**Attention of UK Treasury Select Committee - Monday 7 December 2015 re HBOS and FRC/audit**

# REQUEST TO INVESTIGATE KPMG'S AUDIT FAILURE, BACKED UP BY INDEPENDENT RESEARCH EVIDENCE

## 1. Background – Paul Moore email dated 23 November 2015 following HBOS report

From: Paul Moore
Sent: 23 November 2015 16:15
To: 'tyriea@parliament.uk'
Cc: Sikka, Prem; Dr. Atul K. Shah; Tony Shearer; Brian Little; Ian Fraser

Dear Andrew,

**Well done** in ensuring that the PRA/FCA report into "The failure of HBOS plc" was completed with such a high degree of detail and to such high degree of quality. It is perfectly clear that the appointment of the independent overseers including Andrew Green QC made a huge difference as explained in their own report.

I know that many media commentators pooh-poohed the report as if it would make no difference but, in my view, they were wrong to do so. The devil is in the detail and the detail is in the report. Obviously, some of the thunder of the report was taken away by the earlier input from The Parliamentary Commission on Banking Standards and this may be the reason for the rather ambivalent response.

From the enforcement perspective, it seems to my team and me that there is really no necessity for the FCA/PRA to conduct further investigations into the wrongdoing by the directors and senior managers at HBOS when all the detailed evidence that they require to prove wrongdoing is set out in this latest report. In fact the disclosures of the actions, inactions and appalling misjudgements of all the protagonists in this sorry tale are there for all to see in black and white in the text.

So far as HBOS Financial Reporting is concerned, we were very pleased to hear what you said in your interview with **Paul Lewis on Radio 4's Moneybox** that you were not prepared simply to accept what the **Financial Reporting Council said that they were not going to investigate KPMG**. You may be aware that I was also interviewed for that program and made some robust remarks about the KPMG and FRC role in this debacle.

**The plain fact is that there is much much more investigation that needs to be done into KPMG's role in the HBOS disaster.** Indeed, you are right when you say that either the FRC are wrong in arriving at the conclusion that KPMG's audit should not be investigated or, alternatively, that the audit is simply inadequate. In my view, irrespective of whether the audit is an inadequate protection for investors (which it is), KPMG's performance may very well not even have met that inadequate level of protection. In addition, when you add into the equation the other supposedly independent advice given by KPMG into the "atypical" credit risk management, the certification of the rights issue loan loss provisions (£.5 billion on 21 July 2008 which became £1.7 billion by 30 September 2008) and, finally, the cover up by KPMG of my allegations when Crosby dismissed me which led to the board and the FSA being permitted to appoint a sales manager as group risk director, KPMG still have a very great many questions to answer and it would be totally wrong to let them get under the radar. In fact, KPMG have been involved in a litany of errors which self-corroborate the failure from an auditing perspective as well. It is a series of failures that, when taken together, compound each other and provide the similar fact evidence that demonstrates the state of mind of KPMG when it came to perform its most important role as the statutory auditor i.e. that **it would rather tell the bank what it wanted to hear and retain future fees rather than act with independence and integrity**. The standard that should be applied to audit firms like KPMG that employ the most intelligent and competent people that I have ever worked with in my life is much higher than the one that is being applied either by the FRC all KPMG themselves. On any analysis, they failed miserably and need to be investigated at the most forensic level before we put this whole saga to bed once and for all.

In order to assist you**, a small group of us who are specialists in both HBOS and Financial Reporting** have come together and would like to offer you the opportunity of receiving some input from us. This includes those on the copies list of this email. We do not know when you propose to write to the FRC but we think you might find it helpful to wait until you've had some input from our group before you do so. **We hope to be able to provide this to you by the end of play on Friday, 4 December.** In addition, we would very much welcome the opportunity of meeting with you and discussing our perspectives on this whole area at some stage probably after Christmas.

Kindest regards.

Paul Moore **(Bolden parts in this email only)**

2. The current **participants in this group** are Professor Prem Sikka & Dr. Atul K. Shah (both leading academics in the fields of audit and accounting),Tony Shearer, (ex-audit partner from Deloitte and CFO and CEO of Singer and Friedlander Bank), Ian Fraser, (the well-known financial sector investigative journalist and author of Shredded: Inside RBS, the Bank that Broke Britain) and Brian Little and Paul Moore (both who have been working on the failure of HBOS for many years). The group is currently reaching out to other interested parties and expects other experts to join over time. We are happy to provide further and more detailed evidence to the TSC if requested. We are also likely to make public our support for this investigation into KPMG by the FRC and TSC at an appropriate time in 2016.

