Edited for publication

IN THE MATTER OF A FORMAL COMPLAINT

B E T W E E N:

THE EXECUTIVE COUNSEL TO THE FINANCIAL REPORTING COUNCIL

Complainant

- and -

(1) BAKER TILLY UK AUDIT LLP
(2) RICHARD HAMILTON KING
(3) STEVEN LAURENCE RAILTON

Respondents

THE REPORT OF THE TRIBUNAL

[ISSUE OF MISCONDUCT]

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BAKER TILLY UK AUDIT LLP (1)
(NOW RSM UK AUDIT LLP)

RICHARD HAMILTON KING (2)

STEVEN LAURENCE RAILTON (3)

REPORT OF THE DISCIPLINARY TRIBUNAL[1]

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1. PART 1 – INTRODUCTION

The Tribunal

1.1 On 9 June 2014 we (Mr David Blunt QC, Ms Fiona Daley FCIPFA, and Ms Tania Brisby) were appointed by the Convener to the Financial Reporting Council (the "**FRC**") to hear a Formal Complaint of Misconduct on the part of the Respondents, made by the Executive Counsel of the FRC (the "**Executive Counsel**") under paragraph 7(11) of the Accountancy Scheme. The Formal Complaint was served on the Respondents on 3 June 2014.

Representation

1.2 In these proceedings the Executive Counsel was represented by Ms Joanna Smith QC and Mr Nicholas Medcroft, instructed by Herbert Smith Freehills LLP, and the Respondents were represented by Mr David Turner QC and Mr Edward Harrison, instructed by Taylor Wessing LLP.

[1] References – Bundles [Bundle/Tab/Pages] – Transcripts [Day/Pages]

The Jurisdiction

1.3 The FRC is the independent regulatory body for the accountancy and actuarial professions in the UK. Its rules and procedures in relation to accountants are set out in a Scheme (dated July 2013, effective on 29 May 2014 but subsequently amended). It is referred to below as "**the Scheme**". By paragraph 7(11) of the Scheme it is provided that if the Executive Counsel, having reviewed any representations received for the purposes of paragraph 7(10) of the Scheme, considers that there is a realistic prospect that a Tribunal will make an Adverse Finding against a Member or Member Firm (which expressions in this case denote membership of the ICAEW, ICAS, or ACCA), and that a hearing is desirable in the public interest, the Executive Counsel shall deliver to the Conduct Committee a Formal Complaint against the Member or Member Firm, and send a copy to the Convener. The Convener is then obliged, by paragraph 9(2) of the Scheme to appoint an independent Disciplinary Tribunal to hear the Formal Complaint.

1.4 Paragraph 2(1) of the Scheme provides that an Adverse Finding is a finding by a Disciplinary Tribunal that a Member or Member Firm has committed "***Misconduct***", that is:

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

1.5 Paragraph 9(7) of the Scheme, so far as is relevant, provides that:

"After hearing the Formal Complaint, the Disciplinary Tribunal shall, in relation to the Member or Member Firm which is the subject of the Formal Complaint, either:- (i) make an Adverse Finding in respect of some or all of the alleged Misconduct …. forming the subject matter of the Formal Complaint; or (ii)dismiss the Formal Complaint."

1.6 Paragraph 9(6) of the Scheme provides:

"the Disciplinary Tribunal may take into account any relevant evidence, whether or not such evidence would be admissible in a court. .."

1.7 Paragraph 12 of the Scheme provides:

"The standard of proof to be applied by a Tribunal is the civil standard of proof."

Standards of Conduct

1.8 The relevant standards of conduct include those set out in the Fundamental Principles and Statements contained in the Codes of Ethics (the "Code/s"), applicable at the material time, issued by the relevant professional bodies, namely in this case by ICAS, ICAEW and ACCA, relevant extracts of which are annexed to this Report at Annex A.

1.9 As can be seen from Annex A, the Fundamental Principles of those professional bodies impose a duty on their members to comply with the requirements of principles of professional competence and due care.

1.10 It was common ground before us that the Codes of all these professional bodies incorporated the International Standards on Auditing (UK and Ireland) ("ISAs"). These standards were introduced on the 22 December 2004 for firms in the UK and Ireland and they were effective for audits of financial statements for periods commencing on or after 15 December 2004. Extracts from the applicable ISAs are annexed to this Report at Annex B.

1.11 In the case of **FRC Executive Counsel v Stephen Harrison and PricewaterhouseCoopers,** decided in 2002, Sir Stanley Burnton stated (paragraph 33) that ***"The purpose of ISAs …. Is to establish standards and general principles with which auditors are required to comply in the conduct of any audit of financial statements. Together they form a body of standards that should be applied before an auditor can express an opinion that financial statements give a true and fair view within the meaning of section 393 of the Companies Act 2006."***

1.12 Engagement partners and engagement teams are required to act in accordance with the ISAs - ISA 200, paragraph 5 provides ***"The auditor should conduct an audit in accordance with ISAs")***[2]*.*

The Respondents

1.13 The Formal Complaint is against:-

(a) Baker Tilly UK Audit LLP ("**Baker Tilly**"), now RSM UK Audit LLP, a member firm of the Institute of Chartered Accountants of Scotland ("**ICAS**");

[2] *[B1/3/263]*

(b) Richard King ("**Mr King**"), a partner of Baker Tilly and a member of the Institute of Chartered Accountants in England and Wales ("**ICAEW**"); and

(c) Steven Railton ("**Mr Railton**"), a partner of Baker Tilly and a member of the Association of Chartered Certified Accountants ("**ACCA**").

The Focus of the Formal Complaint

1.14 The Complaint relates to audit work conducted by the Respondents for the Tanfield group of companies ("**the Group**") namely Tanfield Group Plc ("**Tanfield**") and two of its subsidiaries, Tanfield Engineering Systems Limited ("**TES"**) and SEV Group Limited ("**SEV**") between November 2007 and July 2008 in connection with the 31 December 2007 year end audits of these three companies. At the material time […] was finance director of all three companies.

1.15 Baker Tilly has acted as auditor of Tanfield and some of its subsidiaries from 2005 until the present day. To be specific, in 2007 it was retained to carry out a full scope statutory audit for Tanfield and certain of its subsidiaries (including TES and SEV) and in particular to form an opinion as to whether the financial statements of those companies, prepared under International Accounting Standards, showed a true and fair view and complied with the Companies Act in force at the material time. In addition, Baker Tilly was required:

(a) to report on whether, in Baker Tilly's opinion, the information given in the Directors' Report was consistent with the financial statements, and if not, Baker Tilly was required to consider the implication for its audit report;

(b) to indicate if Baker Tilly had not received all the information and explanations required for the audit.

1.16 The appointed engagement partner has overall responsibility for an audit engagement and its performance, and for the auditor's report issued on behalf of the firm and has the appropriate authority from a professional, legal or regulatory body (ISA 220, paragraph 5(a)). Pursuant to ISA 220:

(a) ***"The engagement partner should take responsibility for the overall quality on each audit engagement to which that partner is assigned"*** (para 6); and

(b) ***"The engagement partner should take responsibility for the direction, supervision and performance of the audit engagement in compliance with professional standards and regulatory and legal requirements, and for the***

auditors' report that is issued to be appropriate in the circumstances" (para 21).

1.17 In respect of the 2007 audits and financial statements:

(a) Mr King was the engagement partner responsible for the audit of Tanfield, and signed the audit opinion on the Tanfield financial statements on 21 April 2008; and

(b) Mr Railton was the engagement partner responsible for the audits of TES and SEV, and signed the audit opinion on the TES and SEV financial statements on 21 July 2008.

All three opinions were unqualified.

1.18 Baker Tilly (now RSM UK Audit LLP) is and at all material times was a national firm with a network of offices across the UK.

1.19 Mr King qualified as a Chartered Accountant in 1994. He joined Baker Tilly as a partner in or around October 2006. Mr Railton was admitted to membership of ACCA on 24 November 1994 and joined Baker Tilly on 1 February 2003. Apart from being the partner responsible for the audit opinion in respect of TES and SEV, Mr Railton was also the client service partner for Tanfield and for those subsidiaries of Tanfield which retained Baker Tilly.

The Group

1.20 Tanfield is a UK company listed on the Alternative Investment Market (AIM) of the London Stock Exchange. Tanfield described itself in its Annual Report and Financial Statements for 2007 as a ***"progressive manufacturing company which operates in two of the world's most exciting markets – zero emission electric vehicles and aerial work platforms."***

1.21 Tanfield is, and at the material time was, a holding company: it did not trade. TES comprised of three principal divisions - powered access platforms (or aerial work platforms), zero emission vehicles, and engineering (which included sheet metal fabrication). Certainly at the relevant time, the scale of TES's business was such that a material error in its financial statements could produce the same in the financial statements of Tanfield. SEV provided maintenance services and parts replacement for the Group's zero emission vehicles. In August 2007, Tanfield acquired Snorkel Holdings

LLC, a US entity operating in the aerial work platforms market, for £48.1m. The acquisition was expected to drive significant growth in 2008.

1.22 TES's revenue in 2007 was £67.3m and its operating profit was £5.2m. TES's total current assets at 31 December 2017 were £70.5m, including stock (raw materials, work in progress ("**WIP**"), and finished items), totalling £30.7m, held principally on a site at Vigo, Washington, but also on a site at Tanfield Lea. The stock at Tanfield Lea was mainly comprised sheet metal used in the manufacture of buckets for excavators, [...] being one of the main customers. The TES receivables, in 2007 totalling £31.2m, included a debt of £7.3m owed by [...], a company referred to as "**IPS**", and a debt of £9.2m owed by [...], a company referred to as "**PSE**". These debts are referred to below as the "***IPS debt***" and the "***PSE debt***". In 2006 another UK aerial platform manufacturer, Upright Limited, was acquired and in 2007 it was integrated into TES.

1.23 SEV's revenue was £13.4m, generating an operating loss of £300,000 in 2007. SEV's current assets at 31 December 2007 amounted to £9.2m, including stock totalling £1.3m, which consisted mainly of spare parts for the repair and maintenance of electric vehicles and was held principally on a site at Sheffield. The SEV trade receivables, totalling £2.2m, included a debt of £500,000 owed by a Chinese entity known as W[...] – referred to below as the "***W[...] debt***". Revenue for Tanfield for the year ended 31 December 2007 as reported in its accounts was £123.3m (compared to £40.6m in 2006 and £22.4m in 2005). Operating profit had increased from £3.8m in 2006 to £11.6m. 35% of revenue was made from sales in the UK, 29% from sales in the USA, 24% from sales in Europe and the remainder was made in other territories.

1.24 On 28 April 2008 Tanfield's auditor's report for the year ended 31 December 2007 was signed by Mr King.

1.25 On 1 July 2008 Tanfield issued a public trading update statement to the effect that although trading for the first five months of 2008 had been relatively strong and in line with management expectations, there had been a marked slowing in its markets in June: this resulted in the share price falling by about 83% in one day.

1.26 On 21 July 2008 there was a meeting between Tanfield's finance director, [...], and Mr [...], the senior manager for the audits of the group, to discuss the going concern status of the business and the post balance sheet events for TES and SEV.

1.27 Also on 21 July 2008 the TES and SEV auditor's report for the year ended 31 December 2007 were signed by Mr Railton.

1.28 On 30 September 2008, Tanfield announced its interim results for the six month period to 30 June 2008. The announcement disclosed that impairments had been made totalling £75m, resulting in a loss after impairments of £65m. The impairments made were:

Goodwill	£33.155m;
Intangibles	£15.26m;
Inventories	£15.325m;
Receivables	£11.549m.

1.29 In Tanfield's audited Financial Statements for the period ended 31 December 2008, which were signed on 16 April 2009, the impairments were increased to £89.662m. These included inventories impairment of £22.2m and an impairment of receivables of £22.9m, £6m being written off the IPS debts, £6m being written off the PSE debt, and the W[...] debt being written off in its entirety.

1.30 On 10 September 2009, the Accountancy and Actuarial Disciplinary Board (the "**AADB**"), the fore-runner of the FRC, announced an investigation into ***"the preparation, approval and audit of the financial statements of [Tanfield] for the years ended 31st December 2007 and 2008".*** That investigation proceeded over several years and culminated, more than 4 years and 8 months later, in the issuing of the Formal Complaint, signed on 24 May 2014, and served on 3 June 2014. The Formal Complaint relates only to the audited accounts for the year ended 31st December 2007.

Areas of Contention

1.31 A significant feature of the Tanfield balance sheet for the year ended 31 December 2007 was that the inventories figure had increased from £14.1m at 31 December 2006 to £60.3m at 31 December 2007. This increase was, to a significant degree, attributable to an increase in inventories at TES. TES had inventories totalling £11.5m at 31 December 2006; by 31 December 2007, the amount had increased to £30.7m.

1.32 Executive Counsel submitted that for these reasons, and others, (a) the existence and valuation of inventories and (b) valuation of receivables were, or should have been, key areas of audit focus and that the Respondents' audit work in these areas fell significantly short of the standards reasonably to be expected.

1.33 There are three allegations in relation to each of these two balances. Put shortly, they concern:

(a) failing to obtain sufficient appropriate audit evidence of the existence and valuation of the inventories and receivables (Allegations 1 & 4);

(b) failing to adequately review/discuss the audit documentation to gain comfort that there was sufficient appropriate audit evidence (Allegations 2 & 5); and

(c) failing to carry out and document adequate audit procedures relating to post balance sheet events (Allegations 3 & 6).

2. PART 2 – THE MISCONDUCT ALLEGED

The Allegations

2.1 The Executive Counsel's allegations of Misconduct in the Formal Complaint relate to each of the unqualified (i.e. "***clean***") audit opinions referred to above. It is the Executive Counsel's case, as further detailed in the extract from the Formal Complaint in Annex C to this Report, and as set out individually and addressed in turn below:

***"that the Respondents: (a) failed to obtain sufficient appropriate audit evidence to support their conclusion that no material error existed, in particular in the context of their work on Inventories and Trade Receivables; (b) failed adequately to review the audit documentation and to discuss the audit evidence so as to be satisfied that sufficient appropriate audit evidence had been obtained; (c) failed in relation to post balance sheet events to perform sufficient appropriate audit procedures; and (d) failed to obtain sufficient appropriate audit evidence in relation to Inventories and Trade Receivables in order to express an unqualified audit opinion on the financial statements*."**

2.2 The allegation of Misconduct, based on the first limb of the definition set out at paragraph 1.4 above, is that in the respects alleged the Respondents' conduct of the audits of Tanfield, TES, and SEV fell ***"significantly short of the standards reasonably to be expected of a Member or a Member Firm"***.

The Specific Allegations in Annex C

2.3 It is to be noted that Allegations 1, 2, 4 and 5 are advanced against all the Respondents. Allegations 3 and 6, which only relate to the audits of TES and SEV, are advanced against Baker Tilly and Mr Railton, but not against Mr King.

Allegation 1

2.4 Allegation 1 relates to:

(a) the stocktakes at Tanfield Lea and Vigo and the existence and valuation of TES inventories; and

(b) the stocktake at Sheffield and the existence of SEV inventories.

2.5 The allegation references the Fundamental Principle of Professional Competence and Due Care, ISA 500 paragraph 2 (auditors should ***"obtain sufficient and appropriate audit evidence to be able to draw reasonable conclusions on which to base the audit opinion"),*** ISA 220 paragraph 21 ***("the engagement partner should take responsibility for the direction, supervision, and performance of the audit engagement in compliance with professional standards etc…and for the auditor's report .. to be appropriate in the circumstances"***), and ISA 530 paragraph 50 ("***to be considered an anomalous error the auditor has to have a high degree of certainty that such error is not representative of the population****") .*

Allegation 2

2.6 Allegation 2 asserts that in relation to TES and Tanfield the existence of inventories was a critical area of judgment and/or a difficult or contentious matter and identified as a "significant risk" for TES and Tanfield.

2.7 Apparently in recognition of the fact that the Engagement Partners would not have been directly involved in the initial work giving rise to the alleged shortcomings in respect of TES referred to in Allegation 1, Allegation 2 asserts that the Respondents should have identified and resolved those shortcomings, but failed to do so.

2.8 The allegation references the Principle of Competence and Due Care, and ISA 220 paragraphs 26 and 27 (guidance) – namely that engagement partners ***"through review of the audit documentation and discussion with the engagement team should be***

satisfied that sufficient and appropriate audit evidence has been obtained to support the conclusions reached."

Allegation 3

2.9 Allegation 3 asserts, in effect, that in relation to TES and SEV, Baker Tilly and Mr Railton:

(a) Failed to obtain sufficient appropriate audit evidence that all ***"adjustment or disclosure events"*** between 31 December 2007 and the signing of the auditor's reports had been identified; and

(b) Failed to prepare a sufficient appropriate record which demonstrated that all events which might have required such adjustment or disclosure to be made had been identified and considered.

2.10 The allegation references the Principle of Professional Competence and Due Care, ISA 560 paragraph 4 (auditors should ***"perform audit procedures designed to obtain sufficient appropriate audit evidence that all events up the date of the auditor's report that may require adjustment of, or disclosure in the financial statements have been identified"),*** ISA 230 (revised) paragraphs 2 and 9 (see paragraph 2.20 below above), and ISA 220, paragraph 21 (see Allegation 1 below).

Allegation 4

2.11 Allegation 4 asserts in relation to the audits of the three companies that the Respondents failed to obtain sufficient appropriate audit evidence of the existence and valuation of trade receivables in particular in relation to the debt of £7.3m owed to TES by IPS, the debt of £9.2m owed to TES by PSE, and the Debt of £500,000 owed to SEV by W[...] since 2005.

2.12 The Allegation references the Principle of Professional Competence and Due Care, ISA 500 paragraph 2 – (see Allegation 1 above) – and ISA 220 paragraph 21 – (see Allegation 1 above).

Allegation 5

2.13 Again in apparent recognition of the fact that Mr. King and Mr Railton would not have been directly involved in the initial work giving rise to the alleged shortcomings referred to in Allegation 4, Allegation 5 asserts that the Respondents should have identified and resolved those shortcomings but failed to do so.

2.14 The allegation references the Principle of Professional Competence and Due Care and ISA 220 Paragraphs 26 and 27. (see allegation 2 above).

Allegation 6

2.15 Allegation 6 asserts that, in relation to TES and SEV, Baker Tilly and Mr Railton:

(a) Failed to obtain sufficient appropriate audit evidence of all ***"adjustment or disclosure"*** events between 31 December 2007 and the signing of the auditor's reports; and

(b) Failed to prepare a sufficient appropriate record which demonstrated that all events which might have required such adjustment or disclosure to be made had been identified and considered.

2.16 The allegation references the Principle of Professional Competence and Due Care, ISA 560 paragraph 4 (see allegation 3 above), ISA 230 paragraphs 2 and 9 (see allegation 3 above), and ISA 220 paragraph 21 (see allegation 3 above)

Allegations Not Proceeded With

2.17 Before the close of the hearing, Executive Counsel confirmed that the allegations in Allegation 1.1(b)(ii), relating to inadequate sample sizes selected for the Tanfield Lea stocktake of raw materials, and in Allegation 4.6, relating to insufficient evidence of the basis for decisions regarding provision for bad debts, were no longer pursued.

General

2.18 It is to be noted that no complaint is made that the 2007 financial statements were misstated. No complaint is made in relation to the impairments recorded in the 2008 financial statements. There is no suggestion that the impairments were either inappropriately made, or that they should have been made – in whole or part – in the 2007 (as opposed to 2008) financial statements. No complaint is made as to the 2008 financial statements at all, although they formed part of the FRC's investigation. This, and the matters referred to in the next paragraph gave rise to debate within the Tribunal as to whether or not this kind of case is capable of falling within the purposes of the regulatory scheme. The Tribunal concluded that it could, since although cases involving significant loss, or injury to third parties, may be the most serious, the scheme reflects the public interest in maintaining standards so as to prevent loss, and injury to, amongst others, third parties. Hence, cases involving the potential for serious loss may be justifiably

regarded as ranking close behind, if not as equal in seriousness to, cases in which actual loss is proven.

2.19 It is also to be noted that it is not alleged in the Formal Complaint that there was any causal link between the financial or trading position of Tanfield at 31 December 2007 and the subsequent quantum of difficulties experienced in 2008 leading to the Trading Statement and share price collapse. It can also be seen that the Formal Complaint does not allege any lack of integrity, bad faith, or dishonesty.

Audit Documentation

2.20 As appears from Annex B, ISA 230 (Revised) provides:

(a) Paragraph 2:

"The auditor should prepare, on a timely basis, audit documentation that provides: (i) A sufficient and appropriate record of the basis for the auditor's report; and (ii) Evidence that the audit was performed in accordance with ISAs (UK and Ireland) and applicable legal and regulatory requirements."

(b) Paragraph 9:

"The auditor should prepare the audit documentation so as to enable an experienced auditor, having no previous connection with the audit, to understand: (i) The nature, timing, and extent of the audit procedures performed to comply with ISAs (UK and Ireland) and applicable legal and regulatory requirements; (ii) The results of the audit procedures and the audit evidence obtained; and (iii) Significant matters arising during the audit and the conclusions reached thereon."

2.21 The Executive Counsel alleged, and the Respondents did not dispute, that none of the three audits was adequately documented, there being numerous examples where it was unclear whether actions had been taken or whether judgments had been made in relation to apparent actions or omissions, and if so, what the reasoning behind such judgments actually was. This hampered the Respondents' witnesses, who in the absence of contemporary documentation had to rely on their unassisted recollection of matters which, by the time they gave evidence, were ten years old. The expert witnesses were also hampered by this, with the consequence that their evidence was at times somewhat speculative.

2.22 In fact, the degree to which the audits under consideration were not in compliance with the requirements of ISA 230 paragraph 9 is startling. As a consequence, the audit trail remained obscure in many respects in spite of the investigations by both experts, two senior and experienced auditors, over considerable periods of time. Nevertheless, the Executive Counsel, both in opening and closing the case, stated explicitly, but without explaining why, that the allegations of Misconduct were not based on a general failure to comply with, or a multiplicity of breaches of, the provisions of ISAs which prescribe obligations in relation to documentation, reliance upon breaches of ISA 230 (revised) being restricted to Allegations 3 (b) and 6 (b).

2.23 Executive Counsel did, however, contend that where documentation did not exist to substantiate that a particular step or judgment or procedure had been, as the case may be, taken, made, or implemented, in the course of the audit, it was open to the Tribunal to infer that the works had not in fact been undertaken. We accept that submission.

Issue of Construction

2.24 In paragraph 85 of their written closing submissions the Respondents raised an issue as to the meaning and effect of Allegations 1 and 4:

"Allegations 1 (inventories) and 4 (receivables) are concerned only with whether the Respondents had obtained sufficient appropriate audit evidence. Accordingly, the first question which the Tribunal must ask itself is whether, when viewed in the round, there was some insufficiency in the audit evidence obtained by the Respondents. The nature and reasonableness of judgments made by the Respondents would only become relevant if and to the extent to which the Tribunal had first concluded that the audit evidence was insufficient."

2.25 Consistently with this submission it was argued that, because of the wording of these allegations, if in fact evidence gathered during the audits could be found which would have justified a conclusion on the part of a reasonably competent auditor that there was sufficient appropriate audit evidence to support the conclusions reached (here, as in most cases, that the financial statements were free from material misstatement) then there was no basis for a finding of Misconduct, it being of no materiality if in fact the Respondents had not taken that evidence into account.

2.26 We reject that submission. Firstly, the contention is based on a partial reading of the allegations of Misconduct, and overlooks the general complaint in paragraph 14 of the Formal Complaint – see paragraph 2.1 above: it is plain from that that it is the basis of

the Respondents' conclusions which is under attack. Secondly, the Scheme is designed to address the standard of performance of the planning and implementation of audits, and if, for example, an auditor, performs a grossly incompetent audit, it is of no materiality if, by sheer luck, by a reconstruction or new audit, it could be shown that the auditor's conclusions could have been justified if the audit had been carried out competently: the allegations of Misconduct in the Formal Complaint must be read with the purpose of the Scheme in mind, and so read it is plain that in relation to each of the allegations referred to above it is alleged that it is the sufficiency of the evidence upon which the Respondents' audit opinions were based which is being called into question.

