IN THE MATTER OF:

The Executive Counsel to the Financial Reporting Council

and

(1) PricewaterhouseCoopers LLP

(2) Richard Hughes

Executive Counsel's Final Settlement Decision Notice pursuant to paragraph 108 of the Audit Enforcement Procedure

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

I. INTRODUCTION

1. The Financial Reporting Council (the "**FRC**") is the competent authority for statutory audit in the UK and operates the Audit Enforcement Procedure (the "**AEP**"), effective 5 January 2022. The AEP sets out the rules and procedure for the investigation, prosecution and sanctioning of breaches of Relevant Requirements.

2. The AEP contains a number of defined terms and, for convenience, those defined terms are also used within this document.

3. In this Final Settlement Decision Notice, "**FY17**" means the financial year ended 31 March 2017, "**FY17 financial statements**" means the consolidated financial statements of BT Group plc ("**BT**") for that period and "**FY17 Audit**" means the statutory audit of the FY17 financial statements. (Statutory audits of financial statements for earlier periods are described similarly.)

4. BT was required to prepare its consolidated financial statements in accordance with International Financial Reporting Standards as adopted by the European Union ("**IFRS**") and in compliance with the IFRSs as issued by the International Accounting Standards Board.

5. This Final Settlement Decision Notice is issued pursuant to paragraph 108 of the AEP in respect of the conduct of PricewaterhouseCoopers LLP ("**PwC**") and Richard

Hughes, a partner in PwC ("**Mr Hughes**") (together, the "**Respondents**") in relation to the FY17 Audit.

6. PwC was the Statutory Audit Firm for the FY17 Audit.

7. Mr Hughes was the audit engagement partner and Senior Statutory Auditor for the FY17 Audit, and on 11 May 2017 signed the independent auditors' report in relation to the FY17 financial statements for and on behalf of PwC. FY17 was Mr Hughes's first year as the audit engagement partner with responsibility for the audit of BT's financial statements.

8. The Respondents were required to act in accordance with the International Standards on Auditing (UK & Ireland) ("**ISAs**"). The provisions of the ISAs were all "*Relevant Requirements*" within the meaning of the AEP and the relevant provisions of the ISAs which applied during the material period are set out at Appendix 1.

9. On 16 June 2022 Executive Counsel issued a Proposed Settlement Decision Notice pursuant to Rule 103 of the AEP. On 21 June 2022 the Respondents provided written agreement to the Proposed Settlement Decision Notice. On 28 June 2022 the Independent Reviewer approved the Proposed Settlement Decision Notice.

10. Consequently, and in in accordance with Rules 104 and 108 of the AEP, this Final Settlement Decision Notice:

   10.1 outlines the breaches of Relevant Requirements with reasons;

   10.2 outlines Sanctions with reasons; and

   10.3 specifies an amount payable in respect of the Executive Counsel's costs of the matter.

11. This Final Settlement Decision Notice is structured as follows:

   11.1 This section I acts as introduction.

   11.2 Section II contains an executive summary of the breaches of Relevant Requirements.

   11.3 Section III sets out the background in relation to the key persons, accounting irregularities in BT Italy, and audit materiality.

   11.4 Section IV sets out certain accounting and auditing standards that are relevant in this case, and gives brief analyses or explanations of those standards.

   11.5 Section V sets out relevant facts in relation to BT's accounting and PwC's audit work.

11.6 Section VI sets out the breaches of Relevant Requirements.

11.7 Section VII sets out the appropriate Sanctions and an amount payable in respect of the Executive Counsel's costs.

II. EXECUTIVE SUMMARY

A. Breaches

12. In July 2016, BT discovered a fraud in its Italian operations. The scale of the fraud was such that, in the FY17 financial statements, BT disclosed adjustments of over half a billion pounds. These adjustments were made up of (i) corrections of prior-period errors of £268 million and (ii) changes in accounting estimates of £245 million (together, "**the BT Italy Adjustments**"). The prior-period errors were corrected by restating the prior-period comparatives in the FY17 financial statements. This was disclosed as a "*revision*" (as to which see paragraphs 51 ff below).

13. In the FY17 Audit, there was a need for special audit consideration of, and heightened professional scepticism about, BT's treatment of the BT Italy Adjustments, and in particular the amounts of the corrections of prior-period errors and changes in accounting estimates. This was for (*inter alia*) the following reasons:

13.1 First, International Accounting Standard 8 ("**IAS 8**") defined changes in accounting estimate and corrections of prior-period errors (and the distinctions between the two), prescribed the accounting treatment for each, and set out the disclosures required in the financial statements.

13.2 Second, on BT's analysis, prior-period errors represented approximately 50% of the BT Italy Adjustments by value. A member of PwC USA's regulatory advisory team had (i) noted this was lower than expected based on their general experience, (ii) noted that the BT Italy Adjustments categorised as changes in accounting estimates were very large compared with the size of BT Italy's operations and (iii) queried whether PwC's conclusions were fully supported by the evidence.

13.3 Third, in the 2017 Audit, PwC identified "*the results of the* [BT's] *investigation* [into the accounting irregularities at BT Italy]*, and the accounting treatment and disclosures"* as a significant risk.

13.4 Fourth, if (but only if) the errors were material in any prior period, a "*restatement*" would be required in respect of that prior period for US reporting purposes; and BT had stated the value of the errors to fall short of the materiality thresholds in all relevant years (2012 to 2016), and only just short (by £1 million) of the materiality threshold in 2016.

