IN THE MATTER OF

THE EXECUTIVE COUNSEL OF THE FINANCIAL REPORTING COUNCIL

-and-

(1) KPMG LLP

(2) ANTHONY SYKES

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 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.

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

1.3.1. "**FY2020**" means the financial year ended 26 April 2020, "**FY2020 financial statements**" means the consolidated financial statements of the TheWorks.co.uk plc (the "**Group**") for that period, and "**FY2020 Audit**" means the statutory audit of the FY2020 financial statements.

1.3.2. "**Respondents**" means:

1.3.2.1. KPMG LLP (referred to herein as "**KPMG**"), which was the *Statutory Audit Firm* for the FY2020 Audit; and

1.3.2.2. Anthony Sykes, a former partner of KPMG, who was the *Statutory Auditor* of the Group for the FY2020 Audit and signed the FY2020 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 27 January 2023 pursuant to Rule 103 of the AEP in relation to the conduct of the Respondents in respect of the FY2020 Audit. The Respondents provided written agreement to the *Proposed Settlement Decision Notice*, pursuant to Rule 105 of the AEP, on 30 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 8 February 2023, 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:

1.8.1. Section 2: Background;

1.8.2. Section 3: Executive Summary;

1.8.3. Section 4: *Relevant Requirements* to which the breaches relate;

1.8.4. Section 5: Detail of the breaches of *Relevant Requirements*;

1.8.5. Section 6: *Sanctions*; and

1.8.6. Section 7: Costs.

2. BACKGROUND

TheWorks.co.uk plc

2.1. The Group is a high-street retailer of value gifts, arts, crafts, toys, books and stationery. As at the FY2020 year-end, the Group had 534 stores across the UK and Ireland, and employed nearly 4,000 staff. The Group's shares are listed on the main market of the London Stock Exchange, and as such the company is a *Public Interest Entity*.

The Respondents

2.2. In 2021, KPMG was the fourth largest audit firm in the UK by total fee income (total fee income of £2.433 billion), and the second largest by audit fee income (audit fee income of £646 million).

2.3. KPMG was first appointed to act as auditor to the Group in 2018.

2.4. Mr Sykes was a partner in KPMG and (as noted above) was the Audit Engagement Partner and Senior Statutory Auditor for the FY2020 Audit. Mr Sykes had 25 years' experience as an audit partner at the time of the FY2020 Audit.

2.5. On 27 August 2020, Mr Sykes (on behalf of KPMG) signed an independent auditors' report with an unmodified opinion. In the context of prevailing uncertainty around the disruptive impact of the COVID-19 pandemic, the report also outlined that there existed a material uncertainty which cast significant doubt on the Group's ability to continue as a going concern.

2.6. The purpose of an audit is to enhance the degree of confidence of intended users in the audited entity's financial statements. The Respondents' statutory responsibility was to form an opinion as to whether the FY2020 financial statements showed a true and fair view and had been properly prepared in accordance with International Financial Reporting Standards ("**IFRS**") and the Companies Act 2006. An audit conducted in accordance with the International Standards on Auditing (UK & Ireland) ("**ISAs**") enables the auditor to form that opinion. The ISAs require the auditor to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error.

The context for the FY2020 Audit

2.7. The Group's financial year end fell approximately six weeks after the first national lockdown that followed the onset of the COVID-19 pandemic. That lockdown, in March 2020, led to the temporary closure of all of the Group's retail stores, which began to re-open progressively in May 2020. Access to the Group's warehouses was also reduced around this time, when the Respondents were undertaking work, including inventory testing, on the FY2020 Audit. These circumstances, including the requirement for remote working, created additional, significant challenges for those involved in the FY2020 Audit.

2.8. The FRC provided guidance to auditors in March 2020 which acknowledged that, in light of the circumstances arising out of the COVID-19 pandemic, engagement with audited entities would be necessary to ensure that auditors had sufficient time and support to carry out their work to an appropriate standard. The guidance stressed that the situation should not undermine the delivery of high quality audits, and that full compliance with standards was required. Guidance was also issued that alternative procedures may be necessary to obtain sufficient, appropriate audit evidence, and the FRC acknowledged the likelihood of more modified opinions being issued by auditors insofar as they were unable to obtain such evidence. Separately, the Financial Conduct Authority extended the deadline for publication of audited annual financial reports from four to six months from the end of the financial year, the effect of which was to permit additional time for the preparation of those reports given the exigent circumstances.

