FINAL NOTICE

To: **SFI Group plc**

Of: **SFI House**
165 Church Street East
Woking
Surrey
GU21 1HJ

Date: 11 December 2003

TAKE NOTICE: The Financial Services Authority of 25 The North Colonnade, Canary Wharf, London E14 5HS (“the FSA”) gives SFI Group plc ("SFI") final notice of its decision to take the following action

ACTION

The FSA gave SFI a Decision Notice dated 11 December 2003 which notified SFI that, for the reasons set out below and pursuant to section 91 of the Financial Services and Markets Act 2000 ("the Act") the FSA decided to take action against SFI in respect of a contravention of paragraph 9.3A of the Listing Rules made by the FSA under Part VI of the Act ("the Listing Rules") as follows:

- to publish a statement censuring SFI, substantially in the terms of this Final Notice, for failing to take reasonable care to ensure that an announcement via the Regulatory

Information Service on 30 July 2002 of its preliminary financial results for the year ended 31 May 2002 ("the Preliminary Results Announcement") was not misleading or false.

SFI has confirmed that it does not intend referring the matter to the Financial Services and Markets Tribunal.

REASONS FOR THE ACTION

Relevant Statutory and Regulatory provisions

1. Pursuant to Part VI of the Act, the FSA is responsible for the official listing of securities in the UK. The Listing Rules set out the requirements for the admission of securities to the official list and the continuing obligations of companies whose securities are so admitted.

2. The continuing obligation requirements are set out in Chapter 9 of the Listing Rules. Rule 9.3A of the Listing Rules states that:

   "A company must take all reasonable care to ensure that any statement, forecast or any other information it notifies to a Regulatory Information Service or makes available through the UK Listing Authority is not misleading, false or deceptive and does not omit anything likely to affect the import of such statement, forecast or other information."

3. Section 91(1) of the Act provides that the FSA may impose a penalty of such amount as it considers appropriate where it considers that an issuer of listed securities has contravened any provision of the Listing Rules.

4. Section 91(3) of the Act provides that, where the FSA is entitled to impose a penalty on a person under Section 91, it may instead publish a statement censuring him.

Description of relevant facts

Background

5. SFI's shares were admitted to the London Stock Exchange Official List on 11 September 1998. They were de-listed on 12 May 2003.

6. SFI's principal activity is the operation of a number of chains of pubs and restaurants throughout the UK (including Slug and Lettuce and Litten Tree). Between 1996 and 2002 the number of outlets owned by SFI increased from 24 to 186 as a result of a number of acquisitions as well as a planned opening programme.

7. SFI's results for the five years to 31 May 2001 showed a steady increase in turnover, profit before tax and net assets as follows:

	Year ended 31 May				
	2001	2000	1999	1998	1997
	£m	£m	£m	£m	£m
Turnover	115.2	61.8	41.0	29.8	16.3
Profit before tax	15.0	9.4	7.3	5.3	2.3
Increase on prior year	60%	29%	37%	130%	
Net assets	84.3	51.4	36.0	30.5	25.5

30 July 2002 announcement

8. The Preliminary Results Announcement showed profit before tax of £19.5 million for the year ended 31 May 2002, an increase of 30% on the previous year, and net assets as at 31 May 2002 of £85 million.

9. The Preliminary Results Announcement was positive in its import, stating that:

"SFI Group has now achieved 11 years of continuous growth, with pre-tax profits having increased in that period from just £18,745 to over £20 million[1]. In another successful year, the Company's key performance indicators are all positive."

10. SFI's profit before tax of £19.5 million was broadly consistent with the most up to date market consensus, which on 25 July 2002 indicated profit before tax for the year ended 31 May 2002 of £20.7 million.

11. The Preliminary Results Announcement further stated that:

"…Gearing is higher than we would like. Many shareholders are rightly concerned that the balance sheet needs to be strengthened. We have acknowledged their concerns and are taking appropriate action."

"…Sound management of the financial function is essential and the SFI structure is well established."

