IN THE MATTER OF

THE EXECUTIVE COUNSEL TO THE FINANCIAL REPORTING COUNCIL

-and-

(1) KPMG LLP

(2) STUART PETER JAMES SMITH

FINAL SETTLEMENT DECISION NOTICE

Pursuant to Rule 108 of the Audit Enforcement Procedure

This Final Settlement 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 17 June 2016 (as amended 5 January 2022). 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 Settlement Decision Notice* we adopt the following definitions:

"**the Company**" means Luceco Plc.
"**FY2015**" means the year ended 31 December 2015.
"**FY2016**" means the year ended 31 December 2016.
"**FY2016 financial statements**" means the financial statements of the Company for FY2016.

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

"**FY2017**" means the year ended 31 December 2017.

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

"**FY2017 Audit**" means the *Statutory Audit* of the FY2017 financial statements.

"**the Group**" means the group of companies wholly owned by the Company (directly or through intermediate companies) in FY2016.

"**ISAs**" means the International Standards on Auditing (UK and Ireland) for periods on or after 15 December 2010.

1.3. In this *Final Settlement Decision Notice*, KPMG LLP ("**KPMG**"), and Mr Stuart Peter James Smith ("**Mr Smith**"), a former director of KPMG, are referred to collectively as the "**Respondents**". KPMG was the *Statutory Audit Firm* for the Company for FY2016. At all material times Mr Smith was a director of KPMG, a member of the Institute of Chartered Accountants of England and Wales ("**ICAEW**") and the *Statutory Auditor* of the Company for FY2016. He held *Responsible Individual* status on the FY2016 Audit and signed the relevant audit report on behalf of KPMG.

1.4. In accordance with Rule 102 of the AEP, Executive Counsel entered into settlement discussions with the Respondents.

1.5. A *Proposed Settlement Decision Notice* was issued by Executive Counsel on 22 December 2022 pursuant to Rule 103 of the AEP in relation to the conduct of the Respondents in respect of the FY2016 Audit. The Respondents provided written agreement to the *Proposed Settlement Decision Notice*, pursuant to Rule 105 of the AEP, on 4 January 2023. The *Convener* subsequently appointed an *Independent Reviewer*, pursuant to Rule 106 of the AEP, to consider the *Proposed Settlement Decision Notice.*

1.6. On 25 January 2022, the *Independent Reviewer* approved the issuance of a *Final Settlement Decision Notice* pursuant to Rule 107(a) of the AEP.

1.7. In accordance with Rule 108 of the AEP this *Final Settlement Decision Notice* sets out:

1.7.1. the breaches of *Relevant Requirements* with reasons;

1.7.2. the *Sanctions* imposed on the Respondents with reasons; and

1.7.3. the amount payable by the Respondents in respect of Executive Counsel's costs.

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

Section 2: Executive Summary of the breaches of *Relevant Requirements*

Section 3: Background

Section 4: *Relevant Requirements* to which the breaches relate

Section 5: Details of the breaches of *Relevant Requirements*

Section 6: *Sanctions*

Section 7: *Costs*

2. EXECUTIVE SUMMARY OF THE BREACHES OF RELEVANT REQUIREMENTS

2.1. The breaches of *Relevant Requirements* in this *Final Settlement Decision Notice* relate to the FY2016 Audit.

2.2. During FY2016, the Company was the ultimate parent of a group of companies engaged in the business of producing and distributing lighting products and wiring accessories. Its brands included Luceco and Masterplug. The Company's subsidiaries included a production and manufacturing company in China, subsidiaries in Europe and Dubai, and two distribution companies in the UK.

2.3. The Company was incorporated on 11 October 2004, was admitted to the premium list of the London Stock Exchange ("**LSE**") on 17 October 2016 and was therefore a Public Interest Entity ("**PIE**") for the purposes of the AEP.

2.4. The operations of the Group in FY2016 included a large number of transactions between the Group companies. The manner in which the Group accounted for these intercompany transactions led to material misstatements in the FY2016 financial statements (audit materiality for FY2016 being £714,000). As to this:

2.4.1. The reconciliation of intercompany transactions was carried out using standalone spreadsheets rather than an automated and integrated process.

2.4.2. The Respondents audited that reconciliation using an intercompany matrix, but this matrix did not contain all of the group intercompany balances.

2.4.3. The Respondents additionally tested the sole material intercompany balance not included in the matrix as part of the audit work on supplier statement reconciliations. However, that testing was designed for a different purpose (to test whether balances in the creditors' ledger reconciled to the balance from the supplier), and thereby could not provide sufficient evidence that all intercompany balances appropriately netted off to nil. In addition, during the execution of the work on that balance, the Respondents did not test a number of material reconciling items.

2.4.4. Those intercompany balances that were included on the matrix did broadly reconcile. To account however for the intercompany balances not included in

the matrix, the Group's management made an adjustment, to eliminate the intercompany element of trade payable and trade receivable balances in the consolidated balance sheet, by posting a consolidation journal through intercompany accounts, in the sum of £4.459m. The Respondents carried out no testing of this material adjustment back to the UK payables position.

2.4.5. Further, a number of intercompany balances related to intra-Group trading in respect of sales of goods shipped to UK third party customers. These sales were referred to as "FoB" transactions as they occurred on a "Free on Board" basis. There was a timing difference in the accounting treatment of the intercompany element of these sales.

2.4.6. The accounting for each of these sales included one sales transaction between the third party and the relevant Group entity, and one intercompany transaction between the manufacturing entity in China and the Group entity that recorded the sale to the third party. The intercompany transactions should have been recognised by both entities as occurring on the same date, however, the Group entity recording the sale to the third party and the related intercompany purchase did so at the point that the goods were received by the relevant shipping agent, while the Group manufacturing entity in China used the date of the actual shipment. This meant that there were intercompany purchases recognised in the UK which had not yet been recognised as intercompany sales in China. This led to an asymmetry in the intercompany balances, a number of which did not reconcile because they fell on different sides of the balance sheet cut-off (a "cut-off error").

2.4.7. A consolidation adjustment was required to align the respective accounting treatments and sale dates, however, an error was made by the Company in the consolidation journal, which was not detected by the audit team. The adjustment made reflected the profit that would have been earned in China had the Chinese entity recognised these intercompany sales, however, there was no corresponding balance sheet adjustment to align the different timing of transactions in the UK and China. As a result, inventory and intercompany payables were overstated by an equal amount.

2.4.8. These matters led to a prior year restatement in the FY2017 financial statements, increasing the amount of trade payables by £2.4m (made up of £3.7m relating to the intercompany reconciliation issues referred to in paragraphs 2.4.3 and 2.4.4, less £1.3m relating to the FoB issue referred to in paragraphs 2.4.5 to 2.4.7).

2.5. The Group's intercompany transactions included the sale of stock from its Chinese manufacturing company to its subsidiaries. This stock was shipped to UK distributors, or overseas distributors, or direct to customers.

