

IN THE MATTER OF
THE EXECUTIVE COUNSEL OF THE FINANCIAL REPORTING COUNCIL
-and-
DELOITTE LLP

FINAL SETTLEMENT DECISION NOTICE
Under 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, Deloitte LLP. It does not make findings against any persons or entities other than Deloitte LLP 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 ('**FRC**') is the competent authority for statutory audit in the UK and operates the Audit Enforcement Procedure ('**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. '**FY16**' means the financial year ended 2 July 2016, '**FY17**' means the financial year ended 1 July 2017, '**FY18**' means the financial year ended 30 June 2018, '**FY19**' means the financial year ended 29 June 2019 and '**FY20**' means the financial year ended 27 June 2020.
 - 3.2. '**Financial Statements**' (as in, for example, 'FY16 Financial Statements') means the consolidated financial statements of Go-Ahead Group plc ('**GAG**') for any particular financial year. Where reference is made to the financial statements of one of GAG's subsidiaries, the name of the subsidiary is given and capital letters are not used (as in, for example, 'LSER's FY16 financial statements').

- 3.3. **‘Audit’** (as in, for example, ‘FY16 Audit’) means the statutory audit of the Financial Statements for any particular financial year, and **‘the Audits’** means the statutory audits of the FY16 to FY20 Financial Statements, collectively.
 - 3.4. **‘Deloitte’** means Deloitte LLP, which was the *Statutory Audit Firm* appointed to carry out the Audits.
 - 3.5. The **‘Partner’** means the *Statutory Auditor* at Deloitte who acted as engagement partner for the Audits and signed the audit reports on Deloitte’s behalf.
4. In accordance with Rule 102 of the AEP, Executive Counsel entered into settlement discussions with Deloitte.
5. A *Proposed Settlement Decision Notice* was issued by Executive Counsel on 2 June 2026 under Rule 103 of the AEP in respect of Deloitte’s conduct of the Audits. Deloitte provided written agreement to the *Proposed Settlement Decision Notice* under Rule 105 of the AEP, on 2 June 2026. The *Convener* subsequently appointed an *Independent Reviewer* under Rule 106 of the AEP to consider the *Proposed Settlement Decision Notice*.
6. On 22 June 2026, the *Independent Reviewer* approved the issuance of this *Final Settlement Decision Notice* under 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 Requirement(s)*, with reasons.
 - 7.2. The *Sanctions* imposed on Deloitte with reasons.
 - 7.3. The amount payable by Deloitte in respect of Executive Counsel’s Costs.
8. This *Final Settlement Decision Notice* is divided into the following sections:
 - 8.1. Section B: Summary of the breaches of *Relevant Requirements*.
 - 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. Executive Counsel has decided that it would not be in the public interest to take *Enforcement Action* against the Partner, because of exceptional personal circumstances.

B. SUMMARY OF BREACHES OF RELEVANT REQUIREMENTS

10. GAG is a major international transport business. There were numerous and serious breaches of *Relevant Requirements* by Deloitte in its conduct of the Audits in relation to three of GAG's subsidiaries, which operated passenger rail services: London & South Eastern Railway Ltd ('LSER'), London & Birmingham Railway Ltd ('LM') and Go-Ahead Bayern GmbH ('GABY').
11. In relation to LSER:
 - 11.1. Before Deloitte became GAG's auditor, LSER had received erroneous overpayments from the Department for Transport ('DfT') under a rail franchise agreement known as the Integrated Kent Franchise (the '**IKF Agreement**').
 - 11.2. Although obliged to repay the overpayments to the DfT under the terms of the IKF Agreement, LSER retained the money and made accruals¹ for it, without informing the DfT. LSER had already released £10.5 million of the accruals in respect of the IKF overpayments to profit before Deloitte became GAG's and LSER's auditor in FY16. In FY16, after the franchise had ended, LSER released the remainder of these accruals (totalling £2.4 million) to profit, meaning that it kept the money.
 - 11.3. Deloitte failed to evaluate evidence indicating the existence of fraud risk factors, to make sufficient enquiries, to apply sufficient professional scepticism and to challenge LSER's management sufficiently as to how the accruals could be released, given that the audit team knew that the DfT had entered into a full and final settlement while unaware of the overpayments.
 - 11.4. By FY16, LSER had also begun making accruals for overpayments that it was receiving from the DfT under a separate, ongoing rail franchise, the Direct Award Contract ('**DAC**'). The overpayments and associated accruals continued until FY20, by which time the accruals had reached a cumulative total of £27 million.
 - 11.5. Again, the DfT was unaware of the overpayments and the accruals relating to the DAC. Evidence obtained from LSER's management during the later Audit years suggested an intention to keep the overpayments if they were not discovered.
 - 11.6. LSER management attempted to conceal the overpayments from the DfT by the way in which they were classified in LSER's FY19 and FY20 financial statements. Deloitte failed to consider the implications of the way the accruals were classified and the possible motivations for it.
 - 11.7. Deloitte again failed to evaluate evidence indicating the existence of fraud risk factors, to make sufficient enquiries, to apply sufficient professional scepticism and to challenge LSER's management sufficiently as to its actions

¹ Accrual accounting depicts the effects of transactions in the period in which those effects occur, even if the resulting cash receipts and payments occur in a different period.

in respect of these overpayments and accruals. Deloitte further failed to appreciate that LSER was under a contractual obligation to act in good faith and therefore to bring the overpayments to the DfT's attention.

- 11.8. After the DfT discovered the full extent of the overpayments in 2021, the franchise was not extended and the Secretary of State appointed the Operator of Last Resort to take over running LSER services. The Secretary of State required LSER to repay the outstanding amount and imposed a financial penalty of £23.5 million for breach of the terms of the franchise agreements as set out in more detail in a penalty notice dated 9 May 2022 (the '**Penalty Notice**').

12. In relation to LM:

- 12.1. In FY19, LM held £5.6 million of accruals for sums payable to the DfT under a profit-sharing agreement. The DfT was unaware of these accruals, and in FY20 it was agreed that LM would make a payment of £110,000 in full and final settlement of amounts due to the DfT under the profit-sharing agreement.
- 12.2. In FY20, LM released the accruals to profit and attempted to conceal this by re-wording the relevant note in its FY20 financial statements to remove reference to the profit-share accrual. Deloitte failed adequately to consider the implications and possible motivation for the wording of the note in LM's FY20 financial statements.
- 12.3. Deloitte failed to evaluate evidence indicating the existence of fraud risk factors, to make sufficient enquiries, to apply sufficient professional scepticism and to challenge LM's management as to the sufficiency of the £110,000 settlement in the wider context of the £5.6 million accrual.

13. In relation to GABY:

- 13.1. During the FY20 Audit, GAG initially provided a Value in Use ('VIU') model showing that GABY's franchise contracts would be loss making, and the component audit team concluded that GAG would need to make an onerous contract provision. However, management disagreed and provided an updated VIU model that changed the valuation of the future cashflows from the contracts from a loss of €8 million to a positive value of €3 million.
- 13.2. Deloitte applied insufficient scrutiny to management's explanations and evidence purporting to show why an onerous contract provision was not needed.
- 13.3. Although an onerous contract provision of €8.1 million was eventually recognised in the FY20 Financial Statements, Deloitte applied insufficient oversight of the component audit team, and failed to evaluate whether sufficient appropriate audit evidence had been obtained to support it. In the FY21 Financial Statements, the FY20 onerous contract provision was restated from €8.1 million to €49.5 million. Although information had been

withheld from Deloitte during the FY20 Audit, Deloitte should have done more to ensure adequate audit evidence had been obtained.

14. Section E of this *Final Settlement Decision Notice* sets out the detailed breaches of *Relevant Requirements*.
15. Section F of this *Final Settlement Decision Notice* sets out the following *Sanctions* imposed on Deloitte:
 - 15.1. A financial sanction of £11 million reduced by 10% for exceptional co-operation and 35% for admissions and early disposal, so that the financial sanction payable is £6,050,000.
 - 15.2. A published statement in the form of a severe reprimand.
 - 15.3. A declaration that the reports signed on behalf of Deloitte in respect of the Audits did not satisfy the *Relevant Requirements*, as set out in this *Final Settlement Decision Notice*.
 - 15.4. An order requiring Deloitte to prepare a report for Deloitte's FRC Firm Supervisor setting out the root cause analysis completed, the actions taken and their assessment (based on empirical evidence) of how these mitigate recurrence of the identified breaches.