12. Following the Preliminary Results Announcement there was no significant movement in SFI's share price, which closed at 179p that day compared to an average closing price of 178p in the preceding week. Trading volume in SFI's shares was 1,069,636 shares that day, which was significantly higher than the average daily trading volume of 323,129 shares in the preceding week.

Events leading up to the discovery of the accounting discrepancies

13. At a Board Meeting on 20 August 2002, SFI appointed external advisers to assist with the restructuring of its debt. A report was presented to SFI's bank syndicate on 16 September 2002, stating that SFI was experiencing increased creditor pressure and

[1] pre-tax profit of £20 million is stated before goodwill amortisation and loss on sale of fixed assets

proposing that SFI be released from an obligation to the syndicate under which disposal proceeds would be used to repay bank debt. This would allow an increase in payments to other creditors. SFI also sought to amend financial covenants to avoid breaches that were otherwise likely to occur as at 30 November 2002.

14. On 19 September 2002, a research note published by an external analyst stated that SFI was failing to pay its creditors. SFI's share price fell from 137.0p to 109.5p (a 20% decrease). In response, SFI made an announcement in the following terms on the same date:

"SFI Group has noted the recent movement in the share price with disappointment.

Trading in the first quarter continued to be positive with returns meeting our expectations…

… we have opened eight new sites since June making a total of 22 in the past six months. Whilst this has put short-term pressure on creditors the Group is actively managing the situation.

The company continues to trade within its existing bank facilities and is in the process of making amendments in keeping with the objective announced on 30th July 2002 of reducing gearing to below 100% within 18 months. "

15. SFI then appointed PricewaterhouseCoopers to assist in an initial limited review of its financial position, during the course of which it became evident that a specific review of SFI's net current assets was required. This review commenced on 2 October 2002.

16. On 21 October 2002, the day of its Annual General Meeting, SFI issued an announcement ("the AGM Announcement") which stated:

"The combined effect of the cash flow impact of the Company's significant site opening programme, the current trading environment, delays in the planned disposal programme and increased creditor pressure since 19 September is that it has been necessary for the Company to ask for, and the Company's bankers have granted, temporary waivers in relation to certain breaches of the existing banking facilities… As a consequence of the Company's current cash position, the Board has decided to further limit the Company's site opening programme. Of the planned 12 site openings in the financial year to May 2003, five have now opened…Only one further opening is currently anticipated.

In the circumstances…the Board has concluded that it is not in the best interests of the Company that it recommends the payment of the proposed final dividend of 1.87p per share for the year ended 31 May 2002."

17. The AGM Announcement also stated that SFI was conducting an internal review of its financial position.

18. Following the AGM Announcement SFI's share price fell 67% closing at 26p on 21 October 2002.

The accounting discrepancies

19. On 12 November 2002, SFI announced the suspension of its shares following the discovery of accounting discrepancies. The shares were suspended at 31p.

20. In this announcement ("the Suspension Announcement") it was stated that a full review of SFI's financial position was ongoing and that external accountants had been appointed to assist with that review. As at the date of the Suspension Announcement, conclusions reached included that:

"The Group had operated for some time with a particular focus on its profit and loss account but with less attention being paid to its cash flow statements and balance sheet. The inadequacy of cash flow controls and procedures of the Group, particularly with regard to cut off of accounting periods, was a contributory factor in the continuation of the Group's capital expenditure programme following the Parisa Café Bars acquisition. This has had an impact on the Group's cash flow.

Over a number of years there has been a significant over-statement of current assets and under-statement of liabilities of the Group. The Directors currently believe that the value of current assets are over-stated and liabilities are under-stated to an amount which, in aggregate, is likely to exceed £20 million. The accounting treatment of these over and under-statements is still under review. The fixed assets of the Group are still the subject of the financial review.

…The Group is producing projections and forecasts based on the revised accounting procedures and policies."

