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# The FRC's enquiries and investigation of KPMG's 2007 and 2008 audits of HBOS

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# 1 Executive Summary

- 1.1 HBOS plc (HBOS) failed on 1 October 2008 just over seven months after KPMG Audit plc (KPMG) gave an unqualified audit opinion on its 31 December 2007 financial statements on 26 February 2008. The FRC made a commitment to the Treasury Select Committee to publish a report explaining its scrutiny of KPMG's audits of HBOS' 2007 and 2008 financial statements. This report fulfils that commitment and, in addition, sets out the lessons that the FRC has learnt from its own scrutiny of its work on this particular matter, its enforcement procedures generally and the commentary of stakeholders.
- 1.2 This report explains what the FRC did in relation to KPMG's audit work of the HBOS 2007 and 2008 financial statements under the FRC's Accountancy Scheme and a Supervisory Inquiry. To assist in understanding the detail set out at Section 5, Sections 2 to 4 provide a brief summary of the background, the relevant accounting and audit standards and the provisions of the Accountancy Scheme. Section 6 of the report explains how conflicts of interest were declared and managed within the FRC. Finally, section 7 explains the lessons learnt by the FRC including as a result of the enquiries and investigation of KPMG's audits of HBOS and the actions or changes made or proposed by the FRC.

## ***Work undertaken by the FRC***

- 1.3 From December 2008 to September 2017 the FRC monitored, enquired into and/or investigated matters related to KPMG's 2007 and 2008 audits. This included:
- *2009 and 2010: Monitoring and review.* This included consideration of the financial statements of HBOS and liaison with the Financial Services Authority (FSA) and the accountancy bodies;
  - *September 2009 and November 2010: Considerations by the Accountancy & Actuarial Discipline Board (AADB) of whether to investigate the conduct of KPMG under the Accountancy Scheme.* No decisions to investigate were made;
  - *April 2013: Consideration by the Conduct Committee:* The Conduct Committee approved the commencement of a Supervisory Inquiry to obtain and review information in relation to the audit work on loan loss provisioning at HBOS;
  - *April to October 2013: Supervisory Inquiry.* This involved liaison with the Financial Conduct Authority (FCA) and Prudential Regulation Authority (PRA) and a substantive paper review including of the KPMG audit files, information provided by Lloyds Banking Group plc (LBG) and their auditors, reports published by other regulators and Parliament and other publicly available information;
  - *November 2013: Consideration by the Conduct Committee of the report of the Supervisory Inquiry and whether to investigate the conduct of KPMG in relation to its audit work on loan loss provisions under the Accountancy Scheme.* The Conduct Committee decided that, whilst the public interest test had been met, on balance, the evidential test (i.e. whether there were reasonable grounds to suspect there may have been "Misconduct") had not been met. Accordingly, an investigation under the Scheme was not opened;
  - *December 2013: Thematic review into bank audits announced.* Observations by the FRC as to the nature and extent of KPMG's audit procedures on loan

loss provisions had also been made in its inspection of bank audits performed by the other major audit firms. The FRC announced a thematic review of the audits of a number of banks to prompt improvement. That review was published in December 2014;

- *December 2015: Review of the FCA and PRA Report published in 2015: The failure of HBOS plc (the FCA/PRA 2015 Report).* The Conduct Committee concluded that the report contained no new information in connection with KPMG's audit of loan loss provisions but that it contained additional information relating to the issue of going concern. The Conduct Committee directed the Executive Counsel to carry out preliminary enquiries under the Scheme;
- *January to June 2016: Preliminary enquiries conducted by the Executive Counsel under the Accountancy Scheme.* The preliminary enquiries involved the review of published information, the audit working papers and interviews with KPMG personnel;
- *June 2016: Consideration by the Conduct Committee of the outcome of the preliminary enquiries.* The Conduct Committee decided to direct the Executive Counsel to commence an investigation. The scope of the investigation was the extent to which KPMG considered the appropriateness of management's use of the going concern assumption in the preparation of HBOS's 2007 financial statements and the disclosure of material uncertainties about HBOS' ability to continue as a going concern;
- *June 2016 to September 2017: Investigation under the Accountancy Scheme.* The investigation conducted by the Executive Counsel involved the detailed review of material including the KPMG audit files, confidential regulator material and evidence as to market and financial conditions at the time of KPMG's audit. The Executive Counsel obtained an opinion from an independent audit expert as to whether the conduct of KPMG fell significantly short of the standards reasonably to be expected of them and he also had the benefit of advice from two leading counsel as to whether the evidential test had been met;
- *September 2017: Closure of investigation by the Executive Counsel.* The Executive Counsel presented his detailed report of the findings and the closure of the investigation to the Conduct Committee. The closure of the investigation followed the Executive Counsel's conclusion that there was no realistic prospect that a disciplinary tribunal would make a finding that KPMG's conduct had fallen significantly short of the standards reasonably to be expected of them.

### **Lessons Learnt**

- 1.4 Whilst much work was undertaken in the period between 2009 and 2013, we were not sufficiently proactive in making enquiries in relation to the HBOS audit and relied too heavily on the work of the FSA and the FCA/PRA and on the information provided by them. The FSA was the lead regulator in relation to the banks but it was not right to regard them as the lead regulator in relation to audit. We should have adopted a more proactive role and acted more quickly.
- 1.5 We now take the lead in responding to and investigating audit matters. This approach has been strengthened by the implementation of the EU Audit Regulation and Directive, which gave the FRC, as the designated competent authority for statutory audit in the UK, additional information seeking powers. We have also invested significantly in the resources of our Enforcement Division, to enhance its speed and effectiveness.

- 1.6 In view of the definition of Misconduct, the evidential threshold for taking action against auditors under the Accountancy Scheme was high and did not necessarily allow for holding auditors to account for poor quality audits. This was not entirely consistent with our mission to promote quality and with our wider work in relation to standards, guidance and audit quality review, all of which have the promotion of audit quality at their core. As the competent authority for statutory audit in the UK, we now have direct responsibility for determining, monitoring and enforcing auditing standards. In readiness for our designation as the competent authority, we developed our Audit Enforcement Procedure (the Procedure), which replaced the Accountancy Scheme for audit matters coming to our attention after June 2016. The new Procedure provides a single, streamlined procedure to deal with the full range of audit enforcement based on breach of a relevant requirement which includes auditing standards. Accordingly, the scope of the Procedure ranges from simple “misdemeanour” breaches to breaches which are so serious that they would previously have fallen into the “misconduct” category.
- 1.7 Public interest in and criticism of the outcome of our enquiries and investigation has highlighted a concern that we do not sufficiently explain the reasons for our decisions to close cases. In future, where there is a clear public interest to do so and subject to any applicable legal restraints, we will publish a summary of our reasons for closing an investigation.
- 1.8 Our structure, the Code of Conduct and the design of our enforcement procedures provide for independence of decision-making, free from conflicts of interest. We have, throughout our enquiries and investigation, required all potential decision-makers to declare whether they have relevant interests and to withdraw from the meeting for the relevant discussion and decision where their interests may conflict. Whilst we are satisfied that conflicts of interest have been managed appropriately in this case, the extensive interest and public comment on the outcome of our enquiries and investigation has highlighted the need for increased transparency to promote public confidence. In order to address these concerns, we have updated the Code of Conduct and published a Register of Interests.
- 1.9 There has also been wider commentary on our governance structure, which was established following public consultation in 2012. During 2017, in line with good practice, we started a review of our governance, including our governance structure. This review continues and includes consideration of any necessary changes to reflect developments in our public body status and to respond to changing public expectations.
- 1.10 This report focuses on the work undertaken in relation to our enquiries and investigations. However, our ongoing supervisory work, conducted through standard setting and audit inspection, is fundamental to promoting audit quality. The FRC responded to public expectation that auditors should consistently conduct high quality audits by increasing its audit quality review activities, and we now carry out and publish thematic reviews to raise standards in targeted areas such as the 2014 thematic review on banks and building societies. We have also set targets for stronger performance and expect these to be met. Audits that do not meet our expectations are subject to remedial plans, further supervision and are considered for enforcement action. In addition, we are increasing our focus on leadership in audit firms, firm culture and the effectiveness of the firms’ international networks. We also plan to review with others the scope of audit to assess whether it should be adapted better to meet public expectation.

## 2 Summary Background: HBOS and the contemporaneous banking and financial conditions

- 2.1 HBOS was formed in 2001 from the merger of Halifax plc and The Governor and Company of the Bank of Scotland. In the period from 1 January 2007 to March 2008, HBOS pursued an aggressive corporate loan growth strategy through its Corporate Division and expansion of its International Division. This resulted in high one-off exposures and high portfolio exposures to the corporate real estate sector.
- 2.2 To assist in putting the events of the time and KPMG's audit work into context, we used the overview of the three phases of the financial crisis contained in the report by Ian Plenderleith published in October 2012: *Review of the Bank of England Provision of Emergency Liquidity Assistance in 2008-09*<sup>1</sup> (extracts of which are set out in Appendix 1). The first phase ran from mid-2007 through to the provision of Bank of England liquidity to, and the run on, Northern Rock plc (Northern Rock) in September 2007. The second phase ran from then until the failure of Lehman Brothers Holdings Inc (Lehmans) in September 2008. That collapse precipitated the third, and most damaging, phase of the crisis leading to the rescue of HBOS and The Royal Bank of Scotland Group plc (RBS) by the UK Government.
- 2.3 The timing of events and the impact on HBOS is of particular relevance to KPMG's 2007 audit and our consideration of it:
- In September 2007 the Bank of England provided liquidity to, and there was a run on, Northern Rock;
  - In March 2008 HBOS was rumoured to be under severe strain and its share price fell;
  - In April 2008 HBOS announced a £4 billion rights issue and started to access the Bank of England's Special Liquidity Scheme;
  - By July 2008 take up of the rights issue was minimal;
  - On 15 September 2008 Lehmans failed, HBOS customers started to withdraw deposits and HBOS could only access overnight funding;
  - Three days after Lehmans failed, Lloyds TSB Group plc announced it was taking over HBOS to form LBG;
  - HBOS customers continued to withdraw deposits. On 1 October 2008, seven months after KPMG signed its audit opinion, HBOS drew down on Bank of England emergency liquidity assistance and was subsequently deemed by the FSA in its report to have "failed" at that point. HBOS' use of the emergency liquidity assistance facility peaked, in terms of the market value of bills lent at £25.4 billion, on 13 November 2008;
  - HBOS made final repayment of the facility on 16 January 2009.
- 2.4 KPMG's 2007 audit opinion was signed on 26 February 2008. The audit was therefore carried out during the first and second phases of the crisis, and concluded before the "intensification" of the second phase, marked by the events in March and April 2008.

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<sup>1</sup> Review of the Bank of England's provision of emergency liquidity assistance in 2008-09. Report by Ian Plenderleith, October 2012.

The failure of HBOS occurred during the third phase, when the severity of the crisis further intensified after the failure of Lehmans.

- 2.5 There is little evidence that, at the date of KPMG's 2007 opinion, the further intensification of the financial crisis was expected by market participants. Indeed, there is good evidence that during the period from August 2007 to February 2008 the possibility that HBOS, or indeed any other financial institutions, could fail was seen as remote.
- 2.6 On 13 February 2009 LBG announced that significant additional impairments ("loan loss provisions") had been required on the corporate lending portfolios "*as a result of applying a more conservative provisioning methodology consistent with that used by Lloyds TSB, and reflecting the acceleration in the deterioration in the economy*"<sup>2</sup>. No prior year restatement was made indicating that LBG concluded that the 2007 financial statements were not materially misstated.
- 2.7 HBOS' financial statements for the year ended 31 December 2008, the last year that KPMG were auditors, were approved by the HBOS Board of Directors and signed by KPMG on 26 February 2009. The level of loan loss provisions recognised was increased from £3.4 billion at 31 December 2007 to approximately £10.7 billion at 31 December 2008, of which £5.8 billion related to HBOS' Corporate Division.
- 2.8 Between 2008 and 2011 HBOS recognised further impairments of £52.6 billion in respect of its £522 billion of loans and advances at the end of 2008. HBOS comprised a number of business divisions, with £21.9 billion and £15.5 billion of these impairments recognised in its worst performing divisions, Corporate and International respectively<sup>3</sup>.

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<sup>2</sup> The LBG trading statement is accessible here:  
[http://www.lloydsbankinggroup.com/globalassets/documents/investors/2009/2009feb13\\_lbg\\_trading\\_statement.pdf](http://www.lloydsbankinggroup.com/globalassets/documents/investors/2009/2009feb13_lbg_trading_statement.pdf)

<sup>3</sup> Source: Table 1.2: HBOS Group recognised impairment in the income statement 2008 to 2011, The failure of HBOS plc, A report by the FCA and PRA.



### 3 Accounting Requirements and Auditing Standards

#### The objective of audit

- 3.1 The auditor's overall objective is to obtain reasonable assurance about whether the financial statements, as a whole, are prepared, in all material respects, in accordance with an applicable financial reporting framework and are free from material misstatement.
- 3.2 Although the auditor's opinion enhances the credibility of the financial statements, the user cannot take the audit opinion as assurance of the future viability of the entity or of the efficiency or effectiveness with which management has conducted the affairs of the entity.
- 3.3 Throughout their work the auditor is expected to apply the concept of professional scepticism.
- “an attitude that includes a **questioning mind**, being alert to conditions which may indicate possible misstatement due to error or fraud, and a **critical assessment of audit evidence**” (ISA 200) [Emphasis added.]*
- 3.4 The rest of this section explains key aspects of reporting requirements and audit standards relating to loan loss provisions and going concern to assist understanding of the FRC's enquiries and investigation of KPMG's audit work in those areas as set out in section 5. Appendix 2 provides extracts of the accounting and auditing standards referred to below.

#### Reporting requirements

- 3.5 As a listed company preparing consolidated financial statements, HBOS management was required by law to prepare financial statements that reported under International Financial Reporting Standards (IFRS) adopted for use in the European Union, which incorporated International Accounting Standards (IAS).
- 3.6 KPMG's audit was conducted under International Standards on Auditing (UK and Ireland) (ISAs) that were extant prior to their clarification in 2009.
- 3.7 In carrying out their audit, KPMG would be reaching a view under auditing standards as to whether the financial statements prepared by HBOS management gave a true and fair view. In doing so, KPMG had regard to the relevant accounting standards, in particular:
- Under the relevant accounting standard (IAS 39) used by management to prepare the financial statements, loan loss provisions could only be recognised once a loss had been incurred;
  - Companies are required by law to prepare their financial statements on a going concern basis unless it is inappropriate to presume the group or the company will continue in business. Accounting standards (IAS 1) require management to make an assessment of the company's ability to continue as a going concern and to disclose in the financial statements any material uncertainties related to events or conditions that may cast significant doubt on the company's ability to continue as a going concern. Accounting standards and auditing standards in combination give

effect that the assessment should take into account all available information about the future which is at least, but not limited to, twelve months from the date of the approval of the financial statements.

- 3.8 The two key matters considered during the FRC's enquiries and Investigations were KPMG's audit work under ISAs to:
- evaluate, based on the audit evidence, whether the loan loss provisions in HBOS' financial statements were reasonable in the context of the financial reporting framework (ISA 540)<sup>4</sup>;
  - consider the appropriateness of HBOS management's use of the going concern assumption in the preparation of the financial statements and whether there were material uncertainties about HBOS' ability to continue as a going concern that needed to be disclosed in the financial statements (ISA 570)<sup>5</sup>.

### Loan loss provisioning

- 3.9 For the 2007 financial statements, estimating provisions for loan losses required HBOS management to comply with IAS 39 "Financial Instruments: Recognition and Measurement", determining:
- (a) When impairment losses on loans should be booked (i.e. recognised); and
  - (b) How the amount of such losses should be calculated (i.e. measured).
- 3.10 When HBOS prepared the December 2007 financial statements this was the third year of preparation under IAS 39. In simple terms, the main objective of the relevant requirements of IAS 39 was to ensure that losses that had been incurred at the balance sheet date were recognised in the financial statements (see added emphasis in the extracts from IAS 39 at Appendix 2).
- 3.11 This was different from the requirements previously when estimates of expected losses could be made. Previous approaches allowed the build-up of general provisions which could then be used to smooth earnings and performance in a downturn.
- 3.12 Implementation Guidance notes to IAS 39 state that "*Other factors that an entity considers in determining whether it has objective evidence that an impairment loss has been incurred include information about the debtors' or issuers' liquidity, solvency and business and financial risk exposures, levels of and trends in delinquencies for similar financial assets, national and local economic trends and conditions, and the fair value of collateral and guarantees. These and other factors may, either individually or taken together, provide sufficient objective evidence that an impairment loss has been incurred in a financial asset or group of financial assets.*"
- 3.13 These estimates are often made in conditions of uncertainty regarding the outcome of events that have occurred or are likely to occur. There is significant judgement and complexity involved in management's assessment of whether there is any objective

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<sup>4</sup> ISA (UK&I) 540 Audit of Accounting Estimates (2004).

<sup>5</sup> ISA (UK&I) 570 Going concern (2004).

evidence that loan impairment has been incurred. This was particularly the case during the financial crisis and this was the first time that the provisions of IAS 39 were tested in such adverse financial conditions.

- 3.14 Whilst management is responsible for making accounting estimates included in financial statements, ISA 540 requires the auditor to evaluate management's estimates and judgements made in determining the amounts to be included in the financial statements and to obtain sufficient appropriate audit evidence regarding accounting estimates.
- 3.15 The auditor's procedures would include evaluating and challenging whether the data on which management based the estimate is accurate, complete and relevant; whether the data collected is appropriately analysed and projected to form a reasonable basis for determining the accounting estimate and whether the entity has an appropriate base for the principal assumptions used in the accounting estimate.
- 3.16 The auditor makes a final assessment of the reasonableness of management's accounting estimates based on the auditor's understanding of the entity and its environment and whether the estimates are consistent with other audit evidence obtained during the audit.
- 3.17 We set out in section 7 how accounting standards for loan loss provisions have since developed.

