquiring a number of other businesses and reaching a market capitalisation of £2.7 billion in April 2014. Quindell was the holding company of a group with a number of subsidiaries.

16. Quindell's 2013 annual report describes the company as *"...a provider of sector leading expertise in Software, Consulting and Technology Enabled Outsourcing in its key markets being Insurance, Telecommunications and their Related Sectors."* The Quindell group included two divisions:

    (a) The Services Division included a number of businesses providing legal services and claims management and related services to the insurance industry. The principal subsidiary in this Division was [Legal Services Company].

    (b) The Solutions Division provided technology (primarily software) to the insurance and telecoms sectors. The principal subsidiary in this Division was Quindell Enterprise Technology Solutions Limited ("QETS").

[Legal Services Company]

17. [Legal Services Company] provided legal services, principally to individuals who had suffered personal injury. The 2013 annual report for [Legal Services Company] states:

> *"[Legal Services Company] is an industry leading provider of legal services, focusing on claimant personal injury.*

Our Strategy

[Legal Services Company] is part of the Services division of Quindell pic, which is a leading provider of expertise in Software, Consulting and Technology-Enabled Outsourcing in insurance, telecommunications and their related sectors. We are therefore uniquely placed within the personal injury legal sector to take advantage of the regulatory and legislative changes by working with companies within the Group and other partners providing an end to end solution for our customers, that as a group includes treating the injured party, repairing their vehicle and providing a replacement vehicle, as well as managing their claim for personal injury. As a result there has been a significant growth in our customer and partner base as well as our own operational structure to support such growth."

18. The largest element of [Legal Services Company] was [A Solicitor's Firm] which generated the majority of revenue in 2013. The 2013 annual report for [Legal Services Company] states:

" the Company began trading on 21 December 2012 after the granting of a licence for an Alternative Business Structure (ABS) and the subsequent acquisition of [A Solicitor's Firm]."

19. [A Solicitor's Firm] was one of three established legal services businesses acquired by [Legal Services Company] in 2012.

Quindell Enterprise Technology Solutions Limited

20. QETS provided software and associated services. Most of its revenue was generated by the sale of software licenses and consultancy services. The 2013 annual report for QETS states:

"[QETS] *provide a platform to deliver disruptive business transformation solutions that improve efficiency and effectiveness in our core markets, while driving down costs. At the same time, this strategy is enabling us to use this platform to develop combined propositions that are compelling beyond traditional silo offerings, for the marketplace to achieve significant organic growth through extension of their brands in this period of major technology and regulatory change…"*

BACKGROUND - THE 2013 FINANCIAL STATEMENTS

21. Quindell produced consolidated financial statements for the year ended 31 December 2013, which were signed on 29 March 2014. The financial statements included an unqualified audit opinion.

22. Group revenue in 2013 was £380.1m, divided into £80.4m for the Solutions Division and £299.7m for the Services Division. Profit after tax for the group was £82.7m.

The 2014 Restatements

23. The 2014 Quindell financial statements (**"the 2014 Financial Statements"**) included a series of restatements made to the 2013 financial statements, the effect of which were to:

    (a) Reduce revenue from £380.1m to £246.6m, a drop of £133.5m. This consisted of a £31.1m reduction in revenue for the Solutions Division and a £102.4m reduction for the Services Division.

    (b) Reduce group profit, changing a profit of £82.7m to a loss of £67.7m. This was a drop of £150.4m.

    The restatements included significant reductions in revenue and profit relating to legal services revenue and certain software transactions.

24. For the avoidance of doubt, not all of the restatements in the 2014 Financial Statements related to the matters described in this document.

Legal Services Revenue

25. [Legal Services Company] charged for legal services in personal injury cases on a ‘no win, no fee’ basis. As a result, [Legal Services Company] received little or no payment from an individual case until after it had settled. For many cases this could take over a year.

26. Up to the end of 2013, Quindell’s policy was to account for revenue earned on cases according to the estimated percentage of work completed on each case.

27. However, as part of the 2014 restatements, Quindell retrospectively changed their accounting policy for legal services revenue, from recognising revenue based on work in progress to a more prudent policy i.e. recognising revenue only once liability was admitted or a case was settled. This resulted in a £94.4m reduction in legal services revenue for 2013, and a £94.4m reduction in profit.

Software Transactions

28. In 2013, [subsidiaries of] Quindell sold software and related services to three customers: [Company 1], [Company 2] and [Company 3]. Six of these transactions resulted in £23.4m of revenue in the Financial Statements. This was over 25% of the total revenue for the Solutions Division.

29. For each sale there were other transactions, with the same company:

(a) With [Company 1]:

(i) [QETS] purchased software from [Company 1], for use in [A Healthcare Company] (a consolidated subsidiary of Quindell).

(ii) Quindell made a loan to [Company 1].

(b) With [Company 2]:

(i) Quindell purchased software from [Company 2].

(c) With [Company 3]:

(i) Quindell invested in various entities within [Company 3] group.

30. However, during the course of the 2014 audit it was established that:

(a) The software purportedly sold to [Company 3] UK and [Company 3] US had not been provided, and it was not clear what, if any, software had been provided to [Company 1].

(b) The software purportedly sold to [Company 3] Canada had been provided but had not been used.

(c) The software sold to [Company 2] had been provided and had been implemented, but there had been no onward sales.

(d) There had been significant delays in implementing the software purchased from [Company 1] for [A Healthcare Company], and the implementation was not complete.

(e) [Company 1] were in financial difficulty and had been unable to repay the loan made to them by Quindell as part of the [Company 1] transactions.

(f) [...].

(g) No cash passed between [the relevant Quindell entities] and [Company 1], or [the relevant Quindell entities] and [Company 3], as part of the transactions. Instead, the cash was paid and received via [Quindell's lawyers].

31. The 2014 Financial Statements included prior year adjustments in respect of the sales to [Company 2] and [Company 3]. All of the revenue and profit in relation to [Company 2] and [Company 3] was eliminated. This amounted to a reduction of £9.1m revenue and £9.1m profit for [Company 2], and £9.4m revenue and £9.4m profit for [Company 3].

32. However, the revenue and profit for the [Company 1] transactions were left unchanged.

THE FACTUAL BACKGROUND TO THE ADMITTED ACTS OF MISCONDUCT

LEGAL SERVICES REVENUE - ACCOUNTING

Unbilled revenue and the Work in Progress ("WIP") model

33. The 2013 Quindell annual report provides the following information in relation to the accounting policy for the revenue for these cases:

> *"Revenue from legal services is recognised based on the estimated stage of completion at the period end date. Income can be reliably estimated based on fixed fees established by the Civil Procedures Rules used by the courts in England and Wales and estimates of any fixed and variable fees agreed with clients. Individual case life may span a number of months. Revenue is recognised across the expected life of each case, in line with the typical level of effort expended in relation to that case type, taking into account the total income expected to be earned on that case type. This will include an assessment of fees for cases that are anticipated to be concluded successfully. Costs incurred during the life of a case can be reliably estimated based on contractual terms with suppliers and estimates of internal resource. Such costs are recognised in the income statement across the expected life of the case, on the same basis as the revenue is recognised."*

34. Thus, where a case had not concluded, [Legal Services Company]'s policy was to recognise revenue according to the amount of work performed on each case by the end of the year. This was "Work in Progress" ("WIP").

35. Movement in unbilled revenue (WIP), from one year end to the next, was recognised as revenue in the Financial Statements. Movement in unbilled revenue resulted in the recognition of £92.64m of revenue in 2013, which was 63.4% of the total revenue for [Legal Services Company] and 24.4% of the total group revenue. It was the largest single element of revenue for the group.

36. Usually, a company would estimate WIP using timesheets completed by employees and recording time spent on each case. However, [Legal Services Company] staff did not record their time. Instead, [Legal Services Company] used the WIP model, an Excel spreadsheet produced by their finance staff, which included assumptions about the amount of time spent and the overall duration for each type of case.

