IN THE MATTER OF:

THE EXECUTIVE COUNSEL TO THE FINANCIAL REPORTING COUNCIL

- and -

(1) PRICEWATERHOUSECOOPERS LLP

(2) JONATHAN HOOK

EXECUTIVE COUNSEL'S FINAL DECISION NOTICE

Pursuant to Rule 18 of the Audit Enforcement Procedure

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

A. INTRODUCTION

1. The Financial Reporting Council (the '**FRC**') is the competent authority for Statutory Audit in the UK and operates the Audit Enforcement Procedure (the '**AEP**'), effective 17 June 2016. The AEP sets out the rules and procedure for the investigation, prosecution and sanctioning of breaches of Relevant Requirements.

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

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

   3.1. '**FY2015**' means the financial year ended 30 June 2015;
   3.2. '**FY2017**' means the financial year ended 30 June 2017;
   3.3. **'FY2018'** means the financial year ended 30 June 2018;
   3.4. [Not used]

3.5. ‘**FY2017** financial statements’ means the consolidated financial statements for the Company for that period;

3.6. ‘**FY2017 Audit’** means the Statutory Audit of the FY2017 financial statements;

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

3.8. [redacted]

3.9. the ‘**Company**’ means Kier Group plc.

4. Pursuant to Rule 16(b) of the AEP, Executive Counsel has decided that the Respondents (as defined below) are liable for Enforcement Action, having made Adverse Findings against each of them.

5. This Final Decision Notice is issued pursuant to Rule 18 of the AEP in respect of the conduct of:

5.1. PricewaterhouseCoopers LLP (‘**PwC**’) in relation to the FY2017 Audit. PwC was the Statutory Audit Firm for the FY2017 Audit;

5.2. Mr Jonathan Hook, a partner of PwC, in relation to the FY2017 Audit (‘**Mr Hook**’). For FY2017, Mr Hook was the Statutory Auditor of the Company and signed the FY2017 Audit report on behalf of PwC;

together, the ‘**Respondents**’.

6. On 2 December 2021 Executive Counsel issued Executive Counsel’s Decision Notice pursuant to Rule 17 of the AEP. On 17 December 2021 the Respondents provided written agreement to Executive Counsel’s Decision Notice.

7. Consequently, and in accordance with Rules 17 and 18 of the AEP, this Final Decision Notice:

7.1. outlines the Adverse Findings with reasons;

7.2. outlines Sanctions with reasons; and

7.3. outlines an amount payable in respect of the Executive Counsel’s costs of the matter.

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

  8.1. Section A: Introduction
  8.2. Section B: Executive Summary of the Adverse Findings and Sanctions;
  8.3. Section C: Background;
  8.4. Section D: Relevant Requirements to which the Adverse Findings relate;
  8.5. Section E: Detail of the Adverse Findings;
  8.6. Section F: Sanctions; and
  8.7. Section G: Costs.

B. EXECUTIVE SUMMARY OF THE ADVERSE FINDINGS AND SANCTIONS

9. This Final Decision Notice explains the failings in PwC and Mr Hook's work in the FY2017 Audit of the Company. It also makes Adverse Findings regarding PwC and Mr Hook's audit work. It does not make a finding that the FY2017 financial statements were misstated, save for in relation to the presentation of certain disposals in FY2017 (Adverse Finding 4)[1].

Adverse Findings

10. **Adverse Finding 1**: failure to obtain sufficient appropriate audit evidence, perform adequate testing, challenge management representations or carry out the audit with professional scepticism in relation to the recognition of variations and claims receivable.

11. **Adverse Finding 2**: failure to obtain sufficient appropriate audit evidence, perform adequate testing or procedures or carry out the audit with professional scepticism in support of the central profit override.

12. **Adverse Finding 3**: failure to perform adequate audit testing and procedures, to obtain sufficient appropriate audit evidence, to prepare sufficient audit documentation or to carry out the audit with professional scepticism in relation to forecast costs to complete.

[1] These items were restated by the Company in their FY2018 consolidated financial statements.

13. **Adverse Finding 4**: failure to identify and correct errors in the income statement and cash flow statement relating to the presentation of the gain on disposal of investments and cash inflows.

14. Section E of this Final Decision Notice sets out the detailed Adverse Findings relating to the audit work on the matters set out above.

Sanctions

15. Section F of this Final Decision Notice sets out the Sanctions in respect of the Respondents:

PwC

15.1. A financial sanction of £3,350,000 adjusted for aggravating and mitigating factors by a reduction of 10%, and further discounted for admissions and early disposal by 35% so that the financial sanction payable is £1,959,750.

15.2. A declaration that the FY2017 Audit did not satisfy the Relevant Requirements.

15.3. A published statement, in the form of a Severe Reprimand, to the effect that PwC contravened Relevant Requirements in the FY2017 Audit.

15.4. Non-financial sanctions, in the form of an order pursuant to rule 96(c) of the AEP, requiring PwC to:

15.4.1. Within two months of this Final Decision Notice agree with Executive Counsel and the Executive Director of Supervision a list of PIE audit engagements of audited entities within the Construction, Engineering and Aerospace & Defence industries that include the audit of long-term contracts (the '**Qualifying Audits'**) .

15.4.2. Include each of the Qualifying Audits in PwC's 2022 or 2023 Engagement Compliance Review ('**ECR'**) cycles. (The distribution

of Qualifying Audits across the two ECR cycles to be agreed with Executive Counsel and the Executive Director of Supervision.)

15.4.3. Additionally, the ECR for each Qualifying Audit is to include additional elements focusing on the quality of audit work in relation to long-term contracts. (The details of the additional elements to be agreed with Executive Counsel and the Executive Director of Supervision within two months of this Final Decision Notice.)

15.4.4. Within two months of the conclusion of the 2022 and/or 2023 ECR cycles, provide to Executive Counsel and the Executive Director of Supervision a report evaluating all Qualifying Audits reviewed in the relevant ECR cycle, including a summary of work carried out by the ECR team, the findings and conclusions as regards quality of audit work on long-term contracts, an evaluation of the improvement work undertaken and proposals to address any remaining areas for improvement.

15.4.5. If Executive Counsel or the Executive Director of Supervision consider that an additional report is required to address further issues, such a report to be provided within three months of any such request.

<u>Mr Hook</u>

15.5. A financial sanction of £90,000 adjusted for aggravating and mitigating factors by a reduction of 10%, and further discounted for admissions and early disposal by 35% so that the financial sanction payable is £52,650;

15.6. A published statement, in the form of a Severe Reprimand, to the effect that Mr Hook contravened Relevant Requirements in the FY2017 Audit; and

15.7. A declaration that the FY2017 Audit report signed by Mr Hook did not satisfy the Relevant Requirements as set out in this Final Decision Notice.

C. BACKGROUND

The Respondents

16. PwC is one of the largest audit firms in the UK. In the year to 30 June 2020, its statutory audit fee income was £754m. It is a member firm of the Institute of Chartered Accountants in England and Wales. PwC was appointed as the Statutory Audit Firm for the Company on 13 November 2014 to audit financial years FY2015 onwards.

17. Mr Hook was a partner of PwC with over 30 years' auditing experience. He was admitted as a member of the Institute of Chartered Accountants in England and Wales in 1988.

18. Mr Hook signed the FY2017 Audit report, on behalf of PwC, in respect of the FY2017 financial statements on 20 September 2017. He had been the Statutory Auditor and engagement partner for the Company since PwC's appointment as Statutory Audit Firm in 2014.

19. The purpose of an audit is to enhance the degree of confidence of intended users in the financial statements. This is achieved by the expression of an opinion by the auditor on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework. Mr Hook's and PwC's statutory responsibilities were to form an opinion as to whether the FY2017 financial statements showed a true and fair view and had been properly prepared in accordance with IFRS and the Companies Act 2006. An audit conducted in accordance with the International Standards on Auditing (the '**ISAs**') and relevant ethical requirements enables the auditor to form that opinion.

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

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

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

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

The Company

24. The Company is a leading infrastructure, buildings, developments and housing group listed on the London Stock Exchange and as such is a Public Interest Entity. The Company was during FY2017 part of the FTSE 250.

25. For FY2017, the Company generated revenue of £4.282bn and profits of £11.8m. When reporting on the year's performance, the consolidated income statement presented separately: (i) underlying and non-underlying items; and (ii) continuing and discontinued operations.