### **Going concern**

- 3.18 Companies are required by law to prepare their financial statements on a going concern basis unless it is inappropriate to presume the group or the company will continue in business. The auditors' responsibility is to evaluate management's assessment of going concern and determine how those charged with governance have satisfied themselves on going concern. Extracts from IAS 1 and ISA 570 are at Appendix 2.
- 3.19 As set out in IAS 1, the going concern assumption is a fundamental principle in the preparation of the financial statements. Under the going concern assumption, an entity is ordinarily viewed as continuing in business for the foreseeable future with neither the intention nor the necessity of liquidation, ceasing trading or seeking protection from creditors pursuant to law and regulations. Accordingly assets and liabilities are recorded on the basis that the entity will be able to realise its assets and discharge its liabilities in the normal course of business. IAS 1 (paragraph 26) sets out that management takes into account all available information about the future, which is at least, but not limited to, twelve months from the end of the reporting period.
- 3.20 Auditing standards (ISA 570) state that under the going concern assumption, an entity is ordinarily viewed as continuing in business for the foreseeable future with neither the intention nor the necessity of liquidation, ceasing trading or seeking protection from creditors pursuant to laws or regulations.
- 3.21 The ISAs provide that the auditor should consider the appropriateness of management's use of the going concern assumption and consider whether there are material uncertainties about the entity's ability to continue as a going concern that need

to be disclosed in the financial statements. If the period of the directors assessment is less than one year from the date of approval of the financial statements and the directors have not disclosed that fact the auditor is required to do so in the auditor's report.

- 3.22 The key judgements required of the auditor concern whether there are events or conditions and related business risks which may cast significant doubt on the entity's ability to continue as a going concern and, where the auditor identifies the existence of "events or conditions", the auditor is required to carry out further procedures. UK guidance on the audit of banks provides guidance in respect of the audit of going concern: the auditor may consider capital adequacy ratios, operations/profitability indicators, liquidity indicators, and reputational and other indicators.
- 3.23 We explored what is meant by "going concern" after the financial crisis and the FRC asked Lord Sharman<sup>6</sup> to look into this. The Sharman Inquiry "Going concern and liquidity risks: lessons for companies and auditors"<sup>7</sup> reported in June 2012 that "... *there is considerable scope for differing interpretations about what constitutes a going concern.*"
- 3.24 The Sharman Inquiry also stated:

***"that liquidity support from central banks may be a normal funding source for a bank and therefore reliance on such support if reasonably assured, does not mean that the bank is not a going concern or that material uncertainty disclosures or an emphasis of matter paragraph are required."***;

*and*

***"Under [the] criteria [in each of IAS 1, FRS 18, ISA 570 and the Companies Act], use of the going concern basis of accounting does not require or imply a high degree of certainty that the entity will in fact avoid liquidation and that it will not cease trading. The going concern basis of accounting will, in effect, always be used unless liquidation is in process or imminent, conditions that are in fact rare. The Panel believes that this is the appropriate approach. The Panel also notes that these criteria are in fact criteria for when the 'break-up' or 'liquidation' basis of accounting is appropriate."*** [Emphasis added.]

- 3.25 The Sharman Inquiry led to the FRC issuing separate updated reporting requirements relating to risk management, going concern and viability; including separate going concern guidance for banks and their auditors, in November 2013.

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<sup>6</sup> Lord Sharman was a former KPMG partner and KPMG UK's senior partner until 1999.  
<sup>7</sup> The report is accessible here: <http://www.frc.org.uk/getattachment/4a7f9880-0158-4cf0-b41e-b9e1bf006bd7/Sharman-Inquiry-final-report-FINAL.pdf>

## **4 Supervisory Inquiries and the Accountancy Scheme**

- 4.1 Section 5 sets out the FRC's enquiries and investigation of KPMG's audit work in relation to HBOS. The section includes various references to a Supervisory Inquiry and to decisions to investigate, investigations and preliminary enquiries under the Accountancy Scheme (the Scheme). This section explains the background to the Scheme and those various references.

### ***Development and adoption of the Accountancy Scheme***

- 4.2 The Scheme was developed and adopted primarily in readiness for the Companies (Audit, Investigations and Community Enterprise) Act 2004, which was in part intended to strengthen the independence of the system of supervising auditors. The new provisions required audit supervisory bodies, in order to be recognised as such, to enter into independent arrangements for the investigation and discipline of their audit members where their conduct raised important matters affecting the public interest. Participation in the Scheme satisfied this requirement. The audit Recognised Supervisory Bodies agreed that the scope of the Scheme should include all their members (rather than simply their audit members) and other accountancy professional bodies also agreed that the Scheme should apply to their membership (Members and Member Firms)<sup>8</sup>.
- 4.3 Between 13 May 2004 and 17 June 2016 the FRC's investigation and enforcement activities in relation to statutory audit were conducted pursuant to the Scheme as amended from time to time.
- 4.4 The Scheme was first adopted on 13 May 2004 by the Accountancy Investigation & Discipline Board (AIDB) as the predecessor body to the AADB. The AIDB and AADB were both "operating bodies" of the FRC.
- 4.5 In 2012, following a joint consultation with its sponsoring department, the Department for Business, Innovation and Skills (BIS), on its powers and governance, the FRC reformed its constitution. As part of this reform, responsibility for oversight of the operation of the Scheme passed to the FRC Board and the Conduct Committee. The amendments to the Scheme to reflect these changes were approved with effect from 18 October 2012.
- 4.6 On 17 June 2016, the FRC became the competent authority for statutory audit in the UK and the new Audit Enforcement Procedure was put into effect which is now used for matters relating to statutory audit coming to the FRC's attention after that date.

### ***Governance and oversight of the Scheme***

- 4.7 As stated above, the AADB was an operating body of the FRC. Prior to October 2012 the AADB was responsible for the maintenance and operation of the Scheme. It was

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<sup>8</sup> Participants in the Scheme – Institute of Chartered Accountants in England and Wales (ICAEW); Chartered Institute of Management Accountants (CIMA); Chartered Institute of Public Finance and Accountancy (CIPFA); Chartered Accountants Ireland (CAI) Association of Certified Chartered Accountants (ACCA); Institute of Chartered Accountants of Scotland (ICAS).

also responsible for certain decisions under the Scheme, most notably for the purposes of this report, the decision to investigate.

- 4.8 In October 2012 these responsibilities passed to the Conduct Committee. The Conduct Committee is a committee of, and is appointed by, the Board. It oversees the FRC's conduct activities including its monitoring, oversight and enforcement functions and advises the FRC Board. Its responsibilities include certain decisions under the Scheme. The responsibilities of the Conduct Committee are set out in the FRC's Articles of Association and the terms of reference of the Committee. Extracts of the terms of reference in effect from July 2012 to June 2016 are at Appendix 3.
- 4.9 Individual investigations are overseen by Case Management Committee (CMC) members i.e. a CMC Group. The functions of the CMC include monitoring the conduct of the investigation and advising the Executive Counsel of any factors that he should consider when deciding whether to proceed from an investigation to an independent disciplinary tribunal, chaired by a lawyer, often a QC or retired judge.
- 4.10 From time to time, and in accordance with their respective responsibilities, the AADB and the Conduct Committee issued guidance on aspects of the Scheme. Significant amendments and guidance were consulted on publicly.

### ***The Scheme***

- 4.11 The objectives of the Scheme are to protect the public, maintain public confidence in the accountancy profession and uphold proper standards of conduct. The Scheme provides a system for investigation and, if warranted following such investigation, bringing disciplinary proceedings.
- 4.12 Decisions under the Scheme are taken by the Conduct Committee, the Executive Counsel and independent tribunals. No decisions are taken by the FRC Board.
- 4.13 An investigation may be commenced under the Scheme either where a matter is referred by an accountancy body or where the Conduct Committee (or previously, the AADB) is aware, or becomes aware, of a matter. This may be as a result of inquiries by FRC staff overseen by the Conduct Committee (a Supervisory Inquiry), or by the Executive Counsel to the FRC, as formally instructed by the Conduct Committee (preliminary enquiries).

### ***Preliminary Enquiries***

- 4.14 The Scheme was amended in February 2010 to enable the AADB, and later the Conduct Committee, to direct the Executive Counsel to make preliminary enquiries where it considers it has insufficient information about a matter to determine whether to commence an investigation under the Scheme. The use of preliminary enquiries was, until July 2013, subject to the agreement of a protocol with the participants in the Scheme. A protocol was not agreed and the FRC amended the Scheme in July 2013 to allow for preliminary enquiries without the requirement for any such protocol.
- 4.15 Where preliminary enquiries are directed, the Executive Counsel, in undertaking those enquiries, may use the powers under the Scheme to seek information from Members and Member Firms.

## ***The Decision to Investigate***

- 4.16 The Conduct Committee (and previously the AADB) is responsible for deciding whether to commence an investigation in accordance with the Scheme. In so doing the Conduct Committee must decide whether both the public interest and evidential tests for an investigation under the Scheme are met.
- 4.17 To commence an investigation the Conduct Committee must determine whether, in the opinion of the Committee, the matter raises or appears to raise important issues affecting the public interest in the United Kingdom (public interest test) and, there are reasonable grounds to suspect that there may have been Misconduct (evidential test).
- 4.18 Public interest considerations as to whether to commence an investigation include (but are not limited to):
- the impact on a significant number of people in the UK;
  - the loss or potential loss of significant sums of money; and
  - whether the conduct undermines confidence in financial reporting or corporate governance in the UK.
- 4.19 In coming to its determination, the Conduct Committee considers the guidance entitled, “Guidance on commencement of investigation of cases by the Financial Reporting Council”<sup>9</sup>.
- 4.20 If the Conduct Committee concludes that both tests for an investigation of a matter under the Scheme are met, it refers the matter to the Executive Counsel who conducts an investigation.
- 4.21 The Executive Counsel is a legally qualified officer of the FRC and is responsible for the conduct of investigations and, where applicable, disciplinary proceedings, under the Scheme. Once an investigation has been opened, he is responsible for any decision to proceed to a tribunal or to close the investigation. The Executive Counsel is supported by a team of FRC staff comprising lawyers, forensic accountants and legal assistants. The Executive Counsel may also, and in almost all cases does, instruct external independent experts to provide an opinion and engages external counsel to advise on the merits of a case.
- 4.22 Once Executive Counsel has completed his investigation, he must consider the evidential and public interest tests set out in the Scheme, i.e.:
- (a) Is there a realistic prospect that a tribunal will make an adverse finding of Misconduct? and
  - (b) Are disciplinary proceedings desirable in the public interest?

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<sup>9</sup> The guidance is accessible here: <http://www.frc.org.uk/about-the-frc/procedures-and-policies/enforcement-procedures/supporting-documents,-policies-and-guidance>

In considering the tests, the Executive Counsel must have regard to the Guidance on the Delivery of Formal Complaints<sup>10</sup> issued by the Conduct Committee.

- 4.23 The Executive Counsel can only proceed if both of the tests are met. If the Executive Counsel considers that either of these two tests is not met, the investigation is closed and he reports that decision to the Conduct Committee. If he decides that both tests are met he delivers a Formal Complaint against the Member or Member Firm to the Conduct Committee. The Conduct Committee then serves the complaint on the Member, a Disciplinary Tribunal is convened from the Tribunal Panel and unless the matter is settled, it should proceed to a full and public hearing.

### **Misconduct**

- 4.24 The definition of “Misconduct” which has applied since July 2013 is:

*“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.” [Emphasis added.]*

- 4.25 In July 2013 the word “significantly” was added in relation to “short of standards”. That change in wording reflected and clarified the interpretation of Misconduct which was already at that time being applied by independent disciplinary tribunals. For example, in *The Executive Counsel to the FRC v Deloitte & Touche and Mr Maghsoud Einollahi*<sup>11</sup> the Tribunal considered the definition of “Misconduct” under the former wording and directed itself as follows:

*“Before we can make a finding that the Respondents or either of them are guilty of Misconduct and make a finding adverse to them we have to be satisfied not only that there has been a departure from the conduct reasonably to be expected of a member or member firm **but that that departure has been significant**. Whether that departure is significant is a matter for our judgment. A trivial departure will not suffice. We have to be satisfied before we reach a conclusion that there has been such a departure, that the Executive Counsel has proved that no reasonable accountant would have acted in the way that the Respondents have acted.” [Emphasis added.]*

and

*“for the Respondents to be guilty of Misconduct and to have acted in a way that no reasonable professional would have acted the conduct has to amount to more than mere carelessness or negligence and has to cross the threshold of real seriousness. It is not sufficient for the Executive Counsel to prove that the Respondents failed to act in accordance with good or best practice or that most or many members of the profession would have acted differently. The conduct has to be more serious than that.”*

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<sup>10</sup> The Guidance is accessible here: [http://www.frc.org.uk/getattachment/5c1291eb-8503-44ae-ac9f-61b647ebf20e/Guidance-on-the-Delivery-of-Formal-Complaints-\(1\).pdf](http://www.frc.org.uk/getattachment/5c1291eb-8503-44ae-ac9f-61b647ebf20e/Guidance-on-the-Delivery-of-Formal-Complaints-(1).pdf)

<sup>11</sup> The Report is accessible here: <http://frc.org.uk/getattachment/d4f73443-1e1d-4923-92e0-6dc5d702013c/Tribunal-Report-25-3-15-FINAL-Decision-on-Sanctions-and-Costs.pdf>



- 4.26 Accordingly, the addition of the word “significantly” to the definition of Misconduct in July 2013 did not change the substance of the tests to be applied by the Conduct Committee, the Executive Counsel or a disciplinary tribunal. It merely clarified what was already implicit in the meaning of Misconduct in earlier versions of the Scheme. In the later case of *The Executive Counsel to the FRC v Mr Paul Newsham*<sup>12</sup>, the approach of the earlier Tribunal was endorsed. It was agreed that nothing turned on the difference in language in the definition before and after July 2013.
- 4.27 Disciplinary tribunals convened under the Scheme have consistently approved and adopted that approach to Misconduct.
- 4.28 Therefore, in order for a tribunal to make a finding of Misconduct, it is necessary for the Executive Counsel to prove that, on the balance of probabilities, the respondent’s conduct fell significantly short of the standards reasonably to be expected of a professional accountant. In considering what standards are reasonably to be expected, the standards at the time of the conduct are relevant, notwithstanding standards may have changed between the date on which the conduct occurred and the date on which the matter is considered under the Scheme.

### ***Supervisory Inquiries***

- 4.29 The joint consultation with BIS and the reforms in 2012 (referred to at paragraph 4.5 above) included the proposal to develop a Supervisory Inquiry function. It was proposed that inquiries would be carried out to provide an understanding of the reasons for the collapse or near collapse of a public interest entity or other issue affecting confidence in corporate governance and reporting. The aim of the Supervisory Inquiry function was to enable the FRC to consider whether any further regulatory and/or other action should be taken, including whether any improvements should be made to the corporate reporting and governance regime, or whether more formal disciplinary proceedings should instigated.
- 4.30 The FRC was not given any additional powers to assist in the exercise of a Supervisory Inquiry. Rather, the FRC’s existing powers would be used and any Supervisory Inquiry was likely to consist of a review by a multi-disciplinary team of information in the public domain or provided on a voluntary basis.
- 4.31 Following the consultation and implementation of the resulting reforms to the FRC’s structure and powers in 2012, this function was developed and Supervisory Inquiries commenced in 2013.
- 4.32 The Conduct Committee’s terms of reference include responsibility for deciding whether to commence a Supervisory Inquiry and determining the scope of any such Inquiry and what, if any, action to be taken on its conclusion.

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<sup>12</sup> The Report is accessible here: <https://www.frc.org.uk/getattachment/da7723ee-68c4-48ea-a5e7-d3a7cf91748c/Newsham-report.pdf>

## **5 FRC's Supervisory Inquiry, Preliminary Enquiries and Investigation under the Accountancy Scheme**

- 5.1 As a Member Firm of the Institute of Chartered Accountants in England and Wales (ICAEW), KPMG's conduct in connection with its audits of HBOS was considered under the Scheme. Its audit work was also considered as part of a Supervisory Inquiry.
- 5.2 This section explains the work of the FRC under the Scheme and the Supervisory Inquiry and includes findings and matters identified in the course of the work undertaken. It is important to note that, in the absence of any Formal Complaint and tribunal hearing under the Scheme, KPMG have not had the opportunity to respond to and/or rebut the findings and matters reported below. Accordingly, they have not been tested.

### **Considerations by and work overseen by the AADB**

- 5.3 From December 2008, FRC staff monitored press and intelligence sources in relation to the banks including HBOS. This monitoring related to both accounting and audit matters. Regular reports were provided to the AADB throughout 2009 and 2010.
- 5.4 In February 2009, it was reported to the AADB that FRC staff would meet with representatives of the FSA, as the regulator of banks, to discuss the various issues arising from the monitoring. In May 2009, a meeting took place between representatives of the FRC, the FSA and the accountancy bodies. It was agreed at that meeting that the FRC would provide the FSA with a document setting out the FRC's areas of interest. Regular meetings took place throughout 2009 and 2010 between representatives of the FRC and the FSA and all of the accountancy bodies.
- 5.5 In September 2010 FRC staff prepared and tabled to the AADB a report on the scope of the FSA's information gathering and investigation, and noted that this had not included a review of KPMG's audit papers or the issues in which the AADB were interested. The AADB agreed that there was insufficient information, at that time, for it to take a view as to whether there were any issues that needed investigating but that events during the relevant period meant that an investigation under the Scheme could not be ruled out. The AADB instructed the Executive Counsel to prepare a report for its November 2010 meeting on areas that might be worthy of investigation.
- 5.6 In October 2010 the AADB received an oral update from FRC staff and noted that many of HBOS' difficulties resulted from single credit exposures in their Corporate Division. It was further noted that the FSA had looked at the issues around the exposures including the challenges made by KPMG.
- 5.7 At its November 2010 meeting, the AADB considered the report prepared by the Executive Counsel following its request in September. The report included consideration of KPMG's 2007 and 2008 audits including their work in relation to impairment and the 2008 rights issue.
- 5.8 The AADB noted reports from FRC staff that they had not received from the FSA information to suggest that there were reasonable grounds to suspect Misconduct on the part of the auditors and that there was evidence that KPMG had questioned the level of provisioning being made by HBOS. The AADB considered whether the test for

commencing an investigation under the Scheme was met and decided on the basis of the information then available that it was not. They also agreed that if new information came to the attention of staff, the AADB would look at the matter again.

### **Considerations by and work overseen by the Conduct Committee**

- 5.9 Staff continued to monitor the matter following the AADB consideration in November 2010 and undertook a further review informed by the Final Notices published by the FSA on 9 March 2012 on their investigations into the Bank of Scotland plc Corporate Division and Mr Peter Cummings, the former chief executive of the Corporate Division.

#### *Commencement of the Supervisory Inquiry*

- 5.10 In April 2013, the Parliamentary Commission on Banking Standards (PCBS) published its report on HBOS<sup>13</sup>. Later that month the Conduct Committee considered a paper on the FRC's activities in relation to the major banks. The paper covered the FRC's monitoring and enforcement activities in relation to all the major banks and included a report on HBOS based on the staff review detailed above.