C. BACKGROUND

GAG

16. GAG provides bus and rail services in the UK and other markets. Throughout FY16 to FY20 its shares were listed on the Main Market of the London Stock Exchange and it was therefore a Public Interest Entity ('PIE') for statutory audit purposes. GAG entered private ownership in October 2022 and its shares were de-listed.
17. The group financial results for FY16 to FY20 were as follows:

	<u>Group revenue</u> <u>(£m)</u>	<u>Group operating</u> <u>profit / (loss)</u> <u>(£m)</u>	<u>Profit / (loss)</u> <u>before tax (£m)</u>
FY16	3,361.3	120.4	99.8
FY16 restated	3,361.3	162.6	145.0
FY17	3,481.1	150.6	136.8
FY18	3,461.5	161.0	145.7
FY19	3,807.1	104.3	97.0
FY19 restated	3,674.2	104.3	97.0
FY20	3,898.4	20.8	(0.2)
FY20 restated	3,897.2	(17.3)	(39.5)

18. GAG operates through three segments: regional bus, London and international bus and rail. The rail segment comprised rail franchises in the UK, Germany and Norway. The breaches occurred in the auditing of three of the subsidiaries within the rail segment that delivered GAG's rail franchises: LSER, LM and GABY. GAG had about 30 subsidiaries in total.

Deloitte

19. Over the period 2016-20, Deloitte was the third-largest audit firm in the UK measured by number of PIE audit clients and number of Responsible Individuals able to sign audit reports, and the fourth largest on the basis of annual audit fee income.²
20. As the *Statutory Audit Firm* appointed to conduct the Audits, Deloitte's statutory duty was to state an opinion as to whether the Financial Statements: (i) gave a true and fair view of GAG's state of affairs and profit or loss, and (ii) had been properly prepared in accordance with the relevant financial reporting framework and the Companies Act 2006. An audit conducted in accordance with the International Standards on Auditing (UK & Ireland) ('ISAs') enables the auditor to form this opinion.
21. The ISAs require the auditor to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error. The purpose of an audit, according to the ISAs, is to enhance the degree of confidence of intended users in the audited entity's financial statements.
22. As the *Statutory Audit Firm*, Deloitte is responsible for any breaches of *Relevant Requirements* by its partners or employees, including the Partner, in the course of the Audits. Reference is made in this *Final Settlement Decision Notice* to the acts or omissions of the Partner where they caused or contributed to breaches of *Relevant Requirements* by Deloitte. Because Executive Counsel decided, on public interest grounds, that the Partner should not be subjected to Enforcement Action, no finding has been made as to whether the Partner breached Relevant Requirements.
23. As a result of the announcement of Executive Counsel's investigation, Deloitte did not seek to continue as GAG's auditor after FY22.
24. Deloitte's fees for the Audits amounted to £4.5 million in total.

D. RELEVANT REQUIREMENTS

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. The *Relevant Requirements* include the ISAs, which are issued by the FRC and based on the standards issued by the International Auditing and Assurance Standards Board.

² From data in the 2017-21 editions of the FRC's *Key Facts and Trends in the Accountancy Profession: Key Facts and Trends in the Accountancy Profession*.

26. The following ISAs are referred to in this *Final Settlement Decision Notice*:
- 26.1. ISA (UK) 200 (Overall objectives of the independent auditor and the conduct of an audit in accordance with international standards on auditing).
 - 26.2. ISA (UK) 230 (Audit Documentation).
 - 26.3. ISA (UK) 240 (The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements).
 - 26.4. ISA (UK) 260 (Communication with Those Charged with Governance).
 - 26.5. ISA (UK) 500 (Audit Evidence).
 - 26.6. ISA (UK) 600 (Special Considerations – Audits of Group Financial Statements Including the Work of Component Auditors).
 - 26.7. ISA (UK) 700 (Forming an Opinion and Reporting on Financial Statements).
27. The ISAs relevant to Executive Counsel's *Final Settlement Decision Notice* are those effective for audits of financial statements for periods commencing on or after 17 June 2016 (including relevant updates), except in the case of:
- 27.1. The FY16 Audit, where the relevant ISAs are those effective for audits of financial statements for periods ending on or after 15 December 2010 (including relevant updates).
 - 27.2. ISA 500, where the version effective for audits of financial statements for periods ending on or after 15 December 2010 (including relevant updates) was applicable to all of the Audits and not just the FY16 Audit.
28. Extracts from the ISAs setting out those parts which are of particular relevance to the breaches of *Relevant Requirements* are set out in the **Appendix**.

E. BREACHES OF RELEVANT REQUIREMENTS

Breach Area 1 – LSER – the IKF Overpayments Accruals

Facts

The IKF Agreement

29. LSER operated passenger railway services in London and across Kent and parts of East Sussex under the Southeastern brand. LSER entered into successive franchise agreements with the DfT to operate these services. Each of these agreements was underpinned by a financial model that prescribed the various money flows between LSER and the DfT for the operation of the franchises. Between April 2006 and October 2014, the applicable agreement was the IKF Agreement.
30. The IKF Agreement contained a good faith clause requiring LSER to 'co-operate with the Secretary of State and act reasonably and in good faith in and about the performance of its obligations and the exercise of its rights pursuant to the Franchise Agreement' (the '**IKF Good Faith Clause**').

The IKF Overpayments accruals

31. During the lifetime of the IKF Agreement, the DfT overpaid LSER in respect of six categories of payment that it was obliged to make to LSER. The DfT did not know that the sums it had paid were overpayments. LSER did know this, but did not tell the DfT. Instead, in respect of each of these overpayments, LSER made accruals, recognising these overpayments on the balance sheet rather than as profit.
32. LSER released to profit the accruals in respect of four of the six categories of overpayments (totalling £10.5 million) before Deloitte became GAG's auditor. However, at the beginning of FY16, LSER continued to hold accruals for the remaining two categories of overpayments (the '**IKF Overpayments**'), which totalled £2.4 million (a material amount for LSER, but below group materiality).
33. The audit team was aware at the time of the FY16 Audit that:
 - 33.1. the IKF Overpayments accruals had been made because the DfT had mistakenly paid LSER sums to which LSER was not contractually entitled;
 - 33.2. LSER had held on to this public money and not given it back; and
 - 33.3. the DfT did not know of the IKF Overpayments to which the accruals related.
34. Although the audit teams stated in the FY16 auditor's report that they had read the key elements of the IKF Agreement, they did not identify that the IKF Good Faith Clause obliged LSER to tell the DfT about the IKF Overpayments.

Release of the IKF Overpayments accruals

35. Following a documented full and final settlement with the DfT, LSER released to profit the accruals made in respect of the IKF Overpayments during FY16.
36. Management showed the audit team a 13 June 2016 letter from the DfT to LSER, which referred to a 'full and final settlement' in respect of various matters relating to outstanding issues under the IKF Agreement. The audit team was also told that the DfT remained unaware of the IKF Overpayments, and that management would therefore release the £2.4 million of associated accruals to profit (as it had done with the £10.5 million of IKF Overpayments accruals in prior years). Management subsequently confirmed to Deloitte that this had been done.
37. The audit team did not properly scrutinise the adequacy of the settlement between LSER and the DfT as a basis for releasing the IKF Overpayments accruals to profit. Instead, they accepted the letter from the DfT as sufficient evidence to support the release of the accruals without further enquiry.
38. Although aware that the DfT did not know of the IKF Overpayments, the audit team did not properly consider what information was available to the DfT and whether it was appropriate for LSER and GAG to release the accruals to profit without informing the DfT about the IKF Overpayments. There was, for example, no memo considering the correctness of the release of the accruals in the context of the requirements of the IKF Agreement.

39. It was not objectively reasonable for the audit team to consider at the time that the DfT had been provided with sufficient information to allow it to challenge the IKF Overpayment amounts, in circumstances where there was no record in the audit files of what information (if any) had been provided to the DfT, and how any such information was relevant to the assessment of management's decision not to inform the DfT of the IKF Overpayments.
40. As an example of the further action that could have been taken, the audit team could have obtained legal advice as to whether LSER's actions amounted to a true settlement of the liability to repay the IKF Overpayments accorded with LSER's contractual obligations, and did not give rise to any question of fraud.
41. The audit team did not adequately inform GAG's Audit Committee and Board about the IKF Overpayments issue, although it was a significant matter which had been discussed with LSER management.

