IN THE MATTER OF:

THE EXECUTIVE COUNSEL TO THE FINANCIAL REPORTING COUNCIL

- and -

GRANT THORNTON UK LLP

ALASTAIR NUTTALL

MARCUS SWALES

PARTICULARS OF FACT AND ACTS OF MISCONDUCT

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. On 20 May 2013 the Prudential Regulation Authority ("**PRA**") referred concerns over the work of Grant Thornton UK LLP ("**Grant Thornton**") as the auditor of Manchester Building Society ("**MBS**") to the FRC.

3. On 24 July 2013 the Conduct Committee of the FRC decided to refer the conduct of Members and a Member Firm in relation to the audit of MBS for investigation by the Executive Counsel[1].

4. This is the Executive Counsel's Particulars of Fact and Acts of Misconduct ("**the Particulars**") in relation to the conduct of the audits of MBS for the financial years ending 31 December 2006, 2007, 2008, 2009, 2010 and 2011 ("**FY06, FY07, FY08, FY09, FY10, FY11**").

5. The respondents to the Particulars are:

[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 firm' and 'member' denote their membership of the ICAEW.

(1) Grant Thornton, a member firm of the Institute of Chartered Accountants in England and Wales ("**ICAEW**") at all material times (the "**First Respondent**");

(2) Alastair Nuttall ("**Mr Nuttall**"), a former partner of Grant Thornton, a current partner in Ernst & Young LLP and a member of the ICAEW (the "**Second Respondent**"); and

(3) Marcus Swales ("**Mr Swales**"), a partner of Grant Thornton and a member of the ICAEW (the **"Third Respondent**"); together the "**Respondents**".

Misconduct under the Scheme

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

The Respondents

7. According to its financial statements for 2013, the First Respondent, Grant Thornton, has approximately 206 UK partners and over 4,028 members of staff working in its 28 UK offices. Its fee income in the financial year ending 2013 ("**FY13**") was £471 million. Grant Thornton was appointed as MBS's auditors in 1997.

8. Grant Thornton conducted the audits of MBS's financial statements for the financial years FY06 to FY12 inclusive.

9. The Second Respondent, Mr Nuttall, became a partner in Grant Thornton in January 2002 and was audit engagement partner on MBS for the FY03 to FY07 audits, after which he left Grant Thornton. Mr Nuttall was admitted to membership of the ICAEW in 1994.

10. The Third Respondent, Mr Swales became a partner in Robson Rhodes in 2004 and joined Grant Thornton as a partner when Robson Rhodes merged with Grant Thornton in 2007. He was audit review partner on MBS for the FY07 audit and then audit engagement partner for the audits for FY08 to FY11. Mr Swales was admitted to

membership of the ICAEW in 1996.

11. Mr Nuttall and Mr Swales were Grant Thornton's 'engagement partners', responsible for signing the audit opinions in MBS's FY06, FY07, FY08, FY09, FY10 and FY11 financial statements as set out above. The "engagement partner" is the 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 (ISA 220, paragraph 5(a)). Pursuant to ISA 220:

    (1) *"The engagement partner should take responsibility for the overall quality on each audit engagement to which that partner is assigned"* (para 6); and

    (2) *"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"* (para 21).

12. Mr Nuttall and Mr Swales attended interviews as part of the Executive Counsel's investigation. Transcripts of those interviews have been produced and provided to Grant Thornton.

13. Paragraph 5(11) of the Scheme provides in sub-paragraph (i) that:

    "anything said, done or omitted by an employee of a Member Firm within the scope of his employment, either actual or ostensible, or as an agent of the Member Firm within the scope of his authority, either actual or ostensible, shall be taken as having been said, done or omitted by that Member Firm."

The relevant standards of conduct

14. The standards of conduct reasonably to be expected of the Respondents as a member firm and members of the ICAEW in their conduct of the audits include those set out in the Fundamental Principles and Statements contained in the Guide to Professional Ethics and the Code of Ethics issued by the ICAEW which applies subsequent to 1 September 2006. The Fundamental Principles apply to all members and member firms of the ICAEW. They are framed in broad and general terms and constitute basic requirements of professional behaviour. The Executive Counsel will refer to and rely on the applicable Fundamental Principles and Statements as extracted and annexed to the Particulars as Annex A. Annex A contains the Fundamental Principles and Statements for the whole of the relevant period from 2006 to 2013.

The relevant auditing standards

15. In relation to the conduct of the FY06 to FY11 audits, the technical and professional standards to which the Fundamental Principles make reference include the auditing framework contained in the International Standards on Auditing (UK & Ireland) **("ISAs").** These were introduced on 22 December 2004 and apply to all audits of financial statements for the periods commencing on or after 15 December 2004. The purpose of the ISAs is to establish standards and general principles with which auditors are required to comply in the conduct of any audit. Relevant sections of the applicable ISAs are extracted and annexed to the Particulars as Annex B.

The Respondents' Misconduct

16. As set out more particularly below, the allegations of Misconduct relate to failures on the part of the Respondents to comply with the required standards in connection with the audits of the financial statements of MBS for FY06 to FY11 inclusive and the provision of inaccurate information or advice in the course of those audits.

17. The allegations of Misconduct relate solely to the Respondents' conduct in respect of fair value hedge accounting of portfolios of mortgage assets under IAS 39.

Manchester Building Society

18. MBS is a mutual building society, authorised by the PRA and regulated by the Financial Conduct Authority and the PRA. It is subject to the Building Societies Act 1986. According to its website MBS is the UK's 19th largest building society. Based in Manchester City Centre, the Society has over 22,000 savers and 3,750 borrowers.

MBS - Mortgage Business

19. MBS sold a range of mortgage products. Some of the mortgage products produced income streams by reference to a fixed interest rate:

    (1) Some mortgage products reverted to a variable rate of interest after an initial fixed rate period. The fixed rate products typically provided a fixed period of 3, 5 or 10 years and were GBP denominated. MBS had a limited book of 25 year fixed rate mortgages.

    (2) MBS sold "lifetime mortgage" products, which were GBP denominated in respect of UK properties and Euro denominated in respect of properties located in the EU.

20. The lifetime mortgages were marketed to property owners in their fifties, sixties, seventies and eighties. The owners were paid a lump sum loan, secured on their property, and paid no interest or principal repayments until the owners died, moved from the property or sold the property, each of which triggered the redemption of the mortgage. Interest was added to the loan balance and the entire loan was repaid on redemption. By reason of the terms of the loan, the lifetime mortgages were of an uncertain duration. MBS estimated that the average lifetime of the product would be between 25 and 30 years, with a longer average period for joint products.