- 5.11 The Conduct Committee noted the view of FRC staff that insufficient new information had emerged to warrant revisiting the AADB decisions described above and that the position should continue to be monitored.

- 5.12 The Conduct Committee determined that the FRC should undertake a Supervisory Inquiry which would obtain and review information from KPMG about the provisioning in the Bank of Scotland plc Corporate Division. The Conduct Committee also decided that any decision to commence an investigation under the Scheme should be deferred until after consideration of the information obtained under the Supervisory Inquiry and any material information contained in the FCA's report on HBOS which was then expected to be published in autumn 2013.

- 5.13 The FRC issued a statement that it was considering the report of the PCBS and was in touch with the FCA/PRA as its work developed.<sup>14</sup>

#### *The Supervisory Inquiry*

- 5.14 The Supervisory Inquiry conducted by FRC staff covered HBOS' Retail Banking, International and Corporate Banking Divisions and involved a detailed review of material including:
- KPMG's audit files for the HBOS group audit and audit of corporate loan loss provisions for the years ended 31 December 2007 and 2008 including KPMG's reporting to the relevant Audit Committee in each of these years;
  - PwC's report to LBG at the date of the approval of the 2008 financial statements on "Observations on key judgmental areas 31 December 2008 year end" and PwC's review of fair value adjustments on LBG's acquisition of HBOS on 19 January 2009 for LBG's half year financial statements;

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<sup>13</sup> The Report is accessible here: <https://publications.parliament.uk/pa/jt201213/jtselect/jtpcbs/144/144.pdf>

<sup>14</sup> The Statement is accessible here: <http://www.frc.org.uk/news/april-2013/statement-following-parliamentary-commission-on-ba>

- Other publicly available financial information;
- HBOS' communications with the FRC's Financial Reporting and Review Panel (FRRP). The FRRP wrote to HBOS in 2008 and early 2009 to make enquiries in relation to the disclosures contained in the 31 December 2007 financial statements. Although not the main focus of the FRRP review, there were some enquiries on loan impairment disclosures and processes. The panel closed its enquiry without requiring a restatement.

5.15 At the beginning of and throughout the Supervisory Inquiry, FRC staff held discussions with the FCA/PRA and the Insolvency Service. During discussions at the beginning of the Supervisory Inquiry the representatives of the FCA/PRA expressed their concerns about KPMG's audit work including about work in relation to the adequacy of loan loss provisions. These concerns were used by FRC staff to determine the focus of the review of material relevant to loan loss provisions.

5.16 The review of KPMG's audit files identified that:

- Non-adherence to credit policies and procedures was identified as a significant risk by KPMG. KPMG therefore assessed the audit risk over HBOS' specific loan loss provision to be "significant" and over its collective provision to be "medium";

#### *2007 Audit*

- In auditing the 2007 Corporate Division specific provision, KPMG adopted an audit approach that tested HBOS's controls including categorisation of loans as between the "good" book and the "bad" book against which specific provisions were made. KPMG sample tested those specific loan loss provisions. KPMG did not directly test loans in the good book (those less than 30 days past due) to assess whether they had been correctly assessed and categorised;
- For the Corporate Division 2007 collective provision, KPMG obtained an understanding of and benchmarked the provision based on management's collective provisioning models; and
- KPMG reported to HBOS in 2007 that the provisioning had shifted to the lower end of acceptable values and they were looking for a strengthening of provisions in 2008.

#### *2008 Audit*

- In 2008 as the economic circumstances worsened, KPMG increased and expanded their direct testing of specific provisions and tested the assessment of a sample of loans in the good book. KPMG reviewed the collective provision in the light of actual experience and considered the sensitivity of the provision to changes in the underlying assumptions; and
- There was evidence of KPMG reporting concerns as to the level of the provisions to those charged with governance at HBOS through 2008.<sup>15</sup>

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<sup>15</sup> See Paragraphs 730 to 787 of the FCA/PRA 2015 Report.

### *Conduct Committee consideration of the findings of the Supervisory Inquiry*

- 5.17 In October 2013, the Conduct Committee considered a report on the outcome of the Supervisory Inquiry by FRC staff. The Conduct Committee noted the findings of the Supervisory Inquiry and requested further information and an updated paper for consideration at its November meeting. The information requested included clarification of the roles of KPMG audit review partners and HBOS management and the timeline and the approach of senior KPMG staff in responding to the issues arising throughout the audit.
- 5.18 In November 2013, the Conduct Committee considered a further report on the outcome of the Supervisory Inquiry and whether to commence an investigation into the conduct of KPMG in relation to the audit of the HBOS Corporate Division loan loss provisions in 2007 and/or 2008 under the Scheme.
- 5.19 At the meeting a draft letter from the heads of enforcement of the PRA/FCA to the FRC dated 19 November 2013 was tabled. The draft letter requested that the FRC consider KPMG's audits of the 2007 and 2008 accounts and provided some detail of their concerns including the issues that had come to their attention during the preparation of their report. The central concern expressed related to loan loss provisioning. (A final version of this letter, dated 11 December 2013, was written in substantially similar terms.)
- 5.20 In determining whether to commence an investigation, the Conduct Committee had to consider the public interest and the evidential tests.
- 5.21 The Conduct Committee decided that the public interest test had been met. In considering the evidential test, the Conduct Committee iterated the importance of the definition of Misconduct, and noted that it was more than a failure to comply with standards, with conduct needing to fall significantly below the standards expected of an auditor or audit firm.
- 5.22 The Conduct Committee noted the context of the 2007 and 2008 audits, including the deteriorating economic situation, and had a detailed discussion of the basis of the loan loss provisions and the degree of challenge by KPMG to HBOS' management assumptions.
- 5.23 The Conduct Committee's considerations included the following:
- In the 2007 audit, the extent and nature of KPMG's audit of the specific and collective provisions of the Corporate Division;
  - At the time of the 2007 audit the Bank of England was still forecasting growth. The principal concerns arising in the banking sector related to the US subprime and wholesale funding markets and funding costs rather than the impairment of corporate loans;
  - KPMG reported to HBOS in 2007 that the provisioning had shifted to the lower end of acceptable values and they were looking for a strengthening of provisions in 2008;
  - In the 2008 audit, the nature and extent of KPMG's audit of the loan loss provisions in the Corporate Division and that the level of provisioning was reviewed by the

managements of both HBOS and LBG. KPMG's audit files on loan loss provisions were subsequently reviewed by PwC for the limited purpose of its audit of LBG's acquisition of HBOS. No specific concerns were raised by those reviews;

- KPMG continued to report their concerns over the level of provisions to those charged with governance throughout 2008 as banking and financial conditions deteriorated<sup>16</sup>;
- There had been no prior year adjustment to suggest that subsequent provisions were booked in the wrong period; and
- The nature and extent of audit work performed by KPMG on the loan loss provisions were similar to that seen in other FRC inspections of bank audits undertaken by the major firms at the time (and subsequently).

5.24 The Conduct Committee decided that, although the review of the audit files had raised questions about the adequacy of the nature and extent of some of the audit procedures, on balance the test that there were reasonable grounds to suspect there may have been Misconduct had not been met. On that basis, the Conduct Committee decided not to commence an investigation.

5.25 The Conduct Committee agreed that this matter should be kept under review, pending assessment of any further evidence provided by the FCA/PRA and the content of the anticipated FCA/PRA report.

5.26 At the same meeting, the Conduct Committee considered a paper detailing the FRC's on-going activities in relation to the major banks. They noted that the Corporate Reporting Review (CRR) and Audit Quality Review (AQR) teams had continued their routine monitoring activities which had included reviews of the accounts and audits of the major banks and building societies. An investigation into the accounting at another financial institution had commenced. The Conduct Committee was informed that the observations as to the nature and extent of some of KPMG's audit procedures on loan loss provisions had been observed by AQR in their inspections of bank audits performed by the other major audit firms. The Conduct Committee announced in December 2013, ahead of the audits for that calendar year, that the FRC would carry out a thematic review of the audits of a number of banks to prompt more rapid, step-change improvement. That review was published in December 2014.<sup>17</sup>

#### *The Conduct Committee's consideration of the FCA/PRA 2015 report and the commencement of the preliminary enquiries*

5.27 In November 2015 the FCA and PRA published a report: *The failure of HBOS plc*<sup>18</sup> (the FCA/PRA 2015 Report) and a report by Andrew Green QC: *Report into the FSA's enforcement actions following the failure of HBOS*<sup>19</sup>. In addition *Evidence to the Treasury Committee by Stuart Bernau and Iain Cornish, Specialist Advisers to the*

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<sup>16</sup> FCA/PRA 2015 Report paragraph 92.

<sup>17</sup> "Audit Quality Thematic Review: The audit of loan loss provisions and related IT controls in banks and building societies", December 2014. This Report is accessible here:  
<https://www.frc.org.uk/getattachment/dfed3391-f6ac-409c-81da-d610ff297246/FRC-Audit-Quality-Thematic-Review-banks-and-building-societies-Dec-2014.pdf>

<sup>18</sup> This Report is accessible here:  
<http://www.bankofengland.co.uk/pr/Documents/publications/reports/hbos.pdf>

<sup>19</sup> This Report is accessible here:  
<http://www.bankofengland.co.uk/pr/Documents/publications/reports/agreenreport.pdf>

Committee in relation to the FCA/PRA Review into the Failure of the HBOS Group<sup>20</sup> was published.

- 5.28 The Bernau/Cornish report included the following observations on the role of KPMG and the FRC:

*“KPMG were HBOS's external auditors throughout the Review period and their involvement is covered in detail in the Review although, consistent with its terms of reference, the Review has not sought to opine on whether KPMG met the required standards. However, the FCA/PRA did invite the FRC to consider whether there were grounds to investigate KPMG, relevant senior KPMG people, and relevant senior HBOS management in relation to the audits of HBOS's financial statements for 2007 and 2008. Our understanding is that the FRC's initial conclusion is that the criteria for commencing an investigation have not been met but that they have undertaken to consider any new information in the final Review.*

*We have discussed the basis for this decision with the FRC but have not investigated the matter in detail. We would observe that the circumstances surrounding the audit process, whilst not a root cause of the HBOS failure, were an important aspect of the overall story and certainly bear thorough scrutiny by the FRC. For this reason we think it is important that the FRC should consider its final conclusion very carefully and that there should be transparency in relation to its decision making. We would suggest that this may be a matter in which the Treasury Committee would wish to take a continuing interest.”*

- 5.29 At its meetings on 15 December 2015 and 19 January 2016 the Conduct Committee considered reports from FRC staff which provided information to assist the Committee's consideration of what action the FRC should take in the light of the FCA/PRA 2015 Report, Andrew Green QC's report and the Bernau/Cornish report to the Treasury Select Committee.
- 5.30 On 15 December 2015, the Conduct Committee confirmed the basis of its 2013 decision not to investigate and noted that it had been limited to KPMG's work on loan loss provisioning. It was agreed a further paper would be put to the Committee at its next meeting for a full consideration of whether there were any matters which should be investigated under the Scheme.
- 5.31 On 19 January 2016, the Conduct Committee considered a further report and noted that the FCA/PRA 2015 Report did not suggest that HBOS's failure was due to a lack of compliance with either accounting or auditing standards. The Conduct Committee considered there were three main findings in the FCA/PRA's report that were of particular relevance to the responsibilities of auditors, the first and second of which had been considered during the Supervisory Inquiry in 2013:
- *The adequacy of the bank's loan loss provisions:* The audit team were required to obtain audit evidence and exercise judgment in assessing whether there was any objective evidence that impairment of the loan balances had occurred and that the provisions were sufficient;

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<sup>20</sup> This Evidence is accessible here: <https://www.parliament.uk/documents/commons-committees/treasury/Responses/Independent-Reviewers-Evidence-regarding-FCA-PRA-report-on-HBOS-Group-failure-17-11-2015.pdf>

- *The flawed strategy of the business and lack of focus on proper risk management:* The audit team were required to obtain an understanding of the company's objectives and strategies, and the related risks that may result in material misstatement in the financial statements. One of the main impacts on the financial statements would have been the extent to which loan loss provisions were appropriate; and
  - *The weaknesses in the company's balance sheet (and in particular the bank's reliance on wholesale funding):* The audit team were required to consider the appropriateness of management's use of the going concern assumption in the preparation of the financial statements for the year ended 31 December 2007, and consider whether there were material uncertainties about the entity's ability to continue as a going concern that needed to be disclosed in the financial statements.
- 5.32 The Conduct Committee noted that the Supervisory Inquiry had not included a review of the matters detailed in the third finding i.e. KPMG's audit work in relation to going concern, as it was not one of the concerns raised by the FCA/PRA at the outset of the Supervisory Inquiry.
- 5.33 The Conduct Committee noted that it should only revisit its 2013 decision in respect of the conduct of KPMG in its audit of HBOS' loan loss provisions, where significant new evidence had come to light. Section 2.11 "*HBOS financial reporting*" of the FCA/PRA 2015 Report, focussed almost exclusively on the adequacy of the bank's loan loss provisions. The findings in this section of the report were already well known to the FRC following extensive liaison with the FCA/PRA review team throughout the course of their review. The Conduct Committee therefore concluded that there was no significant new evidence in relation to the audit of the HBOS loan loss provisions for the year ended 31 December 2007, beyond that already obtained in the Supervisory Inquiry, in the FCA/PRA 2015 report, or from any other source.
- 5.34 The Conduct Committee went on to consider whether other sections of the FCA/PRA 2015 Report provided evidence additional to that seen during the Supervisory Inquiry. It considered and noted:
- the report's explanation of HBOS' flawed business strategy and lack of focus on proper risk management;
  - at the time of KPMG's 2007 audit of HBOS, the FSA's concerns regarding the liquidity of HBOS, the addition of HBOS to its Watchlist and the weekly and then daily monitoring by the FSA;
  - the auditors' responsibilities for identifying risk, testing controls and reporting on control weaknesses;
  - KPMG's recognition of the risks associated with the bank's growth strategy, the resulting pressure on their capital resources and the need for the bank to focus on the credit quality of their lending; and
  - the auditors' responsibility to evaluate management's assessment of going concern and determine how those charged with governance have satisfied themselves on going concern (see section 3).
- 5.35 The Conduct Committee agreed that there was insufficient information for it to be able to reach a decision on whether to investigate the conduct of any Member or Member Firm in relation to the going concern issues set out in the FCA/PRA 2015 Report under



the Scheme. However, in the light of the FSA's concerns about HBOS' liquidity in late 2007 and early 2008, at the time of the 2007 audit and approval of the financial statements, the Committee directed the Executive Counsel to undertake preliminary enquiries before deciding whether or not the matter should be investigated.

- 5.36 The scope was the extent to which KPMG, during the course of their audit of HBOS:
- considered the appropriateness of management's use of the going concern assumption in the preparation of the financial statements for the year ended 31 December 2007; and
  - considered whether there were material uncertainties about the entity's ability to continue as a going concern that needed to be disclosed in the financial statements.

5.37 The commencement of the preliminary enquiries was announced on 21 January 2016.

#### *The preliminary enquiries*

5.38 The Executive Counsel undertook the preliminary enquiries as directed by the Conduct Committee from 19 January 2016 to 21 June 2016. This involved review of HBOS' Annual Report and Accounts 2007; KPMG's audit working papers; the applicable standards and guidance; the Combined Code on Corporate Governance; the Combined Code - Requirements of Auditors under the Listing Rules of the FSA; the various published reports on the failure of HBOS; and interviews of KPMG personnel.

#### *Conduct Committee consideration of the outcome of the preliminary enquiries and the decision to investigate*

5.39 The Executive Counsel reported to the Conduct Committee on 21 June 2016 on the results of the preliminary enquiries. His report concluded that there may be matters that needed to be investigated in connection with:

- KPMG's conclusion at the audit planning stage, that it was appropriate for management to prepare the financial statements on a going concern basis; and
- KPMG's conclusion that there were no events or conditions arising in the period up to 26 February 2008 which cast significant doubt on the entity's ability to continue as a going concern.

5.40 The Conduct Committee considered the public interest test and the evidential test in deciding whether to commence an investigation under the Scheme. It decided that both tests were met.

