

**CONFIDENTIAL PURSUANT TO SECTION 1224A COMPANIES ACT 2006**

**IN THE MATTER OF AN INVESTIGATION BY THE EXECUTIVE COUNSEL TO THE  
FINANCIAL REPORTING COUNCIL RELATING TO THE STATUTORY AUDIT OF THE  
FINANCIAL STATEMENTS OF STAGECOACH GROUP PLC FOR THE FINANCIAL  
YEAR ENDED 29 APRIL 2017**

**(1) ERNST & YOUNG LLP**

**AND**

**(2) MR MARK HARVEY**

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**FINAL DECISION NOTICE**  
**Pursuant to Rule 18 of the Audit Enforcement Procedure**

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

**1 INTRODUCTION**

1.1 The Financial Reporting Council (the “**FRC**”) is the competent authority for statutory audit in the UK and is responsible for the operation of the Audit Enforcement Procedure (the “**AEP**”), effective 17 June 2016. The AEP sets out the rules and procedure for the investigation, prosecution and sanctioning of breaches of “*Relevant Requirements*”.

1.2 The AEP contains a number of defined terms and, for convenience, those defined terms are also used within this document. Where defined terms are used, they appear in italics.

1.3 This *Final Decision Notice* also uses the following definitions:

1.3.1 “**Applicable Accounting Framework**” means the International Accounting Standards (“**IAS**”) or International Financial Reporting Standards (“**IFRS**”) as applicable;

1.3.2 “**FY17**” means the financial year commencing 1 May 2016 and ending 29

April 2017;

- 1.3.3 “**Financial Statements**” means Stagecoach’s consolidated financial statements for FY17 signed on 28 June 2017; and
- 1.3.4 “**Audit**” means the statutory audit of the Financial Statements.
- 1.4 Pursuant to Rule 16(b) of the AEP, Executive Counsel has decided that the Respondents are liable for Enforcement Action, having made *Adverse Findings* against each of them. This document is Executive Counsel’s *Final Decision Notice*, issued pursuant to Rule 18 of the AEP, in respect of ERNST & YOUNG LLP (“**EY**”) and Mr Mark Harvey’s conduct in relation to the statutory audit of STAGECOACH GROUP PLC (“**Stagecoach**”) for FY17. EY was the *Statutory Audit Firm* for the Audit and a member firm of the Institute of Chartered Accountants in England and Wales. The *Senior Statutory Auditor* (and the Group Engagement Partner) responsible for the Audit was Mr Mark Harvey (“**Mr Harvey**”), a member of the Chartered Accountants Ireland and the Senior Partner at the relevant time of EY Scotland.
- 1.5 In this *Final Decision Notice*, EY and Mr Harvey are referred to as the “**Respondents**”.
- 1.6 On 29 June 2021 Executive Counsel issued Executive Counsel’s Decision Notice pursuant to Rule 17 of the AEP. On 30 June 2021 the Respondents provided written agreement to Executive Counsel’s Rule 17 Decision Notice. Consequently, and in accordance with Rules 17 and 18 of the AEP this *Final Decision Notice*:
- 1.6.1 Outlines the *Adverse Findings* with reasons;
- 1.6.2 Outlines *Sanctions* with reasons; and
- 1.6.3 Outlines an amount payable in respect of Executive Counsel’s costs of the matter.
- 1.7 This *Final Decision Notice* is divided into the following sections:
- 1.7.1 Section 2: Executive summary of the *Adverse Findings*;
- 1.7.2 Section 3: Background to the Audit;
- 1.7.3 Section 4: *Relevant Requirements* to which the *Adverse Findings* relate;

1.7.4 Sections 5 to 7: Background to and detail of the *Adverse Findings*. The *Adverse Findings* are arranged thematically in three separate sections, having regard to the manner in which the audit file was organised;

1.7.5 Sections 8 and 9: *Sanctions*; and

1.7.6 Section 10: Costs.

## **2 EXECUTIVE SUMMARY**

2.1 This *Final Decision Notice* set outs details of the numerous breaches of *Relevant Requirements* which the Respondents have breached and accept they have breached in respect of the Audit of the Financial Statements.

2.2 The *Adverse Findings* set out in this *Final Decision Notice* are arranged thematically and relate to the following three specific audit areas:

2.2.1 The defined benefit pension scheme obligations (the “**Defined Benefit Pension Scheme Obligations**”);

2.2.2 The provision for insurance liabilities (the “**Insurance Provision**”); and

2.2.3 The onerous contract provision in relation to the [VTEC] (“**VTEC**”) railway franchise (the “**VTEC Onerous Contract Provision**”).

2.3 In each of these three areas, the Audit failed in its principal objective of providing reasonable assurance that the Financial Statements were free from material misstatement.

2.4 The breaches of *Relevant Requirements* occurred in multiple areas of the audit process from planning, through substantive testing to reporting to those charged with governance, disclosures in the Financial Statements and documentation. In certain cases the breaches were of a basic and/or fundamental nature, evidencing a serious lack of competence in conducting the audit work.

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

2.6 Sections 5 to 7 sets out the detailed *Adverse Findings*.

2.7 This *Final Decision Notice* sets out the *Sanctions imposed* in respect of the Respondents:

2.8 EY

2.8.1 A fine of £3,500,000 adjusted by 10% for aggravating and mitigating factors, and discounted for admissions and early disposal by 30% so that the financial penalty payable is £2,205,000;

2.8.2 A published statement in the form of a severe reprimand;

2.8.3 A declaration that the audit report in respect of the Audit of the Financial Statements signed on behalf of EY did not satisfy the audit reporting requirements, as set out in this *Final Decision Notice*; and

2.8.4 A requirement that EY shall report to the FRC in respect of a number of audits (to be specified by the FRC), providing details of the audit work performed by EY in relation to onerous contract provisions, as well as any further information the FRC may reasonably require to enable it to assess EY's compliance with the *Relevant Requirements* in that regard.

2.9 In determining the *Sanctions* to be imposed on EY Executive Counsel has noted that in response to several of the identified failings in the Audit, EY took remedial steps to reduce the likelihood of their recurrence (summarised at paragraph 8.16 below).

2.10 Mr Harvey

2.10.1 A fine of £100,000 adjusted for aggravating and mitigating factors, and further discounted for admissions and early disposal by 30% so that the financial penalty payable is £70,000; and

2.10.2 A published statement in the form of a severe reprimand.

### **3 BACKGROUND**

#### **The Respondents**

3.1 In 2017, EY was ranked as the third largest audit firm in the UK by revenue, with total audit income of £442 million (total fee income of £2.35 billion) and 116 audit principals. FY17 was EY's first year as the Statutory Audit Firm for Stagecoach.

3.2 Mr Harvey was a partner of EY, with 20 years auditing experience. He signed the Audit report on behalf of EY, in respect of the Financial Statements. Mr Harvey was the Managing Partner of EY Scotland between 2015 and 2019. He retired from EY

in April 2020 to take up a role in industry.

- 3.3 The Respondents' statutory responsibility was to form an opinion as to whether the Financial Statements showed a true and fair view and had been properly prepared in accordance with the Applicable Accounting Standards and the Companies Act 2006.

### **The Audit**

- 3.4 At all material times Stagecoach was an international transport group headquartered in Scotland operating buses, trains, trams and express coaches through subsidiaries in the United Kingdom, United States and Canada. At the time of the Audit, Stagecoach was the second largest transport group in the United Kingdom and listed on the main market of the London Stock Exchange (the "**LSE**") and was a constituent of the FTSE 250. Accordingly Stagecoach was a *Public Interest Entity* for the purposes of the AEP.
- 3.5 For the year ended 29 April 2017, Stagecoach's total profit before tax was £17.9 million (2016: £104.4 million) and net assets were £68.5 million (2016: £177.8 million).
- 3.6 This was EY's first year of auditing Stagecoach.
- 3.7 The Financial Statements were signed on 28 June 2017 as was the audit report (the "**Audit Report**"). The Audit Report in relation to the Financial Statements was unmodified.
- 3.8 Audit materiality for the year was £7 million (as 5% of adjusted Profit Before Tax) and performance materiality was £5.3 million (75% of overall materiality).

