

THE FRC'S DECISION TO CLOSE THEIR INVESTIGATION INTO KPMG'S AUDIT OF HBOS PLC

FINAL BRIEFING PAPER FOR MS. NICKY MORGAN AND THE TREASURY SELECT COMMITTEE

JUNE 2018 ?

1. Introduction

1.1 On 4th October 2017, we provided Ms Nicky Morgan and The Treasury Select Committee with a detailed paper entitled "The FRC's decision to close their investigation into KPMG's Audit of HBOS plc and the FCA's decision not to publish their full investigation report into the alleged wrongdoing by RBS' Global Restructuring Group".

1.2 In relation to the first item, we submitted that the TSC should not accept the FRC's decision to close their investigation into KPMG's audit of HBOS without further inquiry for the following key reasons:-

- It did not meet the earlier requirements laid down by the TSC when Chaired by Andrew Tyrie and communicated in publicly available correspondence to the FRC. In particular, its scope and terms of reference were too narrow and it had not been subjected to independent oversight as had been required by Andrew Tyrie and the TSC. It thus did not follow the process as was implemented in relation to the FSA's investigation into the failure of RBS and the PRA / FCA's investigation into HBOS.
- The FRC's responses to the continuous demands to conduct a detailed investigation into KPMG's audit of HBOS (from the report of The Parliamentary Commission on Banking Standards as well as the report of the PRA / FCA into the failure of HBOS as well as the TSC's own demands) appear to many observers as to be disingenuous and intended to avoid proper independent scrutiny.
- The FRC applied a new definition of "Misconduct" requiring acts or omissions to fall "**...significantly short of the standards reasonably to be expected**". This was a much higher threshold than the original standard which should have been applied in relation to accounts drawn up for the year ending 31/12/2007 which required acts or omission merely to fall "**...short of the standards reasonably to be expected**".

- Under the earlier scheme adopted on 13 May 2004 as amended on 13 September 2007, the grounds for investigation and disciplinary proceedings is set out in section 5.1. which states:-

“5(1) A Member or Member Firm shall be liable to investigation under this Scheme only where, in the opinion of the Board:-

(i) (a) the matter raises or appears to raise important issues affecting the public interest in the United Kingdom; and

*(b) the matter needs to be investigated to determine whether there **may have been** an act of misconduct...”*

[As explained “act of misconduct” in this earlier scheme is defined as follows:-

*“**act of misconduct** means any Member’s or Member Firm’s conduct in the course of his or its professional, business or financial activities (including as a partner, member, director or employee in or of any organisation or as an individual), **which falls short of the standards reasonably to be expected** of a Member or Member Firm.”*

- The new test was only introduced in July 2013 and appeared to many commentators as an extraordinary move in the circumstances. Some said that there was an inference that it deliberately changed to make it more difficult to launch and detailed investigation.
- It is also important to note that, in the 2013 definition of “Misconduct”, there is an alternative basis on which an investigation should be launched – see the full definition below and, in particular, the section over lined in yellow:-

Misconduct

4.24 The definition of “Misconduct” which has applied since July 2013 is:

*“an act or omission or series of acts or omissions by a Member or Member Firm in the course of his or its professional activities (including as a partner, member, director, consultant, agent, or employee in or of any organisation or as an individual) or otherwise, **which falls significantly short of the standards reasonably to be expected** of a Member or Member Firm **or has brought, or is likely to bring, discredit to the Member or the Member Firm or to the accountancy profession.**” [Emphasis added.]*

- The FRC did not and could not have adequately considered all the evidence available in numerous material respects and from numerous sources that would have supported the opposite conclusion to the one the FRC arrived i.e. that an investigation should be launched.

- We will not re-state the key evidence to which we drew your attention in our earlier detailed paper but would draw your attention to one item of evidence to which we did not refer and which is of considerable importance. This relates to the work carried out during the standard supervisory activities of the FRC by the department called “The Audit Inspection Unit” relating to the auditing of banking. This only became subject to public scrutiny in [??] when they became required to report publicly on their findings. Without going into any specific detail, it is fair to say that the AIU’s work generally and specifically in relation to KPMG concluded that they considered the majority auditing of banks from [??] to [??] to be sub-standard and requiring improvements in many key respects and in some cases requiring significant improvements. We can provide specific details of these findings in summary form if the TSC requires it.
- The FRC was riddled with potentially serious internal conflicts of interest which made any decision not to launch a detailed disciplinary investigation fail to meet the maxim – “Justice must not only be done but must be seen to be done”.

