

In the matter of:

THE EXECUTIVE COUNSEL TO THE FINANCIAL REPORTING COUNCIL

- AND -

- | | | |
|-----|----------------------------|-------------------|
| (1) | STEPHEN JOHN DENISON | First Respondent |
| (2) | PRICEWATERHOUSECOOPERS LLP | Second Respondent |

PARTICULARS
OF FACT AND ACTS OF MISCONDUCT
10.08.18

The Settlement Agreement (which includes the Particulars of Fact and Acts of Misconduct) is a document agreed between PwC and Mr Denison (the Respondents) and the Executive Counsel. It does not make findings against any persons other than the Respondents and it would not be fair to treat any part of this document as constituting or evidencing findings against any other persons since they are not parties to the proceedings. In particular, it does not make any findings in relation to BHS Group or BHS after completion of the 2014 audit, including the nature and extent of any arrangements Taveta may have put in place to support the BHS Group as part of and/or after the sale. Nor does it reflect the events which subsequently transpired on the sale of BHS.

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. The Misconduct relates to the Respondents’ audit for the year ending 30 August 2014 of Taveta Investments Limited and its subsidiaries (together, “**the Taveta Group**”) which included BHS Limited (“**BHS**”).
3. This document contains the Particulars of Fact and Acts of Misconduct admitted by the Respondents. It forms part of the proposed settlement agreement, as defined in paragraph 2(1) of the Scheme.
4. Sections II to V introduce the parties, the background to the audit and the relevant standards of conduct.
5. Sections VI to XIII correspond to the Allegations. Each section contains a thumbnail sketch of the relevant Allegation and, where necessary, some of the factual background.

6. The final section XIV contains the Allegations of Misconduct.

II. **BHS**

7. BHS was a well-known British high street retailer. By the time of its closure in 2016, it had a total of 163 stores and employed 11,000 staff.

8. In 2000, the BHS retail group (which was at that time part of the Storehouse Group) was bought by Sir Philip Green for £200 million. In July 2009, Taveta Investments (No. 2) Limited ("**Taveta 2**") acquired BHS Group Ltd ("**BHS Group**") for £200 million. BHS Group was the holding company and BHS the principal trading company. In this way, BHS became part of Sir Philip Green's Taveta Group.

9. Arcadia Group Limited ("**Arcadia**") was another wholly owned subsidiary of Taveta 2. Arcadia operates retail brands such as Top Shop, Top Man, Burton, Miss Selfridge, Evans and Dorothy Perkins.

III. **THE RESPONDENTS**

10. The First and Second Respondents, Stephen ("**Steve**") Denison and PwC, are respectively a member and member firm of the Institute of Chartered Accountants in England and Wales ("**ICAEW**").

11. From 2003, PwC was the auditor of the Taveta Group which, from July 2009, included Taveta 2, Arcadia and the BHS Group and its subsidiaries (including BHS Limited).

12. Mr Denison was, from 2009, the PwC Senior Statutory Auditor for the Taveta Group. He was the Engagement Partner responsible for the conduct and overall quality of the audit. He signed relevant auditors' reports on the financial statements in his own name on behalf of PwC.

13. The Misconduct concerns the Respondents' audit opinions on the financial statements for the year ending 30 August 2014 of the Taveta Group, BHS Group and BHS, Arcadia and Taveta 2.

14. The Respondents' statutory responsibility was to form an opinion as to whether the financial statements showed a true and fair view and had been properly prepared in accordance with UK GAAP and the Companies Act 2006.

15. An audit involves obtaining "audit evidence" about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. PwC calculated materiality to be £11.6 million for Taveta Group, £2.2 million for BHS Group and £8.5 million for BHS Limited. Audit evidence is defined in ISA 500 as "*information used by the auditor in arriving at the conclusions on which the auditor's*

opinion is based". Audit evidence is primarily obtained from audit procedures performed during the course of the audit.

IV. THE COMPLETION OF THE AUDIT

16. At the time of the audit, BHS had been loss making for a number of years and was being supported by the Taveta group. In addition, it had very significant deficits in its two defined-benefit pension schemes in relation to which it had been engaging with the Pensions Regulator ("tPR").
17. During the course of the BHS audit, and prior to issuing the audit reports, the Respondents became aware of the likely sale of BHS. Completion of the audit was brought forward to accommodate the sale. BHS's financial statements were likely to be subject to increased scrutiny. The financial statements were likely to be of interest to the purchaser and the purchaser's professional advisors as well as lenders, suppliers, trade creditors and tPR.
18. The audit reports for BHS and BHS Group were signed by Mr Denison on behalf of PwC on Monday 9 March 2015 (Mr Denison backdated them to Friday 6 March 2015). For the avoidance of doubt, it is not alleged that this was at Taveta's request. Two days later, on 11 March 2015, BHS Group was sold to Retail Acquisitions Limited ("RAL") for a nominal sum of £1. As part of the sale, Arcadia wrote off £216 million of a £237 million inter-company loan which was owed by BHS Group and its subsidiaries to Arcadia.
19. Just over a year later, on 23 March 2016, BHS's creditors agreed to a Company Voluntary Arrangement ("CVA")¹. Shortly afterwards, on 25 April 2016, BHS Limited was put into administration, with a deficit in its pension scheme of £571 million.

V. THE RELEVANT STANDARDS OF CONDUCT

20. The standards of conduct reasonably to be expected of the Respondents included those set out in the Fundamental Principles and Statements contained in the Code of Ethics ("the Code") applicable at the material time, issued by the ICAEW. The Fundamental Principles and Statements contained in the Code are made in the public interest and are designed to maintain a high standard of professional conduct by all members and member firms of the ICAEW. In addition, the ICAEW requires its members to comply with the FRC's Ethical Standards. Ethical Standard 1 dealt with "*integrity, objectivity and independence*", Ethical Standard 4 dealt with fees and Ethical Standard 5 dealt with non-audit services provided to audit clients.

¹ A CVA is an insolvency process under Part 1 of the Insolvency Act 1986 by which a company can compromise or reschedule some or all of its unsecured debts.

21. The relevant auditing standards, issued by the Auditing Practices Board, were the International Standards on Auditing (UK and Ireland) (“**ISAs**”). The purpose of ISAs is to establish standards and general principles with which auditors are required to comply. Together they form a body of standards that should be applied before an auditor can express an opinion that financial statements give a ‘true and fair view’ within the meaning of section 393 of the Companies Act 2006.
22. The relevant extracts from the Code, the Ethical Standards and the auditing standards are set out, so far as relevant, at Appendix A.

VI. SUPERVISION AND REVIEW

23. This section relates to Allegation 1.
24. As Engagement Partner, Steve Denison was required to take responsibility for the overall quality of each audit engagement, for the supervision and performance of the audit engagement and for the auditor’s report being appropriate in the circumstances. He was also required, through a review of the audit documentation and discussion with the engagement team, to be satisfied that sufficient appropriate audit evidence had been obtained.
25. Mr Denison, and through him, PwC, failed to discharge these important responsibilities in three key respects.
26. First, *delegation and supervision*. PwC’s Engagement Team included the Audit Senior Manager (“**A**”) and the Audit Manager (“**B**”). **A** was not involved in the final stages of the BHS audit, which had been brought forward to accommodate the sale. This was delegated to **B**. Audit fieldwork for the group (including BHS) was completed during the course of 2014. For BHS Group and BHS specifically, additional audit work took place in December 2014. In December 2014, Steve Denison recorded 1 hour on the audit. The completion stage took place from 1 January 2015 to 9 March 2015. The completion stage of the audit is of considerable importance as it is during this stage that the auditor reviews the evidence obtained during the audit together with the final version of the financial statements with the objective of forming the auditor’s opinion. In this period, from 1 January 2015 to 9 March 2015:
 - 26.1 Steve Denison recorded only 2 hours on the audit of the financial statements of the “Taveta Group”, including BHS Limited, and **A** recorded only 7 hours;
 - 26.2 **B** recorded 29.25 hours (and the remaining members of the audit team, who were junior to **B**, recorded 114.6 hours).

