**IN THE MATTER OF**

**THE EXECUTIVE COUNSEL TO THE FINANCIAL REPORTING COUNCIL**

**-and-**

**(1) KPMG LLP**

**(2) MICHAEL NEIL FRANKISH**

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# EXECUTIVE COUNSEL'S FINAL DECISION NOTICE

**Pursuant to Rule 18 of the Audit Enforcement Procedure**

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***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 operates the Audit Enforcement Procedure (the "**AEP**"), effective 1 January 2021 (reissued 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. Furthermore, in this *Final Decision Notice* we adopt the following definitions:

"**FY2015**" means the year ended 30 June 2015

"**FY2015 financial statements**" means the financial statements of Revolution Bars Group Plc (the **"Company**") for FY2015

"**FY2015 Audit**" means the *Statutory Audit* of the FY2015 financial statements

"**FY2016**" means the 53 weeks ended 2 July 2016

"**FY2016 financial statements**" means the financial statements of the Company for FY2016

"**FY2016 Audit**" means the *Statutory Audit* of the FY2016 financial statements

"**Relevant Period**" means the period covering the FY2015 and FY2016 Audits

"**FY2017**" means the 52 weeks ended 1 July 2017

"**FY2017 financial statements**" means the financial statements of the Company for FY2017

"**FY2018**" means the 52 weeks ended 30 June 2018

"**FY2018 financial statements**" means the financial statements of the Company for FY2018

"**ISAs**" means the International Standards on Auditing (UK and Ireland)

1.3. Pursuant to Rule 16(b) of the AEP, *Executive Counsel* has decided that the *Respondents* are liable for *Enforcement Action*, having made *Adverse Findings* against each of them in relation to the FY2015 and FY2016 Audits. This *Final Decision Notice* is issued pursuant to Rule 17 of the AEP in respect of the conduct of:

1.3.1. KPMG LLP ("**KPMG**"), the *Statutory Audit Firm* of the Company for the FY2015 and FY2016 Audits.

1.3.2. Mr Michael Neil Frankish ("**Mr Frankish**"), a former employee of KPMG and the *Statutory Auditor* of the Company. He signed the relevant audit reports on behalf of KPMG.

1.4. In this *Final Decision Notice*, KPMG and Mr Frankish are referred to collectively as the "**Respondents**".

1.5. On leaving KPMG in early 2017, Mr Frankish became a partner in a different firm which is registered to conduct *Statutory Audits* (the "**new firm**"). The new firm had no involvement in the FY2015 or FY2016 Audits, or in the Adverse Findings made in this Decision Notice.

1.6. On 10 December 2021 Executive Counsel issued *Executive Counsel's Decision Notice* pursuant to Rule 17 of the AEP. On 17 December 2021 the Respondents provided written agreement to *Executive Counsel's Decision Notice*.

1.7. Consequently, and, in accordance with Rules 17 and 18 of the AEP this Final Decision Notice:

1.7.1. Outlines the *Adverse Findings* with reasons;

1.7.2. Outlines *Sanctions* with reasons; and

1.7.3. Outlines an amount payable in respect of *Executive Counsel's* costs of the matter as at the date of this *Final Decision Notice*.

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

Section 2: Executive Summary of the *Adverse Findings*

Section 3: Background

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

Section 5: Details of the *Adverse Findings*

Section 6: *Sanctions*

Section 7: Costs

## 2. EXECUTIVE SUMMARY OF THE ADVERSE FINDINGS

2.1. The *Adverse Findings* in this *Final Decision Notice* relate to the FY2015 and FY2016 Audits. In the Relevant Period, the Company was a leading UK operator of premium bars. The Company was listed on the Main Market of the London Stock Exchange (the "**LSE**") in March 2015, and was therefore a Public Interest Entity ("**PIE**") for the purposes of the AEP.

2.2. The Company's FY2017 and FY2018 financial statements included restatements of previously reported figures, some of which were material. The restatements related to a number of different areas, three of which are of relevance to the FY2015 and FY2016 Audits and the *Adverse Findings* against the Respondents:

2.2.1. Supplier rebates and listing fees;

2.2.2. Share-based payments; and

2.2.3. Deferred taxation.

2.3. The *Adverse Findings* are organised thematically by reference to these three areas:

**Breaches relating to the audit of supplier rebates and listing fees**

<u>*Adverse Finding 1:*</u> *The Respondents' conduct in relation to the audit of the supplier rebates and listing fees constituted breaches of ISA 500 in relation to FY2015 and FY2016, and ISA 230 in respect of FY2016 only, in that the Respondents failed to obtain and document sufficient appropriate audit evidence in respect of supplier rebates and listing fees.*