1.3 Throughout this long and arduous saga to get to the truth and justice in relation to this matter of public and political importance, the FRC have adopted the standard explanation / excuse which can be summarised as follows – “We would have liked to have done something but our hands are tied because we don’t have the powers we need. But, it’s alright now because we are changing the rules and all will be well in the future.” This has been the standard explanation of all regulators following the banking crisis.

1.4 In our view, there will never be any closure on this matter and, in particular the development of appropriate new regulatory policy by government until any further investigatory work into KPMG’s audit of HBOS is carried out by alternative and expert FRC staff whose work covers the appropriate scope and terms of reference and which is subjected to the most rigorous and competent independent oversight and which is fully transparent to public and media scrutiny and comment. It will only be by examining the past thoroughly that appropriate new policy and regulation can be developed to avoid the same debacles happening again.

1.5 Accounting and auditing is at the very heart of effective corporate governance and risk management of our largest public limited companies which form the back-bone of our economy and the shares of which form part of almost every ordinary constituent’s pensions. It **MUST** be carried out to the appropriate standards and regulated as such if the public and the markets are to have confidence in it. Without this, we will continue to have appalling scandals such as the latest one relating to Carillion where, yet again, KPMG’s role as the auditor is rightly being called into question.

The key question which needs to be answered by proper scrutiny is – “Do these large audit firms carry out their professional duties in the public interest or in their own and their clients’ interests?”

1.6 Taking into account all the above, this made it appear to us and other informed commentators that the FRC’s decision not to investigate KPMG was yet another example of a regulator exercising “cognitive dissonance” i.e. marshalling the evidence towards the conclusion to which they had originally arrived (because that suited their agenda) – or putting it another way in the vernacular – “squeezing a square peg into a round hole”.

1.6 Finally, in this introduction to this latest paper, we have reviewed the FRC’s paper called “The FRC’s enquiries and investigation of KPMG’s 2007 and 2008 audits of HBOS” and submit there to be numerous points that can be made to rebut its conclusion that no further detailed investigations should be carried out into KPMG’s audits of HBOS.

2. The purpose of this Final Submission Paper

2.1 The purpose of this paper is to make submissions to the TSC as to the next steps it could take in relation to this matter.

3. Proposed step 1

.....

PREAMBLE: “Another Regulator - a case of déjà vu?..... the Financial Reporting Council!”

The TIMES reported on Monday 16 October 2017 that “MPs have demanded an explanation over the HBOS decision and the FRC has promised a response this month. However, **Sir Win Bischoff, its chairman, has already defended it, saying that decisions have to be taken on available evidence, “not on Political considerations or public clamour”** .

While Mr Stephen Haddrill, the FRC CEO, stated in his speech at a Developments in Audit event on the 25 October 2017 that **“Since we closed our investigation into the audit of HBOS, our enforcement approach has been questioned by some. We will shortly be publishing a paper on what we did and what we found in detail.”**

FRC – HBOS Chronology

In 2009 the FRC told the TSC that their enquiries had not shown evidence of an audit failure.

In late 2010 the FRC repeated that opinion to the House of Lords Economic Affairs Committee. However, notably elsewhere in their submissions the FRC stated that they did not have the appropriate powers and the FRC structure was wrong – Report para 108 – 110.

In October 2011 the BIS/FRC launched a Consultation which one would expect would ensure that the FRC now had all the investigation and powers they needed to do their regulatory and enforcement role. Naturally one of course is left wondering how the FRC could have come to the prior conclusions to Parliament without the necessary evidence and powers.

In April 2013 with the publication of the **PCOBS report on HBOS** the FRC issued a Press release stating that their investigations had again shown no evidence of an audit failure but would stay close to the FCA/PRA on going inquiry.

Subsequently with the publication of the final **FCA/PRA report in November 2015** the FRC finally stated the narrow scope of that 2012/2013 FRC investigation. *“The FRC has carried out a review of the audit work performed on loan loss provisions in the Bank’s Corporate Division, in response to the concerns raised by the PRA/FCA, the Parliamentary Commission on Banking Standards and the public at large.”* Even within this narrow scope, in addition to their auditor responsibilities under the Companies Act 2006 sections 393, 92, 386 ,498 ; the FCA/PRA report records (at paragraph 1181) that HBOS had also engaged KPMG to carry out a review of Corporate’s collective provisioning model, following a request by the FSA.....so....