3. The FRC has consistently said there is nothing for them to investigate in KPMG's audit of HBoS. So the FRC cannot be relied upon to carry out any credible investigation **… alone**. This, in our view, is now the FRC re-run of the FSA actions/behaviour in their short 300-word press release about RBS in December 2010. Since then the appointment by the TSC of independent overseers has been crucial. The most recent HBOS example is the appointment by the TSC of independent overseers and expertise and the primary reason why the public have the evidence and story on HBOS executives / FSA now. Specifically **the work of Stuart Bernau and Iain Cornish (together with Andrew Green QC in relation to FSA Enforcement) should be applauded** in driving the quality and evidence finally disclosed in the HBOS report by the PRA/FCA last month.

   In addition to HBOS KPMG were also auditors of other UK banks where similar situations of accounting, and audit, failures have occurred, including : Co-Op Bank; Kaupthing Singer & Friedlander; and Bradford & Bingley.

   As reported in May 2011 (ref.1), and in this further Daily Telegraph article in April 2012 (Ref.2), there may have been "some" investigation by the FRC re HBOS. But we also know that, amongst other changes, the "misconduct" benchmark was changed by the FRC in 2013 to the conduct of an auditor "which falls significantly short of the standards reasonably to be expected". Can you imagine the consequences if such low thresholds were pursued by regulators of food, medicine, water, gas, electricity and other industries. Yet such low thresholds and their arbitrary interpretations enable the FRC to abandon investigations. For example, Lehman Brothers collapsed in 2008. The FRC managed heightened public anxieties by announcing an investigation in to the audits conducted by Ernst & Young. In January 2013, the FRC abandoned the investigation by issuing a short press release. In sharp contrast, the New York regulators fined Ernst & Young $10 million for its audit failures.

   A *The Times* article published on 11 April 2013 (http://thetim.es/XD6S6i) about the FRC's lack of appetite for probing the "Big Four" over their pre-crisis bank audits also wrote that "*Accounting regulators shied away from a full-scale investigation into the auditing of Britain's troubled banks in the immediate aftermath of the financial crisis because they "did not have the stomach" for such a complex and costly exercise, according to a senior regulatory insider .... A person with direct knowledge of the FRC's operations said that the auditing watchdog had made a mistake by not opening a full review of bank audits five years ago, when the financial crisis first struck. It is understood that instead of opening its own investigation into the role of the auditors .... FRC officials decided to leave the banking investigations to the Financial Services Authority because they were concerned about a lack of resources. "There was a lack of will," a well-placed insider said. There was a general reluctance to get into it. It would be just too disruptive, too damaging."*

**OUR GROUP RECOMMENDATION IN RELATION TO KPMG AUDIT AND SERVICES TO HBOS**

- The Group welcomes the TSC's referral of the HBOS report and supporting evidence to the FRC to carry out a further investigation of KPMG and itself. Like the FSA reporting on HBOS, this by itself is wholly inadequate.

- In 2011 the TSC established the principle of independent overseers, and the TSC in our view should continue that principle and require the FRC to engage Messrs Bernau and Cornish, and supplement that independent oversight with two non –conflicted (past or present) audit experienced people. Perhaps an auditor and an experienced academic?

- In our view the FRC should also be required to appoint somebody independent to review the decisions that it has taken, on a number of occasions, not to investigate KPMG's audits of HBOS, (for example its response to the TSC's request that it look again at its decision not to investigate KPMG's audit of HBOS). This review would be similar to the one that Andrew Green QC carried out into whether the FSA's decisions on enforcement at HBOS were reasonable. That person should then report his/her findings and conclusions as to what changes should be made to the composition, structure and procedures of the FRC.

- Furthermore we believe that early in this process all the documentation which was available in the FRC files between 2001 and 2015 – including all Audit Inspection Reports - in relation to HBOS and KPMG should be disclosed to those independent overseers. Of course for a fully effective investigation KPMG should volunteer or be obliged to open the entire audit file and their working papers to such independent oversight. If KPMG have nothing to hide they should have no problem. In any event the FRC can require KPMG to do so.

