IN THE MATTER OF:

THE EXECUTIVE COUNSEL TO THE FINANCIAL REPORTING COUNCIL

- and -

(1) KPMG AUDIT PLC

(2) MICHAEL FRANCIS BARRADELL

PARTICULARS OF FACT AND ACTS OF MISCONDUCT

The Settlement Agreement (which includes the Particulars of Fact and Acts of Misconduct) is a document agreed between KPMG Audit plc and Michael Francis Barradell (the Respondents) and the Executive Counsel. 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 since they are not parties to the proceedings.

I. INTRODUCTION

1. The Financial Reporting Council ("**the FRC**") is the independent disciplinary body for the accountancy and actuarial professions in the UK. The FRC's rules and procedures relating to accountants are set out in the Accountancy Scheme of 8 December 2014 ("**the Scheme**").

2. On 24 May 2016 the Conduct Committee of the FRC directed the Executive Counsel to investigate the conduct of KPMG Audit PLC and Mr Michael Barradell in relation to:

   "their consideration of and compliance with ethical standards during the audit of the financial statements of Ted Baker Plc and No Ordinary Designer Label Limited for the periods ended 26 January 2013 and 25 January 2014."

3. This is the Executive Counsel's Particulars of Fact and Acts of Misconduct ("**the Particulars**") with respect to:

   3.1 KPMG Audit PLC ("**KPMG**"), a member firm of the Institute of Chartered Accountants in England and Wales ("**the ICAEW**") at all material times; and

3.2 Mr Michael Barradell, a partner at KPMG LLP, an audit director at KPMG and a member of the ICAEW at all material times (together "**the Respondents**").

4. As a member firm and a member of the ICAEW respectively, KPMG and Mr Barradell are a Member Firm and a Member for the purposes of the Scheme.

5. These Particulars concern KPMG and Mr Barradell's Misconduct in relation to the audit of the consolidated financial statements of Ted Baker PLC and its subsidiaries (collectively "**the Ted Baker Group**") for the years ended 26 January 2013 ("**FY13**") and 25 January 2014 ("**FY14**"). One of Ted Baker PLC's subsidiaries is and was No Ordinary Designer Label Limited ("**NODL Ltd**"). Unless the context requires otherwise, references in these Particulars to 'Ted Baker' are to Ted Baker PLC and NODL Ltd.

6. Misconduct is defined at paragraph 2(1) of the Scheme as:

> "an act or omission or series of acts or omissions, by a Member or Member Firm in the course of his or its professional activities (including as a partner, member, director, consultant, agent, or employee in or of any organisation or as an individual) or otherwise, which falls significantly short of the standards reasonably to be expected of a Member or Member Firm or has brought, or is likely to bring, discredit to the Member or the Member Firm or to the accountancy profession".

7. In overview, and as explained in further detail below, the Respondents' Misconduct can be summarised as follows:

7.1 The Ted Baker Group was a longstanding audit client of KPMG, which had audited the group since 2000, and continues to do so to the present day. In June 2012, solicitors acting for Ted Baker in a civil claim that had been brought against its insurers contacted KPMG's forensic department, with a view to KPMG providing expert evidence as to the quantum of Ted Baker's claim. The size of the claim was material to the Ted Baker Group's financial results.

7.2 The engagement posed a self-review threat. KPMG was at risk of reviewing (and relying on for the purposes of the audit) the conclusions reached by its own forensic department if Ted Baker relied upon the opinions of its quantum expert (as was reasonably possible) alongside other evidence when deciding whether to disclose a contingent asset in respect of the claim. However, despite the self-review threat being identified at the time by at least one KPMG employee, the Respondents concluded that it was permissible for the forensic team to take on the engagement. In fact, the forensic engagement was prohibited by the prevailing ethical standards, and should not have been accepted by KPMG.

7.3 Having reached the wrong conclusion at the outset of the engagement, the Respondents' failings were compounded by their failure subsequently to appreciate that, during the audits of the Ted Baker Group's FY13 and FY14 financial statements, the self-review threat had in fact transpired such that KPMG was re-evaluating its own work. The self-review threat that eventuated related both: (i) to the disclosure of the loss of profit claim; and (ii) as to how Ted Baker's management elected to account for its legal costs.[1] In those circumstances, the Respondents failed to conclude, as they should have done, that KPMG had lost its independence, since it was probable that a reasonable and informed third party would conclude that KPMG's objectivity either was impaired or was likely to be impaired. However, the Executive Counsel does not allege that KPMG or Mr Barradell in fact lacked objectivity.

7.4 Moreover, it was anticipated by KPMG at the outset of the engagement that their fees for providing the expert services would be within a range of £10,000 to £100,000. In the event, the unusual demands of the litigation meant the work expanded significantly, requiring, amongst other things, the production of at least three expert reports, a written response to questions, two joint statements and two witness statements from the KPMG Expert. As a result, the fees that were ultimately charged vastly exceeded the original predicted range, and eventually totalled £952,000.

7.5 In total, KPMG received £1.3 million in fees for non-audit services from Ted Baker over 3 financial years from FY13 to FY15 (including £952,000 in fees for KPMG Forensic), significantly exceeding its audit fees in the same period of £434,000. KPMG purported to record the ratio of non-audit to audit fees in internal documents

[1] The Executive Counsel makes no comment in relation to the correctness of the accounting treatment.

called "*Ratio of Audit to Non-audit fees – Ethics Partner approval*". The approval document stated that fees received for interim reviews should be considered to be non-audit fees. However, in FY13 the interim review fee of £20,000 was included in the level of audit fees, not non-audit fees, serving to reduce the ratio of non-audit to audit fees and thereby failing to reveal the true extent of the disparity between the two. The correct ratios for FY13 and FY14, as taken from the figures disclosed in Ted Baker's financial statements, were as follows:

Financial Year	**FY13**	**FY14**
KPMG Forensic fees	£165,000	£218,000
Total non-audit fees[2]	£243,000	£337,000
KPMG audit fees	£110,000	£135,000
Non-audit to audit fee ratio	**2.2:1**	**2.5:1**

7.6 This disparity gave rise to a self-interest threat. However, the Respondents failed properly to consider the cumulative effect of the self-review and self-interest threats posed by the engagement, whether at its outset or during their audits.

7.7 Further, the Respondents repeatedly failed in FY13 and FY14 to provide KPMG's Ethics Partner with details of the anticipated non-audit fees before they had exceeded their audit fees (albeit that in each case Mr Barradell provided these details to the Ethics Partner as soon as he became aware that the ratio had been exceeded). This was not merely a technical breach. The very purpose of the required prospective consultation was to give the Ethics Partner a genuine opportunity to require KPMG either to refuse to supply the non-audit services, or to resign from the audit. That choice was, however, frustrated when, as occurred in this case, the Ethics Partner was presented with substantial costs which had already been incurred, amounting to a *fait accompli*.

8. The Respondents accept that, in relation to the Admitted Acts of Misconduct set out below, their conduct fell significantly short of the standards reasonably to be expected of

[2] These consisted of fees received by KPMG for carrying out forensic services, interim reviews, audit related assurance services and tax services.

a Member Firm and a Member respectively. They have expressed to the Executive Counsel their disappointment with the Admitted Acts of Misconduct with which these Particulars are concerned.

9. For the avoidance of doubt, the Executive Counsel does not allege that the Respondents were reckless, or that they failed to act with integrity or objectivity.

10. The Executive Counsel proceeds against the Respondents in respect of the admitted acts of Misconduct as set out below.

II. BACKGROUND

(i) Ted Baker

11. Ted Baker PLC is a listed company, which entered the FTSE 350 index during FY13, and which has at all material times been the holding company for businesses that distribute and market the Ted Baker clothing brand worldwide, including NODL Ltd in the UK.

(ii) KPMG and Mr Barradell

12. According to their Transparency Report 2012, KPMG and KPMG LLP (the entities through which the KPMG group delivered its audit services in the UK, referred to as "**KPMG UK**") had a turnover in 2012 of £1,774 million. KPMG's revenue from audit and directly related services for 2012 comprised £431 million, and it made an operating profit on those services of £45 million.

13. KPMG was appointed auditor of the Ted Baker Group with effect from the financial year ended 29 January 2000. KPMG UK has conducted the audits of Ted Baker's financial statements for every financial period since then.

