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**"), revised in June 2023. 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:

a) "**FY22**" means the financial year ended 26 February 2022

b) "**FY22 financial statements**" means N Brown Group plc's ("**N Brown**" or "**the Group**") consolidated financial statements for that period

c) "**FY22 Audit**" means the *Statutory Audit* of the FY22 financial statements.

d) **"Respondents"** means:

i. KPMG LLP ("**KPMG**") which was the *Statutory Audit Firm* for the FY22 Audit.

ii. Anthony Sykes ("**Mr Sykes**"), who was the *Statutory Auditor* of N Brown for the FY22 Audit and signed off the independent auditor's report included in the FY22 financial statements (the "**FY22 auditor's 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 21 May 2025 pursuant to Rule 103 of the AEP in relation to the conduct of the Respondents in respect of the FY22 Audit. The Respondents provided written agreement to the *Proposed Settlement Decision Notice*, pursuant to Rule 105 of the AEP, on 29 May 2025. The *Convener* subsequently appointed an *Independent Reviewer*, pursuant to Rule 106 of the AEP, to consider the *Proposed Settlement Decision Notice.*

1.6. On 6 June 2025, the *Independent Reviewer* approved the issuance of this *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:

a) the breaches of *Relevant Requirement(s)*, with reasons;

b) the *Sanctions* imposed on the Respondents with reasons; and

c) 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:

a) Section 2: Background

b) Section 3: Summary of the breaches of *Relevant Requirements*

c) Section 4: *Relevant Requirements* to which the breaches relate;

d) Section 5: Detail of the breaches of *Relevant Requirements*;

e) Section 6: *Sanctions*; and

f) Section 7: *Costs*.

2 BACKGROUND

1.1. 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 FY22 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.

1.2. N Brown is one of the UK's largest online clothing and footwear retailers. Its clothing brands include JD Williams, Jacamo and Simply Be. It also has a homeware offer under the brand Home Essentials. At the relevant time, it was listed on the Alternative Investment Market of the London Stock Exchange.

1.3. A large proportion of the Group's product sales are made on consumer credit, with N Brown's customers utilising a credit account to spread the cost of their purchases over time. The Group is regulated by the Financial Conduct Authority in the UK and the Central Bank of Ireland in Ireland.

1.4. Following a move away from its traditional catalogue business, and the closure of its high-street stores in FY19, N Brown has been focused on online markets. The Group undertook a strategic review to return N Brown to sustainable growth during FY20 and in FY22 a further review was undertaken, supported by a management consultancy.

1.5. The Group's reported revenue, profit before tax and net assets for FY22 were £715.7 million (FY21: £728.8 million), £19.2 million (FY21: £9.2 million), and £442.3 million (FY21: £412.3 million) respectively.

1.6. The Group recognised £113.0 million of intangible assets and £58.5 million of property, plant and equipment as at 26 February 2022, including development costs and assets under construction which are subject to impairment testing. The trigger for impairment testing (per paragraph 12(d) of International Auditing Standard ("**IAS**") 36), was that the market capitalisation of the Group at the balance sheet date was £168.1 million, which was significantly lower than the Group's net assets of £442.3 million.

1.7. The audit team assessed the impairment of these assets as a significant risk and reported this as a Key Audit Matter under the heading “Impairment of the carrying value of non-current assets in the Group cash generating unit…”. The related audit work is referred to as “audit work on impairment” in this *Final Settlement Decision Notice.*

1.8. In 2022, KPMG was one of the largest audit firms in the UK, with revenues of £2,723 million and 152 audit partners. FY22 was KPMG’s sixth year as the *Statutory Audit Firm* for N Brown.

1.9. Mr Sykes was a KPMG partner, with 27 years’ auditing experience at the time of the FY22 Audit. He has since retired from KPMG.

1.10. On 18 May 2022 Mr Sykes signed the FY22 auditor’s report in respect of the FY22 financial statements with an unmodified opinion, on behalf of KPMG.

The FY22 Audit

1.11. Audit materiality was £2.0 million, based on 4.6% of group profit before tax, normalised to exclude exceptional items and by averaging over the last three years to take account of fluctuations in the business cycle.

1.12. The FY22 audit team was led by Mr Sykes and this was his second year as the Statutory Auditor on the engagement. The Engagement Quality Control Reviewer (**“EQCR”**) was in his seventh year on the engagement.

1.13. The Group performed its impairment review as at 26 February 2022. The review was performed over the Group’s total assets under one cash generating unit (“**CGU**”), being the smallest group of assets which generate independent cash inflows.

1.14. The audit approach involved the following steps:

a) evaluating the design and implementation of the Group’s controls over the impairment calculations;

b) assessing the Group’s forecasting accuracy through historical comparison by comparing actual results in the period to what was the previous forecast for the year;

c) benchmarking, together with valuations specialists, by challenging the assumptions made by management with respect to the discount rate and assessing this for reasonableness based on external data and market comparable companies;

d) comparing the sum of the discounted cashflows to the Group's market capitalisation to assess the reasonableness of the Value in Use ("**VIU**") calculations;

e) performing a sensitivity analysis – a 'breakeven' analysis on the key assumptions, including projected revenue and earnings before interest, taxes, depreciation, and amortisation ("**EBITDA**") growth rates in years 1-3, capital expenditure and the discount rate, to assess how sensitive the VIU was to reasonably possible changes in assumptions;

f) performing corroborative inquiries of key personnel outside of the core group finance team to challenge the status of the Group's performance, and corroborate the key assumptions; and

g) assessing the Group's disclosures in accordance with accounting standards.

1.15. During the audit work on impairment the audit team consulted with KPMG's Department for Professional Practice – Accounting & Reporting ("**DPP A&R**") in respect of the Group's proposed change in approach to the cash flow modelling underpinning management's assessment of the VIU calculation used in its impairment assessment. The audit team included specialists from KPMG's Corporate Finance valuations team ("**the CF Team**") with respect to the assessment of the discount rate used in the VIU calculation.

Impairment and IAS 36

1.16. Paragraph 9 of IAS 36 states that "*an entity shall assess at the end of each reporting period whether there is any indication that an asset may be impaired. If any such indication exists, the entity shall estimate the recoverable amount of the asset*."

1.17. An impairment exists when the recoverable amount is less than the carrying value (sometimes referred to as "carrying amount"). The impairment reduces the carrying value of the asset on the balance sheet. Recoverable amount is defined in IAS 36 as the higher of VIU and fair value less costs of disposal. VIU is commonly used for assets expected to continue to be used (e.g. not expected to be sold).

1.18. The amount by which the recoverable amount is higher than the carrying value is referred to as "headroom" during the FY22 Audit and in this *Final Settlement Decision Notice*.