21. MBS paid depositors both variable and fixed rates of interest, but received payments on the fixed rate mortgage book at the rates fixed in the underlying mortgages. MBS therefore ran the risk of the variable rate payable to depositors increasing and the income from the fixed rate mortgages being insufficient to cover interest due to deposit holders.

22. MBS entered into interest rate swaps to mitigate this risk. The interest rate swaps purchased by MBS were straightforward products. Most of the swaps were Bermudan Options, which meant that the parties could exercise break clauses at defined periods prior to the maturity date. From 2006 to 2012 MBS was a party to around 50 swap agreements with periods ranging between 3 years and 50 years.

Hedge Accounting

23. From FY05 MBS needed to prepare its financial statements under standards set out in the International Financial Reporting Standards ("**IFRS**"). MBS prepared its accounting records and management accounts under UK Generally Accepted Accounting Practice **("UK GAAP").** MBS would then make adjustments to the management accounts to prepare its financial statements.

24. In very general terms, items in financial statements are shown either:

(1) at amortised cost to the company, i.e. the costs incurred by the company in acquiring the item, with certain adjustments; or

(2) at fair value, which most often means the current market value of the item.

25. Derivative products such as swaps typically are shown in financial statements at their fair values. For the party receiving payments under the terms of the swap based on the variable interest rate, an increase in current and expected variable rates typically leads to an increase in the market value of the swap, and conversely a decrease in current and expected variable rates typically leads to a decrease in the market value

of the swap. The value of the swap is also affected by the duration of the swap. Changes in the market value of the swaps are reflected in profit or loss.

26. Mortgages are normally shown in financial statements at amortised cost, with certain adjustments. The market value of a fixed rate mortgage would decrease if there was an increase in current or expected variable rates and would increase if there was a decrease in current expected variable rates. Since mortgages are normally shown at cost, there would be no adjustment made in financial statements for changes in market value of the mortgages.

27. Fair value hedge accounting allows a party who holds a derivative product to hedge an asset to adjust the carrying value of the asset in the financial statements by the change in its market value attributable to the risk that has been hedged by the derivative. The impact on the reported profit or loss deriving from the change in fair values of the derivative is countered by the adjustments to the asset. Hedge accounting reflects the commercial reality that movements in the value of the derivatives are countered by movements in the value of the assets. This type of hedge accounting is called fair value hedge accounting as it addresses the volatility in profit or loss caused by changes in fair value of an element in the balance sheet. In the case of MBS, hedge accounting addressed the difference in the accounting treatment between the mortgages and swaps purchased to hedge against interest rate risks on the mortgages.

28. In the context of an entity such as a building society, hedging activity can be a significant part of that entity's risk management. A statement in the financial statements that an institution had adopted hedge accounting would indicate that the institution had adopted an effective means of mitigating, to the extent of the hedges and their effectiveness, income statement volatility arising from changes in interest rates, and that the impact of rate volatility on the balance sheet of the entity was also being mitigated.

29. Hedge accounting is optional and IAS 39 sets out specific requirements before an entity can apply the standard and on-going conditions which must be satisfied to permit ongoing hedge accounting. In particular, the criteria for assessing whether the hedge is effective, referred to as "effectiveness testing", are very specific (although the criteria for performing the effectiveness testing are not). Hedge accounting under IAS 39 is a technical and complex area of accounting and therefore there is a higher risk of error in its application.

MBS seek to implement Hedge Accounting

30. MBS sought to apply hedge accounting for the FY05 period. According to Mr Nuttall, this was first communicated to the Grant Thornton team around the end of December 2005.

31. Paragraph 88(a) of IAS 39 requires that appropriate documentation be in place at the inception of the hedging relationship.

32. In a meeting on 5 January 2006 attended by Mr Nuttall and [redacted], Manager on the MBS audit, of Grant Thornton and [redacted], the Financial Controller of MBS, the adoption of hedge accounting and the documentation required for this was discussed. On 6 January 2006, Mr Nuttall sent [redacted], the Financial Controller of MBS, an email attaching some guidance on fair value hedge accounting. In his email Mr Nuttall noted that the attached documents provided a good guide as to what was required. He also made clear in this email that they would need to be sure that MBS met the requirements under IAS 39 and that they had the documentary evidence in place to support the fair value hedge accounting position.

33. On 18 January 2006, Mr Nuttall sent a further email to Mr Christopher Gee, the Finance Director of MBS, attaching an extract from the application guidance to IAS 39. Mr Nuttall made clear that if MBS were not able to meet all of the requirements, and evidence this at the time of transition to IFRS, the swap would need to be accounted for through the income account.

34. MBS drafted a policy that purported to summarise its hedging activities and how it would apply hedge accounting (the "**Policy**"). The draft Policy was provided to Grant Thornton around the end of January 2006.

35. Versions of Appendix 4 of the Policy, in substantially the form adopted by MBS, were annotated with review notes initialled by Mr Nuttall on 31 January 2006 and 8 February 2006 and have been retained on the audit file. A copy of Appendix 4 was also annotated by [redacted] and has been retained. Mr Nuttall stated in his interview that drafts of the full Policy had been reviewed but these have not been retained on the audit file. In his email to Mr Gee on 11 April, Mr Nuttall also stated that he had reviewed the full Policy (see paragraph 42 below).

36. On 1 February 2006, the audit team, through [redacted], raised a technical query with National Assurance Services ("**NAS**"), Grant Thornton's technical support team. The issues raised in the technical query included whether MBS could change the

mortgages which were notionally hedged by a swap and still maintain compliant effectiveness, whether MBS could substitute in alternate mortgages upon the redemption of existing assigned mortgages and whether MBS could assume there would be no early redemptions. The query noted that the audit team did not think that this was possible. ("*From AG114-132, it would appear that they cannot just substitute mortgages when they are redeemed…*").

37. On 6 February [redacted] from the NAS team forwarded the query to [redacted], a member of Grant Thornton International Inc.'s ("**GTI**") Financial Instruments working group, and asked him to circulate the query to the rest of the financial instruments working group. On 7 February 2006, [redacted] replied with some initial thoughts on the query. (Mr Nuttall was not copied into this email):

[redacted] said:

> *"Applying AG126/7, I agree that the client "cannot just substitute mortgages when they are redeemed". If in any time period total prepayments exceed the prior estimate, ineffectiveness will arise. The new mortgages are brought in after that ineffectiveness has been recognised"*

38. In an email dated 8 February 2006, [redacted] from the NAS team confirmed to others within NAS that the consensus was that early repayment of loans within a portfolio, leading to substitution of that original mortgage, must be recognised as leading to ineffectiveness. The email noted that the query had however been resolved on a different point because MBS had failed to comply with the requirements as to hedge documentation.

