

**IN THE MATTER OF:**

**THE EXECUTIVE COUNSEL TO THE FINANCIAL REPORTING COUNCIL**

**- and -**

**KPMG AUDIT PLC**

**GREG WATTS**

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**FORMAL COMPLAINT**

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**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 of 1 June 2014 ("**the Scheme**").
2. By paragraph 7(11) of the Scheme, if having reviewed any representations received for the purposes of paragraph 7(10) of the Scheme, the Executive Counsel to the FRC ("**Executive Counsel**") considers that there is a realistic prospect that a Tribunal will make an Adverse Finding against a Member or Member Firm and that a hearing is desirable in the public interest, then the Executive Counsel shall deliver a Formal Complaint against the Member or Member Firm to the Conduct Committee.
3. This is the Executive Counsel's Formal Complaint pursuant to paragraph 7(11) of the Scheme in respect of:

- KPMG Audit Plc, a member firm<sup>1</sup> of the Institute of Chartered Accountants in England and Wales (“**ICAEW**”), and
- Greg Watts (“**Mr Watts**”), a partner of KPMG LLP, the parent of KPMG Audit Plc and a member of the ICAEW,

together referred to herein as “**the Respondents**”, in connection with the Respondents’ conduct in relation to (i) KPMG Audit Plc (“**KPMG**”)<sup>2</sup>’s failure to conduct a sufficiently detailed investigation into the full scope and nature of the roles performed by Mr Mel Egglenton (“**Mr Egglenton**”), a former senior partner of KPMG’s Birmingham office, prior to his appointment on 1 December 2010 as non-executive director of Pendragon Plc (“**Pendragon**”), a listed audit client of the firm; (ii) the Respondents’ failure to provide written disclosure to Pendragon’s Audit Committee as to Mr Egglenton’s appointment; and (iii) Mr Watts’ failure to take all reasonable steps to preserve the confidentiality of information received from Pendragon.

4. According to its website, as at December 2013 KPMG LLP is a leading provider of accounting services in the UK and, as a wholly owned subsidiary of KPMG Europe LLP, is “*part of the largest integrated accounting firm in Europe*”. KPMG LLP in the UK has over 10,000 partners and staff working in 22 offices. KPMG reported UK fee income of £1,814 million for 2013. KPMG identifies the existence of audit quality controls which include “*a tone at the top which emphasises quality, ethics and integrity*”.
5. KPMG LLP has its own UK Ethics and Independence Manual 2010 (“**the KPMG Manual**”) incorporating KPMG LLP’s Code of Conduct.
6. KPMG Audit Plc is a wholly owned subsidiary of KPMG LLP (held indirectly through intermediate holding companies) and its principal activity is statutory audits and related services.

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<sup>1</sup> 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 ICAEW.

<sup>2</sup> For convenience, KPMG is used interchangeably in this document to refer to both KPMG Audit Plc and KPMG LLP where the difference is not material.

7. Mr Watts was admitted to membership of the ICAEW on 1 December 1993 and was made a partner in KPMG LLP in October 2005. For the year ending 31 December 2010, Mr Watts was the Senior Statutory Auditor to Pendragon, appointed to that role for and on behalf of KPMG. He ceased to be the Senior Statutory Auditor to Pendragon on 10 May 2011.

## **BACKGROUND**

### **Pendragon**

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

### **Mr Egglenton**

10. Prior to his retirement from KPMG on 31 March 2010, Mr Egglenton was the Senior Partner of KPMG's Birmingham office and the Regional Chairman of KPMG's Midlands Region. Until 30 June 2010, Mr Egglenton continued to act as a consultant to KPMG and his profit share relating to his final six months as a partner was paid to him in November 2010.
11. On 1 December 2010, Mr Egglenton joined Pendragon as a non-executive director and became a member of the Audit, Nomination and Remuneration Committees. He joined Pendragon as chairman-designate of the Audit Committee and was made chairman of that committee on 10 May 2011 after Pendragon's accounts for the year ended 31 December 2010 had been signed.