14. Mr Barradell qualified as a Chartered Accountant on 1 April 1997. He joined KPMG UK in 1993 and became a partner in 2008. Mr Barradell had been the audit engagement partner for the Ted Baker audit since the financial year ended 30 January 2010. He gave an unqualified audit opinion in respect of Ted Baker for FY13 and FY14.

(iii) The relevant standards of conduct

15. The standards of conduct reasonably to be expected of the Respondents at the relevant time included those set out in:

    15.1 The ICAEW's Code of Ethics effective from 1 January 2011 ("**the Code**");

    15.2 APB Ethical Standard 1: Integrity, objectivity and independence ("**ES1**"), and

    15.3 APB Ethical Standard 5: Non-audit services provided to audited entities ("**ES5**").

16. The specific paragraphs of the Code, ES1 and ES5 on which the Executive Counsel relies are extracted and annexed to these Particulars at Annex A.

(iv) The relevant auditing standards

17. The relevant auditing standards were the applicable International Standards on Auditing (UK and Ireland) ("**ISAs**"). The specific ISAs on which the Executive Counsel relies are extracted and annexed to these Particulars at Annex B.

18. As audit engagement partner, Mr Barradell was responsible for the audit engagement and its performance, and for the auditor's reports issued on behalf of KPMG. Accordingly, where criticisms are accepted in relation to the performance of KPMG's conduct in the acts particularised below, Mr Barradell bears responsibility for these shortcomings as the audit engagement partner.

(v) The relevant accounting standards

19. As a listed company preparing consolidated group financial statements, Ted Baker was required to report under International Financial Reporting Standards ("**IFRS**"), which incorporated International Accounting Standards ("**IASs**"). For Ted Baker, this included compliance with IAS 37, in particular as regards contingent assets. Relevant extracts from IAS 37 are set out in Annex C.

(vi) Other KPMG individuals

20. The names of other KPMG individuals have been anonymised in circumstances in which no allegations have been made against these individuals by the Executive Counsel. […].

III. THE FACTUAL CONTEXT

(i) The AXA Litigation

21. Between early 2006 and December 2008 Ted Baker noticed losses at its warehouse in Abbey Road, London, and called in independent security consultants to investigate. On 12 December 2008 an employee at the warehouse was arrested and, on 13 March 2009, pleaded guilty to conspiracy to steal.

22. In 2010, Ted Baker brought proceedings in the English High Court against its insurers (AXA Insurance PLC, Fusion Insurance Services Limited and Tokio Marine Europe Insurance Limited, together "**the Insurers**") in respect of those thefts ("**the AXA Litigation**"). Between February and March 2012, the Commercial Court heard certain preliminary issues concerning policy coverage and related matters ("**Part 1**"). The outstanding issue on liability (termed "claims co-operation" by the Court) and as to quantum were ordered to be determined at a later date ("**Part 2**").

(ii) Part 1: May-June 2012

23. Judgment was handed down in respect of Part 1 in favour of Ted Baker by Mr Justice Eder on 25 May 2012 (recorded at [2012] EWHC 1406 (Comm), "**the Part 1 Judgment**"). He ruled that Ted Baker's claim for loss of property and business interruption was covered by the insurance policy, subject to the "claims co-operation" issue.[3] Whilst expressly not at that stage addressing quantum, Eder J noted at paragraph 3 of his judgment that:

> "…the claims advanced are sizeable and, in broad terms, fall into two main categories. First, there was the loss of the stock itself which, at cost, is said to be of the order of £1 million. Second, there is a claim for what is variously described as 'consequential loss' or 'business interruption' ('BI') which is said to amount to about £3 million."

24. In June 2012 Ted Baker applied for its costs of Part 1 from the Insurers ("**the Part 1 Costs Hearing**"). Mr Justice Eder refused to grant Ted Baker its costs. In his judgment (recorded at [2012] EWHC 1779 (Comm), "**the Part 1 Costs Judgment**"), the judge

[3] A late application for permission to appeal was refused by the Court of Appeal on 19 February 2014: [2014] EWCA Civ 134.

said that while Ted Baker was "*in principle*" entitled to recover its costs of Part 1, he should not make any immediate order because of the possibility that the Insurers might have made Ted Baker a settlement offer, which Ted Baker might ultimately fail to beat at trial. As he stated at paragraph 27:

> "… I remain of the view that although I have not been told and do not know whether a CPR Part 36 [settlement] offer has been made, the possibility that such an offer has been made and, if so, that it might affect any order as to costs are part of all the circumstances to which I must have regard in deciding what order as to costs I should make… [I]t seems to me that justice demands that in the particular circumstances of the present case I should not make any immediate order for costs nor any order for an interim payment in favour of the claimants."

25. The specific type of settlement offer referred to by the judge was one made pursuant to Part 36 of the Civil Procedure Rules ("**a Part 36 offer**"). A Part 36 offer is a type of settlement offer which the Insurers could have made to Ted Baker but which the judge would have been unaware of. If Ted Baker failed to obtain a more advantageous judgment than the amount offered by the Insurers, then the Insurers would be entitled to recover their costs (on a standard basis) plus interest from Ted Baker from the expiry date of the offer, absent unusual circumstances.

26. The Insurers had in fact already made two Part 36 offers – one on 8 July 2010 for £50,000 plus costs, and a second on 28 December 2011 for £250,000 plus costs – together with another more general settlement offer on 7 October 2011 (collectively "**the Settlement Offers**").[4] There was a real risk that Ted Baker would fail to beat the Settlement Offers and, accordingly, not recover any of its costs of Part 1. The recoverability of Ted Baker's Part 1 costs was therefore dependent on the outcome of Part 2.

(iii) KPMG Forensic's instruction as accounting expert for Ted Baker: June-July 2012

27. After the Part 1 Costs Hearing, the solicitors for Ted Baker contacted the forensic accounting team at KPMG LLP ("**KPMG Forensic**") with a view to instructing them to provide evidence as to the quantum of Ted Baker's claim ("**the Expert Witness Engagement**").

[4] See [2014] EWHC 4178 (Comm) at paragraphs 10 to 12.

28. Discussions duly took place within KPMG as to whether KPMG Forensic could accept the Expert Witness Engagement. KPMG and KPMG LLP (of which KPMG Forensic was part) were 'network firms' within the meaning of the APB Ethical Standards glossary and, accordingly, were treated as the same audit firm for the purposes of the relevant standards. Accepting the engagement would therefore result in KPMG providing expert evidence for a client whose financial statements it was auditing. KPMG was also the audit firm for one of the three Insurers which Ted Baker was suing.

29. Individuals from KPMG's Forensic, Audit, and Ethics and Independence Compliance teams were involved in these discussions. KPMG noted that the engagement would require pre-approval from Ted Baker's Audit Committee ("**the Audit Committee**").

30. The basis upon which KPMG ultimately approved the Expert Witness Engagement on 5 July 2012 was recorded in a comment from M1, the audit Senior Manager, on the company's Sentinel global conflict management system ("**Sentinel**") as follows:

> "Exper [sic] witness is a permissible service. KPMG audit team have discussed this with Audit risk and although the potential ammounts [sic] that may be recovered are significant to the financial statements of Ted Baker the nature of the expert witness will not influence any accounting judgements made on recongition [sic]. The team involved in carrying out the expert witness work is not involved with the audit of Ted Baker plc and the nature of the expert witness report will be standard with KPMG acting as an independent expert witness only Pre AC approval was required which Ted Baker have confirmed has been obtained Appropriate regards to safeguards and risk management consultation performed before approval was provided"

31. Sentinel further recorded that:

31.1 The total fee range for the engagement was £10,000 to £100,000;

31.2 The Expert Witness Engagement was a permissible service because:

> "there is (i) no threat of self-review on the basis that no asset would be recognised in the financial statements as it is continent [sic] upon the litigation and (ii) no advocacy threat because the expert witness owes an ultimate duty to the court"; and

31.3 As to safeguards:

> "The engagement leader must ensure that information barriers are in place to preserve confidentiality between your engagement team and other KPMG engagement teams in accordance with the requirements of Chapter 5 of the UK Quality and Risk Management Manual and TS confidentiality and information barriers guidance".

32. Thereafter, pursuant to a written engagement letter dated 25 July 2012, M2, a director of KPMG Forensic, agreed to act as Ted Baker's accounting expert in the AXA Litigation. Pursuant to that engagement letter, M2 was required in the first instance to prepare an expert report setting out his views as to the quantum of Ted Baker's insured losses, which would be used by its Counsel to plead Amended Particulars of Claim.