26. There were five operating segments within the Company, with 87% of revenues generated through the Construction (47%) and Services (40%) segments. For FY2017, the Construction segment generated a loss from continuing operations before tax of £5.0m; the Services segment generated a profit from continuing operations before tax of £47.7m.

27. The nature of the Company's business meant that it was engaged in a series of long-term contracts in its Construction and Services segments. Accordingly, consideration of the Company's accounting for long-term contracts formed an important part of the Respondents' work during the FY2017 Audit. The four contracts considered below in relation to the FY2017 Audit all fell within the Construction operating segment of the Company which consisted of: the UK Building, UK Infrastructure and Overseas businesses.

28. For the FY2017 Audit, overall materiality for the Company was £6.3m, with performance materiality of £4.6m. In addition, there were discrete materiality levels for UK Building (£4.9m overall, £3.675m performance materiality), UK Infrastructure

(£3.03m overall, £2.273m performance materiality) and Overseas (£4.23m overall, £3.17m performance materiality).

Audit of long-term contracts

29. The FY2017 Audit required the Respondents to audit the long-term contracts in which the Company was engaged. This required the Respondents to consider, amongst other things, each of the following (which are addressed further below):

    29.1. the recognition of variations and claims receivable;
    29.2. forecasts of costs to complete; and
    29.3. management's central profit override.

30. For periods ending on 30 June 2017, accounting for long-term contracts was governed by the requirements of IAS 11 'Construction Contracts' ('**IAS 11**') (1993). IAS 11 (paragraph 3) defines a construction contract as '*a contract specifically negotiated for the construction of an asset or a combination of assets that are closely interrelated or interdependent in terms of their design, technology and function or their ultimate purpose or use*'.

31. IAS 11 sets out the principles relating to the treatment and apportionment of contract revenue and contract costs to the accounting periods in which the construction work has been carried out. This is necessary because a feature of construction contracts is that the construction period usually spans several accounting periods.

32. In respect of contract revenue, IAS 11 (paragraph 11) explains that contract revenue shall comprise:

    '(a) the initial amount of revenue agreed in the contract; and

    (b) variations in contract work, claims and incentive payments:
    (i) to the extent that it is probable that they will result in revenue; and
    (ii) they are capable of being reliably measured.'

33. Whilst identifying component (a) of contract revenue ('*the initial amount of revenue agreed in the contract*') is typically straightforward, identifying component (b) ('*variations in contract work, claims and incentive payments*') is often subject to judgment.

34. Variations and claims were of particular relevance to the contracts reviewed as part of the FY2017 Audit.

34.1. Variations: A variation is '*an instruction by the customer for a change in the scope of the work to be performed under the contract*' (IAS 11, paragraph 13). A variation is included in contract revenue when:

(a) '*it is probable that the customer will approve the variation and the amount of revenue arising from the variation*'; and

(b) '*the amount of revenue can be reliably measured*'.

34.2. Claims: A claim is '*an amount that the contractor seeks to collect from the customer or another party as reimbursement for costs not included in the contract price*' (IAS 11, paragraph 14). The recognition of claims usually requires more judgment than variations because claims are often contentious by nature, subject to a high level of uncertainty and often depend on the outcome of negotiations. Therefore, claims are included in contract revenue only when:

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

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

35. IAS 11 (paragraph 16) also explains how costs in construction contracts should be defined and determined. Contract costs include:

(a) '*costs that relate directly to the specific contract*';

(b) '*costs that are attributable to contract activity in general and can be allocated to the contract*'; and

(c) '*such other costs as are specifically chargeable to the customer under the terms of the contract*'.

36. The majority of costs incurred in construction contracts relate to the cost of materials, subcontractors and labour required for the construction. The total contract costs incurred to date can usually be agreed to third party evidence such as supplier

invoices. However, the total contract costs to complete are more subjective, as these costs represent the management's best estimate at the time.

37. IAS 11 distinguishes between instances when the outcome of a construction contract can be estimated reliably and when the outcome of a construction contract cannot be estimated reliably.

37.1. When the outcome of a construction contract can be estimated reliably: '[c]*ontract revenue and contract costs associated with the construction contract shall be recognised as revenue and expenses respectively by reference to the stage of completion of the contract activity at the end of the reporting period. An expected loss on the constructed contract shall be recognised as an expense immediately in accordance with paragraph 36*' (IAS 11, paragraph 22).

37.2. When the outcome of a construction contract cannot be estimated reliably, no profit is recognised and at best the contract is recorded on a break-even basis if all contract costs incurred are deemed recoverable (IAS 11, paragraph 32).

38. IAS 11 refers to the recognition of revenue and expenses by reference to the stage of completion of a contract as the '*percentage of completion method*' (IAS 11, paragraph 25) and provides that '[t]*he stage of completion of a contract may be determined in a variety of ways. The entity uses the method that measures reliably the work performed*' (IAS 11, paragraph 30).

39. Although IAS 11 is not prescriptive over how the stage of completion of a contract should be determined, it refers to the following methods (IAS 11, paragraph 30):

(a) '*the proportion that contract costs incurred for work performed to date bear to the estimated total contract costs*'; or
(b) '*surveys of work performed*'; or
(c) '*completion of a physical proportion of the contract work*'.

40. The Company's own accounting policy for FY2017 stated that:

'The general principles for profit recognition are as follows:

› Profits on short duration contracts are taken when the contract is complete;

› Profits on other contracts are recognised on a percentage of completion basis when the contract's outcome can be estimated reliably;

› Provision is made for losses incurred or foreseen in bringing the contract to completion as soon as they become apparent;

› Claims receivable are recognised as income when received or certified for payment, except that in preparing contract forecasts to completion, a prudent and reasonable evaluation of claims receivable may be included to mitigate foreseeable losses and only to the extent that there is reasonable certainty of recovery; and

› Variations and compensation events are included in forecasts to completion when it is considered highly probable that they will be recovered.

Percentage completion is normally calculated by taking certified value to date as a percentage of estimated final value, unless the internal value is materially different to the certified value, in which case the internal value is used'.

41. Contract accounting was identified by the Respondents as a significant risk for the Company during the planning stage of the FY2017 Audit, as was the risk of fraud in revenue recognition in the UK Building division.

42. The Respondents described the nature of the misstatement risk as being the complexities that exist around contract accounting and that certain areas involve significant estimates from management. In respect of the likelihood of misstatement risk, the Respondents noted that there were a number of projects with uncertainty as to the final outcome and some contracts which were judgmental. Examples given by the Respondents included: [Contract 2], [Contract 3] and [Contract 4] (discussed below). In respect of the magnitude of the misstatement risk, given that construction contracts had a material impact on assets and revenue it followed that a misstatement might also be material.

43. When considering the risk of fraud in relation to the Construction revenue stream, the Respondents noted:

'*In our assessment management is able to manipulate revenue recognition either by recognising claims and taking these to ELF in order to increase ELF value of the project and recognise this as revenue therefore increasing the revenue at a particular period and protecting ELF margin. Or where costs incurred and actual stage of completion*

has been overestimated. Thereby masking losses on contract and protecting ELF margin and ELF profits'.

44. In relation to audit procedures to mitigate the risk of fraud in revenue recognition, the Respondents recorded that they would, amongst other things, test claims, variations and recoveries taken to value to assess completeness in revenue recognition.

45. In the course of the FY2017 Audit, the Respondents carried out work in relation to, amongst others, the following four long-term contracts:

    45.1. [Contract 1];
    45.2. [Contract 2];
    45.3. [Contract 3]; and
    45.4. [Contract 4].

(1) [Contract 1]

46. [Contract 1] was a redevelopment project carried out by the UK Building division. It was selected for testing as part of the FY2017 Audit because it met a number of risk factors that the Respondents had identified, for example: revenue in the financial year and the estimated final margin both exceeded performance materiality. Once testing began, the Respondents further identified the contract as '*one of the key risky contracts due to the large amount of unagreed variations assumed in the final value*'.

47. In relation to unagreed variations arising from the project:

    47.1. As at 30 June 2017, £21.965m of submitted variations remained to be agreed between the Company and its client but, of that amount, £16.762m was included in contract revenue for FY2017.

    47.2. The Respondents considered that the Company's client had agreed c.£19.8m of these variations on the basis of an email with accompanying tracker that the client had sent to the Company that put an expected value of c.£19.8m against unagreed variations of c.£21m. However, this email and tracker did not evidence the client's agreement to the variations but only evidenced the client's acceptance that the variations were yet to be agreed with an estimate of their value. Further, the detail of the tracker showed that:

47.2.1. some of the variations dated back to the previous financial year and there was no consideration of why these variations had not been agreed in the intervening period;

47.2.2. actions requested from the Company before the year end had not been executed with no explanation of why that was the case;

47.2.3. comments on the tracker suggested that the Company had not provided sufficient information to support the variation;

47.2.4. a number of lines showed that the principle of a variation was approved but the quantum was not.