- We also consider that the investigation may wish to look at KPMG's audit failings at HBoS in the context of their audit failings at the Co-Op Bank (which the FRC says it is already investigating), Bradford & Bingley, and Kaupthing and Kaupthing Singer & Friedlander.

Signed by Members of this Group -- 7 December 2015

Ian Fraser, Brian Little, Paul Moore , Tony Shearer, Professor Prem Sikka; Dr. Atul K. Shah;

Appendix 1 to our Paper provides more detail and the evidence and experience base for our input and recommendations to the TSC.

**APPENDIX 1**

(A) Dr Atul K. Shah - one page summary from "Chemistry of KPMG Audit failure" at HBOS – pages 4 and 5 .
(B) House of Lords Economic Affairs Committee - Investigation into Auditors – March 2011 – some extracts – pages 5 and 6.
(C) Paul Moore - observations / comments –pages 7 -10.
(D) Professor Prem Sikka - "Regulation and the FRC" – pages 10 and 11.
(E) Other References / internet links in relation to KPMG and auditing pages 11 and 12.

**Appendix 1**

**A> RELEVANT FINDINGS FROM INDEPENDENT SCHOLARLY RESEARCH**

Dr. Atul K. Shah, a Senior Lecturer from Suffolk Business School, has spent several years examining the failure of HBOS in meticulous detail. He has dedicated a full research paper on the 'Chemistry of Audit Failure' at HBOS, and another one on the 'Politics of Risk Management' at HBOS. He has also examined through research the role of KPMG in helping clients systematically escape regulatory control. The principal findings of this research are:

- Far from challenging its client, KPMG colluded in the mismanagement of HBOS, by endorsing their accounting, risk processes and governance at critical times in their history.
- Even though they were legally bound to report weaknesses to regulators, the auditors never exercised this duty and instead helped Banking regulators in giving them supportive and favourable endorsements about HBOS performance. There was a total failure of professional scepticism, and there is a whole section in the research paper devoted to this (pages 22-24). These related to risk management and systems, the firing of Paul Moore even when he raised real early warnings, and imprudent changes in accounting policies relating to loan loss provisions etc.
- KPMG developed a very friendly and amiable relationship with the HBOS Board, and collected a significant amount of fees from non-audit work, which directly conflicted with their professional rules and standards on independence and challenge.
- After the failure of HBOS, the senior lead partner of the Group Audit for the last five years, Guy Bainbridge, was actually promoted to the Board of KPMG Europe.
- The excellent original parliamentary report on HBOS Chaired by Mr. Andrew Tyrie and published in 2013, uncovered a whole host of evidence about KPMG being a 'trade partner' as opposed to a professional auditor, coming from Board interviews, minutes and reports. There is plenty of evidence of audit negligence, even before reviewing the audit files.
- In a forensic interview of the Senior KPMG Partner in charge of Audit Quality (pages 36-41), Mr David Matthews, Dr. Shah discovered contradictory values and major conflicts between private and public interest. Also as a firm, they have no rules or sanctions on ethical conduct, only a statement of policies which are not explicitly monitored or controlled.
- The Financial Reporting Council has been raising a series of concerns with KPMG about Audit Quality, Ethics and Independence, most of which have not yet been implemented. In particular, they found very poor records and challenges relating to loan loss provisions in Bank Audits on a consistent basis, in spite of these being a major audit risk area. These FRC Audit Inspection Unit reports website links are available at page 10 items 4,5 and 6.
- KPMG has publicly espoused an active strategy of 'Regulatory Risk Management' when it is itself a regulator, raising major contradictions about its willingness to perform quality and independent regulation. This evidence demonstrates that at the very heart and leadership of the firm, there is a willingness to arbitrage regulations, and avoid enforcement for itself and its clients.
- The entire risk management function was undermined by the CEO, James Crosby and the firing of whistle-blower Paul Moore was evidence of this. Professional firms including KPMG colluded with Crosby to endorse his imprudent management. It was power and politics which ran HBOS, not a desire for prudent management.