5.41 The Conduct Committee referred the matter to the Executive Counsel to investigate. The scope of the investigation was:

*"The conduct of Members and a Member Firm during their audit of HBOS plc in relation to the extent to which they:*

- (a) *considered the appropriateness of management's use of the going concern assumption in the preparation of the financial statements for the year ended 31 December 2007; and*

- (b) *considered whether there were material uncertainties about the entity's ability to continue as a going concern that needed to be disclosed in the financial statements."*

### *The investigation*

- 5.42 The following evidence was obtained as part of the investigation in addition to the evidence obtained under the preliminary enquiries:
- KPMG documentation and email correspondence relating to the 2007 audit;
  - KPMG Audit Professional Technical Updates from the relevant period, including those relating specifically to bank audits;
  - KPMG's written evidence to the PCBS and the PCBS reports;
  - Material from the FCA, including evidence obtained for the purpose of the FCA/PRA 2015 Report, and the evidence obtained for the current, further HBOS investigation. That material included documents and witness evidence relating to FSA supervision of HBOS during the period from August 2007 to October 2008; and
  - Further documents that were produced by and/or in the possession of HBOS during the relevant period, which were now in the possession of LBG; the majority of that material was not provided to KPMG in the course of their 2007 audit.
- 5.43 In addition, the Executive Counsel obtained an opinion from an independent audit expert as to whether the conduct of KPMG fell significantly short of the standards reasonably to be expected of them. In accordance with usual practice, the Executive Counsel also had the benefit of advice from independent counsel as to whether the evidential test had been met. The investigation was overseen by a CMC Group.
- 5.44 Through his investigation the Executive Counsel sought to identify whether, having regard to the auditing standards, KPMG had carried out sufficient work to identify whether there were events or conditions which might cast significant doubt on HBOS' ability to continue as a going concern.
- 5.45 The investigation identified that:
- (a) In September 2007 HBOS prepared a paper on its response to the liquidity conditions in the market. The paper noted HBOS' high reliance on wholesale markets; the need to take immediate steps to reduce lending growth; and the imperative of not triggering an HBOS specific liquidity "crunch" through its actions. This paper was reviewed by KPMG in September 2007;
  - (b) The audit planning documentation in respect of going concern was completed on 12 November 2007. In respect of management's assessment of the entity's ability to continue as a going concern, the KPMG audit program cited ISA 570: *"When there is a history of profitable operations and a ready access to financial resources, management may make its assessment without detailed analysis. In such circumstances, our conclusions about the appropriateness of management's assessment is ordinarily also made without the need for performing detailed procedures"* The audit program recorded *"No detailed procedures performed by management. This is appropriate given financial operations"*;

- (c) To support that conclusion, KPMG noted that they reviewed board minutes and had on-going meetings with HBOS management. They also noted that they had considered financial, operating and other factors which suggested HBOS was a profitable and stable financial institution with a strong brand name and was abreast of current regulatory issues. Moreover, it was recorded that HBOS senior management had carefully monitored, and put in place, strategies to address the recent liquidity and credit stresses in the global funding markets, including taking a strategic decision to limit asset growth and monitor its funding position. KPMG noted *“There is limited risk to HBOS as a going concern as a result of the monitoring and responsive strategies which are lead from the top”*;
- (d) The conclusion at the planning stage against the requirement to *“Document any events or conditions identified during Planning that may cast significant doubt on the entity’s ability to continue as a going concern for the foreseeable future...”* was that no conditions had been identified;
- (e) In the period between 12 November 2007 and 26 February 2008, HBOS remained in liquidity contingency planning mode and various papers, including information about HBOS’ performance and liquidity position, were prepared for HBOS’ committees. KPMG either attended or reviewed minutes of these meetings;
- (f) The HBOS Group Business Plan 2008-2012, reviewed by KPMG, noted that the first quarter of 2008 was expected to be particularly challenging. It stated that the key risks to the plan were clearly funding and liquidity and, particularly in the early part of 2008, the availability of capital. In respect of *“Funding and Liquidity”* it concluded that *“we enter 2008 with a more challenging funding position than we have for some years. If the term wholesale markets do not perform as the central plan expects or other adverse trends develop then other actions will need to be taken promptly”*;
- (g) The FSA conducted a review of *“own”* capital requirements during 2007, feeding back to HBOS in December 2007. In respect of liquidity the FSA stated that they expected HBOS to stress test the inability to access wholesale funding markets and for this exercise to be completed by January 2008, and that *“Due to recent market conditions, and your reliance on wholesale funding, we have increased our liquidity monitoring, which we will continue for the foreseeable future”*. The required completion date for the analysis was later confirmed as April 2008;
- (h) KPMG met the FSA on 15 January 2008. KPMG’s note on their audit file of that meeting recorded that liquidity was top of the FSA’s list, and that HBOS was more exposed to the wholesale markets than its peers. However, the note added *“Note we never got the impression that the FSA had major concerns....”*. KPMG’s impression appears broadly consistent with the evidence the Executive Counsel obtained regarding the approach of the FSA Supervisory team during the relevant period. That evidence did not suggest significant concerns about HBOS’ vulnerability prior to the audit opinion having been provided in February 2008;
- (i) KPMG requested that HBOS prepare a paper on going concern for the year end, and advised in general terms on its content. The final going concern paper as presented to HBOS’ February 2008 Audit Committee, included:
- Key metrics from the HBOS Group Plan projecting increasing profitability over the period 2007-2012;
  - Analysis of forecast capital ratios, which concludes that even without Tier 2 issuance, total capital remains above regulatory requirements;

- Detailed forecasting of short term funding, indicating that the funding requirement remains within the Group’s existing funding capacity; and
  - Stress testing of the funding plan, which concludes that the funding requirement is manageable under a range of stress scenarios;
- (j) A KPMG memo prepared in April 2008, records KPMG’s “Assessment of Going Concern Assumption”. The memo records that the following procedures were performed:
- In September 2007, liquidity and funding were discussed with HBOS group CFO;
  - Papers on the topic of Liquidity and Capital Management were sent to the Board of HBOS in September and November 2007. These were reviewed by KPMG;
  - The Business Plan was reviewed;
  - The minutes of the Liquidity and Funding Committee were reviewed;
  - HBOS prepared a paper that went to the Audit Committee in February regarding going concern which was reviewed by KPMG, and discussed with the Group Finance Director, on 14 February 2008;
  - Additional communication was sent to divisional audit teams regarding the going concern assumption reminding them of their responsibilities to consider going concern in the context of their specific legal entities;
- (k) In interview, KPMG personnel said that in the course of the audit “*We were just remaining alert and collecting information...from all sorts of sources internal and external to HBOS*”. In addition they highlighted a meeting with the FSA on 15 January 2008 and the round of closing meetings with executive directors and heads of division, the Chief Executive and Chairman where, “*in the particular environment we were in, we were going to remain vigilant and alert*”;
- (l) KPMG confirmed in correspondence that no “*circumstances or events which cast doubt on going concern assumption (sic) were identified by the audit team...*” and the audit conclusion was that there were no material uncertainties around HBOS’ ability to continue as a going concern which needed to be disclosed in the financial statements.

5.46 The investigation found that KPMG’s audit work on going concern was not above criticism. However, it was also found that KPMG did not carry out the audit simply in reliance on the conclusion that they reached at the planning stage that there were no “events or conditions”. The “Going Concern assessment” recorded that, notwithstanding what conclusion had been reached at the planning stage, there was a risk relating to going concern, albeit it was characterised as “limited”. KPMG’s April 2008 memo sets out additional procedures relating to “going concern assessment”: and correspondence between KPMG and HBOS management did include questioning that related specifically to liquidity risk, which at least demonstrated that the issue was identified by the auditors and flagged to management as a matter that they, i.e. management, would need to consider in their own going concern assessment.

5.47 There were certain factors identified in the audit work that were reasonably treated as mitigating the overall level of risk. These included:

- (a) Apparently as a consequence of the “credit crunch”, HBOS attracted significant additional retail and corporate deposits in Q4 2007;

- (b) Contemporaneous analysts' reports indicated a positive outlook for HBOS, with the majority of analysts "presenting a Hold (43%) or Buy (43%) recommendation through to January 2008"; and
- (c) HBOS were "in touch" daily with the FSA regarding liquidity and funding. From the auditor's viewpoint this would, in part, alleviate concerns over liquidity and/or funding issues as it demonstrated that the regulator was alive to those issues and actively monitoring the position.

5.48 The investigation also noted that none of the audit reports for peer group UK banks at the relevant time included qualifications or emphasis of matter paragraphs, thereby suggesting that the auditors had at that time reached similar conclusions on risk as the KPMG auditors.

#### *Conduct Committee's consideration of the outcome of the going concern Investigation*

5.49 At the conclusion of the investigation, the Executive Counsel provided a detailed report to the Conduct Committee at its September 2017 meeting setting out his findings and conclusions and confirming that he had decided to close the investigation.

5.50 The Executive Counsel's report included the findings detailed above. He also emphasised the importance of assessing the conduct of KPMG in the context of the prevailing conditions and the standards which applied at the relevant time:

*"The failure of HBOS in October 2008 has been the subject of a number of enquiries and formal reports, and there have been many more such enquiries and reports that have considered and documented the wider events occurring between 2007 – 2009, the period during which the UK 'credit crunch' first emerged, and then became a full scale banking and financial crisis. Inevitably, these reports tend to be affected significantly by hindsight, and also involve drawing together information that, whilst in existence during the relevant period, was not at that time all in the possession of key players, or available for, or subject to, the type of analysis that has subsequently been conducted. Consequently, the conclusions reached must be treated with caution.*

*However, we have been assisted in putting the events of the time in context by the overview of the 'three phases' of the financial crisis contained in the Plenderleith Report<sup>21</sup>, which appears to be a helpful and accurate summary of certain key events, including those relating to HBOS.*

*The audit opinion on the Financial Statements was signed on 26 February 2008. It should be noted therefore that, if the analysis above is accepted as essentially accurate, the 2007 HBOS audit engagement was carried out during the first and second phases of the crisis, and concluded before the 'intensification' of the second phase marked by the events in March and April 2008. The failure of HBOS occurred during the third phase, when the severity of the crisis further intensified after the failure of Lehmans.*

*We have also considered in detail the FCA/PRA report on the failure of HBOS<sup>22</sup>. That report did not focus on either the preparation or audit of the FS<sup>23</sup> 2007, and in particular did not address the issue of 'going concern' from an accounting perspective. For the*

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<sup>21</sup> Review of the Bank of England's provision of emergency liquidity assistance in 2008-09. Report by Ian Plenderleith, October 2012.

<sup>22</sup> The failure of HBOS plc (HBOS): A report by the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA), November 2015.

<sup>23</sup> FS means Financial Statements.

*purposes of that report, HBOS was deemed to have failed on 1 October 2008, when it was approaching a point at which it was no longer able to meet its liabilities as they fell due, and so sought Emergency Liquidity Assistance (ELA) from the Bank of England. That approach to the failure of HBOS (which does not equate to the point at which a business is no longer a going concern) provides comparatively little assistance in determining whether it was appropriate to prepare the FS 2007 on a going concern basis or what the approach to that issue of a reasonable, competent auditor should have been.”*

- 5.51 The Executive Counsel noted the dangers of hindsight but also that there was contemporaneous evidence that at the time of the audit, the intensification and worsening of the financial crisis was not expected by market participants. Further, HBOS was seen as positioned positively to benefit from the market disruption as a “safe haven”. The PRA/FCA 2015 report notes in relation to market perceptions of HBOS in 2007 that<sup>24</sup>:

*“a number of analysts considered the stock to be undervalued with the bad news already factored into the share price. One theme appeared to be ‘flight to quality’ towards HBOS and others after the collapse of Northern Rock...”*

- 5.52 The Executive Counsel concluded:

*“In short, in February 2008 HBOS management recognised the liquidity risks posed to it by the credit crunch but did not expect conditions to worsen to the point that HBOS would be unable to fund its activities. They did not foresee, far less expect, a particular event, of the nature of the failure of Lehmans that would precipitate such a significant deterioration in market conditions that HBOS were almost immediately imperiled. Those expectations were to be proved wrong, but were evidently widely held and clearly reasonable at the time, and were accepted as reasonable by the auditors. It is therefore simply not credible to advance a case of Misconduct against KPMG that is essentially premised on that they should have taken a fundamentally different view.”*

- 5.53 The Executive Counsel confirmed his overall conclusion that on the basis of the findings above, there was no realistic prospect that a tribunal would make an adverse finding of Misconduct against KPMG and consequently decided to close the investigation.

- 5.54 The Conduct Committee published the fact of this decision, and a brief summary of its rationale, in a press notice dated 19 September 2017<sup>25</sup>.

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<sup>24</sup> The Report is accessible here:

<http://www.bankofengland.co.uk/pr/ Documents/publications/reports/hbos.pdf> at paragraphs 665 to 666.

<sup>25</sup> The Press Notice is accessible here: <http://www.frc.org.uk/news/september-2017/closure-of-investigation-into-kpmg's-audit-of-hbos>

## 6 Independence and conflicts of interest

- 6.1 This section explains how conflicts of interest were declared and managed in the course of the various activities and decisions detailed in Section 5.

### *Governance, Guidance and Codes*

- 6.2 The importance of independence from the regulated profession has long been recognised and provided for in the FRC's constitution. The AADB's Articles of Association provided for a maximum number of 11 members on the AADB, that no more than 3 members could be accountants or former accountants (including auditors) and that there must always be a lay majority i.e. a majority of members who are not accountants, auditors or actuaries. It was also provided that the Chair of the AADB must be a lay member.
- 6.3 In 2012, as part of the FRC reforms mentioned earlier in this report, the FRC's Articles of Association provided that "*no current practising auditors nor officers of any professional bodies that the Company regulates may serve on the Conduct Committee at any time*". In addition, the terms of reference of the Conduct Committee stipulated that the "*Committee shall have a majority of members who are not practising accountants and/or actuaries and no member shall be a practising auditor or officer of the professional bodies regulated by the Committee*".
- 6.4 In 2016 these provisions were strengthened to reflect the designation of the FRC as the competent authority for audit in the UK and the requirements of the EU Audit Regulation. The FRC's Articles of Association and the terms of reference of the Conduct Committee provide that no member of the Board or the Conduct Committee may be an individual who, in the three years prior to appointment, has been a practising auditor, held voting rights in an audit firm or been an employee, partner or otherwise contracted by an audit firm or a member of the administrative, management or supervisory body of an audit firm or an officer holder of an audit body.
- 6.5 In addition, the Articles provide that the Board must comprise a majority of directors who are not individuals who in the five years prior to such appointment have been practising accountants or actuaries; or held voting rights in an accountancy or actuarial firm; or been employees of an accountancy or actuarial firm, members of the administrative or management body of an accountancy or actuarial firm.
- 6.6 The terms of reference of the Conduct Committee provide, in addition to the prohibition at paragraph 6.3 above that no member of the Committee shall be an officer of any of the accountancy or actuarial professional bodies.
- 6.7 The AADB's considerations of the HBOS case in 2008 and up to 26 May 2009 were subject to its own guidance: *Guidance on Conflicts of Interest and Bias for AADB Staff and the Board Members*. Whilst the Guidance was stated to apply to both staff and to AADB Board members, it acknowledged that the FRC had issued Guiding Principles which applied to staff but provided additional guidance and procedures. The AADB Guidance provided for notification of relevant interest by AADB members with the Chair of the AADB who would determine whether or not the individual member should participate in any relevant discussion or decision.

- 6.8 The guidance stated that examples of conflicts of interest included “Being a current or former partner, director or employee of a Member Firm or Predecessor Firm which is or may be subject to an investigation”.
- 6.9 On 26 May 2009, the FRC Board approved a Code of Conduct which applied to all FRC Board members and the members of each of its operating bodies, including the AADB.
- 6.10 The Code provided for the registration of interests with the Company Secretary and that *“an oral declaration of any relevant interest... should be made at any board or committee meeting if it relates specifically to a particular issue under consideration and should be recorded in the minutes of the meeting”*. It went on to provide that *“If the outcome of any discussion at a meeting could have a direct pecuniary effect on a board member, that member should not participate in the discussion or determination of matters in which he or she has such an interest and, following a declaration, should withdraw from the meeting (even if held in public)”*.
- 6.11 The Code of Conduct has been updated since 2009 and in 2012 was amended to apply to the Members of the FRC Board, the committees and the councils. The principles in relation to the declaration of interests and ensuring that decisions were not influenced or seen to be influenced by competing interests remain unchanged.
- 6.12 The membership of the bodies who made decisions in relation to the HBOS case, the AADB and the Conduct Committee, is set out at Appendix 5. Appendix 5 also sets out the membership of the Case Management Committee and confirms the members of the Group of the Case Management Committee appointed to oversee the HBOS investigation commenced in 2016.
- 6.13 In accordance with the Code of Conduct, where an interest is declared and that interest means that there is a conflict of interests, the individual will not receive any papers about the relevant matter and will not participate in any discussion of the matter at meetings.
- 6.14 Extracts of the Conduct Committee terms of reference in effect from July 2012 to June 2016 are at Appendix 3. The AADB Guidance and Codes of Conduct referred to above are attached at Appendix 4.

#### *AADB members*

- 6.15 During 2008 and 2009, the AADB’s membership included James Miller and Neil Lerner, former KPMG partners (see Appendix 5). The minutes of the AADB meetings where HBOS was discussed record that Mr Miller and Mr Lerner left the meetings while that item was being discussed.

#### *Conduct Committee members*

- 6.16 From 2012, the Conduct Committee’s membership included, at various times, four individuals who had previously been partners at KPMG: namely Joanna Osborne, John Kellas, Sean Collins and Paul George (see Appendix 5). Each of the individuals declared their interest. The minutes of the relevant meetings record the declared interests and in the cases of Ms Osborne, Mr Kellas and Sean Collins, a conflict of



interests is recorded. The minutes of the meetings show that Ms Osborne and Mr Collins left the meeting whilst any KPMG matter was discussed. Given that Mr Kellas retired from KPMG in 2004 and before the matters in question arose, he did not leave the meeting while any matter was discussed but he did not participate in the discussion.

- 6.17 The Conduct Committee discussed the position of Paul George at its meeting in September 2013 and agreed that, in view of the date of his retirement as a partner in KPMG in 1999, there was no general conflict of interests in relation to KPMG matters but that Mr George should declare any matters where there was a specific issue or close personal relationship.

#### *Board members*

- 6.18 As stated earlier in this report, the FRC Board is not responsible for and does not make any decisions under the Scheme or, indeed, any of the FRC's enforcement procedures. However, reports to the Board include reports on the progress of and specific issues in relation to enforcement matters. Where Board members have an interest in the particular enforcement matter, they declare that interest and will leave the meeting while that item is discussed. This is recorded in the minutes of the Board meetings which are published. In addition, where such a conflict has been declared, any papers provided to that Board member will be redacted so that they do not receive any written material on the matter.

#### *FRC Executive*

- 6.19 Throughout the period from 2008 to 2017, the staff of the FRC have been subject to *Guiding Principles on Independence, Confidentiality and Conflicts of Interest* and, from March 2017, a Staff Code of Conduct. Each staff member's contract of employment requires him or her to follow any such guiding principles or code of conduct which may be in force from time to time.
- 6.20 In 2013 and at the time that the Conduct Committee instigated the Supervisory Inquiry, Phil Fitz-Gerald was the Head of Supervisory Inquiries. Mr Fitz-Gerald was formerly an employee of and later worked under contract with KPMG. He declared this conflict and the aspects of the Supervisory Inquiry which involved any review of the audit work undertaken by KPMG was carried out by another member of staff.

## 7 What lessons have we learnt?

7.1 The lessons learnt by the FRC, including as a result of the enquiries and investigation of KPMG's audits of HBOS, fall into 4 main categories:

- The proactivity and speed of enforcement;
- The threshold for investigation under the FRC's audit enforcement procedures;
- The transparency of decision-making; and
- The transparency of and preservation of independence in decision-making.

### *Proactivity and speed of enforcement*

7.2 Much work and detailed review was undertaken in the period between 2009 and 2013. However, we relied too heavily on the work of the FSA and on the information the FSA provided to the FRC. In particular, the FRC regarded the FSA as the lead regulator. It is correct that the FSA was the lead regulator in relation to the banks but it was not right to regard them as the lead regulator in relation to audit. This approach meant that the opinions of the FSA were significant in determining the focus of the Supervisory Inquiry rather than the FRC taking an independent view of the focus of the Supervisory Inquiry.

7.3 For some time, we awaited the anticipated FCA/PRA Report, which was expected to be published in the first half of 2013. The report was delayed and in late 2013, when it became clear that there would be further delays, the Supervisory Inquiry was carried out. We could have been more proactive and instituted the Supervisory Inquiry earlier.

