Edited for publication

Financial Reporting Council

IN THE MATTER OF

THE EXECUTIVE COUNSEL OF THE FINANCIAL REPORTING COUNCIL

-and-

(1) PRICEWATERHOUSECOOPERS LLP

(2) JOHN WATERS

FINAL SETTLEMENT DECISION NOTICE

Pursuant to Rule 108 of the Audit Enforcement Procedure

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

A. 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'**), revised in June 2023. 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. Where defined terms are used, they appear in italics.

3. This *Final Settlement Decision Notice* also uses the following definitions:

3.1. **'Babcock'** or the **'Group'** means Babcock International Group plc.

3.2. **'FY2019'** means the financial year ended 31 March 2019 and **'FY2020'** means the financial year ended 31 March 2020.

3.3. **'FY2019 Financial Statements'** and **'FY2020 Financial Statements'** means Babcock's consolidated financial statements for FY2019 and FY2020, respectively (collectively, the **'Financial Statements'**).

3.4. **'FY2019 Audit'** and **'FY2020 Audit'** means the statutory audit of the FY2019 Financial Statements and the FY2020 Financial Statements, respectively (collectively, the **'Audits'**).

3.5. **'Respondents'** means:

3.5.1. PricewaterhouseCoopers LLP (**'PwC'**), which was the *Statutory Audit Firm* appointed to conduct the Audits; and

3.5.2. John Waters, who was the *Statutory Auditor* designated by PwC as the Group engagement partner for the Audits, and signed the audit reports on behalf of PwC.

4. In accordance with Rule 102 of the AEP, *Executive Counsel* entered into settlement discussions with the Respondents.

5. A *Proposed Settlement Decision Notice* was issued by *Executive Counsel* on 11 February 2026 pursuant to Rule 103 of the AEP in relation to the conduct of the Respondents in respect of the Audits. The Respondents provided written agreement to the *Proposed Settlement Decision Notice*, pursuant to Rule 105 of the AEP, on 27 February 2026. The *Convener* subsequently appointed an *Independent Reviewer*, pursuant to Rule 106 of the AEP, to consider the *Proposed Settlement Decision Notice.*

6. On 18 March 2026, the *Independent Reviewer* approved the issuance of this *Final Settlement Decision Notice* pursuant to Rule 107(a) of the AEP.

7. In accordance with Rule 108 of the AEP, this *Final Settlement Decision Notice* sets out:

7.1. The breaches of *Relevant Requirements*, with reasons.

7.2. The *Sanctions* imposed on the Respondents, with reasons.

7.3. The amount payable by the Respondents in respect of *Executive Counsel's Costs*.

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

8.1. Section B: Executive Summary.

8.2. Section C: Background.

8.3. Section D: *Relevant Requirements* to which the breaches relate.

8.4. Section E: Detail of the breaches of *Relevant Requirements*.

8.5. Section F: *Sanctions*.

8.6. Section G: *Costs*.

9. *Sanctions* have previously been imposed on PwC for breaches of *Relevant Requirements* in the audits of Babcock's consolidated financial statements for FY2017 and FY2018[1]. Mr Waters was not involved in those audits.

B. EXECUTIVE SUMMARY

10. Babcock is a multinational corporation headquartered in the UK providing, among other things, engineering services. Its main business is with public bodies, particularly the UK's Ministry of Defence (**'MOD'**). Babcock's shares are listed on the Main Market of the London Stock Exchange and, as at 31 March 2020, it was a constituent of the FTSE 250 Mid-Cap Index with a market capitalisation of £1.9 billion.

11. As is set out in this *Final Settlement Decision Notice*, there were failures by the Respondents in the manner in which the Audits were conducted. These include a number of breaches of the fundamental requirements to exercise professional scepticism, to obtain sufficient appropriate audit evidence and to achieve fair presentation and compliance with accounting standards. Many of the breaches concern the auditing of the Aviation Division, the smallest of Babcock's four sectors. The Audits failed in their principal objective of providing reasonable assurance that the Financial Statements were free from material misstatement. The Group's financial statements for the period ended 31 March 2021 included restatements of the Financial Statements, including correction of material errors associated with some of the failings set out in this *Final Settlement Decision Notice.*

12. The breaches of *Relevant Requirements* in this *Final Settlement Decision Notice* relate to eight areas of the Audits:

12.1. **Breach area 1 – cash pooling**: cash balances and overdrafts were presented in the Financial Statements on a net rather than gross basis. This was not identified by the Respondents and therefore no audit work was performed to challenge

1 Final Decision Notice against PricewaterhouseCoopers Nicholas Campbell Lambert and Heather Ancient.pdf

whether such offsetting was permitted under the relevant accounting standard. No disclosures were made in the Financial Statements in relation to these cash pooling arrangements.

12.2. **Breach area 2 - Contract A contract financing arrangements**: in FY2019 Babcock decided to derecognise financial assets subject to an invoicing factoring agreement relating to this aviation contract with the defence ministry of another country. This was in response to the adoption of a new accounting standard which required Babcock to evaluate the extent to which it retained the risks and rewards of ownership of the financial assets. The Respondents were aware that this treatment was highly judgemental, but in FY2019 and FY2020 they performed insufficient audit work and exercised inadequate professional scepticism to support their conclusions in respect of the appropriate accounting treatment, and did not report appropriately to the audit committee.

12.3. **Breach area 3 – capitalisation of costs within the Aviation Division**: in FY2019 and FY2020 the Respondents failed to identify the inconsistent application of accounting policies relating to capitalisation of aircraft maintenance costs, and failed to respond appropriately following a reported limitation of scope in this respect by a component audit team. There is no evidence of review of Babcock's internal Group Accounting Manual by the Group audit team, and no evidence as to how the team assessed whether the established accounting practices of the Group were applied consistently and in compliance with the relevant accounting framework. There is also no evidence that the Respondents challenged management to provide detailed guidance on the application of the accounting framework within the Group.

12.4. **Breach area 4 – Oil & Gas intangible assets**: in FY2019 and FY2020 the Respondents did not identify that Babcock had not reviewed the useful life of the finite-life intangible assets of its Oil & Gas business established in a prior period and that, as a result, the Financial Statements were not prepared in accordance with the relevant accounting standard. The Respondents did not challenge management as to whether the useful life of the intangible assets remained appropriate, and did not perform any testing on the assets to ensure compliance with Babcock's own accounting policy on the amortisation of acquired intangibles.

12.5. **Breach area 5 – assessment of goodwill impairment**: in FY2019 and FY2020 the Respondents failed to identify that Babcock's inclusion of the 'Africa' operating segment within the 'Land' Cash Generating Unit (**'CGU'**) for the purpose of goodwill impairment testing, which originated in FY2018 following a Group reorganisation, was not in accordance with the requirements of the relevant accounting standard. In FY2020 Babcock did not change their approach to impairment testing to reflect the adoption of a new accounting standard in respect of leases. The Respondents documented that the impact of the new standard on the impairment testing was expected to be small, but did not require management to prepare the calculations on the basis of the new standard and obtain evidence from them to confirm that expectation.

12.6. **Breach area 6 – accounting for credit notes as income in the Aviation Division**: Babcock's established accounting policy was to record certain credit notes received from aircraft manufacturers, and exercisable against the purchase of future parts and services, as income on receipt. This policy was not compliant with the applicable accounting framework. There is no evidence that the Respondents assessed whether the application of the policy was compliant, in FY2019 or FY2020.

12.7. **Breach area 7 – the Phoenix II contract**: there was insufficient evidence on the FY2019 and FY2020 audit files of how a newly adopted accounting standard in respect of revenue recognition as principal or agent had been considered in relation to this contract with the MOD. In FY2020 there was a lack of evidence regarding the consideration of the impact of the implementation of the new accounting standard in respect of leases, where conflicting audit evidence had been obtained.

12.8. **Breach area 8 – the DSG contract**: there were multiple failings in relation to the auditing of this contract with the MOD. The failings relate to audit work covering revenue forecasts, recognition of savings in forecast costs to complete, and the impairment of the DSG contract acquired intangible asset.

13. As explained further in paragraph 157 of this *Final Settlement Decision Notice*, Mr Waters faced severe challenges in discharging his responsibilities as Group engagement partner because of the circumstances in which he took on the role and the impact of the COVID-19 pandemic.

14. Section E of this *Final Settlement Decision Notice* sets out the detailed breaches of *Relevant Requirements.*

15. This *Final Settlement Decision Notice* sets out the following *Sanctions* imposed on the Respondents:

PwC

15.1. A financial sanction of £5,500,000 discounted by 12.5% for the mitigating factor of exceptional co-operation and further discounted for admissions and early disposal by 32.5%, so that the financial sanction payable is £3,248,437.

15.2. A published statement in the form of a severe reprimand.

15.3. A declaration that the reports signed on behalf of PwC in respect of the Audits did not satisfy the *Relevant Requirements* in relation to the matters set out in this *Final Settlement Decision Notice*.

15.4. An order requiring PwC to take specified action with the aim of preventing the recurrence of the contravention.

Mr. Waters

15.5. A financial sanction of £100,000 discounted by 12.5% for the mitigating factor of exceptional co-operation and further discounted for admissions and early disposal by 32.5%, so that the financial sanction payable is £59,062.

15.6. A published statement in the form of a severe reprimand.

15.7. A declaration that the reports signed on behalf of PwC in respect of the Audits did not satisfy the *Relevant Requirements* in relation to the matters set out in this *Final Settlement Decision Notice*.

C. BACKGROUND

16. Babcock is (and was at the time of the Audits) a major multinational corporation based in the UK providing engineering services and other services (in the UK and internationally) in relation to maintaining, upgrading, operating and managing significant infrastructure and essential equipment. A number of its contracts are highly sensitive UK government contracts, and its work therefore attracts significant public interest in the UK. The structure of the business is complex and was split across four reporting segments in FY2019 and FY2020, namely Aviation, Land, Marine and Nuclear.

17. Babcock's shares are listed on the Main Market of the London Stock Exchange, and during FY2019 and FY2020, it was a constituent of the FTSE 250 Mid-Cap Index. There was and is an evident public and market interest in the truth and fairness of the Group's financial statements, and the proper performance of their statutory audits.