33. M2 was replaced in November 2012 by M3 (a partner of KPMG Forensic), who then became KPMG's expert ("**the KPMG Expert**").

(iv) The audit and Annual Report and Accounts for FY13: January-March 2013

<u>The FY13 audit</u>

34. In respect of its audit of Ted Baker's accounts for FY13 ("**the 2013 Audit**"), KPMG determined its materiality to be £1.7 million. There were two relevant issues for consideration during the 2013 Audit. The first was whether an asset or contingent asset should be recognised or disclosed in respect of Ted Baker's loss of profit claim. This turned on the proper application of IAS 37, *i.e.* whether the realisation of income from the loss of profit claim was:

    34.1 Virtually certain, in which case the income from the claim should have been recognised as an asset;

    34.2 Probable, in which case the income from the claim should have been disclosed as a contingent asset, or

    34.3 Not probable, in which case no amount should have been recognised or disclosed in the financial statements.

35. As for this, KPMG's report to the Audit Committee in respect of the 2013 Audit stated:

> "No disclosure or asset has been recognised in the year end financial statements on the 'loss of profit' claim due to the uncertainty and sensitivity surrounding the claim."

36. The second issue was how Ted Baker's management had chosen to account for the company's legal costs in circumstances in which they had not expensed them. As to this, KPMG's report to the Audit Committee stated that:

> "Legal costs incurred to date of £957,000 … have been deferred on the balance sheet on the basis that the judgement [sic] that granted in favour of Ted Baker for the first part of the case (liability on AXA's part) stipulates that costs of up to £660,000 should be reimbursed by AXA once the final outcome of the case has been decided. The ruling although clear in its award of costs to Ted Baker defers settlement to be agreed during the outcome of the next hearing as part of the overall 'loss of profit' claim. Costs incurred in respect of part 2 have not been awarded to Ted Baker but on the basis of the strength of the claim and expected overall outcome management are confident that these will be recovered through the final court settlement.
>
> Under accounting standards the receivable can only be recognised if management are able to demonstrate recovery is probable. Given the ruling is clear and definitive in its award of costs of part 1 to Ted Baker and the strength of the evidence being put forward in quantifying the loss of profit management have concluded that it is appropriate to recognise these costs as a receivable.
>
> We have reviewed the court ruling for part 1, discussed the status and likely outcome of the case with Ted Baker's lawyers and concur with managements position at the this stage [sic]. We understand that there is a possibility that the court may not award full recovery of costs and that on average costs awarded by the courts are in the region of 70-80% of the total costs incurred. Management have expensed £191,000 which represents 20% of the total costs incurred to date in recognition of this."

<u>KPMG's review of the KPMG Expert's evidence</u>

37. In order for KPMG properly to have concluded that it concurred with management's decision not to disclose the loss of profit claim, the audit team would have needed to examine the strength of Ted Baker's case. Further, in circumstances in which Ted Baker's management had not expensed the company's legal costs, KPMG additionally became involved in examining the strength of the case in respect of the treatment of legal costs (so as to satisfy itself that it had the requisite degree of confidence that Ted Baker would recover those costs from the Insurers). Consistent with both of those matters:

37.1 By email dated 21 January 2013 from M1 to Mr Barradell, M1 said that, in respect of the loss of profit claim:

> "[Ted Baker's solicitor] was pretty confident that the case was strong and the expert witness report will support this position… [Ted Baker's solicitor's] opinion is that Ted have a strong case and the quantum of the award is unlikely to be anywhere close to the initial offer of £250k made by Axa which she is confident based on latest available information is too low. There is a case conference later this week after which we will be provided with a further update. We will also be given a summary of the position in writing from the lawyers as part of our year end procedures."

37.2 By email dated 29 January 2013 from Mr Barradell to M1, Mr Barradell said:

> "Can you make a file note to note that I discussed with [M6, the Engagement Quality Control Review Partner] yesterday evening the AXA claim matter. On balance [M6] was comfortable with the legal fees being recorded on the balance sheet as a prepayment on the basis that there has been an outflow of funds and that there is a high expectation that this will recovered [sic]. [M6] asked us to confirm:
>
> 1/ the legal procedural order of events around the claim and the award of costs
>
> 2/ better understand whether the full costs are likely to awarded or 70%-80%
>
> 3/ get current legal view following the case conference
>
> 4/ speak with the expert witness (KPMG forensic) around the strength of the case around quantum."

<u>The non-audit fees</u>

38. At the outset of the Expert Witness Engagement, KPMG Forensic had estimated that their fees would be between £10,000 and £100,000. However, during the 2013 Audit, it belatedly came to Mr Barradell's attention that the total fees incurred by the KPMG Expert during FY13 had exceeded the level of audit fees for FY13. Permission for those fees to exceed the original fee estimate had not been sought from Mr Barradell before the estimate had been breached. By this stage, the total non-audit fees for FY13 were £243,000, well in excess of the audit fees of £110,000 and thereby exceeding the 1:1 ratio of non-audit to audit fees.

39. This led M1 to seek retrospective approval from M7, the UK Head of Ethics and Independence, in the form of an internal KPMG document titled "*Ratio of Audit to Non-audit fees – Ethics Partner approval*". M1 noted in his covering email to M7 that "*we had not been made aware of the costs increasing beyond the original budget*". However, M1 had incorrectly calculated the ratio of non-audit to audit fees in this document, by including the £20,000 fee for the interim review as audit fees, rather than as non-audit fees.

40. M7 gave his retrospective 'approval' for the non-audit fees to be incurred by email on 18 March 2013, but made clear to Mr Barradell and M1 that:

> "As we discussed on the phone, please can you ensure that you err on the side of caution in future regarding the likely quantum of non-audit fees so that consultation takes place on a timely basis."

<u>The Annual Report and Accounts for FY13</u>

41. Ted Baker's individual and consolidated group accounts were published in an annual report in respect of each financial year. The Annual Reports and Accounts for FY13 and FY14 contained, among other things, a Chairman's Statement, Strategic Report, Directors' Report and Independent Auditors' Report, together with the financial statements for that financial year.

42. The Annual Report and Accounts for FY13 were signed on 21 March 2013, and showed Group revenue of £254.5 million with £31.5 million in profit before tax and exceptional costs.

43. As for the two areas mentioned above:

    43.1 No asset or contingent asset was recognised or disclosed in respect of the loss of profit claim: indeed, no reference was made to the AXA Litigation at all; and

    43.2 Ted Baker treated the majority of its legal costs for both Part 1 and 2 as an asset (being akin to a prepayment/receivable), since it had concluded (and KPMG had accepted) that it had the requisite degree of confidence that it would recover those costs from the Insurers.

(v) The audit and Annual Report and Accounts for FY14: January-March 2014

The FY14 audit

44. In respect of its audit of Ted Baker's accounts for FY14 ("**the 2014 Audit**"), KPMG determined its materiality to be £2.3 million. The same two issues arose for consideration during the 2014 Audit: whether to disclose a contingent asset on the loss of profit claim, and how to treat Ted Baker's legal costs.

45. As for the loss of profit claim, M1 told Ted Baker by email on 12 February 2014 that:

> "it probably is worth thinking about disclosure regardless of how much is on the balance sheet this year end in order to flag up the imminent resolution of the case in the coming year."

46. M1 proposed suggested wording for the disclosure by emails to Mr Barradell in the morning of 21 February 2014, and to Ted Baker later the same day. Likewise, a KPMG file note entitled "*AXA Review*" stated:

> "Based on the expert witness evidence presented by KPMG on behalf of Ted Baker, the best estimate of the compensation due to Ted Baker is around £1.3m. [Their solicitors] have confirmed in their legal letter… that they remain confident of the outcome of Part Two, and that £1.3m is the best estimate currently available of the expected compensation payable to Ted Baker…
>
> Ted Baker should disclose a contingent asset. We have confirmed with Ted Baker that a contingent asset will be included in the PLC Annual Report. The wording of the disclosure will be reviewed as part of our audit of the disclosures."