Breaches

42. In its conduct of the FY16 Audit in relation to the release of the IKF Overpayments accruals, Deloitte breached the following *Relevant Requirements*:
 - 42.1. Paragraphs 15 and 16 of ISA (UK) 200, in that the audit team did not employ sufficient professional scepticism and professional judgement in their consideration of GAG's and LSER's release to profit of the accruals for the IKF Overpayments.
 - 42.2. Paragraph 8 of ISA (UK) 230, in that the audit team failed to prepare sufficient documentation of the audit evidence obtained, the conclusion reached, and the professional judgements made in relation to the release to profit of the accruals for the IKF Overpayments.
 - 42.3. Paragraph 24 of ISA (UK) 240, in that the audit team failed to evaluate sufficiently the evidence indicating the existence of fraud risk factors in relation to the release of the IKF Overpayments accruals, in circumstances where the audit team knew that the DfT was unaware of the IKF Overpayments.
 - 42.4. Paragraph 16(c)(i) of ISA (UK) 260, in that the audit team failed to communicate to those charged with governance at GAG a significant matter that had arisen during the FY16 Audit and been discussed with management, namely the release of the IKF Overpayments accruals.
 - 42.5. Paragraph 6 of ISA (UK) 500, in that the audit team failed to design and perform audit procedures that were appropriate in the circumstances to obtain sufficient appropriate audit evidence in support of GAG's and LSER's release to profit of the accruals for the IKF Overpayments, and in fact did not obtain such evidence; in particular, the audit team did not consider the correctness of the release of the accruals in the context of the requirements of the IKF Agreement.

Breach Area 2 – LSER – the DAC Overpayments Accruals

Facts

The DAC

43. In October 2014 the IKF Agreement was replaced with a new franchise arrangement, the DAC, which continued through different extensions until October 2021, when LSER was precluded from tendering for a new contract in response to the issues described below.

The DAC Overpayments accruals

44. As with the IKF, the DfT also overpaid two categories of payment that it was obliged to make to LSER under the DAC:
- 44.1. LSER identified that it was receiving more than it was due as a result of depot rents being reduced from October 2014 in a manner not anticipated in the financial model (the '**HS1 Depot Overpayments**'); and
 - 44.2. LSER identified that, as a result of an indexation error, the DfT was making overpayments in respect of its reimbursement of a variable track access charge ('**VTAC**') which LSER was required to pay to HS1 Limited for use of the High Speed 1 train tracks (the '**HS1 VTAC Overpayments**', together with the HS1 Depot Overpayments, the '**DAC Overpayments**').
45. As with the IKF Overpayments, the DfT did not know that these sums were overpayments. LSER did know this, but did not tell the DfT and made accruals instead.
46. The DAC Overpayments were accrued for and kept on LSER's and GAG's balance sheets. Each of the DACs, save for the final ('Emergency Measures') DAC, contained profit-sharing provisions under which LSER was obliged to pay a proportion of its profit to the DfT on a stepped scale, with 100% of any profit above a maximum threshold being payable. As balance sheet entries, the DAC Overpayments accruals did not impact on profit and thus were not included at any time in the profit share with the DfT.
47. The following table shows the DAC Overpayments accruals on a year-by-year basis, with figures rounded to the nearest £0.1 million.

	HS1 VTAC Overpayments accrual (£m)		HS1 Depot Overpayments accrual (£m)	
	Accrual in Year	Cumulative Total	Accrual in Year	Cumulative Total
FY16 year end	4.3	7.2	1.2	2.1
FY17 year end	4.3	11.5	1.2	3.3
FY18 year end	4.5	16.0	1.2	4.5
FY19 year end	4.5	20.5	1.2	5.7
FY20 year end	0	20.5	0.8	6.5

48. Taken together, the DAC Overpayments accruals were material for both LSER and GAG in each of the Audits.

Management's justification for making the DAC Overpayments accruals

49. The audit teams were aware throughout all the Audits that the DfT had made the DAC Overpayments by mistake and that LSER had a contractual obligation to repay them to the DfT. The audit teams also knew from management that the DfT was unaware of the DAC Overpayments, and that management knew that the DfT was unaware.
50. Management's justification for accruing for the DAC Overpayments, as provided to the audit teams, was not that the sums would eventually be paid to the DfT whether or not the DfT realised its mistake. Rather, it was that the DfT was sure to discover the mistake and require the repayment of the sums owed. Management said that the DfT would discover the HS1 VTAC Overpayments through a process called a 'model re-run', and would discover the HS1 Depot Overpayments when the lessor of the depots amended its pricing, as it was entitled to do after a government budget.
51. Management maintained these explanations throughout FY16 to FY19, despite its predictions that the overpayments would be discovered by a model re-run being repeatedly disproved, and despite the lessor's price rises failing either to materialise or to reveal the HS1 Depot Overpayments. At times management's language around the possibility of discovery softened, but the audit teams continued to record that it was 'certain' or 'virtually certain' that payment would be necessary.
52. If management believed that the DAC Overpayments would be discovered by the DfT, there was no readily apparent commercially sensible basis for LSER not to inform the DfT of them, but instead to make an accrual for them, to retain them, and at a later date have to explain to the DfT that it had known about them but had

deliberately decided to say nothing. No such explanation was given or documented at the time of the Audits.

53. The need for further scrutiny of the model re-run issue was expressly raised by Deloitte's engagement quality control reviewer³ ('EQCR') in the FY17 Audit but not acted upon.
54. Moreover, by FY18 the audit team had received explicit confirmation from management that there was no intention to voluntarily tell the DfT about the DAC Overpayments; either the DfT would discover them for itself, or it would remain unaware of them. The audit team did recommend to the GAG Audit Committee in FY18, FY19, and FY20 that 'the Board considers whether this [the DAC Overpayments] should be actively discussed with the DfT'. However, this was an inadequate response and the audit team continued to fail properly to evaluate and act on the resulting fraud risk.
55. In FY19 management briefed the audit team that the DfT had identified and corrected the error that had led to it making the HS1 VTAC Overpayments, meaning that it was no longer making those overpayments, and the size of the relevant accrual had stopped growing. However, the DfT had not realised at this point that it had made the HS1 VTAC Overpayments, or that LSER and GAG had made accruals for them.
56. The audit team did not ask management why, if the DfT had identified and corrected the error that had previously caused it to make the HS1 VTAC Overpayments, that correction had not immediately led to the discovery by the DfT of those overpayments. Nor did they ask management why the fact that the DfT had identified and corrected the error increased the likelihood that the DfT would discover the HS1 VTAC Overpayments, as management claimed. Instead, in their workpapers the audit team continued to record their acceptance of management's assertions about the likelihood that the DAC Overpayments would be discovered, despite those assertions becoming less credible over time.
57. LSER used the language of 'risk of detection' and 'risk of identification' in its briefings to the audit teams, demonstrating that it saw discovery of the DAC Overpayments and associated accruals as something to be avoided. In FY19 management told the audit team that it still had no intention of telling the DfT about the DAC Overpayments accruals. It said that it had specifically considered if there was an obligation to inform the DfT about its error, but apparently concluded that it did not, because the accruals were part of the normal 'unders and overs' that occurred in a DfT rail franchise. Management said that it had taken legal advice, which supported the treatment that it had adopted.
58. Throughout the Audits, the audit teams accepted management's rationale for the DAC Overpayments accruals at face value. They did not, for example:

³ A senior, experienced auditor, independent of the audit team, whose role is to evaluate objectively the significant judgements made by the team and the conclusions reached by the team in formulating the auditor's report.

- 58.1. ask management why, when model re-runs had been delayed or had taken place but had not led to identification of the DAC Overpayments, management could have confidence that a further model re-run would occur or would lead to them being identified;
- 58.2. challenge management on the likelihood of the lessor of the depots changing its prices following a government budget, given that this had apparently not happened, or at least had not led to the discovery of the HS1 Depot Overpayments; or
- 58.3. highlight and question the inconsistencies in the level of certainty expressed by management about the discovery of the DAC Overpayments, both between audit years and between different briefing papers in the same audit year.