2.27 The Respondents' contention is based on a literal reading of the allegations in question. It is well established, in the context of the interpretation of contracts that ***"if a detailed and syntactical analysis of the words in a commercial contract is going to lead to a conclusion that flouts business common sense, it must be made to yield to business common sense"*** – per Lord Diplock in **The Antaios [1985] A.C. 191**. Reference may also be made to the dictum of Lord Hoffman in **Mannai Investment Company Ltd v Eagle Star [1997] A.C. 749 at 779*: "The fact that the words are capable of literal application is no obstacle to evidence which demonstrates what a reasonable person with knowledge of the background would have understood the parties to mean, even if this compels one to say they used the wrong words. In this area, we no longer confuse the meaning of words with the question of what meaning the use of the words was intended to convey."***

2.28 Whilst appreciating that we are not concerned with the construction of the words of a contract, we consider that the approach adopted in the cases referred to above is applicable to the issue, raised by the Respondents, as to the meaning of Allegations 1 and 4. Even if these allegations were considered in isolation from the preceding paragraphs, in our judgment the reasonable person with knowledge of the background would appreciate that it is the sufficiency of the evidence on which the Respondents actually based their conclusions which is subject to criticism.

Aggregation

2.29 In her written closing submission counsel for the Executive Counsel submitted that in assessing the seriousness of the Respondents' conduct and whether it fell below the expected standards, the Tribunal should look at the cumulative failings of the Respondents just as the auditor is bound to consider the cumulative impact of errors and potential misstatements identified in tests carried out during the audit: she submitted that

it was artificial to look at audit tests performed in isolation, especially because, she contended, the evidence revealed a pattern of conduct across the audit.

2.30 In her oral closing submissions, she suggested that the Tribunal could look at the individual particulars within each of the six allegations individually, but if it concluded that if an individual particular, taken on its own, was insufficient to amount to Misconduct, the Tribunal could aggregate them together with other particulars within that allegation. She also submitted that the Tribunal could similarly aggregate allegations within an ***"audit area"*** such as ***"inventories"***, and she referred to paragraph 70 of the Disciplinary Tribunal in **FRC v PwC and Harrison** (12 April 2017)("**Connaught**") as providing some support for that approach.

2.31 The Tribunal rejects this submission – had Executive Counsel intended to advance a case that particular conduct taken in isolation or together with other conduct amounted to Misconduct this should and could have been spelled out in the Formal Complaint. It was not. Neither expert witness was asked to address such a case. In **Connaught** the Tribunal did not have to consider whether it could "***aggregate***" separate allegations relating to the same areas of work. The most that can be said is that its decision did not rule out such a possibility. Mr Turner, in his closing submissions, stated that the Tribunal might be able to aggregate between different particulars of the same allegation, but not otherwise. The Tribunal accepts that submission. In this Report, therefore, each of the six "headline" allegations is considered below in turn, the issues of whether Baker Tilly, Mr King, and Mr Railton fell short of the standards reasonably to be expected of a Member Firm or Member in the respects asserted, and, if so, and secondly, whether either singly or with other proven sub-allegations within the same headline allegation, any such sub-standard conduct amounted to Misconduct.

3. PART 3 – THE MEANING OF MISCONDUCT AND THE CORRECT APPROACH

Discussion

3.1 Both parties referred with approval to the **MG Rover Case** (*FRC Executive Counsel v Deloitte and Einollahi Appeal 2014/15*) in which the Tribunal, at paragraph 18 onwards, gave the following summary of the test as to whether what has been done or not done amounts to Misconduct :

"Before we can make a finding that the Respondents or either of them are guilty of misconduct and make a finding adverse to them we have to be satisfied not only that there has been a departure from the conduct reasonably to be expected of a

member or member firm but that that departure has been significant. Whether that departure is significant is a matter for our judgment. A trivial departure will not suffice. We have to be satisfied before we reach a conclusion that there has been such a departure, that the Executive Counsel has proved that no reasonable accountant would have acted in the way that the Respondents have acted.

We accept the Respondents' contention that for the Respondents to be guilty of misconduct and to have acted in a way that no reasonable professional would have acted the conduct has to amount to more than mere carelessness or negligence and has to cross the threshold of real seriousness. It is not sufficient for the Executive Counsel to prove that the Respondents failed to act in accordance with good or best practice or that most or many members of the profession would have acted differently. The conduct has to be more serious than that."

3.2 We were informed that this approach was common ground in the **MG Rover Case** appeal (before the Right Honourable Sir Stanley Burnton) and that this summary has been applied by Tribunals since. The Executive Counsel expressed the view that it was, and adopted it as, "***a helpful summary***". We concur with that view.

3.3 The Respondents emphasised the need not to construe paragraph 18 of the **MG Rover Case** (above) in a way which conflated the test for negligence with the second stage of the test for Misconduct, referring to the decision, dated 15 September 2014, relating to the Complaint against Mr Paul Newsham (the "**Newsham Case**"). In its decision the Tribunal was at pains to draw a distinction (at paragraph 31) between a "***merely***" serious matter, and a falling short that was sufficiently serious as to merit a finding of Misconduct under the Accountancy Scheme:

"***Our view is that [the planning of the audit in respect of long-term accounting] was plainly negligent and careless, and our assessment is that Mr. Newsham failed to carry out his planning obligations adequately. We view this as a serious matter which set the scene for the audit. It was no excuse that this was, in Mr. Newsham's view, a small family-run business. However, applying the principles we have quoted from the Deloitte decision, our unanimous view is that while the shortcomings were undoubtedly serious, on balance we do not consider that the threshold into significance was crossed***".

3.4 Executive Counsel made the point that whilst mere negligence was not Misconduct, conduct which fell short of "***gross incompetence***" could nevertheless amount to Misconduct.

3.5 The Respondents emphasised the need to beware of evidence which amounts to no more than an expression of opinion by an accountant as to what he or she would have done in the relevant circumstances, and of the need to distinguish between "***best practice***", acts or omissions "***falling short***", and acts or omissions "***falling significantly short***". We recognise these distinctions.

3.6 We were referred to, and accept the guidance given in, the judgment of Mr Justice Oliver in **Midland Bank Trust Company v Hett, Stubbs & Kemp** [**1979] 1 Ch. 384 at 402** as endorsed by the Court of Appeal in **Brown v Gould & Swayne [1996] PNLR 130**:

"Clearly, if there is some practice in a particular profession, some accepted standard of conduct which is laid down by a professional institute or sanctioned by common usage, evidence of that can and ought to be received. But evidence which really amounts to no more than an expression of opinion by a particular practitioner of what he thinks that he would have done had he been placed, hypothetically and without the benefit of hindsight, in the position of the defendants is of little assistance to the court…"

3.7 A criticism of conduct "***falling short***" is a criticism that a particular piece of work falls short of the applicable technical standards – the relevant standard in this case being the ISAs - and that the falling short was sufficient to breach the requirement to act with ***"professional competence and due care"***. The parties agreed that this is equivalent to the test for negligence at common law. In **Saif Ali v Sidney Mitchell & Co [1980] A.C. 198 at 218** Lord Diplock stated, in the context of the common law rules applicable to professional negligence, that professional persons are ***"liable for damage caused by their advice, acts, or omissions in the course of their professional work which no member of the profession who was reasonably well-informed and competent would have given or done or omitted to do."*** One appropriate test is to ask whether a "***responsible***" or "***reasonable***" body of professional opinion could do as the accountant did – ***Bolitho v City and Hackney Health Authority*** **[1998] AC 232 at 241F – 242A**. It is no defence to a charge of negligence that even the most skilled professionals occasionally make mistakes, since the test is whether the error is one which ***"would not have been made by a reasonably competent … professional professing to have the standard and type of skill that the defendant held himself out as having, and acting with ordinary care***;" – ***Whitehouse v Jordan*** **[1981] WLR 246 at 263 D – F.** We take the reference to ***"acting with ordinary care"*** to be shorthand for ***"acting with reasonable skill and care"***. In this context, the Respondents submitted that since there is scope for differing interpretations as to the meaning of the relevant professional

standards (including the ISAs), more than one professional view or opinion may satisfy the Bolitho test. We accept this principle, though note that it is qualified by **Wong** (below).

3.8 In the Respondents' further submission, all but one of the allegations fail at this level in the light of the rejection by Mr Main of all but two of the allegations of "falling short". We do not accept this submission. Acts or omissions are not excused simply because an expert defends them. The Tribunal is not bound to unquestionably accept the evidence of an expert as to what reasonably competent auditors would do in any given circumstances.

3.9 It is common ground that in determining what were the relevant reasonable standards applicable to the Respondents the Tribunal is bound to be guided by the Principles and Statements of Guidance set out in the ethical guidance contained in the relevant professional body's codes of ethics and the ISAs. However, Mr Main, at paragraph 3.1.7 of his report[3] stated:

"In my experience, in a high proportion of audits, it is likely that at least some non-compliance with ISAs will be found".

3.10 Mr Main provided substantiation for this evidence by reference to the 2008/9 Audit Quality Professional Oversight Board of the FRC, and this evidence was not challenged. However, it appears to us that this general information is of little value. In the present context, non-compliance through in-advertence would be immaterial, and, as we understand it, it was not suggested that it is evidence of the existence of a body of professional opinion which regards non-compliance with the ISAs as being professionally acceptable.

3.11 Executive Counsel also submitted that the Tribunal must satisfy itself that any body of professional opinion (if such there be), purporting to support the position adopted by the Respondents, is reasonable, and has directed its mind to the issues involved on the matter. This was made clear by Lord Browne-Wilkinson in ***Bolitho v City & Hackney Health Authority*** **[1998] AC 232 (HL) at 241G-232B**, who said:

"The use of these adjectives – responsible, reasonable and respectable – all show that the court has to be satisfied that the exponents of the body of opinion relied upon can demonstrate that such an opinion has a logical basis. In particular, in cases involving, as they so often do, the weighing of risks against benefits, the

[3] [D2/3/248]

judge before accepting a body of opinion as being responsible, reasonable or respectable, will need to be satisfied that in forming their views, the experts have directed their minds to the question of comparative risks and benefits and have reached a defensible conclusion on the matter."

3.12 The Respondents drew attention to the fact that Lord Browne-Wilkinson went on to consider ***Edward Wong Finance Co. Ltd v Johnson Stokes & Master*** **[1984] AC 296 (PC)**, where, as he put it, a ***"body of professional opinion, though almost universally held, was not reasonable or responsible"*** (at **1998 A.C. 242H**), and submitted that the Tribunal remains the final arbiter of what is, and what is not, reasonable. Whilst we accept this submission, we are uncertain as to how it is suggested these principles apply to the present case.

3.13 The Respondents submitted that if the Tribunal gets to a stage of analysis beyond a conclusion that, in relation to any the allegations made by Executive Counsel, any of the Respondents has "***fallen short***" of the standards "***reasonably to be expected etc***.", the question for the Tribunal is whether (applying the formulation from paragraph 31 of the **Newsham Case** – see paragraph 3.3 above) the relevant shortcomings were not merely serious, but were sufficiently serious that the "***threshold into significance***" is crossed. We accept this submission.

3.14 The Respondents went on to allege that ***"Another way of testing the position is to ask whether the shortcomings are so serious that they would undermine public confidence in the accountancy profession".*** We reject this submission, which adds a gloss on the wording of Paragraph 2(1) of the Scheme which in our opinion is not justified. We note that the Scheme definition refers to conduct that ***"is likely to bring, discredit to the Member or the Member Firm or to the accountancy profession"*** as a separate basis for a finding of Misconduct.

3.15 The Respondents also submitted that the issue, at its most basic, is whether, separately in respect of each Allegation, the conduct is such as to raise a basic question as to the fitness to practice of the individual whose judgment or audit work is being considered or should be stigmatised as amounting to professional misconduct. We do not accept this submission, which represents another unjustified gloss on the wording of paragraph 2(1) of the Scheme.

The Correct Approach

3.16 The Respondents submitted, by way of a summary, and we accept (though we consider the test in **Whitehouse v Jordan** to be more apposite), that the correct approach is for the Tribunal:

(a) To start by considering the position of each Respondent (where applicable) in respect of each Allegation, and to ask whether any of the conduct relied upon justifies a "***falling short***" criticism (i.e. that it has failed to satisfy the "***Bolam***" test such that no reasonable or responsible body of opinion could support the conduct). (We do this in Parts 7 – 12 below).

(b) To the extent that the answer to the above question is "***no***" then that is the end of the matter. Alternatively, to the extent that the Tribunal considers that one or more criticisms of "***falling short***" are in fact established, then for each Allegation / Respondent combination the Tribunal should then consider whether in fact the conduct is not merely serious, but sufficiently serious to cross the ***"threshold into significance",*** so as to justify a finding of Misconduct. (We do this in Part 13 below)

4. PART 4 – EVIDENCE

Evidence Presented by Executive Counsel

4.1 The case is put to the Tribunal by the Executive Counsel on the basis of the documents – principally, those drawn from the Respondents' audit files - together with the expert evidence of Mr John Leech - presented in three written reports, in a Joint Memorandum ("**the Joint Memorandum**") in which he, and Mr David Main, the expert instructed by the Respondents, set out the matters about which they agreed or disagreed, and in oral testimony.

Admissions

4.2 The expert instructed on behalf of the Respondents, Mr David Main, expressed the view that Baker Tilly's decision to make no further enquiries to assess the current position with regards to payments outstanding by IPS and PSE after 4 March 2008 fell short of best practice but was within the range of reasonable audit judgments as to the evidence required in the circumstances, and further that in light of the fact that the signing of the TES opinions was delayed until 21 July 2008 following the 1 July 2008 trading statement, the omission to make any further enquiries in July 2008 fell outside the range of

reasonable judgments and that the work in this area fell short of that required by ISA 560 Subsequent Events. Taylor Wessing, in a letter dated 22 September 2017, formally accepted this opinion – which related to Allegation 6 – on behalf of the Respondents. Mr Main, however, expressed the view that these inadequacies did not fall ***"significantly short of the standards reasonably to be expected of a Member or Member Firm"*** and so did not amount to Misconduct.

The Baker Tilly Witnesses

4.3 As stated above, Mr King was the Engagement Partner for the Tanfield 2007 audit, and Mr Railton was the engagement Partner for the TES and SEV 2007 audits. The senior manager for all three audits was Mr [...]. There were two audit seniors, Ms [...] (then Ms [...]) and Mr [...]. The team also included a Mr [...], a graduate trainee (still in 2007), a Mr [...], an audit junior, and a Mr [...].

4.4 No evidence was provided by Mr [...] or Mr [...]. Evidence from Mr [...] was provided in the form of a written statement, but all the other members of the team referred to above gave both written and oral evidence to the Tribunal.

Electronic Documentation

4.5 The Respondents, in their written opening, provided the information that in 2007 Baker Tilly introduced a new electronic method of documenting their audit known as aud-IT and that the 2007 audit was therefore the first occasion in which aud-IT was used for Tanfield. They explained at paragraph 51 that:

(a) The aud-IT software for a particular audit consists of a series of "***steps***" which are organised into three sections reflecting the three main phases of an audit: planning, execution and review. Each step relates to a piece of work which has been undertaken as part of the audit, and the system includes records identifying by whom and when the relevant step has been completed.

(b) Whilst the subsequent practice was for working papers to be uploaded to aud-IT and reviewed on the file, in the case of the audit files for the 2007 audits of Tanfield, TES and SEV (during which the audit team were becoming accustomed to the software) the review of working papers was generally performed off aud-IT, meaning the full review history of a document is not always apparent from the file. In addition, the date on which working papers were uploaded was in some

instances later than the date on which work was actually performed and reviewed.

4.6 The Respondents also stated that it appeared that certain Word and Excel documents, although completed and reviewed, had not been transferred onto the aud-IT file but had been retained on a shared network drive used by the audit team, referred to as the "***K drive***". It was submitted that this was not at the time unusual, and given that ISA 230 includes no requirement that documentation should be filed in a single location, it was appropriate that such documentation be taken into consideration as part of the audit evidence obtained during the course of the audits. The Tribunal accepts this submission, but notes that it is plain that the fact that the audit papers were not in one location hampered the investigations of the experts instructed by the parties.

The Experts

4.7 Mr Leech is an experienced auditor. He has considerable experience in the manufacturing industry, with a particular focus on the UK Automotive Sector, signing audit opinions for, amongst others, […], […], […] and […]. He has also signed audit opinions on listed companies. [redacted]. His CV is at Annex D.

4.8 As already indicated, for their part, the Respondents relied upon the expert evidence of Mr David Main. Mr Main, whose CV is also to be found in Annex D, is a partner in the Chartered Accounting firm of Hazlewoods LLP. During his career, as well as gaining experience as an audit engagement partner for a wide variety of clients, including clients in the manufacturing sector, Mr Main has held a number of senior positions within the accountancy profession. These include:

(a) Acting as Global, European and UK Chairman of the Assurance Services Technical Advisory Committees of Moores Rowland International, then the eighth largest association of independent accountancy firms in the world and the forerunner to the Praxity alliance.

(b) An eight year role as a member of the Auditing Practices Board (the body responsible for setting the auditing standards applicable in the United Kingdom). During this time Mr Main participated in the development of Auditing Standards and other guidance notes issued by the APB.

(c) A six year period as an elected member of the Council of the Association of Chartered Certified Accounts, including a period as vice chairman of the association's auditing committee.

4.9 Mr Main is an experienced expert witness, and is a member of the Academy of Experts and the Expert Witness Institute. However, his evidence did not escape criticism. His approach was to look beyond the evidence upon which the Respondents' audit opinions could be shown to be based and to assemble any other evidence which he could find which might provide some support for those opinions, in effect reconstructing elements of the audits, and to appropriate it to the argument (which we have rejected) that there was in fact sufficient appropriate audit evidence to support Baker Tilly's opinions. In closing submissions Counsel for Executive Counsel submitted that there were various respects in which his evidence was unduly and unjustifiably favourable to the Respondents, and she gave various examples, which have been instrumental in the Tribunal cautioning itself that, notwithstanding his considerable experience, his evidence may at times have been coloured by unconscious bias.

4.10 Mr Leech had never acted as an expert witness before he was instructed in this matter. In his closing submissions, Mr Turner advanced, and, in our opinion, substantiated, a number of criticisms of Mr Leech's evidence. These included criticisms that:

(a) At times it appeared that Mr Leech was basing criticisms of the audit on his own personal subjective auditing standards rather than on appropriate objective standards;

(b) In the course of his three reports criticisms which were advanced were subsequently abandoned or modified;

(c) Various criticisms featured for the first time in his oral evidence;

(d) It was clear that at the time he signed his first report he had not personally read all of the exhibits to that report;

(e) Despite recording in his second report that his express instructions included the consideration of the Respondents' witness statements and exhibits, he admitted that he had not read all of the exhibits (in spite of the fact that they included audit evidence which he had not previously seen) and that he had not read the witness statements in their entirety; and

(f) His evidence was demonstrably erroneous in a number of respects.

The FRC's Audit Inspection Unit

4.11 In October 2008, the Audit Inspection Unit (the "**AIU**") carried out an inspection of Baker Tilly's audit files, including the audit file for Tanfield. It is common ground that the AIU inspection team considered many aspects of the 2007 audits which form the subject matter of these proceedings and that the only point in relation to inventories and trade receivables that the AIU included in their final report (made to Mr King) was a reference to a risk of overstocking. On behalf of the Respondents, comfort was sought on the ground that none of the detailed points relating to inventories and trade receivables which are included within the Formal Complaint were raised by the AIU.

4.12 We considered that it was unlikely we would be assisted by the AIU review because:

(a) The AIU was not considering Misconduct.

(b) The AIU made it clear in a letter to Mr King that the review covered selected aspects of the audit only and ***"it was not designed, nor would it be possible for any such review, to identify all weaknesses which may exist in the audit approach, inappropriate audit judgments or failures to follow requirements or underlying principles of professional standards or the firm's audit methodology. It cannot therefore be relied upon for this purpose."***

(c) No witness was called to speak to its Report or review.

(d) According to the Executive Counsel (and this was not challenged) the AIU did not have the benefit of expert evidence, nor detailed evidence from members of the audit team.

4.13 Accordingly, we took no account of the AIU review or report.

5. PART 5 – PRELIMINARY MATTERS

The Baker Tilly Audit Manual

5.1 Baker Tilly's standard audit procedures are, and at all material times were, set out in an Audit Manual ("**the BT Manual**") in which it is stated (paragraph 4.1) that compliance with the procedures set out therein would ensure compliance with the ISAs. We were not provided with any evidence as to whether or not an audit conducted in accordance with the BT Manual would in fact ensure that that the audit complied with ISAs in every respect, but in any event, the Executive Counsel was not critical of its contents and nor were the

contents of the BT Manual or the Respondents' compliance or non-compliance with it the subject of the Formal Complaint It was not suggested that it in any way derogated from the requirement for the Respondents to comply with the ISAs.

Assessing Risks/Significant Risks/ Engagement Partners

Risks of material Misstatements

5.2 Paragraph. 30 of the IAS Framework defines "materiality" as follows:

"Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the size of the item or error judged in the particular circumstances of its omission or misstatement. Thus, materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic which information must have if it is to be useful."

5.3 In paragraph 100 of ISA 315 it is stated:

"The auditor should identify and assess the risks of material misstatement at the financial statement level and at the assertion level for classes of transactions, account balances, and disclosures..."

5.4 It is common ground that, as stated in Executive Counsel's written opening at paragraph 74 :-

"An auditor should make an assessment of the risk of material misstatement at the planning stage of an audit. However, this risk assessment is not fixed. It is important that the auditor keeps the risk assessment under review. For example, as a result of performing planned audit procedures additional information may come to light which may lead the auditor to amend the initial risk assessment. An auditor may need to update the audit plan, and the planned audit procedures, based on the revised consideration of assessed risks (ISA 300 para 16)."

Significant Risks

5.5 In paragraph 108 of ISA 315 it is provided that:

"as part of the risk assessment as described in paragraph 100, the auditor should determine which of the risks identified are, in the auditor's judgment, risks that require special audit consideration (such risks are defined as "significant risks")"

5.6 In the BT Manual the term "***significant risk***" is used in the same sense and there is a like provision to the guidance given in paragraph 108 of ISA 315. In Chapter 2 C, 3.8 it is stated:

"The planning process also requires consideration of whether there are significant risks particularly associated with the entity's operations which require special attention. These should be identified during the initial review and may be addressed either when dealing with "other (risk) factors", and/or via item risk assessment, and/or via the choice of compliance or detailed substantive tests when planning how to assemble the requisite audit confidence. Identification of significant risks requires the auditor to obtain an understanding of the related internal controls and to confirm they have operated, but not (necessarily) to rely on those controls."

5.7 The BT Manual also provides a pro forma for the preparation of an audit plan. The pro forma provides for the inclusion of an overview identifying what the auditor considered to be "***the key business and audit risks****",* key areas of *"****audit focus/risk****",* and for the proposed audit approach to those risks to be set out. There was no reference in the pro forma to "***significant risks***". In the completed pro forma prepared by Baker Tilly for Tanfield it was explained:

"The risk assessment process is designed to ensure that we focus our audit effort on the areas of highest audit risk to Tanfield Group plc's financial statements. The risk assessment and our responses will be updated throughout the engagement to ensure that all areas of material risk to the financial statements are addressed by our audit."

5.8 According to the Respondents, in and from 2007 the requirements of the BT Manual, which included completion of the Assembly of Audit Confidence ("**AOAC**") were supplemented by the introduction of a "***Key Issues Tracker***" ("**KIT**"). In their written opening, the Respondents stated, at paragraph 52:

"……the purpose of the document was to trace through the audit process those items which had been identified as significant risks. Significant risks are risks requiring special audit consideration as defined in paragraph 108 of ISA 315. Where such risks exist the auditor is required to evaluate the design of the entity's related controls and determine whether they have been implemented."

5.9 It is plain that an area of an audit which poses a risk which needs "***special audit consideration***" (which we take to imply that analytical review alone would not be sufficient) is a significant risk, but otherwise there is little guidance in the ISAs as to what matters might be indicative of a significant risk, though Appendix 3 of ISA 315 lists some conditions that might give rise to risks of material misstatements.

5.10 Nor does the BT Manual provide guidance as to what is meant by "***key business and audit risks***" or "***key areas of audit/focus***", nor what consequences should follow from the identification of any area of the audit as falling within those terms. In his oral evidence, Mr King stated[4] that *"**a key area of audit risk**"* was not the same as a significant risk – "***significant risk is a sub-set of key area of audit focus and one which requires a greater extent of attention***". There was no challenge to this evidence.

The Role of Engagement Partners [See also Part 8 below]

5.11 The BT Manual contains sections setting out the general responsibilities of partners and staff. Mr King confirmed that the term "reporting partner" in the manual has the same meaning as "engagement partner" in ISAs:

(a) Chapter 2.E, of the Manual, "***Responsibilities of Partners and Staff***"[5]: Paragraph 2.5 requires the Partner to review the audit file to confirm that the work has been adequately performed and properly recorded and is sufficient to enable him to form an audit opinion.

