

## STATUTORY AUDIT SERVICES

### Summary of hearing with Deloitte regarding due diligence and reporting accountant work held on 24 April 2012

#### Introduction

1. Deloitte made a presentation to the CC regarding due diligence work and reporting accountant work, in particular concerning their nature and purpose, and how they compare to a statutory audit.

#### Nature of due diligence

2. There was no single definition of due diligence. It was best thought of as an investigation, designed to assist a purchaser evaluate a target company. There was no 'opinion' (unlike statutory audit). In particular, the due diligence firm would give no valuation of the asset. In simple terms, a due diligence report could be compared to a house survey prepared for a buyer thinking of buying a house. Accordingly, due diligence reports typically provided input for the purchaser into the negotiation process, both with regard to price and other terms and conditions that might be included in a sale and purchase agreement.
3. Due diligence typically occurred during a transaction (for example, the buying and selling of a company or when a company wished to raise money) between agreement in principle and closing. The main difference between a statutory audit and due diligence work was that the scope of an audit was defined by legislation and regulation, whereas due diligence was an investigation where the scope could vary widely, depending on the client's specification and what the transaction process allowed. For example, where an asset attracted high levels of interest the seller may provide less information, whereas for a private sale the seller may be willing to provide much greater information on the accounts. For transactions where all parties were listed on public markets, the extent of due diligence was limited by restrictions on the information that could be made public under the stock exchange listing rules.
4. Due diligence enabled prospective purchasers to check that the reported financial condition of a target company was a true reflection of its actual condition. The areas typically covered in a due diligence report included earnings, profit, costs, margins, how the business generated cash and an analysis of the assets and liabilities on the balance sheet. Assumptions underlying the projections of these figures could also be tested—for example, checking that turnover was likely to be persistent and profit was not distorted by one-off items. A recent issue had been checking the growth levels and forecasts of companies emerging from recession. The issue was whether recent high growth levels were likely to be sustained, or would plateau once pre-recession levels were reached. Others might include checking whether profits derived from contracts that had recently expired or would soon expire.
5. Due diligence involved analysis of historical financial statements as well as forecast financial information, usually the management accounts which provided more detailed information about business activity. An important aspect of due diligence was that while checks were undertaken to reconcile management accounts with statutory accounts, the investigating did not give assurance about the accuracy of either set of accounts. Given the absence of this assurance, there was a grey area around whether the firm performing due diligence was at fault if there was something

in the management accounts that looked inaccurate and could reasonably have been expected to be noticed.

6. The investigating firm could be liable under basic contractual principles, ie the test for determining liability was measured against 'what a reasonable professional would have done'. In contrast, for a statutory audit, the test was against the appropriate audit and accounting standards.
7. The maximum liability Deloitte would agree to contractually for due diligence was £25 million (apart from cases of fraud, or other liabilities that could not be contractually limited or excluded, where there was no limit). This limit had been agreed by the British Venture Capital Association as an appropriate limit. For statutory audit, there was unlimited liability. Limits could be agreed, but Deloitte had made no such agreements in practice.
8. Where an acquisition was leveraged the lender would also receive the due diligence report on a 'reliance basis', ie the due diligence firm agreed to have the same duty of care to the lender as it had to the client. The liability limit would be the same for the lender and the client.
9. The skills required to carry out financial due diligence were similar to those required on an audit. A large majority of Deloitte staff working on financial due diligence originally trained in audit. Deloitte mentioned an auditor's 'enquiring mind' and 'professional skepticism'.