2.9. The impact of lockdown closures was also significant for the Group's business, and informed the FY2020 Audit, such that the appropriateness of the going concern assumption, the carrying amount of store assets and the valuation of goodwill were identified as Key Audit Matters. The Group delayed its preliminary results release date from 2 July 2020 to 27 August 2020.

3. EXECUTIVE SUMMARY OF THE BREACHES OF *RELEVANT REQUIREMENTS*

<u>Breaches</u>

3.1. As is set out in this *Final Settlement Decision Notice*, there were numerous failings by the Respondents in their approach to the audit of inventory existence as part of the FY2020 Audit.

3.2. The Respondents initially tested management's controls of inventory held across the Group's stores, with the intention of reverting to substantive testing in the event that testing of those controls failed. However, the audit team's approach was critically undermined by a succession of basic but serious failings including:

3.2.1. A sustained failure to respond appropriately to variances identified in the controls testing of management's stock counts, including a failure to investigate management's explanations for those variances (no criticism is intended of management in this *Final Settlement Decision Notice*);

3.2.2. The adoption of a substantive testing approach based on a subset of the full stock count population of 1,000 Stock Keeping Units ("**SKUs**") used in the controls testing, without further consideration or consultation, and despite variances having been identified in nearly one third of those counts;

3.2.3. The removal of all counts with variances from the stock count population prior to the selection of the substantive testing sample, as part of a selection process described on the audit file as *"random"*;

3.2.4. The omission from the audit file of the results of the controls testing, such that the audit file documentation provided a false degree of assurance; and

3.2.5. Not performing a roll-forward of all of the stock balances counted from the date of the store counts to the period end date.

3.3. The Respondents' testing of inventory existence at two warehouse locations, one of which was operated by a third party, was also seriously flawed. The audit team failed to undertake any roll-back procedure to reconcile the warehouse stock count despite planning to do so, and failed to prepare sufficient audit documentation in respect of discrepancies identified during the count. In addition, the audit team accepted third party confirmation of inventory via the Group's management, rather than directly from the third party itself.

3.4. This *Final Settlement Decision Notice* does not assert that there was a material misstatement in the FY2020 financial statements. Nevertheless, the FY2020 Audit failed in its principal objective: that of providing reasonable assurance that the FY2020 financial statements were free from material misstatement.

3.5. Section 5 of this *Final Settlement Decision Notice* sets out the Respondents' breaches of *Relevant Requirements* in the FY2020 Audit*.*

3.6. Section 6 of this *Final Settlement Decision Notice* sets out the *Sanctions* imposed in respect of the Respondents' breaches of *Relevant Requirements.* Those sanctions are summarised at paragraphs 3.7 and 3.8 below.

<u>*Sanctions*</u>

3.7. Executive Counsel imposes the following *Sanctions* on KPMG:

3.7.1. A financial sanction of £1,750,000, reduced by 10% to reflect the extent of co-operation provided, and further discounted for admissions and early disposal by 35% so that the financial sanction payable is £1,023,750;

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

3.7.3. A declaration that the FY2020 Audit report signed on behalf of KPMG did not satisfy the audit reporting requirements as set out in this *Final Settlement Decision Notice*; and

3.7.4. An order pursuant to rule 136(c) of the AEP, requiring KPMG to take action to mitigate the effect or prevent the recurrence of breaches of the Relevant Requirements. In summary, KPMG will:

a. Put in place arrangements for the additional supervision and monitoring of the future audit work of two members of the audit team, for a period of one year.

b. Undertake a programme of work to review the effectiveness of its second line of defence function, including the trialling of changes intended to improve KPMG's ability to satisfactorily resolve issues identified during second line of defence reviews. KPMG will, by 1 November 2023, provide Executive Counsel with a report describing the outcome of its work and the steps that will be taken to ensure the effectiveness of its second line of defence reviews, and therefore reduce the likelihood of the recurrence of similar breaches.

