IN THE MATTER OF:

THE EXECUTIVE COUNSEL TO THE FINANCIAL REPORTING COUNCIL

- and -

(1) GRANT THORNTON UK LLP

(2) ROBERT NAPPER

PARTICULARS OF FACT AND ACTS OF MISCONDUCT

I. INTRODUCTION

A. THE FINANCIAL REPORTING COUNCIL INVESTIGATION

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 (the "**Scheme**") and Accountancy Regulations of 8 December 2014. Capitalised terms not defined in this Proposed Formal Complaint have the meaning given to them by the Scheme.

2. On 22 July 2014 the Conduct Committee of the FRC directed Executive Counsel to investigate the conduct of the Respondents (and others) in relation to:

   "…the preparation, approval and audit of the financial statements of AssetCo plc for the years ended 31 March 2008 to 31 March 2010 and of Members in the preparation, approval and review of financial information prepared for the period ended 30 September 2011 leading up to the identification of the reported misstatements."

3. This is Executive Counsel's Particulars of Fact and Acts of Misconduct (the "**Agreed Particulars**"), which has been agreed with the Respondents, in relation to the conduct of the Respondents in relation to the audit of the financial statements of AssetCo plc ("**AssetCo**") for the years ended 31 March 2009 and 31 March 2010 (the "**2009 Financial Statements**" and "**2010 Financial Statements**" respectively). The financial statements for the 18 month period to

30 September 2011[1] are referred to herein as the “**2011 Financial Statements”.** Associated terms are “**FY 2009**” and the “**2009 Audit**” (of the 2009 Financial Statements) with such terms used *mutatis mutandis* for the other years.

B. THE RESPONDENTS AND ASSETCO

4. AssetCo was at all material times an Alternative Investment Market listed business, whose business included the provision of outsourced fire and rescue services and the provision and maintenance of fire and rescue equipment under long term asset management contracts in the UK.

5. The First Respondent (“**GT**”) is a member firm of the Institute of Chartered Accountants in England and Wales (“**ICAEW**”). GT is a major accountancy firm in the UK, being the fifth largest by turnover. In their financial statements for the financial year ended 30 June 2016, they reported:

    a. £534m turnover;

    b. £72m profit before tax;

    c. £381,000 average profit per partner; and

    d. 179 partners and 4,450 other full-time-equivalent staff.

6. The ICAEW is a “Participant” within the meaning of the Scheme and accordingly, GT is a “Member Firm” for the purposes of the Scheme. GT provided audit services to AssetCo for the 2009 Financial Statements and the 2010 Financial Statements (the “**Audit Services**”).

7. The Second Respondent (“**Mr Napper**”) was at all material times a partner at GT and was the Engagement Partner for the Audit Services. He was at all material times a member of ICAEW but has since retired from practice at GT.

8. Other employees of GT with a significant role in the provision of the Audit Services in one or both years were:

[1] No allegations are made against the Respondent in respect of the 2011 Financial Statements.

a. M1[2], assistant manager (2009) and subsequently manager (2010);

b. M2, manager; and

c. M3[3], senior manager.

GT's technical departments, the "National Assurance Service" ("**NAS**") and "Valuations Services" ("**VS**"), also provided technical responses to internal queries raised with them by GT employees providing the Audit Services.

9. AssetCo's executive team was led by Mr John Shannon the CEO and Mr Frank Flynn the CFO (both directors). Another material individual at AssetCo was Mr Matthew Boyle (the Financial Controller reporting to Mr Flynn).

C. THE TEST FOR MISCONDUCT AND APPLICABLE STANDARDS

10. Misconduct is defined in the Scheme as:

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

11. As members of the ICAEW at all material times, the ICAEW Code of Ethics in force at the material time[4] (the "**Code**") applied to the Respondents.

12. The Executive Counsel will refer to and rely upon the applicable paragraphs of the Code as annexed to these Agreed Particulars at Annexe A. Key provisions upon which Executive Counsel rely are set out below.

13. Part A of the Code sets out generally applicable principles and Part B sets out the application of those principles to professional accountants in public practice.

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[2] The names of the staff referred to in paragraph have been anonymised. No allegations have been made against these individuals by Executive Counsel.

[3] M3's increased seniority, along with the additional year's audit experience gained by the other two managers, led to his involvement in the 2010 audit being much reduced.

[4] Being the version in force from 1 September 2006 to 31 December 2010

At all material times, the Respondents were professional accountants in public practice within the meaning of the Code.

14. The fundamental principles of professional competence and due care, and professional behaviour apply to the Respondents pursuant to paragraphs 100.4, 130 and 150 of the Code.

15. Specifically, paragraph 130 of the Code required the Respondents to (amongst other things) *"…act diligently in accordance with applicable technical and professional standards when providing professional services".*

16. The technical standards applicable to the Respondents included International Standards on Quality Control (UK and Ireland) and International Standards on Auditing (UK and Ireland) issued by the FRC. Those standards are updated from time to time. These Agreed Particulars refer to the version in force at the time relevant to the Act of Misconduct.

17. Three of the most important applicable technical standards were ISA 200, ISA 230 and ISA 500.

18. ISA 200 sets out the Objective and General Principles governing an audit of financial statements.

    a. Paragraph 4 states:

    "The auditor should comply with the Code of Ethics for Professional Accountants issues by the International Federation of Accountants. Ethical principles governing the auditor's professional responsibilities are:

    (a) Independence

    (b) Integrity

    (c) Objectivity

    (d) Professional competence and due care

    (e) Confidentiality

    (f) Professional behavior

(g) Technical standards."

b. Paragraph 5 states: "*The auditor should conduct an audit in accordance with ISAs (UK and Ireland)."*

c. Paragraph 6 states: "*The auditor should plan and perform an audit with the attitude of professional skepticism recognising that circumstances may exist that cause the financial statements to be materially misstated. An attitude of professional skepticism means the auditor makes a critical assessment, with a questioning mind of the validity of audit evidence obtained and is alert to audit evidence that contradicts or brings into question the reliability of documents or management representations*."

19. ISA 230 (Audit Documentation) provides:

a. Paragraph 2: "*The auditor should prepare, on a timely basis, audit documentation that provides: (a) A sufficient and appropriate record of the basis for the auditor's report; and (b) Evidence that the audit was performed in accordance with ISAs (UK and Ireland)* and applicable legal and regulatory requirements";

b. Paragraph 5: "*…audit documentation serves as a number of purposes, including: (a) Assisting the audit team to plan and perform the audit; (b) Assisting members of the audit team responsible for supervision to direct and supervise the audit work, and to discharge their review responsibilities in accordance with ISA 220 (UK and Ireland), 'Quality control for audits of historical financial information'; (c) Enabling the audit team to be accountable for its work; (d) Retaining the audit of matters of continuing significance to future audits; (e) Enabling an experienced auditor to conduct quality control reviews and inspections ….. (f) Enabling an experienced auditor to conduct external inspections in accordance with applicable legal, regulatory or other requirements*."

c. Paragraph 9: "*The auditor should prepare the audit documentation so as 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 ISAs (UK and Ireland) and applicable* *legal and regulatory requirements; (b) The results of the audit procedures and the audit evidence obtained; and (c) Significant matters arising during the audit and the conclusions reached thereon*."

d. Paragraph 11: "*Oral explanations by the auditor, on their own, do not represent adequate support for the work the auditor performed or conclusions the auditor reached, but may be used to explain or clarify information contained in the audit documentation*."

e. In Paragraph 16: "*The auditor should document discussions of significant matters with management and others on a timely basis*."

f. In Paragraph 18: "*If the auditor has identified information that contradicts or is inconsistent with the auditor's final conclusion regarding a significant matter, the auditor should document how the auditor addressed the contradiction or inconsistency in forming the final conclusion*."

20. ISA 500 (Audit Evidence) provides:

a. Paragraph 5: "…*However, because Accounting records alone do not provide sufficient audit evidence on which to base an audit opinion on the financial statements, the auditor obtains other audit evidence." and Paragraph 6 states that: "Other information that the auditor may use as audit evidence includes …confirmations from third parties…"*

b. Paragraph 9 states that "*The reliability of audit evidence is influenced by its source and by its nature and is dependent on the individual circumstance under which it is obtained.* Further that, "*Audit evidence is more reliable when it is obtained from independent sources outside the entity… Audit evidence obtained directly by the auditor… is more reliable than audit evidence obtained indirectly or by inference… Audit evidence is more reliable when it exists in documentary form… Audit evidence provided by original documents is more reliable than audit evidence provided by photocopies or facsimiles*."

c. Paragraph 11: "*When information produced by the entity is used by the auditor to perform audit procedures, the auditor should obtain audit evidence about the accuracy and completeness of the information*".

21. Accordingly, the obligation to act with professional competence and due care (as set out in paragraph 15 above) required the Respondents to (amongst other things): i) obtain sufficient appropriate audit evidence; ii) act with appropriate professional scepticism[5]; and iii) prepare sufficient and appropriate audit documentation.

22. Certain other applicable standards are explained, where relevant, below:

a. ISA 550 - Related parties;

b. ISA 570 – Going Concern;

c. ISA 620 - Using the work of an auditor's expert; and

d. International Standard on Quality Control (UK and Ireland) 1 - Quality control for firms that perform audits and reviews of financial statements, and other assurance and related services engagements ("**ISQC 1**").

23. The preparers of the 2009 Financial Statements and 2010 Financial Statements (i.e. AssetCo's management) were required to follow International Financial Reporting Standards[6] ("**IFRS**") when preparing AssetCo's consolidated financial statements. Those IFRS were issued by the antecedent International Accounting Standards Council, and endorsed and amended by the International Accounting Standards Board. The standards are updated from time to time and these Agreed Particulars refer to the version in force at the time relevant to the Act of Misconduct. Where the 2009 Financial Statements or the 2010 Financial Statements were in breach of an IAS, and that is relevant

[5] In this document, the spelling of this word adopts the UK spelling, albeit the American spelling is used in the text of the relevant ISA.
[6] Which incorporate the International Accounting Standards ("IAS"), which are referred to in this Formal Complaint.

in the view of Executive Counsel to the conduct of the Respondents, it is highlighted below.