- The Governance of KPMG lacks independence and challenge, and the Chair of its Public Interest Committee Sir Steve Robson is conflicted as he was formally on the Board of the Financial Reporting Council. Almost all of its non-executives are partners from within the firm – totally in contradiction to good Corporate Governance guidelines. Its current non-executive Chairman was formerly a Partner at KPMG before returning.
- KPMG has an active strategy of obtaining 'Political Insurance' for its failures (pages 30-36), through the use of its senior political contacts and networks. It has many senior members who are current partners or alumni of the firm in the Financial Reporting Council. The FRC's Conduct Committee, responsible for deciding on an investigation into KPMG, is led by Paul George who is a former partner of KPMG and until 4 December 2015 was the Executive Director of Conduct. Among the current members of this Conduct Board of 11, three are KPMG alumni of a total of 5 who have audit experience.

**B> Some Extracts from the House of Lords Economic Affairs Committee – Report on auditors March 2011**

In addition to their Report the House of Lords Economic Affairs Committee Press Release in March 2011 recorded **'The breakdown of dialogue between bank auditors and regulators made the financial crisis worse'** Auditors were either unaware of the mounting dangers in the banks or, if they were aware, failed to alert the supervisory authority. The paucity of meetings between bank auditors and the supervisor was a "dereliction of duty" by both auditors and regulators. The Committee recommends legislation to re-establish mandatory two-way confidential dialogue between bank auditors and supervisors to help avoid a similar crisis in future.

**'Audit standards are slipping'** The Committee heard that International Financial Reporting Standards (IFRS), which became mandatory for EU listed companies in 2005 and are intended to pave the way towards common accounting standards around the world, had lowered audit standards. They encouraged box-ticking and reduced scope for auditors to exercise judgement to reach a true and fair view. The Committee recommends that prudence be reasserted as the guiding principle of audit.

Report at Para 142. The Big Four expressed the general view that in auditing banks before and during the crisis they had carried out their duties properly. Mr John Connolly, Senior Partner and Chief Executive, Deloitte, denied there was a failure of audit.[176] Mr John Griffith-Jones, Chairman, KPMG, recalled that the scope of statutory audit is limited: "The auditor's primary role is to count the score at the end of the accounting period ... not trying to forecast next year's profits … not responsible ... for making an assessment of the risk of the business ... if you have a company that has leverage of 100 times and a company that has no leverage at all, the audit report is the same ... It is the role of the auditors to point out weaknesses in controls."[177] Mr Ian Powell, Chairman and Senior Partner, PwC, agreed: "It's not the job of the auditor presently to look at the business model of a business. That is the job of management."[178] He acknowledged however that in "undertaking an audit you do look at the market conditions that were extant at the time of signing off the audit."[179] **'We do not accept the defence that bank auditors did all that was required of them. In the light of what we now know, that defence appears disconcertingly complacent. It may be that**

**the Big Four carried out their duties properly in the strictly legal sense, but we have to conclude that, in the wider sense, they did not do so.'**

And **SOLVENCY / GOING CONCERN**

147. A year later, as bank audits were prepared in late 2007, the writing was on the wall. Mr Powell said: "The closure of the wholesale markets in the second half of 2007 created real difficulty for many banks ... one of the key questions around the banks ... at the year-end 31 December 2007 was ... is there adequate liquidity or is there likely to be liquidity provided to these banks to survive"[186] so that auditors could sign off a going-concern opinion. He added that PwC reported to the FSA on 11 September 2007 that they "had concerns about the going concern of Northern Rock" and "Northern Rock asked for emergency support from the Bank of England on 13 September and were granted that"[187]. But since "other banks were all still funding themselves in the short-term wholesale markets at the end of 2007 and market conditions were still showing signs of easing when banks announced their results in February 2008 ... auditors ... had no reason to believe that a going concern qualification was appropriate with respect to the financial reports for the financial years ending 31 December 2007"[188]. **We do not accept this. A going concern qualification was clearly warranted in several cases, even if the auditors may understandably have been reluctant to make it for the reason referred to in paragraphs 140 and 144 above.**

148. Other bank auditors also maintained that circumstances at the end of 2007 were not so difficult as to justify qualifying going concern opinions on banks. In KPMG's view, there were "two key issues which had given cause for concern during the year—firstly in relation to lack of liquidity, particularly in respect of the securitisation markets, and secondly in relation to the valuation of securitised assets". But "for the UK banking industry in general there was insufficient evidence to believe at that time that a material uncertainty in relation to going concern existed in this regard."[189] Deloitte's view was similar and was reinforced by official intervention in the markets: "We did not have significant concerns about going concern for the majority of our clients. This assessment was reached after considering both the state of the banking market and the actions of the Treasury, the Bank of England and others following the collapse of Northern Rock ... nobody ... predicted the total market dislocation that would occur later in 2008."[190]