2.6. The Group also held quantities of inventory, which was valued as part of the Group's accounting processes. KPMG's audit of this area in FY2016 recognised the risk that stock might be overvalued. The Respondents noted (in the Report to the Audit Committee on the Audit Plan and Strategy for FY2016) that prior years' accounts had needed adjustments to ensure that stock purchased from the Group's Chinese production site was capitalised at the correct cost. They also raised an internal control issue regarding the complexity of the process of costing inventory carried out by the Group. The FY2016 financial statements nonetheless contained errors in the assessment of the cost of inventory leading to a prior year restatement in the FY2017 financial statements. Essentially:

2.6.1. There was an incorrect absorption of overhead costs in China into the cost of products purchased by the Group's UK distributors. The cost of stock held by Group companies but manufactured by the Chinese manufacturing company required an increase, by way of a fixed percentage, in order to comply with International Financial Reporting Standards ("**IFRS**")[1] (an 'uplift' adjustment). An uplift of 16% was applied, whereas the correct figure (and one consistent with the treatment of overhead costs in FY2015) was 8.91%.

2.6.2. There was a further error in applying the uplift to all UK stock, not only the UK stock that was manufactured by the Group's Chinese manufacturing company.

2.6.3. The cut-off error referred to in paragraph 2.4.6 above also impacted on the valuation of inventory.

2.6.4. The Group's inventory was accordingly overvalued in the FY2016 financial statements by £3.1m.

2.7. The breaches of *Relevant Requirements* are organised by reference to these two areas:

2.7.1. intercompany transactions and year end intercompany balances; and

2.7.2. accuracy of the cost of inventory and year end inventory balances.

Breaches relating to the audit of intercompany transactions and year end intercompany balances

Breach 1: The Respondents' conduct constituted a breach of ISA 500.6, in that the Respondents failed to design and perform appropriate audit procedures for the purpose

[1] As adopted by the EU

of obtaining sufficient appropriate audit evidence in respect of intercompany transactions and year end intercompany balances.

Breach 2: The Respondents' conduct constituted a breach of ISA 230.8, in that the Respondents failed to prepare audit documentation that was sufficient to enable an experienced auditor, having no previous connection with the audit, to understand the audit procedures performed, the results of those procedures and the audit evidence obtained, as well as any conclusions reached and judgements made in respect of significant matters arising during the audit of intercompany transactions and year end intercompany balances.

Breach 3: The Respondents' conduct constituted a breach of ISA 330.26 and 330.27, in that the Respondents failed to: (i) conclude that sufficient appropriate audit evidence had not been obtained, in respect of intercompany transactions and year end intercompany balances; and, either (ii) attempt to obtain further audit evidence of that area, or (iii) express a qualified opinion or disclaim an opinion on the financial statements, in circumstances where they had been unable to obtain sufficient appropriate audit evidence of that area.

Breach 4: The Respondents' conduct constituted a breach of ISA 200.15 in that the Respondents failed to exercise professional scepticism in relation to the audit of the intercompany transactions and year end intercompany balances.

Breaches relating to the audit of the accuracy of the cost of inventory and year end inventory balances

Breach 5: The Respondents' conduct constituted a breach of ISA 500.6, in that the Respondents failed to design and perform appropriate audit procedures for the purpose of obtaining sufficient appropriate audit evidence in respect of the cost of inventory and year end inventory balances.

Breach 6: The Respondents' conduct constituted a breach of ISA 230.8, in that the Respondents failed to prepare audit documentation that was sufficient to enable an experienced auditor, having no previous connection with the audit, to understand the audit procedures performed, the results of those procedures and the audit evidence obtained, as well as any conclusions reached and judgements made in respect of significant matters arising during the audit of the cost of inventory and year end inventory balances.

Breach 7: The Respondents' conduct constituted a breach of ISA 330.26 and 330.27, in that the Respondents failed to: (i) conclude that sufficient appropriate audit evidence

had not been obtained, in respect of the cost of inventory and year end inventory balances; and, either (ii) attempt to obtain further audit evidence of those areas, or (iii) express a qualified opinion or disclaim an opinion on the financial statements, in circumstances where they had been unable to obtain sufficient appropriate audit evidence of that area.

Breach 8: The Respondents' conduct constituted a breach of ISA 200.15, in that the Respondents failed to exercise professional scepticism in relation to the audit of the cost of inventory and year end inventory balances.

Sanctions

2.8. This *Final Settlement Decision Notice* sets out the following *Sanctions* imposed on the Respondents.

KPMG

2.8.1. A declaration that, as a result of the breaches of *Relevant Requirements* set out in this *Final Settlement Decision Notice*, the audit report for the FY2016 Audit 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.

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

2.8.3. An order pursuant to Rule 136(c) of the AEP, requiring KPMG to take action to prevent the recurrence of the breach of the *Relevant Requirements*. In summary, within 3 months of the date of this Final Settlement Decision Notice, KPMG is to provide Executive Counsel and the FRC Executive Director for Supervision with a report which identifies why it considers that the breaches occurred, why the firm's processes and controls did not prevent the breaches and whether the firm's current processes would lead to a different outcome, and any further remedial action proposed. Thereafter, the firm shall implement such remedial action as is proposed by Executive Counsel and the Executive Director for Supervision in light of the report, by a date to be agreed between KPMG and the FRC.

2.8.4. A financial sanction of £1,250,000, discounted for admissions and early disposal by 30% to £875,000.

Mr Smith

2.8.5. A declaration that, as a result of the breaches of *Relevant Requirements* set out in this *Final Settlement Decision Notice*, the audit report for the FY2016 Audit did not satisfy the requirement in regulation 4(1) of SATCAR that a *Statutory Audit* must be conducted in accordance with relevant standards.

2.8.6. A published statement that Mr Smith has contravened the *Relevant Requirements*, in the form of a severe reprimand.

2.8.7. A financial sanction of £50,000, discounted for admissions and early disposal by 30% 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 £2,433 million in 2021 (the latest year for which figures are available). Of this, £646 million was derived from audit work. As at 2021, there were 311 *Statutory Auditors* within KPMG entitled to sign audit opinions, and 533 partners across all of the firm's functions. KPMG is a member firm of the ICAEW.[2]

3.2. KPMG was appointed as the *Statutory Audit Firm* for the Company with effect from the financial year ended 31 December 2014.

3.3. During FY2016 Mr Smith was an employee of KPMG, with the job title of Director and he was a *Statutory Auditor*. At all material times he was a member of the ICAEW. Mr Smith carried out the *Statutory Audits* of the Company's financial statements from 2014 until 2017. He signed the relevant audit report for the FY2016 financial statements in his own name, on behalf of KPMG.

3.4. 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 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.

[2] Figures taken from p.46 of Key Facts and Trends in the Accountancy Profession, FRC, July 2022.

The Company

3.5. In its Annual Report for FY2016, the Company described its operations as follows:

"Luceco is a rapidly growing manufacturer and distributor of high quality, innovative LED lighting products and wiring accessories supplying a global customer base. The Group supplies a blue chip and diversified customer base of trade distributors, retailers, wholesalers and project developers with a wide range of products which fall under the market leading brands of Luceco (LED Lighting), British General (Wiring Accessories), Masterplug (Portable Power) and Ross (AV Accessories).

Luceco operates a fully integrated model, which includes wholly-owned manufacturing and product development facilities in the UK and China … ."

3.6. The Company is the ultimate parent company of the Group, which consisted of 20 companies as at FY2016. These subsidiary companies include the following three, which are relevant to the breaches:

3.6.1. Nexus Electrical (Jiaxing) Limited **("NEJ")**, a Chinese company which manufactures electrical products and provides a large proportion of the products sold by the Group; and

3.6.2. Nexus Industries Limited **("Nexus")** and BG Electrical Limited **("BGE")**, both of which are UK distribution companies that acquired products from NEJ **(the "UK entities")**.