## The Chain of Command

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

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

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

- (i) A performance review document for Mr Egglenton entitled "2008/2009 Global Performance Management Process Mel J Egglenton" which includes the following extracts:
- Under the heading "Professional Goals": "Overall ensure that audit quality is the cornerstone for all work undertaken personally and by the teams in the Midlands".
  - Under the heading "Interim – Self Assessment": "The role of Regional Chairman and Birmingham Office Senior Partner title have been used to better effect to visit a number of existing clients in order to further develop relationships and as a door

opener on a number of businesses where we have previously done no work. These are now proving to be capable to (sic) delivering fees and my role as mentor to the younger partners on these occasions has been very satisfying.”

- Under the heading “Audit Performance”: “I have also spent time with some of the younger partners on their audit commitments as a sounding board and mentor in difficult situations, e.g. Pendragon with Greg Watts...”
- Under the heading: “Developing people”: “Coaches less experienced staff. Actively develops or assists the development of others”.
- Under the heading “Performance Manager Feedback” (written by Malcolm Edge): “He has...been providing lots of counselling, mentoring support to other partners in the Midlands who are dealing with difficult issues on their clients. For example, Greg Watts on Pendragon. Going forward on the client side, it is very important that Mel keeps up his own client activity and also holds the partner and director group to account in relation to the managed accounts within the Midlands”.

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

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

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

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

- “Reputation for client centric multi-disciplinary behaviour and cutting through silo behaviour – he or she is the glue between functions”.
  - “Somebody people of all grades view as being approachable to consult with and share ideas etc., provides constructive challenge”.
  - “Mentors and actively develops both current and potential future partners and directors”.
- (iv) A KPMG document identifying goals for regional chairmen which includes the suggestion that 20% of their time is to be spent “running the region – planning / admin / people management / partner issues / account reviews / internal comms”.
- (v) A KPMG document identifying the job specification for the Manchester Office Senior Partner, which identifies both market facing and internal roles. Under the heading “Internal” the job specification includes the following:
- “Responsibility for co-ordination of Manchester office activity for cross-discipline working and approach to market”
  - “Establish mentoring process career development/management”
  - “Attend some Dept meetings”
  - “Evolution of strategy – issues and markets driven”
  - “People
- Recognised by staff and partners as a Market Leader and role model Lead Partner
- Communication of office successes from new work and market development as well office performance and people news
- Lead and inspire partners and directors”.

14. The documents identified in paragraph 13 above should have put KPMG on notice that Mr Egglenton, even if he was not automatically in the chain of

command for Pendragon by virtue of his positions, might in fact have had direct oversight responsibility in respect of audit partners in the Birmingham office, including Mr Watts, because of the particular way in which he performed those roles. As such, KPMG was under an obligation to conduct a detailed investigation into the scope and extent of Mr Egglenton's roles as they were performed by him prior to his appointment to Pendragon.

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

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

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

17. KPMG became aware that Mr Egglenton had been offered an appointment as non-executive director of Pendragon in or about September 2010. In a letter dated 1 March 2013 to the Audit Quality Review Team ("**the 1 March letter**"), KPMG has asserted that at this stage it considered the requirements of "*Ethical Standard 2*" but concluded that Mr Egglenton "*was not in the chain of command for the Pendragon audit and that we were therefore in compliance with the standard*".
18. This conclusion reflected an expectation at KPMG that Regional Chairmen or Senior Partners of its regional offices would not automatically be in the chain of command. Although, KPMG did consider with Mr Egglenton whether he was in fact in the chain of command for the Pendragon audit, KPMG accepts that it did not carry out sufficiently detailed investigations into the scope and nature of the roles that Mr Egglenton had undertaken whilst at KPMG and in particular, KPMG did not consider the documents referred to in paragraph 13 above or seek to discover from Mr Watts the nature of his relationship with Mr Egglenton. Whilst KPMG maintains that Mr Egglenton was not, in fact, in the chain of command for the Pendragon audit as that term is defined in the APB Definition, it was nevertheless possible that a reasonable and informed third party would have considered that KPMG's objectivity might be impaired or was likely to be impaired. In the circumstances KPMG should not have reached its conclusion without first conducting a more detailed investigation into the scope and nature of the roles that Mr Egglenton had in fact undertaken at KPMG pursuant to its obligations under APB Ethical Standard 2 at ES2.48.
19. In the 1 March Letter, KPMG has said, in relation to the issue of KPMG's independence as auditor to Pendragon following Mr Egglenton's appointment more generally, that "*as a safeguard a new EQCR was introduced in 2010 and the partner responsible for the audit was changed in 2011. Both partners had extensive experience and the independence and seniority required to carry out their roles in line with Ethical Standards.*" Whilst the EQCR for the Pendragon audit was due to rotate in 2010 in any event due to the incumbent's retirement, as a result of Mr Egglenton's appointment the identity of the incoming ECQR was changed to a partner who was not very well known to Mr Egglenton.



