**IN THE MATTER OF**

**THE EXECUTIVE COUNSEL TO THE FINANCIAL REPORTING COUNCIL**

**-and-**

**(1) DELOITTE LLP**

**(2) JOHN CHARLTON**

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**EXECUTIVE COUNSEL'S FINAL DECISION NOTICE**

**Pursuant to Rule 18 of the Audit Enforcement Procedure**

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

***This document has been edited for publication in line with the FRC's Publication Policy (Audit Enforcement Procedure). Clarificatory words have been added for the purposes of publication; these are in red font.***

## 1. INTRODUCTION

1.1. The Financial Reporting Council (the "**FRC**") is the competent authority for *Statutory Audit* in the United Kingdom and operates the Audit Enforcement Procedure (the "**AEP**"), effective 17 June 2016. The AEP sets out the rules and procedure for the investigation, prosecution and sanctioning of breaches of *Relevant Requirements*.

1.2. The AEP contains a number of defined terms and, for convenience, those defined terms are also used within this document. Where these defined terms are used, they appear in italics. This *Final Decision Notice* also uses the following additional definitions:

1.2.1. "**the Company**" means Mitie Group plc.

1.2.2. **"the Group"** refers to all Mitie group companies, whose financial results were included within consolidated financial statements issued by the Company.

1.2.3. “**FY2016**” means the financial year ended 31 March 2016, “**FY2016 financial statements**” means the Company’s financial statements for FY2016, which included consolidated financial statements for the Group, and “**FY2016 Audit**” means the *Statutory Audit* of the FY2016 financial statements.

1.2.4. “**Deloitte**” means Deloitte LLP, the First Respondent and the *Statutory Audit Firm* for the FY2016 Audit.

1.2.5. “**Mr Charlton**” means Mr John Charlton, the Second Respondent and the *Statutory Auditor* for the FY2016 Audit.

1.2.6. “**Respondents**” means Deloitte and Mr Charlton.

1.3. Pursuant to Rule 16(b) of the AEP, *Executive Counsel* has decided that the Respondents are liable for *Enforcement Action*, having made the *Adverse Findings* against each of them that are set out in this *Final Decision Notice*.

1.4. This *Final Decision Notice* is issued pursuant to Rule 18 of the AEP in respect of the conduct of the Respondents in relation to the FY2016 Audit.

1.5. On 12 November 2021 Executive Counsel issued *Executive Counsel’s Decision Notice* pursuant to Rule 17 of the AEP. On 14 November 2021 the Respondents provided written agreement to *Executive Counsel’s Decision Notice*.

1.6. Consequently, and in accordance with Rules 17 and 18 of the AEP this *Final Decision Notice*:

1.6.1. outlines the *Adverse Findings* with reasons;

1.6.2. outlines *Sanction* with reasons; and

1.6.3. outlines amount payable in respect of *Executive Counsel*’s costs of the matter.

1.7. This *Final Decision Notice* is divided into the following sections:

1.7.1. Section 2: Background and Executive Summary;

1.7.2. Section 3: *Relevant Requirements*;

1.7.3. Section 4: *Adverse Findings*;

1.7.4. Section 5: *Sanctions*; and

1.7.5. Section 6: Costs.

## 2. BACKGROUND AND EXECUTIVE SUMMARY

2.1. The Group is a group of companies which provide facilities management and professional services. The Company is the parent company within the Group. The FY2016 financial statements reported total revenue of £2,231.9m and operating profit before other items of £128.9m.

2.2. At the time of the FY2016 Audit, Deloitte had audited the Company's financial statements each year since it was listed on the London Stock Exchange in 1988.

2.3. The FY2016 Audit was Mr Charlton's first year as the audit engagement partner.

2.4. In FY2016 the Group's business was split across four divisions (Soft Facilities Management ("**FM**"), Hard FM, Property Management, and Healthcare). The *Adverse Findings* in this *Final Decision Notice* concern the conduct of Deloitte and Mr Charlton in relation to the FY2016 Audit of the valuation of the goodwill of the Healthcare business.

2.5. The Healthcare business during and prior to FY2016 consisted primarily of providing care in private homes ("domiciliary" healthcare). The Company described this domiciliary healthcare business as follows in the Operating Review in its FY2016 Annual Report (p.50):

> *"Our healthcare business provides care at home for people who need help and support due to illness, infirmity or disability. In addition, we also provide nurse-led complex care solutions in the home."*

2.6. In January 2016, shortly before the end of FY2016, the Company acquired Tascor Medical Services Limited, a company which provided healthcare services to individuals in custody. The Company renamed this business as "Care and Custody (Health) Limited".

2.7. By the end of FY2016 the financial performance of the domiciliary healthcare business had been deteriorating for some time and it had repeatedly missed budgets and forecasts set by the Company. In particular, Healthcare profit before tax was £8.4m in the 2014 financial year but had fallen to £0.4m in the 2015 financial year ("**FY2015**") and a loss of £8.6m in FY2016. Healthcare revenue also fell from £91.4m in FY2015 to £78.0m in FY2016.

2.8. Against this background the Company had carried out its annual […] budgeting and forecasting exercise for the Healthcare business from late 2015 onwards, which

culminated in the production of a revised business plan in early 2016 (the "**Revised Business Plan**").

2.9. The Revised Business Plan covered a period of 5 years and:

2.9.1. projected slower growth in the existing domiciliary Healthcare business than had been projected in previous budgets and forecasts; but

2.9.2. projected growth in the Care and Custody Healthcare business; and

2.9.3. included four new business lines which the Company intended to develop, including a new business involving the provision of apprenticeships.

2.10. The Revised Business Plan projected substantial growth in revenues as follows:

| | | 2015/16 (£000) | 2016/17 (£000) | 2017/18 (£000) | 2018/19 (£000) | 2019/20 (£000) | 2020/21 (£000) |
|---|---|---|---|---|---|---|---|
| EXISTING BUSINESS | […] | 55,966 | 60,424 | 65,717 | 71,511 | 78,176 | 85,959 |
| | […] | 15,734 | 17,690 | 19,105 | 20,825 | 22,699 | 24,742 |
| | Live-in | 3,619 | 3,660 | 3,843 | 4,035 | 4,237 | 4,449 |
| | Care Agency | 501 | 556 | 584 | 613 | 643 | 676 |
| NEWLY ACQUIRED BUSINESS | Care & Custody Health | 0 | 13,425 | 19,990 | 25,407 | 28,407 | 33,614 |
| NEW BUSINESS LINES | Agency/Recruitment | 0 | 500 | 1,000 | 1,500 | 1,750 | 2,000 |
| | Telecare (Age UK) | 0 | 1,000 | 2,000 | 3,500 | 4,000 | 4,500 |
| | Community Health Provision | 0 | 500 | 1,000 | 1,500 | 2,000 | 2,500 |
| | Apprenticeships | 0 | 500 | 1,500 | 4,000 | 6,500 | 9,000 |
| | Total Revenue | 75,820 | 98,255 | 114,739 | 132,891 | 148,412 | 167,439 |

(Figures taken from a Deloitte working paper)

2.11. The Revised Business Plan forecast overall growth in revenue of approximately 17% year-on-year from 2015/16, as set out in the table above.

2.12. The Revised Business Plan projected growing profitability for the Healthcare business over its duration since:

2.12.1. the increase in direct costs for each business line (14.1% per year on average) was expected to be less than the projected increase in revenue;

2.12.2. overheads were forecast to increase by an average of 10.7% each year which, again, was less than the projected increase in revenue;

2.12.3. Care and Custody Healthcare and the four […] new business lines were forecast to contribute revenue from the first year of the plan onwards.

2.13. The FY2016 financial statements attributed a total carrying amount of £465.5m to goodwill. Of this sum, £107.2m was attributable to the goodwill of the Healthcare division's cash generating unit ("**CGU**").

2.14. Goodwill can be included in a company's balance sheet as a result of acquiring other businesses. It is defined in IFRS 3 as *"an asset representing the future economic benefits arising from other assets acquired in a business combination that are not individually identified and separately recognised"*. In essence, goodwill is the difference between the amount paid for the acquired business and the net value of its identifiable assets and liabilities. The £107.2m attributed to the goodwill of the Healthcare CGU arose primarily from the acquisition by the Company of […] Group Limited in 2012.