47. KPMG's report to the Audit Committee in respect of the 2014 Audit includes a comment to the same effect.

48. As for Ted Baker's legal costs, the "*AXA Review*" file note stated:

> "Ted Baker is proposing to recognise a prepayment of £1,168k (63% of the total costs incurred)…
>
> The rejection of AXA's appeal regarding Part One of the case means that the reimbursement of legal costs incurred by Ted Baker can reasonably be deemed virtually certain…

> The reimbursement of Part Two costs, whilst likely, cannot be deemed virtually certain as it is dependent on the outcome of the forthcoming hearing.
>
> Therefore, a total of £727k (£660k + £67k) can reasonably be recognised as a prepayment, but the remaining £441k will be included as a judgmental unadjusted audit misstatement."

49. KPMG's report to the Audit Committee in respect of the 2014 Audit contained materially identical statements.

<u>KPMG's review of the KPMG Expert's evidence</u>

50. In order for KPMG properly to have concluded that it concurred with management's decision to disclose the loss of profit claim, the audit team would have needed to examine the strength of Ted Baker's case, including around quantum, as to which the evidence from the KPMG Expert was plainly relevant. Further, in circumstances in which Ted Baker's management had not expensed the company's legal costs, KPMG additionally became involved in examining the strength of the case in respect of the treatment of costs (so as to satisfy itself that it had the requisite degree of confidence that Ted Baker would recover those costs from the Insurers). Consistent with both of those matters, in emails from M1 to members of the Ted Baker finance team:

    50.1 M1 wrote on 12 February 2014, in respect of the accounting treatment of Part 2 costs, that "*<u>whilst we continue to accept</u> your confidence and <u>the strong expert witness case</u> the criteria around being able to record this as an asset at the balance sheet date from an accounting perspective are difficult to support*" (emphasis added);

    50.2 On 20 February 2014, M1 asked to be sent two items, including "*1) Expert witness reports*", and

    50.3 M1 asked again on 21 February 2014 for "*the pages that deal with the conclusions of the 2 expert witnesses appointed i.e. Ted's and AXA's*".

51. Further, on 22 February 2014, M1 responded with his comments on draft working papers which had been sent to him by another member of KPMG's audit team, and said:

> "On Part 2 we need to be more stronger (sic) with the pervasive evidence presented to us of the confidence and describe management's confidence. This is where we need to refer to our review of the expert witness report plus the assessment of part 1 going in their favour. Our conclusion should be that it's not black and white but the uncertainty from the ongoing process is what's making it difficult to be virtually certain."

<u>The non-audit fees</u>

52. On 25 September 2013, M4, a Forensic Senior Manager working with the KPMG Expert, told M1 that KPMG Forensic's total outstanding WIP at 10 August 2013 was just under £50,000. He also told M1:

> "Also, for context, work has ramped up again (we are currently drafting a supplemental report, due by 11 October, and we will then be reviewing the opponent's expert report on 15 December and preparing a joint statement with them by 6 December[)] [sic]."

53. The KPMG Expert continued to work on the AXA Litigation throughout late 2013, preparing a Supplemental Expert Report dated 11 October 2013 and a joint statement dated 18 December 2013 following a meeting with the opposing expert.

54. However, it was not until the 2014 Audit on 13 January 2014 that it came to Mr Barradell's attention that the total fees incurred by the KPMG Expert during FY14 had exceeded the level of audit fees. Permission for those fees to exceed the original fee estimate had again not been sought from Mr Barradell before they had been incurred.

55. A Forensic Senior Manager informed M3 and M4 by email on 14 January 2014 that M5, a Forensic Risk Partner, had advised that "*we should suspend all work until the issue is resolved*". After M4 had received an email from Ted Baker's solicitors the next day, he asked M5 by email:

> "Please could you advise whether I am OK to respond to the request below, as I understand that in theory we should not continue until the Sentinel is approved with the increased fee level? … I cannot see that we can go on a 'pens down' basis without seriously upsetting the client and lawyers at a pivotal time in the case (with a CMC at the end of next week)."

56. This led M5 to chase Mr Barradell and M1 for their approval later that day, telling them "*we have an immediate problem to solve here*" and asking "*How are you getting on with getting audit risk management input on this?*"

57. Mr Barradell and M1 again sought retrospective approval from M7, KPMG's UK Head of Ethics and Independence, in the form of an internal KPMG document titled "*Ratio of Audit to Non-audit fees – Ethics Partner approval*". Mr Barradell had convened a face-to-face meeting with M7 at which the issue was discussed. The total non-audit fees for FY14 were £337,000, well in excess of the audit fees of £135,000 and thereby exceeding the 1:1 ratio of non-audit to audit fees.

58. M7 gave his 'approval' for the non-audit fees to be incurred in January 2014, and again on 20 March 2014.

<u>The Annual Report and Accounts for FY14</u>

59. The Annual Report and Accounts for FY14 were signed on 20 March 2014, and showed improved Group revenue of £321.9 million with £40.0 million profit before tax and exceptional costs.

60. The loss of profit claim was referred to in several places in the Annual Report and Accounts. In particular:

60.1 The Directors' Report (at p15) contained the following text (emphasis added):

> "***2) Legal claim against AXA***
>
> The Group is pursuing a claim against its previous insurers for loss of profit arising from the theft of inventory from its warehouse from 2004 to 2008. There is a significant level of judgement involved in determining the recognition and amount of any contingent asset arising from a successful outcome of the claim or a contingent liability should the Group be unsuccessful in its claim.
>
> Management confirmed to the Committee the basis of its assessment of the outcome of the claim and the accounting implications of its assessment. <u>Management's assessment was based on the latest reports from independent experts appointed by the court</u>, the outcome of court hearings during the year and advice from the Group's external counsel. The auditors explained to the Committee the work they had conducted, including how their audit procedures were focused on the recognition

criteria and/or measurement of any contingent asset or liability arising from the claim. On the basis of their audit work, the auditors reported no inconsistencies or misstatements that were material in the context of the financial statements as a whole."

60.2 The Auditor's Report (at p44) stated (emphasis added):

"***2. Our assessment of risks of material misstatement***

…

Legal claim

…

The risk: The Group is pursuing a claim against its previous insurers for loss of profit arising from the theft of inventory from its warehouse from 2004 to 2008. The level of judgment involved in determining the recognition and amount of any contingent asset arising from a successful outcome of the claim or any unrecognised contingent liability should the Group be unsuccessful in its claim is one of the key judgemental areas that our audit is concentrated on.

Our response: Our audit procedures included, among others, challenging the Directors on the evidence on which they based their assessment of the outcome of the claim. <u>We inspected the latest reports from forensic expert witnesses for both parties</u>, inspected relevant correspondence from the courts. We also assessed the experience and professional standing of the Group's external counsel.

We have also considered the adequacy of the Group's disclosures in respect of the claim."

60.3 Note 23 to the accounts (p82) stated:

"23. Contingent assets and liabilities

The Group is pursuing a claim against its previous insurers for loss of profit arising from the theft of inventory from its warehouse from 2004 to 2008. The costs associated with the loss of inventory were charged to the income statement in the periods they related to through the Company's normal stock loss provisions.

Whilst the directors are confident that the outcome of the case will be favourable, no contingent asset has been recognised at the balance sheet date in respect of any loss of profit that may be awarded to the Company on the basis that accounting standards require the directors to be a) virtually certain of the outcome and b) reliably estimate the quantum of the recovery that maybe awarded to the Company.

Given the ongoing court proceedings to determine the quantum of the loss of profit the directors are unable to satisfy themselves of the 'virtual certainty test' required under accounting standards at the balance sheet date to recognise a contingent asset for any such recovery."

60.4 The loss of profit claim was also discussed in the notes to the accounts at Note 1v) (p57).

61. As for legal costs, Ted Baker had incurred Part 1 costs of £707,000 and Part 2 costs of £1,132,000, with management recognising a prepayment of £1,168,000 (being 63% of the total costs incurred), and the remaining £671,000 had been expensed. KPMG had raised an unadjusted audit difference to expense the residual amount of Part 2 costs that had been deferred on the balance sheet.

(vi) Part 2: April-October 2014

62. From April 2014 the KPMG Expert continued to work on the AXA Litigation, preparing a third expert report dated 4 April 2014 and two witness statements dated 7 May and 22 May 2014. On 9 June 2014 Ted Baker's Group Tax and External Reporting Manager wrote to M4 explaining that the company was "*getting close scrutiny on the size of KPMG non-audit fees but are more than comfortable with the acceptability of the position*". The KPMG Expert also wrote to M4 later that day relaying a conversation with a Ted Baker employee, saying: "*Apparently investors are asking a lot of questions about the level of non audit fees*".