149. In late 2008 and early 2009, banks were audited during a general loss of confidence following the bankruptcy of Lehman Brothers. The Big Four auditors were in close touch with the authorities. Mr Scott Halliday, Managing Partner, Ernst & Young, said: "At the banking crisis, all four of us had meetings with the Bank of England around trying to improve the dialogue between the Bank of England and the firms."[191] Mr Connolly described the Big Four's approach to the Chancellor of the Exchequer[192], which resulted in a meeting at the Treasury on 16 December 2008 with the then Financial Services Secretary, Lord Myners. "All four of the people here had detailed discussions, instigated by the Big Four, with Lord Myners because of the circumstances we were in. It was recognised that the banks would only be going concerns if there was support forthcoming ... it was a proper and appropriate act from the four firms to seek to understand the likelihood of support being forthcoming ... had we concluded ... that there was not going to be support, then a different audit opinion would have been given."[193] Lord Myners "provided evidence of the Government's actions and the extent of their commitment which would support the management, directors and auditors in forming their view on going concern[194] ... we also considered the evidence obtained by ... our banking clients [on] the recapitalisation scheme, the Bank of England's Liquidity Scheme and the Treasury's Credit Guarantee Scheme ... concluded that ... support ... would ... avoid ... significant uncertainty as to going concern."[195]

C> **INPUT FROM PAUL MOORE : -** in addition to a copy of his first book CRASH BANK WALLOP - *which is in post to all TSC members' constituency offices surgeries –*

- In our joint opinion, irrespective of the incomprehensible resistance of The Financial Reporting Council to investigating KPMG (which, in itself, is very concerning), there are obvious reasons for The Treasury Select Committee to require an independent, comprehensive and forensic investigation into the role that KPMG played in the failure of HBOS both as statutory auditor and supposedly independent adviser.

In summary, reasons are as follows:-

- The mere fact of a bank failure the size of HBOS requiring taxpayer capital and liquidity and with loan losses of £52.8 billion between 2008 and 2011 should, of itself, be sufficient reason for a public interest investigation into the role of the auditor, KPMG. There should be no further reasons required.

- In determining whether the audit should be investigated, the Committee must be made aware of the fact that, in 2004, KPMG explicitly signed off an approach to credit risk management approvals in the HBOS Corporate Division which permitted the Division to sign off its own credit approval and consequently its own loan loss provisioning. This means that there was NO independent Group Risk oversight at HBOS in relation to Corporate Division credit approval.

- This "sign off" by KPMG was just plain wrong and set in place a risk and control environment that was fundamentally flawed from the end of 2004 and finally led to losses at HBOS between 2008 and 2011 of £52.8 billion. We attach the relevant Board minute from which proves this to be the case. Here is a key extract:-

  ***"6. REVIEW OF CREDIT APPROVAL PROCESS IN CORPORATE BANKING***

  *In response to the FSA's ARROW Review of Corporate Banking, an independent review of the credit approval process in Corporate Banking, to identify and comment on those aspects of the process that could be described as* ***"atypical",*** *had been carried out by Group Financial Risk ("GFR") and KPMG. Copies of the full GFR/KPMG assessment were available for directors.* ***Andrew Smith*** *confirmed that the key finding in relation to* ***"atypicality"*** *related to the* ***absence of an independent, pre-approval, credit opinion…***

  *It was proposed that additional "objectivity" or "independence" should be added to the process from* ***within Corporate Banking*** *(which was the Group's sole reservoir of expertise in relation to corporate lending and corporate credit assessment) –* ***not*** *from outside the Division."*

- Of course, if the there was no independent oversight by HBOS Group Financial Risk of credit approvals in The Corporate Division, it also follows that there could not have been adequate oversight of loan loss provisioning in any of the year end accounts from 2004 and following.

- In circumstances in which the overall risk and control environment is clearly in question in any large publicly quoted company, the relevant auditing guidance means that KPMG should have refused to perform the statutory audit. This is because, without the right control and risk management framework and environment, the auditor cannot rely on key aspects of the accounting systems and management statements of representation on which the accounts are based.