3.7. Between FY2015 and FY2017 the Group saw large expansion with revenue increasing by 29.8% in FY2016. During that same year the Group completed a major expansion of its manufacturing facility in China, owned by NEJ.

3.8. The Group prepared its financial statements to the 31 December year end, under the Companies Act 2006 and International Financial Reporting Standards as adopted by the EU (**"IFRS"**).

Impact of listing

3.9. In October 2016 the Company listed on the LSE. It therefore became a *Public Interest Entity* within the meaning of the AEP. As at 31 December 2016 it had a market capitalisation of £309 million and revenue of £134 million. As a newly-listed company, the Company needed to implement new governance procedures and a number of financial procedures and controls needed to be addressed.

3.10. The fact that the Company, during 2016, went through an IPO process meant that both

the Company's financial team and the Respondents needed to adjust their approach to the preparation and audit of the FY2016 financial statements, in order to reflect the additional expertise required and amount of work involved where a company is publicly, rather than privately, owned.

Approach to the FY2016 Audit

3.11. The audit team used by KPMG for the FY2016 Audit consisted of a number of the same individuals as in the previous year, before the Company became a listed entity, with Mr Smith having had longer-term involvement as the Responsible Individual for the Company's audits.

3.12. The members of that audit team, including Mr Smith, were aware from the previous year's audit that the Group had identified prior period errors in relation to inventory that had been restated as at 31 December 2015.

3.13. As part of the planning for the FY2016 Audit, the audit team identified and assessed risks of material misstatement and determined which of those risks they considered to be significant. Significant risks were identified in relation to recognition of revenue and related liabilities, management override of controls, capitalisation of development costs and the valuation of the Group's inventory. Neither intercompany balances nor the accuracy of the cost of inventory were identified as giving rise to significant risks of material misstatement.

3.14. The accuracy of the cost of inventory was classified as being an other area of audit focus (i.e. not presenting a significant risk of material misstatement but an area which, in the audit team's judgement, required some audit focus nonetheless). Intercompany balances were not classified as an other area of audit focus.

3.15. The overall materiality level set by the audit team for the audit of the Group was £714k, as disclosed in the audit report within the financial statements for FY2016. This was calculated as 4.5% of the total anticipated Group profit before tax, adjusted for one off fees in relation to the listing process, for FY2016. Performance materiality was set at 70% of overall materiality, i.e. at £500k.

Intercompany balances

3.16. The Group's operations in FY2016 included a large number of intercompany transactions. These intercompany transactions reflected the significant trading between entities within the Group in the ordinary course of business. Many of these transactions arose from the sale of products by NEJ, the principal manufacturing entity

in China, to the trading entities, Nexus or BGE. Not all of those products were shipped to Nexus or BGE; some were shipped direct to consumers. The mechanics of how the Group accounted for the trade between NEJ and the wider Group forms the basis of several of the breaches set out in this *Final Settlement Decision Notice*.

3.17. Whilst the intercompany transactions concerned were not inherently complex, the manner in which the Group handled the transactions increased the complexity of the reconciliation of intercompany accounting. For example, the Group's intercompany transactions were reconciled using standalone spreadsheets rather than an integrated automatic system. Further, intercompany balances were recorded in the Group's balance sheet in two different ways: in specific intercompany accounts and "trading balances" included in the trial balance (e.g. as suppliers in the creditors' ledger or as accruals for goods in transit). The reconciliation process was also made more complex by foreign exchange differences arising from the fact that the Group had entities in different jurisdictions. The balances were made to reconcile by management making adjustments to the UK balances that achieved a reconciliation to nil.

3.18. The FY2016 financial statements contained errors in the figures shown for intercompany balances.

Accuracy of Cost of inventory

3.19. The Group manufactured the majority of the products it sold, in production and manufacturing facilities in Jiaxing, China owed by NEJ. These products were then sold to other Group companies and third party entities, with significant quantities in FY2016 being sold to Nexus and BGE.

3.20. KPMG's Audit Strategy document for the Company in FY2016 explained that: "*KPMG consider the accuracy of inventory to be another area of audit focus due to complexities in the calculation of stock costing and associated inter-company transfer prices, leading to the risk of errors in the accuracy of year end inventory measurements …*".

3.21. The FY2016 financial statements contained errors in respect of the accuracy of year end inventory measurements. As set out in greater detail below, these arose from:

3.21.1. errors in the percentage of Chinese overhead costs that were included in the costs of stock held by Nexus and BGE at year end. This inclusion was achieved by means of an uplift to the cost of the product, known as the "**Jiaxing Uplift Adjustment**";

3.21.2. an error in applying the Jiaxing Uplift Adjustment to all UK stock, not only the

UK stock that was manufactured by NEJ; and

3.21.3. errors in the treatment of FOB sales, the dates for which were recognised differently by the UK entities and the Group's manufacturing entity in China. This issue also led to errors in the intercompany balances at year end.[3]

Restatements

3.22. On 30 April 2018, KPMG issued its Audit Opinion on the financial statements of the Company for FY2017, published the same day.

3.23. The FY2017 financial statements included restatements of previously reported figures, as a result of a number of prior period errors that had been identified by the Company's management. The Company's FY2017 Annual Report stated:

"*Following the identification of the issues announced in December 2017, the Group conducted a thorough review of its balance sheet and financial processes … . The review identified two issues:*

1. *Inventory was incorrectly valued, specifically, the amount of overhead absorbed into inventory in accordance with the Group's accounting policy was incorrectly calculated.*
2. *Inter-company balances were incorrectly reconciled, principally between the Group's manufacturing facility in China and its UK business.*

Both issues have now been resolved.
The review revealed that both errors existed in the Group's previously published financial statements. Comparative financial information in this report has therefore been restated in accordance with IAS 8 to correct these errors. ... The error in the inventory valuation had a further consequence upon the Group's performance in 2017 in that it masked the impact that currency and commodity prices were having on gross margins. … Both errors arose from a manual and complex process environment which has been impacted by the Group's recent rapid growth."

3.24. The restatements and reclassification made in the FY2017 financial statements of the Company are summarised in the following tables:

[3] The 2017 restatements also included a £0.2m foreign exchange revaluation, which was an adjustment identified by KPMG in FY2016 and applied in FY2017. It does not form part of the breaches of *Relevant Requirements* identified in this *Final Settlement Decision Notice*.