63. Shortly afterwards, KPMG asked the Audit Committee to again approve their increased fee limit. A senior executive at Ted Baker wrote to the Audit Committee seeking that approval, and saying that "*it would be inconceivable that we could change to a different expert at this stage*". The Audit Committee gave its approval for the fee limit, but declared that "*whilst this matter remains outstanding … no new non-audit work (aside from existing tax advice matters) should be placed with this firm without the specific prior authority of the Audit Committee whatever the level*".

64. The Part 2 trial was heard between June and July 2014 before Mr Justice Eder. Judgment was handed down on 30 October 2014 (at [2014] EWHC 3548 (Comm), "**the Part 2 Judgment**"). The judge decided against Ted Baker in respect of the outstanding liability issue ('claims co-operation'), which had the result of defeating Ted Baker's entire claim. The judge also decided that Ted Baker would not, in fact, have been able to recover any of its losses even if it had succeeded on claims co-operation as a result of the deductibles in the relevant insurance policies (paragraph 158).

65. On 11 December 2014 Eder J gave judgment on the question of the overall costs of the AXA Litigation ("**the Part 2 Costs Judgment**"). The judge held that, given Ted Baker had failed to beat the three settlement offers made by the Insurers, it should in principle pay their costs of both Part 1 and Part 2 unless it would be unjust to make that order. In the event, Ted Baker did not recover any of their legal costs, and were ordered to pay 25% of the Insurers' Part 1 costs together with the Insurers' Part 2 costs, which were estimated at the time to be around £2.4 million.

(vii) The Annual Report and Accounts for FY15: March 2015

66. In the light of the Part 2 Costs Judgment, the pre-payment in respect of the costs for Parts 1 and 2 was fully released and expensed to exceptional items in the first half of 2015, meaning they were written off in their entirety. Ted Baker's accounts for the 53 weeks ended 31 January 2015 ("**FY15**") disclosed exceptional costs of £5.3 million relating to the AXA Litigation.

67. However, since Ted Baker had failed in its civil claim, there was no question of KPMG reviewing the results of the KPMG Expert's work when carrying out their audit of the FY15 accounts.

(viii) The appeal: February-August 2017

68. The Court of Appeal heard Ted Baker's appeal against the Part 2 Judgment in February 2017. The Court dismissed the appeal, with judgment being handed down on 11 August 2017 (at [2017] EWCA Civ 4097).

IV. THE ADMITTED ACTS OF MISCONDUCT

(A) ACCEPTING THE EXPERT WITNESS ENGAGEMENT

Allegation 1 – Undertaking a prohibited service

1. The conduct of KPMG and Mr Barradell fell significantly short of the standards reasonably to be expected of, respectively, a Member Firm and a Member in that, from July 2012, KPMG agreed to provide litigation support services to Ted Baker PLC, a listed audit client, notwithstanding that such services involved the estimation by KPMG of the likely outcome of a pending legal matter that could be material to the disclosures to be made in Ted Baker PLC's financial statements. The services consequently fell within Ethical Standard 5 paragraph 110(a) and were prohibited. In nonetheless allowing KPMG to provide those services, the Respondents failed to comply with Ethical Standard 5 paragraph 110(a) and thereby failed to act in accordance with Fundamental Principle (c) 'Professional Competence and Due Care'.

Particulars

69. As set out at paragraphs 27 to 33 above, in June to July 2012 KPMG agreed to provide litigation support services to Ted Baker PLC, a listed audit client of KPMG, by way of acting as its expert witness in the civil proceedings (*i.e.* the Expert Witness Engagement).

70. The Expert Witness Engagement involved the estimation by KPMG of the likely outcome of a pending legal matter that could be material to the disclosures to be made in Ted Baker PLC's financial statements within the meaning of Ethical Standard 5 paragraph 110(a). This was because:

70.1 The engagement would require the KPMG Expert to advise on the quantum of the loss suffered by Ted Baker, which was to be used by its Counsel to plead Amended Particulars of Claim in the AXA Litigation.

70.2 The estimation by the KPMG Expert could be material to the disclosures to be made in Ted Baker PLC's financial statements.

(a) The size of the claim was expected to be material. The instructions dated 23 July 2012 to the KPMG Expert stated that Ted Baker's starting point for the value of its claim was over £6 million (paragraph 40), while Ted Baker's profit (before tax and exceptional costs) for the financial year ended 2012 was £27.1 million (and KPMG's materiality for the FY13 audit would be £1.7 million);

(b) The KPMG Expert would be giving a view as to the value of the claim;

(c) It was reasonably possible that Management would rely on that view when deciding to disclose the loss of profit claim as a contingent asset pursuant to IAS 37 paragraph 89; and

(d) Any properly conducted audit would require KPMG to audit management's decision, which it was reasonably possible would therefore involve reviewing the KPMG Expert's conclusions.

70.3 KPMG recognised at the time that the amount being claimed could be material to the disclosures to be made in Ted Baker's financial statements.

(a) M4 wrote on 25 June 2012 that "*This claim is in the order of £4 million, so may well be material to Ted Baker's accounts (turnover of £215m, PBT of £27m)*".

(b) M5 wrote on 25 June 2012 that:

> "if recoveries are deemed probable then the asset would need to be disclosed albeit not recognised – our duties as auditors extend to accounting disclosure as well as the accounts themselves – hence we would be required to take a view as auditors as to whether the recovery [w]as probable."

(c) M4 wrote to M3, M2 and M5 on 26 June 2012 and said:

> "Having thought about this overnight and checked the accounting standards this morning, it looks to me like we would have an issue on the self-review angle…
>
> This is likely to be a material number and if recovery is considered probable (which Ted Baker would clearly want to position itself as thinking, ahead of any trial, especially given that Liability has already been decided) it would need to be disclosed in the accounts as a contingent asset…

> I can't see how we could put any safeguards in place for this – they want us to prepare a number for them which will end up being disclosed in accounts that KPMG will audit."

(d) M4 wrote to M1 and Mr Barradell on 26 June 2012 as follows:

> "Having heard [Ted Baker's] proposed instructions yesterday, you will have to consider carefully the potential self-review issue…
>
> The potential recovery is likely to be a material number and if recovery is considered probable (which would appear to be the case, given that Liability has already been decided) it would need to be disclosed in the accounts as a contingent asset, which you would have to audit. Of course the directors are responsible for the figures and disclosures in the accounts, but it is likely that they would use our calculations (or their own, derived from them) when doing so."

71. In these circumstances, KPMG was not permitted to provide the expert witness services to Ted Baker PLC whilst continuing to audit its financial statements, and should not have undertaken to do so. In nonetheless doing so, the Respondents failed to comply with Ethical Standard 5 paragraph 110(a) and thereby failed to act in accordance with the Fundamental Principle (c) 'Professional Competence and Due Care'.

<u>Allegation 2 – Inadequate assessment of threats during take-on process</u>

2. The conduct of KPMG and Mr Barradell fell significantly short of the standards reasonably to be expected of, respectively, a Member Firm and a Member in that, before accepting the proposed Expert Witness Engagement, KPMG and Mr Barradell failed adequately to:

(i) Consider whether a reasonable and informed third party would conclude that the engagement was inconsistent with the objectives of the audit; and

(ii) Identify and assess the significance of the self-review and self-interest threats of the engagement; and

(iii) Identify and assess the effectiveness of any safeguards to eliminate those threats, or reduce them to an acceptable level.

As a result, the Respondents failed to comply with Ethical Standard 5 paragraph 17 and ISA 220 paragraph 11, and thereby failed to act in accordance with Fundamental Principle (c) 'Professional Competence and Due Care'.

<u>Particulars</u>

72. Before accepting the Expert Witness Engagement, KPMG did take some steps to identify and assess the potential threats from the engagement to KPMG's independence, and to identify and assess the effectiveness of any safeguards to eliminate or reduce those threats to an acceptable level. However, the Respondents failed or failed adequately to consider or identify each of the following matters:

72.1 The Respondents should have, but did not, specifically consider whether it was probable that a reasonable and informed third party would regard the objectives of the proposed Expert Witness Engagement as being inconsistent with the objectives of the audit of Ted Baker's financial statements. The primary purpose of an audit is to enhance the degree of confidence of intended users in the financial statements. The Expert Witness Engagement would be inconsistent with that objective, because KPMG would be evaluating its own work, thereby threatening the perception of its independence. As a result, the Respondents failed to conclude (as they should have done) that a reasonable and informed third party would regard the objectives of the audit and the Expert Witness Engagement as being inconsistent, and consequently that the Expert Witness Engagement should not have been taken on.