<u>*Adverse Finding 2:*</u> *The Respondents' conduct in relation to the audit of the supplier rebates and listing fees for FY2015 and FY2016 constituted a breach of ISA 200 in that the Respondents failed to demonstrate sufficient professional scepticism in respect of supplier rebates and listing fees.*

**Breaches relating to the audit of share-based payments**

<u>*Adverse Finding 3:*</u> *The Respondents' conduct in relation to the audit of share-based payments for FY2015 constituted a breach of ISA 230 in that the Respondents failed to document sufficient appropriate audit evidence in respect of share-based payments.*

*<u>Adverse Finding 4:</u> The Respondents' conduct in relation to the audit of share-based payments for FY2016 constituted breaches of ISA 500 and ISA 230 in that the Respondents failed to obtain and document sufficient appropriate audit evidence in respect of share-based payments and ISA 450 in that the Respondents failed to communicate uncorrected misstatements to Those Charged with Governance.*

**Breaches relating to the audit of deferred taxation for FY2016 only**

*<u>Adverse Finding 5:</u> The Respondents' conduct in relation to the audit of deferred taxation for FY2016 constituted a breach of ISA 230 in that the Respondents failed to prepare documentation which provided a sufficient and appropriate record of the basis for the auditor's report in respect of deferred taxation.*

**Sanctions**

2.4. This *Final Decision Notice* sets out the *Sanctions* in respect of the Respondents:

<u>KPMG</u>

2.4.1. A declaration to the effect that, as a result of the *Adverse Findings* set out in this *Final Decision Notice*, the audit reports for the FY2015 and FY2016 Audits did not satisfy the requirement in regulation 4(1) of the Statutory Auditors and Third Country Auditors Regulations 2016 ("**SATCAR**") that a *Statutory Audit* must be conducted in accordance with relevant standards.

2.4.2. A published statement to the effect that KPMG has contravened the *Relevant Requirements*, in the form of a severe reprimand.

2.4.3. An order pursuant to rule 96(c) of the AEP, requiring KPMG to take action to mitigate the effect or prevent the recurrence of the breach of the *Relevant Requirements*. In summary, the action required is:

(1) KPMG will, by 28 February 2022, provide the *Executive Counsel* with a report (the "**First Report**") which:

a. Identifies the reasons why it considers that the breaches occurred; and

b. Identifies measures taken since the Audits which may have reduced the risk of any repetition of the breaches.

(2) Within three months of the Executive Counsel's approval of the First Report, KPMG will provide a further report to the Executive Counsel (the "**Second Report**") which:

a. Evaluates the effectiveness of the measures recorded in the First Report in reducing the risk of repetition, by the examination of relevant evidence such as the outcome of reviews of audits in the intervening period; and

b. Identifies any additional measures that could reasonably be taken in order to mitigate any residual risk of repetition.

(3) In the event that additional measures are suggested in accordance with paragraph (2)(b) above KPMG will, within 3 months of the Executive Counsel's approval of the Second Report, agree with the *Executive Counsel* and begin to carry out an action plan (the "**Plan**") which:

a. Sets out the steps to be taken in order to implement the measures;

b. Provides for the evaluation of the effectiveness of the measures, by the examination of relevant evidence;

c. Provides for regular reporting to the Executive Counsel on the progress made in implementing and evaluating the measures; and

d. Has a duration not exceeding two years from the date the Plan is approved by the Executive Counsel

2.4.4. A financial penalty of £1,250,000, discounted for admissions and early disposal to £875,000.

<u>Mr Frankish</u>

2.4.5. A published statement to the effect that Mr Frankish has contravened the

*Relevant Requirements*, in the form of a severe reprimand.

2.4.6. An order pursuant to rule 96(c) of the AEP, requiring Mr Frankish to take action to mitigate the effect or prevent the recurrence of the breach of the *Relevant Requirements*. In summary, the action required is:

(1) Mr Frankish will, within three months of the date of the order, provide the *Executive Counsel* with a report prepared by his new firm which:

a. Identifies, from his perspective, the reasons why the breaches occurred;

b. To the extent that the reasons are concerned with his own performance, identifies personal development measures taken since the Audits which may have reduced the risk of any repetition of the breaches; and

c. Identifies any additional personal development measures that could reasonably be taken in order to mitigate any residual risk of repetition.

(2) In the event that any additional personal development measures are identified in accordance with paragraph (1)(c) above, Mr Frankish will implement those measures as part of his next annual performance review cycle with the new firm.

2.4.7. A financial penalty of £50,000, discounted for admissions and early disposal to £35,000.

## 3. BACKGROUND

### The Respondents and their responsibilities

3.1. KPMG is one of the largest audit firms in the UK, with total fee income of £2,303 million in 2020 (the latest year for which figures are available). Of this, £639 million was derived from audit work. As at 2020, there were 276 *Statutory Auditors* within KPMG entitled to sign audit opinions, and 592 partners across all of the firm's functions. KPMG is a member firm of the Institute of Chartered Accountants of England and Wales ("**ICAEW**")[1].