14. Two adjustments were treated as changes in accounting estimates (known as the "**Debt Adjustments**"), comprising two categories of bad debts that were together worth €91 million, or approximately £72 million at the 31 March 2016 exchange rate. (Audit materiality was £130 million.) In respect of the Debt Adjustments, notwithstanding the matters set out at paragraph 13 above, the Respondents:

14.1 did not act with the requisite professional scepticism;

14.2 did not obtain sufficient appropriate audit evidence; and

14.3 did not properly determine whether the changes in accounting estimates were appropriate.

15. Thus, in respect of the Debt Adjustments, the Respondents breached:

15.1 ISA 200 paragraph 15;

15.2 ISA 500 paragraph 6; and

15.3 ISA 540 paragraph 12.

16. Separately, the Respondents did not prepare audit documentation that was sufficient to enable an experienced auditor, having no previous connection with the audit, to understand the nature, timing and extent of the audit procedures performed in relation to the BT Italy Adjustments generally.

17. Thus, the Respondents breached ISA 230 paragraph 8.

B. Sanctions

18. The Executive Counsel imposes the following Sanctions against PwC:

(1) PwC

18.1 a financial sanction of £2,500,000 discounted for admissions and early disposal by 30% so that the financial sanction payable is £1,750,000;

18.2 a published statement, in the form of a Severe Reprimand, to the effect that PwC contravened the Relevant Requirements in the FY17 Audit; and

18.3 a declaration that the FY17 Audit did not satisfy the Relevant Requirements.

(2) Mr Hughes

19. The Executive Counsel imposes the following Sanctions against Mr Hughes:

19.1 a financial sanction of £60,000, discounted for admissions and early disposal by 30% so that the financial sanction payable is £42,000;

19.2 a published statement, in the form of a Severe Reprimand, to the effect that Mr Hughes contravened Relevant Requirements in the FY17 Audit; and

19.3 a declaration that the FY17 Audit report signed by Mr Hughes did not satisfy the Relevant Requirements.

III. BACKGROUND

A. Key persons

(1) BT

20. BT is a telecommunications business headquartered in the UK. BT has a primary share listing on the London Stock Exchange, is a constituent of the FTSE 100 index, and, in FY17, had a secondary share listing on the New York Stock Exchange. As a result of its secondary US listing, BT also had to comply with US reporting requirements. BT's Annual Report and Form 20-F contained one set of consolidated financial statements that were filed in order to meet both its UK and US reporting obligations.

21. BT was structured into a number of "*Lines of Business*", one of which was called "*Global Services*". Global Services supplied "*ICT* [Information and Communication Technology] *services to 5,500 multinational companies in 180 countries*", and included all of BT's overseas activities, including its Italian operations ("**BT Italy**"). In FY17, Global Services accounted for 23% of BT's revenue and 7% of BT's EBITDA.

(2) PwC

22. PwC (or its predecessor firm) was appointed to be BT's auditor in 1984.

23. On 11 May 2017, PwC (by Mr Hughes) signed an independent auditors' report, in which it gave an unmodified audit opinion on the FY17 financial statements.

(3) PwC personnel

24. Mr Hughes is a partner in PwC, and (as noted above) was the audit engagement partner and Senior Statutory Auditor for the FY17 Audit.

25. Person A was a partner in PwC and was "*the lead partner overseeing the work*" on the FY17 Audit in relation to (*inter alia*) BT Global Services.

26. Person B was a director at PwC and was involved in the work on the FY17 Audit in relation to BT Global Services. They spent a considerable amount of time in Italy as part of the FY17 Audit.

27. Person C was also a director at PwC and was also involved in the work on the FY17 Audit in relation to the BT group audit.

28. Person D was a partner in PwC USA's regulatory advisory practice, who was not part of the BT group audit team or involved in any of the detailed audit work but was a specialist in the rules and/or guidance published by the SEC.

B. Accounting irregularities in BT Italy

29. On 29 July 2016, BT "*received a whistle-blower report*", which was sent anonymously by email, disclosing that there were accounting irregularities in BT Italy.

30. On 13 October 2016, BT appointed an accountancy firm ("**Firm A**") to analyse the impact of the accounting irregularities at BT Italy ("**Project X**").

31. On 22 January 2017, Firm A issued its report in draft. In summary, Firm A found that there had been a serious breakdown of accounting processes and controls at BT Italy and that the accounting irregularities were the result of "*misrepresentation*" and "*fictitious transactions*"—i.e., fraud.

32. On 24 January 2017, BT announced to the market that the investigation into the financial position of BT 's Italian business was now substantially complete, and that the BT Italy Adjustments identified totalled around £530 million, but that BT was still evaluating what proportion of the total should be treated as corrections of prior year errors, and what proportion of the total should be treated as changes in accounting estimates.

33. On 27 January 2017, BT published its third-quarter results. The results contained the following narrative description:

> "*Total adjustments relating to the investigation of our Italian business amount to £268m for prior year errors, for which we've revised prior periods, and a specific item charge of £245m for changes in accounting estimates (£145m in Q2 and £100m in Q3).*"

34. In its annual report dated 11 May 2017, BT again disclosed that the financial impact of the accounting irregularities in BT Italy was made up of:

    34.1 £268 million of corrections of "*prior-period errors*"; and

    34.2 £245 million of "*changes in accounting estimates*".

35. Thus, in both January and May 2017, BT disclosed that the total financial impact of the accounting irregularities in BT Italy was £513 million.