II. FACTUAL BACKGROUND

24. The 2009 Financial Statements and 2010 Financial Statements originally showed substantial net assets and profits. However, there were substantial restatements of net assets and profits for the FY 2009 and FY 2010 recognised in the 2011 Financial Statements (which the Respondents did not audit):

Year End	Original Net Assets £M	Restated Net Assets £M	Net Asset Differential £M	Original Profit £M	Restated Profit £M	Profit Differential £M
31/3/09	51.835	(68.754)	(120.589)			
31/3/10	60.818	(85.375)	(146.193)	2.271	(23.268)	(25,539)

25. The Respondents issued unqualified audit opinions in respect of the 2009 and 2010 Financial Statements. In the 2010 Financial Statements, for example, Mr Napper (on behalf of GT) stated (amongst other things):

"In our opinion the group financial statements:

- *give a true and fair view of the state of the Group's affairs as at 31 March 2010 and its profit for the year then ended;*
- *have been properly prepared in accordance with IFRS as adopted by the European Union; and*
- *have been prepared in accordance with the requirements of the Companies Act 2006."*

26. AssetCo's principal business at all material times was in providing outsourced fire and rescue services. Its main contracts were with two local authorities: the London Fire and Emergency Planning Authority ("**LFEPA**" or "**London Fire**"), and Lincolnshire Fire and Rescue ("**Lincoln Fire**"). The relevant contracts with London Fire and Lincoln Fire are referred to as the "**London Contract**" and "**Lincoln Contract**" respectively.

27. AssetCo was also seeking to operate internationally, in particular in the United Arab Emirates where it won contracts in October 2009 and February 2010.

III. THE RESPONDENTS' MISCONDUCT

28. The Respondents accept that, in relation to the Admitted Acts of Misconduct set out below, their conduct fell significantly short of the standards reasonably to be expected of a Member or Member Firm (respectively). They have expressed to Executive Counsel their disappointment with the aspects of the Audit Service with which these Agreed Particulars deal.

29. The root cause of many of the defects in the Audit Services was a significant failing in the application of professional scepticism, which should be at the core of the work of statutory auditors.

30. In particular and without prejudice to the detailed Admitted Acts of Misconduct identified below, the Respondents were aware that AssetCo had experienced significant cash flow difficulties at times during the financial years being audited and in particular that, in the future, continued trading would, be dependent on significant refinancing being obtained. However (although going concern was identified as a risk area for the FY 2009 and FY 2010 Audits[7]), the Respondents ultimately concluded for FY 2009 and FY 2010 that AssetCo **was** a going concern.

31. Having identified going concern as a risk area, the Respondents should have realised the particular importance of professional scepticism in their audit work and applied appropriate professional scepticism in the provision of the Audit Services. This would in turn have prompted the Respondents to appreciate the need to obtain sufficient appropriate evidence (including evidence from third parties) to corroborate information and assertions received from management.

32. Further, during the provision of the Audit Services, there were instances of deceit, of the GT audit team by the senior management of AssetCo. A number of specific examples are dealt with in the Acts below. These instances related to misstatements later identified in the Financial Statements. With the

[7] This was confirmed by Mr Napper in his interview with Executive Counsel.

application of appropriate professional scepticism, and/or in the absence of the factors set out at paragraph 33 below, the Respondents could and would have uncovered the deceits in many (if not all) of the situations. However, it is common ground that the Respondents were in fact misled by AssetCo's management as set out below.

33. Other failings by the Respondents arose as a result of the GT audit team's significant and widespread lack of professional competence and due care in the performance of the FY 2009 and FY 2010 Audits including:

    a. Failures to keep track of tasks and resolve outstanding queries, which led to some key information and issues being overlooked and to confusion;

    b. Flawed judgments; and/or

    c. Deficiencies in understanding and insufficient appreciation of audit risks.

    In respect of various of the Admitted Acts of Misconduct, the failings were ascribable to a confluence of the above factors.

34. Further, the conduct identified in Agreed Particulars evidences significant failings relating to the Audit Services provided to AssetCo in the execution of quality control procedures operating at GT at the relevant time, which are reflected in Act 12 below.

35. It is not alleged in these Agreed Particulars that the Respondents' conduct was "reckless"[8] or breached the Fundamental Principle of Integrity[9].

36. During the course of the investigation, Executive Counsel has interviewed Mr Napper and two other members of the audit team. GT and Mr Napper have at all times co-operated fully with Executive Counsel's investigation.

37. The Executive Counsel proceeds against the Respondents in respect of the following admitted acts of Misconduct.

[8] Within the meaning of the FRC Sanctions Guidance
[9] As defined in the Code

ADMITTED ACTS OF MISCONDUCT

ACT 1: BALLANDERE

The Respondents' conduct fell significantly short of the standards reasonably to be expected of a Member and Member Firm in that they issued an unqualified audit opinion in respect of the 2010 Financial Statements (1) notwithstanding that those financial statements omitted reference to Ballandere in a related party transaction note; (2) notwithstanding that the Respondents had in their possession evidence from which they ought to concluded that such disclosure was required; and (3) having failed to apply appropriate professional scepticism in respect of this matter. The Respondents thereby acted in breach of the fundamental principles of Professional Competence and Due Care contrary to paragraph 130 of the Code.

Particulars

1. Ballandere Limited ("**Ballandere**") purchased Star Rentals Limited ("**Star Rentals**") from AssetCo Group Limited on 10 March 2008 for £1.585 million, with £900,000 payable on completion, deferred consideration of £185,000 payable on the first anniversary of completion and £500,000 payable on the second anniversary.

2. Note 35 to the 2009 Financial Statements recorded the deferred consideration due to AssetCo from Ballandere and noted Ballandere as a related party "*by virtue of the fact that certain directors are considered to be 'connected persons' with John Shannon in accordance with section 346(2) of the Companies Act 1985 and IAS 24 'Related Party Disclosures'*." A member of Mr Shannon's family owned Ballandere and so was a connected person within the definitions of s346(2) of the Companies Act 1985 and IAS 24.

3. Therefore, at the time of the 2009 Financial Statements the Respondents knew that Ballandere was a related party to AssetCo.

4. There were no material changes in control of ownership of either Ballandere or AssetCo, between the end of the FY 2009 and the end of FY 2010. Accordingly, any material transactions with Ballandere should also have been included in

the related party notes to the 2010 Financial Statements. As explained below, such information was not so included.

5. M1 of GT emailed Mr Napper on 23 May 2010 stating that the acquirer of Star Rentals (i.e. Ballandere) was "*a holding company whose principal shareholder was Joel Shannon – John Shannon's son – therefore making this a related party transaction*". That email began "*I understand from [M2, of GT] that you wanted me to look into the RPT's* [related party transactions] *surrounding Star Rentals and Graffic* [sic] *Traffic*".

6. M1's email shows that Mr Napper had turned his mind to the question of related party transactions. Upon receipt of M1's email, Mr Napper knew, or ought to have known, that Ballandere was a related party in FY 2010 because of Joel Shannon's involvement with that company.

7. By a share purchase agreement of 30 March 2010 (the "**Graphic SPA**"), AssetCo Group Limited acquired Graphic Traffic Limited ("**Graphic**"). Prior to that acquisition Mr Shannon was the sole shareholder and director of Graphic.

8. In the email dated 23 May 2010 from M1 to Mr Napper, the former explained:

> "*On 31 March 2010 AssetCo plc acquired Graffic [sic] Traffic - a company for whom John Shannon acts as director. When Graffic Traffic became part of the AssetCo plc group of companies the balanced [sic] owed to John was transferred into AssetCo plc as well as the amount due from the acquisition of Star Rentals. Per Matt, the amount due to AssetCo for the acquisition of Star Rentals was due from John as he was funding the acquisition for his son and therefore the two balance have been netted off against one another so that no balance is shown as payable to or due from related parties"*

9. The purported netting off, on or about 31 March 2010, of the sum outstanding from Ballandere for the purchase of Star Rentals in 2008 against the sums due from Graphic Traffic to John Shannon, is referred to in this document as the "**Ballandere Transaction**". On the face of the information provided to the Respondents, the Ballandere Transaction should have been included in the related party note for the 2010 Financial Statements. It was not.

10. The language for disclosure of the Ballandere Transaction was originally proposed by M1, to James Beard (AssetCo Group Financial Controller) in a marked-up draft of disclosure notes, which M1 attached to an email he sent to AssetCo on 6 July 2010, in the following terms:

> *“The vendor of Graphic Traffic Limited (see note 31) was John Shannon. Prior to acquisition, the Group made purchases of £X (2009: £231,302) from this company. Upon acquisition of Graphic Traffic Limited, £650,000 owed to the Group by Ballandere Limited was offset against monies owed by Graphic Traffic Limited. The net balance owed by Ballandere Limited at 31 March 2010 is £nil.”*

11. Following receipt of that draft text, Mr Shannon emailed Mr Napper in relation to the related party transaction note. Of the relevant paragraph referring to Ballandere, Mr Shannon wrote:

> “*I’m unsure what paragraph 2 actually says. As an unrelated party to Ballandere I do not know what this sentence adds*.”

12. The assertion that Ballandere was “an unrelated party” was false and contradicted the 2009 Financial Statements. Mr Shannon subsequently had a phone call with Mr Napper on 8 July 2010 in which the drafting of this related party note was discussed.

13. The paragraph identified in paragraph 10 above referring to Ballandere was thereafter deleted and the 2010 Financial Statements did not refer to Ballandere as a related party. Instead, the disclosure finally read:

> "*The vendor of Graphic Traffic Limited (see note 31) was John Shannon. Prior to acquisition, the Group made purchases of £235,013 (2009: £231,302) from the company*."

14. The failure by AssetCo to disclose the Ballandere Transaction was a breach of IAS 24, in particular paragraph 18 which states:

> *"If an entity has had related party transactions during the periods covered by the financial statements, it shall disclose the nature of the related party relationship as well as information about those transactions and*

outstanding balances, including commitments, necessary for users to understand the potential effect of the relationship on the financial statements. …At a minimum, disclosures shall include:

a) the amount of the transactions;

b) the amount of the outstanding balanced, including commitments, and

(i) their terms and conditions, including whether they are secured,

and the nature of the consideration to be provided in settlement; and

(ii) details of any guarantees given or received;

c) provisions for doubtful debts related to the amount of outstanding

balances and

d) the expense recognised during the period in respect of bad or doubtful debts due from related parties."

15. There is no contemporaneous evidence available as to why GT decided that AssetCo was entitled to limit the disclosure in this manner. Mr Napper was aware that Ballandere was a related party. Mr Napper believes that the most likely explanation is that, at the time, he considered that the removal of the words referring to the offsetting of equal balances due to and from Ballandere (resulting in a nil balance at year end) would not materially impact the financial statements and that therefore the disclosure was adequate. Mr Napper failed to consider whether the offsetting was the rationale for the transaction rather than one effect of it, and therefore its implications for disclosure in the financial statements.

16. The Respondents admit that their failures in respect of disclosure of the Ballandere Transaction arose by reason of the insufficient application of Professional Scepticism in breach of ISA 200.

17. The Respondents admit that the above conduct fell significantly short of the standards reasonably to be expected, in that it exhibited a serious want of care and/or a serious error of judgment and breached paragraph 130.1(b) of the

Code in that the Respondents did not act diligently in accordance with applicable technical and professional standards, but instead failed to comply with them.

ACT 2: RESTRICTED CASH 2009

The Respondents' conduct fell significantly short of the standards reasonably to be expected of a Member and Member Firm in that they issued an unqualified audit opinion in respect of the 2009 Financial Statements notwithstanding that they had in their possession evidence that disclosure in relation to restricted cash was required. The Respondents thereby acted in breach of the fundamental principles of Professional Competence and Due Care contrary to paragraph 130 of the Code.