3.2. KPMG was appointed as the *Statutory Audit Firm for* the Company and its predecessor companies with effect from the financial period ended 30 June 2006.

3.3. During the Relevant Period Mr Frankish was an employee of KPMG, with the job title of Director. He has been a *Statutory Auditor* since 2010. At all material times, he was a member of the ICAEW.

3.4. Mr Frankish carried out the *Statutory Audits* of the Company's financial statements from 2014 until he left KPMG in 2016. He signed the relevant audit reports for FY2015 and FY2016 in his own name, on behalf of KPMG.

3.5. The purpose of a *Statutory Audit* is to enhance the degree of confidence of intended users in the financial statements. This is achieved by the expression of an opinion by the auditor on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework. The *Respondents'* statutory responsibility was to form an opinion as to whether the Company's FY2015 and FY2016 financial statements showed a true and fair view and had been properly prepared in accordance with the relevant financial reporting framework and the Companies Act 2006.

[1] Figures in this paragraph are from p.46 of *Key Facts and Trends in the Accountancy Profession*, FRC, July 2021.

### The Company

3.6. On 18 March 2015 the Company was admitted to the Main Market of the LSE. Therefore, at the time of the FY2015 and FY2016 Audits, the Company was a newly-listed PIE.

3.7. During the Relevant Period, the Company was a leading UK operator of premium bars, trading under the Revolution and Revolución de Cuba brands via several wholly owned subsidiary companies.

3.8. The Company prepares its financial statements to a Saturday within seven days of 30 June each year (a 52 or 53 week period), under the Companies Act 2006 and International Financial Reporting Standards as adopted by the EU ("**IFRS**"). The FY2015 financial statements showed revenue of £111.8 million, net assets of £36.6 million and profit after tax of £2.3 million. The figures in the FY2016 financial statements were: revenue of £119.5 million, net assets of £41.2 million and profit after tax of £6.1 million.

3.9. On 3 October 2017 the Company approved its FY2017 financial statements. These disclosed restatements of previously reported figures as a result of a number of prior period errors or changes in accounting policies and estimates. The net effect was to decrease the Company's net assets as reported for FY2015 by £2.5 million (from £36.6 million to £34.1 million). The cumulative effect of the restatements was to reduce net assets for FY2016 by £3.3 million (from £41.2 million to £37.9 million) and to reduce profit after tax by £1.7 million (from £6.1 million to £4.4 million).

3.10. The restatements arose from various accounting policy changes and/or issues, including in relation to supplier rebates and share-based payments. Those are areas which are the subject of *Adverse Findings* in this *Final Decision Notice*.

3.11. In respect of supplier rebates, the effect of the restatements was to reduce net assets as at FY2015 by £316,000 and as at FY2016 by £962,000, and to reduce profit after tax as at FY2016 by £646,000. The materiality levels set by the audit team were £570,000 for the FY2015 Audit and £425,000 for the FY2016 Audit, so the impact on net assets in FY2015 was not material, but the impact on net assets and profit in FY2016 was.

3.12. In respect of share-based payments, the impact was to reduce deferred tax liabilities, and hence to increase net assets, by £54,000 for FY2015, and by £202,000 for FY2016. These figures were not material, but there was a material impact on profit after tax for FY2016, which was reduced by £701,000.

3.13. It can be seen that the issues in respect of supplier rebates and share-based payments did not account for the totality of the restatements in FY2017, and in fact other issues in respect of inventory, short-life assets, onerous lease provisions and under accrual of costs had a greater impact, taken together. The restatements in respect of those other areas arose from changes to accounting policies and estimates, and it is not alleged that the Respondents were at fault in failing to identify those issues in the context of the FY2015 and FY2016 Audits.

3.14. In the weeks following the announcement of the FY2017 restatements, the Company's share price fell by over 25%. However, it is not alleged that the Respondents bear any responsibility for this: it is difficult to isolate the impact of the restatements on the share price from general concerns as to disappointing trading results and the Company's future prospects following the failure of a takeover bid, and in any event the restatements arose from a number of issues, only some of which are the subject of *Adverse Findings*. It is unclear whether investors would have made different decisions if the FY2015 and FY2016 financial statements had not contained misstatements.

3.15. On 2 October 2018 the Company approved its FY2018 financial statements (which were not audited by the Respondents). These included a further material restatement in respect of deferred tax in the context of the FY2016 Financial Statements, which is the other area of relevance to the Adverse Findings. The effect of the adjustment for FY2016 was to decrease the deferred tax liabilities, with a consequential increase in profit after tax of £1.7 million. There was a corresponding reduction of £1.7 million in the FY2017 figure for profit after tax.