## **4 RELEVANT REQUIREMENTS**

- 4.1 Rule 1 of the AEP states that "*Relevant Requirements*" has the meaning set out in regulation 5(11) of the Statutory Auditors and Third Country Auditors Regulations 2016 ("**SATCAR**"). Those requirements include, but are not limited to, the International Standards on Auditing (UK and Ireland) ("**ISAs**") issued by the FRC.
- 4.2 The *Relevant Requirements* referred to in this *Final Decision Notice* are the following (in each case the October 2009 version unless otherwise stated):
- 4.2.1 **ISA 200** (Overall objectives of the independent auditor and the conduct of an audit in accordance with international standards on auditing);

- 4.2.2 **ISA 220** (Quality control for an audit of financial statements);
  - 4.2.3 **ISA 230** (Audit documentation);
  - 4.2.4 **ISA 260** (September 2014) (Communication with those charged with governance);
  - 4.2.5 **ISA 315** (June 2013) (Identifying and assessing the risks of material misstatement through understanding the entity and its environment);
  - 4.2.6 **ISA 330** (December 2010) (The auditor's responses to assessed risks);
  - 4.2.7 **ISA 500** (Audit evidence);
  - 4.2.8 **ISA 501** (Audit evidence - specific considerations for selected items);
  - 4.2.9 **ISA 530** (Audit sampling);
  - 4.2.10 **ISA 540** (December 2010) (Auditing accounting estimates, including fair value accounting estimates, and related disclosures);
  - 4.2.11 **ISA 620** (Using the work of an auditor's expert);
  - 4.2.12 **IAS 19** (2011) (Accounting treatment and disclosure for employee benefits);  
and
  - 4.2.13 **IAS 37** (Provisions, contingent liabilities and contingent assets).
- 4.3 The extracts of the ISAs which are of particular relevance to the *Adverse Findings* are set out in Appendix 1 hereto.

## **5 DEFINED BENEFIT PENSION SCHEME OBLIGATIONS**

### **A. Introduction**

- 5.1 The total obligations for all defined benefit pension schemes as disclosed in Note 24(c) of the Financial Statements was £4,257.7 million. As at 29 April 2017 Stagecoach had defined benefit pension obligations for the following schemes:

<b>Scheme type</b>	<b>Obligation £m</b>	<b>% of total obligation</b>
The Stagecoach Group Pension Scheme (" <b>SGPS</b> ")	1,649.6	46%

Various Railway Pension Schemes (“RPS”) <sup>1</sup>	1,609.1	45%
Various UK Local Government Pension Schemes (“LGPS”)	325.1	9%
Other	11.6	0%
Unfunded schemes	4.3	0%
<b>Present value of total obligations</b>	<b>3,599.7</b>	<b>100%</b>

5.2 All of the balances set out above were material balances, except for the unfunded schemes.

5.3 The principal accounting standard relevant to this area of the Financial Statements was IAS 19: the accounting requirements for employee benefits.

5.4 The Audit team identified the account balance: “Group – Pension” as a significant account for assertions (risk of material misstatement) as to: (1) completeness; (2) existence/occurrence; (3) measurement/valuation; and (4) rights and obligations. The Audit team also identified the “retirement benefits” disclosure as a “significant disclosure”.

5.5 The Audit team identified “accounting for pension liabilities” as a Significant Risk and that the Significant Risk was in respect of the obligations for the SGPS, RPS and LGPS schemes only. This *Final Decision Notice* is in relation to the Audit work in respect of the obligations for those schemes only.

5.6 The Audit team also identified “pension valuation”, including pension asset valuations, as an accounting estimate. The Audit team identified the key assumptions as: (1) discount rate; (2) retail price inflation; (3) rate of increase in pensionable salaries; (4) rate of increase of pension payment; and (5) post-retirement mortality.

5.7 The Audit in respect of the obligations for the SGPS, RPS and LGPS schemes was conducted at group level regardless of which component the obligation was held in.

5.8 Stagecoach’s management engaged an external actuarial firm (“**the External Firm**”) as actuarial experts in respect of pensions. There were two External Firm teams:

5.8.1 An External Firm team seconded into Stagecoach who prepared the pension valuation model based on assumptions and inputs provided by Stagecoach

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<sup>1</sup> South West Trains, Island Line, East Midlands Trains, and East Coast Main Line sections of the RPS - A significant element of the RPS obligation did not relate to Stagecoach and was not its liability. The figure of £1,609.1 million is in respect of Stagecoach’s liability.

(the “**Pension Valuation Model**”); and

- 5.8.2 An External Firm team who at year-end reviewed the output from the Pension Valuation Model, known as the “green sheet” (the “**Green Sheet**”). The Green Sheet received formal sign-off at year-end and included all main assumptions and outputs required for pensions accounting.
- 5.9 The Audit team engaged EY’s in-house pension actuarial specialists, the Pensions Advisory Group (“**PAG**”), as auditor’s experts. PAG subsequently prepared a report (the “**PAG Report**”).
- 5.10 In the Audit Report the Audit team communicated the following conclusion on “Accounting for pension liabilities”: “We have concluded that the pension liability is materially correct and that management’s judgments in relation to underlying actuarial assumptions are appropriate.”

**B. Adverse Findings**

**ADVERSE FINDING 1: Audit planning**

- 5.11 The Audit work in relation to audit planning breached ISAs 315, 300, 500 and 540 in the following ways:
- 5.11.1 The Respondents failed to perform sufficient audit work in order to obtain an understanding of and to evaluate: (1) how Stagecoach’s management made the accounting estimates (including evaluating the nature of the relevant actuarial model (the Pension Valuation Model) used by Stagecoach’s management in making its accounting estimate); and (2) the participant/pension member data on which the estimates were based. This represented a breach of paragraph 8(c)(i) and (ii) of ISA 540 (together with paragraphs A24-A28 of the Application Material).
- 5.11.2 The Audit file did not include an assessment of the work of the second External Firm team. Pursuant to paragraph 8(b) and (c) of ISA 500 obtaining an “understanding of the work of that expert” and evaluating “the appropriateness of that expert’s work” necessarily involved the Respondents understanding and evaluating who was doing that work at the External Firm team and their expertise and experience. This was a breach of paragraph 8(b) and (c) of ISA 500.



5.11.3 Although the Respondents were not expected to be provided with access to the Pension Valuation Model itself, they failed to: (1) perform substantive procedures in relation to the assumptions input into the model, which would have been specifically responsive to the Significant Risk that they had identified at the assertion level regarding the reliability of estimates; and (2) having failed to evaluate the nature of the Pension Valuation Model, the Respondents were not in a position to determine what substantive procedures were specifically responsive to the reliability risk. The fact that Stagecoach's management had used a management expert (the External Firm) in making the accounting estimates is not a replacement for the work that should have been undertaken. This represented a breach of paragraph 21 of ISA 330.

5.11.4 Due to the fact that they were dealing with a Significant Risk, the Respondents were required to identify controls in relation to participant/pension member data which could cause misstatements in the valuation. In breach of paragraphs 13, 26(c) and 29 of ISA 315 the Respondents failed to: (1) appropriately relate the identified What Could Go Wroongs ("**WCGWs**") to relevant controls; (2) properly evaluate the design of those controls and determine whether they had been implemented by performing suitable procedures in addition to inquiry of Stagecoach's management; and (3) obtain a proper understanding of Stagecoach's controls, including control activities, relevant to the Significant Risk that the Respondents had determined existed.

#### **ADVERSE FINDING 2: Testing of source data**

5.12 The Audit work performed in relation to the relevant source data was deficient and breached ISAs 200, 220, 330 and 500 in the following ways:

5.12.1 The Respondents failed to design and perform audit procedures that were appropriate in the circumstances for the purpose of obtaining sufficient appropriate audit evidence in relation to all material populations and all pension schemes. Having set out a work plan of procedures to be performed in response to the various pension schemes' characteristics in order to achieve the necessary audit confidence over whether the source data was complete and valid, this work plan was not executed properly or at all by the Respondents. There was also no attempt by the Respondents to design

alternative procedures to deal with the fact that source data was not maintained by Stagecoach for the LGPS and RPS pension schemes (which were in the aggregate material to the Financial Statements) or to consider the possibility of a limitation of audit scope. As a result, the Respondents did not test all material populations and breached paragraph 6 of ISA 500 and paragraph 17 of ISA 200.

5.12.2 The Respondents failed to complete the planned work adequately or at all and therefore did not perform appropriate audit procedures in breach of paragraph 6 of ISA 500 and paragraph 17 of ISA 200.