39. On 8 February 2006 Mr Nuttall informed Mr Gee by email that MBS could not apply hedge accounting for the FY05 period, because the Policy had not been prepared and there was no formal designation and documentation of the hedging relationship at the inception of the hedge. Mr Nuttall reiterated what the Policy would need to cover in order to apply the accounting requirements of IAS 39.

40. Mr Gee replied the same day and asked Mr Nuttall to provide a "tick list" discussed previously, so that he could ensure that the required paperwork could be prepared. Mr Nuttall responded on 10 February 2006 attaching the relevant guidance. He also responded to the query Mr Gee had raised regarding the timing of implementation of hedge accounting. Mr Gee confirmed that MBS would work on the document.

41. On 29 March 2006, Mr Gee emailed Mr Nuttall with a number of questions on various topics. In relation to hedge accounting, he said that he had passed a revised copy of

the Policy to [redacted], and asked for Mr Nuttall's comments on it. Mr Gee noted that the Policy had already been approved by the MBS Risk Committee on 14 February 2006 (although, unbeknown to Grant Thornton, in actual fact the Committee had only accepted the policy as its first draft).

42. By an email to Mr Gee dated 11 April 2006 Mr Nuttall stated that he had reviewed the Policy and that it satisfied the criteria of IAS 39. The Policy made no reference to long dated swaps or to the substitution of mortgages designated to a particular swap.

43. MBS adopted hedge accounting at some time between 1 January 2006 and 1 March 2006; contemporaneous documents are inconsistent as to the precise start date. Hedge accounting was adopted by MBS by 1 March 2006 at the latest.

44. The Policy formed an appendix to the MBS Financial Risk Management Policy. Between 2006 and 2012 it was not subject to any significant substantive revisions. In 2012, the Policy was revised to deal with the impact of break clauses in the swaps purchased by MBS.

MBS hedging activity – Purchases of long-term swaps in period 2006-2012

45. From 2006 to 2012 MBS was a party to around 50 swap agreements which were used by MBS to hedge the interest rate risk relating to the fixed interest rate mortgages. During this period MBS entered into a total of 12 long term swaps with durations of between 40 years and 50 years. These long duration swaps were designated to mortgages with fixed interest periods and to lifetime mortgages. Lifetime mortgages did not have a fixed maturity date, but were allocated a notional maturity date by MBS. These designated mortgages ended or were likely to end significantly earlier than the maturity dates of the long duration swap. The Policy did not refer to such long term swap agreements or to lifetime mortgages.

46. The commercial rationale for entering the longer dated swaps was discussed in Risk Committee meetings on 16 May 2006 and 16 January 2007 and in Board meetings on 25 January 2007 and 22 March 2007 (i.e. after MBS had been informed by Grant Thornton it could implement hedge accounting)[2]. Copies of the minutes of these meetings were provided to Grant Thornton in the course of their audit work.

47. A memorandum prepared by [redacted] dated 12 March 2007 provided to all

[2] MBS had already entered into one long term swap prior to the first of these meetings, on 15 March 2006, which was also before Grant Thornton and Mr Nuttall approved the Policy.

board members ahead of the 22 March 2012 Board Meeting (but not provided to Grant Thornton) stated:

> *"For some time the Society has been hedging long term equity release mortgages with 50 year swaps where MBS pays the swap fixed rate and receives LIBOR. It is extremely unlikely that any of the hedged mortgages will exist for a term of 50 years and perhaps a term of 20 years would be more appropriate. 20 year swap rates are however significantly higher than those of 50 years (a difference of around 0.5%)."*

48. The designation of mortgages to these swaps was inconsistent with the Policy. The Policy referred to swaps of three to five years duration. The Policy did not refer to MBS's decision to enter into long term swaps. The Policy stated that the maturity dates of the swaps and the mortgages would be similar and did not consider the substitution of forecast mortgages, i.e. a mortgage not yet in existence.

49. Grant Thornton maintained IFRS Files (the "**IFRS Files**"). These were hard copy files prepared by Grant Thornton containing audit work and audit evidence for IFRS adjustments to the accounts of MBS. The IFRS Files included the audit work and evidence relating to hedge accounting.

50. A summary based on schedules in the IFRS Files of the swaps used for hedging is as follows:

Year	2006	2007	2008[3]	2009	2010	2011
Notional amount of interest rate swaps	£40.5m	£73.5m	£149.5m	£196.5m	£154.0m	£180.2m
Notional amount of interest rate swaps with periods of 40 years or more	£28.5m	£51.5m	£71.5m	£76.5m	£76.5m	£76.5m

[3] These are the numbers contained in the Schedules in the IFRS Files. In fact the 2008 schedules, when matched to the swaps understated the notional amount of interest rate swaps with periods of 40 years or more by £5m. The figure included in the Schedule should therefore have been £76.5m.

51. An incorrect statement in the financial statements that there was compliance with criteria required by a standard for applying a certain accounting policy can be material, particularly when the impact of a policy can be material in the future by reason of matters outside the control of management. Regardless of the numerical value of the adjustment, hedge accounting was a material consideration in every audit year. The adjustments resulting from hedge accounting were not numerically material to the FY06 and FY07 financial statements, but became so in FY08.

MBS hedging activity – Calculation of fair values and adjustment to mortgages

52. MBS calculated the fair value of the swaps in order to include them at this value in their financial statements. Swaps would need to be shown at fair value in the financial statements whether or not hedge accounting was applied.

53. In order to apply hedge accounting, MBS also needed to calculate the change in the fair values of the hedged mortgages attributable to interest rate risk which was hedged by the swap.

54. Calculation of the changes in fair value was required at two stages:

(1) First, to test the effectiveness of the hedge - the movement in the fair value of the swap needs to be similar to the movement in the fair value of the mortgage attributable to interest rate risk; and

(2) Second, where the hedge is found to be effective, to provide the adjustment to the value of the hedged mortgages shown in the financial statements.