18. Babcock's reported financial results for FY2019 and FY2020 were as follows:

	FY2019	**FY2020**
Revenue	£4,474.8 million	£4,449.5 million
Profit/(Loss) before tax	£235.2 million	(£178.2 million)
Net assets[2]	£2,884.9 million	£2,550 million

19. PwC had been Babcock's *Statutory Audit Firm* since the FY2003 audit. Mr Waters was appointed as *Statutory Auditor* in January 2019. His appointment was precipitated by the sudden and unexpected departure of the previous *Statutory Auditor*. Mr Waters did not have an opportunity to shadow or even speak to his predecessor.

20. A number of Babcock's components were audited by overseas component auditors, who reported their findings to the Group audit team headed by Mr Waters. The Respondents retained responsibility for the performance of the Audits in accordance with the applicable standards and for the auditor's reports on the Financial Statements. The Respondents' objective as auditors included obtaining reasonable assurance about whether the Financial Statements as a whole were free from material misstatement, enabling the Respondents to express an opinion on whether the Financial Statements were prepared, in all material respects, in accordance with an applicable financial reporting framework. The applicable financial reporting framework was the International Financial Reporting Standards (**'IFRS'**).

21. The audit reports for the FY2019 and FY2020 Audits were signed by Mr Waters on behalf of PwC on 21 May 2019 and 11 June 2020 respectively. The signing of the FY2020 audit report had been delayed by two weeks to allow the Respondents to complete the audit in the face of difficulties caused by the COVID-19 pandemic. Audit materiality was £26 million for FY2019 and £21.4 million for FY2020. Both audit reports contained unmodified opinions. PwC's fees for completing the FY2019 and FY2020 Audits were £2.5 million and £3.2 million respectively.

22. In January 2021, following changes to Babcock's management, the Group announced that a detailed review of its balance sheet was being undertaken, with the assistance of an independent accounting firm. This exercise was known as the Contract Profitability and Balance Sheet Review (the **'CPBS Review'**). The outcome of the CPBS Review was announced in July 2021, and reflected in the FY2021 Group financial statements

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[2] Total assets – total liabilities taken from the FY2020 Financial Statements for both years. Calculation as follows: FY2019: £6,178.1m - £3,293.2m = £2,884.9m and FY2020: £7,530.7m - £4,980.7m = £2,550m.

published at the same time. The result was a large number of adjusting entries in the FY2021 financial statements, reflecting impairment of goodwill and other acquired intangibles, changes in estimates, a change in accounting policy and the cumulative correction of prior period errors. Some of the FY2021 restatements in relation to the correction of prior period errors are associated with some of the breach areas – these are summarised below in the relevant sections of this document. The Respondents audited the FY2021 Group financial statements and Mr Waters and the FY2021 Group audit team were responsible for identifying the material prior year errors in all five of the areas which were subject to restatements in FY2021 associated with breaches in this Final Settlement Decision Notice.

23. Since many of the breaches set out in this document concern the auditing of the Aviation Division, some additional explanation of the role and size of that segment of the business is appropriate. The Aviation Division principally delivers critical services to defence and civil customers, ranging from training, equipment support and maintenance to the operation of customer-owned aviation fleets delivering emergency and offshore services. It is the smallest of Babcock's four reporting segments. In FY2019 it contributed 22.3% of Babcock's revenue and 18.4% of its adjusted profit before tax. In FY2020 the percentages were 19.2% of revenue and 12.2% of adjusted profit before tax.

24. There were over 50 individual legal entities within the Aviation Division, of which nine were components within the scope of the FY2019 Audit, and 12 were components within the scope of the FY2020 Audit. None of the in-scope components was classified individually as financially significant or material. Particular reference will be made to three of the in-scope components, in the context of some of the breaches: **'Component A'**, **'Component B'** and **'Component C'**.

D. *RELEVANT REQUIREMENTS* TO WHICH THE BREACHES RELATE

25. Rule 1 of the AEP states that *Relevant Requirements* has the meaning set out in regulation 5(11) of the Statutory Auditors and Third Country Auditors Regulations 2016 (**'SATCAR'**). The *Relevant Requirements* include, but are not limited to, the International Standards on Auditing (UK) (**'ISAs'**), issued by the FRC and based on the standards issued by the International Auditing and Assurance Standards Board.

26. The versions of the ISAs relevant to this *Final Settlement Decision Notice* are those effective for audits of financial statements for periods commencing on or after 17 June 2016, with the exception of:

    26.1. ISA (UK) 330, where the relevant version is that effective for audits of financial statements for periods commencing on or after 15 December 2017; and

26.2. ISA (UK) 500, where the relevant version for the FY2019 Audit is that effective for audits of financial statements for periods ending on or after 15 December 2010, and the relevant version for the FY2020 Audit is that effective for audits of financial statements for periods ending on or after 15 December 2019.

27. The *Relevant Requirements* referred to in this *Final Settlement Decision Notice* are the following:

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

27.2. ISA (UK) 220 (Quality Control for an Audit of Financial Statements).

27.3. ISA (UK) 260 (Communication with those charged with governance).

27.4. ISA (UK) 315 (Identifying and assessing the risks of material misstatement through understanding of the entity and its environment).

27.5. ISA (UK) 330 (The auditor’s responses to assessed risks).

27.6. ISA (UK) 500 (Audit Evidence).

27.7. ISA (UK) 540 (Auditing accounting estimates, including fair value accounting estimates, and related disclosures).

27.8. ISA (UK) 600 (Special considerations—audits of group financial statements (including the work of component auditors)).

27.9. ISA (UK) 700 (Forming an opinion and reporting on financial statements).

28. Extracts from the ISAs setting out those parts which are of particular relevance to the breaches of *Relevant Requirements* are included as an **Appendix**.

29. As the *Statutory Auditor* designated as Group engagement partner for the Audits, Mr Waters was responsible for the overall quality of the Audits and the direction, supervision, and performance of the Audits in compliance with professional standards and applicable legal and regulatory requirements.

30. As the *Statutory Audit Firm* appointed to conduct the Audits, PwC is responsible for any established breaches of *Relevant Requirements* on the part of its partners or employees.

E. DETAIL OF THE BREACHES OF *RELEVANT REQUIREMENTS*

Breach Area 1 – Cash Pooling

<u>Background</u>

31. The Group had a notional cash pooling arrangement, used to manage liquidity, interest and credit risk, which allowed individual accounts to become overdrawn with certain restrictions on the total gross and net overdrawn position.

32. In the FY2019 and FY2020 Financial Statements, cash balances and overdrafts were presented on a net (rather than gross) basis, i.e. the positive cash balance was offset against the bank overdraft balance in the notional cash pooling arrangement, such that the net position was presented in the Financial Statements.

33. No disclosures were made in the FY2019 and FY2020 Financial Statements in relation to the cash pooling arrangements.

34. In both FY2019 and FY2020, the Group audit team assessed this audit area as a 'normal' risk. The audit work was undertaken by the Group and component audit teams.

35. The Group audit team concluded that the accounting and disclosures of cash and cash equivalents and bank and other borrowings were appropriate, and no adjustments were proposed.

36. Under the relevant accounting standard, paragraph 42 of IAS 32 (Financial Instruments: Presentation), a financial asset and liability can only be offset and presented on a net basis when the entity has a legally enforceable right to offset the amounts and intends to settle on a net basis. The Group's cash pooling arrangement did not satisfy the requirements for offsetting and presentation on a net basis. Therefore, the Group was required to present gross cash and overdraft balances.

37. There is no evidence in the FY2019 and FY2020 audit files that the Group audit team noted that cash and borrowings had been offset by Babcock or (therefore) considered whether such offsetting was permitted by accounting standards, and there is no evidence which recorded the rationale for the judgement to do so. In particular, there is no evidence that the Group audit team:

    37.1. made enquiries of management about the existence of cash-pooling arrangements and whether these enabled cash balances to be offset against borrowings in accordance with IAS 32;

    37.2. reviewed banking (or similar) arrangements to ascertain whether offsetting arrangements existed and considered how they should be accounted for; or

    37.3. noted that there were negative balances in the analysis of cash balances by currency which were being offset against positive balances, or made enquiries as to whether such offsetting was in accordance with the requirements of IAS 32.

38. In FY2019, there is also no evidence that the Group audit team considered the implications of a reference in a bank confirmation letter to *'Details of any Set Off Arrangements'* which was followed by a list of Babcock companies.

39. Further, in FY2019 and FY2020 the Group audit team did not identify that the checklist used in their review of the financial statement disclosures stated incorrectly that: *'[t]he entity does not have recognised financial instruments that are set off in accordance with paragraph 42 of IAS 32'*.

40. In the FY2021 Group financial statements, a restatement was made in relation to cash pooling following the identification of this error:

Financial Statement Line item	**Net balances reported in the FY2019 Group financial statements**	**Gross balance as restated in FY2021 Group financial statements**	**Adjustment from Net to Gross balance**
Cash and cash equivalents	£275.2m	£844.7m	£569.5m
Bank and other borrowings	£53.9m	£623.4m[3]	£569.5m

Financial Statement Line item	**Net balances reported in the FY2020 Group financial statements**	**Gross balance as restated in FY2021 Group**	**Adjustment from Net to Gross balance**
Cash and cash equivalents	£1,351.4m	£1,845.9m	£494.5m
Bank and other borrowings	£400.1m	£894.6m[4]	£494.5m

41. There was no impact on the income statement, net assets or cash flows.

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[3] This amount does not agree to the restated figures for FY2019 in the FY2021 financial statements as there are other adjustments impacting the bank and other borrowings line. The difference between £623.4m and the restated figure of £657.3m is £33.9m.
[4] This amount does not agree to the restated figures for FY2020 in the FY2021 financial statements as there are other adjustments impacting the bank and other borrowings line. The difference between £894.6m and the restated figure of £987.9m is £93.3m.

<u>Breaches</u>

42. The audit work in relation to the cash pooling arrangements for FY2019 and FY2020:

42.1. Breached paragraph 15 of ISA 200, in that, notwithstanding indications within the audit workpapers that there were offsetting arrangements, the Respondents failed to exercise professional scepticism or challenge management in respect of the existence of, or accounting for, offsetting arrangements.