2.15. When accounting for goodwill, the Company was required to apply IAS 36 (*Impairment of Assets)* ("**IAS 36**"). Paragraph 1 of the standard explains:

*"The objective of this Standard is to prescribe the procedures that an entity applies to ensure that its assets are carried at no more than their recoverable amount. An asset is carried at more than its recoverable amount if its carrying amount exceeds the amount to be recovered through use or sale of the asset. If this is the case, the asset is described as impaired and the Standard requires the entity to recognise an impairment loss. The Standard also specifies when an entity should reverse an impairment loss and prescribes disclosures."*

2.16. Paragraphs 10(b) and 90 of IAS 36 required the Company to test CGUs to which goodwill had been allocated at least annually for impairment.

2.17. Paragraph 6 of IAS 36 defines the "recoverable amount" of an asset or a cash-generating unit as the higher of its fair value less costs of disposal and its value in use.

2.18. Paragraphs 18-57 of IAS 36 contain rules about how this recoverable amount is to be determined. In particular:

2.18.1. Paragraph 22 of IAS 36 required that the Company conduct its impairment testing in respect of each individual CGU.

2.18.2. Paragraph 30 of IAS 36 required that the following elements be reflected in the calculation of an asset's value in use:

*"(a) an estimate of the future cash flows the entity expects to derive from the asset;*

*(b) expectations about possible variations in the amount or timing of those future cash flows;*

*(c) the time value of money, represented by the current market risk-free rate of interest;*

*(d) the price for bearing the uncertainty inherent in the asset; and*

*(e) other factors, such as illiquidity, that market participants would reflect in pricing the future cash flows the entity expects to derive from the asset."*

2.19. The Company's impairment testing of Healthcare goodwill was based on the forecasts for EBITA[1] contained in the Revised Business Plan, using these as the estimate of future cash flows for the purpose of IAS 36 paragraph 30(a).

2.20. The Revised Business Plan was tabled at a meeting of the Audit Committee on 15 March 2016. The Audit Committee then resolved at a further meeting on 17 May 2016 to recommend that the Board approve the Revised Business Plan. Deloitte (including Mr Charlton) attended these Audit Committee meetings.

2.21. The Revised Business Plan was […] approved by the Board on 18 May 2016.

2.22. The Company concluded, in light of the Revised Business Plan and its impairment testing based on it, that Healthcare goodwill was not impaired.

2.23. The FY2016 financial statements, including a carrying amount of £107.2m attributable to Healthcare goodwill, were approved by the board on 23 May 2016.

2.24. Note 13 to the FY2016 financial statements contained disclosures in relation to goodwill:

2.24.1. This note explained that goodwill was subject to (at least) annual impairment testing (and more frequently if there were indicators that goodwill may be impaired).

2.24.2. It identified the key assumptions relating to goodwill as being those regarding the discount rates, growth rates and expected changes to revenue and direct costs during the period.

2.24.3. It stated that the Company's impairment testing demonstrated headroom of £38.2m in the recoverable amount of the Healthcare CGU (i.e. the net present

[1] Earnings before interest, tax and amortisation.

value of the future cash flows that were expected to be generated by the Healthcare business) over the carrying amount of the Healthcare CGU of 118.5m (which comprised goodwill of £107.2m and intangible assets amounting to £11.3m).

2.24.4. It contained the following disclosures in relation to the impairment testing of goodwill:

*"… Management estimates discount rates using pre-tax rates that reflect current market assessments of the time value of money and the risks specific to the CGUs. …*

*… The pre-tax rates used to discount the forecast cash flows from CGUs are derived from the Company's post-tax Weighted Average Cost of Capital, which was 7.0% at 31 March 2016 (2015: 7.4%), and adjusted for the risks specific to the market in which the CGU operates. …*

*… The Directors remain confident in the long-term prospects of the healthcare sector and continue to closely monitor the financial performance of the group's Healthcare cash-generating unit (CGU). In light of recent trading performance a revised long-term business plan for the Healthcare business has been developed with reductions to forecast profits and cash flows. The Directors have reviewed the revised long-term business plan for the Healthcare business and believe that the assumptions on which it is based are reasonable given current performance and market conditions. … The pre-tax rate used to discount the forecast cash flows for the [Healthcare] CGU is 9.1%, which has been adjusted for the risks specific to the market in which the CGU operates."*

2.24.5. It also disclosed that the carrying amount of goodwill and other intangible assets of the Healthcare CGU would be equal to its recoverable amount in the case of:

2.24.5.1. an increase in the pre-tax discount rate of 1.9%; or

2.24.5.2. a fall of 2.0% in the terminal value growth rate to a long-term inflationary assumption of 0.5%; or

2.24.5.3. a 27% reduction in operating profit in year 5 and subsequent years compared to the Revised Business Plan.

2.25. Deloitte assessed the recoverability of goodwill and intangible assets in the Healthcare business as a significant risk for the FY2016 Audit.

2.26. Deloitte's Independent Auditor's Report, which was included in the FY2016 Annual Report, noted that in recent years there had been a reduction in headroom in Healthcare goodwill. Deloitte's report identified this as one of the material risks of misstatement which had had the greatest impact on their audit strategy.

2.27. Deloitte's auditor's report included the following statement about Deloitte's response to this material risk of misstatement:

*"We critically assessed management's position as to whether or not a reasonably possible change to key operating assumptions could result in an impairment. In doing so, we have considered the output of the Group's budgeting process including the sensitivity of the key assumptions relating to future growth in revenue and cost savings to be achieved. We assessed whether the forecasts adopted in the impairment review were board approved and consistent with those used in the going concern and longer-term viability assessment. In addition we challenged the appropriateness of the inclusion of cash flows relating to new initiatives noting these cash flows are in line with the Group's strategy of expansion in the Healthcare sector. We benchmarked the growth rates employed to available market data and engaged our specialist valuation team to consider the appropriateness of the discount rate including reviewing management's calculation and reconciliation.*

*We performed sensitivity analysis in respect of each of the key assumptions and reperformed management's sensitivity disclosure.*

*We also specifically reviewed the appropriateness of the disclosures set out in note 13 to the accounts detailing the point at which the recoverable value of goodwill would equal the carrying amount."*

2.28. Deloitte's audit opinion on the FY2016 financial statements was unmodified and confirmed that they gave a true and fair view of the Company's affairs as at 31 March 2016; and that they had been properly prepared in accordance with the International Financial Reporting Standards ("**IFRS**"), UK GAAP, and the Companies Act 2006.

2.29. The *Adverse Findings* against the Respondents concern inadequacies in the auditing of the Company's impairment testing of Healthcare goodwill and the disclosures in the FY2016 financial statements concerning Healthcare goodwill. The findings concern:

2.29.1. The Respondents' consideration of working capital;

2.29.2. The inclusion of new[2] business lines in the cashflows used to build the impairment model for impairment testing purposes, including an Apprenticeships business, which Deloitte accepted[3], even though Deloitte had concluded that this new business should not be included in these cashflows;

2.29.3. The inadequate documentation of audit work comparing the actual financial performance of the Healthcare business during the first period of the 2017 financial year to the forecast performance over that time period in the Revised Business Plan;

2.29.4. The failure to obtain sufficient appropriate audit evidence to support the discount rate used by the Company in the impairment model for Healthcare goodwill;

2.29.5. The Respondents' evaluation of the disclosures regarding Healthcare goodwill in the FY2016 financial statements; and

2.29.6. Deficiencies in Deloitte's audit report.

2.30. For the reasons and in the circumstances set out below, the Respondents ought to have […] concluded during the course of the FY2016 Audit that the headroom for impairment of the Healthcare CGU was materially overstated in the FY2016 financial statements.

2.31. If the Respondents had complied with the *Relevant Requirements* set out below, goodwill in the Healthcare CGU might well have been treated as impaired as at the end of FY2016 and deficiencies in the disclosures concerning Healthcare goodwill would have been detected.