7.4 We waited for other regulators to complete their work before carrying out preliminary enquiries and an investigation under the Scheme. Again, the delays this caused could have been avoided.

7.5 We now take the lead in responding to and investigating audit matters. This approach has been strengthened by the implementation of the EU Audit Regulation and Directive in 2016, which involved the FRC's designation as the competent authority for statutory audit in the UK. As the competent authority, we now have direct responsibility for determining, monitoring and enforcing auditing standards. The legislation implementing the EU Audit Regulation and Directive also gave the FRC, as the competent authority, additional information seeking powers. This means that we will need to rely less on the information provided to us by other regulators.

7.6 We have also invested significantly in the resources of our Enforcement Division, to enhance our speed and effectiveness. As we reported in our 2016/17 Annual Report we have made substantial progress in bringing enforcement cases to conclusion. We have published a target for, and will report on, how quickly we bring cases to a conclusion. We have redesigned our enforcement processes to be more efficient and we are investing in technology to support our enforcement activities. The FRC now takes the lead in responding to and investigating audit matters.

### *Threshold for Investigation under the FRC's audit enforcement procedures.*

7.7 There has been criticism that the threshold for taking action against auditors is too high and therefore is not effective in bringing auditors to account for lesser breaches of

standards, which, whilst not amounting to Misconduct as defined in the Scheme, nevertheless lead to a less than satisfactory or poor quality audit.

- 7.8 This has previously been recognised by the FRC on the basis of numerous matters considered over the years. It was also recognised that this limitation did not sit comfortably with our mission which was to promote quality and the wider work of the FRC in relation to its standards, guidance and audit quality review. All of these functions have the promotion of audit quality at their core.
- 7.9 In readiness for the FRC's designation as the competent authority for statutory audit in the UK, we developed our Audit Enforcement Procedure (the Procedure), which replaced the Scheme for audit matters coming to our attention after June 2016. Our aim in developing the new Procedure was that it should, with the other functions of the FRC as the competent authority, protect the public interest, promote the quality of audit and enhance public confidence in audit. The new Procedure was designed to investigate and sanction breaches of the various requirements set out in the EU Audit Regulation and Directive. The principles underlying the design of the new Procedure were:
- A European Convention of Human Rights compliant procedure ensuring fairness to auditors whilst protecting the public;
  - A single, streamlined procedure to deal with the full range of audit enforcement, ranging from simple "misdemeanour" breaches to breaches which are so serious that they would previously have fallen into the "misconduct" category; and
  - An administrative procedure which would promote and facilitate the early resolution of appropriate cases at Executive and Committee level.
- 7.10 In accordance with these principles, the new Procedure provides for action to be taken where there alleged breach of a relevant requirement (including auditing standards) and where there is good reason to do so.

#### *Transparency of decisions*

- 7.11 Public interest in and criticism of the outcome of our enquiries and investigation has highlighted that we could better explain the reasons for our decisions to close cases. When we made public the decision to close the investigation of KPMG's audit work in relation to going concern in September 2017, we took the unprecedented step of publishing a summary of the reasons for this decision.
- 7.12 In future, where there is a clear public interest to do so and subject to any applicable legal restraints, we will publish a summary of our reasons for closing an investigation.
- 7.13 In addition, annually we publish "Developments in Audit". This publication includes and will continue to include a summary of the investigations, opened and concluded during the year and comment on key and recurrent findings.

#### *Transparent independence*

- 7.14 The FRC's structure, Code of Conduct, the design of the Scheme (and now the Audit Enforcement Procedure), provide for independence of decision-making free from conflicts of interest. The FRC has, throughout its enquiries and Investigation, required all potential decision-makers to declare any relevant interests and to withdraw from the

meeting for the relevant discussion and decision where their interests conflict. We are satisfied that conflicts of interest have been appropriately managed during our consideration of KPMG's audits of HBOS.

- 7.15 However, the extensive interest and public comment on the outcome of our enquiries and investigation has highlighted the need for increased transparency to promote public confidence. Recently, the FRC has updated its Code of Conduct and published a Register of Interests setting out the interests of the Board and the FRC's various committees.
- 7.16 In the future, where we publish confirmation of a decision under the Scheme or the Audit Enforcement Procedure we will also confirm whether any member of the Conduct Committee declared an interest and whether they participated in the decision-making process.

#### *FRC Governance*

- 7.17 There has also been wider commentary on our governance structure, which was established following public consultation in 2012. During 2017, in line with good practice, we started a review of our governance, which included consideration of the governance structure, composition of the Board and its committees and the maintenance of diversity and independence. This review continues includes consideration of any necessary changes to reflect developments in our public body status and to respond to changing public expectations.

#### *Other changes and developments*

- 7.18 This report focuses on the work undertaken in relation to enquiries and investigations. However, our ongoing regulatory work, conducted through standard setting and audit inspection, is fundamental to promoting audit quality.
- 7.19 In December 2007, the FRC issued guidance to preparers of accounts and auditors to highlight the going concern issues during the then current economic conditions. From 2007 to 2010 our audit monitoring considered how the major firms were responding at a firm-wide level to the audit challenges arising from the "credit crunch" and the "economic downturn" and audit reviews focused on going concern. This work identified that there were a number of shortcomings relating to the audit of going concern at both major and smaller audit firms. While acknowledging that much of the work in this area was done well, audit teams needed to ensure that the key factors material to the going concern assessment in each individual case were appropriately considered and resolved.
- 7.20 The FRC stepped up its monitoring of bank audits after the financial crisis and reported in 2010/11 that the review of bank audits had led to a particular concern around the audit of loan loss provisions where improvements were required in the majority of the audits reviewed. There was insufficient evidence of the challenge and testing by audit teams of the techniques adopted by management to assess the level of collective provisions. The adequacy of audit evidence supporting the audit team's assessment and challenge of specific loan impairments was also a recurring issue.

- 7.21 We now conduct and publish thematic reviews with the aim of raising standards in targeted areas. In November 2013 the Conduct Committee approved proposals to undertake a thematic review to bring about a step change in the quality of the auditing of banks and building societies. The outcome of the review was published in 2014.
- 7.22 We now publicly report our findings on each of the six largest audit firms and we report to audit committees on our reviews of individual engagements. We also publish on our website a list of those audit engagements we have reviewed.
- 7.23 We have also set targets for stronger performance and expect these to be met. Audits that do not meet our expectations are subject to remedial plans, further supervision and, if appropriate, are considered for enforcement action.
- 7.24 We are now increasing our focus on leadership in the audit firms, firm culture and the effectiveness of the international networks. We are also reviewing the scope of audit to assess whether it should be adapted to better meet public expectation.
- 7.25 The Annex to Stephen Haddrill's letter to Andrew Tyrie dated 10 February 2016 is at Appendix 6 and sets out a list of actions taken by the FRC in response to the crisis. The FRC has in particular addressed the two principal areas of reporting that were reviewed in connection with KPMG's audit of HBOS:
- We encouraged the move to an expected loss recognition model for loan loss provisions in international accounting standards. This has now been introduced by the IASB in its new accounting standard IFRS 9 which becomes effective on 1 January 2018 and has been endorsed, with our support, for use in the EU; and
  - We undertook an inquiry, led by Lord Sharman, to identify lessons for companies and auditors addressing going concern and liquidity risks. That enquiry reported its findings in 2012 and led to separate going concern guidance for banks. We updated the UK Corporate Governance Code, with effect from 2014, to increase boards' focus on and reporting of risk and viability over the longer term. Changes to the auditing standards were made to require auditors to consider and report on narrative disclosures, including risks. Accordingly, auditors now need to consider not only the going concern basis of accounting (and material uncertainties relating thereto), but also the longer term viability statement and risk management disclosures.

## Appendix 1

### Extract from 'Review of the Bank of England's provision of emergency liquidity assistance in 2008-09' – Report by Ian Plenderleith - October 2012

'From the summer of 2007, the financial crisis can be regarded as evolving in three phases. The first phase ran from mid-2007 through to the provision of Bank [of England ("the Bank")] liquidity to, and the run on, Northern Rock in September 2007. The second phase ran from then until the failure of Lehman Brothers in September 2008. That collapse precipitated the third, and most damaging, phase of the crisis.

The first phase of the crisis emerged from mid-2007, with evidence of some financial institutions incurring losses on exposures related to US sub-prime mortgages. In June, Bear Stearns pledged collateralised loans to one of its hedge funds, but elected not to support another. On 9 August, BNP Paribas announced that it was suspending calculation of asset values of three money market funds exposed to sub-prime mortgages, and halting redemptions. At this point, liquidity in short-term money markets became seriously constrained, precipitating more widespread market stress.

Central banks responded to these market conditions in a variety of ways. On 9 August, in response to the problems in money markets, the European Central Bank ("ECB") injected €95 billion overnight to assist liquidity. On 17 August, the US Federal Reserve Bank approved a temporary 50 basis points reduction to its discount window borrowing rate and began to provide term financing up to 30 days, renewable by the borrower. On 13 September, the Bank announced it would widen the range on banks' reserves targets within which they would be remunerated at Bank Rate, in order to remove any impediment to banks electing to hold higher reserve balances at the Bank.

In the UK, the first significant casualty of the crisis was Northern Rock. The Bank announced on 14 September 2007 that it had agreed to provide emergency liquidity support to Northern Rock. Reports of this agreement to provide support had, however, leaked the previous evening and precipitated a loss of public confidence in the bank.

The run on Northern Rock marked the beginning of the second phase of the crisis, in which the Bank initiated further steps to ease the continuing strains in the markets. In September 2007 the Bank announced a series of special auctions to lend cash for three months against a wider range of collateral than normally accepted in Bank operations. There was no participation in these auctions, possibly because the minimum price was seen as being too high. On 18 December, the Bank introduced Extended Collateral Long-Term Repo operations (ELTRs), in which counterparties could bid for reserves for a three-month term, against either standard narrow collateral or a broader set of collateral.

On 21 February 2008 Royal Assent was given to the Banking (Special Provisions) Act 2008, temporary emergency legislation introduced largely in response to the failure of Northern Rock, which gave the Treasury powers to facilitate the orderly resolution of a failing bank in order to maintain financial stability or protect the public interest.

The second phase of the crisis intensified with the purchase of Bear Stearns by JPMorgan Chase & Co on 16 March 2008. The Federal Reserve Bank provided US\$30 billion of funding to support this transaction. On 19 March, an unfounded rumour that HBOS was receiving support from the Bank resulted in its share price falling over 17% during the course of one day before recovering to close 7% lower on the day. The Bank responded to the intensified market pressure, and in particular the continued poor conditions in asset-backed securities markets, with the launch of the Special Liquidity Scheme (SLS) on 21 April 2008, which allowed banks to swap a wider range of collateral than was eligible for the Bank's ELTR operations, including high-quality mortgage-backed and other securities, for UK Treasury bills; liquidity provided under the SLS was available for a term of up to three years.

In light of pressure on its capital, particularly following its acquisition of ABN Amro and mark-to-market losses on structured products, RBS announced a £12 billion rights issue on 22 April and confirmed on 9 June that 95% of the issue had been accepted. HBOS announced a £4 billion rights issue on 29 April, but only 8% of the HBOS rights issue was taken up by private investors in July, with the remainder being left with the underwriters. Also on 29 April 2008 HBOS drew down on the SLS. Bradford & Bingley was also seeking to raise funds during this period, but with difficulty: it announced a £400 million rights

issue in May, which however had to be repriced and restructured in June after a profits warning, and was then restructured again shortly afterwards when one of the underwriters withdrew its support following a ratings downgrade. In the event, only 28% of the issue was taken up, with the remainder being left with the underwriters.

On 13 July 2008, the US Treasury announced a rescue plan for Fannie Mae and Freddie Mac; both were taken into conservatorship on 7 September. On 14 July in the UK, it was announced that Santander UK would purchase Alliance & Leicester.

The third, and most damaging, phase of the crisis began on 15 September 2008, with the failure of Lehman Brothers. From this point onwards, the severity of the crisis intensified significantly.

The same day, Bank of America announced its purchase of Merrill Lynch. On 16 September, the US Government provided a US\$85 billion emergency loan to AIG in exchange for an 80% stake in the company. On 17 September, the Bank announced that it was extending the drawdown window for the SLS, so that instead of closing on 21 October 2008 as had originally been announced, it would now close on 30 January 2009. On 18 September, Lloyds TSB and HBOS announced plans to merge. The same day, a number of central banks announced measures to address continued elevated pressures in the US dollar short-term funding market by putting in place reciprocal swap agreements with the Federal Reserve through which US dollars could be provided to the market.

HBOS first received Emergency Liquidity Assistance (“ELA”) on 1 October 2008. The ELA facility was structured as a collateral swap under which the Bank lent HBOS UK Treasury bills against unsecuritised mortgage assets. This was a structure similar to that used in the market-wide SLS which the Bank had been operating since April 2008. HBOS’s use of the ELA facility peaked in terms of the market value of bills lent at £25.4 billion on 13 November 2008. HBOS made final repayment of the facility on 16 January 2009.’

## Appendix 2

### Extracts from Auditing and Accounting Standards

#### Auditing Standards

*International Standards on Auditing (UK and Ireland) – effective for audits of financial statements for periods beginning on or after 15 June 2006*

The objective of an audit is established in UK company law and is to express an opinion on whether the financial statements give a true and fair view.

#### **ISA (UK&I) 200: Objective and general principles governing an audit of financial statements**

- 2 The objective of an audit of financial statements is to enable the auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework. The phrases used to express the auditor's opinion are “give a true and fair view” or “present fairly, in all material respects,” which are equivalent terms.
- 3 Although the auditor's opinion enhances the credibility of the financial statements, the user cannot assume that the audit opinion is an assurance as to the future viability of the entity nor the efficiency or effectiveness with which management has conducted the affairs of the entity.
- 6 **The auditor should plan and perform an audit with an attitude of professional scepticism recognizing that circumstances may exist that cause the financial statements to be materially misstated.** An attitude of professional scepticism means the auditor makes a critical assessment, with a questioning mind, of the validity of audit evidence obtained and is alert to audit evidence that contradicts or brings into question the reliability of documents or management representations. For example, an attitude of professional scepticism is necessary throughout the audit process for the auditor to reduce the risk of overlooking suspicious circumstances, of over generalizing when drawing conclusions from audit observations, and of using faulty assumptions in determining the nature, timing, and extent of the audit procedures and evaluating the results thereof. In planning and performing an audit, the auditor neither assumes that management is dishonest nor assumes unquestioned honesty. Accordingly, representations from management are not a substitute for obtaining sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the audit opinion.
- 8 An audit is designed to provide reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether due to fraud or error. Reasonable assurance is a concept relating to the accumulation of audit evidence necessary for the auditor to conclude that there are no material misstatements in the financial statements taken as a whole. An auditor cannot obtain absolute assurance because there are inherent limitations of an audit that affect the auditor's ability to detect material misstatement, such as the fact that most audit evidence is persuasive rather than conclusive, the impracticality of examining all transactions or balances and the possibility of collusion or misrepresentation for fraudulent purposes.
- 12 An audit is not a guarantee that the financial statements are free from material misstatement.
- 15 **The auditor should plan and perform an audit to obtain sufficient appropriate audit evidence that reduces audit risk to an acceptably low level.** The auditor reduces audit risk by designing and performing audit procedures to obtain sufficient appropriate audit evidence to



be able to draw reasonable conclusions on which to base an audit opinion. Reasonable assurance is obtained when the auditor has reduced audit risk to an acceptably low level.

- 18 The auditor considers the risk of material misstatement at the overall financial statement level.
- 19 The auditor also considers the risk of material misstatement at the class of transactions, account balance and disclosure level.

#### **ISA (UK&I) 540: Audit of accounting estimates**

- 8 **The auditor should design and perform further audit procedures to obtain sufficient appropriate audit evidence as to whether the entity's accounting estimates are reasonable in the circumstances and, when required, appropriately disclosed.** The audit evidence available to detect a material misstatement in an accounting estimate will often be more difficult to obtain and less persuasive than audit evidence available to detect a material misstatement in other items in the financial statements. The auditor's understanding of the entity and its environment, including its internal control, assists the auditor in identifying and assessing the risks of material misstatement of the entity's accounting estimates.
- 10 **The auditor should adopt one or a combination of the following approaches in the audit of an accounting estimate:**
  - a) **Review and test the process used by management to develop the estimate;**
  - b) **Use an independent estimate for comparison with that prepared by management; or**
  - c) **Review of subsequent events which provide audit evidence of the reasonableness of the estimate made.**
- 11 The steps ordinarily involved in reviewing and testing of the process used by management are:
  - (a) Evaluation of the data and consideration of assumptions on which the estimate is based;
  - (b) Testing of the calculations involved in the estimate;
  - (c) Comparison, when possible, of estimates made for prior periods with actual results of those periods; and
  - (d) Consideration of management's approval procedures.

#### **ISA (UK&I) 570: Going concern**

- 3 Under the going concern assumption, an entity is ordinarily viewed as continuing in business for the foreseeable future with neither the intention nor the necessity of liquidation, ceasing trading or seeking protection from creditors pursuant to laws or regulations.
- 9 The auditor's responsibility is to consider the appropriateness of management's use of the going concern assumption in the preparation of the financial statements, and consider whether there are material uncertainties about the entity's ability to continue as a going concern that need to be disclosed in the financial statements. The auditor considers the appropriateness of management's use of the going concern assumption even if the financial reporting framework used in the preparation of the financial statements does not include an explicit requirement for management to make a specific assessment of the entity's ability to continue as a going concern.
- 10 The auditor cannot predict future events or conditions that may cause an entity to cease to continue as a going concern. Accordingly, the absence of any reference to going concern

uncertainty in an auditor's report cannot be viewed as a guarantee as to the entity's ability to continue as a going concern.

## **Reporting Requirements**

### **IAS 39: Financial Instruments: Recognition and Measurement (with emphasis added)**

#### **Recognition**

46 After initial recognition, an entity shall measure financial assets, including derivatives that are assets, at their fair values, without any deduction for transaction costs it may incur on sale or other disposal...except for the following financial assets: (a) Loans and receivables as defined in paragraph 9, which shall be measured at amortised cost using the effective interest method;

#### **Impairment and uncollectability of financial assets**

58 An entity shall assess at each balance sheet date whether there is any objective evidence that a financial asset or group of financial assets is impaired...If any such evidence exists, the entity shall apply paragraph 63 (for financial assets carried at amortised cost), paragraph 66 (for financial assets carried at cost) or paragraph 67 (for available-for-sale financial assets) to determine the amount of any impairment loss.