37. The WIP model applied a formula that was intended to represent [Legal Services Company]'s revenue recognition policy (the **"WIP Formula"**). It used a number of inputs to estimate WIP for each type of case, based on how long it had been open. In summary:

(a) The WIP model covered five main types of case. For each case type the formula applied was the same, but the inputs were different. These case types were:

(i) 'MOJ' – Road Traffic Accident (RTA) cases which proceeded under the pre-action protocol for low value personal injury cases; processed using the Ministry of Justice ("MOJ") online portal

(ii) 'PIFT (thought to stand for Personal Injury Fast Track)' – RTA non-portal cases;

(iii) 'ELPL' – Employer's Liability (EL) accident and Public Liability (PL) accident cases;

(iv) 'IDC' (Industrial Disease Claims) – EL disease cases;

(v) 'MT' – all Multi Track cases (more complex cases or cases where estimated damages exceed £25,000, which could not be processed using the portal).

(b) The WIP Formula, correctly stated, was: *number of cases x ((average fee per case + client deduction) x WIP curve) x (1-dilution provision percentage)*.

(i) The "average fee per case" referred to the total fees expected to be charged over the lifetime of the case.

(ii) 'Client deduction' referred to a success fee charged to compensate for the risks of taking on a 'no win, no fee' case, which was deducted from the client's damages, if obtained.

(iii) 'WIP curve' is a row of percentages for each specific case type – the percentages provide an estimate of the proportion of the total work on the case completed in each month since the case was opened. For example, in an 'MOJ' case, 81% of work is assumed to be performed in month one, and 5% in month two, with the work assumed to be completed within seven months.

(iv) ‘Dilution provision’ referred to the average failure rate for the particular type of case – the percentage of cases of that type that are not expected to result in any revenue for [Legal Services Company].

The accounting treatment of legal revenue

38. The relevant accounting standard is IAS 18, revenue.

Paragraph 20 of IAS 18 states:

“When the outcome of a transaction involving the rendering of services can be estimated reliably, revenue associated with the transaction shall be recognised by reference to the stage of completion of the transaction at the end of the reporting period. The outcome of a transaction can be estimated reliably when all the following conditions are satisfied:

(a) the amount of revenue can be measured reliably;

(b) it is probable that the economic benefits associated with the transaction will flow to the entity;

(c) the stage of completion of the transaction at the end of the reporting period can be measured reliably; and

(d) the costs incurred for the transaction and the costs to complete the transaction can be measured reliably.”

Paragraph 26 of IAS 18 states:

“When the outcome of the transaction involving the rendering of services cannot be estimated reliably, revenue shall be recognised only to the extent of the expenses recognised that are recoverable.”

Paragraph 28 of IAS 18 states:

"*When the outcome of a transaction cannot be estimated reliably and it is not probable that the costs incurred will be recovered, revenue is not recognised and the costs incurred are recognised as an expense…*"

39. In the case of the WIP model:

    (a) the average fee per case and client deduction assumptions were [Legal Services Company]'s estimate of the amount of revenue;

    (b) the WIP curve assumption was [Legal Services Company]'s estimate of the stage of completion of the work; and

    (c) the dilution provision (failure rate) was [Legal Services Company]'s estimate of the proportion of cases where no future economic benefits (payments) would be received.

40. According to IAS 18 Paragraph 20, each of these estimates needed to be reliable in order for revenue to be measured reliably according to stage of completion, as per Quindell's policy.

41. IAS 18 Paragraphs 26 and 28 state that, if this is not the case, then only recoverable costs can be recognised as revenue. However, if it was not probable that the costs would be recovered, then no revenue would be recognised.

42. As [Legal Services Company] charged for legal services in personal injury cases on a 'no win, no fee' basis, they would only recover their costs if the case was successful. Recognising revenue on the basis of recoverable costs would also therefore depend, partly, on the reliability of the dilution provision (failure rate) assumption.

SOFTWARE TRANSACTIONS - ACCOUNTING

43. Each of the software transactions with [Company 1], [Company 2], and [Company 3] bore striking similarities to the others. For each transaction there were other transactions, with the same company, that appeared to be linked to the sale. Each pair, or group, of transactions involved pairs of cash flows at or around the same time. Each pair of cash flows consisted of one outward cash flow, paid by [a Quindell group company] to a company, and one inward cash flow, paid by the same company to [another Quindell group company].

The [Company 1] transactions

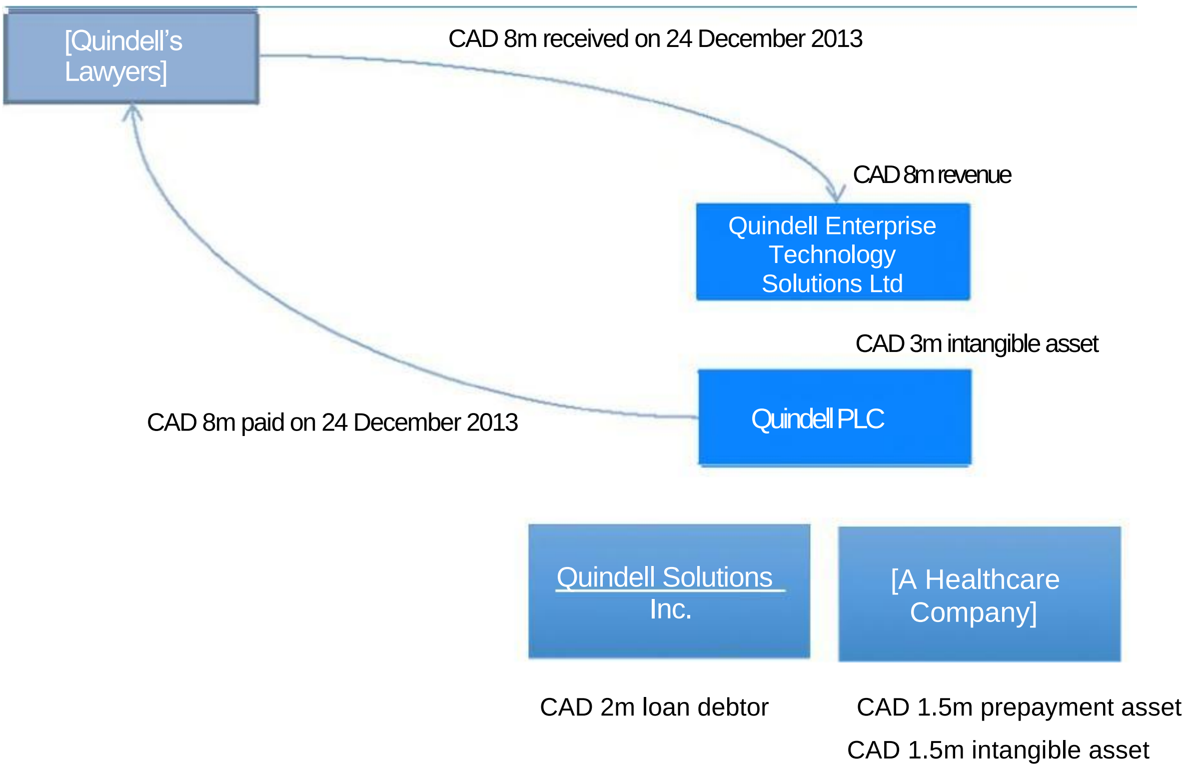
44. [Company 1] was a small company developing software for the health industry. It was listed on the TSX – Venture exchange, the junior market of the Toronto Stock Exchange in Canada.