5.12.3 The Respondents failed to: (1) design and perform substantive procedures for each material class of transaction, in particular the Respondents performed no testing in relation to source data for LGPS and RPS; (2) perform substantive procedures specifically responsive to the Significant Risk that they had identified at the assertion level regarding completeness of source data; (3) perform a test of details even though only substantive procedures were planned; and (4) properly consider whether sufficient appropriate audit evidence had been obtained or the conclusion that they reached as to the sufficiency and appropriateness of the audit evidence was supported. This represented a breach of paragraphs 18, 21 and 26 of ISA 330.

5.12.4 Mr Harvey only became aware of the deficiencies in the planning and transaction testing for the pensions source data area when informed by the FRC's Audit Quality Review ("AQR") team. This constituted a specific breach of paragraphs 16 and 17 of ISA 220.

### **ADVERSE FINDING 3: Evaluation and/or challenge of auditor's expert**

5.13 The Audit work performed in relation to the input from the auditor's own expert was in breach of ISAs 200, 220, 230, 540 and 620 in the following ways:

5.13.1 The Respondents failed to: (1) evaluate the adequacy of PAG's work (as auditor's expert), in particular the relevance and reasonableness of PAG's conclusions in the PAG Report, and their consistency with other audit evidence; and (2) evaluate the relevance, completeness and accuracy of the source data available to PAG. As a consequence, the Audit team was not in a position to provide the Audit Committee with timely observations or to

promote effective two-way communication with the Audit Committee. The Respondents' omissions constituted a breach of paragraph 12 of ISA 620.

- 5.13.2 The Respondents failed to: (1) properly challenge, evaluate and respond to the assumptions used by management in the calculation of the accounting estimate that gave rise to a significant risk of estimation uncertainty; (2) challenge management over why less aggressive assumptions had been rejected; (3) properly consider or address the possibility of management bias as a result of several apparently "optimistic" assumptions (assumptions which PAG concluded were at the "optimistic" or "very optimistic" end of the acceptable range) being used by Stagecoach's management; (4) attempt to reconcile the apparent disconnect between the Audit team and the Audit Committee as evidenced by the minutes of the meeting on 1 December 2016; and (5) obtain sufficient appropriate audit evidence regarding compliance with the requirements of IAS19. These deficiencies in the Audit work constituted a breach of paragraphs 15, 16, 17 and 21 of ISA 540.
- 5.13.3 The Respondents failed to apply proper professional scepticism in relation to the PAG Report in particular: (1) there was a lack of any audit response to the unusually strong language used by PAG in assessing the key actuarial demographic assumptions; and (2) there was a failure to attempt to aggregate and quantify the apparent optimism. This was a breach of paragraph 15 of ISA 200.
- 5.13.4 The Respondents (and in particular Mr Harvey) failed to identify: (1) the contradictory statements in the PAG Report and Stagecoach's Judgemental Accounting Matters ("**JAM**") paper regarding the basis for calculating the relevant rate of inflation, and (2) the inconsistency between the PAG Report and the Audit team's work paper as regards the methodology for "Pension increases in payment" and "Pension increases in deferment". In both instances the Respondents also failed to provide sufficient challenge to see whether this was an isolated incident or something more pervasive in PAG's work/the Audit team's evaluation of PAG's work. These Audit deficiencies meant that the Respondents breached paragraph 12(a) of ISA 620, paragraphs 16 and 17 of ISA 220 and paragraph 11 of ISA 230.

**ADVERSE FINDING 4: Communication with those charged with governance**

- 5.14 The Respondents did not attempt to communicate, and discuss with, the Audit Committee at the year-end the fact that PAG considered there were significant deficiencies in the methodology used to derive the “discount rate” and “RPI assumptions”. Given that these issues had the potential to result in a material misstatement in future accounting periods these findings should have been reported to the Audit Committee at each subsequent occasion of reporting to the Audit Committee, until the risk had been removed. This constituted a breach of paragraph 16(a) of ISA 260.

**ADVERSE FINDING 5: Financial Statements disclosures**

- 5.15 The Respondents did not agree and/or reconcile the disclosures in Note 24(f) of the Financial Statements to the accounting records either properly or at all, in breach of paragraph 20 of ISA 330.

**ADVERSE FINDING 6: Audit documentation**

- 5.16 The Respondents failed to prepare sufficient audit documentation, on a timely basis, to enable an experienced auditor, with no previous connection with the Audit, to understand the work performed by the Audit team in relation to Audit planning and strategy, the substantive work performed by PAG or the Audit team’s response to the PAG Report. This was in breach of paragraphs 7 and 8 of ISA 230.

**6 INSURANCE PROVISION**

**A. Introduction**

- 6.1 The principal accounting standard relevant to this area of the Financial Statements was IAS 37: provisions, contingent liabilities and contingent assets.

- 6.2 In 2017 the Insurance Provision totalled £156.8 million which mainly included:

6.2.1 £123.4 million: the valuation provided by a third party audit firm acting as management’s expert (“**Management’s Expert**”), of Stagecoach’s year-end insurance obligations.

6.2.2 £26.1 million: Stagecoach management’s estimation of potential further excesses payable in the UK (£17.6 million) and the US (£8.5 million). These management estimates were described as “volatility adjustments” and

“judgemental overlays”.

- 6.3 The Insurance Provision was split over the following components: (1) East Midlands Trains (“**EMT**”); (2) South Western Trains (“**SWT**”); (3) VTEC; (4) North America (i.e. Coach USA, “**CUSA**”); and (5) PSV Claims Bureau (“**PSV**”) (an entity set up to handle all UK Bus claims).
- 6.4 The Audit team identified the account balance “Group – Central Provisions including Legal”, which included insurance provisions, as a significant account for the completeness, existence, valuation and rights and obligations assertions. The Audit team documented that “presentation and disclosure”, the only assertion not selected for this significant account, was not selected as it had been associated with the separate “Group – Accounts and Disclosures” significant account: “P&D has only been associated to the accounts step to cover all disclosure work, therefore N/A for all other accounts”.
- 6.5 Of the components relevant to the Insurance Provision, EMT and SWT were selected for “full scope” audits due to size, and VTEC and CUSA were selected for “full scope” due to risk. PSV was designated “specific scope” due to the significant insurance provision risk. (The specific scope was not defined in the scoping memo or elsewhere on the Audit file.) The PSV Audit work was documented on the group audit file.
- 6.6 Management’s Expert was engaged to review the insurance provisions of PSV, and CUSA only. This *Final Decision Notice* considers the Audit work in relation to these components only.
- 6.7 The Audit team documented that:
- 6.7.1 The PSV (UK) provision was based on an independent actuarial assessment plus adjustments by management.
- 6.7.2 The CUSA provision was calculated by management using their claims data and an independent actuarial review was obtained to assist Stagecoach in assessing the adequacy of the provision.
- 6.8 In its year-end Audit Results Report, the Audit team stated that 2017 was the first year that an “independent actuarial review” had been obtained for CUSA at all.
- 6.9 The Audit team engaged EY’s in-house “Insurance Risk and Actuarial Services Practice” (“**IRAS**”), as auditor’s expert to assist in assessing Management’s Expert’s

evaluation of the level of the self-insurance provision, prior to the volatility adjustment added by Stagecoach's management. IRAS subsequently prepared a year-end summary memo dated 15 June 2017 (the "**Summary Memo**").

- 6.10 The Audit team identified that "adequacy of provisions for insurance claims" presented a significant risk of material misstatement. The Audit team identified that the significant assertions for the risk were completeness and valuation.
- 6.11 The Audit team documented that "provisions" (including the Insurance Provision) were a significant disclosure and that the Insurance Provision was an unusual transaction due to its size and nature.

**B. Adverse Findings**

**ADVERSE FINDING 7: Audit planning**

- 6.12 The Audit work performed in relation to audit planning breached ISAs 315, 330 and 540 in the following ways:
- 6.12.1 In respect of the PSV component the Respondents: (1) did not take sufficient steps to identify and understand the design of the controls relevant to claims "incurred but not reported"; and (2) failed to properly understand controls relevant to the accounting estimate to ensure completeness of all claims in the PSV claims database. This represented a breach of paragraphs 13, 26(c) and 29 of ISA 315 and paragraph 8(c)(ii) of ISA 540.
- 6.12.2 In respect of the CUSA component, the Respondents: (1) did not evaluate the design of the controls relevant to the completeness of claims assertion, or determine whether they had been implemented by performing procedures in addition to inquiry of Stagecoach's management; (2) did not obtain an understanding of the business processes relevant to the CUSA component; the "SCOT" (which was used to document and walkthrough financial processes) for the US did not seek to identify each different source of a claim event (incidents that will potentially result in an insurance claim) and then document the transaction flow from "initiation" to the general ledger and then reporting in the Financial Statements; and (3) did not appropriately relate the identified WCGWs to relevant controls, with the result that they failed to perform sufficient audit work in order to obtain an understanding of the controls relevant to the completeness of claims assertion. The Respondents'

work in this respect breached paragraphs 13, 18(b), 26(c) and 29 of ISA 315 and paragraph 8(c)(ii) of ISA 540.