3.8. Executive Counsel imposes the following *Sanctions* on Mr Sykes:

3.8.1. A financial sanction of £75,000, reduced by 10% to reflect the extent of co-operation provided, and further discounted for admissions and early disposal by 35% so that the financial sanction payable is £43,875;

3.8.2. A published statement, in the form of a severe reprimand; and

3.8.3. A declaration that the FY2020 Audit report signed by Mr Sykes did not satisfy the audit reporting requirements as set out in this *Final Settlement Decision Notice*.

3.9. Additionally, Executive Counsel requires that the Respondents pay Executive Counsel's costs of the investigation being £198,430.64.

4. *RELEVANT REQUIREMENTS*

4.1. Rule 1 of the AEP states that *Relevant Requirements* has the meaning set out in Regulation 5(11) of the Statutory Auditors and Third Country Auditors Regulations 2016. 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:

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

4.2.2. ISA 230 (Audit Documentation);

4.2.3. ISA 501 (Audit Evidence – Specific Considerations for Selected Items);

4.2.4. ISA 505 (External Confirmations); and

4.2.5. ISA 530 (Audit Sampling).

4.3. As the Senior Statutory Auditor responsible for the FY2020 Audit, Mr Sykes was responsible for the overall quality of the FY2020 Audit and the direction, supervision, and performance of the FY2020 Audit in compliance with the professional standards and applicable legal and regulatory requirements. Accordingly, Mr Sykes is responsible for any established breaches of *Relevant Requirements* in relation to the FY2020 Audit.

4.4. Extracts from the ISAs of particular relevance to the breaches of *Relevant Requirements* are set out in Appendix 1.

5. BREACHES OF *RELEVANT REQUIREMENTS*

Breach 1: Store Counts

Relevant Requirements engaged by Breach 1

5.1. Paragraph 15 of ISA 200 required the Respondents to plan and perform the FY2020 Audit with professional scepticism.

5.2. Paragraphs 6, 8, 12 and 15 of ISA 530 required the Respondents to: (i) consider the purpose of the audit procedure and the characteristics of the population from which the sample was drawn; (ii) select items for the sample in such a way that each sampling unit in the population had a chance of selection; (iii) investigate the nature and cause of any deviations or misstatements identified, and evaluate their possible effect on the substantive approach to the audit of inventory; and (iv) evaluate the results of the sample, and whether the use of audit sampling had provided a reasonable basis for conclusions about the population that had been tested.

5.3. Paragraph 5 of ISA 501 required the Respondents, where physical inventory counting was conducted at a date other than the date of the financial statements, to perform audit procedures to obtain audit evidence about whether changes in inventory between the count date and the date of the financial statements were properly recorded.

5.4. Paragraph 8 of ISA 230 required the Respondents to prepare audit documentation that was sufficient to enable an experienced auditor, having no previous connection with the FY2020 Audit, to understand the audit procedures that had been performed, the results of those procedures, and any significant matters arising during the FY2020 Audit.

Background

5.5. At the year-end for FY2020, the Group held stock valued at £20.3 million at 534 individual stores across the UK and Ireland.

5.6. The audit team planned to carry out its audit work for the FY2020 Audit in relation to inventory existence in stores by reference to controls testing in the first instance, although it was contemplated by the audit team that the controls testing might fail (that is to say, the controls would be found to be ineffective) and that substantive testing may be required.

5.7. As a precaution, Mr Sykes therefore directed the audit team to undertake sufficient stock counts as part of controls testing to enable them to switch to substantive testing in the event that the controls testing failed. The audit team selected a sample of 1,000 SKUs across 25 stores (40 products per store). There is no documentation on the audit file recording the audit team's rationale for testing 1,000 items nor any explanation of how these items were selected. The sample size of 1,000 items was above the minimum required by KPMG guidance, which at the time advised testing 10 products across 25 stores. Beyond advising the audit team to undertake sufficient stock counts to facilitate substantive testing if required, Mr Sykes did not give the audit team any further direction or guidance as to how a switch from controls testing to substantive testing should be managed or as to any limitations on that approach.