**The investigation**

3.16. On 22 May 2018 *Executive Counsel* was directed by the FRC's *Conduct Committee* to investigate the FY2015 and FY2016 Audits following a referral from the FRC *Case Examiner*. Pursuant to Rule 4 of the AEP, the investigation was delegated to the ICAEW as the appropriate *Recognised Supervisory Body*.

3.17. Following the conclusion of the investigation, Executive Counsel served an *Initial Investigation Report* on the Respondents in accordance with Rule 11 of the AEP which identified *Relevant Requirements* which the Respondents appeared to have breached. The Respondents subsequently provided written representations regarding the alleged breaches. *Executive Counsel* has considered those representations, together with all the evidence and documents obtained during the investigation, in making the *Adverse Findings* in this *Final Decision Notice*.

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

4.1. Rule 1 of the AEP states that *Relevant Requirements* has the meaning set out in regulation 5(11) of SATCAR. The *Relevant Requirements* include, but are not limited to, the ISAs.

4.2. The Relevant Requirements referred to in this Final Decision Notice are the following:

ISA 200 (Overall Objectives of the Independent Auditor and the Conduct of an Audit)
ISA 230 (Audit Documentation)
ISA 450 (Evaluation of Misstatements Identified During the Audit); and
ISA 500 (Audit Evidence).

4.3. The relevant versions of the ISAs are those applicable to audits of financial statements for periods ending on or after 15 December 2010. Extracts from the ISAs which are of particular relevance to the *Adverse Findings* are set out in an Appendix.

## 5. DETAIL OF THE ADVERSE FINDINGS

**Background in respect of supplier rebates and listing fees**

5.1. In December 2014, the FRC published a notice entitled '*FRC urges clarity in the reporting of complex supplier arrangements by retailers and other businesses*'. This notice highlighted that in relation to complex supplier arrangements such as volume rebates: '*The amounts involved are often significant in aggregate to operating margins and other key metrics. Many arrangements require significant judgements to be made by companies when estimating period end amounts receivable and payable for both annual and interim reporting*.' This notice also stated that the FRC's *Conduct Committee* planned to include it as an area of focus when reviewing audits and accounts during 2015.

5.2. Rebates and listing fees paid by suppliers as business incentives to retailers such as the Company are complex supplier arrangements within the meaning of the notice.

5.3. In accordance with the accounting policy applied by the Company in the Relevant Period, supplier rebates and listing fees received and receivable in the year were recognised as a deduction from cost of sales. Amounts not received in cash by the year end were included within trade and other receivables. The amounts involved were material to the FY2015 and FY2016 financial statements, by reference to the materiality levels set by the audit team.

5.4. The audit team did not identify supplier rebates and listing fees as a significant audit risk in the Audit Strategy documents presented to the Company's Audit Committee at the planning stage of the FY2015 and FY2016 Audits, or in the discussion documents presented to the Audit Committee on completion of the relevant audits. In light of the audit team's knowledge of the business and the FRC's notice in relation to complex supplier arrangements, the audit team should have been alert to the risk of material misstatement within the volume rebates, and remained alert to conditions which may have indicated possible misstatement during their conduct of the audits.

**Adverse findings in respect of supplier rebates and listing fees**

*Adverse Finding 1: The Respondents' conduct in relation to the audit of the supplier rebates and listing fees constituted breaches of ISA 500 in relation to FY2015 and FY2016 and ISA 230 in respect of FY2016 only, in that the Respondents failed to obtain and document sufficient appropriate audit evidence in respect of supplier rebates and listing fees.*

5.5. The particulars of this *Adverse Finding* in respect of FY2015 are as follows:

Failure to agree rebates to underlying agreements as part of the analytical review procedures

5.5.1. The audit team carried out an analytical review of rebates receivable to test the figure deducted from cost of sales. The review was conducted by:

(1) Determining the percentage of cost of sales (excluding discounts) represented by rebates received in FY2014.

(2) Applying that percentage to the cost of sales (excluding discounts) for 2015, to arrive at an expected figure for rebates receivable.

(3) Comparing that figure with the actual FY2015 figure of £2,609,000.

5.5.2. The analytical review produced an expected figure for rebates receivable which was £188,000 less than the actual figure. The audit team concluded that this difference was within the acceptable difference (as determined in advance), and concluded that no further work was required.

5.5.3. However, the foundation for the analytical review was the audit team's understanding that the terms of the rebate agreements in place with suppliers had not changed significantly from 2014 to 2015. The results of the review had limited value as audit evidence unless there was a reasonable degree of certainty in that regard. The audit team's understanding was based on an uncorroborated assertion from management that the relevant rebate terms had not changed significantly from year to year. The audit team should have corroborated this information by agreeing the rebate terms to the underlying agreements.

