

FINANCIAL REPORTING COUNCIL:

Before the Disciplinary Tribunal;

HH Stephen Powles QC  
Christopher Whittington  
Paul Acres

Hearing on: Friday 5<sup>th</sup> December 2014

IN THE MATTER OF A FORMAL COMPLAINT

B E T W E E N

THE EXECUTIVE COUNSEL TO THE FINANCIAL REPORTING COUNCIL

- and -

KPMG AUDIT PLC (1)

- and -

GREGORY WATTS (2)

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REPORT OF THE DISCIPLINARY TRIBUNAL

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INTRODUCTION:

1. The case concerns the public interest in ensuring the independence of auditors and the compliance with ethical and other standards. The matters investigated by the FRC and leading to these proceedings arose from a move by the senior partner of KPMG's Birmingham office (and regional chairman) to the board of a client company.
2. The standards concerned are mainly the Audit Practices Board, Ethical Standard 1 paras 15, 18 and 56 requiring: procedures to ensure integrity objectivity and independence; a control environment placing ethical standards above commercial considerations and that the client be informed in writing of matters that bore on objectivity and independence.
3. Miss Joanna Smith QC has appeared on behalf of the FRC and Mr Lomas of Freshfields, Bruckhous Deringer LLP, on behalf of KPMG and Mr Watts.
4. The Formal Complaint is annexed to this report. It comprises an introductory section followed by an analysis of the relevant standards leading to formal allegations. In this case the facts set out are accepted as correct and the allegations are admitted by both

Respondents. The parties adopt this and agree it is both a sufficient and adequate summary. Rather than paraphrase this material and we set it out below:

1. The Financial Reporting Council ("the FRC") is the independent disciplinary body for the accountancy and actuarial professions in the UK. The FRC's rules and procedures relating to accountants are set out in the Accountancy Scheme of 1 June 2014 ("the Scheme").
2. By paragraph 7(11) of the Scheme, if having reviewed any representations received for the purposes of paragraph 7(10) of the Scheme, the Executive Counsel to the FRC ("Executive Counsel") considers that there is a realistic prospect that a Tribunal will make an Adverse Finding against a Member or Member Firm and that a hearing is desirable in the public interest, then the Executive Counsel shall deliver a Formal Complaint against the Member or Member Firm to the Conduct Committee.
3. This is the Executive Counsel's Formal Complaint pursuant to paragraph 7(11) of the Scheme in respect of: KPMG Audit Plc, a member firm<sup>[1]</sup> of the Institute of Chartered Accountants in England and Wales ("ICAEW"), and Greg Watts ("Mr Watts"), a partner of KPMG LLP, the parent of KPMG Audit Plc and a member of the ICAEW, together referred to herein as "the Respondents", in connection with the Respondents' conduct in relation to (i) KPMG Audit Plc ("KPMG")<sup>[2]</sup>'s failure to conduct a sufficiently detailed investigation into the full scope and nature of the roles performed by Mr Mel Egglenton ("Mr Egglenton"), a former senior partner of KPMG's Birmingham office, prior to his appointment on 1 December 2010 as non-executive director of Pendragon Plc ("Pendragon"), a listed audit client of the firm; (ii) the Respondents' failure to provide written disclosure to Pendragon's Audit Committee as to Mr Egglenton's appointment; and (iii) Mr Watts' failure to take all reasonable steps to preserve the confidentiality of information received from Pendragon.
4. According to its website, as at December 2013 KPMG LLP is a leading provider of accounting services in the UK and, as a wholly owned subsidiary of KPMG Europe LLP, is "part of the largest integrated accounting firm in Europe". KPMG LLP in the UK has over 10,000 partners and staff working in 22 offices. KPMG reported UK fee income of £1,814 million for 2013. KPMG identifies the existence of audit quality controls which include "a tone at the top which emphasises quality, ethics and integrity".
5. KPMG LLP has its own UK Ethics and Independence Manual 2010 ("the KPMG Manual") incorporating KPMG LLP's Code of Conduct.
6. KPMG Audit Plc is a wholly owned subsidiary of KPMG LLP (held indirectly through intermediate holding companies) and its principal activity is statutory audits and related services.
7. Mr Watts was admitted to membership of the ICAEW on 1 December 1993 and was made a partner in KPMG LLP in October 2005. For the year ending 31 December 2010, Mr Watts was the Senior Statutory Auditor to Pendragon, appointed to that role for and on behalf of KPMG. He ceased to be the Senior Statutory Auditor to Pendragon on 10 May 2011.

## BACKGROUND

### *Pendragon*

8. Pendragon is a listed company and the largest independent operator of franchised motor vehicle dealerships in the UK. Its Annual Report for 2011 describes it as "the UK's leading automotive retailer" with 235 worldwide franchise points. Its total revenue is recorded as £3.5 billion and its gross profit £471 million. Audit (and audit related) fees totalled £1,275,000. As is clear from the Annual Report for 2010, audit (and audit related) fees for the years 2009 and 2010 were respectively £2,691,000 and £880,700. In each year, Pendragon's operations were predominantly in the UK. Mr Watts is identified in the 2010 Annual Report as the Senior Statutory Auditor. Mr Steventon of KPMG is identified in the 2011 Annual Report as the Senior Statutory Auditor.