5.8. The store counts were carried out prior to the FY2020 year-end. The audit team's store counts for each item were compared to management's own counts and any variances together with any explanations for variances were recorded. There were multiple differences between the counts which affected 164 SKUs. However, there is no documentation on the audit file indicating that the audit team gave any consideration at this stage to whether these variances raised doubts as to the effectiveness of the controls. The audit team also failed adequately to investigate management's explanations for the variances in circumstances where some of those explanations did not appear credible (for example, external theft being cited as a possible explanation, despite the two counts having been carried out at around the same time). If the audit team had given appropriate consideration to the variances that had been found and management's explanations for them, they should have concluded on this basis alone that the controls were ineffective for the purposes of the FY2020 Audit.

5.9. The audit team did subsequently conclude that the controls were ineffective for the purposes of the FY2020 Audit, but only two months later after the year-end, when the audit team found it was unable to reconcile and roll-forward the stock count results to the Group's stock listing at year-end. This was because audit evidence could not be obtained for movements in inventory after the stock count attendance, for reasons including that management had continued to count items that were found at stores after the stock count sheets had been signed off, and inputted these items into its systems. At this stage, the audit team identified variances for a further 128 SKUs, leaving in total a difference in 292 SKUs out of the 1,000 tested.

5.10. There is no documentation on the audit file defining what would constitute a control deviation for store stock counts and whether there was any planned tolerance for such deviations. However, Mr Sykes informed Executive Counsel that any variance in store counts should have been considered a deviation and that tolerance for deviations would have been low, with no more than a few deviations raising questions as to the effectiveness of controls. As a result of the failure to identify in advance what would constitute a control deviation and to plan in advance how the audit team should react to any such deviations, the audit team failed to consider appropriately the consequences of the deviations they had found, which were material to the planning of their next steps.

5.11. In light of the failure of the controls testing, the audit team decided to adopt a substantive testing approach to inventory existence. However, despite having counted 1,000 SKUs, in the course of which variances were identified across 292 SKUs, the audit team decided for the purposes of substantive testing to select a subset of 345 items, a number which the team considered to be consistent with KPMG guidance. Mr Sykes was made aware by the audit team that the controls were ineffective for audit purposes, but he failed to make appropriate enquiries or to ensure that the audit team informed him of the nature, extent and cause of the deviations. Mr Sykes relied on the audit team to bring these issues to his attention on their own initiative, but they did not.

5.12. Given the extent of the deviations found, the audit team would need to have undertaken further enquiries to understand the nature, cause and extent of the deviations and to assess their significance, including by consulting with a sampling specialist and considering other appropriate substantive procedures. In that regard, the audit team's planned approach of using only 345 of the existing stock counts from controls testing for substantive testing would not provide sufficient appropriate audit evidence of inventory existence. As well as analysing the deviations and obtaining technical advice, the team should have used the full population of 1,000 SKUs as the basis for the substantive procedures in order to include all of the SKUs with deviations in their evaluation. As a result of his failure to make appropriate enquiries, Mr Sykes also failed to give the audit team any or sufficient direction or guidance at this stage. Had he done so, the audit team would have appreciated that reliance on the existing stock counts would not be able to provide sufficient appropriate audit evidence for inventory existence.

5.13. In any event, the audit team's approach to substantive testing was further and manifestly flawed. That is because the audit team excluded the 292 items for which variances had already been recorded from the population from which the sample of 345 items for substantive testing was drawn. Unsurprisingly, as a result of the audit team's misguided decision to confine the substantive testing to items for which no variances had been recorded through controls testing, the effect of which was to skew the sample, no errors were found by substantive testing.

5.14. The audit team's approach to selecting the sample of 345 items for substantive testing was also described inaccurately on the audit file as having been "*randomly selected*" out of the sample of 1,000 items that had previously been counted (when, as noted, the audit team had excluded 292 of those 1,000 items from the sample). As a result, it was not apparent on the audit file that the sample selection was heavily skewed and that the substantive testing of items from the 'clean' population could not provide reliable audit evidence.

5.15. The audit team also omitted from the audit file:

5.15.1. The results of the 1,000 counts undertaken for control testing including those which showed variances for 164 of the items; and

5.15.2. The differences as against the stock listing for 292[1] of the 1,000 items.

[1] 292 is a cumulative total, i.e. the 164 differences identified in 5.15.1 form part of the 292.

