IN THE MATTER OF:

THE EXECUTIVE COUNSEL TO THE FINANCIAL REPORTING COUNCIL

- and -

1. PRICEWATERHOUSECOOPERS LLP

2. SIMON BRADBURN

PARTICULARS OF FACT AND ACTS OF MISCONDUCT

I. INTRODUCTION

1. The Financial Reporting Council ("**the FRC**") is the independent disciplinary body for the accountancy and actuarial professions in the UK. The FRC's rules and procedures relating to accountants are set out in the Accountancy Scheme of 8 December 2014 ("**the Scheme**").

2. This is the Executive Counsel's Particulars of Facts and Acts of Misconduct ("**the Particulars**") as referred to in the Settlement Agreement dated 22nd August 2016 in respect of:

2.1 PricewaterhouseCoopers LLP ("**PwC**"), a member firm[1] of the Institute of Chartered Accountants in England and Wales ("**ICAEW**") at all material times; and

2.2 Simon Bradburn ("**Mr Bradburn**"), a former partner of PwC and a member of the ICAEW at all material times (together "**the Respondents**").

3. As, respectively, a member firm and a member of the ICAEW, the Respondents are a Member Firm and Member for the purposes of the Scheme.

4. These Particulars concern the Respondents' conduct in relation to the audit of the financial statements for the year ended 31 December 2007 of Cattles Plc ("**Cattles**" and "**the 2007 Cattles Financial Statements**") and the IFRS 7 disclosures therein and the audit, for the same year, of Welcome Financial Services Limited ("**WFS**" and "**the 2007 WFS Financial Statements**") and the IFRS 7 disclosures therein.

A. Background

The Cattles Group

5. Cattles was the parent company of a financial services group ("**the Cattles Group**") which specialised in "non-standard" (sometimes referred to as "sub-prime") lending. Cattles was a publicly listed company and, at the time of the 2007 audit, was a member of the FTSE 250. The Group's receivables were £2.8 billion according to the 2007 Cattles Financial Statements. WFS was the principal operating subsidiary and operated the principal lending business of the Cattles Group. Its Welcome division ("**Welcome**"), or "monthly business"[2], provided unsecured and secured loans and hire purchase facilities to what it termed "non- standard" customers. These customers typically were in employment, had bank accounts, and repaid monthly by direct debit, but had not been able to borrow from mainstream lenders. As at 31 December 2007, Welcome had over 500,000 customers. (Cattles and WFS are referred to collectively herein as "**the Companies**".)

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

[2] The "weekly business" was known as Shopacheck, and is not the subject of complaint.

PwC and Mr Bradburn

6. According to its financial statements for the year ended 30 June 2015, PwC has 885 equity partners and 19,741 members of staff working in its 31 offices. For the year ending 30 June 2015, PwC's profit, after tax in corporate subsidiaries but before income tax payable on profits by PwC's individual members, was £818m. PwC or its predecessor firms had acted as auditors for the Cattles Group since year end 1996. In November 2009, PwC resigned at the request of Cattles and WFS.

7. Mr Bradburn qualified as a Chartered Accountant on 7 November 1979. He joined Coopers & Lybrand in 1976 and became a Partner in 1986. Mr Bradburn was at all material times PwC's "Engagement Partner" for the Cattles Group audits. Mr Bradburn retired from PwC in July 2009, having given the required one year's notice in June 2008.

The Relevant Auditing Standards

8. In relation to the conduct of the year-end audit of the 2007 Cattles Financial Statements and the 2007 WFS Financial Statements the relevant auditing framework was that of the International Standards on Auditing (UK and Ireland) ("**ISAs**"). These were introduced on 22 December 2004 and applied to all audits of financial statements for periods commencing on or after 15 December 2004. The purpose of ISAs, issued by the Auditing Practices Board, is to establish standards and general principles with which auditors are required to comply in the conduct of an audit. All references in these Particulars to ISAs are to the ISAs in the form in which they stood as at the time PwC carried out its work on the 2007 year-end audit. The applicable ISAs are extracted and annexed to these Particulars at Annex A.

9. The responsibility for the preparation of the financial statements rests with the directors of the company. The objective of a statutory audit of financial statements of any company or group of companies is to enable the auditor to express an opinion as to whether the financial statements, prepared by management, "give a true and fair view". For a listed company like Cattles that is a "true and fair view in accordance with IFRSs adopted by the European

Union"[3]. In reaching this view the auditor must obtain a reasonable degree of assurance that the financial statements are free from material misstatement

10. As Engagement Partner, Mr Bradburn was responsible for the audit engagement and its performance, and for the auditor's report that was issued on behalf of the firm (ISA 220, paragraph 5(a)), and in particular his responsibilities included the following:

10.1 "*The engagement partner should take responsibility for the overall quality on each audit engagement to which that partner is assigned*" (ISA 220, paragraph 6);

10.2 "*The engagement partner should be satisfied that the engagement team collectively has the appropriate capabilities, competence and time to perform the audit in accordance with professional standards and regulatory and legal requirements, and to enable an auditor's report that is appropriate in the circumstances to be issued*" (ISA 220, paragraph 19); and

10.3 "*The engagement partner should take responsibility for the direction, supervision and performance of the audit engagement in compliance with professional standards and regulatory and legal requirements, and for the auditors' report that is issued to be appropriate in the circumstances*" (ISA 220, paragraph 21).

The Relevant Standards of Conduct

11. The standards of conduct reasonably to be expected of the Respondents included those set out in the Fundamental Principles and Statements contained in the 2007 Code of Ethics ("**the Code**") issued by the ICAEW, which came into force on 1 September 2006. Applicable Fundamental Principles and Statements are extracted and annexed to these Particulars at Annex B.

12. The Fundamental Principles set out in Paragraph 100.4 of the Code required the Respondents, inter alia, to act with:

- **Professional Competence and Due Care** – by maintaining professional knowledge and skill at the level required to ensure that a client receives

[3] Article 4 of the Regulation (EC) No 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards.

competent professional service based on current developments in practice and by acting diligently and in accordance with applicable technical and professional standards when providing professional services.

Financial reporting framework applicable to Cattles

13. As a listed company preparing consolidated group financial statements, Cattles was required to report under International Financial Reporting Standards ("**IFRS**"), which incorporated International Accounting Standards ("**IASs**"). For the 2007 Cattles Financial Statements, this included compliance with IAS 39, in respect of loan provisioning, and IFRS 7, specifically in respect of disclosures in relation to renegotiated debt and debt past due but not impaired. In the UK, IFRS had been phased in from 2005 but IFRS 7 first applied in 2007. Relevant extracts from IFRS 7 and IAS 39 are set out in Annex C. WFS was not required to report under IFRS but chose to do so.

PwC's work on the 2007 audit of Cattles and WFS and following events – an overview

14. PwC and Mr Bradburn gave an unqualified audit opinion in respect of each of the 2007 Cattles and WFS Financial Statements. PwC signed its audit report on the 2007 Cattles Financial Statements on 28 February 2008 and the Cattles Group made a preliminary announcement of its results to the market on the same day. The 2007 Cattles Financial Statements showed profit before tax of £165.2m and loans and receivables of £2,844m. The bulk of those loans and receivables related to WFS. According to the 2007 WFS Financial Statements, WFS had profit before tax of £130m and loans and receivables of £2,611.8m. PwC signed its audit report on the 2007 WFS Financial Statements on 18 March 2008.

15. In April 2008, following publication of the 2007 Annual Report and Financial Statements, Cattles undertook a rights issue which raised some £200m.

16. PwC signed its review report on the 2008 Cattles Interim Financial Statements on 28 August 2008. The half year report was not an audit and expressed no opinion on the Companies' financial statements.

17. During 2008, [redacted] became aware, in the course of implementation work in respect of

a new loan accounting system (ICBS / Siebel, which replaced Financier[4]), of debt which appeared to be inappropriately held in the unimpaired part of the Welcome loan book. [redacted] raised his concerns with certain of the Companies' executives and with the internal auditors[5], Deloitte LLP (**"Deloitte"**).

