IN THE MATTER OF THE EXECUTIVE COUNSEL TO THE FINANCIAL REPORTING COUNCIL

-and-

(1) KPMG LLP

(2) NICOLA QUAYLE

FINAL DECISION NOTICE

Pursuant to Rule 18 of the Audit Enforcement Procedure

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

1. INTRODUCTION

1.1. The Financial Reporting Council (the "**FRC**") is the competent authority for statutory audit in the UK and is responsible for the operation of the Audit Enforcement Procedure (the "**AEP**"), effective 1 January 2021 (re-issued 30 March 2021). The AEP sets out the rules and procedure for the investigation, prosecution and sanctioning of breaches of *Relevant Requirements*.

1.2. 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.

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

1.3.1. **"FY2016"** means the financial year ended 1 May 2016.

1.3.2. "**FY2017**" means the financial year ended 30 April 2017, "**2017 Financial Statements**" means the consolidated financial statements of Conviviality plc ("**Conviviality**") for that period, and **"FY2017 Audit"** means the *Statutory Audit* of the 2017 Financial Statements.

1.3.3. "**FY2018**" means the financial year ended 29 April 2018, "**2018 Financial Statements**" means the consolidated financial statements of Conviviality for

that period, and **"FY2018 Audit"** means the *Statutory Audit* of the 2018 Financial Statements.

1.3.4. "**HY2017**" means the 2017 half year at which an interim review was conducted by the Respondents in December 2016 to January 2017.

1.3.5. "**IAS**" means International Accounting Standard**.**

1.3.6. "**Relevant Requirements**" has the meaning given in the AEP, Rule 1 of the AEP states that *Relevant Requirements* has the meaning set out in regulation 5(11) or 11(5)(b) of the Statutory Auditors and Third Country Auditors Regulations 2016 ("**SATCAR**"). The *Relevant Requirements* include, but are not limited to, the ISAs issued by the International Auditing and Assurance Standards Board.

1.4. The Senior Statutory Auditor (and the Group Engagement Partner) responsible for the FY2017 Audit and the FY2018 Audit was Ms Nicola Quayle ("**Ms Quayle**"), a member of the Institute of Chartered Accountants in England and Wales ("**ICAEW**") approved to carry out statutory audits, and a partner of KPMG LLP ("**KPMG**").

1.5. Pursuant to Rule 16(b) of the AEP, Executive Counsel has decided that KPMG and Ms Quayle are liable for Enforcement Action, having made *Adverse Findings* against each of them.

1.6. This *Final Decision Notice* is issued pursuant to Rule 18 of the AEP in respect of the conduct of:

1.6.1. KPMG in relation to the FY2017 Audit and the FY2018 Audit. KPMG was the *Statutory Audit Firm* for the FY2017 Audit and the FY2018 Audit and a member firm of the ICAEW.

1.6.2. Ms Quayle, a partner of KPMG in relation to the FY2017 Audit and the FY2018 Audit. Ms Quayle was the *Statutory Auditor* and engagement partner responsible for the FY2017 Audit and the FY2018 Audit.

1.7. Under the AEP acts and omissions of KPMG employees and partners within the scope of relevant audit engagements are to be attributed to KPMG. Consequently the conduct of KPMG's employees described in this *Final Decision Notice* is to be treated as the conduct of KPMG. Insofar as Ms Quayle is concerned, ISA 220 paragraph 8 states that the engagement partner "*shall take responsibility for the overall quality on each audit engagement to which that partner is assigned*". Any breach of a *Relevant Requirement* by KPMG identified in this *Final Decision Notice* is therefore also

deemed to be a breach by Ms Quayle by virtue of the requirements of ISA 220. Breaches of *Relevant Requirements* attributable to Ms Quayle other than by virtue of her having been engagement partner are identified in this *Final Decision Notice* by Ms Quayle being named specifically in addition to KPMG.

1.8. In this *Final Decision Notice* KPMG and Ms Quayle are referred to as the "**Respondents**".

1.9. On 23 November 2021 Executive Counsel issued Executive Counsel's Decision Notice pursuant to Rule 17 of the AEP. On 1 December 2021 the Respondents provided written agreement to Executive Counsel's Rule 17 Decision Notice. Consequently, and in accordance with Rules 17 and 18 of the AEP this *Final Decision Notice*:

1.9.1. outlines the *Adverse Findings* with reasons;

1.9.2. outlines *Sanctions* with reasons; and

1.9.3. outlines an amount payable in respect of Executive Counsel's costs of the matter.

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

1.10.1. Section 2: Executive Summary of the Adverse Findings;

1.10.2. Section 3: Background;

1.10.3. Section 4: *Relevant Requirements* to which the *Adverse Findings* relate;

1.10.4. Section 5: Detail of the *Adverse Findings* for the FY2017 Audit;

1.10.5. Section 6*:* Detail of the *Adverse Findings* in relation to the FY2018 Audit;

1.10.6. Section 7 and 8: *Sanctions*; and

1.10.7. Section 9: Costs.

2. EXECUTIVE SUMMARY OF THE *ADVERSE FINDINGS*

2.1. Conviviality was, at the time of the Audits, the UK's largest independent drinks distribution business. Conviviality was listed on the Alternative Investment Market ("**AIM**") of the London Stock Exchange in July 2013. Between July 2013 and December 2017 Conviviality grew rapidly through a series of acquisitions.

2.2. In April 2018, nine months after the 2017 Financial Statements were signed, Conviviality went into Administration.

2.3. As is set out in this *Final Decision Notice*, the manner in which the FY2017 Audit was conducted by KPMG failed to meet *Relevant Requirements* in a number of significant respects, and demonstrated a serious lack of competence. In a number of areas of the audit identified in this *Final Decision Notice* KPMG failed sufficiently and adequately to challenge how management reported adjusted Group EBITDA[1], and to perform audit work commensurate with the identified risks:

2.3.1. KPMG should have been more professionally sceptical of how the Group's EBITDA target (of which it had been seriously adrift during the course of FY2017) had reportedly been achieved: at the five-month mark EBITDA had been 30.7% behind budget; after nine months it had been 26% behind budget; and yet in the 2017 Financial Statements, management reported EBITDA for the whole year at £60.87m i.e. £2.57m over budget. In the last three months of FY2017 the Group had more than made up the 26% shortfall that had accumulated over the preceding nine months. This reported achievement should have raised with KPMG serious concerns about whether there had been bias - conscious or unconscious - in the accounts prepared by management in circumstances where management were under pressure and incentivised to achieve particular financial targets including, in particular, EBITDA. In the circumstances, and given the risks, KPMG should not have been satisfied that the evidence which it obtained in relation to certain management accounting judgements the effect of which was to augment EBITDA (including by reducing non-exceptional costs) was sufficient and appropriate.

2.3.2. KPMG identified these judgements (all of which had the same effect of increasing the FY2017 Group EBITDA number) as being right at the "optimistic" end of a scale of acceptability and reported those findings to the Audit Committee. Having identified management optimism in these judgements KPMG failed sufficiently and adequately to give due and proper consideration to the cumulative effect of such judgements on the risk of

[1] The Group used "adjusted EBITDA" defined as "*Earnings before interest, tax, depreciation and amortisation, exceptional items, share based payments and fair value of foreign exchange derivatives*." 2017 Financial Statements, pp.36 and 38, fn 2. This will be referred to below as "EBITDA". But it is important to bear in mind that it excluded exceptional items.

material misstatement. As a consequence KPMG failed adequately to evaluate or challenge certain material adjustments and classifications undertaken by management which contributed to the reported Group EBITDA for FY2017 of £60.87m.