Particulars

1. In January 2009 AssetCo (Abu Dhabi) Limited ("**AADL**"), a company in the AssetCo group, issued preference shares pursuant to an agreement dated 12 January 2009 with North Atlantic Value LLP ("**NAV**")[10], AssetCo plc, and a number of investors (the "**Preference Share Issue**"). The proceeds of the Preference Share Issue were restricted (under the terms of the share issue) for use by AADL in developing a specific category of business in Abu Dhabi (the "**Restriction**"). The share issue terms permitted £5 million of the proceeds to be loaned to AssetCo, repayable within 12 months, for its usual operations outside Abu Dhabi.

2. GT's note of a meeting for the 2009 Audit with Mr Boyle of AssetCo on 7 January 2009 refers to the Restriction. £15 million was said to have been raised and was subject to the Restriction (save that £5 million could be loaned to AssetCo, but had to be repaid within 12 months).

3. The Respondents sent a draft Key Issues Memorandum ("**KIM**")[11], titled "KIM – AssetCo plc AC Draft for discussion FY09", to AssetCo's Audit Committee on 5

[10] A company managed by and under the ultimate control of J O Hambro Capital Management Group ("J O Hambro").
[11] A significant document prepared by the Respondents in the course of the audit, setting out discussion on key audit risks for consideration by the Audit Committee

June 2009 which also referred to the Restriction. The amount of the restriction relating to balances held at 31 March 2009 was stated by the Respondents in the draft KIM to be £7.5 million, in contrast to the £15 million (less the £5 million which could be loaned) identified at the meeting of 7 January 2009).

4. The Restriction was discussed at an Audit Committee meeting on 8 June 2009. The Audit Committee minutes record that GT asserted that certain monies were "*ring fenced for the sole use on the Abu Dhabi project as per the terms of the loan agreement".* The minutes go on to record that:

> "*IAS notes that where cash is ring fenced management enhance the disclosure in this regard and indicate to the users of the accounts where this money can be used.*
>
> *FF [Mr Flynn of AssetCo] considers this not to be the case and therefore does not consider further disclosure to be appropriate*."

And then state:

> *"The board would like some time to review the terms of the loan as, in their opinion, £10 million of the money was ring fenced*."

5. An email from Mr Flynn was forwarded to M1, M2 and M3 by Mr Boyle on 9 June 2009 which explained the position in relation to the £15 million at the financial year end, clarifying that balances totalling £12 million (not £7.5 million), less costs of the deal with NAV and other investors, had been held in bank accounts at that date[12], and that the other £3 million had been used by AssetCo for working capital purposes.

6. Further work was undertaken by M1 after the Audit Committee meeting in relation to various disclosure matters relating to the 2009 Financial Statements including disclosure pertaining to cash balances, which were the subject of emails he sent in the early hours of 10 June 2009 (2.52am) and 12 June 2009 (5.25am). This gives an indication of the pressure under which the GT audit team were working at this time.

[12] These balances were verified by bank confirmations obtained by the Respondents.

7. The 2009 Financial Statements did not refer to the Restriction, in breach of IAS 7 (Statement of Cash Flows). Paragraph 48 of IAS 7 states:

> *"An entity shall disclose, together with a commentary by management, the amount of significant cash and cash equivalent balances held by the entity that are not available for use by the group."*

8. GT issued an unqualified audit opinion in respect of the 2009 Financial Statements, albeit no reference was made to the restricted cash discussed above. The Respondents admit that this was an error but state that they believe it was caused by an oversight or confusion in the follow up on the question of disclosures relating to cash after the Audit Committee meeting on 8 June 2009.

9. The Respondents admit that the above conduct fell significantly short of the standards reasonably to be expected and breached paragraph 130.1(b) of the Code in that the Respondents did not act diligently in accordance with applicable technical and professional standards, but instead failed to comply with them.

ACT 3: JARAS

The Respondents' conduct fell significantly short of the standards reasonably to be expected of a Member and Member Firm in that they issued an unqualified audit opinion in respect of the 2010 Financial Statements which identified an asset balance of £1.5 million owed by Jaras as a debtor, (1) notwithstanding the availability of evidence that contradicted that treatment; (2) without having obtained sufficient appropriate audit evidence regarding the transaction; and (3) having failed to apply appropriate professional scepticism. The Respondents thereby acted in breach of the fundamental principles of Professional Competence and Due Care contrary to paragraph 130 of the Code.

<u>Particulars</u>

1. In FY 2010, Jaras Property Developments Limited ("**Jaras**") was AssetCo Group Limited's landlord in respect of two properties in Northern Ireland. At the material time, Jaras was owned by Mr Shannon.

2. On 10 December 2009, at the request of Mr Shannon, £1.5 million was paid to Jaras by AssetCo. Mr Flynn instructed Ms Chort of AssetCo to make that payment, copying Mr Boyle asking him to "*add this to John's [Shannon] Director's current account*". Mr Shannon sent Mr Flynn an email on 25 January 2010 headed "Director's current account" confirming that he had drawn down £1.5 million through his current account.

3. On 22 March 2010 Mr Shannon instructed Mr Boyle to "correct" the treatment of the £1.5 million payment "*from my Director's current account to a sundry debtor account for Jaras as owner of the NI property*". On 29 March 2010 Mr Shannon emailed Mr Flynn stating "*We both know the transaction could be accounted for as a debtor from Jaras…The payment was to Jaras not to me, so manageable if we agree to manage it*."

4. There is no evidence that the Respondents were provided with copies of the communications set out in paragraphs 2 and 3. Having regard to those paragraphs, the proposed treatment of the £1.5 million payment as a debtor from Jaras (and its subsequent treatment as a prepayment to Jaras) was untrue to the knowledge of Messrs Shannon and Flynn.

5. An invoice, dated on its face 28 March 2010 some three months after the payment was made, was purportedly raised by Jaras against AssetCo Engineering Limited (notwithstanding that AssetCo Engineering Limited was not the tenant). This comprised £1.2 million described as "*6 years['] rental adjustment at £200k per annum*" and £300,000 described as "*facilities and site upgrade*." No detail was given as to the nature of the "upgrade".

6. By using the word "adjustment" the invoice was ambiguous as to whether the invoice related to accrued past liabilities or future liabilities such that the £1.5 million would be a pre-payment.

7. Mr Napper raised the treatment of the £1.5 million payment at an AssetCo Audit Committee Meeting of 17 June 2010, the minutes of which recorded:

> "*RFN [Mr Napper] discussed the potentially sensitive related party transactions relating to Graphic Traffic and Jaras Developments (related via John Shannon) with the non-execs. They have stated they were*

unaware of the exact nature of the transactions but would discuss these with John Shannon and revert back to RFN with any concerns they might have".

8. On 19 June 2010, the Chairman of AssetCo forwarded to Mr Napper an email from Mr Shannon in which Mr Shannon stated:

> *"Jaras Development. The rent…was to have been adjusted from 2005…, however i agreed with the landlord [X] for this charge only to come through when my option to buy the site back was called (May 09). The options for us were to either take the rent hit this year via the previous landlord, or to smooth it out over the next few years with the new landlord. Jaras paid [X] £1.5m to reflect the rental and capital charges "accrued" and AssetCo paid Jaras the equivalent amount."*

9. "Accrued" rental and capital charges refer to past liabilities. No evidence of these "accrued" charges was provided to, or sought by, the Respondents.

10. On 21 June 2010, Mr Napper sent an email to Adrian Bradshaw, Peter Manning and Tim Wightman, non-executive directors of AssetCo, stating about Jaras:

> *"As discussed we noted a prepayment balance of £1.5 million to prepay 6 years of rent on the [Jaras] property and to fund repairs to the site. We note that John Shannon is a director of Jaras Developments and as such should be disclosed as a related party transaction.*
>
> *We note from review of journals at the year end that this amount was journalled from the directors' current account to prepayments - per discussions with management we have been told that this was an error and should not have been posted to the current account originally however we cannot see a journal bringing the debit into the balance sheet.*
>
> *We also note from review of the cashflow forecasts that there is an expected inflow of this same amount in September 2010. We understand from discussions with management that this is due to the fact that management are attempting to request the money back.*

We need to understand the above transactions in the context of the financial statements to 31 March 2010 and would anticipate full disclosure of this in the financial statements. The appropriate journals need to be supplied to us for us to ensure that the correct accounts disclosure is made."

11. Mr Napper's noting of a "prepayment" balance (a) contradicted the information received in the email of 19 June 2010, the significance of which the Respondents did not appreciate, and (b) is unsupported by the invoice dated 28 March 2010, which is silent as to whether the sum is due as a prepayment or otherwise. Mr Napper failed, at the relevant time, to identify these issues but now accepts that he should have done so.

12. Notwithstanding that they required further information to understand the transaction, the Respondents then failed to make further enquiries. In particular, the Respondents failed to contact Mr Shannon directly to obtain the necessary clarifications.

13. The Respondents issued an unqualified audit opinion in respect of the 2010 Financial Statements without obtaining sufficient audit evidence to support the accounting treatment of the £1.5 million payment, notwithstanding Mr Napper's statement that "*we need to understand*" the transaction on 21 June 2010. The 2010 Financial Statements record that the AssetCo Group "*had an asset balance with [Jaras] totalling £1.5m*".

14. This statement was untrue; there was no such asset balance. The Respondents did not account for Mr Shannon's description of the amount being paid to Jaras in an equivalent sum to that which Jaras paid the former landlord in settlement of amounts "accrued".

15. At the relevant time, the Respondents believed that, having raised the issue of the Jaras payment with the AssetCo Audit Committee on 17 June 2010, and having received the explanations outlined above, they had discharged their responsibilities as auditors. The Respondents admit that they ought to have investigated the matter further and that in fact their conduct breached:

    a. ISA 200, in that they applied insufficient professional scepticism; and

b. ISA 500 (Audit Evidence), in that they obtained insufficient appropriate audit evidence regarding the transaction.

16. The Respondents admit that the above conduct fell significantly short of the standards reasonably to be expected, in that it exhibited a serious want of care and/or a serious error of judgment and breached paragraph 130.1(b) of the Code in that the Respondents did not act diligently in accordance with applicable technical and professional standards.

ACT 4: 2010 CAPITALISATION OF BID COSTS – FY 2010

The Respondents' conduct fell significantly short of the standards reasonably to be expected of a Member and Member Firm in that they issued an unqualified audit opinion in respect of the 2010 Financial Statements: (1) having failed to obtain sufficient appropriate audit evidence to support AssetCo's decision to capitalise bid costs in the 2010 Financial Statements; and (2) having failed to apply sufficient professional scepticism. The Respondents thereby acted in breach of the fundamental principles of Professional Competence and Due Care contrary to paragraph 130 of the Code.

