Audit Committee Report

COMMITTEE MEMBERS

Sheryl Lawrence
(member from 1 May 2021, Chair from 3 September 2021)

Joanne Lake
(Interim Chair from 13 February 2021 to 2 September 2021). Left 31 March 2022.

Michael Yeates
(from 1 May 2021)

Sir Nigel Knowles
until he was appointed Board Chair on 1 March 2022

Dear Shareholder,

As the Chair of the Audit Committee, I am pleased to present the Committee's report for the year ended 26 February 2022.

The report provides insight into the composition of the Committee and the work that it undertakes.

In essence, we ensure the integrity of the financial reporting, the robustness of internal operational and financial controls and the independence of the external auditor. Consequently we can assert that in the financial year controls have operated effectively.

WHAT DOES THE COMMITTEE DO?

The key objective of the Committee is to provide assurance to the Board as to the effectiveness of the Company's internal controls and the integrity of its financial records and externally published results.

The Committee monitors and reviews the Group's financial reporting from information provided by management and the auditor. The Committee reports to the Board on the Group's full and half-year results, having examined the accounting policies on which they are based and ensured compliance with relevant accounting standards.

The Committee's terms of reference are available on the Group's website.

The Committee held four scheduled meetings during the year, in alignment with its terms of reference. It also held a special meeting to review and approve a proposed new model for IFRS 9 impairment provisions for the Digital division.

The Committee acknowledges and embraces its role in protecting the interests of shareholders and is committed to monitoring the integrity of the Group's reporting.

The Committee performed reviews of the full-year, interim and trading update announcements, and the Annual Report and Accounts and half-yearly financial statements.

Sheryl Lawrence is a Chartered Accountant with extensive experience within the financial services sector, whilst Sir Nigel Knowles is the CEO of global legal business DWF plc, having been a Managing Partner at the global law firm DLA Piper for nearly 20 years. In addition, Michael Yeates has had over 40 years of experience in the financial services industry.

Composition and governance

As a Chartered Accountant, the Board considers that Sheryl Lawrence has recent and relevant financial experience. All of the independent Non-Executive Directors are members of this Committee, and this has been the practice since the Group's IPO in May 2016.

The other Directors are also invited to attend meetings, as are senior representatives of the external auditor, together with appropriate members of the Executive team, in order to ensure that all relevant information is available to the Committee.

The Committee meets with the external auditor without the presence of Executive Management twice each year to discuss matters relating to its remit and any issues relating to the audit. The Committee has also met each of the Risk & Compliance Director and the Head of Internal Audit individually on an annual basis without the presence of other Executive Management.

The Committee has direct and unrestricted access to both internal and external audit functions. As the Chair, I also have regular contact with the external auditor, the Chief Financial Officer, the Risk & Compliance Director, and the Internal Audit function outside the formal meetings to ensure that any areas for discussion are dealt with in a timely manner.

How the Committee discharged its responsibilities

The Audit Committee held four scheduled meetings during the year in alignment with its terms of reference and with the Group's financial reporting timetable. It also held a special meeting to review and approve a proposed new model for IFRS 9 impairment provisions for the Digital division.

A self-assessment internal review of the performance of the Committee concluded that it had discharged its responsibilities during the year. This was achieved by (i) the Committee members performing an evaluation of the way that the Committee operates, and (ii) comparing the Committee's terms of reference with the Committee's actions and considerations during the year. The Committee was satisfied that it had discharged its responsibilities effectively discharged its responsibilities effectively.

Audit Committee Report
continued

Significant areas of judgement

The external auditor has scoped the audit appropriately and subjected significant areas of judgement to robust challenge.

The Committee considers there to be five significant areas of judgement, and these are detailed below.

1. Loan loss provisioning

IFRS 9 requires management to record impairment provisions based on the stage of credit impairment. The recording of a provision requires management to make complex judgements/estimates.

The Committee regularly challenges the appropriateness of management's judgements, estimates and assumptions underlying the impairment provision calculations and concluded that the provisions held against the loan book are reasonable.

For HCC, management has adopted an approach to IFRS 9 impairment modelling, based on discounting expected future cash flows whereby the probability of default and loss given default are assessed as a single combined measure.