72.2 The Respondents should have, but did not, specifically identify the relevance of Ethical Standard 5 paragraph 110(a). As a result, they failed to conclude that the Expert Witness Engagement was expressly prohibited and should not have been taken on.

72.3 The Respondents should have, but did not, adequately identify and assess the significance of the self-review threat from the proposed engagement to KPMG's objectivity and independence. Consequently, they failed to conclude that the self-review threat posed from taking on the Expert Witness Engagement could not be eliminated or reduced to an acceptable level, and consequently should not have been taken on.

72.4 The Respondents should have, but did not, adequately identify and assess the significance of the potential self-interest threat from the proposed engagement to KPMG's objectivity and independence. The work was to be carried out at an hourly rate and there was scope for the extent of work required (and consequently the fees to be earned) in respect of a major piece of commercial litigation to increase from that envisaged at the outset.

73. As a result, the Respondents failed to comply with Ethical Standard 5 paragraph 17 and ISA 220 paragraph 11, and thereby failed to act in accordance with Fundamental Principle (c) 'Professional Competence and Due Care'.

(B) THE 2013 AUDIT

Allegation 3 – Lack of independence during the 2013 Audit

3. The conduct of KPMG and Mr Barradell fell significantly short of the standards reasonably to be expected of, respectively, a Member Firm and a Member in that, by the conclusion of their audit of Ted Baker's accounts for FY13, they should have concluded that:

(i) KPMG was not independent, in that it was probable that a reasonable and informed third party would conclude that its objectivity either was impaired or was likely to be impaired; and

(ii) The threats to KPMG's independence could not be addressed.

In failing so to conclude, and continuing instead to give their audit opinion, they failed to comply with Ethical Standard 1 paragraphs 6 and 54, and thereby failed to act in accordance with Fundamental Principle (c) 'Professional Competence and Due Care'.

Particulars

74. At the conclusion of the 2013 Audit, KPMG and Mr Barradell stated to the Audit Committee in a letter dated 21 March 2013 that KPMG was independent within the meaning of regulatory and professional requirements. In fact, the Respondents were not in a position to come to that conclusion, and should instead have concluded that KPMG was not independent, and that any threats to its independence could not be addressed. This was because of the following matters:

74.1 The Expert Witness Engagement was a prohibited service pursuant to Ethical Standard 5 paragraph 110(a), and posed a self-review threat to KPMG's independence which could not be adequately addressed, and consequently should not have been taken on by KPMG (for the reasons given above).

74.2 By the conclusion of the 2013 Audit:

(a) A self-review threat had transpired, because, in order properly to conduct their audit, the Respondents were reviewing work carried out by the KPMG Expert; and

(b) A self-interest threat had also arisen, because the total non-audit fees incurred by KPMG had reached £243,000 – more than double the audit fee – and, with the trial more than a year away, there was a real risk that the KPMG Expert would be continuing to incur materially more fees in future. Although this self-interest threat on its own was not enough, in the circumstances of this case, to constitute a lack of independence, it should have been considered cumulatively with the other threats to KPMG's independence.

75. The Respondents should have concluded, but did not, that KPMG was not independent (in that it was probable that a reasonable and informed third party would conclude that KPMG's objectivity either was impaired or was likely to be impaired), and that the threats to its independence could not be addressed. In failing to reach that conclusion, and continuing instead to give their audit opinion, they failed to comply with Ethical Standard 1 paragraphs 6 and 54, and failed to act in accordance with Fundamental Principle (c) 'Professional Competence and Due Care'.

76. For the avoidance of doubt, the Executive Counsel does not allege that KPMG or Mr Barradell in fact lacked objectivity or integrity.

Allegation 4 – Communication with Ted Baker during the 2013 Audit

4. The conduct of KPMG and Mr Barradell fell significantly short of the standards reasonably to be expected of, respectively, a Member Firm and a Member in that during their audit of Ted Baker's accounts for FY13 they failed to ensure that those charged with governance of Ted Baker were informed of all significant facts and matters that impacted upon KPMG's objectivity and independence as auditor, whether on a timely basis or at all. As a result, the Respondents failed to act in accordance with Ethical Standard 1 paragraph 63 and Ethical Standard 5 paragraph 48(a), and thereby failed to act in accordance with Fundamental Principle (c) 'Professional Competence and Due Care'.

Particulars

77. Each of the following comprised significant facts and matters that impacted upon KPMG's independence as auditor, both individually and collectively:

77.1 The Expert Witness Engagement was prohibited by Ethical Standard 5 paragraph 110(a).

77.2 The Expert Witness Engagement posed a self-review threat to KPMG's independence which could not be reduced to acceptable levels.

77.3 By the conclusion of the 2013 Audit, a self-review threat had in fact transpired, in that KPMG was reviewing the results of its own work.

77.4 By the conclusion of the 2013 Audit the total level of non-audit fees incurred by KPMG, which were more than double the audit fee and as to which there was a real risk that the KPMG Expert would be continuing to incur materially more fees in future, comprised a self-interest threat.

78. As a result, in conducting the 2013 Audit, KPMG was not independent, in that it was probable that a reasonable and informed third party would conclude that its objectivity either was impaired or was likely to be impaired (although, for the avoidance of doubt, it is not alleged that KPMG or Mr Barradell in fact lacked objectivity)..

79. However, KPMG and Mr Barradell did not ensure that those charged with governance of Ted Baker were informed of any of the matters set out above, whether on a timely basis

or at all (although they did ensure that those charged with governance of Ted Baker were informed of the total level of non-audit fees incurred by KPMG). As a result, they failed to act in accordance with Ethical Standard 1 paragraph 63 and Ethical Standard 5 paragraph 48(a), and thereby failed to act in accordance with Fundamental Principle (c) 'Professional Competence and Due Care'.

Allegation 5 – Monitoring of the Expert Witness Engagement in FY13

5. The conduct of KPMG and Mr Barradell fell significantly short of the standards reasonably to be expected of, respectively, a Member Firm and a Member in that during FY13 they failed to provide the Ethics Partner with details of the fees for non-audit services, or discuss them with him, until those fees had already exceeded KPMG's audit fees. In so doing the Respondents failed to comply with Ethical Standard 5 paragraph 28, and failed to act in accordance with Fundamental Principle (c) 'Professional Competence and Due Care'.

Particulars

80. As set out at paragraphs 38 to 40 above, during the 2013 Audit it came to Mr Barradell's attention that the total fees incurred by the KPMG Expert during FY13 had exceeded the audit fee of £110,000. Permission for those fees to exceed the original fee estimate of £100,000 had not been sought from Mr Barradell.

81. The total non-audit fees for FY13 were £243,000, well in excess of the audit fees of £110,000. They had thereby exceeded the 1:1 ratio of non-audit to audit fees. This meant that the 'approval' which Mr Barradell sought from M7 to incur those non-audit fees would be retrospective only, and M7 was unable to prevent those non-audit fees from being incurred in advance.

82. In those circumstances, the Respondents failed to comply with Ethical Standard 5 paragraph 28, and failed to act in accordance with Fundamental Principle (c) 'Professional Competence and Due Care'.

(C) THE 2014 AUDIT

Allegation 6 – Lack of independence during the 2014 Audit

6. The conduct of KPMG and Mr Barradell fell significantly short of the standards reasonably to be expected of, respectively, a Member Firm and a Member in that, by the conclusion of their audit of Ted Baker's accounts for FY14, they should have concluded that:

(i) KPMG was not independent, in that it was probable that a reasonable and informed third party would conclude that its objectivity either was impaired or was likely to be impaired; and

(ii) The threats to KPMG's independence could not be addressed.

In failing so to conclude, and continuing instead to give their audit opinion, they failed to comply with Ethical Standard 1 paragraphs 6 and 54, and thereby failed to act in accordance with Fundamental Principle (c) 'Professional Competence and Due Care'.