C. Materiality

(1) Quantitative and qualitative materiality

36. Under ISA 320 paragraph 2, misstatements, including omissions, were to be considered material if they, individually or in the aggregate, could reasonably have been expected to influence the economic decisions of users taken on the basis of the financial statements. Judgments about materiality were to be made in light of surrounding circumstances, and could be affected by the size of a misstatement (quantitative materiality) or its nature (qualitative materiality), or a combination of both. Typically, quantitative materiality would be assessed by reference to thresholds or benchmarks set at the beginning on an audit.

(2) Quantitative materiality thresholds

37. In the BT group audits, quantitative materiality was set at:

37.1 £130 million for the FY17 Audit;

37.2 £130 million for the FY16 Audit;

37.3 £120 million for the FY15 Audit;

37.4 £110 million for the FY14 Audit; and

37.5 £100 million for the FY13 Audit.

IV. RELEVANT STANDARDS

A. Accounting standards

38. As noted above, the difference between prior-period errors and changes in accounting estimates was governed by IAS 8. In particular:

38.1 IAS 8 paragraph 5 defined prior-period errors in the following terms:

> "*Prior-period errors are omissions from, and misstatements in, the entity's financial statements for one or more prior periods arising from a failure to use, or misuse of, reliable information that:*
>
> (a) *was available when financial statements for those periods were authorised for issue; and*
>
> (b) *could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements.*
>
> *Such errors include the effects of mathematical mistakes, mistakes in applying accounting policies, oversights or misinterpretations of facts, and fraud*."

38.2 IAS 8 paragraph 5 defined changes in accounting estimates in the following terms:

> "*A change in accounting estimate is an adjustment of the carrying amount of an asset or a liability, or the amount of the periodic consumption of an asset, that results from the assessment of the present status of, and expected future benefits and obligations associated with, assets and liabilities. Changes in accounting estimates result from new information or new developments and, accordingly, are not corrections of errors*."

39. PwC's Manual of Accounting as it applied at the time of the FY17 Audit stated as follows:

> "*Determining whether or not there has been an error in a prior period requires that reliable information was available and could have reasonably been obtained at the time when the error was made. In some cases, it might be clear that reliable information was available. For example, management might overlook the available evidence, in the form of an invoice or creditor's statement, resulting in the under-accrual of a significant expense item. In other cases, it might be more difficult, especially if there has been a deliberate manipulation of results or fraud. This is because management might have deliberately suppressed or destroyed reliable information or created false and unreliable information in order to conceal or justify incorrect accounting.*
>
> *The errors in these cases would usually still qualify as prior-period errors even though management cannot quantify except by using relevant information that emerges in a future year and reconstruct the accounting records related to the earlier period in that future year. This is because, in many situations, reliable information would have existed in the prior periods, and a reasonable person, who was not involved in making the error, would have obtained and used that information (or, if it was already available, would not have suppressed or destroyed it)*."

40. In light of the above, in a case of fraud:

 40.1 The distinction between corrections of prior-period errors and changes in accounting estimates turns on the information that was or ought to have been available at the time. If, absent the suppression or destruction of information associated with the fraud, and on the basis of sufficient reliable information that in some cases may only become available in a future year, a reasonable accountant preparing or auditor auditing the financial statements would have reached a different conclusion from the one actually reached, there will be a prior-period error. Conversely, if a reasonable accountant preparing or auditor auditing the financial statements would in any event have reached the same conclusion as was actually reached, there will be no prior-period error, but there may need to be changes in accounting estimates to reflect the new information or developments that have come to light.

40.2 Given this distinction, audit procedures suitable for determining whether information that has come to the auditor's attention should result in a correction of a prior-period error or a change in an accounting estimate should require the auditor to:

(a) place itself into the position in which it was or ought to have been in the prior year; and

(b) ask itself what conclusions it would or ought to have reached from that position.

This may amount to a reperformance (or simulated reperformance) of the audit as it ought to have been in the prior year (using only the information that was or ought to have been available then). If the auditor reaches a different conclusion from the one actually reached, there will be a prior-period error; and if the auditor reaches the same conclusion as was actually reached, there will be no prior-period error, but there may need to be a change in an accounting estimate.

41. In short, the correct method of distinguishing between corrections of prior-period errors and changes in accounting estimates seeks to reconstruct what the accounts would have looked like absent the fraud, and treating the difference between those hypothetical accounts and the actual accounts as the prior-period error. In practice, this method involves significant judgement but nevertheless helps to achieve a reasonably accurate assessment of the (quantifiable) effect of the fraud.

B. Auditing standards

(1) Introduction

42. As the Senior Statutory Auditor responsible for the FY17 Audit, Mr Hughes was responsible for the overall quality of the FY17 Audit and the direction, supervision, and performance of the FY17 Audit in compliance with the professional standards and applicable legal and regulatory requirements. Accordingly, Mr Hughes is responsible for any established breaches of Relevant Requirements in relation to the FY17 Audit.

43. As the Statutory Audit Firm responsible for the FY17 Audit, PwC is responsible for any established breaches of Relevant Requirements on the part of its partners or employees.

44. Excerpts from the ISAs setting out those parts which are of particular relevance to the breaches of relevant requirements are set out below and at Appendix 1.

(2) ISA 200

45. ISA 200 paragraph 15 provided as follows:

> "*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*."

46. ISA 200 paragraph 13(l) defined the concept of "*Professional skepticism*" in the following terms:

> *"An attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence.*"

(3) ISA 230

47. ISA 230 paragraph 8 provided as follows:

> "*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.*"

(4) ISA 500

48. ISA 500 paragraph 6 provided as follows:

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

(5) ISA 540

49. ISA 540 paragraph 12 provided as follows:

> "*Based on the assessed risks of material misstatement, the auditor shall determine:* […]
>
> *(a) Whether management has appropriately applied the requirements of the applicable financial reporting framework relevant to the accounting estimate; and* […]
>
> *Whether the methods for making the accounting estimates are appropriate and have been applied consistently, and whether changes, if any, in accounting estimates or in the method for making them from the prior period are appropriate in the*

circumstances.