27. At the time of the audit, **B** was very junior, having only one year of post-qualification experience. In light of this, the work performed by Steve Denison was insufficient to demonstrate the level of supervision that was to be expected.
28. The lack of supervision is highlighted by one further fact: despite the audit being brought forward because of the imminent sale, **B**, at least prior to 27 February 2015 did not know or appreciate that any sale was to take place. **B**'s recollection is that she was not aware of the planned sale of BHS during the time the audit work was completed, which was early February 2015, nor any time prior to that. In interview **B** said, "*I actually wasn't aware that BHS was being sold*". Her impression was rather that "*BHS would continue to be supported by the Taveta group*". She had simply been told to "*prioritise*" the BHS accounts, but did not know why. The sale was not something she remembered being discussed. Her best recollection is that she only became aware of the sale around the time the accounts for BHS were signed.
29. The lack of supervision by Steve Denison and **A** is striking given that they both recorded substantial amounts of time on non-audit services for the same clients in the period from 1 January 2015 to 9 March 2015. Whilst Steve Denison recorded 31 hours on non-audit services in this period, he recorded just two hours on the BHS audit.
30. Secondly, *review of working papers*. In interview, **A** identified four main audit work papers summarising the audit work that PwC carried out in respect of BHS, in addition to work previously performed as part of the group audit. These work papers were identified by **A** (in interview) as being central to the audit of BHS's financial statements. None of these papers were reviewed by Steve Denison or **A**. All were marked "*reviewed-final*" by **B**. In addition, although the Respondents identified four areas of significant risk at the planning stage (fraud in revenue recognition; management override of control; impairment; and onerous lease provision), Steve Denison did not review specific work papers in relation to these areas.
31. Thirdly, *review of the final accounts*. On 12 February 2015, Steve Denison emailed **B** saying that he had reviewed BHS's draft accounts. Amendments to those accounts were subsequently made. On 6 March, Taveta 2 provided written representations. The BHS audit was signed off on 9 March (albeit backdated to 6 March). Minor amendments to those accounts were made later that day. PwC's time recording shows that Steve Denison recorded one hour on the Taveta Group audit on 12 February and one hour of work on 9 March 2015 but no time at all between those dates and no further time after 9 March 2015. This was inadequate.

VII. INDEPENDENCE AND OBJECTIVITY

32. This section relates to Allegation 2.
33. The Respondents were exposed to threats to their independence and objectivity and failed to guard against them.
34. First, the Respondents failed to guard against the self-interest threat created by the substantial fees they generated in providing non-audit services to the Taveta Group:
- 34.1 In 2014, the Taveta Group paid PwC £355,000 in audit fees and £2,859,778 in non-audit fees. PwC's report to Taveta's audit committee suggests that the figure was even higher, at £3,303,000. The value of non-audit services that PwC sold to the Taveta Group therefore exceeded the value of the audit services that it sold to the Taveta Group by a factor of eight. In 2012 and 2013 the factor was three and in 2015 the factor was five.
- 34.2 In addition, the Respondents charged Taveta a contingency fee in relation to a pensions incentive exercise. Ethical Standard 4 warned that contingent fee arrangements for non-audit work provided by a client's auditor "*can create significant self-interest threats to the auditor's objectivity and independence as the auditor may have, or may appear to have, an interest in the outcome of the non-audit service*".
- 34.3 The fees generated from this non-audit work risked inappropriately influencing the Respondents' judgment or behaviour. The Ethical Standards warn against this. Ethical Standard 5 (the standard relating specifically to "non-audit services provided to audited entities") stated: "*Where substantial fees are regularly generated from the provision of non-audit services and the fees for non-audit services are greater than the annual audit fees, the audit engagement partner has regard to the possibility that there may be perceived to be a loss of independence resulting from the expected or actual level of fees for non-audit services.*"
35. Second, the Respondents failed to guard against the familiarity threat created by the non-audit work they performed for the Taveta Group:
- 35.1 As noted above, the Respondents performed a substantial amount of non-audit work for the Taveta Group. Steve Denison, **A** and **B** were involved in performing this non-audit work. PwC was also appointed as liquidator of a number of dormant subsidiaries in the Taveta Group. Steve Denison was the single point of contact at PwC for Sir Philip Green and had a central role in the provision of non-audit services generally. Steve Denison had a long or close business association with the client. In describing his role in 2013, Steve

Denison said that he had “*had a particularly busy year with Arcadia, helping them with a number of key projects*”, including: “*Disposal of 25% of Top Shop*”, where he had “*managed to agree [PwC’s] fees at the full amount of £700,000*”; “*Dealing with the Arcadia and Bhs pension scheme deficits*”; “*Reorganising the group structure*”; and “*Delivering creative ideas around the use of property assets*”. In 2014, Steve Denison stated: “*I continue to receive great feedback from the senior people at my clients (Sir Philip Green and Paul Budge at Arcadia and [])*. As a result, the incidence of them asking the other firms for help or advice is very limited.”

35.2 The circumstances described above gave rise to the risk that Mr Denison and his team were too close to the management of the Taveta Group, with the result that there existed a threat to their objectivity and independence. This risk was underlined by the Code and the Ethical Standards. The Code defines the “*familiarity threat*” as being “*the threat that due to a long or close relationship with a client or employer, a professional accountant will be too sympathetic to their interests or too accepting of their work*”. The Code gives the following example of which may give rise to a familiarity threat: “*Senior personnel having a long association with the assurance client*”.

36. It is not suggested that audit team members should not be involved in (or associated with) any work at all falling outside the strict confines of the audit. Nor is it suggested that the objectivity of Steve Denison (or any other member of the audit team) was in fact impaired. The allegation is that the circumstances described in Allegation 2 threatened the Respondents’ objectivity and independence. The Respondents should have identified these threats and applied safeguards namely: (a) consultation with an ethics partner and/or (b) the appointment of an independent partner on the audit (i.e. an engagement quality control reviewer). They should also have considered (c) complete separation of teams.

VIII. **GOING CONCERN**

37. This section relates to Allegation 3.

38. The going concern assumption is the assumption that a company will remain in business for the foreseeable future. In considering whether a company is a going concern, the key test is whether the company is able to pay its debts as they fall due. Where the going concern assumption is not appropriate, then an entity prepares its accounts on a break-up basis with assets valued on the basis of expected realisation

from a forced sale. The going concern assumption is a fundamental principle in the preparation of financial statements².

39. Management must make an assessment of a company's ability to continue as a going concern. In previous years, the Taveta Group had provided BHS and BHS Group with financial support, primarily through Taveta 2, and on this basis management had prepared financial statements on a going concern basis. For the year ending 30 August 2014, the Respondents had not obtained a going concern assessment from management. In particular, the Respondents had not obtained an assessment of how BHS was likely to remain a going concern in the event it was sold and no longer receiving support from the Taveta Group.
40. The Respondents' responsibilities were (a) to obtain sufficient appropriate audit evidence about the appropriateness of management's use of the going concern assumption (b) to conclude, based on the audit evidence obtained, whether a material uncertainty existed about BHS's ability to continue as a going concern and (c) to determine the implications for the audit report. They failed altogether to discharge these responsibilities.
41. There were several events or conditions that should have appeared to the Respondents to cast significant doubt over BHS's ability to continue as a going concern and therefore to require further investigation:
 - 41.1 BHS had significant net liabilities, its turnover had been decreasing for several years, and it was recording substantial losses.
 - 41.2 BHS had had to make provision for loss-making stores.
 - 41.3 BHS had very significant deficits in its defined-benefit pension schemes.
 - 41.4 In 2014, the Taveta Group had submitted a draft application to tPR for a Regulated Apportionment Arrangement ("**RAA**") (a way of restructuring pension schemes). This was an indicator of potential insolvency since RAAs are only available if an applicant is at risk of insolvency. In September 2014, Taveta decided to "pause" their draft application to consider their options and revisit matters in January 2015.
 - 41.5 The sale of BHS meant, in all likelihood, that Taveta 2's support would fall away. As to the existence of other facilities or financing arrangements in place to support the business in the event of a sale there was no audit evidence.

² ISA 570 para 4

- 41.6 Significantly, in a letter dated 6 March 2015 (i.e. before Steve Denison had signed the audit report) Taveta 2 qualified its letter of support. Taveta 2 stated that it intended to finance BHS Group and BHS “*whilst the companies continued to be under the control of Taveta 2*”. Letters of support in previous years contained no such qualification; nor had the proposed letter of support for 2014 which PwC had drafted for Taveta to sign.
42. The Respondents gave no consideration to how these matters may have impacted BHS’ ability to continue as a going concern. They failed to gather any audit evidence on which to conclude that the going concern assumption was appropriate. Based on the audit evidence obtained, they should have concluded that a material uncertainty existed about BHS Group and BHS’s ability to continue as going concerns.
43. Further, the disclosures in the financial statements of BHS Group and BHS were incomplete, inaccurate and misleading because the financial statements for BHS Group stated that the going concern assumption was appropriate “*as Taveta Investments No. 2 Limited... has given an undertaking to provide the Company with continuing financial support*”. The financial statements of BHS stated the going concern basis was appropriate because of the continued financial support of Taveta 2. In fact, however:
- 43.1 there was no such unqualified undertaking: the financial support Taveta 2 was prepared to offer was expressly qualified. Taveta 2’s letter of 6 March 2015 stated that it intended to finance BHS Group and BHS “*whilst the companies continued to be under the control of Taveta 2*”; and
- 43.2 at the time the audit report was signed on 9 March 2015, the Respondents knew that, within a matter of days, BHS Group and BHS were likely to be sold, and if sold BHS Group and BHS Limited would cease to be under the control of Taveta 2.