<u>Particulars</u>

1. In the 2010 Financial Statements, AssetCo capitalised various bid costs, which did not conform with AssetCo's capitalisation policy, and which was in breach of IAS 8, IAS 11 and IAS 38:

   a. IAS 8 – (Accounting Policies Changes in Accounting Estimates and Errors) which deals with the criteria for selecting and changing accounting policies, together with the disclosure of the accounting policies;

   b. IAS 11 – (Construction Contracts) deals with the accounting for pre-contract costs. Paragraph 11.21 specifies that direct costs associated with securing a contract should be included as part of the contract costs if they can be separately identified and measured reliably, and if it is probable that the contract will be obtained. (Otherwise, such costs should be expensed in the period in which they are incurred); and

c. IAS 38 – (Intangible Assets) deals with the general principles for the recognition and measurement of intangible assets. The standard requires an entity to recognise an intangible asset if specified criteria are met. Those criteria were not met in this case.

2. Those bid costs included:

   a. £2.036 million of costs relating to UAE contracts, including £900,000 which represented the purported Management Fee relating to the preference share issue dealt with in Act 6[13].

   b. £639,000 of costs relating to contracts with London Fire.

3. In the course of auditing the 2010 Financial Statements, GT identified that bid costs had been capitalised and approached NAS around 27 May 2010 with queries regarding this treatment.

4. The KIM prepared by GT for the 2010 Audit, saved on their audit file with filename "KIM AssetCo Plc – final draft 12-7-2010", stated that "*payroll costs where the employee would have been paid regardless…cannot be capitalised*". This was in accordance with advice provided by NAS on 28 May 2010 in response to M1's queries relating to capitalisation. The KIM then refers to AssetCo London payroll costs of £175,000 and proposes "*that these costs are written back to the income statement unless management can evidence that these costs are part of delivering the assets created…*" No further evidence regarding those payroll costs is contained on the audit file. The audit team instead recorded this amount in the Summary of Unadjusted Audit Differences, noting that overall the sum of "*unadjusted jnls not material- agreed with management not to post* [an adjustment] *on this basis*."

5. Having raised these issues, the Respondents obtained insufficient audit evidence to support AssetCo's treatment of bid costs. In addition, the Respondents' audit work papers and audit evidence disclose confusion amongst the GT audit team as to which contracts the bid costs related.

[13] In fact, evidence available to the Respondents indicated that this amount was, in substance, interest on the preference shares, as is set out in Act 6.

6. Further, the Respondents:

   a. obtained no evidence that, other than in respect of one discrete contract with London Fire (the EFCC contract), the contracts from which the bid costs arose were or would probably be awarded in the 2010 financial year, or that they supported the carrying values; and

   b. failed (during the 2010 Audit) to reconsider costs capitalised in the 2009 financial year, given that no contracts, which AssetCo had stated would be awarded, in fact materialised.

7. The Respondents admit that their Audit Services were inadequate in relation to the investigation and consideration of capitalised bid costs and that their conduct breached:

   a. ISA 200, in that they applied insufficient professional scepticism; and

   b. ISA 500, in that they obtained insufficient appropriate audit evidence regarding the transaction.

8. The Respondents admit that the above conduct fell significantly short of the standards reasonably to be expected and breached paragraph 130.1(b) of the Code in that the Respondents did not act diligently in accordance with applicable technical and professional standards.

ACT 5: GRAPHIC TRAFFIC

The Respondents' conduct fell significantly short of the standards reasonably to be expected of a Member and Member Firm in that they issued an unqualified audit opinion in respect of the 2010 Financial Statements, (1) having failed to obtain supporting evidence for the £685,000 liability purportedly due to Mr Shannon from Graphic Traffic (2) having failed to obtain sufficient appropriate audit evidence for the goodwill value of £956,000 for Graphic Traffic which was accounted for in those financial statements; and (3) having failed to apply appropriate professional scepticism in respect of these matters. The Respondents thereby acted in breach of the fundamental principles of Professional Competence and Due Care contrary to paragraph 130 of the Code.

1. As explained in Act 1 above:

   a. By way of the Graphic SPA dated 30 March 2010 AssetCo Group Limited acquired Graphic. Prior to that acquisition Mr Shannon was the sole shareholder and director of Graphic. The Graphic SPA provided that the consideration for the purchase was £1, albeit in later documentation this sum was referred to as £1,000.

   b. In an email dated 23 May 2010 from M1 to Mr Napper, the former explained: "*On 31 March 2010 AssetCo plc acquired Graffic Traffic - a company for whom John Shannon acts as director. Prior to the acquisition some transactions between John and Graffic Traffic had taken place such that Graffic Traffic owed John circa £685,000. When Graffic Traffic became part of the AssetCo plc group of companies the balanced owed to John was transferred into AssetCo plc as well as the amount due from the acquisition of Star Rentals. Per Matt [Boyle], the amount due to AssetCo for the acquisition of Star Rentals was due from John as he was funding the acquisition for his son and therefore the two balance have been netted off against one another so that no balance is shown as payable to or due from related parties*"

2. On 20 June 2010, Mr Shannon emailed Mr Napper seeking to explain the acquisition. On 21 June 2010, Mr Napper emailed the audit committee, copying in Frank Flynn, John Shannon and the GT audit team. That email referred to missing information relating to the c£650,000 creditor[14]:

   "We have now received the acquisition balance sheet of Graphic Traffic. As noted in the audit committee meeting the balance sheet does not tie into the numbers used by management when preparing the consolidated financial statements. The missing information appears to be the creditor of c£650k due to AssetCo plc although we now understand that this may be explained by the Jaras situation outlined below."

[14] Assumed to be an error, intending to refer to the £685,000 claimed by Mr Shannon

3. The explanation of the “Jaras situation” in that email does not refer to Graphic and the two matters were unrelated. It is now unclear why Mr Napper believed the matters were related.

4. Having raised the issue of “missing information”, the Respondents failed to follow up this enquiry and obtain the necessary explanation to satisfy themselves that the issue had been resolved.

5. No documentary or contemporaneous evidence was requested or obtained by the Respondents of the liability allegedly owed to Mr Shannon at the time of the 2010 Audit. No evidence of the existence of this liability has been available subsequently. The inference to be drawn from: (i) the absence of such evidence, and (ii) the fact that the purported liability due to Mr Shannon was in exactly the same amount as the debt owed by Ballandere to the AssetCo group, for the purchase of Star Rentals, and (iii) other instances of deceit of the Respondents in which Mr Shannon was involved that have come to light, is that no such liability ever existed.

6. There was no, alternatively no sufficient, audit evidence to justify the existence of the amount of £685,000 claimed to be due to Mr Shannon from Graphic.

7. Further, AssetCo's 2010 Financial Statements record the acquisition of Graphic at note 31, and include the following table showing the calculation of goodwill relating to Graphic:

	£’000	£’000
Property plant and equipment	43	
Inventories	14	
Trade and other receivables	507	
Total assets		564
Less: Trade and other payables	(1,519)	
Net liabilities		(955)
Total consideration		(1)
Goodwill		956

8. The table in the Financial Statements records net liabilities of £955,000. As the consideration stated was £1,000 (in contrast to the £1 consideration stated in the SPA), the goodwill figure was calculated as £956,000 (as noted in the table)[15]. The note states "*the group completed the acquisition of…Graphic…for a consideration of £1,000 creating goodwill on acquisition of £956,000. This business has been purchased with a view to resale hence the goodwill is included within assets held for sale.*"

9. It is to be inferred that the sum of £1,519,000 stated for "Trade and Other Payables" included the £685,000 liability allegedly due to Mr Shannon (such sum being by its nature a payable and also there being no other category large enough to include that purported debt).

10. There was no, alternatively no sufficient, audit evidence to justify the inclusion of the £685,000 liability within the "Trade and Other Payables" due by Graphic and accordingly to justify the value of £956,000 goodwill. Absent the £685,000 liability, the "Trade and Other Payables" figure would have been £834,000. In that event, Graphic's goodwill value (prior to any write down) would have been no higher than £271,000.

11. The applicable ISAs were ISA 200 (in particular, paragraph 6 which relates to Professional Scepticism) and ISA 550 (Related Parties). The latter deals specifically with audit procedures regarding related parties and transactions with such parties.

    a. Paragraph 2 of ISA 550 states:

    "The auditor should perform audit procedures designed to obtain sufficient appropriate audit evidence regarding the identification and disclosure by management of related parties and the effect of related party transactions that are material to the financial statements."

    b. Paragraph 13 states:

[15] Using the principles of IAS 3 (Business Combinations).

> *"In examining the identified related party transactions, the auditor should obtain sufficient appropriate audit evidence as to whether these transactions have been properly recorded and disclosed."*

12. The Respondents failed to obtain evidence to support the existence of the £685,000 liability, and failed to obtain sufficient appropriate audit evidence to support the goodwill value of £956,000. They failed to exercise appropriate professional scepticism, in breach of ISA 200, in the provision of the Audit Services in respect of this transaction, particularly having regard to the fact that it was a related party transaction.

13. The Respondents admit that the above conduct fell significantly short of the standards reasonably to be expected, in that it exhibited a serious want of care and/or a serious error of judgment and breached paragraph 130.1(b) of the Code: in that the Respondents did not act diligently in accordance with applicable technical and professional standards.

ACT 6: PREFERENCE SHARES

The Respondents' conduct fell significantly short of the standards reasonably to be expected of a Member and Member Firm in that they issued an unqualified audit opinion in respect of the 2009 and 2010 Financial Statements which included inappropriate accounting treatment in respect of preference shares and a management fee. The Respondents failed to identify that evidence in their possession contradicted the appropriateness of such treatment. In doing so, the Respondents failed to obtain sufficient appropriate audit evidence and apply sufficient professional scepticism. The Respondents thereby acted in breach of the fundamental principles of Professional Competence and Due Care contrary to paragraph 130 of the Code.

<u>Particulars</u>

1. These Particulars refer to the Preference Share Issue defined in the Particulars to Act 2.

2. In December 2008, when the Preference Share Issue was first considered, heads of terms were agreed with NAV, which included the term that the preference shares were to carry an annual interest coupon of 6% per annum.

3. On 11 December 2008, Mr Flynn sent M1 by email the heads of terms and asked for advice on:

   a. the proper accounting treatment of the proposed agreement; and

   b. any changes which could reduce the reported liabilities on the balance sheet arising from any Preference Share Issue.

4. Pursuant to IAS 32 (Financial Instruments: Presentation) and IAS 39 (Financial Instruments: Recognition and Measurement), if the coupon rate paid on the preference shares was reduced, then the liability element (shown as debt on AssetCo's balance sheet) would be reduced.