The accounting treatment of the DAC Overpayments

- 59. The audit teams did not challenge management as to its chosen accounting treatment of making accruals in respect of the DAC Overpayments, or consider whether there were other appropriate ways to record them within creditors.

The terms of the DAC

- 60. Similar to the IKF Agreement, the DAC contained a good faith clause requiring LSER to 'co-operate with the Secretary of State and act reasonably and in good faith in and about the performance of its obligations and the exercise of its rights pursuant to the Franchise Agreement' (**'the DAC Good Faith Clause'**).
- 61. Although the audit teams recorded throughout the Audits that they had read the DAC, they did not identify and appreciate that the DAC Good Faith Clause obliged LSER to tell the DfT about the DAC Overpayments. This was despite the fact that the DAC Good Faith Clause was one of only nine clauses in the front end of the DAC (it was followed by lengthy and complex appendices, which appear to have occupied the focus of the audit team).
- 62. If the audit teams were left in any doubt about LSER's obligations under the DAC, they should have required management to obtain legal advice, and share it. In FY19, having been told by management that it had received legal advice, the audit team requested a copy. Management's email response was to state that it had only received verbal rather than written legal advice, and to summarise the conclusions that it had reached as a result. The email was misleading, but the audit team nonetheless failed to clarify what it meant and did not insist that management obtain and share written legal advice about the correctness of management's position.

Management's intention to release the DAC Overpayments accruals to profit

- 63. The audit teams knew that repayment of the DAC Overpayments depended on the DfT identifying the overpayments. But they also knew that overpayments such as the DAC Overpayments might never be discovered by the DfT. Management's failure to state that LSER would in any event pay the sums to the DfT, and its

emphasis instead on the supposed inevitability of DfT discovering the error, should have given the audit teams reason to suspect that LSER intended not to restore the DAC Overpayments to the DfT if the DfT failed to realise the error.

64. By the time the FY16 LSER auditor's opinion was signed, and as explained above, the audit team was also aware that LSER had decided to release the remainder of the IKF Accruals to profit on the basis that they had not been discovered by the DfT and LSER had entered into a full and final settlement with the DfT.
65. These circumstances amounted to fraud risk factors, which should have been identified by the audit team. Following the FY16 Audit, such indications of fraud risk factors continued to accumulate:
 - 65.1. In FY17, management told the audit team that it planned to change the description of the IKF Overpayments accruals in accounting documents that were to be given to the DfT. The implicit but obvious aim was to disguise the nature of the accruals which, by that time, had been released to profit.
 - 65.2. In FY18, management unambiguously stated to the audit team that repayment of the DAC Overpayments was dependent on the DfT discovering the errors, and that there was no plan to voluntarily disclose them. Management spoke of a 'risk of detection', language which made it apparent to the audit team that, so far as management was concerned, discovery of the DAC Overpayments by the DfT was a negative outcome that was to be avoided. Management also acknowledged the possibility that the DAC Overpayments accruals might not 'crystallise', and the result would be an increase in operating profit. Management said that LSER might retain the accruals for a period of time – perhaps six months after the franchise ended – and then release them to profit.
 - 65.3. In FY19, as well as explicitly reinforcing that it had no intention of telling the DfT of the DAC Overpayments, management repeatedly indicated to the audit team, both in writing and orally, that if the DfT did not discover the DAC Overpayments, LSER would release the accruals to profit. Management noted in briefing papers the possibility that the DfT would learn about the DAC Overpayments when they were released to profit, stating that any change in the accounting treatment for the accruals was likely to lead to them being detected. This demonstrated that management was concerned that the financial statements should not be allowed to reveal the DAC Overpayments to the DfT.
 - 65.4. Also in FY19, the DfT identified that it was overpaying LSER in respect of the HS1 VTAC Overpayments and corrected this error on a prospective basis only. This did not prompt management to bring the historical HS1 VTAC Overpayments, which by year-end amounted to £20.5 million, to the DfT's attention.
 - 65.5. In FY19 and FY20, management classified the DAC Overpayments accruals in the LSER financial statements in a way that disguised the fact that they

were sums owed to the DfT under the DAC (the '**DAC Overpayments Reclassification**', discussed in more detail below).

- 65.6. In FY20, the DfT identified the historical HS1 VTAC Overpayments, but remained unaware that LSER and GAG had been making an accrual for them and thought that much of the overpayment would already have been returned via the profit share. Management did not give any indication that they planned to correct the DfT's misunderstanding, or disclose the HS1 Depot Overpayments, which were continuing.
66. In FY18, the EQCR raised concerns to the audit team that an intention by management not to make restoration of the DAC Overpayments if they were not noticed by the DfT might amount to fraud.
67. In FY18 and FY19, management discussed with the audit teams that much of the increased profit generated by releasing the DAC Overpayments accruals would be returned to the DfT under the profit-sharing arrangements. This did not diminish the fraud risk. The only route to partial retention of the DAC Overpayments necessarily involved continuing to conceal them from the DfT, given that, as management had repeatedly stated, it was unlikely the DfT would even consider settling for being repaid anything less than the full amount. In any event, retention of some of the DAC Overpayments – on management's account, around £3.3 million if most of the Overpayments were returned through the profit-share arrangements – would be no less wrongful than retention of all of them.
68. Throughout the Audits, the audit teams did not properly evaluate the evidence indicating the existence of fraud risk factors. Deloitte's audit working papers did not specifically discuss fraud risk in relation to the DAC Overpayments at all.
69. The audit teams did not invite management to take appropriate measures, such as taking legal advice as to whether the intention to keep an overpayment unless the payer detected it amounted to fraud. The audit teams did not alert the GAG Audit Committee or the Board that management had indicated an intention to release the accruals to profit if they were not detected by the DfT, or that management had adopted a form of disclosure in relation to the DAC Overpayments accruals (the DAC Overpayments Reclassification) which concealed the overpayments from the DfT.
70. Instead, in FY18 and FY19 the audit teams included in its report to the GAG Audit Committee a recommendation that 'the Board considers whether this [the DAC Overpayments] should be actively discussed with the DfT'. The Audit Committee decided not to do so. In FY18 a member of the audit team advised management not to use the word '*detection*' when briefing the Audit Committee on the DAC Overpayments, and in its own reporting to the Audit Committee the audit team deliberately did not use the language of detection.

The DAC Overpayments Reclassification

71. From FY16 to FY18, the DAC Overpayments were included in the 'Trade creditors' line in the disclosure notes to LSER's financial statements and the 'Payable to central government' line in the disclosure notes to the GAG Financial Statements. There was no 'Payable to central government' line, or equivalent, in LSER's financial statements prior to FY19.
72. In FY19, LSER's financial statements included an updated and expanded creditors disclosure that (for the first time) had a separate 'Central Government Creditors' line. This made LSER's financial statements more consistent with the Financial Statements. However, during the later stages of preparing LSER's FY19 financial statements, management changed the mapping of the DAC Overpayments accruals so that they were re-classified from the 'Central Government Creditors' line to the 'Accruals' line in the creditors' note.
73. Omitting the DAC Overpayments accruals from the 'Central Government Creditors' line was misleading because: (i) that line was where other amounts payable to the DfT were recorded, (ii) it corresponded to the 'Payable to central government' line in the Financial Statements, and (iii) the reclassification was inconsistent with the treatment in LM's financial statements of the accrual made in respect of sums owed to the DfT in respect of profit share (discussed in Breach Area 3 below).
74. The DAC Overpayments Reclassification was an attempt by management to conceal the DAC Overpayments from the DfT. A member of the audit team emailed the Partner highlighting that management did not want to 'draw attention' to the DAC Overpayments accruals. However, the Partner failed to appreciate the significance of the DAC Overpayments Reclassification or the motivation behind it, and signed the auditor's report on LSER's FY19 financial statements on the basis that the statements gave a true and fair view of the state of LSER's affairs.
75. The DAC Overpayments Reclassification was also made in FY20. A workpaper prepared by the audit team and reviewed by the Partner explained that this was done in order to 'hide' the DAC Overpayments accruals. Nevertheless, the Partner failed to appreciate that this was a deliberate attempt by management to conceal the DAC Overpayments from the DfT, and again signed the auditor's report on the basis that LSER's FY20 financial statements gave a true and fair view.
76. The audit teams did not at any stage challenge management as to its reason for the DAC Overpayments Reclassification, or the appropriateness of it.