- 6.12.3 In respect of the CUSA component, the Respondents failed to design and perform adequate tests of their selected controls to obtain sufficient appropriate audit evidence of their effectiveness; the controls that the Respondents selected (the reconciliations of aggregate financial data between CUSA's claims handler's "SCMS" database and Stagecoach's "Stars" database), were inadequate for this purpose. By their actions, the Respondents breached paragraph 8(a) of ISA 330.

#### **ADVERSE FINDING 8: Execution of testing**

- 6.13 The testing performed by the Audit team was deficient and breached ISAs 200, 500 and 530 in the following ways:

- 6.13.1 In breach of paragraph 6 of ISA 500 and paragraph 17 of ISA 200 the Respondents failed to obtain sufficient appropriate audit evidence around the completeness assertion for both the PSV and CUSA components. In particular there is no evidence in the Audit work papers that the Audit team carried out any testing to ensure the completeness of either the data in the PSV database, or the SCMS database or the Stars database in the US. The work done to reconcile the aggregate financial values between the two US databases did not provide an assurance as to the completeness of the US claims population.
- 6.13.2 The Respondents' selection of just 'Large Claims' from the claims population in the SCMS database and Stars database meant that they failed to test a representative sample, which constituted a breach of paragraph 8 of ISA 530 and paragraph 10 of ISA 500 (together with paragraphs A54 and A55 of the Application Material).
- 6.13.3 The Respondents failed to independently corroborate the base data in respect of claims provided to Management's Expert by Stagecoach in breach of paragraph 8(c) of ISA 500.

#### **ADVERSE FINDING 9: Audit evidence**

- 6.14 The Respondents failed to design and perform procedures that were appropriate in the circumstances for the purpose of obtaining sufficient appropriate audit evidence

in relation to: (1) the volatility adjustment to the PSV component; and (2) the judgmental/volatility overlay to the CUSA component. This represented a breach of paragraph 6 of ISA 500 and paragraph 17 of ISA 200.

- 6.15 Further, the Respondents failed to explain and resolve the inconsistency in approach which appeared on the face of the Audit work (the inconsistency being on the one hand justifying the application of a CUSA volatility overlay “as per the UK” but on the other hand using a different, unsupported volatility overlay to that adopted for the UK). This constituted a breach of paragraph 11(a) and (b) of ISA 500.

#### **ADVERSE FINDING 10: Management’s expert**

- 6.16 The Respondents failed in a number of respects to obtain a sufficient understanding of the work of Management’s Expert, and failed sufficiently to evaluate the suitability of them to act as independent management’s expert: (1) the Audit team did not document any consideration of whether Management’s Expert had sufficient competency to perform the CUSA review. There is no evidence in the work papers documenting the body of experience apparently possessed by the US Management’s Expert team members or even their names; (2) given the lack of evidence mentioned in point (1), it would not have been possible for the Audit team to have made the appropriate challenge to the suitability of the Management’s Expert’s team; (3) the Audit team failed adequately to evaluate the potential familiarity threat from Management’s Expert’s previous length of service (13 years) in carrying out insurance reserving reviews for Stagecoach; and (4) the Audit team failed sufficiently to challenge Stagecoach as to why there was no standalone engagement letter for Management’s Expert for the year-end work for 2017. Stagecoach had agreed a detailed letter of engagement with Management’s Expert for their year-end review for 2016. There was an obvious inconsistency in Stagecoach’s approach which the Audit team did not challenge. These matters caused the Respondents to breach paragraph 8(a) to (c) of ISA 500.

#### **ADVERSE FINDING 11: Evaluation and/or challenge of auditor’s expert**

- 6.17 The Audit work performed in relation to the evaluation and challenge of the work of the auditor’s expert was in breach of ISAs 200, 500, 540 and 620 in the following ways:

- 6.17.1 The Respondents failed to: (1) obtain IRAS’ views on the processes and controls adopted by Stagecoach; (2) adequately evaluate whether the key



personnel within IRAS who actually performed the actuarial expert work had the necessary competence, capabilities and objectivity for the auditor's purposes, including their proficiency to perform a review of the US liabilities; and (3) evaluate the adequacy of IRAS's work (as auditor's expert) in particular the relevance and reasonableness of the conclusions in the IRAS Summary Memo. This constituted a breach of paragraphs 7, 9, 10(a) and (b), and 12 of ISA 620.

6.17.2 The Respondents failed to: (1) evaluate how management considered alternative assumptions or outcomes and why it had rejected them as a result of the significant issues identified in the Summary Memo; (2) properly consider or address the possibility of management bias as a result of significant issues identified in the Summary Memo; (3) apply proper professional scepticism in relation to the key reserving judgments being used by Stagecoach's management; and (4) obtain sufficient appropriate audit evidence regarding compliance with the requirements of IAS 37. The Respondents consequently breached paragraph 15 of ISA 200 and paragraphs 15(a) and (b), 17 and 21 of ISA 540.

6.17.3 The Respondents failed to obtain sufficient appropriate audit evidence to support their overall conclusion in respect of the work of IRAS that: "There are no significant issues identified per the specialist's report that impacts the financial position of the group" which was a breach of paragraph 6 of ISA 500 and paragraph 17 of ISA 200.

#### **ADVERSE FINDING 12: Communication with those charged with governance**

6.18 The Respondents' communication with those charged with governance was in breach of ISA 260 in the following ways:

6.18.1 The Respondents failed to: (1) communicate clearly, or at all, to the Audit Committee the disparity between the methodology used by Stagecoach's management in the JAM paper, and that used by the Audit team in the Audit Results Report which nonetheless produced precisely the same value of the required Insurance Provision; (2) alert the Audit Committee, properly or at all, to a contrary opinion in relation to management's position about the basis of a material judgmental provision; or (3) explain to the Audit Committee whether they considered both methodologies to be compliant with generally

accepted accounting principles and how the components of the two different approaches could be reconciled. This was in breach of paragraphs 16(a) and 16(d) of ISA 260.

6.18.2 The communication by the Respondents with those charged with governance, as evidenced principally by the Audit Results Report, did not: (1) contain any of the key reserving judgments in relation to: the Ogden Discount Rate, Recent UK Auto Claims Development, Burning Cost per Unit Exposure, Recent Accident Cohorts or Mesothelioma Provision; (2) provide any detail on the findings of IRAS in the Summary Memo; or (3) include any sensitivity analysis. These were “significant qualitative aspects of [Stagecoach’s] accounting practice” within the meaning of ISA 260, paragraph 16(a) which should have been communicated to the Audit Committee.

#### **ADVERSE FINDING 13: Financial Statements disclosures**

6.19 The Respondents failed to audit: (1) the movements in the Insurance Provision from the 2016 year-end to 29 April 2017; and (2) the current/non-current split of the Insurance Provision which were relevant to the disclosures in Note 23 of the Financial Statements, in breach of paragraph 20 of ISA 330.

#### **ADVERSE FINDING 14: Audit documentation**

6.20 The Respondents failed to prepare sufficient audit documentation, on a timely basis, to enable an experienced auditor, with no previous connection with the Audit, to understand the work performed by the Audit team in relation to: (1) the design and implementation of controls to ensure completeness of claims for either the PSV or CUSA components; (2) updating their understanding of processes and controls during their work at year-end (applicable to both PSV and CUSA components); (3) the precise nature of the testing of the claims file; (4) the Audit team’s consideration of management’s adjustments/overlays; and (5) the substantive work performed by IRAS or the Audit team’s response to the Summary Memo. The Respondents’ failings in this respect constituted breaches of paragraphs 7 and 8 of ISA 230.