45. [A Healthcare Company] was consolidated as a subsidiary of Quindell in 2013. Quindell's 2013 annual report describes the company as:

> *"...a leading provider of healthcare and rehabilitation services with over 100 physiotherapy and rehabilitation clinics across Canada."*

46. Quindell Solutions Inc. was a Canadian subsidiary of Quindell.

47. The following cash flows took place between [Company 1] and [Quindell group companies][2]:



[2] CAD refers to Canadian dollars, the exchange rate was CAD 1.7367 : £1 on 24 December 2013

(a) CAD 8m paid to [Quindell's lawyers], on 24 December 2013. This was accounted for as follows:

(i) CAD 3m for the purchase of a software licence from [Company 1].

(ii) CAD 3m for the purchase of consultancy services from [Company 1], on behalf of [A Healthcare Company], in respect of implementation of the software purchased by [QETS]. Specifically:

- CAD 1 .5m as a prepayment.
- CAD 1.5m capitalised as an intangible asset.

(iii) CAD 2m loan from [Quindell Solutions Inc] to [Company 1].

(b) CAD 8m received from [Quindell's Lawyers] on the same day, 24 December 2013. This was accounted for as follows:

(i) CAD 5m software licence sale from Quindell to [Company 1].

(ii) CAD 3m consultancy services provided by Quindell to [Company 1] in respect of implementation of the software purchased by [Company 1].

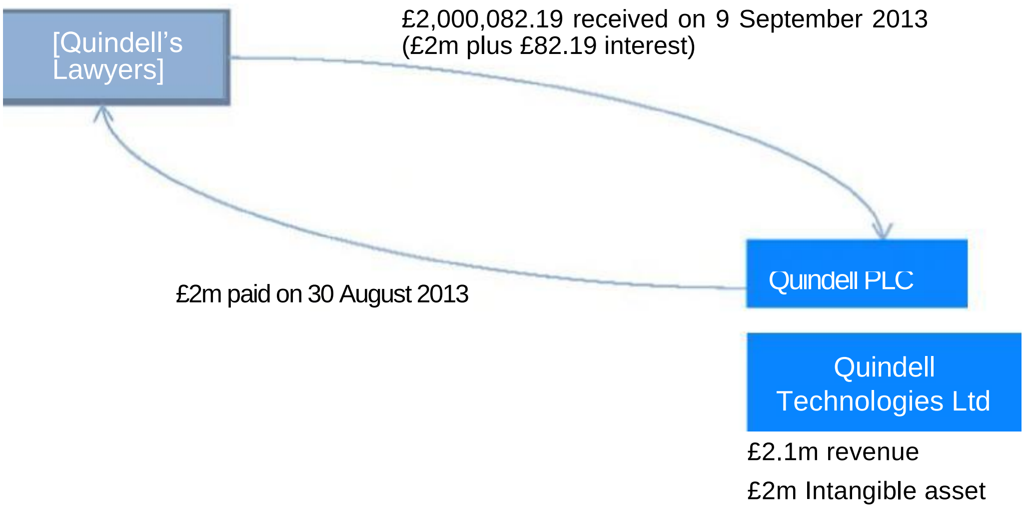
The [Company 2] transactions

48. [Company 2] was a small software company. [Company 2] had investments in other software companies, including a wholly owned subsidiary and an 80% stake in another company. However, it did not produce consolidated accounts as it applied an exemption for small companies.

49. Quindell Limited was renamed Quindell Technologies Limited on 2 December 2013.

50. The following cash flows took place between [Company 2] and Quindell:

(a) In August/September 2013:

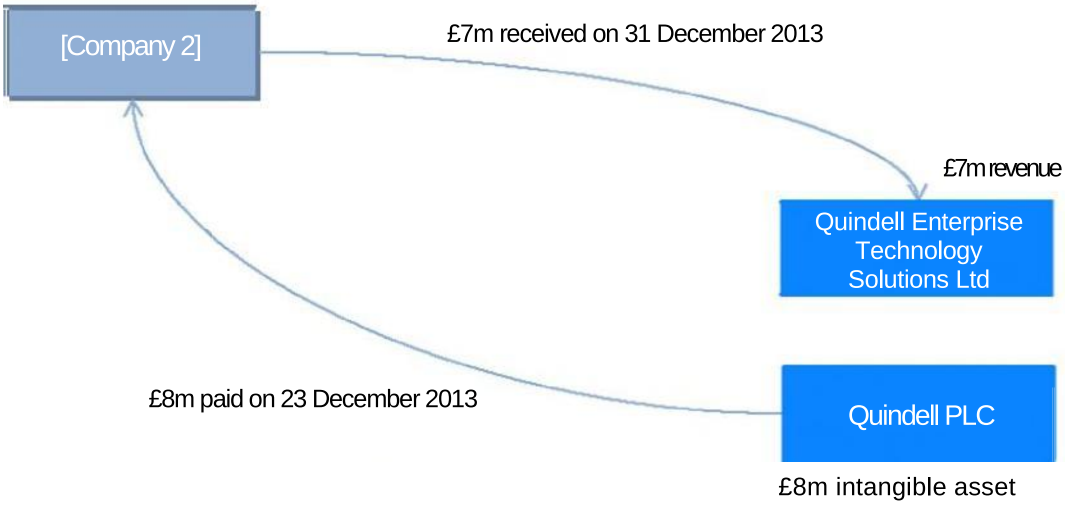


(i) £2m paid to [Quindell's lawyers], on 30 August 2013. Accounted for as the purchase of a software licence and distribution agreement.

(ii) £2,000,082.19 received from [Quindell's Lawyers] less than two weeks later.

- £82.19 accounted for as interest received.
- £2m accounted for as the sale of a software licence and distribution rights for £2.1m.

(b) In December 2013:



(i) £8m from Quindell to [Company 2] on 23 December 2013, accounted for as the purchase of an extended, global, software licence and distribution agreement.

(ii) £7m from [Company 2] to Quindell just over a week later, accounted for as the sale of an extended, global, software licence and distribution agreement.

The [Company 3] transactions

51. [Company 3]'s financial statements for the year ending 31 December 2012 state that its principal activity was to:

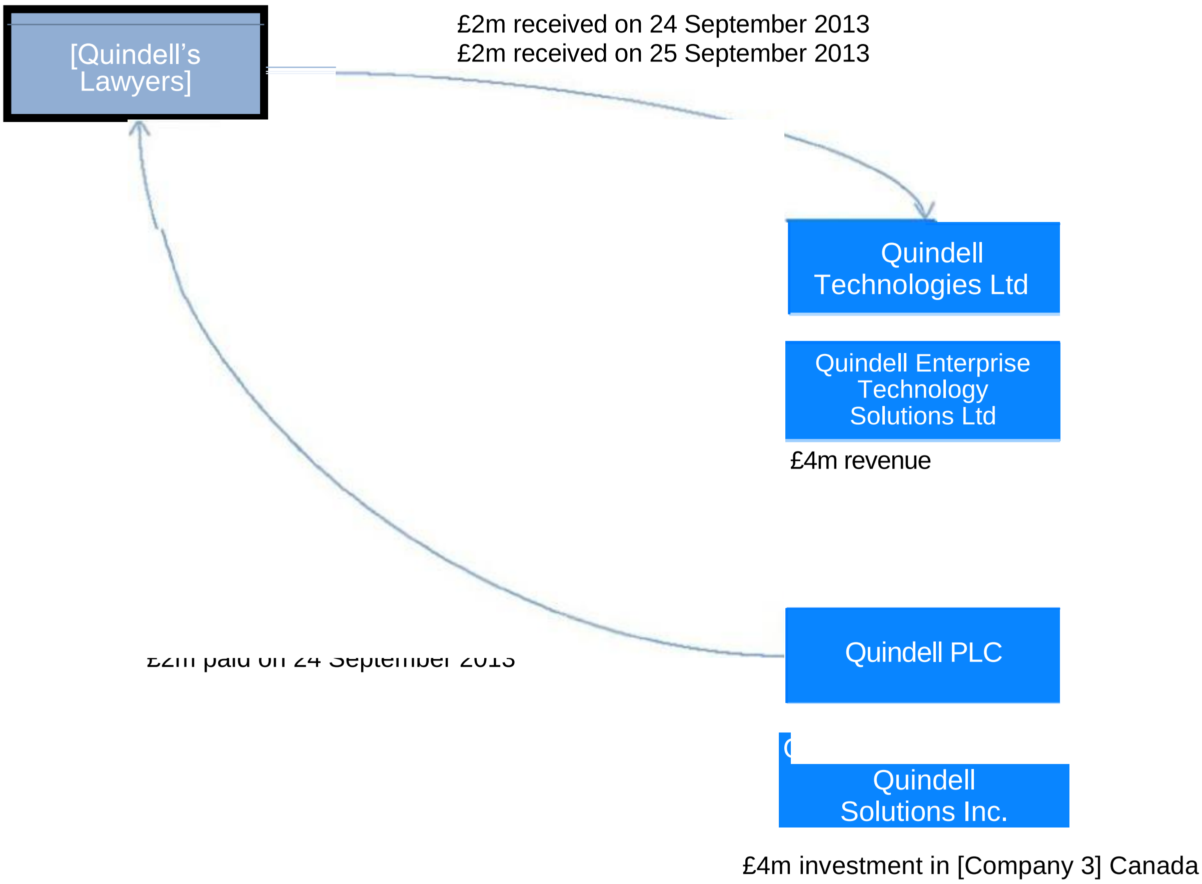
> *"...provide insurance intermediary services and to develop telematics-based technology relating to the provision of car insurance"*