9. Prior to, and at all material times since 2010 to the date hereof, Pendragon has been a listed audit client of KPMG.

*Mr Egglenton*

10. Prior to his retirement from KPMG on 31 March 2010, Mr Egglenton was the Senior Partner of KPMG's Birmingham office and the Regional Chairman of KPMG's Midlands Region. Until 30 June 2010, Mr Egglenton continued to act as a consultant to KPMG and his profit share relating to his final six months as a partner was paid to him in November 2010.

11. On 1 December 2010, Mr Egglenton joined Pendragon as a non-executive director and became a member of the Audit, Nomination and Remuneration Committees. He joined Pendragon as chairman designate of the Audit Committee and was made chairman of that committee on 10 May 2011 after Pendragon's accounts for the year ended 31 December 2010 had been signed.

*The Chain of Command*

12. In his roles as Senior Partner of KPMG's Birmingham office and/or Regional Chairman of KPMG's Midlands Region, Mr Egglenton was potentially a partner in the chain of command for the purposes of KPMG's audit of Pendragon, either by virtue of his holding those positions depending on the inherent content and responsibilities of those roles, or as a matter of fact because of the particular manner in which Mr Egglenton performed those roles. A partner in the chain of command for an audit is defined in the APB Ethical Standards Glossary of Terms ("the APB Definition") , as including:

"All persons who have a direct supervisory, management or other oversight responsibility over either any audit partner of the audit team or over the conduct of audit work in the audit firm. This includes all partners, principals and shareholders who may prepare, review or directly influence the performance appraisal of any audit partner of the audit team as a result of that partner 's involvement with the audit engagement".

13. KPMG did not have formal job descriptions or job specifications for the roles that were undertaken by Mr Egglenton as Senior Partner of KPMG's Birmingham office and/or Regional Chairman of KPMG's Midlands Region. The following documents, provided by KPMG, should have put KPMG on notice that Mr Egglenton might, as a matter of fact, be a partner in the chain of command for KPMG's audit of Pendragon so as to cause it to conduct a detailed factual investigation of the scope and extent of the roles undertaken by him prior to his appointment by Pendragon:

(i) A performance review document for Mr Egglenton entitled "2008/2009 Global Performance Management Process Mel J Egglenton" which includes the following extracts:

Under the heading "Professional Goals": "Overall ensure that audit quality is the cornerstone for all work undertaken personally and by the teams in the Midlands".

Under the heading "Interim - Self Assessment": "The role of Regional Chairman and Birmingham Office Senior Partner title have been used to better effect to visit a number of existing clients in order to further develop relationships and as a door opener on a number of businesses where we have previously done no work. These are now proving to be capable to (sic) delivering fees and my role as mentor to the younger partners on these occasions has been very satisfying."

Under the heading "Audit Performance": "I have also spent time with some of the younger partners on their audit commitments as a sounding board and mentor in difficult situations, e.g. Pendragon with Greg Watts ..."

Under the heading: "Developing people": "Coaches less experienced staff. Actively develops or assists the development of others".

Under the heading "Performance Manager Feedback" (written by Malcolm Edge): "He has...been providing lots of counselling, mentoring support to other partners in the Midlands who are dealing with difficult issues on their clients. For example, Greg Watts on Pendragon. Going forward on the client side, it is very important that Mel keeps up his own

client activity and also holds the partner and director group to account in relation to the managed accounts within the Midlands".

(ii) A performance review document for Mr Watts entitled "2008/2009 Global Performance Management Process Greg A Watts" which includes the following extracts:

Under the heading "Year End – Performance Manager Feedback" (written by Wayne Cox):  
"I have been really impressed with the way in which Greg has handled himself on the Pendragon engagement. He has been clear and concise with his consultations and without causing a stir he has made sure that he kept me, Godfrey (as EQCR) and Mel fully in the loop".

(iii) A KPMG document identifying the skills and attributes required by a Regional Chairman which includes the following:

"Is a wise sounding board who is trusted by everyone to act in the best interests of the firm as a whole".

"Reputation for client centric multi-disciplinary behaviour and cutting through silo behaviour - he or she is the glue between functions".

"Somebody people of all grades view as being approachable to consult with and share ideas etc ., provides constructive challenge".

"Mentors and actively develops both current and potential future partners and directors".

(iv) A KPMG document identifying goals for regional chairmen which includes the suggestion that 20% of their time is to be spent "running the region – planning / admin / people management / partner issues / account reviews / internal comms".

(v) A KPMG document identifying the job specification for the Manchester Office Senior Partner, which identifies both market facing and internal roles. Under the heading "Internal" the job specification includes the following:

"Responsibility for co-ordination of Manchester office activity for cross-discipline working and approach to market"

"Establish mentoring process career development/management

"Attend some Dept meetings"

"Evolution of strategy - issues and markets driven"

"People Recognised by staff and partners as a Market Leader and role model Lead Partner Communication of office successes from new work and market development as well office performance and people news Lead and inspire partners and directors".

14. The documents identified in paragraph 13 above should have put KPMG on notice that Mr Egglenton, even if he was not automatically in the chain of command for Pendragon by virtue of his positions, might in fact have had direct oversight responsibility in respect of audit partners in the Birmingham office, including Mr Watts, because of the particular way in which he performed those roles. As such, KPMG was under an obligation to conduct a detailed investigation into the scope and extent of Mr Egglenton's roles as they were performed by him prior to his appointment to Pendragon.