48. In addition to the variations referred to above, four adjustments to margin totalling £13.3m were made, materially affecting the profit recognised for the contract. The Company's 'best', 'worst' and 'most likely' outcomes for each of these adjustments were recorded as follows, with the 'most likely' figures being adopted:

48.1. <u>Company Extended Programme Value Recovery:</u>

(a) Total value claimed: £7.2m

(b) Best: £5.8m

(c) Worst: £4.6m

(d) Most likely: £5.2m

48.2. <u>Supply Chain Extended Programme Value Recovery</u>:

(a) Total value claimed: £4.0m

(b) Best: £2.5m

(c) Worst: £1.7m

(d) Most likely: £2m

48.3. <u>Extended Programme Disruption Value Recovery</u>:

(a) Total value claimed: £5m

(b) Best: £2.5m

(c) Worst: £1.5m

(d) Most likely: £2m

48.4. <u>Additional Unagreed Compensation Events Value Recovery</u>:

(a) Total opportunity: £8.2m

(b) Best: £6.0m

(c) Worst: £2.5m

(d) Most likely: £4.0m

49. On the audit file, the Respondents set out how the first two of these claims ('*Company Extended Programme Value Recovery*' and '*Supply Chain Extended Programme Value Recovery*') had been calculated. However, in respect of the third claim ('*Extended Programme Disruption Value Recovery*'), the Respondents recorded only that the figure of £5m was '*to be assessed*'.

50. No further audit work was performed by the Respondents in relation to these three adjustments such as to verify the underlying numbers, how (in the case of the third adjustment) disruption costs had been quantified or how the best, worst and most likely outcomes which were recorded for each of the adjustments had been assessed.

51. In respect of the fourth adjustment to profit ('*Additional Unagreed Compensation Events Value Recovery*'), the Respondents relied upon an analysis performed by a [Company's employee] that historically 90-95% of variations which had been submitted had been approved by the client. The Respondents used this analysis to estimate the potential range of unapproved variations, based on an expected approval rate of 90-95%. On this basis, the Respondents considered that taking to value £4m of a total opportunity of £8.2m did not appear to be over-optimistic.

52. The audit documentation in respect of [Contract 1] is unclear in a number of respects:

52.1. It does not reconcile the forecast contract value of £163.8m (including £13.3m of adjustments to margin for the compensation events referred to above) to the original contract sums, variations and claims tested within the audit workpaper.

52.2. The Expected Final Margin reported to the Risk Management and Audit Committee ('**RMAC**') was £9.3m, compared to £9.8m within the audit workpaper. No reconciliation between the two was performed.

52.3. The report to the RMAC stated '*of £10.8m of related claims for delays and disruption and the associated prelim costs submitted to the client, £5.8m has been assumed in the ELF value*'. The £10.8m related to the 'best case' and not

the total value claimed, and it is not evident where the £5.8m figure included in the report to the RMAC has been taken from.

53. The amounts recognised in respect of the unagreed variations and the adjustments to profit referred to above were material to both UK Building and the Company generally. Therefore, if these amounts were not recoverable, they had the potential to lead to a material misstatement in the FY2017 financial statements.

(2) [Contract 2]

54. [Contract 2] was a joint venture between the Company and [redacted] carried out through a unincorporated contractual joint venture (the '**JV**'). It was a fixed price contract to construct a new [redacted], undertaken by the Company's Infrastructure division.

55. By 30 June 2017, the contract was nearing its final stages with the expectation that hand over of the [redacted] would occur in September 2017.

56. As set out in 42 above, [Contract 2] was specifically referred to in the Respondents' audit plan and it was selected by the Respondents for review.

57. The Company's end of life forecast for the project was that it would be loss making to the extent of c.£18m, with the Company's one third share being a loss of c.£6m.

58. The forecast was based on the Company's estimated 'best' case scenario for the project. The range of outcomes estimated by the Company was:

58.1. Best: (£18m)
58.2. Worst: (£79.5m)
58.3. Most likely: (£66.9m)

59. The documentation on the audit file does not record consideration being given by the Respondents in respect of each of these scenarios or whether it was appropriate to recognise the 'best' case scenario and not the 'most likely' scenario.

60. In order to assess the range of outcomes presented by the Company, the Respondents were required to consider the forecast costs to complete and any claims taken into account.

61. In respect of the costs to complete the project, the Company forecast its share as £23.1m (one third of costs to complete of the full JV of £69.3m). The Respondents obtained a cost breakdown of the forecast costs to complete, prepared a reconciliation, and discussed the work left to complete and forecast costs with the Company's management. The Respondents agreed the costs forecast to information provided by the JV finance team, stating that this was valid third-party evidence even though it had not been independently audited.

62. The total of the claims taken into account in the end of life forecast was £57m (for the full JV). These consisted of the following:

62.1. '[Claim A]'. This was the most significant claim against the project designers and encompassed six complaints totalling c.£25m. The Respondents' conclusions in respect of [Claim A] were that:

'*There still remains a significant amount of work to do to substantiate these claims, both from a legal perspective and evidencing the costs involved…*

[redacted] has been notified (and in turn their PI providers) but no formal claims have been submitted and [the Company] *are targeting mediation in FY 19*'.

62.2. '[Claim B]'. This was a claim for £15m against the Company's client, as a result of a revised design arising from problems with the existing sewer. However, the JV (who would be the party bringing any claim) did not have a contractual relationship with the client but only with a special purpose vehicle which the client had employed (the '**SPV'**). There was, therefore, no contractual basis on which the client would be liable for the claim. In their working paper, the Respondents referred to discussions held with the client and that £8m had been verbally offered. The conclusion in relation to this claim was that:

'*We understand that discussions are expected to conclude prior to Permission to use (PTU) which will crystallise any contribution* [Company's client] *are willing to make and the mechanism for this. Recovery of £8m from* [Company's client] *appears to be at an advanced stage of discussion (albeit there is no written evidence available). Through negotiation the CJV* [the JV] *may achieve*

a higher figure however, [Company's client] *have no contractual obligation to pay anything therefore it is optimistic to recognise the full value requested thus we have adjusted this claim downwards by a further £5m'.*

62.3. '[Claim C]'. This was a claim for £12m in respect of ground contamination work and delays and disruption as a consequence of a sewer having to be replaced. The Respondents' conclusion in relation to the claim was that:

'[t]*he claim against* [utilities company] *does not meet the hurdle of advanced stage of negotiation and there is currently uncertainty over the responsibility of* [utilities company] *to pay anything. We consider it too early to assume recovery from an accounting perspective thus £0m taken*'.

62.4. '[Claim D]'. This was a claim for £1.5m from the SPV in respect of which the Respondents noted:

'[Claim D] *is generally much harder as* [the JV] *are contracted by them through a fixed price lump sum contract of £455m with* [the JV] *taking all the risk for the design and build of the contract. Thus the SPV are bullet proof by virtue of the contract and the only way monies would be able to be recovered would be through the goodwill of the SPV…*

…Even though te [sic] *SPV has no contractual requirement to make any payment we understand there have been positive discussions with the SPV in respect of recovery of £1.5m which they had previously set aside for exceptional events. However these are yet to be agreed. Given this PwC assume the £1.5m as a more reasonable sum.'*

62.5. '[Claim E]'. This was a claim against a port operator for £3.5m in relation to delayed access rights.

63. The Respondents' overall conclusion on the testing of [Contract 2] in relation to the claims was that:

'*…there is a significant amount of judgement in the end of life numbers as a result of several claims and cost savings being taken to value. Majority of these claims are still at an early stage and thus difficult to conclude on the future outcome of these. We*

have thus raised these within our RMAC report and also have raised SUMs within the wizard for those claims and savings where the evidence provided suggest they are still at early stages of negotiations'.

64. The audit file indicates that, in addition to discussing matters with the Company's management and internal legal team, the Respondents relied on documents the Company's external legal advisers had prepared in respect of the claims (excluding [Claim B]), however, the Respondents did not seek direct communication with those legal advisers as to their views.