Consolidated statement of profit and loss account for the year ended 31 December 2016

	As previously reported £m	Restatement impact £m	As restated £m	Chinese costs to be included in COGS £m	31 December 2016 Restated £m
Revenue	133.7	-	133.7	-	133.7
Cost of Sales	(85.9)	(3.0)	(88.9)	(4.3)	(93.2)
Gross Profit	47.8	(3.0)	44.8	(4.3)	40.5
Distribution expenses	(11.0)		(11.0)		(11.0)
Administrative expenses	(21.9)		(21.9)	4.3	(17.6)
Operating profit	14.9	(3.0)	11.9		11.9
Net financing expense	(2.8)		(2.8)		(2.8)
Profit before tax	12.1	(3.0)	9.1		9.1
Tax	(2.5)		(2.5)		(2.5)
Profit after tax	**9.6**	**(3.0)**	**6.6**		**6.6**

Consolidated statement of financial position as at 31 December 2016

	As previously reported £m	Restatement impact £m	31 December 2016 Restated £m
Non-current assets	33.7	-	33.7
Inventories	38.5	(3.1)	35.4
Trade and other receivables	29.3	-	29.3
Cash and cash equivalents	4.1	-	4.1
Current assets	71.9	(3.1)	68.8
Interest bearing loans and borrowings	(21.6)	-	(21.6)
Trade and other payables	(33.0)	(2.4)	(35.4)
Other financial liabilities	(0.6)	-	(0.6)
Current liabilities	(55.2)	(2.4)	(57.6)
Non-current liabilities	(12.1)	-	(12.1)
Net assets	38.3	(5.5)	32.8

3.25. The effect of the restatements was to reduce profit after tax by £3 million (approximately 4.2 times audit materiality). The cumulative effect was to decrease the Group's net assets, as reported at 31 December 2016, by £5.5 million (approximately 7.7 times audit materiality).[4]

4. RELEVANT REQUIREMENTS TO WHICH THE BREACHES 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 Settlement Decision Notice* are the following:

ISA 200 (Overall Objectives of the Independent Auditor and the Conduct of an Audit)
ISA 230 (Audit Documentation)
ISA 330 (The Auditor's Responses to Assessed Risks)
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 breaches are set out in an Appendix to this *Final Settlement Decision Notice*.

4.4. As the Senior *Statutory Auditor* responsible for the FY2016 Audit, Mr Smith was responsible for the overall quality of the FY2016 Audit and the direction, supervision, and performance of the FY2016 Audit in compliance with the professional standards and applicable legal and regulatory requirements. Accordingly, Mr Smith is responsible for any established breaches of *Relevant Requirements* in relation to the FY2016 Audit.

4.5. As the *Statutory Audit Firm* responsible for the FY2016 Audit, KPMG is responsible for any established breaches of *Relevant Requirements* on the part of its partners or employees.

5. DETAIL OF THE BREACHES OF *RELEVANT REQUIREMENTS*

[4] Additionally, £4.3 million of the Chinese manufacturing facility costs were reclassified from Selling General and Administrative costs where they had historically been reported and included in Cost of Goods Sold (COGS). The reason for the reclassification was because the costs represented a direct cost of the goods sold rather than an overhead. It does not form part of the breaches of *Relevant Requirements* identified in this *Final Settlement Decision Notice*.

Background in respect of intercompany transactions and year end intercompany balances

5.1. The Group did not perform intercompany reconciliations using an automatic or integrated system. Instead, the reconciliations were performed in stand-alone spreadsheets. Intercompany balances were recorded in the Group's balance sheet in two different ways.

5.1.1. In specific intercompany accounts recorded in the trial balances of the relevant group companies. These were included in an intercompany matrix that was provided to KPMG for its audit work on the intercompany balances by the Company's management.

5.1.2. Certain inter-company transactions were recorded in "trading" ledger balances within creditors rather than through intercompany accounts.

5.2. Whilst there were separately identifiable intercompany accounts, the agreement and reconciliation of intercompany balances was a complex process given the manner in which the Group handled the intercompany transactions and the high volume of such. The fact that the transactions were in different currencies also added to the complexity and the fact that certain trading balances were held outside of the specific intercompany accounts meant that the risk of error was increased.

Intercompany reconciliation

5.3. The audit team documented its approach to auditing the intercompany balances in the relevant workpaper. They explained, under the heading "*Method*"", that they would "*obtain the trial balances for the Nexus group and intercompany balances from it to form an Intercompany matrix and would attempt to reconcile each intercompany value on the matrix in order to verify that the corresponding debtor and creditor values between the various companies are consistent across the matrix*".

5.4. However, although most balances shown on the intercompany matrix agreed to trial balances of the relevant companies, not all balances were included on it, as the Respondents knew at the time. The intercompany matrix related only to accounts coded as intercompany and not all intercompany trading balances were therefore included. Other balances were included in the trade creditors and trade receivables ledgers and were not marked therein as intercompany balances.

5.5. The Respondents' audit work on supplier statement reconciliations involved testing the material intercompany balance in trade payables. However, the objective of the supplier statement testing was to test whether a sample of balances in the creditors ledger

reconciled to the balance per the supplier. It was not to test whether all intercompany balances netted off to nil (which was the objective of auditing the intercompany reconciliation aspect of the accounts).

5.6. The intercompany matrix recorded that KPMG had "*agreed* [each intercompany value on the matrix] *to corresponding debtor/creditor in relevant company*". This involved a comparison of the relevant values and, after making a small number of adjustments, the intercompany matrix reconciled to a figure of £1,603 across all Group companies. This was, in itself, immaterial.

5.7. The intercompany balances that were not included in the intercompany matrix, and were held within trade payables / trade receivables, were manually adjusted for and eliminated on consolidation by means of a journal. A material adjustment of £4,459,894 (approximately 6.25 times materiality) was posted between trade receivables and trade payables at the FY2016 year end. This manual adjustment was referred to by the audit team in their review of the consolidation journals impacting the balance sheet. This adjustment was not tested for accuracy; in particular no check was performed to ensure the payable balance in the UK company accounts was the same as the receivable balance (which did agree with the Chinese company accounts). The adjustment was not agreed to supporting documentation.

5.8. The audit team had, among other things, planned to "*obtain a list of intra-group transactions and examine whether transactions had been appropriately reconciled between components, reconciling items adequately explained and transactions had been correctly eliminated in the consolidation*". This was not done in respect of the material intercompany balance sitting in the trade payables / trade receivables ledgers.

5.9. The audit team did not, during the supplier statement testing, test a USD $3.2m debit amount which formed part of one of the five balances due to be tested as part of the supplier statement audit work (the material intercompany balance in trade payables). The balance due to be tested was included in the China (Jiaxing) purchase ledger balance and totalled £682,571. It was made up of two separate amounts: one in Chinese currency (CNY 24,433,231) and the other in USD ($3,247,740). The balance was intercompany in nature, but the USD element was notable in that it was over 120 days old. It was not queried by the audit team, nor did they include it in the supplier statement reconciliations.

5.10. Further, the audit team did not test, as part of the supplier statement testing or otherwise, intercompany items that the Group had included in a Goods Received Not Invoiced ("**GRNI**") accrual of £2.1 million (approximately 2.9 times audit materiality) in

FY2016. Therefore, the auditors did not realise that the intercompany creditor balance included in the GRNI balance for Nexus and BGE was not reconciled with the corresponding receivable balance in NEJ, as part of the consolidation adjustments made by the Company.

“Free on Board” (“FoB”) Sales

5.11. As noted above, the Group operated a wholly owned manufacturing facility and product development facilities in the UK and China. Goods were shipped from China to the Group’s larger customers on a FoB basis, with the sale to the end customer booked in the accounts of the relevant UK entity. For goods shipped directly to the UK a large proportion were made in the wholly-owned China facility, NEJ, located in Jiaxing.

5.12. Just under one half of the Group’s sales were made using the FoB model. The Group’s FY2016 Annual Report and Financial Statements explained that the Group’s split of sales by distribution channel was 46% FoB and 54% direct distribution.

5.13. Where a sale is made on the FoB basis, the purchaser acquires the risks of ownership at the point of the goods leaving the vendor’s control. Once the manufacturing entity has transferred the goods, it records an intercompany sale to the UK entity and accounts for the reduction in inventory and the recognition of revenue, and any profit margin made on the sale. The UK entity recognises a corresponding intercompany purchase and raises the external sales invoice to the customer, recognising any remaining profit.