2.32. The Respondents communicated some of the relevant issues to the Audit Committee as matters of judgement. They did not however report them as uncorrected misstatement(s), nor did they request that they be corrected [...].

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[2] References to 'new businesses' in this document include both the Care and Custody Health business that had recently been acquired by the Company and new business lines which the Company intended to develop within the Healthcare CGU. All references to new businesses in the rest of this document are marked with * to indicate the same.
[3] Deloitte accepted inclusion on the basis that the removal of cashflows for the Apprenticeships business could be mitigated by potential reductions in overheads.

## 3. RELEVANT REQUIREMENTS

3.1. Rule 1 of the AEP states that *Relevant Requirements* has the meaning set out in regulation 5(11) of the Statutory Auditors and Third Country Auditors Regulations 2016. The *Relevant Requirements* include, but are not limited to, the International Standards on Auditing (UK and Ireland) ("**ISAs**") issued by the International Auditing and Assurance Standards Board. Deloitte was obliged to comply with the ISAs when conducting the FY2016 audit. The *Relevant Requirements* also extend to particular provisions of the Companies Act 2006. The *Relevant Requirements* referred to in this *Final Decision Notice* are:

3.1.1. ISA 200 (*Overall objectives of the independent auditor and the conduct of an audit in accordance with International Standards on Auditing (UK and Ireland)*);

3.1.2. ISA 220 (*Quality control for an audit of financial statements*);

3.1.3. ISA 230 (*Audit documentation)*;

3.1.4. ISA 450 (*Evaluation of misstatements identified during the audit*);

3.1.5. ISA 500 (*Audit evidence*);

3.1.6. ISA 540 (*Auditing accounting estimates, including fair value accounting estimates, and related disclosures*);

3.1.7. ISA 700 (*The independent auditor's report on financial statements*); and

3.1.8. Section 495 of the Companies Act 2006.

3.2. Extracts from the ISAs setting out those parts which are of particular relevance to the *Adverse Findings* are set out in Appendix 1 hereto.

## 4. ADVERSE FINDINGS

### Adverse Finding 1 – Incorrect treatment of working capital

4.1. IAS 36 required the Company to recognise an impairment loss if and to the extent that the recoverable amount was less than the carrying amount in respect of any of its CGUs (paragraph 104).

4.2. The rules for determining the carrying amount of the Company's CGUs included paragraphs 75 and 76 of IAS 36. These required (amongst other things) that:

4.2.1. The carrying amount of a CGU be determined on a basis consistent with the way the recoverable amount of the CGU was determined (paragraph 75); and

4.2.2. The carrying amount of a CGU exclude any recognised liability unless the recoverable amount of the CGU could not be determined without consideration of that liability.

4.3. Deloitte stated in a key audit working paper considering Healthcare goodwill that the carrying amount of a CGU is usually the sum of net permanent working capital, fixed assets, intangible assets and goodwill.

4.4. The same audit working paper noted that the Company's impairment model compared the value in use of the CGU (i.e. the recoverable amount as calculated by its model) to the carrying amount of goodwill and intangible assets only. The carrying amount used for the Company's impairment testing did not include any sum in respect of working capital or fixed assets.

4.5. Deloitte concluded that the exclusion of working capital and fixed assets from the carrying amount of the Healthcare CGU was acceptable because: (i) the Company "*has a high cash conversion ratio, therefore the expectation is that permanent elements of working capital are kept to a minimum*"; and (ii) Deloitte had challenged this expectation by reviewing the balance sheet at the year-end and had concluded, in light of that review, that the financial effect of including working capital and fixed assets as at 31 March 2016 totalled £0.1m and so would have an insignificant impact on headroom if carried through the model.

4.6. As to (i), the assertion that the Company "*has a high cash conversion ratio*" was consistent with the Company's calculation of the value in use of the Healthcare CGU, which assumed a 100% cash conversion ratio each year. Deloitte failed, however, to bring a questioning mind to bear on whether the Company's cash conversion ratio for the Healthcare CGU could be as high as 100% in any year let alone every year. In particular, they should have questioned whether this could be correct each year in circumstances in which the Revised Business Plan anticipated growth and the development of new areas of business. They failed to do so.

4.7. As to (ii), the analysis of the balance sheet on which Deloitte relied was the position at the 2016 year-end, which Deloitte recorded as being as follows:

| **Account balance** | **£m** |
|---|---|
| Fixed assets | 1.65 |
| Other Debtors | 8.66 |
| Trade Debtors | 8.22 |
| Cash | -16.47 |
| Accruals and DI | -1.19 |
| Trade Creditors | - 0.77 |
| **Total** | 0.1 |

4.8. This table shows that Deloitte's conclusion that the Company Healthcare CGU had a minimal permanent working capital requirement depended on including the negative cash entry of £16.47m in the calculation. [...] This analysis of the balance sheet did not support the conclusion that the Company Healthcare CGU had a minimal permanent working capital requirement since (i) cash (positive or negative) should not have been included in the calculation of working capital; (ii) the Company's need for a […] negative cash balance as at 31 March 2016 (i.e. a borrowing requirement) should not in any event have been treated by Deloitte as reducing the working capital balance of the […] Healthcare CGU by the amount of the […] negative cash balance; and (iii) the debtor balances and substantial […] negative cash balance were inconsistent with the […] Healthcare CGU having a 100% cash conversion ratio even as at 31 March 2016. Further information and analysis would be required to determine the true balance of the Company's permanent working capital requirement but on the face of this table, the requirement may well have been substantial.

4.9. Moreover, Deloitte's sensitivity testing of the effect of including fixed assets and working capital was flawed. This testing took the table above and applied it as if it reflected the financial effect of including working capital and fixed assets but:

4.9.1. The […] negative cash balance could not itself have been included in the CGU's carrying amount because IAS 36 paragraph 76(b) prohibits the inclusion of a recognised liability and, in any event, as set out above, it was wrong in principle for Deloitte to include […] a negative cash balance of £16.47m in a calculation of the Company's working capital requirement.

4.9.2. If the balance sheet at the 2016 year end was to be regarded as evidence of the Company's permanent working capital requirement (as Deloitte's testing

assumed), the quantum of the recorded balances (excluding fixed assets and the […] negative cash balance) was £14.92m and this suggested that the Company had a substantial working capital requirement. On the face of this calculation, the combined effect of including working capital and fixed assets at the 2016 year end, in respect of that year alone, would be to increase the carrying amount of the CGU by £16.57m (i.e. the balance shown by the table above, excluding the […] negative cash balance).

4.9.3. Deloitte should, therefore, have concluded from its own testing that work was required to assess the net impact on headroom of including working capital. Its testing showed that including working capital would have a material effect on the carrying amount of the CGU. This meant that consideration needed to be given to the effect of including cashflows arising from working capital requirements in the estimated value in use of the CGU (to comply with the requirement for consistency stipulated by IAS 36 paragraph 75). Absent this further analysis, Deloitte did not obtain reasonable assurance as to whether the recoverable amount of the Healthcare CGU was more than its carrying amount.

4.10. In all the circumstances:

4.10.1. In breach of ISA 540.8(a) and ISA 700.9(c), Deloitte failed to evaluate adequately whether the accounting policies selected and applied by the Company were consistent with IAS 36 in circumstances in which the Company's impairment model did not include any amounts in respect of working capital;

4.10.2. In breach of ISA 540.8(c) and ISA 700.9(d), Deloitte failed to give adequate consideration to the reasonableness of the assumption that the Company had and would have a minimal permanent working capital requirement in relation to its Healthcare CGU;

4.10.3. In breach of ISA 200.15, Deloitte failed to plan or perform the FY2016 Audit with sufficient professional skepticism, because they accepted without adequate challenge that the permanent working capital requirement of the Healthcare CGU was negligible as at the end of FY2016 and would be negligible over the 5 years of the Revised Business Plan, without bringing to bear a questioning mind as to

whether that could be correct as at 31 March 2016 and was a reasonable assumption for the future.