65. In summary, the claims (as well as various costs saving) accepted by the Respondents were the following:

	Company position		**PwC position**		**Reduction**	
	Total JV	**Company share**	**Total JV**	**Company share**	**Total JV**	**Company share**
	£000	**£000**	**£000**	**£000**	**£000**	**£000**
Claims						
[Claim A]	25,000	8,333	15,000	5,000	10,000	3,333
[Claim B]	15,000	5,000	10,000	3,333	5,000	1,667
[Claim C]	12,000	4,000	3,700	1,233	8,300	2,767
[Claim D]	1,500	500	1,500	500	0	0
[Claim E]	3,500	1,167	0	0	3,500	1,167
Total	**57,000**	**19,000**	**30,200**	**10,066**	**26,800**	**8,934**
Cost savings						
Subcontractor	7,000	2,333	4,000	1,333	3,000	1,000
[Claim A] final accounts projections	2,000	667	2,000	667	0	0
[Claim C] cost reductions	3,000	1,000	3,000	1,000	0	0
Prelims, project wide, and other savings	4,000	1,333	2,000	667	2,000	666
Recovery of expat rates (net)	2,000	667	2,000	667	0	0
Total	**18,000**	**6,000**	**13,000**	**4,334**	**5,000**	**1,666**
Grand total	**75,000**	**25,000**	**43,200**	**14,400**	**31,800**	**10,600**
Recovery of Company closed book		5,000		3,000		2,000
Net shortfall		**30,000**		**17,400**		**12,600**

66. In the Respondents' report to the RMAC:

66.1. In relation to [Claim A], the Respondents concluded that '*the claim is not in advanced state of negotiation and the amounts recoverable are uncertain*'. Despite this, the Respondents only required the Company to reduce the £25m recognised by the Company (for the full JV) to £15m.

66.2. In relation to [Claim B], the Respondents noted that '[p]*ositive discussions indicate an element of this claim is at an advanced stage of negotiation and therefore reasonable to recognise*', however, it was also noted that there was no written evidence to support this position and that the client had no contractual obligation to make this payment. The Respondents only reduced the £15m recognised by the Company (for the full JV) to £10m.

66.3. In relation to [Claim C], the Respondents concluded that '[t]*he claim against* [utilities company] *does not meet the hurdle of advanced stage of negotiation and there is currently uncertainty over the responsibility of* [utilities company] *to pay anything. We consider it too early to assume recovery from an accounting perspective*'. Despite this, the Respondents only required the Company to reduce the amount of £12m recognised by the Company (for the full JV) to £3.7m.

66.4. In relation to [Claim D], the Respondents noted that '[t]*o date £1.5m has been discussed and we are assured has been offered by the SPV. This however has not been formally agreed*'. The Respondents did not propose a reduction in the amount recognised by the Company (for the full JV) of £1.5m.

66.5. In relation to [Claim E], the Respondents concluded that '[w]*e consider recovery of £3.5m from* [port operator] *too uncertain to recognise at this stage*'. The Respondents required the Company to provide against the whole of £3.5m recognised by the Company (for the full JV).

67. Accordingly, overall, the Respondents required the Company to record additional provisioning of £31.8m against the £75m of valuation adjustments recorded (for the full JV) (consisting of £57m of claims receivable and £18m of costs savings). This increased the estimated loss from £18m under the Company's end of life forecast to £49.8m. However, this was still £17.1m short of the assessed '*most likely*' outcome of a loss of £66.9m. The Company's share of the difference between the assessed '*most*

likely' outcome and the loss reflected after the Respondents' provision is £5.7m which is above materiality for the Infrastructure division and above performance materiality for the Company as a whole.

(3) [Contract 3]

68. [Contract 3] was a contract to undertake improvement works to a ██████ in the UK, which included constructing an extension to the existing quay. It was undertaken by the Company's Infrastructure division. By 30 June 2017, the project was complete and had been handed over to the client.

69. The Respondents selected this contract for review because it met the risk criteria of work in progress ('**WIP**') being greater than performance materiality. As set out in 41-42 above, [Contract 3] was specifically referred to in the Respondents' audit plan as a contract with uncertainty and which was judgmental.

70. There were two sets of relevant claims in relation to [Contract 3] for FY2017.

70.1. 'Customer Claim'. This was a claim seeking a total recovery of £13.17m against the customer. It consisted of three heads of claim: (i) arising out of a delay in the issue of a Marine Management Organisation ('**MMO**') licence to the Company; (ii) arising out of contamination connected to the operations of the client's own tenants of the quay; (iii) caused by delay and disruption with locating the jack up barge on the outside of the quay.

70.2. 'Project Design Claim'. This was a claim seeking a total recovery of £4.58m against the project designer. The Project Design Claim was made up of two heads of claim against the project designer for negligence: (i) relating to material excavated for the quay extension; and (ii) relating to the method of 'anchoring' the quay extension. The Company had submitted a formal claim against the project designer on 27 October 2016 and had engaged an independent expert in the field of geotechnical engineering who had advised that the project designer had been negligent.

71. In the end of life forecast which the Company had prepared in respect of the project, the two claims were recognised in amounts of £7.2m (for the Customer Claim) and £3.2m (for the Project Designer Claim). Those amounts (totalling £10.4m) reflected the Company's assessed 'best' case recovery across both claims whereas the 'most

likely' position was lower at £9.326m (in total). The higher 'best case' figures were also the amounts that the Respondents ultimately accepted as their traded value to be reflected in the FY2017 financial statements. The audit file does not contain an explanation of why the Respondents did not consider it necessary to ensure the outcome assessed as 'most likely' was adopted.

72. The two claims were treated as a WIP adjustment (of £10.4m) which served to reduce the level of costs recognised in respect of [Contract 3]. Whilst this treatment did not impact the profit margin, it did not comply with the Company's accounting policy (see paragraph 40 above).

73. In the course of its audit of [Contract 3], the Respondents received a number of documents from the Company in relation to the claims. The Respondents also held numerous meetings with the Company's in-house legal team, the [Contract 3] project manager and the central finance team in which the claims were discussed. From these, the Respondents were aware that the Company had engaged third party legal advisers to advise in relation to the claims. However, the Respondents did not seek direct communication with those third-party legal advisers as to their views of the Customer Claim or of the Project Design Claim.

74. The evidence that is available on the audit file demonstrates that the client had accepted a small part of one complaint in relation to the MMO licence delay totalling £230,000 but had rejected the rest of the Customer Claim based on advice from a Queen's Counsel. Whilst the Company's solicitors were preparing a legal claim, this had not been submitted at the time of the audit.

75. In their conclusion on the testing of [Contract 3], the Respondents noted in the key areas of judgment that:

> '*Of the £17m claims submitted, £10.3m has been taken to value. There seems to be a case for* [the Project Design] *claim however the* [Customer] *claim has already been rejected and now mediation is being scheduled. Thus the* [Customer] *claim seems overly optimistic and there is a risk that there may be losses to come*.'

76. The Respondents' overall conclusion was:

> '*Whilst work has been performed during the year on the merits of the case and discussions are ongoing, recovery remains uncertain. We continue to*

consider the overall traded position optimistic, in particular with regard to [customer] *and anticipate that future losses may arise*'.

77. The Respondents' view that the overall traded level of the claims was optimistic was repeated in other audit working papers ('*Fraud in revenue recognition and & complexities associated with long term contract accounting*', '*Contract Accounting*').

78. This conclusion was reflected in the Respondents' final report to the RMAC. However, despite reporting that the overall traded level of the claims was optimistic and noting a downside risk of recovery in the range of £0 to £5m, no downside adjustment of the claim amount was proposed by the Respondents.

(4) [Contract 4]

79. [Contract 4] was a project to construct a hotel, undertaken within the Company's Overseas division. The project completion date had been delayed several times and at the date of signing the audit report (20 September 2017) it was forecast to be substantially complete by October 2017.

80. The contract value in the tender was US$72.5m, with a tender margin of US$7.2m. A settlement agreement was reached in 2017 confirming the final agreed value of the contract as US$58m. The project was forecast to make a loss of circa US$102m.

81. As stated in paragraph 42 above, [Contract 4] had been identified as a risk area within the Respondents' audit plan which also referred to '*continuing issues with the completion of the* [hotel] *where costs incurred are expected to exceed the latest reforecast*'.

82. In respect of the Respondents' testing of costs of sales:

   82.1. the Respondents tested cost of sales other than payroll by selecting 47 items, all of which related to costs incurred in the year and agreed them back to third party invoices. This amounted to testing of c. £77,000 out of a total of £58.9m non payroll costs, representing a coverage of 0.13% of the balance. The audit file does not record the Respondents carrying out any additional analysis or consideration of the composition of the balance of these costs. The Respondents did not note any issues from its testing.