Findings of the Review

21. The review and investigation of the accounting discrepancies found that SFI's net current assets had been overstated since at least the year ended 31 May 2000. An unaudited estimate of the effect of the net current asset accounting discrepancies on the figures for the year ended 31 May 2002 is set out below:

	Preliminary Results Announcement £000	Adjusted figure £000	Adjustment £000	Adjustment %
Profit before tax	19,539	13,415	6,124	31.3%
Net assets	85,465	62,427	23,038	27.0%

22. The accounting discrepancies were primarily the result of accounting errors. While these errors can, in part, be attributed to SFI's rapid growth which put pressure on the finance department in terms of the resource available to it, the situation was exacerbated by SFI being without a Finance Director from 30 April 2002 to 8 July 2002, an important period for SFI in that it straddled the year-end and, consequently, the period when SFI's annual accounts were being prepared.

23. In addition, SFI had serious failures in its management of cash flow and capital expenditure due to both inaccurate forecasting and process shortcomings in approval and subsequent monitoring.

24. A summary of the factors contributing to the accounting discrepancies is set out in paragraphs 25 to 29.

Structure and operations of the finance department

25. Between 1996 and 2002 the number of outlets owned by SFI increased from 24 to 186, which placed strains on SFI's finance department and accounting systems. The high volume of work resulted in mispostings, missing accounting entries and the postponement of certain tasks, particularly the reconciliation of individual accounts.

26. The pressure on the finance department was compounded by the shortage of experienced and qualified staff. Further, due to illness and personal problems, key members of the finance department were absent at critical times. The shortage of staff also resulted in the work of more junior members of the finance department going unchecked and errors going unnoticed.

Reliance on spreadsheets

27. Due to limitations in its original accounting system, SFI became reliant on a series of spreadsheets to calculate figures that were subsequently used in SFI's accounts. When the accounting system was upgraded in light of the rapid growth of the business, the use of spreadsheets continued. The increase in the number of outlets owned by SFI meant that these spreadsheets became increasingly unwieldy and unreliable.

Operations driven management culture

28. The management of SFI was heavily focused on operations to the extent that the finance department adopted a secondary role. Remuneration of operations managers was performance driven through bonus payments. Bonuses were based on sales and profit performance against budget and were paid on a monthly basis until 2002, after which they were paid quarterly. This bonus system led to pressure from operations being applied to the finance department to maximise profits by, for example, the inappropriate capitalisation of costs and the spreading of invoices across months.

Lack of focus on the balance sheet

29. Due to the operations driven management culture, there was little focus on the balance sheet and, due to time pressure, reconciliation of the balance sheet accounts was not always done to a sufficient level of detail.

Accuracy of the Preliminary Results Announcement and compliance with Listing Rule 9.3A

30. In assessing SFI's compliance with Listing Rule 9.3A with respect to the Preliminary Results Announcement, the first issue considered by the FSA is whether, objectively,

it was misleading or false. The Preliminary Results Announcement was misleading and false in that it:

i. stated that profits before tax for the year ended 31 May 2002 were £19.5 million, when (allowing for the net current asset discrepancies) the correct figure should have been approximately £13.4 million, a difference of 31%;

ii. stated that net assets as at 31 May 2002 were £85.5 million, when (allowing for the net current asset discrepancies) the correct figure should have been approximately £62.4 million, a difference of 27%;

iii. contained headline figures in the profit and loss account and balance sheet within which individual items were materially misstated;

iv. contained statements of expectation based, in part, on inadequate and unreliable accounting information; and

v. stated that SFI was in a strong position and that a strong earnings growth would continue, when this was not, in fact the case.

31. The second issue considered by the FSA in assessing compliance with Listing Rule 9.3A is whether SFI took reasonable care to ensure that the Preliminary Results Announcement was not misleading or false. SFI failed, for the purposes of Listing Rule 9.3A, to take such reasonable care in that:

i. SFI's accounting systems and controls failed to, and had for some time failed to, determine reliably SFI's current and historical financial position as a whole;

ii. SFI's accounting systems and controls were not, and had for some time not been, appropriate to SFI's business or to its growth strategies; and

iii. SFI's accounting systems and controls were not, and had for some time not been, robust enough to support internal forecasts and projections that proved misleading and false.