5.16. Instead the audit file only included the results of the substantive testing of 345 items drawn from those of the original 1,000 items for which no variances had been identified. As a result the documentation on the audit file provided a false degree of assurance.

5.17. Further, quite apart from the flawed selection of the sample for substantive testing, the substantive procedures that were carried out by the audit team were also inadequate:

5.17.1. First, other than for 65 items, the audit team failed to reconcile the stock counts for the 345 items to management's stock listing as at the date of the stock counts, such that the interim testing was not complete and the starting point for the roll-forward testing of the remaining 280 items had not been verified by the audit team against management's records for those items as at the date of the counts.

5.17.2. Second, the audit team only rolled forward and reconciled to the year-end stock listing the same 65 items out of the skewed sample of 345 items, which they did on the basis of Information Produced by the Entity (IPE) direct testing (against sales log data produced by the Group that had previously been tested for the audit of revenue), rather than undertaking substantive testing for all 345 items. The team therefore failed entirely to reconcile the stock counts for the remaining 280 items in the sample to the year-end stock listing.

5.18. Notably, Mr Sykes was made aware of performance issues within the audit team and asked for further scrutiny to be applied, but his awareness did not prompt him to personally apply that closer scrutiny to the audit team's work over the stock counts, or to ensure that sufficient scrutiny had otherwise been applied by others within the audit team.

<u>Breaches</u>

5.19. In breach of paragraph 15 of ISA 200, the Respondents failed to perform the audit of inventory existence with sufficient professional scepticism.

5.20. In breach of paragraph 12 of ISA 530, the Respondents failed to investigate the nature, extent and cause of the differences found through controls testing between the audit team's stock counts and management's stock counts and stock listings, and to evaluate their possible effect on the substantive approach to the audit of inventory.

5.21. When selecting the sample of items for substantive testing, the Respondents:

5.21.1. failed to give adequate consideration to the purpose of the audit procedure and the characteristics of the population from which the sample would be drawn, in breach of paragraph 6 of ISA 530;

5.21.2. failed to select items for the sample for substantive testing in such a way that each sampling unit in the population had a chance of selection, in breach of paragraph 8 of ISA 530; and

5.21.3. failed to evaluate the results of the sample and whether the use of audit sampling had provided a reasonable basis for conclusions about the population that had been tested, in breach of paragraph 15 of ISA 530.

5.22. In breach of paragraph 5 of ISA 501, the Respondents failed to design and perform a roll-forward procedure that was appropriate for the purposes of obtaining sufficient appropriate audit evidence.

5.23. In breach of paragraph 8 of ISA 230, the Respondents failed to prepare audit documentation sufficient to enable an experienced auditor, having no previous connection with the FY2020 Audit, to understand the outcome of the controls testing and the nature and extent of the substantive testing.

Breach 2: Warehouse Counts

Relevant Requirements engaged by Breach 2

5.24. Paragraph 5 of ISA 501 is discussed at paragraph 5.3 above.

5.25. Paragraph 8 of ISA 230 is discussed at paragraph 5.4 above.

Background

5.26. At the year-end for FY2020 the Group held stock valued at £6 million at a central warehouse.

5.27. The stock count for the central warehouse was originally planned to take place on 21 March 2020, but this was delayed as a result of COVID-19 restrictions. The audit team attended the central warehouse stock count virtually after the year-end on 21 May 2020.

5.28. The audit team therefore planned to carry out a roll-back procedure to reconcile the warehouse stock count to the Group's year-end stock listing. However, the audit team failed to carry out any roll-back procedure.

5.29. Mr Sykes was aware of: (a) the challenges involved in carrying out the stock count during the COVID-19 lockdown period; (b) the failure of controls testing for the store stock counts; and (c) multiple significant changes by the audit team to the planned approach for warehouse stock counts in May and June 2020 (including, at one stage, a decision by the team to treat the stock housed in the stores and warehouse as a homogenous population for the purpose of audit testing, which represented a material departure from the prior agreed approach).