42.2. Breached paragraphs 16 and 17 of ISA 220, in that the Respondents' review of the audit documentation failed to detect that:

42.2.1. there were indications within the audit workpapers that the Group was operating offsetting arrangements; and

42.2.2. there was incorrect tailoring of the financial statement review checklist.

42.3. Breached paragraph 11(c) of ISA 315, in that the Respondents failed, in carrying out their assessment of the risks of material misstatement in the Financial Statements through understanding the entity and its environment, to:

42.3.1. obtain an adequate understanding of Babcock's selection and application of accounting policies in relation to the presentation of financial instruments; and

42.3.2. to evaluate whether Babcock's accounting policies in that regard were appropriate for its business and consistent with the applicable financial reporting framework and accounting policies used in the relevant industry.

42.4. Breached paragraph 26 of ISA 330, in that, in forming an opinion as to whether sufficient appropriate audit evidence had been obtained, the Respondents failed to consider all relevant audit evidence, including considering whether the audit evidence for FY2019 appeared to corroborate or to contradict the assertions made in the Financial Statements.

42.5. Breached paragraph 6 of ISA 500, in that the Respondents failed to design and perform audit procedures for the purpose of obtaining sufficient appropriate audit evidence in response to the fact that cash and borrowings had been offset, and as to whether this was permitted by accounting standards.

42.6. Breached paragraphs 12, 13(b), 13(d) and 14(b) of ISA 700, in that:

42.6.1. the Respondents failed to make sufficient enquiries regarding, or adequately evaluate, whether Babcock's presentation of the Groups' notional cash pooling arrangement complied with the applicable financial reporting framework (IAS 32); and

42.6.2. in their evaluation as to whether the Financial Statements achieved fair presentation, the Respondents failed adequately to consider whether, by presenting cash and borrowings on a net basis, the Financial Statements represented the underlying transactions in a way that achieved fair presentation.

Breach Area 2 – Contract A contract financing arrangements

Background

43. Contract A was a 10-year contract with a foreign government agency (the **'Counterparty'**) for the provision of defence material and services.

44. Part of Contract A included hire purchase agreements, for which the Counterparty paid Babcock in instalments (the **'HP Receivables'**), with legal title passing to the Counterparty on payment of the final instalment.

45. Babcock had entered into an invoicing discounting agreement with its bank (the **'Bank'** and the **'Bank Agreement'**) under which the Bank advanced funds to Babcock against the HP Receivables and Babcock repaid the Bank once it had collected the HP Receivables from the Counterparty.

46. Babcock's management determined that it was appropriate to derecognise on the balance sheet: (i) the HP Receivables due from the Counterparty; and (ii) the liabilities owed to the Bank pursuant to the Bank Agreement (the **'Offsetting Arrangement'**). In FY2019, the value of the receivables and liabilities derecognised was £137 million. In FY2020, the corresponding amount was £101 million. These balances, together with an explanation of the treatment adopted*,* were disclosed in the FY2019 and FY2020 Financial Statements.

47. In both FY2019 and FY2020, the Group audit team assessed this audit area as a 'normal' risk. The relevant audit work was ultimately undertaken by the Group audit team.

48. Derecognition of financial assets and financial liabilities was a complex area of accounting, and FY2019 was the first year in which a new accounting standard, IFRS 9 (Financial Instruments), was adopted by Babcock. To determine whether the transfer of a financial asset qualified for derecognition, Babcock had to evaluate the extent to which it retained the risks and rewards of ownership of the financial asset.

49. Contract A was audited by a component audit team. Their view was that the Offsetting Arrangement was not in compliance with IFRS 9. At the request of the Group audit team, it was agreed that the component audit team would scope the Offsetting Arrangement out of their audit work and the evaluation of the Offsetting Arrangement would be performed by the Group audit team. The Group audit workpapers do not explain why the decision was made to scope this matter out of the component auditor's opinion.

50. The accounting treatment of the Offsetting Arrangement was highly judgemental, as illustrated by the recommendation of its disclosure as a 'critical judgement' (see paragraph 55 below) and by the opposing conclusions reached by the component audit team and ultimately by the Group audit team once it was scoped out of the component team's work.

51. The Group audit team proceeded to consider the Offsetting Arrangement, reviewing papers provided by the component audit team and Babcock Group management, discussing the issue with them, and seeking advice and input from PwC's internal accounting specialists, the Accounting Consulting Services team (**'ACS'**).

52. ACS advised the Group audit team, in relation to its consideration of whether the Offsetting Arrangement complied with IFRS 9:

> *'The burden of proof is to show that substantially all the [risks and rewards] have transferred to [the Bank]. If you cannot prove this, then you cannot derecognise the receivable. …*
>
> *You need to be able to show, on a relative basis, that Babcock has transferred substantially all of the risk that exists across to [the Bank]. So if the risks are small in the first place when the receivable is recognised (because of customer acceptance), this simply means that you are […] looking to prove that substantially all of that small risk has passed to [the Bank].'*

53. The Group audit team identified four risks for the basis of their assessment: (i) credit risk; (ii) late payment risk; (iii) dilution risk; and (iv) termination risk, and assessed the extent to which those risks had been transferred to the Bank. In respect of each risk, the Group audit team concluded that management's position in relation to the transfer of risk was supportable. However, the Group audit team's analysis did not: (i) assess the impact of all of the potential recourse events and termination provisions on the risks that remained; and (ii) did not fully demonstrate that substantially all the risks and rewards considered had been transferred to the Bank. Consequently, the Group audit team had not fully carried out the approach advised by ACS.

54. The Group audit team's overall conclusion was that whilst there was "*judgement associated with the interpretation of certain clauses in the contract, on balance we believe management's position that substantially all of the risks and rewards associated with the receivable have been transferred to* [the Bank] *to be supportable"*.

55. In FY2019, a PwC 'hot review'[5] strongly recommended that the Offsetting Arrangement should be disclosed as a 'critical judgement'[6] as the amounts were material and it was a judgemental area.

56. In a report to Babcock's audit committee in FY2019, it was stated that the Group audit team were reviewing the Offsetting Arrangement and would provide a verbal update at the audit committee meeting. However, there is no record that the Group audit team did so. Accordingly, it is not evident that the Group audit team reported to the audit committee the level of judgement involved in the matter, the Group audit team's conclusion regarding the accounting judgement, and that fuller disclosures may therefore be required.

57. As in FY2019, in FY2020 the component team reported to the Group audit team with a limitation of scope qualification, excluding the Offsetting Arrangement from their opinion. The Group audit workpapers again do not explain why the decision was made to scope this matter out of the component team's audit opinion.

58. In FY2020, the Group audit team relied on the analysis conducted in FY2019 and carried out no additional substantive audit work. The deficiencies in the Group audit team's FY2019 analysis were not identified or addressed and the overall conclusion of the Group audit team in FY2020 remained the same as in FY2019.

59. In FY2020, there is also no evidence that it was reported to the audit committee that the accounting treatment of the Offsetting Arrangement was highly judgemental or that fuller disclosure may be required.

<u>Breaches</u>

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[5] A hot review is an internal independent review of in-progress audit work, intended to identify and remediate issues before an audit opinion is signed.

[6] This was a shorthand reference to the types of judgement referred to in IAS 1 paragraph 122: '*An entity shall disclose…, the judgements… that management has made in the process of applying the entity's accounting policies and that have the most significant effect on the amounts recognised in the financial statements'.* By way of amplification of paragraph 122, paragraph 123 of IAS 1 identifies accounting judgements akin to that in respect of the Offsetting Arrangement: '*For example, management makes judgements in determining…when substantially all the significant risks and rewards of ownership of financial assets…are transferred to other entities*'.

60. The audit work for FY2019 and FY2020 in relation to Contract A financing arrangements:

60.1. Breached paragraph 15 of ISA 200, in that the Respondents failed sufficiently to challenge Babcock management as to whether their accounting judgement in respect of the Offsetting Arrangement complied with the applicable financial reporting framework (IFRS 9).

60.2. Breached paragraph 16(a) of ISA 260, in that the Respondents failed to report to the audit committee:

60.2.1. that the accounting judgement in respect of the Offsetting Arrangement was highly judgemental;

60.2.2. the Group audit team's conclusion regarding that accounting judgement; or

60.2.3. that fuller disclosures may therefore be required.

60.3. Breached paragraph 6 of ISA 500, in that the Respondents failed to obtain sufficient appropriate audit evidence to support the conclusion that Babcock's management's accounting judgement in respect of the Offsetting Arrangement complied with the applicable financial reporting framework (IFRS 9).

Breach Area 3 – Capitalisation of costs within the Aviation Division

<u>Background</u>

61. In both FY2019 and FY2020, the Group audit team assessed the capitalisation of maintenance costs as a 'normal' audit risk. The audit work in this area was performed by the relevant component audit teams with direction, supervision and review by the Group audit team.

62. Babcock's internal guidance on its accounting policies was set out within the Group Accounting Manual which was attached by the Group audit team to its instructions to the component teams and included in the Group audit file in both FY2019 and FY2020. The Group Accounting Manual comprised guidance to the Babcock finance function in a number of areas. However, the accounting policies as set out in the Group Accounting Manual were insufficiently detailed to be able to assess if they were compliant with applicable accounting standards with respect to the specific accounting for capitalisation of maintenance costs in the Aviation Division.

63. There is no evidence of review of the Group Accounting Manual by the Group audit team, and therefore no evidence as to how the Group audit team assessed whether the accounting practices of the Group were applied consistently and in compliance with

IFRS. There is also no evidence that the Group audit team challenged management to provide detailed guidance on the application of IFRS within the Group.

64. Babcock's accounting policies in relation to capitalisation of aircraft costs were inconsistent across the Group. In particular, there was inconsistent componentisation of airframes and rotables[7], with differing useful lives applied to each element which impacted depreciation being charged, and inconsistent treatment of maintenance parts. These inconsistencies appear to have been long-standing and resulted from the retention of legacy accounting policies of a business which was acquired by Babcock in FY2015 (**'Business A'**). Some legacy accounting policies and practices were not compliant with IFRS, which led to accounting errors.