## 7 VTEC ONEROUS CONTRACT PROVISION

### A. Introduction

7.1 The East Coast mainline franchise was awarded to [VTEC], a joint venture between Stagecoach and [JV Partner], in November 2014. Pursuant to the terms of among other agreements a Franchise Agreement between VTEC and the Department for Transport (“**DfT**”) dated 9 December 2014 (the “**Franchise Agreement**”), VTEC as Franchisee was to secure that East Coast Main Line Company Limited (“**ECML**”) as Franchise Operator would provide certain rail passenger services on the East Coast Main Line. The franchise was due to run from 1 March 2015 to 31 March 2023. The Franchise Agreement was accompanied by a Funding Deed which governed the obligations of Stagecoach as guarantor to ensure that VTEC remained financially resilient and able to satisfy its obligations under the Franchise Agreement (the “**Funding Deed**”). The franchise did not operate as expected and it began to incur losses. Unlike the previous year, by the time the Financial Statements came to be prepared by Stagecoach, the Franchise Agreement had become an onerous one for Stagecoach within the meaning of IAS 37, paragraph 68:

*“...an onerous contract is a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it. The unavoidable costs under a contract reflect the least net cost of exiting the contract, which is the lower of the cost of fulfilling it and any compensation or penalties arising from failure to fulfil it.”*

7.2 The Franchise Agreement was not assessed to be onerous at 2016 year-end or at the 2017 half-year. The Financial Statements were the first in which the Franchise Agreement was considered onerous. The Audit team documented that this was the result of further challenges in the second half of the financial year including issues arising from delays in the procurement of new rolling stock.

7.3 Under the Funding Deed, Stagecoach was committed to making a £165 million “Parent Company Shareholder Loan” (“**PCS Loan**”), available to ECML. At the 2017 year-end Stagecoach had loaned £57.5 million of this commitment, with £107.5 million remaining. Under the Funding Deed Stagecoach was not obliged to fund ECML in excess of the £165 million PCS Loan amount. In addition to the PCS Loan there were financial commitments by Stagecoach in respect of a Performance Bond and a Season Ticket Bond (the “**Bonds**”).

- 7.4 The Audit team documented that Stagecoach had made a commercial conclusion that the current Franchise Agreement was “not working for the group” and as a result the Board had determined that they would not inject further funding in excess of the £165 million PCS Loan.
- 7.5 However the Audit team were aware that as ECML progressively consumed the PCS Loan, coupled with the fact that no further funding would be injected in excess of the £165 million PCS Loan, it was “inevitable” that ECML/VTEC would breach a key financial covenant in the Franchise Agreement, namely that Forecast Modified Revenue to Forecast Operating Costs for the next 13 Reporting Periods would equal or exceed the ratio of 1.050:1 (the “**Financial Covenant**”). Breach of the Financial Covenant was an “Event of Default” under the Franchise Agreement which entitled the DfT to terminate the Franchise Agreement and to “call in” the Bonds.
- 7.6 The only contractual means or rights of terminating the Franchise Agreement were: (1) expiry on 31 March 2023; or (2) the express rights of termination afforded to the Secretary of State (i.e. the DfT). Nothing in either of the Funding Deed or the Franchise Agreement enabled VTEC or ECML to terminate the Franchise Agreement upon exhaustion of the maximum amount of the PCS Loan.
- 7.7 In June 2016, VTEC approached the DfT and sought a contractual variation to the Franchise Agreement. At the date of signature of the Financial Statements, Stagecoach was still in discussions with the DfT with a view to agreeing a new “management contract” to in effect replace the existing franchise arrangement, but the matter had not been resolved. Management assumed that the management contract would be successfully negotiated with the DfT and VTEC/Stagecoach would continue to operate the franchise.
- 7.8 In auditing this area of estimation uncertainty in the Financial Statements, the Respondents were required to evaluate the scenarios and alternative outcomes used by management in their calculation of the provision in accordance with the recognition and measurement criteria in the Applicable Accounting Framework (IAS 37). In this regard, the Respondents considered three alternative outcomes/scenarios (described as “Options 1 - 3”) and concluded that Option 3 was the most likely outcome. Under Option 3, the Franchise Agreement was terminated once the PCS Loan had been exhausted, but a new management contract was then entered into with the DfT.

- 7.9 Significantly, the calculation of the provision under Option 3 did not include the value of the Bonds because the Respondents concluded they were not “unavoidable costs” under the Franchise Agreement and did not therefore fall within the recognition and measurement criteria of IAS 37, paragraph 68. In this respect, the Respondents considered the question of ‘unavoidability’ from the position of the Secretary of State (his ability to “call” the Bonds).
- 7.10 The Audit Results Report (presented at a 22 June 2017 Audit Committee meeting) and the Financial Statements were therefore premised on the expectation that the Franchise Agreement would be renegotiated and in effect replaced by a management contract. It was stated that there would be a loss on the termination of the Franchise Agreement that had +/- £10 million estimation uncertainty but that the ongoing management contract would be profitable from 2019.
- 7.11 An £84.1 million exceptional charge was recognised in the Financial Statements to provide for anticipated losses under the current Franchise Agreement over the next two years. £44.8 million of intangible assets associated with the franchise was also written off as an exceptional charge due to the Franchise Agreement being onerous.
- 7.12 The Bonds were audited and ultimately disclosed in the Financial Statements as contingent liabilities.
- 7.13 The Audit work over the VTEC Onerous Contract Provision was documented at group level (as opposed to being part of the Rail component audit). The Audit team engaged an EY rail specialist to advise and assist in reviewing the franchise documentation, termination clauses, and challenging management.
- 7.14 In February 2018 the Secretary of State announced that VTEC “had breached a key financial covenant” and that the DfT was terminating the Franchise Agreement. No new management contract was negotiated with the DfT. Operations on the East Coast mainline were returned to public control in May 2018.
- 7.15 The 2018 Financial Statements disclosed that the DfT had terminated the franchise for default by VTEC, and that the provision included a payment in lieu of the Bonds under the Franchise Agreement, that the onerous contract provision had been increased to a level significantly in excess of the disclosed estimation uncertainty of £10 million, and that no new management contract had been awarded to VTEC.

**B. Adverse Findings**

**ADVERSE FINDING 15: Audit evidence in relation to the Bonds as contingent liabilities**

7.16 The Respondents' Audit work in relation to the Bonds as contingent liabilities breached ISAs 200, 500 and 501 in the following ways:

7.16.1 The Respondents failed to: (1) obtain sufficient appropriate audit evidence to support the assertion that a new management contract would be forthcoming (and therefore the probability of the Secretary of State calling the Bonds was considered to be unlikely) or that the selected scenario, Option 3, was the best estimate of the liability; and (2) request, review or evaluate the evidence regarding the potential claims against the DfT and/or Network Rail in relation to "infrastructure issues" which management considered might provide Stagecoach with "leverage" in their negotiations with the DfT and which supported their view that a management contract would be awarded. This constituted a breach of paragraph 6 of ISA 500, paragraphs 9 and 10 of ISA 501 and paragraph 17 of ISA 200.

7.16.2 The Respondents failed to apply proper professional scepticism to the assertions of Stagecoach's management about discussions and negotiations with the DfT and did not seek any third-party validation, which constituted a breach of paragraph 15 of ISA 200 in this regard.

**ADVERSE FINDING 16: Performing substantive procedures**

7.17 The Audit work comprising substantive procedures in this Audit area breached ISAs 330 and 540 in the following ways:

7.17.1 The Respondents failed to perform sufficient substantive procedures specifically responsive to the Significant Risk that they had identified around the VTEC Onerous Contract Provision. In particular: (1) there was insufficient work documented in the work papers as to the forecast costs included in the two-year profit forecast; (2) with regard to non-passenger revenue streams included in the 17/18 and 18/19 profit forecast there was no evidence in the work papers of any Audit procedures other than "inquiry of management"; and (3) there was no detailed work performed on forecast capital expenditure or forecast working capital. The procedures described in

that work paper in respect of capital expenditure and working capital are no more than an “inquiry” of management with no corroboration. This constituted a breach of paragraph 21 of ISA 330 (together with Application Material paragraph A53).

7.17.2 The Respondents further failed sufficiently to evaluate whether and how Stagecoach’s management had adequately addressed the effects of estimation uncertainty (sensitivity) in the passenger revenue forecasts. This represented a breach of paragraphs 15 and 16 of ISA 540.