The key judgement/estimate is around the estimation of expected future cash flows used to determine the provision. The management approach to HCC loan loss provisioning was reviewed with the Committee and the external auditors at one of the Committee's scheduled meetings. This approach of using cash collection curves for the previous five individual year-end snapshots of data with three years of forward-looking cash flows (in this case, 2016-2020 – see below) has remained consistent with the previous year. The Committee believes that continuing to use a weighting of the individual cash curves to give more prominence to the most recent cohort to be most appropriate in estimating the loan loss provision required.

In this way, the cash collection curves have been weighted to give prominence to the 2020 cohort using a weighting of 60%, with a 10% weighting for each of the other four cohorts. Management and the Committee feel that weighting the selection of data towards the 2020 data, which reflects the most recent performance of the loan book, will give a closer fit to the performance of the end of year loan book than the other years in the data set. This approach is consistent with that taken at the last year-end and the interim half-year-end.

In the financial year the mix of customers paying monthly and fortnightly rather than weekly has increased, resulting in the existing weekly impairment model requiring adjustment to ensure monthly and fortnightly payers are not deemed to have missed payments not yet expected to have been received. That adjustment resulted in a £1.0m reduction to impairment at the year-end.

After discussion with management and the external auditor, the Committee considered the 2016-2020 cash curves to be appropriate for the purposes of determining the base level of impairment provision required at year end.

- The adoption of multiple cohorts to construct the cash curves remained consistent with the Company's IFRS 9 policy. The impact of transitioning from 2015-2019 weighted curves used in FY21 to the 2016-2020 weighted curves used in FY22 was a £1.5m reduction in impairment.
- FY22 actual cash collections were within c.5% of those forecast in the FY21 year-end provision.

IFRS 9 requires that the impairment assessment considers reasonable and supportable information, including forward-looking information, that is relevant for the financial instrument being assessed.

In order to protect the performance of the business against any macro-economic factors that would have an impact on customers' abilities to repay (such as rising household bills, increases to energy-related costs and the impacts of inflation) an affordability buffer is built into Income and Expenditure affordability assessments. Whilst economic data is monitored, the collection performance experienced through the Covid-19 pandemic (which showed improvement immediately post first lockdown and no drop off in performance in subsequent lockdowns) is evidence that HCC is not impacted by traditional macro-economic events, partly because of the affordability buffers, and partly because these factors do not impact HCC customers. This view has been widely held among peers and sector analysts over time and leads management to the conclusion that no specific macro-economic overlay is required.

In H2 FY22 there was further evidence of the immunity of collections performance to macro-economic factors. The ending of furlough, changes to Universal Credit, and increases to energy prices experienced in the financial year did not cause collections performance to deteriorate. As such, whilst cost of living increases are monitored, and will be considered when stress-testing forecasts, management does not believe there will be an adverse impact on collections performance post year-end directly due to increased inflation.

The HCC credit policies incorporate the ONS expenditure model and has been updated for recent increases to inflation and the cost of energy. Based on the review described above as well as considering the economic factors impacting the loan receivables balance, such as inflation, interest rates, and t he ending of furlough, the Committee concluded that the underlying provisions held against the HCC loan book are reasonable.

For Digital, management has updated its Digital IFRS 9 impairment methodology and modelling approach since the prior year. A relatively simplistic approach has previously been applied due to the Digital business being in its infancy and growth being lower than anticipated. The new methodology is more complex to better estimate the provisions required under IFRS 9.

Management's approach has been to determine c.800 different customer behavioural data points or nodes which are based on a combination of predictive variables including loan term, number of previous loans taken by a customer, past due status and credit scoring. Each customer is assigned a particular node and based on this assignment management then applies probability of default (PD), exposure at default (EAD), loss given default (LGD) and time to default assumptions in order to determine individual impairment provisions. The key judgement is around the determination of the estimates of the PD, EAD and LGD for each node which then drives the calculation of the estimates of the PD, EAD and LGD for each node. As the period which was sampled included the Covid-19 pandemic and associated forbearance payment breaks, the data available for use was limited. Data from agreements issued in the period November 2020 to October 2021 has been used for PD and EAD purposes to allow sufficient time for an account to reach default and May 2020 to January 2021 for LGD purposes to allow sufficient time for post-default recoveries.