82.2. Payroll costs of US$11,734,508 were tested by: (a) reconciling cost reports to total payroll; (b) agreeing monthly salary for 16 employees to payroll listings; and (c) agreeing a sample of 10 transactions from payroll expense listings to payslips and bank statements. The Respondents did not note any issues from its testing.

83. The working papers on the audit file provide different amounts for the end of life costs and the costs incurred in the project. These differences are summarised in the table below:

$'000	**Total ELF costs**	**Incurred costs**	**Forecast costs**
Total costs per VCR	156,884	141,125	15,759 (calculated)
Total costs per cost forecast ([Contract 4] business stream forecast June 17)	158,100	145,555 [to July 17]	12,545 [from July 17]
		141,125 [to June 17 per VCR – see row above]	16,975 (calculated)
[Contract 4] – Contract revenue audit working paper "*Forecast & Rev. Adj*" tab	160,639	141,125	12,606 19,514 (calculated)

84. Further, the audit file recorded contradictory explanations for the second increase in the cost forecast from US$158.1m to US$160.6m, with references to the cause being either a one week or a two week delay. There is no evidence of any consideration of the likely costs of a delay of either one or two weeks.

85. There is no evidence on the audit file that the Respondents carried out specific testing of the final costs to complete figure for the project.

85.1. The Respondents compared the total costs of construction for FY2017 with those for FY2016. This comparison identified three classes of costs (materials, preliminaries and design fees) that had increased significantly but could not be explained solely by delays to the completion date. Despite this, the

Respondents accepted the explanations provided by management as reasonable '*given the delay in completion date*'.

85.2. In conducting this comparison, the Respondents used a forecast of costs to complete for FY2017 which failed to take into account the two adjustments to the forecast, totalling US$3.7m (with one adjustment made immediately prior to the audit of US$1.2m and another made during the audit of US$2.5m) set out in the table in paragraph 83 above. Neither of these adjustments was subjected to testing.

85.3. The Respondents also asked a [Company Employee] his view of the likelihood of meeting the current completion date and whether the customer had flagged any quality issues. The Respondents noted that the the [Company Employee] stated *'the current cost that the project has incurred since the year end is in line with expectation and there has been no instances of quality issue* [sic] *being flagged by the customer'* but there is no evidence that the Respondents looked beyond, or sought to test, this statement.

85.4. There is no evidence of any challenge to management's explanations or additional audit enquiries.

86. In the financial information provided in the Respondents' report to the RMAC, the cumulative loss was stated to be £78.5m. However, this figure did not correspond with the final loss (of £80.4m) after both of the adjustments referred to above were taken into account.

87. The costs to complete were material to [Contract 4] (which had its own separate materiality levels: £1.382m (overall), £1.036m (performance) and to the Company as a whole. Since [Contract 4] was loss making, any additional costs anticipated would have had to be written off in FY2017 and therefore would have directly impacted profits.

Central Profit Override

88. As set out in paragraph 40 above, the Company's accounting policy for FY2017 stated that '*percentage completion is normally calculated by taking certified value to date as a percentage of estimated final value, unless the internal value is materially different to certified value, in which case the internal value is used*'.

89. For FY2017, the cumulative net adjustment applied by the Company (i.e. the project manager or quantity surveyor) to reflect the internal value across contracts within the UK Buildings division amounted to a £82m reduction in profit.

90. Following this, management within the head office of the UK Buildings division then undertook a further contract review as they considered that contract estimates provided by the project managers or quantity surveyors may have been overly prudent on the basis of the disparity between the UK Building division's cash position of £114m and the cumulative profit of £49m. As a result of this review, management reduced accruals for some contracts, thereby increasing the contract margins. This exercise gave rise to what was referred to as the 'central profit override' ('**CPO**') (or alternatively, the 'additional profit take').

91. As noted in paragraph 41 above, contract accounting and fraud in revenue recognition were identified as significant risk areas in the Respondents' audit plan. There is a particular risk of fraud in revenue recognition where the actual stage of completion is overestimated.

92. The CPO adjustment initially made within the head office of the UK Buildings division resulted in additional profit of £3.3m being recognised. This £3.3m CPO was 60% of the full profit available on a total of 14 contracts included in the contract listing.

93. The Respondents tested five contracts that comprised £1.615m of the CPO. The testing was as follows:

    93.1. seeking explanations from management;

    93.2. reviewing the basis for the change in profit;

    93.3. verifying figures to the MAPS data; and

    93.4. reviewing the VCR for each selected contract to assess whether any elements within the contract may cause issues for future profit, such as unagreed variations or increases in costs through delays.

94. The Respondents queried why only 60% of the upside identified by management was taken. The explanation the Respondents received was that this was due to uncertainty with contracts and profits. As, in the Respondents' view, there was no specific justification for this percentage, the Respondents recommended increasing the profit

take to 100%. This increased the CPO recognised on the contracts identified by management from £3.3m to £5.3m.

95. The Respondents then reviewed the CPO listing to ensure its completeness by applying the same criteria as management, identifying '*any negative adjustments over £2m and subcontractors accruals over £2m*'. The Respondents filtered the list for those contracts that had already been identified by management and for those which were below 50% completion which left an additional 12 contracts for review by management. Following this review by management, the Respondents concluded that four contracts should be included in the revised CPO, but no upside should be included for the remaining eight contracts.

96. The audit team then reviewed a revised CPO listing which showed an additional seven amounts compared to the original CPO listing:

    96.1. four identified through the Respondents' completeness testing;

    96.2. two subsequently identified by the Company's management from the July 2017 VCRs which they decided to include in the revised CPO; and

    96.3. an additional amount for a previously identified contract.

97. The Respondents noted in their working paper on the CPO that '*the July MAPS information and VCR post year end support the improvement to profit'* but there is no consideration of what led to the significant changes in the one month since the year end and whether those changes justified releasing additional profit at the year end.

98. There was no further work on these additional seven amounts or challenge by the audit team of management. The audit file indicates that the Respondents tested and agreed the process for identifying additional profit on contracts that could be released, rather than testing the CPO was appropriate by reference to the specific projects.

99. Set out below is a reconciliation between the original CPO value and the revised CPO value:

	£
Original CPO value	3,300,000
Adjustment to include 100% of the contract to which a CPO initially applied	1,989,000
Additional CPO adjustment	3,272,000
Total revised CPO value	**8,561,000**

100. Separately from consideration of the CPO, the Respondents had tested costs to complete and accruals across the whole population of construction contracts. However, the Respondents inconsistently concluded positively on their testing of profit recognised on construction contracts but then accepted (and proposed an increase to) an adjustment by way of the CPO.

101. The total CPO for FY2017 was £8.561m which was material to the UK Buildings division and the Company.

Presentation of gains/losses on disposals

102. During FY2017, the Company disposed of Mouchel Limited ('**Mouchel**') and a joint venture interest in Company A ██████).

103. IFRS 5 ('*Non-current assets held for sale and discontinued operations*') requires that the results attributable to discontinued operations are shown separately on the face of the income statement and excluded from continuing operations. IAS 7 requires cash flows of an entity to be analysed into operating, investing and financing activities.

104. In the FY2017 financial statements:

104.1. The operating losses from Mouchel (of £2.6m) and Company A (of £1.5m) prior to their disposal were disclosed in the consolidated income statement <u>as discontinued operations</u>.

104.2. The net profit/(loss) on the disposals of Mouchel (of £40m) and Company A (of (£7.6m)) was disclosed in the consolidated income statement <u>in continuing operations as a non-underlying item</u>.

104.3. In the cash flow statement, the cash inflow from the sale of Mouchel and Company A was included as an operating activity (rather than an investing activity).