2.4. The *Adverse Findings* set out in this *Final Decision Notice* in relation to the FY2017 Audit have been organised thematically and relate to the following areas of the audit:

2.4.1. Risk assessment;

2.4.2. Revenue Recognition - Franchise Licence Fees;

2.4.3. The Company 1 Wine Contract (defined below);

2.4.4. Capitalisation of Costs and Exceptional Items;

2.4.5. Accrued Supplier Income; and

2.4.6. Goodwill.

2.5. In the areas listed in 2.4.2 to 2.4.6 above the FY2017 Audit failed in its principal objective: that of obtaining sufficient appropriate audit evidence to provide reasonable assurance that the 2017 Financial Statements were free from material misstatement whether caused by fraud or error.

2.6. The *Adverse Finding* in relation to the FY2018 Audit concerns the Respondents' conduct in relation to documenting the decision to provide non-audit services in relation to preparing a Financial Position and Prospects Procedures report (the "**FPPP Services**") to Conviviality during the period of the FY2018 Audit, which breached the FRC's Revised Ethical Standard 2016 (the "**Ethical Standard**").

2.7. The breaches in relation to the FY2017 Audit and the FY2018 Audit were neither intentional, dishonest, deliberate nor reckless.

2.8. This *Final Decision Notice* imposes the following *Sanctions* in respect of the Respondents:

<u>KPMG</u>

2.8.1. A fine of £4,300,000 discounted for admissions and early disposal by 30% so that the financial sanction payable is £3,010,000;

2.8.2. A published statement in the form of a severe reprimand;

2.8.3. A declaration that the audit report in respect of the Audit of the 2017 Financial Statements signed on behalf of KPMG did not satisfy the *Relevant Requirements*, as set out in this *Final Decision Notice*; and

2.8.4. A requirement that KPMG shall report to the FRC identifying: (i) the causes of the deficiencies in the 2017 Audit as set out in this *Final Decision Notice*; and (ii) the steps KPMG has taken to prevent them recurring or what measures will be implemented to prevent them recurring, demonstrating how those remedial measures either have been or will be, effective.

Ms Quayle

2.8.5. A fine of £110,000, adjusted upwards by 5% for aggravating factors, but discounted for admissions and early disposal by 30% so that the financial sanction payable is £80,850; and

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

3. BACKGROUND to the FY2017 and FY2018 Audits

Conviviality

3.1. Between July 2013 and December 2017 Conviviality grew through a series of acquisitions as follows:

3.1.1. Wine Rack – August 2013

3.1.2. Matthew Clark – October 2015

3.1.3. Peppermint – December 2015

3.1.4. Bibendum PLB Group – May 2016

3.1.5. Central Convenience – December 2017.

3.2. The annual reports and accounts show the following revenue, profit and net assets:

£m	52 weeks ended 30 April 2017	53 weeks ended 1 May 2016	52 weeks ended 26 April 2015	52 weeks ended 27 April 2014
Revenue	1,560	841	364	356
Profit	18.4	5.3	7.0	3.5
Net assets	215.8	182.8	52.7	49.9

3.3. At the time of the FY2017 Audit and the FY2018 Audit, Conviviality operated in the following three divisions (as described in the FY2017 annual report):

3.3.1. Conviviality Retail – The UK's largest franchised off-licence and convenience chain with 352 Franchisees and more than 700 retail stores trading primarily under the fascia of Bargain Booze, Select Convenience and Wine Rack.

3.3.2. Conviviality Direct – The UK's largest independent wholesaler to the On Trade, serving c.25,000 outlets from national prestige hotel chains to independent food led pubs and restaurants, trading through two businesses – Matthew Clark and Bibendum.

3.3.3. Conviviality Trading – A full-service drinks brand and wine agency business with national sales and activation capability from traditional On and Off Trade retail, to festivals and events.

3.4. The 2017 Financial Statements were signed on 17 July 2017.

3.5. On 29 January 2018 Conviviality stated in its half year results for the 26 weeks ended 29 October 2017 that "*it continues to trade in line with the Board's expectations for the full year*". Revenue was up by 9.2%, adjusted EBITDA was up 1.7% but profit after tax was down 10.3% compared to the previous year.

3.6. On 8 March, 13 March and 14 March 2018 Conviviality issued trading updates stating, among other things, that EBITDA for FY2018 was expected to be approximately 20% below current market expectations (from a range of £69.1m to £70.5m down to £55.3m to £56.4m); there had been a material error in the financial forecasts of the Conviviality Direct business which meant that the EBITDA for the current period would be impacted by £5.2m and a £30m payment due to HM Revenue & Customs on 29 March 2018 had not been accrued for within the company's short term cash flow projections.

3.7. On 14 March 2018 Conviviality's shares were suspended from trading on AIM.

3.8. On 21 March 2018 Conviviality released an update outlining plans to raise equity of £125m in order to provide capital for the company to resolve overdue payments with its creditors, settle liabilities to HMRC, repay its revolving credit facility and provide working capital headroom (the "**equity fund raise**"). Conviviality also provided a trading update which stated that if the equity fund raise was successful, the expectation for EBITDA was now £45.5m to £46.0m.

3.9. On 28 March 2018 Conviviality announced that it had failed to obtain support for the equity fund raise and on 5 April 2018 Conviviality went into Administration.

The Respondents

3.10. In 2017, KPMG was ranked as the fourth largest audit firm in the UK by total fee income (total fee income of £2,172m) and second largest by audit fee income (income from audit and directly related services for audited entities of £548m), with 597 principals and 136 audit principals. The FY2017 Audit was KPMG's second year as the *Statutory Audit Firm* for Conviviality.

3.11. Ms Quayle was appointed as Senior Partner of KPMG's Manchester office on 1 October 2017 having previously been a non-executive director on the Board of KPMG UK and Chair of KPMG's Audit and Risk Committee (from 1 October 2014 to 30 September 2017) and Head of KPMG's Audit practice in the North (from 1 June 2016 to 30 September 2017).

3.12. Ms Quayle signed an unmodified audit opinion on 17 July 2017, on behalf of KPMG, in relation to the 2017 Financial Statements.

3.13. The Respondents' statutory responsibility was to form an opinion as to whether the FY2017 Financial Statements showed a true and fair view and had been properly prepared in accordance with International Financial Reporting Standards ("**IFRS**") and the Companies Act 2006.

3.14. An audit involves obtaining sufficient appropriate "audit evidence" about the amounts and disclosures in the financial statements in order to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error.

3.15. Audit evidence is defined in International Standards on Auditing (UK) ("**ISA**") 500 as "*information used by the auditor in arriving at the conclusions on which the auditor's opinion is based*". Audit evidence is primarily obtained from audit procedures performed during the course of the audit.

4. *RELEVANT REQUIREMENTS* TO WHICH THE *ADVERSE FINDINGS* RELATE

4.1. The *Relevant Requirements* relevant to this *Final Decision Notice* in relation to the FY2017 Audit are (in each case the October 2009 version unless otherwise stated):

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

4.1.2. ISA 220 (Quality control for an audit of financial statements);

4.1.3. ISA 230 (Audit documentation);

4.1.4. ISA 240 (Auditors' responsibilities relating to fraud);

4.1.5. ISA 300 (Planning an audit of financial statements);

4.1.6. ISA 315 (Identifying and assessing the risks of material misstatement through understanding the entity and its environment) (June 2013 version);

4.1.7. ISA 500 (Audit evidence); and

4.1.8. In relation to the FY2018 Audit only, the *Relevant Requirement* relevant to this *Final Decision Notice* is the Ethical Standard.

4.2. Extracts of the ISAs and the Ethical Standard which are of particular relevance to the *Adverse Findings* are set out in Appendix 1 hereto.