1.19. In calculating an asset's VIU, paragraph 30 of IAS 36 requires the following elements to be reflected:

a) an estimate of the future cash flows the entity expects to derive from the asset;

b) expectations about possible variations in the amount or timing of those future cash flows;

c) the time value of money, represented by the current market risk-free rate of interest;

d) the price for bearing the uncertainty inherent in the asset; and

e) other factors, such as illiquidity, that market participants would reflect in pricing the future cash flows the entity expects to derive from the asset.

1.20. Paragraph 31 of IAS 36 explains that estimating the VIU of an asset involves the following steps:

a) estimating the future cash inflows and outflows to be derived from continuing use of the asset and from its ultimate disposal; and

b) applying the appropriate discount rate to those future cash flows.

1.21. Paragraph 32 of IAS 36 explains that the elements identified in (b), (d) and (e) of paragraph 30 can be reflected either as adjustments to future cash flows or as adjustments to the discount rate. Whichever approach an entity adopts to reflect expectations about possible variations in the amount or timing of future cash flows, the result shall be to reflect the expected present value of the future cash flows, i.e. the weighted average of all possible outcomes.

1.22. Paragraph 33 of IAS 36 requires the future cash flows used for the purposes of the VIU calculation to be:

a) based on reasonable and supportable assumptions, representing management's best estimate of the range of economic conditions that will exist over the remaining useful life of the asset, with greater weight given to external evidence;

b) based on the most recent financial budgets/forecasts (up to a maximum of five years) approved by management, excluding any estimated cash inflows or outflows expected to arise from future restructurings or from improving or enhancing the asset's performance; and

c) estimated beyond the period covered by the most recent budgets/forecasts by extrapolating the projections based on the budgets/forecasts using a steady or declining growth rate for subsequent years, unless an increasing rate can be justified.

1.23. Additionally IAS 36 paragraph 55 allows the discount rate to reflect "*the risks specific to the asset for which the future cash flow estimates have not been adjusted*", making it clear that there should not be double counting. Thus forecasting risk could be accounted for either in the cash flows themselves, or the discount rate.

1.24. A CGU is a unit of account for determining impairment (i.e. what the test is performed on) and per paragraph 6 of IAS 36 it is defined as the smallest collection of assets capable of generating independent cash flows. The calculation of the carrying amount of a CGU is important as this is the amount that the VIU is compared to in establishing whether or not impairment is required. Therefore, if the carrying amount of the CGU is overstated, then the headroom in the impairment calculation will be understated.

1.25. Paragraph 76 of IAS 36 requires that:

> "*The carrying amount of a cash-generating unit:*
>
> *(a) includes the carrying amount of only those assets that can be attributed directly, or allocated on a reasonable and consistent basis, to the cash-generating unit and will generate the future cash inflows used in determining the cash-generating unit's value in use; and*
>
> *(b) does not include the carrying amount of any recognised liability, unless the recoverable amount of the cash-generating unit cannot be determined without consideration of this liability."*

Performance of Audit Procedures

1.26. The audit team undertook a number of audit procedures on impairment and each of these are dealt with below under the following headings: controls testing, CGU carrying value, model methodology, cash flow forecasts, discount rate, sensitivity analysis, and the reconciliation to market capitalisation.

Controls testing

1.27. The audit team evaluated the controls over impairment and deemed the design and implementation of the controls as ineffective for audit purposes. As a result, the controls could not be relied upon to reduce the nature and extent of substantive testing and the work performed by the audit team was fully substantive.

CGU carrying value

1.28. In its assessment of impairment the Group's management concluded that there was one CGU, which had a carrying value of £400.0 million. This was calculated by deducting the cash and cash equivalents balance of £43.2 million from net assets of £443.2 million.

1.29. The audit team followed KPMG's standard audit programme to assess whether it was appropriate for the Group to only have one CGU and then went on to test the allocation of the Group's assets and liabilities to that CGU. This work involved evaluating:

a) whether the CGU was the smallest identifiable group of assets that generated cash inflows that were largely independent of the cash inflows from other assets or groups of assets;

b) whether the carrying amount of the CGU included assets and liabilities directly attributable to the CGU; and

c) whether the carrying amount of the CGU had been determined on a basis consistent with the way in which the recoverable amount of the CGU had been determined.

<u>Model methodology</u>

1.30. The Group's management initially prepared a model based on their historic approach to impairment considerations which was provided to the audit team via email on 18 February 2022. This model showed headroom of £95 million.

1.31. Management's model was subject to initial challenge by the audit team with a number of errors being identified, in respect of the tax rate used, the level of capital expenditure in the model and the inclusion in the model of cash flows arising from initiatives not yet started.

1.32. A number of iterations of the model were received from the Group's management in response to points raised by the audit team. A version received on 5 April 2022, showed headroom of £59 million using a discount rate of 11.1%.

1.33. On 18 April 2022 a senior individual at the Group emailed Mr Sykes suggesting a change to the model methodology stating:

> *"I've always been uncomfortable with how this is calc'd these last few years [Redacted.].*
>
> *Ironically, now that we have a stronger B/Sheet with the work of the last few years, this method of calculating future value vs current asset value is giving us a harder position. Fundamentally I think this is being driven by the way it is calculated – the*

starting asset point to clear is the asset value grossed up for the removal of the securitised debt. It then looks at normal cash generation on the go forward using the net move in receivables, i.e. not the gross receipts we get for the current debt, but the net picture with new customer loans being made but no funding being drawn down.

For any "bank" this way of calculating will look under pressure – you'd never be able to effectively run a loan business this way. I think it's essentially a legacy of viewing us as a retailer primarily and not understating the FS side fully, which we now do.

Rather than the teams get into a lot of the other small print detail on the numbers I'd value us lifting back and thinking through what it is doing and whether it is correct for a loan business - I don't believe it is, but as ever open to external insight….."

1.34. The audit team consulted with DPP A&R on the appropriateness of the suggested change in methodology in order to understand whether the treatment of the securitisation facility balance as working capital for the purposes of the VIU calculation was in line with the requirements of IAS 36. Mr Sykes did not share the email from a senior individual at the Group, instead setting out his concerns in a separate email dated 18 April 2022 to a DPP A&R Partner stating:

"I set out below a brief summary of the issue

1. N Brown offers credit to its customers and c80% of its sales are on credit
2. It finances it's [sic] credit arrangements through a securitization facility secured on its debtor book.
3. The business' market capitalization has dropped significantly and management is conducting and [sic] impairment review - there is only one CGU
4. The carrying amount of the CGU includes the customer receivables but currently excludes amounts drawn down in the securitization facility on the basis that it is sent
5. The cash flows used to determine VIU reflect changes in the receivables position as a movement in working capital in the normal way

Management is challenging this approach on the basis that in their view it doesn't reflect the fact that, whilst 80% of its sales are on credit, this is in effect realized in cash through the securitization facility. Their view therefore is that either, the analysis should be based on cash flows that reflect the inflows from the *securitization or the amounts drawn down on the securitization facility should be deducted from the carrying amount of the CGU*

I think that they are wrong on the basis that the securitization facility is financing the business' working capital requirements and should be excluded from the analysis in the usual way".