Management and the Committee feel that the data periods used reflect the most recent performance of the loan book and will give a closer fit to the performance of the end of year loan book.

The management approach to Digital loan loss provisioning was reviewed with the Committee and the external auditors at one of the Committee's scheduled meetings. After discussion with management and the external auditor, the Committee considered the updated methodology to be appropriate for the purposes of determining the base level of impairment provision required at year end. The impact of adopting the updated methodology model in FY22 was a reduction of £1.4m. Given the short-term nature of most of the Digital lending, and that affordability buffers are put in place at loan inception, management does not believe there will be an adverse impact on collections performance post year-end directly due to increased inflation.

Based on the review described above, the Committee concluded that the underlying provisions held against the Digital loan book are reasonable.

2. Revenue recognition

IFRS 9 requires management to recognise interest using the effective interest rate (EIR) method based on the stage of credit impairment.

For HCC, in order to arrive at the average expected life for each product type, management have taken an average of the expected lives of loans within the December 2016-2020 cohorts. These expected lives were adjusted where appropriate to reflect the actuals. As with prior year, in FY22, the cohorts have been weighted to give prominence to the 2020 cohort using a weighting of 60%, with a 10% weighting for each of the other four cohorts. This approach is deemed reasonable given the data sets align with those used to construct the cash collection curves for loan loss provisioning purposes (as described above), thereby resulting in consistency across management's IFRS 9 modelling methodology. The Committee has reviewed the expected life assumptions and management's judgement paper.
The management treatment of revenue recognition was reviewed with management and the external auditors at one of the Committee's scheduled meetings. This treatment has remained consistent with the previous year. The Committee has also challenged the expected life of products by reference to both historical and forecast data and comparability with the contractual life under IFRS 9. As a result of this review, the Committee has concluded that the Group's treatment of this is reasonable.

For Digital, the modelling approach for revenue recognition has been updated alongside the impairment methodology. The EIR for each agreement is used for the purposes of revenue recognition rather than an expected average life for each product. The effective interest rate is calculated using estimated cash flows with revenue recognised on the gross receivable when accounts are in IFRS 9 stages 1 and 2 and on the net receivable for accounts in stage 3.

For both HCC and Digital brokers are used to generate new business leads. As with revenue, and in line with IFRS 9, broker commission costs are recognised on an EIR basis in the income statement spread over the term of the related customer contract. As this is a cost of generating revenue, revenue is stated net of this cost.

3. Goodwill impairment

A third significant area of judgement/estimation is that of goodwill impairment.

Management is required by accounting standards to perform an annual impairment review for goodwill balances. Assessment of impairment involves estimating the fair value less costs to sell and value in use of certain intangible assets at each reporting period. This requires an assessment of whether there are any impairment triggers which, given the nature of the assets, focuses on performance and cash flows.

The Committee has reviewed the forecast cash flows in the goodwill impairment model. These are based on the expectations within the current business plan, which are the key assumptions in driving the first five years of projections. Longer-terms growth rates, which are at a lower level, reflect a level of anticipated maturity, which together with the discount rate used, are also key factors underpinning the forecast in perpetuity. The Company used a pre-tax weighted average cost of capital (WACC) of 13.36% in order to discount future cash flows. If the WACC were to decrease by 1% to 12.36% the headroom over the discounted future cash flows would increase by £11.7m.

In considering the future projected cash flows, the Committee reviewed the current performance of the business and through the use of sensitised scenarios, including a 'Collect Out' scenario as recommended by the Regulator, is satisfied that performance is at a sufficient level and that there was no requirement to impair goodwill.

In reviewing impairment indicators, the Committee considered a number of factors. The key area under consideration was the market capitalisation of the entity compared to the carrying value of its net assets. At the year end the market capitalisation of £18.1m was below net assets of £32.2m. It is the view of management that the share price is artificially low as a result of uncertainty surrounding the complaints liability and availability of funding and that once resolved the share price will recover. The share price would need to increase to 23p to have parity

Audit Committee Report
continued

with the balance sheet valuation. Whilst the Committee considered this as a potential impairment indicator, it has concluded that this is insufficient evidence of a permanent impairment of balance sheet value, and that it is unconnected to goodwill. It is the expectation of management that the share price will recover and as such no impairment to goodwill has been recognised.

