ANNEX TO SETTLEMENT AGREEMENT DATED 25TH JANUARY 2016

IN THE MATTER OF

THE EXECUTIVE COUNSEL TO THE FINANCIAL REPORTING COUNCIL

-and-

(1) MOORE STEPHENS (NI) LLP

(2) DAVID McCLEAN

PARTICULARS OF FACT AND ACTS OF MISCONDUCT

Introduction

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 the Accountancy Regulations ("**the Regulations**"), both dated 8 December 2014.

2. This is the Executive Counsel's Particulars of Fact and Acts of Misconduct ("**the Particulars**") in relation to the audit of the financial statements of the Presbyterian Mutual Society ("**PMS**") for the year end 2007 and year end 2008 and, more specifically, the allegations of Misconduct relate to PMS's compliance with its own rules and applicable legislation in both 2007 and 2008 and PMS's liquidity in respect of 2008. However, certain facts and matters relating to the period from 2000 to 2008 ("**the relevant period**") are relied on by way of factual background to the allegations of Misconduct, as more particularly set out below.

The Respondents

3. The respondents to the Particulars are: (a) Moore Stephens (NI) LLP (formerly Moore Stephens Chartered Accountants Northern Ireland) ("**Moore Stephens**"), a member firm of the Institute of Chartered Accountants in Ireland ("**CAI**")[1]. For the avoidance of doubt, Moore Stephens (NI) LLP is the Successor Member Firm of Moore Stephens Chartered Accountants Northern Ireland and, as such, Moore Stephens (NI) LLP is liable pursuant to paragraph 5(8) of the Scheme to investigation and disciplinary proceedings in respect of any alleged Misconduct by Moore Stephens Chartered Accountants Northern Ireland; and (b) David McClean, a member of the CAI; together "**the Respondents**". By virtue of their membership of the CAI, the Respondents are also a Member Firm and Member respectively for the purposes of the Scheme. Mr McClean left Moore Stephens in July 2011. Moore Stephens is a 9 partner firm with five offices in Northern Ireland. Moore Stephens is a legally distinct and economically separate entity from Moore Stephens U.K. and Moore Stephens International.

4. Throughout the relevant period, Moore Stephens was the auditor of PMS, David McClean being the audit engagement partner as from part way through the audit for the year end 2005, following the death of the former audit engagement partner, and for both 2007 and 2008 year ends.

Misconduct under the Scheme

5. Paragraph 2(1) of the Scheme provides that an Adverse Finding, (referred to at paragraph 2 above) is a finding by a Disciplinary Tribunal that a Member or Member Firm has committed "Misconduct", that is defined 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*

[1] References to "Member Firm" and "Member" in this document relate to the definition as set out in paragraph 2(1) of the Scheme. References to 'member firm' and 'member' denote their membership of the CAI.

likely to bring, discredit to the Member or the Member Firm or to the accountancy profession."

PMS

6. PMS was registered in 1982 as an industrial and provident society ("**IPS**") under the Industrial and Provident Societies Act (Northern Ireland) 1969 (as amended by the Industrial and Provident Societies (Amendment) (Northern Ireland) Order 1976) ("**the 1969 Act**").

7. The Board of PMS were volunteers (some of them retired) and comprised prominent members of the Presbyterian community, including clergy, lawyers and accountants. The Board met four times a year, in addition to the AGM, for no more than about 2 hours on each occasion.

8. PMS had a staff of 7 in 2008, (of whom 2 were part time). PMS was managed by the Company Secretary, Colin Ferguson, who did not hold any professional qualifications.

9. As at October 2008, PMS was the largest IPS in Northern Ireland and had 10,500 members (who had to be Presbyterians and who generally only became members after a referral from a local minister), who held some £100 million in withdrawable shares and had made loans to PMS of some £200 million. Mr McClean described PMS in an interview with the FRC[2] as having been a "unique type of organisation in Northern Ireland".

10. The approximately £200 million in loans from members of PMS as at October 2008 were, in fact, deposits which PMS had taken in breach of both the 1969 Act and its own rules, as more particularly set out in Annex A.

11. Since PMS was accepting deposits in breach of the 1969 Act and its own rules, its registration as an IPS was liable to be cancelled or suspended by the Department for Enterprise, Trade and Investment in Northern Ireland ("**DETI**"). Moreover, PMS ought to have been (but was not) authorised to carry on the regulated activity of deposit-taking by the Financial Services Authority ("**FSA**")

[2] The interview was conducted by the Accountancy and Actuarial Discipline Board ("AADB"). However, the responsibilities of the AADB passed to the FRC in October 2012. References to the FRC in this Complaint in relation to any time prior to this date should be understood as references to the AADB.

(as it then was) under the provisions of the Financial Services and Markets Act 2000 ("**FSMA 2000**"). As a consequence of not being authorised, members of PMS did not have the protection of a guarantee under the Financial Services Compensation Scheme ("**FSCS**") for their deposits, nor was PMS subject to any prudential supervision due to the 'regulatory gap; explained further below (at paragraphs 36-38).

12. Furthermore, as at its year end 31 March 2008 and indeed throughout the 2008 financial year, PMS's liquidity was inadequate which made it particularly vulnerable to a liquidity shock such as a run, as was still the case as at October 2008.

13. For a number of reasons, including the failure of Northern Rock and Lehman Brothers, the Irish Government guarantee to Irish banks and the lack of an FSCS guarantee, some members of PMS withdrew their funds, causing a run on PMS during October 2008, which resulted in its entering administration on 17 November 2008. The Administrator's Statement of Affairs estimated the realisable value of PMS's assets at approximately £180 million.

14. Members of PMS have now received back a significant part of their funds as a result of government intervention. Under a Scheme of Arrangement approved in July 2011, PMS has received a loan of £225 million from DETI and has made repayments to those with total holdings of shares and loans under £20,000 of 100% of their shares and 85% of their loans and to those with total holdings above £20,000 of between 77% and 85% of their total holdings. The administration was closed on 7 November 2013. The Joint Supervisors of the Scheme of Arrangement are responsible for the orderly realisation of PMS's assets and do not anticipate being in a position to make any further repayments to members of PMS before 2021 and whether sufficient funds will be available to repay the loan from DETI and enable them to do so is not certain. The financial statements of PMS for the year ending 31 March 2014 record net liabilities of £130 million.

Moore Stephens and Mr McClean

15. Moore Stephens (or predecessor firms) acted as auditors to PMS from its inception and throughout the relevant period.

16. The audit team for PMS consisted of the audit engagement partner, audit manager, audit senior and audit junior. The time which Moore Stephens planned to spend on the audit appears to have been relatively short (for example, 14 days in 2007 and 3 weeks in 2008). The fees charged were relatively modest (for example, around £7,900 for each of 2007 and 2008). Mr McClean himself charged about two and a half hours time to the audit.

17. The audit engagement partner from year end 2005 onwards was Mr McClean, who qualified as a chartered accountant in 1980. Mr McClean's other audit clients included one other IPS and an insurance broker (the latter became FSA authorised during the early 2000s). As audit engagement partner, Mr McClean had responsibility for the audit engagement and its performance and in particular (under ISA 220) for:

    a. the auditor's report that is issued on behalf of the firm (ISA 220.5(a));
    b. the overall quality of the audit (ISA 220.6);
    c. satisfying himself that the engagement team collectively has the appropriate capabilities, competence and time to perform the audit engagement (ISA 220.19); and
    d. the direction, supervision and performance of the audit engagement in compliance with professional standards and regulatory and legal requirements, and for the auditor's report that is issued to be appropriate in the circumstances (ISA 220.21).

The Relevant Standards of Conduct

18. The standards of conduct reasonably to be expected of each of the Respondents included those set out in the ICAI's 2006 Code of Ethics for Members ("**2006 Code**"). Executive Counsel will refer to and rely upon relevant extracts annexed to this Complaint at Annex B.

19. The Fundamental Principles set out in Paragraph 100.4 of the 2006 Code required the Respondents, inter alia, to act with "Professional Competence and Due Care". In summary, this required the Respondents to maintain professional knowledge and skill at the level required to ensure that a client receives competent professional service based on current developments in practice and

to act diligently and in accordance with applicable technical and professional standards when providing professional services.

The Relevant Accounting Standards

20. Under the 1969 Act and FRS 18, PMS had a duty to produce a revenue account and balance sheet each year which showed a true and fair view of the financial position of the society. Executive Counsel will refer to and rely upon relevant extracts annexed to this Complaint at Annexes C and D.

The Relevant Auditing Standards

21. In relation to the conduct of the year end 2007 and 2008 audits, the relevant auditing framework was that of the International Auditing Standards ("**ISAs**"). These were introduced on the 22 December 2004 and apply to all audits of financial statements for periods commencing on or after 15 December 2004. The purpose of ISAs, issued by the Auditing Practices Board, is to establish standards and general principles with which auditors are required to comply in the conduct of any audit. The applicable ISAs are extracted and appended to this Complaint at Annex D.

Moore Stephens's and Mr McClean's Misconduct

22. In summary, and as more particularly set out at paragraphs 69 and following, each of the Respondents' conduct fell significantly short of the standards reasonably to be expected of them in the following respects:

    a. in relation to the audits of the PMS financial statements for each of year ends 2007 and 2008, they failed to obtain an adequate general understanding of the legal and regulatory environment in which PMS operated for the purposes of the audit and, failed adequately to test the assumption on the part of PMS's Board and management that it was complying with its own rules and with applicable legislation and regulation and failed to apply professional scepticism and to obtain sufficient audit evidence to corroborate assurances and representations provided by management (including in particular by recognising or acting upon the need to consider or obtain specialist legal advice);

b. during the 2008 audit, they failed adequately to test management's assertions that the inadequacy of the liquidity levels at the 2008 year end would be remedied and had insufficient evidence to conclude that the going concern assumption was appropriate and that PMS's lack of liquidity had no impact on the audit opinion.

23. For the avoidance of doubt:

    a. The Executive Counsel limits the allegations of Misconduct to the audit of PMS's financial statements for the year ends 2007 and 2008. To the extent that matters relating to prior financial statements/audits are referred to these are as background only to those allegations.

    b. The Executive Counsel does not seek to establish that the Respondents, as auditors, were expected to have known the answers to the legal and regulatory issues which the first of these allegations relates to or to have identified the "regulatory gap" (described below at paragraphs 36-38).

    c. The Executive Counsel does not seek to establish that it was inappropriate for management to use the going concern assumption in PMS's preparation of its financial statements for the year end 2007 or 2008. Rather the Executive Counsel contends that the Respondents failed to give adequate consideration or obtain appropriate evidence to justify their conclusion that the use of the going concern assumption was appropriate and/or that there was no significant doubt as to PMS's ability to continue as a going concern in 2008.

BACKGROUND

PMS's Rules

24. The conditions of PMS's registration as an IPS included that it must be a co-operative society (which does not include a society which carries on, or intends to carry on, business with the object of making profits mainly for the payment of interest, dividends or bonuses on money invested or deposited with, or lent to, the society or any other person), or that the business of the society was being, or was intended to be conducted for the benefit of the community (section 1 of the 1969 Act).

25. The rules of PMS provided, amongst other things, in summary:

   a. that its objects included to promote thrift among its members by the accumulation of their savings; to use and manage such savings for the mutual benefit of members; and to create a source of credit for the benefit of its members at a fair and reasonable rate of interest (rule 3);
   b. that membership was only available to members of the Presbyterian Church in Ireland (rule 4);
   c. for shares to be issued to members in lots of £100 up to the limit on withdrawable share capital permitted by the 1969 Act (rule 8);
   d. that members could apply to withdraw the amount paid in respect of any share or shares, subject to PMS's right to require not less than 21 days' notice (rule 11);
   e. that PMS may borrow money for its purposes from members and others and may secure the repayment thereof by mortgages and charges of the Society's property (rule 26);
   f. that PMS may make loans to members for the purposes of its objects as set out in rule 3 (rule 28);
   g. that PMS shall not receive money on deposit (rule 29).

26. The rules do not prescribe any upper limit on the loans from members, or the terms of such loans.

PMS's treatment of loans from members of PMS and withdrawable share capital

27. Where a member of PMS whose share capital had reached the £20,000 statutory limit under section 6(1) of the 1969 Act wished to place more money with PMS, the member was issued with a loan receipt rather than a share certificate.