(b) Paragraph 2.6 provides ***"He is responsible for ensuring that all major issues are resolved and all key decisions are properly documented. In short he needs to be satisfied that the audit file supports the audit opinion without further explanation or justification."***

5.12 In Section 4, Chapter 4.K, of the Manual ,"***Review and Completion***"[6]:

(a) Paragraph 4.2 provides:

"…it is essential that he is involved to some degree in every phase of the assignment. Although his role is primarily that of reviewer and decision maker, there will be occasions when he is required to assume some of the

[4] [T4/215,216]

[5] [M1/77 – 78]

[6] [M1/202 – 204]

review and overall responsibilities of the assignment management, and hence it is emphasised that the procedures below attempt to identify the minimum level of partner participation at each stage of the assignment".

(b) Paragraph 4.3 provides that during the planning stage, the reporting partner must review and approve the audit plan.

(c) Paragraph 4.4 provides:

"during the on-site stage, the reporting partner must: (a) be aware of analytical and compliance tests and their consequent impact upon the original audit plan (c) be aware of any significant error or difference of opinion regarding the presentation of the annual financial statements as soon as this becomes known to the on-site staff."

(d) Paragraph 4.5 provides:

"At the final stage of the assignment, the reporting partner must examine and review files in sufficient detail to be satisfied that all staff including the assignment manager have discharged their responsibilities adequately…."

(e) Paragraphs 5.1 and 5.2 provide:

"The firm's standard procedures are designed to minimise the cost of expensive review time by recognising the concept of the "review pyramid" and tailoring documentation to fit into that concept.

The idea behind the review pyramid is that, as responsibility increases, the need for detailed knowledge reduces. In other words, whilst the reporting partner has overall responsibility for the conduct of the audit assignment, it is not necessary for him to know every detail of what testing we have done. He must, however, know what our standard procedures require us to do and that we have complied with those procedures".

(f) Paragraph 5.3(c) provides:

"(I)t is not necessary for the reporting partner to review the working papers in detail, provided that the assignment manager has completed all the checklists and conclusions for which he is responsible. All that the reporting partner need do is to review those conclusions (including the

points for partner schedule) and the file dividers to see if there are any areas of the financial statements about which he is particularly concerned. The way that the current audit file is organised, and the proper completion of the points for partner (see paragraph 5.4 below), will assist the reporting partner in this process. Provided he is satisfied with the evidence of completion provided by these standard documents, the reporting partner can complete his own review checklist and conclusion form".

5.13 However, the Manual also provides in relation to the standard procedures that:

"In practice it is likely that there will be relatively few cases where any reviewer would feel able to restrict his work to the full extent made possible by the standard system and, it is suggested, none where all the levels of review could be as curtailed as implied above"[7]

5.14 There was much debate between the parties as to the extent to which an engagement partner's review of an audit should include a consideration of detail, and in particular whether it should include a consideration of some or all of the working papers, or could be limited simply to discussion with members of the engagement team.

5.15 The Respondents referred to the concept of a "***review pyramid***" referred to in paragraph 5.12(e) above and submitted that it was common ground that in terms of the process of conducting a review:

(a) as well as reviewing working papers, an appropriate form of review is discussion between the audit engagement partner and the audit manager together with consideration of the issues that have been generated on the schedule of issues, and consideration of the way that those issues have been closed off.[8]

(b) in exercising his judgment as to whether appropriate evidence had been obtained, it was appropriate for an engagement partner to be influenced by: (i) his knowledge of the audit team; (ii) his knowledge of the applicable procedures (iii) his discussions with the audit team; and (iv) his knowledge that if the team had perceived significant issues they would have raised them to him.[9]

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[7] [M1/205]

[8] [T4/120]

[9] [T4/121-122]

5.16 They further submitted that Mr Main had not been challenged on his evidence at paragraph 14.3.1 of his report that, in the context of the engagement partner's review, it would be:[10]

"unduly onerous for the auditors to have to document all internal discussions that take place and I consider it would be rare to do so".

5.17 In the event, it appeared to be common ground that any area of the audit assessed as being a key risk would be an area of particular focus both for the audit team generally and for the engagement partner. However, we were not taken to anything in the BT Manual equivalent in terms to paragraph 27 of ISA 220 (see paragraph 5.21 below), and accordingly it appears to us that in such circumstances under the terms of the BT Manual, in each case the reasonably competent engagement partner, whilst under a duty to carry out a careful review of that area of the audit, would make a judgment as to whether that review should include a personal review of any of the working papers and, if so, would make a further judgment as to the level of that review.

5.18 It might be that in relation to some audits the engagement partner's review can properly be carried out at the high level described in the extract from the BT Manual set out in paragraph 5.12(f) above, but we consider that such instances will be rare, as is emphasised in the manual itself, and it is conceivable that in some cases an engagement partner's review could properly be based simply on discussions with the engagement team, but, as set out below, we do not consider that a competent auditor exercising reasonable care and skill would consider that discussions alone could provide sufficient confidence in the audit, even if the engagement team was believed to be of a high standard, if the audit had been identified as including any risks requiring special audit contribution.

The Impact of ISAs

5.19 The role of engagement partner is clearly defined in ISAs: he is responsible for the overall quality of the audit – and for the report which is issued in the auditor's name. The engagement partner is responsible for the direction, supervision and performance of the audit engagement in compliance with professional standards. (ISA 220, para 5, 6 and 21)

5.20 This role involves ensuring that the audit is conducted in accordance with the ISAs (see ISA 200 paragraph 5 at paragraph 1.12 above) and the Engagement Team has gathered

[10] [D2/3/345]

sufficient appropriate audit evidence to be able to express an opinion on whether the financial statements were free from material misstatement – in other words ***"true and fair"***. (ISA 200 paragraphs 2 & 8).

5.21 ISA 220, paragraphs 26 and 27 (both "***guidance***") provide:

"Before the auditor's report is issued, the engagement partner, through review of the audit documentation and discussion with the engagement team, should be satisfied that sufficient appropriate audit evidence has been obtained to support the conclusions reached and for the auditor's report to be issued.

The engagement partner conducts timely reviews at appropriate stages during the engagement. This allows significant matters to be resolved on a timely basis to the engagement partner's satisfaction before the auditor's report is issued. The reviews cover critical areas of judgment, especially those relating to difficult or contentious matters identified during the course of the engagement, significant risks, and other areas the engagement partner considers important. The engagement partner need not review all audit documentation. However, the partner documents the extent and timing of the reviews. Issues arising from the reviews are resolved to the satisfaction of the engagement partner."

5.22 In paragraphs 9 and 10 of their Joint Memorandum[11], Mr Leech and Mr Main noted:

"9. The Experts agree that an audit engagement partner should consider in greater detail areas of the audit identified as significant risk areas. The Experts also agree that this consideration does not necessarily mean that all of the work papers related to these areas should be reviewed by the audit engagement partner.

10. The Experts disagree on the Interpretation of paragraphs 26 and 27 In ISA 220 (Quality review of audit documentation required by the audit engagement partners, Mr King and Mr Railton). The Experts however agree that ISA 220 (paragraph 27) requires that the reviews cover critical areas of judgment, especially those relating to difficult or contentious matters identified during the course of the engagement, significant risks and other areas the engagement partner considers important"

[11] [D2/5/439]

5.23 In paragraph 3.3.8 of his first report[12], Mr Leech stated that although ISA 315 did not mandate that an audit engagement partner must review the workpapers in respect of each significant risk before signing an audit report, he would expect an audit engagement partner to do so. In his oral evidence he explained that in his opinion the engagement partner did not have to personally review all working papers relating to an area of the audit classified as a significant risk. In the Joint Memorandum and under cross-examination he was insistent that in his opinion all reasonably competent engagement partners would personally review working papers dealing with issues calling for the exercise of judgment or with estimates, and that the valuation of inventories of a manufacturing company was likely to involve estimates and judgments.[13] He stated that ISA 220 predicated a review of some of the working papers as well as discussion with the engagement team.

5.24 Mr Main, in his report, at paragraph 14.3.25[14] rejected any suggestion that an engagement partner should review all the working papers where a significant risk had been highlighted:

"Even if a significant risk has been highlighted, the procedures designed to address those risks are often quite straightforward. I would not expect the engagement partner to review such working papers in detail, but would expect him to discuss the outcomes with a relevant member of the audit team (often the audit manager)."

5.25 In his oral evidence[15] he stated that it was a matter of judgment for the engagement partner as to whether or not he would actually look in any detail at the working papers.

"It depends very much on how the discussion goes with the manager and how much comfort you get from the discussion with the manager and how much trust you place in the manager as to how much you then want to drill down into that detail."

5.26 The implication of the evidence given by Mr Main and referred to in the last paragraph is that at least some "***drilling down***" on the part of the engagement partner is required, and that he would not be supportive of a process which places "blind faith" in subordinates.

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[12] [D1/1/19]

[13] [T3 p 89/90/91:T4 p 120]

[14] [D2/3/350]

[15] [T9/29]

5.27 Mr Leech's evidence is encapsulated in the following passage from his oral evidence:[16]

MR LEECH I do believe it's a matter for the engagement partner to use his judgment to determine which work papers he should review. So I don't think -- because it's a significant risk he has to review every single work paper but in my experience an engagement partner would review work papers -- significant work papers with judgment and estimates in it within a significant risk area.

But I also think an engagement partner would go beyond that as well and a reasonable engagement partner would look anywhere in the file where there have been difficult or contentious matters with the client, where there have been other judgments and estimates that maybe didn't quite reach significant risk level but he was concerned that in the aggregate if they -- you know, there's lots of judgments and estimates and in the aggregate if these get to a material issue, then, you know, That's a potential qualification.

THE CHAIRMAN: Let me make sure I understand this. Assuming that in this case the engagement partners were not specifically alerted by their subordinates to a particular area, are you saying that even if there was no specific alert, the engagement partners in this case should have been looking at or delving into the working papers in relation to this valuation of inventories?

MR LEECH. I am

5.28 Referring to the concept of the "***review pyramid***" the Respondents submitted that it is an important part of the guidance in Paragraph 27 of ISA 220, which Mr Leech accepted in paragraph 8.4.2 of his first report[17], that there is no requirement – even as a matter of best practice – for an engagement partner to review all audit documentation: this would be unworkable as a matter of practice, and was not how the audit profession operates.

5.29 Our conclusion is that the classification of a risk as a significant risk (i.e. as requiring special audit consideration) enhances the level of the review which, it is contemplated in paragraph 26 of ISA 220, should be carried out by the engagement partner before the issue of the auditor's report. In our judgment the engagement partner's review needs to be sufficiently detailed to provide confidence that the conclusions reached by the senior manager (in this case Mr [...]) are sound. This will involve discussion but it will also

[16] [T3/96,7]

[17] [D1/1/127]

necessarily involve looking at some of the key papers on which those conclusions were based, although the ultimate breadth and depth of the review of such documentation would be a matter of judgment on the part of the engagement partner, depending on the extent to which, if at all, the review, in its initial stages, disclosed the presence or absence of any errors or questionable judgments. The effect of a failure to carry out such a check on the conclusions of the senior manager of the audit in relation to at least some areas assessed as significant risks would be to delegate the engagement partner's responsibility for the audit to the senior manager, which is plainly unacceptable.

Audit Risk/Confidence

5.30 According to a summary of the Baker Tilly approach, provided in the Respondents' written opening submissions, so far as audit risk is concerned, in order to obtain reasonable assurance that a set of financial statements being audited are free from material misstatement, the BT Manual provides for a system in which a specified number of "***audit confidence points"*** are required for each audit ***"item"*** *(*i.e. for each revenue or cost stream or balance sheet item).

(a) The total number of points required depends initially on a threefold classification based on an assessment of the level of overall risk presented by the audit as a whole. For a "***high***" audit risk client, 10 points are required; for a "***medium***" audit risk client, 8 points are required; for a "***low***" audit risk client, 6 points are required.

(b) The total number of audit confidence points required for an audit as a whole provides the starting point for determining the level of testing that is required to obtain sufficient confidence for each individual audit item. Thus if an audit is assessed as being medium risk overall, then the starting point is that 8 audit confidence points will be required for each audit item (i.e. 8 points for "***Trade receivables***", 8 points for "***Cash and Cash Equivalents***," and so on).

(c) The Manual provides that each individual audit item is initially presumed to be "***high item risk***". This means that the full number of audit confidence points need to be obtained for that item through audit testing procedures. However, the Manual also provides for circumstances in which an item, or an element thereof, can be classified as a "***low item risk"***. Where an audit item is classified as low risk, 2 audit confidence points are allocated to that item thereby reducing the number of further audit confidence points that need to be obtained through testing.

(d) In order to obtain the necessary number of audit confidence points, the BT Manual places an emphasis on substantive analytical review procedures and requires analytical tests to be performed at the outset of the assignment. The Manual provides that, if the results of the substantive analytical tests are satisfactory, 4 audit confidence points are obtained.

(e) Once substantive analytical tests have been completed, the Manual provides at Chapter 2.D, paragraph 3.4 as follows:

"To the extent that additional audit confidence is required, it will be obtained from compliance or detailed substantive tests, or a combination of both. The choice will be exercised by the assignment manager based on his assessment of the most effective way of obtaining the requisite audit confidence, in accordance with the general guidance given in Chapter 4.A. Appendix 4 to that Chapter includes tables which show how many confidence points are generated by various levels of sampling."

5.31 Mr [...], in his witness statement[18] explained that in the instant case the audit team's assessment was that:

(a) Tanfield represented a medium audit risk, requiring that 8 confidence points be obtained, which it was proposed would be obtained through performing substantive analytical review and detailed substantive testing (4 points) in relation to the existence and valuation of inventories.

(b) TES was assessed as low audit risk, requiring 6 confidence points, 4 from analytical review and 2 from detailed substantive testing.

(c) SEV was also identified as low risk.

5.32 Mr [...] stated[19] that where the client risk was assessed as low and the item risk was assessed as low, it meant that 2 confidence points were automatically obtained, and substantive analytical review alone would have provided sufficient points, but that, in the event, the team decided to carry out detailed substantive testing to ensure there were sufficient confidence points for the Tanfield audit. Although there is no record that this

[18] [Paragraphs 52 and 53, and the AOAC there referred to]

[19] [Paragraph 95 C1/1/20]

was the reason why Baker Tilly adopted this course, we have no reason to doubt Mr [...]'s evidence that it was.

Analytical review

5.33 There is a summary of this procedure in Executive Counsel's written closing submissions:

(a) Analytical review involves the evaluation of financial information through the study of plausible relationships among financial and non-financial data – ISA 520 paragraph 3. Analytical reviews are primarily used as a risk assessment procedure, but may also be applied as substantive procedures where they are better suited than tests of detail to address the risk of material misstatement – ISA 520 paragraph 2.

(b) Baker Tilly used analytical procedures in their audit of Tanfield to compare actual financial information relating to inventories and trade receivables with their expectations.

(c) Used in this way, analytical review involves three steps: (1) developing a reliable, precise and independent expectation; (2) comparing the expectation with the actual figures to compute the difference; and (3) investigating significant differences (including through corroboration of management representations and, if necessary, further audit procedures), and drawing conclusions – ISA 520 paragraphs 12 and 17. The Manual mirrors ISA 520 in setting out these steps to an analytical review.

(d) The BT Manual mandates the use of analytical review as part of the audit fieldwork; a successful analytical review provides 4 of the 10 audit confidence points which the Auditor must obtain. The remaining points are gained from compliance or substantive testing, or are awarded automatically in respect of low risk clients or items.

Sampling Materiality

5.34 The BT Manual provides for the calculation of a value, designated "***M***", for the purpose of determining levels of substantive testing (both analytical and detailed), including sampling intervals. M is the average of two revenue based figures (turnover and profit) and two balance sheet items (gross assets and the smallest balance on the face of the balance sheet). The calculation of M in this case was based on the most recent management

accounts i.e. the 10 months to the end of October 2007, and in the event, the values arrived at were £429,000 for TES, £34,000 for SEV, and £1,128m for Tanfield.

5.35 The BT Manual emphasises that: "M is not the measure of whether an error is material, as the firm's standard procedure requires all errors to be followed up and considered both individually and cumulatively, and the final judgment as to whether an audit qualification is required rests with the reporting partner". Nonetheless, "M" is a useful yardstick as to whether an error was material and was evidently used by members of the engagement team as such.

6. PART 6 – OVERVIEW OF THE AUDITS

The Audit Team

6.1 Mr King is currently a partner of RSM UK Audit LLP, having become such following a merger between Baker Tilly and RSM Tenon. He qualified as a chartered accountant in 1994 at KPMG. In October 2006 he joined Baker Tilly as a partner in its Leeds office. He acted in 2007 as audit engagement partner for the 2007 Tanfield audit because Mr Railton (the client service partner for the Tanfield group) did not have the necessary authorisation to conduct audits of listed companies. Mr King acted as the audit engagement partner for Group from 2007 – 2010. The audit of Tanfield's 2007 financial statements is the only engagement in which Mr King has been involved in respect of which a regulator has raised concerns.

6.2 Mr Railton qualified as a Chartered Certified Accountant in 1994. He is currently a member of RSM Tax and Advisory Services LLP. He became a partner at Forrestals in around 2002. This firm was acquired by, and he became a partner in, Baker Tilly in 2003. Since December 2012, he has been Managing Partner at the Newcastle office. He no longer undertakes work as an audit engagement partner. Mr Railton acted as engagement partner for the TES and SEV audits from 2005 until 2011 (at which point Tanfield sold its majority interests in TES and SEV following a restructuring). The 2007 audits of TES and SEV are the only engagements for which Mr Railton has been responsible in relation to which a regulator has raised concerns.

6.3 Mr [...] qualified as an accountant with the Association of Chartered Certified Accountants in […]. He is currently an associate director at [redacted] LLP. He was involved in the Tanfield audits from 2005. He was the Senior Manager for the 2007 Tanfield audit. As senior manager, Mr [...] had responsibility together with Mr King and Mr Railton for the planning of the audit and for briefing the audit team in relation to the manner in which the

audit was to be conducted. He did not undertake the detailed audit testing, which was mostly done by more junior members of the team. However, as the audits progressed Mr [...]'s responsibilities included:

(a) reviewing the team's work;

(b) visiting the team during on-site fieldwork to discuss progress;

(c) keeping Mr King and Mr Railton informed of progress through regular discussions and emails; and

(d) at the end of the execution work, reviewing the team's work and making sure that any material points were brought to the attention of Mr King and Mr Railton.

6.4 Mr [...]'s main contact at Tanfield was [...], but he also liaised directly with other members of the finance team and with management. Mr [...] also attended the main meetings with Tanfield's audit committee to present the Group audit plan and then (following execution) to present the audit findings. It was he who met with Mr. [...] on 21st July 2008 to discuss the updated position with regards to post balance sheet events, going concern and the trading statement issued by Tanfield on 1st July 2008.

6.5 Ms [...] is a fellow of the Association of Chartered Certified Accountants, having qualified in […]. She is currently a Group Financial Accountant at [redacted], but worked at Baker Tilly UK Audit LLP from August 2004 to June 2010. Her responsibilities included the audit planning and (with the assistance of the audit juniors) executing the performance of the audit fieldwork. She was involved in the Group audit and carried out much of the work relating to the TES audit, but was less involved in the audit of SEV. She reported directly to Mr [...].

6.6 Mr [...] became a member of the Institute of Chartered Accountants of England and Wales in […]. He is a finance manager at […], but worked at Baker Tilly UK Audit LLP from November 2005 to October 2014 – first as an audit assistant, then as an audit senior, assistant manager, and manager. As with Ms [...], Mr [...]'s responsibilities included the audit planning and (with the assistance of the audit juniors) executing the performance of the audit fieldwork. Mr [...] was involved in all aspects of the audits but focused on SEV.

6.7 Mr [...] joined Baker Tilly's Newcastle office as a graduate trainee in […]. He qualified as a member of the ICAEW in […]. He is currently a training manager at [redacted]. The 2007 audit was Mr [...]'s only involvement with the Tanfield Group. He was an audit junior. He attended the stocktake at the Vigo premises operated

by TES on 20 December 2007, and assisted with the onsite fieldwork carried out in January and February 2008, and later assisted with collating the necessary information for the preparation of the Group level documents.

Audit Chronology

6.8 Based on the witness statement of Mr [...], the chronology of the audit was as follows:

(a) Planning of the audits commenced with meetings in October and November 2007 between the finance Director of Tanfield Group and Baker Tilly personnel.

(b) On 29 November 2007 Ms [...] carried out a review of correspondence and billing.

(c) Mr [...] and Ms [...] prepared an initial draft of a plan for the audit of the group ("**the Group Audit Plan**"), and from 30 November this was developed in exchanges between Mr [...] and Mr King, with some input from Mr Railton.

(d) On 3 December 2007 the developments of the Tanfield business in 2007 were discussed by Tanfield personnel and Mr [...] and Ms [...] to enable Baker Tilly to prepare expectations of the performance of the business.

(e) A Planning Memorandum was prepared by Ms [...] on 4 December 2007. This replicated the particular matters included in the Group Audit Plan and referred to below.

(f) Other documentation generated at the planning stage included documents entitled "***Audit Review Programme***" ("**ARP**"), "***Assembly of Audit Confidence***" ("**AOAC**"), and "***Working Assembly of Audit Confidence***" ("**WAOAC**").

(g) On 6 December the Group Audit Plan was presented to the Tanfield Audit Committee (three non-executive directors) and Mr [...], by Mr King, Mr Railton, and Mr [...].

(h) The Group Audit Plan included a column entitled "***Key area of audit focus/risk…***". That column included "***Snorkel Holdings LLC & its Subsidiaries***", "***Stock holding***" at TES and SEV ("***expected to be a highly significant figure within the group balance sheet...a risk associated with this high stockholding"*** being ***"the risk of damage and obsolescence***"), and "***valuation of work in progress***" at SEV, it having been discovered during the

2006 audit that work in progress ("**WIP**") of £281k actually included completed work awaiting invoicing.

(i) A spreadsheet of consolidated expectations for the group was prepared by Mr [...] and Ms [...] setting out their estimate, using the 2006 figures as a starting point, of the figures (in terms of income. stock etc.) for 2007: it is dated 10 December 2007.

(j) The KITs (the Key Issues Tracker documents) were prepared for TES by Ms [...] and for SEV by Mr [...] on 10 December 2007, and for Tanfield by Mr [...] on 14 December 2007. In these documents the existence and valuation of inventories, and the existence of the W[...] debt of £500,000 (noted to have been outstanding since 2005) were identified as "***significant risks***".

(k) The ARP referred to Stockholding as "***a potential problem***", and the AOAC and WAOAC records inventories as being assessed as "***high risk***".

(l) Prior to the stocktakes on 20 December 2007 calculations were prepared by Mr [...] to determine the sample sizes for stock testing, these calculations being documented in a work paper "***Sampling Materiality***".

(m) On 20 December 2007 audit work, described by Baker Tilly as stocktakes, were carried out on TES stock at Vigo and Tanfield Lea and on SEV stock at Sheffield. The Vigo stocktake work (the bulk of the TES stock) was undertaken by Mr [...] and Mr [...]. The TES stocktake at Tanfield Lea was attended by Ms [...]. The SEV stocktake at Sheffield was attended by Mr [...]. The results of the sampling were recorded in work papers. Because the financial year did not end until 31 December, follow-up work was identified.

(n) On 9 January planning documents for the TES and SEV audits were approved by Mr [...] and Mr. Railton.

(o) On 14 January 2008 Mr [...] and Mr King met and discussed and approved similar planning documents in relation to the Tanfield audit.

(p) The planning phase was completed by 28 January 2008, after which the audit team spent several weeks on site performing detailed audit testing: substantive testing and follow-up work was carried out in and around February 2008.

(q) On 28 February 2008 Baker Tilly presented an Audit Findings Report to the Tanfield audit committee.

(r) During March and April 2008 Baker Tilly continued to work on the audits and liaised with Tanfield's management in connection with preparation of Tanfield's consolidated financial statements: these were finalised in mid-April.

(s) On 21 April 2008 the audit opinion on the financial statements of Tanfield was signed off by Mr. King and a letter of representation letter was signed by Mr [...]: this included a statement that the directors believed that the W[...] debt was recoverable.

(t) On 1 July 2008 Tanfield issued the trading statement referred to in paragraph 1.25 above.

(u) The final versions of the financial statements for TES and SEV were only made available to Baker Tilly on 21 July 2008. On that date Mr [...] met with Mr [...] to discuss, amongst other things, the trading statement. Tanfield provided Baker Tilly with signed letters of representation from the directors of TES and SEV (the letter from the directors of SEV included the statement that they believed that the W[...] debt was recoverable and would be paid), and with signed post balance sheet event faxes for TES and SEV[20], and Mr Railton signed the audit opinions on the financial statements of TES and SEV, having, he said, had a discussion with Mr [...] about the latter's meeting with Mr [...][21] though he made no note of that discussion.