**Adverse Finding 2 – Inclusion of Apprenticeships business in Revised Business Plan**

4.11. IAS 36 also required that:

4.11.1. The calculation of a CGU's value in use should reflect an estimate of future cashflows the entity expects to derive from the CGU and expectations about possible variations in the amount and timing of such cashflows (paragraph 30(a) and (b)); and

4.11.2. Cashflow projections should be based on reasonable and supportable assumptions representing management's best estimate of the range of economic conditions that will exist over the period covered by those future cashflows (paragraph 33(a)); and

4.11.3. Future cashflows should be estimated for the CGU in its current condition and should not include cashflows that are expected to arise from:

4.11.3.1. a future restructuring to which an entity is not yet committed, or

4.11.3.2. improvements or enhancements of the CGU's performance (paragraphs 33(b) and 44).

4.12. The Revised Business Plan included estimates of the projected profit and loss for a new Apprenticeships business that had not yet been launched by the Company. Expected cashflows from this business were included within the value in use attributed to the Healthcare CGU for the purpose of the Company's impairment testing.

4.13. Deloitte concluded in relation to the Apprenticeships business that the Company *"is not in a position to enter this market at the current point in time"*; *"As a result this element of the business could be considered restructuring"*; and *"… we have been unable to obtain sufficient evidence to suggest this element of the business will succeed and in comparison with the other areas of complementary business this element of the plan requires most work to achieve."*

4.14. Deloitte also reported to the Audit Committee that:

*"Based on our procedures, we found insufficient evidence to support the cash-flows deriving from the apprenticeships programme. Therefore we believe the apprenticeship cash-flows should be excluded from the model, reducing headroom in the goodwill model by £22m when using management's discount rate. Management believe the headroom impact of removing the apprenticeships element of the plan would be mitigated through reduced overheads which is currently not factored into the plan."*

4.15. Deloitte did not obtain or document any audit evidence in respect of the potential for *"reduced overheads"* referred to in this report to the Audit Committee. They did not bring a questioning mind to bear on whether overheads could be reduced to the extent of the £22m reduction in headroom which would have flowed from the exclusion of the Apprenticeship business cashflows from the value in use calculation, or at all, especially in circumstances in which: (i) the Revised Business Plan already sought to make costs savings across all aspects of the business where possible; and (ii) the £22m reduction in headroom was a net figure, which itself removed the overheads forecast to be incurred in relation to the Apprenticeships business, so any further costs savings would need to be found from other areas of the business.

4.16. The headroom and the sensitivities disclosed in the Notes to the FY2016 financial statements were based on the Company's impairment model. They included the expected cashflows from the Apprenticeships business.

4.17. Despite Deloitte's conclusion that cashflows from the Apprenticeships business should be excluded from the forecasts which generated the value in use of the Healthcare CGU:

4.17.1. Deloitte itself included the expected cashflows from the Apprenticeships business within the base case which it used for the purpose of its sensitivity analysis in relation to the Company's impairment testing for Healthcare goodwill;

4.17.2. Deloitte did not modify or qualify its audit opinion in relation to the FY2016 financial statements despite the inclusion of these cashflows within the headroom and sensitivity testing disclosed in the financial statements; and

4.17.3. Deloitte stated in the auditor's report in the FY2016 financial statements that it had *"challenged the appropriateness of the inclusion of cash flows relating to new initiatives noting these cash flows are in line with the Group's strategy of expansion in the Healthcare sector"* without referring to its disagreement with the Company over the inclusion of Apprenticeships (which is addressed further in Adverse Finding 6).

4.18. The Respondents therefore breached *Relevant Requirements* as follows:

4.18.1. In breach of ISA 500.6, they did not obtain sufficient appropriate audit evidence to support (a) the inclusion of cashflows for the Apprenticeships business in the calculation of the value in use of the Healthcare CGU; and (b) […] that the removal of cashflows for the Apprenticeships business could or would be mitigated by potential reductions in overheads; and

4.18.2. In breach of ISA 200.15, they failed to plan or perform the FY2016 Audit with sufficient professional skepticism, because they accepted without adequate challenge that overheads could be reduced to make up any shortfall in the forecast cashflows from the Apprenticeships business, and without bringing to bear a questioning mind as to whether that was a reasonable assumption.

4.19. Further breaches relating to Deloitte's audit report are set out in Adverse Finding 6 below.

## Adverse Finding 3 – Estimates for new* business lines in Revised Business Plan

4.20. As already noted, IAS 36 required that cashflow projections be based on reasonable and supportable assumptions representing management's best estimate of the range of economic conditions that will exist over the useful life of the asset.

4.21. In addition to the Apprenticeships business, the Revised Business Plan also included projections for a new* business in Care and Custody Health that had recently been acquired by the Company and new businesses in Community Health, Agency / Recruitment and Telecare. The total annual revenue from these new* businesses (excluding the Apprenticeships business) at the end of the five year period covered by the Revised Business Plan was projected to be £42.6m (out of total Healthcare revenue of £167.4m).

4.22. Deloitte should have been alert to the fact that the cashflow projections for new* business lines may not have been a "*best estimate*" for the purpose of IAS 36 in circumstances where:

4.22.1. The Healthcare business had repeatedly failed to meet previous budgets, which raised questions about the reliability of the Company's Healthcare CGU forecasting;

4.22.2. The Revised Business Plan was on its face ambitious in relation to these new* businesses because it assumed growth in the new businesses at rates that were markedly higher than the projected growth rates for the Company's other CGUs and markedly higher than long term average growth rates, in the context of new business streams which within the Healthcare CGU had no track record at all;

4.22.3. The value in use of the Healthcare CGU was heavily dependent on the significant growth in cashflows that had been projected for new* businesses by the end of the five year period covered by the Revised Business Plan […]; and

4.22.4. There was considerable uncertainty both as to the timing and quantum of future cashflows from the new business lines that had not yet started and any failure or delay in the implementation of the plans for these new businesses would have had a significant impact on the value in use calculation.

4.23. Deloitte did note that the contribution of new* business lines had increased significantly in the Revised Business Plan as compared with previous versions of the Company's business plan and that this introduced a significant level of judgement given the lack of historical precedent for the new business lines. However, the documented consideration by Deloitte on the 2016 Audit file of the basis for the cashflow projections for new business lines in the Revised Business Plan was high level and not supported by sufficient appropriate audit evidence.

4.24. Deloitte appears also to have focussed not on whether those projections were a best estimate (as required by IAS 36), but on whether there was positive evidence that the Revised Business Plan was *"incorrect"* or *"unsupportable"* or *"overly ambitious"*. Deloitte's workpapers also recorded, among other things, that *"insufficient time has elapsed* [since the start of the period covered by the Revised Business Plan] *to categorically conclude an impairment charge is required"* and that it had *"insufficient evidence to suggest the plan won't be achieved and therefore that an impairment charge should be recognised"*.

4.25. This was despite Deloitte being aware that the removal of all new* business lines (including the Apprenticeships business) would have resulted in an impairment of Healthcare goodwill of £14.3m and the removal of the Telecare and Apprenticeships businesses alone would have reduced the headroom figure to £4.9m.

4.26. The Respondents therefore breached *Relevant Requirements* as follows:

4.26.1. In breach of ISA 500.6 and ISA 540.17, they failed to obtain sufficient appropriate audit evidence that the estimates of future cashflows for new* business lines derived from the Revised Business Plan were a best estimate based on reasonable and supportable assumptions as required by IAS 36;

4.26.2. In breach of ISA 700.9, ISA 540.13 and ISA 540.15, they failed adequately to evaluate the reasonableness of the estimates of cashflows for new* business lines in the Revised Business Plan or the assumptions on which they were based.

## Adverse Finding 4 – Documentation of post-year-end audit work

4.27. As at the date of approval of the FY2016 financial statements, P1 management accounts for April 2016 were available. The FY2016 Audit file states that Deloitte performed *"a detailed review"* of the P1 management accounts. The FY2016 Audit file also refers to discussions Deloitte held with individuals at the Company about performance of the Healthcare CGU during the course of the FY2016 Audit, including after the meeting of the Audit Committee on 17 May and before the FY2016 financial statements were signed. However, the outcome of Deloitte's review of the P1 management accounts is not documented on the FY2016 Audit file beyond a brief acknowledgement that the performance of the Healthcare business in P1 was *"behind expectation due to anticipated contract phasing"* and an unsubstantiated assertion that *"P1 typically falls behind budget due to public sector budgets also running to a March year end"*.