18. In October 2008, [redacted] approached Mr Bradburn, the gist of [redacted] concerns being that there was "*a large chunk of debt which has been kept out of provisioning, inappropriately*"[6]. [redacted] explained that this debt was being held in the "Asset Management Division" (also known as the Asset Management Branches or "**AMB**s"). Mr Bradburn was asked at interview with the FRC why PwC had not found out about the AMBs in the course of the 2007 audit. Mr Bradburn stated: "*I think, to a degree, because we hadn't been looking for it there and because nobody had told us about it."* Mr Bradburn referred to his belief that PwC had been *"systematically misled and that information [had been] withheld from [PwC] which should have been given to [the auditors]*".[7]

19. Following further investigation between October 2008 and February 2009, PwC obtained from the Companies details of the AMBs and, later, another unit holding unimpaired debt called the Specialist Collection Unit ("**SCU**"), the existence of which had also not been revealed to or identified by the auditors during the course of their 2007 audit work. In light of these investigations, PwC refused to sign an unqualified opinion on the Cattles financial statements for the year ended 31 December 2008 ("**the 2008 Cattles Financial Statements**").

20. On 20 February 2009, Cattles announced that publication of the 2008 Annual Report would be delayed[8]. The market reaction to this announcement was a 74% drop in share price from 13.25 pence on 19 February 2009 to 3.5 pence the following day[9]. The Board reported on 10 March 2009 that it believed

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[4] Financier was the loan accounting system used by WFS in the relevant period. It was replaced in February 2008 by ICBS / Siebel. Financier contained the accounting records of each individual loan, including the due dates for payment.

[5] Deloitte were the internal auditors at the time, having taken over from KPMG LLP in 2007.

[6] Transcript of AADB interview with Simon Bradburn, 30 June 2010, p.160.

[7] Transcript of AADB interview with Simon Bradburn, 30 June 2010, p.161.

[8] RNS announcement 20 February 2009.

[9] Bloomberg data.

Cattles was in breach of covenants under its borrowing arrangements[10]. Trading in Cattles shares was suspended on 23 April 2009[11]. In November 2009, PwC resigned as auditors at the request of the Board and Grant Thornton UK LLP ("**Grant Thornton**") were appointed as auditors in December 2009.

21. In the period following February 2009, three separate processes into the conduct of the Companies' executives or employees were commenced: the Companies instituted disciplinary proceedings against a number of their own executives and employees (as described further in paragraph 53 below); the FSA commenced an investigation into various executives at the Companies and the Companies themselves (as to which see paragraphs 54-57 below); and the FRC commenced another disciplinary investigation into members employed by the Companies (see paragraphs 58-59 below).

22. The 2008 Cattles Financial Statements, audited by Grant Thornton, were not published until May 2010. They recorded, amongst other things, that the Cattles Audit Committee had during 2009 commissioned:

22.1 Deloitte to conduct an independent review of the Group's impairment policies and their application in the Cattles accounts; and

22.2 Freshfields Bruckhaus Deringer LLP ("**Freshfields**") to carry out, with the assistance of Deloitte, a forensic review into the events at the Companies.

23. The Executive Chairman's[12] statement recorded as follows:

"The Forensic Review demonstrated that certain of the former executive directors of Cattles and certain of the former senior executives of WFS, over a period of time, had provided incomplete and misleading information and documents and/or failed to escalate matters of concern relating to impairment to the full Board and Audit Committee. The provision of such incomplete and misleading information and documents to the full Board and Audit Committee, in conjunction with the withholding of certain other information and documents,

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[10] RNS announcement 10 March 2009.

[11] RNS announcement 23 April 2009.

[12] [redacted] also former chair of the Cattles Audit Committee.

combined to mask the true state of Welcome's loan book and, in particular, the correct level of arrears within that book."

24. The 2008 Cattles Financial Statements included a restatement of the 2007 results, according to which:

24.1 Cattles' interest and fee income had been overstated by £42.6m, profit after tax had been overstated by £212m, net assets had been overstated by £360.8m and its loans and receivables balance had been overstated by £287.2m;

24.2 WFS's interest and fee income had been overstated by £42.6m (the same amount as in respect of Cattles as a whole), profit after tax had been overstated by £179.5m, net assets by £329m and its loans and receivables balance had also been overstated by £287.2m. Hence the bulk of the restatement of the Cattles Financial Statements related to WFS and, in particular, WFS's loans and receivables balance.

25. The primary reason for the difference between the original 2007 figures and the restated 2007 figures was the different bases upon which the WFS loan loss provision was calculated. The loan loss provision in the restated 2007 figures was calculated on the basis of loans which were 120 days in arrears, treating deferments as the equivalent of a missed payment. (This basis has sometimes been described as "strict contractual arrears", to distinguish it from the basis that was previously used by Cattles and WFS, which did not treat a deferment as a missed payment. This was variously referred to as "deferred arrears" or "deferred contractual arrears", although such terminology was not commonly in use at the time of the PwC audits.)

26. The 2008 Cattles Financial Statements calculated the loan loss provision for 2008 on the basis of strict contractual arrears; in addition, what was described as an Incurred But Not Reported ("**IBNR**") provision of £150m was made to provide for impaired debt which had not yet reached the 120 day trigger point on a strict contractual arrears basis. The Statement of Accounting Policies in the notes to the 2008 Cattles Financial Statements explained that "*objective evidence of impairment occurs after the customer misses one contractual payment*". This was, therefore, a different impairment trigger from that applied in Cattles 2007 Financial Statements (as to which see further below).

27. The effect of the restated figures was that Cattles' pre-tax profit figure for 2007 was adjusted from a pre-tax profit of £165.2m to a pre-tax loss of £96.5m. The very substantial difference in the restated figures is primarily attributable to the loan loss provision in respect of WFS. The loan loss provision in respect of WFS in the 2007 Financial Statements was substantially understated, in breach of IAS 39.

28. Furthermore, the description of the impairment policy as disclosed by Cattles, when taken together with the disclosures made in the 2007 Cattles Financial Statements in respect of renegotiated debt and debts past due but not impaired (which disclosures did not comply with IFRS 7 as it then was) was inadequate since the impact of deferments on the calculation of the loan loss provision was not made clear to a user of the financial statements. These matters are more particularly described at paragraphs 29 to 52 below.

Breach of IAS 39 – an overview

29. In determining WFS's loans and receivables balance in the 2007 WFS Financial Statements, an assessment had to be made by WFS as to the extent to which there was "objective evidence" that a debt (a financial asset) was impaired, as required by IAS 39.[13] This required, first, identification of the population of the impaired debt, based on objective evidence of impairment; and second, an assessment of how much of that debt was recoverable, in order to include a loan loss impairment provision for the amount by which the debt was impaired. IAS 39 required any loans that had not been considered individually for impairment to be grouped with loans with similar credit risk characteristics and assessed for impairment collectively.

30. The impairment policy disclosed in the 2007 Cattles Financial Statements for WFS was as follows: "*Welcome Financial Services determines that there is objective evidence of an impairment loss at the point at which they are not prepared to offer any further credit to a customer who has encountered serious repayment difficulties. In Welcome Finance this is assessed by reference to the number of days an account is* ***contractually in arrears****. When an account has reached 120 days arrears, there is an acceptance that the original contractual relationship has broken down. At this stage specialist account*

[13] Relevant extracts are in Annex C.

managers in Local Collection Units seek to establish a different working relationship with the customer, focusing instead on recovering part payments over a rescheduled repayment plan. At this point, interest on the account is suspended and no longer added to the outstanding balance." (Emphasis supplied.) (The Welcome trigger point for impairment, as described above, is referred to in this document as the "**120 days trigger**".)

31. That description of the WFS impairment policy was inadequate without further explanation because, unless the relevance of deferments to the impairment trigger was explained in the notes to the financial statements or in the IFRS 7 disclosures (which was not the case), it would naturally be understood by a reader of the financial statements as meaning that the trigger point for identifying the population of impaired debt was the point at which the customer had missed four of their monthly payment instalments according to the **original** loan agreement. It would not have been clear to the reader that the effect of deferments was to defer instalments which would otherwise have been due under the original terms, meaning that loans with many deferments may not be treated as overdue.

32. In fact, the basis on which the 2007 WFS and Cattles Financial Statements had been prepared was such that many customers had missed substantially more than four of their monthly instalments according to the contractual terms agreed at the inception of the loan, and yet their loans (by reason of deferments) were treated as not having reached the trigger point and as not being impaired.

33. As a lender operating in the "non-standard" market, Welcome expected that a proportion of its customers would experience payment difficulties; and that some would recover and ultimately meet their payment obligations whilst others would go on into default. This expectation was articulated in the phrase "in our market place 10 out of 12 payments represents a good customer"[14]. A missed payment, in itself, was not necessarily an indicator of impairment.