59 A financial asset or a group of financial assets is impaired and impairment losses are incurred...if, and only if, there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the asset (a 'loss event') and that loss event (or events) has an impact on the estimated future cash flows of the financial asset or group of financial assets that can be reliably estimated. It may not be possible to identify a single, discrete event that caused the impairment. Rather the combined effect of several events may have caused the impairment. Losses expected as a result of future events, no matter how likely, are not recognised. Objective evidence that a financial asset or group of assets is impaired includes observable data that comes to the attention of the holder of the asset about the following loss events:

- (a) Significant financial difficulty of the issuer or obligor;
- (b) A breach of contract, such as a default or delinquency in interest or principal payments;
- (c) The lender, for economic or legal reasons relating to the borrower's financial difficulty, granting to the borrower a concession that the lender would not otherwise consider;
- (d) It becoming probable that the borrower will enter bankruptcy or other financial reorganisation;
- (e) The disappearance of an active market for that financial asset because of financial difficulties; or
- (f) Observable data indicating that there is a measurable decrease in the estimated future cash flows from a group of financial assets since initial recognition of those assets, although the decrease cannot yet be identified with the individual financial assets in the group, including:
  - i. Adverse changes in the payment status of borrowers in the group (e.g. an increased number of delayed payments or an increased number of credit card borrowers who have reached their credit limit and are paying the minimum monthly amount); or
  - ii. National or local economic conditions that correlate with defaults on the assets in the group [etc.]

## Financial assets carried at amortised cost

- 63 If there is objective evidence that an impairment on loans and receivables or held-to-maturity investments carried at amortised cost has been incurred...the amount of the loss is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows (excluding future credit losses that have not been incurred) discounted at the financial asset's original effective interest rate (i.e. the effective interest rate computed at initial recognition). The carrying amount of the asset shall be reduced either directly or through use of an allowance account. The amount of the loss shall be recognised in profit and loss.
- 64 An entity first assesses whether objective evidence of impairment exists individually for financial assets that are not individually significant (see paragraph 59). If an entity determines that no objective evidence of impairment exists for an individually assessed financial asset, whether significant or not, it includes the asset in a group of financial assets with similar credit risk characteristics and collectively assesses them for impairment. Assets that are individually assessed for impairment and for which an impairment loss is or continues to be recognised are not included in a collective assessment of impairment.

## IAS 1: Presentation of Financial Statements

- 23 When preparing financial statements management shall make an assessment of an entity's ability to continue as a going concern. Financial statements shall be prepared on a going concern basis unless management either intends to liquidate the entity or to cease trading, or has no realistic alternative but to do so.**

### Other ISA extracts

#### **ISA 260: Communication of audit matters with those charged with governance**

- 11-14** In the course of the audit of the financial statements, the auditor considers the qualitative aspects of the financial reporting process, including items that have a significant impact on the relevance, reliability, comparability, understandability and materiality of the information provided by the financial statements. The auditor discusses in an open and frank manner with those charged with governance the auditor's views on the quality and acceptability of the entity's accounting practices and financial reporting. Such discussions may include the appropriateness of accounting estimates and judgments, for example in relation to provisions, including the consistency of assumptions and degree of prudence reflected in the recorded amounts.

#### **ISA 315: Understanding the entity and its environment and assessing the risks of material misstatement**

- 2** The auditor should obtain an understanding of the entity and its environment, including its internal control, sufficient to identify and assess the risks of material misstatement of the financial statements whether due to fraud or error, and sufficient to design and perform further audit procedures [etc.]
- 28** **The auditor should obtain an understanding of the entity's selection and application of accounting policies and consider whether they are appropriate for its business and consistent with the applicable financial reporting framework and accounting policies used in the relevant industry.** The understanding encompasses the methods the entity uses

to account for significant and unusual transactions; the effect of significant accounting policies in controversial or emerging areas for which there is a lack of authoritative guidance or consensus; and changes in the entity's accounting policies. The auditor also identifies financial reporting standards and regulations that are new to the entity and considers when and how the entity will adopt such requirements. When the entity has changed its selection of or method of applying a significant accounting policy, the auditor considers the reasons for the change and whether it is appropriate and consistent with the requirements of the applicable financial reporting framework.

**41 The auditor should obtain an understanding of internal control relevant to the audit.**

The auditor uses the understanding of internal control to identify types of potential misstatements, consider factors that affect the risks of material misstatement, and design the nature, timing, and extent of further audit procedures. Internal control relevant to the audit is discussed in paragraphs 47-53 below. In addition, the depth of the understanding is discussed in paragraphs 54-56 below.

**54** Obtaining an understanding of internal control involves evaluating the design of a control and determining whether it has been implemented. Evaluating the design of a control involves considering whether the control, individually or in combination with other controls, is capable of effectively preventing, or detecting and correcting, material misstatements. Further explanation is contained in the discussion of each internal control component below. Implementation of a control means that the control exists and that the entity is using it. The auditor considers the design of a control in determining whether to consider its implementation. An improperly designed control may represent a material weakness in the entity's internal control and the auditor considers whether to communicate this to those charged with governance and management as required by paragraph 120.

**55** Risk assessment procedures to obtain audit evidence about the design and implementation of relevant controls may include inquiring of entity personnel, observing the application of specific controls, inspecting documents and reports, and tracing transactions through the information system relevant to financial reporting. Inquiry alone is not sufficient to evaluate the design of a control relevant to an audit and to determine whether it has been implemented.

**56** Obtaining an understanding of an entity's controls is not sufficient to serve as testing the operating effectiveness of controls, unless there is some automation that provides for the consistent application of the operation of the control (manual and automated elements of internal control relevant to the audit are further described below). For example, obtaining audit evidence about the implementation of a manually operated control at a point in time does not provide audit evidence about the operating effectiveness of the control at other times during the period under audit. However, IT enables an entity to process large volumes of data consistently and enhances the entity's ability to monitor the implementing security controls in applications, databases, and operating systems. Therefore, because of the inherent consistency of IT processing, performing audit procedures to determine whether an automated control has been implemented may serve as a test of that control's operating effectiveness, depending on the auditor's assessment and testing of controls such as those over program changes. Tests of the operating effectiveness of controls are further described in ISA (UK and Ireland) 330.

**108 As part of the risk assessment as described in paragraph 100, the auditor should determine which of the risks identified are, in the auditor's judgment, risks that require**

**special audit consideration (such risks are defined as “significant risks”).** In addition, ISA (UK and Ireland) 330, paragraphs 44 and 51 describe the consequences for further audit procedures of identifying a risk as significant.

**109** The determination of significant risks, which arise on most audits, is a matter for the auditor’s professional judgment. In exercising this judgment, the auditor excludes the effect of identified controls related to the risk to determine whether the nature of the risk, the likely magnitude of the potential misstatement including the possibility that the risk may give rise to multiple misstatements, and the likelihood of the risk occurring are such that they require special audit consideration. Routine, non-complex transactions that are subject to systematic processing are less likely to give rise to significant risks because they have lower inherent risks. On the other hand, significant risks are often derived from business risks that may result in a material misstatement. In considering the nature of the risks, the auditor considers a number of matters, including the following:

- Whether the risk is a risk of fraud.
- Whether the risk is related to recent significant economic, accounting or other developments and, therefore, requires specific attention.
- The complexity of transactions.
- Whether the risk involves significant transactions with related parties.
- The degree of subjectivity in the measurement of financial information related to the risk specially those involving a wide range of measurement uncertainty.
- Whether the risk involves significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual.

**113** **For significant risks, to the extent that the auditor has not already done so, the auditor should evaluate the design of the entity’s related controls, including relevant control activities, and determine whether they have been implemented.** An understanding of the entity’s controls related to significant risks is required to provide the auditor with adequate information to develop an effective audit approach. Management ought to be aware of significant risks; however, risks relating to significant non-routine or judgmental matters are often less likely to be subject to routine controls. Therefore, the auditor’s understanding of whether the entity has designed and implemented controls for such significant risks includes whether and how management responds to the risks and whether control activities such as a review of assumptions by senior management or experts, formal procedures for estimations or approval by those charged with governance have been implemented to address the risks. For example, where there are one-off events such as receipt of notice of a significant lawsuit, consideration of the entity’s response will include such matters as whether it has been referred to appropriate experts (such as internal or external legal counsel), whether an assessment has been made of the potential effect, and how it is proposed that the circumstances are to be disclosed in the financial statements.

#### **ISA 330: The auditor’s procedures in response to assessed risks**

**4** **The auditor should determine overall responses to address the risks of material misstatement at the financial statement level.** Such responses may include emphasizing to the audit team the need to maintain professional scepticism in gathering and evaluating

audit evidence, assigning more experienced staff or those with special skills or using experts, providing more supervision, or incorporating additional elements of unpredictability in the selection of further audit procedures to be performed. Additionally, the auditor may make general changes to the nature, timing or extent of audit procedures as an overall response, for example, performing substantive procedures at period end instead of at an interim date.

**7 The auditor should design and perform further audit procedures whose nature, timing and extent are responsive to the assessed risks of material misstatement at the assertion level.** The purpose is to provide a clear linkage between the nature, timing and extent of the auditor's further audit procedures and the risk assessment. In designing further audit procedures, the auditor considers such matters as the following:

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

The nature of the audit procedures is of most importance in responding to the assessed risks.

**8** The auditor's assessment of the identified risks at the assertion level provides a basis for considering the appropriate audit approach for designing and performing further audit procedures. In some cases, the auditor may determine that only by performing tests of controls may the auditor achieve an effective response to the assessed risk of material misstatement for a particular assertion. In other cases, the auditor may determine that performing only substantive procedures is appropriate for specific assertions and, therefore, the auditor excludes the effect of controls from the relevant risk assessment. This may be because the auditor's risk assessment procedures have not identified any effective controls relevant to the assertion, or because testing the operating effectiveness of controls would be inefficient. However, the auditor needs to be satisfied that performing only substantive procedures for the relevant assertion would be effective in reducing the risk of material misstatement to an acceptably low level. Often the auditor may determine that a combined approach using both tests of the operating effectiveness of controls and substantive procedures is an effective approach. Irrespective of the approach selected, the auditor designs and performs substantive procedures for each material class of transactions, account balance, and disclosure as required by paragraph 49.

**12** In determining the audit procedures to be performed, the auditor considers the reasons for the assessment of the risk of material misstatement at the assertion level for each class of transactions, account balance, and disclosure. This includes considering both the particular characteristics of each class of transactions, account balance, or disclosure (i.e., the inherent risks) and whether the auditor's risk assessment takes account of the entity's controls (i.e., the control risk). For example, if the auditor considers that there is a lower risk that a material

misstatement may occur because of the particular characteristics of a class of transactions without consideration of the related controls, the auditor may determine that substantive analytical procedures alone may provide sufficient appropriate audit evidence. On the other hand, if the auditor expects that there is a lower risk that a material misstatement may arise because an entity has effective controls and the auditor intends to design substantive procedures based on the effective operation of those controls, then the auditor performs tests of controls to obtain audit evidence about their operating effectiveness. This may be the case, for example, for a class of transactions of reasonably uniform, noncomplex characteristics that are routinely processed and controlled by the entity's information system.

- 23** **When the auditor's assessment of risks of material misstatement at the assertion level includes an expectation that controls are operating effectively, the auditor should perform tests of controls to obtain sufficient appropriate audit evidence that the controls were operating effectively at relevant times during the period under audit.** See paragraphs 39-44 below for discussion of using audit evidence about the operating effectiveness of controls obtained in prior audits.
- 26** Testing the operating effectiveness of controls is different from obtaining audit evidence that controls have been implemented. When obtaining audit evidence of implementation by performing risk assessment procedures, the auditor determines that the relevant controls exist and that the entity is using them. When performing tests of the operating effectiveness of controls, the auditor obtains audit evidence that controls operate effectively. This includes obtaining audit evidence about how controls were applied at relevant times during the period under audit, the consistency with which they were applied, and by whom or by what means they were applied. If substantially different controls were used at different times during the period under audit, the auditor considers each separately. The auditor may determine that testing the operating effectiveness of controls at the same time as evaluating their design and obtaining audit evidence of their implementation is efficient.
- 29** **The auditor should perform other audit procedures in combination with inquiry to test the operating effectiveness of controls.** Although different from obtaining an understanding of the design and implementation of controls, tests of the operating effectiveness of controls ordinarily include the same types of audit procedures used to evaluate the design and implementation of controls, and may also include reperformance of the application of the control by the auditor. Since inquiry alone is not sufficient, the auditor uses a combination of audit procedures to obtain sufficient appropriate audit evidence regarding the operating effectiveness of controls. Those controls subject to testing by performing inquiry combined with inspection or reperformance ordinarily provide more assurance than those controls for which the audit evidence consists solely of inquiry and observation. For example, an auditor may inquire about and observe the entity's procedures for opening the mail and processing cash receipts to test the operating effectiveness of controls over cash receipts. Because an observation is pertinent only at the point in time at which it is made, the auditor ordinarily supplements the observation with inquiries of entity personnel, and may also inspect documentation about the operation of such controls at other times during the audit period in order to obtain sufficient appropriate audit evidence.
- 30** The nature of the particular control influences the type of audit procedure required to obtain audit evidence about whether the control was operating effectively at relevant times during the period under audit. For some controls, operating effectiveness is evidenced by documentation. In such circumstances, the auditor may decide to inspect the documentation to obtain audit evidence about operating effectiveness. For other controls, however, such documentation may not be available or relevant. For example, documentation of operation

may not exist for some factors in the control environment, such as assignment of authority and responsibility, or for some types of control activities, such as control activities performed by a computer. In such circumstances, audit evidence about operating effectiveness may be obtained through inquiry in combination with other audit procedures such as observation or the use of CAATs.

## **ISA 500: Audit evidence**

- 2 The auditor should obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the audit opinion.**
- 11 When information produced by the entity is used by the auditor to perform audit procedures, the auditor should obtain audit evidence about the accuracy and completeness of the information.** In order for the auditor to obtain reliable audit evidence, the information upon which the audit procedures are based needs to be sufficiently complete and accurate. For example, in auditing revenue by applying standard prices to records of sales volume, the auditor considers the accuracy of the price information and the completeness and accuracy of the sales volume data. Obtaining audit evidence about the completeness and accuracy of the information produced by the entity's information system may be performed concurrently with the actual audit procedure applied to the information when obtaining such audit evidence is an integral part of the audit procedure itself. In other situations, the auditor may have obtained audit evidence of the accuracy and completeness of such information by testing controls over the production and maintenance of the information. However, in some situations the auditor may determine that additional audit procedures are needed. For example, these additional procedures may include using computer-assisted audit techniques (CAATs) to recalculate the information.
- 19** The auditor obtains audit evidence to draw reasonable conclusions on which to base the audit opinion by performing audit procedures to:
- (a) Obtain an understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement at the financial statement and assertion levels (audit procedures performed for this purpose are referred to in the ISAs (UK and Ireland) as “risk assessment procedures”);
  - (b) When necessary or when the auditor has determined to do so, test the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level (audit procedures performed for this purpose are referred to in the ISAs (UK and Ireland) and “tests of controls”); and
  - (c) Detect material misstatements at the assertion level (audit procedures performed for this purpose are referred to in the ISAs (UK and Ireland) as “substantive procedures” and include tests of details of classes of transactions, account balances, and disclosures and substantive analytical procedures).
- 32** The auditor performs audit procedures in addition to the use of inquiry to obtain sufficient appropriate audit evidence. Inquiry alone ordinarily does not provide sufficient audit evidence to detect a material misstatement at the assertion level. Moreover, inquiry alone is not sufficient to test the operating effectiveness of controls.



## Appendix 3

### Extracts from Conduct Committee Terms of Reference

#### Terms of Reference in effect from 1 July 2012

#### 1. Membership

The Conduct Committee is a Committee of and shall be appointed by the FRC Board of Directors. Membership of the Committee shall comprise

- Chair of the Conduct Committee
- Executive Director of Conduct
- Other non-executive Directors of the FRC
- Chair of the Monitoring Committee
- Chair of the Case Management Committee
- Other Committee members.

The Committee shall have a majority of members who are not practising accountants and/or actuaries and no member shall be a practising auditor or officer of the professional bodies regulated by the Committee.

#### 8. Responsibilities

##### Matters reserved to the Committee

The Committee shall

- a) Exercise the delegated functions of the Secretary of State under section 457 Companies Act 2006 and section 14(2) of the Companies (Audit, Investigations and Community Enterprise) Act 2004;
- b) Maintain the Conduct Committee Operating Procedures;
- c) Appoint members of the Financial Reporting Review Panel;

##### Matters delegated to the Committee by the FRC Board

The Committee shall:

- a) Oversee the FRC's conduct work with the objective of promoting high quality corporate governance and reporting;
- b) Approve the executive's monitoring of each RSB and RQB's compliance with the requirements of the Companies Act 2006;
- c) Advise the FRC Board on its exercise of the delegated functions of the Secretary of State under Part 42 of the Companies Act 2006 and its exercise of the functions of the Independent Supervisor appointed under Chapter 3 of Part 42 of the Companies Act 2006 including on
  - i) the continued recognition of bodies to offer a recognised audit qualification and/or to supervise auditors
  - ii) the need to impose a direction or penalty on an RSB or RQB
  - iii) the need to apply to the court for an Order to require a RSB or RQB to meet its statutory obligations
  - iv) the recognition of an Overseas audit qualification
  - v) the maintenance and exercise of the arrangements necessary to supervise the Auditors General
- d) Advise the FRC Board on the maintenance and exercise of the arrangements for the independent monitoring of the performance of statutory audit functions by means of inspections and for independent investigation and discipline of public interest cases

- e) Advise the FRC Board on the publication of annual public reports of the FRC's conduct activities
- f) Advise the FRC Board on the approach to be taken to non-statutory oversight of the actuarial and accountancy professions
- g) Approve operating plans governing the FRC's conduct activities and oversee the quality of work and delivery of the plan;
- h) Set strategic goals for the FRC's supervisory, monitoring and disciplinary work, including by identifying the main areas of risk that need to be addressed;
- i) Set standards for the quality of supervisory, monitoring and disciplinary work and the criteria to be applied in regulatory decisions;
- j) Decide whether to commence an investigation under the Accountancy or Actuarial Scheme, determine its scope, and thereafter have general oversight of cases and budgets;
- k) Maintain the Panel of Tribunal Members from which Disciplinary and Appeal Tribunals and persons who decide whether to give leave to appeal shall be appointed for the purposes of the Accountancy or Actuarial Schemes;
- l) Decide whether to commence a supervisory inquiry, determine the scope of any such inquiry and what, if any, action to be taken on its conclusion;
- m) Identify the current, emerging and potential risks to the quality of corporate governance and reporting in the UK;
- n) Assess the risks to the quality of corporate governance and reporting in the UK and approve the adequacy of actions to mitigate those risks
- o) Approve any plans for thematic studies and the publication of any findings from such work;
- p) Appoint members of the Monitoring Committee and Case Management Committee;
- q) Perform such other functions as shall be determined by the Board from time to time.