#### **ADVERSE FINDING 17: Financial Statements disclosures**

7.18 The Audit work performed in respect of the disclosures in the Financial Statements breached ISAs 200 and 540 in the following ways:

7.18.1 By IAS 37 paragraph 86(b) Stagecoach was required to disclose for each class of contingent liability at the end of the reporting period a brief description of the nature of the contingent liability and, where practicable an indication of the uncertainties relating to the amount or timing of any outflow. The disclosures did not do so adequately and there is inadequate evidence in the work papers that the Respondents properly considered this. This represented a breach of paragraphs 19 and 20 of ISA 540.

7.18.2 The Respondents failed to apply proper professional scepticism and consider the possibility of management bias in relation to Stagecoach’s approach to disclosures concerning the Bonds. The Respondents defaulted to accepting management’s position and had not exercised sufficient professional scepticism in relation to the adequacy of the disclosures in relation to the Bonds. This was a breach of paragraph 15 of ISA 200.

#### **ADVERSE FINDING 18: Audit documentation**

7.19 The Respondents failed to prepare sufficient audit documentation, on a timely basis, to enable an experienced auditor, with no previous connection with the Audit, to understand the work performed by the Audit team in relation to the calculation of the VTEC Onerous Contract Provision. In one particular respect, the Respondents failed to document the judgments and evaluations made by the Audit team in relation to the Bonds as “unavoidable costs”, not just the (implied) conclusions. The extent, quality and accuracy of the audit documentation (which is supposed to be a detailed and

reliable contemporaneous record of the work performed by the Audit team) in respect of this area of the Audit was particularly poor. This constituted a breach of paragraphs 7 and 8 of ISA 230.

## **8 SANCTIONS - EY**

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

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

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

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

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

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

8.3 Executive Counsel imposes the following *Sanctions* against EY:

8.3.1 A fine of £3,500,000 adjusted by 10% for aggravating and mitigating factors, and discounted for admissions and early disposal by 30% so that the financial penalty payable is £2,205,000. The financial penalty shall be paid no later than 28 days after the date of this *Final Decision Notice*;

8.3.2 a published statement in the form of a severe reprimand;

8.3.3 a declaration that the Audit Report in respect of the Audit of the Financial Statements signed on behalf of EY did not satisfy the audit reporting requirements, as set out in this *Final Decision Notice*; and



- 8.3.4 a requirement that EY shall report to the FRC in respect of a number of audits (as shall be specified by the FRC), providing details of the audit work performed by EY in relation to onerous contract provisions, as well as any further information the FRC may reasonably require to enable it to assess EY's compliance with the *Relevant Requirements* in that regard.
- 8.4 In reaching this decision, the Executive Counsel has, in summary, considered the following matters in accordance with the Policy.

Nature, seriousness, gravity and duration of the breaches

- 8.5 As a result of the breaches of *Relevant Requirements*, the Audit failed in its principal objective namely to obtain reasonable assurance about whether the Financial Statements as a whole were free from material misstatement.
- 8.6 The breaches of the *Relevant Requirements* concerned a number of basic and fundamental audit concepts including:
- 8.6.1 the planning and design of the Audit including developing a suitable audit strategy and the identification and assessment of audit risks through understanding the entity and understanding and designing and performing tests of controls (ISAs 315 and 540);
- 8.6.2 obtaining sufficient appropriate audit evidence, and the design and implementation of appropriate audit procedures to obtain sufficient audit evidence in relation to source data in particular (ISAs 500, 200 and 330);
- 8.6.3 auditing accounting estimates (ISA 540);
- 8.6.4 the use of and reliance on experts (ISA 620);
- 8.6.5 communication with those charged with governance (ISA 260);
- 8.6.6 audit documentation (ISA 230); and
- 8.6.7 disclosures in financial statements (ISAs 330 and 540).
- 8.7 Many of the breaches also reflected a failure to challenge management and to exercise professional scepticism (ISA 200), which is at the heart of auditors' duties in discharging their role. The poor standard of the audit documentation maintained (which is supposed to be a thorough, clear and accurate record of the audit processes

and responses taken, and judgments and conclusions reached) is not trivial; it is of particular concern.

8.8 The breaches of *Relevant Requirements* were numerous and occurred across three significant areas of the Financial Statements (Defined Benefit Pension Obligations, Insurance Provision and VTEC Onerous Contract Provision) each involving material financial balances, and in many cases similar breaches were identified in one or more of those audit areas.

8.9 Whilst it is not alleged that the Financial Statements were in fact misstated, in aggregate the breaches:

8.9.1 Potentially adversely affected a significant number of people in the United Kingdom (such as the public, investors or other market users), and could have harmed investor, market and public confidence in the truth and fairness of the financial statements published by *Statutory Auditors* or *Statutory Audit Firms*. Stagecoach's shares were at the material time (and remain) listed on the main market of the London Stock Exchange.

8.9.2 Undermine confidence in the standards of conduct in general of *Statutory Auditors* and *Statutory Audit Firms*, and/or in Statutory Audit.

8.10 The breaches relate only to one audit year.

8.11 Executive Counsel considers that notwithstanding the remedial steps taken by EY (considered below) there is a risk that the same or similar type of breaches may reoccur, absent further deterrence in the form of *Sanctions*.

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

#### Identification of Sanction

8.13 Having assessed the nature, seriousness, gravity and duration of the breaches, Executive Counsel has identified the following combination of *Sanctions* as appropriate: a financial penalty of £3,500,000; a published statement in the form of a severe reprimand; a declaration that the Audit Report signed on behalf of EY did not satisfy the *Relevant Requirements*, as set out in this *Final Decision Notice*; and reporting requirements in respect of subsequent audits concerning onerous contract provisions.

- 8.14 Executive Counsel has then taken into account any aggravating and mitigating factors that exist (to the extent that they have not already been taken into account in relation to the seriousness of the breaches).

*Aggravating factors*

- 8.15 There are no aggravating factors that have not already been considered in the context of the seriousness of the breaches.

*Mitigating factors*

- 8.16 The FRC's AQR team conducted an inspection of the Audit in early 2018 and identified a number of audit deficiencies, which correlate with many of the breaches of *Relevant Requirements* which comprise the *Adverse Findings* in this *Final Decision Notice*. In response to AQR's inspection, EY: (i) conducted a Root Cause Analysis ("RCA") to identify how the breaches of *Relevant Requirements* had occurred; and (ii) agreed with AQR to take certain remedial steps in response to the audit deficiencies identified. EY has confirmed that those remedial actions were duly implemented in respect of the subsequent audit of Stagecoach in 2018, and that the issues identified in the RCA have fed into the firm's broader audit quality programme.
- 8.17 In light of the mitigating factors, Executive Counsel considers that a discount to the financial penalty of 10% is appropriate.
- 8.18 Executive Counsel notes that the Respondents provided a good level of cooperation throughout the investigation.

Deterrence

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

Discount for Admissions and Settlement

- 8.20 Having taken into account the admissions by EY and the stage at which those admissions were made (at an early point within Stage 1 of the case in accordance with paragraph 84 of the Policy), Executive Counsel determined that a reduction of 30% as to the financial penalty is appropriate, such that a financial penalty of £2,205,000 is payable.

### Other considerations

8.21 In accordance with paragraph 47(c) of the Policy, Executive Counsel has taken into account the size/financial resources and financial strength of EY and the effect of a financial penalty on its business, and whether any financial penalty would be covered by insurance.

## **9 SANCTIONS – MR HARVEY**

9.1 Executive Counsel imposes the following Sanctions against Mr Harvey:

9.1.1 a financial sanction of £100,000, adjusted for aggravating and mitigating factors, and which may be further discounted for admissions and early disposal by up to 30%. The financial penalty shall be paid no later than 28 days after the date of this *Final Decision Notice*; and

9.1.2 a published statement, in the form of a severe reprimand.

9.2 In reaching this decision, Executive Counsel has, in summary, considered the following stages and taken account of the following factors in accordance with the Policy.

### Nature, seriousness, gravity and duration of the breaches

9.3 The factors set out in paragraphs 8.5 to 8.12 are repeated.

### Identification of Sanction

9.4 Having assessed the nature, seriousness, gravity and duration of the breaches, Executive Counsel has identified the following combination of *Sanctions* as appropriate: a financial penalty of £100,000; and a published statement in the form of a severe reprimand.

9.5 Executive Counsel has then taken into account any aggravating and mitigating factors that exist (to the extent that they have not already been taken into account in relation to the seriousness of the breaches).

### *Aggravating factor*

9.6 Mr Harvey held a senior position with supervision responsibilities (he was the Senior Partner of EY in Scotland and head of EY's Glasgow office at the relevant time).