5. The correspondence between GT and AssetCo (detailed below) indicates:

   a. AssetCo wanted to reduce the amount relating to the preference share shown as a liability in its financial statements;

   b. AssetCo understood that if the coupon rate paid on the preference shares was reduced then the liability element would be reduced; and

   c. Mr Flynn proposed replacing the preference shares with a management fee and the Management Agreement for such fee, equal to the originally proposed coupon payable on the shares, was drawn up shortly after.

6. On 12 December 2008, M1 emailed Mr Flynn stating:

   "…you have asked us to advise on how the terms of the agreement could be changed to ensure that the minimum possible liability is shown on the balance sheet at any given reporting date."

7. In that email, M1 explained that "Option 3" provided for the removal of the interest element from the agreement, which would reduce the corresponding liability.

8. Mr Flynn replied on 17 December 2008:

"*Option 3 - Remove the interest element*

I think this can be achieved by removing the interest element and replacing it with a non executive directors fee."

9. On 8 January 2009 Mr Napper forwarded an email to Mr Flynn from M1 which set out the final review of the £15 million investment and an agreement for management services. This email identified the issue that GT, as auditor, needed to consider in relation to these contracts. M1 stated (*inter alia)*:

"Essentially it is a critical judgement area that the management fee[16] *represents an arms length deal between two related parties. (i.e. stands up on its own without the debt and warrant contract) We therefore need to understand management's considerations when determining that this is an arms length deal*."

10. The investment agreement effecting the Preference Share Issue was agreed and executed on 12 January 2009. On 28 January 2009, AssetCo and AssetCo (Abu Dhabi) Limited signed an agreement with AC Management Services Limited ("**ACMS**") for the provision of management consultancy and advisory services by ACMS for AssetCo (Abu Dhabi) Limited (the "**Management Agreement**"). ACMS was at all material times a company connected to NAV and J O Hambro. Notwithstanding that ACMS were a party to the Management Agreement, AssetCo and GT predicated their discussions on the basis that NAV was the provider of services pursuant to that agreement.

11. The fee stated to be payable under the Management Agreement (the "**Management Fee**") was £900,000 per annum, equivalent to 6% of the proceeds raised and the 6% interest coupon originally proposed. Under the terms of the Management Agreement (the definitions and clause 3), the Management Fee was due until the shares were redeemed with a proportionate reduction in the fee payable for a redemption of some of the shares.

12. On 6 May 2009, during the audit of the 2009 Financial Statements, M1 emailed Mr Flynn (copying, amongst others, Mr Boyle) under the subject "*significant*

[16] This is the "non-executive directors fee" referred to in Mr Flynn's email of 17 December 2008.

audit issues." One of those was the Management Agreement which M1's email referred to as being with NAV and involving an agreement to pay NAV £900,000. M1's email referred back to an Audit Strategy Document tabled at an Audit Committee meeting on 25 February 2009 which had noted that "*there is risk that the two contracts could be considered to be closely related*", and had stated that GT's concerns surrounded the separation of the management charge from the preference shares. Further, M1 noted in his email that clause 3.2, providing for a proportionate reduction of the Management Fee on redemption of any of the Preference Shares appeared to be an indicator that the contracts were closely related.

13. Mr Flynn emailed Mr Boyle a purported explanation of the fee on 8 June 2009 which Mr Boyle sent on to GT. That explanation referred to "*the JO Hambro team, behind ACMS*" and their experience in the Middle East, before explaining the fees as follows:

> *"Although [the management company] are not required to devote a fixed amount of time to the provision of services, the £900k was calculated on the basis of Christopher Mills (CEO Jo Hambro) time at £20k a day for 3 days a month (£20k x 35 days) being £700k and the balance of £200k relates to the rest of the Jo Hambro team."*

14. Further, Mr Flynn wrote that "*the fees have been charged on an arms length basis and we believe that J O Hambro will be critical to assisting AssetCo Abu Dhabi Ltd securing contracts with revenues in excess of £500m*".

15. Following a telephone call between Mr Flynn and M1, M1 set out his understanding of AssetCo's management's judgments in relation to the Preference Share Issue and Management Agreement. He emailed Mr Flynn and Mr Boyle on 15 July 2009 in the following terms:

> "*should the Abu Dhabi contract not be won after the two years it is management's opinion that the services received from* [the management company] *would not be yielding a return. On this basis management reserve the right to redeem the preference shares and cancel the management fee…*

it is management's opinion, that although legally the Investment Agreement and the Management Agreement appear closely related, in substance the two contracts are both contingent on the same factor which is outside management's control, that is, [the management company] *being able to negotiate the Abu Dhabi contract on their behalf.*

By linking the fair value of the management fee, and the services provided under the contract, to the redemption of the shares and the award of the agreement management have managed internal risk of [the management company] *not acting in their interest and aligned AssetCo and* [the management company's] *goals.*

To conclude, in substance the agreements were negotiated independently from one another. However certain clauses were included to ensure that, in the event the [management company] *did not deliver the services outlined in the contract effectively and the Abu Dhabi contract was not awarded, AssetCo could reduce the management fee to better reflect the value they were receiving…*"

16. Mr Shannon was also involved in the negotiation of the Preference Share Issue and Management Agreement. He has subsequently confirmed to Executive Counsel that:

"I am unaware of NAV providing any tangible services…"

17. GT obtained no third party evidence to support the statement relied upon by M1 (from Mr Flynn during the course of the telephone call referred to at paragraph 15 above) that the agreements had been "*negotiated independently*" (which statement was untrue). The correspondence between GT and Mr Flynn during December 2008 referred to above and the inclusion of a specific clause reducing the Management Fee on redemption of the preference shares evidenced that the agreements had in fact been negotiated together and were not independent. The creation of the Management Fee, which (contrary to the representations accepted by GT) bore no relationship to the value of services being provided, was a sham designed to obtain a favourable accounting treatment for AssetCo.

18. The accounting treatment applied by AssetCo was in breach of IAS 32 (Financial Instruments: Presentation) and IAS 39. In particular, a fundamental principle of IAS 32 is that a financial instrument should be classified as either a financial liability or an equity instrument according to the substance of the contract, not its legal form, and the definitions of financial liability and equity instrument. Paragraph 16 of IAS 32 gives further guidance as follows:

> "*When an issuer applies the definitions in paragraph 11 to determine whether financial instrument is an equity instrument rather than a financial liability, the instrument is an equity instrument if, and only if both conditions (a) and (b) below are met.*
>
> *(a) the instrument includes no contractual obligation: (i) to deliver cash or another financial asset to another entity; or (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the issuer.*
>
> (b) *if the instrument will or may be settled in the issuer's own equity instruments, it is: (i) a non-derivative that includes no contractual obligation for the issuer to deliver a variable number of its own equity instruments; or (ii) a derivative that will be settled only by the issuer exchanging a fixed amount of cash or another financial asset for a fixed number of its own equity instruments*. "

19. In the 2009 Financial Statements, the liability element of the preference shares was stated as £7.045 million. If the liability element had been calculated accounting for the £900,000 per annum that AssetCo had agreed to pay ACMS, which had been disguised by AssetCo as the Management Fee, the liability element would have been substantially greater (approximately £4 million, if a discount rate of 13% were assumed, but the precise amount would depend on the specific discount rate used). This treatment of the liability element of the preference shares was repeated in the 2010 Financial Statements.

20. The Respondents were aware during their provision of the Audit Services on the 2009 Financial Statements of their advice and discussions in December

2008 and January 2009 relating to the Preference Share Issue, but did not document the full course of that correspondence in their audit working papers.

21. The Respondents say that they did not know or suspect that the circumstances in which the Management Agreement had come into being required that the Management Fee be treated as disguised interest on the preference shares.

22. Nevertheless, the Respondents admit that their Audit Services fell below acceptable professional standards in that they:

    a. relied on assertions made by Mr Flynn that the management agreement was separate from the issue of preference shares. In so doing, they did not apply appropriate professional scepticism and did not take account of correspondence from December 2008 that contradicted these assertions.

    b. relied on evidence prepared by AssetCo to show that the fees payable by AssetCo represented a fair value for the services provided under the Management Agreement, and that the services were real rather than illusory. None of that evidence provided specific details of the services actually to be provided.

    c. failed to obtain evidence from third parties to support or value the provision of such services.

23. In all the circumstances the Respondents failed to account for evidence in their possession which contradicted this treatment and in doing so failed to apply sufficient professional scepticism (in breach of ISA 200). They further failed to obtain sufficient appropriate audit evidence (in breach of ISA 500) to justify the accounting treatment of the liability element of the Preference Share Issue in the 2009 Financial Statements and 2010 Financial Statements as required by IAS 32.

24. The Respondents admit that the above conduct fell significantly short of the standards reasonably to be expected, and breached paragraph 130.1(b) of the Code in that the Respondents did not act diligently in accordance with applicable technical and professional standards.

ACT 7: FY 2010 GOING CONCERN

The Respondents' conduct fell significantly short of the standards reasonably to be expected of a Member and Member Firm in that they issued an unqualified audit report in respect of the 2010 Financial Statements which made no disclosure of any material uncertainty as to AssetCo's ability to continue as a going concern: (1) having undertaken insufficient work to verify whether or not AssetCo's banking covenants had been, or were likely to be, breached; (2) having failed to obtain sufficient appropriate audit evidence to support the going concern assumption; (3) having failed to prepare sufficient audit documentation as to the nature, timing and extent of the verification processes undertaken for covenant testing in relation to the 2010 Financial Statements; and (4) having failed to apply sufficient professional scepticism. The Respondents thereby acted in breach of the fundamental principle of Professional Competence and Due Care contrary to paragraph 130 of the Code.

Particulars

1. The 2010 Financial Statements were prepared on a going concern basis with no disclosures of any material uncertainty as to AssetCo's ability to continue as a going concern.

2. From at least June 2010[17], AssetCo had arrears of PAYE and VAT with HM Revenue & Customs. By October 2010, AssetCo's Board was aware that it had serious cash flow problems, which deteriorated in the following months. Events from which those cash flow problems are apparent included the following:

   a. in a board meeting 27 October 2010, Scott Brown, the new Chief Financial Officer, expressed significant concern over the cash position of AssetCo;

   b. in a board meeting 3 November 2010 Nabarro LLP advised the directors of AssetCo on their legal responsibilities and duties in respect of a company that was close to insolvency;

   c. on 8 February 2011 AssetCo announced it had short term debt requirements of £4m;

[17] Arrears to HMRC were also experienced prior to this time.

d. on 3 March 2011 AssetCo announced an equity placing to raise a further £16,000,000 by the issue of 160,000,000 new ordinary shares. The circular referred to funds being required due to delays in securing the refinancing transaction and also a winding up petition issued by HMRC. If the placing did not proceed the directors did not believe AssetCo could continue in its current form. The Directors therefore concluded that it would not be practicable to carry out a pre-emptive offer to all shareholders;

e. on 21 March 2011 AssetCo announced it would need £3 to £4 million of working capital in addition to the £16 million placing; and

f. on 9 September 2011 AssetCo announced proposals to recapitalise and enter into an insolvent scheme of arrangement with creditors. This was approved on 29 September 2011.