Failure to consider the correct period in which to account for £89,000 of listing fees accrued under agreements straddling the year-end

5.5.4. In addition to the analytical review of rebates receivable, the audit team performed substantive testing of rebates. They received from management a detailed listing of rebates and other fees receivable and subjected this to audit testing by selecting a sample of ten items using monetary unit sampling. The items selected were agreed back to underlying agreements and other relevant information such as volume purchase reports in order to gain assurance over the rebates figure.

5.5.5. The schedule recording the rebates and other fees receivable (from which the sample referred to in paragraph 5.5.4 was selected), included a total of £631,002 in respect of listing, marketing, support and P4P fees – an amount in excess of the materiality level of £570,000. In a number of cases, the period of the listing fees straddled different accounting periods, so that the conditions under the relevant agreement were not met within any particular period and the fees should therefore have been accounted for over the length of the agreement, in accordance with the applicable accounting standard IAS 18.

5.5.6. This was not done in the case of fees of £89,000 (an immaterial balance). While the listing fees were included in the schedule from which the sample for the rebates testing was selected, only one listing fee was in fact selected in the sample and there is no documentation to show that the audit team considered the period to which the overall listing fees related. It is estimated that of the £89,000 listing fees, approximately £55,000 should have been recognised in FY2015, with the overstatement being approximately £34,000.

5.6. The particulars in respect of FY2016 are as follows:

Failure to agree rebates to underlying agreements

5.6.1. As in FY2015, the audit team held discussions with management who informed them for the purposes of their analytical review of rebates receivable that there had been no significant changes to the terms of the relevant rebate agreements. The audit team did not seek to corroborate the information provided by the Company by agreeing rebates to underlying agreements. This was a more significant failure in FY2016, because a number of significant rebate agreements were due to expire in that year, and there was no evidence that they had been extended or replaced with new agreements. The Respondents stated in the course of the investigation that the audit team were shown a detailed listing of rebates which appeared to demonstrate an increase of £455,922 for new rebates. Whilst the figure of £455,922 does appear on the analytical review work paper, annotated "per rebates listing", there is no evidence that this was the subject of audit testing.

Using erroneous figures in the audit testing and retaining this flawed information on the audit file

5.6.2. As part of their analytical review of rebates receivable, the audit team calculated rebates vs. revenue as a percentage in FY2015, and used this to calculate an expected value of rebates in FY2016, comparing this to actual rebates in

FY2016. However, instead of calculating the percentage of rebates to revenue in FY2015 using theFY2015 figure for rebates, they used the FY2014 figure, and instead of applying the percentage to revenue for FY2016, they applied the percentage to the figure for revenue in FY2015. The results of the audit procedures as recorded on the audit file were therefore inaccurate.

*Adverse Finding 2: The Respondents' conduct in relation to the audit of the supplier rebates and listing fees for FY2015 and FY2016 constituted a breach of ISA 200 in that the Respondents failed to demonstrate sufficient professional scepticism in respect of supplier rebates and listing fees.*

5.7. The particulars in respect of this Adverse Finding are essentially as set out in paragraphs 5.5.3 and 5.6.1 above: the failure to corroborate information and explanations given by the Company with regard to the terms of the rebate agreements, in the context of the analytical reviews of rebates receivable conducted in both years, amounted to a failure of professional skepticism as well as a failure to obtain sufficient appropriate audit evidence. The failure was the more significant in FY2016, for the reasons given in paragraph 5.6.1.

**Background in respect of share-based payments**

5.8. Upon listing on the LSE in March 2015, the Company introduced an equity-based incentive scheme for senior staff known as the Performance Share Plan. The Notes to the FY2017 financial statements include this explanation:

> *"The Group issues equity-settled share-based payments to certain employees. Equity-settled share-based payments are measured at fair value at the date of grant. The fair value determined at the grant date of the equity-settled share based payments is expensed on a straight line basis over the vesting period, based on the Group's estimate of shares that will eventually vest.…*
> *The amounts charged to the income statement for share-based payments in the period ended 2 July 2016 and 27 June 2015 were understated due to errors in the calculations. Net assets at 2 July 2016 and 27 June 2015 were understated as a result of errors in the recognition of the corresponding deferred tax asset."*

**Adverse Findings in respect of share-based payments**

*Adverse Finding 3: The Respondents' conduct in relation to the audit of share-based payments for FY2015 constituted a breach of ISA 230 in that the Respondents failed to document sufficient appropriate audit evidence in respect of share-based payments.*

5.9. The particulars of this Adverse Finding are that the *Respondents* failed to record on the audit file their acceptance of management's conclusion that the share-based payment charge for FY2015 would not be significant, bearing in mind the short period for which the scheme had been in operation by the year-end. The audit strategy document provided to the Company's Audit Committee at the planning stage had said that the audit team would substantively audit the share-based payment charge, so it was important to record the reasons for not doing so.