V. FACTS

A. Introduction

50. This section V is structured as follows:

    50.1 Section V.B describes the relevant aspects of BT's accounting and PwC's work leading up to BT's January 2017 market update and the release of BT's third-quarter results.

    50.2 Section V.C describes relevant aspects of PwC's audit work at the final stage (i.e., the year-end).

B. BT's accounting and PwC's work prior to BT's January 2017 market update and the release of BT's Q3 results

51. By January 2017, PwC had recognised that "*the debate on change in estimate vs error* [wa]*s going to be key*", and had identified that "*additional matters*"—including in particular the distinction between a "*restatement*" and a *revision*"—might need to be considered in relation to companies with shares listed in the United States. The terms "*restatement*" and "*revision*" are applicable to US financial reporting; both result in a "*restatement*" under IFRS of prior period financial information. However, a US "*restatement*" involves the withdrawal of financial statements previously filed in the US, whereas a US "*revision*" does not. The source of the relevant rules and/or guidance in the United States was called "*SAB 108*".

52. BT prepared a draft paper titled "*Project* [X] *Briefing Paper for Board Audit & Risk Committee*", dated 23 January 2017, which included BT's assessment (at that stage) of the potential split of the BT Italy Adjustments. The paper stated that work was ongoing to distinguish between "*errors and judgments*".

53. This draft paper was provided to Mr Hughes and Person A during the FY17 Audit, and was used as a basis to create two more formal papers prepared by BT. One of these was titled "*Assessment of materiality of errors identified in our investigation into our Italian business*" (the "**Errors Paper**").

54. On 23 January 2017, there was a telephone call which Mr Hughes, Person A, Person B, Person C, and Person D attended. PwC's note of that call records a discussion about the difference between a "*Restatement*" and a "*revision*" under "*SAB 108*".

55. Also, on 23 January 2017, there was a telephone call with two BT employees and BT's external legal counsel, Person A, Person C, and Person D. PwC's note of that call records a discussion about *"the difference between a revision and a restatement*" and whether BT's adjustments should be treated as corrections of prior-period errors or

changes in accounting estimates.

56. As noted at paragraph 32 above, on 24 January 2017, BT announced to the market that the investigation into the financial position of BT's Italian business was now substantially complete, and that the BT Italy Adjustments identified totalled around £530 million, but that BT was still evaluating the split of the adjustments between corrections of prior year errors and changes in accounting estimates.

57. On 25 January 2017, there was a "*technical panel*" meeting which Mr Hughes, Person A, Person B, and Person C attended. (A Technical Panel is a form of consultation within PwC to consider issues of major importance and to reach a collective decision on the appropriate course of action.) PwC's note of that meeting records that:

57.1 following the telephone call on 23 January 2017 and subsequent discussions with management and Person D, Mr Hughes updated the panel and explained that a "*revision*" (rather than a US "*restatement*") was "*the most appropriate outcome*" for the purposes of US reporting;

57.2 the technical panel was shown "*Numerical breakdowns detailing the impact of the potential restatement/revision*"; and

57.3 it was highlighted in discussion that the amounts being treated as corrections of prior-period errors were now larger than the amounts being treated as changes in accounting estimates, and that the latter would likely attract greater scrutiny from the FRC and SEC.

58. The same day, PwC sent BT information about SAB 108 and the distinction between a "*restatement*" and a "*revision*" for US reporting purposes. One of the principles articulated in the documents that PwC sent was that the distinction depended on the materiality of the prior-period errors.

59. On 25 January 2017, PwC prepared a working paper setting out PwC's initial views on BT's assessment of whether each adjustment should be treated as a change in accounting estimate or a correction of a prior-period error. Two of the adjustments stated to result in the largest changes in estimates (and both falling under the heading "*Trade and other receivables*") were:

59.1 "*Bad Debt Corporate (incl. Telecom Italia and government customers)*", which was stated to result in a change in estimate of €48 million (approximately £38 million at the 31 March 2016 exchange rate); and

59.2 "*Bad Debt SMB*", which was stated to result in a change in estimate of €43 million (approximately £34 million at the 31 March 2016 exchange rate) (the "**Debt Adjustments**").

60. On 26 January 2017, PwC produced a report to BT's board audit and risk committee (the "**BARC**") on "*Project* [X]*"*, in which PwC explained that:

60.1 if the prior-period errors were material in relation to any year's previously-issued financial statements, a "*restatement*" would be required under SAB 108;

60.2 if the prior-period errors were not material in relation to any year's previously-issued financial statements, but were cumulatively material in the current period, a "*restatement*" would not be required under SAB 108, but a "*revision*" would be required to the prior-period financial information in the company's next filing of the financial statements;

60.3 whilst noting that it would need to perform detailed testing of management's analysis, PwC concurred with management's assessments that the prior-period errors in this case were not material to any year's previously-issued financial statements, but the cumulative adjustment in the current year was material, meaning that a "*revision*" was required; and

60.4 PwC concurred with management's treatment recording the changes in accounting estimates in the current year.

61. As noted at paragraph 33 above, on 27 January 2017, BT announced its third-quarter results.

C. PwC's year-end audit work

(1) PwC's approach generally

62. ISA 315 defined a "*significant risk*" as "*an identified and assessed risk of material misstatement that, in the auditor's judgement, requires special audit consideration*". PwC identified Project X as giving rise to a significant risk, and in particular described the risk as arising from "*the results of the investigation and the accounting treatment and disclosures*".