Particulars

83. At the conclusion of the 2014 Audit, KPMG and Mr Barradell represented to the Audit Committee in writing that KPMG was independent within the meaning of applicable regulatory and professional requirements. In fact, they were not in a position to come to that conclusion, and should instead have concluded that KPMG was not independent, and that any threats to its independence could not be addressed. This was because of the following matters:

83.1 The Expert Witness Engagement was a prohibited service pursuant to Ethical Standard 5 paragraph 110(a), and posed a self-review threat to KPMG's independence which could not be adequately addressed, and consequently should not have been taken on by KPMG (for the reasons given above).

83.2 By the conclusion of the 2014 Audit:

(a) A self-review threat had transpired, because, in order properly to conduct their audit, the Respondents were reviewing work carried out by the KPMG Expert; and

(b) A self-interest threat had also arisen, because the total non-audit fees incurred by KPMG had reached £337,000 – two and a half times the audit fee – and KPMG knew from as early as 25 September 2013 that significant further work would be required during FY14. Although this self-interest threat on its own was not enough, in the circumstances of this case, to constitute a lack of independence, it should have been considered cumulatively with the other threats to KPMG's independence.

84. As a result, the Respondents should have concluded, but did not, that KPMG was not independent (in that it was probable that a reasonable and informed third party would conclude that KPMG's objectivity either was impaired or was likely to be impaired), and that the threats to its independence could not be addressed. In failing to reach that conclusion, and continuing instead to give their audit opinion, they failed to comply with Ethical Standard 1 paragraphs 6 and 54, and failed to act in accordance with Fundamental Principle (c) 'Professional Competence and Due Care'.

85. For the avoidance of doubt, the Executive Counsel does not allege that KPMG or Mr Barradell in fact lacked objectivity or integrity.

Allegation 7 – Communication with Ted Baker during the 2014 Audit

7. The conduct of KPMG and Mr Barradell fell significantly short of the standards reasonably to be expected of, respectively, a Member Firm and a Member in that during their audit of Ted Baker's accounts for FY14 they failed to ensure that those charged with governance of Ted Baker were informed of all significant facts and matters that impacted upon KPMG's objectivity and independence as auditor, whether on a timely basis or at all. As a result, the Respondents failed to act in accordance with Ethical Standard 1 paragraph 63 and Ethical Standard 5 paragraph 48(a), and thereby failed to act in accordance with Fundamental Principle (c) 'Professional Competence and Due Care'.

Particulars

86. Each of the following comprised significant facts and matters that impacted upon KPMG's independence as auditor, both individually and collectively:

86.1 The Expert Witness Engagement was prohibited by Ethical Standard 5 paragraph 110(a).

86.2 The Expert Witness Engagement posed a self-review threat to KPMG's independence which could not be reduced to acceptable levels.

86.3 By the conclusion of the 2014 Audit, a self-review threat had in fact transpired, in that KPMG was reviewing the results of its own work.

86.4 By the conclusion of the 2014 Audit the total level of non-audit fees incurred by KPMG, which were more than double the audit fee and as to which there was a real risk that the KPMG Expert would be continuing to incur materially more fees in future, comprised a self-interest threat.

87. As a result, in conducting the 2014 Audit, KPMG was not independent, in that it was probable that a reasonable and informed third party would conclude that its objectivity either was impaired or was likely to be impaired (although, for the avoidance of doubt, it is not alleged that KPMG or Mr Barradell in fact lacked objectivity). However, KPMG and Mr Barradell did not ensure that those charged with governance of Ted Baker were informed of any of the matters set out above, whether on a timely basis or at all (although they did ensure that those charged with governance of Ted Baker were informed of the

total level of non-audit fees incurred by KPMG). As a result, they failed to act in accordance with Ethical Standard 1 paragraph 63 and Ethical Standard 5 paragraph 48(a), and thereby failed to act in accordance with Fundamental Principle (c) ‘Professional Competence and Due Care’.

<u>Allegation 8 – Monitoring of the Expert Witness Engagement in FY14</u>

8. The conduct of KPMG and Mr Barradell fell significantly short of the standards reasonably to be expected of, respectively, a Member Firm and a Member in that during FY14 they failed to provide the Ethics Partner with details of the fees for non-audit services, or discuss them with him, until those fees had already exceeded KPMG's audit fees. In so doing the Respondents failed to comply with Ethical Standard 5 paragraph 28, and failed to act in accordance with Fundamental Principle (c) 'Professional Competence and Due Care'.

<u>Particulars</u>

88. As set out at paragraphs 52 to 58 above, during the 2014 Audit it came to Mr Barradell's attention that the total fees incurred by the KPMG Expert during FY14 had exceeded the audit fee of £135,000. Permission for those fees to be incurred had not been sought from Mr Barradell in advance. The breach was felt sufficiently serious within KPMG that M5, a Forensic Risk Partner, advised that KPMG Forensic should suspend all work until the issue had been resolved.

89. The total non-audit fees for FY14 were £337,000, well in excess of the audit fees of £135,000 and thereby exceeding the 1:1 ratio of non-audit to audit fees. This meant that the 'approval' which Mr Barradell sought from M7 would be retrospective only, and M7 was unable to prevent those non-audit fees from being incurred in advance.

90. In those circumstances, the Respondents failed to comply with Ethical Standard 5 paragraph 28, and failed to act in accordance with Fundamental Principle (c) 'Professional Competence and Due Care'.

ANNEX A

Extracts from the applicable standards of conduct

ICAEW's Code of Ethics (effective 1 January 2011)

100.5 A professional accountant shall comply with the following fundamental principles:

(c) **Professional Competence and Due Care** – to maintain professional knowledge and skill at the level required to ensure that a client or employer receives competent professional services based on current developments in practice, legislation and techniques and act diligently and in accordance with applicable technical and professional standards.

100.6 The circumstances in which professional accountants operate may create specific threats to compliance with the fundamental principles. It is impossible to define every situation that creates threats to compliance with the fundamental principles and specify the appropriate action. In addition, the nature of engagements and work assignments may differ and, consequently, different threats may be created, requiring the application of different safeguards. Therefore, this Code establishes a conceptual framework that requires a professional accountant to identify, evaluate, and address threats to compliance with the fundamental principles. The conceptual framework approach assists professional accountants in complying with the ethical requirements of this Code and meeting their responsibility to act in the public interest. It accommodates many variations in circumstances that create threats to compliance with the fundamental principles and can deter a professional accountant from concluding that a situation is permitted if it is not specifically prohibited.

100.7 When a professional accountant identifies threats to compliance with the fundamental principles and, based on an evaluation of those threats, determines that they are not at an acceptable level, the professional accountant shall determine whether appropriate safeguards are available and can be applied to eliminate the threats or reduce them to an acceptable level. In making that determination, the professional accountant shall exercise professional judgment and take into account whether a reasonable and informed third party, weighing all the specific facts and circumstances available to the professional accountant at the time, would be likely to conclude that the threats would be eliminated or reduced to an acceptable level by the application of the safeguards, such that compliance with the fundamental principles is not compromised.

100.8 A professional accountant shall evaluate any threats to compliance with the fundamental principles when the professional accountant knows, or could reasonably be expected to know, of circumstances or relationships that may compromise compliance with the fundamental principles.

100.9 A professional accountant shall take qualitative as well as quantitative factors into account when evaluating the significance of a threat. When applying the conceptual framework, a professional accountant may encounter situations in which threats cannot be eliminated or reduced to an acceptable level, either because the threat is too significant or because appropriate safeguards are not available or cannot be applied. In such situations, the professional accountant shall decline or discontinue the specific professional service involved or, when necessary, resign from the engagement (in the case of a professional accountant in public practice) or the employing organisation (in the case of a professional accountant in business).

100.12 Threats may be created by a broad range of relationships and circumstances. When a relationship or circumstance creates a threat, such a threat could compromise, or could be perceived to compromise, a professional accountant's compliance with the fundamental principles. A circumstance or relationship may create more than one threat, and a threat may affect compliance with more than one fundamental principle. Threats fall into one or more of the following categories:

(a) Self-interest threat ─ the threat that a financial or other interest will inappropriately influence the professional accountant's judgment or behaviour;

(b) Self-review threat ─ the threat that a professional accountant will not appropriately evaluate the results of a previous judgment made or service performed by the professional accountant, or by another individual within the professional accountant's firm or employing organisation, on which the accountant will rely when forming a judgment as part of providing a current service;

APB Ethical Standard 1 'Integrity, Objectivity and Independence' (revised December 2010, updated December 2011)

6 Auditors shall conduct the audit of the financial statements of an entity with integrity, objectivity and independence.