IX. IMPAIRMENT OF FIXED ASSETS

44. This section relates to Allegation 4.
45. Impairment testing is the process of testing that the reported value of assets does not exceed the value they are likely to realise through either their continued use in the business (“**value in use**”³) or their sale.

³ In accordance with paragraphs 25 of FRS 11, the value in use of a fixed asset is the “*present value of the future cash flows obtainable as a result of the assets’ continued use, including those resulting from their ultimate disposal*”.

46. The reported value of tangible fixed assets in the BHS's 2014 Financial Statements (essentially freehold and leasehold stores, and their fixtures and fittings) was £183 million. The reported value of tangible fixed assets for all of the subsidiaries of BHS Group was £257.1 million. BHS had, however, made losses for several years and during the year it had reported a loss of £69 million. In addition, it faced difficult trading conditions. In light of these 'impairment indicators', management carried out an impairment review in order to test that the reported value of assets in BHS's accounts did not exceed the amount to be earned from their use in business (i.e. their value in use).
47. Management sought to establish the value in use of BHS's fixed assets by forecasting cash flows for the BHS brand over the average lease life of a BHS store (around 27 years). This exercise was based on a number of assumptions and estimates. Management then compared that figure with the reported value. Management calculated the 'value in use' of the fixed assets for the BHS brand to be £264.5 million. This exceeded, albeit by only £7.4 million, the carrying value of fixed assets (£257.1 million). Management concluded that there was no impairment and it was not necessary to reduce the value of the fixed assets in the accounts.
48. At the planning stage, the Respondents deemed impairment of assets and investments to be an area of significant risk and, in around October 2014, reviewed management's impairment review. The Respondents, however, failed to apply sufficient professional scepticism and obtain sufficient appropriate audit evidence. The Respondents failed adequately to understand and to test many of management's assumptions and estimates. In particular:
- 48.1 Management had assumed that BHS's like-for-like retail sales would go up by 6.7% in 2015. However, BHS's retail sales had gone down 2.6% between 2012 and 2014; the entire UK womenswear market was only expected to grow by 2.9% and the UK menswear market by 3.6%; and BHS's retail sales had fallen 1.8% by January 2015, three months before the audit was finished.
- 48.2 Management had estimated that BHS's losses in the following year (year one of the forecast) would reduce by over £30 million (before contingency and allowances for cost inflation) because of ambitious "targeted management objectives". These included, amongst other things, (a) margin growth for the year of nearly £8 million and (b) like for like growth for the year of £22 million. Such margin and sales growth were unsupported by audit evidence and should have appeared to the Respondents to be unrealistic and require further investigation.

- 48.3 Management had adjusted the forecast losses over the next 30 years. Management assumed BHS's losses would reduce by 10% each year over the next 5 years (years 2 to 6 of the forecast). This assumption should have appeared to the Respondents to be very optimistic given that there was a general trend of increasing losses.
- 48.4 Management had assumed a break-even position from 2022 onwards (i.e. within 8 years). In other words, BHS was forecast to make a loss of £34.6 million in year seven but break-even in year 8. This assumption was unsupported by audit evidence and should have appeared to the Respondents to be unreasonable and require further investigation.
- 48.5 Management had made further adjustments which had the effect of improving BHS's earnings. Many of these adjustments were unsupported by audit evidence; some appeared to be incorrect. For example, management included £12 million annually from "profit held in Arcadia". The audit team understood "profit held in Arcadia" to comprise profits made by concessionaires. On this basis, it should have been included in the accounts of the concessionaires and not attributed to BHS. Other adjustments were made which were unsupported by audit evidence namely (a) 'Shared Depreciation' (£5 million annually, which PwC concluded should not have been included but omitted to resolve with management) (b) 'Property Companies Over Recovery' (£3 million annually) (c) 'BHS specific rates and rents rebate' (£2 million annually) and (d) pension charges (£600,000 annually).
49. Modest adjustments to these assumptions and estimates would have substantially reduced the 'value in use' figure resulting in a material impairment. For example, had the 'profit held in Arcadia' been removed, the value in use figure would have dropped by £105 million. Nonetheless, the Respondents concluded: "*[management] said they would be happy to take on board impairment in the next year if nothing improved with the brand in the coming year. Ultimately, we were happy they had proved to us no impairment required this year.*" For the reasons set out in Allegation 4, there was no or no sufficient audit evidence for the Respondents' conclusion. In summary:
- 49.1 management's impairment review was based on assumptions and estimates, many of which were unsupported by audit evidence.
- 49.2 the Respondents failed to apply professional scepticism when assessing management's forecasts and estimates; and

49.3 the Respondents failed to obtain sufficient appropriate audit evidence to draw a reasonable conclusion that fixed assets were not impaired and that BHS's financial statements gave a true and fair view.

X. IMPAIRMENT OF INVESTMENTS

50. This section relates to Allegation 5.

51. BHS Group's immediate parent before the sale was Taveta 2. Taveta 2 held investments in BHS Group valued at around £201 million. On 11 March 2015, BHS Group was sold to RAL for £1. Taveta 2's 2014 financial statements were signed just over two months later, on 21 May 2015. On the same date, Mr Denison signed the auditor's report. There was, however, no reference in Taveta 2's 2014 financial statements to the sale for £1. Nor was there any reference to Taveta 2's investment being written off, or the effect of the sale on the assessment of the value of that investment.

52. The Respondents failed to identify that the sale for £1 on 11 March 2015 suggested that the investment may not have been worth £201 million on 30 August 2014. This failure gave rise to a material misstatement in Taveta 2's 2014 financial statements.

XI. LOAN OWED BY BHS TO ARCADIA

53. This section relates to Allegation 6.

54. The financial statements for Arcadia included a debt due from BHS of £236.5 million at 30 August 2014, indicating that this amount would be received from BHS. However, as part of the sale to RAL on 11 March 2015, Arcadia wrote off £216.8 million of this debt. Therefore, by the time the audit report for Arcadia was signed on 21 May 2015, it was known that this amount would not be paid. There was, however, no reference in Arcadia's 2014 financial statements to the sale nor to the debt being written off.

55. Despite knowing that the debt had largely been written off, the Respondents failed to ensure that this was reflected in Arcadia's 2014 financial statements. This resulted in a material misstatement.

XII. INCOME STATEMENT

56. This section relates to Allegation 7.

57. BHS's income statement showed revenue of £668 million and total cost of sales and operating expenses of £745 million. The loss for the financial year was stated to be £69 million.
58. Put shortly, the Respondents did not obtain sufficient appropriate evidence regarding revenue, cost of sales and operating expenses to draw a reasonable conclusion that these figures were not materially misstated. They considered the income statement primarily from the perspective of the Taveta Group. They failed to give proper consideration to the position of subsidiary undertakings. The Respondents did not have enough evidence to confirm whether BHS had made a profit or a loss. This was a particularly serious failing in circumstances where the Respondents knew that BHS was likely to be sold out of the group very soon after the audit was completed.

(1) Revenue⁴

59. Taveta Group's revenue was £2.7 billion. BHS's financial statements showed revenue of £668 million.
60. The criticisms of the Respondents' audit work in relation to revenue fall under three headings: (1) Audit testing (2) the Burton Adjustment and (3) intra-group concession income.

Audit testing – paragraphs 5, 7 and 8 of Allegation 7

61. The Respondents failed to identify and address the risk that the revenue of BHS might have been misstated.
62. The Respondents' approach to auditing revenue involved the use of "computer-aided audit techniques" or "computer aided tools" ("**CAATs**"). These tests, which were the only substantive tests of detail the Respondents performed, were inadequate for the following reasons:
- 62.1 The tests were directed at identifying anomalies at the level of the consolidated accounts of Taveta Investments Limited. They did not address the risk that revenue was misallocated among individual subsidiaries and in particular did not address the risk that the revenue of BHS might have been misstated.
- 62.2 Despite planning to do so, the Respondents did not subject all of the Taveta Group's revenue to CAATs.

⁴ Whilst revenue and costs of sales and operating expenses are dealt with in one allegation, for ease of exposition, they are dealt with separately here.