55. The effectiveness testing undertaken by MBS produced figures that indicated substantial effectiveness. However that impression was incorrect, as it was based upon the artificial attribution of the maturity dates of the swaps to the mortgages being hedged by those swaps.

56. MBS used Quantum software to calculate the fair value of the swaps and the adjustment for the mortgages. The IFRS File for the 2009 audit includes a schedule headed "Assets Mark to Market". This includes a handwritten note stating the following:

> *"The mortgages are matched against the interest rate swaps every quarter. The value (redemption value) is entered into Quantum. The mortgages are grouped together and then matched against particular swaps. When the mortgages and swaps have been matched Quantum automatically used the same yield curve to fair value both sides of the*

hedge".

57. The Quantum reports were held on the IFRS File. The "Assets Mark to Market" schedule showed the fair value calculations for the mortgages. The maturity dates that were used to calculate the fair value of the mortgages were that of the swap and not the maturity date of the mortgage. This was the approach of MBS even where there was a significant difference between the maturity date of the swap and the maturity date of the mortgages.

58. Similarly, the schedule which sought to demonstrate effectiveness testing, headed "Summary of movements on fair values on swaps and their corresponding mortgages", also gives the swaps' maturity date for that of the mortgages.

59. The designated mortgages were revalued by MBS as if they were Gilts. In the context of lifetime mortgages this process was inappropriate because lifetime mortgages had no periodic payments, in contrast to a Gilt. Rather in lifetime mortgages interest is rolled up into the mortgage balance. The fair value of an instrument which pays a cash interest coupon may be different from one where interest is rolled up even if all the other terms match. Using the Quantum Gilt model could have produced incorrect valuations of lifetime mortgages.

60. MBS tested the effectiveness of the hedge by comparing the change in fair value of the swap with the change in the fair value of the mortgage attributable to the interest rate risk. IAS 39 mandates that the fair values over the period must be within 80% to 125% of each other in order for the hedge to be considered effective. Effectiveness testing schedules were prepared by MBS for Grant Thornton's audit each year.

MBS did not comply with IAS 39

61. For the periods from 2006 to 2012, MBS did not comply with the requirements of IAS 39 and therefore was never entitled to use hedge accounting in these periods.

62. The key areas in which MBS did not comply with IAS 139 were:

    (1) Documentation.
    (2) Designation.
    (3) Retrospective effectiveness testing.
    (4) Prospective effectiveness testing.

63. The categories of non-compliance are particularised at paragraphs 78 to 86 below.

The FY12 audit and the discovery of problems with hedge accounting by MBS

64. Mr Bartlett was the audit engagement partner for FY12 having been audit review partner for FY09, FY10 and FY11.

65. The Audit Committee meeting took place on Tuesday, 5 March 2013. That morning, Mr Bartlett reviewed the effectiveness testing documentation and realised that there was a problem with hedge accounting. This followed three requests between December 2012 and February 2013 from Grant Thornton for MBS to produce further details of the hedge accounting documentation and the hedge accounting policy. Mr Bartlett raised his concerns over hedge accounting at the meeting that afternoon.

66. It became apparent that MBS had not complied with the requirements of IAS 39 at any time between 2006 and 2012. Over the next few days, Mr Bartlett consulted further with NAS, and MBS sought independent advice. Mr Bartlett advised MBS that Grant Thornton would be contacting the PRA on Tuesday, 12 March 2013, but invited MBS to speak to the PRA first.

67. On 12 March 2013, MBS and Grant Thornton informed the PRA of the likelihood of a substantial restatement being made in MBS' 2012 financial statements.

68. The 2012 financial statements included a restatement of prior years' reported figures relating to hedge accounting. A summary of the impact of the hedge accounting on the value of mortgages in MBS's financial statements is as follows:

Year	Adjustment to hedged mortgages in the financial statements
2006	-£0.361m
2007	-£0.862m
2008	£26.169m
2009	£8.873m
2010	£14.161m
2011	£37.667m

69. The cumulative effect of the restatement of financial position significantly depleted the reserves of MBS. After allowing for tax, the restatements resulted in a reduction of

£28.712 million on retained earnings as at 31 December 2011 of £38.418 million, a reduction of 75% on equity prior to restatement.

70. As a result of the discovery of the hedge accounting problems, MBS had to take urgent action to raise sufficient capital to secure its existence and protect its members. Specifically, in April 2013 MBS issued £18m of new equity in the form of Profit Participating Deferred Shares. The raising of the capital allowed the directors to state that they were satisfied that they could proceed as a going concern.

ALLEGATION 1 - 2006 AND 2007 AUDITS OF HEDGE ACCOUNTING

On 11 April 2006, Mr Nuttall, and hence Grant Thornton, advised MBS that he had reviewed the Policy and confirmed that it satisfied the criteria set out in IAS 39 (the "**Policy Advice**"). Grant Thornton and Mr Nuttall subsequently failed to identify in the FY06 and FY07 audits that MBS had failed to comply with the requirements of IAS 39 and that MBS were not entitled to apply that hedge accounting standard in those financial years. In so doing, the conduct of Grant Thornton and Mr Nuttall fell significantly short of the standards reasonably to be expected of a Member Firm and a Member in that:

1.1 In providing the Policy Advice, Mr Nuttall failed to give proper consideration as to whether the Policy satisfied the requirements of IAS 39, and, in particular the requirements set out in paragraph 88 of IAS 39 and failed thereby to act in accordance with paragraphs 28 and 30 of ISA 315, Fundamental Principle C "Professional Competence and Due Care" in the Code of Ethics and the Guidance in Section 130.

1.2 In the course of providing the Policy Advice, Mr Nuttall failed to report to MBS that the Policy did not satisfy the requirements of IAS 39 and that MBS could not adopt hedge accounting in reliance upon the Policy and failed thereby to act in accordance with Fundamental Principle C "Professional Competence and Due Care" in the Code of Ethics and the Guidance in Section 130.

1.3 Mr Nuttall failed to record adequately or at all in the working papers the basis upon which he exercised his judgment and conclusions drawn therefrom in determining that the Policy satisfied the requirements of paragraph 88 of IAS 39, contrary to paragraph 9 of ISA 230, paragraph 2 of ISA 500, paragraphs 21 and 26 of ISA 220, Fundamental Principle C "Professional Competence and Due Care" in the Code of Ethics and the Guidance in Section 130.