65. In FY2019, the component audit team for Component A included a scope limitation in their interoffice audit report on Component A in relation to: (i) the depreciation of aircraft; and (ii) the accounting treatment of capitalised 'Parts by the Hours' (**'PBH'**)[8] costs. As a result, the Component A audit team did not express an opinion on the net book value of aircraft of €137 million.

66. The Component A audit team limited the scope in this way because of: (i) the capitalisation of PBH expenses, and (ii) local management's approach of applying a single depreciation rate to the whole value of the aircraft, which might have led to an overstatement of fixed assets as it did not reflect the fact that different parts of an aircraft have different useful lives.

67. The Group audit team documented that they were involved in discussion of the matter, and challenged the approach but ultimately agreed with the accounting treatment on the stated basis that it was below the group reporting threshold and therefore would not impact at a group level. The Group audit team therefore concluded that no further work was required.

68. There is no evidence to support these statements in the Group audit team's documented evaluation of the work of the Component A audit team. There is also no evidence of a substantive response to the scope limitation or an attempt to assess the implications of the scope limitation for the Group audit opinion.

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[7] Major life-limited aircraft parts such as engines, gearboxes and rotor blades.

[8] This phrase refers to expenses related to maintenance contracts for finance lease/owned helicopters that were capitalised – the term 'Power by the Hour' is used interchangeably.

69. In FY2019, the Component A audit team also reported a control deficiency in the following terms:

> *'The Babcock group accounting manual which is included in your instructions does not cover the specific issues related to* [redacted] *business such as capitalization of helicopters, depreciations, PBH, etc. In addition, local management is not aware of the existence of a Group Accounting Manual.'*

70. The Component A audit team therefore reported the following risk: '[n]*on- compliance with IFRS, inconsistency of accounting treatment across the group entities*'.

71. The Group audit team documented that the control deficiency raised by the Component A audit team would be '[r]*eported to management at sector clearance*'. The Group Accounting Manual was included in the Aviation year-end clearance meeting as an agenda item under '*Audit Findings – Control Observations*'. However, it is not clear from the notes of the meeting what was discussed on this issue. There is no evidence of further discussion or consideration of the reported risk by the Group audit team or that this specific issue was drawn to the attention of Group management. Further, there is no evidence that the Group audit team made enquiries regarding such concerns with other component auditors in the Aviation Division.

72. Similar scope limitations were included by the Component A audit team for FY2020 and the same control deficiency was also raised in FY2020. The Group audit team's response to the matters reported by the Component A audit team in FY2020 was substantively the same as in FY2019.

73. In FY2021, restatements were made in relation to the FY2019 and FY2020 Group Financial Statements in respect of capitalisation of maintenance costs in the Aviation Division. The balance sheet adjustments occurred in the following areas:

	Reduction in net assets	
	FY2019	**FY2020**
Maintenance of leased aircraft	£39.1 million	£47.1 million
Rotables – Maintenance of owned aircraft	£25.8 million	£30.8 million
Rotables – Maintenance of customer aircraft	£25.1 million	£28.1 million

Other[9]	£22.3 million	£19.9 million

Breaches

74. The audit work in relation to the capitalisation of costs in the Aviation Division for FY2019 and FY2020:

74.1. Breached paragraph 15 of ISA 200, in that the Respondents did not perform the work with adequate professional scepticism, in particular, by failing to recognise the possibility of material misstatement due to facts which had been brought to their attention.

74.2. Breached paragraph 11(c) of ISA 315, in that the Respondents failed, in carrying out their assessment of the risks of material misstatement in the Financial Statements through understanding the entity and its environment, to:

74.2.1. obtain an adequate understanding of Babcock's selection and application of accounting policies; and

74.2.2. to evaluate whether Babcock's accounting policies were appropriate for its business and consistent with the applicable financial reporting framework and accounting policies used in the relevant industry.

74.3. Breached paragraph 25 of ISA 330 in that, in relation to the control deficiency reported by the Component A audit team, the Respondents failed to:

74.3.1. assess adequately the risks of material misstatement;

74.3.2. design and implement appropriate procedures to respond to the risk of material misstatement; and therefore

74.3.3. evaluate adequately, before the conclusion of the audit, whether the assessments of the risks of material misstatement at the assertion level remained appropriate, based on the audit procedures performed and the audit evidence obtained.

74.4. Breached paragraph 6 of ISA 500, in that the Respondents did not design and perform audit procedures that were appropriate in the circumstances for the purpose of obtaining sufficient appropriate audit evidence that:

[9] This is a balancing figure including additional restatements for errors in property, plant and equipment balances, which are not solely related to maintenance costs.

74.4.1. Babcock's accounting policies for the capitalisation of costs and for depreciation in the Aviation Division were in accordance with IFRS; and

74.4.2. the work performed by the Group audit team and the component auditors on the financial information of Component A was adequate to support the Group audit opinion.

74.5. Breached paragraphs 42D-1(a) and 44 of ISA 600, in that, in relation to the limitation of scope reported by the Component A audit team, the Respondents failed adequately to:

74.5.1. evaluate and review the work performed by the component auditor for the purpose of the Group audit; or

74.5.2. evaluate whether sufficient appropriate audit evidence had been obtained from the work performed by the Group audit team and the component auditors on the financial information of Component A, on which to base the Group audit opinion.

74.6. Breached paragraphs 12, 13(b), 13(d) and 14(b) of ISA 700, in that, in relation to Babcock's approach to the capitalisation of costs and depreciation in the Aviation Division, the Respondents failed to evaluate whether:

74.6.1. the Financial Statements were prepared, in all material respects, in accordance with the requirements of the applicable financial reporting framework;

74.6.2. the accounting policies selected and applied were consistent with the applicable financial reporting framework and were appropriate;

74.6.3. the information presented in the Financial Statements was relevant, reliable, comparable and understandable; and

74.6.4. the Financial Statements represented the underlying transactions and events in a manner that achieves fair presentation.

Breach Area 4 – Oil & Gas intangible assets

Background

75. The acquisition of Business A in FY2015 resulted in finite-life intangible assets being recorded in Babcock's Aviation Division totalling £440 million. The intangible assets comprised brands and customer relationships relating to two Aviation Division businesses, one of which was Oil & Gas.

76. Following the initial recognition of an intangible asset, the relevant accounting standard IAS 38 (Intangible Assets) requires the intangible asset to be carried on the balance sheet at its cost less any accumulated amortisation and any accumulated impairment losses. Intangible assets with a finite life are amortised on a systematic basis over the assets' useful lives in a way that reflects the pattern in which the assets' future economic benefits are expected to be consumed by the entity.

77. IAS 38 also requires that the amortisation period is reviewed annually and changed if the estimated useful life changes.

78. In both FY2019 and FY2020, the Group audit team assessed this audit area as a 'normal' risk. The audit work performed in this area was undertaken by the Group audit team.

79. There is no evidence on the FY2019 Group audit file that the Group audit team made enquiries of management as to whether they had carried out the assessment required under IAS 38, of the amortisation period and the amortisation method of the finite-life Oil & Gas intangible assets (**'OGIA'**). Further, there is no evidence that the audit team performed any testing on the OGIA to ensure compliance with Babcock's own accounting policy on the amortisation of acquired intangibles.

80. At the FY2019 half year, the Group audit team were advised that management considered that the customer relationships on which the intangible assets were calculated had not delivered growth, were no longer of value in bidding or rebidding for work, and had initially proposed a write-off of the OGIA. The Group audit team did not seek evidence of the possible impact on useful lives.

81. The Group audit team failed to identify that management had not performed an assessment of the OGIA useful economic lives and hence did not challenge management to perform such an assessment. Had such an assessment been carried out, it would likely have identified in FY2019 that the customer relationships, which formed the basis of the OGIA value, had been lost in earlier years, that the useful economic lives were no longer appropriate, and that there may have been a prior year error.

82. In FY2020:

    82.1. there is no evidence that management reviewed the useful lives of the finite-life intangible assets of the Oil & Gas business;

82.2. there is no evidence that the Group audit team made enquiries of management as to their assessment under IAS 38 of whether the useful lives of such intangible assets remained appropriate; and

82.3. it is not evident that the Group audit team performed any testing on these assets to ensure compliance with Babcock's own accounting policy on the amortisation of acquired intangibles.

83. Although a £395 million impairment of goodwill in the Aviation CGU was recorded in FY2020 following challenge by the Group audit team, it does not appear that any separate consideration was given to whether this affected the remaining useful lives of the OGIA, or whether they remained appropriate. Had these possibilities been considered by the Group audit team, enquiries of management may have led to the realisation that the OGIA should have been revised. There had been sufficient indicators apparent in FY2019 in the Oil & Gas business that the useful economic lives were no longer appropriate then, and these remained present in FY2020.

84. In the FY2021 financial statements, Babcock reported that adjustments were necessary to reduce the carrying value of the OGIA to zero at 1 April 2019, the earliest date in relation to which a restatement could be made in FY2021.

<u>Breaches</u>

85. The audit work in relation to the audit of OGIA for both FY2019 and FY2020:

85.1. Breached paragraph 15 of ISA 200, in that the Respondents failed to demonstrate professional scepticism and failed to challenge management regarding the carrying value and the useful economic lives of the OGIA.

85.2. Breached paragraph 11(c) of ISA 315, in that the Respondents failed to evaluate whether Babcock's accounting policy was appropriate for its business and consistent with the applicable financial reporting framework.

85.3. Breached paragraph 26 of ISA 330, in that: (i) the Respondents failed to consider all relevant audit evidence, regardless of whether it appeared to corroborate or contradict the assertions in the Financial Statements; and (ii) there is no evidence as to how the Respondents assessed the risk that the useful economic lives of the OGIA did not remain appropriate.

85.4. Breached paragraph 6 of ISA 500, in that, despite being aware of factors raising the risk of an impairment of assets in the Aviation Division and having received audit evidence that was inconsistent and contradictory, the Respondents did not consider the risk that the useful economic lives of the OGIA did not remain appropriate and did not design and perform audit procedures that were appropriate in the circumstances for the purpose of obtaining sufficient appropriate audit evidence.