*Adverse Finding 4: The Respondents' conduct in relation to the audit of share-based payments for FY2016 constituted breaches of ISA 500 and ISA 230 in that the Respondents failed to obtain and document sufficient appropriate audit evidence in respect of share-based payments and ISA 450 in that the Respondents failed to communicate uncorrected misstatements to Those Charged with Governance.*

5.10. The particulars of this Adverse Finding are as follows:

Failure to perform audit procedures in such as a way as to identify errors in the Company's calculation of the share-based payment charge

5.10.1. The audit team identified an error in the Company's calculations which had led to a £260,000 understatement of the share-based payment charge, which they noted was below the £425,000 materiality threshold for the audit. However, they failed to identify a further £230,000 error which took the total misstatement (£490,000) above the materiality level.

Failure to report uncorrected misstatements

5.10.2. Although the £260,000 error identified by the audit team was not material, it was above the £21,000 threshold for reporting to the Company's Audit Committee, and the audit team noted on the file that they intended to raise an audit difference. In the event, while the Audit Committee Report noted that the valuations team had assessed management's calculation and noted a small difference, which when worked through the calculation did not result in an audit difference being recorded, the quantum of the matter was not reported.

Failure to document the basis for concluding that the position in respect of share-based payments had been satisfactorily resolved at the time the audit report was signed

5.10.3. The audit report was signed on 3 October 2016, but the report from the valuation team providing the basis for the audit team's conclusions in respect of the share-based payment charge is dated 11 October 2016. The *Respondents* stated during the investigation that the KPMG valuations team's conclusions were provided in a telephone call on the morning of 3 October 2016, but there is no evidence of this in the audit documentation.

**Background in respect of deferred taxation**

5.11. The Notes to the FY2018 financial statements explain that:

> *"As a result of an internal review following an enquiry from the Financial Reporting Council regarding a material deferred tax credit reported in the accounts for the period ended 1 July 2017, the Directors have now determined that this item should have been treated as a prior period adjustment. This item relates to temporary timing differences on fixed assets as at 2 July 2016 that were originally calculated using a closing tax written down value of £14.1 million whereas the capital allowances summary submitted with the 2016 tax computations subsequently showed a tax written down value of £24.3 million. The income statement credit arising from this reduction in deferred tax liability has now been recognised in the period ended 2 July 2016."*

**Adverse Finding in respect of deferred taxation**

<u>Adverse Finding 5:</u> *The Respondents' conduct in relation to the audit of deferred taxation for FY2016 constituted a breach of ISA 230 in that the Respondents failed to prepare documentation which provided a sufficient and appropriate record of the basis for the auditor's report in respect of deferred taxation.*

5.12. The particulars of this Adverse Finding are that the calculations prepared by management of the Company failed to include the correct brought forward Tax Written Down Value ("**WDV**") for a particular subsidiary of the Company. The calculation used the closing Tax WDV figure for FY2015, as recorded in the relevant FY2015 working paper, as the FY2016 opening figure. However, this figure had subsequently been revised when the FY2015 tax computations were finalised (as shown in a separate tab in the spreadsheet which included the calculation), and the calculation should have used the updated amount. This led to the calculation of an incorrect closing figure for FY2016, and therefore resulted in the deferred tax liability being understated by £1.7m. The audit team did not identify management's error as part of their audit work.

## 6. SANCTIONS

6.1. Paragraph 10 of the FRC's Sanctions Policy (AEP) (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:

6.1.1. 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.

6.1.2. 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.

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

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

6.2. 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.

6.3. In reaching a decision on *Sanctions*, *Executive Counsel* has considered the following matters in accordance with the Policy (in summary).

**Nature, seriousness, gravity and duration of the breaches**

6.4. The principal objective of a *Statutory Audit* is to obtain reasonable assurance that the financial statements as a whole are free from material misstatement. As a result of the breaches of *Relevant Requirements*, the FY2015 and FY2016 Audits failed to achieve this objective in relation to specific matters set out in this *Final Decision Notice*.

6.5. The FY2015 and FY2016 financial statements included multiple misstatements in relation to areas of the FY2015 and FY2016 Audits in respect of which *Adverse Findings* have been made, and which were subsequently corrected by restatement. In respect of FY2016, these misstatements were material. It is acknowledged, however, that the restatements relating to areas in respect of which no criticism is made of the Respondents were more significant, in aggregate.

6.6. The *Relevant Requirements* contravened in this case are all important ones which are designed to ensure the quality and effectiveness of an audit. ISAs 200, 230 and 500, in particular, are basic and fundamental to the work of an auditor.

6.7. The failings in respect of supplier rebates and listing fees are made more serious by the fact the FRC had indicated prior to the FY2015 Audit that complex supplier arrangements would be the subject of particular focus in the review of audits by the FRC. Accordingly, the Respondents were on notice to ensure that their work in relation to such arrangements should be of high quality, even though they were not a critical element of the Company's business model and financial performance.