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

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

21. Pendragon asked Mr Watts if he could recommend an individual to replace the retiring Chairman of their Audit Committee, following which Mr Watts asked Mr Egglenton and others for suggestions as to people who might be appropriate. Mr Egglenton expressed an interest personally and, by email dated 6 April 2010, Mr Egglenton sent to Mr Watts a copy of his CV for onward transmission to Pendragon. Mr Watts subsequently informed Mr Egglenton by email on 22 April 2010 that Pendragon wanted to meet him for coffee.
22. Mr Egglenton's secretary arranged a meeting with Pendragon for 10 May 2010 and, in an email sent on 23 April 2010, Mr Egglenton asked Mr Watts for a "briefing" in advance of the meeting.
23. In an email with the subject reference "Pendragon" sent on 17 June 2010 to Mr Watts, Mr Egglenton informed Mr Watts that he was seeing "the headhunter" on Monday and stated "Any input gratefully received".
24. By 9 August 2010, Mr Egglenton had ceased to have any role with KPMG. However, for reasons which KPMG and Mr Watts have been unable to identify, a blank email was sent at 12.04pm on 9 August 2010 from Mr Watts' email account to Mr Egglenton forwarding an email from Tim Holden of Pendragon which, in turn, attached a password protected copy of

Pendragon's draft Interim Statement. Mr Holden's email attaching the draft Interim Statement had been sent to Mr Watts the previous day in the normal course of his professional relationship with Pendragon. Mr Watts has no recollection of sending the email. It is not alleged that Mr Watts intended to send the email to Mr Egglenton and there is no evidence that Mr Watts sent Mr Egglenton the password or that Mr Egglenton knew the password required to open the document or that he was in fact able to open it. It was public knowledge that the Interim Statement was due to be published at 7am on 10 August 2010.

### **Communications with Pendragon**

25. KPMG sent letters to Pendragon on 16 February 2011 and 5 July 2011 ("**the Independence Letters**") purporting to comply with professional ethical standards requiring KPMG to communicate in writing all significant facts and matters that in their professional judgment may reasonably be thought to bear on KPMG's independence and the objectivity of the Audit Director and the audit team. Neither of these letters referred to, or commented upon, Mr Egglenton's position or the question of whether his appointment as a non-executive director at Pendragon might bear on KPMG's independence as auditors. In particular, there was no reference to the potential familiarity threats to objectivity and independence identified by KPMG as a consequence of Mr Egglenton's appointment at Pendragon or indeed the safeguards put in place to address them referred to in the 1 March Letter.
26. On 21 February 2012, KPMG sent a letter to the Audit Committee members of Pendragon ("**the Audit Letter**") purporting to comply with professional ethical standards requiring KPMG at the conclusion of the audit to provide written disclosure of relationships that bear on KPMG's objectivity and independence, the threats to KPMG's independence that these create, any safeguards that have been put in place and why they address such threats, together with any information necessary to enable KPMG's objectivity and independence to be assessed. The Audit Letter did not refer to, or comment upon, Mr Egglenton's position or the question of whether his appointment as a non-executive director at Pendragon might bear on KPMG's independence as auditors. In particular, there was no reference to the potential familiarity threats to objectivity and independence identified by KPMG as a

consequence of Mr Eggleton's appointment at Pendragon or indeed the safeguards put in place to address them referred to in the 1 March Letter.