85.5. Breached paragraphs 12, 13(b), 13(d) and 14(b) of ISA 700, in that the Respondents:

85.5.1. failed to assess and identify that the application of Babcock's accounting policy for amortising the finite-life OGIA in the Aviation Division did not comply with IAS 38;

85.5.2. failed to identify that management had not reviewed the useful lives of the finite-life OGIA and reduced their reported value;

85.5.3. failed to perform any testing on the OGIA to ensure compliance with Babcock's own accounting policy on the amortisation of acquired intangibles; and

85.5.4. failed to evaluate whether the Financial Statements represented the underlying transactions and events in a manner that achieves fair presentation.

Breach Area 5 – Assessment of goodwill impairment

<u>Background</u>

86. Goodwill with a value of c.£2.6 billion was recorded in the FY2019 Group balance sheet and allocated between four CGUs (Marine, Aviation, Land and Nuclear), which reflected Babcock's four reporting segments. This amount represented future benefits that were expected to arise for Babcock from acquisitions that it had made, principally in 2010 and 2015. A reorganisation of the Group's operating segments was completed in FY2018.

87. The relevant accounting standard IAS 36 (Impairment of Assets) set out that each CGU shall:

87.1. represent the lowest level within the entity at which the goodwill is monitored for internal management purposes; and

87.2. not be larger than an operating segment as defined by the separate accounting standard IFRS 8 (Operating Segments).

88. IAS 36 required Babcock to perform an annual impairment assessment to assess whether the carrying value of goodwill was recoverable at the year end.

89. For each CGU, Babcock compared: (i) the carrying value of the net assets of each CGU; with (ii) the CGU's recoverable amount (being the higher of the CGU's fair value less costs of disposal and its value in use (**'VIU'**)).

90. Provided that the recoverable amount exceeded the carrying value, no impairment was required. A positive difference between the recoverable amount and the carrying amount is referred to in this document as 'headroom'.

91. Consistent with FY2018, the Group's Africa business was included within the Land CGU. However, the Africa business met the definition of an operating segment as defined in IFRS 8, and its cashflows should have been considered separately and not included within the Land CGU.

92. The impact of incorrectly including the Africa business cashflows within the Land CGU was that the large amount of headroom attributable to the Africa business led to an overstatement of the headroom in the Land CGU (excluding Africa), potentially understating the risk of impairment in that CGU.

93. In FY2019 and FY2020, the impairment of goodwill was identified as an 'elevated' audit risk and reported in the auditor's report as a key audit matter. The audit work in this area was performed by the Group audit team.

94. In FY2019 the Group audit team performed work on operating segments and documented that IAS 36 requires a CGU to be no larger than an operating segment (as defined by IFRS 8).

95. The Group audit team was aware that the Africa business had been aggregated with the Land Division for goodwill impairment testing as it had performed a sensitivity analysis to remove the Africa cashflows from the Land CGU VIU model *'to ensure that there is no risk of impairment once the cash flows relating to Africa are removed'*. The Group audit file recorded that this test was performed given that *'none of the goodwill included in the Land operating segment relates to the Africa business'.* This was incorrect, as there was approximately £2 million of goodwill that related to the Africa business.

96. The Group audit team was also aware of increased disclosures within Note 3 to the FY2019 Financial Statements (Segmental information). These included a statement that Babcock's business in Africa met the definition of an operating segment.

97. However, there is no documented consideration by the audit team that the Africa business should have been identified as a CGU for impairment testing purposes in accordance with IAS 36.

98. In FY2020, Babcock's goodwill had a carrying value of c.£2.2 billion following the £395 million impairment charge against goodwill for the Aviation CGU referred to in paragraph 83 above.

99. The fact that the Africa business was incorrectly included in the Land CGU was not identified by the Group audit team during the FY2020 Group audit either, despite the FY2020 Financial Statements including the same disclosures that explained that the Africa business met the definition of an operating segment.

100. In FY2020, the Group audit team noted that combining the impact of sensitivities tested in the Land Division almost '*entirely eroded*' headroom for the Land CGU.

101. A new accounting standard IFRS 16 (Leases) became effective for reporting periods beginning on or after 1 January 2019. FY2020 was therefore the first year of implementation of IFRS 16 by Babcock. PwC's Valuations team recommended to the Group audit team that impairment testing was performed on a post IFRS 16 basis.

102. Despite this, in FY2020 Babcock continued to carry out its goodwill impairment testing on the basis of the old accounting standard IAS 17 (Leases) and did not adjust cash flows, discount rate and asset and liability values for IFRS 16 in the VIU calculation. The Group audit team carried out its audit work on goodwill impairment on management's pre-IFRS 16 workings, as management were unable to prepare calculations on a post-IFRS 16 basis during FY2020. The Group audit team recorded their expectation that performing the impairment assessment on an IFRS 16 basis would have an immaterial net impact, but there is no documented audit work to support that conclusion.

103. In FY2021, a prior year restatement was made to record an impairment of £123 million in respect of the Land CGU, in the year ended 31 March 2020. This was to correct the error in assessing the Africa business as a separate CGU, and a separate computational error identified in the Land CGU model.

<u>Breaches</u>

104. The audit work in relation to the assessment of goodwill impairment:

104.1. Breached paragraph 15 of ISA 200, in that the Respondents failed to inform management that aggregating the results of the Africa business in the Land CGU was inappropriate and failed to require management to re-conduct the goodwill impairment testing, and thereby exhibited a lack of professional scepticism.

104.2. Breached paragraph 6 of ISA 500, in that:

104.2.1. the Respondents failed to obtain sufficient appropriate audit evidence to support their conclusions in respect of the carrying value of goodwill in the Land CGU and the disclosures in the Financial Statements required by IAS 36; and

104.2.2. in relation to FY2020 only, the Respondents failed to obtain sufficient appropriate audit evidence to support their conclusion that carrying out impairment testing on an IFRS 16 basis would have an immaterial impact.

104.3. Breached paragraphs 12, 13(b) (and, in relation to FY2019 only, paragraph 13(d)) of ISA 700, in that the Respondents failed to assess and identify that management's inclusion of the Africa business within the Land CGU for the purpose of goodwill impairment testing was not in accordance with the requirements of IAS 36.

Breach Area 6 – Accounting for credit notes as income

<u>Background</u>

105. In FY2019 and FY2020, based on the existing accounting practices of the Group since the acquisition of Business A in FY2015, credit notes received from aircraft manufacturers at the point of placing orders for an aircraft, exercisable against the purchase of future parts and services, were recorded as income on receipt. The aircraft cost was then capitalised or subject to a sale and leaseback arrangement on the basis of the full price, effectively resulting in a gain being recorded on the purchase of the aircraft.

106. In both FY2019 and FY2020, the Group audit team assessed this audit area as a 'normal' risk. The audit work was undertaken by the component audit teams for three components in the Aviation Division that were within the scope of the Audits – Component A, Component B and Component C – with direction, supervision and review by the Group audit team.

107. As set out in paragraph 62 above, Babcock's internal guidance on its accounting policies was set out in its Group Accounting Manual which was attached by the Group audit team to its instructions to the component audit teams. There was insufficient detail in the Group Accounting Manual to guide Babcock finance teams on the application of the general accounting policies to specific areas such as accounting for credit notes provided on the acquisition of an aircraft.

108. There is no evidence of review of the Group Accounting Manual by the Group audit team and therefore no evidence as to how the Group audit team assessed whether the

accounting practices of the Group were applied consistently and in compliance with IFRS. There is also no evidence that the Group audit team challenged management to provide detailed guidance on the application of IFRS within the Group.

109. Babcock's application of its accounting policies in relation to credit notes received on the acquisition of aircraft was not compliant with IFRS, when evaluated against the substance of the associated contractual relationships. The resulting error was not identified in the FY2019 or FY2020 Audits and the component audit teams for Component A, Component B and Component C did not report any misstatements in this respect.

110. In FY2021, management determined that the above accounting treatment of credit notes was incorrect and that such credit notes should be accounted for as a discount on the purchase price of an aircraft. This resulted in a reduction in the cost of aircraft recorded in the balance sheet, with the credit note benefit recognised in the form of lower depreciation. A prior year adjustment was recognised to reduce net assets at 1 April 2019 by £37.7 million and at 31 March 2020 by £42.8 million, and increase operating costs by £5.1 million in the year ended 31 March 2020.

Breaches

111. The audit work in relation to the accounting for credit notes in the Aviation Division for FY2019 and FY2020:

111.1. Breached paragraph 15 of ISA 200, in that the Respondents failed to exercise professional scepticism and challenge management sufficiently as to whether Babcock's application of its accounting policy complied with IFRS and failed to recognise the possibility of a material misstatement.

111.2. Breached paragraph 11(c) of ISA 315, in that the Respondents in carrying out their assessment of the risks of material misstatement in the Financial Statements, through understanding the entity and its environment, failed to:

111.2.1. obtain an adequate understanding of Babcock's selection and application of accounting policies; and

111.2.2. failed to evaluate whether Babcock's accounting policies were appropriate for its business and consistent with the applicable financial reporting framework and accounting policies used in the relevant industry.

111.3. Breached paragraph 6 of ISA 500, in that the Respondents failed to perform audit procedures that were appropriate in the circumstances for the purpose of obtaining sufficient appropriate audit evidence that Babcock's accounting practices for the recording of credit notes in the Aviation Division were in accordance with IFRS.

111.4. Breached paragraphs 12, 13(b), 13(d) and 14(b) of ISA 700, in that the Respondents failed to evaluate whether:

111.4.1. the Financial Statements were prepared, in all material respects, in accordance with the requirements of the applicable financial reporting framework;

111.4.2. the accounting policies selected and applied were consistent with the applicable financial reporting framework and were appropriate;

111.4.3. the information presented in the Financial Statements is relevant, reliable, comparable and understandable; and

111.4.4. the Financial Statements represented the underlying transactions and events in a manner that achieves fair presentation.

Breach Area 7 – The Phoenix II contract

<u>Background</u>

112. The Phoenix II Contract was a 6-year contract (with the option for a further 4-year extension) entered into in February 2016 between Babcock and a branch of the MOD, for Babcock to provide management of leased vehicle fleet and provision of rental bookings across the UK and Northern Europe.