5. ADVERSE FINDINGS – FY2017 Audit

<u>ADVERSE FINDING 1 – Risk assessment in relation to the FY2017 Audit</u>

5.1. The audit work in relation to risk assessment breached ISAs 230, 240 and 315. As set out below, KPMG failed adequately to re-assess and revise the risks of material misstatement arising from fraud and/or accounting management bias and failed appropriately to respond to those risks and adjust their audit procedures in light of information obtained during the course of the audit. KPMG therefore failed to design and perform sufficient audit procedures to counteract those risks.

5.2. KPMG was aware that management was under pressure from the expectations of shareholders, market analysts, from the Board, and from their own bonus terms to report the achievement of particular financial targets.

5.3. In its audit planning documents, as it was required to do by ISA 240, KPMG identified in its Audit Strategy Document ("**ASD**") significant fraud risks relating to:

5.3.1. Management override of controls. KPMG concluded that it had not "*identified any specific additional risks of management override relating to this audit*". KPMG assessed the risk as having a higher than medium potential impact on the financial statements but a low likelihood of occurrence.

5.3.2. Revenue recognition, namely the risk that "*fraudulent misstatement (over or under-statement) of revenue occurs*". KPMG assessed the risk as having a

medium financial statement impact and a below medium likelihood of occurrence.

5.4. KPMG also identified the following specific risks in relation to revenue recognition *in an audit paper entitled "Fraud Risk Identification and Assessment"*:

> "*Management is under pressure from sources outside - being shareholders (PLC), to achieve an expected earnings target or financial outcome by overstating profits. As the group is changing - i.e. acquisition of Bibendum - there are pressures for this to go smoothly. Particularly since the consequences to management for failing to meet financial goals can be significant and impacts the remuneration package rewarded to management which is directly correlated to financial performance of the company [Source: ISA 240.A1]. This risk factor is expected to most likely manifest around the period end when management can most easily manipulate revenue recognition by bring forward revenue that should be recognised in subsequent periods. This may be the case if management become aware that they are unlikely to meet set profit targets either being those that drive remuneration or those that were announced to the market"*.

5.5. Against that background the following information obtained during the course of the audit should have resulted in KPMG revising its risk assessment and ensuring that the audit procedures planned and performed were a sufficient response to the assessed risks of material misstatement.

5.6. KPMG knew that EBITDA performance in FY2017 had been 30.7% below budget at the five-month mark, and approximately 26% below budget after nine months. Yet in the 2017 Financial Statements management reported EBITDA for the whole year at £60.87m, i.e. £2.57m over budget. Therefore in the last three months of FY2017 the Group had more than made up the 26% shortfall that had accumulated over the preceding nine months.

5.7. Approximately 33% of reported EBITDA was booked in the final month of the period as part of a management's year-end process. This was achieved by management taking a series of accounting actions in the FY2017 year-end accounting and entering into transactions which appeared to be aggressive, resulting in a dramatic increase to the EBITDA figure reported in the 2017 Financial Statements.

5.8. A number of optimistic or aggressive accounting judgements and estimates were identified by KPMG after the initial risk assessment: revenue recognition (see further **Adverse Finding 2**); the treatment by management of the Company 1 Wine Contract (**Adverse Finding 3**); the allocation of costs i.e. capitalisation and exceptional items

(**Adverse Finding 4**); and the Accrued Supplier Income (**Adverse Finding 5**), all of which served to increase reported EBITDA.

5.9. These matters should collectively have caused the audit team to revise its initial risk assessment of risk of management override in respect of reported profits and of risk of inappropriate revenue recognition. However KPMG failed adequately to re-evaluate its assessment of the fraud risks relating to management override of controls or improper revenue recognition.

5.10. While the more subjective items which contributed to the achievement of budget by the end of the year were subjected to scrutiny by the audit team, as is more particularly described in Adverse Findings 2 to 5, the work undertaken by the audit team in those areas was not sufficient to address the risk of misstatement in reported EBITDA which KPMG should have recognised in the light of information obtained during the audit.

5.11. In light of the other indicators of management bias that existed at the time, KPMG should have paid close attention to the fact that management declined to adjust for audit differences identified by KPMG in its Report to the Audit Committee totalling approximately £1.3m against planning materiality set at £1.4m, which was a further indicator of a risk of management bias and/or fraud in the reporting of Conviviality's financial results. Although the audit team identified management's optimistic judgements and examples of aggressive accounting in reporting to the Audit Committee, the audit documentation is inconsistent in that regard suggesting that insufficient attention was given to the implications of the management bias that had been identified. KPMG therefore failed sufficiently to assess, design or take audit measures to detect potential audit misstatements arising from management bias.

5.12. In its workpaper "4.5.4.4 Management override of controls", KPMG concluded that it had "*evaluated accounting estimates and* ***did not identify any indicators of management bias****, although we note the significant number of costs recorded as fair value adjustments or exceptional items, and the capitalisation of a number of overhead costs*" (emphasis added).

5.13. Audit workpaper "4.7.1.3 EQCR Overall Evaluation" included a section on management bias relating to estimates. Although it concluded that the key accounting judgements were "optimistic" (and the Respondents reported the same to the Audit Committee), it wrongly concluded that "*The entity's accounting practices do not indicate possible bias in management's judgments*". On the contrary, the risk of

management bias (whether conscious or unconscious) was evident in management's accounting estimates and judgements, giving rise to a real risk of material misstatement.

5.14. By the matters set out above, KPMG breached the requirement in **paragraph 31 of ISA 315** to revise the assessment of the risks of material misstatement and the requirements in **paragraphs 28, 30 and 32b of ISA 240** to design and perform audit procedures responsive to the risks of material misstatement due to fraud.

5.15. KPMG also failed adequately to document its audit procedures in respect of its risk assessment and fraud risk assessment, in that it failed:

5.15.1. to appropriately and consistently document the evidence that it had identified of management bias;

5.15.2. adequately to document its concerns about the financial reporting culture in its Entity Level Controls Workpaper and in its other audit workpapers; and

5.15.3. to correctly document in audit workpaper 4.5.6 (summary of control deficiencies) a significant control deficiency identified in relation to Bibendum PLB[2].

In failing to document these matters KPMG breached **paragraph 8 of ISA 230**.

ADVERSE FINDING 2 – Revenue recognition: franchise licence fees

5.16. The audit work in relation to revenue recognition in relation to franchise licence fees breached ISAs 200 and 500 as set out below.

5.17. KPMG failed to obtain sufficient appropriate audit evidence to support management's recognition of £5.9m as accrued franchise licence fee revenue in FY2017:

5.17.1. Conviviality signed 62 Franchise and License Agreements in the year ended 30 April 2017. The length of these agreements varied between three and 10 years, but the majority were 10 years in length. The agreements included a 'Franchise Licence Fee' ("**FLF**"), which was stated, in the only such agreement retained on the audit file, to be payable in respect of "*the rights granted under the agreement*". The FLFs were payable in instalments over several years. Management recognised as accrued income some £5.9m in

[2] A business unit in the Conviviality Direct division.

FLFs. An audit adjustment proposed by KPMG was a deduction of £0.4m to reflect the net present value of the deferred instalments.

5.17.2. In order to determine whether it was appropriate to accrue this FLF revenue upfront, KPMG considered that four criteria needed to be complied with, which were derived from IAS 18.IE.20 (Illustrative Example paragraph 20 to IAS 18 (Revenue)).

5.17.3. These criteria were: (i) the rights to the asset are assigned to the licensee in return for a fixed fee or non-refundable guarantee; (ii) the contract is non-cancellable; (iii) the licensee is able to exploit its rights to the asset freely - i.e. the licensor no longer retains managerial control; and (iv) the licensor has no remaining obligations to perform.