## THE RELEVANT STANDARDS

### The Relevant Standards of Conduct

27. The standards of conduct reasonably to be expected of the Respondents (and current at the relevant time) included those set out in:
- (i) APB Ethical Standard 1 (2008): Integrity, objectivity and independence.
  - (ii) APB Ethical Standard 2 (2008): Financial, business, employment and personal relationships.
  - (iii) ISQC (UK and Ireland) 1: Quality control for firms that perform audits and reviews of financial statements, and other assurance and related services engagements.
  - (iv) ICAEW Code of Ethics.
28. Executive Counsel will refer to and rely upon the applicable standards. These standards are made in the public interest and they are designed to maintain a high standard of integrity, objectivity and independence. Key provisions upon which Executive Counsel intends to rely are set out in paragraphs 29-33 below.
29. APB Ethical Standard 1 includes, inter alia, the following requirements and principles:
- (i) *"Auditors shall conduct the audit of the financial statements of an entity with integrity, objectivity and independence"* (paragraph 6);
  - (ii) *"Integrity is a prerequisite for all those who act in the public interest. It is essential that auditors act, and are seen to act, with integrity, which requires not only honesty but a broad range of related qualities such a fairness, candour, courage, intellectual honesty and confidentiality"* (paragraph 7);
  - (iii) *"It is important that the directors and management of an audited entity can rely on the auditor to treat the information obtained during an audit*

*as confidential, unless they have authorised its disclosure, unless it is already known to third parties or unless the auditor has a legal right or duty to disclose it. Without this, there is a danger that the directors and management will fail to disclose such information to the auditor and that the effectiveness of the audit will thereby be impaired'* (paragraph 8);

- (iv) *"The audit firm shall establish policies and procedures, appropriately documented and communicated, designed to ensure that, in relation to each audit engagement, the audit firm, and all those who are in a position to influence the conduct and outcome of the audit, act with integrity, objectivity and independence"* (paragraph 15);
- (v) *"The leadership of the audit firm shall take responsibility for establishing a control environment within the firm that places adherence to ethical principles and compliance with APB Ethical Standards above commercial considerations"* (paragraph 18);
- (vi) *"The audit engagement partner shall ensure that those charged with governance of the audited entity are appropriately informed on a timely basis of all significant facts and matters that bear upon the auditor's objectivity and independence"* (paragraph 56);
- (vii) *"In the case of listed companies, the audit engagement partner shall ensure that the audit committee is provided with: (a) a written disclosure of relationships that bear on the auditor's objectivity and independence, any safeguards that are in place and details of non-audit services provided to the audited entity and the fees charged in relation thereto"* (paragraph 59).

30. In addition APB Ethical Standard 1 includes, inter alia, the following guidance:

*"The need for independence arises because, in most cases, users of the financial statements and other third parties do not have all the information necessary for judging whether the auditor is, in fact, objective. Although the auditor may be satisfied that the auditor's objectivity is not impaired by a particular situation, a third party may reach a different conclusion. For example, if a third party were aware that the auditor had certain financial, employment, business or personal relationships with the audited entity, that*

*individual might reasonably conclude that the auditor could be subject to undue influence from the directors or would not be impartial or unbiased. Public confidence in the auditor's objectivity could therefore suffer as a result of this perception, irrespective of whether there is any actual impairment.*

*Accordingly, in evaluating the likely consequences of such situations and relationships, the test to be applied is not whether the auditor considers that the auditor's objectivity is impaired but whether it is probable that a reasonable and informed third party would conclude that the auditor's objectivity either is impaired or is likely to be impaired" (paragraphs 13 and 14).*

31. APB Ethical Standard 2 includes, inter alia, the following requirement:

- (i) *"Where a partner leaves the firm and is appointed as a director (including as a non-executive director) or to a key management position with an audited entity, having acted as audit engagement partner (or as an engagement quality control reviewer, key partner involved in the audit or a partner in the chain of command) at any time in the two years prior to this appointment, the firm shall resign as auditor" (paragraph 48).*

32. ISQC (UK and Ireland) 1 includes, inter alia, the following requirements:

- (i) *"The Firm shall establish policies and procedures designed to provide it with reasonable assurance that the firm and its personnel comply with relevant ethical requirements. (ref: Para A7-A10)" (paragraph 20);*
- (ii) *"The firm shall establish policies and procedures designed to provide it with reasonable assurance that the firm, its personnel and, where applicable, others subject to independence requirements...maintain independence where required by relevant ethical requirements..." (paragraph 21);*
- (iii) *"The firm shall establish policies and procedures for the acceptance and continuance of client relationships and specific engagements, designed to provide the firm with reasonable assurance that it will only undertake or continue relationships and engagements where the*

firm:... (b) can comply with the relevant ethical requirements...".  
(paragraph 26);