- Although the PwC S166 report into risk management effectiveness supposedly signed off HBOS' approach in 2004, the report itself and board minutes that relate to it, make it quite clear that it was predicated on a very large number of required recommended improvements in risk management and on the new style of much more rigorous Group Risk oversight of risk management systems and controls required by Group Regulatory Risk.

- When Mr. Moore was dismissed by James Crosby at the end of 2004 and was replaced by a sales manager (Jo Dawson) as Group Risk Director, KPMG in their role as auditors will have been put on notice that they could no longer rely on the PwC S166 report in relation to the effectiveness of the overall risk and control environment.

- The problem was that the KPMG auditors were now conflicted because another part of KPMG had conducted a supposedly independent investigation into Mr Moore's allegations that he had been dismissed for raising "Protected Disclosures" (i.e. whistleblowing claims) and found against him. At the same time, KPMG concluded that it was appropriate to appoint a sales manager as the new Group Risk Director. This is ridiculous and the FSA should not have accepted it. Mr Moore continues to allege that the KPMG investigation into his allegations was a "cover-up". His allegations have never been investigated by the FRC notwithstanding his demands that they should have been.

- It is also now clear that Dr Angela Smith who had been The Head of Group Financial Risk at HBOS also complained to the FSA about the appointment of Jo Dawson as Group Risk Director as well as the lack of seriousness with which HBOS approached overall risk management environment. As a direct result, Angela Smith, was required to leave HBOS.

- This meant that within six months, the two most experienced specialists in risk management had been required to leave HBOS leaving the Group Risk Functions led by someone with no experience in risk management and only experience is sales management. Dr Angela Smith testifies that James Crosby explained this to her in front of Lord Dennis Stevenson as because he needed someone in the Group Risk Director role who "could support his strategy".

- With this obviously flawed risk control environment, KPMG just could not perform an audit which could even follow the relevant loan loss accounting provisions let alone give an evidentially based opinion of the accounts showing a "true and fair view" which always over-rides the accounting standards themselves. KPMG had advised that Corporate Division could sign off their own credit approvals with no group oversight. KPMG had also signed off that it was appropriate to dismiss their Head of Group Regulatory Risk when he insisted on much stronger group oversight of risk management and compliance. KPMG had signed off that it was appropriate to appoint a person with no technical experience risk management as Group Risk Director. This must be investigated. This fundamentally affected KPMG's ability to conduct the audit.

- We now know that from the failure of Northern Rock in September 2007 from the evidence given to the PCBS that the FSA corresponded directly with HBOS (and, therefore, with KPMG) about their serious concerns as to the liquidity risk at HBOS. Stevenson kept "batting the concerns away".

- Auditors, irrespective of the narrower terms of reference of the audit itself, have access to all the knowledge and information they need to be able to assess the overall strategic risks of the banks they audit. We should bear in mind that KPMG hold themselves out as (and are) experts in all aspects of risk management and cannot deny that they would have recognised the growing and ultimately extreme liquidity risk that HBOS was running as it grew its balance sheet at break-neck speed with the use of wholesale finance.

- An ex KPMG Senior Manager working in the Treasury Division said to Mr. Moore, "We all knew we had an absolutely massive liquidity risk." Phil Hodkinson the CFO told Mr Moore that the liquidity risk was the top risk on the risk register in 2007.

- We now know that by March 2008, HBOS needed to refinance £125 billion of wholesale funding within three months (see PRA / FCA HBOS Report paragraph 65). This is more than 1 ¼ times the cost of the NHS in three months!

- There are, therefore, clear questions as to whether KPMG had statutory duties to report the obvious liquidity and credit risks at HBOS and, therefore, the risks to the regulatory system to the FSA during 2006 and 2007.

- Bearing all this in mind, for KPMG to have signed off the 2007 HBOS accounts showing a profit before tax of nearly £5.5 billion and a secure balance sheet in circumstances in which HBOS had what KPMG knew was a massive liquidity risk along with a miniscule Corporate Loan loss provision of a mere £370mn (on a loan book of £116bn) and without ANY qualifications raises an obvious inference of misconduct.