15. KPMG itself appears to have taken this view of Mr Egglenton's role as Senior Partner of the Birmingham office in its draft answers to questions posed by the Audit Quality Review Team in 2013. KPMG's draft response to a query about Mr Egglenton's job description includes the following: "The Senior Partner role is to provide leadership for the whole firm in that office, leading on joint working across departments and on internal issues such as staff development and communication", a response which is entirely consistent with the job specification document referred to in paragraph 13(v) above. In a comment on this draft, Jane Sawyer of KPMG has written "This sounds like chain of command to me". KPMG omitted all reference to the detail of the Senior Partner role from its final response provided on 1 March 2013

Mr Egglenton's appointment as non-executive director of Pendragon

16. The prospect of Mr Egglenton taking a position with "a listed audit client of (KPMG's) Birmingham office" was brought to KPMG's attention in an email sent by Mr Egglenton to Julian Walker ("Mr Walker"), Head of Ethics and Independence Compliance, on 24 March 2010. The email stated that Mr Egglenton "had never had an audit involvement with this client." The enquiry was general and did not refer specifically to Pendragon at that stage. On the same day, Mr Walker sent an email in response to Mr Egglenton advising, in general terms, that he would not be barred from joining such a client if he had severed all ties with KPMG and any "familiarity or intimidation" threats arising from his role at KPMG were manageable through appropriate safeguards. At the end of the email, Mr Walker says "I don't believe the independence rules require us to consider whether you are in the chain of command for this purpose". This advice was given on the basis that Mr Egglenton was not automatically in the chain of command according to KPMG's policies at the time and on the assumption that Mr Egglenton would ask for consent for a particular appointment as he was required to do (which he subsequently did).

17. KPMG became aware that Mr Egglenton had been offered an appointment as non-executive director of Pendragon in or about September 2010. In a letter dated 1 March 2013 to the Audit Quality Review Team ("the 1 March letter"), KPMG has asserted that at this stage it considered the requirements of "Ethical Standard 2" but concluded that Mr Egglenton "was not in the chain of command for the Pendragon audit and that we were therefore in compliance with the standard".

18. This conclusion reflected an expectation at KPMG that Regional Chairmen or Senior Partners of its regional offices would not automatically be in the chain of command. Although, KPMG did consider with Mr Egglenton whether he was in fact in the chain of command for the Pendragon audit, KPMG accepts that it did not carry out sufficiently detailed investigations into the scope and nature of the roles that Mr Egglenton had undertaken whilst at KPMG and in particular, KPMG did not consider the documents referred to in paragraph 13 above or seek to discover from Mr Watts the nature of his relationship with Mr Egglenton. Whilst KPMG maintains that Mr Egglenton was not, in fact, in the chain of command for the Pendragon audit as that term is defined in the APB Definition, it was nevertheless possible that a reasonable and informed third party would have considered that KPMG's objectivity might be impaired or was likely to be impaired. In the circumstances KPMG should not have reached its conclusion without first conducting a more detailed investigation into the scope and nature of the roles that Mr Egglenton had in fact undertaken at KPMG pursuant to its obligations under APB Ethical Standard 2 at ES2.48.

19. In the 1 March Letter, KPMG has said, in relation to the issue of KPMG's independence as auditor to Pendragon following Mr Egglenton's appointment more generally, that "as a safeguard a new EQCR was introduced in 2010 and the partner responsible for the audit was changed in 2011. Both partners had extensive experience and the independence and seniority required to carry out their roles in line with Ethical Standards." Whilst the EQCR for the Pendragon audit was due to rotate in 2010 in any event due to the incumbent's retirement, as a result of Mr Egglenton's appointment the identity of the incoming EQCR was changed to a partner who was not very well known to Mr Egglenton.

20. Also in the 1 March Letter, KPMG has said that, during its consideration of Mr Egglenton's appointment at Pendragon, KPMG reviewed its guidance as to whether Regional Chairmen should be regarded as part of the chain of command and concluded that this was not automatically the case. KPMG concluded that there might be circumstances where a Regional Chairman might be in the chain of command and it clarified their guidance on this. KPMG said that it now sends out advisory letters to all Regional Chairmen informing them that they are not "formally" in the chain of command but that there are certain circumstances in which they will be considered to be in the chain of command for independence purposes. These circumstances mirror those identified in the KPMG Manual at Appendix 4, as set out below in paragraph 35.

*Assistance provided by Mr Watts to Mr Egglenton in securing his appointment with Pendragon*

21. Pendragon asked Mr Watts if he could recommend an individual to replace the retiring Chairman of their Audit Committee, following which Mr Watts asked Mr Egglenton and others for suggestions as to people who might be appropriate. Mr Egglenton expressed an interest personally and, by email dated 6 April 2010, Mr Egglenton sent to Mr Watts a copy of his CV for onward transmission to Pendragon. Mr Watts subsequently informed Mr Egglenton by email on 22 April 2010 that Pendragon wanted to meet him for coffee.

22. Mr Egglenton's secretary arranged a meeting with Pendragon for 10 May 2010 and, in an email sent on 23 April 2010, Mr Egglenton asked Mr Watts for a "briefing" in advance of the meeting.

23. In an email with the subject reference "Pendragon" sent on 17 June 2010 to Mr Watts, Mr Egglenton informed Mr Watts that he was seeing "the headhunter" on Monday and stated "Any input gratefully received".