33. The ICAEW Code of Ethics included at the relevant time, inter alia, the following requirements:

(i) *"The principle of confidentiality is not only to keep information confidential, but also to take all reasonable steps to preserve confidentiality. Whether information is confidential or not will depend on its nature. A safe and proper approach for professional accountants to adopt is to assume that all unpublished information about a client's or employer's affairs, however gained, is confidential..."* (paragraph 140.0).

(ii) *"The principle of confidentiality imposes an obligation on professional accountants to refrain from:*

*(a) Disclosing outside the firm or employing organisation confidential information acquired as a result of professional and business relationships without proper and specific authority or unless there is a legal or professional right or duty to disclose; and*

*(b) Using confidential information acquired as a result of professional and business relationships to their personal advantage or the advantage of third parties"* (paragraph 140.1).

#### **APPLICABLE KPMG POLICIES AND PROCEDURES**

34. In addition, Executive Counsel will rely upon the KPMG Manual, and in particular paragraph 3.4.3:

*"Partners and professional staff are required to notify both the lead audit engagement partner (or if the lead audit engagement partner is not a partner of ELLP, the local lead audit engagement partner) and a UK member of the Ethics and Independence team of any situation involving their potential full time or part time employment (whether as an employee or an independent contractor) with an audit client to whom they are providing professional services. The UK member of the Ethics and Independence team will determine what safeguards are necessary.*

...  
*You are not permitted to be appointed as a director (including non-executive director) or to a key management position with an audit client for whom you have acted as the audit engagement partner, an engagement quality control reviewer, a key audit partner (as defined in the APB ethical standard) or been in the chain of command in the two years prior to the appointment...*

*In addition to the above restrictions, the partnership deed requires all partners to obtain the approval of the firm if they intend to take up employment as a director or in a senior financial position with any listed company (whether or not an audit client) and are required to observe any relevant 'cooling off' period. Such approval is to be obtained through the UK Head of Ethics and Independence Compliance".*

35. The chain of command is defined in the KPMG Manual at Appendix 4 in a manner which is not identical to the definition of chain of command in the APB Definition (see paragraph 12 above) as follows:

*"The chain of command comprises all individuals who:*

- Supervise or have a direct management responsibility for the audit;*
- Evaluate the performance or recommend the compensation of the lead audit engagement partner; or*
- Provide quality control or other oversight of any aspect of the audit".*

## **THE RESPONDENTS' MISCONDUCT**

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

37. As set out more particularly below, the allegations of Misconduct relate to failures on the part of KPMG and Mr Watts to comply with the required standards of integrity, objectivity and independence in connection with (i) KPMG's failure to conduct a sufficiently detailed investigation into the full scope and extent of the roles performed by Mr Egglenton, a former senior partner of KPMG's Birmingham office, prior to his appointment as non-executive director of Pendragon, a listed audit client of the firm, on 1 December 2010; (ii) the Respondents' failure to provide written disclosure to Pendragon's audit committee as to Mr Egglenton's appointment; and (iii) Mr Watt's failure to take all reasonable steps to preserve the confidentiality of information received from Pendragon.
38. Paragraph 5(11) of the Scheme provides in sub-paragraph (i) that "*anything said, done or omitted by an employee of a Member Firm within the scope of his employment, either actual or ostensible, or as an agent of the Member Firm within the scope of his authority, either actual or ostensible, shall be taken as having been said, done or omitted by that Member Firm*".