The DfT's discovery of the DAC Overpayments

77. It was not until May 2021, when the DfT wrote to LSER requesting a full breakdown of the DfT creditor balances, that LSER advised the DfT that accruals had been made in its accounts for the DAC Overpayments on the basis that LSER recognised that the DAC Overpayments (totalling £27 million) would fall to be repaid to the DfT. LSER made this admission because the breakdown requested by the DfT would

have revealed the existence of the HS1 Depot Overpayments and the full amount of the HS1 VTAC Overpayments which remained due to the DfT.

78. On 28 July 2021, the DfT issued LSER with an enforcement letter referring to the failure to notify the DfT of the existence of the DAC Overpayments. On 11 August 2021, GAG wrote to the DfT acknowledging a 'grave error of judgement' in respect of the DAC Overpayments and also explained that it had set up an Independent Committee to investigate the matters raised in the DfT's letter.
79. On 28 September 2021, the DfT announced its decision to appoint the Operator of Last Resort to take over delivery of passenger services on the Southeastern franchise when LSER's existing contract expired on 17 October 2021. It was also announced that the GAG CFO was resigning and standing down from the Board of Directors with immediate effect.
80. On 9 May 2022, the DfT issued the Penalty Notice to LSER in which it said that LSER had breached the DAC Good Faith Clause by virtue of the wrongful retention of the DAC Overpayments, the failure to disclose them to the DfT, the attempts to conceal the true position and further measures to wrongfully maximise the resulting profits.

Breaches

81. In its conduct of the Audits in relation to the DAC Overpayments accruals, Deloitte breached the following *Relevant Requirements*:
 - 81.1. Paragraphs 15 and 16 of ISA (UK) 200, in that in the FY16 to FY20 Audits the audit teams did not employ sufficient professional scepticism and professional judgement in their consideration of the making of accruals for the DAC Overpayments. In particular, the audit teams failed:
 - 81.1.1.to challenge management's explanations as to why the DfT would discover the DAC Overpayments and the accruals made in respect of them would therefore be used to repay the DAC Overpayments, despite those explanations becoming less credible over time;
 - 81.1.2.(in the FY19 and FY20 Audits only) to consider how the DAC Overpayments should have been disclosed within creditors;
 - 81.1.3.properly to review the DAC and identify and understand the DAC Good Faith Clause;
 - 81.1.4.(in the FY19 Audit only) to scrutinise management's explanation of the legal advice it had received; and
 - 81.1.5.(in the FY19 and FY20 Audits only) to scrutinise and challenge the DAC Overpayments Reclassification.
 - 81.2. Paragraph 14 of ISA (UK) 240, in that in the FY18 and FY19 Audits the audit teams failed to investigate the inconsistency between, on the one hand, the explanations provided by management that the DfT would discover the DAC

Overpayments, and on the other hand, the indications being given by management that it intended to release the accruals and for LSER to retain the DAC Overpayments.

- 81.3. Paragraph 24 of ISA (UK) 240, in that in the FY16 to FY20 Audits the audit teams failed to evaluate evidence indicating the existence of fraud risk factors, in the form of:

81.3.1.an intention by management for LSER to retain the DAC Overpayments and (if they had not been identified by the DfT) to release the accruals made in respect of them to profit;

81.3.2.(in the FY20 Audit only) further evidence that it was management's intention for LSER to (i) retain the HS1 Depot Overpayments, (ii) fail to inform the DfT that contrary to the DfT's expressed belief, the HS1 VTAC Overpayments had not been mitigated by the profit share mechanism but had been the subject of accruals by LSER; and

81.3.3.(in the FY19 and FY20 Audits only) the DAC Overpayments Reclassification, which was intended to and had the effect of concealing the DAC Overpayments in the LSER financial statements.

- 81.4. Paragraph 29(b) of ISA (UK) 240, in that in the FY19 and FY20 Audits the audit teams failed to evaluate whether the application of accounting policies by LSER in carrying out the DAC Overpayments Reclassification may have been indicative of fraudulent financial reporting.

- 81.5. Paragraph 41R-1 of ISA (UK) 240, in that in the FY17 to FY20 Audits the audit teams failed to inform GAG that there were reasonable grounds to suspect that irregularities, including fraud with regard to LSER's financial statements, had occurred (although it is accepted that the audit teams did not as a matter of fact suspect the occurrence of such irregularities). Instead, in the FY18, FY19, and FY20 Audits the audit teams recommended to the GAG Audit Committee that the Board should 'consider ...actively discussing' the DAC Overpayments with the DfT.

- 81.6. Paragraph 6 of ISA (UK) 500, in that in the FY16 to FY20 Audits the audit teams failed to design and perform audit procedures that were appropriate to obtain sufficient appropriate audit evidence to support management's explanation that the DAC Overpayments should be accrued for because the DfT would discover them, and (in the FY19 Audit only) management's assertion that LSER was not obliged to inform the DfT of the DAC Overpayments.

- 81.7. Paragraph 9 of ISA (UK) 500, in that in the FY19 Audit the audit team failed to obtain from management written legal advice concerning LSER's obligations to the DfT, but rather accepted and did not query management's misleading response.

81.8. Paragraph 11 of ISA (UK) 500, in that in the FY17 to FY20 Audits the audit teams failed to determine what modifications or additions to the audit procedures were necessary to resolve:

81.8.1.the inconsistency between, on the one hand, the non-discovery by the DfT of the DAC Overpayments and, on the other hand, the justification for the maintenance of accruals for the DAC Overpayments recorded in Deloitte's workpapers; and

81.8.2.the doubt over the reliability of that justification.

81.9. Paragraph 13(d) of ISA (UK) 700, in that in the FY19 and FY20 Audits the audit teams failed properly to evaluate whether, in light of the DAC Overpayments Reclassification, the information in LSER's financial statements was understandable and comparable.

Breach area 3 – LM

Facts

The DAFA

82. LM operated a rail franchise in the West Midlands between 1 April 2016 and 9 December 2017 under a Direct Award Franchise Agreement ('**DAFA**') with the DfT.
83. The DAFA included a profit-sharing agreement whereby LM was required to share with the DfT a proportion of profits in excess of pre-determined thresholds. Above a certain threshold, the DfT retained all remaining profit. The DAFA also included a clause which required LM to act reasonably and in good faith in relation to the performance of its obligations under the agreement (the '**LM Good Faith Clause**').
84. The auditor's reports in the FY19 and FY20 Financial Statements identified that '[f]ranchise compliance and associated income under rail contracts' was a key audit matter, and stated in LM's financial statements that the audit teams had 'read the key elements of the franchise agreements to understand the critical elements'.

The LM Profit Share Accrual

85. After the end of the franchise in December 2017, LM continued to receive income and incur expenditure related to the DAFA. LM was required to share profits with the DfT irrespective of whether the income and expenditure had arisen after the end of the franchise agreement. In its accounts for the year ending 29 June 2019, LM accrued the sum of £5.6 million (the '**LM Profit Share Accrual**') for the amounts which it calculated it would consequently be required to share with the DfT.
86. During the FY19 Audit the audit team was aware of the LM Profit Share Accrual and its purpose. The audit team concluded that the accounting treatment and quantum of the LM Profit Share Accrual was appropriate
87. The DfT did not know that the LM Profit Share Accrual existed. It was included as part of an 'Other creditors' balance of £6.023 million in a note to LM's FY19 financial statements, but it was not the subject of any specific disclosure. It was not apparent from the financial statements that LM was holding amounts that it anticipated it would have to pay to the DfT as part of the profit share arrangement.

The decision to release the LM Profit Share Accrual

88. During 2019 LM was in discussion with the DfT about the profit share payments to be made following the conclusion of the DAFA. On 24 October 2019, the DfT confirmed in an email to LM that it required LM to pay £110,000 in full and final settlement of the profit share arrangement (the '**LM Settlement Email**'). LM paid the £110,000 to the DfT on or about 8 November 2019. Following, and because of, the LM Settlement Email, management decided that it would release the £5.6 million balance of the LM Profit Share Accrual to profit in FY20, without putting it through the profit-sharing arrangement.