28. The loans were treated by PMS in an identical way to the share capital in terms of notice for withdrawal (which in practice was on demand for both, despite the rules allowing PMS to require 21 days' notice of withdrawal of share capital) and the rate and timing of interest paid (an annual payment which was calculated identically for each type of investment and depended on PMS's

profits but which was described in the case of loans as 'interest' and in the case of shares as 'dividend').

29. In legal terms, however, there was a distinction between the share capital and the loans from members, in that the share capital was an equity investment in PMS, which was at risk, whereas PMS assumed an obligation to repay the sum loaned (together with interest which was calculated on the same basis as the dividend on shares by reference to PMS's profits). In the event of insolvency, holders of share capital would not receive their money unless and until the loans had been repaid.[3]

Internal auditors

30. Internal auditors, Harbinson Mulholland, were engaged in 2005 but were not instructed to review PMS's regulatory position or compliance, other than in respect of money laundering.

Changes in scale and scope of activities of PMS over the relevant period

31. PMS was the largest IPS in Northern Ireland by 2008, having grown quickly over the relevant period. The combined total of share capital and loans from members in PMS grew from some £13 million at 31 March 2000 to some £310 million on 31 March 2008. The number of members grew from 2,179 as at year end 31 March 2000 to 10,503 as at year end 31 March 2008.

32. As at year end 31 March 2000 PMS held some £4 million as loans and some £8.9 million as withdrawable share capital. By year end 2004, the sums held as loans exceeded sums held as share capital (respectively, some £42.4 million and £42.2 million at that point). During the remainder of the relevant period, the growth in loans significantly outpaced the growth in share capital, which was itself rapid. By year end March 2007, sums held as loans were £190,985,380, more than twice the amount of £92,198,600 held as share capital. By year end 2008, loans were £210,990,892 and share capital was £98,241,700.

[3] Section 7(3) of the 1969 Act makes clear that any (permitted) deposits are to be repaid before any withdrawable share capital.

Extracts from the financial statements of PMS

	FY00 £'000	FY01 £'000	FY02 £'000	FY03 £'000	FY04 £'000	FY05 restated £'000	FY06 £'000	FY07 restated £'000	FY08 £'000
Income	757	1,039	1,227	2,015	3,702	6,723	9,685	14,628	20,428
Total assets	13,028	14,428	24,242	47,364	85,239	135,049	203,951	296,620	311,164
Called up share capital	8,726	9,058	14,373	25,107	41,804	57,823	75,158	92,199	98,242
Loans from members	4,075	5,102	9,513	21,705	42,426	71,497	118,748	190,985	210,991

33. In addition, as from the year end 31 March 2003 PMS expanded its activities to include investing in a portfolio of commercial property, generating rental income. As at year end 2003 the property portfolio was valued at £9.6 million. By year end 2008 it was valued at £129.5 million.

34. Despite these changes in the scale and scope of its activities, there was no corresponding increase in PMS's resources for managing its activities. From 31 March 2000 to 31 March 2008 the income reported by PMS grew by £19.7 million and over the same period the total assets of PMS grew by £298 million. However, PMS's costs (excluding bad debt) were only some £450,000 in the year ended 31 March 2008 (as compared with approximately £110,000 for the year ended 31 March 2000).

Absence of peers

35. At the relevant time, there was no other IPS in Northern Ireland which was operating on a comparable basis to PMS in terms of the scale and nature of its activities (and no other IPS was FSA authorised).

Role of DETI and the "regulatory gap"

36. The Companies Registry of Credit Unions and Industrial and Provident Societies ("**CRCU**"), a part of DETI, is responsible for registering IPSs under the 1969 Act. That responsibility as registrar includes the initial registration and the approval of any changes to the rules of an IPS (as was the case in respect of changes to PMS's rules in 1994 and 2003) and the suspension or cancellation of registrations. The 1969 Act also requires IPSs to prepare audited financial statements giving a true and fair view and to file copies of the financial statements with their annual returns to DETI.

37. DETI was during the relevant period also responsible for carrying out prudential supervision of Credit Unions in Northern Ireland (a role which has subsequently been transferred to the Prudential Regulation Authority). However, DETI's evidence to the House of Commons Treasury Committee enquiry into the failure of PMS was that its powers as registrar under the 1969 Act did not extend to prudential supervision of IPSs. This was noted in each of CRCU's annual reports, published by DETI under section 100 of the 1969 Act, which after setting out the aims of the Registry (including prudential supervision of credit unions) stated: "The Registry does not have any prudential supervisory role in relation to industrial and provident societies".

38. In the rest of the United Kingdom, the role of registrar for IPSs was fulfilled by the FSA (as it then was), which was also responsible (both in Northern Ireland and in the rest of the UK) for authorisation under the FSMA 2000 of any IPS whose activities were such as to require such authorisation.[4] The FSA's

[4] It should be noted however that the 1969 Act prohibited any IPS with withdrawable share capital (such as PMS) from carrying on the business of banking, save that the taking of deposits

evidence to the House of Commons Treasury Committee enquiry into the failure of PMS was that (whilst identification of the need for authorisation was primarily a matter for the Society) if, when considering the rules of an IPS as part of its function as registrar, it came across an IPS which needed to be authorised under FSMA 2000, it would raise this with the IPS. DETI's evidence was that it did not accept this was part of its function. The Committee's Report identified this difference in approach as a "regulatory gap".

PMS's Annual Returns to DETI

39. In each year, PMS's annual return submitted to DETI answered "no" to the question "Does the society take deposits (excluding withdrawable shares) within the meaning of the Banking Act 1987?" and, likewise, "no" to the question whether PMS held sums previously taken as deposits.[5]

40. On being asked at interview what his understanding was of the rule prohibiting the acceptance of deposits by PMS, Mr Ferguson's response was to the effect that he did not know what the legal definition was but, as a layman, his understanding was that a deposit was for a fixed term and that the loans were not deposits (a) because members had immediate access to them and (b) because the return was not guaranteed, since it was determined by the profit distribution at the end of the year. Mr Ferguson said that he assumed everything was in order because PMS made the returns to DETI every year and heard nothing back from DETI. On being asked why he answered "no" to the question in the annual return as to taking deposits he said: "I didn't sit down and think, right, I'm answering that question. I answered "no" last year, should I still be answering "no" to that because nothing had changed."

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of not more than £2 in any one payment and not more than £50 in total from any one depositor, payable on not less than 2 clear days' notice, was not treated as the business of banking for the purposes of the 1969 Act: see section 7 of the 1969 Act.

[5] The form for the Annual Return, AR 30, erroneously referred throughout the relevant period to the Banking Act 1987, despite the fact that, from 1 December 2001, it should instead have referred to the FSMA 2000. As explained below, the definition of a deposit did not change as between the 1987 Act and FSMA 2000.

Lack of consideration by the Board of, and apparent absence of expert legal advice about, financial services regulatory compliance

41. FSMA 2000 (or indeed the Banking Act 1987) was never considered by the Board during the relevant period. This was so despite the changes in the scale and nature of PMS's activities (paragraphs 31 to 33 above), the coming into force of FSMA 2000 on 1 December 2000 and the extension of FSA regulation to some mortgages in October 2004.

42. No legal advice was taken on the definition of deposit-taking, or whether any and if so what financial services regulation applied to PMS, at any time during the relevant period (other than advice from the internal auditors on regulation of money-laundering). There is a statement in the PAF prepared on 25 April 2006: "*Reported that society received legal opinion that not "acting as a bank" in the past – no copy available however"*. No such opinion was provided to the Respondents.

43. It is noted that the Board included professionals with legal and/or financial services experience, including two chartered accountants, at least one solicitor, and a commercial/corporate law QC. It should not, have been assumed by the Respondents that any of them was a specialist in financial services regulation and/or that they had directed their minds to these issues and formed a considered view that PMS was in compliance with the applicable legislation and regulation.

44. In addition to its role as auditor Moore Stephens was engaged by the Board to provide additional services to PMS including, in 2004, a review of the Society's corporate governance. The Audit Committee was established as a result of the corporate governance review and its functions included overseeing the compilation of a risk register. A draft risk register was prepared by Moore Stephens. The only legislation referred to in the draft risk register under the heading 'regulatory risks' was the Money Laundering Regulations 2003. There are no risks identified in relation to PMS operating within its own Rules, in compliance with the 1969 Act or in compliance with the regulatory requirements of DETI, the FSA or any other regulatory body. The draft risk register was discussed by the Board. No substantial amendments were made

to the draft risk register as far as this heading is concerned following this discussion by the Board.

45. In addition, Mr Black, a former director of PMS, has provided to the Executive Counsel a document entitled ‘Developments in Policy from 1982 to Date’ which the Executive Counsel understands that PMS maintained to document the developments in the policies of the Society. This document does not appear to have been regularly updated and is contained on only two and a half pages, yet covers the period from 1982, with the latest update in 2007, and there is only one version contained in Mr Black’s File of Papers. Under the heading ‘Lending’ and sub heading ‘R of I’ (presumed to refer to Republic of Ireland), the document contains the following entry: “1998 Concerns expressed that the Society is not registered as a lending body in the R of I.” There is no further information contained within the document to indicate the nature of such concerns or to record any action taken by PMS as a result of these concerns. There is no indication that Mr Black or PMS made this document available to the Respondents.

46. There is no evidence that the Board of PMS considered or questioned the laws and regulations applicable to PMS other than as set out above.

Lack of consideration by the Respondents as to laws and regulations applicable to PMS

47. Although the Respondents had identified the 1969 Act as relevant, there was no copy of the 1969 Act (or subsequent amendments) on the Permanent Audit File (“**PAF**”). The PAF includes a note dated April 2006 which appears to have been produced in the course of the 2006 audit. This refers to the 1969 Act and notes “Relevant sections of the Acts include: 7) Societies may not carry on the business of banking (defined as taking deposits £2-£50 payable <2 days notice)”. The note misstates the position, since the 1969 Act in fact provides that the acceptance of deposits within that limit is not to be treated as carrying on the business of banking for the purposes of the 1969 Act (see Annex A).

48. The work done by the Respondents in the 2007 and 2008 audits in relation to compliance is set out at paragraphs 69 and following, below.

Letters of Representation in 2007 and 2008

49. Letters of Representation, drafted by the Respondents, were signed by Mr Ferguson on behalf of the directors of PMS for the year end 2007 and year end 2008 audits, representing inter alia that:
    a. they had disclosed all known instances of actual or possible non-compliance with laws and regulations which have or could have an effect on the financial statements (2008 letter only);
    b. they were not aware of any events which involved possible or actual non-compliance with laws or regulations which are central to the society's ability to conduct its business or which would otherwise have a potentially material effect on the financial statements (each year);
    c. they had reviewed the going concern considerations and were satisfied that it was appropriate for the financial statements to have been drawn up on the going concern basis having taken account of all relevant matters of which they were aware and having considered a future period of at least one year from the date on which the financial statements were to be approved (each year);
    d. these representations had been made on the basis of enquiries of management and staff with relevant knowledge and experience (and, where appropriate, of inspection of supporting documentation) sufficient to satisfy themselves that they could properly make each of them (2008 letter only).

50. The Letters of Representation were seen by the Audit Committee at their meeting to review the accounts but copies were not sent to the full Board, which resolved that they be signed without having seen them. The Respondents were not aware that this was the case and it is noted that they received the letters which were signed on behalf of the Board.

51. There had been no discussion of, or enquiry into, or advice taken by the Board or Audit Committee as to the financial services regulatory position at any time during the relevant period, in order to consider whether the representations at paragraphs 49 (a) or 49(b) could be made.[6]

[6] See paragraphs 40 to 47 above.

52. On being asked at interview as to the basis for the representations made to the auditors as to regulatory compliance, Mr Black's response was to the effect that he assumed PMS was in compliance because annual returns were made to DETI, and there had been "no feedback" from DETI, and because the auditors (internal and external) had raised no issues. Mr Clements made statements to similar effect when he was interviewed. It is acknowledged that it is management's responsibility to ensure that an entity's operations are conducted in accordance with laws and representations and that the auditor is not, and cannot be held responsible for preventing non-compliance with laws and regulations.