34. The forbearance techniques used by WFS included rewrites (where the terms of the loan were rewritten and treated as a new loan), renewals (where a further advance was made under a new loan and the old loan was treated as having been repaid) and deferments (also referred to as deferrals). Both rewrites and renewals were subject to new credit scoring. Deferment meant that WFS could, with or often

[14] WFS presentation to the Cattles board, 13 October 2004.

(although unbeknownst to PwC) without prior discussion with the customer, defer payments to the end of the contract term and treat them as not overdue until that point was reached.

35. The rationale for such techniques, which are commonly used in the non-standard lending industry, is that by showing forbearance[15] the customer may be managed back into meeting payment obligations. It is expected that non-standard borrowers will not repay as reliably as prime customers - this is part of the business model and loans are priced accordingly – and the use of such techniques can be appropriate loan management. Payment holidays are, for example, also common practice in the credit card market. A lender may grant a payment holiday and not seek repayment in a particular month; the customer would not be expected to pay and would not be regarded as being in arrears for that month. Forbearance techniques are also capable, however, of being misused to mask inappropriate loan impairment (and were in fact so used within Welcome as described below).

36. The scale on which deferments, in particular, were used in Welcome was very substantial. In the year ended 31 December 2007, almost 55% of the WFS loan book was subject to at least one deferment and over 22% was subject to 4 or more deferments[16]. The Companies have stated that this information was available at the time of the 2007 audit from "Financier" (WFS's accounting system).

37. As noted above, Welcome assessed whether or not an account was 120 days in arrears after applying any deferments. For example, if four monthly payments were missed and not deferred, a loan would be 120 days in arrears. However, if two of those payments were deferred, Welcome would treat only two of the payments as in arrears, and the loan would therefore be treated as being only 60 days in arrears.

38. The effect of applying deferments to an account when calculating the arrears was to delay a loan reaching 120 days in arrears, which was used by Welcome as the trigger point for impairment. The same was also true of loans that had been

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[15] Sometimes also referred to as a "payment holiday".

[16] See the Companies' Re-Re-Re Amended Particulars of Claim, Schedule 3

renewed or rewritten, which also had the effect of “restarting the clock” in relation to arrears, because the old loan was replaced with a new one[17].

39. No IBNR (i.e. a provision for unidentified losses "Incurred But Not Reported") was applied by Welcome to loans which had not reached the trigger point. The explanation for this which WFS management provided to PwC was that the nature of Welcome's business was such that it focused on customer relationships so that it was in active and regular contact with its individual borrowers[18]. Management asserted that: in those circumstances, Welcome was aware of impairment events more quickly than, say, a prime lender (with a less active relationship with its customers); that if Welcome was aware of such an impairment event, the loan would be impaired regardless of whether it had reached 120 days in arrears since the trigger point was the breakdown of the relationship with the customer; and so any provision relating to unidentified loss events was unlikely to be material.

40. Welcome had developed a structure for managing loans, whereby loans that were less than 60 days in arrears were managed by the relevant Operational Branch, loans between 60 days in arrears and 120 days were managed by a Local Management Branch (“**LMB**”) or, as from 2007 (but unbeknownst to PwC at the time of the 2007 audit), by an AMB in the case of secured loans, or a SCU and only once a loan reached the trigger point of 120 days (on a deferred arrears basis) was it treated as impaired and transferred to a Local Collection Unit (“**LCU**”). As a result, only the debt located in the LCUs was treated by WFS as impaired, whilst the debt located in the branches, LMBs, AMBs and SCUs was treated as wholly unimpaired, notwithstanding the fact that it may contain loans with more than four missed payments.

41. In short, that part of the WFS loan book which was less than 120 days in arrears, after taking into account deferments (which could be multiple deferments), renewals and rewrites, was treated by WFS as unimpaired debt and no loan loss provision at all was made in respect of it.

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[17] Deloitte Credit Impairment Report to the Audit Committee, February 2008.

[18] If a loan repayment instalment was missed – in effect a direct debit instruction returned by the customer’s bank for any reason – the customer account manager was responsible for immediately contacting the customer to establish the reasons for non-payment, and to agree arrangements for its subsequent payment (according to speaker notes dated 17 January 2008 prepared by [redacted] for Mr Corr's presentation to analysts in relation to Welcome Credit Quality, 80% of customers who missed a payment were contacted within 24 hours).

42. As PwC discovered in late 2008 / early 2009, and Deloitte subsequently found[19] when they investigated the impairment policy and the unimpaired loan book in 2009, there was objective evidence that much of the debt that had not reached the LCUs was in fact impaired, since debt had not been treated as impaired due to the use of forbearance techniques and the concealment of debt within the AMBs and SCU. This holding back of debt from impairment had not however been detected in the course of PwC's 2007 audit work, nor had it been detected in the course of Deloitte's internal audit work[20].

43. Following Deloitte's investigation in 2009, the Companies decided to adopt a strict contractual arrears basis for the year end 2008 financial statements, to restate the 2007 results on that basis, and to make an IBNR provision of £150m for impairment below the 120 days trigger point in respect of the year end 2008 loan loss provision. The Statement of Accounting Policies in the notes to the 2008 Cattles Financial Statements explained that "*objective evidence of impairment occurs after the customer misses one contractual payment*". What was described as an IBNR was applied from that point, calculated on the basis of expected future cash flows, excluding future credit losses, and once the account reached 120 days contractual arrears the customer relationship was judged to have broken down and the credit losses were deemed fully incurred. The Companies took the view that "*it has not been practicably possible, without the use of hindsight, to calculate the amount of IBNR that could have been required as at 31 December 2007"*.[21] Accordingly, the impairment trigger was re-set as one day in arrears, ignoring deferments.

44. To sum up, as a result of the fact that deferments (and to a lesser extent rewrites, but not renewals) had been used to hold back debt that was in fact impaired and to prevent that debt reaching the LCUs, WFS's loan loss provision was found to have been materially under-stated in the 2007 WFS Financial Statements and, hence, in the 2007 Cattles Financial Statements, in breach of IAS 39, and, as a result, profits were likewise materially overstated.

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[19] The Project Cornwall Report dated November 2009.

[20] Deloitte carried out internal audit work in 2008 relating to deferments and rewrites, and produced two reports for the Audit Committee. The remit of these engagements differed from that of an external audit and the Executive Counsel makes no criticism of Deloitte.

[21] 2008 Annual Report and Financial Statements, p45.

45. The fact that WFS assessed impairment on the basis of deferred arrears, rather than simply by reference to 120 days strict contractual arrears (i.e. whether four monthly payments had been missed), would not have been clear to a reader of the 2007 Cattles Financial Statements from the description of the impairment policy and the IFRS 7 disclosures (addressed below). Cattles' disclosures in relation to its impairment policy were therefore inadequate.

Breach of IFRS 7 – an overview

46. The specific disclosure made in the 2007 Cattles Financial Statements in respect of debts past due but not impaired did not comply with IFRS 7.[22]

47. IFRS 7 required a number of disclosures relating to the ageing of debt and credit risk which should have enabled a reader of the 2007 Cattles Financial Statements to make an assessment of the quality of the loan book. Cattles was required to disclose, among other things, an analysis of the age of debt that was categorised as past due but not impaired (IFRS 7 para 37(a)) and the amount of debt that would otherwise be past due or impaired whose terms had been renegotiated (IFRS 7 para 36(d)).

48. In making disclosure for the purposes of IFRS 7, in note 18 of the 2007 Cattles Financial Statements, Cattles made those disclosures on the basis that deferred payments were neither "past due" nor "renegotiated."

49. IFRS 7 disclosures were the subject of considerable correspondence between the Companies' and PwC during the course of the 2007 audit. Although there was extensive debate within the Companies as to whether deferments should be included within the value of negotiated loans, the Companies' management and

[22] These disclosure requirements have now been withdrawn. IFRS 7, paragraph 36 (d) was deleted in May 2010 for the reasons set out at IFRS paragraph BC54A:

"*In Improvements to IFRSs issued in May 2010, the Board addressed a practical concern relating to the disclosure requirements for renegotiated financial assets. The Board deleted the requirement in paragraph 36(d) to disclose the carrying amount of financial assets that would otherwise be past due or impaired whose terms have been renegotiated. The Board considered the difficulty in identifying financial assets whose terms have been renegotiated to avoid becoming past due or impaired (rather than for other commercial reasons). The Board noted that the original requirement was unclear about whether the requirement applies only to financial assets that were renegotiated in the current reporting period or whether past negotiations of those assets should be considered. Moreover, the Board was informed that commercial terms of loans are often renegotiated regularly for reasons that are not related to impairment. In practice it is difficult, especially for a large portfolio of loans, to ascertain which loans were renegotiated to avoid becoming past due or impaired*."

executives did not share that debate (or the documents evidencing it) with PwC. For example:

49.1 An IFRS7 discussion paper, prepared by the Companies' management in May 2007, noted: "*It would appear to be a challenge to argue that debt having deferments is neither renegotiated nor in arrears*…" [redacted] noted in an email dated 23 August 2007 which enclosed an updated version of an internal IFRS 7 discussion paper:

> "*James [Corr, Cattles finance director] and I have agreed that it will not go into the bound board papers so we can "keep our powder dry" – as PwC routinely receive a copy of the board papers. James will hand it round the meeting*."