1.35. Based on a consideration of the facts and N Brown's business model, DPP A&R confirmed that the methodology proposed by management was an acceptable basis, under the applicable IFRS accounting standards, on which to assess the carrying value of the business' assets for impairment.

1.36. The revised model adopted by management used the same underlying forecast cash flows that had been used for the initial modelling, but the revised model now sought to reflect the additional cash flows arising from the inclusion of the securitisation balance within working capital. On 19 April 2022, management sent the audit team a version of the updated impairment model (described as an "early view") to check it was in line with the audit team's expectations. This version showed significantly increased headroom of £449 million.

1.37. Mr Sykes responded by email on the same day, identifying a number of errors, inconsistencies, and additional considerations that should be reflected in the model, noting that headroom would come down as a result but would still be ample based on the cash flow projections as they stood (i.e. assuming no further audit adjustments).

1.38. A revised model reflecting adjustments for Mr Sykes' initial comments was received from management on 21 April 2022, showing headroom of £121 million with a post-tax discount rate of 15.2% and using a three-year plan, and the final version received on 5 May 2022 reflecting changes made following the identification of additional errors and required adjustments by the audit team showed headroom of £56 million with the same discount rate.

1.39. In respect of the change in management's modelling approach, the audit team noted the following in its report to the Audit & Risk Committee in May 2022 (the "**FY22 Audit Committee Report**"):

"*A change to note from the prior year approach management has taken is to treat the securitisation facility as part of working capital and include the draw downs in the cash flows and in the net assets, by showing net receivables. This is solely for the purpose of the VIU analysis and is required to achieve symmetry between the cash flow projections and net assets being assessed for impairment. KPMG concurs with this approach*."

Cash flow forecasts

1.40. The initial cash flow forecasts used by the Group's management were derived from the Board approved three-year plan ("**3YP**") reflecting growth assumptions built upon the results of a strategy review conducted with the assistance of a management consultancy, plus extrapolations for years four and five. The FY23 forecasts in the 3YP were later updated to reflect the Board approved budget for FY23 which arrived at the same EBITDA of £90 million.

1.41. The audit team challenged the use of a five year period on the basis that the Board had only approved the 3YP. An adjustment was made as a result to reduce the base cash flow projections from five years to three years.

1.42. The audit team conducted further procedures over the integrity of the model which produced the final cash flows that were used for the VIU calculation. These included consideration of the appropriateness of the cash flows, the basis for their inclusion (or exclusion) and the accuracy of their calculation.

1.43. This work included consideration of: the accuracy of previous forecasting, revenue growth assumptions, capital expenditure assumptions, working capital assumptions and the terminal growth rate.

Accuracy of previous forecasting:

a) The audit team sought to analyse management's ability to accurately forecast cash flows by comparing management's historic cash flow forecasts against actual performance. In one working paper, this work concluded that prior to COVID management's forecasts were largely in line with actual performance and, whilst there were significant inaccuracies in the forecasts impacted by COVID these were not unexpected. The audit team concluded that it was not possible to fully assess post COVID forecasting accuracy. Another working paper noted that there was a range of accuracies in management's forecasting ability and the average of all the variances was a 12% adverse variance.

Revenue growth assumptions:

b) The revenue growth assumptions forecast a progressive return by FY25 to the pre-COVID profit levels reported in FY20, reflecting a return to 'historic trading patterns' and the anticipated benefit of a number of growth initiatives. The audit team considered management's revenue and gross margin growth assumptions using analysis and enquiry and with reference to external data sources, including: the

Economist Intelligence Unit, GlobalData's UK retail forecast to 2025 and International Monetary Fund's World Economic Outlook reports.

c) The Economist Intelligence Unit insights suggested that the Group's revenue growth assumptions were broadly in-line with market forecasts for the retail sector as a whole in FY23 and FY24, but somewhat above expectations for FY25. The other data sources indicated that management's growth assumptions were optimistic in comparison.

d) Adjustments made following audit team challenge included:

   i. exclusion of revenue growth attributable to future capital expenditure;

   ii. reduction in the base cash flow projections from five years to three years; and

   iii. replacing the FY23 forecasts with a subsequently approved updated budget for FY23

e) The audit team concluded that the revenue growth assumptions remained optimistic given the execution risks associated with the growth initiatives they reflected and emerging inflationary pressures.

Capital Expenditure assumptions

f) The amounts initially included by management (£15 million per annum) did not reflect the audit team's understanding of the level of investment anticipated in maintenance and substantially commenced ongoing projects. The audit team challenged management's capital expenditure assumptions both in the period covered by the 3YP and in the terminal period. As a result of this challenge the capital expenditure assumption was increased by £15 million in each of FY23 to FY25 and by £5 million in the terminal year.

Working capital assumptions

g) The audit team considered the movements in working capital following the change in model methodology. This included management's adjustment to the forecast trade receivables in the impairment analysis for the securitisation drawdown. This adjustment assumed that 88% of the trade receivables were eligible to be securitised and that 72% of the eligible balance could be drawn down in advance. The audit team concluded that this was in line with their understanding of the 3YP and their view that it was an ambitious and challenging plan that would require significant investment.

Terminal growth rate

h) The audit team noted that management's selected long term growth rate of 1.4% was supported by an International Monetary Fund World Economic Outlook report projecting output growth of 1.4% for the Euro area. The audit team assessed this as a reasonable long term growth rate given the rate for other advanced economies was projected to be 2.0%.

1.44. Significant changes to the cash flow forecasts were made as a result of the issues identified by the audit work performed, including in respect of capital expenditure, revenue growth attributed to initiatives which were not sufficiently advanced to be recognised and moving from a five year forecast to a three year forecast.

1.45. Despite the number of changes made to the cash flows following challenges by the audit team, they still considered that there was optimism in the cash flows. This was most evident in the FY25 cash flows which drove the terminal value in the VIU calculations.