5.17.4. KPMG had insufficient audit evidence to satisfy itself that all of these criteria were met. As noted, only a single signed Franchise and Licence Agreement, made between Bargain Booze and a third party entity and dated 26 April 2017 (the "**Agreement**") was considered for the purpose of considering whether the criteria were satisfied and retained on the audit file. Although the terms of the Agreement supported the satisfaction of criterion (ii) "*the contract is non-cancellable*", it did not provide sufficient appropriate audit evidence to support (and there was no other evidence obtained to support) KPMG's conclusion that the other three criteria were satisfied. In particular:

1) Criterion (i)

There was no evidence that any of the payments under the Agreement represented a fixed fee for an assignment of rights. The Agreement identified a charge of £124,320 defined as the "FLF", payable in monthly instalments over the first seven years of the term of the Agreement; and another much smaller monthly charge of £367.95 described as 'Continuing Franchise Fees' ("**CFF**").

The FLF was not defined in the Agreement as being in relation to the sale of an asset. Schedule 1 Part 3 of the Agreement defined the Franchise Licence Fee as being in respect of "*the rights granted under this Agreement*". The terms of the Agreement did not therefore provide sufficient appropriate audit evidence to support the conclusion that the FLF was not consideration for performance of both initial and

continuing obligations of the franchisor as set out in Sections 2, 4 and 5 of the Agreement.

2) <u>Criterion (iii)</u>

Sections 6, 7 and 20.1 and Schedule 5 Clause 3 of the Agreement imposed extensive obligations upon the franchisee, continued compliance with which was a condition of the franchise, and granted the franchisor extensive rights, all of which, in the absence of further evidence, raised questions about consistency with the IAS 18 requirement that the franchisee must be able to exploit its rights to the asset freely. KPMG did not obtain any further evidence to support the conclusion that criterion (iii) was satisfied.

In its workpaper KPMG accepted management's assertion that, whilst the franchisor could provide "guidance", the franchisee had "discretion" to determine opening hours. This conclusion was not supported by Clause 6 of the Agreement, but there was no evidence of KPMG challenging management's assessment on this point.

3) <u>Criterion (iv)</u>

Section 5 of the Agreement was entitled "*Continuing Obligations of Franchisor*", and listed several ongoing obligations on the franchisor including providing advice, guidance, training, products and services and convening meetings to discuss the franchisor's proposals for promotional activities. Bargain Booze therefore appeared to have a number of continuing obligations to perform throughout the life of the agreement. KPMG did not obtain additional audit evidence to support the conclusion that the value of the CFF reflected a fair market value which was sufficient to cover the ongoing obligations of Bargain Booze as franchisor.

Nor did KPMG challenge management's assessment that there were no ongoing obligations of the franchisor in the agreements.

5.17.5. If, as KPMG concluded, there were no further obligations required to be performed by Conviviality in consideration of the payment of the FLFs, then it also failed to obtain sufficient appropriate audit evidence to satisfy itself that the CFFs were sufficient to provide a reasonable profit on the continuing services under the agreements.

5.17.6. KPMG also failed to obtain sufficient appropriate audit evidence to support the assertion made by management that the franchise agreements were all of a standard form and had consistent terms to each other and that the accounting policy could be applied consistently across all agreements.

5.17.7. In the circumstances, there was insufficient evidence to support a conclusion that it was appropriate to recognise and accrue the FLF income upfront.

As a result of the matters set out above, KPMG breached **paragraph 6 of ISA 500**.

5.18. KPMG failed adequately to apply professional scepticism in its audit of revenue recognition relating to the FLFs:

5.18.1. KPMG had correctly identified that pressures and incentives on management might lead to improper recording of recognition of revenue and that the business was performing significantly below budget for the first five months of the financial year (actual EBITDA was then 30.7%, or £7.2m, below budget) and was 26% behind budget after nine months. The additional income and EBITDA to be derived from the upfront recognition and accrual of the FLF income was £5.9m, providing a material increase in EBITDA for the year. Although KPMG was, at the planning stage of the 2017 Audit, alert to the risks of material misstatement due to management bias, it did not approach its actual review and work in respect of the terms of the Franchise and License Agreements and the resulting accounting treatment with sufficient scepticism or challenge of management.

5.18.2. KPMG failed to challenge management about the appropriate accounting treatment of the Franchise and License Agreements, in circumstances where a very substantial proportion of the accrued franchise fee income apparently related to Franchise and License Agreements concluded in April 2017, the last month of FY2017. This is despite the fact that in its planning KPMG had identified precisely this risk: see paragraph 5.4 above.

This represented a breach of **paragraph 15 of ISA 200.**

<u>**ADVERSE FINDING 3 – Company 1 Wine Contract**</u>

5.19. At HY2017 management increased an existing fair value provision (established on the acquisition of Matthew Clark in October 2015) for a contract with onerous terms between Matthew Clark and the wine supplier “Company 1”, covering wine sales until 2025 (the “**Company 1 Wine Contract**”). The provision was increased at HY2017

by £5.8m, to £10.1m (by means of a post-acquisition “fair value adjustment” to Matthew Clark’s goodwill). The Company 1 Wine Contract contained penalty clauses which applied if a particular percentage of total annual Conviviality wine sales were not of Company 1 wines.

5.20. Then, at the FY2017 year-end, 18 months after the acquisition of Matthew Clark, management proposed a further adjustment to the provision, because the Company 1 Wine Contract had since been substantially renegotiated. Management’s revised, year-end calculation indicated now a reduction in the provision, from £10.1m down to £5.948m, based on expected reductions in the penalties payable over the remaining life of the Company 1 Wine Contract (2017-2025), as a result of its renegotiation. This would result (following utilisation of the provision to pay penalties under the Company 1 Wine Contract in FY2017, of £0.27m) in a reduction in the provision required of approximately £3.9m. At the same time management proposed that £3.9m of costs supposedly incurred during FY2017 in mitigating/ avoiding penalties under the Company 1 Wine Contract should be offset against this release of the provision thus increasing EBITDA by £3.9m.

5.21. KPMG did not in fact appropriately assess and record in its audit work papers the accounting basis for the Company 1 Wine Contract provision. In the course of Executive Counsel’s investigation, KPMG justified the establishment/ retention of the provision under IFRS3 as a “fair value provision”. However, throughout its workpapers both at the half year and year-end (and including in their report to the Audit Committee), it referred to the provision as “the [Company 1] onerous contract provision” notwithstanding that since Conviviality made a margin on the contract it did not meet the IAS 37 (Provisions, contingent liabilities and contingent assets) definition of an onerous contract.

5.22. The audit work in relation to the treatment of the Company 1 Wine Contract breached ISAs 200, 230 and 500 as set out below.

5.23. KPMG failed to obtain sufficient appropriate audit evidence, in the following areas:

5.23.1. In a paper entitled “HY.7.1.1.3.00320 [Company 1] Onerous Contract Provision” KPMG had considered: (1) whether the upward adjustment of the provision at the half-year represented an adjustment within the fair value adjustment measurement period; and (2) the reasonableness of the adjusted provision itself. KPMG concluded it was made within the measurement

period and that the basis for the adjusted provision was reasonable. However, KPMG:

1) failed to obtain sufficient appropriate audit evidence to determine whether this highly material increase of £5.8m in the provision at HY2017 was reasonable; and

2) failed in its review papers relied on for the year-end audit to show how they had checked management's calculation. Its audit work was limited to gaining an understanding of management's calculation without obtaining appropriate evidence to substantiate the basis for that calculation.