89. During FY20, management explained to the audit team the nature of the LM Profit Share Accrual and the circumstances of its release, and provided a copy of the LM Settlement Email. The LM Settlement Email was the only evidence relied upon by the audit team to support the release of the LM Profit Share Accrual. The audit team accepted it as sufficient evidence for that purpose.
90. The audit team did not:
- 90.1. Properly review the DAFA and realise that it contained an obligation to act in good faith (the LM Good Faith Clause), and therefore required LM to disclose to the DfT the LM Profit Share Accrual and the liability to which it related;
 - 90.2. Ask LM whether it had any contractual obligation to inform the DfT of the balances payable to the DfT upon which the LM Profit Share Accrual was based.
 - 90.3. Apply proper scrutiny to the adequacy of the LM Settlement Email as evidence in support of the release of the LM Profit Share Accrual.
 - 90.4. Ask management why the DfT had accepted payment of £110,000 in full and final settlement of the profit share arrangements when the LM Profit Share Accrual had been made in the previous year on the basis that LM expected it would be required to pay £5.6 million.
 - 90.5. Consider the commercial plausibility of the DfT settling for such a small amount unless it was unaware of LM Profit Share Accrual or the information on which it was based.
 - 90.6. Take account of the fact that (as the audit team knew) management had refused to disclose sums due to the DfT under another franchise (the DAC Overpayments).
 - 90.7. Evaluate whether management's decision nevertheless to release the LM Profit Share Accrual was a fraud risk, and to consider what actions they should consequently take.

The concealment of the release of the LM Profit Share Accrual

91. The release of the £5.6 million LM Profit Share Accrual meant that LM, whose only franchise had ended two-and-a-half years earlier, had an operating profit in FY20 of £8.6 million (although it had revenue of only £0.45 million). The release required an explanation in the accounts. Under the relevant accounting standard, IAS 1, the nature and amount of material items of income or expense must be disclosed separately. The LM Profit Share Accrual was material for LM and for GAG.
92. LM first provided a draft of its FY20 financial statements to the audit team on 24 November 2020, where the release of the LM Profit Share Accrual was recorded under note 4, which was titled, 'Operating (income)/costs'. The release was classified within a negative (i.e. credit) balance of £8.186 million under 'Other operating (income)/costs' and accompanied by an explanatory narrative (the '**Note 4 Narrative**').

93. The Note 4 Narrative went through a number of iterations but each of them made separate, explicit reference to the LM Profit Share Accrual, noting the amount, the fact that it reflected the release of 'a profit share accrual with the DfT', and that the release was based on the agreement of a 'full and final settlement'. On 30 March 2021, the Partner approved a version of LM's draft financial statements in which the Note 4 Narrative was in those terms. The Partner had previously indicated to the audit team that the LM Profit Share Accrual should be disclosed separately and clearly.
94. The following day, management told the audit team that it proposed to reword the Note 4 Narrative so that it no longer referred to the LM Profit Share Accrual specifically. The reworded narrative merely gave the total amount of the operating income balance and referred to a 'final settlement relating to the end of franchise net assets transfer'. The explanation given by management for the proposed change was that the existing wording 'might not go down well with the DfT'.
95. A member of the audit team forwarded management's proposal to the Partner, highlighting the change and asking the Partner if it was acceptable. The Partner approved the rewording with no further discussion, and it was carried through to the final, filed version of LM's FY20 financial statements. It was no longer apparent from the financial statements that £5.6 million of accruals made in anticipation of having to make profit-share payments to the DfT had been released to profit.
96. The audit team did not:
- 96.1. Question the meaning or ask for any further elaboration of management's explanation for the rewording of the Note 4 Narrative.
 - 96.2. Consider what legitimate reason there could be for the change.
 - 96.3. Identify that the rewording of the Note 4 Narrative caused LM's financial statements to contain a misstatement.
97. The Partner approved the rewording of the Note 4 Narrative, despite previously having recognised and instructed colleagues that the LM Profit Share Accrual should be disclosed separately. As with the DAC Overpayments Reclassification, the Partner failed to appreciate at the time that it was a deliberate attempt on the part of management to conceal information from the DfT, and the Partner signed the auditor's report on LM's FY20 financial statements on the basis that the statements gave a true and fair view of the state of LM's affairs.

Breaches

98. In their conduct of the FY20 Audit in relation to LM, Deloitte breached the following *Relevant Requirements*:
- 98.1. Paragraphs 15 and 16 of ISA (UK) 200, and paragraph 12 of ISA (UK) 240, in that the audit team failed properly to exercise and maintain professional scepticism and professional judgement in relation to the release of the LM

Profit Share Accrual, and in relation to rewording of the Note 4 Narrative and LM's purported reason for it.

- 98.2. Paragraph 24 of ISA (UK) 240, in that, upon the release of the LM Profit Share Accrual and the rewording of the Note 4 Narrative, the audit team failed to evaluate evidence indicating the existence of a fraud risk.
- 98.3. Paragraph 29(b) of ISA (UK) 240, in that, upon the rewording of the Note 4 Narrative, the audit team failed to evaluate whether the application of accounting policies by LM may have been indicative of fraudulent financial reporting.
- 98.4. Paragraph 41R-1 of ISA (UK) 240, in that the audit team failed to inform GAG that they had reasonable grounds to suspect that irregularities, including fraud with regard to LM's financial statements, had occurred (although it is accepted that the audit team did not in fact suspect the occurrence of such irregularities).
- 98.5. Paragraph 6 of ISA (UK) 500, in that the audit team failed to design and perform audit procedures that were appropriate in the circumstances for the purpose of obtaining sufficient appropriate audit evidence to support the release of the LM Profit Share Accrual.
- 98.6. Paragraph 9 of ISA (UK) 500, in that the audit team failed to evaluate whether the information produced by LM (the LM Settlement Email) was sufficiently reliable and detailed for the purpose of auditing the release of the LM Profit Share Accrual, and failed to obtain audit evidence about the accuracy and completeness of that information.
- 98.7. Paragraph 11 of ISA (UK) 500, in that the LM Settlement Email was evidence that was inconsistent with the evidence that LM had accrued for profit share payments 50 times greater than the amount for which the DfT settled, yet the audit team failed to determine what modifications or additions to the audit procedures were necessary to resolve the matter.
- 98.8. Paragraph 13(e) of ISA (UK) 700, in that the audit team failed properly to evaluate whether, in light of the rewording of the Note 4 Narrative, LM's financial statements provided adequate disclosures to enable the intended users to understand the effect of the release of the LM Profit Share Accrual.

Breach Area 4 - GABY

Facts

Recognition of an onerous contract provision

99. During FY20, GABY had two contracts to operate rail franchises in the German state of Bavaria, which were due to commence in December 2021 and December 2022 respectively ('**ENA**' and '**ABN**'). The audit of GABY for FY20 was performed by a component audit team in Germany, instructed by the group audit team in the UK.
100. At an early stage of the FY20 Audit, the group and component audit teams identified a possibility that the ENA and ABN contracts might be loss-making, such that an onerous contract provision might be required. The component audit team sought information from GAG to enable this issue to be assessed, but GAG, which had previously said that there were too many uncertainties to calculate a robust VIU, was initially resistant on the basis that the contracts had not yet started and therefore it would be too early to reliably calculate a provision. Nevertheless, on 14 August 2020, GAG supplied a VIU model for GABY which showed a negative €8.0 million cash flow, i.e. that the ENA and ABN contracts would make a loss. The component and group audit teams recognised that this suggested the need for an onerous contract provision, but when this was put to management, it disagreed.
101. Later in August 2020, GAG supplied an updated VIU model with a (positive) €3.0 million cash flow figure, which management said justified its position that no onerous contract provision was needed. However, on 3 September 2020, the component audit team told the group audit team that its own assessment was that a provision of €10.6 million would be needed. When on the same day the component audit team informed management of its assessment, management reacted negatively.
102. The group audit team did not accept the component audit team's assessment and provisionally concluded that an onerous contract provision should not be made.
103. During the FY20 Audit, the group audit team did not:
 - 103.1. Sufficiently challenge management's initial reluctance to perform the onerous contract assessment, despite the fact that it would be extremely rare for an entity to be unable to make an estimate of contractual obligations that was sufficiently reliable to use in recognising a provision.
 - 103.2. Demonstrate scepticism about management's updated VIU model which showed a significant change in forecast performance with little or no explanation as to how the change had come about.
 - 103.3. Maintain sufficient professional judgement and scepticism in relation to the assumptions and projected cost savings on which management's updated VIU model was based, or ensure that, for example, the assumptions were agreed to third party evidence.
 - 103.4. Consider whether further audit evidence or audit procedures were required.