- In addition, as we have said, KPMG clearly knew the liquidity risks at HBOS and yet allowed HBOS to launch the rights issue at the end of April 2008. They knew that the only way HBOS was avoiding becoming insolvent was by massive use of the Bank of England's Special Liquidity Scheme which the Bank set up in April 08 to prevent RBS, HBOS and other wholesale funding dependent banks from becoming insolvent. Indeed it was the bank executives including Hornby and Stevenson who persuaded the BoE to set up the scheme in the first place. It is clear that without the SLS HBOS would have been insolvent well before the completion of the rights issue. KPMG will have known this.

- KPMG knew about the liquidity risk and the use of the SLS both when the rights issue was launched but also when it completed. In addition, they also capitulated in accepting a loan loss provision for the Corporate Division in the rights issue of £0.5bn which ten weeks later on 30/9/08 was revised to £1.7bn, over three times higher and which escalated to about £33bn including equity losses by 2011.

- In these circumstances, KPMG clearly agreed with HBOS, the investment banks, The FSA, The Bank of England and The Treasury to permit the rights issue to be launched and completed without the use of the SLS being disclosed to investors in the prospectus. The use of the SLS was a material fact. Without the SLS, HBOS would have been insolvent. This is primary evidence of a conspiracy to defraud.

- The latest HBOS Reports by PRA / FCA provide all the evidence that either KPMG committed misconduct or were wilfully blind to the plainly obvious risks that HBOS was to the financial system. KPMG recruit the very brightest people and so this makes no sense.

- Finally, the fact that the FRC were invited to reconsider their decision not to investigate KPMG means that the PRA and FCA believe that there should be an investigation into the audit and other advice given by KPMG to HBOS.

Along with the above specific reasons why KPMG must be investigated, we make the following additional points:-

- We have email correspondence from Phil Hodkinson, the CFO until the end of 2007, saying the he believed that one of the main causes of the banking crisis was "accounting standards designed for a different purpose" which means that he knew that he was applying accounting standards to HBOS's P&L and Balance Sheet which did not give the over-riding "true and fair view" of the financial position of HBOS. If he knew this, KPMG must also have known it.

- There is overwhelming evidence from the PCBS report into HBOS that KPMG as auditors and advisers far from acting with the serious scepticism with which they are required to act in relation to their audit client, they did the exact opposite. The behaved towards one another as members of a "cosy club". Neither Stevenson, nor Hobson (Chairman of HBOS and Chairman of HBOS Group Audit Committee) nor Bainbridge (KPMG Audit Partner) can ever remember any disagreements between the parties.

**D> RESEARCH FINDINGS FROM PROFESSOR PREM SIKKA**

The FRC has a poor track record of regulation of the Big 4 audit firms for a number of reasons. That is why great care needs to be taken if Parliament/TSC were to ask the FRC to conduct this investigation into KPMG. Hence our group input/ recommendation at page 3 regarding independent oversight by the TSC.

For regulators to be effective, there needs to be a clear distance between the regulators and the regulated. Regulators must be solely concerned with advancing the interest of society and not be promoters of the industry. This is important because audits have a bearing on the distribution of income, wealth, risks, financial stability. The FRC is too close to big accounting firms. Many of its committees and working parties are dominated by individuals from the big accounting firms. They play a key role in developing and drafting auditing standards and codes of ethics. Such standards have not been very effective as demonstrated by the banking crash and other collapses. They are not developed by a body independent of the industry. Such standards are the lowest common denominator. Even then the firms often do not meet them, as evidenced by the FRC's annual reports which are critical of the big firms.

There is not a single auditing standard on public accountability of auditing firms.

By any standard, the FRC has failed and is unfit to be a regulator. The activities of the 4 large auditing firms (and other large businesses in the City) are intertwined with many other parts of Government, political activity, the Civil Service and the regulators, through the way these auditing firms provide funds and services to the political parties, and earn large sums of money from services that they provide to them. Professor Prem Sikka has been actively researching and writing on the Big Audit firms for three decades, and his research is widely cited and studied all over the world. In The Pin-Stripe Mafia, Austin Mitchell and Prem Sikka give detailed evidence about the range of areas in which the Big 4 have been caught, and how often they get away with it. It is ironic, given its audit failures, that KPMG frequently acts as regulatory experts, and receives large sums of money from the work given to it by the PRA, FCA and in the past the FSA.