5.23.2. At the FY2017 year-end, following the renegotiation of the Company 1 Wine Contract, management's new calculation of the required (reduced) amount of the provision was based on a series of assumptions, which were not adequately supported by sufficient and appropriate evidence. One of the key assumptions was that the Group would be able to increase the proportion of Company 1 to total Conviviality wine sales by 0.32% each year from 2017 through to 2025. At HY2017, management had assumed a 0.25% annual reduction in the same performance measure. The impact of the movement in this assumption from negative 0.25% at HY2017 to positive 0.32% at FY2017 was £6.07m, a material figure. KPMG failed to obtain sufficient appropriate audit evidence to support management's revised, year-end calculations, or to justify the material changes in the assumptions made, from those which had been made at HY2017.

5.23.3. Management's proposal that £3.9m of costs supposedly incurred in FY2017 in mitigating/ avoiding penalties under the Company 1 Wine Contract should be charged/ offset against the release of provision was initially rejected by KPMG. But, instead, KPMG accepted that these "mitigatory" costs could be treated as exceptional, and therefore netted-off in the Income Statement against the exceptional credit arising from the release of the provision (KPMG having previously been concerned that any releases from the acquisition provision should be treated as exceptional rather than benefitting pre-exceptional results).

5.23.4. KPMG failed to obtain any sufficient appropriate audit evidence that these costs were in fact exceptional in character. The "mitigatory" costs did not

appear to meet the criteria for being included as exceptional costs in accordance with the Group's accounting policy because they did not "*possess a high degree of abnormality which arise from events or transactions that fall outside the ordinary activities of the Group and which are not expected to recur*". They were not abnormal, because they were clearly costs incurred in the normal operating activities of the Group (i.e. supporting and promoting sales of Company 1 Wine wines). Nor were they one-off non-recurring costs. If (as management contended) it was cheaper to support the Company 1 sales (by incurring these costs) than to pay the contract penalties, such costs were likely to be incurred for the entire length of the Company 1 Wine Contract (which was 10 years).

5.23.5. Ultimately the costs were offset in the provision movement and a net release of £0.5m (before discounting effects) was credited to exceptional items. KPMG failed to obtain sufficient appropriate audit evidence that these claimed costs had actually been incurred specifically for the stated purpose of mitigating contract penalties.

This was a breach of **paragraph 6 of ISA 500**.

5.24. KPMG failed to exercise sufficient professional scepticism in relation to the treatment of the £3.9m "mitigatory costs" relating to the Company 1 provision. KPMG should have recognised that such a treatment would result in an increase in adjusted EBITDA, and therefore called for a more careful assessment of the accounting for the contract as a whole and the risk of improper manipulation by management of the recording in the accounts of that measure. This was a breach of **paragraph 15 of ISA 200**.

5.25. KPMG failed to prepare sufficient audit documentation to enable an experienced auditor, with no previous connection with the Audit, to understand the work performed in relation to the Company 1 Wine Contract. This was a notable breach of **paragraph 8 of ISA 230**.

<u>ADVERSE FINDING 4 – Capitalisation of Costs and Exceptional Items</u>

5.26. The audit work in relation to the capitalisation of costs and exceptional items breached ISAs 230 and 500 as set out below.

Capitalisation of Costs

5.27. KPMG failed to obtain sufficient appropriate audit evidence with respect to the audit of capitalisation of costs as explained below.

5.27.1. Although KPMG initially challenged management's assessment that 100% of the salaries of the recruitment and acquisition team should be capitalised, it failed to obtain sufficient appropriate audit evidence to support whether or not management's revised calculation of 82% was a reasonable allocation of salary and other costs relating to the recruitment and acquisition team to the creation of capital assets of expected economic benefit.

This was a breach of **paragraph 6 of ISA 500**.

5.28. KPMG failed to adequately document its audit procedures in the following areas:

5.28.1. Management sought to capitalise various salary and time-related costs, of which some were said to be attributable to the development of a new software system. Notwithstanding the fact that no timesheets appear to have been kept by Conviviality, KPMG concluded that they were satisfied that such costs were properly capitalised since an asset had been produced as part of the project. Elsewhere in KPMG's workpapers it identified that the new software system implementation was on-going and it would be typical for related costs to be capitalised. However, KPMG failed adequately to document or explain the asset said to have been created (or its value) or the economic benefit that was expected to be derived from the asset; both of which were requirements of IAS 38 (Intangible Assets).

5.28.2. KPMG failed to include within its adjustment schedule presented to the Audit Committee an audit adjustment for £200,830 relating to a balance sheet reclassification regarding an individual's salary costs, which it had identified.

This was a breach of **paragraph 8 of ISA 230**.

Exceptional Items

5.29. KPMG failed to obtain sufficient appropriate audit evidence with respect to the audit of exceptional items in the following areas:

5.29.1. KPMG failed to obtain sufficient appropriate audit evidence that the items classified as exceptional were appropriately classified in accordance with the Group's accounting policy which provided:

> *"The Group classifies certain items as exceptional where they possess a high degree of abnormality which arise from events or transactions that fall outside the ordinary activities of the Group and which are not expected to recur".*

5.29.2. Exceptional costs included at least £1.8m of employee-related costs incurred on integration projects across the Group. There was no evidence that all these employee-related costs possessed a high degree of abnormality or arose from events or transactions that fell outside the ordinary activities of the Group. Further, KPMG's statement in its Report to the Audit Committee that "*a number of the employees included within exceptional costs may remain with the business on an ongoing basis*", was inconsistent with management's accounting policy that exceptional items were not expected to recur.

5.29.3. KPMG failed to obtain sufficient appropriate audit evidence that the following items classified as exceptional had a high degree of abnormality and met the Group's accounting policy for exceptional items (see paragraph 5.29.1 above): (i) share based payment costs £0.497m; (ii) other non-recurring events and projects £0.568m; (iii) the unwinding of discounts on provisions and deferred consideration £0.229m; (iv) Journal 57 relating to an employee bonus of £0.288m; and (v) Journal 100 relating to an accounting report of £0.162m.

5.29.4. KPMG failed to obtain sufficient appropriate audit evidence that demonstrated that it was appropriate to include these costs within exceptional items. This failure was compounded by the fact that during the course of the FY2016 audit, KPMG had informed management that its classification of £0.5m of directors' salaries for time spent on acquisitions as exceptional items was inappropriate and that such salary costs should not be classified as exceptional items going forward (i.e. in FY2017).

The matters set out above represented a breach of **paragraph 6 of ISA 500**.

5.30. KPMG did not document its rationale, nor did it document what additional procedures, if any, it performed as a result of the increase in perceived risks relating to exceptional items from an "*Other Area of Audit Focus*" in its ASD to a "*significant risk*" in its Report to the Audit Committee. This was a breach of **paragraph 8 of ISA 230.**

ADVERSE FINDING 5 – Accrued supplier income

5.31. The audit work in relation to the accrued supplier income breached ISA 500 as set out below.

5.32. KPMG failed to obtain sufficient appropriate audit evidence with respect to the audit of accrued supplier income, as explained below:

5.32.1. Conviviality based its calculation of accrued supplier income on a Red, Amber, Green ("**RAG**") system, reflecting the assessed probability of receiving the relevant income from the supplier. Any revenue assessed as "Red" was to be accrued for at only 25% of its potential value. Amber was accrued at 75% and Green was accrued at 100%.

5.32.2. Pursuant to IAS 2 (Inventories) if it was probable that a rebate or volume discount will be earned and the amount can be estimated reliably, the discount or rebate should be recognised as a reduction in the purchase price when the inventory is purchased.

5.32.3. KPMG did not obtain sufficient appropriate audit evidence, either by reference to IAS 2 or by reference to management's own RAG system, to support:

1) The amounts which management had rated as "Green" in the RAG system;

2) Management's RAG categorisation of the "Backhaul" and "Project Charge" categories of supplier income; or

3) £0.45m of accrued supplier income claimed by management to arise from higher sales volumes, said to have been achieved under a £80m wholesale supply agreement with a supplier ("**Supplier A**"). The failures in this regard included failing to obtain audit evidence: (i) regarding the Supplier A FY2016 turnover; and (ii) the additional supplier income in FY2017 generated as a result of that supply agreement.