Liquidity position

53. As noted above, PMS in practice treated both share capital and loans as repayable on demand. PMS's non-cash assets consisted largely in loans to members secured on property and investments in commercial property. There was therefore a mismatch between the short term and on demand nature of PMS's liabilities and the relatively long term nature of its assets, as was recognised by the Respondents during the year end 2008 audit in a document entitled "Possible Factors That May Indicate Going Concern Issues".

54. The audit papers record that the Board of PMS had agreed an internal policy of maintaining liquidity levels at 15% of the aggregate sums due to members in respect of share capital and loans to enable it to meet such demands for repayment. PMS's policy in relation to liquidity levels is also referred to in the document entitled 'Developments in Policy from 1982 to Date'. However, this document records that PMS had an internal policy or target of maintaining liquidity levels at 15% of *"total assets"*, not members' loans and share capital, which level was raised to 20% in 1996 but reduced again to 15% in 1998,[7] where it remained throughout the relevant period. The basis on which that 15% figure was arrived at is not recorded, although Mr Black suggested in his interview that it was derived at least in part from his own experience of auditing credit unions.

[7] There is no reference to "total assets" as at 1998. The document simply states "15% suggested liquidity ratio" without giving any further indication as to how that ratio was to be calculated.

55. Mr Black stated at interview that he received management accounts at every board meeting and he became very concerned about PMS's liquidity position in around March 2008 and spoke to Mr Ferguson about it.

56. As at year end 2008 and throughout that financial year PMS's liquidity ratio was far short of the internal target of 15% (whichever method of calculation was used – see paragraph 54 above). There had been a marked worsening of liquidity buffer as compared with the position in prior years.

   a. Over the period from year end 2000 to year end 2005, PMS's liquidity ratio as at the year end (i.e. PMS's cash balances as a percentage of the aggregate sums due to members in respect of share capital and loans) had ranged from 30.80% (in 2002) at its highest to 15.05% at its lowest (in 2001). The equivalent figures calculated on the basis of PMS's cash balances as a percentage of total assets were 30.35% (in 2002) and 14.77% (in 2001).
   b. However, PMS's liquidity ratio as at year end 2008 was significantly lower: As at year end 31 March 2008, the cash balance was 1.56% of the aggregate sum due to members (both withdrawable share capital and loans from members), with PMS holding only £4.8 million against £310 million in withdrawable share capital and loans repayable on demand, and 1.55% of the total assets.
   c. The missing of the internal 15% target as at year end 2007 and year end 2008 was not a temporary state of affairs affecting only the year end, as was evident from the management accounts. From November 2006 onwards the liquidity ratio was consistently below the 15% internal target, at 10.86% of total assets in November 2006 and then within the range of 2.16% to 6.56% of total assets from February 2007 to September 2008. Furthermore, the missing of the internal 15% target as at year end 2008 was not remedied after the year end. By September 2008, cash of approximately £21.7 million was held; given the level of total assets and/or the members' interests (i.e. loans and share capital) on the balance sheet, the liquidity ratio of PMS in September 2008 was still significantly below the 15% internal target.
   d. Although in May 2003 liquidity was 6.46% it had otherwise been above the internal 15% internal target at all other occasions from January 2003

to September 2006. The position over 2008, described above, therefore represented a significant change from prior years.

57. The decline in PMS's liquidity target was such as to call in question whether the going concern assumption remained appropriate. There appears to have been little or no consideration of the liquidity position or the appropriateness of the going concern assumption by PMS's Audit Committee or Board in 2008. The work done by Moore Stephens in the 2008 audit in relation to liquidity and going concern is set out at paragraphs 74 and following, below. For the avoidance of doubt, Executive Counsel does not assert that use of the going concern assumption was in fact rendered inappropriate by PMS's liquidity position, or that Moore Stephens ought to have issued an adverse opinion on that basis. The audit files contain insufficient evidence from which to reach a conclusion in that respect. Rather, the nature of the case advanced by Executive Counsel is that Moore Stephens did not obtain adequate evidence from which they could conclude that management's continued use of the going concern assumption remained appropriate, as more particularly set out below.

PMS's financial statements

58. Funds received from shareholders exceeding the £20,000 limit were described by PMS in their financial statements as 'loans' (accounts for year ends 2000-2005) or 'loans repayable on demand' (accounts for year ends 2006-2008). The withdrawable share capital was described as "Shareholders funds – equity interests" (accounts for year ends 2000-2006) or "Share capital repayable on demand" (accounts for year ends 2006-2008.

59. In the accounts for each of the years ends 2007 and 2008 the Director's report included a statement in the following terms:

> "**Risk management**
> The directors have conducted a review of the major risks to which the society is exposed. These risks are considered regularly by the directors and they have developed systems to monitor and control these risks in order to mitigate any impact they may have on the society. The main risks arising from the society's financial instruments are interest rate risk, credit risk and liquidity risk.

The policies for managing these risks are summarised below.

Liquidity risk

The directors seek to manage financial risk by ensuring sufficient liquidity is available to meet foreseeable needs.

Interest rate risk

The society finances its operation through a mixture of loans to members[8] and rental income. The interest rate charged is based on the Bank of England base rate.

Credit risk

The society's principal financial assets are cash, investment properties and loans to members. The credit risk associated with cash is limited. The investment properties are revalued annually. The principal credit risk arises from loans to members..."

60. Had PMS been regulated as a bank, it would have been required to make more detailed disclosures in its financial statements of matters relating to credit risk and liquidity risk. This could potentially have identified to investors and potential investors the potential mismatch between the short term nature of its liabilities and the long term nature of its assets and the consequent risks to liquidity (as more particularly described below).

61. Moore Stephens gave unqualified auditors' reports on each of PMS's financial statements.

Events in Autumn of 2008

62. The 2008 audit report was signed in June 2008. In September 2008 Lehman Brothers filed for bankruptcy. This event, along with other similar events and worsening international economic conditions led to an unprecedented and unforeseen global financial crisis, which resulted in the need for the UK Government to rescue many major banks in the UK.

63. Further:

[8] This is plainly a typing error and should read "loans from members".

a. On 30 September 2008, the Irish Government announced its decision to guarantee all deposits and debts of six Irish banking institutions for two years.

b. On 3 October 2008 the UK Government announced that it was increasing the guarantee on retail deposits from £35,000 to £50,000 through the FSCS with effect from 7 October 2008.

64. Following publicity during September and early October 2008 for the deposit guarantees available from the Irish government and from the FSCS, members of PMS began calling its offices to ask whether their money had the benefit of these guarantees and, on being told (correctly) that it did not, many of them withdrew their funds.

65. Within 3 weeks, £21 million had been withdrawn, leaving PMS with cash reserves of just £4 million, prompting an emergency Board meeting on 25 October at which it was resolved to suspend payments pending advice and to invoke the 21 day notice period for share capital. By 17 November 2008, over £50 million in further withdrawal requests had been made by members of PMS.

66. On 6 November 2008 the Board resolved to put PMS into administration. Emergency legislation was passed to enable PMS to be put into administration, which took place on 17 November 2008. The administration has now concluded with the putting in place of the Scheme of Arrangement described at paragraph 14 above.

67. In the period after the collapse of PMS, the FSA undertook an investigation of PMS and published the results on its website which included the following statement: "We have concluded our investigation and have decided that [PMS] was conducting regulated activities without the necessary authorisation or exemption." Further, by a letter dated 23 April 2009, the FSA informed DETI that it appeared that PMS had been accepting deposits in the form of "loans" from members without the required authorisation in breach of section 19 of FSMA. The FSA also expressed concerns to DETI in this letter that Moore Stephens had not identified that PMS was operating in breach of the requirements of FSMA.

Directors' Disqualification Proceedings

68. In 2010, Directors Disqualification proceedings were brought in Northern Ireland by DETI against a number of directors of PMS, including Mr Black, and the Company Secretary, Mr Ferguson. Those proceedings were concluded by consent in May 2013, by the directors giving disqualification undertakings. By Mr Black's form of disqualification undertaking, dated 9 May 2013, he undertook not to be a director or receiver of a company or act as an insolvency practitioner for 3 years from 30 May 2013. He accepted responsibility as a director (in summary) for PMS's carrying on a deposit-taking business, in breach of its rules and without authorisation under the Banking Act 1987 or FSMA 2000, for its having entered into regulated mortgage contracts without being authorised under FSMA 2000, for its failure to seek professional or legal advice as to the impact of the coming into force of FSMA and for inadequately monitoring the affairs of PMS in certain other specified respects. DETI accepted that he did not act dishonestly, in bad faith or for his own personal gain.

ALLEGATIONS

ALLEGATION 1

In relation to the audit of PMS's financial statements for the years ended 31 March 2007 and 31 March 2008, the conduct of Moore Stephens and Mr McClean fell significantly short of the standards reasonably to be expected of, respectively, a Member Firm and a Member, in that:

1.1 Moore Stephens and Mr McClean issued unqualified audit opinions in respect of PMS having failed to obtain and document an adequate understanding of the legal and regulatory framework that applied to PMS and as a result failed to identify relevant risks and to plan and perform the audit so as to minimise the risk of material misstatement in the financial statements, and failed thereby to act in accordance with Fundamental Principle (C) 'Professional Competence and Due Care' of the ICAI's 2006 Code of Ethics for Members.

1.2 Moore Stephens and Mr McClean issued unqualified audit opinions in respect of PMS having failed to exercise professional scepticism in the conduct of the audit and to obtain corroborating evidence and document their conclusions in relation to compliance, relying on assurances and representations from PMS's management and Board, and failed thereby to act in accordance with Fundamental Principle (C) 'Professional Competence and Due Care' of the ICAI's 2006 Code of Ethics for Members.

ALLEGATION 2

In relation to the audit of PMS's financial statements for the year ended 31 March 2008, the conduct of Moore Stephens and Mr McClean fell significantly short of the standards reasonably to be expected of, respectively, a Member Firm and a Member, in that: Moore Stephens and Mr McClean issued unqualified audit opinions in respect of PMS having:

(i) failed to document adequate audit testing and to obtain sufficient and appropriate audit evidence in the assessment of the appropriateness of the going concern assumption, and (ii) failed to exercise professional scepticism in the assessment of management's view that it was appropriate to apply the going concern assumption; and (iii) failed to give sufficient consideration to

the adequacy of the disclosures in the financial statements regarding liquidity and going concern,

and failed thereby to act in accordance with Fundamental Principle (C) 'Professional Competence and Due Care' of the ICAI's 2006 Code of Ethics for Members.

PARTICULARS

Particulars of Allegation 1.1 (understanding of PMS and the legal and regulatory framework, identification of risks and planning and performance of audit)

69. The Respondents were required to obtain an adequate general understanding, for the purposes of the planning and performance of their audits, both of PMS and of the applicable legal and regulatory framework, and as a result they failed to identify relevant risks of non-compliance with laws and regulations (in particular the need for FSMA authorisation) and failed to recognise that non-compliance by PMS with laws and regulations may materially affect the financial statements and plan and perform the audit appropriately to address that risk (see, in particular, the extracts from ISA 250A and ISA 315 referred to in Annex D at paragraphs 3 a (i) – (iv) and 4 d (i) – (vi)).

70. In this regard, the Respondents ought reasonably to have taken into account in their risk assessment and planning and performance of the audit that:

    a. PMS had a volunteer board who met only four times a year and was reliant on one individual, the Company Secretary Colin Ferguson, who had no professional qualifications (paragraphs 7 to 8 above);
    b. PMS was experiencing very rapid growth without concomitant growth in the resource for managing its business (paragraphs 31 to 34 above);
    c. PMS had no known peers conducting comparable business on a similar scale using a comparable IPS model (paragraph 35 above);
    d. PMS was operating in the financial services sector, which is typically a sector subject to complex (and changing) regulation;
    e. The audit team had expertise (but limited experience of the financial services industry (and none of the audit team had had training in respect of IPSs or financial services);

f. In 2007-8 liquidity was extremely low and far below the internal policy target of 15% minimum cash holding which PMS's board sought to meet (paragraphs 53 to 57 above).