5.30. Mr Sykes had not identified inventory existence as a significant risk, and consistent with that approach, he did not review the workpapers. However, he should at least have made enquiries of the audit team as to the outcome of the central warehouse counts. Had he made appropriate enquiries, Mr Sykes would have identified that the audit team had failed to carry out any roll-back procedure. Mr Sykes also therefore did not identify that discrepancies had been identified by the audit team in respect of four items in the course of the warehouse count, only three of which had been adequately explained by management, and none of which were recorded on the audit file as they should have been.

Breaches

5.31. In breach of paragraph 5 of ISA 501, the Respondents failed to perform a roll-back procedure for the warehouse stock counts (despite having planned to do so) to reconcile these stock counts to the Group's year-end stock listing and they thereby also failed to obtain sufficient appropriate audit evidence.

5.32. In breach of paragraph 8 of ISA 230, the Respondents failed to prepare audit documentation sufficient to enable an experienced auditor, having no previous connection with the FY2020 Audit, to understand the nature, extent and outcome of the testing of warehouse stock counts.

Breach 3: Third Party Stock Confirmation

Relevant Requirement engaged by Breach 3

5.33. Paragraph 16 of ISA 505 required the Respondents to evaluate whether the results of external confirmation procedures provided relevant and reliable audit evidence, or whether further audit evidence was necessary.

Background

5.34. At the year-end for FY2020 the Group held stock valued at £1.2 million at a warehouse managed by a third party.

5.35. The audit team originally planned to attend a stock count at the third party warehouse, but this also did not take place as a result of COVID-19 restrictions. The audit team instead sought confirmation from the third party of the inventory that it held, which was provided to the audit team via the Group's management in a different format. This was despite the fact that the audit team had made clear to management and therefore knew that the third party confirmation would need to be sent to the audit team directly by the third party.

Breaches

5.36. In breach of paragraph 16 of ISA 505, the Respondents failed to ensure that the third party confirmation was received directly from the third party, and instead accepted the third party confirmation in a different format which had been received via the Group's management.

6. *SANCTIONS*

6.1. Paragraph 10 of the FRC's Sanctions Policy (Audit Enforcement Procedure) (January 2022 edition) (the "**Sanctions Policy**") provides that *Sanctions* are intended to be effective, proportionate and dissuasive. The reasons for imposing *Sanctions* are identified in paragraph 11 of the Sanctions 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 of 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*; and

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

6.3. In reaching a decision on *Sanctions,* Executive Counsel has followed the reasoning set out below in accordance with the Sanctions Policy. Where any element of the reasoning is specific to one Respondent alone, this is made clear. Otherwise, each element of the reasoning applies to each Respondent.

Factors in paragraph 24 of the Sanctions Policy, including nature, seriousness, gravity and duration of the breaches

6.4. The breaches of the *Relevant Requirements* concern a number of basic and fundamental audit concepts including the requirements to plan and perform an audit with professional scepticism, to prepare sufficient audit documentation and to design and perform audit procedures in order to obtain sufficient appropriate audit evidence.

6.5. The breaches of *Relevant Requirements* in this case took place in the context of the challenges posed by COVID-19, and were limited to one specific area of the FY2020 Audit, namely inventory existence. Whilst this area was not identified as a significant risk area, the breaches occurred as part of a course of conduct that critically undermined the approach to the audit of inventory, which remained material to the Group's balance sheet: at the FY2020 year-end, inventory comprised approximately £26.6 million, included within the Group's net asset position totalling £13.4 million on the Consolidated Statement of Financial Position.[2]

6.6. The conduct of the audit team giving rise to certain breaches demonstrated a serious lack of basic competence, in particular:

6.6.1. A sustained failure to respond appropriately to variances identified in the controls testing of management's stock counts, including a failure to investigate management's explanations for those variances;

6.6.2. The adoption of a substantive testing approach based on a subset of the full stock count population of 1,000 SKUs used in the controls testing, without further consideration or consultation, and despite variances having been identified in nearly one third of those counts;

6.6.3. The removal of all counts with variances from the stock count population prior to the selection of the substantive testing sample, as part of a selection process described on the audit file as *"random"*;

6.6.4. The omission from the audit file of the results of the controls testing, such that the audit file documentation provided a false degree of assurance; and

6.6.5. Not performing a roll-forward of all of the stock balances counted from the date of the store counts to the period end date.