52. [Company 3] had a number of subsidiaries, including [Company 3] UK, [Company 3] Canada and [Company 3] USA.

Edited for publication

53. The following cash flows took place between [Company 3] and Quindell:

(a) On 23 – 25 September 2013, the “Canada transactions”:

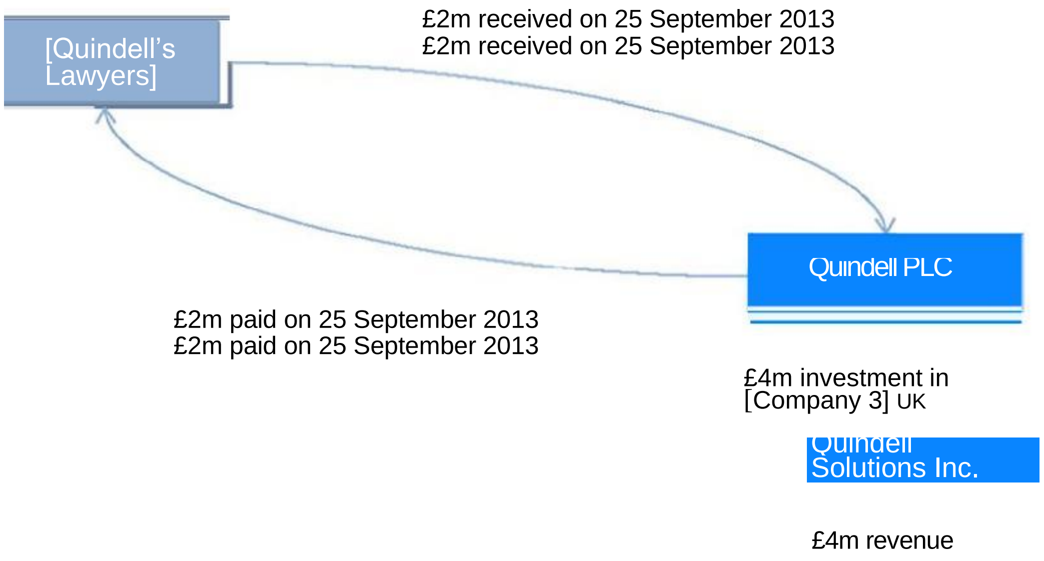


(i) Two £2m payments to [Quindell’s Lawyers], on 23 and 24 September 2013. Accounted for as the purchase of 40% of [Company 3] Canada.

(ii) Two £2m payments received from [Quindell’s Lawyers], each one day later. Accounted for as follows:

- £3m software licence sale from Quindell to [Company 3] Canada.
- £1m consultancy services provided by Quindell to [Company 3] Canada, in respect of implementation of the software purchased.

(b) On 25 September 2013, the "UK transactions":

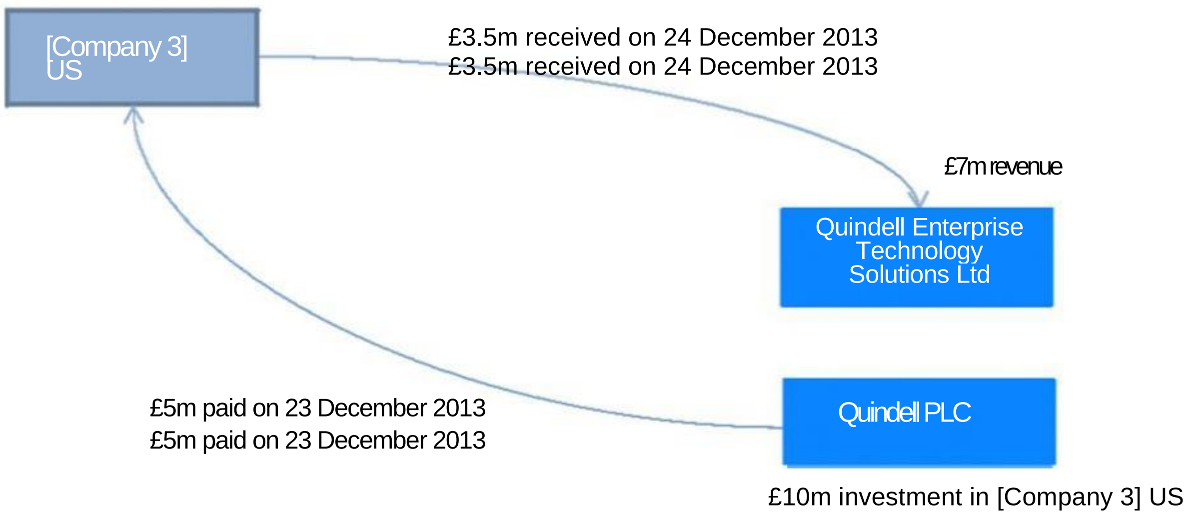


(i) Two £2m payments to [Quindell's lawyers], on 25 September 2013. Accounted for as the purchase of 40% of [Company 3] UK.

(ii) Two £2m payments received from [Quindell's Lawyers], on the same day. Accounted for as follows:

- £3m software licence sale from Quindell to [Company 3] UK.
- £1m consultancy services provided by Quindell to [Company 3] UK, in respect of implementation of the software purchased.

(c) On 23 – 24 December 2013, the “US transactions”:



(i) Two £5m payments to [Company 3] US on 23 December 2013, accounted for as the purchase of 40% of [Company 3] US.

(ii) Two £3.5m payments received from [Company 3] US the following day, accounted for as the sale of a software licence.

54. £1m of the revenue for services was deferred at year-end, and £4.6m of the revenue was eliminated on consolidation, as the [Company 3] entities were considered associates at the time of the transactions.

55. In total, £9.4m of revenue was recognised in relation to the [Company 3] transactions in 2013.

Features of the transactions

56. For each set of transactions, a number of distinctive features were present:

(a) The outward cash flow (paid by Quindell [or the relevant Quindell entity]) preceded the inward cash flow (received by Quindell [or the relevant Quindell entity]);

(b) The cash flows occurred within two weeks of each other. In two cases, the cash flows were exchanged on the same day

(c) The outward cash flow and inward cash flow were often for the same amount, and, where they were different, the outward cash flow was greater than the inward cash flow;

(d) Both cash flows were for round-sum amounts;

(e) The contracts for the outward and inward cash flows were agreed at the same time, or the contracts were signed at different times but there were indications that they were agreed at the same time;

(f) A key contact at the transacting company was a former senior executive at [TP1], a company previously founded by [a member of Quindell's senior management] ; and

(g) The most recent published financial statements for the company indicated that, without the inward cash flow, they might not have been able to pay the outward cash flow.