4.28. Deloitte's workpapers also record in this context their conclusion that the Company's forecasting was *"highly accurate over a 12 month period"* and *"no significant issues or immediate concerns are noted"* despite the Healthcare business having repeatedly missed previous budgets and the valuation in use of the Healthcare CGU being heavily dependent on cashflows for the existing and new* businesses growing in line with the projections in the Revised Business Plan both as to the timing of receipt and quantum.

4.29. The Respondents therefore breached *Relevant Requirements* as follows:

4.29.1. In breach of ISA 230.8, they failed adequately to document their review of the P1 management accounts and how that review provided comfort that there were no significant issues or immediate concerns arising from the fact that, as they acknowledged, the Healthcare business was already behind expectation.

## Adverse Finding 5 – Discount rate for Healthcare CGU

4.30. IAS 36 paragraph 55 required the discount rate used for a value in use calculation to be a pre-tax rate that reflected current market assessments of the time value of money and the risks specific to the asset for which the future cashflow estimates had not been adjusted.

4.31. The Company used a pre-tax discount rate of 9.1% in its value in use calculation for the Healthcare CGU.

4.32. The FY2016 financial statements stated that this pre-tax discount rate of 9.1% (which is equivalent to a post-tax risk-adjusted rate of 8.0%) had been calculated by the Company adding a risk premium of 1.0% for Healthcare (i.e. an adjustment *"for the risks specific to the market in which the CGU operates"*) to the Company's assessment of the group's weighted average cost of capital ("**WACC**") of 7.0%.

4.33. Deloitte engaged an internal valuations specialist to assist in auditing the Company's calculation of the group WACC. The internal valuations specialist's analysis estimated the post-tax group WACC for the Group as a whole to be in a range of 8.0% to 9.0%.

4.34. If a risk premium of 1.0% was added to this range, to reflect the higher risk of the Healthcare business compared with the group as a whole, this would give a Healthcare-specific WACC of 9.0% to 10.0% (i.e. 1-2% higher than the rate calculated by the Company). Deloitte did not ask its internal valuations specialist to provide an independent calculation of an appropriate discount rate for the Healthcare CGU, as opposed to the WACC for the Group as a whole. Nor did it ask its internal valuations specialist whether an adjustment to the discount rate should be made to reflect the risks specific to the Healthcare CGU and, if so, in what amount.

4.35. Furthermore, Deloitte did not clearly document on the audit file how the audit team reached the conclusions that they did regarding the appropriateness of the discount rate which had been used by the Company in its impairment model, save for referring to peer analysis to assess contradictory evidence in relation to the discount rate for the Healthcare CGU. It was not clear on the face of the audit file whether Deloitte had agreed or disagreed that the 8.0% post-tax discount rate applied to the Healthcare CGU lay within a reasonable range and, if it agreed with this, what audit evidence it had relied upon in reaching that conclusion.

4.36. The Respondents therefore breached *Relevant Requirements* as follows:

4.36.1. In breach of ISA 500.6, they failed in all the circumstances to obtain sufficient appropriate audit evidence to support the 8.0% post-tax (9.1% pre-tax) discount rate used by the Company for its value in use calculation for the Healthcare CGU (including, in particular, by failing to ask the internal valuations specialist to provide an independent calculation of the appropriate discount rate for the Healthcare CGU, as opposed to the WACC for the Group as a whole).

4.36.2. In breach of ISA 540.18 and/or ISA 700.9, they failed to evaluate sufficiently, based on the audit evidence, whether the pre-tax discount rate of 9.1% used by the Company for its value in use calculation for the Healthcare CGU was reasonable and appropriate in the context of the applicable financial reporting framework.

4.36.3. In breach of ISA 230.8, they failed to prepare audit documentation which was sufficient to enable an experienced auditor having no previous connection with the audit, to understand (a) the nature, timing and extent of the audit procedures performed to comply with the ISAs (UK) and applicable legal and regulatory requirements, (b) the results of the audit procedures performed and the audit evidence obtained, and (c) significant matters arising during the audit, the conclusions reached thereon, and significant professional judgments made in reaching those conclusions.

4.36.4. In breach of ISA 220.18, Mr Charlton also failed to ensure that:

4.36.4.1. appropriate consultation took place between the engagement team and the internal valuations specialist in relation to the discount rate used by the Company for its value in use calculation for the Healthcare CGU; and

4.36.4.2. the conclusions from such consultation were properly implemented.

## Adverse Finding 6 – Misstatement of the FY2016 financial statements

4.37. The FY2016 financial statements disclosed that the headroom between the carrying amount of the Healthcare CGU and the recoverable amount was £38.2m. However, in view of the matters set out above (in particular, Adverse Finding 2 (Apprenticeships)), it should have been appreciated by Deloitte that this figure was materially misstated.

4.38. Moreover, if Deloitte had adequately challenged management's impairment testing in the respects set out in Adverse Findings 1, 2, 3 and 5 set out above, an impairment loss might have been recognised for the Healthcare CGU in the FY2016 financial statements.

4.39. Deloitte should, therefore, have appreciated that the FY2016 financial statements contained a material uncorrected misstatement or misstatements in relation to the headroom and/or carrying amount of the Healthcare CGU. However, Deloitte did not:

4.39.1. identify this/these material misstatement(s);

4.39.2. inform the Company's management or the Audit Committee that the FY2016 financial statements contained this/these material misstatement(s);

4.39.3. request that this/these material misstatement(s) be corrected before the FY2016 financial statements were published […].

4.40. Instead, the Respondents signed off on an auditor's report confirming that the FY2016 financial statements gave a true and fair view and that they had been prepared in accordance with applicable IFRSs, UK GAAP and the Companies Act 2006.

4.41. The auditor's report in the FY2016 financial statements was inadequate and incomplete in that:

4.41.1. Deloitte did not disclose that the Company had rejected Deloitte's challenge to the appropriateness of the inclusion of cashflows relating to the Apprenticeships business, but that Deloitte remained of the view that these cashflows should not be included in the Company's impairment testing model; and

4.41.2. Deloitte stated that they had engaged their specialist valuation team to consider the appropriateness of the discount rate applied in the impairment review. When this statement was read in combination with the disclosure in Note 13 that a discount rate of 9.1% pre-tax had been applied to the Healthcare CGU cashflows, comprising the Group's WACC of 7.0% post-tax plus an adjustment specific to the risks in the market in which the CGU operated, it gave the impression that Deloitte's specialist valuation team had considered the discount rate applicable to the Healthcare CGU and had concluded that a WACC for the Group of 7.0% plus a risk specific adjustment of 1.0% for the Healthcare CGU after tax led to a […] discount rate which the

specialist valuation team had concluded was appropriate. The true position was that:

4.41.2.1. The specialist valuation team had concluded that a WACC of 7.0% post-tax lay outside an acceptable range for the Group. In their view, an acceptable range for the Group WACC was 8% to 9% post tax; and

4.41.2.2. The specialist valuation team had not been asked to consider what adjustment for the Healthcare CGU might be appropriate to reflect the specific risks of that business.

4.42. The Respondents therefore breached *Relevant Requirements* as follows:

4.42.1. They failed to identify that, and/or to record in the audit documentation their conclusion as to whether, the FY2016 financial statements contained a material uncorrected misstatement or misstatements as to the headroom and/or the carrying amount of the Healthcare CGU in breach of ISA 450.11, ISA 450.15 and ISA 540.18;

4.42.2. In breach of ISA 450.12, they failed:

4.42.2.1. to communicate to those charged with governance the uncorrected misstatement(s) and the effect that they, individually or in aggregate, might have had on the opinion expressed in the auditor's report; and

4.42.2.2. to request that the uncorrected misstatement(s) be corrected;

4.42.3. […] failed to comply with their overarching obligation under section 495 of the Companies Act 2006 to report to members whether, in their opinion, the FY2016 financial statements gave a true and fair view of the state of affairs of the company and its profit and loss for the year, and had been properly prepared in accordance with the relevant accounting framework (and thereby breached the requirements of ISA 700.8 and ISA 700.10-11 in relation to the required content of the auditor's report);

4.42.4. Mr Charlton failed to ensure that the auditor's report was appropriate in the circumstances in breach of ISA 220.15(b).