5.32.4. KPMG did not obtain sufficient appropriate evidence in relation to management's treatment of £0.542m of accrued supplier income from the prior year, referred to in the Report to the Audit Committee. This income related to FY2016, but had not been recovered by the date of KPMG's

Report to the Audit Committee (14 July 2017); over 14 months after it had been accrued. KPMG relied on management's representation that they were *"confident"* of its eventual recovery, without obtaining any further evidence.

5.32.5. KPMG failed to identify an error in the accrued supplier income calculation, which resulted in an overstatement of accrued supplier income of £428,265.

5.32.6. KPMG's audit procedures were inadequate in the following further areas:

1) In relation to one of the sample suppliers, £0.3m of supplier income was assessed as "'Green" under the RAG testing regime, and therefore accrued in full, even though it was not in the supply agreement. KPMG's conclusion that management's explanation was not aggressive was not substantiated. KPMG should have obtained appropriate audit evidence to support management's representation.

2) Forecasts of supplier income for the 2017 calendar year were important assumptions in this category of accrued income. However, in several instances KPMG's comments relating to this income type were simply that: "*KPMG agree that these terms are not aggressive and are easy to achieve*". KPMG should have obtained appropriate audit evidence to support each conclusion of that type.

The matters set out above represent a breach of **paragraph 6 of ISA 500**.

ADVERSE FINDING 6 – Goodwill

5.33. The audit work in relation to goodwill breached ISAs 200, 230, 300 and 500 as set out below.

5.34. KPMG failed properly to plan and document the audit of goodwill. KPMG identified the risk of goodwill impairment as a significant risk in the ASD. Before any full year audit work had commenced KPMG's initial impression was that "*headroom sufficient last year, forecasts look sensible*". KPMG failed to develop and document an audit plan which adequately described the nature, timing and extent of planned risk assessment and the audit procedures to be undertaken to determine whether the carrying values of goodwill had been impaired. This was a breach of **paragraph 9 of ISA 300**.

5.35. KPMG failed to exercise appropriate professional scepticism and failed to perform audit procedures adequate to obtain sufficient appropriate audit evidence to gain reasonable assurance that the carrying value of the goodwill of each cash-generating

unit ("**CGU**") in the Group had not been impaired. KPMG's review of the assumptions underlying the FY2018 budget by CGU should have been performed in greater depth and as such it failed to obtain sufficient appropriate audit evidence, in relation to each CGU in the Group, that the cash-flow forecasts used to derive the value-in-use ("**VIU**") of that CGU were robust and reliable; failed to sensitivity-test the forecasts and VIU calculations against appropriate uncertainties; and failed to approach them with appropriate professional scepticism, as follows:

5.35.1. KPMG did not perform adequate audit work to determine the historical accuracy of the forecasts. KPMG should have compared the FY2017 forecasts from the previous year per CGU to actual FY2017 results achieved in more detail. KPMG's failure to do so meant that it did not obtain sufficient appropriate evidence to help determine the robustness of the forecasts.

5.35.2. KPMG failed to consider whether the FY2017 results themselves provided a reliable and reasonable basis for future forecasting, particularly given that the £60.87m Group EBITDA reported in FY2017 was only achieved by the application of a series of what appeared to be aggressive accounting treatments and estimates, all going the same way, which had the effect of improving EBITDA. See further, **Adverse Findings 1 to 5** above.

5.35.3. KPMG's comparison of the actual results for FY2017 with the forecast for FY2018 was superficial. KPMG identified that: (i) for Bibendum PLB the forecast EBITDA for FY2018 (less Group costs) was £4.2m (50%) higher than that achieved in FY2017; and (ii) for Peppermint Events[3] the forecast EBITDA for FY2018 was £0.7m higher than that achieved in FY2017 (FY2017 was a loss of £0.1m). KPMG did not obtain sufficient audit evidence to support these forecast improvements and did not perform an adequate assessment of the sensitivities in relation to these matters. KPMG showed a lack of professional scepticism in that regard.

5.35.4. Limited audit work was performed on management's working capital assumptions and the Budget Pack which set out forecast working capital movements was not retained within the audit working papers. The information provided by management to KPMG contained limited support for their assumptions and workings. Based on that information, KPMG's conclusion that the working capital movements "*appeared reasonable*" was

[3] A business unit in the Conviviality Trading division.

not in the circumstances justified. As a minimum KPMG should have: (i) obtained the analysis of working capital by category, e.g. debtors, inventory, creditors and understood the assumptions made for each of these categories; (ii) compared actual working capital movements in FY2017 to forecast working capital movements in FY2018; (iii) challenged management's assumptions relating to a working capital improvement plan and gained an appropriate understanding of the status of the plan during the audit and the likelihood of it being successful in FY2018; and (iv) challenged why management were forecasting working capital to grow at lower rates than EBITDA in Bibendum PLB and Peppermint.

5.35.5. KPMG does not appear to have considered whether any amounts treated as exceptional in the FY2017 results and FY2018 budget required inclusion in the VIU calculations for the CGUs, in order for the calculations to comply with IAS 36 (Impairment of Assets). KPMG was aware that exceptional costs had: (a) been significantly higher in FY2017 (£9.8m compared with £3.0m forecast for FY2018); and (b) included employment costs which related to employees who were likely to continue to be employed in the business. KPMG did not assess whether the omission of these costs from the VIU calculations was appropriate or assess the impact of their omission.

5.35.6. KPMG should have performed additional work to identify potential additional areas of challenge to management's forecasts, including reviewing sensitivities. Management had hard-coded increases to EBITDA in the VIU forecasts for both Bargain Booze and Peppermint Events, but this was not appropriately challenged by KPMG. KPMG should have considered whether the asset enhancement plan relating to new stores in Bargain Booze was properly included in the light of the requirements of IAS 36 and assessed whether the related sensitivities were sufficient. KPMG's audit work on the contingent consideration in relation to the acquisition of Peppermint was not sufficient to support management's proposed increases to Peppermint's EBITDA. KPMG should have challenged management to explain the increases and considered additional sensitivity analysis as appropriate. Had KPMG done this it is likely that the headroom identified by management and KPMG in these CGUs would have been significantly lower, leading to consideration of whether material audit adjustments to the carrying value of goodwill were required.

5.35.7. Further, management's VIU calculations for Bargain Booze were premised on EBITDA increases and growth from the figure reported in FY2017. But that figure had included £5.9m of revenue from FLFs, accrued in FY2017 but in fact receivable only over extended periods.

5.35.8. Assuming similar patterns of FLF deferment in future Franchise and License Agreements, concluded in subsequent years, significant further negative adjustments to Bargain Booze's expected future cashflows (discounted to net present value) may have been required. Management's calculations appeared to take no account of this potential deferment of cash inflows, and KPMG did not consider whether they should have done or whether a potential adjustment was required.

5.36. KPMG failed adequately to document its audit procedures by:

5.36.1. Failing to retain on the audit file the copy of the Budget Pack, on which some of work on the forecast assumptions was performed.

5.36.2. Failing to retain on the audit file a copy of the calculation of a revised Weighted Average Cost of Capital used in preparing the alternative "auditors estimate" of VIU, which incorporated the "alpha factor" adjustment of 1%.