10 Objectivity is a state of mind that excludes bias, prejudice and compromise and that gives fair and impartial consideration to all matters that are relevant to the task in hand, disregarding those that are not. Like integrity, objectivity is a fundamental ethical principle and requires that the auditor's judgment is not affected by conflicts of interest.

13 Independence is freedom from situations and relationships which make it probable that a reasonable and informed third party would conclude that objectivity either is impaired or could be impaired. Independence is related to and underpins objectivity. However, whereas objectivity is a personal behavioural characteristic concerning the auditor's state of mind, independence relates to the circumstances surrounding the audit, including the financial, employment, business and personal relationships between the auditor and the audited entity and its connected parties. Relationships with parties whose interests may be contrary to the interests of the audited entity (for example, a hostile bidder) may also be relevant to the appearance of the auditor's independence.

14 The need for independence arises because, in most cases, users of the financial statements and other third parties do not have all the information necessary for judging whether the auditor is, in fact, objective. Although the auditor may be satisfied that the auditor's objectivity is not impaired by a particular situation, a third party may reach a different conclusion. For example, if a third party were aware that the auditor had certain financial, employment, business or personal relationships with the audited

entity, that individual might reasonably conclude that the auditor could be subject to undue influence from the directors or would not be impartial or unbiased. Public confidence in the auditor's objectivity could therefore suffer as a result of this perception, irrespective of whether there is any actual impairment.

15 Accordingly, in evaluating the likely consequences of such situations and relationships, the test to be applied is not whether the auditor considers that the auditor's objectivity is impaired but whether it is probable that a reasonable and informed third party would conclude that the auditor's objectivity either is impaired or is likely to be impaired. As a result of the influence that the board of directors and management have over the appointment and remuneration of the auditor absolute independence cannot be achieved or maintained. The audit engagement partner considers the application of safeguards where there are threats to auditor independence (both actual and perceived).

28 Whenever a possible or actual breach of an APB Ethical Standard, or of policies and procedures established pursuant to the requirements of an APB Ethical Standard, is identified, the audit engagement partner, in the first instance, and the Ethics Partner, where appropriate, assesses the implications of the breach, determines whether there are safeguards that can be put in place or other actions that can be taken to address any potential adverse consequences and considers whether there is a need to resign from the audit engagement.

35 The principal types of threats to the auditor's objectivity and independence are:

self-interest threat: A self-interest threat arises when the auditor has financial or other interests which might cause the auditor to be reluctant to take actions that would be adverse to the interests of the audit firm or any individual in a position to influence the conduct or outcome of the audit (for example, where the auditor has an investment in the audited entity, is seeking to provide additional services to the audited entity or needs to recover long-outstanding fees from the audited entity).

self-review threat: A self-review threat arises when the results of a non-audit service performed by the auditor or by others within the audit firm are reflected in the amounts included or disclosed in the financial statements (for example, where the audit firm has been involved in maintaining the accounting records, or undertaking valuations that are incorporated in the financial statements). In the course of the audit, the auditor may need to re-evaluate the work performed in the non-audit service. As, by virtue of providing the non-audit service, the audit firm is associated with aspects of the preparation of the financial statements, the auditor may be (or may be perceived to be) unable to take an impartial view of relevant aspects of those financial statements

54 At the end of the audit process, when forming an opinion but before issuing the report on the financial statements, the audit engagement partner shall reach an overall conclusion that any threats to objectivity and independence on an individual and cumulative basis have been properly addressed in accordance with APB Ethical Standards. If the audit engagement partner cannot make such a conclusion, he or she shall not report and the audit firm shall resign as auditor.

55 In addition to assessing individual threats to auditor objectivity and independence, the audit engagement partner assesses the cumulative impact of all the threats identified on the audit engagement so as to reach a conclusion that the threats identified, when viewed individually and cumulatively, have been reduced to an acceptable level through the application of safeguards.

63 The audit engagement partner shall ensure that those charged with governance of the audited entity are appropriately informed on a timely basis of all significant facts and matters that bear upon the auditor's objectivity and independence.

APB Ethical Standard 5 'Non-Audit Services Provided to Audited Entities' (revised December 2010, updated December 2011)

17 Before the audit firm accepts a proposed engagement to provide a non-audit service, the audit engagement partner shall:

(a) consider whether it is probable that a reasonable and informed third party would regard the objectives of the proposed engagement as being inconsistent with the objectives of the audit of the financial statements; and

(b) identify and assess the significance of any related threats to the auditor's objectivity, including any perceived loss of independence; and

(c) identify and assess the effectiveness of the available safeguards to eliminate the threats or reduce them to an acceptable level.

28 In the case of listed companies where the fees for non-audit services for a financial year are expected to be greater than the annual audit fees, the audit engagement partner shall provide details of the circumstances to the Ethics Partner and discuss them with him or her. Where the audit firm provides audit services to a group, the obligation to provide information to the Ethics Partner shall be on a group basis for all services provided by the audit firm and its network firms to all entities in the group.

48 The audit engagement partner shall ensure that those charged with governance of the audited entity are appropriately informed on a timely basis of:

(a) all significant facts and matters that bear upon the auditor's objectivity and independence, related to the provision of non-audit services, including the safeguards put in place

109 Although management and advocacy threats may arise in litigation support services, such as acting as an expert witness, the primary issue is that a self-review threat will arise in all cases where such services involve a subjective estimation of the likely outcome of a matter that is material to the amounts to be included or the disclosures to be made in the financial statements.

110 The audit firm shall not undertake an engagement to provide litigation support services to:

(a) an audited entity that is a listed company or a significant affiliate of such an entity, where this would involve the estimation by the audit firm of the likely outcome of a pending legal matter that could be material to the amounts to be included or the disclosures to be made in the listed company's financial statements, either separately or in aggregate with other estimates and valuations provided;

ANNEX B

Extracts from the applicable auditing standards

ISA 220: Quality control for an audit of financial statements

7 For purposes of the ISAs (UK and Ireland), the following terms have the meanings attributed below:

(a) Engagement partner – The partner or other person in the firm who is responsible for the audit engagement and its performance, and for the auditor's report that is issued on behalf of the firm, and who, where required, has the appropriate authority from a professional, legal or regulatory body.

8 The engagement partner shall take responsibility for the overall quality on each audit engagement to which that partner is assigned.

11 The engagement partner shall form a conclusion on compliance with independence requirements that apply to the audit engagement. In doing so, the engagement partner shall:

(a) Obtain relevant information from the firm and, where applicable, network firms, to identify and evaluate circumstances and relationships that create threats to independence;

(b) Evaluate information on identified breaches, if any, of the firm's independence policies and procedures to determine whether they create a threat to independence for the audit engagement; and

(c) Take appropriate action to eliminate such threats or reduce them to an acceptable level by applying safeguards, or, if considered appropriate, to withdraw from the audit engagement, where withdrawal is possible under applicable law or regulation. The engagement partner shall promptly report to the firm any inability to resolve the matter for appropriate action.

15 The engagement partner shall take responsibility for:

(a) The direction, supervision and performance of the audit engagement in compliance with professional standards and applicable legal and regulatory requirements; and

(b) The auditor's report being appropriate in the circumstances.

ANNEX C

Extracts from IAS 37

'Provisions, Contingent Liabilities and Contingent Assets'

31 An entity shall not recognise a contingent asset.

32 Contingent assets usually arise from unplanned or other unexpected events that give rise to the possibility of an inflow of economic benefits to the entity. An example is a claim that an entity is pursuing through legal processes, where the outcome is uncertain.

33 Contingent assets are not recognised in financial statements since this may result in the recognition of income that may never be realised. However, when the realisation of income is virtually certain, then the related asset is not a contingent asset and its recognition is appropriate.

34 A contingent asset is disclosed, as required by paragraph 89, where an inflow of economic benefits is probable.

89 Where an inflow of economic benefits is probable, an entity shall disclose a brief description of the nature of the contingent assets at the end of the reporting period, and, where practicable, an estimate of their financial effect, measured using the principles set out for provisions in paragraphs 36–52.

91 Where any of the information required by paragraphs 86 and 89 is not disclosed because it is not practicable to do so, that fact shall be stated.