4. Complaints
IAS 37 (Provisions, Contingent Liabilities and Contingent Assets) describes the accounting for provisions as the present value of the best estimate of the expenditure required to settle a present obligation.

During FY21 Morses Group PLC adopted a policy to recognise at the balance sheet date the cost to settle existing complaints received by customers. In FY22 this policy continues to be adopted.

CMCs prompted a review of complaints received, identifying any key root causes. A review was undertaken with an external technical specialist (Huntswood CTC Limited) outlining proposals for any redress methodology which could be considered as part of any potential Scheme of Arrangement.

IAS 37 requires recognition of a liability when there is a present obligation. The original lending to the customer gives rise to the present obligating event, and not the raising of the complaint. Review of root cause indicated that outflow is probable as a discernible trend and becomes identifiable from FOS decisions. The proposals for any redress methodology under a potential Scheme, with the input from the external technical specialist, sets out a total potential gross quantum liability and provides management with a best estimate of likely take-up rates from customers from similar types of Schemes, giving an ability to measure.

The Directors accept there is a liability in relation to customer redress claims for unaffordable lending against the Company at the balance sheet date, however there is material uncertainty of the total liability which will be paid. This is due to the methodology for assessing the population of claims is yet to be agreed, and the level of subsequent customers who may claim against that methodology not yet being known. Using a risk-free discount rate of 2.1% a discounted liability of £39.1m has been calculated and recognised in these financial statements. Management and the Committee believe this is the best estimate of the present value of the liability payable to customers in relation to unaffordable lending complaints. An amount totalling £3.5m has been written off the gross loan book in relation to claims expected to be received where customers have an existing loan. The total exceptional charge to the Income Statement is £42.6m.

5. Going concern and business plan
In assessing going concern, Management and the Committee have reviewed the latest forecasts of the business and satisfied themselves of the ongoing viability of the business.

This assessment is subject to two factors. Firstly, the agreement of a Scheme of Arrangement on a timely basis with the FCA to facilitate an orderly settlement of the liability in relation to unaffordable lending complaints. Secondly, the extension of, or securing of an alternative, funding facility, with the renewal date currently set at 31 March 2023.

The assessment of the Group's business plan included review of a number of scenarios relating to the key areas of sensitivities, namely:
- complaints levels;
- collections and loan book quality;
- loan volumes and credit risk; and
- cash availability.

The Group has previously demonstrated its agility in adapting to emerging challenges, such as the impact of the Covid-19 pandemic in FY21. The scenarios produced covering the key areas of sensitivities include corrective action to adapt to potential strains on cash flows arising on rising levels of complaints or impacts on collections.

In assessing the business plan management derived three scenarios:

1. A base case scenario demonstrated the ongoing viability of the business providing that the settlement of Redress Claims occurs in an orderly manner over a period of time and that complaints levels do not remain at recent peak levels. If complaints volumes are higher than this level then this will accelerate the settlement of the redress claims liability and will therefore have a detrimental impact on liquidity. The timing of the settlement of the redress claims liability is key to the going concern assessment of the Group. The base scenario also assumes funding is available through the forecast period in line with the current facility.

2. A scheme scenario showed that with the agreement of a Scheme of Arrangement with the FCA, together with the protection a related moratorium on paying complaints would place on cash, the business would be viable in terms of cash generation and future profitability, again subject to assumed funding in line with current facility.

3. In an alternative collect-out scenario the business would enter a solvent wind-down with no further lending. In this scenario the cash remaining to redress customer complaints relating to unaffordable lending would be significantly less.

The base case and the scheme scenarios both assume a level of funding in line with current facility. In May 2021, the Group agreed a new loan facility with a consortium of two lenders and this was subsequently extended to 31 March 2023. Discussions continue with lenders regarding the future facility options, as well as other funding sources. These discussions have led to a temporary deferral of the testing of two covenants from August to September 2022, to allow time for further discussions with the lenders. These two covenants are linked to profitability and, if tested, would fall outside of covenant range. There has been no breach, nor waiver of covenants up to the date of the report. The Committee recognise that the quantum of the redress claim liability and timing of settlement, as well as the availability of funding beyond March 2023 create a material uncertainty that may cast significant doubt about the Group's and Company's ability to continue as a going concern such that it may be unable to realise its assets and discharge its liabilities in the normal course of business.