1.4 Grant Thornton and Mr Nuttall failed to ensure that the audits of MBS for FY06 and FY07 were planned adequately to ensure that audit procedures were undertaken to obtain sufficient, appropriate audit evidence to enable Grant Thornton and Mr Nuttall to assess whether MBS had complied with the requirements of IAS 39, thereby failing to comply with the requirements of paragraph 2 of ISA 300, paragraph 2 of ISA 500, paragraphs 21 and 26 of ISA 220, Paragraphs 31, 32 and 87 of Practice Note 23 (2002) and Fundamental Principle C "Professional Competence and Due Care" in the Code of Ethics and the Guidance in Section 130.

1.5 In the course of the audits of MBS for FY06 and FY07 Grant Thornton and Mr Nuttall failed to obtain sufficient, appropriate evidence that MBS had satisfied the requirements of IAS 39 to permit MBS to adopt hedge accounting, thereby failing to comply with the requirements of paragraph 2 of ISA 500, paragraphs 21 and 26 of ISA 220, Paragraphs 31, 32 and 87 of Practice Note 23 (2002) and Fundamental Principle C "Professional Competence and Due Care" in the Code of Ethics and the Guidance in Section 130.

1.6 In the course of the audits of MBS for FY06 and FY07 Grant Thornton and Mr Nuttall failed properly to review the Policy to ensure that the Policy complied with the requirements of IAS 39 and that the Policy reflected the hedging activities and testing as in fact implemented by MBS. As a result thereof Grant Thornton failed to correct the Policy Advice and failed thereby to act in accordance with ISA 315, and Fundamental Principle C "Professional Competence and Due Care" in the Code of Ethics and the Guidance in Section 130.

Particulars

71. Paragraph 88(a) of IAS 39 and paragraph AG107 of the application guidance at Appendix A to the standard require that before hedge accounting can be applied, there must be appropriate documentation setting out details of the hedging relationship including details of:

(1) The hedging instrument;
(2) The hedged item or transaction;
(3) The nature of the risk being hedged; and
(4) How the hedging instrument's effectiveness in offsetting the risk will be assessed, retrospectively and prospectively.

72. MBS had assumed they could apply hedge accounting in their 2005 financial statements. Mr Gee and [redacted] were unaware that formal documentation needed to be in place prior to the inception of the hedges which were to be the subject of hedge accounting.

73. Mr Nuttall informed MBS of this requirement for formal documentation in a meeting on 5 January 2006 and in emails dated 6 and 18 January 2006 from Mr Nuttall to [redacted] and Mr Gee respectively.

74. In the course of the initial review of the Policy, on 1 February 2006, the audit team, through [redacted], raised a technical query with Grant Thornton's technical support team, asking whether MBS could change the mortgages which were notionally hedged

by a swap and still maintain compliant effectiveness, whether MBS could substitute in alternate mortgages upon the redemption of existing assigned mortgages and whether MBS could assume there would be no early redemptions. NAS confirmed in a response dated 8 February 2006 that mortgage substitution could not be used within the IAS 39 hedge accounting framework.

75. On 8 February 2006 Mr Nuttall informed Mr Gee by email that it would not be appropriate for MBS to apply hedge accounting in the 2005 financial statements, primarily because the documentation required had not yet been prepared prior to transition to IFRS (which in the case of IAS 39 was 1 January 2005 (see further paragraph 39 above).

76. Versions of Appendix 4 of the Policy, in substantially the form adopted by MBS, were annotated with review notes, initialled, by Mr Nuttall on 31 January 2006 and 8 February 2006 and have been retained on the audit file. A copy of Appendix 4 was also annotated by [redacted] and has been retained. Mr Nuttall stated in his interview that drafts of the full Policy had been reviewed but have not been retained on the audit file. In his email to Mr Gee on 11 April, Mr Nuttall also stated that he had reviewed the full Policy (see paragraph 42 above).

77. In an email dated 11 April 2006, Mr Nuttall confirmed to Mr Gee that the Policy satisfied the criteria set out in IAS. The date when the Policy was adopted by MBS is not clear. On 29 March 2006, Mr Gee proposed to Mr Nuttall that the Policy should be implemented from 1 March 2006 and that MBS would start to hedge account on this date. The 2006 MBS financial statements state that hedge accounting was implemented from 1 January 2006. In any event from January 2006, at the earliest, or March 2006, at the latest, MBS applied hedge accounting to its fixed rate mortgage products and those mortgages were adjusted for the hedged risk.

78. The Policy did not comply with the requirements of IAS 39. The Policy was incomplete, inaccurate and ambiguous.

    (1) The Policy did not identify adequately how retrospective effectiveness testing would be undertaken. The Policy merely referred to the Quantum system but gave no explanation of what this system did. The Policy did not identify the methodologies adopted for effectiveness testing.

(2) The Policy was internally inconsistent on how frequently effectiveness testing would be carried out. Paragraph 3(2)(f) on page 5 of the Policy stated that the effectiveness tests would be carried out twice a year. However Appendix 4 of the Policy stated that effectiveness would be tested monthly.

(3) The Policy did not refer to how prospective testing would be performed (although it did state that prospective testing would be undertaken).

(4) The Policy did not identify whether each hedge would be a portfolio hedge or a hedge over a group of assets. The appropriate treatment would vary depending on which basis was selected, so proper identification of the hedging basis was necessary.

(5) The Policy primarily referred to 3 year fixed rate products and the characteristics and profile of those products. It did not address the hedge accounting for lifetime products or other longer dated products. Grant Thornton and Mr Nuttall have stated that, at the time of the Policy Advice, they were not however aware of MBS' intention to hedge lifetime mortgages.

(6) The Policy did not identify that MBS would be substituting mortgage products within existing swaps on an ad hoc basis, or designating, de-designating and re-designating mortgage products to hedges or provide sufficient (or any) explanation of the monitoring, updating and measurement of hedge effectiveness to permit dynamic hedging. Grant Thornton and Mr Nuttall have stated that, at the time of the Policy Advice, they were also not aware that MBS intended to substitute the hedged mortgage products.

Mr Nuttall failed, following his email to Mr Gee of 8 February 2006, to record his consideration of the Policy or the basis upon which he concluded that the Policy satisfied the criteria of IAS 39.