1.46. In the FY22 Audit Committee Report, the audit team noted the following summary in respect of the key assumptions in the forecasts:

"We have challenged management on the reasonableness of the revenue, margin and operating expenses assumptions. The Group are in very early stages of executing a challenging and ambitious strategy, particularly on the retail side of the business, which generates an execution risk, particularly around forecast growth figures. KPMG have challenged the building blocks used in management's forecasting and performed a set of sensitivities that shows only a small reduction in the assumed growth of product revenue could lead to a material impairment. In the current environment with rapid cost of living increases, it is not unplausible for a challenging strategy not to be realised in its entirety"

<u>Discount rate</u>

1.47. The audit team engaged members of the CF Team to assist with the audit of the discount rate. Management's original Weighted Average Cost of Capital ("**WACC**") methodology, calculating an average cost of capital based on a model that did not include the securitisation cash flows and balances, gave a rate of 10.97% which was within the range calculated by the CF Team, including an illustrative alpha factor (or allowance for forecasting risk) of 2%.

1.48. Following management's decision to change the model methodology to include the securitisation facility into working capital movements, management needed to update the discount rate calculation to take into account that the calculation was now a cost of equity model because there was no longer any debt.

1.49. The updated discount rate calculated and used by management in their impairment model was 15.2% (18.6% on a pre-tax basis). Management's discount rate calculation used a beta factor of 1.69 (representing the relative systematic equity market risk of the Group compared to the market as a whole) and an alpha factor of 1% (reflecting forecasting risk).

1.50. The CF Team developed an independent discount rate (excluding forecasting risk) of 10.7%, taking each element of the discount rate build up and comparing it to external benchmarks or evaluating the judgements made by management based on their knowledge and experience. The audit team and the CF Team assessed the difference of 4.5% (post tax) between that rate and management's 15.2% rate as reflecting the forecasting risk premium (the 'alpha factor').

1.51. The CF Team's conclusion was that an appropriate beta for the Group was in the range of 0.9 to 1.1. The CF Team calculated a range for the discount rate, including the 'implied alpha' of 4.5%, as between 14.5% to 16%.

1.52. In respect of the discount rate used by management, the audit team's conclusion was set out in a file note prepared by Mr Sykes as follows:

> *"Management's WACC s [sic] is within KPMG CF's calculated range, albeit at the cautious end of that range reflecting an alpha factor which is commensurate with the risks in the cash flow projections which are, in our view, optimistic given the execution risks associated with implementing its strategy and the headwinds facing the retail sector more generally. Furthermore, the business has underperformed against the forecasts prepared in FY21 for the purposes of the going concern, viability and impairment analyses for that year."*

<u>Sensitivity analysis</u>

1.53. The audit team undertook a sensitivity analysis to assess the implications of what they considered to be the more likely downside scenarios. The results of that sensitivity analysis were set out in summary in the FY22 Audit Committee Report as follows:

	VIU	Carrying value of CGU	Headroom
	£ million	£ million	£ million

Management's base case	457	400	57
KPMG Sensitivities			
Terminal value capex breakeven	400	400	0
3% reduction in yearly product revenue growth	393	400	(7)
1% yearly margin reduction in product and FS	430	400	30
Combined 3% reduction in yearly product revenue growth and 1% margin reduction in product and FS	343	400	(56)
Reduction in new customer building block benefit by 50%	413	400	13

1.54. The audit team also requested that management ran breakeven sensitivity analysis. The audit team noted in the FY22 Audit Committee Report:

"The model is sensitive to small, reasonably possible changes in assumptions, in particular with respect to the forecast revenue and EBITDA assumptions. We recognise that the risk could be mitigated in the short to medium term through management actions within their control which are not currently reflected in the cashflows, but note that the implications for the business' long term prospects could be severe in these circumstances. Following our challenge of management, enhanced disclosure has been included in the financial statements to highlight the sensitivity of the key assumptions in the impairment review, and the risk of an impairment charge materialising should these assumptions, particularly around revenue and EBITDA growth, not be achieved."

1.55. The enhanced disclosure referred to above, in the form of the breakeven sensitivity analyses, was included in Note 12 to the FY22 financial statements and detailed the key assumptions as follows:

"Years 1-3 expected product revenue and EBITDA growth;

Replacement Capital expenditure of £30m per year in years 1-3 and £20m in the terminal year; and

Pre-tax discount rate: 18.6% (2021: 13.1%).

The impairment review performed over the Group's CGU has indicated that no impairment is required over the remaining assets of the Group. The recoverable amount exceeds its carrying amount by £57m. The following sensitivities have been performed within the value in use calculation, and do not therefore include any management action or mitigation:

a. Within years 1-3 expected cashflows, if product revenue were to decrease by more than 4.2% on average per annum with a respective decrease in FS revenue for loss of credit sales, the value in use would indicate an impairment;

b. An increase to replacement capital expenditure cashflows by greater than £11.0m in the terminal year (55% increase) would indicate an impairment; and

c. An increase to the discount rate of more than 1.8% would indicate an impairment.

It is reasonably possible that the Revenue and EBITDA growth assumptions may not be realised in full or in the timescale envisaged. The value in use would indicate an impairment if, all other things being equal, EBITDA per annum was on average 10% lower than forecast."

Reconciliation to market capitalisation

1.56. As part of its consideration of possible indicators of impairment, the audit team compared the Group's net assets and VIU with its market capitalisation. A working paper setting out this work recorded the following:

a) market capitalisation of £168 million compared to net assets of £443 million – calculating a shortfall of £275 million; and

b) market capitalisation of £168 million compared to VIU less debt of £197 million (£456 million less net debt of £259 million) – calculating a shortfall of £29 million.

1.57. The audit team noted that the Group's market capitalisation was significantly below its adjusted net assets (less cash), indicating that they may be impaired.

1.58. The audit team assessed management's analysis of the reasons for the differences through enquiry with management and discussion, concluding that the difference between market capitalisation and VIU of £29 million could be reasonably justified but that it did indicate that some of management's assumptions were optimistic.

1.59. In the FY22 Audit Committee Report, the audit team's comments in respect of the comparison were as follows:

> *"We have assessed potentially disconfirming or contradictory evidence and any other indicators of impairment. In doing this, we have compared the sum of management's discounted cashflows (adjusted for net debt) to the Group's market capitalisation at year end. Management have bridged the gap from market capitalisation of £168m to net assets of £400m based on target share prices of brokers. Management then consider the remaining variance to be bridged by the strategic growth expected by management which is not factored by the market. The gap between current market capitalisation and the VIU highlights there may be a risk of future impairment if the share price and subsequent market capitalisation do not recover to previous or expected levels."*

1.60. In the Executive Summary of the FY22 Audit Committee Report the audit team also stated that the significant difference of £289 million between the Group's market capitalisation and management's base case VIU of £457 million related mainly to the Group's debt of £259 million.