### ***Types of due diligence***

10. There were seven main areas where due diligence could be performed. The extent that each was performed for a transaction varied on a case by case basis (depending on the client's requirements), although financial, tax and pensions due diligence was always carried out:
  - (a) Financial: examining the key financial indicators as described in paragraph 4.
  - (b) Tax: examining tax compliance and a company's tax position which might not be apparent from the accounts.
  - (c) Pensions: many companies had defined-benefit schemes in deficit. Valuation was highly judgemental and could be different under different accounting standards.
  - (d) IT: examining whether the IT systems would continue to function properly and if they required investment.
  - (e) Operational: examining whether a company had sufficient capacity.
  - (f) Commercial: examining the competitive position of a company and the outlook for the market.
  - (g) Environmental: purchasers might be liable for cleaning up pollution caused by a previous owner.
11. Deloitte almost always performed finance and tax due diligence for any transaction. Pensions due diligence was also frequently performed by Deloitte, but sometimes an outside firm of actuaries would be used. Deloitte would not subcontract work to other firms—the client would have a preference for a particular firm for a particular type of due diligence.

12. Vendor due diligence was a particular type of due diligence, performed for the vendor in a transaction which was expected to attract a lot of interest from potential bidders. It could include any of the areas listed in paragraph 10. It helped to speed up the process, reduced intrusion into the vendor company, allowed interested parties to make informed bids, and allowed the vendor to hold a bidder to an offer. Vendor due diligence could be performed by the statutory auditor but this was dependent on company policy.
13. With regard to liability, the vendor due diligence report was given to potential bidders on a non-reliance basis but on completion of the transaction the purchaser received the report on a reliance basis.
14. Due diligence contracts were awarded as a result of mixture of competitive tenders and existing relationships. If a firm had performed some work in a particular sector, other companies in the sector might look to that firm as they had relevant sector experience. In Deloitte's experience, FTSE 350 companies tended to use a Big 4 accountant to undertake due diligence.

### **Reporting accountant work**

15. Reporting accountant work was part of due diligence work required before an initial public offering could be made. Specific to the London Stock Exchange, the sponsoring institution had a duty to ensure that the applicant had satisfied the applicable listing and prospectus rules. As part of the process, the accountant would be commissioned to perform due diligence on the listing company, producing a 'long form report' which was private to the sponsoring institution and the directors of the company.
16. The accountant was also responsible for providing an accountant's report. Forming part of the listing company prospectus, it was a public report. It included three years' worth of audited financial information of the company and an audit opinion. The outcome of the report was very similar to audit output in that the reporting accountant was required to give a 'true and fair' opinion. The starting point for the audit work was an independent review of the audit file to ensure there was evidence that sufficient audit work had been done, and whether any circumstances had changed to doubt this.
17. Where the reporting accountant authorized the inclusion of an accountants report in a prospectus, and failed to meet the required standard in forming its opinion, it might have statutory liability under the Prospectus Rules, whereas, in the circumstances of statutory audit, there was a direct duty of care in law owed by the auditor to the shareholders as a body.
18. The quantity of work required to produce the report varied depending on the individual circumstances of the listing company. For example, the process would not be onerous for the accountant if an audit had just been carried out and little had changed in the business since the year end. The process could be complicated by having to make local overseas accounting standards compliant with the listing market standards (for example, converting Indian GAAP to IFRS) or reviewing the audit files of another audit firm (where the reporting accountant had been appointed as auditor for less than three years). It was also possible that the listing company had never been audited, for example if it was in a jurisdiction where it had been exempt from audit.
19. There were also a number of comfort letters the reporting accountant produced to support the information provided in the prospectus. One was the working capital

report where the listing company directors had to make a public declaration that in their opinion the company had enough working capital for at least the next 12 months. The reporting accountant produced a comfort letter for the sponsoring institution analysing the listing company's projections and expressing support that the directors' declaration was made after due and careful enquiry.

20. A second comfort letter was to meet the London Stock Exchange requirement that the listing company had sufficiently robust financial reporting procedures that could report to the market in a timely manner. This was in a private letter to the sponsoring institution that these systems were in place. There were five or six other comfort letters which could be required depending on the circumstances.
21. All such reporting work was classed as non-audit work according to the Ethical Standards. In theory it could be performed by any accountant registered in the UK but in practice it made sense to use the statutory auditor. For example, if a different firm from the auditor conducted the accounting report for a listing company's prospectus it would have to analyse all the auditor's work again. Sometimes different firms produced the accountants report and long form report but this was still rare.