79. Mr Nuttall should not have advised MBS that the Policy satisfied the criteria of IAS 39.

Instead Mr Nuttall should have informed MBS that the Policy did not satisfy the criteria and that MBS could not begin to adopt hedge accounting in reliance upon the Policy as drafted. As a consequence of the matters at paragraph 78(1) to (4) above the Policy Advice was incorrect. Mr Nuttall states that at the time of the Policy Advice, neither he nor Grant Thornton were however aware of

MBS's intention to hedge lifetime mortgages or to substitute mortgages within existing swaps, or to designate, de-designate and re-designate mortgage products. The audit planning for the FY06 and FY07 periods failed adequately to provide for testing of hedging activity undertaken by MBS to permit GT and Mr Nuttall to comply with their audit obligations for those periods. The audit planning specifically did not provide adequate testing to ensure that MBS complied with the requirements of IAS 39, or to ensure that the information would be available as indicated in Practice Note 23, relating to the auditing of derivative financial instruments, paragraphs 31, 32 and 87.

80. There is no evidence that there was any planned testing that the Policy was compliant with IAS 39 or that MBS complied with the Policy. There is no evidence that there was any assessment of where the risks of misstatement might arise and how the work planned would address them. The file note which recorded the planning for the audit of hedge accounting fails adequately to identify the planned work on hedge accounting as detailed below.

81. For the FY06 and FY07 audits, the planning of audit tests to be performed was documented in a file note headed "IFRS Transition". The file note does not explicitly include a check that MBS were complying with the Policy. The following testing was listed:

> "As *part of our work we will:*
>
> *check that hedges have been designated*
> *check effectiveness has been measured appropriately*
> *Ensure interest rate FV changes have been measured using valuations from the Group's Quantum treasury management system".*

82. The file note does not provide any detail as to how this work was to be carried out.

83. There are no specific checks listed to ensure:

(1) MBS hedge activity and hedge accounting complied with the Policy;

(2) The fair value adjustments of the mortgages were appropriate and agreed with that given by Quantum;

(3) Effectiveness testing used appropriate fair value calculations; and

(4) The Policy complied with the requirements of IAS 39.

84. The audits for FY06 and FY07 failed to identify each of the significant problems with the operation of hedge accounting within MBS:

(1) The Policy failed to comply with IAS 39 as particularised at paragraph

78 above.

(2) The Policy failed to accurately describe the profiles and characteristics of the MBS products that were hedged.

(3) The Policy did not in fact reflect the manner in which MBS undertook hedge accounting.

(4) MBS designated mortgage products to swaps with significantly different maturity periods.

(5) MBS de-designated mortgage products and re-designated products in a manner that was not compliant with IAS 39.

(6) MBS assigned artificial maturity dates to the valuation of mortgage products, which were designed to match the maturity dates of the swap to which the products were designated and, failed to take into account properly or at all the effect of mortgage impairment and pre-payment.

(7) MBS failed to conduct any prospective effectiveness testing.

85. MBS did not comply with the requirements of IAS 39 in FY06 and FY07 and therefore was not entitled to use hedge accounting in these periods.

86. The key areas in which MBS did not comply with IAS 39 were:

(1) Documentation.

(2) Designation.

(3) Retrospective effectiveness testing.

(4) Prospective effectiveness testing.

Documentation

87. MBS failed to comply with the documentation requirements of IAS 39 as set out in paragraphs 78 above and as set out in paragraphs 89 to 101 below.

88. The Policy formed an appendix to the MBS Financial Risk Management Policy.

Following the provision of the Policy Advice no detailed reviews of the Policy took place by Grant Thornton as part of the 2006 and 2007 audits.

Designation

89. The Policy did not reflect the designation methodology adopted by MBS. The Policy states:

> *"The hedge will be taken for a period, which will match against the fixed rate maturity profile of the portfolio of mortgages being*

hedged against"

90. This is not what MBS did. The maturity profiles of the mortgages in many cases did not match the maturity profiles of the swaps, particularly in respect of the longer-term swaps.

91. Through the entire period of the application of the hedge accounting policy, MBS held swaps for which the maturity dates significantly exceeded the maturity dates of the mortgage products designated to that swap for hedge accounting purposes. IAS 39, and in particular IAS 39, paragraph 75, did not permit "part" designation of derivative instruments, and accordingly as the period of the swap beyond the maturity dates of the mortgages was unhedged, hedge accounting could not be applied for movements in the values of those mortgages.

92. MBS substituted and replaced mortgage products within existing swap designations on an ad hoc basis. This was not permitted under IAS 39. Changes to the designated mortgages would require hedge de-designation and re-designation. On de-designation the fair value adjustment should be frozen and an amortisation profile set up to match the remaining life of the hedged item. This was not done.

Retrospective effectiveness testing

93. The assessment of the fair value of a hedged item was commonly inconsistent with the hedged item's contractual terms and with its expected cash flows. The retrospective effectiveness tests assumed that the maturity dates and the interest payment dates of the mortgages matched those of the swaps. They did not match. As noted previously, the maturity dates of the mortgages were often shorter than that of the swaps which were used to hedge the interest rate obligations of those mortgages. These differences are likely to have created increased ineffectiveness had proper testing been applied. Moreover no interest was paid on the lifetime mortgages until the date of their redemption.

94. By assuming that the maturity dates and interest payments on the mortgages and swaps matched, the effectiveness tests carried out by MBS made the hedging look effective for IAS 39 purposes when it may not have been.

95. The designated mortgages were revalued by MBS as if they were Gilts. In the context of lifetime mortgages this process was inappropriate because lifetime mortgages had no periodic payments, in contrast to a Gilt. Rather in lifetime mortgages interest is rolled up into the mortgage balance. The fair value of an

instrument which pays a cash interest coupon can be different from one where interest is rolled up even if all the other terms match. Using the Quantum Gilt model could have produced incorrect valuations of lifetime mortgages.

96. The retrospective effectiveness testing did not take into account any impairment which was likely to affect cash flows or the likelihood that mortgages would redeem prior to maturity. The effectiveness testing proceeded on the assumption that impairment and early redemption would not happen and this assumption was not tested.

97. The basis of retrospective effectiveness testing was based upon flawed assumptions.

These assumptions had the effect of giving the impression of high levels of effectiveness because the assumptions led to the incorrect comparison of income streams with matching characteristics.

98. IAS 39, paragraph 75, provides that the hedging instrument must be designated for the entire life of the hedging instrument. Appendix 2 of the Policy gave an example of effectiveness testing, showing a comparison of fair value movements on the mortgages and swaps. This shows movements for only the past year. However, there was documentation indicating that in practice the effectiveness calculation was done on a cumulative basis, calculating movements for the entire hedge relationship. That methodology was inconsistent with the Policy.