24. By 9 August 2010, Mr Egglenton had ceased to have any role with KPMG. However, for reasons which KPMG and Mr Watts have been unable to identify, a blank email was sent at 12.04pm on 9 August 2010 from Mr Watts' email account to Mr Egglenton forwarding an email from Tim Holden of Pendragon which, in turn, attached a password protected copy of Pendragon's draft Interim Statement. Mr Holden's email attaching the draft Interim Statement had been sent to Mr Watts the previous day in the normal course of his professional relationship with Pendragon. Mr Watts has no recollection of sending the email. It is not alleged that Mr Watts intended to send the email to Mr Egglenton and there is no evidence that Mr Watts sent Mr Egglenton the password or that Mr Egglenton knew the password required to open the document or that he was in fact able to open it. It was public knowledge that the Interim Statement was due to be published at 7am on 10 August 2010.

*Communications with Pendragon*

25. KPMG sent letters to Pendragon on 16 February 2011 and 5 July 2011 ("the Independence Letters") purporting to comply with professional ethical standards requiring KPMG to communicate in writing all significant facts and matters that in their professional judgment may reasonably be thought to bear on KPMG's independence and the objectivity of the Audit Director and the audit team. Neither of these letters referred to, or commented upon, Mr Egglenton's position or the question of whether his appointment as a non executive director at Pendragon might bear on KPMG's independence as auditors. In particular, there was no reference to the potential familiarity threats to objectivity and independence identified by KPMG as a consequence of Mr Egglenton's appointment at Pendragon or indeed the safeguards put in place to address them referred to in the 1 March Letter.

26. On 21 February 2012, KPMG sent a letter to the Audit Committee members of Pendragon ("the Audit Letter") purporting to comply with professional ethical standards requiring KPMG at the conclusion of the audit to provide written disclosure of relationships that bear on KPMG's objectivity and independence, the threats to KPMG's independence that these create, any safeguards that have been put in place and why they address such threats, together with any information necessary to enable KPMG's objectivity and independence to be assessed. The Audit Letter did not refer to, or comment upon, Mr Egglenton's position or the question of whether his appointment as a non-executive director at Pendragon might bear on KPMG's independence as auditors. In particular, there was no reference to the potential familiarity threats to objectivity and independence identified by KPMG as a consequence of Mr Egglenton's appointment at Pendragon or indeed the safeguards put in place to address them referred to in the 1 March Letter."

5. Foot notes make clear that KPMG describes both KPMG LLP and KPMG Audit plc where the difference is not material. However, this case is about KPMG AUDIT plc only and henceforth we shall refer to it as AUDIT unless referring to KPMG specifically.
6. The allegations against AUDIT are three fold. In summary: (1) the failure to have sufficient or appropriate policies and procedures in place that would have identified whether Mr Eggleton was in the chain of command at AUDIT such that his appointment by Pendragon as a non-executive director would require AUDIT's resignation as auditor (Allegation 1); (2) the failure to establish a control environment within AUDIT that placed adherence to ethical principles and compliance with APB Ethical Standards above commercial considerations (Allegation 2); and (3) the failure to provide the Audit Committee of Pendragon with full written disclosure of relationships that bore on AUDIT's objectivity and independence together with any safeguards that had been put in place (Allegation 3).
7. The allegations against Mr Watts, audit engagement partner for the Pendragon audit at the relevant time, are two fold in summary: (1) it is alleged that he failed to provide the Audit Committee of Pendragon with full written disclosure of relationships that bore on AUDIT's objectivity and independence together with any safeguards that had been put in place (Allegation 4). (2) there is a free-standing allegation of breach of the fundamental principle of confidentiality against Mr Watts regarding a blank email sent from his email account to Mr Eggleton on 9 August 2010 (at a time when Mr Eggleton was no longer a member of AUDIT) attaching a password protected copy of a Pendragon draft Interim Statement (Allegation 5).
8. In light of the admissions made and under paragraph 9(7)(i) of the Accountancy Scheme we find the allegations established and make adverse findings in respect of each formal allegation of misconduct.
9. The importance of ethical standards to ensure the independence, objectivity and integrity of auditors cannot be over stated. They are at the very heart of the public confidence in the audit process on which in turn the public confidence in capital markets and the conduct of public entities, depends.
10. Such is their importance that in 2003 the Government established the Auditing Practices Board to take over from the professions, responsibility for Standard setting in this area. This task is now assimilated within the FRC.

11. The Tribunal accepts that Mr Matthews who became Head of Quality and Risk Management on 1<sup>st</sup> January 2012 and Ethics Partner in 13<sup>th</sup> September 2013 is correct in stating that AUDIT firmly believes that integrity and trust are fundamentally important to the way it operates and places those qualities at the very heart of its business. It also accepts (it has not been challenged) that since the events giving rise to these proceedings changes have been made in systems, procedures and training to ensure that the risk of recurrence has been minimised.
12. However, clear breaches of the standards occurred from the Autumn of 2010 which were picked up by the FRC on a compliance review in 2012 and reveal a shortfall in compliance with the documented procedures.
13. The Panel's powers of sanction derive from paragraph 9(8)(i) of the Scheme. It may make no order, or impose any of the sanctions set out in appendix 1 to the Scheme. These include Reprimand, Severe Reprimand and a fine which may be imposed singly or in combination. In addition it may order a Respondent to pay costs.
14. We are grateful to Counsel for the FRC for setting out the relevant provisions of the Scheme and of the Sanctions Guidance including paragraphs 9, 11, 13, 16 and onwards. These provisions are advisory only and are not binding on the Tribunal, however should we decide to depart from them we should explain why we are doing so.
15. All parties' submissions have focussed on the six stage approach set out in paragraph 16 of the guidance which for convenience is set out below:

“16. It follows, therefore, that the normal approach to determining the sanction to be imposed in a particular case should be to:

- i. Assess the nature and seriousness of the Misconduct found by the Tribunal (paragraphs 17 to 21);
- ii. Identify the sanction (including the range within which any fine might fall) or combination of sanctions that the Tribunal considers potentially appropriate having regard to the Misconduct identified in i above (paragraphs 22 to 47);
- iii. Consider any relevant aggravating or mitigating circumstances and how those circumstances affect the level of sanction under consideration (paragraph 48 to 54);
- iv. Consider any further adjustment necessary to achieve the appropriate deterrent effect (see paragraphs 55 and 56);
- v. Consider whether a discount for admissions or settlement is appropriate (paragraphs 57 to 61);



- vi. Decide which sanction(s) to order and the level/duration of the sanction(s) where appropriate; and
- vii. Give an explanation at each of the six stages above, sufficient to enable the parties and the public to understand the Tribunal's conclusions."

Stage 1; Nature and seriousness;

16. Miss Smith submits by reference to paragraph 18 of the guidance that

- (i) the conduct complained of was unintentional
- (ii) the standards are of fundamental importance
- (iii) no dishonest or reckless behaviour is involved
- (iv) the procedures adopted by AUDIT and enshrined in their manual were fundamentally defective both in approach to "chain of command" in ES 1 and ES 2 and to the need for and importance of investigation into the specific roles and functions of the outgoing partner.
- (v) the misconduct is capable of undermining public confidence in the profession generally, of its members and in financial reporting standards particularly so given that it occurred within a "Big Four" firm on an audit of a UK publicly traded company.
- (vi) there is a breach of ISQC 1, effective procedures were not in place, and internal procedures were not fully complied with
- (vii) senior management were not aware of the misconduct but on it being pointed out to them initially held the view that the departing partner had been in the chain of command but subsequently argued and have maintained that he was not.
- (viii) AUDIT have made changes to its policies and procedures, guidance and training programme but the defective manual had been used firm wide for a long time - upwards of three years until November 2013.
- (ix) Mr Watts was audit partner and had sole responsibility to make disclosure to the client.

17. Mr Lomas reminded us that the primary purpose of sanctions is not to punish but to protect the public and the wider public interest as provided in Paragraph 9 of the Guidance and submits, in summary;

*Allegation 1 & 2 (AUDIT)*

- (i) It is admitted AUDIT failed to have policies and procedures sufficient to determine on his moving to an audit client, the extent of the roles he played whether he was in the chain of command.
- (ii) failure to comply with a fundamental standard does not necessarily give rise to serious misconduct
- (iii) the departing partner was not in fact in the “chain of command” so there has been no substantive breach
- (iv) consideration was given at the appropriate time to whether he was in the “chain of command”
- (v) AUDIT accepts it did not carry out a sufficiently detailed investigation and did not look at the documentary record nor (importantly for Mr Watts' position), seek to corroborate the position with Mr Watts
- (vi) AUDIT rotated Mr Watts off the audit as a precaution
- (vii) independence was not threatened
- (viii) this is not a failure to identify a risk nor to have procedures in place but is a lack of quality and vigour in following the process.
- (ix) failures were not intentional, dishonest, deliberate or reckless. No financial benefit or loss ensued.
- (x) the breach did not affect (or potentially affect) a significant number of people in the UK
- (xi) the breach was not capable of undermining confidence in part because the public did not know about it.
- (xii) action has been taken to strengthen the arrangements to guard against risk which FRC accept are now appropriate

*Allegation 3 (AUDIT)*

- (xiii) AUDIT admits it did not inform Pendragon's Audit committee in writing about the familiarity threat, as required by APB Ethical Standard 1 and para 59
- (xiv) substantive disclosure was given but not put in writing as required. This is not a serious breach
- (xv) there was no threat to independence

- (xvi) the potential threat of actual or apparent independence was discussed with Pendragon
- (xvii) For the various reasons set out at paragraph 4.6 (d) of his submissions that Pendragon had sufficient material to conclude and rightly did so conclude that there was no actual or perceived threat to independence
- (xviii) It was a matter of oversight not resulting in any gain or loss nor did it affect the public in any way. The absence of a single step, the requirement for writing, is not capable of undermining confidence.
- (xix) Mr Watts has been given an adverse risk rating and had his pay for one year reduced by £20,000 (in total in relation to the matters arising in Allegations 4 and 5)
- (xx) Appropriate remedial measures are in place.

*Allegation 4 (Mr Watts)*

- (xxi) Mr Watts adopts much of what has been submitted on behalf of AUDIT and we only give a summary of what appear to be additional points or those specific to the two allegations he faces
- (xxii) he was aware of potential independence problems and discussed the matter internally with the lead partner, Mr Steventon and the EQCR for Pendragon and his own business unit head of audit. Thereafter he and Mr Steventon discussed the matter with Pendragon
- (xxiii) Pendragon were aware that of the roles Mr Eggleton had performed during his time at AUDIT because they had his cv and they knew his engagement would end in November 2010 and so delayed his new appointment until 1 December 2010
- (xxiv) he has been sanctioned by AUDIT in the sum of £10,000 and has undertaken mandatory annual independence training and is committed never to make a similar mistake again as he explains inter alia in his personal letter to the Tribunal.