Baker Tilly's Assessment of Item Risks

6.9 In the Formal Complaint it was alleged that the Respondents had considered certain risks to be "***significant risks***" in the sense used in ISA 315:

(a) Allegation 1.2 (a) – the valuation of TES inventories;

(b) Allegation 2.1 - the existence of TES and Tanfield inventories;

(c) Allegation 2.2 – the valuation of TES and Tanfield inventories;

[20] [[...] WS paragraph 229:C/1/49: G2/40/363:H/33/255]

[21] [Railton WS paragraph 158 C/2/80]

(d) Allegation 4.2 – the existence and valuation of SEV trade receivables (the W[...] debt);

(e) Allegation 5 - the existence and valuation of SEV and Tanfield trade receivables (the W[...] debt);

(f) Allegation 6.1 - the existence and valuation of SEV trade receivables – again the W[...] debt.

6.10 This allegation was evidenced by the KITs completed at the planning stage for the three companies:

(a) The KIT for TES[22] categorised management's assertions in relation to existence and valuation of inventories as "***Significant risk***" and a "***key audit area***". The "planned audit response" stated, "***Stocktake attendance planned to gain assurance re existence. Test counts on a sample basis are planned to obtain assurance as to the completeness of stock.***" Ms [...] was the author of the TES KIT. She confirmed in evidence that (a) it reflected the identification of existence and valuation as a significant risk and (b) she understood at the time that reference to significant risk was the term as defined in the ISA[23].

(b) The KIT for Tanfield[24] largely replicated the KIT for TES. The existence and Under/Overstatement of inventories at TES was categorised as a significant risk. It states that the test counts are to gain assurance as to completeness of the stock and accuracy in relation to the quantities. The valuation of SEV's W[...] debt was also identified as a significant risk.[25] Mr [...] prepared the Group KIT on 19th December 2007. He stated in evidence that (a) he had specifically identified inventories (existence and under- or overstatement) as a significant risk and (b) he appreciated at the time that this was a term of art in the ISAs[26]. He also stated that he regarded the existence of the IPS debt as a significant risk.

(c) The KIT for SEV[27] identifies the existence and valuation trade receivables - the W[...] debt (£500,000 outstanding since 2005) as a significant risk and notes

[22] [G1/4/72]

[23] [T5/36]

[24] [F1/11/89]

[25] [F1/11/91]

[26] [T6/21-22]

[27] [H/5/75]

"risk being that the balance is no longer recoverable as a result of changed circumstances/ongoing relationship with W[...]."

6.11 In their evidence, Mr Railton[28], Mr [...][29], and Mr [...][30] all stated that they regarded the valuation/recoverability of the W[...] debt as a significant risk for SEV, but not the existence of the debt. Mr King, who had no direct responsibility for that debt was not concerned with the significance of the debt for SEV – though he stated that it was not by itself a significant risk for Tanfield, it being "***less than half of sampling materiality***".[31]

6.12 However, except as stated in the last paragraph, the evidence of Mr King, Mr Railton, and Mr [...] was that in fact they did not regard the existence or valuation of inventories or receivables (including the IPS and PSE debts) at any of the three companies (except in the case of those referable to the recent acquisition of Snorkel) as significant risks, in spite of it being clear that the TES and Tanfield KITs, once populated by the more junior staff, had been provided to Mr King, Mr Railton, and Mr [...], that the KIT for SEV had been provided to Mr Railton and Mr [...], and that none of them saw fit to change any of the classifications of significant risk with which they now say they disagree. It was common ground between the experts that all reasonably competent auditors who change their assessment of item risks in the course of an audit would record that fact and record their reasons. The Respondents did not anywhere document any changes in the assessment of risks in any of the KITs.

6.13 Their explanation is that the KIT was a relatively new audit tool at Baker Tilly, it was not properly understood at the time, this was the first occasion in which the KIT had been used for the Tanfield group audits, and that with hindsight they ***"over-completed***" this document and did not restrict it to issues which were in fact "***key***". This was reflected, they submitted, in the fact that the document included as significant risks a number of items that are plainly insignificant - for example inter-company debts. Notwithstanding this explanation the evidence is that the partners allowed the audit team to proceed to conduct the audit on the understanding that TES and SEV inventories and trade receivables comprised significant risks.

6.14 Mr Leech's evidence was that at planning stage the valuation of inventories at TES and Tanfield should have been assessed as a significant risk (see Joint Statement at

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[28] [T7/134]

[29] [Witness statement paragraph 189: C/1/39]

[30] [T6/27]

[31] [T6/209-210]

paragraph 75)[32]. In 2.3.11 of his Supplemental report[33] he stated that once significant stocktake errors had been identified the reasonable auditor would have identified the existence and valuation of inventories and the valuation of trade receivables of TES and SEV as significant risks. However, in cross-examination he agreed that not all reasonably competent auditors would have shared the view that valuation of inventories was a significant risk. Mr Main did not regard either the existence or valuation of inventories as being areas which should have been regarded as significant risks. So far as receivables are concerned, ultimately it appeared to us to be common ground between the experts that the recoverability of the W[...] debt should have been regarded as a significant risk, but only for SEV, and that otherwise receivables were not regarded as constituting significant risks.

6.15 Nevertheless, we find the evidence of Mr King, Mr Railton, and Mr [...] that the KITs did not reflect their actual assessment of the risks and their explanation for this quite startling in the light of the terms of paragraph 108 of ISA 315, and of the fact that the ISAs had been introduced in 2004. Mr King acknowledged that he had reviewed the KITs and uploaded the Tanfield KIT onto the system[34].

6.16 In the Audit Plan for Tanfield[35], Stock-holding was identified as a Key area of audit focus/risk, and in the TES AOAC[36], the TES WAOAC[37], and the Tanfield WAOAC[38], the item risk for Inventories was assessed as ***"high"***. Mr [...], in his witness statement, at paragraph 55[39], asserted that in the context of Baker Tilly's audit procedures a risk could only be assessed as "***high risk"*** or a ***"low risk***", so that ***"high risk"*** meant "***normal risk"***. However, at paragraph 188 he stated that "***high risk"*** meant "***not low risk***" or "***normal risk"***[40]. It is correct that the relevant pro formae applicable to the Assembly of Audit Confidence and to the Working Assembly of Audit Confidence, in the column entitled ***"Item Risk***" do provide for only a binary choice of "***High/Low"***. However, Mr [...] also stated that a "***high risk***" item was "***something which required further audit work in***

[32] [D2/5/448]

[33] [D1/2/209]

[34] [T5/121]

[35] [G1/1/13]

[36] [G1/ 7/79]

[37] [G1/11/162]

[38] [F1/20/179]

[39] [C/1/11]

[40] [C/1/38].

addition to substantive analytical review"[41] – a definition not dissimilar to that of the term "***significant risk***" in ISA 315. In the light of this it is difficult to know what weight to attach to Baker Tilly's population of this binary system.

6.17 In his witness statement[42] Mr King stated that he considered that the "***most important "significant risk" in the context of the Group audit was the accounting for the acquisition of Snorkel***": It is clear that he did regard Snorkel as a significant risk for the purposes of ISA 315. Snorkel *("**Valuation in respect of the Snorkel group of companies**")* appeared in the Tanfield KIT as a "***significant risk***" just as did the existence and under/overstatement of inventories at TES.

6.18 The Audit Plan[43], which was submitted to the Tanfield Audit Committee on 6 December 2007, included a section entitled *"**Key risks affecting our audit plan.**".* This is followed by an explanatory note: *"**Set out in the following pages is an overview of those matters that we consider to be the key business and audit risks arising from our preliminary risk assessment for the 31 December 2007 audit, together with our proposed approach to those risks. The risk assessment process is designed to ensure that we focus our audit effort on the areas of highest audit risk to Tanfield Group plc's financial statements. This risk assessment and our responses will be updated throughout the engagement to ensure that all areas of material risk to the financial statements are address in the audit.**"*

6.19 A column headed in the Audit Plan "***Key area of audit focus/risk***" included Snorkel, Stockholding, and Valuation of WIP. It was noted that "***Stock is expected to be a highly significant figure within the group Balance Sheet at 31 December 2007***", and "***A risk associated with this high stock holding is the risk of damage and obsolescence.***" No differentiation was made between Snorkel and Inventories. There is no evidence that at the material time Mr King, Mr Railton, or anyone else in the audit team differentiated between them. Evidence to the contrary is supplied by the KIT and the evidence of Ms [...] as to her understanding.

6.20 There is no suggestion that Mr King, Mr Railton, or Mr [...] ever informed Ms [...] or Mr [...] that their superiors disagreed with the risk assessments with which they had populated the KITs. In the light of the changes in the level of stock and the increases in the already

[41] [C/1/11 paragraph 55]

[42] [Paragraph 83: C/3/98]

[43] [G1/1/12]

substantial balances of IPS and PSE since year end 2006, and the fact that the business of the group was in manufacturing, their assessment as significant risks by the Respondents is unsurprising and reasonable.

6.21 Against the background summarised in the last four paragraphs we are unable to accept the evidence of Mr King, Mr Railton, and Mr [...] that the risk assessments in the TES and Tanfield KITs did not reflect the views which they held at that time. There is no doubt that the lacunae in the audits and audit documentation are at odds with the assessments in the KITs, and so it is perhaps not surprising that these witnesses, looking back many years later, concluded and now believe that the KITs do not reflect the views which they actually held at the time. We do not doubt that that Mr King, Mr Railton, and Mr [...] do now hold that belief, but in our judgment it is based on a reconstruction and not on any actual recollection.

6.22 Even if that conclusion were incorrect and the KITs should be wholly disregarded, our conclusions as to the Respondents' actual assessment of the risks in question, informed by the other audit documentation, taking account of how they planned to address the risks highlighted in those planning documents would be that:

(a) They did regard the existence and valuation of inventories at TES and Tanfield to be areas of heightened risk, and therefore areas of particular concern requiring particular attention; Mr King, at paragraph 89 of his witness statement identified stockholding and the valuation of WIP as key areas of the audit focus.

(b) Receivables at TES and Tanfield were not identified in the Audit Plan as being a key area of audit focus/risk, and though it was recorded in the TES AOAC[44] and the WAOAC[45] as high risk, no special measures are recorded in the planning documents, and hence it would appear that the Respondents did not regard these receivables as posing any unusual risk**.**

(c) So far as SEV is concerned, in the Audit Plan the valuation of work in progress was identified as an area of audit focus/risk, specific reference being made to problems encountered in the previous year's audit, and steps proposed to be taken to address this potential problem were spelled out. In the AOAC for SEV[46] the item risk for work in progress was assessed as ***"high"***.

[44] [G1/7/80]

[45] [G1/11/163]

[46] [H/8/79]

(d) As stated above, it is clear that the Respondents did regard receivables at SEV, and the recoverability of the W[...] debt in particular, to be a significant risk at least for SEV.

6.23 Leaving aside the issue of significant risks, in our judgment on any view every competent auditor exercising reasonable care and skill would have assessed the existence and valuation of inventories and the valuation of receivables at TES and Tanfield, to be items of particular concern which required particular attention. That hypothetical auditor would also have regarded the W[...] debt as a significant risk for SEV.

Approach to Inventories

6.24 Baker Tilly's approach to inventories is set out in the audit plan[47]:

"***We will attend stocktakes at all premises and perform test counts on a sample basis to obtain assurance as to the completeness and existence of stock. Attendance at Vigo, Stanley [Tanfield Lea] and Sheffield is planned for 20 December 2007…..We will also review the stock listings at the end of the year end and ensure that all damaged stock items are separately identified. Further we will ensure that all stock lines which are of "significant age" have been adequately provided against.***"

6.25 In the audit plan, in relation to valuation of WIP, it was stated:

"***We will revisit the Group's practices in this area and hence determine whether completed jobs are still being recorded as work in progress as opposed to accrued income …***"

Sampling Intervals and Stocktakes

6.26 As stated above, the BT Manual provided for the establishment of audit confidence by an audit confidence points system. It is not necessary to consider this system in any detail. It is sufficient to state that the level of testing required is a function of M and the number of outstanding audit confidence points required. In order to obtain the necessary audit confidence points Baker Tilly calculated that a sampling interval of £846,000 was needed for Tanfield and £643,000 for TES. The lower sampling figure of £643,000 was adopted

[47] [G1/1/13]

by Baker Tilly in order that the evidence could be used for the audits of both Tanfield and the subsidiaries.

6.27 Since the anticipated value of the stock held at TES at the year-end was £22.1m, the sampling interval of £643,500 required a sample size of 35 for testing. In the event a higher sample sizes of 40 at Vigo and 5 each way at Tanfield Lea were selected. In order to reflect the expected comparative total values of each category of inventory, the Vigo sample of 40 was made up of: (i) 28 items of raw materials; (ii) 8 items of WIP; and (iii) 4 items of finished goods. The analysis of stocks at Tanfield Lea was £511k raw material, £1.173m WIP and £325k finished goods. Applying the same sampling interval to the value of stocks at Tanfield Lea using the detailed analysis would have resulted in testing on one item of WIP. If the approach had been applied to the total £2.1m of stock at Tanfield Lea then 3 items would have been selected, at least one of which would have been WIP.

6.28 As stated above, stocktake work for TES was carried out on 20 December 2007. At the Vigo site 28 items of raw materials, 8 items of WIP and 4 items of finished goods were physically verified and inspected each way (that is, from the physical inventory to the inventory records and vice versa). This was documented in the work paper "***Vigo Stock Count***". Further follow up work carried out in relation to the Vigo stocktake is recorded in the working paper "***Section 10 – Stocktake follow up***". At the Tanfield Lea site, a sample of 5 items of raw material were tested each way giving a total sample size of 10 items. According to the Baker Tilly sampling interval, the sample as stated above, should have included at least one item of WIP but there were no tests of WIP despite the value of WIP at Tanfield Lea being above the value of M for both TES and Tanfield.

7. PART 7 – ALLEGATION 1 – INADEQUATE EVIDENCE OF THE EXISTENCE AND VALUATION OF INVENTORIES

Between 26 November 2007 and 22 July 2008, in relation to the engagement of Baker Tilly to act as auditor of the financial statements of Tanfield Group, TES and SEV for the year ended 31 December 2007 the Respondents failed to obtain sufficient appropriate audit evidence of the existence and valuation of Inventories, thereby:

(a) ***failing to comply with the requirements of paragraph 2 of ISA 500 and paragraph 21 of ISA 220; and/or***

(b) ***failing to act in accordance with the Fundamental Principle of Professional Competence and Due Care of the Code of Ethics of ICAS, ICAEW and ACCA.***

Particulars

The TES Stocktake – Existence of Inventories

1. In relation to the TES stocktake on 20 December 2007 the Respondents failed to obtain sufficient appropriate audit evidence of the existence of Inventories in that:

(a) no, or no sufficient, audit evidence was obtained for the existence of Work in Progress and Finished Goods;

(b) ***at the Tanfield Lea Estate site the Respondents carried out a test for the existence of raw materials which was inadequate and insufficient in that they:***

(i) identified a sample size for testing without reference to their assessment at the planning stage, as recorded in the Key Issues Tracker, that there was a significant risk in respect of existence of Inventories;

(ii) tested for the existence of raw materials on the basis of an insufficient sample size, namely a count of five line items from physical inventory to listing and a further count of five line items from listing to physical inventory;

(iii) identified errors in 7 out of 10 of the items tested and assessed a net error rate in the value of the items tested of 9% but failed sufficiently to evaluate and document whether the identified errors were isolated and therefore failed to consider whether it was appropriate to extrapolate using the net error rate of 9% revealed within the sample, over the entirety of the population being tested;

(iv) used the net error rate of 9% to extrapolate across the entirety of the population being tested despite it being inappropriate to do so;

(v) failed properly to consider their further actions and conclusions once they had identified the high level of errors in the sample tested.

(c) ***the tests undertaken at the Vigo site for the Upright, Electric Vehicles and Spares stocktake of raw materials demonstrated errors in many of the lines sampled, and:***

(i) where there is evidence of discussions with management concerning the said errors, the Respondents failed to obtain sufficient appropriate follow up evidence or corroboration;

(ii) where there is no such evidence of discussion, the Respondents failed to obtain sufficient appropriate follow up evidence regarding the errors.

(d) ***no, or no appropriate audit evidence was obtained in respect of the roll forward testing, which showed differences in 21 out of 22 of the Upright, Spares and EV lines sampled.***

TES – Valuation of Inventories

2. In relation to the audit of TES, the Respondents failed to obtain sufficient appropriate audit evidence of the valuation of Inventories in that:

(a) the Respondents found errors in the entire sample of 38 items tested in the comparison between the unit cost of the inventory items in the TES inventory system and the unit purchase price on the invoices. However despite the valuation assertion for Inventories being considered by the Respondent at the planning stage in the Key Issues Tracker as a significant risk:

(i) in respect of two of these items, the total variance was almost £103,000. The Respondent identified these errors as "isolated errors" from "discussions with the client" but failed to obtain sufficient evidence on which to conclude that they were isolated errors, contrary to the requirements of paragraph 50 of ISA 530;

(ii) in respect of all 38 items tested, the Respondent failed to obtain sufficient appropriate evidence of freight charges;

(iii) in respect of 23 of these items, the Respondents failed to obtain any, or any sufficient, appropriate audit evidence to explain why the cost of freight added was not either 10% (or 20% for US purchases).

(b) ***despite recognising in the Final Audit Findings document that inventory levels needed to be monitored against forecast demand to ensure stock levels were appropriate and despite a significant increase in inventory levels, the Respondents failed to carry out testing designed to identify whether there were any issues with slow moving or obsolete inventory.***

The SEV Stocktake – Existence of Inventories

3. In relation to the SEV stocktake in December 2007 the Respondents failed to obtain sufficient appropriate audit evidence of the existence of Inventories in the roll forward testing in that

(a) differences between listing on the day of the stocktake and the year-end inventory listing were found in 7 out of 20 items originally sampled. However, the Respondents only checked two of these variances to corroborative evidence in order to verify the movements between the count and the year end; and

(b) ***the Respondents failed to obtain sufficient appropriate audit evidence regarding the other five discrepancies, relying instead on uncorroborated management representations, the evidence of which was not retained on the audit file.***

7.1 It is to be noted that the Formal Complaint advances no criticism of the planning of the audit work that was carried out in relation to inventories.

Sub-Allegation 1.1(a) – Existence of Work in Progress ("WIP") and Finished Goods ("FG") held by TES

The Allegation

7.2 Allegation 1.1(a) is that:

"In relation to the TES stocktake on 20 December 2007 the Respondents failed to obtain sufficient appropriate audit evidence of the existence of Inventories in that:

(a) no, or no sufficient audit evidence was obtained for the existence for Work in Progress and Finished Goods."

Existence of TES WIP & FG – Issues

7.3 TES financial statements for the year ended 31 December 2007 disclosed balances of £4.3m for WIP and £2.6m for finished goods. These balances were material to the financial statements of both TES (M was £427,000) and Tanfield (M was £1.128m). (Note 12 Financial Statement[48].)

7.4 Planned sampling at Vigo was 28 items of raw materials, 8 items of WIP, and 4 items of finished goods.

7.5 Mr [...] and Mr [...] attended the Vigo stocktake on 20 December 2007. Mr [...] recalled testing WIP. He could not now recall whether he had tested finished goods. The work papers for the stocktake on TES[49] and Tanfield[50] contain a record in respect of raw material only (7 items tested each way). There is no reference to WIP or finished goods. The work paper records that some differences between the system and the floor were noted, and the likely reasons for these discrepancies.

7.6 However, a workpaper referred to by the Respondents as "***the Vigo stock count workpaper***"[51] (which was not uploaded to aud-IT) documents the testing of raw materials (16 items each way), WIP (4 items each way), and finished goods (2 items each way)**.** This workpaper refers to two discrepancies in the raw materials at Vigo but otherwise states "***no significant issues were identified.***"

7.7 Further it appears from a follow up work paper (which records, amongst other things, the Engagement Team's roll forward testing) that 8 items of WIP and 4 items of finished goods had indeed been tested.[52] There are some puzzling features about the notes on this workpaper which gave rise to criticisms by the Executive Counsel which are addressed below. Mr [...] was unable to explain the workpaper.

7.8 It is right to state that the Experts agreed that the audit documentation for both Vigo and Tanfield Lea was deficient in that it did not sufficiently describe the basis of selection of

[48] [E/5/1015]

[49] [G2/27/230]

[50] [F2/41/284]

[51] [E2/296]

[52] .[TES file at G2/28/238; Tanfield file at F2/43/298].

the items to be tested: however, they also agreed that as a matter of fact the selection was at random, and therefore correct. The work papers referred to above, taken together, do show that the sampling at Vigo was implemented as planned. However, as appears below, the adequacy of the sampling at Tanfield remained in issue.

7.9 This allegation (1.1a) was originally supported by the understanding, reflected in Mr Leech's first report, that at Vigo only one item of WIP and two items of finished goods had been tested. He based this on his reading of the follow up working paper.[53] It subsequently emerged that this paper includes rows that were hidden when the Excel spreadsheet was archived. Baker Tilly's tests and findings in relation to the stocktake on 20 December 2007 are recorded in the first seven columns of this document, from which it appears that appropriate numbers of samples of the stock at Vigo were tested.

7.10 To be more particular, these additional lines record, as also stated in the paper referred to in paragraph 7.7 above, that further items of WIP and finished goods were tested, taking the total number of items tested to 8 items of WIP and 4 items of finished goods, as planned. This was accepted by Mr Leech in paragraph 3.2.5 of his Second Report.[54]

7.11 However, Executive Counsel advanced further criticisms of the follow up procedures carried out by Baker Tilly in relation to the stock at Vigo, and those criticisms remained in issue.

7.12 Ms [...] attended the Tanfield Lea stocktake. Whilst 10 items of raw material were tested (5 items each way), no tests were carried out on WIP and finished goods at that site. Ms [...] confirmed this in her oral evidence.[55] It was accepted that at least one item of WIP or finished goods should have been tested – see Mr Main's report at paragraph 6.4.6.[56]

7.13 The Respondents' case was that sufficient appropriate audit evidence of the existence of WIP and finished goods at both Vigo and Tanfield Lea had been assembled, the principal source being the substantive analytical procedures which they carried out, and that there was no substance in the other detailed criticisms.

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[53] [F2/43/298]

[54] .[D1/2/215]

[55] [T5/47]

[56] [T5/47]

Existence of TES WIP & FG - Executive Counsel's case

Significant Risk

7.14 Executive Counsel contended that the Respondents should have reviewed their risk assessment and audit approach in the light of errors identified during the stocktake at Vigo and to treat the existence of inventories as a significant risk (if they were not in fact doing so).

Reliance on the analytical review

7.15 It was submitted that the Respondents were wrong to place as much reliance as they did on analytical review procedures in relation to WIP and finished goods on the grounds that:

(a) it was not permissible under the Baker Tilly system of Audit Confidence points for the Respondents to use the analytical review to make up for deficiencies in the substantive tests of detail; this amounts to "double counting"; and

(b) the analytical review was of limited evidential value in terms of establishing existence of WIP and finished goods and was no substitute for physically verifying the existence of goods.

7.16 As we understand it, Mr Main and the Respondents rely principally upon the parts of the record of the analytical review which show that the audit team sought corroboration of the existence of WIP by production schedules, and of the existence of Finished Goods by reference to despatch records reviewed as part of follow-up testing (Ms [...] stated that they planned to look at WIP at Tanfield Lea as part of follow up testing). So far as this latter exercise is concerned, Executive Counsel contended (paragraph 67 (b) on pages 31/32) that whilst it provided some positive evidence of the existence of Finished Goods at the year end, the test was flawed as, since some of the despatch records were dated 8 February 2008, it was likely to cover goods finished in January 2008, and so did not provide support for the actual numbers recorded as being Finished Goods at the year end.

Sample sizes

7.17 In Executive Counsel's written closing submissions (paragraph 93) it was submitted that when it became clear that TES was holding substantially more stock than anticipated, the Engagement Team failed to review their sample sizes and audit procedures, reference

being made to: paragraph 2.1 of Chapter 4.E of the BT Manual, which emphasised the importance of ensuring that the sample is representative of the population. We understood this to be principally a criticism of a failure to review the sample sizes. In this context, in his oral evidence Mr Leech stated he was no longer criticising the sample sizes.[57]. Ultimately it appeared to be common ground that even using the year end figures no additional numbers of samples were required[58] except in relation to Tanfield Lea, the criticism of the failure to sample a single item of WIP or finished goods at Tanfield Lea being strongly maintained.

Vigo

7.18 Executive Counsel submitted that it is apparent on the face of the follow up workpaper[59] of the stocktake at Vigo that the audit work was deficient, and that the additional tests on WIP and finished goods at Vigo carried out during the follow up fieldwork raised questions which should have led to further investigation. As regards WIP:

(a) In relation to the testing on 20 December 2007: (a) the commentary in the "***build stage per floor***" appeared to be inconsistent with the "***build stage per sheet***"; (b) it was not clear what, if any, work the Engagement Team did to reconcile these explanations/descriptions; and (c) the comments in the "comments" column were not corroborated.