113. Under part of the contract, Babcock was responsible for selecting and paying suppliers to the MOD, and recharging these amounts to the MOD. There was no margin attached to this revenue, which was described as 'passthrough' revenue. Babcock recorded the revenue and costs in its income statement on a principal basis; had it been an agent, both revenue and costs would have been removed from its income statement. In FY2019 'passthrough' revenue was £98.1 million and in FY2020 it was £96.2 million.

114. The Phoenix II Contract was preceded by an earlier Phoenix contract in FY2012. On inception of the original Phoenix contract the component audit team concluded, following consultation with ACS, that whilst the accounting treatment under the relevant accounting standard IAS 18 (Revenue) was a fine judgement, recognition of revenue as principal was appropriate. When the Phoenix II Contract was signed in FY2016 (at which time IAS 18 remained the relevant accounting standard for revenue) the component audit team concluded that recognition as principal remained appropriate due to the similarity of the two contracts.

115. In FY2019 and FY2020, the Group audit team identified as a specific significant risk, '*Fraud in revenue recognition – contract accounting and revenue / profit recognition*', which is applicable to this audit area. The relevant audit work was undertaken by a component audit team with direction, supervision and review by the Group audit team.

116. In FY2019, a new accounting standard IFRS 15 (Revenue from Contracts with Customers) was adopted by Babcock, and therefore became the relevant accounting standard for revenue.

117. The impact of the incoming IFRS 15 standard on the treatment of revenue under the Phoenix II Contract had been considered by Babcock's management in FY2018, with its assessment set out in a paper (**'management's FY2018 paper'**). The component audit team reviewed management's FY2018 paper during the FY2018 audit (including consulting with ACS) and it was concluded in FY2018 that Babcock could continue to be treated as the contract principal.

118. The FY2019 audit files referred to management's FY2018 paper but did not include sufficient explanation of how that paper had been considered by the component audit team (including any challenge of management) in reaching the documented conclusion that it was appropriate for Babcock to continue to be treated as principal.

119. Management's FY2018 paper failed to demonstrate a clear understanding of the difference, as between the outgoing accounting standard (IAS 18) and incoming accounting standard (IFRS 15), in relation to the factors to be taken into account when making the judgement as to whether the entity was principal or agent.

120. There is no documented evidence that the component audit team evaluated management's FY2018 paper, identified the apparent weaknesses and questioned management about them. Whilst the component audit team did document their assessment of why the initial ACS consultation in 2012 was relevant to Phoenix II, the FY2019 audit files do not refer to evidence obtained or document the details of the FY2018 consultation with ACS on IFRS 15.

121. As a result, there is inadequate documentation on the FY2019 audit files setting out the considerations in contract accounting treatment under IFRS 15 and how the conclusion that Babcock could be treated as the contract principal as regards 'passthrough' revenue under IFRS 15 was reached. Consequently, there is inadequate evidence to support that conclusion.

122. IFRS 15, paragraph B36 states that, '[a]*n entity is an agent if the entity's performance obligation is to arrange for the provision of the specified good or service by another*

party'. Given that Babcock's role as regards the 'passthrough' revenue was to arrange for the provision of a '*specified good or service*' (i.e. vehicles) '*by another party*' (i.e. lessors), the component audit team should have challenged management as to why Babcock's role under the Phoenix II Contract did not meet the description of an agent under IFRS 15. In particular, evidence should have been obtained to assess whether Babcock controlled the vehicles before they were transferred to the customer, the MOD. There is no documentation on the FY2019 audit files to evidence any such challenge.

123. As in FY2019, there is inadequate evidence within the FY2020 audit files of how the considerations in contract accounting under IFRS 15 had been applied to the recognition of 'passthrough' revenue under the Phoenix II Contract.

124. In FY2020, another new accounting standard IFRS 16 (Leases) was adopted by Babcock. During the FY2020 Group Audit, the component audit team was informed that management did not consider the Phoenix II vehicle leases to be Babcock's leases and that as a result, they were not recognised as right-of-use assets on Babcock's balance sheet, together with corresponding liabilities.

125. The ACS team questioned the apparent inconsistency between management's position that the Phoenix II leases were not Babcock's leases for the purposes of IFRS 16, whilst maintaining that Babcock was the principal under IFRS 15 in respect of 'passthrough' revenue. This was addressed in emails between ACS and both the Group audit team and the component audit team. ACS explained that they needed to ensure there was sufficient evidence on the audit files to show that Babcock was not the lessee in the contracts. This discussion was documented in the Group audit team hot review where it was raised as a review matter. The Group audit team formally responded to the hot review comment, and the action was concluded as a Group audit team judgment.

126. Despite ACS's recommendations, the Group and component audit teams did not revisit or challenge the agent/principal judgement with management and therefore failed to adequately explore and resolve the issue.

<u>Breaches</u>

127. The audit work for FY2019 and FY2020 in relation to the Phoenix II Contract:

127.1. Breached paragraph 15 of ISA 200, in that the Respondents failed to challenge management as to why Babcock's role under the Phoenix II Contract did not meet the description of an agent under IFRS 15 and (in FY2020 following the coming into effect of IFRS 16) failed to do so despite the inconsistency of not recognising the leases whilst continuing to treat Babcock as principal for the purposes of ‘passthrough’ revenue.

127.2. Breached paragraph 6 of ISA 500, in that insufficient audit evidence was obtained in relation to the required considerations for assessing the contract accounting treatment under IFRS 15 and IFRS 16, and consequently there was insufficient audit evidence to support the conclusion that Babcock should be treated as principal as regards ‘passthrough’ revenue.

Breach Area 8 – The DSG Contract

Background

128. The DSG Contract was a 10-year contract agreed in March 2015 between the MOD and a subsidiary of Babcock for the provision of military vehicle fleet management services.

129. In FY2019 and FY2020 the Respondents identified a specific significant risk relevant to this audit area: ‘*Fraud in revenue recognition - contract accounting and revenue / profit recognition’*. The audit work was undertaken by a component audit team with direction, supervision and review by the Group audit team.

130. There were deficiencies in the auditing of three aspects of the DSG Contract:

130.1. Revenue forecasting.

130.2. Recognition of savings in forecast costs to complete.

130.3. Impairment of the DSG Contract acquired intangible.

Revenue forecasting

131. About 40% of Babcock’s revenue under the DSG Contract was for the provision of fleet management and vehicle maintenance and repair services. This amounted to £137.7 million in FY2019 and £153.3 million in FY2020. Babcock calculated these figures by using an Estimate at Completion (**‘EAC’**) model to estimate the long-term margin that would be earned over the lifetime of the contract. The EAC model included ‘unsecured’ revenue – revenue that was not committed to under the terms of the contract, but which management believed met the criteria for recognition.

132. Management provided narrative explanations for the elements of this unsecured revenue, but there is limited evidence of challenge or consideration by the component audit team of whether the criteria for recognition of the revenue under the relevant accounting standard (IFRS 15) had been met or whether there was additional evidence to support management’s assumptions. There was no assessment on a disaggregated basis which considered whether each unsecured revenue item was variable

consideration or a contract modification and therefore what the appropriate accounting treatment was for such unsecured revenue under IFRS 15.

133. Further, the component audit team did not consider whether it was necessary to develop a range with respect to forecast revenue or forecast costs to complete, with which to evaluate the reasonableness of the accounting estimate.

134. These issues apply to both Audits.

Recognition of savings in forecast costs to complete

135. The EAC model estimated that £499 million in costs savings would be achieved over the 10-year life of the DSG Contract.

136. In the FY2019 Audit, the component audit team compared this target with the savings achieved to FY2019 (the **'run rate'**) across a number of categories. Where there was a significant variance, the component audit team questioned management as to how they expected to meet the target. However, it was not explained how the run rate was calculated, or its significance as support for the achievement of future savings. There was no explanation of the source of the analysis of FY2019 savings, and no evidence that these savings were agreed to Babcock's accounting records.

137. £39.7 million of 'cost savings identified' were expected to be achieved in FY2020 as a result of two projects to streamline the workforce. The component audit team challenged Babcock's ability to reduce the workforce while still maintaining customer service standards, and obtained some documentary evidence to support the achievement of the savings. However, the component audit team did not evaluate the evidence by obtaining further information to test the savings figures provided by management.

138. A further £29.2 million of 'cost savings unidentified' were expected across the remainder of the life of the contract, arising from various sources. There is no evidence that the component audit team challenged management on the inclusion of these savings. Reliance was placed on savings achieved in the first four years of the contract, with no additional evidence being sought to support the achievement of future savings.

139. The component audit team performed a sensitivity analysis to assess the impact on the margin if the unidentified cost savings could not be achieved. The basis of this calculation was not clearly explained but the analysis indicated a margin reduction of £15 million. This was a sufficiently significant sum that it should have led the component audit team to challenge more robustly the basis for including the unidentified cost savings and to seek better supporting evidence. Instead, the component audit team

documented that, while there would be a material impact if the additional savings were not achieved, the likelihood of this was extremely low.

140. In the FY2020 Audit, the component audit team did not record that they had compared the total cost savings estimated in the EAC model with the savings achieved to FY2020 across different categories. Consequently, the component audit team did not seek to obtain explanations from management for variances, as had been done in FY2019.

141. Although in FY2019 it had been estimated that £39.7 million of identified cost savings would be achieved in FY2020, the actual savings achieved in FY2020 were only £6 million. This does not appear to have been noted by the component audit team in the FY2020 Audit, and it did not lead the team to challenge the achievability of the forecast savings over the remainder of the contract.

142. In relation to the £29.2 million of unidentified cost savings, in the FY2020 Audit the component audit team documented analysis, calculations and narrative explanations provided by management, agreed some of the calculations to source and noted that gross savings targets had been reduced by 25-50%. However, there is no evidence that the component audit team challenged the achievability of the savings and their suitability for inclusion in the EAC model. Reliance was placed on savings achieved in previous years without seeking additional evidence.

143. In the FY2020 Audit, the component audit team did not perform a sensitivity analysis to assess the impact on the margin if the remaining cost savings could not be achieved.