71. Despite this the Respondents did not obtain an adequate general understanding to inform their consideration of compliance, in breach of ISA 250 and ISA 315, and as a result failed to plan the audit in a way that was appropriate for meeting the objectives in ISA 250 Section A, at paragraphs 18 and 19:

a. Although the Respondents had in prior years identified the 1969 Act as relevant, and the Permanent Audit File identified that section 7 of the 1969 Act prohibited an IPS with withdrawable share capital (such as PMS) from carrying on the business of banking (paragraph 47 above), and although they were also aware both of the statutory limit on withdrawable share capital (referred to in PMS's rules) and the prohibition on taking deposits set out in PMS's rules, the Respondents failed to obtain an adequate understanding, for the purpose of the 2007 or 2008 audits, of what constituted banking or a deposit, or of the correct characterisation, for these purposes, of the loans to members, as more particularly set out below.

b. Whilst ISA 315 is referred to in Section 6 of the 2007 audit file as being particularly relevant in relation to "Management's consideration of law and regulation", the Respondents did not document what work was done in that respect.

c. In planning the audit, the Respondents did not record what systems or controls, if any, PMS had in place to ensure compliance, and described the position as "satisfactory" as regards the register of relevant legislation, enquiries of the Board as to laws and regulation and the design of tests to consider compliance without having done or documented any work to support those conclusions. In this regard, the Respondents adopted a standard audit programme for credit unions ("CUs") without adequately tailoring it to an IPS and/or to the specific position of PMS in particular as a unique institution in Northern Ireland. The Respondents failed to give adequate consideration or failed adequately to document how the CU audit programme should be applied to PMS.

d. There is no evidence in the 2007 and 2008 audit files that the Respondents ever considered how the prohibition in PMS's rules on taking deposits, and/or the limit on deposits in s7(3) of the 1969 Act, were each supposed to interact with the rule permitting loans to be accepted from members. Nor is there any evidence that they considered whether and how unlimited loans to members were consistent with the statutory limit of £20,000 on withdrawable share capital.

e. The Respondents ought to have realised that the average interest per member (combining loans and share capital) was in excess of £20,000 and thus ought to have considered whether there were any material differences between share capital and loan capital which justified PMS in treating the latter separately as regards the £20,000 statutory limit.

f. In fact, there were no material differences, in that, so far as relevant, PMS treated share capital and loan capital as being substantially the same (as more particularly set out at paragraph 28 above). As should have been apparent to the Respondents, by taking unlimited loans from members (as opposed to the strictly limited deposits permitted by s7(3) of the 1969 Act) PMS was in effect circumventing the £20,000 limit on share capital, which may not have been permissible. On the other hand, if the loans from members were not equivalent to share capital, then the Respondents should have considered whether they were deposits to which the limit in s7(3) applied.

g. If, therefore, loans were simply an extension of share capital (as Mr McClean and the audit manager appear from their answers at interview to have thought), then the combined total of loans and share capital was such that the average, per member, exceeded the statutory limit on share capital. If on the other hand the correct analysis was that loans were not share capital, there would then be no breach of the £20,000 limit on share capital but the Respondents would instead need to be satisfied as to how the loans were to be differentiated from deposits, such that the limit in s7(3) of the 1969 Act on permissible deposits was not exceeded. A conclusion could not be reached as to whether PMS was in compliance without an understanding as to which of these was the right way of characterising the loans.

h. As auditors, the Respondents were not expected to answer those questions themselves but were expected to recognise that the questions needed to be answered by someone appropriately qualified to do so. Mr McClean accepted in his interview with the FRC on 6 August 2009 that he could see "the argument that those loans are not unlike deposits" and that, whilst he thought there were differences between the loans accepted by PMS and deposits, "you can put the similarity spin on it".

i. The Respondents could have been expected to recognise that financial services regulation was a complex and changing field where up to date advice from a specialist was likely to be needed by PMS as to what PMS needed to do to be in compliance.

j. In particular, they ought to have recognised that:

    i. The Banking Act 1987 and/or FSMA 2000 might potentially be relevant to PMS

    ii. PMS had never undertaken a review of its position in the light of FSMA 2000 (or subsequent developments such as the extension of FSA regulation to certain mortgages);

    iii. PMS had also not undertaken a review of its position in the light of the significant changes in the scale of its activities over the relevant period, or the fact that, by year end 2004, the sums held as loans exceeded sums held as share capital;

    iv. The fall in PMS's liquidity indicated that, if there were any regulatory requirements that applied to PMS in respect of liquidity (beyond the 15% internal target), these should be identified and complied with.

k. The Respondents should also have recognised that:

    i. whether PMS was taking deposits, and its compliance more generally, was a complex issue which would require proper consideration, discussion with the management of PMS and potentially the benefit of legal advice;

    ii. there was a need for proper consideration of whether PMS's activities were, in fact, in compliance with its own rules and this could not be presumed;

    iii. this in turn required proper consideration of (at the very least) how a deposit and the business of banking was defined for the purposes of the 1969 Act, whether or not they was also aware (as they should have been at least in general terms) of the possible relevance of FSMA 2000 or the Banking Act 1987;

iv. these were legal questions which might potentially be addressed with the benefit of expert legal advice.

l. These matters (and each of them) ought to have caused the Respondents to conclude that they could not rely on their own assumptions and/or understanding without the benefit of such expert advice if obtained by the PMS Board.

m. Such informal discussion between Mr McClean and his predecessor as the audit engagement partner for PMS as took place prior to Mr McClean's involvement in the audit would not amount to adequate consideration of FSMA 2000. Consideration of FSMA 2000 by the Respondents following Mr McClean's appointment as audit engagement partner in 2005 was not documented (beyond the statement in the 2006 PAF referred to at paragraph 42 above). The Respondents did not identify, as a relevant risk facing PMS, breach of the general prohibition in FSMA 2000 or breach of the Banking Act 1987.

n. The Respondents correctly identified that PMS's rules prohibited deposits and that the 1969 Act did not permit an IPS with withdrawable share capital (such as PMS) to carry on the business of banking and concluded from this that therefore no other financial regulation applied. This was a non-sequitur because the question remained whether PMS was in compliance with its own rules and the provisions of the 1969 Act, without regard to FSMA 2000 and/or the Banking Act 1987. That question (which again the Respondents should have recognised was potentially a matter for expert advice) was never properly addressed, rather the Respondents assumed such compliance. Moore Stephens' Audit Strategy Memorandum on the 2007 audit file stated that they were "not aware of any breaches" of the 1969 Act or PMS's rules but did not record any work that had been undertaken or planned to justify the conclusion that there had been no breaches. The same is true of the 2008 audit file. Moore Stephens' Audit Completion Memorandum on the 2007 audit file stated that PMS "appears to have complied" with applicable laws and regulations, in particular the 1969 Act, without identifying what enquiries had been made or tests carried out in the course of the audit before reaching that conclusion.

o. The Respondents also appear to have erroneously assumed that DETI was regulating PMS from a prudential perspective.The Respondents appear to have had doubts as to the scope and/or effectiveness of any such regulation by DETI yet did not check the position. The Respondents should not have relied on an assumption that DETI was regulating PMS without taking any steps to check that this was correct and to understand the scope of that regulation. The fact that there was no substantial correspondence between PMS and DETI (other than the annual returns) and no evidence of inspections by DETI, such as might be expected if DETI was regulating PMS, was further reason for the Respondents to question that assumption. Reference to DETI's annual reports, which were published on its website, would have shown that DETI did not provide any prudential supervision of IPSs.[9] Enquiry directly of DETI may have established the same but the Respondents did not make enquiries. Review of the 1969 Act would potentially have established what DETI's powers were as Registrar and that these were limited in scope.

p. The Respondents did not question why, despite the similarity in the business that PMS was carrying on, PMS was not subject to similar regulation (i.e. prudential supervision by DETI) to that which applied to CUs.

q. There is no evidence documented in the audit files of the Respondents considering and recording its conclusion as to how deposits were defined, whether for the purposes of PMS's rules or the 1969 Act or the Banking Act 1987[10] or FSMA 2000, as opposed to assuming that PMS did not take deposits because its rules prohibited this. Nor is there any record in the audit files that the Respondents considered how the business of banking was defined for the purposes of the 1969 Act.

[9] See paragraph 37 above. Mr McClean accepted in his interview with the FRC on 22 October 2010 that he would have received a copy of the reports but said he would not have read it in detail.

[10] The Banking Act 1987 was referred to in the Annual Returns to DETI: see paragraph 38 above. Much as the form ought after December 2001 to have referred to FSMA 2000, and therefore in that respect was out of date, this reference to the Banking Act 1987 was in practical terms a prompt to consider the self-same definition of a deposit as also appears in the RAO.

r. To the extent that the Respondents considered at the time how deposits were defined, or how the business of banking was defined, their understanding was erroneous:

   i. The audit manager attached significance to the fact that PMS only supplied services to its members. The fact services were supplied only to members was not in fact relevant to the limits imposed on it by the 1969 Act or to whether FSMA 2000 and/or the Banking Act 1987 applied to its activities in accepting loans from members (see Annex A). In interview with the FRC, the audit manager characterised the loans as investments in PMS and "an extension of the share capital." That potentially should have raised the questions identified at paragraph 71(e) and (f) above.

   ii. Mr McClean likewise said in interview with the FRC that he regarded PMS's activities as different from a bank because to be a loan creditor you also had to have shares in PMS. He added that although the certificates distinguished between dividend (in the case of share certificates) and interest (in the case of loan certificates) "It's always been talked about, from the company's point of view, as a dividend". Again, that should potentially have prompted Mr McClean to pose himself the questions identified at paragraph 71 (e) and (f) above.

s. The need to consider (potentially with the benefit of expert advice) the proper characterisation of the loans ought to have been evident to them from consideration of the limits in the 1969 Act, which the Respondents knew to be applicable to PMS.

   i. Any characterisation of the loans as investments equivalent to PMS's share capital ignores the fact that the extent to which members were permitted to invest in PMS's equity by way of withdrawable share capital was specifically limited by section 6(1) of the 1969 Act to £20,000. There was also a strict limit under s7(3) of the 1969 Act on any deposits.

   ii. In the light of those statutory limits, the Respondents ought to have considered and potentially sought expert advice as to the regulatory implications of the fact that the share capital and loans were in practice treated by PMS as being essentially equivalent.

iii. If it was correct for PMS to treat the loans as equivalent to share capital then the combined total could not exceed £20,000 per member and hence PMS would be in breach of that limit in each case where an individual's combined interest by way of share capital and loans exceeded that limit. If, on the other hand, loans were to be differentiated from share capital, the basis for differentiating the two needed to be understood before a conclusion could be reached as to compliance with the £20,000 limit on share capital, as too did the basis for concluding that the loans were not deposits and hence not subject to the limit in s7(3).

iv. Either way, a conclusion could not be reached as to compliance without first considering and documenting how the loans were properly to be characterised.

t. The Respondents did not identify the potential need for expert legal advice on which to base the assessment and/or testing of compliance issues despite their awareness that a legal opinion had previously been obtained by the PMS Board and that they had not seen a copy.

Particulars of Allegation 1.2 (conduct of the audit in respect of compliance)

72. The Respondents were required to:

a. bring to bear professional scepticism in evaluating representations from management in respect of compliance (see, in particular, the extracts from ISA 200 referred to in Annex D, at paragraphs 4 a (iv)).

b. Obtain corroborating evidence and document their conclusions (see, in particular, the extracts from ISA 580 referred to in referred to in Annex D, at paragraph 4 (f)).