5.14. The Company’s business model necessitated a sale in China to the relevant UK entity, and then a purchase and a simultaneous sale by the UK entity to the end consumer. For accounting purposes, the intercompany transactions were recognised in the UK as occurring when the goods were received by the shipping agent. In China, by contrast, such transactions were recognised as occurring when the goods were shipped. This gave rise to risks of different intercompany balances in the Group’s records in the UK and China, as a different date of sale was applied in China to the date of purchase in the UK. It also led to a risk of asymmetry in the accounting period in which the transactions were recorded, creating a cut-off difference.

5.15. An adjustment was made to the Company’s accounts on consolidation for the cut-off treatment but that adjustment was limited to reflecting the profit element of these transactions (£83,000), which was not material. This adjustment did not reflect the balance sheet impact[5] of the difference, leading to a cut off error, which was later

[5] This amount has not been calculated as part of this investigation.

assessed to be material and led to part of the 2017 restatements.

Prior year adjustments in FY2017 in respect of intercompany transactions and year end balances

5.16. On 15 December 2017, a profit warning was issued.

The Group has seen gross margins weaken during the second half of the year and will now deliver gross margin of approximately 33%, leading to a £3.5m reduction in profit after tax to £13.2m, versus current market expectations.

Regrettably, the gross margin weakness was not identified sooner due to an incorrect assessment of the value of the Group's stock…. System improvements are being put in place to make sure this does not recur.

5.17. In their Report to the Audit Committee for the FY2017 Audit, KPMG stated:

"*Following the December 2017 announcement, management performed an extensive balance sheet review and identified inconsistencies in intercompany positions between UK and China. ...*

The work identified that the inconsistencies go back a number of years. To date, management have not been able to identify the reconciling items. Management are therefore making a judgement that all of the accumulated error is an historic profit overstatement (net) and you should confirm you are comfortable with this position." …

You should be clear that a key judgement is that the differences identified have been posted to the historic P&L accounts. Without a more detailed 'forensic' re-examination of multiple entries in multiple years, it is not possible to identify all the reconciling items – and indeed may still not be possible in full even with more time and effort. In the meantime the identified differences have been fully written off, which management consider to be the most prudent treatment. We concur with this."

5.18. The following adjustments were made to the FY2016 financial statements in respect of intercompany:

5.18.1 FY2016 profit and loss account: reduction of profit by £1.6m; and

5.18.2 FY2016 balance sheet: reduction of net assets by £3.7m (this adjustment was partly offset by the £1.3m adjustment made to intercompany in respect of the FoB sales cut-off differences error, which reduced the overall

adjustment to intercompany to £2.4m (made up of £3.7m relating to the intercompany reconciliation issues, less £1.3m relating to this issue)).

Breaches in respect of intercompany transactions and year end intercompany balances

Breach 1: The Respondents' conduct constituted a breach of ISA 500.6, in that the Respondents failed to design and perform appropriate audit procedures for the purpose of obtaining sufficient appropriate audit evidence in respect of intercompany transactions and year end intercompany balances.

5.19. The particulars of this *Breach* are as follows.

5.20. As regards the design of the audit procedures, the Respondents designed the audit of intercompany balances without sufficient regard for the fact that the intercompany matrix they were using did not contain all intercompany accounts. Further, the Respondents performed supplier statement testing in respect of the material intercompany balance in trade payables, but this had insufficient regard to the fact that the objective of the supplier statement testing was to test whether balances in the creditors' ledger reconciled to the balance from the supplier. Therefore, even if the supplier statement testing work had been performed appropriately there remained a gap in the designed audit procedures for achieving the objective of ensuring that the Group's intercompany balances netted off to nil.

5.21. As regards performance of the audit procedures:

5.21.1. The audit team failed to obtain audit evidence that a consolidation journal of £4.459m was appropriate and reconciled to the trade receivables and trade payables balances that were being adjusted. The audit team should have corroborated the consolidation adjustment between the UK entities and NEJ to ensure that the balances were reconciled appropriately.

5.21.2. The testing of the supplier statement reconciliation for the UK entity/NEJ accounts took on a greater prominence as a result of a number of balances being excluded from the matrix. The audit team knew the intercompany matrix did not contain all the intercompany accounts and that, accordingly, the risk of error was enhanced. It was incumbent on them to be alert for any intercompany account identified outside of the matrix and to identify how the Company had dealt with such accounts in the consolidation. However, the supplier statement testing work carried out failed to obtain sufficient audit evidence as to the

reconciliation of material items.

5.21.3. In particular, the purchase ledger used in the supplier statement testing contained a material US$3.2m debit amount which was intercompany in nature and was over 120 days old. It was part of one of the balances for which KPMG planned to obtain supplier statements but was not tested to supplier statements by the audit team, and not investigated further.

5.21.4. Additionally, the audit team failed to consider the impact on the consolidation of intercompany balances contained in GRNI and/or the impact of such amounts on the supplier statement reconciliation.

5.21.5. The audit team failed to obtain sufficient audit evidence of the cut-off issue in respect of the FoB sales and to appropriately consider the necessary adjustments, in particular in respect of the balance sheet, to be made in respect of the issue.

5.22. These matters meant that the Respondents could not, and did not, obtain sufficient appropriate audit evidence in relation to a section of the accounts that was an important aspect of the Company's financial statements, for the purpose of expressing an opinion as to the truth and accuracy of the FY2016 financial statements.

Breach 2: The Respondents' conduct constituted a breach of ISA 230.8, in that the Respondents failed to prepare audit documentation that was sufficient to enable an experienced auditor, having no previous connection with the audit, to understand the audit procedures performed, the results of those procedures and the audit evidence obtained, as well as any conclusions reached and judgements made in respect of significant matters arising during the audit of intercompany transactions and year end intercompany balances.

5.23. The particulars of this *Breach* are as follows.

5.24. This *Breach* concerns the supplier statement testing working paper that was prepared and reviewed by the audit team. This paper is difficult to follow and omits relevant information.

5.25. As regards the omission, Note 4 within the working paper is intended to document the reconciliation of a ledger balance and a supplier statement balance for NEJ (the overall balance being material). However, the note shows several adjustments being made in order to reconcile these balances, without any record of any testing carried out or explanation of these adjustments being made.

5.26. The Respondents' documentation was therefore insufficient to enable an experienced auditor, having no previous connection with the audit to understand what has been carried out, why, and with what conclusions.

Breach 3: The Respondents' conduct constituted a breach of ISA 330.26 and 333.27, in that the Respondents failed to: (i) conclude that sufficient appropriate audit evidence had not been obtained in respect of intercompany transactions and year end intercompany balances; and either (ii) attempt to obtain further audit evidence of those areas, or (iii) express a qualified opinion or disclaim an opinion on the financial statements, in circumstances where they had been unable to obtain sufficient appropriate audit evidence of those areas.

5.27. The particulars of this *Breach* are as follows.

5.28. During the course of the FY2016 Audit, and prior to reaching an opinion as to whether the financial statements were free from material misstatements, the Respondents ought to have concluded that insufficient appropriate audit evidence had been obtained in respect of intercompany transactions and year end intercompany balances and then attempted to obtain further audit evidence of those areas (or expressed a qualified opinion or disclaimed their opinion on the financial statements if they were unable to obtain such evidence).

5.29. The audit evidence that the audit team had obtained by the end of the FY2016 Audit as regards intercompany transactions and year end intercompany balances was insufficient, for the reasons set out above (paragraph 5.22).