3. In both FY 2009 and FY 2010, AssetCo did not generate enough cash to cover its debt repayment obligations.

4. The Respondents identified going concern as a key issue when planning and performing their Audit Services in relation to the 2010 Financial Statements.

5. The relevant ISAs are:

a. ISA 570 (Going Concern). Paragraph 8 provides examples of events or conditions, which may give rise to business risks, that individually or collectively may cast significant doubt about the going concern assumption, this includes "*inability to comply with the terms of loan agreements*". In carrying out work on examining the borrowing facilities, as described in paragraph 21 of IAS 570, the standard refers to additional audit work being needed if "*the entity has breached the terms of borrowing covenants, or are indications of potential breaches*". Paragraph 26(b) specifically provides, at, that, "*when events or conditions have been identified which may cast significant doubt on the entity's ability to continue as a going concern, the auditor should…(b) Gather sufficient appropriate audit evidence to confirm or dispel whether or not a material uncertainty exists through carrying out audit procedures considered necessary…*"

a. ISA 230, which provides at paragraph 9 that:

> "*The auditor should prepare the audit documentation so as 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 ISAs (UK and Ireland) and applicable legal and regulatory requirements;*
>
> *(b) The results of the audit procedures and the audit evidence obtained; and*
>
> *(c) Significant matters arising during the audit and the conclusions reached thereon."*

b. ISA 500, which provides at paragraph 11 that "*where information produced by the entity is used by the auditor to perform audit procedures, the auditor should obtain audit evidence about the accuracy and completeness of the information.*"

c. ISA 200 (paragraph 6 of which relates to professional scepticism).

6. In the course of his investigation, Executive Counsel reviewed GT's audit files relating to the Respondent's work verifying AssetCo's compliance (or otherwise) with the covenants. The Respondents admit that there was insufficient documentation prepared on the audit file to meet the requirements of ISA 230 in this regard and they undertook insufficient work to satisfy ISAs 570 and 500.

7. The Respondents based their judgment on going concern upon their review of a cash flow forecast (prepared by AssetCo management) for the period to June 2011. However:

a. it accounted for projected monthly receipts and included reference to other potential inflows, some of which were contingent on transactions occurring which might provide headroom if the monthly projections proved optimistic that were not fully verified by the Respondents to third party or documentary evidence. These amounts together totalled around £20 million and included:

i. £1.5 million repayment purportedly due from Jaras[18];

ii. £3.7 million cash inflow from operations in Abu Dhabi;

iii. £10 million inflow from a possible re-financing with a party known as Gatehouse, and £9.5 million from prospective sales of Supply 999 Limited and Treka Bus Limited, which were not included in the projected monthly cash flow figures, but were referred to elsewhere in the forecast as possible additional sources of finance. The figure for the inflow from Gatehouse was not verified by the Respondents and insufficient evidence was provided from which to form a view that an offer of finance was a realistic possibility. The figures for sales included £2.7 million deferred consideration and approximately £3 million required to settle debts of these companies on their sale.

b. the forecast included £14 million inflows from businesses held for sale which were classified as "discontinued" for the 2010 financial year.

c. the forecast values for finance lease and loan payments were inconsistent with the amounts stated in the 2010 Financial Statements.

8. In so doing, the Respondents admit that they failed to apply appropriate professional scepticism and/or obtain sufficient audit evidence for the proposed cash flow forecast to justify giving an unqualified audit opinion on a going concern basis, without further disclosure. This was in breach of ISA 200 (paragraph 6 relating to professional scepticism), ISA 500 (Audit Evidence) and IAS 570 (Going Concern).

9. AssetCo had various finance agreements containing covenants which, if breached, would have resulted in the loans advanced under the agreements becoming immediately repayable. This would have had a significant detrimental effect on AssetCo's ability to continue as a going concern. The Respondents were obliged as set out in paragraph 5 above to test whether or not those

[18] As set out more fully in Act 3.

covenants had been or were likely to be breached for the purposes of the 2010 Financial Statements, as part of their work on going concern.

10. The Respondents failed to undertake sufficient work to verify, or obtain sufficient audit evidence in respect of, AssetCo's compliance (or otherwise) with the covenants:

    a. There is no evidence that the Respondents verified calculations prepared by AssetCo to establish whether or not the covenants had been breached or were likely to be breached;

    b. There is no evidence that the Respondents applied sensitivity testing to forecast amounts relied upon for the calculations.

    c. The 2010 financial statements note: "*Included within the cash balance are sums amounting to £11.1m which were transmitted from clients prior to the year end. These amounts were received shortly after the year end*." The Respondents failed to verify whether re-classification of the sums amounting to £11.1 million, which may not have satisfied the criteria for cash and cash equivalents, would affect AssetCo's compliance with the covenants in the finance agreements.

11. The Respondents admit that the above conduct fell significantly short of the standards reasonably to be expected, and breached paragraph 130.1(b) of the Code in that the Respondents did not act diligently in accordance with applicable technical and professional standards.

ACT 8: ACCOUNTING FOR THE EFCC CONTRACT

The Respondents' conduct fell significantly short of the standards reasonably to be expected of a Member and Member Firm in that they issued an unqualified audit opinion in respect of the 2010 Financial Statements, 1) which recognised revenue, relating to the EFCC contract when the Respondents had failed to properly verify the claimed forecast costs for the EFCC contract and notwithstanding evidence in their possession indicating that costs would be significantly larger; and 2) having failed to question the improbably high profit margin, where such matters should have caused the Respondents to seek

further audit evidence. The Respondents thereby acted in breach of the fundamental principle of Professional Competence and Due Care contrary to paragraph 130 of the Code.

Particulars

1. In July 2009, AssetCo entered into a contract with London Fire to provide services and assets in relation to a 700 strong Emergency Fire Crew Capability Service (the "**EFCC Contract**"). The contract was to run for five years.

2. In the 2010 Financial Statements, revenue to be earned by AssetCo for the EFCC Contract was recognised in line with the proportion of estimated total costs incurred in the period. It was estimated that 58% of costs for the contract had been incurred in the year and so an adjustment was made such that 58% of revenue from the contract was also recognised in FY 2010.

3. The relevant accounting standard was IAS 18 (Revenue):

    a. Paragraph 9 states: "*Revenue should be measured at the fair value of the consideration received or receivable*";

    b. Paragraph 20 states: "*When the outcome of a transaction involving the rendering of services can be estimated reliably, revenue associated with the transaction shall be recognised by reference to the stage of completion of the transaction at the end of the reporting period. The outcome of a transaction can be measured reliably when all the following conditions are met:*

        [i.] *the amount of revenue can be measured reliably;*

        [ii.] *it is probable that the economic benefits associated with the transaction will flow to the seller;*

        [iii.] *the stage of completion of the transaction at the end of the reporting period can be measured reliably; and*

        [iv.] *the costs incurred for the transaction, and the costs to complete the transaction, can be measured reliably."*

c. Paragraph 13 states: "*The recognition criteria in this Standard are usually applied separately to each transaction. However, in certain circumstances, it is necessary to apply the recognition criteria to the separately identifiable components of a single transaction in order to reflect the substance of the transaction*."

4. That adjustment for the EFCC Contract was calculated using a work paper, prepared by AssetCo, showing estimated total costs of £2,002,000 for the life of the contract. However, the Respondents failed to conduct any verification work covering this cost estimate, and other documents available to the Respondents, showed that this amount was incorrect and in fact total future recurring costs of over three times this amount (some £6,210,000) were budgeted for the contract. Accordingly, a much lower proportion of the total estimated costs was incurred during the FY 2010[19] and so in recognising 58% of the revenue in the FY 2010, revenue, and the related debtor, were overstated. The amount of the overstatement in respect of accrued revenue was £2,545,000.

5. In issuing an unqualified audit opinion for the 2010 Financial Statements in respect of the EFCC Contract, the Respondents admit that they failed to apply appropriate professional scepticism, in breach of ISA 200 (paragraph 6 relating to Professional Scepticism) and ISA 500 (Audit Evidence)[20], particularly in view of the high profit margin apparently being earned on the contract.

6. The Respondents admit that the above conduct fell significantly short of the standards reasonably to be expected and breached paragraph 130.1(b) of the Code in that the Respondents did not act diligently in accordance with applicable technical and professional standards.

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[19] i.e. lower than 58%, see paragraph 2

[20] E.g. paragraph 36 which states that recalculation consists of checking the mathematical accuracy of documents or records and paragraph 38 which states that analytical procedures consist of evaluations of financial information made by a study of plausible relationships among financial and non-financial data.

ACT 9: IMPAIRMENT OF GOODWILL (EVIDENCE OF IMPAIRMENT AND CARRYING VALUE)

The Respondents' conduct fell significantly short of the standards reasonably to be expected of a Member and Member Firm in that they issued unqualified audit reports in respect the 2009 and 2010 Financial Statements, having failed to: (1) obtain sufficient appropriate audit evidence to support the impairment review of goodwill in those years; (2) apply sufficient professional scepticism; and (3) comply with the requirements of ISA 620. The Respondents thereby acted in breach of the fundamental principle of Professional Competence and Due Care contrary to paragraph 130 of the Code.

<u>Particulars</u>

1. The objective of IAS 36 (Impairment of Assets) is to prescribe the procedures that an entity applies to ensure that its assets are carried at no more than their recoverable amount; and to define how the recoverable amount is determined. Paragraph 9 states that at the end of each reporting period, an entity is required to assess whether there is any indication that an asset may be impaired. If there is an indication that an asset may be impaired, then the asset's recoverable amount must be estimated. Paragraph 10(b) provides, specifically in respect of goodwill that "*Irrespective of whether there is any indication of impairment, an entity shall also…test goodwill acquired in a business combination for impairment annually*". Paragraph 30 states that the calculation of value in use should reflect the following elements:

   a. an estimate of the future cash flows the entity expects to derive from the asset;

   b. expectations about possible variations in the amount or timing of those future cash flows;

   c. the time value of money, represented by the current market risk-free rate of interest;

   d. the price for bearing the uncertainty inherent in the asset; and

   e. other factors, such as illiquidity, that market participants would reflect in pricing the future cash flows the entity expects to derive from the asset;

Paragraph 90 states that the impairment review for a cash-generating unit ("**CGU**") to which goodwill has been allocated should be undertaken annually.

2. The contracts with London Fire and Lincoln Fire were operated by subsidiaries of AssetCo Group Limited. The business of this sub-group was the most important element of AssetCo's business. The reported value of goodwill of the London and Lincoln businesses was around £44 million in 2009 and around £48 million in 2010. That sum was the largest item by value on the AssetCo group consolidated balance sheet and almost equal to the total reported net assets for the whole of the AssetCo group of companies (as stated in the 2009 and 2010 consolidated financial statements). The reported value of goodwill was therefore a very significant element of AssetCo's financial statements.