57. In addition, in most cases:

(a) The cash was paid and received via [Quindell's lawyers]; and

(b) Quindell bought a stake in the transacting company at the same time as agreeing the transactions.

58. The following tables summarise some key features of the transactions:

	Cash flows exchanged on the same day	Date(s) of cash flows		Cash flows exactly the same amount	Amount (s)	
		Outward	Inward		Outward	Inward
[Company 1]	✓	24 Dec			CAD 8m	
[Company 2] (1)		30 Aug	9 Sep		£2m	
[Company 2] (2)		23 Dec	31 Dec		£8m	£7m
[Company 3] (1)		23 & 24 Sep	24 & 25 Sep	✓	2 x £2m	
[Company 3] (2)		25 Sep		✓	2 x £2m	
[Company 3] (3)		23 Dec	24 Dec		2 x £5m	2x £3.5m

	Money paid and received via Quindell's lawyers	Quindell bought a stake in company	Round sum amounts	Indications contracts agreed at the same time	Company accounts indicated they might not have been able to afford purchase	Key contact's former role at [TP1]
[Company 1]						**[...]**
[Company 2] (1)						**[Member of Company 2's senior management]**
[Company 2] (2)				✓	✓	
[Company 3] (1)						**[Member of Company 3's senior management]**
[Company 3] (2)		✓	✓	✓	✓	
[Company 3] (3)						

59. For each pair of cash flows, Quindell recognised the following:

(a) For the outward cash flows (paid by Quindell [or the relevant Quindell entity]) it recognised an asset on the balance sheet, either as (i) an intangible asset, relating to the purchase of a software licence, distribution rights or installation services; (ii) a stake in the transacting company; or (iii) a loan.

(b) For the inward cash flows (received by Quindell [or the relevant Quindell entity]) it recognised revenue, for the sale of a software licence or installation services.

The accounting treatment of the transactions

60. The relevant accounting standard is IAS 18, revenue.

IAS 18 Paragraph 9 states:

"Revenue shall be measured at the fair value of the consideration received or receivable."

IAS 18 Paragraph 7 states:

"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."

IAS 18 Paragraph 12 states:

"When goods are sold or services rendered in exchange for dissimilar goods or services, the exchange is regarded as a transaction which generates revenue. The revenue is measured at the fair value of the goods or services received, adjusted by the amount of any cash or cash equivalents transferred. When the fair value of the goods or services received cannot be measured reliably, the revenue is measured at the fair value of the goods or services given up, adjusted by the amount of any cash or cash equivalents transferred."

IAS 18 Paragraph 13 states:

"...the recognition criteria are applied to two or more transactions together when they are linked in such a way that the commercial effect cannot be understood without reference to the series of transactions as a whole."

61. Under normal circumstances, the revenue earned for the sale of a software licence is measured according to the agreed price; the amount ultimately received in cash.

62. However, if there are indications that the transaction is not at arm's length, then it is necessary to consider whether the agreed price represents the fair value of the consideration received.

63. If two or more transactions are linked, as described in IAS 18 Paragraph 13 above, then they should be considered together.

64. If the transactions were, in substance, an exchange of goods or services then IAS 18 Paragraph 12 requires the measurement of the fair value of either (i) the goods or services received, or (ii) those given up.

LEGAL SERVICES REVENUE - AUDIT

65. As the revenue recognised in respect of each main case type was material at the Group level, the auditors needed to obtain sufficient appropriate evidence that each input into the WIP model was reliable, and consequently that revenue recognition was appropriate.

66. The auditors also needed to check that the appropriate calculation was being performed correctly within the WIP spreadsheet, so that the published accounting policy was being correctly applied.

WIP spreadsheet

67. The audit team planned to test the WIP model spreadsheet itself, to ensure that it was performing the calculation correctly. The audit team checked the WIP Formula as applied by the spreadsheet, but failed to identify that it was incorrect, leading to a material misstatement.

68. The audit team failed to identify that the incorrect formula used in the WIP model did not multiply the client deduction by the WIP curve.

69. The practical effect of this error was that the client deduction (success fee) was being recognised in full at the beginning of the case. Revenue was overstated by £4.6m as a result. [Legal Services Company] component materiality was £2m and group materiality was £4m.

70. The work evidencing the audit team's review of the formula was not finished, was not marked as reviewed, and was not filed on the audit file.

WIP curves – all case types

71. For MOJ, PIFT and ELPL cases, the audit team established that [Legal Services Company] created the WIP curves based on its understanding of the business and by randomly selecting 79 cases and costing them by time. The audit team selected three cases from the 79, and reviewed them in detail to check that work had progressed in line with the assumptions in the WIP model.

72. The WIP model contained over 56,000 cases. The audit team reviewed only three cases in detail, and did not review any PIFT case in detail. PIFT cases contributed £43.1m to unbilled revenue.

73. The three cases reviewed in detail were chosen from within the 79 cases previously chosen by [Legal Services Company]. Therefore within the population being audited, most of the cases had no chance of being selected for testing.

74. The working papers do not record any consideration by the audit team of: (i) why [Legal Services Company] management had selected the 79 cases or (ii) whether 79 was a sufficient number. The working papers demonstrate that the audit team confined their testing to [Legal Services Company]'s selection – they did not test any cases from the wider population. The working papers do not record any explanation of why the audit team considered this to be appropriate.

75. Furthermore, the working papers do not explain how the audit team concluded whether the 79 cases selected by [Legal Services Company] were representative of the total population, particularly given that they did not compare any of the 79 cases with the wider population. There was evidence that the 79 cases were not representative – the average lengths of PIFT and ELPL cases within the 79 are significantly shorter than the average length for those case types used in the WIP model.

76. The 79 cases also included a substantial amount of work which was performed by other companies, rather than by [Legal Services Company], and so, without clear justification, that work should not have been included in the revenue calculations.

77. The audit team relied on the testing of three from the 79 cases to support their conclusion that the WIP curves for MOJ, PIFT and ELPL cases were appropriate. These case types contributed £19m, £43.1m and £20.8m respectively to unbilled revenue.

78. [Legal Services Company]did not believe that they had appropriate data to provide an accurate WIP curve for IDC cases. Instead, they decided to use the ELPL WIP curve. The audit team did not review any IDC cases, as the only ones available were at an early stage. IDC cases contributed £17.5m to unbilled revenue.

79. The audit team identified that no exercise had been conducted to cost Multi Track cases – the Multi Track WIP curve was based on management judgement, rather than any data. [Legal Services Company]explained that, because Multi Track cases were so varied, costing a number of cases would not provide an accurate WIP curve. The audit team did not review any Multi Track cases. Multi Track cases contributed £9m to unbilled revenue.

Dilution rates – PIFT, ELPL and Multi Track case types

80. The audit team established that [Legal Services Company]based their dilution provision (expected failure rates) on their understanding of each case type. The audit team commented:

> *"Due to the changing nature of the business (rapid growth, change in strategy) it means that historic data cannot be used to form an exact answer and therefore the percentages are very much based on subjectivity".*

81. For PIFT and ELPL cases, the testing was based on seven months of data provided by [Legal Services Company]: four months of data covering cases opened 20-23 months previously, and three months covering cases opened 11-13 months previously. For both PIFT and ELPL cases, the older data set showed significantly higher failure rates than the newer data set. Given that the average lives of PIFT and ELPL cases were 16 and 17 months respectively, the newer data set would have included a number of ongoing cases which might yet fail. The newer data set would therefore be expected to show a below average failure rate. Because of this, the older data set was more reliable for the purposes of estimating failure rates.