63. On 11 May 2017, PwC finalised its "*significant matter*"[1] working papers relevant to Project X. One of those working papers, titled "*Impact of Project* [X]- *Adjustments*", considered the quantification of the BT Italy Adjustments, their classification as corrections of prior-period errors or changes in estimate, the completeness of those adjustments, and residual balance sheet risk. That working paper showed that:

63.1 PwC's approach *"focused on substantive auditing of the adjustments posted*

[1] In this context, the phrase "*significant matter*" appears to have been used to refer to a significant risk within the meaning of ISA 315.

by management (largely led by PwC Italy) including re-performing elements of their testing and the performance of independent audit work", with oversight from PwC's group audit team, and on the review of BT's classification of each adjustment as either a correction of a prior-period error or a change in accounting estimate; and

63.2 PwC's conclusion was that the amount representing corrections of prior-period errors was overstated by £45 million, an immaterial amount.

(2) The input from PwC's USA regulatory advisory team

64. As noted at paragraphs 54 and 55 above, PwC had the benefit of input from Person D, who had specific knowledge of and expertise in relevant rules and guidance on the approach to the distinction between corrections of prior-period errors and changes in accounting estimates for the purposes of US reporting. The conclusion of the discussion with Person D on 23 January 2017 recorded on the audit file (cited at paragraph 54 above) was that "*the breakdown was far from clear and further review was to be undertaken by the E*[ngagement]*T*[eam]".

65. It appears from later documentation that, during the calls on 23 January 2017 and/or discussions that took place subsequently, Person D continued to challenge PwC's conclusions. In very broad summary:

65.1 Person D took the view that PwC ought to assume that adjustments were corrections of prior-period errors unless it was clear that they should be treated as changes in accounting estimates.

65.2 Generally (and including in relation to the Debt Adjustments), Person D believed that the adjustments categorised as changes in accounting estimates were very large compared with the size of BT Italy's operations.

65.3 In relation to the Debt Adjustments, in particular, Person D queried whether BT's and PwC's conclusions were fully supported by the evidence.

(3) Consultations

66. On 21 and 27 April, and 2, 5, and 9 May 2017, there were "*technical panel*" meetings which Mr Hughes, Person A, Person B, and Person C variously attended. PwC's note of those meetings records substantial involvement by the "*The E*[ngagement]*T*[eam]" (i.e., the PwC group audit team in the UK) in the audit of the adjustments.

67. During its year-end audit work, PwC revisited the distinctions that had been drawn between prior-period errors and changes in accounting estimates, and reconsidered questions arising out of SAB 108. In the relevant working paper (which appears to be from 8 May 2017), PwC recorded the following:

67.1 management's analysis had not substantially changed since the third quarter;

67.2 PwC considered the "*prior year revision*" to be "*too conservative*" by approximately €50 million (£45 million);

67.3 if the prior-period errors were material in relation to any previously-issued financial statement, a "*restatement*" would be required;

67.4 if the prior-period errors were not material in relation to any previously-issued financial statement, a "*restatement*" would not be required, but a "*revision*" would be required if the impact in the current year was material; and

67.5 PwC concurred with management's assessments that the prior-period errors in this case were not material to any previously-issued financial statement, but the cumulative adjustment in the current year was material, meaning that a "*revision*" was required.

(The last three points effectively repeated conclusions drawn during PwC's interim work prior to the release of BT's Q3 results: see paragraph 60 above.)

68. A "*consultation memo*" (which took a form similar to that of the minutes of the "*technical panel*" meetings described above) dated 10 May 2017 and bearing "*Sign-off*" approval from Mr Hughes and a partner in PwC's accounting consulting services team (who was also the accounting consulting services specialist on the technical panels noted above) stated as follows:

68.1 The engagement team concurred with the views expressed at the "*technical panel*" meeting on 25 January.

68.2 The engagement team considered "*the prior year revision*" to be "*too conservative*" by approximately £45 million.

VI. BREACHES OF RELEVANT REQUIREMENTS

A. Breach 1: scepticism, audit evidence, and accounting estimates relating to the audit of the Debt Adjustments

(1) The need for special audit consideration

69. As noted at paragraph 62 above, PwC identified Project X as giving rise to a significant risk in the FY17 Audit, and in particular described the risk as arising from "*the results of the investigation and the accounting treatment and disclosures*". Therefore, the Respondents were required to subject the BT Italy Adjustments to special audit consideration as required by ISA 315.

(2) The need for heightened professional scepticism

70. As noted at paragraphs 32 to 34 above, the adjustments that BT made following its discovery of the accounting irregularities in Italy came to £513 million in total, and were made up of £268 million of corrections of prior-period errors and £245 million of changes in accounting estimates. Thus, the ratio of corrections of prior-period errors to changes in accounting estimates was approximately 50:50.[2] Mr Hughes recalled in interview that PwC USA's regulatory advisory team had noted that in its experience this was unusual. In principle, there might have been good reasons for the USA regulatory advisory team to take this view: a ratio of 50:50 suggested that the adjustment needed to correct the effects of a widespread fraud at BT Italy (i.e., the corrections of prior-period errors) was not significantly greater than the adjustments made to reflect changes in the business's outlook (i.e., the changes in accounting estimates).