73. The Respondents did not evidence on the audit files that they had exercised professional scepticism in evaluating whether PMS was in compliance nor did it obtain corroborating evidence and document the conclusions, in breach of ISA 200 and ISA 580, and its performance of the audit was inadequate as a means of addressing the risk of non-compliance materially affecting the financial statements, in breach of ISA 250 Section A:

a. The Respondents approached the question of compliance on the footing that nothing relevant had changed, when in fact the applicable legislation had changed, with the advent of FSMA in 2000 and the extension of regulation to certain mortgages in 2004, and moreover the relative proportions of share capital and loan capital had also changed, such that the average interest per member was in excess of £20,000. Further, the Respondents ought to have revisited this question in the light of the greater risks to investors arising from the increased scale and scope of PMS's activities during the relevant period and the fact that PMS's liquidity had deteriorated by financial years 2007 and 2008 compared with prior years. The Respondents failed to recognise that these were significant developments which required the Respondents to revisit their understanding of the regulatory environment. The Respondents did not identify the need to conduct, and did not conduct, any enquiry and/or tests to determine whether PMS was complying with:
    i. The £20,000 limit on shareholdings;
    ii. The prohibition in PMS's own rules on deposit taking;
    iii. The limits on deposit-taking in s7(3) of the 1969 Act;
    iv. The prohibition on unauthorised deposit-taking under FSMA 2000 (or previously, the provisions of the Banking Act 1987 making unauthorised deposit-taking an offence).
b. The Respondents drew for the purposes of their audit on materials relating to other types of entity (CUs and Friendly Societies) without adequately tailoring the audit to PMS[11] and without asking themselves the questions which those comparisons should have prompted:
    i. The PAF contains a Technical statement (MR23) relating to CUs (PAF501), a practice note (24) relating to Friendly Societies (PAF504), annotated by the audit manager of Moore Stephens. The annotations on these documents indicate the alleged errors outlined at paragraphs 71 (n)-(r) above, i.e. a failure to identify that PMS was accepting deposits in breach of its rules and the 1969 Act and that DETI was not regulating PMS. Parts of PN24 relating to the FSA were marked by the audit manager as not

[11] In fact, during his interview with the FRC on 22 October 2010, Mr McClean said that he had never audited a CU so it was "difficult" for him to identify the differences between CUs and PMS.

applicable, without that prompting any consideration by the Respondents of the broader relevance of FSMA 2000.

ii. In financial years 2007 and 2008 the audit manager made use of an audit programme for CUs in NI but treated large parts of it as inapplicable (as more particularly detailed at paragraphs 77 to 78 below). Mr McClean failed to evidence on the audit file the appropriateness of this approach or to identify or address the questions it raised.

iii. The audit programme for CUs was used because there was no suitable programme for IPSs. The overall audit risk was increased by the fact that PMS was a unique operation subject to its own particular rules, there being no other IPS in NI engaging in comparable activities. This in itself indicated a need for heightened caution.

iv. Comparison with the requirements for CUs and Friendly Societies detailed in those materials should have prompted the Respondents to question whether PMS's liquidity risks were adequately controlled and how it could be the case that PMS was permitted to conduct its business without being subject to any equivalent capital, solvency or liquidity requirements imposed on it by a regulator, and to take the steps of obtaining, or advising PMS to take, expert legal advice as to compliance, including as to the definition of a deposit and as to whether DETI was, in fact, responsible for any prudential supervision and if so by reference to what parameters.

v. Other parts of the audit programme for CUs, relating specifically to law and regulation, were signed off as satisfactory:

    1. without the Respondents recording any basis for reaching that conclusion; or
    2. referencing documents which do not support the conclusion.

c. The Respondents relied on information from management and the Letters of Representation, as to compliance, when this was a high risk area.

d. The Respondents assumed that because PMS was a mutual society and because PMS's rules prohibited it from taking deposits, it was not in fact doing so, and failed to recognise that management's assurances about compliance were based on the same untested assumption. No audit work was planned or undertaken to verify this. The Audit Completion Memo for 2007 and 2008 state with reference to ISA 250 that "The society appears to have complied with applicable laws and regulations, in particular the Industrial and Provident Societies Acts 1969 and 1976", without identifying any work as having been undertaken to justify that conclusion. No such work was carried out or documented on the audit file for 2007 or 2008.

e. The audit manager noted (in the PAF 205) that PMS had received a legal opinion in the past that it was not acting as a bank but that no copy was available. There is no evidence recorded in the audit files as to when and from whom the legal opinion was obtained by PMS. When asked about it at interview Mr Black was unaware of any such opinion. The Respondents did not obtain a copy or obtain any satisfactory evidence that any such opinion had ever existed.

f. In any event, the existence of an unavailable opinion on the issue was primarily relevant as demonstrating that the matter was properly one for expert legal advice and that in the light of the growth in the scale of PMS's business and the changes in financial services regulation during the relevant period, it was necessary to obtain fresh, up-to-date advice on compliance. However, the Respondents did not so advise PMS.

g. The Respondents appear to have assumed that DETI's approval of rule changes in 2003 indicated that PMS's activities were being regulated by DETI and/or that they were in compliance with the 1969 Act. However, there was no evidence to confirm that DETI had tested PMS's compliance with the rule prohibiting deposit-taking or had questioned what controls were in place to ensure that permitted loans did not become day-to-day acceptance of deposits (in excess of the limits in s7(3)). Review of the rules, as such, would not have established whether PMS was in compliance.

h. Equally, it was not safe to rely on the fact DETI had raised no issue based on PMS's annual returns, given that the Respondents were uncertain what regulation DETI was carrying out (see paragraph 71 (o) above), and given the lack of evidence that this involved active prudential supervision of PMS or included setting any requirements for its capital adequacy or liquidity.

i. The Respondents failed adequately to consider the question as to what the loans from members on the balance sheet represented and how (if at all) they differed in substance from withdrawable share capital which was subject to the £20,000 statutory limit. The Respondents should have recognised that the on demand nature of PMS's liabilities required a strong risk management framework, given its investment strategy of investing in mortgages and commercial properties, which were relatively long term and illiquid assets. That in turn should (when taken with the other matters set out above) have led the Respondents to question management's understanding as to what regulation applied and by whom and as to whether management had an adequate basis for that understanding (including as to the basis for distinguishing the loans from share capital and/or deposits).

Particulars of Allegation 2 (conduct of the audit in respect of liquidity and going concern)

74. The Respondents were required to evaluate the appropriateness of management's use of the going concern assumption, whether there were material uncertainties and whether disclosures were required (see, in particular, extracts from ISA 570 referred to in Annex D at paragraphs 3 b (i)). In carrying out that evaluation, the Respondents were required to exercise professional scepticism and to seek corroborating evidence and document their conclusions (see, in particular, extracts from ISA 200 and ISA 580 referred to in Annex D at paragraphs 4 a (iv) and 4 (f)).

75. The Respondents were aware that the Board had set an internal target of a 15% level of cash for liquidity purposes and recognised that liquidity was an important factor in PMS's business. However, in 2008 the Respondents did not test compliance with the internal target (other than at the year end), or establish what systems and procedures were in place to secure compliance throughout the year, or enquire as to how the 15% figure had been arrived at, or evaluate the reasonableness of that level of cash holdings to meet PMS's rapidly escalating liabilities to repay loans or share capital on demand and whether the policy could (if observed) realistically be expected to be adequate for going concern purposes.

76. In financial year 2008, the Respondents identified that cash was 1.6% at the year end and was "far below the Society's own target":

a. The explanation recorded as having been received by Moore Stephens from management was to the effect that this was due to failure to sell one of PMS's properties and slower than usual receipt of loan/interest payments, that March was typically a cash trough but that post-year end investment had been strong and moderately improved the position.

b. A document headed "Going Concern Review" records further discussion with Mr Ferguson to the effect (inter alia) that a "Significant factor is the ability of the Society to control outflows re its dividend payable at the end of the year – although significant reduction could cause a run on the Society"; "Agreed liquidity was an issue and cash reserves are lower than desired"; and "The Society could potentially borrow against its investment properties should it require additional cash in the short term … If possible investment properties may be sold". The conclusion reached in the light of these explanations was that PMS remained solvent and had considerable assets against which it could borrow.

c. A Letter of Representation was obtained signed on behalf of the Board confirming inter alia the appropriateness of the going concern assumption (see paragraph 49 (c) above).

d. As more particularly set out below, the documentation of the audit work in respect of liquidity or going concern was inadequate.

e. The completion memorandum for the 2008 audit notes that a planned sale had fallen through and that the level of cash had increased since the year end (without giving figures). (However, whilst the cash position did improve somewhat after the 2008 year end it was still almost half the 15% internal target as at September 2008: see paragraph 56 (c) above).

77. In financial year 2008 the Respondents made use of an audit programme for CUs in Northern Ireland without questioning the decision by the audit manager to treat large parts of that audit programme as inapplicable and without addressing the issue of what alternative audit steps should be taken to identify risks to going concern posed by inadequate capital reserves, solvency ratios, or liquidity, or what PMS's management were doing to manage those risks:

a. The audit manager had marked up a copy of the Technical Statement M23 (PAF501), dealing with auditing CUs in Northern Ireland, to the effect that PMS was not a CU but the principles were similar and compliance with this guidance would ensure key audit areas were addressed.

b. The audit manager noted that the provision detailed at paragraph 21 of M23, requiring CUs to establish and maintain a general reserve from its surplus on operations of at least 10% and not more than 20% of total assets, was a “useful benchmark. To be discussed with PMS”. What discussion, if any, took place is not recorded.

c. However, Technical statement M23 also detailed other requirements applying to CUs in Northern Ireland. These included that they were prohibited from carrying on the business of banking, that they were prohibited from accepting deposits other than as a subscription for its shares or up to a limit of £250, which must be separately accounted for and invested only in specified trustee investments, and that temporary borrowings were permitted only if the total amount borrowed did not exceed 50% of the total share and deposit balances (Articles 24-27 of the Credit Unions (Northern Ireland) Order 1985). The audit manager’s only comment on these requirements was “N/A refer PMS own rules”.

d. During the year end 2008 audit, the audit manager made manuscript notes on Appendix 5 of the audit programme for CUs in the rest of the United Kingdom (other than Northern Ireland). Appendix 5 includes amongst factors that may indicate going concern issues:

    i. “the credit union operating at or near the limit of its individual capital guidance or limit otherwise set by management under the FSA’s capital requirements” (against which Moore Stephens commented “N/A in NI or to PMS”);

    ii. “unjustified attempts to reduce the size of the buffer over and above the threshold solvency ratio that management has agreed to operate at” (against which Moore Stephens commented “Cash is low. Refer GC Rew [Going Concern Review]”;

    iii. Liquidity indicators including “low ratio of liquid assets to total relevant liabilities (against which the audit manager commented “V low – Refer GC Rew [Going Concern Review]”; “mismatch between loans being issued and shares in the ~~credit union~~ PMS” (the words “credit union” having been crossed out by the audit manager; “anticipated defaults on loan repayments” (against which the audit manager commented “some but good security”);

"expected cash flows" (against which the audit manager commented "post y/e cashflow has been good").

e. During the year end 2008 audit, the audit manager:
    i. Gave similar answers to those above;
    ii. Did not answer the parts of the "Financial Statements Overall Review" (8) concerned with going concern review (parts 3-5).

78. The Respondents did not address their mind to the fact that:

a. There was a potential mismatch between the long term nature of PMS's assets (mortgages and investment property) and the short term nature of its liabilities (loans and share capital both treated as repayable on demand or at most on 21 days' notice). This created a need for strong risk management systems. The Respondents should have identified this and considered whether such systems were in fact in place and were effective.

b. Comparison with businesses engaged in similar activity (such as CUs or building societies) put in question both the adequacy of PMS's liquidity and whether any and if so what regulation should apply.
    i. Even if the detailed audit programme steps CUs were not directly applicable, more consideration needed to be given to tailoring them to PMS in order to address the risks to which the tests were directed and, in particular, to test the appropriateness of the going concern assumption.
    ii. Further or alternatively, the lowest recorded liquidity ratio for the top 60 building societies in 2007-8 was 13.90%.

c. Either of those comparisons should have highlighted to the Respondents that more work needed to be undertaken by them in relation to addressing compliance and the inadequacy of PMS's actual liquidity levels, including gaining expert advice, given that:
    i. there is no evidence on the audit file that advice had been taken by PMS on the definition of a deposit;
    ii. PMS's compliance with its own rules prohibiting deposits had not been tested;
    iii. its compliance with the limits in s7(3) of the 1969 Act had not been tested;
    iv. even if at the time the Respondents did not consider the loans from members to be deposits, it knew that PMS had taken loans

from members, repayable on demand, which far exceeded 50% of its share capital (reaching 200% of share capital by 2008) (cf. the limit on temporary borrowing by CUs under Article 27 of the Credit Unions (Northern Ireland) Order 1985);

v. the 15% internal target was historic, had not been arrived at by reference to PMS's financial circumstances as at 2008 and no active consideration had been given by the Board of PMS to what cash reserves would be prudent and appropriate to the scale and nature of its business, having regard to material risks including the risks of a liquidity shock, given the levels of its on-demand liabilities at that time;

vi. PMS was not complying with the 15% internal target and PMS's actual liquidity levels were far short of that target or those that applied to CUs or were typical of building societies at the time;

vii. No stress-testing had been done by PMS (or reviewed by Moore Stephens and Mr McClean), in the course of the audit, to test the adequacy of PMS's liquidity levels.