104.4. The cash proceeds from the disposals of Mouchel and Company A (totalling £69m) are disclosed in Note 4 of the FY2017 financial statements:

'*The disposal of Mouchel Consulting in October 2016 generated a profit on sale of £40.0m and net cash proceeds of £58.9m. Company A was sold in April 2017 generating a loss of £7.6m and net cash proceeds of £9.7m, following an impairment charge of £5.0m in the prior year. The integration of Mouchel is complete and consequently there are no further costs of acquisition or integration in the current year (2016: £49.9m)'.*

105. The auditor's report on the FY2017 financial statements identified as a key matter the Company's classification of certain items as '*non-underlying items*' including the £40m gain on the disposal of Mouchel and the £7.6m loss on the disposal of the investment in Company A, noting '*the determination of which items are classified as 'non-underlying' is subject to judgement and therefore users of the accounts could be misled if amounts are not classified appropriately or presented consistently*'. It stated that, '[h]*aving considered the nature and quantum of these items, overall we were satisfied that the presentation of non-underlying and exceptional items in the financial statements for the year ended 30 June 2017 is materially appropriate'.*

106. In the Respondents' audit plan for FY2017 provided to the RMAC, accounting for non-underlying items was identified as an elevated risk because it required judgment. The Respondents specifically stated that they would focus on judgmental areas including the recognition and presentation of the Mouchel disposal.

107. The Respondents carried out an analytical review of the Company's subsidiaries at the year end. Their working paper identified that the profit on the disposal of Mouchel was included in the operating income from continuing operations within the income statement of the draft financial statements but that the loss in the year from discontinued operations related to the disposal of Mouchel and Company A. On the audit file there was no reference to this inconsistency in classification, and no other evidence that the different classification of operating losses and profit on disposal of Mouchel was identified.

108. The Respondents considered whether management's judgment of classifying Mouchel as a discontinued operation was reasonable and concluded that it was. However, the Respondents disagreed with management's treatment of Company A as a discontinued activity and proposed an adjustment to reclassify the operating losses prior to disposal. However, this was not a material amount and was included as an unadjusted audit misstatement in the final report to the RMAC.

109. The audit file included a working paper with a checklist in relation to cashflow statements which included the following:

'*Balances relating to the purchase and sale of PPE or intangibles, acquisition and disposal of subsidiaries or JV's is regarded as investing activity.'*

110. The Respondents had put a tick next to the following:

'*Verified items for which cash effects are investing or financing cash flows have been appropriately excluded from operating cash flows*'*;*

'*Operating cash flows have been appropriately presented*'; and

'*Investing and financing cash flows have been appropriately classified and presented*'.

111. Within the same working paper, the Respondents identified that the proceeds from the disposals of Mouchel and Company A were included as an operating cash flow but did not consider whether they should have been included as cash flow from investing activities.

112. If the gain on the Mouchel disposal had been classified as arising from discontinued operations, this would have changed the profit from continuing operations before tax of £25.8m to a loss of £14.2m.

113. If the related cashflows from the disposals had been classified as investing cash flows, this would have reduced the cash inflows from operating activities from £128.7m to £59.7m.

114. The effects of the Mouchel and Company A transactions were restated in the Company's FY2018 consolidated financial statements.

114.1. The comparative figures (for FY2017) were restated to show the profit on sale of Mouchel (£40.0m) and associated tax credit (£1.1m) within non-underlying discontinued, rather than non-underlying continuing operations.

114.2. The Company's directors concluded that the operating results of Company A should have been classified as continuing in the comparative figures. However, the prior year figures were not restated to reflect this on the grounds of materiality.

114.3. The comparative cash flow was restated to show the net proceeds arising from the sale of Mouchel (£58.9m) and Company A (£9.7m) as non-underlying investing activities rather than non-underlying operating activities.

D. RELEVANT REQUIREMENTS

115. Rule 1 of the AEP states that Relevant Requirements has the meaning set out in regulation 5(11) of the Statutory Auditors and Third Country Auditors Regulations 2016 ('**SATCAR**'). The Relevant Requirements include, but are not limited to, the ISAs, issued by the International Auditing and Assurance Standards Board.

116. The ISAs relevant to this Final Decision Notice are those effective for audits of financial statements for periods ending on or after 17 June 2016.

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

117.1. ISA 200 (Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing);
117.2. ISA 230 (Audit documentation);
117.3. ISA 330 (the Auditor's Responses to Assessed Risks);
117.4. ISA 500 (Audit evidence);
117.5. ISA 501 (Specific Considerations for Select Items); and
117.6. ISA 540 (Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures).

118. Extracts from the ISAs setting out those parts which are of particular relevance to the Adverse Findings are set out in the Appendix 1 hereto.

119. As the Statutory Auditor responsible for the FY2017 Audit, Mr Hook was responsible for the overall quality of the 2017 Audit[2] and the direction, supervision and performance of the 2017 Audit in compliance with professional standards and applicable legal and regulatory requirements[3]. Accordingly, Mr Hook is responsible for any established breaches of Relevant Requirements in relation to the 2017 Audit.

120. As the Statutory Audit Firm responsible for the 2017 Audit, PwC is responsible for any established breaches of Relevant Requirements on the part of any of its partners or employees.

E. <u>ADVERSE FINDINGS</u>

Audit of long-term contracts

<u>Adverse Finding 1 – Audit evidence, testing and challenge of management representations in relation to recognition of variations and claims receivable</u>

121. In breach of paragraphs 12(a), 13, 15(a) and (b), 17 and 18 of ISA 540, paragraphs 6 and 9 of ISA 500, paragraph 26 of ISA 330 and paragraphs 15 to 17 of ISA 200, the Respondents failed adequately to determine whether the Company had appropriately applied the requirements of the applicable financial reporting framework, failed adequately to test or carry out substantive procedures in relation to the Company's accounting estimates or to obtain sufficient appropriate audit evidence in relation to accounting estimates or information produced by the Company and failed to carry out the audit with professional scepticism in that they:

121.1. in relation to [Contract 1]:

121.1.1. failed to obtain sufficient audit evidence that it was 'probable' (in accordance with the requirements of IAS 11) that revenue from unagreed variations would be received, and instead relied on an email from the

---

[2] ISA 220.8
[3] ISA 220.15(a)

Company's client (with an attached tracker of unagreed variations) which recognised the outstanding variations but did not agree to them;

121.1.2. performed insufficient audit testing on a £9.3m adjustment to profit margin for the 'extended programme' claims (as described in the audit working papers) relating to the overrun of the project;

121.1.3. in relation to additional unagreed compensation events, relied on the historically high level of approval of variations by the client without doing any further audit work;

121.1.4. accepted the Company's management's explanations for unagreed variations and adjustments to profit without applying professional scepticism to the explanations received.

121.2. In relation to [Contract 2]:

121.2.1. the Respondents accepted a proportion of claims (i.e. [Claim A], [Claim B], [Claim C] and [Claim D]) despite the evidence not supporting it being 'probable' (in accordance with the requirements of IAS 11) that the claims would be accepted and the Respondents' own recorded conclusions (in relation to [Claim A], [Claim C] and [Claim D]) that the claims did not meet the IAS 11 criteria for recognition;

121.2.2. the Respondents relied, in relation to [Claim B], on the Company's management's oral assurances that the claim would be accepted without: an explanation from the Company explaining the basis on which the client (a public sector organisation) could justify an agreement to pay a sum it was not contractually obliged to pay; seeking confirmation from the client of its intention to pay; evidence that the Respondents considered a third party legal opinion in relation to [Claim B];

121.2.3. the Respondents proposed an additional adjustment to the overall provision (for the full JV) against the claims and cost savings of £31.8m despite this being £17.1m lower than the 'most likely' outcome included in the Company's forecast end of life position, and without any explanation on the audit file as to why the Respondents did not consider

that the 'most likely' assessed position should be reflected in the financial statements.

121.3. In relation to [Contract 3]:

121.3.1. the Respondents accepted a value of £7.2m for claims against the customer despite: the rejection of the claims to date by the customer; the evidence indicating that the claims were not at an advanced enough stage to meet the recognition criteria under IAS 11; the Respondents' conclusions within the audit working papers, and also statements in the report to RMAC, that recovery was 'uncertain' and the overall traded position was 'optimistic';

121.3.2. the Respondents accepted the recognition of claims at a value higher than the 'most likely' outcome included in the Company's forecast end of life position, and without any explanation on the audit file as to why the Respondents did not consider that the 'most likely' assessed position should be reflected in the financial statements.

122. In breach of paragraph 10 of ISA 501, the Respondents failed to seek direct communication with the Company's experts in relation to [Contract 2] and [Contract 3], in that they did not seek direct communication with third party legal advisers as to their views of each of the claims.

123. In breach of paragraph 8 of ISA 230, the Respondents failed to prepare sufficient audit documentation in that in relation to [Contract 1], there is no reconciliation of the contract value and contract costs on the audit file, the record of the audit work performed is not clear and there are inconsistencies on the audit file between amounts reported and the underlying documents provided by the Company.