Way back on **2 December 2010** the **Financial Services Authority (FSA)**, prior to its demise, issued a less than 300 word public statement in which it announced that the **FSA had completed its Supervisory inquiry into RBS** and *“The issues we investigated do not warrant us taking any enforcement action, either against the firm or against individuals. [...] The FSA cannot publish the content of the RBS review as information gathered from the bank during the course of the review remains confidential under the Financial Services and Markets Act 2000 (FSMA).*

Two years later, after the imposition of independent assessors by the TSC in March/May 2011, the FSA finally published its report on 19 October 2012 “The FSA’s report into the failure of RBS”.

Whilst for HBOS plc the Parliamentary Commission on Banking Standards (PCBS) produced its report on HBOS – An Accident waiting to happen on 4 April 2013. This was also chaired by TSC Chairman Mr Andrew Tyrie MP. This 2013 report examined why HBOS failed and the implications of its failure for culture and standards in UK banking. It also identified a number of issues which it expected the subsequent regulatory FCA / PRA report on “The failure of HBOS plc” to expand upon.

That FCA/PRA Report and its separate Report on Enforcement Actions, with independent oversight by TSC, was finally published in November 2015 and found amongst many other things that

“In its supervision of HBOS, the FSA failed to establish an appropriate standard of safety and soundness.” ...and ...“Prior to the Review Period, the FSA had identified a number of the key risks that would ultimately contribute to the firm’s failure. Nevertheless, the FSA subsequently failed to take appropriate steps to mitigate these risks effectively, thus indicating deficiencies in the FSA’s prevailing approach to the supervision of systemically important firms. Supervisors need to employ their judgement and take appropriate actions in response where necessary. A particular challenge is to intervene sufficiently early when a firm is apparently successful but supervisors can identify weaknesses that are sufficiently important to pose a threat to the firm that is inconsistent with the objectives of supervision. HBOS was such a firm.”

So turning to the Financial Reporting Council (FRC), as regulator for accounting and auditors KPMG, (5 years after HBOS Plc failure) it published a statement on 10 April 2013

Statement following Parliamentary Commission on Banking Standards report into failure of HBOS

The FRC will consider the report from the Parliamentary Commission on Banking Standards and the forthcoming PRA report to identify whether there is a case for an investigation under our powers.

As the FRC and government made clear during the reform process, the FRC is committed to robust, rigorous and timely action.

We are in touch with the PRA about their work as it develops. The FCA and PRA have access to information from companies’ books and records that we could not obtain under our powers and therefore it is necessary for us to work closely with them to build a full picture.

If there is evidence that financial statements were misleading, and there were deficiencies in the audit, we would take this as a basis to launch an investigation into potential misconduct under our powers.

As we told the Treasury Select Committee in 2009, our enquiries had not shown evidence of an audit failure. We gave further evidence on this to the House of Lords Economic Affairs Committee.”<2011>

In light of this reported statement by the Chairman in October 2016 “that decisions have to be taken on available evidence, not “on Political considerations or public clamour”and the FRC press release above it is insightful to read that House of Lords Select Committee on Economic Affairs (document 22) in 2011 report where at paragraphs 108 and 109 records

108. "The FRC also wants more power to conduct preliminary investigations. Mr Haddrill said: "At the moment it's quite difficult for us to conduct a comprehensive investigation into whether or not there has been an audit failure, if we don't have some real hard evidence of that being available. We have very limited powers to call into account and to question directors, for example, unless they happen to be accountants. So we find it quite hard to get a thorough review of whether something has gone wrong and would like our investigatory powers to be strengthened in that respect."^[142] and then on

109. The FRC argues for these changes on the grounds that too many audits seen by its Audit Inspection Unit (AIU)—which monitors the audits of all organisations in whose financial condition there is considered to be a major public interest—are substandard.^[143]

So did the FRC get the powers and all the evidence they require for their investigations following the BIS/FRC Consultation on the Reform of the FRC in late 2011/2012. See Part D. What we do know

is that for a second time an FRC statement following PRA/FCA 2015 report on HBOS
19 November 2015 PN 68/15

"The Financial Reporting Council (FRC) has continued to liaise with the PRA/FCA review team in the course of its review of HBOS. As its work developed, the PRA/FCA requested that the FRC consider whether there are grounds to investigate KPMG in relation to their audits of HBOS for the financial years ended 31 December 2007 and 2008, and by extension any of HBOS' senior management who are members of a professional body overseen by the FRC, under its disciplinary arrangements.