49.2 Immediately following a meeting between the Companies' internal accountants and PwC on 20 September 2007 to discuss IFRS 7 disclosures, [redacted] noted the following in an email sent to [redacted], copied to Mr Corr, [redacted] and [redacted], and forwarded to [redacted]: "*As [PwC] did not raise any challenge re deferments, we did not raise it either. I feel that deferments are not particularly on their radar screen either re IFRS 7 or generally and I suggest we keep it that way…Overall,* [redacted] *and myself think that we got a really good result today and should be prepared to concede the 1-29 days point in the interests of the bigger prize."*

50. Notwithstanding the Companies' conduct in this respect, Cattles' basis of disclosure was a breach of IFRS 7 and should not have been accepted by PwC. If deferments were not disclosed as a renegotiation, they should not then have been taken into account when disclosing the ageing of debts, and the ageing analysis should instead have been presented on the basis of strict contractual arrears. What could not be justified was treating deferred payments (to the extent they related to debt that was not impaired) as being neither renegotiated nor past due.

[redacted]

Impact on the 2007 Cattles Financial Statements and 2007 WFS Financial Statements

51. For the reasons set out above, the 2007 Cattles Financial Statements and 2007 WFS Financial Statements did not show a true and fair view of the state of Cattles or WFS at 31 December 2007, respectively, or of their profit and loss for the year ended 2007.

52. The IFRS 7 disclosures taken together with the description of the impairment policy in the 2007 Cattles and WFS Financial Statements were inadequate. A reader of the 2007 Cattles and WFS Financial Statements could not reasonably have appreciated from the description of the impairment policy that deferments were of any relevance to how WFS provided for impairment. It was not reasonably apparent from the description of the impairment policy that a customer could have missed significantly more than four months' worth of payments according to the original contractual terms and yet, because those payments had been treated as deferred, the debt was not treated as impaired and no provision would have been made in respect of it. Nor could a reader reasonably have understood from the IFRS 7 disclosures the impact of deferments on the ageing of debt and the quality of loan book; but rather they would be likely to have gained the incorrect impression that more customers were paying their instalments in accordance with the original contractual due dates than in fact was the case.

The Companies' disciplinary proceedings

53. The Companies carried out disciplinary proceedings against a number of their executives and employees in 2009. The Companies terminated the employment contracts of a number of executives, including Mr Corr (executive finance director, Cattles) and Mr Miller (finance director, WFS), and issued written or verbal warnings to a number of other employees (including a number of qualified accountants within the Companies' finance teams).

Financial Services Authority ("FSA") proceedings

54. The FSA (subsequently the Financial Conduct Authority) undertook an investigation into Cattles, WFS and a number of executives of the Companies. That investigation concluded with the issuing of Final Notices dated 28 March 2011 in respect of Cattles, WFS and three directors: Mr Blake (managing director of WFS), Mr Corr (executive finance director of Cattles) and Mr Miller (finance director of WFS).

55. In summary, it was found by the FSA in those Final Notices, among other things, that deferments had been routinely deployed by WFS but had neither been treated as arrears for the purpose of the 120 days trigger nor properly disclosed (whether as “past due” or as “renegotiated”) for the purposes of IFRS 7, and that, as a result, the 2007 Cattles and WFS Financial Statements had been false and misleading in respect of the disclosure of debt as past due but not impaired, the statement of the impairment policy and the pre-tax profits.[26]

56. In addition, the FSA found that information had been withheld from the auditors on a number of occasions by Cattles, WFS and the three directors. The FSA found that:

56.1 Cattles (through Mr Corr): "*failed to ensure that the use, extent and significance of the use of deferments was explicitly brought to the attention of PwC"*. The FSA also found that Mr Corr had withheld an IFRS 7 progress report from a Board pack, which he knew PwC would receive, and had instead sent the information to the Board separately.

56.2 WFS (through Mr Blake and Mr Miller) had not taken sufficient steps to ensure that PwC and Cattles' Audit Committee understood the significance of deferments. In particular, at a meeting on 20 September 2007, certain members of the IFRS 7 project team met with PwC to discuss the IFRS 7 disclosures. In advance of the meeting, the project team had produced two versions of a progress report. One version mentioned deferments, but the second version (which was given to PwC) made no mention of determents at all. The FSA found that Mr Miller and Mr Blake were aware in the months leading up to the signing of WFS' 2007 Annual Report that deferments were not on PwC's "*radar screen*", but did nothing to ensure that they were properly informed. The FSA found that Mr Blake had "*had numerous opportunities, over a sustained period, to provide full details to PwC and Cattles' Audit Committee of Welcome's use of deferments and to seek advice as to the correct accounting treatment of deferments*", but that he avoided doing so.

57. The FSA imposed financial penalties on each of Mr Corr, Mr Miller and Mr Blake and prohibited each of them from performing any functions in relation to any

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[26] Final Notice dated 28 March 2011 in respect of Cattles, para. 2.3. and 2.5.

regulated activity and imposed public censure on Cattles and WFS (which would also have been subject to financial penalties had they been going concerns with significant surplus assets).[27] The FSA's stated reasons included the very serious impact on shareholders and on market confidence and the fact Mr Corr, Mr Miller and Mr Blake had failed to act with integrity in discharging their duties.[28]

FRC investigation and sanction in respect of Mr Corr and Mr Miller

58. Mr Corr was at all material times a member of the Institute of Chartered Accountants of Scotland ("**ICAS**") and Mr Miller was a member of ICAEW, and therefore they were each Members for the purposes of the Scheme.

59. Following the FRC's investigation into their conduct, Mr Corr and Mr Miller on 1 February 2013 and 19 February 2013 respectively accepted exclusion from ICAS and ICAEW for a period of eight and six years respectively on the basis that the FSA's findings set out in the Final Notices were conclusive evidence of Misconduct.

Civil proceedings

60. Cattles and WFS brought a damages claim against PwC in the Queen's Bench Division, Commercial Court, Claim No CL-2013-001063, alleging negligence on the part of PwC in signing unqualified audit reports in relation to the 2006 and 2007 Cattles and WFS financial statements.

61. The civil proceedings settled shortly before trial in October 2015, on confidential terms.

B. The Respondents' Misconduct

62. Paragraph 2(1) of the Scheme provides that an Adverse Finding (referred to at paragraph 2 above) is a finding by a Disciplinary Tribunal that a Member or Member Firm has committed "Misconduct". That is defined as: "*an act or omission or series of acts or omissions, by a Member or Member Firm in the course of his or its professional activities (including as a partner, member, director, consultant, agent, or employee in or of any organisation or as an individual) or otherwise, which falls significantly short of the standards reasonably to be expected of a Member or*

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[27] Final Notice dated 28 March 2011 in respect of each of them, respectively, at para. 7.1 and 7.2.

[28] Final Notice dated 28 March 2011 in respect of each of Mr Corr and Mr Miller, respectively, at para. 7.1 and 7.4

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

63. As set out in further detail below, at paragraphs 66 to 67 below, the conduct of each of PwC and Mr Bradburn fell significantly short of the standards reasonably to be expected of them in the following respects:

63.1 In issuing unqualified audit opinions in respect of the 2007 Cattles Financial Statements and the 2007 WFS Financial Statements in circumstances where PwC had insufficient audit evidence as to the adequacy of the loan loss provision; and

63.2 In issuing unqualified audit opinions in respect of the 2007 Cattles Financial Statements and the 2007 WFS Financial Statements having failed to identify the fact that the impairment policy was not adequately disclosed and that the disclosures in the 2007 Cattles Financial Statements and the 2007 WFS Financial Statements were not in compliance with IFRS 7.

64. As a result of that Misconduct, the audited 2007 WFS Financial Statements and, in consequence, those of Cattles were materially misstated and the disclosures made in those Financial Statements were inadequate.