*Allegation 5 (Mr Watts)*

- (xxv) Sending the email was an unintentional and isolated mistake that caused no actual harm or give any advantage. The attached statement was password protected and the password never revealed.

(xxvi) Mr Watts has been sanctioned a further sum by AUDIT of £10,000

Stage 2: Identify appropriate sanctions

18. Miss Smith submits that Repayment of fees, Preclusion, Exclusion or in light of the changes made a direction are not appropriate in these cases, leaving Reprimand, Severe Reprimand and Fine in the frame.
19. She reminds us that under paragraph 15 of the Guidance ordinarily if the misconduct warrants a severe reprimand it will be appropriate for it to be ordered in conjunction with another sanction. A fine can be ordered in conjunction with any other sanction. She has drawn our attention to paragraphs 22 – 25 in respect of Reprimands, and 29 to 36 in respect of fines. In particular that it is normally in the public interest for any conduct warranting the imposition of a fine to be accompanied by some degree of censure (a Reprimand or Severe Reprimand). She submits there is no suggestion of financial gain.
20. Mr Lomas submits that this and the case of Marsh, which we heard first, are the first cases before the FRC for breach of independence rules particularly where there has been no impact in fact on the independence they seek to protect. He referred us to cases in the ICAEW concerning BDO and KJ Pittalis in both of which a Reprimand was given coupled with a fine. He submits that a Reprimand alone would be appropriate sanction both in respect of AUDIT and of Mr Watts. In Mr Watts case he points out the lasting damage a Reprimand will have to his reputation and career.

Stage 3: Aggravating and Mitigating circumstances

21. By reference to paragraph 53 of the Guidance, Miss Smith has drawn our attention to the following;
  - (i) the misconduct only came to light through the work of the FRC's quality Review Team
  - (ii) AUDIT having initially taken the view the departing partner was in the chain of command did not admit to this fact when responding to questions from the Review Team

- (iii) KPMG face sanction for breach of ethical standards in the case of Marsh heard on 5<sup>th</sup> December. The misconduct which occurred at much the same time is admitted.
- (iv) Mr Watts has a good compliance history and disciplinary record.
- (v) full cooperation has been given
- (vi) AUDIT has changed its policies and strengthened guidance
- (vii) Mr Watts has suffered a reduction in his risk rating within AUDIT and hence a reduction in his pay. We are told his total loss is £20,000
- (viii) while it can be said a partner leaving to join a client is an isolated event the investigation in fact reveals systemic failures by KPMG and AUDIT which has led to breaches in the case of Marsh and possibly others not detected.
- (ix) it is not contended that anyone stood to gain or profit
- (x) regret has been expressed

22. Mr Lomas highlights that:

- (i) AUDIT has cooperated fully and has been open and transparent about what occurred
- (ii) substantial steps have been taken to remedy matters
- (iii) the breaches were isolated events
- (iv) there was no gain or loss
- (v) AUDIT has a good compliance history
- (vi) the above points apply in equal measure although Mr Watts has suffered financial loss through the sanction applied by his employers, AUDIT

#### Stage 4: Adjustments for deterrence

23. We have been reminded of paragraphs 55 and 56 of the Guidance by Miss Smith. Mr Lomas says there is no case here for any increase to provide deterrence in the light of the full cooperation and remedial steps taken.

#### Stage 5: Discount for admissions or settlement

24. Miss Smith suggests that regard might be had by analogy to the guidance in relation to settlements set out in paragraph 59 of the Guidance. Mr Lomas submitted that there is

no basis for a financial penalty but if the Tribunal thinks otherwise it should be at the bottom end of the scale and any adjustment should be discounted by 35% in light of the early and complete co-operation.

### **Discussion**

25. The parties approach to this hearing has been ventilated in our Report in the case of Marsh, which we heard first but which spilled over into the time set aside for this hearing. Miss Smith invites us to take account of the evidence we have heard in the case of Marsh and to come to a more serious view of the misconduct of AUDIT than we otherwise would have done. In the case of Marsh we found that even if there was added to the evidence in that case the evidence of this case the result did not establish any increase in seriousness or justify an inference that such state of affairs as we did find had been in existence for longer or involved a larger number of people within the firm.
26. The events we are dealing with occurred at the end of 2010 when Mr Eggleton, having retired on 31st March (but continued to act as a consultant to KPMG until 30 June 2010, with his profit shares relating to his final six months as a partner paid to him in November 2010) joined Pendragon on 1<sup>st</sup> December 2010. The allegations have a time bracket to 30<sup>th</sup> June 2012 which is when the matter was discovered by the investigation team of the FRC. However no other failure of process on a partner leaving the firm to join a client is alleged to have occurred in the meantime.
27. The events in the Marsh case arose on the recruiting of Mr Marsh from an audit client on 3<sup>rd</sup> October 2011 and subsequent appointment as COO on 11<sup>th</sup> May 2012.
28. It can be said that both cases concern a lack of attention to ethical standards on personnel moving between client and KPMG or AUDIT, but it is difficult to see how later breaches of different standards, on different facts, by other people over a year later can have an impact on the seriousness of the breach by AUDIT or Mr Watts in the instant case and we reject the contention.
29. We have set out in the case of Marsh our approach to the level of sanction and do not repeat it here. However we do need to ensure that the result in this case is consistent with our own decision in Marsh.