- 62.3 The Respondents failed to use materiality thresholds appropriate for the subsidiaries in the Taveta Group. The tests were performed using Taveta Group materiality of £8.7 million.
63. Finance staff routinely adjusted BHS's accounts by manually making adjustments (or "manual journals") to the revenue, costs of sales and operating expenses of BHS. During the year, they made thousands of manual adjustments worth millions of pounds (it is not suggested that this was irregular). One of these, the "Burton adjustment", is considered separately below. The Respondents' testing of these adjustments only considered those which had a material impact on Taveta Group. This meant that the following were not tested:
- 63.1 adjustments which were material to the revenue of BHS but not the Taveta Group as a whole; and
- 63.2 adjustments which had a material impact on two subsidiaries but cancelled out at group level (for example, a reallocation of revenue from one subsidiary to another).
64. The only substantive audit work designed to address the risk that the revenue of BHS as a standalone entity might have been materially misstated was a high-level analytical review comparing revenue in 2014 with revenue in 2013. This analytical review was not, by itself, sufficient appropriate audit evidence.

The Burton Adjustment – paragraph 9.3 of Allegation 7

65. Burton purchased stock for BHS menswear sales, with the result that the resulting costs, sales and profit were automatically recorded in Burton's accounts rather than BHS. To address this, management made annual adjustments to attribute the menswear profit to BHS. In 2014, the adjustment resulted in an increase in BHS's revenue of approximately £69.6 million ("**the Burton Adjustment**"). This adjustment was material to BHS. This was a manual adjustment typed-in by a member of staff and as such, because it could have been subject to human error, it should have been scrutinised more carefully by the Respondents.
66. The Respondents failed to perform any audit tests on the Burton Adjustment. Indeed, the audit file does not contain any reference to the Burton Adjustment. Working paper 'Turnover Account Codes' shows that there is a £69.6 million difference between the turnover figures in the BHS trial balance and those in the management accounts and an opposite difference in Burton. There is no description contained on the audit file about what this difference is or how it has been tested. There is no other indication on the audit file that this difference existed.

Intra-group concession income – paragraph 10 of Allegation 7

67. Various non-Taveta businesses, including Sharps Bedrooms and Mothercare, had concessions in BHS. Revenue generated in these concessions was recorded in the accounts of the concessionaires, with BHS recording only the revenue it generated from commission on concession sales.
68. The Respondents failed to detect that BHS's income had been understated by approximately £21.8 million as a result of a mis-classification of intra-group concession income by BHS: BHS had subtracted £21.8 million from costs instead of adding this sum to income. This did not affect profit but meant that BHS's revenue was understated by £21.8 million (about 3%) and its costs were understated by the same amount (again, about 3%).

(2) Cost of Sales & Operating Expenses

69. BHS's financial statements showed total cost of sales to be £695 million and operating expenses to be £50 million.
70. The criticisms of the Respondents' audit work in relation to costs of sales and operating expenses fall under four headings: (1) controls testing (2) substantive testing (3) manual journals and (4) intra-group concession income.

Controls testing - paragraph 4 of Allegation 7

71. The Respondents' audit work on controls was inadequate. The testing focused exclusively on cost of sales generated *outside* the Taveta Group (such as the cost of purchases of inventory from entities outside the Taveta Group). The Respondents did not test cost of sales generated inside the Taveta Group (such as intercompany charges). A substantial amount of BHS's cost of sales were paid through the Taveta Group and were (wrongly) excluded from controls testing.

Substantive testing - paragraph 6 of Allegation 7.

72. The Respondents did not subject two thirds of BHS's costs of sales, or any of its operating expenses (a total of £484 million) to direct substantive testing.
73. The Respondents tested cost of sales and operating expenses of subsidiaries in the Taveta Group by means of (a) a high-level analytical review at the brand level; (b) limited classification testing (to check whether expenses had been properly classed as cost of sales or operating expenses); and (c) the agreement of balances between subsidiaries. These tests were inadequate. None addressed the risk that BHS's costs of sales and operating expenses might have been materially misstated.

Manual journals - paragraph 8 and 9 of Allegation 7

74. A substantial amount of BHS's cost of sales, and all of its operating expenses, were made up of intra-group charges recorded using manual adjustments.
75. The Respondents' tests of manual journals were inadequate. They were performed at the Taveta Group level (by reference to group materiality) and focused on the possible misstatement of *revenue*, meaning that they did not test manual adjustments which might have had a material impact on *cost of sales* or *operating expenses*.
76. Below are three specific examples of manual cost adjustments which the Respondents did not test:
- 76.1 First, a management charge levied by Arcadia on BHS which, in 2014, was stated to be £41.9 million (the "**Arcadia Management Charge**"). This charge was in recognition of the fact that Arcadia had been providing BHS with management services. This was shown in BHS's financial statements as part of BHS's administrative expenses and was disclosed in the notes to the financial statements. A corresponding revenue item was shown in Arcadia's financial statements as part of Arcadia's "*other operating income*". The Respondents did not, however, perform any audit work on the Arcadia Management Charge. This is particularly striking since the Taveta Group's historical reporting of the Arcadia Management Charge contained a number of apparent anomalies.
- 76.2 Second, an e-commerce charge agreed between BHS and Zoom.co.uk Limited, increasing BHS's costs of sales (and reducing BHS's profit) by approximately £9.8 million.
- 76.3 Third, the Burton Adjustment, referred to above. This increased BHS's costs by £40.2 million (and its sales by £69.6 million).

Intra-group concession income - paragraph 10 of Allegation 7.

77. As noted above, the Respondents failed to detect that BHS's cost of sales had been understated by approximately £21.8 million as a result of a misclassification of intra-group concession income. This led to BHS's revenue being understated by the same amount.

XIII. INTEGRITY

78. This section relates to Allegation 8.

79. Put shortly, Steve Denison agreed to back-date, and in due course he back-dated, his audit opinion relating to the financial statements of BHS. He then attempted to conceal or obfuscate the truth about when the audit was completed by making a false statement on PwC's electronic audit file.
80. The relevant chronology is set out below.
81. On 4 March 2015, **B** emailed Arcadia Group Limited, and stated: "*I spoke to Steve [Denison], and in this instance, he said he would sign on Monday [9 March] but back date to Friday, easing my administrative burden a bit which helps!*".
82. On 9 March 2015:
- 82.1 At 09:01, **B** emailed Steve Denison stating, "*in the excitement of a busy day at [*****Plc] on Friday, I forgot to ask you to do two things. One being to sign the BHS audit opinions ([*****] has them and will get you to do them this morning) and the other was to click off the file*". (The expression "*click off the file*" is understood to be an informal term sometimes used at PwC to refer to the audit partner marking, as reviewed and completed, the relevant audit completion steps on the electronic audit file.) **B** added, "*Would you mind replicating then ticking them off? If you could put a sentence in saying there were IT issues on Friday therefore you couldn't tick off then, that would be great?!*".
- 82.2 At 09:14, Steve Denison replied to **B**, saying "*I've signed off and put in a comment re Friday*".
- 82.3 Audit paper 8000-7010 shows the results of Steve Denison's activities on 9 March 2015. The paper sets out a series of steps that need to be completed in order for the audit to be concluded. Step 16 is called "*Evidence of Review*". Against that step Mr Denison wrote the following comment: "*Confirmed. I had IT issues on Friday 6th March...I reviewed and signed off the final steps in the file incl this one but replication didn't work so I am retrospectively approving the final 3 steps (incl this one) whilst attached to the PwC network on 9th March.*" This statement was false.
83. Mr Denison provided the following explanation to the FRC⁵:
- 83.1 He was in the office for a short time on the morning of Friday 6 March and then attended two pre-existing work engagements after which he went straight home. Consequently, as she had anticipated in her email of 4 March, **B** was unable to ensure that Mr Denison had hard copies of the various BHS financial statements for signature that day.

⁵ Letter from Taylor Wessing LLP dated 19 January 2018

- 83.2 Accordingly, he did not have access to a hard copy of the audit opinions for signature on that day, and so did not sign the audit opinion or click off the file.
- 83.3 On 9 March 2015, **B** asked Steve Denison to click off the file, and suggested that he refer to IT issues, which he did. The explanation he put on the audit file about IT issues was not accurate.
- 83.4 Steve Denison dated the audit opinion 6 March *“because that was neater and because that accorded with the client’s expectations”*. He nonetheless accepts that the audit opinion ought to have been dated 9 March 2015, the actual date of signature.

XIV. ALLEGATIONS OF MISCONDUCT

Allegation 1: Supervision & review

In relation to their audit of the financial statements of BHS Limited for the year ending 30 August 2014, Steve Denison and PricewaterhouseCoopers LLP failed to comply with the requirements of ISA 220 (quality control for an audit of financial statements); and failed to act in accordance with Fundamental Principle (c) (professional competence and due care) and section 130 of the Code of Ethics. Their conduct thereby fell significantly short of the standards reasonably to be expected of a Member and a Member Firm (as the case may be).