65. For the avoidance of doubt:

65.1 The Particulars are limited to the conduct of the 2007 audit and the IFRS 7 disclosures made in the 2007 Cattles and WFS Financial Statements. To the extent that matters relating to prior audits are referred to these are as background only;

65.2 In principle, a deferred arrears basis for the 120 days trigger was capable of being justified. What was not justified, however, was PwC's failure sufficiently to investigate the unimpaired loan book to establish that the lack of any IBNR or provision in respect of loans subject to forbearance could be supported, in circumstances where PwC knew that Cattles combined a deferred arrears basis for reaching the trigger point with an absence of any provision for debt that was in arrears that had not reached that trigger point.

65.3 The Executive Counsel accepts as common ground that executive directors and senior management, including qualified accountants, were colluding to conceal from PwC the fact that deferments were being used to hold back and hide impairment. That does not alter the fact that PwC and Mr Bradburn fell significantly short of the standards reasonably to be expected of a Member Firm and Member respectively.

II. ADMITTED ACTS OF MISCONDUCT

ACT ONE – AUDIT YEAR END 2007 LOAN LOSS PROVISION

In relation to the audit of the 2007 Cattles and WFS Financial Statements, the conduct of PwC and Mr Bradburn fell significantly short of the standards reasonably to be expected of, respectively, a Member Firm and a Member, in that PwC and Mr Bradburn issued an unqualified audit opinion in respect of each of Cattles and WFS, having failed to obtain sufficient or appropriate audit evidence to provide reasonable assurance that the WFS loan loss provision was complete. PwC and Mr Bradburn thereby failed to act in accordance with the Fundamental Principle of Professional Competence and Due Care, sections 100.4(c) and 130 of the Code.

Particulars of Act 1 (Misconduct in respect of audit of loan loss provision)

66. Particulars of Act 1 are set out in paragraphs 66.1 to 66.3.4 below.

Lack of understanding of risks to completeness of loan loss provision

66.1 PwC and Mr Bradburn identified the loan loss provision as a significant audit risk but failed adequately to understand, or to communicate to the audit team, the nature of the risks to the completeness of the WFS loan loss provision, in breach of ISA 315 (paragraphs 2, and 28) and ISA 220 (paragraph 21).[29]

66.1.1 PwC failed to gain an adequate understanding of Cattles' impairment policy in respect of the loans and receivables in WFS and/or an adequate understanding of the method by which Cattles in practice calculated impairment, namely that the trigger used for impairment was 120 days arrears on a deferred basis, in breach of ISA 315 (paragraph 28).

66.1.1.1 There was confusion in the audit team as to the basis upon which the 120 days trigger was applied. [redacted] and [redacted] both stated in interview that they understood the impairment trigger to be 120 days contractual arrears, and that they had not considered the

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[29] For extracts from all applicable ISAs, see Annex A.

impact of deferments. The audit team's incorrect understanding of the impairment policy meant that their analysis of the risks to the completeness of the loan loss provision failed to focus on the right issues and they failed to design and conduct the audit in a way that addressed those risks.

66.1.1.2 Mr Bradburn, who did understand the impairment trigger to be 120 days deferred contractual arrears, ought to have identified and corrected this confusion within his team.

66.1.2 PwC and Mr Bradburn did not assess the risk of misstatement of the loan loss provision by the application or abuse of deferments to be significant. That assessment was based in particular on the following factors:

- the levels of review within different levels of the management hierarchy at the Companies in relation to the application of deferments (branch, area and risk managers, compliance, group risk, internal audit, executive directors and management charged with internal controls and governance);

- the Companies' statements that the process was tightly controlled; the large number of small loans (in excess of 500,000 loan accounts) across a large number of different branches such that a very large number of manual interventions would be required over an extensive period in order to affect the truth and fairness of the financial statements;

- PwC's assessment of the control environment within the Companies; and

- the fact that the abuse of deferments required a coincidence of factors the likelihood of which PwC and Mr Bradburn judged to be remote.

66.1.3 PwC and Mr Bradburn's assessment of the level of audit risk was inappropriate, however. PwC and Mr Bradburn should have appreciated that deferments constituted a significant risk to the completeness of the loan loss provision and required investigation.

PwC and Mr Bradburn approached the audit on the basis of an erroneous assumption that deferments did not pose a significant risk and were tightly controlled, and they failed to plan work to establish their extent or impact in breach of ISA 315 paragraphs 2, 108 and 113 and contrary to the guidance at ISA 315 paragraph 109.

66.1.4 PwC and Mr Bradburn failed to plan adequate work to establish the extent of deferments or their impact, in breach of ISA 315 (paragraph 2).

66.1.4.1 ISA 315 (paragraph 108) requires the auditor to identify significant risks. That assessment of risk must be undertaken by reference to the nature of the risk, the likely magnitude of potential misstatement and the likelihood of the risk occurring. For each 'significant risk' the auditor must then evaluate the design of the related controls to determine whether they have been implemented and to consider whether substantive procedures will by themselves provide appropriate audit evidence, or whether testing of the operating effectiveness of controls is also required.

66.1.4.2 Mr Bradburn and PwC should have recognised that the use by WFS of deferments was directly relevant to the amount of loans treated as impaired and that their use posed a significant risk to the completeness of the loan loss provision which required investigation, based on (i) Mr Bradburn's own understanding of the 120 days trigger; (ii) knowledge of the non-standard lending sector; (iii) review of audit working papers from 2005 and 2006 and (iv) evidence obtained during the 2007 audit, which should have prompted enquiry into the volume of deferments and how these were controlled and which ought to have caused Mr Bradburn and PwC to revisit the risk assessment and planning of the audit so as to address the risk posed by deferments (including by making such enquiries and by investigating the unimpaired loan book).

Accordingly, Mr Bradburn and PwC should have ensured that the audit team designed and conducted the audit on that basis. PwC's audit work should have included further work in identifying what controls in fact existed in respect of deferments in order to determine whether a controls-based audit approach was appropriate and what substantive testing was required.

66.1.4.3 Both the 2006 and 2007 versions of the working paper *Perform analytical review of the profile of the loan book and transfers to LCU – WFS* included a histogram entitled 'Branch debt (not in provision) analysed by days delinquency', plotting 'debt as % of total' against 'days delinquency'. Taken at face value the histogram shows that as at December 2006 42% of branch debt (i.e. the unimpaired loan book, in respect of which no provision had been made) had one or more deferments applied and that as at December 2007 some 40% of loans had one or more deferments applied.

66.1.4.4 However, PwC proceeded on the erroneous basis that the risk of misstatement of the loan loss provision by reason of the application or abuse of deferments was low, and therefore accepted (with insufficient audit evidence) management's assertions that deferments were deployed by WFS in strictly controlled circumstances. The 2007 audit file discloses no planned work to assess the extent or impact of deferments. No consideration of the possible risk posed to the completeness of the loan loss provision is documented and no testing is identified to confirm that any such risk could properly be discounted. Mr Bradburn approached the audit on the mistaken footing that deferments were significantly used but strictly controlled and therefore did not pose a significant risk of material error in the loan loss provision. That assumed what the audit should have tested.

66.1.5 Further PwC and Mr Bradburn failed, in breach of ISA 315 (paragraphs 2, 108 and 113) to recognise that an increased risk to the completeness of the loan loss provision was posed by Welcome's combination of (a) an impairment trigger set on a deferred arrears basis (meaning that fewer loans reached the trigger point) and (b) the absence of a provision for loans which had not reached the trigger point.

66.1.5.1 WFS did not apply an IBNR for impairment in the 2007 Financial Statements. This policy had been set in 2005 on transition to IFRS. The justification for this by WFS management was that deferments and rewrites were strictly controlled; that impairment events were quickly identified in light of Welcome's close relationship with its customers, and hence loans promptly impaired; and that the risk of unidentified impairment events was therefore low such that any IBNR was likely to be immaterial.

66.1.5.2 Other businesses in the non-standard sector at the time also did not apply an IBNR provision (as noted in Deloitte's Credit Impairment report to the Audit Committee dated February 2008).

66.1.5.3 However, the combination of a deferred arrears trigger point and no IBNR increased the risk that there were loans which should have been impaired but which were not being considered for impairment.

66.1.5.4 For example, a table in the 2007 working paper *Perform analytical review of the profile of the loan book and transfers to LCU – WFS* showed that £296 million was aged 30 or more days overdue in 2007 but not impaired.

66.1.6 PwC and Mr Bradburn failed, in breach of ISA 540 (paragraph 10) and ISA 315 (paragraph 28), adequately to recognise the need to plan the audit work to include evaluation of the unimpaired loan book.