104. By mid-September 2020, the group audit team began to explore the possibility with the component audit team that any loss on the ENA and ABN contracts would be at a level below materiality, such that an onerous contract provision would not need to be recognised in the FY20 Financial Statements. Ultimately, the component audit team concluded that an onerous contract provision of a still-material €8.1 million was needed and the group audit team agreed with this conclusion, as did management. This provision was therefore recorded in the FY20 Financial Statements.
105. In the FY21 Financial Statements, GAG made a prior-year adjustment in respect of the GABY onerous contract, restating it from €8.1 million to €49.5 million (a restatement of €41.4 million). As part of a subsequent investigation performed by GAG, it identified that certain information, which was the subject of the prior-year adjustment regarding GABY in FY21, existed within GAG during the FY20 Audit, but was not shared with Deloitte at that time.

The group audit team's supervision of the component audit team's work

106. The component audit team's work on the need for and quantum of an onerous contract provision involved a 'sensitivity analysis', which was based on the updated VIU model supplied by GAG. That VIU model involved various forecasts, assumptions and projections about what would happen when the ENA and ABN contracts began. For example, management made assumptions about the rate of 'income deduction penalties' that would be chargeable to GABY, about how many drivers would transfer from another rail operator to GABY, and about inflation of staffing costs. The component audit team in turn made adjustments to those forecasts, assumptions and projections as part of its sensitivity analysis.
107. The group audit team did not adequately review and evaluate the audit evidence that was obtained by the component audit team, and the component audit team's own assessment of that evidence. For example, the group audit team did not:
- 107.1. Evaluate or review the component audit team's verification of the arithmetical accuracy of GAG's VIU model.
 - 107.2. Seek to understand how the component audit team's adjustment to the income deduction penalties was calculated.
 - 107.3. Question the component audit team's conclusion that, on the assumption that no drivers would transfer to GABY, €1.7 million of 'additional training costs' would constitute a saving for GABY, rather than being incurred in training new drivers.
 - 107.4. Scrutinise the component audit team's omission to account for inflation of any costs other than staffing costs.
108. There was other information available at the time of the FY20 Audit, for example relating to maintenance outsourcing costs and energy and infrastructure costs, that was not evaluated by the component audit team, but about which no challenge was raised by the group audit team. Further, there was no document on the audit file that

supported the €8.1 million provision which the component audit team eventually calculated should be made.

Breaches

109. In its conduct of the FY20 Audit in relation to GABY, Deloitte breached the following *Relevant Requirements*:

109.1. Paragraphs 15 and 16 of ISA (UK) 200, in that the group audit team failed to exercise sufficient professional scepticism and judgement in relation to the recognition and measurement of an onerous contract provision in respect of GABY. The group audit team demonstrated a lack of professional scepticism and judgement through their failure adequately to respond to, and question, the information received from management.

109.2. Paragraphs 8 and 9 of ISA (UK) 230, in that the group audit team failed to ensure that:

109.2.1. audit documentation prepared by the component audit team was correct and consistent with other audit documentation on the group file; and

109.2.2. detailed and accurate records were retained which explained the work performed by the component audit team, and the review, evaluation and challenge by the group audit team of that work.

109.3. Paragraph 32(b) of ISA (UK) 240, in that, despite being aware of the potential for management bias, the group audit team:

109.3.1. did not adequately evaluate whether other judgements and decisions made by management in making accounting estimates including in the Financial Statements indicated an expression of management bias that would represent a risk of material misstatement due to fraud; and

109.3.2. did not take adequate steps to perform a retrospective review of the management judgements and assumptions related to significant accounting estimates reflected in the Financial Statements of the prior year.

109.4. Paragraph 6 of ISA (UK) 500, in that the group audit team failed to design and perform audit procedures that were appropriate in the circumstances for the purpose of obtaining sufficient appropriate audit evidence about the recognition and measurement of an onerous contract provision in respect of GABY.

109.5. Paragraph 11 of ISA (UK) 500, in that the group audit team failed to respond adequately to evidential inconsistencies in respect of the component audit team's review and understanding of the GABY contracts, and failed to consider whether modifications or additions to the audit procedures were

required in response to material inconsistencies in the cashflows presented in the different versions of the VIU models prepared by GAG.

109.6. Paragraph 42D-1 of ISA (UK) 600, in that the group audit team failed adequately to evaluate and review the work performed by the component audit team.

109.7. Paragraph 44 of ISA (UK) 600, in that, in consequence of its inadequate evaluation of and review of the work performed by the component audit team, the group audit team failed properly to evaluate whether sufficient appropriate audit evidence had been obtained on which to base the group audit opinion.

F. SANCTIONS

110. 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:

110.1. 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.

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

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

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

111. In considering *Sanctions* to be imposed on Deloitte, Executive Counsel has, in summary, considered the following matters in accordance with the Sanctions Policy.

Nature, seriousness, gravity and duration of the breaches

112. The breaches were extremely serious, having regard to:

112.1. The number of different contraventions, across three different subsidiaries (although it is noted that these were only relatively a small part of GAG's business).

112.2. The fact that the breaches in relation to the DAC Overpayments persisted for five years. Although some of those breaches amounted to the continuation of the same failings, further information became available over the years that made the explanations given by management less and less credible, making the audit teams' failure to identify and properly respond to the issues more serious as time went on.

- 112.3. The fact that there were multiple contraventions of ISA requirements that are fundamental to the work of the auditor.
- 112.4. The fact that the work of the audit teams fell far below the level of competence expected of the reasonable auditor. Of particular note are:
- 112.4.1. The multiple failures by the audit teams to apply professional scepticism to management's accrual for the IKF and DAC Overpayments, its release of the IKF Overpayments accruals and LM Profit Share Accrual, and its initial reluctance to recognise an onerous contract provision for GABY and the amount of the provision ultimately recognised, in circumstances where these decisions were clearly questionable and intended to achieve outcomes that were favoured by management.
 - 112.4.2. The significant failure of professional judgement by the Partner in not identifying the misleading purpose of the DAC Overpayments Reclassification and the LM Note 4 Narrative rewording, which should have been obvious from the emails that they received and workpapers that they reviewed.
- 112.5. The fact that the breaches were in relation to matters identified by Deloitte as significant audit risks.
- 112.6. To the extent that the breaches were concerned with the profitability of several of GAG's rail franchises, the fact that they related to a core activity of the business rather than peripheral matters.
- 112.7. The very serious actual and potential consequences of the breaches:
- 112.7.1. The breaches occurred in the audits of a large PIE engaged in providing essential transport services to the UK public.
 - 112.7.2. The sums involved in all the breaches were material, either at the subsidiary or the group level.
 - 112.7.3. In the case of LSER and LM, the audit teams failed to challenge from an audit perspective the wrongful retention by GAG of over £30 million of public money for an extended period of time.
 - 112.7.4. In the case of GABY, a restatement was required in FY21 to increase the size of the onerous loss provision by more than €40 million.
- 112.8. The fact that LSER ultimately lost the franchise and received a significant financial penalty, with resulting reputational damage, causing a serious adverse impact on shareholders. If the breaches had not occurred, this outcome might have been avoided.

112.9. The fact that the nature and seriousness of the breaches is such that they are bound to undermine confidence in the truth and fairness of financial statements and the standards of conduct of auditors in general.

112.10. The fact that Deloitte has been the subject of previous sanctions for audit failings, including for another failure to address a serious breach of trust in the context of contracts with a public body.