30. In the Marsh case, KPMG were fined £350,000 reduced to £227,500 for admissions and Mr Marsh £60,000 reduced to £39,000. Both he and KPMG were reprimanded.
31. The Tribunal invited Miss Smith to assist them by suggesting a bracket and explain how it had been arrived at. The suggested bracket for AUDIT was £650,000 to £1 million and for Mr Watts £40,000 to £50,000. It is not a criticism of anybody because in truth there is very little on which to ground an analysis but no real explanation was provided.
32. Like the case of Marsh, Mr Lomas seeks to argue that the events are isolated. Like the case of Marsh and for similar reasons, we reject that contention. What the FRC Quality Review team discovered was a state of affairs in which AUDIT lacked procedures properly to identify whether there should be an investigation into the roles a leaving partner had undertaken before transferring to a client company, still less any criteria for triggering or conducting such investigation were it necessary. This situation cannot be described as an isolated event, rather it is a state of affairs that existed within AUDIT in which there was no properly documented requirement to ensure that ethical considerations were in the forefront of the relevant management's consideration on a partner leaving to join an audit client.
33. We have no direct evidence of the duration or extent of that failure because Mr Lomas decided not to tender any witness for cross examination nor call any evidence about it. It certainly appears that the inadequate and defective manual had been in existence for some time before the Autumn of 2010 and was not finally corrected (or supplemented) until November 2013 when advice was added that an individual might be in the chain of command as a result of his role in appraisal and other matters. While that might have been prompted by a change to the appraisal system which drew more partners into consideration as "chain of command" as Mr Lomas told us, nevertheless Miss Smith's point remains valid. We have no information about training programmes and the history of those involved in undertaking training. It is however clear that the importance of the ethical standards concerned was, for a significant time, not covered in the manual and hence not in the forefront of the minds of those responsible for assenting to partners joining audit clients and for ensuring that the independence letter properly referred to all matters that might impinge on their independence and the steps taken to address them. Fortunately no other breaches have come to light before or since, apart from the case of Mr Marsh which was discovered by the FRC during the same review.

34. In some respects the facts of this case are worse than that of Mr Marsh because the AUDIT manual has been shown not to have given sufficient definition to those who might be in “chain of command” for the purpose of the standards. In other respects there may be stronger mitigation because it is not raised before us that Mr Egglenton was in fact in the chain of command, rather it is said that AUDIT’s approach to reaching that conclusion was flawed. This enables Mr Lomas to submit, rightly as we find, that Mr Egglenton’s appointment did not of itself breach any substantive standard and the allegations go to process only. That submission however does not engage with the fact that the manual itself did not alert partners to the full breadth of “chain of command” issues covered by the standards.
35. Turning to the failure to record potential independence problems relating to Mr Egglenton in the independence letter Mr Watts sent on 16<sup>th</sup> February 2011, it had already been decided that Mr Watts would be rotated off the Pendragon audit when on 1<sup>st</sup> December 2010 Mr Egglenton was appointed non-executive director of Pendragon and chairman designate of its audit committee. The annual report for year ending 31<sup>st</sup> December 2010 was published on 22<sup>nd</sup> February 2011 and Mr Egglenton became chairman of the audit committee on 10<sup>th</sup> May 2011.
36. Pendragon knew full well that Mr Egglenton had been a partner in AUDIT, they had his c.v. and had interviewed him. They recorded their consideration in the 2013 annual report. What they would not have known is the detail of the mentoring and support he had given to Mr Watts then conducting the 2010 audit such that there was or might be a familiarity threat or that that such considerations might have led to a conclusion that Mr Egglenton was in the chain of command.
37. We accept that Mr Watts was convinced in his own mind that there was no live independence issue and that Pendragon were aware of the issues. However we acknowledge the point made by Miss Smith that the written record is important in itself and its absence may impact on the public’s confidence in the profession.
38. Allegation 5, is concerned solely with the email forwarded to Mr Egglenton with a password protected confidential attachment. The evidence before us is that Mr Egglenton had not the means to and did not open that attachment. Of course the email should not have been forwarded and it is far from clear how or why it happened.



39. On the one hand it can be said that Mr Watts' email of 22<sup>nd</sup> April 2010 suggests he had spoken favourably of Mr Egglenton and it might be inferred that he was seeking and continued to seek to assist him. On the other, the interim statement was due to be made public on 10<sup>th</sup> August 2010 so at best the information could only have given him a few hours more notice. Mr Watts has consistently denied that he either sent or had knowledge of the email leaving his account.
40. We cannot find that it was more than an innocent mistake and do not consider the facts of this allegation to have any adverse effect on the overall sanction we are considering.