As explained on page 2, the financial statements have been prepared on a going concern basis, whilst noting the aforementioned material uncertainty.

Critical accounting judgements/estimates and key sources of estimation uncertainty

There are both critical accounting judgements/estimates and key sources of estimation uncertainty contained within this Annual Report. Further details are found on pages 109 to 111.

Meetings of the Committee

The Committee held four scheduled meetings during the year, in accordance with its terms of reference. It also held a special meeting to review and approve a proposed new model for estimating IFRS 9 impairment provisions for the Digital division.

Attendance records can be found on page 56.

The work undertaken by the Committee included the following activities:

- A review of the full-year results including the Annual Report and Accounts, preliminary results, and the external auditor's report, providing advice (where requested by the Board) on whether the Annual Report and Accounts, taken as a whole, is fair, balanced and understandable, and provides the information necessary for shareholders to assess the Group's position and performance, business model and strategy.
- In reviewing these documents and determining whether they were fair, balanced and understandable, the Committee also considered the work and recommendations of management.
- An interim results review.
- A consideration of the appropriateness of accounting policies and critical accounting estimates and judgements/estimates, including a review of information from the Chief Financial Officer and reports from the external auditor setting out its views on the accounting treatments and judgements/estimates in the financial statements.
- A review of the external auditor's control observations arising from their external audit of the Company's 2021 accounts, and management's response to the recommendations included within it.
- A consideration of the level of non-audit work carried out for the Group by the external auditor seeking confirmation from the auditor that it maintains suitable policies and processes to ensure independence. The Committee has a non-audit work policy which is reviewed annually.
- Overseeing the activities of the Group's Internal Audit function, including its resourcing, its planning, and the output of its audit work.
- Approving the budgets for internal and external audit activities.
- Reviewing the adequacy and effectiveness of the Group's Internal Audit function and the robustness of the Group's internal operational and financial controls.
- Reviewing access controls, and especially the procedure to cover employee joiners, leavers and reassignments.
- A review of the going concern assumptions when considering interim and final results statements and long-term viability in the case of the Annual Report & Accounts, taking into account internal financial projections.

Review of the 2022 Annual Report and Financial Statements

At the request of the Board, the Committee considered whether, in its opinion, the 2022 Annual Report and Financial Statements, taken as a whole, is fair, balanced and understandable and provides the necessary information for the reader to assess the Group's position and performance, business model and key audit matters.

Process

In justifying this statement, the Committee considered the process in place to create the Annual Report and Financial Statements including:

- the timely involvement of the Committee in the preparation of the Annual Report and Financial Statements which enabled it to provide input into the overall messages and tone;
- the input provided by Group senior management and the process of review, evaluation and verification to ensure balance, accuracy and consistency;
- the regular review of the Group's internal audit reports which are presented at Committee meetings and the opportunity for the Non-Executive Directors to meet both the external auditors and the Head of Internal Audit without any executive of the Group being present via the private sessions of the Committee;
- the Committee meetings reviewed and considered the draft Annual Report and Financial Statements in advance of the final sign-off; and
- the final sign-off process by the Board.

When forming its opinion, the Committee reflected on the information it had received and its discussions through the year. In particular, the Committee considered whether:

The report is fair

- Are the key messages in the narrative reporting reflective of the financial reporting?
- Are the KPIs disclosed appropriate to understanding the underlying performance of the Group?

The report is balanced

- Is there a good level of consistency between the narrative reporting and the financial reporting and is the messaging in each consistent when read independently of each other?
- Are both the statutory and adjusted financial measures explained clearly and given equal priority and prominence?
- Are the key judgements/estimates referred to in the narrative reporting and the significant issues reported in this Audit Committee Report consistent with the disclosures and critical judgements/estimates set out in the financial statements?
- How do these judgements/estimates and issues compare with the risks that the external auditor will include in its report?