Particulars

1. PwC's time recording system shows that from 1 January to 9 March 2015:
 - 1.1 Steve Denison recorded only 2 hours on the audit of the financial statements of Taveta Investments Limited ("**Taveta**") and its subsidiaries (together, the "**Taveta Group**"), including BHS Limited ("**BHS**"), for the year ending 30 August 2014; and
 - 1.2 Steve Denison and the Senior Manager ("**A**") between them recorded only 9 hours on the audit of the Taveta Group's financial statements for the year ending 30 August 2014, whereas **B**, a member of PwC's audit team with only one year of post-qualification experience, recorded 29.25 hours, and the remaining members of the audit team, who were junior to **B**, recorded over 114 hours.
2. Steve Denison did not review specific work papers in relation to areas which had been identified as significant risk and elevated risk. Nor did he review the four work papers that were identified by **A** as being central to the audit of BHS's financial statements, namely:
 - 2.1 paper 2400-7000 Test Statutory Disclosures;
 - 2.2 paper 2400-7290 Test balance sheet;
 - 2.3 paper 2400-7580 Test profit & loss; and
 - 2.4 paper 2400-7870 Determine Materiality.
3. Steve Denison reviewed BHS's draft accounts on 12 February 2015. Amendments to BHS's accounts were subsequently made on 6 March 2015. Steve Denison signed off

the final steps of the audit of BHS's accounts at or before 09:14 on 9 March 2015. Further amendments to BHS's accounts were subsequently made on the same day. PwC's time recording shows that Steve Denison recorded one hour on the Taveta Group audit on 12 February 2015, and one hour on 9 March 2015, but no time at all between those two dates. PwC's time recording system also shows that Steve Denison recorded no further time on the Taveta Group audit after 9 March 2015. In view of the above, Steve Denison performed no adequate review of the amendments to BHS's accounts described in this paragraph.

4. Steve Denison was aware that BHS was likely to be sold to Retail Acquisitions Limited shortly after the audit opinion in respect of BHS's financial statements was signed. Nonetheless, Steve Denison:
 - 4.1 did not review the nature, timing and extent of the direction and supervision of engagement team members;
 - 4.2 delegated responsibility for the work done on the audit of BHS's financial statements in 2015, or allowed responsibility for that work to be delegated, to **B** who (a) had only one year of post-qualification experience and (b) did not know or appreciate that any sale was to take place; and
 - 4.3 failed adequately, or at all, to supervise and review **B**'s work.
5. In addition, as set out in allegations 3 (going concern), 5 (impairment), 6 (intra-group loans), and 7 (income statement), the quality of the audit work was so poor that Steve Denison's direction, supervision, performance and review of the audit engagement were evidently inadequate.
6. For the reasons set out at paragraphs 1 to 5 above, in breach of ISA 220 and Fundamental Principle (c) and section 130 of the Code of Ethics, the Respondents failed to:
 - 6.1 review the audit file appropriately and discuss it with the engagement team; and
 - 6.2 take responsibility for the direction, supervision and performance of the audit engagement.

Allegation 2: Independence and Objectivity

In relation to their audit of the financial statements of Taveta Investments Limited and its subsidiaries for the year ending 30 August 2014, Steve Denison and PricewaterhouseCoopers LLP (“PwC”) failed to comply with the requirements of ISA 220 (quality control for an audit of financial statements); and failed to act in accordance with Fundamental Principle (c) (professional competence and due care) and section 120 of the Code of Ethics or with APB Ethical Standards 1, 4, and 5. Their conduct thereby fell significantly short of the standards reasonably to be expected of a Member and a Member Firm (as the case may be).

Particulars

(1) **Non-audit fees**

1. Over several years, the value of non-audit fees that the Respondents charged Taveta Investments Limited and/or one or more of its subsidiaries (together with Taveta Investments Limited, the “**Taveta Group**”) exceeded by a wide margin the fees that the Respondents charged the Taveta Group for audit services. In particular:
 - 1.1 in the year ending 30 August 2012, the value of non-audit fees was over three times the value of audit fees;
 - 1.2 in the year ending 30 August 2013, the value of non-audit fees was over three times the value of audit fees;
 - 1.3 in the year ending 30 August 2014, the value of non-audit fees was over eight times the value of audit fees; and
 - 1.4 in the year ending 30 August 2015, the value of non-audit fees was over five times the value of audit fees.
2. In addition, the Respondents provided services to the Taveta Group in connection with a pensions incentive exercise which formed part of a wider project known as Project Paddington. The Respondents’ fees for the pensions incentive exercise were related to and contingent upon the number of pension scheme members accepting the incentive.
3. The circumstances described at paragraphs 1 and 2 above gave rise to a self-interest threat to independence and objectivity within the meaning of the Code of Ethics and the APB Ethical Standards.

(2) Time recorded on non-audit work

4. The Respondents' senior audit team for the audit of the financial statements of entities within the Taveta Group for the year ending 30 August 2014 (i.e., Steve Denison, **A** and **B**) performed a substantial amount of non-audit work for the Taveta Group. For example:
 - 4.1 Steve Denison and **B** worked on providing auditors' turnover certificates for landlords;
 - 4.2 Steve Denison, **A** and **B** provided miscellaneous accounting services, including technical accounting assistance, general advice, attendance at meetings, and PwC account administration;
 - 4.3 Steve Denison and **A** were involved in or worked on the restructuring projects known as Steak and Chips 1 and Steak and Chips 2; and
 - 4.4 Steve Denison was client service partner; he acted as the single point of contact at PwC for Sir Philip Green, and had a central role in the provision of non-audit services generally.
5. The circumstances described at paragraph 4 above gave rise to a familiarity threat to independence and objectivity within the meaning of the Code of Ethics and the APB Ethical Standards.

(3) Response to threats

6. Despite the threats identified at paragraphs 1 to 5 above:
 - 6.1 in breach of ISA 220, Fundamental Principle (c) and section 120 of the Code of Ethics, and APB Ethical Standards 1, 4, and 5, the Respondents failed to, or failed to adequately, identify or evaluate the significance of the threats to their independence and objectivity; and
 - 6.2 in breach of ISA 220, Fundamental Principle (c) and section 120 of the Code of Ethics, and APB Ethical Standards 1, 4, and 5, the Respondents failed to implement any, or any adequate, safeguards to eliminate those threats or reduce them to an acceptable level.
7. The Respondents' failures as described above are particularly striking in relation to the contingency fee arrangement described at paragraph (1)2 above given that contingency fee arrangements of that nature contravened guidance issued by the Pensions Regulator and by PwC itself (albeit not on grounds of objectivity).

Allegation 3: Going Concern

In relation to their audit of the financial statements of BHS Group Limited (“BHS Group”) and its subsidiaries, in particular BHS Limited (“BHS”), for the year ending 30 August 2014, and in relation to management’s use of the going concern assumption, Steve Denison and PricewaterhouseCoopers LLP (“PwC”) failed to act in accordance with the requirements of paragraph 15 of ISA 200 (professional scepticism), ISA 500 (audit evidence), and ISA 570 (going concern); and failed to act in accordance with Fundamental Principle (c) (professional competence and due care) and section 130 of the Code of Ethics. Their conduct thereby fell significantly short of the standards reasonably to be expected of a Member and a Member Firm (as the case may be).

Particulars

(1) Planning

1. When planning the audit, and performing risk assessment procedures as required by paragraph 5 of ISA 315 and paragraph 11 of ISA 570, the Respondents failed to consider adequately or at all whether there were events or conditions that might have cast significant doubt on the ability of BHS Group and its subsidiaries, and BHS Limited in particular, to each continue as a going concern. In particular:
 - 1.1 The Respondents considered the appropriateness of the going concern assumption primarily from the perspective of the Taveta Group (namely, Taveta Investments Limited and its subsidiaries). They failed to give any, or any adequate, consideration to the position of subsidiary undertakings and, in particular, to BHS Group and its subsidiary BHS.
 - 1.2 There were several events and conditions that, individually or collectively, might have cast significant doubt on the ability of BHS Group and BHS to continue as going concerns. In particular:
 - 1.2.1 BHS had significant net liabilities, its turnover had been decreasing for several years, and it was recording substantial losses.
 - 1.2.2 There was an increase in the provision for onerous leases on BHS loss-making stores.
 - 1.2.3 BHS had very significant deficits in its two defined-benefit pension schemes.
 - 1.2.4 In July 2014, the Taveta Group had also submitted a draft application to the Pensions Regulator for a Regulated Apportionment Arrangement.