## Terms of reference in effect from 13 December 2012

### 8. Responsibilities

#### Matters reserved to the Committee

The Committee shall

- a) Exercise the delegated functions of the Secretary of State under section 457 Companies Act 2006 and section 14(2) of the Companies (Audit, Investigations and Community Enterprise) Act 2004;
- b) Maintain the Conduct Committee Operating Procedures;
- c) Appoint members of the Financial Reporting Review Panel;

#### Matters delegated to the Committee by the FRC Board

The Committee shall:

- a) Oversee the FRC's conduct work with the objective of promoting high quality corporate governance and reporting;
- b) Oversee the executive's monitoring of compliance with the requirements of the Companies Act 2006 by each recognised supervisory body (RSB) and recognised qualifying body (RQB);
- c) Advise the FRC Board on its exercise of the delegated functions of the Secretary of State under Part 42 of the Companies Act 2006 and its exercise of the functions of the Independent Supervisor appointed under Chapter 3 of Part 42 of the Companies Act 2006 including on
  - i) the continued recognition of bodies to offer a recognised audit qualification and/or to supervise auditors
  - ii) the need to impose a direction or penalty on an RSB or RQB
  - iii) the need to apply to the court for an Order to require a RSB or RQB to meet its statutory obligations

- iv) the recognition of an Overseas audit qualification
- v) the maintenance and exercise of the arrangements necessary to supervise the Auditors General;
- d) Advise the FRC Board on the approach to be taken to non-statutory oversight of the actuarial and accountancy professions;
- e) Advise the FRC Board on the maintenance and exercise of the arrangements for the independent monitoring of the performance of statutory audit functions by means of inspections and for independent investigation and discipline of public interest cases;
- f) Exercise those functions delegated to the Conduct Committee in accordance with the Accountancy and Actuarial Schemes, including the commencement of an investigation and the determination of its scope, and have general oversight of cases and budgets;
- g) Decide whether to commence a supervisory inquiry, determine the scope of any such inquiry and what, if any, action to be taken on its conclusion;
- h) Advise the FRC Board on the publication of annual public reports of the FRC's conduct activities;
- i) Appoint members of the Monitoring Committee and Case Management Committee;
- j) Approve operating plans governing the FRC's conduct activities and oversee the quality of work and delivery of the plan;
- k) Set strategic goals for the FRC's supervisory, monitoring and disciplinary work, including by identifying the main areas of risk that need to be addressed;
- l) Set standards for the quality of supervisory, monitoring and disciplinary work and the criteria to be applied in regulatory decisions;
- m) Identify the current, emerging and potential risks to the quality of corporate governance and reporting in the UK;
- n) Assess the risks to the quality of corporate governance and reporting in the UK and approve the adequacy of actions to mitigate those risks;
- o) Approve any plans for thematic studies and the publication of any findings from such work;
- p) Perform such other functions as shall be determined by the Board from time to time.

## **Terms of reference in effect from 1 April 2016**

### **1. Membership**

The Conduct Committee is a Committee of and shall be appointed by the FRC Board of Directors. Membership of the Committee shall comprise

- Chair of the Conduct Committee
- Executive Director of Audit
- Other non-executive Directors of the FRC
- Chair of the CRR Committee
- Chair of the AQR Committee
- Chair of the Case Management Committee
- Other Committee members.

The Committee shall have a majority of members who are not practising accountants and/or actuaries and no member shall be a practising auditor or officer of the professional bodies regulated by the FRC.

### **8. Responsibilities**

#### Matters reserved to the Committee

The Committee shall

- a) Exercise the delegated functions of the Secretary of State under section 457 Companies Act 2006 and section 14(2) of the Companies (Audit, Investigations and Community Enterprise) Act 2004;
- b) Maintain the Conduct Committee Operating Procedures; and
- c) Appoint members of the Financial Reporting Review Panel.

## Matters delegated to the Committee by the FRC Board

The Committee shall:

- a) Oversee the FRC's conduct work with the objective of promoting high quality corporate governance and reporting;
- b) Oversee the executive's monitoring of compliance with the requirements of the Companies Act 2006 by each recognised supervisory body (RSB) and recognised qualifying body (RQB);
- c) Advise the FRC Board on its exercise of the delegated functions of the Secretary of State under Part 42 of the Companies Act 2006 and its exercise of the functions of the Independent Supervisor appointed under Chapter 3 of Part 42 of the Companies Act 2006 including on
  - i) the continued recognition of bodies to offer a recognised audit qualification and/or to supervise auditors
  - ii) the need to impose a direction or penalty on an RSB or RQB
  - iii) the need to apply to the court for an Order to require a RSB or RQB to meet its statutory obligations
  - iv) the recognition of an Overseas audit qualification
  - v) the maintenance and exercise of the arrangements necessary to supervise the Auditors General;
- d) Advise the FRC Board on the approach to be taken to non-statutory oversight of the actuarial and accountancy professions;
- e) Advise the FRC Board on the maintenance and exercise of the arrangements for the independent monitoring of the performance of statutory audit functions by means of inspections and for independent investigation and discipline of public interest cases;
- f) Exercise those functions delegated to the Conduct Committee in accordance with the Accountancy and Actuarial Schemes, including the commencement of an investigation and the determination of its scope, and have general oversight of cases and budgets;
- g) Decide whether to commence a supervisory inquiry, determine the scope of any such inquiry and what, if any, action to be taken on its conclusion;
- h) Advise the FRC Board on the publication of annual public reports of the FRC's conduct activities;
- i) Consider and respond to requests for advice from the Codes & Standards Committee, having taken the advice of one or more of the AQR, CRR or Case Management Committees if appropriate;
- j) Appoint members of the AQR, CRR and Case Management Committees;
- k) Approve operating plans governing the FRC's conduct activities and oversee the quality of work and delivery of the plan;
- l) Set strategic goals for the FRC's supervisory, monitoring and disciplinary work, including by identifying the main areas of risk that need to be addressed;
- m) Set standards for the quality of supervisory, monitoring and disciplinary work and the criteria to be applied in regulatory decisions;
- n) Identify the current, emerging and potential risks to the quality of corporate governance and reporting in the UK;
- o) Assess the risks to the quality of corporate governance and reporting in the UK and approve the adequacy of actions to mitigate those risks;
- p) Approve any plans for thematic studies and the publication of any findings from such work;
- q) Perform such other functions as shall be determined by the Board from time to time.

## Terms of reference in effect from 17 June 2016

### Terms of Reference

#### 1. Membership

The Conduct Committee is a Committee of and shall be appointed by the FRC Board of Directors. Membership of the Committee shall comprise

- Chair of the Conduct Committee
- Executive Director of Audit
- Other non-executive Directors of the FRC
- Chair of the CRR Committee
- Chair of the AQR Committee
- Chair of the Case Management Committee
- Other Committee members.

The Committee shall have a majority of members who are not practising accountants and/or actuaries and no member shall be:

- a. a member of the Codes & Standards Committee;
- b. a practising auditor or an individual who has during the previous 3 years
  - i. carried out statutory audits;
  - ii. held voting rights in an auditing firm;
  - iii. been a member of an administrative management or supervisory body of an audit firm; or
  - iv. been a partner, employee or otherwise contracted by an audit firm; or
- c. an officer of any of the accountancy or actuarial professional bodies.

#### 8. Responsibilities

##### Matters reserved to the Committee

The Committee shall

- a) Exercise the delegated functions of the Secretary of State under section 457 Companies Act 2006 and section 14(2) of the Companies (Audit, Investigations and Community Enterprise) Act 2004;
- b) Maintain the Conduct Committee Operating Procedure; and
- c) Appoint members of the Financial Reporting Review Panel.

##### Matters delegated to the Committee by the FRC Board

The Committee shall:

- a) Oversee the FRC's supervisory, monitoring and enforcement work with the objective of promoting high quality corporate governance and reporting;
- b) Oversee the executive's monitoring of compliance with the conditions of the delegation arrangements with each recognised supervisory body (RSB) under SATCAR16;
- c) Oversee the executive's monitoring of compliance with the requirements of the Companies Act 2006 by each (RSB) and recognised qualifying body (RQB);
- d) Advise the FRC Board on its exercise of the functions of the competent authority under SATCAR16 including on the delegation of tasks to the RSBs or their removal or retention;

- e) Advise the FRC Board on its exercise of the delegated functions of the Secretary of State under Part 42 of the Companies Act 2006 and its exercise of the functions of the Independent Supervisor appointed under Chapter 3 of Part 42 of the Companies Act 2006 including on
  - i) the continued recognition of bodies to offer a recognised audit qualification and/or to supervise auditors
  - ii) the need to impose a direction or penalty on an RSB or RQB
  - iii) the need to apply to the court for an Order to require a RSB or RQB to meet its statutory obligations
  - iv) the recognition of an Overseas audit qualification
  - v) the maintenance and exercise of the arrangements necessary to supervise the Auditors General;
- f) Advise the FRC Board on the approach to be taken to non-statutory oversight of the actuarial and accountancy professions;
- g) Advise the FRC Board on the maintenance and exercise of the arrangements for the monitoring of the performance of statutory audit functions by means of inspections and for investigation and discipline of public interest cases and audit enforcement;
- h) Exercise those functions delegated to the Conduct Committee in accordance with the Accountancy and Actuarial Schemes, the Auditor Regulatory Sanctions Procedure, Crown Dependency Auditor Regulatory Sanctions Procedure and the Audit Enforcement Procedure;
- i) Exercise those functions delegated to the Conduct Committee in accordance with the FRC's processes pursuant to Articles 4(2), 17(6) and 17(8) EU Audit Regulation and section 511A Companies Act 2006;
- j) Decide whether to commence a Case Enquiry, determine the scope of any such enquiry and what, if any, action to be taken on its conclusion;
- k) Advise the FRC Board on the publication of annual public reports of the FRC's conduct activities;
- l) Consider and respond to requests for advice from the Codes & Standards Committee, having taken the advice of one or more of the AQR, CRR or Case Management Committees if appropriate;
- m) Appoint members of the AQR, CRR, Case Management and Enforcement Committees;
- n) Approve operating plans governing the FRC's supervisory, monitoring and enforcement activities and oversee the quality of work and delivery of the plan;
- o) Set strategic goals for the FRC's supervisory, monitoring and enforcement work, including by identifying the main areas of risk that need to be addressed;
- p) Set standards for the quality of supervisory, monitoring and enforcement work and the criteria to be applied in regulatory decisions;
- q) Identify the current, emerging and potential risks to the quality of corporate governance and reporting in the UK;
- r) Assess the risks to the quality of corporate governance and reporting in the UK and approve the adequacy of actions to mitigate those risks;
- s) Approve any plans for thematic studies and the publication of any findings from such work;
- t) Perform such other functions as shall be determined by the Board from time to time.

## **Appendix 4**

### **GUIDANCE ON CONFLICTS OF INTEREST AND BIAS FOR AADB STAFF AND THE BOARD MEMBERS**

The FRC has issued “guiding principles on independence, confidentiality and conflicts of interest”, which apply to all FRC staff.

This document sets out the detailed procedures which apply to AADB staff and board members in respect of conflicts of interest and other circumstances where there is a danger of a perception of bias. It provides some guidance as to situations in which a conflict of interest or perception of bias might exist, but is not prescriptive. Rather, staff and board members should be guided by the FRC’s guiding principles and the guidance set out in this document.

#### **Conflicts of Interest**

A conflict of interest may arise where a person’s financial, professional or personal interests conflict, or could potentially conflict, with the interests of the AADB. Such conflicts can arise, for example, in the following circumstances:

Having a financial interest in an entity connected with a case; for example, a shareholding in a company the accounts or the audits of which may be subject to an investigation;

Receiving or due to receive a pension from an entity which is connected with a case;

Being a current or former partner, director or employee of a Member Firm or Predecessor Firm which is or may be subject to an investigation;

Being a current or former director, officer or employee of an entity which is connected with a case;

Acting or having acted in a professional capacity in relation to the subject matter of a case;

Having a spouse, partner or immediate family member who has one of the interests outlined above.

#### **Bias**

It is also important that AADB staff and board members should act, and be seen to act, objectively and independently. They should not be biased or prejudiced and should not be involved in taking decisions where there is a real likelihood that they may be perceived to be biased. In addition to conflicts of interests discussed above, a perception of bias may arise in various other circumstances, for example:

where there is a close personal, business or family relationship with an individual or firm which is the subject of an investigation;

previous involvement in a dispute with an individual or firm which is the subject of an investigation;

involvement in other legal or disciplinary proceedings connected to an investigation;

a past or continuing professional involvement with any individual, firm or matter connected to an investigation;

publication of views or comments relating to any individual, firm or matter connected to an investigation

### **Disclosure**

Should any AADB staff or board member become aware of any matters which might give rise to a conflict of interest or a perception of bias, they should disclose this to the Chairman or the Executive Counsel. Staff and Board members should err on the side of caution and should declare any matters which might reasonably be perceived to give rise to a conflict of interest or perception of bias.

The Chairman (or, in his absence or in the event of a conflict on his part, a legally qualified barrister/solicitor board member) will decide whether or not any matter notified should prevent the relevant person from becoming involved in a particular case or decision.

In the event that the Executive Counsel has a conflict or potential conflict of interest or where there might be a perception of bias in relation to a particular case, he should report this to the Chairman. The AADB board will decide whether or not to appoint an alternate executive counsel.

### **Hospitality and Gifts**

This is also covered in the FRC guiding principles. Staff and board members should also be careful not to accept undue gifts or hospitality from Participants, Members or Member Firms. FRC guidelines require hospitality estimated to have cost more than £100 per person or a gift estimated to have cost more than £25 to be reported to the FRC Secretary for inclusion in a register, regardless of whether the hospitality or gift is accepted or refused.

### **Tribunal and Appeal Tribunal Members**

Although similar issues will apply to Tribunal and Appeal Tribunal members, they have been briefed separately on conflicts of interest and bias at the induction day.



## **Code of Conduct for Board Members**

### **Introduction**

This document sets out a code of conduct for “board members” i.e. all non executive and executive members of the board of FRC Ltd and all members of each of the operating bodies (the OBs) of the FRC. The Code has been prepared with reference to the “Seven Principles of Public Life” set out by the Committee on Standards in Public Life (Appendix 1).

The Code applies to board members in the conduct of their work as a board member and the application of the Code will depend on the particular remit of the relevant board and/or OB.

### **General principles**

Board members will at all times

- Observe the highest standards of impartiality, integrity and objectivity in relation to the regulatory activities undertaken by and the management of the FRC and/or its OBs
- Ensure that the activities of the FRC and/or its OBs are undertaken in the most economical, efficient and effective way, within available resources
- Be accountable to the FRC’s stakeholders, to the public and where appropriate, Parliament for the activities of the FRC and/or its OBs
- Ensure that the FRC and/or its OBs operate in accordance with the Better Regulation Executive’s principles of good regulation

### **Collective responsibilities of board members**

Board members have collective responsibility for the success of the FRC and/or its OBs. They must

- Ensure that high standards of corporate governance are observed at all times;
- Establish the strategic aims of the FRC/relevant OB within the policy and resources framework agreed by the FRC Board;
- Ensure the relevant board operates within the limits of its authority, whether statutory, delegated or derived by agreement with any stakeholder;
- Ensure that the obligations of the relevant board to its stakeholders and others are understood and met.

### **Responsibilities of individual board members**

Individual board members should be aware of their wider responsibilities as members of the FRC Board or one of its OBs. All board members must act in the way they consider, in good faith, would be most likely to promote the success of the FRC for the benefit of its stakeholders and in the public interest.

Board members must

- Comply at all times with this Code of Conduct;
- Act in the way they consider, in good faith, would be most likely to promote the success of the FRC for the benefit of its stakeholders and in the public interest;
- Not misuse information gained in the course of their public service for personal gain nor seek to use their position within the FRC to promote their private interests or those of connected persons, firms, businesses or other organisations and to declare to the chair of their OB or the FRC Chair as appropriate and the Company Secretary any private interests which may be perceived to conflict with their duties;
- Ensure that they comply with the FRC rules on the acceptance of gifts and hospitality; and
- Ensure that they comply with the Confidentiality requirements set out below.

## **Conflicts of Interest**

Board members are entitled to manage their own affairs in privacy. However, their work must be carried out in an environment which is free from any suggestion of improper influence. Those providing information must be confident that it will be properly handled and conflicts of interest must be identified immediately they arise and be properly managed.

Board members must take steps to ensure that any conflict of interest which they may be subject to does not affect a decision taken by the FRC and/or its OBs.

The chair and other board members are therefore expected to register in the FRC's Register of Interests any personal or business interests which might influence their judgment or which could be perceived (by a reasonable member of the public) to do so.

Board members should register

- Relevant personal direct and indirect pecuniary interests
- Relevant direct and indirect pecuniary interests of close family members of which Board members could reasonably be expected to be aware and
- Relevant personal non-pecuniary interests, including those which arise from membership of clubs and other organisations.

In this paragraph "relevant" interest, whether pecuniary or non-pecuniary and whether direct or indirect, means any such interest which might influence the judgment of a board member or which could be perceived (by a reasonable member of the public) to influence his or her judgement in the exercise of his or her public duties; "indirect pecuniary interest" means an interest which arises from a connection with bodies which have a direct pecuniary interest in the activities of the FRC or from being a business partner of, or employed by, a person with such an interest.

The declaration form for the register of board members' interests is at Appendix 2. A short questionnaire which may assist in identifying conflicts which should be declared is at Appendix 3.

An oral declaration of any relevant interest, as defined above, should be made at any board or committee meeting if it relates specifically to a particular issue under consideration and should be recorded in the minutes of the meeting.

If the outcome of any discussion at a meeting could have a direct pecuniary effect on a board member, that member should not participate in the discussion or determination of matters in which he or she has such an interest and, following a declaration, should withdraw from the meeting (even if held in public).