Audit Committee Report
continued

The report is understandable

- Is there a clear and understandable structure to the report?
- Are the important messages highlighted appropriately and consistently throughout the document with clear signposting to where additional information can be found?
- Is the narrative within the Annual Report and Financial Statements straightforward and transparent?

This assessment was also underpinned by the following:

- The papers on critical accounting judgements/estimates and key sources of estimation uncertainty presented by management to the Audit Committee which documents the approach taken to the critical accounting judgements/ estimates and key sources of estimation uncertainty documented in the financial statements on pages 109 to 111. The assumptions and the going concern statement were challenged by the Committee as part of the year-end process.
- The consistency between the risks identified and the issues that are of concern to the Committee.
- The comprehensive reviews of the Annual Report and Financial Statements 2022 undertaken at different levels in the Group which aims to ensure consistency and overall balance.
- The external auditor's report on the Annual Report and Financial Statements 2022.

Conclusion

Following its review, and having taken into account all the matters considered by the Audit Committee and brought to their attention during the year, the Committee reported to the Board that it was satisfied that the Annual Report and Accounts, taken as a whole, is fair, balanced and understandable.

External audit

The Group's external auditor is Deloitte LLP.

The Committee is responsible for reviewing the objectivity, independence and cost-effectiveness of the external auditor.

The Committee also reviews the performance of the auditor, taking into account the services and advice provided to the Group and the fees charged for these services. The CFO, Finance Director and other senior executives provide feedback to the Board and Audit Committee, on a regular basis regarding the services received from the external auditor.

During the year, the Committee reviewed its non-audit work policy which is designed to mitigate any risks threatening, or appearing to threaten, the external auditor's independence and objectivity.

As part of the Committee's remit, we monitor the level of non-audit work carried out by the external auditor. During the year to 26 February 2022, the level of audit fees amounted to £728k (FY21: £312k), and non-audit fees amounted to £36k (FY21: £35k). The ratio of non-audit fees to audit fees was 4.9% (FY21: 11.2%). The non-audit work carried out during FY22 related solely to the review of the interim results.
Deloitte LLP was first appointed as auditor of Morses Club Limited with effect from 1 March 2009 as a result of a competitive audit tender. As a company listed on AIM, Morses Club PLC is not a Public Interest Entity and therefore is not required to review its external auditor after 10 years.

Deloitte LLP have notified the Company of their intent to stand down as external auditor. A new external auditor will be announced once appointed.

Internal Audit function

The Group has an Internal Audit function which was headed for the majority of the year by an experienced and highly qualified Head of Internal Audit who reported directly to the Chair of the Audit Committee. The Internal Audit function objectively reviews the Group's internal control processes using a risk-based internal audit plan and audit charter approved annually by the Committee. The plan is based primarily on output from the risk management process, but it is flexible and may include ad hoc investigations and other assurance work agreed by the Committee. Specialist technical knowledge and resources are sourced externally when required.

During the year, the Head of Internal Audit undertook an internal promotion to another part of the Group. Since then, any reviews normally undertaken by the Internal Audit department have been outsourced and the Company is currently reviewing its approach to Internal Audit.

During the year, the Internal Audit function delivered a diverse selection of reviews. This year saw assurance work on areas such as lead generation for the Digital division, penetration testing, and IT development. Outsourced work included an audit of financial crime management within the Digital division and financial resilience in the HCC division.

The Committee closely reviews the reports of the Internal Audit function. Its work is primarily risk-based, utilising the Group's risk registers and in consultation with the Executive team to identify key risks which are then prioritised. The Committee has found the reports to be both incisive and timely, and presented in a way that is well articulated.

The Head of Internal Audit was invited to attend all of the Committee's meetings and met the Committee members on an annual basis without management present, the last time being in June 2021.

The Committee annually assesses the effectiveness of the Internal Audit function and has satisfied itself that the quality, independence, experience and expertise of the function is appropriate for the business.

FRC Corporate Reporting Review team

There was no interaction with the FRC's Corporate Reporting Review team during the year.

Approval

On behalf of the Audit Committee

Sheryl Lawrence
Chair
25 August 2022