66.1.7 PwC and Mr Bradburn failed, in breach of ISA 315 (paragraph 41) and contrary to the guidance at ISA 315 paragraph 54, adequately to identify and understand what controls existed to ensure that deferments and other forbearance techniques did not result in a material understatement of the loan loss provision.

66.1.8 PwC and Mr Bradburn identified the risk of deliberate manipulation by management of the financial results but failed to identify, or take adequate account of, the specific risk of deliberate manipulation by management of the loan loss provision by holding back impairment and the lack of sufficient controls apt to prevent this, in breach of ISA 240 (paragraph 57).

66.1.8.1 PwC and Mr Bradburn were required to identify and assess the risks of material misstatement due to fraud (ISA 240, paragraph 57). Any such risks were 'significant risks' and so PwC and Mr Bradburn should have evaluated the design of any relevant controls and determined whether they had been implemented and, if they were going to rely on these controls, their operating effectiveness.

66.1.8.2 The 2007 working paper *Assess and Respond to fraud risks* set out a number of fraud risks relevant to the CAR balance, including "*Management inclination to intentionally misstate financial reporting*". The working paper stated: "*Management sometimes shows a disregard for fair and accurate financial statement presentation. Management might have a tendency to change the accounting policies – or more likely to tweak account estimation techniques – to achieve the targeted results. Although historically their tendencies have still remained within legitimate boundaries, this might have a negative impact on fair presentation (or at least transparency) of the financial statements. These have been communicated to the audit team and fraud risk is included as a key risk on the ACM [audit comfort matrix]"*". The working paper classified this as 'high risk'.

66.1.8.3 However, the identified fraud risks were said to be mitigated since "…*our overall view of senior management is that they have a strong reputation and set store by* *achieving accurate financial reporting. Regardless of this we will ensure that appropriate audit procedures are performed to mitigate the risk in this area*".

66.1.8.4 The working paper set out a number of management controls and the work planned to evaluate them. These included "*compliance department – branch audits", "whistleblowing procedures in place", "Fraud risk and risk maps"* and "*Fraud event log*". PwC was also aware of the three lines of defence model operated by the Companies: management controls; risk and compliance; and internal audit. Of these controls, only the compliance department branch audits were capable of detecting or preventing management override of controls in respect of the manipulation of the loan loss provision by holding back impairment. PwC's assessment of the branch audits was based, in particular, upon a "show me" meeting with the Head of Compliance, a high level review of the Compliance branch audits, and the review of the six monthly reports of Compliance audits as delivered to the Audit Committee. The working paper stated that "*meetings with branch, area and regional managers are to be attended. Controls will be evaluated at all levels and validated at regional management level and therefore detailed review of branch audit reports is not considered necessary…*"

66.1.8.5 In fact, no such evaluation was carried out. The minutes of the 'show me' meetings do not evidence that PwC adequately evaluated the design of the controls or tested their implementation. They did not provide sufficient evidence that controls were operating effectively and so should not have been used as audit evidence over a financial statement assertion.

66.1.8.6 In the 2007 working paper Audit Comfort Matrix, PwC identified the risk of material misstatement of the loan loss provision as 'significant'. Two key risks were identified. The first concerned the calculation of the loan loss provision rather than the identification of impaired debt (i.e. it concerned the amount by which identified impaired debts were impaired, not the risk that the population of impaired debts had not been correctly identified). The second risk concerned whether the methodology used to calculate loan loss impairment complied with IAS 39.

66.1.8.7 The only reference in the Audit Comfort Matrix to a procedure concerning the identification of impaired debt is the substantive testing of the appropriateness of the impairment trigger point. This was linked to the working paper "*Obtain comfort over data flowing into and through the bad debt provision model*". However, this working paper related only to the data flowing into the back-testing model.

Failures in design and conduct of audit

66.2 In consequence of their (inappropriate) judgement as to the level of audit risk relating to deferments at Welcome, and their reliance on controls operating within the Companies, PwC and Mr Bradburn failed to design and conduct the audit so as properly to address the risks over the completeness of the loan loss provision and obtain sufficient appropriate audit evidence on which to base the opinion that the loan loss provision was sufficient, in breach of ISA 330 (paragraphs 4 and 7), and ISA 500 (paragraph 2).

66.2.1 PwC and Mr Bradburn failed adequately to investigate the unimpaired loan book in order to test whether the population of impaired loans had been correctly identified and whether and to what extent any provision needed to be made in respect of loans that WFS had treated as unimpaired.

66.2.1.1 In the 2007 audit PwC should have planned work to obtain evidence that deferments were strictly controlled and that there was no material unimpaired debt which should have been provided for. The audit file contains no evidence that any such work was planned or performed.

66.2.1.2 There were a number of factors that should have prompted PwC to assess whether there was an increased likelihood that the provision was being materially understated, including the volume of deferments as evidenced by the histogram referred to at paragraph 66.1.5.3 above.

66.2.1.3 PwC should have gained assurance that all impaired debt under 120 days arrears had been properly identified. This should have been done either by substantive testing of debt less than 120 days in arrears; or by identifying controls which provided sufficient assurance that loans under 120 days arrears were properly not impaired, and then testing the operating effectiveness of those controls.

66.2.2 PwC and Mr Bradburn purported to conduct a controls based audit, without having an adequate understanding of the design and implementation or testing the operating effectiveness of Welcome's controls in relation to deferments, and placing inappropriate reliance on enquiry in breach of ISA 315 (paragraph 41), ISA 330 (paragraphs 7, 23, and 29) and ISA 500 (paragraphs 2) and contrary to the guidance in ISA 315 paragraphs 54, 55 and 56, ISA 330 paragraphs 8, 12, 26 and 30 and ISA 500 paragraphs 19 and 32).

66.2.2.1 Management controls to mitigate the risk of fraud were identified by PwC but they were not sufficiently tested for design, implementation or operating effectiveness.

66.2.2.2 The summary of comfort set out the planned work on controls to obtain assurance over CAR. For example, one objective was to understand the controls in place in the branches to control CAR, and this was to be done through a review of compliance audits. The stated objectives of a 'show me' meeting with the WFS Regional Manager were to obtain an understanding of the reports used in monitoring the region and validating the controls.

66.2.2.3 In reality, the 'show me' meeting was an inadequate assessment of the controls in place for these purposes.

For example, the Regional Manager confirmed that compliance audits took place within each branch during the year, but PwC did not consider the scope of these audits, or whether the audits tested any element of controls over CAR, and they did not review a sample of the branch audits to gain assurance that the controls were operating effectively.

66.2.2.4 Another objective of this and other ‘show me` meetings was to review and validate the controls employed by Regional, Area and Branch Managers to control volumes, collections and delinquency. PwC drew broad conclusions that the managers monitored the compliance of the branches or staff below them, and were shown sample documents which the managers used as part of that process. However, insufficient testing back to supporting evidence was carried out and so excessive reliance was placed on management representations.

66.2.2.5 ITGC work carried out focused on IT general controls and did not test controls in respect of CAR.

66.2.2.6 In interview Mr Bradburn stated that he did not consider deferments to result in risks requiring separate consideration or testing. This was due to an erroneous assessment of the audit risk relating to deferments (referred to above).

66.2.3 PwC and Mr Bradburn failed, in breach of ISA 520 (paragraph 8) and contrary to the guidance at ISA 520 paragraph 12, to carry out adequate analytical review procedures, in that the analytical review work conducted by PwC was inadequate to provide comfort as to the completeness of the loan loss provision, focused substantially on the impaired loan book rather than the unimpaired loan book, and did not consider the potential impact of deferments despite evidence that should have alerted the PwC audit team to the need for this (including the histogram referred to at paragraph 66.1.5.3 above).

66.2.3.1 The analytical work planned by PwC was insufficiently directed to enable PwC to draw any meaningful assurance from it. It focused on the amount of the provision for debt identified as impaired rather than on whether the population of impaired debt had been correctly identified.

66.2.3.2 The analytical review of CAR balances was not detailed enough to provide sufficient assurance.

The analytical review of transfer rates from the branches to the LCUs (set out in Perform analytical review of the profile of the book and transfers to LCU – WFS) was similarly insufficient to provide reliable evidence. It did not set precise expectations, did not focus on the possibility that arrears should have been higher than shown by the accounting system and no evidence was obtained to corroborate management explanations for the higher transfer rate.