## **Hospitality and gifts**

All Board members should exercise discretion in accepting, in their FRC or OB capacities, gifts or hospitality from persons or bodies whom the FRC regulates or from providers or potential providers of services to the FRC. Gifts or hospitality which could be construed by a reasonable onlooker as creating a sense of obligation to the donor or host in their favour must be refused.

Generally speaking, Board members should avoid gifts of more than a token nature and/or a frequent pattern of gifts from the same person or institution. Board members must not solicit gifts. Hospitality which is not associated with other activities in which the FRC should be represented should be treated with caution.

If Board members are in any doubt as to whether to refuse or accept hospitality or gifts they should consult the Chair of their operating body, the FRC Chair or Chief Executive or General Counsel.

The Company Secretary maintains a register of gifts and hospitality. Board members are asked to report the acceptance or refusal of hospitality and/or gifts of more than a token nature to the Company Secretary for inclusion in the register.

## **Confidentiality**

All information acquired by board members in the exercise of their functions as board members during their appointment is confidential to the FRC and/or its OBs. Board members must not during their appointment or afterwards (unless he or she is authorised by the FRC Chair or the relevant OB or is under a legal obligation to do so):

- i. use for his/her own benefit or the benefit of any other person; or
- ii. disclose to any person; or
- iii. through any failure to exercise all due care and diligence, cause or permit any unauthorised disclosure of:

any confidential information that he or she obtains by virtue of their position as a board member.

Your attention is drawn to the requirements under both legislation and regulation as to the disclosure of inside information. Consequently you should avoid making any statements that might risk a breach of these requirements without prior clearance from the Chair or Company Secretary.

## **Personal liability of board members**

Legal proceedings by a third party against individual board members of regulators are rare and board members are likely to have the benefit of a statutory exemption and/or the indemnity set out in the FRC's Articles of Association.

The Companies (Audit, Investigations etc) Act 2004 provides that the FRC, its OBs and their members are exempt from liability in damages for anything done or omitted to be done for the purposes of or in connection with the carrying out of the activities listed in the Act unless the act or omission is shown to have been in bad faith or where the claim is for damages for a breach of the European Convention of Human Rights. The FRC's Articles provide for individual board members to be indemnified by the FRC against damages and costs (including the costs of defending an action) incurred in connection with the execution of their duties as a board member provided that they have acted honestly and in good faith.

It may be necessary to rely on the indemnity set out in the Articles because either the statutory exemption does not apply or there is a dispute as to whether the exemption applies. In any event, the indemnity will not cover any liability incurred where the board member has acted, or failed to act, in bad faith or where his or her acts or omissions are outside or inconsistent with the scope of their responsibilities. Board members may also be personally liable if, for example, he or she makes a fraudulent statement which results in a loss to a third party or commits a breach of confidence under common law or a criminal offence under insider dealing legislation.

The FRC indemnity is conditional upon the following requirements and failure to comply may invalidate the indemnity:

Board members should inform General Counsel immediately they become aware of the possibility of a claim against them or the FRC. They should avoid any discussion of the matter with the potential claimant and under no circumstances admit liability on their own or the FRC's behalf or try to settle or compromise the potential claim. External legal advice should not be sought without the authority of General Counsel. Board members should give the FRC all reasonable cooperation and assistance in the handling of the claim or potential claim.

**This Code of Conduct was adopted by the FRC Board on 26 May 2009.**

## Code of Conduct for Board Members<sup>26</sup>

### Introduction

This document sets out a code of conduct for “board members” i.e. all non-executive and executive members of the board of FRC Ltd, all members of the Codes & Standards Committee and its Councils, the Conduct Committee and its Monitoring and Case Management Committees and the Financial Reporting Review Panel. The Code has been prepared with reference to the “Seven Principles of Public Life” set out by the Committee on Standards in Public Life.

The Code applies to board members in the conduct of their work as a board member and the application of the Code will depend on the particular remit of the Board and/or Committee etc of which they are a member.

### General principles

Board members will at all times

- Observe the highest standards of impartiality, integrity and objectivity in relation to the regulatory activities undertaken by and the management of the FRC
- Ensure that the activities of the FRC are undertaken in the most economical, efficient and effective way, within available resources
- Be accountable to the FRC’s stakeholders, to the public and where appropriate, Parliament for the activities of the FRC
- Ensure that the FRC operates in accordance with the Better Regulation Executive’s principles of good regulation

### Collective responsibilities of board members

Board members have collective responsibility for the success of the FRC. They must

- Ensure that high standards of corporate governance are observed at all times;
- Foster a culture of impartiality, integrity and objectivity among the FRC Executive;
- Establish the strategic aims of the FRC within the policy and resources framework agreed by the FRC Board;
- Ensure the relevant Board, Committee and/or Council operates within the limits of its authority, whether statutory, delegated or derived by agreement with any stakeholder;
- Ensure that the obligations of the relevant Board, Committee and/or Council to its stakeholders and others are understood and met.

### Responsibilities of individual board members

Individual board members should be aware of their wider responsibilities as board members. All board members must act in the way they consider, in good faith, would be most likely to promote the success of the FRC for the benefit of its stakeholders and in the public interest.

Board members must

- Comply at all times with this Code of Conduct;
- Act in the way they consider, in good faith, would be most likely to promote the success of the FRC for the benefit of its stakeholders and in the public interest;
- Not misuse information gained in the course of their public service for personal gain nor seek to use their position within the FRC to promote their private interests or those of connected persons, firms, businesses or other organisations and to declare to the chair of their Committee

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<sup>26</sup> The FRC published an updated Code of Conduct in October 2017. It can be found in the FRC’s “Governance Bible which is accessible here: <https://www.frc.org.uk/getattachment/ea7866a0-261c-4cc5-a89f-c84f9ff68e92/Governance-Bible-October-2017-final-for-web.pdf>

or Council or the FRC Chair as appropriate and the Company Secretary any private interests which may be perceived to conflict with their duties;

- Ensure that they comply with the FRC rules on the acceptance of gifts and hospitality; and
- Ensure that they comply with the Confidentiality requirements set out below.

### **Conflicts of Interest**

Board members are entitled to manage their own affairs in privacy. However, their work must be carried out in an environment which is free from any suggestion of improper influence. Those providing information must be confident that it will be properly handled and conflicts of interest must be identified immediately they arise and be properly managed.

Board members must take steps to ensure that any conflict of interest which they may be subject to does not affect a decision taken by the FRC.

Board members are therefore expected to register in the FRC's Register of Interests any personal or business interests which might influence their judgment or which could be perceived (by a reasonable member of the public) to do so.

Board members should register

- Relevant personal direct and indirect pecuniary interests
- Relevant direct and indirect pecuniary interests of close family members of which Board members could reasonably be expected to be aware and
- Relevant personal non-pecuniary interests, including those which arise from membership of clubs and other organisations.

In this paragraph "relevant" interest, whether pecuniary or non-pecuniary and whether direct or indirect, means any such interest which might influence the judgment of a board member or which could be perceived (by a reasonable member of the public) to influence his or her judgement in the exercise of his or her public duties; "indirect pecuniary interest" means an interest which arises from a connection with bodies which have a direct pecuniary interest in the activities of the FRC or from being a business partner of, or employed by, a person with such an interest.

An oral declaration of any relevant interest, as defined above, should be made at any board or committee meeting if it relates specifically to a particular issue under consideration and should be recorded in the minutes of the meeting.

If the outcome of any discussion at a meeting could have a direct pecuniary effect on a board member, that member should not participate in the discussion or determination of matters in which he or she has such an interest and, following a declaration, should withdraw from the meeting (even if held in public).

### **Hospitality and gifts**

All board members should exercise discretion in accepting, in their FRC capacity, gifts or hospitality from persons or bodies whom the FRC regulates or from providers or potential providers of services to the FRC. Gifts or hospitality which could be construed by a reasonable onlooker as amounting to a bribe and/or creating a sense of obligation to the donor or host in their favour must be refused.

Generally speaking, board members should avoid accepting excessive hospitality and/or hospitality which amounts to pure entertainment or gifts of more than a token nature and/or a frequent pattern of gifts from the same person or institution offered to them in their capacity as a board member. Board members must not solicit gifts. Hospitality which is not associated with other activities in which the FRC should be represented should be treated with caution.

If board members are in any doubt as to whether to refuse or accept hospitality or gifts they should consult the Chair of their operating body, the FRC Chair or Chief Executive or General Counsel.

The Company Secretary maintains a register of gifts and hospitality. Where hospitality estimated to have a value of more than £50 per person or a gift estimated to have cost more than £25 is offered to a Board member in their capacity as a Board member, whether it is accepted or refused, this should be

reported to the FRC Company Secretary for inclusion in the register. Board members are also encouraged to report gifts and hospitality of more than a trivial nature and which are estimated to have cost below the stated limits particularly where the gift or hospitality is received from a body or person the FRC regulates.

### **Confidentiality**

All information acquired by board members in the exercise of their functions as board members during their appointment is confidential to the FRC. Board members must not during their appointment or afterwards (unless he or she is authorised by the FRC Chair or the relevant Committee or is under a legal obligation to do so):

- i. use for his/her own benefit or the benefit of any other person; or
- ii. disclose to any person; or
- iii. through any failure to exercise all due care and diligence, cause or permit any unauthorised disclosure of:

any confidential information that he or she obtains by virtue of their position as a board member.

Your attention is drawn to the requirements under both legislation and regulation as to the disclosure of inside information. Consequently you should avoid making any statements that might risk a breach of these requirements without prior clearance from the Chair or Company Secretary.

### **Personal liability of board members**

Legal proceedings by a third party against individual board members of regulators are rare and board members are likely to have the benefit of a statutory exemption and/or the indemnity set out in the FRC's Articles of Association.

The Companies (Audit, Investigations etc) Act 2004 provides that the FRC, its members, officers and/or members of staff are exempt from liability in damages for anything done or omitted to be done for the purposes of or in connection with the carrying out of the activities listed in the Act unless the act or omission is shown to have been in bad faith or where the claim is for damages for a breach of the European Convention of Human Rights. The FRC's Articles provide for individual board members to be indemnified by the FRC against damages and costs (including the costs of defending an action) incurred in connection with the execution of their duties as a board member provided that they have acted honestly and in good faith.

It may be necessary to rely on the indemnity set out in the Articles because either the statutory exemption does not apply or there is a dispute as to whether the exemption applies. In any event, the indemnity will not cover any liability incurred where the board member has acted, or failed to act, in bad faith or where his or her acts or omissions are outside or inconsistent with the scope of their responsibilities. Board members may also be personally liable if, for example, he or she makes a fraudulent statement which results in a loss to a third party or commits a breach of confidence under common law or a criminal offence under insider dealing legislation.

The FRC indemnity is conditional upon the following requirements and failure to comply may invalidate the indemnity.

Board members should inform General Counsel immediately they become aware of the possibility of a claim against them or the FRC. They should avoid any discussion of the matter with the potential claimant and under no circumstances admit liability on their own or the FRC's behalf or try to settle or compromise the potential claim. External legal advice should not be sought without the authority of General Counsel. Board members should give the FRC all reasonable cooperation and assistance in the handling of the claim or potential claim.

**This Code of Conduct is adopted by the FRC Board with effect from 2 July 2012.**

## Appendix 5 – AADB, Conduct Committee and Case Management Committee Membership

### AADB

A list of members at the times of the considerations in 2009 and 2010 is set out below:

Name	Start of Term	End of Term
Timothy Walker (Chairman)	27/05/2008	18/10/2012
Graham Aslet	04/02/2008	18/10/2012
Jeremy Barnett	04/02/2008	18/10/2012
Sarah Brown	01/04/2004	31/03/2010
Dr Norval Bryson	04/02/2008	01/08/2009
Mark Eames	11/05/2010	18/10/2012
James Gemmell	01/07/2009	18/10/2012
Mike Green	11/05/2010	18/10/2012
Jan Kamieniecki	01/09/2009	18/10/2012
James Kellock	01/04/2009	18/10/2012
Chris Laine	01/04/2004	31/03/2009
Neil Lerner	01/04/2009	25/10/2010
Elizabeth Llewellyn-Smith	01/04/2004	17/10/2009
Stuart McKee	01/04/2004	31/03/2010
James Miller	01/08/2005	31/07/2009
Laurence Shurman	01/04/2004	31/03/2009
Paul Smith	01/04/2009	18/10/2012
Philip Taylor	01/03/2011	18/10/2012
David Thomas	01/04/2004	30/06/2009
Stephen Walzer	01/07/2009	18/10/2012

### Conduct Committee

A list of current and previous members at the time of key decisions is set out below:

Name	Start of term	End of term
David Childs* (Chairman)	01/05/2014	
Peter Baxter	01/04/2015	
Sir Brian Bender*	01/03/2014	
David Cannon	01/09/2015	
Sean Collins†	01/09/2015	
Geoffrey Green	01/04/2015	
John Hitchins	01/07/2017	
Gay Huey Evans*	01/01/2013	
Helen Jones	01/09/2015	
Emmy Labovitch	01/04/2017	
Melanie McLaren*	01/04/2016	

Name	Start of term	End of term
Malcolm Nicholson†	01/04/2012	
Martin Slack	01/07/2013	
Richard Fleck* (Chairman to 30/04/2014)	01/04/2012	31/03/2015
Lillian Boyle	01/04/2009	31/03/2016
Hilary Daniels	01/04/2012	31/03/2015
Mark Eames†	01/04/2012	31/03/2016
Paul George*	02/07/2012	31/03/2016
Jan Kamieniecki†	01/04/2012	31/03/2014
John Kellas*	01/04/2012	01/09/2015
Lois Moore	01/05/2012	31/03/2015
Joanna Osborne	01/04/2012	31/05/2017
Philip Taylor†	01/04/2012	31/05/2015
Timothy Walker*	01/04/2012	18/10/2012
Ian Wright	01/06/2014	31/05/2017

\* – FRC Board members

† – CMC members

#### **Case Management Committee ('CMC')**

Name	Start of Term	End of Term
Malcolm Nicholson* (Chairman)	18/10/2012	
David Brew	01/07/2013	
Sean Collins	01/07/2013	
Geraint Davies	01/03/2014	
Mark Eames*	01/09/2015	
Mike Green	18/10/2012	17/10/2013
Peter Hinchcliffe	01/09/2015	
Jim Jack*	01/04/2015	
Eilish Jamieson	01/07/2017	
Jan Kamieniecki	18/10/2012	31/03/2014
James Kellock	18/10/2013	17/10/2015
Richard Murray*	25/08/2016	
David Patterson	19/01/2016	
Cathy Robertson	01/07/2013	
Paul Smith	18/10/2012	13/03/2013
Philip Taylor	01/07/2012	31/03/2017
Stephen Wooler	01/07/2013	02/04/2017

\*Members of CMC appointed to the HBOS GCMC on 6 October 2016.



## Appendix 6

### Annex to Stephen Haddrill's letter to Andrew Tyrie dated 10 February 2016

The FRC has undertaken the following actions during and since the financial crisis to alert those responsible for corporate reporting and audit firms to emerging issues and to address concerns exposed by the crisis.

#### 1. Action taken in response to the crisis

- In December 2008 the FRC published a bulletin to highlight going concern issues during the then current economic conditions.
- In 2010 the UK Corporate Governance Code was updated with new measures to improve the effectiveness of Boards and their accountability to shareholders. The measures included the annual election of directors and regular reviews of Board effectiveness.
- Updates to the Corporate Governance Code in 2012 required annual reports and accounts to be 'fair, balanced and understandable', increased the responsibility and transparency of audit committees, and introduced extended auditors reports to enhance the scope and transparency of audit. This revision of the Code also introduced the requirement for audit contracts to be put to tender every 10 years.
- We encouraged the move to an expected loss model in international accounting standards. This has now been introduced by the IASB in its IFRS9 accounting standard and we are encouraging its adoption in Europe for use by banks in line with the international timetable.
- We undertook an inquiry, led by Lord Sharman, to identify lessons for companies and auditors addressing going concern and liquidity risks. That enquiry reported its findings in 2012 which led to separate going concern guidance for banks.
- In 2014 we updated the UK Corporate Governance Code to increase Boards' focus on risk and viability over the longer term.
- We maintain regular liaison meetings with the FPC and have agreed Memoranda of Understanding with the PRA and the FCA to aid collaboration between our organisations.
- In 2015 we developed with the FCA a standard to cover the work of auditors when reporting to the Financial Conduct Authority (FCA) on the compliance by financial services firms, with the FCA's Client Asset (CASS) rules. These provide for the effective safekeeping of client assets and client monies.

#### 2. Action taken to increase FRC supervision

- In our annual regime of audit monitoring we have, since the crisis, increased the scope of financial institutions monitored, focused on the degree of auditor scepticism and increased our focus on inspecting bank and building society audits, including reporting specifically on our findings regarding these institutions.
- From 2010/11 we have reported separately within our annual audit inspection report findings from our inspections of bank audits.
- In January 2011 we enhanced our liaison with the then FSA leading to a Memorandum of Understanding and better sharing of information between our two organisations. • In 2013 we initiated a thematic review of the auditing of banks and building societies over our concerns that the audits of these institutions were not showing as much improvement as the audits of other types of entities. The subsequent report published in 2014 was able to report that audit firms had taken on board our feedback and had improved their work in this sector.

**3. Disciplinary action where the auditor of a bank or building society or an accountant in the business may be guilty of misconduct. The FRC has brought a number of disciplinary cases for misconduct against auditors and accountants since the crisis. Some of the outcomes of these cases involving financial institutions include:**

- An admission of misconduct by PwC in 2011 in respect of the preparation of Client Asset reports to the FSA regarding JP Morgan Securities Limited.
- The exclusion from practice as accountants of two finance directors of Cattles PLC by the Independent Tribunal in 2013.
- A settlement agreed in 2014 against the former finance director of Bradford & Bingley plc over financial information and its relevance to the rights issue being planned by B&B and for failing to advise the Board appropriately.
- A settlement agreed in 2015 against Grant Thornton and two of its audit engagement partners and the finance director of the building society in relation to accounting issues at Manchester Building Society.
- A settlement agreed in 2015 in relation to the actions of a member of the Institute of Chartered Accountants in Ireland regarding the financial statements of the Presbyterian Mutual Society.
- Ongoing investigations involving events at financial institutions include:
  - PwC for its role in events at Cattles plc.
  - KPMG Audit Plc and The Co-operative Bank plc
  - KPMG and the audit of compliance with the client assets rules at BNY Mellon
  - PWC and the audit of compliance with the client assets rules at Barclays Bank PLC





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