82. However, the audit team concluded that the data sets indicated a drop in failure rates:

> *"...which can be attributed to changes in the business (with rapid growth) which has also meant the business becoming a lot slicker (more robust and automated) in order to deal wit* [sic] *squeezed margins. Based on the fact that business has pushed to reduce fail rates in order to aid margins, it seems reasonable to expect a dilusion* [sic] *rate below those seen in 2012."*

83. No evidence was identified in the working papers to support [Legal Services Company]'s assertion that [Legal Services Company] had reduced failure rates through improved processes.

84. Indications on the audit file suggest that the audit team intended to test the dilution provision for Multitrack cases, but no tests were performed.

Average fee per case – IDC cases

85. Two average fee figures were used in the WIP model for IDC cases; £10,000 was used for cases opened before April 2013, and £5,997 was used for cases from April 2013 onwards. However:

(a) The audit team did not perform any audit work on the £10,000 pre-April 2013 figure. Apart from its inclusion in the WIP model, there is no mention or explanation of this figure in the working papers.

(b) The audit team established that Quindell had derived the post-April 2013 figure, £5,997, from ten cases from another law firm . There is no evidence in the working papers that the audit team (i) tested the data, (ii) queried the source of the data or (iii) questioned why the average figure was based on only ten cases.

The £10,000 pre-April 2013 figure gave rise to £1m of revenue and the £5,997 post-April 2013 figure gave rise to £11.3m of revenue.

86. The audit team requested further evidence, and [Legal Services Company]prepared a paper asserting that they had obtained case data from a firm of solicitors outside the Quindell group, [A Legal Firm]. The paper states that the average fees for the last 100 IDC cases settled by [A Legal Firm] was £4,697. This was £1,300 lower than the post-April 2013 figure used for IDC cases in the WIP model.

87. [Legal Services Company]also asserted that they would earn two types of additional fees, on top of the average fees earned by [A Legal Firm]: (i) the ["Costs Drafting Company Uplift"] of £1,302 and (ii) the "Additional Work" of £1,288.

88. The ["Costs Drafting Company Uplift"] was [Legal Services Company]'s assertion that, because they had acquired a cost drafting company named [Costs Drafting Company], they would earn extra fees of around 20-30%. However, the audit team noted that *"Due to the inherent uncertainty and lack of evidence for the uplift in costs that the [Costs Drafting Company] involvement will achieve, it would be imprudent to assume this uplift."*

89. The “Additional Work” was [Legal Services Company]’s assertion that extra work would be required because of the introduction of the Ministry of Justice portal for IDC cases. However, the Ministry of Justice portal was a streamlined process that was introduced to reduce legal fees[3]. Therefore it was likely that fees would reduce after the introduction of the portal, rather than increase as claimed by [Legal Services Company].

SOFTWARE TRANSACTIONS - AUDIT

90. During planning, the audit team designated revenue recognition for technology contracts as a significant risk for the group audit, and then went on to identify:

    (a) The unusual pattern of the sales to [Company 1], [Company 2] and [Company 3].

    (b) That there were other transactions which were potentially linked and/or not at arm’s length.

    (c) A risk that Quindell may not have identified linked transactions or barter transactions and so was not accounting appropriately for such transactions.

91. The audit team noted:

> *“A key focus area will be the commercial substance of the transactions and whether the cash going out and back in should be recognised net as the transactions have no individual commercial substance. Each transaction identified will be considered.”*

92. During the audit work, the audit team identified several indications that each group of transactions may be linked and/or the transactions may lack commercial substance.

93. However, the audit team ultimately discounted these indications on the basis that they were not “conclusive”, and accepted Quindell’s assertions that the [Company 1] and [Company 3] transactions were not linked, and that all the transactions were at fair value.

[3] https://www.justice.gov.uk/courts/procedure-rules/civil/protocol/pre-action-protocol-for-low-value-personal-injury-employers-liability-and-public-liability-claims#3.1

[Company 1] transactions

94. The [Company 1] transactions involved the following cash flows:

(a) Quindell paid their lawyers [...], a round number of Canadian Dollars, CAD 8m, on 24 December 2013.

(b) Quindell received the exact same amount back from their lawyers, on the same day.

95. Quindell accounted for the [Company 1] cash flows as (i) revenue for the sale of software and installation services to [Company 1], (ii) the purchase of software and installation services from [Company 1] and (iii) a loan to [Company 1].

96. The audit team identified the following distinctive features of the [Company 1] transactions:

(a) [Company 1]'s most recent published financial statements showed the following indications that they could not afford to purchase [...]software and services from Quindell's subsidiaries:

(i) Results for the nine months ending 30 September 2013, including revenue of only CAD 34.0k, an overall loss of CAD 3.2m and an accumulated shareholder's deficit of CAD 37.4m

(ii) Disclosures stating that *"The Company has yet to generate significant revenues or reach profitable operations and as such is dependent on financing activities. Management believes the Company will need imminent funding to operate through the year 2013 Management is considering all financing alternatives and seeks to raise additional funds for operations until it achieves, and maintains, profitable operations to continue development and marketing of its technologies...*

As the outcome of these matters cannot be predicted at this time, there is significant uncertainty regarding the Company's ability to continue as a going concern."

(b) A key contact at [Company 1] for the sale had previously been [...] at [TP1], a company founded by [a member of Quindell's senior management].

(c) The amount that [QETS] charged [Company 1] for installation advice was high compared to other similar sales, and this was unexpected because [Company 1] had software expertise.

(d) The software that [QETS] had sold to [Company 1] had not gone live.

(e) The software that [QETS] had purchased from [Company 1] had only been trialled at one clinic, for three and a half weeks.

(f) At the time of the audit the only evidence of installation services [Company 1] had provided to [Quindell group companies] was of a training session for one member of staff, lasting less than two hours. The audit team noted in a draft working paper:

"[Need analysis of how much time was expected to be sent on both sides to implement the services – this would give indication of fv for market approach – Marks paper may answer].

[Need detail of what [A Healthcare Company] has or has not done and how much time has been spent by [Company 1] at [A Healthcare Company], Initial discussions with [A Healthcare Company] indicate that only Pilot services and implementation of software at one site has taken place. No further roll out of implementation has been performed. No way would this represent $3m of effort.]"

(g) The terms of the loan to [Company 1] were unusually favourable, and, as the audit team commented, that: *"As such it would seem it is not a genuine commercial loan."*

97. The audit team considered whether [Company 1] agreed to purchase [QETS'] software, before, after or at the same time as Quindell agreed to purchase [Company 1]'s software. This was a key part of the audit team's consideration of whether or not the transactions were linked.

98. The contracts for each sale were dated two months apart. The software licence and service contracts for Quindell's software were dated 29 September 2013 and 1 October 2013, and the software licence and service contracts for [Company 1]'s software were both dated 6 December 2013.

99. However, the audit team's notes state that work to install [Company 1]'s software was due to start before the contracts were finalised. The service order for the installation of Company 1's software, which is dated 25 September 2013, states:

> *"Software Licence Required: [Company 1] – Quindell Portfolio Plc licence to be entered into"*

This indicates that Quindell agreed to purchase [Company 1]'s software a few days before [Company 1] agreed to buy [QETS'].