The shortcomings of the FRC were exposed by the banking crash. It claims to look at a sample of FTSE250 audits. But none of this alerted it to any of auditing issues raised by the crash. There has been no post-crash investigation of any of the bank auditors. For any regulatory action to be effective, it must be swift and effective. However, that is not the case with FRC. For example, investigation into the failure of MG Rover began in 2005 and was finalised in 2015. This of course, is not an isolated case. The investigation into audit of Cattles Plc began in 2007 and there is still no announcement of the outcome.

As the TSC know the FRC is responsible for oversight of the UK accountancy profession and it should also be noted that to date, no accountancy firm has ever been investigated, fined or disciplined for developing and selling tax avoidance schemes even when the courts have declared the schemes to be unlawful.

E> References and internet links


(1) Daily Telegraph articles - 2011
http://www.telegraph.co.uk/finance/newsbysector/supportservices/8490501/PwC-reported-to-accounting-regulator-after-taking-out-criticism-of-client-from-report.html

(2) Daily Telegraph article - 2012
http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/9233840/KPMG-faces-inquiry-over-rescue-of-HBOS.html

(3) Times Articles - Tesco and HBOS :
http://www.thetimes.co.uk/tto/business/industries/supportservices/article4630510.ece

(4) FRC – Audit Inspection Unit – 2008/2009 – KPMG - https://www.frc.org.uk/Our-Work/Publications/AIU/Public-Report-on-the-2008-9-inspection-of-KPMG-LLP.pdf

(5) FRC – Audit Inspection Report – KPMG – 2011 – https://www.frc.org.uk/Our-Work/Publications/AIU/Public-Report-on-the-2011-12-inspection-of-KPMG-LL.aspx

(6) FRC – Audit Inspection Report - KPMG – latest in 2014 - https://www.frc.org.uk/Our-Work/Publications/Audit-Quality-Review/Audit-Quality-Inspection-Report-May-2014-KPMG-LLP.pdf

(7) FRC – Consultation and Final Paper – Auditor Scepticism – 2011 - https://www.frc.org.uk/Our-Work/Publications/APB/Briefing-Paper-Professional-Scepticism.pdf

**Ian Fraser – some other inputs from his research**

## KPMG bank audits that have been already found wanting via court or regulatory action

BancaMonte dei Paschi di Siena (Italy) - Consob fined KPMG €450,000 for audit failures http://bit.ly/1LTNqGM

Corporate Commercial Bank (Bulgaria) - Bulgaria's Commission for Public Oversight of Statutory Auditors found "significant gaps and inconsistencies" in KPMG's audits http://bit.ly/1lDcHj6 In April 2015 two KPMG Sofia partners were charged for not reporting CCB's shortcomings to the regulator http://reut.rs/1SEvQMD

Countrywide (US) - KPMG paid $24m as part of a $624m settlement to resolve class-action litigation http://reut.rs/1LTMnqf

Fannie Mae (US), KPMG and Fannie May jointly paid a $153 settlement of for overstating income and breaching GAAP in 2001 to 2004 http://nyti.ms/1SDLnMB

New Century Financial (US)- KPMG paid $44.75m as part of a £125m settlement to resolve class-action litigation http://reut.rs/1PGsY3Y

TierOne Bank Nebraska (USA) - two KPMG partners have been charged by the SEC http://1.usa.gov/1O8CSVO

Wachovia (US) - KPMG paid $37m as part of a $627m settlement to resolve a class-action litigation http://bit.ly/1O8Dg6S

## KPMG bank audits that are currently under investigation

Co-operative Bank (UK) KPMG's audits are currently being investigated by the FRC. The probe was announced 20 January 2014 http://bit.ly/1m3cNky

Stanbic IBTC (Nigeria) Nigeria's Financial Reporting Council has requested that Central Bank of Nigeria and the Economic and Financial Crimes Commission investigate Stanbic IBTC and KPMG over financial misstatements made in 2013-2014 http://bit.ly/1IvCnsw

## Other relevant KPMG articles – a selection

FIFA --- http://www.marketwatch.com/story/fifa-auditor-kpmg-missed-scandal-but-stays-out-of-spotlight-2015-06-03

NAVISTAR --- http://www.marketwatch.com/story/sec-complaints-against-navistar-feature-a-whos-who-of-chicago-clout-2015-09-04

http://retheauditors.com/2014/01/28/not-that-satisfying-sec-slams-kpmg-for-independence-violations/