113. Conversely, it is also relevant to note that:

113.1. The breaches relate to only three of GAG's subsidiaries, of which there are about 30 in all.

113.2. The breaches were not intentional or deliberate, reckless or dishonest.

113.3. The breaches were not motivated by financial gain and did not result in any financial benefit to Deloitte.

113.4. Deloitte reported the issues to the FRC and carried out its own internal investigations.

113.5. Deloitte has apologised for the breaches and demonstrated contrition.

114. Further, Deloitte has carried out a Root Cause Analysis ('RCA') to identify the causes of the breaches, and has implemented significant changes since the Audits which should reduce the risk of any recurrence. Executive Counsel is mindful of the fact that several years have passed without any similar case arising and has seen evidence of Deloitte responding positively and appropriately when faced with similar recent situations. Nonetheless, Executive Counsel considers it reasonable to require Deloitte to carry out a specific assessment of the effectiveness of the remedial measures taken, so as to provide additional reassurance that the breaches will not recur.

115. Deloitte is now the largest audit firm in the UK by total fee income (£4,908 million), the second largest by audit fee income (£900 million) and the third largest by number of Responsible Individuals qualified to sign auditor's reports (335) and number of PIE audit clients (214).⁴

Identification of Sanction

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

116.1. A financial sanction of £11 million.

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

⁴ From data in the 2025 edition of the FRC's *Key Facts and Trends in the Accountancy Profession*.

116.3. A declaration that the reports signed on behalf of Deloitte in respect of the Audits did not satisfy the *Relevant Requirements*, as set out in this *Final Settlement Decision Notice*.

116.4. An order requiring Deloitte to prepare a report for Deloitte's FRC Firm Supervisor setting out the root cause analysis completed, the actions taken and their assessment (based on empirical evidence) of how these mitigate recurrence of the identified breaches.

Aggravating and mitigating factors

117. Executive Counsel has taken into account all relevant aggravating and mitigating factors in assessing the nature, seriousness, gravity and duration of the breaches, with the exception of the level of co-operation provided by Deloitte during the investigation of the breaches.

118. Under paragraph 69 of the Sanctions Policy, only an exceptional level of co-operation will be regarded as a mitigating factor. The level of co-operation provided by Deloitte was exceptional in that, as well as engaging fully with the lengthy and intensive investigation, it provided the FRC with extensive and detailed reports of its own internal enquiries which were of significant assistance to Executive Counsel in establishing the facts.

119. Executive Counsel considers that a reduction in the financial sanction of 10% is appropriate to reflect this particular mitigating factor.

Deterrence

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

Discount for Admissions and Settlement

121. Having taken into account the full admissions by Deloitte and the fact that those admissions were made at an early point within Stage 1 of the case, as defined in paragraph 84 of the Sanctions Policy, Executive Counsel determined that a further reduction of 35% to the financial sanction is appropriate

122. The amount of the financial sanction payable by Deloitte is therefore £6,050,000.

G. COSTS

123. Executive Counsel requires that Deloitte pay her costs to the value of £1,981,133. 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: 26 June 2026

APPENDIX – EXTRACTS FROM RELEVANT REQUIREMENTS

Note: for brevity, only extracts from the versions of the ISAs applicable to the FY20 Audit have been included. There is no material difference in the wording of the versions of the ISAs applicable to the earlier Audits.

ISA (UK) 200 (Overall objectives of the independent auditor and the conduct of an audit in accordance with international standards on auditing)

Paragraph 15

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. (Ref: Para. A20-A24)

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.

Paragraph 16

16. The auditor shall exercise professional judgment in planning and performing an audit of financial statements. (Ref: Para. A25-A29)

ISA (UK) 230 (Audit Documentation)

Paragraph 8

8. The auditor shall prepare audit documentation that is sufficient to enable an experienced auditor, having no previous connection with the audit, to understand: (Ref: Para. A2–A5, A16–A17)
- (a) The nature, timing and extent of the audit procedures performed to comply with the ISAs (UK) and applicable legal and regulatory requirements; (Ref: Para. A6–A7)
 - (b) The results of the audit procedures performed, and the audit evidence obtained; and
 - (c) Significant matters arising during the audit, the conclusions reached thereon, and significant professional judgments made in reaching those conclusions. (Ref: Para. A8–A11)

Paragraph 9

9. In documenting the nature, timing and extent of audit procedures performed, the auditor shall record:
- (a) The identifying characteristics of the specific items or matters tested; (Ref: Para. A12)
 - (b) Who performed the audit work and the date such work was completed; and

(c) Who reviewed the audit work performed and the date and extent of such review.
(Ref: Para. A13)

ISA (UK) 240 (The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements)

Paragraph 12

12. In accordance with ISA (UK) 200 (Revised June 2016),⁵ the auditor shall maintain professional skepticism throughout the audit, recognizing the possibility that a material misstatement due to fraud could exist, notwithstanding the auditor's past experience of the honesty and integrity of the entity's management and those charged with governance. (Ref: Para. A7–A8)

Paragraph 14

14. Where responses to inquiries of management or those charged with governance are inconsistent, the auditor shall investigate the inconsistencies.

Paragraph 24

24. The auditor shall evaluate whether the information obtained from the other risk assessment procedures and related activities performed indicates that one or more fraud risk factors are present. While fraud risk factors may not necessarily indicate the existence of fraud, they have often been present in circumstances where frauds have occurred and therefore may indicate risks of material misstatement due to fraud. (Ref: Para. A23–A27)

Paragraph 29(b)

29. In determining overall responses to address the assessed risks of material misstatement due to fraud at the financial statement level, the auditor shall:

...

(b) Evaluate whether the selection and application of accounting policies by the entity, particularly those related to subjective measurements and complex transactions, may be indicative of fraudulent financial reporting resulting from management's effort to manage earnings; and

...

Paragraph 41R-1

- 41R-1. For audits of financial statements of public interest entities, when an auditor suspects or has reasonable grounds to suspect that irregularities, including fraud with regard to the financial statements of the entity, may occur or has occurred, the auditor shall, unless prohibited by law or regulation, inform the entity and invite it to investigate the matter and take appropriate measures to deal with such irregularities and to prevent any recurrence of such irregularities in the future. (Ref: Para. A63-1–A63-2)

ISA (UK) 260 (Communication with Those Charged with Governance)

Paragraph 16(c)(i)

16. The auditor shall communicate with those charged with governance: (Ref: Para. A17–A18)

...

(c) Unless all of those charged with governance are involved in managing the entity:

- (i) Significant matters arising during the audit that were discussed, or subject to correspondence, with management; and (Ref: Para. A22)

...

ISA (UK) 500 (Audit Evidence)

Paragraph 6

6. The auditor shall design and perform audit procedures that are appropriate in the circumstances for the purpose of obtaining sufficient appropriate audit evidence. (Ref: Para. A1–A25)

Paragraph 9

9. When using information produced by the entity, the auditor shall evaluate whether the information is sufficiently reliable for the auditor's purposes, including as necessary in the circumstances:

(a) Obtaining audit evidence about the accuracy and completeness of the information; and (Ref: Para. A49–A50)

(b) Evaluating whether the information is sufficiently precise and detailed for the auditor's purposes. (Ref: Para. A51)

Paragraph 11

11. If:

(a) audit evidence obtained from one source is inconsistent with that obtained from another; or

(b) the auditor has doubts over the reliability of information to be used as audit evidence,

the auditor shall determine what modifications or additions to audit procedures are necessary to resolve the matter, and shall consider the effect of the matter, if any, on other aspects of the audit. (Ref: Para. A57)

ISA (UK) 600 (Special Considerations – Audits of Group Financial Statements Including the Work of Component Auditors)

Paragraph 42D-1

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; or

(b) Where the group engagement team is unable to request or secure the agreement required by paragraph 19D-1, take appropriate measures (including carrying out additional work, either directly or by outsourcing such tasks, in the relevant component) and inform the competent authority.^{9a}

^{9a} In the UK, the competent authority designated by law is the FRC or the Recognised Supervisory Body to whom the FRC has delegated regulatory tasks, as applicable.

Paragraph 44

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.¹⁰ 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. (Ref: Para. A62)

ISA (UK) 700 (Forming an Opinion and Reporting on Financial Statements)

Paragraph 13(d) and (e)

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

...

(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. (Ref: Para. A5)

(e) The financial statements provide adequate disclosures to enable the intended users to understand the effect of material transactions and events on the information conveyed in the financial statements; and (Ref: Para. A6)

...