100. This was identified by the audit team. A draft version of the audit team's analysis of the [Company 1] transactions states:

> *"The transactions were not entered into concurrently, however there is evidence that the transactions were entered into in contemplation of further transactions.*
> *[This is because whilst the revenue sale was completed on 29 September 2013 and purchase of licence on 6 December 2013, the service agreement for [Company 1] to install and configure the software in [A Healthcare Company] is dated 25 September 2013.]*
> *However the service agreement does not contain a contract value – this was finalised in December 2013, however clearly if implementation services to be received by [A Healthcare Company] were proposed in September 2013 then the further licence and services sale by [Company 1] would have been contemplated at least at the time of the sale of the QETS software."*

[yellow highlighting and square brackets included in the original document]

101. Following discussions with management, in the final version of the working paper the audit team removed any reference to the service order dated 25 September 2013. They also changed the description of when [Company 1] agreed to purchase [QETS'] software, from *"...at the time of the sale of the QETS software."* to *"...shortly after..."* They then concluded that because [Company 1] had agreed to purchase Quindell's software first, without any guarantee of a sale to Quindell, this indicated that the transactions were not linked:

> *"The transactions were not entered into concurrently, however there is evidence that the transactions were entered into in contemplation of further transactions. This is because whilst the licence revenue sale & implementation sale was completed on 29 September 2013 and the purchase of licence on 6 December 2013, the relative short period of time between the two events may indicate linkage.*
>
> *Furthermore, if implementation services to be received by [A Healthcare Company] were proposed in October 2013 then the further licence and services sale by [Company 1] wo uld have been contemplated at least shortly after the time of the sale of the QETS software. However this was not contracted for until early December 2013.*
>
> *On balance whilst there is evidence of potential linkage, this indicator is not particularly strong. The overriding factor here, from the perspective of [Company 1], is that that*[sic] [*Company 1] entered into material contracts for the purchase of licences without the contractual guarantee of future sales to Quindell. The fact the company entered into this arrangement indicates that the transactions are not likely to be linked."*

102. Ultimately, the audit team concluded that the transactions did have commercial substance, were not linked and were at fair value. This was based on the following:

(a) Publicly available information about [Company 1]'s acquisition of another company in 2013 and a contract guaranteeing $5m revenue over five years;

(b) A review of [Company 1]'s investor update call *"...which is optimistic about* [Company 1]'s *2014 outlook and a return to profitability."*;

(c) The contracts did not specify that they were dependent on each other;

(d) The contracts were signed by [a member of Company 1's senior management], who had no apparent association with [TP1]; and

(e) Unsupported management assertions, including an accounting paper written by Quindell and discussions with [a member of Quindell's senior management]:

(i) that the transactions were not entered into in contemplation of each other and were not linked;

(ii) that [Company 1] and QETS could use each other's software to develop new or valuable products; and

(iii) that QETS would benefit from the installation of [Company 1]'s software in [A Healthcare Company]

(f) The audit team discussed the transactions with the Audit Committee Chairman who confirmed that these were "all discussed at the Board".

103. The audit team concluded that *"On balance, there is no conclusive evidence that the revenue and purchase transactions are linked"*.

[Company 3] transactions

104. The [Company 3] transactions involved three sets of cash flows:

(a) The first set of cash flows, for the Canada transactions, were:

(i) Quindell paid their lawyers [...], two round sums of £2m on 23 and 24 September.

(ii) Quindell received the exact same amounts back from their lawyers, one day later, on 24 and 25 September 2013.

(b) The second set, for the UK transactions, were:

(i) Quindell paid their lawyers [...], two round sums of £2m on 25 September.

(ii) Quindell received the same amounts back from their lawyers, on the same day.

(c) The third set, for the US transactions, were:

(i) Quindell paid [Company 3] US two round sums of £5m on 23 December 2013.

(ii) Quindell received two round sums of £3.5m back from [Company 3] US on the following day, 24 December 2013.

105. Quindell accounted for each cash flow they received as revenue for the sale of software and installation services to [Company 3], and they accounted for each cash flow paid out as an investment in a [Company 3] subsidiary.

(a) The Canada transactions were agreed on the same day: 19 September 2013. [Company 3] Canada agreed to buy Quindell's software, and Quindell agreed to buy 40% of [Company 3] Canada.

(b) The UK transactions were agreed one day apart:

(i) [Company 3] UK agreed to buy Quindell's software on 18 September 2013.

(ii) Quindell agreed to purchase 40% of [Company 3] UK on 19 September 2013.

(c) The agreement for Quindell to purchase 40% of [Company 3] US is not available on the audit file. However:

(i) [Company 3] US was incorporated on 20 December 2013.

(ii) Quindell paid two sums of £5m to purchase 40% of [Company 3] US on 23 December 2013.

(iii) [Company 3] US agreed to purchase Quindell's software on the same day, 23 December 2013.

106. The audit team identified the following distinctive features of the [Company 3] transactions:

(a) [A member of Company 3's senior management] had co-founded [TP1] with [a member of Quindell's senior management].

(b) Quindell had loaned £300k to [a member of Company 3's senior management] during 2013, £250k before any of the [Company 3] transactions, and £50k between the second and third set of transactions:

Date	Amount
24/01/2013	£100,000
24/05/2013	£150,000
22/11/2013	£50,000
	£300,000

(c) [A member of Company 3's senior management] was on the advisory board of Quindell.

(d) All three directors of [Company 3] had shares in Quindell.

(e) Quindell owned a stake in [Company 3] which had been increased in stages:

(i) At the start of 2013, Quindell owned about 19% of [Company 3].

(ii) On 19 September 2013, Quindell signed a subscription agreement with [Company 3] to increase their ownership of the company from 19% to 43%. This was the day after [Company 3] UK agreed to buy Quindell's software, and on the same day that [Company 3] Canada agreed to buy it and Quindell agreed to buy 40% of [Company 3] Canada and [Company 3] UK.

(iii) This 19 September 2013 subscription agreement included a clause that required [Company 3] to: (i) enter into an outsourcing agreement with Quindell, for all non-fault motor accident services, and (ii) to provide Quindell with right of first refusal for all other outsourced services.

(iv) In February 2014, shortly after year-end, Quindell increased their stake in [Company 3] to 49%, and acquired an option to increase it to above 50%.

(v) The agreements to purchase 40% of [Company 3] Canada and [Company 3] UK gave Quindell the right to appoint half of the directors of each company and required a 75% majority of shareholders to approve various actions. As Quindell owned 40% of each company, these actions would have required their consent.

107. The agreement for Quindell to purchase 40% of [Company 3] US is not available on the audit file.

108. There is no evidence in the working papers that the audit team considered [Company 3]'s most recent financial statements as part of their analysis.

109. However, [Company 3]'s consolidated accounts for the year ended 31 December 2012 gave the following indications that they could not afford to purchase Quindell's software and services: revenue of £1.2m, a loss for the year of £843k and net assets of £2.1m, £839k of which was cash.

110. Ultimately, the audit team concluded that the transactions did have commercial substance, were not linked and were at fair value. This was based on:

(a) unsupported management assertions that the transactions were not linked, and that they were at arm's length;

(b) a written representation from the Board of Directors that the transactions had been appropriately disclosed and accounted for;

(c) the audit team discussed the transactions with the Audit Committee Chairman who confirmed that these were "all discussed at the Board";

(d) the shareholders of [Company 3] included two well-known insurers. The audit team considered that the other investors would have been aware of, and scrutinized, any transactions; and

(e) the contracts did not specify that they were dependent on each other.

111. The audit team discounted the indications that the transactions were linked, concluding:

(a) *"There is therefore some evidence these transactions are linked and not at fair value. However based on the previous sales of licences above £1m, management assertion that these are not linked transactions, the likely value of a US market licence to be significantly higher than UK, and as highlighted by the client, the fact that the board of the [Company 3] entities includes other major insurers, some revenue recognition does appear appropriate."*

(b) *"... there are indicators the transactions may be linked, there is no clear evidence supporting this assertion."*

(c) *"...none of these indicators are conclusive..."*

(d) *"On balance there is insufficient evidence to conclude that the transactions are linked."*

[Company 2] transactions

112. The [Company 2] transactions involved two sets of cash flows:

(a) In August/September:

(i) Quindell paid their lawyers [...], a round sum of £2m on 30 August 2013.

(ii) Quindell received £2m back from their lawyers, plus £82.19 in interest, on 9 September 2013.

(b) In December:

(i) Quindell paid [Company 2] a round sum of £8m on 23 December 2013.

(ii) Quindell received a round sum of £7m back from [Company 2] on 31 December 2013.