79. The seriousness of the liquidity situation as at year end 2008 was exacerbated by the fact that:

a. PMS's policy was to distribute available profits and therefore it had very low retained reserves in its balance sheet as at 2008;

b. As at year end 2008, 47% of PMS's outward loans were concentrated in only 4 borrowers. In 2008 property prices began to decline, hence security levels were potentially lower than the value of the loans due to declining property prices.

80. The steps the Respondents took to evaluate the appropriateness of the going concern assumption and whether disclosures were necessary, or to document their conclusions on those matters, as required by ISA 570 and ISA 580, were inadequate in the circumstances and the Respondents failed to exercise professional scepticism, as required by ISA 200:

a. Having noted that the liquidity levels as at the 2008 year end were below PMS's internal target of 15%, the Respondents failed to investigate or consider, adequately, the reasons for this decline.

b. There is no evidence that the Respondents in fact tested compliance with the 15% internal target during the course of the year (although its audit papers for 2008 recorded the need to do so).

c. The Respondents' notes on their review of the minutes file shows nothing to suggest the directors did consider the impact of decisions on liquidity (contrary to the answer given at paragraph 77 (d)(i) above).

d. The Respondents relied on uncorroborated assurances from Mr Ferguson and from the Board by way of a Letter of Representation signed by Mr Ferguson, in circumstances where corroboration was required. The Respondents did not document appropriate audit evidence for the basis of the conclusions reached that management had adequately evaluated the risks posed by PMS's poor liquidity levels or had adequate plans for resolving it. No evidence was documented of existing or available credit facilities, far less any in an amount that could be expected to be sufficient to plug the gap in liquidity.

e. Since no historic or projected cashflows or budgets existed, the Respondents should have questioned what work management had done to satisfy itself in respect of its liquidity risk and should have taken alternative procedures to review or stress-test, with a view to assessing the likely requirements for liquidity. There was no evidence that PMS's management or the Audit Committee or the Respondents had obtained or considered cash flow forecasts, evidence as to historic patterns (such as withdrawals by members) affecting liquidity, subjected cash flow forecasts to stress testing, or considered any other ways in which the liquidity deficit could be mitigated. Nor were up to date management accounts required before the Respondents signed off the financial statements. Nor did the Respondents analyse post year end cashflows to test management assertions that the liquidity position had been remedied post year end.

e. The Respondents should not have relied upon uncorroborated assurances from management in financial year 2008, when liquidity was found to be short of PMS's internal limit, and given the fact that Northern Rock had experienced a run. The 2008 audit papers suggest that the Respondents did indeed recognise that there were factors indicating heightened risks in respect of going concern and that liquidity was too low, yet that recognition did not result in sufficient audit work to corroborate management assurances.

f. The explanation from management (in respect of the year end 2008 position) that March was a “cash trough” did not bear examination given that the extra £7.25m which the audit manager had recorded (in the Going Concern Review/PBSE on the 2008 Audit File) as being expected to be received in respect of outstanding cheques would raise the cash ratio to only 3.9%. There is no evidence of any work having been done to corroborate that assertion.

g. The Respondents were aware that liquidity throughout financial year 2008 had deteriorated by comparison with earlier years, as set out at paragraphs 56 to 57 above.

h. The Respondents made no investigation of the reasons why the 15% internal target had not been met by PMS throughout the year (or indeed any investigation as to the liquidity position otherwise than at the year end). The liquidity deficiency was not identified as a weakness in internal controls (or mentioned at all) in the auditor’s letter to management in 2008.

i. The Respondents made no assessment of the feasibility of relying on borrowing or property sales to meet any shortfall in liquidity, particularly in the circumstances of 2008, by which time the value of PMS’s property portfolio had fallen, wiping out the revaluation reserve previously carried on its balance sheet, PMS had already failed to sell a property and was experiencing slower than usual receipt of loan/interest payments and the prospects of borrowing were affected by the credit crunch.

j. The Respondents failed to carry out adequate audit work to address the risk that PMS’s liquidity could affect its ability to continue as a going concern. Mr McClean said at interview that he had seen and written “noted” in the margin on the 2008 Going Concern Review/PBSE. That was an inadequate response. The Respondents had insufficient evidence to conclude that the going concern assumption remained appropriate and that PMS’s lack of liquidity had no impact on the audit opinion, notwithstanding PMS’s poor liquidity as at year end 2008 and the lack of evidence that the risk posed by low liquidity levels had been adequately mitigated since the year end. The Respondents failed adequately to document their conclusions as to liquidity and going concern.

Annex A

Proper application to PMS of relevant legislation

1. By virtue of section 6(1) of the 1969 Act, no member of PMS could have an interest in PMS's shares exceeding £20,000. That provision was reflected in rule 8 (see paragraph).

2. Section 7(1) of the 1969 Act, provides that a society which has any withdrawable share capital, if registered under the Act, shall not carry on the business of banking. That prohibition applied to PMS, since PMS had withdrawable share capital.

3. Section 7(3) provides a limited carve out from section 7(1) namely that:

> "The taking of deposits of not more than two pounds in any one payment and not more than fifty pounds for any one depositor, payable on not less than two clear days' notice, shall not be treated for the purposes of subsections (1) and (2) as carrying on the business of banking; but no society which takes such deposits shall make any payment of withdrawable capital while any payment due on account of any such deposit is unsatisfied."

4. The "business of banking" was not defined in the 1969 Act, other than negatively, by reference to the fact that taking the very limited deposits provided for in section 7(2) was not the business of banking for the purposes of that Act. At the time the 1969 Act was passed, the definition was a matter for the common law: see *United Dominions Trust v Kirkwood* [1966] 2 QB 431.

5. However, by the period with which this Complaint is concerned, the 1969 Act had to be read consistently with the Banking Act 1987 and, from December 2001, FSMA 2000. Whatever else may be within the scope of the term "business of banking", taking deposits by way of business (as now successively defined in those two statutes) in circumstances where those deposits are not covered by section 7(3) of the 1969 Act, amounts to carrying on the business of banking in breach of section 7(1) of the 1969 Act.

6. Under section 19 of FSMA 2000 no person may carry on a regulated activity in the United Kingdom unless authorised or exempt.

7. Section 22 of FSMA provides (in summary) that a regulated activity is an activity of a specified kind which is carried on by way of business and relates to an investment of a specified kind. Specified activities and specified investments for the purposes of FSMA 2000 are then defined by way of various statutory instruments so as to include (in summary, and among other matters) accepting deposits and carrying on certain mortgage business.

8. More specifically:

    a. So far as relevant, Article 5 of the Financial Services and Markets (Regulated Activities) Order 2001 ("**RAO"**) provides that:

        > "(1) Accepting deposits is a specified kind of activity if—
        > (a) money received by way of deposit is lent to others; or
        > (b) any other activity of the person accepting the deposit is financed wholly, or to a material extent, out of the capital of or interest on money received by way of deposit.
        > (2) In paragraph (1), "deposit" means a sum of money, other than one excluded by any of articles 6 to 9, paid on terms—
        > (a) under which it will be repaid, with or without interest or premium, and either on demand or at a time or in circumstances agreed by or on behalf of the person making the payment and the person receiving it; and
        > (b) which are not referable to the provision of property (other than currency) or services or the giving of security."

    b. Article 2 of the Financial Services and Markets (Carrying on Regulated Activities by Way of Business) Order 2001 ("**By Way of Business Order**") provides that:

        > "(1) A person who carries on an activity of the kind specified by article 5 of the Regulated Activities Order (accepting deposits) is not to be regarded as doing so by way of business if—
        > (a) he does not hold himself out as accepting deposits on a day to day basis; and

(b) any deposits which he accepts are accepted only on particular occasions, whether or not involving the issue of any securities.

(2) In determining for the purposes of paragraph (1)(b) whether deposits are accepted only on particular occasions, regard is to be had to the frequency of those occasions and to any characteristics distinguishing them from each other."

c. Article 4 of the Financial Services and Markets (Exemption) Order 2001 ("**Exemption Order**") provides that

"Subject to the limitations, if any, expressed in relation to him, each of the persons listed in Part II of the Schedule is exempt from the general prohibition in respect of any regulated activity of the kind specified by article 5 of the Regulated Activities Order (accepting deposits)."

d. The persons so listed include:

"An industrial and provident society, in so far as it accepts deposits in the form of withdrawable share capital."

9. Therefore, any sums accepted by PMS as share capital were not deposits. However, under the 1969 Act, there was a limit of £20,000 per member on the sums that could be accepted on that basis.

10. As regards sums accepted by PMS as loans from members, these loans were in substance and form deposits and in accepting them PMS was accepting deposits by way of business, within the meaning of the RAO and/or was carrying on the business of banking within the meaning of the 1969 Act:

a. The exemption for withdrawable share capital did not apply to the loans (and was subject to the limits imposed by the 1969 Act).
b. The loans from members satisfied the definition of deposits for the purposes of the RAO:
    i. The loans were made on terms that the sum loaned was to be repaid. (Indeed, in practice, PMS treated them, and described them in its accounts, as loans repayable on demand.) PMS undertook an obligation to repay the capital amount of the loan

in full, regardless of the success of the ventures in which it invested those funds (success, or otherwise, in such ventures going only to the amount that would be paid by way of interest and not the member's entitlement to repayment of the capital). In that respect, the loans were legally distinct from PMS's share capital, which represented the members' investment in the equity of PMS and was at risk (although this was a distinction which it appears PMS did not make clear to its members at the time).

   ii. The sums received by way of loan were loaned to others by PMS and/or were applied to finance PMS's business activities (including the purchase of commercial properties with a view to generating returns to be applied in paying dividends or interest to members).

c. PMS held itself out as accepting these deposits from members on a day to day basis. In this respect, the situation differed crucially from that of a mutual society which might borrow from its members only "on particular occasions", in order to raise finance for its activities, without that amounting to deposit taking "by way of business".

d. The loans grossly exceeded the very limited amounts permitted under section 7(3) of the 1969 Act to be taken as deposits, without that causing PMS to be carrying on the business of banking.

11. By accepting these deposits PMS was:

    a. Acting in breach of its own rules;

    b. Acting in breach of the 1969 Act, by engaging in the business of banking in breach of section 7(1) in a manner not permitted by section 7(3) of the 1969 Act;

    c. Acting in breach of the general prohibition under FSMA 2000 (as regards the period after 1 December 2001, when FSMA 2000 came into force).

12. The definition of deposit and deposit taking business under sections 5 and 6 of the Banking Act 1987 were not materially different to that in Article 5 of the RAO and Article 2 of the By Way of Business Order. It follows that the loans were, likewise, deposits within the meaning of the Banking Act 1987 and that by

accepting them, as well as acting in breach of its own rules and the 1969 Act, PMS committed an offence under section 3(2) of that Act.

13. Had PMS at any point during the relevant period taken external advice as to its regulatory position from a specialist who was competent to advise it on financial services regulation, that advice would have been to the effect set out at paragraphs 2-12 above and that PMS therefore needed to apply to the FSA (or prior to 1 December 2001, the Bank of England) for authorisation to accept deposits (or, at the very least, that the risk that this was so was sufficiently great that PMS should as a matter of urgency contact the FSA to discuss its position, at which point the FSA would have told PMS that it needed to be authorised).

14. In addition, with effect from 31 October 2004, under Article 61(1) of the RAO, entering into a regulated mortgage contract as lender became a specified activity for the purposes of FSMA 2000, as did administering such contracts. Regulated mortgage contracts are defined in Article 61(2) as follows:

> "a contract under which—
>
> (i) a person ("the lender") provides credit to an individual or to trustees ("the borrower"); and
>
> (ii) the obligation of the borrower to repay is secured by a first legal mortgage on land (other than timeshare accommodation) in the United Kingdom, at least 40% of which is used, or is intended to be used, as or in connection with a dwelling by the borrower or (in the case of credit provided to trustees) by an individual who is a beneficiary of the trust, or by a related person".