3. The issue of impairment of goodwill was identified by the Respondents during the 2009 and 2010 Audits as a key risk. As part of the 2009 and 2010 Audits, the Respondents carried out assessments of impairment, particularly in respect of the value of goodwill relating to the London and Lincoln CGU and this required them to consider cash flow forecasts prepared by AssetCo's management.

4. The Respondents' approach and calculations for the assessment of impairment of goodwill was defective in numerous ways, and in particular, in the course of preparation of the 2009 and 2010 Financial Statements, the Respondents disregarded evidence in relation to potential impairment of goodwill, as follows:

   a. The audit files for the 2009 and 2010 Audits disclose no details of the analysis undertaken by the audit team when reviewing the cash flow forecasts;

   b. The cash flow forecasts produced by AssetCo in relation to the review for impairment of goodwill:

      i. provided for zero capital expenditure in 2010 (which was inherently unlikely);

ii. contained a value for capital expenditure in 2009 that contradicted other work papers provided to the Respondents and reviewed by them;

iii. did not make clear whether tax costs were deducted in the projected cash flows, which would have been contrary to IAS 36 (paragraph 50); and

iv. covered varying periods, including of over 20 years, and assumed extensions of the London Contract and Lincoln Contract without any independent justification for that assumption and contrary to IAS 36 (paragraph 35).

c. In relation to the 2009 audit, the Respondents failed to account for the carrying values of other assets of the relevant cash generating unit in the impairment review.

d. At the time the 2009 Audit was signed, the audit team had consulted the VS team. The VS team's calculations suggested that goodwill was impaired but this was on the incorrect assumption as to the debt of the London and Lincoln CGU (£90m when it was actually £62m). The audit team had not instructed the VS team to provide a final report and had not provided the additional information to the VS team that would have been necessary to enable the VS team to complete their work. This was not in accordance with ISA 620 (Using the Work of an Auditor's Expert).

5. The net present value ("**NPV**") calculation for the London and Lincoln CGU considered in the 2010 Audit, unlike that reviewed in the 2009 audit, assumed that the contracts were extended by 10 years and (correctly) excluded interest payments but (incorrectly) excluded capital expenditure and (incorrectly) deducted tax for Lincoln. The forecast in 2010 produced an increase of around 300% in the CGU's estimated NPV compared to the calculation that had been performed in 2009.

6. There was no sufficient evidence on the audit file of any detailed review of the cash flow forecasts and other variables used in these calculations or the Respondents adequately challenging AssetCo on the details of the forecast or

the basis for the assumption of contract extensions and documenting the justification, in view of such a significant increase in the NPV. Given the significance of the goodwill figure to AssetCo's balance sheet, the Respondents failed to obtain sufficient appropriate audit evidence to support the Respondents' calculations for the impairment reviews of goodwill and failed to apply appropriate professional scepticism. This was a breach of ISA 500 (Audit Evidence) and ISA 200 (paragraph 6 relating to Professional Scepticism).

7. Had the errors in the Respondent's Audit Services identified above been corrected, the Respondents may have identified an impairment of goodwill. As it was, the Respondents wrongly issued an unqualified audit report in respect of those financial statements.

8. The Respondents admit that the above conduct fell significantly short of the standards reasonably to be expected and breached paragraph 130.1(b) of the Code in that the Respondents did not act diligently in accordance with applicable technical and professional standards.

ACT 10: IMPAIRMENT REVIEW OF INVESTMENTS

The Respondents' conduct fell significantly short of the standards reasonably to be expected of a Member and Member Firm in that they issued unqualified audit opinions in respect of the 2009 and 2010 Financial Statements having failed to: (1) undertake sufficient work to test whether the value of AssetCo's investments should be impaired; (2) obtain and document sufficient audit evidence in respect of the values of those investments; and (3) apply sufficient professional scepticism. The Respondents thereby acted in breach of the fundamental principle of Professional Competence and Due Care contrary to paragraph 130 of the Code.

<u>Particulars</u>

1. The most significant asset on AssetCo's balance sheet for both the 2009 and 2010 Financial Statements was the investment in AssetCo Group Limited, a subsidiary whose principal operations were the London and Lincoln Contracts. That investment was valued at £92.522 million in both FY 2009 and FY 2010.

2. IAS 36 (Impairment of Assets) states that:

> "*An entity shall assess at the end of each reporting period whether there is any indication that an asset may be impaired. If any such indication exists, the entity shall estimate the recoverable amount of the asset*."

Further, it provides guidance as to indicators of impairment and how the assessment of impairment should be carried out by the reporting entity.

3. The Respondents identified the carrying value of the investments as a significant audit risk for the 2009 and 2010 Audits. In particular, in 2010, GT noted that the market capitalisation of AssetCo was less than the carrying value of the net assets, which was an indicator of an impairment in the carrying value of the investments. GT also noted that that any impairment of the carrying values of AssetCo plc's investments would impact the distributable reserves and, consequently, the legality of any dividends paid. In those circumstances, the Respondents should have applied particular care and professional scepticism[21] to the impairment review of the carrying value of the investments.

4. In respect of the impairment review carried out for the 2009 and 2010 Audits to test whether the value of the relevant investments impaired: (1) the Respondents undertook insufficient work; and (2) the Respondents further failed to obtain and / or document sufficient evidence to approve the carrying value of the investments. The particular errors in the Respondents' work included:

    a. The Respondents' audit files do not contain a sufficiently detailed review or analysis of the cash flow forecasts used to estimate the value in use[22] of the assets;

    b. In FY 2010, the Respondents failed to identify that no allowance was made in the forecasts for capital expenditure (which was inherently unlikely to be correct); and

[21] As required by ISA 200
[22] i.e. the value of all future cash flows expected to be generated by those assets

c. No sensitivity analysis was carried out, by the Respondents, to test whether changes to any of the cash flow amounts, growth rates or other assumptions (save discount rates) would result in an impairment of value.

5. The Respondents admit that the above conduct fell significantly short of the standards reasonably to be expected and breached paragraph 130.1(b) of the Code in that the Respondents did not act diligently in accordance with applicable technical and professional standards, being ISA 200, ISA 500 and ISA 230.

ACT 11: TREATMENT OF FINANCE LEASES IN FY2010

The Respondents' conduct fell significantly short of the standards reasonably to be expected of a Member and Member Firm in that they issued an unqualified audit opinion in respect of the 2010 Financial Statements, which contained fictitious income and debtors, having failed to: (1) obtain sufficient appropriate audit evidence; and (2) apply appropriate professional scepticism. The Respondents thereby acted in breach of the fundamental principle of Professional Competence and Due Care contrary to paragraph 130 of the Code.

<u>Particulars - general</u>

1. The London Contract provided that each month London Fire would make a payment, called a "Unitary Payment", to AssetCo. The calculation of the Unitary Payment, which was set out in the London Contract, was based on (among other factors) the number of slots and the values attributable to those slots. Fundamentally, the Unitary Payment was fixed throughout the term of the London Contract save in the event of changes arising from:

   a. the introduction of additional slots agreed with London Fire;

   b. indexation (i.e. in relation to the retail price index); and

   c. replacement of assets at a higher specification but only where it was agreed with London Fire that this would lead to an increase in the Unitary Payment.

2. In 2009 and 2010 additional assets and services were provided to London Fire, being, in 2009, modifications to foam pumps, and, in 2010, thermal imaging cameras as well as equipment and services for the EFCC contract. The 2009 and 2010 Financial Statements include significant income and debtors, stated to arise from these assets and services. The income and debtors did not, in fact, exist.

3. As a result, revenue and debtors were increased as follows:

   a. in the 2009 Financial Statements by revenue of c.£7.5 million and by debtors of c.£5 million

   b. in the 2010 Financial Statements by revenue of c.£13 million and by debtors of c.£17 million.

4. AssetCo management asserted to the Respondents that the: (i) modifications to foam pumps, (ii) thermal imaging cameras, and (iii) equipment for the EFCC Contract resulted in an increase in the monthly Unitary Payment due from London Fire to AssetCo over a period of 14 years[23] or 13 years[24] respectively. This was untrue.

5. This fictitious additional income was treated as sales of finance leases in both 2009 and 2010.

6. IAS 17 states that a "finance lease" is a "*lease that transfers substantially all the risks and rewards incidental to ownership of an asset. Title may or may not eventually be transferred*."

7. In Note 2.12 on accounting policies, the 2010 Financial Statements state:

   "*Finance leases where the group is the lessor*

   When assets are leased out under a finance lease, the present value of the lease payments is recognised as revenue and the receivable shown as a finance asset. The difference between the gross receivable and the present

[23] Modifications to foam pumps
[24] Thermal imaging cameras, and equipment for the EFCC Contract

value of the receivable is recognised on a constant periodic rate as unearned finance income."

8. Essentially this treatment meant that the income that was said to arise over the subsequent 14 or 13 years was aggregated and recognised immediately in the Financial Statements.

Particulars – modifications to foam pumps

9. In the course of FY 2009, AssetCo made modifications including to foam pumps attached to fire engines provided under the London Contract.

10. The amount charged upfront to London Fire was £2.6 million.

11. In addition to the upfront fee, according to Mr Boyle, this work led to an additional monthly payment (i.e. in addition to the Unitary Payment) of £46,975 from April 2009. This assertion was, however, untrue and no additional payment was due to AssetCo. It was not included in the invoices for the London Contract actually sent by AssetCo to London Fire.

12. AssetCo recognised £4.991 million as revenue and a finance lease debtor in the 2009 and 2010 Financial Statements in respect of this additional monthly payment. As the £46,975 monthly income did not exist, it follows that the entire £4.991 million revenue and related debtor also did not exist and should not have been recognised in the financial statements.

Particulars – Thermal imaging cameras

13. In July 2009, AssetCo agreed to provide thermal imaging cameras ("**TICs**") to London Fire. This was done under AssetCo's existing contract with London Fire. London Fire signed an authorisation for the TICs on 30 July 2009, requiring 140 cameras (each taking one "slot" under the contract) at a price per slot of £2,367.45. Thus, the total price agreed by London Fire under the contract was £331,443 per year (or £27,620 per month). In accordance with the contract, the monthly Unitary Payment for the TICs was therefore £27,620. This was payable in addition to the standard Unitary Payment for the London Contract.

14. On 29 October 2009, Mr Flynn wrote to Mr Napper of GT informing him of the TICs stating that the 144 cameras were supplied at a cost of £842,000 and

AssetCo would charge £160,000 for the modification and fitting of the cameras: a total of £1,002,000.

15. Mr Boyle provided the Respondents with documentation on 10 June 2010 comprising a spreadsheet, an invoice issued for the April Unitary Payment, and a bank statement evidencing payment of the sum invoice (the "**10 June Papers**"). The spreadsheet included two rows for TICs, one showing an annual slot price of £2,367.45, (supported by the authorisation referred to above in paragraph 13) and another showing an annual slot price of £4,826. This latter row was highlighted by Mr Boyle as being additional and forming part of a number of items to be treated as a finance lease. However the assertion that AssetCo had the benefit of an additional annual slot price of £4,826 was entirely false.