113. Quindell accounted for the August/September cash flows as the purchase of software and a distribution agreement, and the sale of software and a distribution agreement. Quindell accounted for the December cash flows as payments to extend the licence and distribution agreements worldwide.

114. The audit team identified the following distinctive features of the [Company 2] transactions:

(a) [A member of Company 2's senior management had previously worked at TP1].

(b) The first sale and purchase transactions were agreed in the same contract, and the second sale and purchase transactions were also agreed in the same contract.

(c) The contract for the first sale and purchase also included an agreement for Quindell to buy 19% of [Company 2].

(d) Quindell bought a majority stake in [Company 2] shortly after the end of the year.

115. There is no evidence in the working papers that the audit team considered [Company 2]'s most recent financial statements as part of their analysis.

116. However, [Company 2]'s abbreviated accounts for the year ended 31 March 2013 gave the following indications that they could not afford to purchase [QETS'] software:

(a) [Company 2] only had £333k of cash.

(b) [Company 2] had net assets of £14.46m. However, £12.5m of this was a software licence that had been revalued from £0 to £12.5m by the company in the previous year[4]. Apart from this, [Company 2] only had net assets of £1.96m.

117. The audit team concluded that the transactions relating to the August/September cash flows were linked, and, similarly, that those relating to the December cash flows were also linked.

4 See [Company 2]'s accounts for the year ended 31 March 2012.

118. The audit team then requested a fair value analysis of the [Company 2] distribution rights acquired, in accordance with IFRS 13.

IFRS 13 Paragraph 9 states:

"This IFRS defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date." [emphasis added]

119. The audit team received two versions of a net-present value calculation from Quindell, however:

(a) Following a discussion with [a member of Quindell's senior management], they noted that the valuation:

"...may not be reflective of what a market participant would pay."

(b) The two calculations gave two ranges of possible values:

i. £24m - £146m

ii. £99m - £199m

(c) The audit team did not review the assumptions underlying the calculation, and did not review the actual calculation in detail or include it on the audit file.

(d) The calculation was based on optimistic forecasts that were not checked by the audit team.

(i) The forecast assumed that the number of subscribers for [Company 2]'s software would rise to 10m within six years.

(ii) However, [Company 2]'s software was an optional add-on for Quindell's telematics car insurance services that would be charged for separately. There was no evidence of any sales of [Company 2]'s software.

120. However, notwithstanding their conclusion that the transactions were linked, the audit team accepted Quindell's decision to recognise the assets and revenue at the contracted values.

121. In reaching that conclusion, the audit team relied on the following:

(a) discussions with the Audit Committee Chairman who confirmed that the transactions were "all discussed at the Board"; and

(b) a written representation from the Board of Directors that the transactions had been appropriately disclosed and accounted for.

ADMITTED MISCONDUCT

Allegation 1 – Legal Services Revenue

122. The conduct of the Respondents fell significantly short of the standards reasonably to be expected of, respectively, a Member and a Member Firm in that, in respect of the legal services revenue:

(a) The Respondents failed to obtain sufficient appropriate audit evidence to provide reasonable assurance that the Financial Statements were free from material misstatement.

(b) The Respondents failed to demonstrate sufficient professional scepticism.

and thereby the Respondents failed to comply with the requirements of ISA 200, 220, and 500 and failed to act in accordance with the Fundamental Principle of Professional Competence and Due Care contained in the Code, as set out at paragraphs 7 to 14 above.

Particulars

123. The effectiveness of the audit of legal services revenue depended on the testing of the WIP model. As set out at paragraphs 65 to 88 above, that testing was deficient in a number of respects:

(a) The WIP model spreadsheet included an error and, as a consequence, the stated revenue recognition policy was wrongly applied. This resulted in a material overstatement of revenue of £4.6m. The auditors failed to identify the error (ISA 500, Paragraph 9).

(b) The WIP curves for MOJ, PIFT and ELPL case types were derived from 79 cases chosen by [Legal Services Company]. The auditors did not obtain sufficient evidence that the 79 cases were representative of the population, and the three cases that the auditors tested in detail were selected from within Quindell's chosen 79. Consequently, the evidence obtained provided little or no evidence over the population (ISA 500, Paragraph 10).

(c) The WIP curve for ELPL cases was used for IDC cases. The auditor did not obtain sufficient evidence to support the use of the ELPL WIP curve to measure revenue for IDC cases (ISA 500, Paragraph 7).

(d) The WIP curve for Multitrack cases was based on [Legal Services Company]'s estimate. The auditor did not obtain sufficient evidence that the use of the Multitrack WIP curve was appropriate (ISA 500, Paragraph 7).

(e) The auditors did not obtain sufficient evidence to support the dilution rates used for PIFT and ELPL cases, and no evidence was obtained in relation to Multitrack dilution rates. Further, the auditors accepted without evidence assertions that improvement in case take on procedures supported the use of dilution rates that were lower than indicated by historical data (ISA 500, Paragraph 9).

(f) The auditors did not obtain sufficient evidence to support the average fee rates used for IDC cases. Further, the auditors accepted without evidence assertions that [Legal Services Company]. would earn higher average fees than indicated by the sample tested. Changes in MOJ processes, aimed at reducing costs, suggested that this was unlikely (ISA 500, Paragraph 6).

124. The audit work on legal services revenue did not comply with ISAs 200 and 500. The evidence obtained did not provide reasonable assurance that the use of the WIP model enabled Quindell to reliably measure unbilled revenue. In these circumstances, an unqualified audit opinion should not have been given.

Allegation 2 – Software Transactions

125. The conduct of the Respondents fell significantly short of the standards reasonably to be expected of, respectively, a Member and a Member Firm in that, in respect of the software transactions:

(a) The Respondents failed to obtain sufficient appropriate audit evidence to provide reasonable assurance that the l Financial Statements were free from material misstatement.

(b) The Respondents failed to demonstrate sufficient professional scepticism.

and thereby the Respondents failed to comply with the requirements of ISA 200, 220 and 500 and failed to act in accordance with the Fundamental Principle of Professional Competence and Due Care contained in the Code as set out at paragraphs 7 to 14 above.

Particulars

126. As set out at paragraphs 89 to 118 above, the auditors identified numerous features in relation to the transactions with [Company 1], [Company 2] and [Company 3] that indicated that the transactions within each group were linked and/or not at arm's length. These features raised questions about whether the transactions had commercial substance, and whether the contracted values could be relied on as fair values for each element of the transactions.

127. In each case the auditors relied on management representations and discounted contrary evidence. In relation to the [Company 1] and [Company 3] transactions, they relied on the lack of 'conclusive evidence' that the transactions were linked. This was inappropriate and wrongly treated the absence of evidence as if it could be equated with obtaining sufficient appropriate evidence to support the recognition of revenue and assets at contracted values (ISA 500, Paragraph 6).

128. In relation to the [Company 1] and [Company 3] transactions, the evidence clearly suggested that each group of transactions was linked and were not at arm's length. The auditors should have concluded that those transactions were linked and, consequently, obtained sufficient evidence that the contracted values could be relied on as fair values. No fair value calculations were sought from Quindell and no other evidence was obtained to support the contracted values as fair values (ISA 500, Paragraph 7).

129. In relation to the [Company 2] transactions, a fair value calculation was produced but the auditors did not test the assumptions adopted or otherwise perform sufficient audit work such that the calculation could be relied on as evidence to support fair values (ISA 500, Paragraph 9).

130. The auditors did not consider with appropriate scepticism whether the contractual documents were consistent with the economic substance of the transactions and consequently whether it was appropriate to recognise all or part of any revenue and/or assets in respect of each group of transactions (ISA 200).

131. The audit work on these transactions did not comply with ISAs 200 and 500. The evidence obtained did not provide reasonable assurance that the revenue and assets were recognised at appropriate values or should have been recognised at all. In these circumstances, an unqualified audit opinion should not have been given.