<u>Audit Team's overall conclusions in respect of impairment</u>

1.61. The audit team's overall conclusion on impairment was set out in the FY22 Audit Committee Report as follows:

> *"Whilst we agree that the discount rate used by management is at the cautious end of an acceptable range and acknowledge that the consistency between the implied multiples described above suggests the IAS 36 projections are aligned with the market's view of the business' risk profile, we believe that there are reasonably possible downside scenarios in which an impairment would be required. In particular, we believe that there are considerable execution risks associated with the Group's strategy and it is possible that the impact of cost inflation on the revenue growth and sales price assumptions could be more severe than anticipated. We recognise that these could be mitigated in the short to medium term through management actions within their control which are not currently reflected in the cashflows, but note that the implications for the business' long term prospects could be severe in these circumstances.*
>
> *Accordingly, whilst we agree that no impairment is required, the headroom is relatively low in the context of forecast growth assumptions which we would regard as ambitious. As a result, we believe clear disclosure of these sensitivities from an appropriately struck base case is important."*

3 SUMMARY OF THE BREACHES OF RELEVANT REQUIREMENTS

2.1. The breaches of *Relevant Requirements* in this *Final Settlement Decision Notice* relate to the audit work on impairment, in respect of:

a) **The carrying value of the CGU:** Failing to perform audit procedures to consider whether assets and liabilities had been incorrectly included in the CGU carrying value, in breach of paragraph 6 of ISA 500.

b) **Model methodology**: Failing to evaluate whether the change in the impairment methodology was indicative of management bias in breach of paragraph 32 of ISA 540; insufficient documentation on the audit file of management's rationale for the proposed change and its implications, in breach of paragraph 8 of ISA 230; and failing to properly report to the Audit Committee, in breach of paragraph 16 of ISA 260.

c) **Cash flow forecasts**: Failing to subject the cash flow forecast assumption to a greater degree of challenge and scrutiny and failing to identify a number of errors in management's forecasts, in breach of paragraph 6 of ISA 500.

d) **Discount rate**: Failing to conduct audit procedures to obtain sufficient appropriate audit evidence in relation to management's discount rate, in breach of paragraph 6 of ISA 500.

e) **Sensitivity analysis and disclosures**: Failing to use the correct tax rate in the sensitivity calculations thereby overstating the headroom, in breach of paragraph 6 of ISA 500.

f) **Reconciliation to market capitalisation**: Failing to obtain adequate explanations for the actual difference between the VIU and the Group's market capitalisation, in breach of paragraph 6 of ISA 500.

g) **The audit team's overall conclusions**: Failing to address whether the significant assumptions behind the cash flow forecasts and the discount rate were consistent with each other, in breach of paragraph 24(c) of ISA 540.

2.2. There are also breaches of ISAs 220 and 230 concerning quality control of the audit in relation to the matters listed above.

2.3. Section 5 of this *Final Settlement Decision Notice* sets out the detailed breaches of *Relevant Requirements.*

2.4. Whilst this *Final Settlement Decision Notice* explains the failings in the Respondents' audit work it does not question the truth or fairness of the FY22 financial statements. In particular, whilst the audit work on impairment was inadequate, it is not alleged that N Brown was required to recognise an impairment in FY22.

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

<u>KPMG</u>

2.6. In total:

a) A financial sanction of £1.25 million adjusted for the mitigating factor of exceptional co-operation by a reduction of 12.5%*,* and further discounted for admissions and early disposal by 35% so that the amount payable is £710,937.50;

b) A published statement in the form of a Severe Reprimand; and

c) A declaration that the FY22 auditor's report signed on behalf of KPMG did not satisfy the *Relevant Requirements*, as set out in this *Final Settlement Decision Notice*.

2.7. In determining the *Sanctions* to be imposed on KPMG Executive Counsel has noted that in response to the identified failings in the FY22 Audit, KPMG took a number of remedial steps and in those circumstances no further firm-wide non-financial sanctions are required.

<u>Anthony Sykes</u>

2.8. In total:

a) A financial sanction of £90,000 adjusted for the mitigating factor of exceptional co-operation by a reduction of 12.5%*,* and further discounted for admissions and early disposal by 35% so that the amount payable is £51,187.50;

b) A published statement in the form of a Severe Reprimand; and

c) A declaration that the FY22 auditor's report signed on behalf of KPMG did not satisfy the *Relevant Requirements*, as set out in this *Final Settlement Decision Notice*.

2.9. Executive Counsel highlights that the discounts given for co-operation and settlement reflect that the Respondents: conducted self-reviews identifying a number of the breaches of *Relevant Requirements*; have shown insight into their failings; and prior to this *Final Settlement Decision Notice*, undertook remedial actions to prevent recurrence of the breaches.

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 ("**SATCAR**"). The *Relevant Requirements* include, but are not limited to, the ISAs, issued by the FRC and which are based on the standards issued by the International Auditing and Assurance Standards Board.

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

4.2.1. ISA (UK) 220 (Quality Control for an Audit of Financial Statements);

4.2.2. ISA (UK) 230 (Audit Documentation);

4.2.3. ISA (UK) 260 (Communication With Those Charged With Governance);

4.2.4. ISA (UK) 500 (Audit Evidence); and

4.2.5. ISA (UK) 540 (Auditing Accounting Estimates and Related Disclosures)

4.3. Extracts from the ISAs setting out those parts which are of particular relevance to the breaches of *Relevant Requirements* are set out in Appendix 1 hereto.

4.4. As the Senior *Statutory Auditor* responsible for the FY22 Audit, Mr Sykes was responsible for the overall quality of the audit and the direction, supervision, and performance of the audit in compliance with professional standards and applicable legal and regulatory requirements. Accordingly, Mr Sykes is responsible for any established breaches of auditing standards in relation to the FY22 Audit.

4.5. As the *Statutory Audit Firm* responsible for the FY22 Audit, KPMG is responsible for any established breaches of *Relevant Requirements* on the part of its partners or employees.

5 BREACHES OF *RELEVANT REQUIREMENTS*

5.1. There are 8 areas where the audit work on impairment was in breach of Relevant Requirements.

Breach Area 1 - Carrying value of the CGU

5.2. Paragraph 6 of ISA 500 requires an auditor to design and perform audit procedures that are appropriate in the circumstances for the purpose of obtaining sufficient appropriate audit evidence.

5.3. The audit work undertaken by the audit team on the assets and liabilities included in the CGU carrying value was limited to checking that the balances were consistent with the approach used in the previous year and that they agreed to the underlying accounting records.

5.4. The audit work performed did not include, as required by KPMG's standard audit programme, consideration of the appropriateness of the inclusion of these balances to comply with the requirements of paragraph 76 of IAS 36.