(b) By way of example, items X32 and TL49 were, according to stock listing ("***build stage per sheet @ 14 Dec***") both at the "***scissors***" stage but at the 20 December stocktake, one item appeared to have not yet been physically created whereas the other appeared to have been complete and awaiting testing.

(c) Mr [...]'s evidence on this testing was limited. He had little recollection of it[60]. He was unable to explain the relevant workpaper. Mr [...] accepted in evidence that the workpaper did not make sense in a number of respects[61]. Mr Main, too, agreed that it would have been helpful if the audit paper had explained the apparent inconsistency.

[57] [T2 /97 to 103]

[58] [Leech T2/103]

[59] [G2/28/238]

[60] [T6 97 – 109]

[61] [T6 101/20]

7.19 It was also submitted that four of the eight items of WIP were inexplicably not on the 2007 year end stock listing, and it appeared that in relation to four other items no corroboration had been sought. Mr Leech also advanced a criticism in relation to lines 378 to 387 of the WIP analytical review paper[62] and in particular he commented that the fact that the majority of jobs appeared to be 80% complete called for further investigation.

7.20 In relation to Finished Goods at Vigo, it was contended, at paragraph 92 of Executive Counsel's written closing submissions, that the stocktake was deficient in that:

(a) The roll forward worksheet referred to G2/ 28/239 above did not identify the test carried out on 20 December 2007: it simply contained the comment "***appears reasonable***".

(b) In relation to roll-forward testing, it was not clear what, if any, corroboration was sought.

(c) In paragraph 3.2.6[63] of his second report Mr Leech referred to a number of odd features in the roll forward worksheet stating that it was unclear whether the explanations had been corroborated. For example, in relation to finished Goods at Vigo, he commented that it was not clear from the document that the reported sales of two items had been corroborated (by, for example, the sight of invoices).

Tanfield Lea

7.21 Executive Counsel submitted in relation to the stocktake at the Tanfield Lea site that:

(a) No consideration was given by the Engagement Team to the split between raw materials, finished goods and WIP or to the basis of selection, and that as a result, no tests were carried out on WIP and finished goods at Tanfield Lea, which together comprised around 80% of the stock held at Tanfield Lea.

(b) Mr Main had accepted that a physical count would provide the best evidence as to the existence of inventories, and that analytical review was not a substitute for it.

7.22 It was further submitted that to the extent that Baker Tilly sought to rely on procedures at Vigo or on TES' raw material as evidence of the existence of WIP and finished goods (if

[62] [G1/20/208,9]

[63] [D1/2/216]

they did, as to which there is no evidence on the audit file), this was not permissible. Substantive tests of detail only provide assurance on the population tested: Mr Main now accepted it was not permissible to rely upon procedures at Vigo: Tanfield Lea and Vigo sites operated different systems.

Existence of TES WIP & FG - The Respondents' Case

7.23 The Respondents relied on paragraphs 6.3.10, 6.3.11, and 6.3.15[64] of Mr Main's report in which he referred to the working papers for the analytical review and the inventory count follow up paper as providing evidence of the physical verification of WIP and finished goods at Vigo.

7.24 At paragraph 6.4.6 of his report[65] he suggested that in relation to Tanfield Lea sufficient evidence would have been derived from the sample of WIP items inspected at Vigo and referred to the detailed analytical procedures in the working paper "***Group-AR= Inventories***"[66] as showing that stage of completion was confirmed by physical verification for a sample of items.

7.25 In relation to the flaw in the Tanfield Lea stocktake, the Respondents' relied principally on the fact that the analytical review papers record that at the fieldwork stage Baker Tilly did carry out a substantive check which involved cross-referencing items of WIP at Tanfield Lea to production schedules[67], and Mr [...] gave evidence[68] that WIP formed part of the analytical review on inventories in which the audit team tested the stage of WIP at the year end with production plans. Mr Main, in his oral evidence, stated that this provided direct assurance of the existence of WIP.

7.26 Reference was made to Mr Main's oral evidence[69] that he did not accept that analytical review was not an appropriate form of testing (not least given the extremely high error rate in WIP that would be needed to give rise to a material error):

Q That's not an appropriate substitute for the count that was identified as being required in the audit plan, is it?

[64] [D2/3/271 et seq]

[65] [D2/3/274]

[66] [F1/31/246]

[67] [G1/20/208]

[68] [paragraph 150 of his witness statement C/1/31]

[69] [T10/91-92]

A It's a checking to the production schedules, which are produced independently of the accounting records. So physical inspection might have been the best evidence, but quite often for work in progress you'll check back to production schedules and verification to the documentation.

Q Yes.

A of the production schedules, rather than the physical count.

Q I'm not saying you wouldn't do that later, but what I'm saying is that that is not an appropriate substitution for the count that you've identified needs to be done, is it?

A The count would give you the best evidence

Q And the answer, Mr Main, to my question: this is not a substitute for that?

A ***I think it is a substitute, bearing in mind the risk of material error. You'd have to have a very, very high error rate on the work in progress for it to be material at Tanfield Lea. It was 1.5 million on materiality, 1.1 at a group level. So almost just by seeing there was work in progress there, you'd get some confidence that it wasn't materially misstated. It's 5 per cent of the total stock value for TES.***

7.27 More generally, the Respondents in their written closing submissions contended that the evidence during the course of the hearing had done nothing to dislodge Mr Main's original conclusion in relation to this allegation in his report:

"In my opinion, Baker Tilly followed their audit approach in obtaining audit evidence in relation to the existence of WIP and finished goods held by TES. Their approach was rational and logical and properly applied their audit methodology.

I therefore disagree with the Allegation set out in the Formal Complaint that insufficient audit evidence was obtained relating to the existence of WIP and finished goods held by TES at the TES stocktake on 20 December 2007."[70]

[70] [Paragraphs 6.5.1 – 6.5.2 D2/3/274]

The Existence of TES WIP & FG - Falling Short - Conclusions in Relation to Baker Tilly

Significant Risk

7.28 This criticism is not made in the Formal Complaint in relation to this sub-allegation. The allegation here is of failing to obtain sufficient appropriate audit evidence (from substantive testing and analytical review) and not of a failure on the part of Baker Tilly to review its risk assessment. Nevertheless, our conclusion (at paragraph 6.21 above) that the risks assessments in the KITs did reflect their actual assessments, is relevant to the criticisms of the Engagement partners.

Analytical review

7.29 In spite of the evidence of Mr Main set out in paragraph 7.26 above, we consider that it is plain that the analytical review procedures were not an appropriate substitute for those involving physical inspection and were of lesser evidential value than the count contemplated in the audit plan. Further, it appeared to us that it was not permissible under the Baker Tilly Audit Confidence points system to use the analytical review to make up the deficiencies in the substantive tests in detail, in that this would amount to double counting. Mr Main's view was that the Baker Tilly confidence points system was essentially a planning tool, and that the auditor was free effectively to *forget it* and consider whether overall there is sufficient overall audit evidence.[71] The Baker Tilly witnesses did not suggest that the confidence points system was just a planning tool, and it appears to us that unless it was intended to be applied during the audit, performing it would be a futile exercise. However, it would not necessarily follow from the fact that Baker Tilly may not have applied its own procedures that the evidence which they assembled as to the existence of WIP and Finished Goods was inadequate.

Vigo

7.30 In relation to the allegations referred to in paragraph 7.16 above that because of the date of the despatch records the year end test was flawed, we agree that this is a weakness in that evidence. The fact that goods were despatched early in February is not necessarily inconsistent with their having been completed before January 1st 2007, but given Ms [...]'s evidence that items remained in WIP for only two or three days it is possible that goods despatched in February had been completed after the year end.

[71] [T9/169 and 174]

7.31 In relation to the allegations referred to in paragraph 7.18 above, Mr Turner concluded that the apparent incoherence of the WIP section on the worksheet was because columns had been transposed, and in re-examination he put this suggestion to Mr [...] in the form of a leading question - with which Mr [...] agreed. Executive Counsel initially submitted that this explanation was wholly without foundation - none of the witnesses suggested that such an error had taken place and there was "***no basis on which the Tribunal could conclude that it had***". In our view the document did make some sense if Mr Turner's suggestion is applied, but in any event when a later version of the original working paper for the stocktake emerged[72] which showed that there had indeed been a transposition of the column headings, Executive Counsel withdrew this assertion.[73]

7.32 As to the allegations referred to in paragraph 7.19 above:

(a) The fact that four items were not on the "***year end list***" does not suggest that they were not in existence at the year end, as other notes on the sheet suggest they did (except in two cases which on 20 December were still deemed WIP) Nor are we satisfied that one can definitely infer from the sheet that no corroboration was sought in relation to the four other items mentioned.[74] The documentation, however, is neither satisfactory nor fully self-explanatory, but that is not an element of this allegation.

(b) In relation to the further allegation in that paragraph, we note that this criticism had not – as Mr Leech himself accepted – featured, at least not in clear terms, in any of his reports. However, as stated above, the working paper expressly records that the stage of production for a sample of WIP had been vouched to production schedules. Mr Main stated that in his experience, it was not unusual in a manufacturing company for various items to have reached a fixed stage of production, and also made the point that the stage of completion had been directly verified by reference to production schedules. We accept that evidence, which seems to us to be entirely plausible.

7.33 As to the allegation set out in paragraph 7.20 above:

(a) In paragraphs 3.2.6 and 3.2.7 of his second report, Mr Leech commented on some of the items relating to WIP and Finished Goods at Vigo referred to in the

[72] [E 2/296]

[73] [T 11/165]

[74] [G2/28/239]

roll forward document[75]. The document provides information as to the results of queries in relation to a number of items of WIP but does not document the source or sources of that information. The suggestion is that the audit team relied entirely on what they were told by Tanfield personnel: we do not consider that Executive Counsel has shown that to be so: a plausible alternative reading, if every column of the document in relation to those items is taken into account, is that the audit team actually assessed explanations provided by the Tanfield personnel and concluded, as documented, that the explanations were "***reasonable***".

(b) We agree with the criticisms of the worksheet relating to Vigo, but the evidence as a whole, and in particular the first seven columns of that document, does establish that the requisite number of items were sampled at Vigo, that differences noted were followed up, and that, generally, plausible explanations were obtained. However, we note that ISA 230 paragraphs 16 and 17 provide the guidance that when auditors rely upon outside information in relation to significant matters the name of the person providing the information and the date when it is provided should be documented – something which Mr [...] failed to do.

Tanfield Lea

7.34 It is not correct that no consideration was given by Baker Tilly to the split between raw materials, WIP, and finished goods at Tanfield Lea. The testing at Tanfield Lea was carried out by Ms [...]. As stated above, the maximum sample required would have been only one item of WIP and no items of Finished Goods in order to obtain sufficient evidence. Ms [...] was cross-examined on this issue: she accepted in her evidence that the testing at Tanfield Lea had in fact focused on raw materials rather than WIP or finished goods:

Q. There's no evidence in this note that you tested the work in progress or the finished goods, is there?

A. No, I don't think so. Partly the work in progress was a decision that was taken in advance of the stocktake attendance based on the stocktake attendance that happened in the prior year, because -- because of the nature of operations, work in progress was never work in progress for more than a few days, so testing anything in work in progress should have moved itself to finished goods or moved

[75] [G2/28/238]

on by year end, so it was because of the timing of the stocktake it was tested -- was designed to focus mainly on raw materials because that is what would still be there at year end.

7.35 It is unfortunate, however, that Ms [...]'s reasoning was flawed. It is irrelevant that WIP only remained as such for two or three days. What matters is what the numbers are on the day of the stocktake. The purpose of a stocktake is to verify what physically exists on a given day and vouch that to stock records – it is not to guestimate what might or might not be there at the year end. The fact that WIP was fast moving and could change in a matter of a few days would make it more important to check that the amount recorded on the system on a given day was correct.

7.36 As stated above, it is common ground that that no physical testing was carried out at Tanfield Lea into WIP or Finished Goods during the stocktake on 20 December 2007, and we consider that to have been a serious error. The whole purpose of sample testing using materiality and MUS is to obtain a statistically reliable estimate. By not testing the selected sample the validity of the testing is negated. Hence, by missing one sample, (the only one in this case) without considering the implications, evaluating the risks or carrying out further testing, the auditor failed to carry out its work in accordance with its own plan and its approach using MUS.

7.37 As can be seen from paragraph 7.26 above, Mr Main considered that the risk of an error in the existence of WIP at Tanfield Lea giving rise to a material misstatement at group level was low. We agree that there would have to be a high error rate for there to be a material impact on the financial statements, but without adequate testing there is no evidence of what the error rate is. Further, there was no proper basis for the Respondents to have regarded the risk of material misstatement at Tanfield Lea as "***very low***" (if indeed, they did). The mix at Tanfield Lea was as follows: £1.541m of WIP and £571,000 of finished goods. These were material amounts, and the Auditor was required to perform a stocktake in these circumstances.[76]

Overall

7.38 We do not agree with the opinion expressed by Mr Main in the first sentence of the quotation set out in paragraph 7.27 above. The stocktake in respect of WIP at Tanfield Lea on 20 December 2007 was not in accordance with Baker Tilly's planned approach.

[76] [Main T10/148-149]

We do not agree that there was little point in testing WIP because of its short life-span. We are not persuaded that Baker Tilly did properly apply their audit methodology in that reliance on the analytical review was in effect to double count for the purposes of the Baker Tilly audit confidence points system. Further any decision to depart from the audit plan, and the reasons for so doing should have been clearly documented at the time.

7.39 Nevertheless, in the context of the terms of Allegation 1.1(a), Baker Tilly's failure to follow its audit approach or comply with the Manual is not the principal issue. The principal issue is whether for the year ended 31 December 2007 the audit evidence on which Baker Tilly based its audit opinion (see paragraph 2.24 to 2.28 above) as to the existence of inventories at TES was sufficient and appropriate.

7.40 Mr Main accepted that evidence of the testing at Vigo could not be used as evidence in relation to stock at Tanfield Lea, the recording systems being different. Irrespective of this, Mr Main's evidence in relation to the issue of sufficiency was that there was sufficient audit evidence of the existence of TES WIP and Finished Goods at both Vigo and Tanfield Lea, and that a reasonably competent auditor would be of the same view.

7.41 Whilst, as set out above, we have rejected some of the criticisms advanced by the Executive Counsel, Baker Tilly's performance of this part of the audit, particularly in relation to Tanfield Lea, was sub-standard in a number of significant respects. It departed from the approach mandated by the BT Manual and the original audit plan, and provided examples of fundamental misunderstandings of standard procedures – eg on the part of Ms [...]. Auditing based on statistical sampling requires tests and plans to be followed meticulously: this is a core principle. The flawed test actually carried out was statistically valueless. No reasonably competent auditor exercising reasonable care and skill would have failed to carry out the test as planned without constructing adequate alternative procedures and formally documenting the amendment to the original plan.

7.42 As stated, Mr Main's opinion is that the evidence which he relied upon was an adequate replacement for the properly executed statistical test which had been planned, and provided sufficient appropriate audit evidence of the existence of TES WIP and Finished Goods. We consider it to be questionable whether any competent auditor in Baker Tilly's position and acting with reasonable care and skill would have shared that view – the BT Manual requires specific consideration of the suitability of substitute tests, but there is no evidence of such consideration, no explanation was advanced as to how the additional testing contributed to the accumulation of audit confidence points, and the substitute tests (particularly for WIP) were undertaken in February 2008, and there was no convincing

evidence that the WIP at that date had not been created after 1 January 2008. But in any event, whilst Mr Main considered that Baker Tilly's actual approach was rational and logical the fact is that his assertion that his approach had also been Baker Tilly's was essentially supposition - the evidence did not establish that Baker Tilly had adopted the approach which Mr Main subsequently did.

7.43 Accordingly we are satisfied and find that in the respects alleged in this sub-allegation (1.1 a) Baker Tilly failed to comply with the requirements of paragraph 2 of ISA 500 and failed to act in accordance with the Fundamental Principle of professional competence and due care, and hence this conduct fell short of that reasonably to be expected of a Member Firm.

The Existence of TES WIP & FG – Falling Short - the Engagement Partners

7.44 We have concluded that Baker Tilly considered the existence of TES inventories to be a significant risk. Irrespective of that conclusion, it was an area of the audit which was singled out for attention – inventories and WIP were classified key areas of audit focus in the audit plan. It was incumbent on Mr [...] to check the work of his subordinates. If he had checked Ms [...]'s note of the stocktake at Tanfield Lea[77] he would have seen that only raw materials had been sampled, and would also have picked up the erroneous calculations in extrapolating the errors identified. The inevitable conclusion is that either he carried out no review of that note, or else it was not a review in any detail. There is no evidence that Mr King or Mr Railton were aware of these errors, but they would have been if they had spent only a short time reviewing Ms [...]'s note.

7.45 In what they recognised as a significant risk and a key area neither Mr King nor Mr Railton judged it necessary to check the working papers relating to the stocktake – although stock was recognised in terms as being likely to be a highly significant figure. Mr King's evidence was that he did not carry out a check at this level but did review the analytical review.[78] Our understanding of Mr Railton's evidence was that it was not his practice to review working documents himself, but he would deal with any matters in discussions – he might have working papers before him but rather than review them himself he would discuss them[79]. He stated that he relied upon the competence of the team – especially Mr [...]. In our opinion every competent engagement partner in the position of Mr King

[77] [F2/40/281]

[78] [T5/134 and T5/152]

[79] [T7/82 et seq]

and Mr Railton acting with reasonable care and skill would have recognised that he had an obligation to check that Mr [...] was discharging his duties adequately – even if, based on past experience and the favourable comments of clients, Mr [...]'s work was held in high regard – which appears to have been so in Mr [...]'s case.

7.46 The fact is, as exemplified by the flawed stocktake at Tanfield Lea and other undiscovered errors which are referred to below in relation to other allegations, Mr [...] was not carrying out adequate checks on the work of his subordinates. It was not suggested that there was any reason for the Engagement Partners not to act in accordance with the guidance in ISA 220 paragraphs 26 and 27. If either Mr King or Mr Railton had carried out a personal check on work papers which it was Mr [...]'s duty to review (in any of the areas recognised as significant risks or a key area of audit focus/risk areas - other than the risks relating to the W[...] debt, which would be unlikely to trigger wider concerns) it would have been appreciated that, on this audit, for some reason or other, Mr [...]'s work was not up to standard. This would inevitably have led to a review of the working papers in all those areas, and an appreciation that the stocktake had not been carried out as planned. With this recognition the audit could have been brought back on track so as to ensure that the auditor's opinion was supported by sufficient appropriate audit evidence.

7.47 For the reasons given above therefore, and on the basis of our findings as set out in paragraph 7.43 above, we find that Mr King and Mr Railton failed to comply with paragraph 2 of ISA 500 and paragraph 21 of ISA 220 in the respects alleged in this sub-allegation 1.1 (a) and that in these respects their conduct fell short of the standards reasonably to be expected of them.

Sub-Allegation 1.1(b) – The Tanfield Lea Inventory Count of Raw Materials and Related Audit Work

The Allegation

7.48 Sub-Allegation 1.1(b) is that:

In relation to the TES stocktake on 20 December 2007 the Respondents failed to obtain sufficient appropriate audit evidence of the existence of inventories in that:

b) at the Tanfield Lea Estate site the Respondents carried out a test for the existence of raw materials which was inadequate and insufficient in that they:

(i) identified a sample size for testing without reference to their assessment at the planning stage, as recorded in the Key Issues Tracker, that there was a significant risk in respect of the existence of Inventories;

(ii) tested for the existence of raw materials on the basis of an insufficient sample size, namely a count of five line items from physical inventory to listing and a further count of five line items from listing to physical inventory;

(iii) identified errors in 7 out of 10 of the items tested and assessed a net error rate in the value of the items tested of 9% but failed sufficiently to evaluate and document whether the identified errors were isolated and therefore failed to consider whether it was appropriate to extrapolate using the net error rate of 9% revealed within the sample, over the entirety of the population being tested;

(iv) used the net error rate of 9% to extrapolate across the entirety of the population being tested despite it being inappropriate to do so;

(v) failed properly to consider their further actions and conclusions once they had identified the high level of errors in the sample tested."

7.49 As already noted, the allegation in (b)(ii) was not pursued by Executive Counsel. This also implies the abandonment of the criticism in relation to sampling in (b) (i), but we understood the reference to the assessment of the existence of inventories as a significant risk was not withdrawn.

TES Inventory Count at Tanfield Lea - The Issues

7.50 The raw materials at Tanfield Lea consisted mainly of sheet metal used in the manufacture of buckets for excavators. According to Mr [...], it was anticipated that at the stocktake there would be certain variances in the measurements of raw sheet metal, which was measured and cut to be turned into buckets or other products.

7.51 As stated at paragraph 6.10 above, the KIT for TES created at the planning stage, categorised management's assertions in relation to existence and valuation of inventories as "***Significant risk***" and a "***key audit area***". The "planned audit response" stated, ***"Stocktake attendance planned to gain assurance re existence. Test counts on a sample basis are planned to obtain assurance as to the completeness of stock."*** Ms [...] was the author of this document. She confirmed in evidence that (a) it reflected

the identification of existence and valuation as a significant risk and (b) she understood at the time that reference to significant risk was the term as defined in the ISA 315[80].

7.52 The Tanfield Lea stocktake testing on 20 December was carried out by Ms [...]. The sampling interval that was used is recorded in the AOAC file - see paragraph 6.26 above - for the TES audit as £643,000, which was sufficient to provide the two further audit confidence points that were required from substantive tests of detail.

7.53 The results of the stocktake can be found in a working paper "***AP TES Stocktake Attendance 20***"[81] prepared by Ms [...]. In respect of the sample size, the working paper records that: "***Based on M on £429k and a sampling interval of 1.5M (low risk client) we need a minimum sample of 3. It is planned to test 5 each way and therefore the stock testing planned should more than satisfy our audit assurance required***".

7.54 The testing therefore comprised five items checked from the floor to the live system and five items that were checked from the live system to the floor. This was a larger sample than required by the AOAC (i.e. ten items rather than three), to allow sufficient headroom should the actual year end figures require a higher sampling interval.[82]

7.55 The working paper records that the sampling work identified differences in 7 of 10 items tested (i.e. in 7 of the tests the quantity of raw material on the floor did not correspond with the quantity recorded on the system). If unresolved, this represented an error rate (by value) of 7% for the 5 floor to systems tests and of 11% for the 5 systems to floor tests. The total value of stock tested (as per the Tanfield system) was £10,519.50 and the value of the difference was £1139.14.

7.56 Of the 10 items, 7 related to sheet metal, and 3 to other stock. In 3 of the 7 discrepancies there was actually more stock on the floor than was recorded. The shortfalls were of 21 m^2, (value £21.12 per m^2) and 4 m^2 (value £10.77 per m^2) of sheet metals, 10 (value £33.50 each) and 166 (value £9 each) in the case of the two other items. Ms [...] netted off the value of the overstatements and the understatements to arrive at a net error rate of 9%. She projected (or "***extrapolated***") this error rate in order to establish an estimate of the potential value of the error in the whole population, and concluded that an error rate of 9% over the expected stock value would lead to potential overstatement of £180k. Ms [...]'s evidence was that the extrapolation was calculated at that point in time on a

[80] [T5/36-37]

[81] [G2/26/224]

[82] [T5/45/14-21]

"worst-case scenario", should it come to light that those differences were not isolated errors.

7.57 In the working paper she noted (emphasis in original):

"This is < M although the global error (i.e. the error combining all locations) needs to be considered in similar terms.

Based on the work done I can conclude that the stocktake procedures in place could be improved".

7.58 It is clear that Ms [...] considered these differences needed following up, and that whilst on site she sought explanations for the differences, but, being unable to get any, referred the matter to Mr [...]. She was not involved in investigating these differences any further. In her witness statement she expressed the belief that each difference was investigated with the client in follow up emails.

7.59 However, the only email correspondence relating to this issue which the Respondents have produced consists of an email sent on the afternoon of the stocktake, by [...], Financial Controller of the Tanfield group, to a colleague in the following terms:

"Hi Tony, I have just had Baker Tilly on who expressed concern re the stock sampling at Tanfield which puts in doubt the year end figures. They have said stock discrepancy of over 10% which is unacceptable. There are 2 items in particular which are screwing the sample – BOCO-BOSS_VE24_0475 Floor stock of 76 and system stock at zero BOCO_PROF_1738590 System stock of 212 and 46 on the floor." [83]

The colleague responded the same afternoon:

"The auditor counted 10 separate items of raw stock, 8 of which were spot on against the system. The 1738590 profile has 2 part numbers on the system, the figure I gave the auditor was for BOCO-PROF-1738590. The actual part was PROF-1738590 (as below). The phantom part number has now been deleted to stop any further confusion.