1.2.5 The Taveta Group was providing BHS and BHS Group with financial support, primarily through Taveta Investments No. 2 Limited ("**Taveta 2**"), one of BHS Group's and BHS's intermediate parents, but (a) there was a possibility that the Taveta Group might be re-structured and/or that BHS Group or BHS (or both) might be sold, and it was expected that Taveta 2 would withdraw its support from BHS and BHS Group if the sale took place; and (b) even if the sale did not take place, there was no sufficient audit evidence as to whether Taveta 2 was in a position to stand behind the level of support necessary for BHS Group and BHS to continue as going concerns.

1.3 The Respondents failed adequately to identify and/or consider and/or assess the significance of the events and conditions identified immediately above.

(2) Execution

2. In performing the audit, the Respondents failed to (a) exercise sufficient professional scepticism or (b) obtain sufficient appropriate evidence about the appropriateness of management's use of the going concern assumption. In particular, the Respondents failed adequately to consider and assess the impact on the going concern assumption of the events and conditions set out in paragraph 1.2 above.

(3) The impact of the sale of BHS Group

3. The Respondents became aware of the likely sale of BHS Group to Retail Acquisitions Limited ("**RAL**") prior to issuing the audit report. PwC had obtained a copy of the draft share purchase agreement effecting that sale (the "**Draft SPA**") prior to signing the BHS Group and BHS Limited financial statements. Completion of the audit had been brought forward to accommodate the sale. Further, PwC's tax team had advised on aspects of the sale (and, in the context of its advice about whether pension contributions could be deducted for tax purposes after the sale, an individual within the tax team had expressed the view that BHS was "effectively bust"). Nonetheless, the Respondents failed to consider adequately, or at all, the impact of the sale on the going concern assumption or perform additional procedures. They failed thereby to obtain sufficient appropriate evidence about the appropriateness of management's use of the going concern assumption. In particular:

3.1 According to the financial statements, management had prepared BHS Group's and BHS's financial statements on a going concern basis on the ground that Taveta 2 continued to provide financial support. The proposed sale should have appeared to the Respondents to cast serious doubt on the continued support of Taveta 2 and, therefore, in the absence of audit evidence as to alternative financing, on the going concern assumption.

- 3.2 This doubt was underlined by Taveta 2's letter of support dated 6 March 2015, the apparent meaning of which was that Taveta 2 intended to finance BHS Group and BHS Limited only whilst the companies continued to be under the control of Taveta 2. Letters of support in previous years contained no such qualification; nor did the proposed letter of support for 2014 which PwC had drafted for Taveta to sign.
- 3.3 The disclosures in the financial statements of BHS Group and BHS Limited were incomplete, inaccurate and misleading because the financial statements for BHS Group stated that the going concern assumption was appropriate "as *Taveta Investments No. 2 Limited... has given an undertaking to provide the Company with continuing financial support*". The financial statements of BHS Limited stated the going concern basis was appropriate because of the continued financial support of Taveta 2. In fact, however:
- 3.3.1 there was no such unqualified undertaking. As set out above, the financial support Taveta 2 was prepared to offer was expressly qualified: Taveta 2's letter of 6 March 2015 stated that they intended to finance BHS Group and BHS "*whilst the companies continued to be under the control of Taveta 2*"; and
- 3.3.2 at the time the audit report was signed on 9 March 2015, the Respondents knew that, within a matter of days, BHS Group and BHS were likely to be sold, and if sold BHS Group and BHS would cease to be under the control of Taveta 2.
- 3.4 The Respondents gave no or no proper consideration to the matters set out at paragraphs (1)1.1, (1)1.2 & 3.1 - 3.2 above . Without prejudice to the generality of the foregoing, no or no proper consideration was given to:
- 3.4.1 whether Taveta 2's support would continue beyond the date of the sale to RAL when BHS Group and BHS Limited ceased to be under the control of Taveta 2;
- 3.4.2 the terms of the Draft SPA; or
- 3.4.3 how BHS Group and BHS Limited would survive without the continued support of Taveta 2.
- 3.5 In the absence of an assessment and/or detailed analysis of the going concern assumption and in light of the events and conditions set out in paragraphs (1)1.1, (1)1.2 & 3.1 - 3.2 above the Respondents should have carried out additional audit procedures to determine whether the use of the going concern assumption was appropriate. In particular, they should have:

- 3.5.1 required management to provide an assessment of BHS Group and BHS Limited's ability to continue as going concerns;
- 3.5.2 analysed and discussed cash flow and profit forecasts with management;
- 3.5.3 evaluated the reliability of the data generated to prepare the forecasts and the reasonableness of the underlying assumptions;
- 3.5.4 evaluated management's plans for future actions in relation to its going concern assessments;
- 3.5.5 reviewed the latest management accounts;
- 3.5.6 assessed the accuracy of management's previous forecasts; and
- 3.5.7 determined what facilities or other financing arrangements were in place to support the business in the event of sale.

(4) Breaches

4. For the reasons set out at paragraphs (1) to (3) above:

- 4.1 in breach of ISA 200, ISA 500, ISA 570, and Fundamental Principle (c) and section 130 of the Code of Ethics, the Respondents failed to gather sufficient appropriate evidence on which to conclude that the going concern assumption was appropriate; and
- 4.2 in the absence of further audit evidence, unless management were able to demonstrate why disclosures were not necessary, the Respondents should have requested that management include appropriate disclosures in the financial statements as to the material uncertainties over going concern (in accordance with FRS 18). In breach of ISA 200, ISA 570, and Fundamental Principle (c) and section 130 of the Code of Ethics, the Respondents failed to do so.

Allegation 4: Impairment of Fixed Assets

In relation to their audit of the financial statements of BHS Group Limited (“BHS Group”) and its subsidiaries for the year ending 30 August 2014, and in relation to impairment of fixed assets, Steve Denison and PricewaterhouseCoopers LLP (“PwC”) failed to comply with the requirements of paragraph 15 of ISA 200 (professional scepticism), and ISA 500 (audit evidence); and failed to act in accordance with Fundamental Principle (c) professional competence and due care and section 130 of the Code of Ethics. Their conduct thereby fell significantly short of the standards reasonably to be expected of a Member and a Member Firm (as the case may be).

Particulars

(1) Introduction

1. The carrying value of fixed assets in BHS Limited’s 2014 Financial Statements (essentially freehold and leasehold stores, and their fixtures and fittings) was £183 million. The carrying value of fixed assets for all of the subsidiaries within BHS Group was £257.12 million.
2. Management performed an impairment review whereby they forecast cash flows for the BHS brand over the average lease life of a BHS store, around 30 years, in order to calculate the “value in use” of the fixed assets for the BHS brand. Management calculated this to be £264.5 million. This exceeded, by around £7.4 million, the carrying value of fixed assets. Management concluded that no impairment was necessary.
3. The Respondents identified impairment of assets to be an area of significant risk. They purported to audit management’s impairment review. As set out more particularly below, when assessing expected future cash flows to be generated by the BHS brand and whether management’s forecasts were based on reasonable and supportable assumptions, the Respondents failed to (a) apply sufficient professional scepticism and (b) obtain sufficient appropriate audit evidence.

(2) Management’s ability to forecast

4. The Respondents failed to consider adequately, or at all, management’s ability to forecast cash flows and whether management’s forecasts were reliable. As the Respondents knew, or should have appreciated, management’s forecasts had in the past proved inaccurate and, by the time of the 2014 audit, the BHS brand was performing below the levels forecast in (a) management’s 3-year recovery plan and (b) management’s impairment review.

(3) Management's assumptions

5. The Respondents failed adequately to understand, and to test, management's forecast that like-for-like sales growth would lead to an improvement in EBIT of £22 million. More particularly:

5.1 The Respondents proceeded on the premise that the £22 million figure was based on assumptions of retail growth of 3% and e-commerce growth of 20%. However, the Respondents misunderstood the assumptions. Management's records indicate that the £22 million figure was based on assumptions of like-for-like retail sales growth of 6.7% and e-commerce growth of 39.8%.

5.2 Management's assumptions about sales growth were not supported by audit evidence and should have appeared to the Respondents to be unreasonable and require further investigation. They were, on the face of it, inconsistent with, amongst other things:

5.2.1 Like-for-like sales growth in previous years;

5.2.2 Management's 3-year recovery plan which assumed a 3% increase in retail sales and e-commerce growth of 20% in 2014/2015;

5.2.3 The 'Taveta 3 year Desktop Plan', which assumed that like-for-like retail growth would be 1.5% in 2014/15;

5.2.4 Taveta's board minutes for January 2015, which recorded that in the year-to-date retail sales were down by 1.8% and e-commerce growth had been 22%.