32. These failures in SFI's accounting systems and controls had persisted for at least two years prior to the Preliminary Results Announcement and it was only in November 2002 that SFI eventually identified the accounting discrepancies which caused the Preliminary Results Announcement to be misleading and false.

Conclusion

33. The FSA regards the continuing obligation requirements of Chapter 9 of the Listing Rules as a fundamental protection for shareholders. These requirements are designed to promote full disclosure to the market as a whole and to ensure that the information emanating from listed companies is timely, sufficient and relevant.

34. To this end, listed companies have a continuing obligation to take reasonable care to ensure and to consider carefully that any information it announces to the market is accurate, complete and not misleading, false or deceptive. This obligation also implies that, if announcements are made to the market regarding financial results and

forecasts, reasonable care should be taken to ensure that these are arrived at by employing and maintaining accurate and appropriate accounting systems, controls and records. Observance of these continuing obligations is essential to the maintenance of an orderly market in securities and of confidence in the financial system.

35. The FSA will consider the circumstances and the standard of reasonable care required by Listing Rule 9.3A on a case by case basis. The FSA will also consider the fact that shareholders and the market in general place reliance on the contents of announcements to the market regarding the financial position and performance of a company when forming a view on the company's financial state and when making investment and other related decisions.

36. The FSA views SFI's conduct as set out in paragraphs 30 and 31 as a serious failure to take reasonable care for the purposes of Listing Rule 9.3A. In addition, the Preliminary Results Announcement presented a materially overstated and overoptimistic view of SFI's financial results and its future prospects, not only as at 30 July 2002, but also in relation to the results for the two financial years prior to that date. Had the true position as at the date of the Preliminary Results Announcement been made known then to the market, the FSA considers it likely that:

   i. both the market and SFI's shareholders would have held views on SFI's financial position and its historic and future prospects, which would have been fundamentally different to those they held subsequent to the Preliminary Results Announcement; and

   ii. there would have been a substantial movement in SFI's share price, as is evident from the movement of the share price which followed the negative statement in the AGM Announcement, when the share price fell by 67%.

RELEVANT RULES AND GUIDANCE ON SANCTION

37. Section 93 of the Act requires the FSA to prepare and publish a statement of its policy with respect to the imposition and amount of penalties. The FSA's policy in this regard is set out in Chapter 8 of the UKLA Guidance Manual ("the Manual"), which was issued in April 2002. The principal purpose of financial penalties is to promote high standards of regulatory conduct by deterring those who have breached regulatory requirements from committing further contraventions and by demonstrating generally the benefits of compliant behaviour. The FSA has considered the contravention by SFI in this context and has had regard in particular to the relevant factors set out in paragraphs 8.5 and 8.8 of the Manual, which are discussed in paragraphs 38 to 40.

38. Were it not for the matters set out in paragraphs 39 and 40, the FSA would have considered it appropriate to propose the imposition of a significant financial penalty in respect of SFI's contravention. The factors which it considers would be most relevant in determining the amount of such a penalty are that:

   i. SFI's failure to ensure that its announcement on 30 July 2002 was not misleading or false, combined with the fact that its results had been substantially overstated since at least the financial year ended 31 May 2000, is expected to result in the restatement of SFI's historically reported profits. SFI did not identify the overstatement and the weaknesses in its financial systems and controls which caused it until November 2002; and

ii. the consequences of SFI's failure, as well as the reasons for it, have been to cause investors and other market participants to be materially prejudiced over a prolonged period of time.