*Mitigating factor*

9.7 Mr Harvey has no previous adverse compliance or disciplinary record.

9.8 Executive Counsel considers that the Aggravating and Mitigating factors have a neutral overall effect on the *Sanction* imposed and no further adjustment is therefore required in this case.

Deterrence

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

Discount for Admissions and Settlement

9.10 Having taken into account the admissions by Mr Harvey (see paragraph 8.20 above) and the stage at which those admissions were made (at an early point within Stage 1 of the case in accordance with paragraph 84 of the Policy), Executive Counsel determined that a reduction of 30% as to the financial penalty is appropriate, such that a financial penalty of £70,000 is payable.

Other considerations

9.11 In accordance with paragraph 47(d) of the Policy, Executive Counsel has taken into account the financial resources and annual income of Mr Harvey, the effect of a financial penalty on Mr Harvey and his future employment, and whether he is insured as to any financial penalty.

**10 COSTS**

10.1 The Executive Counsel requires the Respondents to pay her costs in full in this matter, being £596,735. Such costs shall be paid no later than 28 days after the date of this *Final Decision Notice*.

*Edited for publication*

**SIGNED:**

[...]

**CLAUDIA MORTIMORE**

**DEPUTY EXECUTIVE COUNSEL**

**DATE: 30 JUNE 2021**

## APPENDIX

### EXTRACTS OF RELEVANT REQUIREMENTS

<b>ISA 200</b>	
<b>Paragraph 15</b>	The auditor shall plan and perform an audit with professional scepticism recognising that circumstances may exist that cause the financial statements to be materially misstated. (Ref: Para. A18-22)
<b>Paragraph 17</b>	To obtain reasonable assurance, the auditor shall obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion. (Ref: Para. A28-A52)
<b>ISA 220</b>	
<b>Paragraph 16</b>	The engagement partner shall take responsibility for reviews being performed in accordance with the firm's review policies and procedures. (Ref: Para. A16-A17, A20)
<b>Paragraph 17</b>	On or before the date of the auditor's report, the engagement partner shall, through a review of the audit documentation and discussion with the engagement team, be satisfied that sufficient appropriate audit evidence has been obtained to support the conclusions reached and for the auditor's report to be issued. (Ref: Para. A18-A20)
<b>ISA 230</b>	
<b>Paragraph 7</b>	The auditor shall prepare audit documentation on a timely basis. (Ref: Para. A1)
<b>Paragraph 8</b>	The auditor shall prepare audit documentation that is sufficient to enable an experienced auditor, having no previous connection with the audit, to understand: (Ref: Para. A2-A5, A16-A17) <ul style="list-style-type: none"> <li>(a) The nature, timing and extent of the audit procedures performed to comply with the ISAs (UK and Ireland) and applicable legal and regulatory requirements; (Ref: Para. A6-A7)</li> <li>(b) The results of the audit procedures performed, and the audit evidence obtained; and</li> <li>(c) Significant matters arising during the audit, the conclusions reached thereon, and significant professional judgments made in reaching those conclusions. (Ref: Para. A8-A11)</li> </ul>
<b>Paragraph 11</b>	If the auditor identified information that is inconsistent with the auditor's final conclusion regarding a significant matter, the auditor shall document how the auditor addressed the inconsistency. (Ref: Para. A15)
<b>ISA 260</b>	
<b>Paragraph 16</b>	The auditor shall communicate to those charged with governance (Ref: Para. A16):

	<p>(a) The auditor’s views about significant qualitative aspects of the entity’s accounting practices, including accounting policies, accounting estimates and financial statement disclosures. When applicable, the auditor shall explain to those charged with governance why the auditor considers a significant accounting practice, that is acceptable under the applicable financial reporting framework, not to be most appropriate to the particular circumstances of the entity.(Ref: Para. A17)</p> <p>(b) Significant difficulties, if any, encountered during the audit (Ref: Para. A18)</p> <p>(c) Unless those charged with governance are involved in managing the entity:</p> <p>(i) Significant matters, if any, arising from the audit that were discussed, or subject to correspondence with management; and (Ref: Para. A19)</p> <p>(ii) Written representations the auditor is requesting; and</p> <p>(d) Other matters, if any, arising from the audit that, in the auditor’s professional judgment, are significant to the oversight of the financial reporting process. (Ref: Para. A20)</p>
<b>ISA 315</b>	
<b>Paragraph 13</b>	<p>When obtaining an understanding of controls that are relevant to the audit, the auditor shall evaluate the design of those controls and determine whether they have been implemented, by performing procedures in addition to inquiry of the entity’s personnel. (Ref: Para. A.73-75)</p>
<b>Paragraph 18(b)</b>	<p>The auditor shall obtain an understanding of the information system, including the related business processes, relevant to financial reporting, including the following areas:</p> <p>(a) [...]</p> <p>(b) The procedures, within both information technology (IT) and manual systems, by which those transactions are initiated, recorded, processed, corrected as necessary, transferred to the general ledger and reported in the financial statements; [...].</p>
<b>Paragraph 26(c)</b>	<p><i>25. The auditor shall identify and assess the risks of material misstatement at:</i></p> <p><i>(a) the financial statement level; and (Ref: Para. A118-A121)</i></p> <p><i>(b) the assertion level for classes of transactions, account balances, and disclosures (Ref: Para. A122-A126)</i></p> <p><i>to provide a basis for designing and performing further audit procedures.</i></p> <p>26. For this purpose, the auditor shall:</p>



	<ul style="list-style-type: none"> <li>(a) Identify risks throughout the process of obtaining an understanding of the entity and its environment, including relevant controls that relate to the risks, and by considering the classes of transactions, account balances, and disclosures in the financial statements; (Ref: Para. A127-A128)</li> <li>(b) Assess the identified risks, and evaluate whether they relate more pervasively to the financial statements as a whole and potentially affect many assertions;</li> <li>(c) Relate the identified risks to what can go wrong at the assertion level, taking account of relevant controls that the auditor intends to test; and (Ref: Para. A129-A131)</li> <li>(d) Consider the likelihood of misstatement, including the possibility of multiple misstatements, and whether the potential misstatement is of a magnitude that could result in a material misstatement.</li> </ul>
<b>Paragraph 29</b>	If the auditor has determined that a significant risk exists, the auditor shall obtain an understanding of the entity's controls, including control activities, relevant to that risk. (Ref: Para. A137-A139)
<b>ISA 330</b>	
<b>Paragraph 8(a)</b>	<p>The auditor shall design and perform tests of controls to obtain sufficient appropriate audit evidence as to the operating effectiveness of relevant controls if:</p> <ul style="list-style-type: none"> <li>(a) The auditor's assessment of risks of material misstatement at the assertion level includes an expectation that the controls are operating effectively (that is, the auditor intends to rely on the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures); or</li> <li>(b) Substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level. (Ref: Para. A20-A24)</li> </ul>
<b>Paragraph 18</b>	Irrespective of the assessed risks of material misstatement, the auditor shall design and perform substantive procedures for each material class of transactions, account balance and disclosure (Ref: Para. A42-47)
<b>Paragraph 20</b>	<p>The auditor's substantive procedures shall include the following audit procedures related to the financial statement closing process:</p> <ul style="list-style-type: none"> <li>(a) Agreeing or reconciling information in the financial statements with the underlying accounting records, including agreeing or reconciling information in disclosures, whether such information is obtained from within or outside of the general and subsidiary ledgers; and</li> <li>(b) Examining material journal entries and other adjustments made during the course of preparing the financial statements. (Ref: Para A52)</li> </ul>
<b>Paragraph 21</b>	If the auditor has determined that an assessed risk of material misstatement at the assertion level is a significant risk, the auditor shall perform substantive procedures that are specifically responsive to that