**Adverse Finding 7 – Inadequate disclosures in the FY2016 financial statements**

4.43. IAS 36 required the disclosures in the FY2016 financial statements to include:

4.43.1. Each key assumption on which the cashflow projections for the Healthcare CGU that were derived from the Revised Business Plan were based;

4.43.2. A description of the approach to determining the value assigned to each key assumption, whether those values reflected past experience or, if appropriate, were consistent with external sources of information, and, if not, how and why they differed from past experience or external sources of information; and

4.43.3. If a reasonably possible change in a key assumption underlying the cashflow projections for the Healthcare CGU that were derived from the Revised Business Plan would lead to impairment, the value assigned to the key assumption and the amount by which this value would need to change in order for the recoverable amount of the Healthcare CGU to equal the carrying amount.

4.44. IAS 1 (*Presentation of Financial Statements*) ("**IAS 1**") also required the disclosures in the FY2016 financial statements to include the judgements, apart from those involving estimations, that had been made in the process of applying the Company's accounting policies and that had the most significant effect on the amounts recognised therein.

4.45. The disclosures in the FY2016 financial statements in relation to the valuation of the Healthcare CGU did not comply with these requirements of IAS 36 and IAS 1 because they did not refer to the inclusion of cashflows from new* business lines or the value attributable to the new business lines even though:

4.45.1. The growth of the new* business lines in accordance with the projections in the Revised Business Plan was a key assumption and a reasonably possible change in that assumption would cause impairment of the Healthcare CGU; and

4.45.2. The inclusion of new* business lines, including Care and Custody Health, in the Healthcare CGU was a judgement that had been made in the process of applying the Company's accounting policies that had a significant effect on the amounts recognised in the FY2016 financial statements (in that, if they had not been included, this would have led to impairment of the Healthcare CGU).

4.46. The Respondents therefore breached *Relevant Requirements* as follows:

4.46.1. In breach of ISA 700.9, they failed to evaluate whether:

4.46.1.1. the information presented in the FY2016 financial statements was relevant, reliable, comparable and understandable; and/or

4.46.1.2. the FY2016 financial statements provided adequate disclosures to enable the intended users to understand the effect of material transactions and events on the information conveyed therein.

4.46.2. In breach of ISA 540.19, they failed to obtain sufficient appropriate audit evidence that the disclosures in the FY2016 financial statements relating to accounting estimates were in accordance with the requirements of the applicable financial reporting framework;

4.46.3. In breach of ISA 540.20, they failed to evaluate the adequacy of the disclosure of estimation uncertainty in relation to the valuation of the Healthcare CGU (as an estimate that gave rise to significant risks) in the FY2016 financial statements in the context of the applicable financial reporting framework.

## 5. SANCTIONS

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

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

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

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

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

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

5.3. In reaching this decision, *Executive Counsel* has, in summary, considered the following matters in accordance with the Policy.

Nature, seriousness, gravity and duration of the breaches

5.4. The breaches of *Relevant Requirements* in this case concern deficiencies in the auditing of the Company's impairment testing of Healthcare goodwill:

5.4.1. The *Adverse Findings* all concern the Company's Healthcare Division, which had a record of poor financial performance prior to FY2016. Whilst Healthcare only accounted for 8% of revenue in FY2016, the FY2016 Annual Report emphasised the opportunities that the Company saw for this aspect of its business in the future. The forecast performance of the Healthcare CGU in future was considered as part of the Company's impairment testing.

5.4.2. Goodwill was highly material to the Company's reported financial position. The FY2016 financial statements attributed £465.5m to the value of goodwill. This was the single largest figure in the balance sheet and amounted to 37.5% of the total reported assets. It was more than the Company's reported net assets (£415.1m). Goodwill attributed to the Healthcare CGU in FY2016 amounted to £107.2m (23% of the Company's total carried goodwill in FY2016).

5.4.3. The forecast future performance of the Healthcare CGU, including the value attributed to Healthcare goodwill, was a significant issue in FY2016 due to (i) previous poor financial performance; (ii) management's continued efforts to achieve a turnaround in the financial performance of the Healthcare Division; and (iii) the Division's relevance to the Company's long-term growth plans (including the Revised Business Plan).

5.4.4. Recoverability of the goodwill in the Healthcare CGU was identified by Deloitte as a significant risk for the FY2016 Audit and was also identified in the audit report as one (of two) assessed risks of material misstatement. It was clearly an area that required robust and rigorous audit work.

5.4.5. Despite being aware of the significant risk the Respondents did not properly challenge management, and failed to exercise sufficient professional skepticism, in relation to management's assertions about working capital requirements and about possible reductions in overhead expenses; failed to obtain sufficient audit evidence to gain appropriate comfort regarding the future cashflows and the discount rate used in the impairment model; failed adequately to document their audit work in relation to the discount rate, and allowed inadequate disclosures and incomplete statements in the auditor's report.

5.4.6. Due to the Respondents' breaches, the FY2016 financial statements contained a material uncorrected misstatement or misstatements in relation to the headroom and/or carrying amount of the Healthcare CGU.

5.4.7. There is a clear risk that users of the FY2016 financial statements would have been unclear as to (i) the audit work carried out to address a significant risk (recoverability of goodwill in the Healthcare CGU); (ii) the judgements and assumptions applied in the financial statements; and (iii) the extent of the Respondents' agreement or disagreement with the Company regarding forecast cashflows and the appropriate discount rate for the Healthcare CGU.

5.4.8. As to Mr Charlton, the *Adverse Findings* include two additional ISA 220 breaches concerning his failure to ensure that (i) the auditor's report was appropriate in all the circumstances; and (ii) the audit team consulted appropriately with Deloitte's internal valuations expert regarding the discount rate for the Healthcare CGU and that they properly implemented the expert's conclusions.

5.4.9. As against this:

5.4.9.1. the failings only related to one part of the FY2016 Audit;

5.4.9.2. the breaches relate to one audit year;

5.4.9.3. there is no suggestion the breaches were intentional, dishonest or reckless; and

5.4.9.4. there is no suggestion of any financial benefit to the Respondents, aside from payment of the audit fee to Deloitte (and associated benefit for Mr Charlton, as a partner in Deloitte).

5.5. *Executive Counsel* considers that, notwithstanding the remedial steps taken by Deloitte (considered at 5.12 below), there is a risk that the same types of breaches may reoccur, absent further deterrence in the form of *Sanctions*.

Identification of *Sanction*

5.6. Having assessed the nature, seriousness, gravity and duration of the breaches, Executive Counsel has identified the following combination of *Sanctions* as appropriate for Deloitte:

5.6.1. A financial sanction of £2 million;

5.6.2. A published statement in the form of a severe reprimand;

5.6.3. A declaration that the audit report signed on behalf of Deloitte did not satisfy the *Relevant Requirements,* as set out in this *Final Decision Notice*;

5.6.4. A non-financial sanction, in the form of an order pursuant to rule 96(c) of the AEP requiring Deloitte to:

5.6.4.1. Review the root cause analysis previously prepared for the FY2016 Audit (the "**RCA**"), extend that RCA to address any further issues that arise out of the breaches set out in this *Final Decision Notice* (the "**Extended RCA"**) and provide the RCA and Extended RCA to Executive Counsel and the FRC Deloitte Supervisor within 120 days of the date of this *Final Decision Notice*;

5.6.4.2. By 16 May 2022, provide a report to Executive Counsel and the Executive Director of Supervision summarising how the initiatives introduced by Deloitte since the FY2016 Audit (including but not limited to (i) the Impairment Centre of Excellence; (ii) the use of the 'Challenge Panel'; and (iii) introduction of refreshed audit documentation templates) have addressed the causal factors of failure identified in the RCA and Extended RCA and provide empirical data to demonstrate whether the initiatives have led to improvements in the quality of Deloitte's audit work. If Executive Counsel or the FRC Director of Supervision consider that an additional report is required to address further issues, such a report to be provided within 3 months of the FRC's request.