The FRC has carried out a review of the audit work performed on loan loss provisions in the Bank's Corporate Division, in response to the concerns raised by the PRA/FCA, the Parliamentary Commission on Banking Standards and the public at large. The review primarily focussed on whether there are reasonable grounds to suspect that there may have been misconduct in the application of the relevant accounting and auditing standards at the time. Based on the findings from this review of the relevant audit work the Conduct Committee of the FRC has concluded that there were not reasonable grounds to suspect that there may have been misconduct as defined under the disciplinary scheme for members of the accounting profession. The FRC will review the full report to ascertain whether it contains any relevant new information."

whilst now for the third time (at least) the FRC on 19 September 2017 published this

"The Financial Reporting Council ('FRC') announces the closure of its investigation into the conduct of KPMG's audit of HBOS plc for the year ended 31 December 2007.

The Executive Counsel to the FRC has, following a detailed investigation, concluded that there is not a realistic prospect that a Tribunal would make an Adverse Finding against KPMG in respect of the matters within the scope of the investigation. The firm's work did not fall significantly short of the standards reasonably to be expected of the audit, the test that a Tribunal would apply.

The investigation related to the extent to which KPMG, during the course of their audit of HBOS plc:

- *considered the appropriateness of management's use of the going concern assumption in the preparation of the financial statements for the year ended 31 December 2007; and*
- *considered whether there were material uncertainties about the entity's ability to continue as a going concern that needed to be disclosed in the financial statements.*

In early 2008 HBOS concluded that its financial statements for the year ended 31 December 2007 should be prepared on a "going concern" basis. HBOS did not expect market conditions to worsen and judged that it would be able to fund itself. The auditor considered and accepted this conclusion. HBOS published its audited financial statements in February 2008 on that basis. The evidence of market conditions at that time did not show this decision of HBOS or the auditor's assessment of it to be unreasonable at the time. The extreme funding conditions which arose in October 2008 were not anticipated.

The FRC conducted a thorough investigation, liaising with other regulators with knowledge of the relevant events, and obtaining expert advice from independent and experienced lawyers and audit professionals.

The FRC will publish in October a report on its actions in audit and corporate reporting developments since the financial crisis, including on the audits of banks."

We noted with interest and agreement the prior Daily Telegraph reporting on 14 December 2015

Accounting watchdog accused of flunking HBOS probe

The Financial Reporting Council's decision not to investigate KPMG over its audits in the run-up to the collapse of HBOS was made prematurely and before the evidence was available, MPs are told

HBOS crashed in 2008, and MPs want regulators to look more thoroughly into the way KPMG audited the bank

The decision not to investigate KPMG over its audits in the run-up to the collapse of HBOS was made prematurely and before the evidence was available, it has been claimed.

The Financial Reporting Council (FRC) decided two years ago [not to investigate audits that had been carried out by KPMG](#) in the months before the spectacular failure of HBOS in 2008 had made it the symbol of the financial crisis in the UK.

According to officials appointed by MPs to oversee [last month's long-awaited reports into the collapse of HBOS](#), that decision by the FRC was premature.

"The FRC made their decision to not make a referral before they received the final letter [from regulators investigating the bank's failure] and before they received the bundle of information from the review team from the actual report ... in November 2013," said Stuart Bernau, the former head of Chelsea Building Society who was hired by the Treasury select committee to look into the process.

His colleague Ian Cornish, the chairman of Shawbrook Bank and ex-chief executive of the Yorkshire Building Society, agreed.

He said that the FRC received some documentation from regulators but did not discuss it further with officials, or show signs of further interrogation, for example by asking for more documents.

"It struck us as quite shocking, a lack of curiosity, given it was a situation of such obvious public interest," Mr Cornish said. Treasury select committee chairman [Andrew Tyrie MP said he was "flabbergasted" by the revelations.](#)