71. As noted at paragraphs 51, 58, 60, and 67 above, reporting rules in the US meant that the financial reporting steps that BT would be required to take in response to the accounting irregularities in Italy depended on whether or not the errors were material to any prior period. Specifically:

71.1 if the errors were material in any prior period, a US "*restatement*" would be required in respect of that prior period;

71.2 if the errors were not material in any prior period, but were cumulatively material in the current period, a "*revision*" (consistent with a restatement under IFRS) would be required in respect of the relevant prior periods; and

71.3 if the errors were neither material to any prior period nor cumulatively material in the current period, any necessary correction could be made in the current period's accounts.

72. The three options set out above are in decreasing order of seriousness (a full US "*restatement*" being most likely to prompt an adverse market reaction, or the most adverse market reaction). Consequently, BT had an incentive to ensure that the errors were not material in any prior period.

73. The materiality thresholds applicable to the BT group audit for each year (noted at paragraph 37 above) and the value of the corrections of prior-period errors made by BT in relation to each year are set out in the table below.

Year ended 31 March	Materiality	Value in year	Cumulative value
2016	£130,000,000	£129,000,000	£268,000,000
2015	£120,000,000	£79,000,000	£139,000,000

[2] More accurately stated, the ratio was 52:48.

2014	£110,000,000	£26,000,000	£60,000,000
2013	£100,000,000	(£19,000,000)	£34,000,000
2012	£90,000,000	£53,000,000	£53,000,000

74. As the table above shows, although the total value of the prior-period errors was £268 million, in relation to no single year was the value of the corrections of prior-period errors stated to exceed the materiality threshold. In relation to 2016, the value of the corrections of prior-period errors was stated to be a mere £1 million below the materiality threshold. PwC had assessed that prior-period errors were overstated by £45 million (see paragraphs 63.2, 67.2, and 68.2 above). However, PwC did not identify the split of this overstatement by year.

75. In light of:

75.1 the fact that the distinction between corrections of prior-period errors and changes in accounting estimates was a matter of accounting standards, and in particular IAS 8 (see paragraphs 38 to 41 above);

75.2 Person D's comments (especially those to the effect that the changes in accounting estimates were very large compared with the size of BT Italy's operations and those querying whether PwC's conclusions were fully supported by the evidence) (see paragraphs 64 and 65 above);

75.3 the unusual ratio of corrections of prior-period errors to changes in accounting estimates in BT's figures (see paragraph 70 above);

75.4 the importance of the question whether the prior-period errors were material in any prior periods in a US reporting context (see paragraphs 71 and 72 above); and

75.5 the fact that the amounts of the prior-period errors (before the £45 million overstatement identified by PwC) were stated to be close to the relevant materiality thresholds in certain periods, at least in 2016 (see paragraphs 73 and 74 above),

the Respondents should, in relation to the Debt Adjustments, have adopted an attitude of heightened scepticism in its approach to auditing whether the amount of the prior-period errors in relation to each period (and especially 2016) was correct.

(3) The breaches

76. Despite the need for special audit consideration described in section VI.A(1) above and the need for heightened scepticism described in section VI.A(2) above, the Respondents did not consistently approach the Debt Adjustments with a questioning

mind, alert to conditions which might indicate possible misstatement, and did not consistently perform critical assessments of the audit evidence with which they had been provided. Possibly as a result, they did not obtain sufficient appropriate audit evidence in relation to the Debt Adjustments and did not properly determine whether the Debt Adjustments were appropriate (including under IAS 8). Specifically:

76.1 The Respondents were required to perform a thorough analysis of each adjustment, taking into account the requirements of IAS 8, with significant input from senior members of the audit team. The evidence shows that in respect of the Debt Adjustments the Respondents did not do this.

76.2 The Respondents did not adequately respond to Person D's comments. In particular:

(a) There is no evidence that any adequate "*further review*" described at paragraph 64 above took place.

(b) There is no evidence that the Respondents adequately took into account Person D's view (described at paragraph 65.1 above) that the adjustments should have been treated as corrections of prior-period errors unless it was clear that they should be treated as changes in accounting estimates.

(c) There is no evidence that the Respondents adequately took into account Person D's view (described at paragraph 65.2 above) that the changes in accounting estimates in this case were very large for the size of BT Italy's operations.

(d) In its response to Person D's comments on the Debt Adjustments (described at paragraph 65.3 above), PwC wrote, "*there is no indication that Group management's historical decisions on accounts receivable provisions were based on false information*". This statement is difficult to reconcile with the fact that there had been a fraud, and there is no reasoning or evidence to support it. For the avoidance of doubt, the Executive Counsel has not made a finding that the Debt Adjustments were a consequence of fraud and should have been treated as prior-period errors.

(e) The result of this was that the Respondents' approach to the Debt Adjustments was insufficiently rigorous, did not involve appropriate challenge of management, did not result in the gathering of audit evidence of such quality and in such amount on the group audit file as was necessary under the Relevant Requirements, and did not involve a proper determination of whether the Debt Adjustments were appropriate (under IAS 8 or in the circumstances generally).

77. Thus, the Respondents:

77.1 did not subject BT's assessment of the Debt Adjustments, and in particular BT's approach to distinguishing between corrections of prior-period errors and changes in accounting estimates for the Debt Adjustments, to adequate scrutiny or critical assessment, and did not approach this aspect of the audit with the requisite professional scepticism, and so **breached ISA 200 paragraph 15**;

77.2 did not perform audit procedures that were appropriate in the circumstances for the purpose of obtaining sufficient appropriate audit evidence in relation to the Debt Adjustments, and so **breached ISA 500 paragraph 6**; and

77.3 did not properly determine:

(a) whether management had applied IAS 8 consistently and appropriately in its treatment of the Debt Adjustments; or

(b) whether the Debt Adjustments were appropriate in the circumstances,

and so breached **ISA 540 paragraph 12**.