5.5. As a result, the audit team failed to identify that the assets and liabilities relating to the retirement benefit surplus, deferred tax and current tax had been incorrectly included in the CGU carrying value. The exclusion of these balances would have reduced the carrying value of the CGU by £29.2 million as set out in the table below:

	£ million
Retirement benefit surplus	37.4
Deferred tax assets	11.5
Current tax asset	1.0
Deferred tax liabilities	(20.7)
Total	**29.2**

5.6. In addition, the carrying value of the CGU included, in error, a provision in respect of an ongoing legal dispute. The cash flow forecasts also included cash outflows in respect of this dispute, but at a different amount. The net impact of this was an understatement of the carrying value of the CGU of £2.9 million.

5.7. As a result of these errors, the net overstatement of the carrying value of the CGU was £26.3 million.

5.8. By failing to perform audit procedures to consider whether assets and liabilities had been correctly included in the CGU carrying value, the Respondents breached paragraph 6 of ISA 500 which required them to perform audit procedures that were appropriate in the circumstances for the purposes of obtaining sufficient appropriate audit evidence.

Breach Area 2 – <u>Model Methodology</u>

5.9. Paragraph 32 of ISA 540 requires an auditor to evaluate whether judgments and decisions made by management in making the accounting estimates included in the financial statements, even if they are individually reasonable, are indicators of possible management bias. When indicators of possible management bias are identified, the auditor shall evaluate the implications for the audit.

5.10. Additionally paragraph 8 of ISA 230 requires an auditor to 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 (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.

5.11. Paragraph 16 of ISA 260 requires an auditor to communicate with those charged with governance regarding significant findings from the audit, including;

5.11.1. the auditor's views about significant qualitative aspects of the entity's accounting practices - including accounting estimates;

5.11.2. details of any significant difficulties that have been encountered during the audit; and

5.11.3. other significant matters that are relevant to the oversight of the financial reporting process.

5.12. As set out at paragraph 2.33, during the Respondents audit work the a senior individual at the Group suggested changes to the impairment modelling methodology. Following the change in methodology the headroom in the model increased initially to £449 million and reduced to £121 million following the audit team's initial challenge.

5.13. A number of revised models were received throughout April 2022 in response to the audit team's further challenge and the integrity of those models were tested by the audit team by reperforming the calculations and the formulae in management's model. The audit team continued to test the key assumptions in the model including those relating to the changes in methodology, those being the cash flow forecasts (including movements in the working capital and capital expenditure) and the discount rate, with the final version of the model showing reduced headroom of £56 million, as a result of the audit team's challenge.

5.14. However, the revised treatment of the securitisation facility should have been offset by the inclusion of interest cash flows, plus the change to an unlevered WACC, with no overall impact on the headroom. Despite this, the audit file does not evidence any assessment on the part of the audit team as to the impact on the headroom of the change in the model methodology.

5.15. There is no evidence on the audit file to demonstrate that the audit team considered whether the change in approach to impairment calculations, which came at a time when there was challenge from the audit team, indicated an element of management bias. The Respondents failure to evaluate whether the change was indicative of management bias amounted to a breach of paragraph 32 of ISA 540.

5.16. In addition, whilst the Respondents consulted with the DPP A&R regarding the appropriateness of the revised approach, there was insufficient documentation on the audit file of management's rationale for the proposed change in approach and the audit implications of that change.

5.17. In these circumstances, the Respondents did not satisfy the Relevant Requirement in respect of the documentation of the audit work performed and conclusions reached, in breach of paragraph 8 of ISA 230.

5.18. As set out at paragraph 2.39, the reporting to the Audit Committee of the change in the model methodology was brief and did not adequately explain the rationale for and the impact of the change in model approach. The reporting should have been more extensive to better reflect the conduct of the audit and provide the opportunity for more informed debate. The Respondents conduct therefore breached paragraph 16 of ISA 260.

Breach Area 3 – Cash flow forecasts

5.19. The Respondents performed audit work on the cash flow forecasts used in the VIU calculation in respect of: the accuracy of previous forecasting, the revenue growth assumptions, capital expenditure assumptions, working capital assumptions and the terminal growth rate.

5.20. IAS 36 required the base case cash flows to be:

5.20.1. based on reasonable and supportable assumptions that represented management's best estimate of the range of economic conditions that would exist over the remaining useful life of the asset (with greater weight to be given to external evidence).

5.20.2. based on the most recent financial budgets/forecasts (up to a maximum of five years) approved by management, excluding any estimated cash inflows or outflows expected to arise from future restructurings or from improving or enhancing the asset's performance.

5.21. The audit team's work on historic forecast accuracy sought to gather evidence on management's ability to forecast accurately. However, this work was inconclusive, with both specific and average adverse variances observed in management's historical forecasting.

5.22. Whilst the audit team noted that the forecasts were Board approved and had been prepared with input from a management consultancy, they concluded that the 3YP on which the forecasts were based was an ambitious and challenging plan and management's revenue growth assumptions were optimistic. The audit team responded to this assessment by conducting a range of sensitivities intended to illustrate the impact of a range of reasonably possible downsides as illustrated in the sensitivities section above.

5.23. The forecasts resulted in a return by FY25 to the level of trading pre-COVID, as reported in FY20, against a backdrop of a continued reduction in retail revenue over the period FY18 - FY22 (partly as a result of the move away from the traditional catalogue business, and the closure of its high-street stores in FY18 and FY19). The forecast increase in retail revenue drove the expected growth in EBITDA for the FY23 to FY25 years, which should have led to a stronger challenge by the audit team, considering the possibility that retail revenue might continue to decline.

5.24. Despite some changes being made as a result of the audit team's challenge, the audit team concluded that the cash flow forecasts remained both optimistic and ambitious. Although sensitivities were run, they did not provide sufficient evidence over the extent of the optimism and ambition in the forecasts.

5.25. In failing to subject these assumptions to a greater degree of challenge and scrutiny the Respondents failed to perform audit procedures appropriate in the circumstances to obtain sufficient appropriate audit evidence in breach of paragraph 6 of ISA 500.

5.26. The audit team also failed to identify a number of errors in the cash flow forecasts, namely:

5.26.1. An inconsistency in the terminal value, whereby a capital expenditure of £20 million per annum was assumed but with a depreciation tax deduction of £40 million, overstating the tax effect in terms of net deductibility. This would erode the asset base and eventually turn it negative.

5.26.2. Management did not include interest cash flows in the calculations, despite this being the key change in methodology that the Respondents had considered closely. Whilst interest payments would normally be excluded from an impairment model, the inclusion of the securitisation facility balance in the CGU carrying value necessitated adding both the cash flows for the movement in the principal balance and the cash flows for the servicing of the borrowings.

5.26.3. A UK-specific long term growth rate should have been used instead of a Euro area rate.

5.27. As a result of these errors not being identified during the FY22 Audit, the Respondents failed to perform audit procedures appropriate in the circumstances to obtain sufficient appropriate audit evidence in respect of the cash flow forecasts, in breach of paragraph 6 of ISA 500.