Prospective Effectiveness Testing

99. IAS 39, and in particular IAS 39, paragraph 88, requires hedges to be prospectively tested to confirm that they are expected to remain highly effective. While the methodology of prospective testing is not prescribed, prospective effectiveness testing must be set out in the inception documentation and performed in accordance with that documentation. Such testing must be conducted, at a minimum, at each time the entity prepares its annual or interim financial statements.

100. The Policy does not set out any methods for prospective effectiveness testing. There was no documented evidence of prospective testing being undertaken. The requirements of IAS 39, paragraph 88 were never met.

101. Furthermore the effectiveness testing ought to have taken into account the impact of mortgage impairment and mortgage pre-payment, but did not do so.

Grant Thornton audit work in respect of hedge accounting 2006 and 2007

102. In each of the IFRS Files for the 2006 and 2007 audits, a copy of the Policy is included with a note confirming:

(1) The Policy was reviewed in February and March 2006 to determine its suitability to meet the documentary requirements of IAS 39

(2) That according to [redacted], the Policy applies to the relevant year end.

103. There is no reference in any of the years to work done by Grant Thornton to verify that MBS were complying with the Policy or that the Policy was consistent with the business and hedging activities of MBS.

104. The IFRS Files for each audit year contain documentation provided by MBS to Grant Thornton for the purpose of the audit of hedge accounting. The key documents provided were headed:

(1) "Summary of movements on fair values on swaps and their corresponding mortgages";

(2) "Fixed rate mortgages designated to be hedged";

(3) "Hedging transaction";

(4) "Assets mark to market" and

(5) "Swap Report.

105. The documents showed:

(1) The retrospective testing used the maturity date of the swaps for the valuation of the mortgages;

(2) MBS was hedging mortgage products with significantly different maturity dates than the corresponding swap; and

(3) MBS were designating different mortgages to the swaps during the course of the lifetime of the swaps.

106. Annotations and notes made on these schedules by Grant Thornton's staff demonstrate the following checks were undertaken:

(1) The details given on each of the schedules correspond with each other;

(2) A sample of the mortgage details are checked to the mortgage files; and

(3) The rates used by Quantum in calculating amounts for the swaps and

mortgages are checked to Reuters or the British Bankers Association websites.

107. The mortgage maturity dates were inconsistent on these schedules. In particular the maturity date is given as that of the corresponding swaps in the "Summary of movements on fair values on swaps and their corresponding mortgages" and the "Assets Mark to Market" but the contractual maturity date of the non-lifetime mortgages and the notional maturity date on lifetime mortgages is identified in "Fixed Rate Mortgages Designated to be Hedged" and the "Hedging Transaction" memo.

108. No reference is made by Grant Thornton to this difference, despite cross-checks being undertaken between these schedules. There was a post-it note on a schedule of mortgages and swaps in the 2007 IFRS File. Grant Thornton have stated that the post-it note is likely to have been written by a junior member of the audit team, [redacted], and states:

"Swap maturity 2056. The mortgage fixed rate end 2030?"

Mr Nuttall has stated that he does not have any recollection of this point being raised with him and there is no other reference to this in the audit working papers.

109. By May 2006 at the latest Grant Thornton had evidence that showed that MBS was designating mortgages for hedge accounting purposes to swaps with considerably longer maturity dates than the designated mortgages. An email from [redacted] sent to [redacted] (a Grant Thornton valuations specialist), copied to Mr Nuttall, among others, on 10 May 2006 attached a schedule of MBS swaps used for hedge accounting that included a swap with a maturity date of March 2056.

110. The schedules provided by MBS to Grant Thornton for the 2006 and 2007 audits evidenced that long-dated swaps were being used by MBS for fair value hedge accounting. For example a memorandum dated 11 January 2007 indicated that MBS were using 5 swaps with a 2056 maturity date and that these swaps had lifetime mortgages designated to them. While the lifetime mortgages had no fixed maturity dates, by definition, the memorandum indicated that lifetime mortgages were allocated a theoretical maturity date of 12 December 2030. MBS did not own swaps maturing in late 2030 or early 2031. Mr Nuttall initialled these schedules as being reviewed by him but stated in interviews that he was not aware that long-term swaps were being used for hedge accounting.

111. Actuarial analysts at Grant Thornton prepared an "Audit review of the valuation of interest rate swaps under IAS 39". Only the valuation of the swap side of the hedge was reviewed. There was no check of the details entered into Quantum to calculate the fair value adjustment of the mortgages. Such a check, properly done, would have shown that the valuation calculation parameters for the mortgage valuation were artificial and that the hedging process ought not to have been relied on to show effectiveness.

112. By reason of the matters stated at paragraphs 71 to 111 above:

(1) Grant Thornton and Mr Nuttall failed to identify that the Policy did not comply with the requirements of IAS 39 in FY06 and FY07.

(2) Grant Thornton and Mr Nuttall failed to identify that the Policy did not reflect the hedge accounting processes adopted by MBS in FY06 and FY07.

(3) Grant Thornton and Mr Nuttall failed to identify that MBS was not entitled to adopt hedge accounting in FY06 and FY07.

(4) Grant Thornton and Mr Nuttall issued unqualified audit opinions for both FY06 and FY07 in respect of financial statements which incorrectly purported to be compliant with IAS 39.

Grant Thornton and Mr Nuttall signed the audit opinions for FY06 and FY07 having failed to obtain sufficient or appropriate audit evidence from which to draw a reasonable conclusion that MBS's reliance upon hedge accounting and IAS 39 was appropriate.

ALLEGATION 2 - 2008, 2009, 2010 AND 2011 AUDIT OF HEDGE ACCOUNTING

Grant Thornton and Mr Swales issued an unqualified audit opinion for FY08, FY09, FY10 and FY11. Those opinions indicated that MBS was in compliance with IFRS. In so doing, the conduct of Grant Thornton and Mr Swales fell significantly short of the standards reasonably to be expected of a Member Firm and a Member in that:

2.1 Grant Thornton and Mr Swales failed to ensure that the audit of MBS for FY08 was planned adequately to ensure that audit procedures in relation to hedge accounting were undertaken to obtain sufficient, appropriate audit evidence to enable Grant Thornton and Mr Swales to assess whether MBS had complied with the requirements of IAS 39, thereby failing to comply with the requirements of ISA 300, ISA 500, ISA 220, Practice Note 23, Fundamental Principle C "Professional Competence and Due Care" in the Code of Ethics and the Guidance in Section 130.