### **The Sanctions**

#### *Stage 1 – initial assessment of the potential sanction*

41. Of the matters listed in paragraph 18 of the Sanctions Guidance we consider the following to be most relevant: there was no financial benefit and the breaches occurred unintentionally; all breaches of ethical standards have the potential to undermine public confidence; procedures and definitions within AUDIT about “chain of command” clearly needed revision; once senior management were aware of the issue they decided Mr Egglenton was not in the chain of command; it is not challenged that Mr Egglenton was not in the chain of command; Mr Watts was responsible for the independence letter but the lack of clarity in the manual and inconsistency of approach by AUDIT did not assist him (allegation 4), it is the Tribunal's view that AUDIT were responsible for creating the situation of uncertainty around Mr Egglenton's position and was as much to blame as Mr Watts, if not more so; Mr Watts was solely responsible for the sending of the email to Mr Egglenton (Allegation 5)

#### *Stage 2 – identify sanction range*

42. Considerations of the size of a fine engage paragraphs 29 to 36 of the Sanctions Guidance. The revenue and operating profit for AUDIT in the year 2012 were £195m and £19m respectively. The fee income generated by the Pendragon audit in 2010 was £880,700.
43. Reprimand should be considered for both AUDIT and Mr Watts, with an accompanying fine for AUDIT between £150k to £300k, and for Mr Watts the question would be

whether there should be a fine and if so between £0 and £20k. As far as allegation 5 alone is concerned, the allegation is less serious but the Tribunal at this stage do not seek to select a separate sanctions bracket.

44. Mr Watts has suffered a penalty of £20,000 imposed by AUDIT

*Stage 3 – aggravation and mitigation*

45. Of the examples set out in paragraph 53 of the Guidance; while true that these matters were not drawn to the attention of the FRC this is because the deficiency in AUDIT's systems had not been identified by them; where there is a deficient system the problem lasts for the duration of the deficiency and it cannot be dressed up as an isolated event.

46. As far as mitigating factors are concerned the following of the examples set out in paragraph 54 of the Guidance are relevant: there has been full cooperation throughout; as soon as senior management was aware of the deficiencies in the definitions and procedures relating to "chain of command" action was taken to improve and strengthen the manual and procedures; as a further precaution on the standard rotation of auditors, they ensured that Mr Watts' replacement was little known to Mr Eggeleton; breaches of this type are unlikely to be repeated so long as staff receive regular training and refresher courses; both the firm and Mr Watts have good compliance and disciplinary records (the adverse determination made in the case of Marsh, coming 4 years after the events in question, does not alter this fact); both have demonstrated contrition. Lastly but not included in paragraph 54, Mr Watts has had a penalty of £20,000 imposed on him by his employers, AUDIT.

47. Putting these factors into our consideration and before discount for admissions we find the sanction for AUDIT should be a reprimand and a fine of £250k. We cannot accept that no fine is called for as Mr Lomas submits. Mr Lomas, for Mr Watts, submits he should receive a reprimand only for failing to include full information in the independence letter without accompanying fine and no sanction in respect of the email. The Tribunal agrees with this submission. Allegation 5 (in respect of the email) adds nothing significant to the seriousness of Allegation 4 and had Allegations 1 to 3 not been brought against AUDIT the Tribunal doubts that allegation 5 could have come to the FRC for consideration.

#### *Stage 4 – adjustment for deterrence*

48. It is this Tribunal's view that neither AUDIT nor Mr Watts need further deterrence. They clearly recognise the importance of ethical considerations and have demonstrated a determination to achieve compliance. As far as other firms are concerned it is important to bear in mind that it is deterrence from the particular kind of breach we are concerned with and not deterrence in general from breaching ethical standards. We see no warrant to increase what we consider to be proper sanctions on this account by increasing the amount of any fine. The overall sanction, imposed as it is on one of the largest firms, will send a proper message to other members of the profession.

#### *Stage 5 – discount for admissions*

49. AUDIT is entitled to a discount of 35% which reduces their fine to £162,500

### **Decision**

50. We made adverse findings on all allegations in the course of the proceedings. We have followed the Sanctions Guidance in determining the appropriate type and level of sanction as set out above. We are satisfied that these fines are proportionate to the breach and the financial circumstances of the respondents.

51. KPMG AUDIT plc is sanctioned by a Reprimand and a fine of £162,500.

52. Mr Watts is sanctioned by a Reprimand only in respect of allegation 4 and no sanction in respect of allegation 5.

### **Costs**

53. After the hearing the parties handed to the Tribunal Secretary a signed document whereby AUDIT agreed to pay the costs of the proceedings in the sum of £38,103.73 in 28 days regardless of any appeal. It subsequently transpired that the figure for costs had omitted the Tribunal Members and Secretary's time based fees for preparatory work, both before and after the hearing as well as expenses and disbursements.

54. The Tribunal has been informed via the Secretary that these additional costs are agreed to be paid by AUDIT.

55. The totality of these costs will not be known until after the Report has been published. In the circumstances a proper order would seem to be that KPMG AUDIT plc should (1) pay the FRC the agreed sum of £38,103.73 with 28 days (2) pay the FRC such further sums as are not included in the above sum but which are paid to the Tribunal Members and Secretary together with any expenses or disbursements in connection with the hearing within 14 days of being notified of the total thereof by the FRC (3) in the event of any dispute as to the amount of the additional sum the matter is to be referred to a costs judge for determination (4) Liberty to apply to the Tribunal Chairman (a) for reconsideration of this order within 14 days of it being notified to the parties and (b) for further directions if needed.
56. The Tribunal were unanimous in the above decisions.



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HH Stephen Powles QC  
(Tribunal Chairman)

Dated 26 January 2015