B. Breach 2: documentation in relation to BT Italy Adjustments

78. The overall responsibility for auditing the split between corrections of prior-period errors and changes in accounting estimates lay with PwC's group audit team in the UK. As set out at paragraph 63.1 above, PwC noted in its "significant matter" working papers that "*[o]ur approach has focused on substantive auditing of the adjustments posted by management (largely led by PwC Italy), including re-performing elements of their testing and the performance of independent audit work*." As group auditor, PwC UK was required to produce and maintain a file that contained a record of how and why it came to its conclusions in relation to the split between corrections of prior-period errors and changes in accounting estimates.

79. In fact, however, the group audit file did not contain a sufficiently detailed record of how and why PwC's group audit team in the UK came to its conclusions in relation to the split. This issue affected PwC's work on the BT Italy Adjustments (that is, not only the Debt Adjustments).

80. Thus, the Respondents did not prepare audit documentation that was sufficient to enable an experienced auditor, having no previous connection with the audit, to understand, in relation to the split between corrections of prior-period errors and changes in accounting estimates, the nature, timing and extent of the audit procedures performed, the results of those procedures and the audit evidence obtained, or the conclusions reached, including significant professional judgments made in reaching such conclusions, and so **breached ISA 230 paragraph 8**.

VII. SANCTIONS AND COSTS

A. Sanctions

81. Paragraph 10 of the FRC's Sanctions Policy (Audit Enforcement Procedure) (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:

81.1 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;

81.2 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 of the accountancy profession;

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

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

82. 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.

83. In reaching a decision on the Sanctions, the Executive Counsel has followed the reasoning set out below in accordance with the Policy. Where any element of the reasoning is specific to one Respondent alone, this is made clear. Otherwise, each element of the reasoning applies to each Respondent.

(1) Nature, seriousness, gravity and duration of the breaches

84. The breaches of Relevant Requirements in this case concern the Respondents' audit of adjustments disclosed by BT in its FY17 financial statements, which were made further to the identification of a fraud at BT Italia. The BT Italy Adjustments amounted

to £513 million in total, being made up of £268 million of corrections of prior-period errors and £245 million of changes in accounting estimates, of which the Debt Adjustments accounted for £72 million.

85. BT was one of the largest FTSE 100 companies with group revenue of c.£24 billion in 2017. There is an obvious public interest in ensuring that such entities are subject to robust audit. PwC had identified Project X (specifically, the results of the investigation and the accounting treatment and disclosures) as one of nine significant risks. There was therefore a need for the Respondents to give special audit consideration and apply heightened professional scepticism about BT's treatment of the adjustments given the factors set out at paragraph 12 above.

86. The breaches of Relevant Requirements in this case include the Respondents' failures:

86.1 to act with the requisite professional scepticism in respect of BT's assessment of the Debt Adjustments;

86.2 to obtain sufficient appropriate audit evidence in relation to the Debt Adjustments;

86.3 to properly determine whether the changes in accounting estimates were appropriate in relation to the Debt Adjustments; and

86.4 to prepare audit documentation in relation to the split between corrections of prior-period errors and changes in estimates that was sufficient to enable an experienced auditor, having no previous connection with the audit, to understand the nature, timing and extent of the audit procedures performed in relation to the adjustments generally.

87. These are important standards many of which go to the heart of a robust audit. Breaches of such standards of this type and in the way outlined in this Final Settlement Decision Notice could undermine the confidence in (i) the standards of conduct in general of statutory auditors and statutory audit firms, and (ii) statutory audit. They could also harm investor, market, and public confidence in the truth and fairness of the financial statements published by statutory auditors or statutory audit firms.

88. The breaches had the *potential* to cause loss to a significant number of people in the United Kingdom. For the avoidance of doubt, the Executive Counsel has not alleged or found that there was in fact such loss.

89. The Executive Counsel recognises that PwC has implemented certain remedial measures following the FY17 Audit.

90. The breaches of Relevant Requirements relate to only one audit year and occurred in the context of a very large audit, of which the audit of adjustments was one, albeit

significant, element. The most serious breaches relate to only one category of the adjustments (the Debt Adjustments), albeit the Executive Counsel has made the finding of documentary failings in relation to PwC's work on the BT Italy Adjustments generally. However, the Debt Adjustments were less than overall materiality and the Executive Counsel does not make any findings that the overall amount of the adjustments was incorrect.

91. It is not suggested that the breaches were intentional, dishonest, deliberate or reckless.

92. The audit fee for the engagement was £4.3 million. The Respondents did not derive or intend to derive any specific financial benefit from the breaches.

93. PwC has been sanctioned four times since 2018:

93.1 In May 2018, a financial sanction of £10 million (reduced to £6.5 million on settlement) and a severe reprimand were agreed for Misconduct in relation to PwC's audit of Taveta / BHS for FY2014.

93.2 In May 2019, a financial sanction of £6.5 million (reduced to £4.55 million on settlement) and a severe reprimand were agreed for breaches of Relevant Requirements in relation to PwC's audit of Redcentric plc for FY2015 and FY2016.

93.3 In December 2021, a financial sanction of £3.35 million (reduced to £1,959,750 on settlement) and a severe reprimand were agreed for breaches of Relevant Requirements in relation to PwC's audit of Kier Group plc for FY2017.

93.4 In March 2022, a financial sanction of £5.5 million (reduced to £3,038,750 for settlement) and a severe reprimand were agreed for breaches of Relevant Requirements in relation to PwC's audits of Galliford Try for FY2018 and FY2019.