## ALLEGATIONS AGAINST KPMG

### ALLEGATION 1:

Between September 2010 and 30 June 2012, when Pendragon was an audit client of KPMG, KPMG failed to have sufficient or appropriate policies and/or procedures as required by ES1.15 and/or ISQC (UK and Ireland) 1, paragraphs 20, 21 and 26, appropriately documented and communicated, which were designed to ensure that, in relation to each audit engagement, KPMG and all those who were in a position to influence the conduct and outcome of the audit, act with integrity, objectivity and independence and thereby the conduct of KPMG fell significantly short of the standards reasonably to be expected of a Member Firm, in that:

- 1.1 KPMG failed to ensure that its procedures required a sufficiently detailed and thorough investigation as to the roles undertaken by a departing partner in circumstances where that partner had been engaged in a senior role within the firm and was joining an audited entity as a director such that the provisions of ES2.48 might be applicable;
- 1.2 KPMG failed to ensure that its policies and procedures were sufficient to identify whether or not Mr Egglenton's roles as Senior Partner of the Birmingham office and/or Regional Chairman of the Midlands region at KPMG had in fact placed him in the chain of command (as that term is defined in the APB Ethical Standards) such that his appointment by Pendragon as a non-executive director would require KPMG's resignation as auditor; and
- 1.3 KPMG failed to ensure that its own policies matched the requirements of the APB Ethical Standards and, in particular, that its definition of individuals falling within the chain of command in Appendix 4 of the KPMG Manual was fully consistent with the definition of that term in the APB Definition.

### **Particulars of Allegation 1:**

KPMG failed to have in place procedures sufficient to ensure that the full scope and extent of Mr Egglenton's roles as Senior Partner of KPMG's Birmingham office and/or Regional Chairman of KPMG's Midlands Region could be identified upon his appointment as a non-executive director of Pendragon. It did not have sufficient procedures requiring a detailed investigation into the full scope and extent of those roles and in the circumstances it did not have sufficient policies or procedures in place that were capable of identifying whether or not Mr Egglenton was involved in the chain of command, as that term is defined in the APB Definition. KPMG's own definition of individuals falling within the chain of command was not entirely consistent with the APB Definition. As a result, no properly informed decision can have been made by KPMG as to whether Mr Egglenton was in the chain of command and further, whether or not there was a need for KPMG to resign as auditor of Pendragon.

### **ALLEGATION 2:**

**Between March 2010 and 30 June 2012, when Pendragon was an audit client of KPMG, KPMG's leadership failed to take responsibility for establishing a control environment within the firm as required by ES1.18, that placed adherence to ethical principles and compliance with APB Ethical Standards above commercial considerations and thereby the conduct of KPMG fell significantly short of the standards reasonably to be expected of a Member Firm, in that:**

- 2.1 KPMG failed to ensure it had a procedure in place which would sufficiently pick up the detail of the roles undertaken by its regional senior partners and/or regional chairmen and thereby facilitate the identification of a possible breach of ES2.48;**
- 2.2 KPMG failed to establish policies and/or procedures that ensured compliance with the APB Ethical Standards.**

### **Particulars of Allegation 2:**

#### ***Failure to establish policies and procedures***

KPMG did not establish sufficient policies and/or procedures to ensure compliance with APB Ethical Standards. The deficiencies in the KPMG policies and/or

procedures as identified in Allegation 1 above are repeated. In particular, KPMG failed to establish procedures to ensure that where a partner who had occupied a senior role or roles with KPMG was departing and was joining an audit client as a director, a detailed and thorough investigation as to the role or roles undertaken by that departing partner would be undertaken with a view to identifying whether or not he had acted in the chain of command for that particular audit client as that term is defined in the APB Definition and thus whether the requirements in ES2.48 were likely to be applicable.

### **ALLEGATION 3:**

**Between 1 December 2010 and 30 June 2012, KPMG (acting through the audit engagement partners Mr Watts and Mr Steventon as its agents) failed to provide the Audit Committee of Pendragon, a listed company, with full written disclosure of relationships that bore on the auditor's objectivity and independence together with any safeguards that had been put in place contrary to the requirements of ES1.59 and thereby the conduct of KPMG fell significantly short of the standards reasonably to be expected of a Member Firm, in that:**

- 3.1 KPMG failed to inform Pendragon's Audit Committee in writing that Mr Egglenton's appointment as non-executive director created a relationship that bore upon KPMG's objectivity and independence in that it created a potential familiarity threat;**
- 3.2 KPMG failed to inform Pendragon's Audit Committee in writing of the safeguards that it had put in place in address that potential threat.**