Breach Area 4 – Discount rate

5.28. The calculation supporting management's post tax discount rate of 15.2% used a beta factor of 1.69 and an alpha factor of 1%.

5.29. The CF Team concluded that the appropriate unlevered beta for the Group was in the range of 0.9 to 1.1, which was then used to recalculate the Group's WACC resulting in a discount rate of 10.7% and hence an "implied alpha" of 4.5%.

5.30. The change in model methodology resulted in management using a VIU model prepared on an unlevered basis, with the securitisation facility subsumed into working capital movements. The discount rate needed to be considered on a consistent basis.

5.31. The audit team should have properly considered what weight could be given to the implied alpha in reflecting forecasting risk in circumstances where it was not the result of any attempt to evaluate that risk, just the difference between the 10.7% calculated by the CF Team and the 15.2% used by management.

5.32. The 15.2% used by management included an alpha factor of 1%, which had been reduced during the course of the audit from 3.3%. This was to reflect management's view that forecasting risk in the cash flows had reduced following the removal of certain cash flows as a result of challenge by the audit team.

5.33. Further, although the audit team ran sensitivity analysis on the cash flow forecasts and Mr Sykes considered and documented that the alpha factor of 4.5% added a level of caution to the calculations there was no proper basis for concluding that the implied alpha sufficiently catered for the optimism in management's cashflow forecasts, given no work had been done to calculate a financial value for the level of "optimism" in the cash flow forecasts.

5.34. There was similarly no proper basis for management's discount rate of 15.2% being described as "at the cautious end of an acceptable range" when mathematically it was in the middle of the indicative range provided by the CF Team (14.5% to 16.0%)

5.35. The Respondents therefore failed to conduct audit procedures to obtain sufficient appropriate audit evidence in this regard in breach of paragraph 6 of ISA 500.

Breach Area 5 – Sensitivity analysis and disclosures

5.36. Whilst the audit team ran a range of sensitivities, as detailed in the table at paragraph 2.53 above, the sensitivities that the audit team ran were impacted by a formula error in the sensitivities working paper which resulted in incorrect tax rates being used in the underlying calculations. The incorrect tax rate of 19% for FY24 onwards was used when this should have been 25%. As a result of this error each of the sensitivities overstated the available headroom.

5.37. The Respondents' use of an incorrect tax rate in the sensitivity calculation was an error that should have been avoided and demonstrates a failure to perform audit procedures that were appropriate in the circumstances for the purposes of obtaining sufficient appropriate audit evidence, in breach of paragraph 6 of ISA 500.

Breach Area 6 – Reconciliation to market capitalisation

5.38. The audit team's comparison between VIU and the Group's market capitalisation, as detailed in paragraph 2.56 above, deducted net debt from the VIU. This was not consistent with the revised method used in the impairment assessment, which included debt as working capital. If calculated correctly (without any adjustment for debt) the comparison would have shown a shortfall of £288 million, instead of £29 million, and would have been in line with the result of the comparison with net assets.

5.39. Whilst the FY22 Audit Committee Report did correctly include reference to the £288 million difference, the inclusion of debt as a reason for the difference was incorrect.

5.40. The audit team did not therefore obtain adequate explanations for the actual difference between VIU and the Group's market capitalisation.

5.41. The lack of adequate explanations obtained represented a failure by the Respondents to perform audit procedures that were appropriate in the circumstances for the purposes of obtaining sufficient appropriate audit evidence, in breach of paragraph 6 of ISA 500.

Breach Area 7 – Overall conclusions on impairment

5.42. The audit team considered a range of factors in coming to their conclusions in respect of impairment. Of particular significance were the audit work and assumptions in relation to the caution considered by the audit team to be in the discount rate, and the optimism identified in the cash flow forecasts.

5.43. Paragraph 24(c) of ISA 540 requires that:

> *"…with respect to significant assumptions, the auditor's further audit procedures shall address:*
>
> *…*
>
> *(c) Whether the significant assumptions are consistent with each other and with those used in other accounting estimates, or with related assumptions used in other areas of the entity's business activities, based on the auditor's knowledge obtained in the audit…"*

5.44. There is no clear evidence on the audit file setting out how the conclusion was reached that the optimism in the cash flow forecasts was sufficiently addressed by the implied allowance for forecasting risk in the discount rate, and no clear evidence that either was considered in value terms.

5.45. The Respondents therefore failed to address whether the significant assumptions behind the cash flow forecasts and the discount rate were consistent with each other, in breach of paragraph 24(c) of ISA 540.

Breach Area 8 – Quality Control

5.46. Pursuant to paragraph 16 of ISA 220 it was Mr Sykes responsibility to ensure that reviews were performed in accordance with KPMG's review policies and procedures. Quality control processes within KPMG include a review performed by the EQCR. A Second Line of Defence review of the audit file was also completed, which identified issues relevant to the errors in the impairment calculations and the overall conclusions on impairment.

5.47. The failure of the audit team members to identify basic errors in: the mechanics of the calculations surrounding the calculation of the carrying value of the CGU, the model calculating the VIU, the audit team's sensitivity analysis and the comparison between CGU carrying value and market capitalisation demonstrate that the reviews undertaken by the Respondents did not comply with KPMG's policies and procedures. These types of errors and omissions should be identified and corrected through effective review of the audit working papers involved. As a result, the Respondents' conduct was in breach in paragraph 16 of ISA 220.

5.48. Documentation in respect of the involvement of the EQCR was not completed in a sufficient level of detail. This inadequate documentation is a breach by the Respondents of paragraph 8 of ISA 230.

6 *SANCTIONS*

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

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*; 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 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 considering *Sanctions* to be imposed on the Respondents, Executive Counsel has, in summary, considered the following matters in accordance with the Policy.

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

6.4. The ISAs engaged in this case are all important Relevant Requirements, designed to ensure the quality and effectiveness of an audit. The requirements to document the audit work (ISA 230), obtain sufficient appropriate audit evidence (ISA 500) and report the findings to those charged with governance (ISA 260) are fundamental to the duties of an auditor. Other requirements, for example those under ISA 540, establish basic pre-requisites for the effective conduct of standard audit procedures.

6.5. The breaches of *Relevant Requirements*:

6.5.1. were serious and numerous throughout the audit approach to impairment;

6.5.2. related to only one audit year;

6.5.3. were not intentional or deliberate, reckless or dishonest; and

6.5.4. did not involve financial gain.

6.6. Whilst it is not alleged that the FY22 financial statements were in fact misstated, it is clear that correcting for the errors set out in Section 5 above materially reduced the headroom (which was already limited at £57 million). In aggregate the breaches:

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

6.6.2. Had the potential to undermine confidence in the standards of conduct in general of *Statutory Auditors* and *Statutory Audit Firms*, and/or in S*tatutory Audit*.