5.7. Having assessed the nature, seriousness, gravity and duration of the breaches, *Executive Counsel* has identified the following combination of *Sanctions* as appropriate for Mr Charlton:

5.7.1. a financial sanction of £65,000;

5.7.2. a published statement, in the form of a severe reprimand, to the effect that Mr Charlton contravened *Relevant Requirements* in the FY2016 Audit; and

5.7.3. a declaration that the audit report signed by Mr Charlton did not satisfy the *Relevant Requirements*, as set out in this *Final Decision Notice*.

5.8. In view of the remedial steps taken by Mr Charlton (as set out at 5.18 below), *Executive Counsel* does not consider any additional non-financial sanction is necessary.

**Aggravation and Mitigation**

5.9. *Executive Counsel* has taken into account any aggravating and mitigating factors that exist (to the extent that they have not already been taken into account in relation to the nature, seriousness, gravity and duration of the breaches).

Deloitte

Aggravating factors

5.10. Deloitte has been sanctioned three times in the previous three years for failings in relation to audits:

5.10.1. In February 2019, Deloitte was fined £6.5 million (reduced to £4.225 million for settlement) and issued with a severe reprimand for Misconduct in relation to its audit of Serco Geografix Limited for the financial years ending 2011 and 2012;

5.10.2. In August 2020, Deloitte was fined £15 million by an Independent Disciplinary Tribunal and issued with a severe reprimand for Misconduct in relation to its audit of Autonomy Corporation plc for periods between January 2009 and June 2011; and

5.10.3. In September 2020, Deloitte was fined £500,000 (reduced to £362,000 for settlement) and issued with a reprimand for breaches of *Relevant Requirements* in relation to its audit of an unnamed entity for the 52 weeks ended 2 January 2016.

5.11. Whilst each of these cases concluded after the failures in the present case occurred, all three cases, as well as the present case, include failures to exercise professional skepticism.

Mitigating factors

5.12. Deloitte has taken remedial steps since 2016 in relation to the failures identified in this *Final Decision Notice,* including:

5.12.1. Introducing an 'Impairment Centre of Excellence', staffed with a number of specialists with significant experience of auditing complex impairment issues;

5.12.2. Introducing refreshed audit documentation and templates for impairment reviews and the audit of accounting estimates; and

5.12.3. Providing training to audit teams on exercising appropriate professional skepticism.

5.13. Whilst Deloitte was paid an audit fee for the FY2016 Audit it did not stand to gain any profit or benefit from the breaches.

Conclusion

5.14. Executive Counsel considers that the aggravating and mitigating factors have an overall neutral effect on the *Sanctions* imposed and no adjustment is therefore required.

Mr Charlton

Aggravating Factors

5.15. There are no aggravating factors in respect of Mr Charlton.

Mitigating Factors

5.16. Mr Charlton has no previous adverse compliance or disciplinary record.

5.17. Mr Charlton has responded positively and constructively to the AQR inspection of the FY2016 Audit and *Executive Counsel's* subsequent investigation. Prior to the delivery of *Executive Counsel's Adverse Findings*, Mr Charlton has considered and reflected on the deficiencies in his direction, supervision and performance of the FY2016 Audit. Mr Charlton has taken active remedial steps as detailed at paragraph 5.18 below in order

to enhance his own audit skills and to try to ensure that the failures in the FY2016 audit work are not repeated.

5.18. He has proactively sought to utilise his experience of, and learnings from, the FY2016 audit by:

5.18.1. Developing a more challenging mindset to his audit work, in particular, by increasing his focus on:

5.18.1.1. Challenge of audit evidence;

5.18.1.2. Performing a stand-back challenge on the consistency of management's judgements;

5.18.1.3. Adopting a more challenging mindset to discussion with both the audit teams and management;

5.18.1.4. Ensuring appropriate specialists are involved in an audit engagement at an early stage, and the work is scoped appropriately with clear responsibilities;

5.18.1.5. Supporting teams in pushing back deadlines to ensure both the audit team and management have sufficient time to undertake all the necessary audit procedures and the sufficiency of audit evidence; and

5.18.1.6. Ensuring clear and transparent communication by the engagement team to Those Charged with Governance ("TCWG") about issues encountered in the audit and key matters of estimation uncertainty.

5.19. *Executive Counsel* notes that Mr Charlton's most recent Deloitte performance appraisals (for FY20 and FY21) have received the top grade and therefore indicate a sustained improvement in his audit quality contribution.

5.20. Mr Charlton has also used his experience of the failings in the FY2016 Audit work to enhance Deloitte's firm-wide quality of audits. This has included:

5.20.1. Mentoring and coaching Deloitte audit teams on his experiences and learnings from the FY2016 Audit;

5.20.2. Helping develop firm-wide improvements to the quality of long-term contract audits, including delivering training and acting as a 'challenge partner reviewer' on a number of Deloitte's audits;

5.20.3. Leading practice reviews of large, complex audits; and

5.20.4. Undertaking Engagement Quality Control Review ("**EQCR**") roles for audits with impairment issues.

5.21. He has recently taken on a lead role in a firm-wide project aimed at improving the quality of Deloitte's EQCR function.

5.22. Mr Charlton did not stand to gain any profit or benefit from the breaches.

5.23. Executive Counsel considers that a reduction to the financial sanction of 15% is appropriate to reflect the mitigating factors.

Deterrence

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

Co-Operation

5.25. Executive Counsel notes that the Respondents provided a good level of co-operation throughout the investigation (albeit co-operation must be exceptional to constitute a mitigating factor).

Discount for Admissions and Settlement

5.26. Having taken into account the admissions made by the Respondents and the stage in the process at which those admissions were made (at a point within Stage 1 of the case, in accordance with paragraph 84 of the Policy), Executive Counsel determines that a reduction of 27.5% as to the financial sanction is appropriate, such that the financial sanctions payable are: (i) Deloitte - £1,450,000; and (ii) Mr Charlton - £40,056.25.

Other considerations

5.27. In 2021, Deloitte was one of the largest audit firms in the United Kingdom, with revenue of £3.7bn (of which £508m was for audit). Deloitte's total audit fee for the FY2016 Audit was £766,000.

5.28. In accordance with paragraph 47(c) of the Policy, Executive Counsel has taken into account the size / financial resources and financial strength of Deloitte and the effect of a financial sanction on its business.

## 6. COSTS

6.1. Executive Counsel requires that the Respondents pay £658,000 of the investigation costs.

## 7. TIMING OF PAYMENT

7.1. The financial sanctions and costs shall be paid no later than 28 days after the date of this *Final Decision Notice*.

**Signed:**

……………………………..

**CLAUDIA MORTIMORE**

**DEPUTY EXECUTIVE COUNSEL**

**Date: 16 November 2021**

# APPENDIX 1 – EXTRACTS OF RELEVANT REQUIREMENTS

## International Standards on Auditing (UK and Ireland) ("ISA")

### ISA 200 - Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing

**Professional Skepticism**

15. The auditor shall plan and perform an audit with professional skepticism recognizing that circumstances may exist that cause the financial statements to be materially misstated.

### ISA 220 – Quality Control for an Audit of Financial Statements

**Engagement Performance**

*Direction, Supervision and Performance*

15. The engagement partner shall take responsibility for:

    (a) The direction, supervision and performance of the audit engagement in compliance with professional standards and applicable legal and regulatory requirements; and

    (b) The auditor's report being appropriate in the circumstances.

…

*Consultation*

18. The engagement partner shall:

    (a) Take responsibility for the engagement team undertaking appropriate consultation on difficult or contentious matters;

    (b) Be satisfied that members of the engagement team have undertaken appropriate consultation during the course of the engagement, both within the engagement team and between the engagement team and others at the appropriate level within or outside the firm;

    (c) Be satisfied that the nature and scope of, and conclusions resulting from, such consultations are agreed with the party consulted; and

    (d) Determine that conclusions resulting from such consultations have been implemented.