16. Using the amounts from the highlighted row, indicating an additional monthly Unitary Payment of £57,910, Mr Boyle calculated that the net present value of the TICs for finance lease purposes was £5,875,614.

17. Mr Boyle's calculations indicated that AssetCo's profit margin on the TICs was around 80%, which was inherently unlikely. No explanation or justification was given for this high profit margin.

18. As the £57,910 monthly amount did not exist, it follows that the £5,875,614 revenue and related debtor also did not exist and should not have been recognised in the 2010 Financial Statements.

<u>Particulars – EFCC additional assets</u>

19. The EFCC Contract was entered into in July 2009 (to run to August 2014) and was separate to the London Contract. However, in the 2010 Financial Statements, AssetCo treated certain EFCC costs separately from the EFCC Contract and as a sale under a finance lease.

20. AssetCo represented that certain assets, variously described as "capital guard assets"; "equipment that [London Fire] will be using for training purposes"; and "ladders and hoses", were used to help train the emergency fire crew (the "**EFCC Additional Assets**"). Purported income relating to the provision of these assets was treated as the sale of a finance lease.

21. AssetCo provided no explanation or justification to the Respondents as to why the EFCC Additional Assets were treated as a separate finance lease rather than goods and services provided under the EFCC Contract.

22. Mr Boyle's 10 June Papers provided for an additional monthly Unitary Payment of £71,095 in respect of the EFCC Additional Assets. This sum was not included in the invoices provided to London Fire. That is because the income did not exist.

23. Using the purported monthly revenue of £71,095 generated by the EFCC Additional Assets, Mr Boyle calculated the net present value of the EFCC Additional Assets of £7.213 million. These calculations assumed that such purported income would be earned over a period of 13 years.

24. Mr Boyle's calculations indicated that AssetCo's profit margin on the EFCC Additional Assets was approximately 83% which was inherently unlikely. No explanation or justification was given for this high profit margin.

<u>Particulars – The Respondents' Audit Services</u>

25. The Respondents failed to obtain sufficient appropriate audit evidence (contrary to ISA 500), and failed to apply sufficient professional scepticism to the evidence they did obtain (contrary to ISA 200), in respect of the above matters for the 2010 Audit. In particular:

    a. The third party evidence obtained by the Respondents during the 2010 Audit did not clearly demonstrate in the circumstances that any additional income was due under the London contract, or otherwise had been agreed to be paid, or that any additional income was part of the amounts that had actually been received in FY 2009 or 2010, for the provision of the relevant assets and services.

    b. Specifically, the Respondents requested proof of acceptance by London Fire of the liability to make payment in respect of the TICs, but they received none and failed to follow-up this query prior to issuing their audit opinion.

c. The Respondents' work papers record that AssetCo claimed improbably high profit margins for the provision of these assets and services. For example, profit margins (on the upfront payment) for TICs were c.80%, and for EFCC Additional Assets they were around 83%. Such high profit margins (on the provision of goods) are intrinsically improbable and the Respondents should have applied appropriate professional scepticism and made further enquiries.

d. Concerns had been raised within the GT audit team as to the improbably high profit margins. For example, on 27 May 2009, M3 emailed M1 stating:

   "I am concerned about is how Assetco can demonstrate LFEPA [London Fire] willingly paid £2.6m for something which cost £100k - why would they do this?

   Suggests:

   1. They were massively ripped off - extremely unlikely

   2. They paid for something different.

   I am struggling to believe Assetco provided LFEPA with nothing to support the £2.6m, difficult to believe."

e. The Respondents should have applied appropriate professional scepticism and closely investigated such concerns (for example by asking for written agreements with London Fire recording the increased Unitary Payments, which should have been readily available, and obtaining further evidence to support receipt of the alleged income in FY 2009 and FY 2010) prior to issuing their 2010 unqualified audit opinion. The Respondents did not do so.

f. The Respondents obtained some documentation which on its face provided some support for the increase in Unitary Payments. In particular, they obtained from Mr Boyle (under cover of an email dated 10 June 2010) a spreadsheet, an invoice issued for the April Unitary Payment, and a bank statement evidencing payment of the sum invoice. However, the

Respondents accept that in all the circumstances they failed to treat such documentation with appropriate professional scepticism.

g. The calculations of the value of the finance leases assumed a growth rate of 3% and a discount rate of 10%. There was no explanation or justification given by AssetCo for these assumptions, nor for the periods over which the values were calculated. The Respondents failed sufficiently to challenge these assumptions.

26. The Respondents gave an unqualified audit opinion on the 2010 Financial Statements which recognised revenue of c.£13 million and debtors of c.£17 million which should not have been recognised.

27. The Respondents admit that the above conduct fell significantly short of the standards reasonably to be expected and breached paragraph 130.1(b) of the Code in that the Respondents did not act diligently in accordance with applicable technical and professional standards.

ACT 12: FAILURE IN QUALITY CONTROL

GT's conduct fell significantly short of the standards to be reasonably expected of a Member Firm in that it failed in its obligations pursuant to ISQC 1 to ensure that: (i) Mr Napper would be sufficiently competent in all material aspects of the Audit Services so that his conduct would not fall significantly short of the standards to be reasonably expected of a Member undertaking the role of statutory auditor for AssetCo; (ii) for the Audit Services, the audit team possessed sufficient skill and experience to provide the Audit Services competently; and (iii) non-partner members of the audit team were sufficiently supervised in the conduct of the Audit Services so as to ensure that those services were performed in accordance with professional standards and regulatory and legal requirements.

Particulars

1. This Act relates to the 2009 and 2010 Audits.

2. As set out in the foregoing Acts in these Agreed Particulars the audit teams demonstrated a significant lack of care and competence in performing many material and significant areas of the Audit Services.

3. In respect of GT's obligation to ensure that Mr Napper was sufficiently competent in all material aspects of the AssetCo audits:

   a. GT was required, pursuant to paragraph 28(b) of ISQC 1 to "*establish policies and procedures for the acceptance and continuance of client relationships and specific engagements, designed to provide [GT] with reasonable assurance that it [would] only undertake or continue relationships and engagements where [GT was]… competent to perform the engagement and [had] the capabilities, including time and resources to do so*". In making this consideration, the firm was required to consider, *inter alia*, whether:

      i) "*Firm personnel have knowledge of relevant industries or subject matters"*; and

      ii) "*The firm has sufficient personnel with the necessary capabilities and competence*."

   b. In assigning an engagement partner to the Engagements, GT was required, pursuant to paragraph 42(b) of ISQC 1, to ensure that Mr Napper had "*the appropriate capabilities, competence, authority and time to perform"* the roles of Responsible Individual and Senior Statutory Auditor.

   c. The number and significance of the failings outlined in the preceding Acts in these Agreed Particulars evidence that Mr Napper was not sufficiently competent in his performance of the roles of Responsible Individual and Senior Statutory Auditor in the 2009 and 2010 Audits, as required by paragraphs 28(b) and 42(b) of ISQC 1.

   d. Mr Napper's performance of the roles of Responsible Individual and Senior Statutory Auditor in relation to the Audit Services indicates that GT's system of quality control designed to ensure that the firm and its personnel comply with the aforementioned requirements of ISQC 1 failed to operate as required in respect of these audits.

4. In respect of GT's obligation to ensure that the audit team providing the Audit Services possessed sufficient skill and experience to conduct the audit work competently:

   a. The senior members of the audit team who actively oversaw the audit work mainly comprised Mr Napper, M1 and M2, as well as (in 2009) M3

   b. GT was required, pursuant to paragraph 44 of ISQC 1, to assign appropriate staff to carry out the Audit Services with the "*necessary capabilities, competence and time to perform engagements in accordance with professional standards and regulatory and legal requirements*."

   c. Prior to the provision of the Audit Services, M1 and M2 had no, or very limited, experience with auditing some of the key issues in relation to the financial statements of AssetCo, such as PFI contracts, impairment of goodwill and impairment of investments in subsidiaries, and finance lease accounting. These were important audit areas where there was a risk of material misstatement of the financial statements, with the potential to cause a material impact on the income statement and balance sheet. Further, those individuals had limited knowledge of the industry in which AssetCo operated, beyond the audits they had already performed of AssetCo, so that they were unable sufficiently to identify and assess the risks of material misstatement of the financial statements and respond to those risks accordingly, including challenging management's assertions. In these circumstances it was inappropriate that M1 and M2 undertook the day-to-day work required for the Engagements without receiving more direction, supervision and review than they were given by more experienced staff.

   d. Therefore the fact that M1 and M2 undertook the roles they did in relation to the Audit Services demonstrates failings by GT's system of quality control designed to ensure that the firm and its personnel comply with the requirements of ISQC 1.

5. In respect of GT's obligations to ensure that non-partner members of the audit team were sufficiently supervised in the conduct of the Audit Services so as to ensure they were performed in accordance with professional standards and regulatory and legal requirements:

    a. Mr Napper was aware of the inexperience of M1 and M2 with aforementioned key areas of the AssetCo audits.

    b. Pursuant to paragraph 46 of ISQC 1, GT was required to *"establish policies and procedures designed to provide it with reasonable assurance that engagements are performed in accordance with professional standards and regulatory and legal requirements, and that the firm or the engagement partner issue reports that are appropriate in the circumstances."*

    c. Pursuant to paragraph 49 of ISQC 1, GT, through the establishment of policies and procedures, had supervision requirements including, inter alia, (i) "*tracking the progress of the engagement*"; and (ii) *"considering the capabilities and competence of individual members of the engagement team, whether they have sufficient time to carry out their work, whether they understand their instructions and whether the work is being carried out in accordance with the planned approach to the engagement."*

6. However, the inadequate execution in these audits of the procedures in GT's system of quality control resulted in a failure to ensure that members of the audit team below the rank of senior manager were sufficiently supervised in the provision of the Audit Services. Further, aspects of the Misconduct reflect failures either to consult more fully with NAS or VS on issues that had been raised with them (e.g. in some cases referring back to NAS or the VS after discussing the position further with the audit client), or to understand and apply correctly the guidance that had been received from them.

7. Further, the execution of the firm's processes in these audits failed to highlight that the quality of Mr Napper's performance in relation to aspects of the audit fell significantly short of professional standards, and failed to prompt realisation

that in light of those issues and the relative inexperience of M1 and M2 , the firm would be unable, in relation to numerous aspects of the Audit Services, to obtain reasonable assurance that they would be performed in the manner required by paragraph 46 of ISQC 1.

8. Accordingly, as GT admits, its conduct fell significantly short of the standards reasonably to be expected of a Member Firm in that it failed to act in accordance with ISQC 1.