<u>Adverse Finding 2 – Central Profit Override</u>

124. In breach of paragraphs 12(a), 13, 15(a) and (b), 17 and 18 of ISA 540, paragraphs 6 and 9 of ISA 500, paragraphs 15 to 17 of ISA 200 and paragraph 26 of ISA 330, the Respondents failed adequately to determine whether the Company had appropriately applied the requirements of the applicable financial reporting framework, failed adequately to test or carry out substantive procedures in relation to the Company's

accounting estimates or to obtain sufficient appropriate audit evidence in relation to accounting estimates or information produced by the Company and failed to carry out the audit with professional scepticism in that they:

124.1. failed to obtain sufficient appropriate audit evidence to support the CPO and therefore that it was 'probable' (in accordance with IAS 11) that the additional profit would be received and instead accepted management explanations without sufficient challenge and purported to corroborate the adjustment through a review of the July 2017 month end contract VCRs without recording any explanation of what had changed so significantly in the month since the financial year end to justify releasing additional profit;

124.2. failed to determine that the CPO did not invalidate the prior conclusions drawn from the testing of construction contracts, given that it appears that the Respondents concluded positively on their testing of profit recognised on construction contracts but then subsequently accepted (and, in fact, proposed an increase to) the CPO.

Adverse Finding 3 – Audit testing and procedures for forecast costs to complete

125. In breach of paragraphs 13, 15(a) and (b), 17 and 18 of ISA 540, paragraphs 15 and 17 of ISA 200, paragraph 26 of ISA 330, paragraph 8 of ISA 230 and paragraphs 6 and 9 of ISA 500, the Respondents failed adequately to test or carry out substantive procedures in relation to the Company's accounting estimates or to obtain sufficient appropriate audit evidence in relation to accounting estimates or information produced by the Company; failed to prepare sufficient audit documentation; and failed to carry out the audit with professional scepticism, in that they:

125.1. in relation to [Contract 4]:

125.1.1. failed to carry out adequate audit procedures or challenge explanations provided by the Company's management in relation to the accuracy of the Company's forecast costs to complete, and in particular failed to test two increases made to the forecast cost to complete figures (the first of which was made immediately prior to the audit and the second during the course of the audit) in circumstances in which contradictory explanations

for the second of those increases were recorded on the audit file. The Respondents only compared the total costs of construction for FY 2017 with those for FY 2016 but when doing so failed to take into account the two increases to the forecast costs to complete for FY 2017;

125.1.2. failed to identify or reconcile differences in the estimated final costs and costs to complete which were included within different working papers on the audit file and the VCR report and were inconsistent with the margin reported to the RMAC.

125.2. In relation to [Contract 2]:

125.2.1. failed to carry out adequate audit procedures or challenge explanations provided by the Company's management in relation to the accuracy of the Company's forecast costs to complete from August 2017 onwards.

Classification Error

<u>Adverse Finding 4 – errors in the income statement and cash flow statement relating to the presentation of the gain on disposal of investments and cash inflows</u>

126. In breach of paragraph 24 of ISA 330, the Respondents failed to identify and correct a classification error in the income statement in that:

126.1. contrary to the requirements of IFRS 5, the gain on the disposal of Mouchel (of £40m) was wrongly disclosed as a non-underlying item within continuing operations rather than as a non-underlying item within discontinued operations, despite its inclusion within continuing operations clearly being inconsistent with the disclosure of the operating loss of Mouchel (of £2.6m) within discontinued operations.

127. In breach of paragraph 24 of ISA 330, the Respondents failed to identify and correct a material error in the cash flow statement, in that:

127.1. the cash inflows from the sales of Mouchel and Company A (totalling £69m) were wrongly disclosed as operating cash inflows rather than investing cash

inflows (contrary to paragraphs 6, 16 and 39 of IAS 7), despite the audit working papers identifying that cash flows relating to the disposal of subsidiaries or joint ventures are regarded as investing activities.

F. SANCTIONS

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

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

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

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

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

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

130. In reaching this decision, Executive Counsel has, in summary, considered the following matters in accordance with the Policy.

Nature, seriousness, gravity and duration of the breaches

131. The breaches of Relevant Requirements in this case largely relate to the audit of long-term contracts operated by the Company. Long-term contracts accounted for the majority of its Construction segment revenue in FY2017 and had a material impact on assets and revenue.

132. Given the nature of the Company's business, long-term contracts were an important area of the FY2017 Audit. Contract accounting was identified by PwC and Mr Hook as a significant risk during the planning stage of the FY2017 Audit. The Respondents identified "*accounting for long-term contracts (including profit recognition, work in progress and provisioning)*" and "*accounting for adjustments to underlying profit*" as both "*area*[s] *of focus*" for the FY2017 Audit and a Key Audit Matter in the Auditor's Report.

133. The breaches of Relevant Requirements in this case included the Respondents' failure:

133.1. to obtain sufficient appropriate evidence;

133.2. adequately to determine whether the Company had appropriately applied the requirements of the applicable financial reporting framework;

133.3. adequately to test, or carry out substantive procedures in relation to, the Company's accounting estimates;

133.4. to prepare sufficient audit documentation to support conclusions reached; and

133.5. to exercise professional skepticism or properly challenge management's representations.

134. Given that Construction contracts had a material impact on assets and revenue it followed that a misstatement might also be material. Accordingly, whilst it is not alleged that there was a misstatement in the 2017 financial statements, the breaches outlined at 133 above (relating to Adverse Findings 1-3), created a risk of material misstatement(s) in relation to the relevant Construction contract(s).

135. The Classification Error (Adverse Finding 4) caused a material misstatement in the 2017 financial statements in relation to the effects of the disposal of Mouchel and Biogen. Whilst the Classification Error required the Company to restate its FY17 results and cash flow statement, the Company's underlying results, total statutory profits and cash flows were unaffected by the restatement. Further, the available information suggests analysts were unlikely to have been misled by the Classification Error.

136. Breaches of Relevant Requirements such as these undermine confidence in the standards of conduct in general of Statutory Auditors and Statutory Audit Firms, and/or in Statutory Audit.

137. The internal review and quality procedures applied at PwC were not effective to prevent the breaches of the Relevant Requirements outlined in this Final Decision Notice.

138. Executive Counsel considers that there is a risk that the same types of breaches could re-occur.

139. The breaches of Relevant Requirements relate to only one audit year.

140. The breaches were neither intentional, dishonest, deliberate nor reckless.

Identification of Sanction

141. In 2020, PwC was the largest audit firm in the United Kingdom with revenue of £3,478m (of which £754m was for audit). PwC's total audit fee for the FY2017 Audit was £1.3m.

142. Having assessed the nature, seriousness, gravity and duration of the breaches, Executive Counsel has identified the following combination of Sanctions as appropriate for PwC:

    142.1. a financial sanction of £3,350,000;

    142.2. a declaration that the FY2017 Audit did not satisfy the Relevant Requirements;

    142.3. a published statement, in the form of a Severe Reprimand, to the effect that PwC contravened Relevant Requirements in the FY2017 Audit; and

    142.4. non-financial sanctions, in the form of an order pursuant to rule 96(c) of the AEP, requiring PwC to:

142.4.1. Within two months of this Final Decision Notice agree with Executive Counsel and the Executive Director of Supervision a list of PIE audit engagements of audited entities within the Construction, Engineering and Aerospace & Defence industries that include the audit of long-term contracts (the '**Qualifying Audits'**).

142.4.2. Include each of the Qualifying Audits in PwC's 2022 or 2023 Engagement Compliance Review ('**ECR'**) cycles. (The distribution of Qualifying Audits across the two ECR cycles to be agreed with Executive Counsel and the Executive Director of Supervision.)

142.4.3. Additionally, the ECR for each Qualifying Audit is to include additional elements focusing on the quality of audit work in relation to long-term contracts. (The details of the additional elements to be agreed with Executive Counsel and the Executive Director of Supervision within two months of this Final Decision Notice.)

142.4.4. Within two months of the conclusion of the 2022 and/or 2023 ECR cycles, provide to Executive Counsel and the Executive Director of Supervision a report evaluating all Qualifying Audits reviewed in the relevant ECR cycle including, a summary of work carried out by the ECR team, the findings and conclusions as regards quality of audit work on long-term contracts, an evaluation of the improvement work undertaken and proposals to address any remaining areas for improvement.

142.4.5. If Executive Counsel or the Executive Director of Supervision consider that an additional report is required to address further issues, such a report to be provided within three months of any such request.