5.3 The Respondents failed to (a) identify or consider the apparent inconsistencies set out above and (b) test whether management's assumptions were reasonable and supported by evidence. Insofar as the Respondents relied on management's representations, the Respondents failed to obtain any or any sufficient corroboration.

5.4 PwC attributed the forecast like-for-like growth in 2014/15 in part to a "food rollout" which was planned, in the long term, for 100 stores. However, there is no evidence on file to support the assumption that the "food rollout" would lead to like-for-like sales growth. To the extent that this sales growth was predicated on future capital expenditure, then it was precluded by FRS 11 (which prohibits the inclusion of benefits from future capital expenditure that will improve or enhance the income-generated units or assets).

6. The Respondents failed adequately to understand, and to test, management's assumption that cost savings would lead to margin growth of £7.99 million (of which

£2.3 million the Respondents stated was attributable to a discount BHS anticipated negotiating with its supplier, £4.4 million the Respondents stated resulted from “improvements in buying practices” and £1.3 million the Respondents failed to explain).

7. The Respondents failed to gain a proper understanding of the £12 million adjustment ‘Profit held in Arcadia’ and concluded erroneously, and in the absence of sufficient appropriate audit evidence, that it was appropriate to add this to forecast cashflows for the BHS brand. The audit team understood ‘Profit held in Arcadia’ to comprise profits made by concessionaires and, on this basis, it should have been included in the accounts of the concessionaires.
8. The Respondents failed to gain a proper understanding of the ‘Shared Depreciation’ adjustment. On the available audit evidence, this amount should not have been added to BHS’s cashflow forecast for the BHS brand, as the Respondents concluded at the time but failed to resolve with management.
9. The Respondents failed adequately to understand, and to test, the following additional adjustments, each of which had the effect of improving EBIT: (a) ‘Property Companies Over Recovery’ (b) ‘BHS specific rates & rents rebate’ and (c) ‘Pension based on FRS17’.
10. The Respondents failed adequately to understand, and to test, the basis for the 10% improvement in EBIT for the years 2 – 6. There is no record on the audit file of the Respondents’ assessment and why, for example, they considered it to be reasonable and consistent with up-to-date budgets. Nor was any sensitivity analysis performed around this assumption.
11. The Respondents failed adequately to understand, and to test, management’s “break-even assumption”. The BHS brand was forecast to make a loss of £34.6 million in year 7 but break-even in year 8. This assumption was unsupported by audit evidence. It was also inconsistent with FRS 11 paragraph 36 (viz cash flows for the period beyond that covered by formal budgets and plans should assume a steady or declining growth rate). The assumption should have appeared to the Respondents to be unreasonable and require further investigation.
12. There is no record on the audit file that the Respondents considered whether the benefits of future restructuring or capital expenditure had properly been excluded from the forecasts. In calculating future value in use, future cash flows should be estimated for assets in their current condition. The costs and benefits of future restructuring, and of capital expenditure to enhance the performance of the assets, should be excluded from cash flows.

13. The Respondents failed to consider adequately, or at all, the further evidence provided by the sale of BHS Group and in particular (a) the impact of the sale on cash flow forecasts and (b) whether the carrying amount of fixed assets was recoverable.

(4) Breaches

14. For the reasons set out above:
 - 14.1 when assessing expected future cash flows to be generated by the BHS brand and whether management's forecasts were based on reasonable and supportable assumptions, the Respondents failed to apply sufficient professional scepticism;
 - 14.2 in breach of ISA 240 and Fundamental Principle (c) and section 130 of the Code of Ethics, the Respondents failed to obtain reasonable assurance that the value of fixed assets was not materially misstated; and
 - 14.3 in breach of ISA 500 and Fundamental Principle (c) and section 130 of the Code of Ethics, the Respondents failed to obtain sufficient appropriate audit evidence to draw a reasonable conclusion that fixed assets were not impaired and that the financial statements of BHS Group and its subsidiaries gave a true and fair view.

Allegation 5: Impairment of Investment

In relation to their audit of the financial statements of Taveta Investments Ltd (No. 2) (“Taveta 2”) for the year ending 30 August 2014, and in relation to the value of Taveta 2’s investments in the BHS group, Steve Denison and PricewaterhouseCoopers LLP (“PwC”) failed to comply with the requirements of ISA 500 (audit evidence) and ISA 560 (post balance sheet events); and failed to act in accordance with Fundamental Principle (c) professional competence and due care and section 130 of the Code of Ethics. Their conduct thereby fell significantly short of the standards reasonably to be expected of a Member and a Member Firm (as the case may be).

Particulars

1. Taveta 2 held very substantial investments in subsidiaries including in BHS Group Limited (“**BHS Group**”). On 11 March 2015, BHS Group was sold to Retail Acquisitions Limited (“**RAL**”) for £1. Taveta 2’s financial statements were signed just over two months later, on 21 May 2015. On the same date, Mr Denison signed the auditor’s report. There was, however, no reference in Taveta 2’s 2014 financial statements to the sale for £1 nor to Taveta 2’s investment in BHS Group being written off. (The investment was written off in the 2015 financial statements and the carrying value of £201 million was recorded as a loss on disposal of investment.)
2. The sale of BHS Group on 11 March 2015 was an adjusting event after the balance sheet date within the meaning of FRS 21 which ought to have affected the assessment of the value of Taveta 2’s investments at the balance sheet date and led to an adjustment under paragraph 8 of FRS 21. No such adjustment was made. Alternatively, the sale was a material non-adjusting event after the balance sheet date within the meaning of FRS 21 which ought to have led to a disclosure under paragraph 21 of FRS 21. No such disclosure was made.

3. In breach of ISA 500, ISA 560, and Fundamental Principle (c) and section 130 of the Code of Ethics, the Respondents failed to perform audit procedures designed to obtain sufficient appropriate evidence that:
 - 3.1 all relevant post balance sheet events, including the sale, had been identified; and
 - 3.2 appropriate consideration had been given to the effects of the sale and whether they should be reflected in Taveta 2's 2014 financial statements in the manner described above (either by way of an adjustment or a disclosure).

4. In breach of ISA 500, ISA 560, and Fundamental Principle (c) and section 130 of the Code of Ethics, the Respondents failed:
 - 4.1 to give any, or any adequate, consideration to whether the sale was an adjusting or non-adjusting event after the balance sheet date for the purposes of FRS 21;
 - 4.2 to identify whether the sale was an adjusting or non-adjusting event after the balance sheet date for the purposes of FRS 21; and
 - 4.3 to request management to make an appropriate adjustment to, or a disclosure in, Taveta 2's financial statements. The failure to reflect the sale in Taveta 2's 2014 financial statements resulted in a material misstatement.

Allegation 6: Loan owed by BHS to Arcadia

In relation to their audit of the financial statements of Arcadia Group Limited (“Arcadia”) for the year ending 30 August 2014, and in relation to the intra-group balances owed by BHS Group Limited and its subsidiaries to Arcadia, Steve Denison and PricewaterhouseCoopers LLP failed to comply with the requirements of ISA 500 (audit evidence) and ISA 560 (post balance sheet events); and failed to act in accordance with Fundamental Principle (c) (professional competence and due care) and section 130 of the Code of Ethics. Their conduct thereby fell significantly short of the standards reasonably to be expected of a Member and a Member Firm (as the case may be).

Particulars

1. The Respondents’ work papers record that, as at 30 August 2014, BHS Group Limited and its subsidiaries owed Arcadia £236,458,000. As part of the sale of BHS Group to Retail Acquisitions Limited (“RAL”), Arcadia wrote off approximately £216,751,000 of this inter-company debt balance. The sale completed on 11 March 2015. Arcadia’s 2014 financial statements were signed just over two months later, on 21 May 2015, and Mr Denison signed the auditor’s report on the same date. There was, however, no reference in Arcadia’s 2014 financial statements to the sale nor to the waiver of the inter-company loan.
2. The sale of BHS on 11 March 2015 (the “Sale”), and the subsequent waiver of the inter-company loan (the “Waiver”), were “*adjusting events after the balance sheet date*” within the meaning of FRS 21 which ought to have affected the assessment of the recoverability of the inter-company loan at the balance sheet date and led to an adjustment under paragraph 8 of FRS 21. No such adjustment was made. Alternatively, the Sale and Waiver were material “*non-adjusting events after the balance sheet date*” within the meaning of FRS 21 which ought to have led to a disclosure under paragraph 21 of FRS 21. No such disclosure was made.
3. In breach of ISA 500, ISA 560, and Fundamental Principle (c) and section 130 of the Code of Ethics, the Respondents failed to perform audit procedures designed to obtain sufficient appropriate evidence that:
 - 3.1 all relevant post balance sheet events, including the Sale and Waiver, had been identified; and
 - 3.2 appropriate consideration had been given to how the effects of the Sale and Waiver should be reflected in Arcadia’s 2014 financial statements in the manner described at paragraph 2 above (either by way of an adjustment or a disclosure);

4. In breach of ISA 500, ISA 560, and Fundamental Principle (c) and section 130 of the Code of Ethics, the Respondents failed to give any, or any adequate, consideration to whether the Sale and Waiver were adjusting or non-adjusting events after the balance sheet date for the purposes of FRS 21; and in breach of ISA 500, ISA 560, and Fundamental Principle (c) and section 130 of the Code of Ethics, the Respondents failed to:
 - 4.1 identify that the Sale and Waiver were adjusting or non-adjusting events after the balance sheet date for the purposes of FRS 21; and
 - 4.2 request management to make an appropriate adjustment to, or a disclosure in, Arcadia's 2014 financial statements. The failure to reflect the Waiver in Arcadia's 2014 financial statements resulted in a material misstatement.