The other part number BOCO-BOSS-VE24-0475 was received this week (for a qty of 76 but not booked in - I have copies of the delivery note that I can send you."

[83] [E1/293]

Finally, the following day, [...] emailed Mr [...]:

"I spoke to Tony and Craig yesterday and they have looked into the two items of stock. It looks like there are 2 similar part numbers on the system which meant that the part on the system was not the part shown on the floor - see Craig's explanation below.

In addition it looks like some stock has not been booked into the system. Do you want the delivery note sent."

7.60 These emails were not on the audit files but were exhibited to Mr [...]'s witness statement. He did not remember making the telephone call referred to but accepted that it could have been with him. The thrust of his evidence was that in the light of Ms [...]'s note of the stocktake there would and must have been follow-up procedures and satisfactory explanations obtained, though he could point to no other emails to substantiate this. As regards the email exchange Mr [...] stated,

"I can't recall how we got it and I can't get to the bottom of it now….But what I do know is if I don't understand it now, I wouldn't have understood the detail of the email at the time and therefore I would have followed it up again".[84]

7.61 [...] also provided Baker Tilly with a spreadsheet explaining the differences in stock between the count date and the year end.[85] This included a column purporting to record the quantities on the system of the items tested on 20 December 2007. It appears that there were still some differences. No other documentation relating to these errors was produced. Nevertheless, in her oral evidence Ms [...] stated[86] that she recalled having a conversation with Mr [...] in which he indicated that the discrepancies had been resolved to his satisfaction. In the Audit Findings Report it was stated :

" The stocktakes were attended as planned with no significant differences notes (sic)"

7.62 Executive Counsel's case is that the Tribunal should infer from the absence of further documentation that no satisfactory explanations for the errors had been obtained, and in Executive Counsel's written closing submissions (paragraph 106) it was contended that

[84] [T8/95].

[85] [E3/552].

[86] [T5/51]

this was a "failed stocktake" which raised serious issues about Tanfield's stock taking systems, that these were not followed up, and that in the circumstances, the Respondents had insufficient audit evidence as to the existence of the raw materials supposedly held at Tanfield Lea.

7.63 The Respondents did not accept that it is to be inferred that from the absence of documentation that satisfactory explanations for the 7 discrepancies were not obtained. They also contend that in any event the allegation even if true did not come close to establishing a breach of the relevant standards, let alone a "***falling short***" amounting to Misconduct.

TES Inventory Count at Tanfield Lea - Executive Counsel's Case

7.64 More particularly, Executive Counsel submitted[87] that:

(a) Ms [...] identified errors in 7 of 10 items tested. Only the "***BOCO BOSS***" and "***BOCO PROF***" discrepancies were considered further. One of the discrepancies was said to be attributable to a "***phantom***" part: this did not explain why the system showed 212 and yet only 46 were counted on the floor: no enquiries were made to establish whether or not this was a one-off or whether there might be other "***phantom***" parts in the system. The other discrepancy was attributed to what may have been a systems failure or a controls or procedural failure - a quantity of 76 parts had been delivered "***but not booked in***". This was not followed up, in spite of Ms [...]'s conclusion that the stock procedures in place at Tanfield Lea could be improved. The explanations obtained no or no sufficient corroboration, raised more questions than they answered, and should have heightened the Audit Team's professional scepticism and led to further procedures.

(b) No attempt was made to obtain an explanation for the other 5 differences: these were not trivial or estimating differences; Ms [...] clearly did not regard them as such; they were high in number; one of the differences was 21 square metres; and sheet metal was identified as one of "***high value stock items***".

[87] [Paragraph 106 of Executive Counsel's Closing Submissions]

(c) In calculating the error rate of 9%, Ms [...] netted off the errors. There was no reason to do so. The BT Manual Chapter 4F paragraph 4.4 states, ***"In general, errors cannot simply be "netted off"***.[88]

(d) Whilst Mr [...] acknowledged[89] that the Audit Team needed to carry out further audit procedures and the thrust of his evidence was that these must have been carried out, he was unable to point to any such evidence. Furthermore, the email exchange[90] stated, erroneously, that of the 10 items tested ***"8 … were spot on"***. This gives the lie to the suggestion that these errors would have been followed up.

(e) Baker Tilly failed: (a) to analyse the potential errors to establish whether they had a common cause and/or were systemic errors; (b) to extend audit procedures in order to quantify more accurately the likely overall error; and (c) assess the errors on a collective basis, across TES.

(f) It ill-behoved the Respondents to seek to minimise these potential errors in the light of the email indicating that members of their own Audit Team: (i) advised that stock discrepancies of over 10% were "unacceptable"; (ii) advised that the potential errors be considered "globally"; (iii) concluded that stock procedures could be improved; and (iv) expressed concern that the stock sampling put in doubt the year-end figures.

(g) The Tribunal should accept Mr Leech's view[91] as to the appropriate response of a reasonable auditor to the errors identified in this stocktake:

"Q. And the fact that such a large sample had been taken would itself provide some confidence that there weren't going to be hidden variances that were going to put the 9 per cent judgment out of kilter?

A. Well, the differences found, the 9 per cent net differences, there were some explanations sought, but I don't think that explanation got to the level of identifying whether the errors were isolated and should not be extrapolated or projected, or whether they were in fact recurring and

[88] [M1/180].

[89] [T8/93]

[90] [E1/293 – 294]

[91] [T2/178-179]

understanding -- I think, you know, it is important to understand the nature of a difference, because that difference, even if it's recurring, might not be evenly spread over the population either. So there's a need to get under the skin of these differences a little bit more than took place here particularly given that, you know, it's approaching half materiality for TES. That's a not -- you know, that's a larger than expected number. I'm sure that was above, you know, what a reasonable auditor would have expected to have found."

TES Inventory Count at Tanfield Lea – The Respondents' Case

7.65 In support of their contentions they made the following points:

(a) Mr [...] stated[92] and Mr Leech accepted when questioned that one would expect to see some variances in relation to the measurement of sheet metal.[93]

(b) More importantly, the simple answer to the criticisms was that, given that a reasonable auditor would not necessarily have tested raw materials at Tanfield Lea at all given the low value of the stock, a failure to follow up discrepancies identified cannot be a "***falling short***" from the professional standards. Still less can this be a failing crossing the threshold into real seriousness or "***significance***".

(c) In cross-examination Mr Main explained specifically why any differences found were unlikely to be of significance:[94]

" ***… we're talking about stock with a total value of under £500,000 on a total value of £30 million of stock. So how far a reasonable auditor, bearing in mind, you know, the £500,000 stock in the context of a balance sheet worth, I don't know, 100 million total gross assets -- you know, how significant is a few differences on a count of total stock value of 500,000? You know, it would have to be nearly wholly wrong to be material, even to TES, and when you extrapolate that to -- well, it's just not material to the group.***"

(d) Mr Main also explained that the calculated extrapolation was in fact over-prudent. Since only raw materials stock had in fact been tested, the extrapolation, if

[92] [C/1/24,29)]

[93] [T2/180]

[94] [T10/95-96]

correctly limited to raw materials stock, would have suggested an error of only £48,000 (and therefore even more obviously of a level that would not require further follow up).[95] Mr Main also pointed out the confusion inherent in the suggestion that any error could be applied to the different stock population at Vigo[96] in order to assess the potential impact of the errors on TES stock as a whole. This was inappropriate because of the different stock systems in place at Vigo and Tanfield Lea.

TES Inventory Count at Tanfield Lea - Falling Short – Conclusions in Relation to Baker Tilly

7.66 It can be seen that in effect the Executive Counsel's case is that:

(a) Insufficient audit evidence was obtained to establish that the 7 differences were isolated rather than systemic ones;

(b) It was wrong to net-off the errors, the implication of the criticism being that 9% was too low.

(c) It not having been established that the errors were isolated, and in the light of Ms [...]'s comment that the stocktake procedures could be improved, further procedures should have been undertaken to quantify more accurately the likely percentage error rate and that rate should have been applied to the whole stock.

(d) The importance of such further procedures and the fact that they should not have been dispensed with was demonstrated by the fact that the existence of inventories at TES had been identified in the Key Issues Tracker as a significant risk, and that the email referred to in paragraph 7.59 above indicated that members of the Audit Team had (i) advised that stock discrepancies of over 10% were "unacceptable" (ii) advised that the potential errors be considered "globally" (iii) concluded that stock procedures could be improved and (iv) expressed concern that the stock sampling put in doubt the year-end figures.

7.67 Whether or not the Audit Team did obtain satisfactory explanations for the 7 errors and obtain evidence that they were isolated and not systemic errors, is a question of fact. From the fact that the email chain ended with a report to Mr [...], we consider it to be more likely than not that it was he who raised the two queries, and that therefore it is more likely

[95] [T10/100].

[96] [T10/101]

than not that he also selected them, and decided to raise only the two rather than all 7: if he had judged it necessary to raise queries with all 7 of the errors then he would have done so all at the same time. We do not consider the meaning of the emails referred to in paragraph 7.59 above is as obscure as Executive Counsel suggests. The reference to 8 out of ten being "***spot-on***" were the words of one of the TES personnel: it was inconsistent with the position as perceived by Ms [...] and their inaccuracy could well be a reflection of a misunderstanding of what Baker Tilly were saying. The reference to the "***phantom part***" is capable of meaning that the explanation was that Ms [...] had been directed to count items which did not correlate with the items identified in the system. The year end spreadsheet[97] referred to by Mr [...] in paragraph 147 of his witness statement, did show that the 76 parts had been booked in since the 20 December 2007 stocktake.

7.68 The fact that only two items were queried by Mr [...] is likely to have been a consequence of his view that where raw sheet metal was cut to make buckets there were bound to be variances in measurements and, of his evidence that, based upon his knowledge of the site, Ms [...] would have been able to see most of the stock when she selected her sample, and that the estimated overstatement of £182,000 was below "***M***" for both TES and Tanfield Group.

7.69 In her oral evidence Ms [...] stated that she recalled a later conversation with Mr [...] in which he indicated that the discrepancies had been resolved to his satisfaction.[98] It would have been easy for her to embellish her evidence to provide more substantial support for a finding that the Audit Team did obtain sufficient evidence to allay the concerns which she had high-lighted. She did not do this. Accordingly, we accept that Mr [...] did, at some time after 20 December 2007, tell her that the discrepancies had been resolved, and it was not suggested that he would have had any reason to mislead her. However, we do not interpret this as evidence that Mr [...] raised queries about any of the other 5 errors, and we are satisfied on the balance of probabilities that he did not – because, on our findings, he had determined that it was not necessary to look at more than the 2 largest discrepancies. We do not consider that the answers to the queries which Mr [...] did raise provided clear evidence that the 2 errors were not systemic, but we infer that the matter was not pursued by Mr [...] – if it had been, we would have expected the chain of emails to be more extensive. We therefore accept that there was insufficient evidence to establish that the errors were not systemic.

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[97] [E3/552,3]

[98] [T5/51-52]

7.70 As to Executive Counsel's submission that it was wrong to net off the discrepancies, we note that, in paragraph 21 of their joint statement, the experts recorded that they agreed that it can be appropriate to net off positive and negative errors, but that if an auditor is to do this it should consider whether errors are likely to be isolated errors and should exclude these from any projection.

7.71 The contentions referred to above in sub-paragraphs (a) and (b) of paragraph 7.64 need to be weighed against the evidence of Mr Main referred to in paragraph 7.65(c) above. However, as a preliminary point, it is material to note that a failure to exclude isolated errors before extrapolating from a percentage error rate which has been assessed on a sample basis would not have the effect of understating the likely total value of errors in the full population.

7.72 The witness statement of Mr [...] does, in our judgment, establish that Baker Tilly did consider that its testing and further investigation of the existence of raw materials at Tanfield Lea was sufficient[99] – he thought that the total stock figure was materially correct and stock levels at Tanfield Lea were a relatively minor part of the stock at TES, the vast majority being held at Vigo.[100] The total value of TES stock was £30m. The stock at Tanfield Lea consisted of raw materials of £511,000, work in progress of £1.173m, and finished goods £325,000, a total of £2,009,000.[101]

7.73 It is not entirely clear whether Mr Leech would have considered the inventories at Tanfield Lea on their own to be a significant risk (the stock recording systems at the two TES sites not being the same) but it appears from the extract from his evidence set out in paragraph 7.64(g) above that in practical terms he considered that more should have been done to investigate the differences which had been found. Under the terms of ISA 530 paragraph 50 consideration needs to be given to errors identified through testing regardless of whether or not the errors are found in an area of significant risk.

7.74 As noted in paragraph 7.57 above, Ms [...] observed that the systems at Tanfield Lea were in need of improvement. There was no evidence that this was ever followed up. We have already found that Baker Tilly did not do enough to be able to establish which of the errors were isolated. There is no dispute that the percentage ascertained by Ms [...] was incorrect and wrongly applied to the whole population. We do not accept Mr Main's

[99] [Paragraphs 138 – 150 and T8/96]

[100] [T8/82].

[101] [F2/40/278]

approach to this issue as noted in paragraph 7.65(c) above. That approach fundamentally undermines the principles of statistical sampling.

7.75 Baker Tilly did not need to undertake the testing of raw materials at Tanfield Lea at all. One view is that having done so they should have completed the task professionally, and having embarked upon the sampling exercise should have pursued it at least until more clarity was achieved, but that they did not. However, we consider that there would undoubtedly be some competent auditors acting with reasonable care and skill who would have taken the view that, having regard to the fact that there was no need for the exercise at all, no further investigation was required - as Mr Main pointed out, the value of the individual items was relatively small, the total value of the raw materials at Tanfield Lea was not material to either TES or Tanfield Group, and some variances were to be expected, and there was nothing to *"**cause any lights to flash**"*.

7.76 Our conclusion, therefore, is that Baker Tilly's conduct of the audit in the respects referred to in this sub-allegation 1.1(b) did not fall short of the standards reasonably to be expected of a Member Firm.

TES Inventory Count at Tanfield Lea – Falling Short - Conclusions in Relation to the Engagement Partners

7.77 It follows from the conclusion expressed in the last paragraph that there is no basis for any finding of a "***falling short***" by either Mr King or Mr Railton in relation to the deficiencies in the audit alleged in this sub-paragraph.

Sub-Allegation 1.1 (c) – the Vigo Inventory Count – Existence of Raw Materials

The Allegation

7.78 Sub-Allegation 1.1(c) is that:

In relation to the TES stocktake on 20 December 2007, the Respondents failed to obtain sufficient appropriate audit evidence of the existence of inventories in that:

"c) the tests undertaken at the Vigo site for the Upright, Electric Vehicles and Spares stocktake of raw materials demonstrated errors in many of the lines sampled, and:

(i) where there is evidence of discussion with management concerning the said errors, the Respondents failed to obtain sufficient appropriate follow up evidence or corroboration;

(ii) where there is no such evidence of discussion, the Respondents failed to obtain sufficient appropriate follow up evidence regarding the errors".

Vigo Inventory Count Raw Materials - The Issues

7.79 The stock at Vigo was held on an Avante stock system. The stocktake at the Vigo site was carried out on 20 December 2007 by Mr [...] and Mr [...]. Mr [...] was the junior audit member, and according to Mr [...], he had relatively little experience of complicated stocktakes such as this was. Mr [...]'s recollection is that Mr [...] dealt with raw materials and he dealt with WIP.

7.80 The stocktake test itself is documented in a working paper prepared by Mr [...]: "***PAA Stocktake 20 December 2007***"[102]. The working paper includes four tabs for:

(a) "***Upright***" stock - stocktaken over on the acquisition of Upright (see paragraph above).

(b) "***Electric vehicle***" stock;

(c) "***Spares***"; and

(d) The extrapolation of errors.

7.81 Mr [...] tested a total of 28 items of raw material items (seven items of Upright raw material each way; 6 items of Electric Vehicle stock (cranes) each way and 1 item of "Spares" tested each way.)

7.82 In respect of the two items of spares there was no discrepancy.

7.83 Of the remaining 26 items:

(a) 14 lines tested related to the category "***Upright***", of which 9 lines were found to have discrepancies (i.e. the quantities on the floor did not correspond with the quantities recorded on the stock system)

[102] [G2/27: F2/41]

(b) 12 lines tested related to the category "***Electric Vehicle***", of which one line was found to have a (significant) discrepancy ("***Accelerator pedals***").

7.84 The follow up work at Vigo was recorded in a stocktake follow-up work paper.[103] In paragraph 24 of his witness statement, Mr [...] said that he did not recall carrying out the follow-up testing but that he believed he may have set it up

7.85 Executive Counsel submitted that it is to be inferred from the working papers that the discrepancies were not investigated adequately or at all and/or that no or no sufficient corroboration was obtained of the existence of TES raw materials.

7.86 The Respondents asserted that as a matter of fact the follow-up was adequate and that the corroboration and evidence obtained provided sufficient appropriate audit evidence of the existence of TES raw materials.

Vigo Inventory Count - Executive Counsel's Case

7.87 Based on the working paper Executive Counsel asserted that:

(a) two discrepancies were not explained or followed up:

(i) in the paper in relation to the "***E-Down Battery***" (containing a discrepancy of 26 units) it was noted "***stock only kept in one location, client could not explain reason for discrepancy. Count re-checked***".

(ii) in the paper in relation to "***Accelerator pedal***" (containing a discrepancy of 11 units) it was noted "***unknown discrepancy***".

(b) The "**Energy Chain**" (a discrepancy of 7 units) – 7 more on the floor than in the system) was accompanied by the following note: "***A possible reason for the discrepancy is as follows: Stock is entered in primary locations. Occasionally some of the locations show negative stock figures when deductions are made from the wrong location***". The follow up (which identified a total of "***8***" in other locations) left one unresolved discrepancy.

(c) 5 items of Upright Stock (cranes) (a total discrepancy of 24 units) were accompanied by Note 1: "***The most likely reason for this is that stock is selected for orders from one location but removed from a different location***

[103] [F2/43/298 and G2/28/238]

in the system". The follow up ("***to check this, all tanks on the floor were counted, which should agree to the total per system***") left one unresolved discrepancy.

(d) In respect of two further Upright items, in notes 2 and 3 it was recorded that "***[...] in the stores had provided possible explanations"***, but these were neither corroborated nor followed up.

(e) An attempt was made by the Engagement Team to extrapolate the errors (arriving at an error rate of 2%). It appears this extrapolation was not pursued, but it is common ground that this attempt was thoroughly misconceived, the Experts agreeing that the 2% error rate calculated by Baker Tilly was based (wrongly) on the count of items and ignored the relative values of the inventory tested.[104]

7.88 Mr Leech's evidence was that a reasonable auditor would have followed up the differences and obtained corroboration[105]:

"***Well, I think a reasonable auditor follows up all differences. So once you've picked a sample -- so you've already introduced sampling risk by selecting a sample of items, so as you find differences within that sample, the reasonable auditor would follow all of those through in order, for example, to make an extrapolation….***"

7.89 In the premises, the Respondents failed to obtain sufficient appropriate audit evidence:

(a) Inventory was material to the financial statements.

(b) The discrepancies were significant in number.

(c) The Engagement Team failed: (a) adequately to analyse the discrepancies to establish whether they had a common cause and/or were the product of systemic errors; (b) to obtain sufficient appropriate follow up evidence or corroboration in relation to these discrepancies; and (c) to extend audit procedures in order to quantify more accurately the likely overall error.

(d) The calculation of the error rate was wrong and not pursued.

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[104] [Joint Memo para 23: D2/5/441]

[105] [T3/12]

Vigo Inventory Count - The Respondents' Case

7.90 The Respondents contend that the audit evidence was sufficient and appropriate. The Respondents relied upon:

(a) Mr [...]'s oral evidence that, although not recorded in the stocktake working paper, the discrepancies would have been and were followed up, and also on the follow up working paper as being consistent with and supporting that evidence[106].

(b) Mr Main's disagreement with the allegation that insufficient audit evidence had been obtained in relation to the tests at Vigo and his opinion that the auditors took account of the impact of the differences identified, sought and obtained corroboration of management's explanation for the most significant of the differences identified, followed that up by testing the explanation against a count over the whole site of one of the items in question and finding a discrepancy of only one out of a total of 38, did not act unreasonably in not taking the investigation further, and that they applied reasonable judgments when considering the implications for the audit findings[107].

(c) In any event, Mr Leech's criticisms were limited to the small number of the items not followed up, and which, in cross-examination[108] he did not regard as particularly serious ones : he also accepted that he had seen no evidence that any issues relating to this stocktake were ever escalated to Mr King or Mr Railton and that, unless the area was one of significant risk, he would not have expected the engagement partner to be reviewing detailed stocktake working papers of this nature: ultimately the shortcomings which Mr Leech identified were reduced to the status of a review point for the audit junior.

Vigo Inventory Count - Falling Short - The Tribunal's Conclusions in Relation to Baker Tilly

7.91 According to the evidence of Mr [...][109] it was anticipated that £19.5 m of TES's total stock of £22.1m would be held on the Vigo site. Plainly, therefore the existence of inventories at Vigo was material to the financial statements, "***M***" being £429k.

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[106] [F2/43/298]

[107] [Report 6.15,1: D2/3/285]]

[108] [T3/12 – 31]

[109] [WS paragraph 116: C/1/24]

7.92 The most common explanation for the differences was recorded as being that the stock was selected for orders from one location but removed from a different location in the system. In other words, a particular item of stock was held in more than one area; an item might be removed for production purposes from one area but the item was erroneously recorded on the system as having been removed from another area. Mr [...] confirmed in his witness statement that this explanation was given to him by [...] - his contact at TES[110]. The working paper also records that this explanation was tested by Mr [...] by selecting a single item (Mr [...] selected "***tanks***") and then counting that item on the floor across all locations to see if this matched the number of items in the system as a whole. The test revealed a difference between the system and floor across all locations of only one tank out of a total of 38. Substantially the same explanation was given for the energy chain and, according to the work paper, was checked and corroborated. We accept that this did happen. Mr Main, in paragraph 6.14.2[111] of his report, observed that it is not unusual in manufacturing for stock of the same type to be held in multiple locations.

7.93 In his oral evidence[112] Mr Leech whilst accepting, on the basis of the documentation, that there had been adequate follow up testing in relation to tanks and energy chain maintained his position in relation to the other four items for which the same explanation had been given, stating that he would have subjected them to the same test or at least requested management to confirm that the explanation held good for each of them. It appears that if that request had been made Mr Leech would have accepted that it would have been reasonable for an auditor to conclude that the explanation was plausible, there was an adequate degree of corroboration, and no further testing was needed to support the explanation[113].

7.94 In his third report Mr Leech also stated[114] that the audit juniors ought to have followed up a single discrepancy in relation to the electric vehicle inventory – the "***accelerator pedal***"[115]. Mr [...] regarded this as not sufficiently material to require following up[116] and Mr Main supported this view[117], albeit that this was not recorded in the working paper,

[110] [[...] WS para 16/17: C/7/131-132]

[111] [D2/3/283]

[112] [T3/21 – 24]

[113] [T3/ 26]

[114] [6.14.2 D2/3/283]

[115] [4.3.32.: D1/1/60]

[116] [Witness statement paragraph 135 :C/1/28/28]

[117] [paragraph 6.14.3,4:D1/3/284]

stating that it appeared that the audit team considered this to be an isolated error. We do not accept this, as Mr [...] stated plainly that he regarded it as not material.

7.95 Without the benefit of Mr [...]'s oral evidence the experts were agreed that the documentation recording the follow up procedures at Vigo was unclear[118]). They exchanged views on the basis that some differences had not been followed up.

7.96 In paragraph 6.14.2 of his report Mr Main stated:

"***Whilst I accept that one could always undertake more testing, it is a matter for the auditor's judgment as to what evidence he needs in order to dispel concerns that there was an actual error in the light of differences uncovered in a sample. In my view, that judgment was exercised reasonably in this case***"[119]

7.97 Executive Counsel pointed out that there had been no documented judgment by the Engagement Team not to obtain further audit evidence.

7.98 However, in his cross-examination Mr [...] did assert that all the differences had been followed up and satisfactorily resolved:[120]

"Q. No. Insofar as those were not followed up, Mr [...], that was a breach of the manual, wasn't it, which we've seen required errors to be followed up?

A. No, they would have been followed up, it is just that it wasn't possible to follow them up with the stores manager at that point in time -- well, we will have followed them up in that we will have asked if he could explain them, but he wouldn't have been able to explain them himself, so there would have been a reason for the difference that he wasn't aware of.