94. Mr Hughes does not have any record of disciplinary findings against him.

95. Mr Hughes did not cause or encourage other individuals to breach the Relevant Requirements.

(2) Identification of Sanction

96. In 2020, PwC was the largest audit firm in the United Kingdom with revenue of £3,478 million (of which £754 million was for audit). PwC's total audit fee for the FY17 Audit was £4.3 million.

97. Having assessed the nature, seriousness, gravity and duration of the breaches, the

Executive Counsel has identified the following combination of Sanctions as appropriate for PwC:

97.1 a financial sanction of £2,500,000;

97.2 a published statement, in the form of a Severe Reprimand, to the effect that PwC contravened Relevant Requirements in the FY17 Audit; and

97.3 a declaration that the FY17 Audit did not satisfy the Relevant Requirements.

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

98.1 a financial sanction of £60,000;

98.2 a published statement, in the form of a Severe Reprimand, to the effect that Mr Hughes contravened Relevant Requirements in the FY17 Audit; and

98.3 a declaration that the FY17 Audit report signed by Mr Hughes did not satisfy the Relevant Requirements.

(3) Aggravating and mitigating factors

99. The Executive Counsel has then considered whether there are any aggravating or mitigating factors that have not already been taken into account above and has concluded that there are no such factors.

(4) Deterrence

100. Having considered the matters set out at paragraphs 72 and 73 of the Policy, the Executive Counsel does not consider that any adjustment for deterrence is required in this case.

(5) Discount for admissions and settlement

101. Having taken into account the admissions by the Respondents and the stage at which those admissions were made (at a point within Stage 1 of the case in accordance with paragraph 84 of the Policy), the Executive Counsel determines that a discount of 30% is appropriate.

(6) Financial sanctions payable

102. Having taken account of the discounts to be applied to reflect (i) the balance of aggravating and mitigating factors; and (ii) early admissions and settlement, a financial sanction of £1,750,000 is payable by PwC and £42,000 by Mr Hughes. These sums

are to be paid no later than 28 days after the date of this Final Settlement Decision Notice.

(7) Other considerations

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

B. Costs

104. The Executive Counsel proposes that the Respondents pay the costs of this matter, amounting to £665,000. Such costs shall be paid no later than 28 days after the date of this Final Settlement Decision Notice.

Signed:

……………………………..

CLAUDIA MORTIMORE

DEPUTY EXECUTIVE COUNSEL

Date: 28 June 2022

APPENDIX 1 – EXTRACTS OF RELEVANT REQUIREMENTS AND APPLICABLE ACCOUNTING STANDARDS

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 *(Effective for audits of financial statements for periods ending on or after 15 December 2010)*

Definitions

13. For purposes of the ISAs (UK), the following terms have the meanings attributed below:

…

(l) Professional skepticism – An attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence.

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 230 – Audit Documentation *(Effective for audits of financial statements for periods beginning on or after December 15, 2009)*

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 315</u> – Identifying and Assessing the Risks of Material Misstatement through understanding the Entity and its Environment *(Effective for audits of financial statements for periods beginning on or after December 15, 2009)*

Definitions

4. For purposes of the ISAs, the following terms have the meanings attributed below:

…

(e) Significant risk – An identified and assessed risk of material misstatement that, in the auditor's judgment, requires special audit consideration

<u>ISA 320</u> – Materiality in Planning and Performing an Audit *(Effective for audits of financial statements for periods beginning on or after December 15, 2009)*

Materiality in the Context of an Audit

2. Financial reporting frameworks often discuss the concept of materiality in the context of the preparation and presentation of financial statements. Although financial reporting frameworks may discuss materiality in different terms, they generally explain that:

   - Misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements;

   - Judgments about materiality are made in light of surrounding circumstances, and are affected by the size or nature of a misstatement, or a combination of both; and

   - Judgments about matters that are material to users of the financial statements are based on a consideration of the common financial information needs of users as a group.2 The possible effect of misstatements on specific individual users, whose needs may vary widely, is not considered.

<u>ISA 500</u> – Audit Evidence *(Effective for audits of financial statements for periods beginning on or after December 15, 2009)*

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 *(Effective for audits of financial statements for periods beginning on or after December 15, 2009)*

Responses to the Assessed Risks of Material Misstatement

12. Based on the assessed risks of material misstatement, the auditor shall determine:

(a) Whether management has appropriately applied the requirements of the applicable financial reporting framework relevant to the accounting estimate; and

(b) Whether the methods for making the accounting estimates are appropriate and have been applied consistently, and whether changes, if any, in accounting estimates or in the method for making them from the prior period are appropriate in the circumstances."

International Accounting Standard ("IAS")

IAS 8 – Accounting Policies, Changes in Accounting Estimates and Errors *(applied for annual periods beginning on or after 1 January 2005)*

Definitions

5. … *A change in accounting estimate* is an adjustment of the carrying amount of an asset or a liability, or the amount of the periodic consumption of an asset, that results from the assessment of the present status of, and expected future benefits and obligations associated with, assets and liabilities. Changes in accounting estimates result from new information or new developments and, accordingly, are not corrections of errors.

… *Prior period errors* are omissions from, and misstatements in, the entity's financial statements for one or more prior periods arising from a failure to use, or misuse of, reliable information that:

(a) was available when financial statements for those periods were authorised for issue; and

(b) could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements.

Such errors include the effects of mathematical mistakes, mistakes in applying accounting policies, oversights or misinterpretations of facts, and fraud.