### **Particulars of Allegation 3:**

KPMG (acting through the audit engagement partners Mr Watts and Mr Steventon as its agents) did not provide Pendragon's Audit Committee with any written information about the potential impact or significance of Mr Egglenton's appointment as a non-executive director, in particular about the potential familiarity threat that such appointment created which bore upon KPMG's objectivity and independence. Nor did it provide written disclosure of the safeguards that KPMG had put in place to address this potential threat, namely introducing a new EQCR in 2010 and changing the partner responsible for the audit in 2011. KPMG sent the Audit Letter to Pendragon's Audit Committee on 21 February 2012 but this letter neither referred to,

nor commented upon, Mr Egglenton's position or the question of whether his appointment as a non-executive director at Pendragon created a relationship that might bear on KPMG's independence as auditor.

## ALLEGATIONS AGAINST MR WATTS

### ALLEGATION 4:

Between 1 December 2010 when he was audit engagement partner on the Pendragon audit and the date on which he ceased to be the audit engagement partner on that audit, 10 May 2011, Mr Watts failed to provide the Audit Committee of Pendragon, a listed company, with full written disclosure of relationships that bore on the auditor's objectivity and independence together with any safeguards that had been put in place contrary to the requirements of ES1.59 and thereby his conduct fell significantly short of the standards reasonably to be expected of a Member, in that:

- 4.1 Mr Watts failed to inform Pendragon's Audit Committee in writing that Mr Egglenton's appointment as non-executive director created a relationship that bore upon KPMG's objectivity and independence in that it created a potential familiarity threat;
- 4.2 Mr Watts failed to inform Pendragon's Audit Committee in writing of the safeguards that KPMG had put in place to address that potential threat.

### **Particulars of Allegation 4:**

Although the fact of Mr Egglenton's relationship with KPMG and the potential issues arising for the factual determination of independence and a consideration of the appearance of independence were discussed with Pendragon (which concluded that there were no independence issues), such communications were mainly oral and not properly recorded. Mr Watts did not provide Pendragon's Audit Committee with written information about the potential impact or significance of Mr Egglenton's appointment as a non-executive director, in particular about the potential familiarity threat that such appointment created which bore upon KPMG's objectivity and independence. Nor did he provide written disclosure of the safeguards that had been put in place to address that potential threat, namely introducing a new EQCR in 2010 and changing the partner responsible for the audit in 2011. There is no evidence that Mr Watts provided Pendragon's Audit Committee with any appropriate written information.

### **ALLEGATION 5:**

On 9 August 2010, a blank email was sent from Mr Watts' email account to Mr Egglenton, a former member of KPMG, attaching a password protected copy of a Pendragon draft Interim Statement which Mr Watts had acquired as a result of his professional relationship with Pendragon, in breach of the principle of confidentiality in paragraph 140.0 of the ICAEW Code of Ethics, and thereby his conduct fell significantly short of the standards reasonably to be expected of a Member.

### **Particulars of Allegation 5:**

In his role as audit engagement partner on the Pendragon audit and consistent with normal processes, Mr Watts was sent by Mr Tim Holden of Pendragon, on 8 August 2010, a password protected copy of the Pendragon draft Interim Statement. The email from Tim Holden was forwarded by way of a blank email timed at 12.04pm on 9 August 2010 from Mr Watts' email account to Mr Egglenton with the password protected draft Interim Statement attached. It was public knowledge that the Interim Statement was due to be published at 7am on 10 August 2010. At this stage, Mr Egglenton was no longer a member of KPMG and did not fall within a category of persons to whom disclosure of the draft Interim Statement could legitimately be made. It is not alleged that Mr Watts intended to send the email to Mr Egglenton and there is no evidence that Mr Watts sent Mr Egglenton the password or that Mr Egglenton knew the password required to open the document or that he was in fact able to open it. However Mr Watts' conduct was in breach of the requirement of paragraph 140 of the ICAEW Code of Ethics to take all reasonable steps to preserve the confidentiality of Pendragon's information.

**Signed:**



**GARETH REES QC  
EXECUTIVE COUNSEL**

**Date:**

9<sup>th</sup> July 2014.