6.8. Breaches of some of the *Relevant Requirements* were identified in multiple areas and persisted for two successive audit years, showing that the breaches were not isolated incidents but were indicative of broader deficiencies which pervaded these particular audits.

6.9. While there is no clear evidence that any person suffered financial loss as a result of the breaches of these *Relevant Requirements*, it is clear that they could undermine confidence in the standard of conduct of statutory audits generally.

6.10. It is acknowledged that the breaches were neither intentional, dishonest, deliberate nor reckless. Neither of the Respondents stood to benefit from the breaches.

6.11. While KPMG has not taken any remedial action as a result of the FY2015 and FY2016 Audits, it has undertaken a general improvement programme in respect of its audit work in recent years, aspects of which should reduce the likelihood of a repetition of these breaches. However, *Executive Counsel* is not convinced that similar issues could not re-occur, in the absence of further action by KPMG.

6.12. KPMG is a large audit firm, with 592 partners across all functions, and 276 *Statutory Auditors* in 2020. Its UK revenue in the year to 30 September 2020 was £2,303 million and its audit fee income was £639 million.

6.13. There have been previous breaches by KPMG. The firm has been the subject of sanctions in seven cases in the last four years. In particular, one of these cases concerned breaches of Relevant Requirements in respect of supplier rebates, in the context of another FY2016 audit. This shows that, in respect of that aspect at least, this current case is not an isolated incident. However, because of the timing of the two cases there is no suggestion that the Respondents failed to learn from the breaches in that particular case and apply those lessons to the FY2015 and FY2016 Audits.

6.14. In the case of Mr Frankish, he has a good prior regulatory record, and he held a junior position at KPMG, being an employee with the grade of Director rather than a partner. The latter fact does not lessen his statutory responsibility for the conduct of the FY2015 and FY2016 Audits, however.

**Identification of Sanction**

6.15. Having assessed the nature, seriousness, gravity and duration of the breaches of *Relevant Requirements*, *Executive Counsel* has determined that the following combination of *Sanctions* is appropriate in this case:

<u>KPMG</u>

6.15.1. A declaration to the effect that, as a result of the *Adverse Findings* set out in this *Final Decision Notice*, the audit reports for the FY2015 and FY2016 Audits did not satisfy the requirement in regulation 4(1) of the SATCAR that a *Statutory Audit* must be conducted in accordance with relevant standards.

6.15.2. A published statement to the effect that KPMG has contravened the *Relevant Requirements*, in the form of a severe reprimand.

6.15.3. An order pursuant to rule 96(c) of the AEP, requiring KPMG to take action to mitigate the effect or prevent the recurrence of the breach of the *Relevant Requirements*. In summary, the action required is:

(1) KPMG will, by 28 February 2022, provide the *Executive Counsel* with a report (the “**First Report**”) which:

a. Identifies the reasons why it considers that the breaches occurred; and

b. Identifies measures taken since the Audits which may have reduced the risk of any repetition of the breaches.

(2) Within three months of the Executive Counsel’s approval of the First Report, KPMG will provide a further report to the Executive Counsel (the “**Second Report**”) which:

a. Evaluates the effectiveness of the measures recorded in the First Report in reducing the risk of repetition, by the examination of relevant evidence such as the outcome of reviews of audits in the intervening period; and

b. Identifies any additional measures that could reasonably be taken in order to mitigate any residual risk of repetition.

(3) In the event that additional measures are suggested in accordance with paragraph (2)(b) above KPMG will, within 3 months of the Executive Counsel’s approval of the Second Report, agree with the *Executive Counsel* and begin to carry out an action plan (the “**Plan**”) which:

a. Sets out the steps to be taken in order to implement the measures;

b. Provides for the evaluation of the effectiveness of the measures, by the examination of relevant evidence;

c. Provides for regular reporting to the Executive Counsel on the progress made in implementing and evaluating the measures; and

d. Has a duration not exceeding two years from the date the Plan is approved by the Executive Counsel.

6.15.4. A financial penalty of £1,250,000.

<u>Mr Frankish</u>

6.15.5. A published statement to the effect that Mr Frankish has contravened the *Relevant Requirements*, in the form of a severe reprimand.

6.15.6. An order pursuant to rule 96(c) of the AEP, requiring Mr Frankish to take the following action to mitigate the effect or prevent the recurrence of the breach of the *Relevant Requirements*:

(1) Mr Frankish will, within three months of the date of the order, provide the *Executive Counsel* with a report prepared by his new firm which:

a. Identifies, from his perspective, the reasons why the breaches occurred;

b. To the extent that the reasons are concerned with his own performance, identifies personal development measures taken since the Audits which may have reduced the risk of any repetition of the breaches; and

c. Identifies any additional personal development measures that could reasonably be taken in order to mitigate any residual risk of repetition.