5.36.3. The documentation relating to the audit work performed in relation to a £10.2m contingency which was included in the Board approved budget (the "**Contingency**") and the allowance for forecasting risk in the "auditor's estimate" of VIU appeared to be insufficient in that:

5.36.3.1. The Contingency was not directly reflected in the VIU calculations, which used the board approved individual divisional budgets aggregating EBITDA of £80.19m rather than the Group approved budgeted EBITDA of £69.99m. KPMG concluded that it was justified to exclude the balance since the Contingency was "*high level*" and "*was not allocated between CGUs, given that it relates to a general contingency and the reliability and probability of this is uncertain*". VIU calculations are required to be based on management approved budgets but KPMG has explained that its chosen alpha factor

included the forecasting risks arising from the inclusion of the general Contingency in the budget.

5.36.3.2. However, in calculating the alpha factor, KPMG noted that it had to:

"*consider whether there are any specific issues that may impact the risk profile of Conviviality based on our knowledge of the business For example, where the cash flow forecasts are not considered to be appropriately risk-weighted, or if there are specific forecasting risks that are not otherwise reflected in the cash flow assumptions we would expect a higher alpha factor. If the client forecasts are particularly aggresive (that is, they are more optimistic than catious) then we would expect a higher alpha factor to build additional risk into the WACC* [Weighted Average Cost of Capital] *and therefore discount rate.*"

5.36.3.3. KPMG concluded that "*a reasonably low alpha factor is appropriate but one which is greater than nil as currently used by management*" and it therefore settled with an alpha factor of 1%. To support its conclusion in this regard, KPMG relied on the fact that "*The client has generally acheived management forecasts for the Group in the past and for the current year…*". However, it did not properly document the issue of how those historical forecasts had been achieved.

5.36.4. KPMG included in its Report to the Audit Committee, a table showing the effect of several sensitivities applied to management's VIU calculations to derive a reduced VIU, including the revised headroom for each CGU. Due to an error in the spreadsheet from which this table was drawn, one line of the table was incorrect and the table did not cast (although the net headroom figures were arithmetically correct).

KPMG thereby failed to meet the requirements of **paragraph 8 of ISA 230**.

6. ADVERSE FINDINGS – FY2018 Audit

ADVERSE FINDING 1 – Non-Audit Services

6.1. **KPMG breached Part B, paragraphs 5.36 and 5.37 of the Ethical Standard** as follows:

6.1.1. On 27 November 2017, KPMG entered into an engagement letter with Conviviality to provide audit services and certain other services for the year ended 29 April 2018. The engagement letter was signed by Ms Quayle on behalf of KPMG.

6.1.2. On 16 March 2018 Ms Quayle became aware of the potential engagement of KPMG to assist with the FPPP Services in connection with the proposed admission of new ordinary shares in Conviviality to AIM, as part of Conviviality's proposed equity fundraising, which engagement KPMG accepted on 23 March 2018.

6.1.3. While a consultation took place, KPMG failed to adequately document the reasoning behind its decision to provide non-audit services in relation to the FPPP Services, including documenting identified threats to independence, safeguards adopted and communications to those charged with governance.

7. *SANCTIONS* – KPMG

7.1. Paragraph 10 of the FRC's Sanctions Policy (Audit Enforcement Procedure) (the "**Policy**") provides that *Sanctions* are intended to be effective, proportionate and dissuasive. The reasons for imposing *Sanctions* are identified in paragraph 11 of the Policy as the following:

7.1.1. 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;

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

7.1.3. to protect the public from *Statutory Auditors* and *Statutory Audit Firms* whose conduct has fallen short of the *Relevant Requirements*; and

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

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

7.3. Executive Counsel imposes the following *Sanctions* against KPMG:

7.3.1. A fine of £4,300,000 discounted for admissions and early disposal by 30% so that the financial sanction payable is £3,010,000. The financial sanction shall be paid no later than 28 days after the date of this *Final Decision Notice*;

7.3.2. a published statement in the form of a severe reprimand;

7.3.3. a declaration that the Audit Report in respect of the Audit of the 2017 Financial Statements signed on behalf of KPMG did not satisfy the *Relevant Requirements*, as set out in this *Final Decision Notice*; and

7.3.4. A requirement that KPMG shall report to the FRC identifying: (i) the causes of the deficiencies in the 2017 Audit as set out in this *Final Decision Notice*; and (ii) the steps KPMG has taken to prevent them recurring or what measures will be implemented to prevent them recurring, demonstrating how those remedial measures either have been or will be, effective.

7.4. In reaching this decision, the Executive Counsel has, in summary, considered the following matters in accordance with the Policy.

<u>Nature, seriousness, gravity and duration of the breaches</u>

7.5. Several of the audit failings relate to areas identified as significant risks by KPMG in their audit strategy document (revenue recognition, goodwill and intangible items and supplier income).

7.6. Several of the audit areas in which breaches of *Relevant Requirements* have been identified involved balances which were substantially in excess of the planning materiality threshold of £1.4m. The goodwill balance in particular accounted for approximately one third of the company's asset value, having increased after a period in which the company had experienced rapid growth. A thorough audit in this area was required.

7.7. The breaches of the *Relevant Requirements* in respect of the FY2017 Audit concerned a number of basic and fundamental audit concepts including:

7.7.1. Developing an adequate audit plan (ISA 300) and reassessing risks of material misstatement (ISA 315);

7.7.2. obtaining sufficient appropriate audit evidence (ISA 500);

7.7.3. the application of sufficient professional scepticism (ISA 200); and

7.7.4. audit documentation (ISA 230).

7.8. The breaches of *Relevant Requirements* were numerous and occurred across several significant areas of the 2017 Financial Statements. The failure to obtain sufficient appropriate audit evidence across five different areas of the audit, coupled with three instances of a lack of application of sufficient professional scepticism is serious, as is the poor standard of the audit documentation maintained in respect of both: (i) four areas of the FY2017 Audit; and (ii) the decision to provide non-audit services in FY2018. These *Relevant Requirements* are central to an auditor's role and function.

7.9. As a result of the breaches of *Relevant Requirements*, the FY2017 Audit failed in its principal objective namely to obtain reasonable assurance about whether the 2017 Financial Statements as a whole were free from material misstatement.

7.10. The 2017 Financial Statements were in fact materially misstated as a consequence of the breaches of *Relevant Requirements* in respect of the overstatement of accrued supplier income of £428,265 described in *Adverse Finding* 5 at paragraph 5.32 above, which together with the identified unadjusted audit differences, exceeded the level of planning materiality.

7.11. Conviviality's shares were at the material time listed on AIM. It was one of the largest entities in its sector and a significant number of customers, suppliers and employees relied on it being audited to a high standard. In aggregate the breaches therefore:

7.11.1. Potentially adversely affected a significant number of people in the United Kingdom (such as the public, investors or other market users), and could have harmed investor, market and public confidence in the truth and fairness of the financial statements published by *Statutory Auditors* or *Statutory Audit*

Firms.

7.11.2. Could undermine confidence in the standards of conduct in general of *Statutory Auditors* and *Statutory Audit Firms*, and/or in Statutory Audit.

7.12. The fact that KPMG had appointed Ms Quayle to the position of Head of Audit in the North could also undermine confidence in the standards of conduct in general of *Statutory Auditors* and *Statutory Audit Firms.*

7.13. KPMG has a poor regulatory track record:

7.13.1. Deficiencies in KPMG's audit work in relation to impairment review of goodwill (the subject of *Adverse Finding* 6) were identified by the FRC's Audit Quality Review ("**AQR**") team in several inspection reviews in the years immediately preceding the FY2017 Audit.

7.13.2. Extensive breaches of *Relevant Requirements* have been found in relation to KPMG's audit work on multiple occasions in recent years. The breaches in a recent case[4] are of a similar nature to the breaches in *Adverse Finding* 5 of this *Final Decision Notice*.

7.14. Whilst recognising that KPMG has, subsequent to the audit, undertaken a significant audit quality transformation programme, nonetheless, Executive Counsel considers that, particularly in light of the matters in paragraph 7.13 above, there is a risk that the same or similar type of breaches may reoccur, absent further deterrence in the form of *Sanctions*.