	risk. When the approach to significant risk consists only of substantive procedures, those procedures shall include tests of details (Ref: Para. A53)
<b>Paragraph 26</b>	The auditor shall conclude whether sufficient appropriate audit evidence has been obtained. In forming an opinion, the auditor shall consider all relevant audit evidence, regardless of whether it appears to corroborate or to contradict the assertions in the financial statements. (Ref: Para. A62)
<b>ISA 500</b>	
<b>Paragraph 6</b>	The auditor shall design and perform audit procedures that are appropriate in the circumstances for the purpose of obtaining sufficient appropriate audit evidence. (Ref: Para. A1-A25)
<b>Paragraph 8</b>	<p>If information to be used as audit evidence has been prepared using the work of a management's expert, the auditor shall, to the extent necessary, having regard to the significance of that expert's work for the auditor's purposes: (Ref: Para. A34-A36)</p> <ul style="list-style-type: none"> <li>(a) Evaluate the competence, capabilities and objectivity of that expert; (Ref: Para. A37-A43)</li> <li>(b) Obtain an understanding of the work of that expert; and (Ref: Para. A44-A47)</li> <li>(c) Evaluate the appropriateness of that expert's work as audit evidence for the relevant assertion (Ref: Para. A48)</li> </ul>
<b>Paragraph 10</b>	When designing tests of controls and tests of details, the auditor shall determine means of selecting items for testing that are effective in meeting the purpose of the audit procedure. (Ref: Para. A52-A56)
<b>Paragraph 11</b>	<p>If:</p> <ul style="list-style-type: none"> <li>(a) audit evidence obtained from one source is inconsistent with that obtained from another; or</li> <li>(b) the auditor has doubts about reliability of information to be used as audit evidence,</li> </ul> <p>he shall determine what modifications or addition to procedures are necessary to resolve the matter and shall consider the effect of the matter, if any, on other aspects of the audit (Ref: Para. A57)</p>
<b>ISA 501</b>	
<b>Paragraph 9</b>	<p>The auditor shall design and perform audit procedures in order to identify litigation and claims involving the entity which may give rise to a risk of material misstatement, including: (Ref: Para. A17-A19)</p> <ul style="list-style-type: none"> <li>(a) Inquiry of management and, where applicable, others within the entity, including in-house legal counsel;</li> </ul>

	<p>(b) Reviewing minutes of meetings of those charged with governance and correspondence between the entity and its external legal counsel; and</p> <p>(c) Reviewing legal expense accounts. (Ref: Para. A20)</p>
<b>Paragraph 10</b>	<p>If the auditor assesses a risk of material misstatement regarding litigation or claims that have been identified, or when audit procedures performed indicate that other material litigation or claims may exist, the auditor shall, in addition to the procedures required by other ISAs (UK and Ireland), seek direct communication with the entity's external legal counsel. The auditor shall do so through a letter of inquiry, prepared by management and sent by the auditor, requesting the entity's external legal counsel to communicate directly with the auditor. If law, regulation or the respective legal professional body prohibits the entity's external legal counsel from communicating directly with the auditor, the auditor shall perform alternative audit procedures. (Ref: Para. A21-A25)</p>
<b>ISA 530</b>	
<b>Paragraph 8</b>	<p>The auditor shall select items for the sample in such a way that each sampling unit in the population has a chance of selection. (Ref: Para. A12-13)</p>
<b>ISA 540</b>	
<b>Paragraph 8</b>	<p>When performing risk assessment procedures and related activities to obtain an understanding of the entity and its environment, including the entity's internal control, as required by ISA (UK and Ireland) 315, the auditor shall obtain an understanding of the following in order to provide a basis for the identification and assessment of the risks of material misstatement for accounting estimates: (Ref: Para A12)</p> <ul style="list-style-type: none"> <li>(a) The requirements of the applicable financial reporting framework relevant to accounting estimates, including related disclosures. (Ref: Para. [A13-A15])</li> <li>(b) How management identifies those transactions, events and conditions that may give rise to the need for accounting estimates to be recognized or disclosed in the financial statements. In obtaining this understanding, the auditor shall make inquiries of management about changes in circumstances that may give rise to new, or the need to revise existing, accounting estimates. (Ref: Para. A16-A21)</li> <li>(c) How management makes the accounting estimates, and an understanding of the data on which they are based, including: (Ref: Para. A22-A23) <ul style="list-style-type: none"> <li>(i) the method, including where applicable the model, used in making the accounting estimate; (Ref: Para. A24-A26)</li> <li>(ii) Relevant controls; (Ref: Para. A27-A28)</li> <li>(iii) Whether management has used an expert; (Ref: Para. A29-A30)</li> </ul> </li> </ul>

	<ul style="list-style-type: none"> <li>(iv) The assumptions underlying the accounting estimates; (Ref: Para. A31-A36)</li> <li>(v) Whether there has been or ought to have been a change from the prior period in the methods for making the accounting estimates, and if so, why; and (Ref: Para. A37)</li> </ul> <p>Whether and, if so, how management has assessed the effect of estimation uncertainty. (Ref: Para. A38)</p>
<b>Paragraph 15</b>	<p>For accounting estimates that give rise to significant risks, in addition to other substantive procedures performed to meet ISA (UK and Ireland) 330, the auditor shall evaluate the following (Ref: Para.A102):</p> <ul style="list-style-type: none"> <li>(a) How management considered alternative assumptions or outcomes and why it rejected them, or how management has otherwise addressed estimation uncertainty in making the accounting estimate (Ref: Para. A103-106);</li> <li>(b) Whether the significant assumptions used by management are reasonable. (Ref: Para. A107-109)</li> <li>(c) Where relevant to the reasonableness of the significant assumptions used by management or the appropriate application of the applicable financial reporting framework, management's intent to carry out specific courses of action and its ability to do so. (Ref para A110)</li> </ul>
<b>Paragraph 16</b>	<p>If, in the auditor's judgment, management has not adequately addressed the effects of estimation uncertainty on the accounting estimates that give rise to significant risks, the auditor shall, if considered necessary, develop a range with which to evaluate the reasonableness of the accounting estimate. (Ref: Para. A.111-112)</p>
<b>Paragraph 17</b>	<p>For accounting estimates that give rise to significant risks, the auditor shall obtain sufficient appropriate audit evidence about whether:</p> <ul style="list-style-type: none"> <li>(a) management's decision to recognize, or to not recognize, the accounting estimates in the financial statements; and (Ref: Para. A113-A114)</li> <li>(b) the selected measurement basis for the accounting estimates, (Ref: Para. A115) are in accordance with the requirements of the applicable financial reporting framework.</li> </ul>
<b>Paragraph 19</b>	<p>The auditor shall obtain sufficient appropriate audit evidence about whether the disclosures in the financial statements related to accounting estimates are in accordance with the requirements of the applicable financial reporting framework. (Ref: Para. A120-A121)</p>
<b>Paragraph 20</b>	<p>For accounting estimates that give rise to significant risks, the auditor shall also evaluate the adequacy of the disclosure of their estimation uncertainty in the financial statements in the context of the applicable financial reporting framework. (Ref: para. A122-A123)</p>

<b>Paragraph 21</b>	The auditor shall review the judgments and decisions made by management in the making of accounting estimates to identify whether there are indicators of possible management bias. Indicators of possible management bias do not themselves constitute misstatements for the purposes of drawing conclusions on the reasonableness of individual accounting estimates. (Ref: Para. A124-A125)
<b>ISA 620</b>	
<b>Paragraph 7</b>	If expertise in a field other than accounting or auditing is necessary to obtain sufficient appropriate audit evidence, the auditor shall determine whether to use the work of an auditor's expert. (Ref: Para. A4-A9)
<b>Paragraph 9</b>	The auditor shall evaluate whether the auditor's expert has the necessary competence, capabilities and objectivity for the auditor's purposes. In the case of an auditor's external expert, the evaluation of objectivity shall include inquiry regarding interests and relationships that may create a threat to that expert's objectivity. (Ref: Para. A14-A20)
<b>Paragraph 10</b>	<p>The auditor shall obtain a sufficient understanding of the field of expertise of the auditor's expert to enable the auditor to: (Ref: Para. A21-A22)</p> <ul style="list-style-type: none"> <li>(a) Determine the nature, scope and objectives of that expert's work for the auditor's purposes; and</li> <li>(b) Evaluate the adequacy of that work for the auditor's purposes.</li> </ul>
<b>Paragraph 12</b>	<p>The auditor shall evaluate the adequacy of the auditor's expert's work for the auditor's purposes, including: (Ref: Para. A32)</p> <ul style="list-style-type: none"> <li>(a) The relevance and reasonableness of that expert's findings or conclusions, and their consistency with other audit evidence; (Ref: Para. A33-A34)</li> <li>(b) If that expert's work involves use of significant assumptions and methods, the relevance and reasonableness of those assumptions and methods in the circumstances; and (Ref: Para. A35-A37)</li> <li>(c) If that expert's work involves the use of source data that is significant to that expert's work, the relevance, completeness, and accuracy of that source data. (Ref: Para. A38-A39)</li> </ul>