5.30. Had an adequate review been carried out of the evidence obtained prior to the Respondents reaching their conclusion on the truth and accuracy of the financial statements, it would have been apparent to them that they could not have reached the conclusion that they did, at least not without further audit work being carried out. As it was, the opinion they expressed was not accurate as there were in fact material misstatements in the FY2016 financial statements.

Breach 4: The Respondents' conduct constituted a breach of ISA 200.15 in that the Respondents failed to exercise professional scepticism in respect of the audit of the intercompany transactions and year end intercompany balances.

5.31. The particulars of this *Breach* are as follows.

5.32. In the following respects the Respondents failed to exercise professional scepticism

and follow up on matters that should have led them to query whether the audit evidence obtained was complete and/or reliable:

5.32.1. failing to properly consider and address the implications of the fact that the matrix did not contain all intercompany balances;

5.32.2. failing to investigate material reconciling items in the supplier statement testing, in particular a material USD debit amount over 120 days old; and

5.32.3. failing to properly consider the cut-off difference in respect of FOB sales.

5.33. Importantly, at no point did the Respondents stand back and critically assess the audit evidence obtained during the audit of the accuracy of intercompany transactions and year end intercompany balances. This is a vital step for auditors performing a *Statutory Audit* under the ISAs and must be conducted across all areas of the audit, not only those considered to present a significant risk of material misstatement.

Background relating to the cost of inventory and year end inventory balances

5.34. The Group's accounting policy for inventory was described as follows in the FY2016 financial statements.

"Inventories are stated at the lower of cost and net realisable value. Cost is based on the weighted average principle and includes expenditure incurred in acquiring the inventories, production or conversion costs ***and other costs in bringing them to their existing location and condition. In the case of manufactured inventories and work in progress, costs include an appropriate share of overheads based on normal operating capacity****. Provision is made for slow moving and obsolete stock by comparing the stock holding against the product sales for the financial year and applying a provision to reflect the discount required to sell the product or to rework it into a different product."* (emphasis added).

5.35. As previously stated (at paragraph 3.14), the audit team's assessment was that the accuracy of the cost of inventory was an other area of audit focus. This was due to the risk of errors in the accuracy of year end inventory cost measurement. Errors in the calculation of the overhead absorption rates for costs in FY2014 had led to prior year adjustments being included in the FY2015 financial statements and this led in turn to the establishment of a methodology intended to be followed consistently in subsequent periods. When carrying out the risk assessment for the cost of inventory, the audit team determined that it would be necessary, in order to address the risk of material

misstatement in this area, for the audit procedures designed and performed to be capable of providing assurance that the same costing methodology had been applied by the Company in FY2016 as had been agreed in FY2015 as part of the process of addressing the 2014 misstatements. It was on the basis that such assurance would be obtained that the accuracy of the cost of inventory was assessed as an other area of audit focus as opposed to a significant risk.

5.36. In the course of carrying out their audit of the inventory costs the Respondents raised a number of concerns as to control deficiencies in relation to management's costing methodology and the "*overly complex revaluation of stock at the year end*." As KPMG explained to the Audit Committee, at the end of the FY2016 Audit, their issue was with "Process accuracy" that had been the subject of a letter to management.

Jiaxing Uplift Adjustment

5.37. The "Jiaxing Uplift" refers to an additional costs and overhead uplift added to the cost of inventory produced by the Group's Chinese subsidiary, NEJ. An uplift was necessary because the business model adopted required that NEJ sell stock to group companies at the Chinese cost. The Chinese cost arrived at, using local accounting principles, is lower than cost arrived at under IFRS. This is because International Accounting Standard ("**IAS**")[6] 2, which was applicable to the Group financial statements of the Company for FY2016, specifies more costs to be included in stock than had been applied in China.

5.38. Paragraph 10 of IAS 2 states that:

'The cost of inventories shall comprise all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition.'

Therefore, the cost of stock held by Group companies but manufactured by NEJ required an increase, by way of a fixed percentage, in order to comply with IFRS. This is the 'uplift' adjustment, which added various costs into the overall cost of this stock.

Prior year adjustments in FY2017 in respect of the accuracy of the cost of inventory

5.39. The inventory figures that were included in the FY2016 financial statements were

[6] The IAS was a set of standards that was developed by the International Accounting Standards Committee (IASC). They have since been replaced by the IFRS.

materially misstated. The restatement in the FY2017 financial statements resulted in a total reduction to the inventory balance of £3.1m (approximately 4.3 times audit materiality), and consisted of four components:

- Adjustment for FoB sales £1.3m[7]
- Adjustment to the "Jiaxing uplift" of £1.2m
- Overhead allocation £0.4m[8]
- Foreign exchange revaluation £0.2m

5.40. The first three of these are explained below. The last, a foreign exchange revaluation, was an adjustment identified by KPMG in FY2016 and applied in 2017[9]. It does not form part of the breaches of *Relevant Requirements* identified in this *Final Settlement Decision Notice*.

FoB Sales Adjustment

5.41. As noted in the above section on intercompany transactions and year end intercompany balances, KPMG failed to carry out appropriate testing of the intercompany position between China and the UK and failed to adequately consider, in light of a profit and loss adjustment having been made, what balance sheet adjustments were also required to address the fact that the Group's UK and Chinese entities had been accounting for sales differently, resulting in a risk of cut-off errors and, in due course, leading to part of the FY2017 restatements.

5.42. In addition to the impact on intercompany balances identified above, this also had an impact on the value of stock shown on the balance sheet of the Company at the year end. Stock and accounts payable were overstated by £1.3m, requiring adjustment.

Jiaxing Uplift Adjustment

5.43. The element of the restatement that related to the Jiaxing Uplift resulted from an incorrect percentage uplift being applied. The methodology underlying the calculation of the Jiaxing Uplift in FY2016 should have been consistent with the methodology used in FY2015, however, five line items in the calculation in the FY2015 spreadsheet were different to the line items in the FY2016 calculation. These five cost line items (all of

[7] This was a balance sheet only adjustment.
[8] This was a balance sheet only adjustment.
[9] The Company decided not to adjust for this in FY2016, and it was therefore reported to the Audit Committee as an unadjusted audit difference in the Schedule of Unadjusted Audit Differences (SUAD). The Company later decided to make the adjustment in FY2017 as part of the prior year adjustments.

which were elements of miscellaneous income) form the basis of the £1.2m Jiaxing Uplift Adjustment made in FY2017.

5.44. Whilst there may have been an intention to carry out a line by line comparison of the FY2015 methodology against the FY2016 methodology, that intention was neither recorded on the audit file nor followed through. No procedures were either designed or carried out by the audit team during the course of the FY2016 Audit that could have identified the fact that the methodology for calculating the Jiaxing Uplift had been applied differently in FY2016 as compared with the previous year. Specifically, the testing performed did not include completeness testing, which would have confirmed whether all elements forming part of the FY2015 calculation were also included in the FY2016 calculation.

Overhead allocation

5.45. At the FY2016 year end, inventory held by the Group in the UK purchased from China included, but was not limited to, items manufactured by NEJ. In 2017, the Company's management identified, from workings shared with KPMG, that the Jiaxing Uplift had incorrectly been applied to all items purchased from China, not only those manufactured by NEJ. The stock listings provided to the audit team by management did not contain the names of the suppliers and the audit team did not request information on the manufacturer of each of the stock items. They did not therefore identify that the calculation also applied an uplift to stock not manufactured by NEJ. The consequence of the Jiaxing Uplift being applied, in error, to all UK inventory was to inflate the overhead allocation by £0.4m. This was rectified by the restatements in FY2017.