6.7. The Respondents did not derive or intend to derive any profit or benefit from the breaches of the Relevant Requirements (beyond the audit fee chargeable for the FY22 Audit).

6.8. The circumstances of the Respondents are also relevant to the determination of *Sanction*. KPMG is a large audit firm, its UK fee income in 2024 was £2,999 million. KPMG received an audit fee of £1.3m for the FY22 Audit.

6.9. KPMG has implemented a number of significant changes and improvements to its audit processes and procedures in relation to impairment since the FY22 Audit was performed which reduce the risk of recurrence of the breaches. This includes:

6.9.1. Impairment Triage Process: launched in March 2023 to provide an additional support mechanism for engagement teams in the audit of impairment.

6.9.2. Second Line of Defence Reviews: changes to bolster the effectiveness of its Second Line of Defence function following findings identified during internal and external quality inspections.

6.9.3. Audit Working Papers: In summer 2023 KPMG updated all impairment risk assessment workpapers and substantive procedures incorporated into its workflow library. KPMG has developed updated impairment substantive testing work papers to incorporate additional guidance on areas of complexity including: forecast period and terminal value assumptions; discount rates; reconciliation of VIU to market capitalisation; and other accounting matters including the treatment of pension surplus/deficit and other liabilities in cash flow forecasts and determinations of the carrying amount of the CGU.

6.9.4. Guidance and Training: KPMG released new guidance relating to the audit of impairment and provided training on impairment and as part of the 2023 Audit University syllabus.

6.10. KPMG has a poor disciplinary history. KPMG has had *Sanctions* imposed on it under the AEP on six previous occasions in the last three years.

6.11. Mr Sykes' senior role is also relevant to the gravity of the offence; he had accumulated 27 years' experience as an audit partner at the time of the Audit. It is also relevant that he has had *Sanctions* imposed on him in two previous FRC Enforcement decisions made under the AEP, in 2021 and 2023.

6.12. Both Respondents have accepted their responsibility for the breaches and expressed contrition.

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

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

6.13.1. Financial sanctions of £1.25 million in the case of KPMG, and £90,000 in the case of Mr Sykes;

6.13.2. A published statement in the form of a Severe Reprimand, in the case of each of them; and

6.13.3. A declaration that the FY22 auditor's report signed on behalf of KPMG did not satisfy the *Relevant Requirements* in the case of each of them.

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

6.15. Executive Counsel has decided not to require KPMG to undertake any additional non-financial sanctions in this matter because it considers that the remedial and improvement work in relation to impairment performed by KPMG since the FY22 Audit (and as a result of other ongoing non-financial sanctions and engagement with the FRC's Supervision Division) are effectively designed and implemented to likely reduce the risk of the particular breaches of Relevant Requirements identified in this Notice reoccurring.

<u>Aggravating and mitigating factors</u>

6.16. Executive Counsel has then considered whether any 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

6.17. There are no aggravating factors that have not already been considered in the context of the seriousness of the breaches.

Mitigating factors

6.18. All relevant mitigating factors have already been considered, except the level of co-operation provided by the Respondents. Paragraph 60 of the Policy explains that, since Statutory Auditors and Statutory Audit Firms are required to co-operate with any investigation under the AEP, only an exceptional level of cooperation will be regarded as a mitigating factor at the point of determining Sanctions.

6.19. During the course of the investigation the Respondents:

6.19.1. conducted early into the investigation two self-reviews as to how the breaches of *Relevant Requirements* had occurred and admitted, within those self-reviews, breaches of *Relevant Requirements;* and

6.19.2. dealt timeously, properly and fully with all requests for information made on behalf of Executive Counsel.

6.20. Having regard to the timing and impact of these steps Executive Counsel considers that they amount to an exceptional level of cooperation worthy of a discount to the financial sanction of 12.5%. The financial sanction for KPMG is therefore reduced to £1,093,750 and the financial sanction for Mr Sykes is reduced to £78,750.

Deterrence

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

Discount for Admissions and Settlement

6.22. 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 Policy), Executive Counsel determined that a further reduction of 35% as to the financial sanction is appropriate. The financial sanction against KPMG is therefore further reduced to £710,937.50 and the financial sanction against Mr Sykes is further reduced to £51,187.50.

7 COSTS

7.1. Executive Counsel requires that the Respondents pay her costs in full in this matter, being £229,913. Such costs shall be paid no later than 28 days after the date of this *Final Settlement Decision Notice*.

Signed:

[Redacted.]

JAMIE SYMINGTON
DEPUTY EXECUTIVE COUNSEL

Date: 10 June 2025

APPENDIX 1 – EXTRACTS OF RELEVANT REQUIREMENTS

Extracts from ISAs

1. ISA 220: Quality Control for an Audit of Financial Statements

1.1. Paragraph 16 states as follows:

"The engagement partner shall take responsibility for reviews being performed in accordance with the firm's review policies and procedures"

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:*

(a) The nature, timing and extent of the audit procedures performed to comply with the ISAs (UK) 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."

3. ISA 260: Communication With Those Charged With Governance

3.1. Paragraph 16 states as follows:

"The auditor shall communicate with those charged with governance:

(a) The auditor's views about significant qualitative aspects of the entity's accounting practices, including accounting policies, accounting estimates and financial statement disclosures. When applicable, the auditor shall explain to those charged with governance why the auditor considers a significant accounting practice, that is acceptable under the applicable financial reporting framework, not to be most appropriate to the particular circumstances of the entity;

(b) Significant difficulties, if any, encountered during the audit;

(c) Unless all of those charged with governance are involved in managing the entity:

(i) Significant matters arising during the audit that were discussed, or subject to correspondence, with management; and

(ii) Written representations the auditor is requesting;

(d) Circumstances that affect the form and content of the auditor's report, if any; and

(e) Any other significant matters arising during the audit that, in the auditor's professional judgment, are relevant to the oversight of the financial reporting process."

4. ISA 500: Audit Evidence

4.1. 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.*"

5. ISA 540: Auditing Accounting Estimates and Related Disclosures

5.1. Paragraph 24(c) states as follows:

"In applying the requirements of paragraph 22, with respect to significant assumptions, the auditor's further audit procedures shall address:

(c) Whether the significant assumptions are consistent with each other and with those used in other accounting estimates, or with related assumptions used in other areas of the entity's business activities, based on the auditor's knowledge obtained in the audit"

5.2. Paragraph 32 states as follows:

"The auditor shall evaluate whether judgments and decisions made by management in making the accounting estimates included in the financial statements, even if they are individually reasonable, are indicators of possible management bias. When indicators of possible management bias are identified, the auditor shall evaluate the implications for the audit. Where there is intention to mislead, management bias is fraudulent in nature."