Q. You don't know now whether those were then followed up further after the stocktake, do you?

A. We followed up the differences at the final audit….I'm certain that they were followed up."

7.99 He described this additional audit work as painstaking:

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[118] [paragraph 18 Joint Statement: D2/5/440]

[119] [D2/3/283]

[120] [T6/73-74]

"***A I absolutely, absolutely remember this due to the level of detail and the amount of time it took me. It was absolutely painstaking and quite frustrating, and I accept the level of documentation on here is not great, but the work was absolutely done.***"

7.100 The critical evidence did not appear in either of his two witness statements, and nor did it emerge in his initial oral evidence. Nevertheless the worksheet[121] does reflect not only that follow up work was done, but also some motivation on the part of those concerned to record what had been done. More importantly, the year end follow up paper[122] does record that "***All movements investigated by client and all reasons have been corroborated***", and there is no basis for concluding that this was a deliberately false entry. In the light of that document, and in spite of the belated manner in which it emerged, we have concluded that Mr [...]'s evidence should be accepted. It is not absolutely clear that that comment was intended to apply to all the items listed, but, on balance, we consider that it was so intended, and therefore did apply to them all, including the accelerator pedal item. It follows that the deficiency is one of documentation (eg failure to record the nature of the corroboration) rather than failing to obtain corroboration. Mr [...] did not comply with ISA 230 paragraphs 16 and 17, but that is not a criticism advanced in relation to this sub-allegation.

7.101 In the light of the evidence given by Mr [...] and referred to in paragraph 7.98 above, it appears to us that not only did Baker Tilly plan to follow up the discrepancies found at the December 20th 2007 stocktake at Vigo, but it actually did so. It remains the fact that the documentation of the exercise did not include details of the corroboration obtained and was generally unsatisfactory, but the allegation that Baker Tilly's opinion as to the financial statements in so far as those reflected TES raw materials at Vigo was not supported by sufficient appropriate audit evidence is not made out.

Vigo Inventory Count – Falling Short - Conclusions in Relation to the Engagement Partners

7.102 In the light of our findings in the last paragraph, there is no basis for any finding of a "***falling short***" by either Mr King or Mr Railton in relation to this sub-allegation 1.1 (c).

[121] [G2/27/230]

[122] [G2/28/238]

Sub-Allegation 1.1(d) – Roll Forward Testing - the Vigo Inventory Count

The Allegation

7.103 Sub-Allegation 1.1(d) is that,:

> ***"in relation to the TES stocktake on 20 December 2007, the Respondents failed to obtain sufficient appropriate audit evidence of the existence of inventories in that:***
>
> ***d) no, or no appropriate audit evidence was obtained in respect of the roll forward testing, which showed differences in 21 out of 22 of the Upright, Spares and EV lines sampled."***

Vigo Roll Forward Testing – The Issues

7.104 Roll forward procedures were required to adjust for movements of stock between the date of the stocktake, 20 December 2007, and the year end.

7.105 The roll forward procedures on the Vigo inventory count are contained in the "***Section 10 – Stocktake follow up***" working paper.[123] The working paper was originally created by Mr [...], although he did not recall carrying out the follow up testing and believed that it is likely that another member of the team would have also worked on the paper.

7.106 The working paper records (once a number of "***hidden rows***" are revealed) that at the year end differences were found in 21 of the 28 raw materials items tested. At the right hand side of the working paper, the paper records that: ***"All movements investigated by client and reasons have been corroborated".*** However, no details or reasons are noted and there is no information as to how the reasons were corroborated.

7.107 There is a further version of the working paper of the original stocktake[124], referred to in paragraph 127[125] of Mr [...]'s witness statement, and apparently last modified on 29 December 2007. This document includes two notes which were not on the original document – lines 18 and 23 to the effect that ***"no issues were noted in relation to"*** work in progress or finished goods "***sampled items***". The paper also records some zero differences in relation to raw materials of Upright and Electric Vehicle Stock, implying a resolution of certain earlier differences.

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[123] .[G2/28/238 F2/43/298]

[124] [E2 /296,]

[125] [C/1/26-27]

7.108 In Executive Counsel's written opening it was contended that in the absence of:

(a) any evidence on file explaining the nature of the client's apparent investigations, the client's reasons, and how Baker Tilly corroborated the client's reasons; and

(b) any explanation for the lack of documentation,

it was to be inferred that no or no sufficient appropriate audit evidence had been obtained.

7.109 Following the service of Executive Counsel's opening, the Respondents served an additional witness statement from Mr [...] in which he stated, *inter alia*, that he did recall carrying out the raw materials roll-forward testing whilst on site at Vigo:

"***This involved me reviewing on screen with a member of the finance team the stock movements in between the time of the stocktake and the year end. I identified any differences between the stock figures at the time of the sample count and the current figures and asked to see the details of movements in the raw materials samples. These comprised receipts in from suppliers and orders out from stores to production. Receipts were agreed with to delivery notes and orders out from stores to production to WIP jobs. I recall there were a number of very small movements due to corrections where, for example, a stock item had been found in an incorrect location. Where this was the case I would not have pursued any further corroboration.***"

Vigo Roll Forward Testing - Executive Counsel's Case

7.110 Mr Leech accepted that, if Mr [...] performed the audit tests which he says he did, this would be adequate. However, Mr Leech expressed skepticism:[126]

"***Q. Yes. But, again, if you came across this worksheet from an audit junior and the audit junior said to you "This is what I did", you would say to that audit junior "Well, next time make sure you set out all your workings on the spreadsheet, wouldn't you?***

A. I would say to him "How did you manage to do it without retaining any working?" And that would -- if there was really no working was ever prepared, I would be sceptical as to whether he'd done the procedure."

[126] [T3/35-37]

7.111 The Executive Counsel submitted that Mr [...]'s account in relation to these roll-forward tests cannot be relied upon:

(a) Mr [...] made no mention of this audit work in his first witness statement.

(b) The detailed account he provides in his second witness statement (namely that he reviewed the screen, identified differences and asked to see the details) is inconsistent with what is said on the audit file (namely that all movements were investigated by *the client*.)

(c) If, as Mr [...] contends, he had carried out detailed roll-forward testing procedures and if (as Mr [...] seems to suggest in evidence) he had discussed this with Mr [...], it is extremely unlikely that no record *at all* would exist evidencing such audit procedures (no work paper, no workings out on the K drive, no emails etc.). However, there is no such record. In such circumstances, it seems that Mr [...] must be mistaken in his recollection.

7.112 Accordingly, in the absence of any evidence on file explaining the nature of the client's and/or Mr [...]'s apparent investigations and any, or any adequate, explanation for the absence of any record of such investigation, it is to be inferred that no sufficient appropriate audit evidence was obtained: Mr [...] simply relied on management's uncorroborated assertions that they had investigated.

Vigo Roll Forward Testing - The Respondents' Case

7.113 Mr Main's evidence was that if the corroborative evidence was obtained, as the working paper says it was, he did not consider that in respect of this allegation the conduct of the Respondents fell short of the standards reasonably to be expected of a member or member firm.[127]

Vigo Roll Forward Testing - Falling Short - The Tribunal's Conclusions in Relation to Baker Tilly

7.114 It is, of course, correct that Mr [...]'s detailed account of the follow up did not appear in his first witness statement. That statement is dated 25 May 2017. Only the first of Mr Leech's three reports had been served at that date, and the criticism which he advanced in that report, at paragraph 4.3.53[128], in relation to the roll-forward at Vigo was that the comment

[127] [Report 6.20.2: D2/3/287]

[128] [D1/1/66-67]

in the working paper that "***all movements investigated by client and reasons have been corroborated***" fell short of the documentation required by ISA 230 (Documentation). Notwithstanding the fact that the Formal Complaint had been served before 25 May 2017, the terms of the report referred to in the last sentence may explain the apparent omission referred to in Mr [...]'s first statement. It is to be noted that it was clear from paragraph 31 of Mr [...]'s first witness statement that he was involved in the follow-up work.

7.115 We do not accept the Executive Counsel's suggestion that the comment quoted in the last paragraph is inconsistent with Mr [...]'s updated account of what was done by way of follow-up: since, in an audit, it is the auditor who is looking for corroboration, the implication is that corroboration was provided to the audit team, but in any event, in the context of an ill-documented audit we do not consider that the note should be construed as if it were a statute or a contractual term.

7.116 The fact that there are no other records of the follow-up – whether by Mr [...] or Mr [...], is not particularly surprising given the generally poor documentation of the audit. There is no basis for any finding that the note relied on by Mr [...] is a false entry, and accordingly it is, in our view, corroborative of Mr [...]'s evidence as to what was done by way of follow up. In all the circumstances therefore we accept Mr [...]'s evidence in relation to this issue. We have already recorded the fact that Mr [...] failed to record the name of his informant or the date when the information was provided, contrary to the guidance in ISA 230 paragraphs 16 and 17.

7.117 As indicated above, it was common ground between the experts that this allegation could not succeed if the follow up work was done as described by Mr [...]. Based on our conclusions above, therefore, this allegation should be dismissed.

Vigo Roll Forward Testing – Falling Short - Conclusions in Relation to the Engagement Partners

7.118 It follows from the conclusion expressed in the last paragraph that there is no basis for any finding of a "***falling short***" by either Mr King or Mr Railton in relation to the allegations made in this sub-allegation 1.1(d).

Allegation 1.2(a) – Valuation of TES Inventories – Unit Cost Testing

The Allegation

7.119 Sub-Allegation 1.2(a) is the first of two allegations relating to the valuation of inventories at TES. It is alleged that:

> ***"In relation to the audit of TES, the Respondents failed to obtain sufficient appropriate audit evidence of the valuation of Inventories in that:***
>
> ***(a) the Respondents found errors in the entire sample of 38 items tested in the comparison between the unit cost of the inventory items in the TES inventory system and the unit purchase price on the invoices. However despite the valuation assertion for Inventories being considered by the Respondent at the planning stage in the Key Issues Tracker as a significant risk:***
>
> > ***(i) in respect of two of these items, the total variance was almost £103,000. The Respondent identified these errors as "isolated errors" from "discussions with the client" but failed to obtain sufficient evidence on which to conclude that they were isolated errors, contrary to the requirements of paragraph 50 of ISA 530;***
> >
> > ***(ii) in respect of all 38 items tested, the Respondent failed to obtain sufficient appropriate evidence of freight charges;***
> >
> > ***(iii) in respect of 23 of these items, the Respondents failed to obtain any, or any sufficient, appropriate audit evidence to explain why the cost of freight added was not either 10% (or 20% for US purchases)."***

Valuation of TES Inventories – The Issues

7.120 The value of inventories in TES's financial statements, for the year end 2007, was £30.7m (an increase of nearly £19m since 2006, when TES had inventories of £11.5m). In the Key Issues Tracker TES inventories were identified as a Significant Risk. The other audit planning documents also indicated that valuation of inventories was a key area of audit focus/risk and an area of particular concern.

7.121 Tanfield and its subsidiaries valued the "***cost***" of inventories using a weighted average rather than the cost of the purchase. The cost comprised direct materials and, where

applicable, direct labour costs and overhead which had been incurred in bringing the inventories to their present location (freight).

7.122 Baker Tilly tested the valuation of stock at TES by selecting a sample of 38 stock lines in TES and comparing the unit cost recorded in TES's inventory lists with recent purchase invoices, the objective being to confirm that the price of each item was not different from the current average unit cost. The sample of 38 was selected using a method of sampling known as Monetary Unit Sampling ("MUS").

7.123 The relevant audit papers are:

(a) In the TES file: TES Inventories Subs Testing[129].

(b) In the Tanfield file: Stock Subs.[130]

7.124 These papers record that Baker Tilly found potential errors, in the entire sample of 38 items, generally falling within a range of 1% to 20%, though with a handful of much larger discrepancies. It is common ground that the existence of some minor discrepancies across the sample was not altogether surprising. This is a consequence of the use of the weighted average cost basis for valuing stock, and of movements in currency exchange rates. It is common ground that this could not sensibly explain the size and number of the discrepancies which plainly required further investigation

7.125 In addition it is common ground that there were two very significant overstatements totaling around £825,000 in TES's stock records:

Error 1 "***Motor P120***" (a single machine or motor) which been overvalued by €63,328.63 (693%) per item.

Error 2, "***SL26SL CE MACH***" (single machine) which had been overvalued by €36,554 (182%) per item.

7.126 The audit papers record that, following discussions with management, Baker Tilly concluded that these two large items were isolated errors. As such Baker Tilly discounted them (save that £825,000 was included in the financial statements as an adjusted error).

[129] [G2/25/220 and a similar version at G2/29/249]

[130] [F2/42/292]

7.127 Having stripped out the two large items (Motor P120 and SL26SL CE MACH) on the basis that they were considered to be isolated errors, Baker Tilly calculated the error rate to be 0.1% by:

(a) adding up the differences to the unit cost (shown in column M) and stripping out the two "***isolated errors***". This produced the figure of €8,063.65; and

(b) dividing €8,063.65 by the total value of the sample size (€8,478,010.18).

7.128 It is common ground that this calculation was erroneous in that Baker Tilly overlooked the fact that there was more than one unit of each item in the sample. In other words, the column in the paper recording the quantity of each of the units tested (column "H") was overlooked. Baker Tilly calculated the projected value of error to be around £36,000 (i.e. 0.1% of the total inventory at TES, stated in this workpaper to be £31.252m)[131]. Mr Main, leaving out the two large items, calculated the projected error, using the appropriate figure (EUR 6.96m) reflecting the true number of units involved at EUR.909,000, which he calculated to be approximately 13%.

7.129 The papers also record[132]:

"The reason for the difference between the stock value per the day book report and the stock value per the system is that a 10% freight charge is applied to all stock items (20% for USA purchases).

The client is currently in the process of amending the system to more accurately reflect the charge applied by each supplier. However, at the year end, a standard rate was applied to all stock".

7.130 The working paper records[133] that Baker Tilly carried out a reasonableness check which suggested that a 10% freight charge lead to a difference, in the charges tested, of EUR1.134m. Whilst, therefore, the reasonableness test in relation to freight alone might suggest a charge of 8% rather than 10%, Baker Tilly, at lines 37-40, recorded their account for the difference as follows: "***The difference indicates that applying 10% freight charge to purchases results in stock being overstated. However, the figure for purchases includes labour costs which account for a significant amount of the***

[131] [G2/25/221]

[132] [Note 1:G2/25/222]

[133] [G2/25/222]

cost of the sales. Therefore the application of a freight charge to stock appears reasonable". Mr [...], at paragraph 168 of his witness statement, related that in the Final Audit Finding ("***FAF***") Baker Tilly asked the client for evidence that the freight charge was reliably measured and that this was followed up with the client[134]. In his oral evidence, however, he stated[135] that the request in the FAF related to another topic and that Baker Tilly were satisfied with the evidence recorded in the papers referred to above**.**

7.131 There is a measure of common ground between the experts which is reflected in paragraphs 49– 52 of their Joint Memorandum.[136] In summary:

(a) The Experts agreed that the extrapolation calculation was wrong (Joint Memorandum paragraph 51).

(b) Assuming (contrary to the Executive Counsel's case) that the two errors (in relation to Motor P120 and SL26SL CE MACH) were isolated and could therefore be stripped out, the difference between the book value of the items selected for testing and the price shown on the latest purchase invoice was approximately 13% of the value of inventory tested (Joint Memorandum paragraphs 51 and 52).

(c) The 13% difference would in part have been accounted for - to an extent that is not documented on the audit file - by freight charges. The Experts agreed that the work paper does not document the reasonableness of the freight charges (Joint Memorandum paragraph 49).

(d) The Experts agreed that it was appropriate to project the error across the whole population of inventory at TES (as this was an MUS test) (Joint Memorandum paragraph 52).

(e) 13% of £30.7m (£31.2m excluding the 2 errors) gives a potential unexplained difference of £3.9m. It is from this value that freight charges should be deducted.

7.132 It can be seen that the allegation raises three issues:

(a) As to the adequacy of the evidence upon which Baker Tilly concluded that the two large errors referred to above were "***isolated***";

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[134] [C/1/34]

[135] [T8/144]

[136] [D2/5/444]

(b) In relation to the 38 items, as to the adequacy of the evidence obtained by Baker Tilly in respect of "***freight charges***";

(c) In respect of 23 of the 38 items, as to the adequacy of the evidence obtained by Baker Tilly to explain why the freight charges were not either 10% (or 20% in the case US purchases) – referred to as the "***Other Variances***".

7.133 The Executive Counsel's closing submissions focused on four aspects: isolated errors, freight charges, other variances and the extrapolation/rate errors, and it was submitted that in the light of the fact that the valuation of TES inventories was, if not a significant risk, a key area of audit focus/risk, Baker Tilly's work in this area was manifestly inadequate.

7.134 In their written closing submissions the Respondents asserted that the allegation was concerned with:

(a) whether there was sufficient appropriate audit evidence for valuation: if there was, then the allegation failed even if criticism could be made of Baker Tilly's detailed work;

(b) substantive tests of detail carried out by Baker Tilly (which would not have been and were not reviewed by the engagement partners), by which the unit cost of a sample of inventory items from inventory records were compared to a recent purchase invoice (we took this to be a reference to an exercise relied upon by the Respondents to show that freight costs were checked against purchase costs)

7.135 Leaving aside for the moment the argument in relation to the engagement partners, we reject the submissions referred to in paragraphs 7.134(a). This issue has been addressed at paragraphs 2.24 to 2.28 above.

7.136 In the oral closing submissions[137] it was submitted on behalf of the Respondents that the error rate and extrapolation and other variances did not fall within the scope of the terms of Allegation 1.2(a).

7.137 We agree with the Respondents that the erroneous extrapolation itself does not fall within the terms of this sub-allegation, but the admitted miscalculation at the root of it does, and

[137] [T11/137,138]

it is a relevant component of the background, and had the potential to provide a sense of false security about this area of the audit. The "***Other Variances***" we take to be a reference to the assertions in sub-paragraphs (ii) and (iii) of the sub-allegation, and therefore are within its scope.

7.138 The issues as to whether the valuation of inventories was regarded by Baker Tilly as a significant risk is addressed at paragraphs 6.10 and 6.21 above.

7.139 The Respondents further submitted that by the close of the evidence the allegations in relation to the isolated errors had "***fallen away***", that Mr Main's evidence established that there was adequate evidence in relation to freight charges and the remaining variances, and that if there were failings in respect of this part of the audit the Tribunal should accept Mr Main's evidence that an engagement partner would not be required or expected to review working papers recording the procedures undertaken.

Isolated errors - Executive Counsel's Case

7.140 As indicated above, Baker Tilly concluded that these overstatements were isolated errors and not systemic or otherwise indicative of the population as a whole. Executive Counsel referred to the statement in ISA 530 paragraph 50 that: "***To be considered an anomalous error the auditor had to have a high degree of certainty that such error is not representative of the population. …"*** , and submitted that there was insufficient evidence on which Baker Tilly could safely conclude that the errors were not recurring.

7.141 The "***TES Inventories Substantive***" working paper recorded Baker Tilly's conclusion that the errors were likely to be isolated ones in the following terms[138]:

> ***"Error 1[139]: From discussions with the client, we are satisfied that this is an isolated error, as it relates to the value being added into the stock system on initial purchase. This initial purchase price was significantly higher than subsequent purchase price as it covered the development cost associated with the part. This is a one-off as TES very rarely buy in specially developed parts, especially now they are developing more themselves with there (sic) new design team."***

[138] [G2/25/223]

[139] [Motor p120: G2/25/223]

"Error 2[140]: From discussions with the client we are satisfied that this is an isolated error. We have confirmed this by ensuring the sales prices are < the BOMS [Bills of Materials] for all other significant valued machines".

7.142 In paragraph 160 of his witness statement[141] Mr [...] corroborated this note, explaining that the audit team had raised these errors with […], a management accountant within the group. He also stated[142] that the issue was also picked up in both the substantive analytical review and the substantive testing, and that he had discussed them with Mr King and Mr Railton. The Audit Findings Report referred to the fact that overstatements totalling £825,000 had been found and had been included as adjusted errors and noted that in the light of the further work undertaken Baker Tilly were satisfied that the errors were not indicative of the population as a whole. In his cross-examination he pointed out[143] that the audit team, from previous years, had a detailed understanding of the TES business and the machines which it manufactured. It was put to him that the effect of ISA 530 was that Baker Tilly had to carry out sufficient investigations for it to be confident that this was an isolated error and that this had not been done: he answered that he disagreed.[144]

7.143 Executive Counsel referred to the statement in the quotation referred to in paragraph 7.141 above (that "***TES very rarely buy in specially developed parts***") as suggesting that this was not a one-off, and that TES had bought prototypes in such numbers in the past that TES was able to justify setting up a new design team to develop prototype parts for itself ("***now they are developing more themselves with there [sic] new design team***"), and submitted that this strongly suggested that the "***error***" may not have been an isolated error and that other prototypes might have existed in the population as a whole.

7.144 In this context Executive Counsel referred to paragraph 24 of Ms [...]'s witness statement[145] in which she recounted: "***The nature of the client meant that they needed lots of raw material parts designed – it was not unusual for the first part to cost***

[140] [SL26SL CE Mach: G2/25/223]

[141] [C/1/33]

[142] [Paragraphs 161 – 163]

[143] [T8/132]

[144] [T8/132 – 133].

[145] [C/5/127]

more, because the design costs were rolled into the cost." In her oral evidence[146] she stated:

" .. I think what I am trying to get across there is that that -- sorry, as their trading developed within TES, there was less and less need to buy in this parts in which included a development cost. …

…. So this P20 was one of the -- was the last one at that time that was deemed to have included development costs.

THE CHAIRMAN: So ….. this was becoming a diminishing problem? ..

A. Yes. As they were getting a bigger and bigger an operation it was becoming less and less frequent that this happened.

The Chairman: Yes. But it had been happening in the relevant period in which you were considering?

A. Yes.

7.145 As appears from paragraph 7.141 above, in relation to the second error, the audit work paper contains the following explanation: "***We have confirmed this by ensuring the sales prices are < the BOMS for all other significant valued machines***". It is common ground that this sentence contains a typographical error and that it should be read as indicating that the sales prices for "***significant valued machines***" were not less than the cost prices. Executive Counsel submitted that the absence of an explanation for the second error could not possibly support a finding that it was an isolated error, that it was not at all clear why bills of material had been reviewed only for "***significant valued machines***", nor which machines those were, or how many fell into this category and hence caught by the test. On the face of it, it seems as if this test did not pick up machine X32 CE MACH (the unit cost for which was €10,673; the cost on the stock list was €7,117, a difference of roughly 50%).

Isolated Errors - The Respondents' Case

7.146 The Respondents contended that Mr Leech's position was as summarised at paragraph 56 – 57 of the Joint Memorandum:[147]

[146] [T5/80 et seq]

[147] [D2/5/155-157]

"Mr Leech agrees that documentation indicates that "significant valued machines" were partly investigated to identify if the error identified in the sample was indeed isolated. However, there is no record of the items checked and it is not clear what procedures were undertaken by the Auditor.

In the absence of details of the additional procedures performed Mr Leech is unable to form an opinion on whether these procedures were adequate e.g. in terms of sample size etc."

7.147 The Respondents submitted that, in respect of the Motor P120 error, at the hearing before us Mr Leech did not appear to pursue any criticism in respect of this part in isolation. He accepted[148] that the management's explanation was understandable, and agreed in cross-examination[149] that it was "***acceptable to accept***" the explanation that was provided by management. In re-examination, in a leading question, Mr Leech had been asked whether, if an explanation from management was acceptable it meant that there was no need for the auditor to carry out further work. His answer[150] was that because of the terms of the ISA a higher burden of evidence was required, so generally one would go beyond enquiry and here the auditor for example could have looked at the prototype invoices to determine that these costs were in fact billed from a third party – "***a reasonable auditor would have corroborated the management explanation and that could have been done by … obtaining the purchase invoice*** .." Under further questioning, he re-iterated the need for corroboration of the explanation. The Respondents submitted that the words "***acceptable to accept***" spoke for themselves, and could not legitimately be undermined by the leading questions put in re-examination.

7.148 The Respondents also made points, developed from paragraph 7.4.5 of Mr Main's report[151], that:

(a) This issue was picked up by both the substantive analytical review and the substantive testing, but that no other similar items were highlighted, so that this provided evidence that these were isolated errors;

[148] [T4/157]

[149] [T3/51 – 52]

[150] [T4/155-157]

[151] [D2/3/293]

(b) The use of MUS (looking at every £643,000 item) meant that made it more likely that higher value items were selected for testing and hence would have helped identify other material errors of this type; and

(c) In fact, Mr Leech, in cross-examination agreed that any materially overstated item at TES level had a high chance of being detected, and that any materially overstated item at group level was pretty well guaranteed to be selected.