6.7. The breaches created a risk that the FY2020 financial statements were materially misstated. Breaches such as these could harm investor, market and public confidence in the truth and fairness of financial statements.

[2] The £26.6 million within the FY2020 financial statements consists of £27.6 million goods for resale (stores £20.3 million, warehouse £6.0 million, third party warehouse £1.2 million and £0.1 million relating to hedge accounting adjustment and stock held on pallets not delivered to stores during lockdown) <u>plus</u> £0.8 million Stock on Water <u>less</u> £1.9 million Shrinkage and Obsolescence provision.

6.8. The failure to conduct the FY2020 Audit in accordance with the *Relevant Requirements* could undermine confidence in the standards of conduct in general of *Statutory Auditors* and *Statutory Audit Firms*, and/or in statutory audit.

6.9. The audit fee for the FY2020 Audit was £141,000. It is not suggested that any financial benefit flowed, or was intended to flow, directly from the breaches.

6.10. It is not alleged that the breaches were intentional, dishonest, deliberate or reckless.

6.11. Executive Counsel recognises that the Respondents have implemented certain remedial measures following the FY2020 Audit.

<u>KPMG</u>

6.12. KPMG has a poor recent disciplinary record, and has been sanctioned 10 times since 2019 in respect of breaches of various Relevant Requirements.

6.13. As regards the "financial strength" of KPMG, the firm's audit fee income for 2021 was £646 million and its total fee income in 2021 was £2.433 billion.

<u>Mr Sykes</u>

6.14. Mr Sykes previously received a financial sanction of £150,000 (reduced to £112,500 on settlement) in respect of breaches arising from the audit of Rolls-Royce Group plc in FY2010, on which he was the Audit Engagement Partner.

6.15. Mr Sykes was made aware of performance issues within the audit team, and asked for further scrutiny to be applied, but his awareness did not prompt him to personally apply closer scrutiny to the audit team's work over the stock counts, or to ensure that sufficient scrutiny had otherwise been applied by others within the audit team.

6.16. Mr Sykes' senior role is also relevant to the seriousness of the breaches, with 25 years' experience as an audit partner at the time of the FY2020 Audit. Executive Counsel has also considered the remedial actions Mr Sykes has undertaken in his audit practice since the FY2020 Audit.

<u>Identification of *Sanction*</u>

6.17. Having assessed the nature, seriousness, gravity and duration of the breaches, Executive Counsel has identified the following combination of *Sanctions* as appropriate for KPMG:

6.17.1. A financial sanction of £1,750,000;

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

6.17.3. A declaration that the FY2020 Audit report signed on behalf of KPMG did not satisfy the audit reporting requirements as set out in this *Final Settlement Decision Notice*; and

6.17.4. An order pursuant to rule 136(c) of the AEP, requiring KPMG to take action to mitigate the effect or prevent the recurrence of breaches of the Relevant Requirements. In summary, KPMG will:

a. Put in place arrangements for the additional supervision and monitoring of the future audit work of two members of the audit team, for a period of one year.

b. Undertake a programme of work to review the effectiveness of its second line of defence function, including the trialling of changes intended to improve KPMG's ability to satisfactorily resolve issues identified during second line of defence reviews. KPMG will, by 1 November 2023, provide Executive Counsel with a report describing the outcome of its work and the steps that will be taken to ensure the effectiveness of its second line of defence reviews, and therefore reduce the likelihood of the recurrence of similar breaches.

6.18. Having assessed the nature, seriousness, gravity and duration of the breaches, Executive Counsel has identified the following combination of *Sanctions* as appropriate for Mr Sykes:

6.18.1. A financial sanction of £75,000;

6.18.2. A published statement, in the form of a severe reprimand; and

6.18.3. A declaration that the FY2020 Audit report signed by Mr Sykes did not satisfy the audit reporting requirements as set out in this *Final Settlement Decision Notice*.

6.19. Executive Counsel has taken into account the aggravating and mitigating factors that exist (to the extent that they have not already been taken into account in relation to the nature, seriousness, gravity and duration of the breaches).