39. However the FSA considers that the following issues are also relevant:

i. there is no evidence to suggest that SFI contravened Listing Rule 9.3A deliberately or that it knowingly failed at any time to have proper regard to its obligations under the Listing Rules. Rather it appears that SFI's contravention of Rule 9.3A arose largely from the collective failure of an inadequate finance department and its inability to provide appropriate financial data to SFI's Board of Directors;

ii. the position regarding SFI's financial means (discussed more fully in paragraph 40);

iii. SFI notified the UKLA as soon as it became aware of the overstatement in its accounts on 12 November 2002 and its shares were immediately suspended. On 20 December 2002 SFI announced that Simmons & Simmons had been instructed to undertake a full investigation into its financial position and the accounting discrepancies;

iv. SFI has implemented a three year Recovery Plan (subject to completion of refinancing discussions) to attempt to rebuild the profitability of the business and has employed new management and strategies to this end. It has implemented internal changes to its organisational structure, personnel and processes to install the necessary management and accounting controls to prevent a recurrence of the matters under consideration by the FSA. The structure of the finance department has been changed and process changes have been implemented to correct previous inappropriate accounting practices;

v. SFI has not previously been the subject of formal disciplinary action arising from breaches of the Listing Rules; and

vi. although the FSA has not previously disciplined an issuer of listed securities for a contravention of the Listing Rules involving conduct after 30 November 2001 ("N2"), in previous cases involving contraventions prior to N2, the FSA has taken a very serious view of the conduct in question but, not having had the power to impose a penalty, instead has published statements of censure.

40. The position regarding SFI's financial means is that, as at 3 October 2003, SFI had bank indebtedness almost fully drawn down against facilities of £151.2 million, rolled up interest and unpaid fees due to its bankers of £6.7 million and further significant exposure arising from interest rate hedges taken out at higher than current market rates, less some £9 million in a prepayment account arising largely from recent disposals of assets. Neither current nor projected trading is sufficient to support

repayment of such a high level of debt and it is likely that SFI's equity value is completely eroded.

41. Paragraph 8.11.3 of the Manual lists the considerations which the FSA may take into account when determining whether to publish a statement of censure rather than to impose a financial penalty. In particular:

- Paragraph 8.11.3 (6) states:

"if the person has inadequate means…to pay the level of financial penalty which their misconduct would otherwise attract, this may be a factor in favour of...public censure. However it would only be in an exceptional case that the UKLA would be prepared to agree to impose a public statement rather than a financial penalty, if a financial penalty would otherwise be an appropriate sanction. Examples of such exceptional cases would include:…….. verifiable evidence that a person would suffer serious financial hardship if the UKLA imposed a financial penalty…."; and

- Paragraph 8.11.3(4) of the Manual states:

"if the person has admitted to the misconduct and provides full and immediate co-operation to the UKLA, this may be a factor in favour of a public censure, depending on the nature and seriousness of the misconduct"

42. The FSA considers that the present case is sufficiently exceptional that when the position regarding SFI's financial means is taken into account along with the other matters set out in paragraph 39, it has decided to publish a statement of censure; even though it considers that, in view of the factors described in paragraph 38, a significant financial penalty would otherwise have been an appropriate sanction.

43. In reaching its decision to publish a statement of censure rather than the imposition of a significant financial penalty, the FSA has also taken into consideration that SFI has:

i. co-operated fully with the FSA since SFI identified the accounting discrepancies and financial systems and controls failures and reported them to the UKLA; and

ii. moved quickly to agree the facts of the investigation and to settle the matter. This has helped the FSA to work expeditiously towards achieving its statutory objectives, which include the maintenance of an orderly market in securities and of confidence in the financial system.

IMPORTANT NOTICES

This Final Notice is given to SFI in accordance with Section 390 of the Act.

Publicity

Sections 391(4), 391(6) and 391(7) of the Act apply to the publication of information about the matter to which this Notice relates. Under these provisions, the FSA must publish such information about the matter to which this Notice relates as the FSA considers appropriate. The information may be published in such a manner as the FSA considers appropriate. However, the FSA may not publish information if such publication would, in the opinion of the FSA, be unfair to SFI or prejudicial to the interests of consumers.

The FSA intends to publish such information about the matter to which this Final Notice relates as it considers appropriate.

FSA Contact

For more information concerning this matter generally, you should contact Lize Lombard (direct line: 020 7066 1398/fax: 020 7066 1399) of the Enforcement Division of the FSA.

Martyn Hopper
Head, Market Integrity
FSA Enforcement Division