**<u>ISA 230</u> – Audit Documentation**

**Documentation of the Audit Procedures Performed and Audit Evidence Obtained**

*Form, Content and Extent of Audit Documentation*

8. The auditor shall prepare audit documentation that is sufficient to enable an experienced auditor, having no previous connection with the audit, to understand:

   (a) The nature, timing and extent of the audit procedures performed to comply with the ISAs (UK and Ireland) and applicable legal and regulatory requirements;

   (b) The results of the audit procedures performed, and the audit evidence obtained; and

   (c) Significant matters arising during the audit, the conclusions reached thereon, and significant professional judgments made in reaching those conclusions.

**<u>ISA 450</u> – Evaluation of Misstatements identified during the Audit**

**Evaluating the Effect of Uncorrected Misstatements**

11. The auditor shall determine whether uncorrected misstatements are material, individually or in aggregate. In making this determination, the auditor shall consider:

    (a) The size and nature of the misstatements, both in relation to particular classes of transactions, account balances or disclosures and the financial statements as a whole, and the particular circumstances of their occurrence; and

    (b) The effect of uncorrected misstatements related to prior periods on the relevant classes of transactions, account balances or disclosures, and the financial statements as a whole.

**Evaluating the Effect of Uncorrected Misstatements**

*Communication with Those Charged with Governance*

12. The auditor shall communicate with those charged with governance uncorrected misstatements and the effect that they, individually or in aggregate, may have on the opinion in the auditor's report, unless prohibited by law or regulation. The auditor's communication shall identify material uncorrected misstatements individually. The auditor shall request that uncorrected misstatements be corrected.

…

**Documentation**

15. The auditor shall include in the audit documentation:

    (a) The amount below which misstatements would be regarded as clearly trivial (paragraph 5);

(b) All misstatements accumulated during the audit and whether they have been corrected (paragraphs 5, 8 and 12); and

(c) The auditor's conclusion as to whether uncorrected misstatements are material, individually or in aggregate, and the basis for that conclusion (paragraph 11).

**ISA 500 – Audit Evidence**

**Sufficient Appropriate Audit Evidence**

6. The auditor shall design and perform audit procedures that are appropriate in the circumstances for the purpose of obtaining sufficient appropriate audit evidence.

**ISA 540 – Auditing Accounting Estimates, including Fair Value Accounting Estimates, and Related Disclosures**

**Risk Assessment Procedures and Related Activities**

8. When performing risk assessment procedures and related activities to obtain an understanding of the entity and its environment, including the entity's internal control, as required by ISA 315, the auditor shall obtain an understanding of the following in order to provide a basis for the identification and assessment of the risks of material misstatement for accounting estimates:

(a) The requirements of the applicable financial reporting framework relevant to accounting estimates, including related disclosures.

(b) How management identifies those transactions, events and conditions that may give rise to the need for accounting estimates to be recognized or disclosed in the financial statements. In obtaining this understanding, the auditor shall make inquiries of management about changes in circumstances that may give rise to new, or the need to revise existing, accounting estimates.

(c) How management makes the accounting estimates, and an understanding of the data on which they are based, including:

(i) The method, including where applicable the model, used in making the accounting estimate;

(ii) Relevant controls;

(iii) Whether management has used an expert;

(iv) The assumptions underlying the accounting estimates;

(v) Whether there has been or ought to have been a change from the prior period in the methods for making the accounting estimates, and if so, why; and

(vi) Whether and, if so, how management has assessed the effect of estimation uncertainty.

…

**Responses to the Assessed Risks of Material Misstatement**

13. In responding to the assessed risks of material misstatement, as required by ISA (UK and Ireland) 330, the auditor shall undertake one or more of the following, taking account of the nature of the accounting estimate:

    (a) Determine whether events occurring up to the date of the auditor's report provide audit evidence regarding the accounting estimate.

    (b) Test how management made the accounting estimate and the data on which it is based. In doing so, the auditor shall evaluate whether:

        (i) The method of measurement used is appropriate in the circumstances; and

        (ii) The assumptions used by management are reasonable in light of the measurement objectives of the applicable financial reporting framework.

    (c) Test the operating effectiveness of the controls over how management made the accounting estimate, together with appropriate substantive procedures.

    (d) Develop a point estimate or a range to evaluate management's point estimate. For this purpose:

        (i) If the auditor uses assumptions or methods that differ from management's, the auditor shall obtain an understanding of management's assumptions or methods sufficient to establish that the auditor's point estimate or range takes into account relevant variables and to evaluate any significant differences from management's point estimate.

        (ii) If the auditor concludes that it is appropriate to use a range, the auditor shall narrow the range, based on audit evidence available, until all outcomes within the range are considered reasonable.

…

**Further Substantive Procedures to Respond to Significant Risks**

*Estimation Uncertainty*

15. For accounting estimates that give rise to significant risks, in addition to other substantive procedures performed to meet the requirements of ISA (UK and Ireland) 330, the auditor shall evaluate the following:

    (a) How management has considered alternative assumptions or outcomes, and why it has rejected them, or how management has otherwise addressed estimation uncertainty in making the accounting estimate.

    (b) Whether the significant assumptions used by management are reasonable.

(c) Where relevant to the reasonableness of the significant assumptions used by management or the appropriate application of the applicable financial reporting framework, management's intent to carry out specific courses of action and its ability to do so.

…

*Recognition and Measurement Criteria*

17. For accounting estimates that give rise to significant risks, the auditor shall obtain sufficient appropriate audit evidence about whether:

(a) management's decision to recognize, or to not recognize, the accounting estimates in the financial statements; and

(b) the selected measurement basis for the accounting estimates, are in accordance with the requirements of the applicable financial reporting framework.

**Evaluating the Reasonableness of the Accounting Estimates, and Determining Misstatements**

18. The auditor shall evaluate, based on the audit evidence, whether the accounting estimates in the financial statements are either reasonable in the context of the applicable financial reporting framework, or are misstated.

**Disclosures Related to Accounting Estimates**

19. The auditor shall obtain sufficient appropriate audit evidence about whether the disclosures in the financial statements related to accounting estimates are in accordance with the requirements of the applicable financial reporting framework.

20. For accounting estimates that give rise to significant risks, the auditor shall also evaluate the adequacy of the disclosure of their estimation uncertainty in the financial statements in the context of the applicable financial reporting framework.

**<u>ISA 700</u> – The independent Auditor's Report on Financial Statements**

**Forming an Opinion on the Financial Statements**

8. The auditor's report on the financial statements shall contain a clear written expression of opinion on the financial statements taken as a whole, based on the auditor evaluating the conclusions drawn from the audit evidence obtained, including evaluating whether:

(a) Sufficient appropriate audit evidence as to whether the financial statements as a whole are free from material misstatement, whether due to fraud or error has been obtained;

(b) Uncorrected misstatements are material, individually or in aggregate. This evaluation shall include consideration of the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgments;

(c) In respect of a true and fair framework, the financial statements, including the related notes, give a true and fair view; and

(d) In respect of all frameworks the financial statements have been prepared in all material respects in accordance with the framework, including the requirements of applicable law.

9. In particular, the auditor shall evaluate whether:

(a) The financial statements adequately refer to or describe the relevant financial reporting framework;

(b) The financial statements adequately disclose the significant accounting policies selected and applied;

(c) The accounting policies selected and applied are consistent with the applicable financial reporting framework, and are appropriate in the circumstances;

(d) Accounting estimates are reasonable;

(e) The information presented in the financial statements is relevant, reliable, comparable and understandable;

(f) The financial statements provide adequate disclosures to enable the intended users to understand the effect of material transactions and events on the information conveyed in the financial statements; and

(g) The terminology used in the financial statements, including the title of each financial statement, is appropriate.

10. With respect to compliance frameworks an unqualified opinion on the financial statements shall be expressed only when the auditor concludes that they have been prepared in accordance with the identified financial reporting framework, including the requirements of applicable law.

11. With respect to true and fair frameworks an unqualified opinion on the financial statements shall be expressed only when the auditor concludes that they have been prepared in accordance with the identified financial reporting framework, including the requirements of applicable law, and the financial statements give a true and fair view.