Stock held in China

5.46. At the FY2016 year end there was approximately £11.2m of stock that was manufactured by NEJ that was held in China. However, the Jiaxing Uplift was only applied to the stock purchased from NEJ held in the UK. As the purpose of the Jiaxing Uplift was to bring the cost of stock manufactured by NEJ, as measured in China, into line with the cost of stock as determined by IAS 2 it is not clear why the uplift was not applied to the same stock located in China.

5.47. There are no audit working papers which explain the respective treatment between Chinese stock held in the UK and in China regarding the Jiaxing Uplift. Accordingly, whilst there was a difference in treatment between stock held in China and the UK in 2016 it cannot now be determined whether it was correct, for the Company's

management, to apply the uplift only to stock held in the UK.

Breaches relating to the audit of the cost of inventory and year end inventory balances

Breach 5: The Respondents' conduct constituted a breach of ISA 500.6, in that the Respondents failed to design and perform appropriate audit procedures for the purpose of obtaining sufficient appropriate audit evidence in respect of the cost of inventory and year end inventory balances.

5.48. The particulars of this *Breach* are as follows.

5.49. As regards design, the Respondents failed to design their audit procedures so as to include a comparison of the methodology used to calculate the Jiaxing Uplift with the methodology used in prior years.

5.50. As regards performance, as a result of not carrying out any such comparison, the Respondents failed to obtain appropriate audit evidence that the methodology used for calculating the Jiaxing Uplift applied in FY2016 was in line with the FY2015 methodology. This had an impact on the value of inventory shown on the Balance Sheet of the Group (in the FY2016 financial statements) and hence on FY2016 reported profits.

5.51. In addition, the Respondents failed to perform any audit work that could have identified that the Jiaxing Uplift had incorrectly been applied by management to all items purchased from China, not only those from NEJ, and whether the Jiaxing Uplift should have been applied by management to stock manufactured by NEJ and held in China as well as NEJ stock held in the UK.

5.52. These failures in the design and performance of the audit procedures meant KPMG's work did not (and could not) allow it to express an audit opinion in accordance with the ISAs on whether the FY2016 financial statements showed a true and fair view of the Group's cost of inventory and year end inventory balances.

Breach 6: The Respondents' conduct constituted a breach of ISA 230.8, in that the Respondents failed to prepare audit documentation that was sufficient to enable an experienced auditor, having no previous connection with the audit, to understand the audit procedures performed, the results of those procedures and the audit evidence obtained, as well as any conclusions reached and judgements made in respect of

significant matters arising during the audit of the cost of inventory and year end inventory balances.

5.53. The particulars of this *Breach* are as follows.

5.54. In the Jiaxing Uplift workpaper the Respondents failed to document whether audit work was performed to test that the methodology used to calculate the Jiaxing Uplift in FY2016 was consistent with that for the prior year. As explained above, this was a critical element of the audit testing, and given the focus on the Jiaxing Uplift in FY2015 the audit documentation for FY2016 should have covered both the fact that such work was not carried out and the reasons why.

5.55. The Respondents' documentation was therefore insufficient to enable an experienced auditor, having no previous connection with the audit to understand what has been carried out, why, and with what conclusions.

<u>*Breach* 7:</u> The Respondents' conduct constituted a breach of ISA 330.26 and 330.27, in that the Respondents failed to: (i) conclude that sufficient appropriate audit evidence had not been obtained in respect of the cost of inventory and year end inventory balances; and either: (ii) attempt to obtain further audit evidence of those areas, or (iii) express a qualified opinion or disclaim an opinion on the financial statements, in circumstances where they had been unable to obtain sufficient appropriate audit evidence of those areas.

5.56. The particulars of this *Breach* are as follows.

5.57. During the course of the FY2016 Audit, and prior to the signing of the audit opinion, the Respondents ought to have concluded that insufficient appropriate audit evidence had been obtained in respect of the accuracy of the cost of inventory and year end inventory balances and attempted to obtain further audit evidence of those areas (or expressed a qualified opinion or disclaimed their opinion on the financial statements if they were unable to obtain such evidence).

5.58. The audit evidence that the audit team had obtained by the end of the FY2016 Audit as regards the accuracy of the cost of inventory and year end inventory balances was insufficient for the reasons set out above (paragraphs 5.50 and 5.51).

5.59. As with the audit of the intercompany accounts, had an adequate review been carried out of the evidence obtained prior to the Respondents reaching their conclusion on the

truth and accuracy of the financial statements, it would have been apparent to them that they could not have reached the conclusion that they did, at least without further audit work being carried out. As it was, the opinion expressed was not accurate as there were in fact material misstatements in the FY2016 financial statements.

Breach 8: The Respondents' conduct in relation to the audit of the cost of inventory and year end inventory balances constituted a breach of ISA 200.15, in that the Respondents failed to exercise professional scepticism in its audit of that area.

5.60. The particulars of this *Breach* are as follows.

5.61. The audit team were aware that it would be necessary, in order to address the risk of material misstatement in this area, for the audit procedures designed and performed to be capable of providing assurance that the same costing methodology had been applied by the Company, when calculating the Jiaxing Uplift, in FY2016 as had been agreed in FY2015. Not planning, designing or performing a test demonstrates a lack of professional scepticism, given that this was an area where management had made errors in the past.

5.62. The Respondents also failed to adequately consider the reliability and completeness of the application of the Jiaxing Uplift to the following inventory elements, in light of factors that should have led them to query whether the audit evidence obtained was complete and/or reliable.

5.62.1 Stock from different Chinese sources. As the Respondents were aware the uplift should only be applied to NEJ they should have challenged the incomplete information contained within the stock listings provided by management and requested the supplier details, which would have allowed them to check that the uplift was being applied correctly.

5.62.2 NEJ manufactured stock held in different locations (the UK and China). The audit team should have noticed that the uplift was only applied by management to manufactured stock held in the UK and that fact should have led them to investigate management's treatment of manufactured stock held in China and establish if it was correct.

5.63. At no point did the Respondents stand back and critically assess the audit evidence obtained during the audit of the accuracy of the cost of inventory.

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.

Nature, seriousness, gravity and duration of the breaches

6.3. In reaching a decision on *Sanctions*, Executive Counsel has considered the following matters in accordance with paragraph 24 of the Policy (in summary).

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 FY2016 Audit failed to achieve this objective in relation to specific matters set out in this *Final Settlement Decision Notice*.

6.5. The FY2016 financial statements included multiple material misstatements in relation to the two areas of the FY2016 Audit in respect of which breaches of *Relevant Requirements* occurred, as set out above. Those misstatements had to be subsequently corrected by restatement in FY2017.

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, 330 and

500 are basic and fundamental to the work of an auditor. They are particularly important to an auditor's work because they extend to all areas of an audit (whatever the risk level assessed as applying to those areas at the planning stage of an audit) and because they apply throughout the course of an audit. For example, the need to apply professional scepticism and the need to scrutinise whether the auditor has obtained sufficient appropriate audit evidence to support the auditor's conclusions applies throughout the period of the engagement.