Allegation 7: Income Statement

In relation to their audit of the financial statements of Taveta Investments Limited and its subsidiaries for the year ending 30 August 2014, and in relation to the revenue, cost of sales and operating expenses of the subsidiaries of Taveta Investments Limited (including BHS Limited), Steve Denison and PricewaterhouseCoopers LLP failed to comply with the requirements of ISA 330 (responses to assessed risks), ISA 500 (audit evidence), ISA 550 (related parties), and ISA 600 (audits of group financial statements); and failed to act in accordance with Fundamental Principle (c) (professional competence and due care) and section 130 of the Code of Ethics. Their conduct thereby fell significantly short of the standards reasonably to be expected of a Member and a Member Firm (as the case may be).

Particulars

(1) Background

1. Taveta Investments Limited and its subsidiaries (together, the “**Taveta Group**”) made a large number of postings to their general ledger using manual journals. (This was not irregular.) Material adjustments were made to the revenue, cost of sales, and operating expenses of BHS Limited (“**BHS**”) using such journals.
2. A substantial amount of BHS’s cost of sales, and all of its operating expenses, were made up of intra-group charges (including recharges from elsewhere in the BHS group), and these charges were recorded using manual journals.
3. Where a manual journal entry was made to record an intra-group charge, the accounting system would:
 - 3.1 reflect the charge in the accounts of each entity involved; and
 - 3.2 automatically post a separate journal entry to record a balancing adjustment in the intra-group loan account of each entity involved.

(2) Controls testing

4. The Respondents did not subject at least a third of BHS’s cost of sales to controls testing.

(3) Substantive testing

5. The Respondents’ substantive testing gave comfort that there was no material misstatement of the revenue of the Taveta Group, but gave no, or no adequate, comfort that there was no material misstatement of the revenue of BHS.

6. The Respondents did not subject two thirds of BHS's cost of sales or any of its operating expenses to direct substantive testing. They instead relied on:
 - 6.1 a high-level analytical review;
 - 6.2 limited classification testing (to check whether expenses had been properly classed as cost of sales or operating expenses), and
 - 6.3 the agreement of balances between entities.
7. The Respondents' substantive testing did not address the risks that BHS's revenue and/or cost of sales and/or operating expenses might have been materially misstated on account of misallocation among Taveta Group entities (albeit that any such misstatement in BHS's accounts would have been accompanied by an equal and opposite misstatement in the accounts of another Taveta Group entity).

(4) Manual journals

8. The respondents only tested manual journals which affected group revenue, with the result that the Respondents did not consider manual journals that:
 - 8.1 had a material impact on two subsidiaries but cancelled out at group level; or
 - 8.2 had a material impact on cost of sales or operating expenses (and therefore profit) but not revenue; or
 - 8.3 had a material impact on the revenue of individual entities in the Taveta Group but not of the Taveta Group as a whole.
9. The Respondents did not, for instance, obtain adequate explanation or evidence in relation to the following adjustments:
 - 9.1 a management charge agreed between BHS and Arcadia Group Limited, increasing BHS's operating expenses (and reducing BHS's profit) by approximately £41.9 million;
 - 9.2 an e-commerce charge agreed between BHS and Zoom.co.uk Limited, increasing BHS's cost of sales (and reducing BHS's profit) by approximately £9.8 million; and
 - 9.3 an adjustment designed to transfer certain menswear sales recorded elsewhere in the Taveta Group to BHS's accounts, increasing BHS's revenue by approximately £69.6 million, its cost of sales by approximately £40.2 million, and its profit by approximately £29.4 million

(5) Intra-group concession income

10. The Respondents failed to detect that BHS's income had been understated by approximately £21.8 million as a result of a mis-classification of intra-group concession income by BHS. This did not affect profit but meant that BHS's revenue was understated by £21.8 million and its costs were understated by the same amount.

(6) Breaches

11. For the reasons set out at paragraphs 1 to 10 above:
- 11.1 in breach of ISA 240 and Fundamental Principle (c) and section 130 of the Code of Ethics, the Respondents failed to obtain reasonable assurance that revenue, cost of sales and operating expenses were not materially misstated in the financial statements of BHS Limited, whether as a result of fraud or error;
 - 11.2 in breach of ISA 330 and Fundamental Principle (c) and section 130 of the Code of Ethics, the Respondents failed to design and implement overall responses to the risks that revenue, cost of sales and operating expenses were materially misstated in the financial statements of BHS Limited, in particular as a result of the misallocation of revenue, cost of sales, or operating expenses among such subsidiaries;
 - 11.3 in breach of ISA 500 and Fundamental Principle (c) and section 130 of the Code of Ethics, the Respondents failed to obtain sufficient appropriate audit evidence to draw a reasonable conclusion that revenue, cost of sales and operating expenses were not materially misstated in the financial statements of BHS Limited;
 - 11.4 in breach of ISA 550 and Fundamental Principle (c) and section 130 of the Code of Ethics, the Respondents failed to obtain an understanding of related-party relationships and transactions within the Taveta Group that was sufficient to be able to conclude that the presentation of revenue, cost of sales and operating expenses in the financial statements of BHS Limited was fair and not misleading; and
 - 11.5 in breach of ISA 600 and Fundamental Principle (c) and section 130 of the Code of Ethics, the Respondents failed to audit the revenue, cost of sales or operating expenses of BHS Limited in accordance with the concept of "*component materiality*".

Allegation 8: Integrity

In relation to his audit of the financial statements of BHS Limited (“BHS”) for the year ending 30 August 2014, Steve Denison failed to comply with the requirements of ISA 700 (the independent auditor’s report on financial statements); and failed to act in accordance with Fundamental Principle (a) (integrity) and section 110 of the Code of Ethics or with APB Ethical Standard 1. His conduct thereby fell significantly short of the standards reasonably to be expected of a Member.

Particulars

1. On Wednesday 4 March 2015, **B** emailed Arcadia Group Limited, and stated: “*I spoke to Steve [Denison], and in this instance, he said he would sign on Monday [9 March] but back date to Friday, easing my administrative burden a bit which helps!*”.
2. On Monday 9 March 2015, at 09:01, **B** emailed Steve Denison stating, “*in the excitement of a busy day at [****Plc] on Friday, I forgot to ask you to do two things. One being to sign the BHS audit opinions (**** has them and will get you to do them this morning) and the other was to click off the file*”. (The expression “*click off the file*” is an informal term sometimes used at PwC to refer to the audit partner marking, as reviewed and completed, the relevant audit completion steps on the electronic audit file). **B** added, “*Would you mind replicating then ticking them off? If you could put a sentence in saying there were IT issues on Friday therefore you couldn’t tick off then, that would be great?!*”.
3. Later on Monday 9 March 2015, Steve Denison signed the audit opinion relating to BHS’s financial statements but back-dated his signature to Friday 6 March 2015.
4. Also on 9 March 2015, Steve Denison attempted to conceal or obfuscate the truth about when the audit was completed by making a false statement in audit paper 8000-7010. He stated that he (a) had reviewed the electronic audit file on 6 March 2015 and (b) had been unable to mark the file as reviewed and completed because of computer problems. This statement was false.
5. For the reasons set out at paragraphs 1 to 4 above:
 - 5.1 in breach of paragraph 23 of ISA 700, Steve Denison dated the audit opinion relating to BHS’s financial statements 6 March 2015, when in fact the date on which he signed the report expressing his opinion on those financial statements was 9 March 2015; and

5.2 in breach of Fundamental Principle (a), Integrity, and section 110 of the Code of Ethics, Steve Denison agreed to make and intentionally made false statements or representations as to:

5.2.1 the date on which he signed the audit opinion relating to BHS's financial statements; and

5.2.2 his being unable to approve and sign off the electronic audit file on Friday 6 March due to IT issues.