Aggravating factors

6.20. Potentially aggravating factors, including the disciplinary records of each of the Respondents, have been considered in the context of the seriousness of the breaches (as discussed at paragraphs 6.12 and 6.14 above).

Mitigating factors

6.21. Both Respondents have demonstrated contrition for the breaches.

6.22. Other potential mitigating factors, including the context of the FY2020 Audit and the remedial actions undertaken by the Respondents, have been considered in the context of the seriousness of the breaches.

Co-operation

6.23. Given the extent of co-operation provided by the Respondents, Executive Counsel considers that a discount to the financial sanctions of 10% is appropriate.

Deterrence

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

Discount for Admissions and Settlement

6.25. Having taken into account the full admissions by the Respondents and the stage at which those admissions were made (at an early point within Stage 1 of the case in accordance with paragraph 84 of the Sanctions Policy), Executive Counsel determines that a discount of 35% is appropriate, such that a financial sanction of £1,023,750 is payable in respect of KPMG and a financial sanction of £43,875 is payable in respect of Mr Sykes.

Other considerations

6.26. In accordance with paragraph 47(c) of the Sanctions Policy, Executive Counsel has taken into account the size, financial resources and financial strength of KPMG and the effect of a financial sanction on its business.

7. **COSTS**

7.1. Executive Counsel requires that the Respondents pay the costs in full in this matter, being £198,430.64. Such costs shall be paid no later than 28 days after the date of the *Final Settlement Decision Notice*.

Signed:

CLAUDIA MORTIMORE

DEPUTY EXECUTIVE COUNSEL

Date: 10 February 2023

APPENDIX 1: EXTRACTS OF RELEVANT REQUIREMENTS

Extracts from ISAs

1. ISA 200: Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing

1.1. 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. (Ref: Para. A20-A24)

In the UK, the auditor shall maintain professional skepticism throughout the audit, recognising the possibility of a material misstatement due to facts or behaviour indicating irregularities, including fraud, or error, notwithstanding the auditor's past experience of the honesty and integrity of the entity's management and of those charged with governance."

2. ISA 230: Audit Documentation

2.1 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: (Ref: Para. A2–A5, A16–A17)*

(a) The nature, timing and extent of the audit procedures performed to comply with the ISAs (UK) and applicable legal and regulatory requirements; (Ref: Para. A6–A7)

(b) *The results of the audit procedures performed, and the audit evidence obtained; and*

(c) *Significant matters arising during the audit, the conclusions reached thereon, and significant professional judgments made in reaching those conclusions. (Ref: Para. A8–A11)*"

3. ISA 501: Audit Evidence – Specific Considerations for Selected Items

3.1 Paragraph 5 states as follows:

"*If physical inventory counting is conducted at a date other than the date of the financial statements, the auditor shall, in addition to the procedures required by paragraph 4, perform audit procedures to obtain audit evidence about whether changes in inventory between the count date and the date of the financial statements are properly recorded. (Ref: Para. A9–A11)*"

4. ISA 505: External Confirmations

4.1 Paragraph 16 states as follows:

"*The auditor shall evaluate whether the results of the external confirmation procedures provide relevant and reliable audit evidence, or whether further audit evidence is necessary. (Ref: Para A24-A25)*"

5. ISA 530: Audit Sampling

5.1 Paragraph 6 states as follows:

"*When designing an audit sample, the auditor shall consider the purpose of the audit procedure and the characteristics of the population from which the sample will be drawn. (Ref: Para. A4-A9)*"

5.2 Paragraph 8 states as follows:

"*The auditor shall select items for the sample in such a way that each sampling unit in the population has a chance of selection. (Ref: Para. A12-A13)*"

5.3 Paragraph 12 states as follows:

"*The auditor shall investigate the nature and cause of any deviations or misstatements identified, and evaluate their possible effect on the purpose of the audit procedure and on other areas of the audit. (Ref: Para. A17)*"

5.4 Paragraph 15 states as follows:

"*The auditor shall evaluate:*

(a) *The results of the sample; and (Ref: Para. A21-A22)*

(b) *Whether the use of audit sampling has provided a reasonable basis for conclusions about the population that has been tested. (Ref: Para. A23)*"