Annex B

Extracts from relevant ethical standards

1. Regulatory provisions applicable to each of the Respondents from 1 July 2006:
    a. Paragraph 1.4 of the 2006 Code of Ethics for Members ("**2006 Code**"), which provides that Professional Accountants (defined as Members and Member Firms) are expected to follow the guidance contained in the fundamental principles in the 2006 Code in all of their professional and business activities whether carried out with or without reward and in other circumstances where to fail to do so would bring discredit to the profession.
    b. Fundamental Principle (c) of Professional Competence and due care (from the 2006 Code), which imposed on each of them "a continuing duty to maintain professional knowledge and skill at the required level to ensure that a client or employer receives competent professional service based on current developments in practice, legislation and techniques" and required each of them to "act diligently and in accordance with applicable technical and professional standards when providing professional services".

2. Additional regulatory provisions applicable to each of the Respondents from 1 July 2006:
    a. Part B of the 2006 Code is entitled 'Professional Accountants in Public Practice' (defined as a firm that provides professional services, which in turn are defined as including auditing). It illustrates the application of the fundamental principles in that context, including the following:
        i. (at 210.7) *"A professional accountant in public practice should agree to provide only those services that the professional accountant in public practice is competent to perform.......a threat to professional competence and due care is created if the engagement team does not possess or cannot acquire, the competencies necessary to carry out the engagement."*
        ii. (at 210.8) Safeguards against this threat are identified as including:
            1. Acquiring an appropriate understanding of the nature of the client's business, the complexity of its operations, the

specific requirements of the engagement and the purpose, nature and scope of the work to be performed.

2. Possessing or obtaining experience with relevant regulatory or reporting requirements.
3. Assigning staff with the necessary competencies.
4. Using experts where necessary.

Annex C

Extracts from the 1969 Act (as amended)

Sections of the 1969 Act relevant to the duties of the directors of PMS:

3. Under the Act, an industrial provident society has a duty to produce a revenue account and balance sheet each year which show a true and fair view of the financial position of the society. Sections 35(1)-(4) of the Act provide as follows:

> *"(1) Every revenue account of a registered society shall give a true and fair view—*
>
> *a. if it deals with the affairs of the society as a whole, of the income and expenditure of the society as a whole, or*
>
> *b. if it deals with a particular business conducted by the society, of the income and expenditure of the society in respect of that business,*
>
> *for the period to which the account relates.*
>
> *(2) Every registered society shall, in respect of each year of account, cause to be prepared either—*
>
> *(b) a revenue account which deals with the affairs of the society as a whole for that year, or*
>
> *(c) two or more revenue accounts for that year which deal separately with particular businesses conducted by the society.*
>
> *…*
>
> *(4) Every balance sheet of a registered society shall give a true and fair view of the state of the affairs of the society as at the date of the balance sheet."*

4. With respect to the obligations of committee members, Section 36(6) of the Act states:

> *"(6) If in relation to any revenue account, revenue accounts or balance sheet of a society a member of the committee of the society fails to take all reasonable steps to secure compliance—*

(d) with the provision of subsection (1) or subsection (4) which is applicable in that case, or

(e) in a case falling within subsection (2)(b), with subsection (3),

he shall be guilty of an offence and liable on summary conviction to a fine not exceeding [F1 level 1 on the standard scale], unless he proves that he had reasonable grounds to believe, and did believe, that a competent and reliable person was charged with the duty of seeing that the relevant provision was complied with and was in a position to discharge that duty."

Sections of the 1969 Act relevant to the duties of the Respondents:

5. With respect to the auditor of an IPS, sections 43(1) and (2) of the Act state that:

"(1) The auditors of a registered society shall make a report to the society on the accounts examined by them, and on the revenue account or accounts and the balance sheet of the society for the year of account in respect of which they are appointed.

(2) The report shall state whether the revenue account or accounts and the balance sheet for that year comply with the requirements of this Act and whether, in the opinion of the auditors—

(f) the revenue account or accounts give a true and fair view in accordance with section 37 of the income and expenditure of the society as a whole for that year of account and, in the case of each such account which deals with a particular business conducted by the society, a true and fair view in accordance with that section of the income and expenditure of the society in respect of that business for that year, and

(g) the balance sheet gives a true and fair view in accordance with that section of the state of the affairs of the society as at the end of that year of account."

6. Section 43(4) of the Act further states:

"(4) It shall be the duty of the auditors of a registered society, in preparing their report under this section, to carry out such investigations

as will enable them to form an opinion as to the following matters, that is to say—

- *(h)* *whether the society has kept proper books of account in accordance with the requirements of section 35(1)(a);*
- *(i)* *whether the society has maintained a satisfactory system of control over its transactions in accordance with the requirements of section 35(1)(b); and*
- *(j)* *whether the revenue account or accounts, the other accounts, if any, to which the report relates, and the balance sheet are in agreement with the books of account of the society;*

and if the auditors are of opinion that the society has failed to comply with section 35(1)(a) or (b), or if the revenue account or accounts, the other accounts, if any, and the balance sheet are not in agreement with the books of account of the society, the auditors shall state that fact in their report."

Annex D

Extracts From Relevant Financial Reporting, Accounting and Auditing Standards applicable to the PMS y/e 07 and 08 financial statements and audits

Standards relevant to the duties of a directors of PMS:

1. Financial Reporting Standard 18 ("FRS 18") sets out the principles to be followed in selecting accounting policies and the disclosures needed to help users understand them. The Directors and the Respondents could be expected to have regard to FRS 18 when considering the financial statements of PMS. It includes passages dealing with the duties of Directors as regards a true and fair view, going concern and disclosures as follows:
    a. (at paragraph 23) *"When preparing financial statements, directors should assess whether there are significant doubts about an entity's ability to continue as a going concern."*
    b. (at paragraph 24) *"If the directors, when making the assessment required by paragraph 23, are aware of material uncertainties related to events or conditions that may cast significant doubt upon the entity's ability to continue as a going concern, paragraph 61 requires them to disclose those uncertainties."*
    c. (at paragraph 61) *"The following information should be disclosed in the financial statements in relation to the going concern assessment required by paragraph 23:*

        (a) any material uncertainties, of which the directors are aware in making their assessment, related to events or conditions that may cause significant doubt upon the entity's ability to continue as a going concern."]

2. The following ISAs include relevant guidance on the responsibility of Directors as regards compliance with law or regulations and on the use of the going concern assumption. The Directors could be expected to be familiar with, and have regard to, these Standards when considering what the Regulatory Provisions set out above required of them. The Respondents could be expected to have regard to them in assessing whether or not the directors of PMS had a reasonable basis for the statements they made about compliance

and going concern in the Letter of Representations and for concluding that the directors' use of the going concern assumption was appropriate:

a. ISA 250 – 'Consideration of laws and regulations in an audit of financial statements' ("ISA 250"):

   i. (at 250 section A.9) *"It is management's responsibility to ensure that the entity's operations are conducted in accordance with laws and regulations. The responsibility for the prevention and detection of non-compliance rests with management."* Footnote '4' to that text states *"In the UK and Ireland, this responsibility rests with those charged with governance."*[12]

   ii. (at 250 section A.10) *"The following policies and procedures, among others, may assist management in discharging its responsibilities for the prevention and detection of non-compliance:*

      - *Monitoring legal requirements and ensuring that operating procedures are designed to meet these requirements.*

      - *…*

      - *Engaging legal advisors to assist in monitoring legal requirements.*

      - *Maintaining a register of significant laws with which the entity has to comply within its particular industry and a record of complaints."*

b. ISA 570 - 'Going Concern' ("ISA 570"):

   i. (at 570.3) *"The going concern assumption is a fundamental principle in the preparation of financial statements. Under the going concern assumption, an entity is ordinarily viewed as continuing in business for the foreseeable future with neither the intention nor the necessity of liquidation, ceasing trading or seeking protection from creditors pursuant to laws or*

[12] ISA 250 Section A paragraph 1-1 defines governance: "The term 'governance' describes the role of persons entrusted with the supervision, control and direction of an entity."

regulations. Accordingly, assets and liabilities are recorded on the basis that the entity will be able to realize its assets and discharge its liabilities in the normal course of business."

ii. (at 570.4) *"Some financial reporting frameworks contain an explicit requirement for management to make a specific assessment of the entity's ability to continue as a going concern, and standards regarding matters to be considered and disclosures to be made in connection with going concern. For example, International Accounting Standard 1 (revised 2003), 'Presentation of Financial Statements,' requires management to make an assessment of an enterprise's ability to continue as a going concern."*

iii. (at 570.5) *"In other financial reporting frameworks, there may be no explicit requirement for management to make a specific assessment of the entity's ability to continue as a going concern. Nevertheless, since the going concern assumption is a fundamental principle in the preparation of the financial statements, management has a responsibility to assess the entity's ability to continue as a going concern even if the financial reporting framework does not include an explicit responsibility to do so."*

iv. (at 570.6) *"When there is a history of profitable operations and a ready access to financial resources, management may make its assessment without detailed analysis."*

v. (at 570.7) *"Management's assessment of the going concern assumption involves making a judgement, at a particular point in time, about the future outcome of events or conditions which are inherently uncertain. The following factors are relevant:*

- *In general terms, the degree of uncertainty associated with the outcome of an event or condition increases significantly the further into the future a judgement is being made about the outcome of an event or condition. For that reason, most financial reporting frameworks that require an explicit management assessment specify the period for which management is required to take into account all available information.*

- *Any judgement about the future is based on information available at the time at which the judgement is made. Subsequent events can contradict a judgement which was reasonable at the time it was made."*

- *The size and complexity of the entity, the nature and condition of its business and the degree to which it is affected by external factors all affect the judgement regarding the outcome of events or conditions."*

vi. (at 570.8) *"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 are set out below. This listing is not all-inclusive nor does the existence of one or more of the items always signify that a material uncertainty exists."* [partial extract only]

vii. (at 570.9-2) the auditor must consider *"both of the current and the possible future circumstances of the business and the environment in which it operates."* [partial extract only]

Standards relevant to the duties of the Respondents:

3. The following Auditing Standards are also particularly relevant to the responsibility of Auditors as regards, respectively, compliance with law or regulations and the use of the going concern assumption:

   a. ISA 250, which provided inter alia as follows:

      i. (Section A.2): *"When designing and performing audit procedures and in evaluating and reporting the results thereof, the auditor should recognize that non-compliance by the entity with laws and regulations may materially affect the financial statements. However, an audit cannot be expected to detect non-compliance with all laws and regulations. Detection of non-compliance, regardless of materiality, requires consideration of the implications for the integrity of management or employees and the possible effects on other aspects of the audit."*

ii. (at 250 Section A.11) *"The auditor is not, and cannot be held responsible for preventing non-compliance. The fact that an annual audit is carried out may, however, act as a deterrent."*

iii. (at 250 Section A.15 and 15-1): *"15. In order to plan the audit, the auditor should obtain a general understanding of the legal and regulatory framework applicable to the entity and the industry and how the entity is complying with that framework.*
"15-1. In the UK and Ireland, the auditor should obtain a general understanding of the procedures followed by the entity to ensure compliance with that framework."

iv. (at 250 Section A.17): *"To obtain the general understanding of laws and regulations, the auditor would ordinarily:*

- *Use the existing understanding of the entity's industry, regulatory and other external factors;*
- *Inquire of management concerning the entity's policies and procedures regarding compliance with laws and regulations;*
- *Inquire of management as to the laws or regulations that may be expected to have a fundamental effect on the operations of the entity;*
- *Discuss with management the policies or procedures adopted for identifying, evaluating and accounting for litigation claims and assessment; and*
- *Discuss the legal and regulatory framework with auditors of subsidiaries in other countries (for example, if the subsidiary is required to adhere to the securities regulations of the parent company).*"

v. (at Section A 18-1): *"In the UK and Ireland, the auditor's procedures should be designed to help identify possible or actual instances of non-compliance with those laws and regulations which provide a legal framework within which the entity conducts its business and which are central to the entity's ability to conduct its business and hence its financial statements";*