2.2 In the course of the audits of MBS for each of FY08, FY09, FY10 and FY11, Grant Thornton and Mr Swales failed to obtain sufficient, appropriate evidence that MBS had satisfied the requirements of IAS 39 to permit MBS to adopt hedge accounting, thereby failing to comply with the requirements of ISA 500, ISA 220, Practice Note 23, and Fundamental Principle C "Professional Competence and Due Care" in the Code of Ethics and the Guidance in Section 130.

2.3 In the course of the audit work conducted in FY08, FY09, FY10 and FY11, Grant Thornton and Mr Swales failed to properly review the Policy to ensure that the Policy complied with the requirements of IAS 39 and that the Policy reflected the hedging activities and testing as in fact implemented by MBS. As a result thereof Grant Thornton failed to correct the Policy Advice and failed thereby to act in accordance with ISA 315, Fundamental Principle 3 "Competence" and Fundamental Principle 4 "Performance" in the Guide to Professional Ethics and Fundamental Principle C "Professional Competence and Due Care" in the Code of Ethics and the Guidance in Section 130.

113. There is no record of planning for the audit of hedge accounting on the FY08 IFRS File. By reason of the manner in which the FY08 audit was conducted it is to be inferred that any audit planning failed to provide adequately for testing of hedge accounting processes adopted by MBS to permit Grant Thornton and Mr Swales to comply with their audit obligations and that any audit planning did not provide adequate testing to ensure that MBS complied with the requirements of IAS 39, or to

ensure that the information would be available as indicated in Practice Note 23, paragraphs 31, 32 and 87.

114. Grant Thornton has been unable to provide any planning documentation for the audit of hedge accounting in the FY08 audit[4]. This is the year when Mr Swales became the audit partner and the year in which the adjustments resulting from MBS hedge accounting became numerically material.

115. There is no evidence that there was any planned testing that the Policy was compliant with IAS 39, that MBS complied with the Policy, that the fair value adjustment of the mortgages was appropriate and agreed with the Quantum calculations, and that there was appropriate calculation or testing of retrospective or prospective effectiveness testing.

116. For the FY09, FY10 and FY11 audits, the relevant section in the IFRS work programme, headed "Section 4 - Hedge Accounting of SWAPs and Mortgages", is identical for each of the three years. It sets out the following tests:

> *"Check all adds and calcs*
> *Recalculate effectiveness of hedges ("effective" = 80 - 125%)*
> *Agree SWAP details to Quantum SWAP report (separate reports for Sterling and Euro SWAPs)*
> *Agree SWAP details to SWAP agreement (this only needs to be done once, in the year in which the SWAP is taken out)*
> *Agree new SWAPs to Risk Committee minutes*
> *Agree SWAP and mortgage values b/f to prior year IFRS file*
> *Agree cash SWAP interest yield rates for Sterling and Euro to Reuters information*
> *Agree Sterling/Euro rate at year end to Reuters information*
> *Agree libor rates to Reuters information"*

117. There was no further provision within the work programme for:

(1) An overall test objective or specific step to ensure that MBS complied with the Policy;

(2) An assessment of the risk of misstatement in the course of hedge accounting activities;

(3) Testing to ensure that hedged items and hedging instruments were properly designated;

(4) Testing to ensure that the mortgage end dates had been correctly recorded in Quantum in relation to the life time mortgage fair values, leading to an inappropriate valuation of these mortgages for the purpose of the testing;

(5) Testing of prospective effectiveness.

[4] The testing in FY08 was materially the same as that carried out in FY09, FY10 and FY11

118. The audits for FY08, FY09, FY10 and FY11 failed to identify each of the significant problems with the operation of hedge accounting within MBS:

(1) The Policy failed to comply with IAS 39 as particularised at paragraphs 71 to 101 above.

(2) The Policy did not in fact reflect the manner in which MBS undertook hedge accounting.

(3) Mr Swales states that he did identify that MBS designated mortgage products to swaps with significantly different maturity periods. This was not, however, identified as a problem as Mr Swales states that he incorrectly understood that when one mortgage was redeemed, a new mortgage could be substituted in its place.

(4) MBS de-designated and re-designated mortgage products in a manner that was not compliant with IAS 39.

(5) MBS conducted retrospective effectiveness testing in a manner inconsistent with IAS 39, and, in particular assigned artificial maturity dates to the valuation of mortgage products which were designed to match the maturity dates of the swap to which the mortgage products were designated and failed to take into account properly or at all the effect of mortgage impairment and pre-payment.

(6) MBS failed to conduct prospective effectiveness testing.

119. The particulars of the hedge accounting failures listed above were as set out at paragraphs 85 to 101 above in respect of the FY06 and FY07 audits. A properly conducted audit of the FY08, FY09, FY10 and FY11 financial statements would have identified each of the matters listed above at paragraph 118 and would have led an auditor to conclude that MBS could not apply hedge accounting for the financial period in question and resulted in the management of MBS being so informed.

120. Mr Swales was aware from the review of the IFRS Files that MBS was using long-term swaps to hedge account for fixed rate products with shorter maturity dates. Mr Swales has stated in interview that he was of the view that MBS was permitted to substitute new mortgages into the designation when originally designated mortgages matured or were repaid and that such substitution was compatible with IAS 39. MBS was not so permitted. When Mr Swales was interviewed on 6 December 2013 he said he now understands that he was wrong in his belief.

121. By reason of the matters alleged at paragraphs 113 to 118 above:

(1) Grant Thornton and Mr Swales failed to identify that the Policy did not comply

with the requirements of IAS 39 in FY08, FY09, FY10 and FY11.

(2) Grant Thornton and Mr Swales failed to identify that the Policy did not reflect the hedge accounting processes adopted by MBS in FY08, FY09, FY10 and FY11.

(3) Grant Thornton and Mr Swales failed therefore to identify that MBS were not entitled to adopt hedge accounting in FY08, FY09, FY10 and FY11.

(4) Grant Thornton and Mr Swales issued unqualified audit opinions for FY08, FY09, FY10 and FY11 in respect of financial statements which, as a result of the above, incorrectly purported to be compliant with IAS 39 and incorrectly stated that those statements represented to true and fair view of the state of the affairs of MBS for those periods.

(5) Grant Thornton and Mr Swales signed the audit opinions for FY08, FY09, FY10 and FY11 having therefore failed to obtain sufficient or appropriate audit evidence from which to draw a reasonable conclusion that MBS reliance upon hedge accounting and IAS 39 was appropriate.