Lack of professional scepticism

66.3 In consequence of their (inappropriate) judgement as to the level of audit risk relating to deferments at Welcome, PwC and Mr Bradburn also failed to exercise sufficient professional scepticism, in breach of ISA 200 (paragraph 6) and ISA 240 (paragraph 24).

66.3.1 PwC relied on “show me” meetings to evidence that controls were operating effectively, which in effect amounted to excessive reliance on management representations that this was so in breach of ISA 500 (paragraph 2) (and contrary to the guidance in ISA 500, paragraph 32 and in ISA 580, paragraphs 6 and 7).

66.3.1.1 Where PwC received management representations relating to matters which were material to the financial statements, they were required to seek corroborative audit evidence, evaluate whether the representations seemed reasonable and consistent with other audit evidence and consider whether the individual making the representations could be expected to be well informed on the particular matters. Representations by management alone were not a substitute for other audit evidence and enquiry alone was not, in this case, sufficient to test the operating effectiveness of controls.

66.3.1.2 The record of the 2007 'show me' meeting with the WFS Regional Manager states that no controls were validated because the controls identified were not key controls and so validation was unnecessary. It records that these controls had been validated in the previous year. The equivalent 2006 working paper records a discussion with the Regional Manager concerning the volume of deferments exceeding targets and concludes that the controls were deemed appropriate to the nature of the branch network and validated where deemed appropriate but does not record what the key controls in respect of CAR were considered to be, whether they were operating effectively or how they mitigated any risks to the completeness of the loan loss provision.

66.3.1.3 The 'show me' meetings amounted to excessive reliance on inquiry, and to the extent that PwC relied upon these meetings as evidence that controls were operating effectively, that amounted to inappropriate reliance upon management representations.

66.3.2 PwC and Mr Bradburn accepted, without adequate challenge or enquiry, in breach of ISA 580 (paragraph 4), and continued to rely upon representations and explanations from the Companies' executives and management to the effect that deferments were "strictly controlled", and that all impaired debt was properly transferred to the LCU. Those representations and explanations were in fact false.

66.3.2.1 There were a number of procedures the audit team could have employed to test the assertion that deferments were strictly controlled and to establish the extent to which they were deployed, including:

- A review of procedures and identification of key controls over deferments and rewrites and then testing the operating effectiveness of key controls; and

- Tests of detail on debt less than 120 days in arrears to ensure that it was in the correct arrears category.

66.3.2.2 In 2005 PwC took no steps to verify management assertions justifying the absence of a collective provision/IBNR. These assertions remained unchallenged during the 2007 audit.

66.3.3 PwC and Mr Bradburn failed, in breach of ISA 520 (paragraph 13) and contrary to the guidance at ISA 520 paragraphs 17 and 18, to corroborate explanations for unexpected variances identified in the analytical review.

66.3.3.1 An auditor is required to investigate and corroborate the reasons for significant deviations from predicted amounts identified by analytical procedures. However, PwC did not corroborate the reasons for unexpected variances in its substantive analytical review procedures relating to transfer rates to the LCU.

66.3.3.2 For example, the 2007 working paper Perform analytical review of the profile of the loan book and transfers to LCU–WFS records that PwC expected the debt in the LCU s to reduce in 2007 compared to 2006 because by then the LMBs had been operational for a full year. However, the percentage of debt in the LCUs actually increased. PwC's working paper stated that further investigation was required, but PwC merely obtained an explanation from management which they stated 'appeared reasonable' and which they did not corroborate.

66.3.3.3 Furthermore, the 2007 working paper EIR: Test calculation of EIR within Oracle IFRS Solution for sample of agreements records that to test the calculation of the

EIR a sample of 70 agreements was selected and the EIR was recalculated. 22 exceptions were identified where the loan term was not recorded on the system which resulted in the EIR being shown as zero. The PwC RAS team were told by management that these were all agreements where the loan had been rewritten over a longer term and WFS was no longer permitted to charge interest. This explanation was accepted by PwC. Given the significant proportion of exceptions (31%), PwC should have concluded that the process was not operating correctly. If the exceptions could not be corroborated, a purely substantive approach would have been required because the controls in relation to the EIR calculation could not be relied upon.

66.3.4 Having identified the risk that management had an inclination to intentionally misstate financial reporting *(*but that *"historically their tendencies have still remained within legitimate boundaries"*), the PwC audit team nevertheless concluded, without adequate basis, that their overall view of management was that "*they have a strong reputation and set store by achieving accurate financial reporting*". Mr Bradburn did not challenge that view.

ACT TWO – AUDIT YEAR END 2007 DISCLOSURE OF THE WFS IMPAIRMENT POLICY AND IFRS 7 DISCLOSURES

In relation to the audit of the 2007 Cattles and WFS Financial Statements, the conduct of PwC and Mr Bradburn fell significantly short of the standards reasonably to be expected of, respectively, a Member Firm and a Member, in that PwC and Mr Bradburn issued unqualified audit opinions in respect of each of Cattles and WFS, having failed to identify the fact that the disclosures in the 2007 Cattles and WFS Financial Statements in relation to Welcome's impairment policy were not adequate and not in compliance with IFRS 7 and, on the contrary, having stated in the audit report that "*the financial statements give a true and fair view, in accordance with IFRSs as adopted by the European Union...*". PwC and Mr Bradburn thereby failed to act in accordance with the Fundamental Principle of Professional Competence and Due Care, sections 100.4(c) and 130 of the Code.

Particulars of Act 2 (Misconduct in respect of audit of IFRS 7 disclosure)

67. Particulars of Act 2 are set out in paragraphs 67.1 to 67.3 below.

Lack of proper disclosure of impairment policy

67.1 PwC and Mr Bradburn failed, in breach of ISA 315 (paragraph 28), to recognise that the impairment policy was not adequately described in the 2007 Cattles Financial Statements in that the description in the notes failed to make clear that the impairment trigger was applied on the basis of deferred arrears. This could have been explained by reference to the IFRS 7 disclosures but was not (as explained further below).

67.1.1 The 2007 Cattles Financial Statements described the WFS impairment policy as follows: "*WFS determines that there is objective evidence of an impairment loss at the point at which they are not prepared to offer any further credit to a customer who has encountered serious repayment difficulties. In [WFS] this is assessed by reference to the number of days an account is contractually in arrears. When an account has reached 120 days in arrears, there is an acceptance that the original contractual relationship has broken down. At this stage specialist account managers in Local Collection Units seek to establish a different working relationship with the customer, focusing instead on recovering part payments over a* *rescheduled repayment plan. At this point, interest on the account is suspended and no longer added to the outstanding balance."*

67.1.2 That description was inadequate without further explanation because, unless the relevance of deferments to the impairment trigger was explained in the notes to the financial statements or in the IFRS 7 disclosures (which was not the case), it would naturally be understood by a reader of the 2007 Cattles and WFS Financial Statements that "*contractually in arrears*" meant that the trigger point for identifying the population of impaired debt was the point at which the customer had missed four of their monthly payment instalments according to the original loan agreement. It would not have been clear to a reader that a customer could have missed significantly more than four months' worth of payments and yet the debt was not treated as impaired because those missed payments had been treated as deferred and "contractually in arrears" in fact meant the number of days in arrears would be calculated after deferments.

67.1.3 This deficiency should have been evident to PwC and Mr Bradburn.

Lack of competence in respect of IFRS 7 disclosures

67.2 PwC and Mr Bradburn failed to act in accordance with applicable technical and professional standards in relation to the IFRS 7 disclosures, as required by the Fundamental Principle of Professional Competence and Due Care, sections 100.4(c) and 130 of the Code and in breach of ISA 315 (paragraph 28).

67.2.1 PwC and Mr Bradburn should have appreciated and advised that it was not justifiable for Cattles and WFS to treat deferred payments as neither "past due" nor "renegotiated" for the purposes of IFRS 7.

67.2.1.1 Cattles and WFS were required to disclose "*the carrying amount of financial assets that would otherwise be past due or impaired whose terms have been renegotiated*"[30].

[30] IFRS 7, paragraph 36(d). This paragraph of IFRS 7 was deleted in May 2010, for reasons set out at IFRS 7 paragraph BC54A.

67.2.1.2 If deferments were treated as delaying the due date, so that debt subject to deferments was 'neither past due nor impaired', it was then inconsistent to exclude them in the disclosure of renegotiated debt. However, if deferments were not disclosed as a renegotiation whose effect was to delay the date the debt fell due, then the deferred debt should have been treated as past due. Either way, the disclosure would have presented a materially different view to readers of the financial statements. What could not be justified was the failure to disclose deferments under either head. It obscured the extent of the use of deferments and their impact on the ageing of debt and the quality of the loan book.