Impairment of DSG Contract acquired intangible asset

144. An acquired contract intangible asset of £140.9 million was recorded when Babcock took on the DSG Contract in 2015, reflecting the cash flows from the DSG Contract and additional cash flows from future opportunities that were expected to arise out of the MOD/DSG relationship. During FY2019 the MOD confirmed that one of these opportunities would not proceed as it did not meet their value for money criteria, but management did not consider this an impairment indicator and did not carry out an impairment assessment. In the FY2019 Audit, the component audit team did not adequately challenge management on why there was no impairment indicator, and did not require management to carry out an impairment assessment. Instead, the component audit team updated an impairment assessment model from FY2017 and discussed this with management.

145. Key to supporting the carrying value was the inclusion of additional revenue to replace the revenue from the opportunity that was no longer available. In the FY2019 Audit the

component audit team obtained an analysis of future growth opportunities and included in its impairment calculation forecast profits of £59.4 million from various proposals being discussed with the MOD. This figure was 72% of the total profits projected from future growth opportunities, at a margin of 60%. It is not evident that the component audit team considered the probability of Babcock achieving such a high proportion of projected profits from opportunities that were still at the proposal stage. The component audit team also did not challenge whether the margin was achievable bearing in mind that value for money was the MOD's reason for rejecting the earlier opportunity. In addition, the component audit team did not consider the impact on the impairment assessment model if the additional revenue was not fully achieved or the profit margin was lower than estimated.

146. In FY2020, management carried out an impairment review of the DSG Contract intangible asset. Their assessment assumed that the MOD would extend the contract for five years to 2030. In the FY2020 Audit, the component audit team recorded that they were satisfied that this assumption was reasonable, on the basis of strong KPI performance and the high barriers to entry for a competitor. However, it is not evident how the component audit team reached the conclusion that the MOD would take up the full five-year extension. There is no evidence that the component audit team evaluated whether the contract extension had been granted or the likelihood of it being granted, or considered whether it was appropriate under the applicable accounting standard (IAS 38) to conclude that the useful life of the intangible asset had been increased to 15 years and therefore to include cash flows in the VIU model that extended beyond the original 10-year useful life.

147. In FY2021 the DSG Contract acquired intangible asset was impaired by £56.4 million because its carrying value could no longer be justified following a reassessment of the contract profitability under the CPBS Review.

<u>Breaches</u>

148. In FY2019 and FY2020 the audit work in relation to the DSG Contract:

148.1. Breached paragraph 15 of ISA 200, in that the Respondents failed to demonstrate adequate professional scepticism in the evaluation of the evidence in relation to forecast unsecured revenue, forecast costs to complete and impairment of the intangible asset.

148.2. Breached paragraphs 15, 16 and 17 of ISA 220, in that in relation to the auditing of forecast unsecured revenue, forecast costs to complete and impairment of the intangible asset, Mr Waters failed adequately to:

148.2.1. take responsibility for the direction, supervision and performance of the Audits in accordance with the ISAs;

148.2.2. take responsibility for reviews being performed in accordance with PwC's policies and procedures; or

148.2.3. satisfy himself that sufficient appropriate audit evidence had been obtained to support the conclusions reached.

148.3. Breached paragraph 6 of ISA 500, in that the Respondents failed to obtain sufficient appropriate audit evidence in relation to forecast unsecured revenue, forecast costs to complete and impairment of the intangible asset.

148.4. Breached paragraphs 9, 12, 15, 16, 17, 18, 21, 21-D and 23 of ISA 540, in that the Respondents failed adequately to:

148.4.1. review the outcome of accounting estimates in relation to forecast costs to complete and impairment of the intangible asset that were included in the prior period financial statements, in breach of paragraph 9 of ISA 540;

148.4.2. determine whether management had appropriately applied the relevant requirements of the applicable financial reporting framework, and whether management's methods for making the accounting estimates in relation to forecast costs to complete and impairment of the intangible asset were appropriate, in breach of paragraph 12 of ISA 540;

148.4.3. evaluate how management had considered alternative assumptions or outcomes or had otherwise addressed estimation uncertainty in making the accounting estimates in relation to forecast revenue and forecast costs to complete savings, and evaluate the reasonableness of the significant assumptions used by management and management's intent and ability to carry out specific courses of action relevant to the significant assumptions used, in relation to forecast costs to complete, in breach of paragraph 15 of ISA 540;

148.4.4. develop a range with which to evaluate the reasonableness of the accounting estimates in relation to forecast costs to complete, where management had not adequately addressed the effects of estimation uncertainty, in breach of paragraph 16 of ISA 540;

148.4.5. obtain sufficient appropriate audit evidence about whether management's decision to recognise the accounting estimates in relation to forecast costs to complete, and the selected measurement basis for the accounting estimates, were in accordance with the requirements of the applicable financial reporting framework, in breach of paragraph 17 of ISA 540;

148.4.6. evaluate whether the accounting estimates in relation to forecast costs to complete and impairment of the intangible asset were reasonable in the context of the applicable financial reporting framework, in breach of paragraph 18 of ISA 540;

148.4.7. review the judgments and decisions made by management in making the accounting estimates in relation to forecast costs to complete and impairment of the intangible asset, to identify whether there were indicators of possible management bias, in breach of paragraph 21 of ISA 540;

148.4.8. maintain professional scepticism when reviewing the management estimates in relation to forecast costs to complete and impairment of the intangible asset, in breach of paragraph 21-D of ISA 540; and

148.4.9. include in the audit documentation the basis for the component audit team's conclusions about the reasonableness of the accounting estimates and indicators of possible management bias, in relation to forecast costs to complete, in breach of paragraph 23 of ISA 540.

148.5. Breached paragraphs 42 and 44 of ISA 600, in that the Respondents failed to:

148.5.1. review the communications from the component audit team adequately in relation to forecast revenue, forecast costs to complete and impairment of the intangible asset; and

148.5.2. evaluate whether sufficient appropriate audit evidence had been obtained from the work performed by the Group audit team and the component auditors on the financial information of the components in relation to those matters, on which to base the Group audit opinion.

F. *SANCTIONS*

149. Paragraph 10 of the FRC's Sanctions Policy (Audit Enforcement Procedure) (the **'Sanctions Policy'**) provides that *Sanctions* are intended to be effective, proportionate

and dissuasive. The reasons for imposing *Sanctions* are identified in paragraph 11 of the Sanctions Policy as the following:

149.1. 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.

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

149.3. To protect the public from *Statutory Auditors* and *Statutory Audit Firms* whose conduct has fallen short of the *Relevant Requirements*.

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

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

151. Paragraph 21 of the Sanctions Policy sets out the following process for determining *Sanctions*:

151.1. Assess the nature and seriousness, gravity and duration of the breaches and the degree of responsibility of the Respondents.

151.2. Identify the *Sanctions* considered potentially appropriate.

151.3. Consider any relevant aggravating or mitigating circumstances.

151.4. Consider any further adjustment necessary to achieve the appropriate deterrent effect.

151.5. Consider whether a discount for admissions or early disposal is appropriate.

<u>The nature, seriousness, gravity and duration of the breaches, and the degree of responsibility of the Respondents</u>

152. The breaches were serious and numerous, affecting eight audit areas, and across two audit years. There were failures of professional scepticism and failures to obtain sufficient appropriate audit evidence in all eight areas, and failures to achieve fair presentation or compliance with accounting standards in five. These are all fundamental requirements of any audit. Across the areas investigated, there were failures to challenge management adequately as to whether their accounting approach was compliant with the financial reporting framework, and an insufficient audit response to the risk of material misstatement.

153. It is right to note that:

153.1. Five of the eight breach areas had been assessed by the Respondents as carrying a ‘normal’ rather than an ‘elevated’ or ‘significant’ level of audit risk (and this assessment is not challenged).

153.2. A number of the breaches are concentrated in the Aviation Division, which was the smallest of Babcock’s four reporting segments, and did not include any individually material components or Aviation Division specific significant risk areas in either audit year. However, other breaches concerned the larger Land Division (the issues concerning the assessment of goodwill impairment and the DSG and Phoenix II Contracts) or otherwise affected the business more widely (the cash pooling issue).

154. Restatements were made in FY2021 to correct material prior period errors associated with five of the eight breach areas (although these did not impact the core performance measures of the business and there was no quantifiable effect on shareholder value). As a result of the breaches, the Audits failed in their principal objective, namely to obtain reasonable assurance about whether the Financial Statements as a whole were free from material misstatement.

155. In aggregate the breaches:

155.1. Potentially adversely affected a significant number of people in the United Kingdom (such as the public, investors or other market users), and could have harmed investor, market and public confidence in the truth and fairness of the financial statements published by *Statutory Auditors* or *Statutory Audit Firms*. Babcock’s shares are listed on the main market of the London Stock Exchange.

155.2. Had the potential to undermine confidence in the standards of conduct in general of *Statutory Auditors* and *Statutory Audit Firms*, and/or in S*tatutory Audit*.

156. The breaches were not dishonest, deliberate or reckless. They were not done with a view to gain, and did not in fact result in any financial benefit to the Respondents (the fees for the Audits being payable to PwC in any event).

157. With regard to the position of Mr Waters, he faced severe challenges in discharging his responsibilities as Group engagement partner. He was appointed to the FY2019 Audit at short notice and without the opportunity for any handover from his predecessor, after work on the audit had begun. Understandably, his focus was on those audit areas identified as being of significant risk (which, it is acknowledged, were not the areas affected by the majority of the FY2019 and FY2020 breaches). The COVID-19 pandemic

then made the FY2020 Audit significantly more difficult, preventing Mr Waters from meeting in person with management, the component audit teams or members of the Group audit team.

158. PwC is one of the four largest audit firms in the UK, with audit fee income of £1,046 million and total fee income of £4,271 million in 2025.

159. PwC has been the subject of *Sanctions* on seven previous occasions in the past five years, receiving financial sanctions ranging from £2.5 million to £7.5 million, prior to any discount for mitigating factors and settlement. The largest financial sanction of £7.5 million was imposed in January 2023 for breaches in the course of the FY2017 and FY2018 audits of Babcock. Mr Waters was not involved in those audits. The findings of Executive Counsel's investigation into the FY2017 and FY2018 audits were not available to the Respondents at the time of the Audits, although the Respondents were aware that the investigation had been opened. The breaches identified in respect of the FY2017 and FY2018 audits mainly related to accounting for long term contracts; with the exception of some overlap in relation to assessment of goodwill impairment and the Phoenix II and DSG Contracts, the breaches identified in respect of the Audits are largely of a different nature.