6.7. The breaches occurred in relation to only one financial year, but they extended over the whole of the FY2016 Audit because they involved failures in the design of audit procedures, through to failures in performance of the procedures used and failures to adequately review and critically assess the audit evidence that the Respondents obtained, prior to the audit opinion being signed.

6.8. The breaches of these Relevant Requirements are made more serious by the fact that each of the Audit areas within which they were identified related to aspects of the entity's accounting which were important to the preparation of its financial statements, in the sense that if either one contained material errors then the financial statements would likely be materially misstated.

6.9. As regards the importance of the accounting areas affected:

6.9.1. Intercompany transactions were an integral part of the Company's operations and included the sale of large amounts of stock from its Chinese production company to UK based subsidiaries. Due to the significant intercompany trading taking place, material misstatements in the intercompany section of the accounts had the potential to materially impact other areas of the financial statements (e.g. inventory).

6.9.2. Inventories amounted to more than a third of the Company's total assets at 31 December 2016. Errors in the audit of the cost of inventory thus had the potential to result in misstatements of a material proportion of the Company's balance sheet.

6.10. Yet further, certain of the breaches occurred despite the Respondents realising that the areas of the FY2016 Audit in which they occurred needed particular focus following prior year errors in one of those areas (i.e. the accuracy of the cost of inventory).

6.11. Given all of the above, the fact that the Respondents failed to conduct the audit in

accordance with *Relevant Requirements* could undermine confidence in the standard of conduct of statutory audits generally.

6.12. As against the above matters:

6.12.1 There is no evidence to suggest that the breaches were repeated, and they are not ongoing.

6.12.2 This is not a case where the breaches adversely affected a significant number of people in the UK. The largest shareholding, by a significant margin, when the Company was both private and listed was held by an investment company, the shareholders of which are the non-executive directors of Luceco.

6.12.3 Neither Respondent stood to benefit from the breaches.

6.12.4 It is acknowledged that the breaches were neither intentional, dishonest, deliberate nor reckless.

6.12.5 Neither of the Respondents encouraged others to breach the *Relevant Requirements*.

6.13. At the time of the FY2016 Audit, Mr Smith 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 FY2016 Audit, however.

6.14. As regards the likelihood of the same type of breach recurring, while KPMG has not taken any remedial action as a direct result of the FY2016 Audit, it has introduced a general improvement programme in respect of its audit work in 2018, referred to as the "Audit Quality Transformation Programme", 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, hence she is imposing the *Sanctions* set out below.

6.15. There have been previous breaches by KPMG. The firm has been the subject of sanctions in 12 cases in the past four years. Several of these concerned failures to demonstrate sufficient professional scepticism and to obtain sufficient appropriate audit evidence. There has been one previous instance of failing to obtain sufficient audit evidence in relation to supplier statement reconciliations. However, because of the timing of these cases there is no suggestion that KPMG failed to learn from the breaches in any particular case and apply those lessons to the FY2016 Audit.

6.16. Mr Smith has one matter of misconduct on his disciplinary record. It concerns conduct that is different in nature to that addressed in this *Final Settlement Decision Notice*.

Sanctions

6.17. Having assessed the nature, seriousness, gravity and duration of the breaches of *Relevant Requirements*, Executive Counsel imposes the following combination of *Sanctions* in this case.

KPMG

6.18. A declaration to the effect that, as a result of the breaches of *Relevant Requirements* set out in this *Final Settlement Decision Notice*, the audit report for the FY2016 Audit did not satisfy the requirement in regulation 4(1) of SATCAR that a *Statutory Audit* must be conducted in accordance with relevant standards.

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

6.20. An order pursuant to rule 136(c) of the AEP, requiring KPMG to take action to prevent the recurrence of the breach of the *Relevant Requirements*. In summary, the action required is within 3 months of the date of this *Final Settlement Decision Notice*, KPMG to provide Executive Counsel and the FRC Executive Director for Supervision with a report which identifies why it considers that the breaches occurred, why the firm's processes and controls did not prevent the breaches and whether the firm's current processes would lead to a different outcome, and any further remedial action proposed. Thereafter, the firm shall implement such remedial action as is proposed by Executive Counsel and the Executive Director for Supervision in light of the report, by a date to be agreed between KPMG and the FRC. If Executive Counsel or the FRC Director of Supervision consider that an additional report is required to address further issues, such a report to be provided within 3 months of the FRC's request.

6.21. A financial sanction of £1,250,000.

Mr Smith

6.22. A declaration to the effect that, as a result of the breaches of *Relevant Requirements* set out in this *Final Settlement Decision Notice*, the audit report for the FY2016 Audit did not satisfy the requirement in regulation 4(1) of SATCAR that a *Statutory Audit* must be conducted in accordance with relevant standards.

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

6.24. A financial sanction of £50,000.

Other Considerations

6.25. KPMG is a large audit firm, with 533 partners across all functions, and 311 Statutory Auditors in 2021. Its UK revenue in the year to 30 September 2021 was £2,433 million and its audit fee income was £646 million.

6.26. In accordance with paragraph 47(c) of the Policy, Executive Counsel has taken into account the financial resources of KPMG, the effect of a financial sanction and other *Sanctions* on their business, and whether they are insured as to any financial sanction.

Aggravating factors

6.27. In the case of KPMG and Mr Smith, the only notable aggravating factor is the fact that they both have prior disciplinary records. 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 *Sanctions* is required.

Mitigating factors

6.28. The Respondents have provided the level of co-operation required of them during the investigation but not the exceptional level of co-operation which would amount to a positive mitigating factor.

6.29. Mr Smith's relatively junior position within KPMG (a director, rather than partner) is a potential mitigating factor, but it has already been taken into account in assessing the nature, seriousness, and gravity of the breaches.

Deterrence

6.30. 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

6.31. 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 sanctions is appropriate, such that the financial sanction for KPMG is reduced to £875,000 and that for Mr Smith is reduced to £35,000.

7. COSTS

7.1. *Executive Counsel* requires that the Respondents pay the costs in full in this matter. These costs amount to £191,163 (comprising £89,067 in respect of the ICAEW investigator's costs and £103,075 for Executive Counsel's costs). Such costs shall be paid no later than 28 days after the date of this *Final Settlement Decision Notice*.

Signed:

[Redacted.]

CLAUDIA MORTIMORE
DEPUTY EXECUTIVE COUNSEL

Date: 30 January 2023

<u>**APPENDIX – EXTRACTS OF RELEVANT REQUIREMENTS**</u>

Extracts from relevant ISAs in force during the Relevant Period[10]

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:*
> *(a) The nature, timing and extent of the audit procedures performed to comply with the ISAs (UK and Ireland) and applicable legal and regulatory requirements;*
> *(b) The results of the audit procedures performed, and the audit evidence obtained; and*
> *(c) Significant matters arising during the audit, the conclusions reached thereon, and significant professional judgments made in reaching those conclusions."*

ISA 330: The Auditor's Responses to Assessed Risks

Paragraph 26 states as follows:

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

“The auditor shall conclude whether sufficient appropriate audit evidence has been obtained. In forming an opinion, the auditor shall consider all relevant audit evidence, regardless of whether it appears to corroborate or to contradict the assertions in the financial statements.”

Paragraph 27 states as follows:

“If the auditor has not obtained sufficient appropriate audit evidence as to a material financial statement assertion, the auditor shall attempt to obtain further audit evidence. If the auditor is unable to obtain sufficient appropriate audit evidence, the auditor shall express a qualified opinion or disclaim an opinion on the financial statements.”

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.”