67.2.1.3 PwC failed to challenge the position adopted by WFS management that although rewrites were a form of renegotiation, deferments were not. PwC should have asked how deferments had been treated for the purposes of the IFRS 7 disclosure.

67.2.2 Before concluding that the disclosure was materially correct, PwC and Mr Bradburn should have considered the extent to which the disclosure would have been different on a contractual basis, rather than relying on an assumption, which was insufficiently supported by audit evidence, that deferments were strictly controlled and would not materially affect the disclosure.

67.2.3 PwC and Mr Bradburn ought to have identified from PwC's own analysis of delinquency bandings that the disclosure was likely to be materially inaccurate.

67.2.3.1 There was evidence within PwC's own working papers that indicated the disclosure of 'past due but not impaired' debt was materially inaccurate.

67.2.3.2 For example, the 2007 working paper *Perform analytical review of the profile of the loan book and transfers to LCU – WFS* contained a table banding 'by "days delinquency'", which showed that 40% of debt in the operational branches[31] was treated as being up to date as a result of deferments and so would be excluded from disclosure as 'past due but not impaired'.

Lack of professional scepticism in respect of IFRS 7 disclosure

67.3 Notwithstanding the Companies' own conduct in this respect, PwC and Mr Bradburn failed to exercise sufficient professional scepticism, in failing to ask how deferments had been treated for the purposes of the IFRS 7 disclosures.

[31] i.e. circa £861m

ANNEX A

EXTRACTS FROM THE APPLICABLE ISAs

ISA 200: Objective and general principles governing an audit of financial statements

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.

ISA 220: Quality control for audits of historical financial information

5 (a) "Engagement partner" – the partner or other person in the firm who is responsible for the audit engagement and its performance, and for the auditor's report that is issued on behalf of the firm, and who, where required, has the appropriate authority from a professional, legal or regulatory body;"

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

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

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

ISA 240: The auditor's responsibility to consider fraud in an audit of financial statements

24 The auditor should maintain an attitude of professional scepticism throughout the audit, recognizing the possibility that a material misstatement due to fraud could exist, notwithstanding the auditor's past experience with the entity about the honesty and integrity of management and those charged with governance.

57 When identifying and assessing the risks of material misstatement at the financial statement level, and at the assertion level for classes of transactions, account balances and disclosures, the auditor should identify and assess the risks of material misstatement due to fraud. Those assessed risks that could result in a material misstatement due to fraud are significant risks and accordingly, to the extent 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.

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 performance of control activities and to achieve effective segregation of duties by 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 reperfomance 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 reperfomance 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.**

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.

ISA 520: Analytical procedures

8 **The auditor should apply analytical procedures as risk assessment procedures to obtain an understanding of the entity and its environment.** Application of analytical procedures may indicate aspects of the entity of which the auditor was unaware and will assist in assessing the risks of material misstatement in order to determine the nature, timing and extent of further audit procedures.

12 When designing and performing analytical procedures as substantive procedures, the auditor will need to consider a number of factors such as the following:

- The suitability of using substantive analytical procedures given the assertions (paragraphs 12a and 12b).

- The reliability of the data, whether internal or external, from which the expectation of recorded amounts or ratios is developed (paragraphs 12c and 12d)

- Whether the expectation is sufficiently precise to identify a material misstatement at the desired level of assurance (paragraph 12e).

- The amount of any difference of recorded amounts from expected values that is acceptable (paragraph 12f).

[see also 12a – 12g]

13 **The auditor should apply analytical procedures at or near the end of the audit when forming an overall conclusion as to whether the financial statements as a whole are consistent with the auditor's understanding of the entity.** The conclusions drawn from the results of such audit procedures are intended to corroborate conclusions formed during the audit of individual components or elements of the financial statements and assist in arriving at the overall conclusion as to the reasonableness of the financial statements. However, they may also identify a previously unrecognized risk of material misstatement. In such circumstances, the auditor may need to re-evaluate the planned audit procedures, based on the revised consideration of assessed risks for all or some of the classes of transactions, account balances, or disclosures and related assertions.

17 When analytical procedures identify significant fluctuations or relationships that are inconsistent with other relevant information or that deviate from predicted amounts, the auditor should investigate and obtain adequate explanations and appropriate corroborative audit evidence.

18 The investigation of unusual fluctuations and relationships ordinarily begins with inquiries of management, followed by:

(a) Corroboration of management's responses, for example, by comparing them with the auditor's understanding of the entity and other audit evidence obtained during the course of the audit; and

(b) Consideration of the need to apply other audit procedures based on the results of such inquiries, if management is unable to provide an explanation or if the explanation is not considered adequate.

ISA 540: Auditing of 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.**

ISA 580: Management representations

4 **The auditor should obtain written representations from management on matters material to the financial statements when other sufficient appropriate audit evidence cannot reasonably be expected to exist.** The possibility of misunderstandings between the auditor and management is reduced when oral representations are confirmed by management in writing. Matters which might be included in a letter from management or in a confirmatory letter to management are contained in the example of a management representation letter in the Appendix to this ISA (UK and Ireland).

6 During the course of an audit, management makes many representations to the auditor, either unsolicited or in response to specific inquiries. When such representations relate to matters which are material to the financial statements, the auditor will need to:

(a) Seek corroborative evidence from sources inside or outside the entity-;

(b) Evaluate whether the representations made by management appear reasonable and consistent with other audit evidence obtained, including other representations-; and

(c) Consider whether the individuals making the representations can be expected to be well informed on particular matters.

7 Representations by management cannot be a substitute for other audit evidence that the auditor could reasonably expect to be available. For example, a representation by management as to the cost of an asset is not a substitute for the audit evidence of such cost that an auditor would ordinarily expect to obtain. If the auditor is unable to obtain sufficient appropriate audit evidence regarding a matter which has, or may have, a material effect on the financial statements and such audit evidence is expected to be available, this will constitute a limitation in the scope of the audit, even if a representation from management has been received on the matter.

ANNEX B

RELEVANT EXTRACTS FROM THE ICAEW CODE OF ETHICS

Note: All extracts are taken from the 2007 edition of the Code of Ethics effective from 1 September 2006.

Fundamental Principles

100.4 A professional accountant is required to comply with the following fundamental principles:

a) [...]

b) […]

c) **Professional competence and due care**

A professional accountant has a continuing duty to maintain professional knowledge and skill at the level required to ensure that a client or employer receives competent professional service based on current developments in practice, legislation and techniques. A professional accountant should act diligently and in accordance with applicable technical and professional standards when providing professional services.

d) [...]

Each of these fundamental principles is discussed in more detail in Sections 110-150.

Section 130: Professional competence and due care

130.1 The principle of professional competence and due care imposes the following obligations on professional accountants:

a) To maintain professional knowledge and skill at the level required to ensure that clients or employers receive competent professional service; and

b) To act diligently in accordance with applicable technical and professional standards when providing professional services.

130.2 [...]

130.3 The maintenance of professional competence requires a continuing awareness and an understanding of relevant technical, professional and business developments. Continuing professional development develops and maintains the capabilities that enable a professional account to perform competently within the professional environments.

Further guidance on continuing professional development is available at www.icaew.com/cpd and in the Learning & Professional Development Directorate Regulations which are available in the Members Handbook at

www.icaew.co.uk/membershandbook.

130.4 Diligence encompasses the responsibility to act in accordance with the requirements of an assignment, carefully, thoroughly and on a timely basis.

[...]

ANNEX C

RELEVANT EXTRACTS FROM IFRS 7 AND IAS 39

IFRS 7

Credit Risk

36 An entity shall disclose by class of financial instrument:

(a) The amount that best represents its maximum exposure to credit risk at the reporting date without taking account of any collateral held or other credit enhancements…

(b) …

(c) Information about the credit quality of financial assets that are neither past due nor impaired; and

(d) The carrying amount of financial assets that would otherwise be past due or impaired whose terms have been renegotiated.

Financial assets that are either past due or impaired.

37 An entity shall disclose by class of financial asset:

(a) An analysis of the age of financial assets that are past due as at the reporting date but not impaired;

(b) An analysis of financial assets that are individually determined to be impaired as at the reporting date, including the factors the entity considered in determining that they are impaired; and

(c) For the amounts disclosed in (a) and (b), a description of collateral held by the entity as security and other credit enhancements and, unless impracticable, an estimate of their fair value.

IAS 39

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.