160. During Executive Counsel's investigation, PwC carried out a Root Cause Analysis (**'RCA'**), with the participation of Mr Waters, to identify the underlying causes of the admitted audit failings and assess the extent to which they had been addressed by remedial actions already taken by PwC. The RCA report identified numerous changes to PwC's audit practice since the Audits which should reduce the likelihood of any recurrence of the breaches that occurred in this case. However, Executive Counsel considers that there remains a residual risk that can only be adequately mitigated by requiring PwC to monitor the measures taken and implement further improvements, if needed.

161. Mr Waters has retired from PwC and is no longer registered as a *Statutory Auditor*. Throughout his long career, Mr Waters maintained an unblemished regulatory record.

<u>Identification of potential *Sanctions*</u>

162. Having assessed the nature, seriousness, gravity and duration of the breaches (and having regard to the financial resources of the Respondents, so far as relevant) Executive Counsel identified the following combination of *Sanctions* as potentially appropriate:

162.1. A financial sanction of £5,500,000 in the case of PwC and £100,000 in the case of Mr Waters.

162.2. A published statement in the form of a severe reprimand, in the case of each Respondent.

162.3. A declaration that the reports signed on behalf of PwC in respect of the Audits did not satisfy the *Relevant Requirements* in relation to the matters set out in this *Final Settlement Decision Notice*.

162.4. In the case of PwC, an order requiring the firm to take the following action with the aim of preventing the recurrence of the contravention:

162.4.1. To: (i) develop and trial additional measures to ensure that there is more formalised ongoing central monitoring of indicators of increasing audit risk, and mitigation of that risk where this is required, and (ii) report to the FRC, within a period to be agreed, on the outcome of the trial, including any enhancements to the measures to be adopted.

162.4.2. To report to the FRC, within a period to be agreed, on the effectiveness of the measures in place within the firm to mitigate the risks arising where there is a change of engagement leader on an ongoing audit, and on any enhancements to the measures needed as a result of the effectiveness assessment.

<u>Aggravating and mitigating factors</u>

163. Executive Counsel then considered any aggravating and mitigating factors not already taken into account in relation to the nature, seriousness, gravity and duration of the breaches.

164. There are no aggravating factors that have not already been considered in the context of the seriousness of the breaches. In particular, PwC's disciplinary record has already been taken into account.

165. With regard to mitigating factors, Mr Waters' clean disciplinary record, the remedial steps already taken by PwC and the fact that neither Respondent stood to gain any financial benefit from the breaches have already been taken into account. The only mitigating factor not already considered is the co-operation provided by the Respondents during the investigation.

166. Both Respondents provided an exceptional level of co-operation during the investigation of the breaches by Executive Counsel, in that:

166.4. PwC carried out two separate critical self-reviews of different areas of the Audits at the request of Executive Counsel, and disclosed the findings.

166.5. PwC carried out the RCA to which reference has already been made, and disclosed the findings.

166.6. Mr Waters participated fully in these exercises and continued to engage with Executive Counsel's investigation in a professional and fully co-operative fashion before and after his retirement.

167. In light of this exceptional co-operation, Executive Counsel concluded that a discount to the financial sanction of 12.5% is appropriate in the case of each Respondent.

Deterrence

168. Having considered the matters set out at paragraphs 72 and 73 of the Sanctions Policy, Executive Counsel concluded that no adjustment for deterrence was required in this case.

Discount for Admissions and Settlement

169. Having taken into account the full admissions by the Respondents and the stage at which those admissions were made (early in Stage 1, as defined in paragraph 84 of the Sanctions Policy, but not at the earliest possible point in time), Executive Counsel determined that a reduction of 32.5% as to the financial sanction was appropriate in the case of each Respondent.

170. The amount payable in respect of the financial sanctions is therefore £3,248,437 in the case of PwC and £59,062 in the case of Mr Waters.

G. *COSTS*

171. Executive Counsel requires that the Respondents pay her costs in full in this matter, being £1,085,360. Such costs shall be paid no later than 28 days after the date of this *Final Settlement Decision Notice*.

Signed:

[Redacted]

JAMIE SYMINGTON
DEPUTY EXECUTIVE COUNSEL

Date: 23 March 2026

APPENDIX – EXTRACTS FROM *RELEVANT REQUIREMENTS*

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

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.

    In the UK, the auditor shall maintain professional skepticism throughout the audit, recognising the possibility of a material misstatement due to facts or behaviour indicating irregularities, including fraud, or error, notwithstanding the auditor's past experience of the honesty and integrity of the entity's management and of those charged with governance.

ISA (UK) 220 (Quality control for an audit of financial statements)

15. The engagement partner shall take responsibility for:

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

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

16. The engagement partner shall take responsibility for reviews being performed in accordance with the firm's review policies and procedures.

17. On or before the date of the auditor's report, the engagement partner shall, through a review of the audit documentation and discussion with the engagement team, be satisfied that sufficient appropriate audit evidence has been obtained to support the conclusions reached and for the auditor's report to be issued.

ISA (UK) 260 (Communication with those charged with governance)

16. The auditor shall communicate with those charged with governance:

    (a) The auditor's views about significant qualitative aspects of the entity's accounting practices, including accounting policies, accounting estimates and financial statement disclosures. When applicable, the auditor shall explain to those charged with governance why the auditor considers a significant accounting practice, that is acceptable under the applicable financial reporting framework, not to be most appropriate to the particular circumstances of the entity;

ISA (UK) 315 (Identifying and assessing the risks of material misstatement through understanding of the entity and its environment)

11. The auditor shall obtain an understanding of the following:

    …

    (c) The entity’s selection and application of accounting policies, including the reasons for changes thereto. The auditor shall evaluate whether the entity’s accounting policies are appropriate for its business and consistent with the applicable financial reporting framework and accounting policies used in the relevant industry.

ISA (UK) 330 (The auditor’s responses to assessed risks)

25. Based on the audit procedures performed and the audit evidence obtained, the auditor shall evaluate before the conclusion of the audit whether the assessments of the risks of material misstatement at the assertion level remain appropriate.

26. The auditor shall conclude whether sufficient appropriate audit evidence has been obtained. In forming an opinion, the auditor shall consider all relevant audit evidence, regardless of whether it appears to corroborate or to contradict the assertions in the financial statements.

ISA (UK) 500 (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 (UK) 540 (Auditing accounting estimates, including fair value accounting estimates, and related disclosures)

9. The auditor shall review the outcome of accounting estimates included in the prior period financial statements, or, where applicable, their subsequent re-estimation for the purpose of the current period. The nature and extent of the auditor’s review takes account of the nature of the accounting estimates, and whether the information obtained from the review would be relevant to identifying and assessing risks of material misstatement of accounting estimates made in the current period financial statements. However, the review is not intended to call into question the judgments made in the prior periods that were based on information available at the time.

    …

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.

…

15. For accounting estimates that give rise to significant risks, in addition to other substantive procedures performed to meet the requirements of ISA (UK) 330 (Revised July 2017),7 the auditor shall evaluate the following:

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

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

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

16. If, in the auditor's judgment, management has not adequately addressed the effects of estimation uncertainty on the accounting estimates that give rise to significant risks, the auditor shall, if considered necessary, develop a range with which to evaluate the reasonableness of the accounting estimate.

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

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

    (b) the selected measurement basis for the accounting estimates,

    are in accordance with the requirements of the applicable financial reporting framework

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

…

21. The auditor shall review the judgments and decisions made by management in the making of accounting estimates to identify whether there are indicators of possible management bias. Indicators of possible management bias do not themselves constitute misstatements for the purposes of drawing conclusions on the reasonableness of individual accounting estimates.

21D-1. In accordance with ISA (UK) 200 (Revised June 2016),7 the auditor shall maintain professional skepticism throughout the audit and in particular when reviewing management estimates relating to fair values, the impairment of assets and provisions.

…

23. The auditor shall include in the audit documentation:

(a) The basis for the auditor's conclusions about the reasonableness of accounting estimates and their disclosure that give rise to significant risks; and

(b) Indicators of possible management bias, if any.

ISA (UK) 600 (Special considerations—audits of group financial statements (including the work of component auditors))

42. The group engagement team shall evaluate the component auditor's communication (see paragraph 41). The group engagement team shall:

(a) Discuss significant matters arising from that evaluation with the component auditor, component management or group management, as appropriate; and

(b) Determine whether it is necessary to review other relevant parts of the component auditor's audit documentation.

42D-1. The group engagement team shall:

(a) Evaluate and review the work performed by the component auditor for the purpose of the group audit;

…

44. The auditor is required to obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion. The group engagement team shall evaluate whether sufficient appropriate audit evidence has been obtained from the audit procedures performed on the consolidation process and the work performed by the group engagement team and the component auditors on the financial information of the components, on which to base the group audit opinion.

ISA (UK) 700 (Forming an opinion and reporting on financial statements)

12. The auditor shall evaluate whether the financial statements are prepared, in all material respects, in accordance with the requirements of the applicable financial reporting framework. This evaluation shall include consideration of the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgments.

13. In particular, the auditor shall evaluate whether, in view of the requirements of the applicable financial reporting framework:

…

(b) The accounting policies selected and applied are consistent with the applicable financial reporting framework and are appropriate;

…

(d) The information presented in the financial statements is relevant, reliable, comparable, and understandable. In making this evaluation, the auditor shall consider whether:

- The information that should have been included has been included, and whether such information is appropriately classified, aggregated or disaggregated, and characterized.
- The overall presentation of the financial statements has been undermined by including information that is not relevant or that obscures a proper understanding of the matters disclosed.

14. When the financial statements are prepared in accordance with a fair presentation framework, the evaluation required by paragraphs 12–13 shall also include whether the financial statements achieve fair presentation. The auditor's

evaluation as to whether the financial statements achieve fair presentation shall include consideration of:

(a) The overall presentation, structure and content of the financial statements; and

(b) Whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.