- (at Section A 19): *"Further, the auditor should obtain sufficient and appropriate audit evidence about compliance with those laws and regulations* *generally recognized by the auditor to have an effect on the determination of material amounts and disclosures in financial statement. The auditor should have sufficient understanding of these laws and regulations in order to consider them when auditing the assertions related to the determination of the amounts to be recorded and the disclosures made."*

b. ISA 570, which provided inter alia as follows:

   i. (at 570.9): *"The auditor's responsibility is to consider the appropriateness of management's use of the going concern assumption in the preparation of the financial statements, and consider whether there are material uncertainties about the entity's ability to continue as a going concern that need to be disclosed in the financial statements."* [partial extract only]

   ii. (at 570.11): *"In obtaining an understanding of the entity, the auditor should consider whether there are events or conditions and related business risks which may cast significant doubt on the entity's ability to continue as a going concern."*

   iii. (at 570.12): *"The auditor should remain alert for audit evidence of events or conditions and related business risks which may cast significant doubt on the entity's ability to continue as a going concern in performing audit procedures throughout the audit. If such events or conditions are identified, the auditor should, in addition to performing the procedures in paragraph 26, consider whether they affect the auditor's assessment of the risks of material misstatement."*

   iv. (at 570.17) *"the auditor should evaluate management's assessment of the entity's ability to continue as a going concern*" (and at 570.17-1) *"the auditor should assess the adequacy of the means by which those charged with governance have satisfied themselves that: (a) it is appropriate for them to adopt the going concern basis in preparing the financial statements; and (b) the financial statements should include such disclosures, if any, relating to going concern as are necessary for them to give a true and fair view.* [partial extract only]

i. (at 570.26) *"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:*

(a) Review management's plans for future actions based on its going concern assessment;

(b) Gather sufficient appropriate audit evidence to confirm or dispel whether or not a material uncertainty exists through carrying out audit procedures considered necessary, including considering the effect of any plans of management and other mitigating factors; and

(c) Seek written representations from management regarding its loans for future action."

vi. (at 570.20.1) *"The auditor may need to consider some or all of the following matters ………. The plans of those charged with governance for resolving any matters giving rise to the concern (if any) about the appropriateness of the going concern basis. In particular, the auditor may need to consider whether the plans are realistic, whether there is a reasonable expectation that the plans are likely to resolve any problems foreseen and whether those charged with governance are likely to put the plans into practice effectively*";

vii. (at 570.30 and 570.30-1):

"30. Based on the audit evidence obtained, the auditor should determine if, in the auditor's judgement, a material uncertainty exists related to events or conditions that alone or in aggregate, may cast significant doubt on the entity's ability to continue as a going concern."

"30-1. The auditor should document the extent of the auditor's concern (if any) about the entity's ability to continue as a going concern."

a. (at 570.31-1) *"the auditor should consider whether the financial statements are required to include disclosures relating to going concern in order to give a true and fair view."*

4. Other relevant Auditing Standards relating to the conduct by the Respondents of its audit work in respect of years ended 2007 and 2008 were:

a. ISA 200 ‘Objective and general principles governing an audit’ (“ISA 200”), which includes the following:

    i. (at 200.5) *“the auditor should conduct an audit in accordance with ISAs (UK and Ireland). These contain basic principles and essential procedures together with related guidance in the form of explanatory and other material.”*

    ii. (at 200.2) “*The objective of an audit of financial statements is to enable the auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework…”*

    iii. (at 200.2-1) *“The ‘applicable financial reporting framework’ comprises those requirements of accounting standards, law and regulations applicable to the entity that determine the form and content of its financial statements.”*

    iv. (at 200.6) *“The auditor should plan and perform an audit with an attitude of professional scepticism recognizing that circumstances may exist that cause the financial statements to be materially mis-stated. An attitude of professional scepticism 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. For example, an attitude of professional scepticism is necessary throughout the audit process for the auditor to reduce the risk of overlooking suspicious circumstances, of over generalizing when drawing conclusions from audit observations, and of using faulty assumptions in determining the nature, timing, and extent of the audit procedures and evaluating the results thereof. In planning and performing an audit, the auditor neither assumes that management is dishonest nor assumes unquestioned honesty. Accordingly representations from management are not a substitute for obtaining sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the audit opinion.”*

    v. (at 200.10) *“Also, the work undertaken by the auditor to form an audit opinion is permeated by* judgment, *in particular regarding: (a) The gathering of audit evidence, for example, in deciding the* *nature, timing and extent of audit procedures; and (b) The drawing of conclusions based on the audit evidence gathered, for example, assessing the reasonableness of the estimates made by management in preparing the financial statements.*"

b. ISA 220 'Quality Control for an Audit of Financial Statements' ("ISA 220"), which includes the following:

   i. (at 220.3) *"Under International Standard on Quality Control (UK and Ireland) …, 'Quality Control for Firms that perform Audits and Reviews of Historical Financial Information, …' a firm has an obligation to establish a system of quality control designed to provide it with reasonable assurance that the firm and its personnel comply with professional standards and regulatory and legal requirements, and that the auditor's reports issued by the firm or engagement partners are appropriate in the circumstances."*

   ii. (at 220.5(a) defines Engagement partner as *"the partner or other person who is responsible for the audit engagement and its performance, and for the auditor's report that is issued on behalf of the firm, and who, where required, has the appropriate authority from a professional, legal or regulatory body".*

   iii. (at 220.6 and 220.7):

      "6. The engagement partner should take responsibility for the overall quality on each audit engagement to which that partner is assigned.

      7. The engagement partner sets an example regarding audit quality to the other members of the engagement team through all stages of the audit engagement. Ordinarily, this example is provided through the actions of the engagement partner and through appropriate messages to the engagement team. Such actions and messages emphasize:

         (a) The importance of:

            (i) Performing work that complies with professional standards and regulatory and legal requirements;

(ii) Complying with the firm's quality control policies and procedures as applicable; and

(iii) Issuing auditor's reports that are appropriate in the circumstances; and

(b) The fact that quality is essential in performing audit engagements."

iv. (at 220.8 and 220.19):

"8. The engagement partner should consider whether members of the engagement team have complied with ethical requirements."

19. The engagement partner should be satisfied that the engagement team collectively has the appropriate capabilities, competence and time to perform the audit engagement in accordance with professional standards and regulatory and legal requirements, and to enable an auditor's report that is appropriate in the circumstances to be issued."

v. (at 220.21 and 220.22):

"21. The engagement partner should take responsibility for the direction, supervision and performance of the audit engagement in compliance with professional standards and regulatory and legal requirements, and for the auditor's report that is issued to be appropriate in the circumstances.

22. The engagement partner directs the audit engagement by informing the members of the engagement team of:

- *Their responsibilities;*
- *The nature of the entity's business;*
- *Risk related issues; …*

...The engagement team's responsibilities include maintaining an objective state of mind and an appropriate level of professional scepticism, and performing the work delegated to them in accordance with the ethical principle of due care. Members of the engagement team are encouraged to raise questions with more experienced team members …"

c. ISA 315 – Understanding the entity and its environment includes the following:

(i) *(at 67) - The auditor should obtain an understanding of the control environment. The control environment includes the governance and management functions and the attitudes, awareness, and actions of those charged with governance and management concerning the entity's internal control and its importance in the entity. The control environment sets the tone of the organization, influencing the control consciousness of its people. It is the foundation for effective internal control, providing discipline and structure.*

(ii) *(at 69) – In evaluating the design of the entity's control environment, the auditor considers the following elements and how they have been incorporated into the entity's processes:*

(a) Communication and enforcement of integrity and ethical values – essential elements which influence the effectiveness of the design, administration and monitoring of controls.

(b) Commitment to competence – management's consideration of the competence levels for particular job and how those levels translate into requisite skills and knowledge.

(c) Participation by those charged with governance – independence from management, their experience and stature, the extent of their involvement and scrutiny of activities, the information they receive, the degree to which difficult questions are raised and pursued with management and their interaction with internal and external auditors.

(d) Management's philosophy and operating style – management's approach to taking and managing business risks, and management's attitudes and actions towards financial reporting, information processing and accounting functions and personnel.

(e) *Organizational structure – the framework within which the entity's activities for achieving its objectives are planned, executed, controlled and reviewed.*

(f) *Assignment of authority and responsibility – how authority and responsibility for operating activities are assigned and how reporting relationships and authorization hierarchies are established.*

(g) *Human resources policies and practices – recruitment, orientation, training, evaluating….".*

d. ISA 315 – 'Understanding the entity and its environment and assessing the risk of material misstatement' ("ISA 315"), which includes the following:

  i. (at 315.2) *"The auditor should obtain an understanding of the entity and its environment, including its internal control, sufficient to identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, and sufficient to design and perform further audit procedures."* [partial extract only}

  ii. (at 315.12) *"When the auditor intends to use information about the entity and its environment obtained in prior periods, the auditor should determine whether changes have occurred that may affect the relevance of such information in the current audit."* [partial extract only]

  iii. (at 315.22) *"The auditor should obtain an understanding of relevant industry, regulatory, and other external factors, including the applicable financial reporting framework."* [partial extract only]

  iv. (at 315.41) "*The auditor should obtain an understanding of the entity's internal control relevant to the audit".* [partial extract only] and (at 315.43) *"Internal control, as discussed in this ISA (UK and Ireland), consists of the following components: (a) The control environment. (b) The entity's risk assessment process. (c) The information system, including the related business* *processes, relevant to financial reporting, and communication. (d) Control activities. (e) Monitoring of controls."*

v. (at 67) *"The auditor should obtain an understanding of the control environment. The control environment includes the governance and management functions and the attitudes, awareness, and actions of those charged with governance and management concerning the entity's internal control and its importance in the entity. The control environment sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for effective internal control, providing discipline and structure".*

vi. (at 76) *"The auditor should obtain an understanding of the entity's process for identifying business risks relevant to financial reporting objectives and deciding on actions to address those risks, and the results thereof…."*

vii. (at 100) *"The auditor should identify and assess the risks of material misstatement at the financial statement level, and at the assertion level for classes of transactions, account balances, and disclosures….."*

e. ISA 330 'The Auditor's Procedures in Response to Assessed Risks'

i) (at 4) *"The auditor should determine overall responses to address the risk of material misstatement at the financial misstatement level. Such responses may include emphasizing to the audit team the need to maintain professional scepticism in gathering and evaluating audit evidence, assigning more experienced staff or those with special skills, or using experts, providing more supervision, or incorporate additional elements of unpredictability in the selection of further audit procedures to be performed. Additionally, the auditor may make general changes to the nature, timing, or extent of audit procedures as an overall response, for example, performing substantive procedures at period end instead of at an interim date..*

ii) (at 7) "*The auditor should design and perform further audit procedures whose nature, timing, and extent are responsive to the assessed risks* *of material misstatement at the assertion level…In designing further audit procedures, the auditor considers such matters as the following:*

- *The significance of the risk.*
- *The likelihood that a material misstatement will occur.*
- *The characteristic of the class of transactions, account balance, or disclosure involved.*
- *The nature of the specific controls used by the entity and in particular whether they are manual or automated.*
- *Whether the auditor expects to obtain audit evidence to determine if the entity's controls are effective in preventing, or detecting and correcting, material misstatements."*

f. ISA 580 – 'Written Representations' ("ISA 580"), (at 7) *"Representations by management cannot be a substitute for other audit evidence that the auditor could reasonably expect to be available".* [partial extract only]

g. ISA 500 – 'Audit Evidence' - (at 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. In order for the auditor to obtain reliable audit evidence, the information upon which the audit procedures are based needs to be sufficiently complete and accurate. For example, in auditing revenue by applying standard process to records of sales volume, the auditor considers the accuracy of the price information and the completeness and accuracy of the sales volume data. Obtaining audit evidence about the completeness and accuracy of the information produced by the entity's information system may be performed concurrently with the actual audit procedure applied to the information when obtaining such audit evidence is an integral part of the audit procedure itself. In other situations, the auditor may have obtained audit evidence of the accuracy and completeness of such information by testing controls over the production and maintenance of the information. However, in some situations the auditor may determine that additional audit procedures are needed. For example, these additional procedures may include using computer-assisted audit techniques (CAATs) to recalculate the information".*