(2) In the event that any additional personal development measures are identified in accordance with paragraph (1)(c) above, Mr Frankish will implement those measures as part of his next annual performance review cycle with the new firm.

6.15.7. A financial penalty of £50,000.

**Aggravating factors**

6.16. In the case of KPMG, the only notable aggravating factor is the fact that KPMG has a poor disciplinary record. This has already been taken into account in assessing the nature, seriousness, gravity and duration of the breaches, and no further adjustment to the level of *Sanction* is required.

6.17. There are no applicable aggravating factors in the case of Mr Frankish.

**Mitigating factors**

6.18. The Respondents have provided good co-operation during the investigation (as they are required to do), but not the exceptional level of co-operation which would amount to a positive mitigating factor.

6.19. Mr Frankish's good disciplinary record and junior position within KPMG are relevant mitigating factors, but they have already been taken into account in assessing the nature, seriousness, gravity and duration of the breaches.

6.20. Consideration has also been given to various points of personal mitigation advanced on Mr Frankish's behalf, in respect of both the stress caused by the proceedings and the likely impact of the *Adverse Findings* and *Sanctions* on his future career prospects and earning potential. However, *Executive Counsel* does not consider that his personal circumstances are so out of the ordinary as to merit a specific reduction in the *Sanction*.

**Deterrence**

6.21. Having considered the matters set out at paragraphs 72 and 73 of the Policy, *Executive Counsel* does not consider that any increase in the *Sanctions* is required for the purposes of deterrence.

**Discount for Admissions and Settlement**

6.22. Having taken into account the admissions by the Respondents and the stage at which those admissions were made, Executive Counsel has determined that a reduction of 30% in the financial penalties is appropriate, such that the financial penalty for KPMG is reduced to £875,000 and that for Mr Frankish is reduced to £35,000. The maximum discount of 35% for settlement during Stage 1 of the investigation, in accordance with paragraph 84 of the Policy, was not appropriate because acceptable admissions were not made at the earliest possible point within that Stage.

## 7. COSTS

7.15. The Respondents have agreed to pay *Executive Counsel's* costs in full in this matter, being £69,000. Such costs shall be paid no later than 28 days after the date of this *Final Decision Notice*.

**Signed:**

[redacted]

**Jamie Symington**
**DEPUTY EXECUTIVE COUNSEL**
**Date: 29 December 2021**

**Corrected on 12 January 2022 to rectify an administrative error in the preparation of the document.**

## APPENDIX – EXTRACTS OF RELEVANT REQUIREMENTS

**Extracts from relevant ISAs in force during the Relevant Period[2]**

### ISA 200: Overall Objectives of the Independent Auditor and the Conduct of an Audit in accordance with International Standards on Auditing

Paragraph 15 states as follows:

> *"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."*

### ISA 230: Audit Documentation

Paragraph 5 states as follows:

> *"The objective of the auditor is to prepare documentation that provides:*
> *A sufficient and appropriate record of the basis for the auditor's report; and*
> *Evidence that the audit was planned and performed in accordance with ISAs (UK and Ireland) and applicable legal and regulatory requirements."*

Paragraph 8 states as follows:

> *"The auditor shall prepare audit documentation that is sufficient to enable an experienced auditor, having no previous connection with the audit, to understand:*
> *The nature, timing and extent of the audit procedures performed to comply with the ISAs (UK and Ireland) and applicable legal and regulatory requirements;*
> *The results of the audit procedures performed, and the audit evidence obtained; and*
> *Significant matters arising during the audit, the conclusions reached thereon, and significant professional judgments made in reaching those conclusions."*

### ISA 450: Evaluation of Misstatements Identified During the Audit

Paragraph 12 states as follows:

> *"In accordance with ISA (UK and Ireland) 200, the auditor shall maintain professional skepticism throughout the audit, recognizing the possibility that a material misstatement due to fraud could exist, notwithstanding the auditor's past experience of the honesty and integrity of the entity's management and those charged with governance."*

[2] Issued October 2009 and effective for audits of financial statements for periods ending on or after 15 December 2010.

**ISA 500: Audit Evidence**

Paragraph 6 states as follows:

> *"The auditor shall design and perform audit procedures that are appropriate in the* circumstances for the purpose of obtaining sufficient appropriate audit evidence."

Paragraph 9 states as follows:

> *"When using information produced by the entity, the auditor shall evaluate whether the information is sufficiently reliable for the auditor's purposes, including as necessary in the circumstances:*
>
> *(a) Obtaining audit evidence about the accuracy and completeness of the information; and*
>
> *(b) Evaluating whether the information is sufficiently precise and detailed for the auditor's purposes."*
>
> *(c)*