7.15. The breaches were, however, neither intentional, dishonest, deliberate nor reckless.

Identification of Sanction

7.16. Having assessed the nature, seriousness, gravity and duration of the breaches, Executive Counsel has identified the following combination of *Sanctions* as appropriate: a financial sanction of £4,300,000; a published statement in the form of a severe reprimand; a declaration that the Audit Report signed on behalf of KPMG did not satisfy the *Relevant Requirements*, as set out in this *Final Decision Notice*; and reporting requirements in respect of the causes of the deficiencies identified in

[4] Published Decision Notice in respect of (1) KPMG LLP and (2) Nicola Quayle in respect of the audit of "A Company", dated 23 December 2019

respect of the FY2017 Audit.

7.17. Executive Counsel notes that the Respondents provided a good level of cooperation throughout the investigation.

Aggravating and mitigating factors

7.18. Executive Counsel has concluded that there are no aggravating or mitigating factors that exist (to the extent that they have not already been taken into account in relation to the seriousness of the breaches) and which need to be considered.

Deterrence

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

Discount for Admissions and Settlement

7.20. Having taken into account the admissions by KPMG and the stage at which those admissions were made (at an early point within Stage 1 of the case in accordance with paragraph 84 of the Policy), Executive Counsel has determined that a reduction of 30% as to the financial sanction is appropriate, such that a financial sanction of £3,010,000 is payable.

Other considerations

7.21. In accordance with paragraph 47(c) of the Policy, Executive Counsel has taken into account the size/financial resources and financial strength of KPMG and the effect of a financial sanction on its business, and whether any financial sanction would be covered by insurance.

8. *SANCTIONS* – Ms Quayle

8.1. Executive Counsel imposes the following *Sanctions* against Ms Quayle:

8.1.1. a financial sanction of £110,000, adjusted by 5% for aggravating factors to a total of £115,500, discounted for admissions and early disposal by 30%. The financial sanction shall be paid no later than 28 days after the date of this *Final Decision Notice*; and

8.1.2. a published statement, in the form of a severe reprimand.

8.2. In reaching this decision, Executive Counsel has, in summary, considered the following stages and taken account of the following factors in accordance with the Policy.

Nature, seriousness, gravity and duration of the breaches

8.3. The factors set out in paragraphs 7.5 to 7.11 and 7.15 are repeated.

8.4. Ms Quayle has a poor regulatory track record:

8.4.1. Deficiencies in Ms Quayle's audit work have been identified by the FRC's AQR team on several occasions.

8.4.2. Ms Quayle was the subject of *Sanctions* imposed by Executive Counsel in respect of her audit work as the *Senior Statutory Auditor* in respect of the statutory audit of a company as described in the published Decision Notice dated 23 December 2019. The breaches in that case are of a similar nature to the breaches in *Adverse Finding* 5 of this *Final Decision Notice*.

Identification of Sanction

8.5. Having assessed the nature, seriousness, gravity and duration of the breaches, Executive Counsel has identified the following combination of *Sanctions* as appropriate: a financial sanction of £110,000; and a published statement in the form of a severe reprimand.

Aggravating and mitigating factors

8.6. Executive Counsel has then taken into account any aggravating and mitigating factors that exist (to the extent that they have not already been taken into account in relation to the seriousness of the breaches).

8.7. Ms Quayle held the senior management responsibilities within KPMG (including within the audit practice), referred to in paragraph 3.11 above. Executive Counsel considers this to be an aggravating factor in accordance with paragraph 67(o) of the Policy which causes the financial sanction to be increased by 5% to £115,500.

8.8. There are no other aggravating factors that have not already been considered in the context of the seriousness of the breaches of *Relevant Requirements*.

8.9. Executive Counsel has not identified any mitigating factors and no further adjustment

is therefore required.

Deterrence

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

Discount for Admissions and Settlement

8.11. Having taken into account the admissions by Ms Quayle (see paragraph 7.20 above) and the stage at which those admissions were made (at an early point within Stage 1 of the case in accordance with paragraph 84 of the Policy), Executive Counsel determined that a reduction of 30% as to the financial sanction is appropriate, such that a financial sanction of £80,850 is payable.

Other considerations

8.12. In accordance with paragraph 47(d) of the Policy, Executive Counsel has taken into account the financial resources and annual income of Ms Quayle, the effect of a financial sanction on Ms Quayle and her future employment, and whether she is insured as to any financial sanction.

9. COSTS

9.1. The Executive Counsel requires the Respondents to pay her costs in full in this matter, being £684,000. Such costs shall be paid no later than 28 days after the date of this *Final Decision Notice*.

SIGNED:

CLAUDIA MORTIMORE

DEPUTY EXECUTIVE COUNSEL

DATE: 2 December 2021

APPENDIX – EXTRACTS OF ISAs AND THE ETHICAL STANDARD RELEVANT TO THE *ADVERSE FINDINGS*

ISA 200	
Paragraph 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. A18-A22)
ISA 220	
Paragraph 8	The engagement partner shall take responsibility for the overall quality on each audit engagement to which that partner is assigned. (Ref: Para. A3)
ISA 230	
Paragraph 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 Ireland) 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)
ISA 240	
Paragraph 28	In accordance with ISA (UK and Ireland) 330, the auditor shall determine overall responses to address the assessed risks of material misstatement due to fraud at the financial statement level. (Ref: Para. A33)
Paragraph 30	In accordance with ISA (UK and Ireland) 330, the auditor shall design and perform further audit procedures whose nature, timing and extent are responsive to the assessed risks of material misstatement due to fraud at the assertion level. (Ref: Para. A37-A40)
Paragraph 32(b)	Irrespective of the auditor's assessment of the risks of management override of controls, the auditor shall design and perform audit procedures to: (a) […]

	(b) Review accounting estimates for biases and evaluate whether the circumstances producing the bias, if any, represent a risk of material misstatement due to fraud. In performing this review, the auditor shall: (i) Evaluate whether the judgments and decisions made by management in making the accounting estimates included in the financial statements, even if they are individually reasonable, indicate a possible bias on the part of the entity's management that may represent a risk of material misstatement due to fraud. If so, the auditor shall reevaluate the accounting estimates taken as a whole; and (ii) Perform a retrospective review of management judgments and assumptions related to significant accounting estimates reflected in the financial statements of the prior year. (Ref: Para. A45-A47) (c) […]
ISA 300	
Paragraph 9	The auditor shall develop an audit plan that shall include a description of: (a) The nature, timing and extent of planned risk assessment procedures, as determined under ISA (UK and Ireland) 315. (b) The nature, timing and extent of planned further audit procedures at the assertion level, as determined under ISA (UK and Ireland) 330. (c) Other planned audit procedures that are required to be carried out so that the engagement complies with ISAs (UK and Ireland). (Ref: Para. A12)
ISA 315	
Paragraph 31	The auditor's assessment of the risks of material misstatement at the assertion level may change during the course of the audit as additional audit evidence is obtained. In circumstances where the auditor obtains audit evidence from performing further audit procedures, or if new information is obtained, either of which is inconsistent with the audit evidence on which the auditor originally based the assessment, the auditor shall revise the assessment and modify the further planned audit procedures accordingly. (Ref: Para. A143)

ISA 500	
Paragraph 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)
Ethical Standard	
Part B, paragraph 5.36	For an engagement other than an investment circular reporting engagement, the engagement partner shall ensure that the reasoning for a decision to provide non-audit / additional services, and any safeguards adopted and why they are effective, is appropriately documented.
Part B, paragraph 5.37	Matters to be documented include any significant judgments concerning: • threats identified; • safeguards adopted and the reasons why they are considered to be effective; and • communication with those charged with governance.