143. Having assessed the nature, seriousness, gravity and duration of the breaches, Executive Counsel has identified the following combination of Sanctions as appropriate for Mr Hook:

143.1. a financial sanction of £90,000;

143.2. a published statement, in the form of a severe reprimand, to the effect that Mr Hook contravened Relevant Requirements in the FY2017 Audit; and

143.3. a declaration that the FY2017 Audit report signed by Mr Hook did not satisfy the Relevant Requirements.

Aggravating Factors

144. PwC has been sanctioned four times since 2017:

144.1. In April 2017 a £5 million sanction and a severe reprimand were imposed by an independent Disciplinary Tribunal for Misconduct in relation to PwC's audit of Connaught plc for FY09.

144.2. In June 2017 sanction of £6 million (reduced to £5.1m on settlement) and a severe reprimand were agreed for Misconduct in relation to PwC's audit of RSM Tenon Group plc for FY2011.

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

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

145. There are no aggravating factors in respect of Mr Hook.

Mitigating Factors

146. The Respondents' approached Executive Counsel at an early stage with detailed admissions and formulated breaches, which resulted in less time and expense in the investigation.

147. Since 2017, PwC has introduced a number of measures to seek to improve audit quality in the audit of long-term contracts, including:

147.1. Conducting interviews with the 2016 Audit team to understand the cause of the failings identified in this Final Decision Notice;

147.2. Mandatory firm wide training on the audit of long-term contracts;

147.3. Introduction of new audit guidance, processes and templates, including tailored audit workpapers and 'a practical guide' to the audit of long-term contracts;

147.4. Implementing new audit culture behaviours in relation to collborative working and challenge by and within audit engagement teams; and

147.5. Piloting a project management initiative to improve project management of audit engagements.

148. Whilst PwC was paid an audit fee for the engagement (see paragraph 141 above), the Respondents did not stand to gain any profit or benefit from the breaches.

149. Mr Hook has over 30 years of auditing experience and during this time has an unblemished disciplinary record.

150. Considering the aggravating and mitigating factors together and, in particular, the level of co-operation by the Respondents, Executive Counsel considers that a discount to the financial Sanctions of 10% is appropriate.

<u>Deterrence</u>

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

<u>Discount for Admissions and Settlement</u>

152. Having taken into account the admissions by the Respondents and the stage at which those admissions were made (at a point within Stage 1 of the case in accordance with paragraph 84 of the Sanctions Policy), Executive Counsel determines that a further discount of 35% is appropriate.

Financial Sanctions Payable

153. Having taken account of the discounts to be applied to reflect (i) the balance of aggravating and mitigating factors; and (ii) early admissions and settlement, a financial sanction of £1,959,750 is payable by PwC and £52,650 by Mr Hook. These sums are to be paid no later than 28 days after the date of this Final Decision Notice.

Other considerations

154. In accordance with paragraph 47(c) of the Policy, Executive Counsel has taken into account the size/financial resources and financial strength of PwC, and the effect of a financial penalty on their business.

G. COSTS

155. Executive Counsel requires that the Respondents pay the costs of this matter, amounting to £442,000. Such costs shall be paid no later than 28 days after the date of this Final Decision Notice.

Signed:

CLAUDIA MORTIMORE
DEPUTY EXECUTIVE COUNSEL
Date: 20 December 2021

APPENDIX 1 – EXTRACTS OF RELEVANT REQUIREMENTS

ISA 200 - Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing

Paragraph 15 of ISA 200 states 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. In the UK, the auditor shall maintain professional skepticism throughout the audit, recognising the possibility of a material misstatement due to facts or behaviour indicating irregularities, including fraud, or error, notwithstanding the auditor's past experience of the honesty and integrity of the entity's management and of those charged with governance."*

Paragraph 16 of ISA 200 states that "*The auditor shall exercise professional judgment in planning and performing an audit of financial statements."*

Paragraph 17 of ISA 200 states 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 230 – Audit Documentation

Paragraph 8 of ISA 230 states that *"The auditor shall prepare audit documentation that is sufficient to enable an experienced auditor, having no previous connection with the audit, to understand:*

(a) The nature, timing and extent of the audit procedures performed to comply with the ISAs (UK and Ireland) and applicable legal and regulatory requirements;

(b) The results of the audit procedures performed, and the audit evidence obtained; and

(c) Significant matters arising during the audit, the conclusions reached thereon, and significant professional judgments made in reaching those conclusions."

ISA 330 – The Auditor's Responses to Assessed Risks

Paragraph 24 of ISA 330 states that *"The auditor shall perform audit procedures to evaluate whether the overall presentation of the financial statements is in accordance with the applicable financial reporting framework. In making this evaluation, the auditor shall consider whether the financial statements are presented in a manner that reflects the appropriate:*

- *Classification and description of financial information and the underlying transactions, events and conditions; and*
- *Presentation, structure and content of the financial statements."*

Paragraph 26 of ISA 330 states that *"The auditor shall conclude whether sufficient appropriate audit evidence has been obtained. In forming an opinion, the auditor shall consider all relevant audit evidence, regardless of whether it appears to corroborate or to contradict the assertions in the financial statements."*

ISA 500 – Audit Evidence

Paragraph 6 of ISA 500 states that *"The auditor shall design and perform audit procedures that are appropriate in the circumstances for the purpose of obtaining sufficient appropriate audit evidence."*

Paragraph 9 of ISA 500 states that *"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."

ISA 501 – Specific Considerations for Selected Items

Paragraph 10 of ISA 501 states that *"If the auditor assesses a risk of material misstatement regarding litigation or claims that have been identified, or when audit procedures performed indicate that other material litigation or claims may exist, the auditor shall, in addition to the procedures required by other ISAs (UK), seek direct communication with the entity's external legal counsel. The auditor shall do so through a letter of inquiry, prepared by management*

and sent by the auditor, requesting the entity's external legal counsel to communicate directly with the auditor. If law, regulation or the respective legal professional body prohibits the entity's external legal counsel from communicating directly with the auditor, the auditor shall perform alternative audit procedures."

<u>ISA 540</u> – Auditing Accounting Estimates, including Fair Value Accounting Estimates, and Related Disclosures

Paragraph 12(a) of ISA 540 states that *"Based on the assessed risks of material misstatement, the auditor shall determine:*

(a) Whether management has appropriately applied the requirements of the applicable financial reporting framework relevant to the accounting estimate"

Paragraph 13 of ISA 540 states that *"In responding to the assessed risks of material misstatement, as required by ISA (UK) 330 (Revised July 2017), the auditor shall undertake one or more of the following, taking account of the nature of the accounting estimate:*

(a) Determine whether events occurring up to the date of the auditor's report provide audit evidence regarding the accounting estimate.

(b) Test how management made the accounting estimate and the data on which it is based. In doing so, the auditor shall evaluate whether:

(i) The method of measurement used is appropriate in the circumstances; and
(ii) The assumptions used by management are reasonable in light of the measurement objectives of the applicable financial reporting framework.

(c) Test the operating effectiveness of the controls over how management made the accounting estimate, together with appropriate substantive procedures.

(d) Develop a point estimate or a range to evaluate management's point estimate. For this purpose:

(i) If the auditor uses assumptions or methods that differ from management's, the auditor shall obtain an understanding of management's assumptions or methods sufficient to establish that the

auditor's point estimate or range takes into account relevant variables and to evaluate any significant differences from management's point estimate.

(ii) If the auditor concludes that it is appropriate to use a range, the auditor shall narrow the range, based on audit evidence available, until all outcomes within the range are considered reasonable."

Paragraphs 15(a) and 15(b) of ISA 540 state that *"For accounting estimates that give rise to significant risks, in addition to other substantive procedures performed to meet the requirements of ISA (UK) 330 (Revised July 2017), the auditor shall evaluate the following:*

(a) How management has considered alternative assumptions or outcomes, and why it has rejected them, or how management has otherwise addressed estimation uncertainty in making the accounting estimate.

(b) Whether the significant assumptions used by management are reasonable."

Paragraph 17 of ISA 540 states that *"For accounting estimates that give rise to significant risks, the auditor shall obtain sufficient appropriate audit evidence about whether:*

(a) management's decision to recognize, or to not recognize, the accounting estimates in the financial statements; and

(b) the selected measurement basis for the accounting estimates, are in accordance with the requirements of the applicable financial reporting framework."

Paragraph 18 of ISA 540 states that *"The auditor shall evaluate, based on the audit evidence, whether the accounting estimates in the financial statements are either reasonable in the context of the applicable financial reporting framework, or are misstated."*