7.149 They further relied on the Notes in the working paper[152] referred to paragraph 7.141 above, and Mr [...]'s witness statement[153] which record that in respect of the SL26SL CE Mach, the audit team compared sales price and bills of materials for all other significantly valued machines, and in all cases the sales price was greater than the bill of materials (thereby providing assurance that the error was isolated). There is no reason to doubt that this is true. The Respondents submitted that this would also have provided additional assurance that the error with the Motor P120 was isolated. They asserted that Mr Leech had also accepted that checking sales prices against bills of materials was an appropriate process, though Executive Counsel criticised the absence of any definition of the phrase "***significant valued machines***".

7.150 The Respondents submitted that that criticism would not even amount to a breach of the ISAs since it was another example of where paragraph 11 of ISA 230 would permit the documented fact of the general nature of the work carried out to be amplified orally**.** Mr Main[154] considered that the note provided *" **a fair description of the procedure performed and did not necessitate listing every item:**".* The Respondents also emphasised that documentation issues are not part of the complaint pursued in relation to this issue, and submitted that it was also clear from elsewhere within the working papers that Baker Tilly also compared BOMS to selling prices for at least ten lower-value Upright machines, and referred to the analytical review to substantiate this.[155]

7.151 In cross-examination[156] it was put to Mr Main that the 38 items included a third "***error***" of some magnitude and that there was no evidence in the working paper of this having been investigated. Mr Main agreed with these propositions. It was then suggested that the existence of this error might suggest that the two errors considered above were not

[152] [G2/25/223]

[153] [paragraph 165 C/1/39]

[154] [Paragraph 7.4.5 D2/3 /293]

[155] .[G1/15a/190.1 and T9/214]

[156] [T9/200 et seq]

isolated and that there might be others which should have been pursued. Mr Main rejected this contention on the grounds that this third error (relating to the "***CE Mach***" unit) was of a different order of magnitude and in any event would have been identified by Baker Tilly's procedures. Mr Main explained that the third error was an error of 50 per cent, the other two being 693 per cent and 182 per cent – *"**a different scale**" :*

"So they then did an exercise, they looked at all of the significant valued machines, and I agree that they didn't appropriately define what significantly valued machines are to understand how many that included, but I would have thought it's going to catch most of the material items, and they looked at all of those and made sure that on those cases the selling price was more than the stock value."

7.152 A suggestion was then made that lower value machines ought to have been investigated further. However, the Respondents submitted that it was clear that some lower value machines were investigated as part of the analytical review work on "***Raw Materials & Consumables***",[157] and that Mr Main was also clear that it was higher value items where errors had been found, and that errors on lower items were less likely to be material.[158]

7.153 In summary, Mr Main's opinion[159] was that Baker Tilly considered the issues diligently, made the further enquires that, in their judgment, were necessary, and that there was no evidence to suggest that these errors were other than isolated errors.

Isolated Errors - Falling Short - Conclusions in Relation to Baker Tilly

7.154 It is relevant background that Baker Tilly had classified TES inventories (without differentiating between existence and valuation) as significant risks, and, as Executive Counsel emphasised, that paragraph 50 of ISA 500 prescribes " ***a high degree of certainty****"* before Baker Tilly could conclude that the two errors were isolated errors.

7.155 As noted, Executive Counsel questioned Ms [...]'s acceptance of management's statement that the circumstances relating to the P120 error were a *"**one-off**".* Ms [...]'s statement (corrected as it was delivered) that P20 (she was plainly referring to P120) was the last item which included development costs does not sit entirely comfortably with her statement that this practice "***was becoming less and less frequent****".* Executive Counsel submitted that whilst it was right to note that when giving evidence Ms [...] stated she also

[157] [G1/15A/190.1 lines 40 – 49]

[158] [T9/206, 6-25 and T9/207 1 – 5]

[159] [D2/3/293 paragraph 7.4.5]

reviewed the stock listing to see if any high value items ***"stood out"***, her evidence on this point should be approached with caution – the suggestion that P120 was the last such item was mentioned by Ms [...] for the first time when giving evidence during the hearing, and there was no reference to this in the audit file or in her first witness statement. We accept this submission. Nevertheless, the note on the working paper does refer to this item as being a "***one-off***", and we consider that the inference must be that Mr […], an accountant, would have understood that Baker Tilly were concerned to establish whether this was an isolated error and that the information which he provided would have been informed by that understanding and by knowledge that if it was not an isolated error it would affect the audit. A competent auditor might reasonably consider it reasonable to rely upon Mr […]'s statements. The explanation, which is entirely plausible, as to how the error arose is recited at some length in paragraph 163 of Mr [...]'s witness statement.[160]

7.156 We agree that, leaving aside the third error, the fact that no similar items were found during the analytical and substantive reviews, and that the use of MUS based on a figure of £643,000 did mean that the chances of detecting materially overstated items were high; the checking of significantly valued machines, provided additional relevant evidence; and that the analytical review paper referred to in paragraph 7.152 above did provide evidence that some lower value items were investigated.

7.157 We do not accept that Mr Leech carried out any kind of volte face over his suggestion that further corroboration was required in relation to P120. He had made this point earlier and consistently - in his second report[161] at paragraph 3.6.5 and his third report[162] para 7.6.4 he had stated that he considered that without corroboration of management's explanation there was insufficient evidence that this was an isolated error. Again, whilst errors in lower value items were unlikely to be material individually, they may have been cumulatively, and Mr Main's evidence that the testing of significantly valued machines was likely to catch most of the material items was essentially speculation.

7.158 Whilst it is clear that it was poor practice for Baker Tilly not to have recorded what was meant by "***significantly valued machines***", it is clear that this would be a matter of judgment informed by values of items across the inventory, and there is no basis for concluding that an erroneous judgment was made in this case. We consider that there

[160] [C/1/33]

[161] [D1/2/221]

[162] [D2/4/399]

are reasonably competent auditors who might reasonably share Mr Main's approach to the "***third error".***

7.159 In relation to P120 we have concluded that on balance the information provided by Mr […], the plausibility of the explanation, the exercises carried out into both all significantly valued machines (MUS) and lower valued items, would have been regarded by at least some reasonably competent auditors exercising reasonable care and skill as providing the necessary degree of certainty that this was an isolated error.

7.160 We have also concluded that there are reasonably competent auditors, exercising reasonable care and skill, who would have considered that Baker Tilly had assembled sufficient evidence to support the necessary degree of certainty to conclude that SL 26SL CE Mach was also an isolated error. The conclusion was based on the information provided by Mr […] and the tests of other significantly valued machines showing that in all cases the sales price was greater than the bill of materials.

7.161 It follows that we do not consider that Baker Tilly's conduct of the audit in relation to the issue of the two isolated errors fell short of the standard reasonably to have been expected of a Member Firm, and this allegation should be dismissed.

Isolated Errors – Conclusions in Relation to the Engagement Partners

7.162 It follows from the conclusions set out in the last paragraph that the allegations against the engagement partners in relation to this issue should also be dismissed.

Freight charges

7.163 As stated above in paragraph 7.129, Baker Tilly concluded that numerous differences between the stock values per day book report and the stock values per the system were attributable to freight charges of 10% (UK) and 20% (USA).

7.164 This issue gave rise to a complicated debate before us – principally directed, it seems to us, to the estimate of the actual freight charges and the potential total value of the differences thrown up by the sample of 36 items not regarded as isolated. However, as was pointed out in Executive Counsel's oral closing submissions,[163] the core issue relates to Baker Tilly's response or lack of response to the fact that whilst management assessed freight charges at 10% Baker Tilly itself assessed them at 8%, so that a discrepancy of

[163] [T11/86]

2% still remained; this was suggested to be explained by labour costs (allegedly not sufficiently explored by Baker Tilly).

7.165 It is common ground that Baker Tilly's calculation of the difference thrown up by the 36 items which needed to be accounted for was incorrect – see paragraphs 7.128 and 7.131 above. As noted in paragraph 7.131 above, in the Joint Memorandum the experts recorded their agreement that the difference between the book value of the 38 items tested and the prices shown on the latest purchase invoices was 13% - that is after stripping out the two errors regarded as isolated errors.

7.166 The Joint Memorandum also records[164] that Mr Main considered that 13% was not in fact the error rate because it included freight charges. If 10% of the 13% difference in the sample related to freight charges the remaining unquantified difference is reduced to 3% and an error rate of 3% on the total stock value would give an extrapolated error of £937,000 based on a total inventory value of £31.252m.

7.167 Mr Leech's view was that the audit file does not contain sufficient evidence to assess the reasonableness of the freight charges and thereby provide an alternative deduction from the 13%. However, had an 8% figure been used (which was the percentage derived from the actual freight charges recorded at lines 20 – 29 on the working paper "***TES Inventories substantive testing***")[165] the projected error would have been £1.56m (i.e. 5% of £31.252m).[166]

7.168 As can be seen, the allegation is of failure to obtain adequate evidence of the freight charges. The relevance of the extrapolations is that they project the quantum of potential misstatements if the figures for freight charges adopted by management were too high.

Freight Charges - Executive Counsel's case

7.169 Executive Counsel submitted that Baker Tilly had insufficient evidence that the 10 and 20 percentages were reliable estimates:

(a) No procedures were performed to test whether these percentages were accurate. Baker Tilly did not, for example, test a sample of invoices.

[164] [Paragraph 52: D2/5/444]

[165] [G2/25/222]

[166] [Joint Memorandum paragraph 52: D2/5/446]

(b) No procedures were performed as to whether the 10% or 20% was applied correctly and consistently.

(c) The "reasonableness check" comparing 10% of all purchases (€5,940,010) with actual freight charges (€4,801,166) was no substitute for audit testing. In any event, the "reasonableness check" highlighted a discrepancy of €1,134,844, indicating that 8% and not 10% or 20% was a better estimate of freight charges. The discrepancy was justified by Baker Tilly on the basis that the figures for purchases includes labour costs. There were, however, no procedures performed in relation to the labour costs.

(d) It spoke volumes that, at the time of the Audit Findings Report, Baker Tilly acknowledged that they did not have evidence that freight charges were reliably measured: ***"awaiting information to confirm material costs and freight are reliably measured***" [167]: there was no evidence that this further information was provided.

(e) No procedures were undertaken to establish the reasonableness of the labour element added to inventory balances, for example, by considering payroll and transactions. Mr Main agreed with Mr Leech that such a procedure would have provided better evidence – see Joint Memorandum paragraphs 63 - 65.[168]

7.170 Whilst Mr Leech was originally under the misapprehension that there was no evidence that Baker Tilly had tested a sample of invoices to confirm the reasonableness of the freight charges applied by management, he later appreciated that there was a workpaper[169] which recorded "***some limited testing of carriage charges***" but he remained critical of the work which had been done.

Freight Charges - The Respondents' Case

7.171 The Respondents relied upon Mr Main's opinion[170] that the procedures carried out by Baker Tilly gave a reasonable level of assurance as to the reasonableness of the freight charges applied by management, and, as we understand it, also assert that in any event

[167] [F2/49/345]

[168] [D2/5/446]

[169] [G1/1/15A/190.1]

[170] [Joint Statement paragraph 61:D2/5/445]

there was sufficient appropriate evidence to support the reasonableness of utilising those percentages.

7.172 Mr Main noted that the analytical review paper "***RM & Consumables Used AR***" showed that the auditors carried out a specific verification of freight costs by verifying all carriage cost transactions over £15,000 included in one of the carriage cost accounts to the nominal ledger to purchase invoices.[171] The Respondents submitted that when the point was explored with Mr Leech he did not appear to advance any criticism on the assumption that this verification was in fact performed, and referred to Mr Leech's cross-examination[172]:

Mr Turner: If there was in fact substantive verification of carriage costs transactions in excess of £15,000, would that then meet your criticism, Mr Leech?

A. Well, provided the sample was appropriately drawn from this 4.8 million trial balance number and there was an appropriate sample drawn from that, then that would be –

Q. Well, if it was all carriage cost transactions in excess of £15,000 --

A. Yes, and that you could reconcile through to that 4.8 million number, then that sounds -- well, assuming that that gives you a substantial coverage, then yes.

Q. Given the need for costs to reflect both freight, which has been addressed in this page of the working paper, and also making allowance for labour and overhead, can I suggest to you that an end landing of a 10 per cent uplift is not unreasonable?

A. I don't think I can make that assessment. There's not enough really information, really. So it is hard to tell how much that labour and overhead cost particularly in relation to WIP and finished goods would be. It could be 20 per cent, an extra cost, maybe, I don't know.

7.173 The Respondents went on to submit that it was clear as a matter of fact that this verification was performed, as Mr Main explained in paragraph 61 of the Joint

[171] [G1/15A/190.4]

[172] [T3/77]

statement[173] and in his cross-examination,[174] by reference to a verification of freight costs reflected in a ***schedule reference 02.04.00.1a/3***[175], and that his evidence on this issue was robust in response to the suggestion that the information obtained had not been adequate.[176]

Q. But it's not information of the type that Baker Tilly wanted to obtain in respect of the document at G2/25 to address their more general query around the system of reflecting the charge applied by each supplier.

A. From that test they were looking to confirm that the amount of carriage costs included in the value of stock was reasonable.

So they took the total value of the purchases, which they'd identified included items that weren't really purchases, and then they identified all of the carriage and freight cost accounts in the nominal ledger, totalled those up, and said: was that a reasonable percentage to apply to the stock?

Now, as has been pointed out, how do you know those were valid carriage costs? Well, you go back to your work on the profit and loss account, and your work on the profit and loss account says, "We've looked at carriage costs and these are valid because we've looked at all the invoices over £15,000 to prove that those are carriage costs".

So I –

Q. What that doesn't do is provide any evidence as to the 10 and 20 per cent and the application of that across the board that Baker Tilly then applies….

A. What they are doing is proving from that test that those were reasonable percentages to apply. That's what that test is showing.

Now, I agree that it could be better documented.

Q. Yes.

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[173] [D2/5/445]

[174] [T9/213 et seq]

[175] [G1/15A/190.3-4]

[176] [T9/216 et seq]

A. But that's the purpose of the test, and I would have approached it in a similar way but I might have written it down a bit better.

7.174 The Respondents made the point that Mr Leech accepted in cross-examination that it was not unreasonable to allocate freight charges across purchase items in this way[177], and submitted that Mr Leech's suggestion that further procedures should have been undertaken to establish the reasonableness of the direct labour element added to the inventory balance, was a counsel of perfection: Mr [...], in paragraph 169 of his witness statement[178] explained that it would have been impractical to provide an exact freight charge for each item as items would often be delivered together and covered by a single invoice in which the freight charges would not be apportioned: Mr [...] also stated in his witness statement[179] that the note in the Audit Findings Report indicating that Baker Tilly were awaiting evidence that the freight charge was reliably measured was followed up. However, in his oral evidence he stated that his reference to this note in the context of this Allegation was a mistake, since it was actually concerned with a different point – *"**material costs and the freight costs included in those materials within intangible assets"**[180].* Mr Railton also gave evidence that this note referred to intangible assets.

7.175 Reliance was also placed on Mr Main's evidence at paragraph 63 of the Joint Memorandum[181] that labour costs form a small part of overall production costs, so that the risk of material error in relation to the labour element of WIP and finished goods was likely to be low, and in any event the value of labour included in work in progress of "***Upright***" had been addressed in the "***Resolution of Issues Schedule***" at lines 547 to 554.[182]

7.176 In what was apparently a further effort to show that a freight charge of 10% was realistic Mr Main also produced, during the course of the hearing, a further calculation of freight charges at 12.2%, which was based on the same trial balance as that used by Baker Tilly.[183]

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[177] [T3/74-75]

[178] [C/1/34]

[179] [Paragraph 168]

[180] [T8/144]

[181] [D2/5/446]

[182] [F2/57/18]

[183] [T10/137]

7.177 Mr Main explained, when questioned on this issue by the Tribunal, that this did not itself suggest that Baker Tilly's calculation of freight charges as 8% was incorrect since (as set out at paragraph 7.130 above) their own working paper recognised that this was not in fact the right number as further costs (such as labour costs) had incorrectly been included in the figure for purchases and needed to be excluded in order to calculate the actual percentage of freight costs as a proportion of purchases.[184]

7.178 It was further submitted that whilst in cross-examination Mr Main had agreed with Mr Leech's proposition that procedures should have been undertaken to establish the reasonableness of the direct labour element added to inventory balances by considering payroll end transactions[185], he stated that there was documentation in the analytical review of stocks which showed that the labour element of stocks was considered – though he did not point to any evidence that it was taken into account by Baker Tilly in the present context.[186]

7.179 The Respondents submitted that since the question was ultimately whether there was sufficient appropriate audit evidence, Mr Main's work was directly relevant to the reasonableness of Baker Tilly's conclusions, that his calculation of 12.2% provided direct support for the view that the freight charges were in fact reasonable, and that his evidence that the residual extrapolated variance (of approximately £250k) would not require further investigation was plainly correct[187].

Freight Charges - Falling Short – Conclusions in Relation to Baker Tilly

7.180 Executive Counsel's response[188] to the evidence provided by the working paper referred to in paragraph 7.172 above and to Mr Leech's evidence in relation to it, was that the suggestion put to him (in paragraph 7.172 above) that all freight costs had been verified through to £4.8m was incorrect, as in fact only £2m carriage costs had been identified, which left a substantial balance untested, and that in any event none of the factual witnesses gave evidence about this, and there was no evidence that this was how Baker Tilly approached the issue at the time: Mr Main's thesis was undermined by the fact that, as already stated, at the time of the Audit Findings Report, Baker Tilly acknowledged that they did not have evidence that freight charges were reliably measured: Mr Main

[184] [T9 234]

[185] [T9/223]

[186] [T9/227]

[187] [T10/163-164]

[188] [T11 /88]

acknowledged that he was putting matters together for himself after the event and that there was no evidence on the audit file to suggest that this was Baker Tilly's reasoning.

7.181 In response to Mr Main's assessment of freight charges at 12.2%, the Executive Counsel pointed out that in the course of giving evidence, Mr Main in attempting to justify, ex post facto, the standard 10% or 20% freight charge by reference to various documents in the audit file, had on Day 9 suggested, for the first time, that the freight charge might be as high as 12.4%[189] and on the following day recalculated this to be 12.2%: this was not the percentage which management or Baker Tilly used at the time. Mr Main acknowledged that his figure for freight charges was the result of his putting matters together for himself after the event and that there was no evidence on the audit file to suggest that this was Baker Tilly's reasoning. Executive Counsel submitted that Mr Main's approach did not further the Tribunal's understanding of whether and if so how Baker Tilly assessed the reasonableness of the 10% or 20% freight charges at the time.

7.182 Executive Counsel referred to the following exchange, dealing with the provenance of Mr Main's 12.4% figure, as illustrating the point[190]:

A. So Mr Leech and I both had a go at working out what the freight percentage was, and you'll remember that I said 10 per cent and Mr Leech said 8 per cent.

Q. He took the auditor's figure of 8 per cent from their reasonableness check?

A. Yes, and then I looked at the line below and saw in the line below that the auditors had made the point that that -- they'd started off with the wrong figure on the top line, because that figure included a labour element. So after we'd gone away and done the joint report, I thought, well, let's see if I can get any closer.

Q. Yes.

A. And is there anything on the file that would get me a bit closer? And that is when I did this exercise to see whether my 10 per cent was realistic or whether really it was more than 10 per cent or less than 10 per cent. That's how I did this and why I did it.

Q. I understand. And you're not suggesting this was an exercise that was done at the time?

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[189] [T9/210]

[190] [T10/143-144]

A. No, no.

Q. No. And so it doesn't help us as to how the auditor assessed reasonableness of freight at the time, does it?

A. Well, can I just go back on what I've just said, and I think I said no too quickly, because obviously they have said on the working paper that the total included labour costs. So they've identified that the total did include labour costs. What they haven't done is written the calculation down. So I'd qualify my comment on that. So they haven't done the numbers, they haven't documented the numbers, but obviously they had identified that there was labour costs in there.

Q. But they haven't identified how much in the way of labour costs, have they?

A. No, they haven't written that down.

Q. All they've written down is it includes labour costs; they haven't said how much or said they've done any calculation to assess that at all.

A. No, I agree, they haven't documented that.

Q. No. So this doesn't help us, does it, this exercise you've now done after the event as to how the auditor assessed reasonableness of freight at the time?

A. At the time, no.

7.183 In their oral closing submissions[191] the Respondents accepted, in the context of the issues concerning freight charges, that there was no evidence that Baker Tilly itself carried out further procedures based on the evidence available to them in order to support the conclusion that there was reasonable evidence as to the valuation of inventory, but submitted that the Tribunal had to consider whether a reasonable auditor could have concluded that there was sufficient appropriate audit evidence to support the valuation of inventories, and relied on Mr Main's evidence as providing an affirmative answer. However, for the reasons given in paragraph 2.27 to 2.28 above, we do not consider Mr Main's ex post facto reasoning to be the end of the matter, the relevant enquiry being as to the basis upon which Baker Tilly formed its opinion in relation to the freight charges applied by management.

[191] [T11/140]

7.184 Mr [...]'s evidence of the impracticability of ascertaining the exact freight charges for each item is plainly correct, but is really beside the point. We consider there to be substance in the criticisms advanced by Executive Counsel which are set out in paragraph 7.169 above (leaving aside sub-paragraph (d), which may be based on an erroneous factual assumption as to the application of the note – see paragraph 7.174), and subject to paragraph 7.170, and we do not accept the suggestion that it was to be inferred that Mr Leech was satisfied of the adequacy of the "***verification test***" referred to in paragraph 7.174 above, since the evidence relied upon by the Respondents was somewhat hypothetical. As noted at paragraph 7.169(d) above, Executive Counsel relied on the note in the FAF as evidence that there had been no adequate follow-up, and Mr [...] in his oral evidence stated that that note actually related to a different topic - see paragraph 7.174 above.

7.185 In his report, Mr Main stated that Baker Tilly had sought to gain assurance that the freight charges were reasonable, and he did not see what more Baker Tilly could have been expected to have done[192], but he was under the impression[193] from paragraph 168 of Mr [...]'s witness statement that management had confirmed that the freight charges were reliably measured whereas, as stated in the last paragraph, in his oral evidence Mr [...] stated that that evidence was mistaken. Thus there is no contemporaneous evidence that management confirmed that freight charges were reliably measured, and the statement in Mr [...]'s witness statement that the freight charges issue had been followed up is unreliable and cannot be accepted. It follows that Mr Main's conclusion[194] that sufficient evidence had been obtained in relation to the errors found in the sample was based on a false premise, and we reject that conclusion. Further, we take the concession made by the Respondents' counsel, referred to in paragraph 7.183 above, to mean that the only evidence taken into account was that referred to by Mr [...] in his witness statement, namely the results of the tests reflected in the "Stock subs" work paper[195] and the reasonableness test.

7.186 The lengths to which Mr Main went, following the delivery of his report, and as reflected in the Joint Statement and his oral evidence, to find other evidence to support the freight charges applied by management is a clear indication that he considered that Baker Tilly's audit work in respect of freight charges was inadequate. We consider that this aspect of

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[192] [Paragraph 7.4.7: D2/3/294].

[193] [paragraph 7.3.8:D2/3/291]

[194] [Paragraph 7.5.1:D2/3/296]

[195] [F2/42/292]

the audit was very poorly executed. No reasonably competent auditor would have been satisfied that the evidence relied upon by Baker Tilly was sufficient to enable it to be satisfied as to the validity of the management's 10% freight charge assumption. We consider and find that in relation to this issue that Baker Tilly failed to comply with paragraph 2 of ISA 500 and with the fundamental principle of professional competence and due care and their work fell below the standard reasonably to be expected of a Member Firm.

Freight Charges - Falling Short – Conclusions in Relation to the Engagement Partners

7.187 Neither Mr King nor Mr Railton had any recollection of any issues about freight charges - both effectively disclaimed any knowledge of the subject issue.[196] On behalf of the Respondents it was submitted that the Tribunal should in any event accept Mr Main's evidence that he would not consider that an engagement partner would be required (and he would not expect such a partner) to review an audit working paper recording the procedures undertaken. It was not suggested to Mr Main or to Mr King or Mr Railton that either or both of the engagement partners should have reviewed the "***Inventories Substantive Testing***" paper[197], and therefore it followed that, even if there were failings in respect of this part of the audit, this cannot support a conclusion that Mr King or Mr Railton fell short of the relevant standards.

7.188 We accept that that submission would be sound in ordinary circumstances, but for the reasons given in paragraph 7.44 to 7.46 above, we consider that both Mr King and Mr Railton should have carried out a sufficient review of Mr [...]'s work to confirm that he was discharging his duties adequately, and if they had done so they would have discovered that he was not. Mr [...] should have picked up the errors manifest in the working paper referred to in the last paragraph, and had Mr King and Mr Railton been alert to his failings, the errors in that paper would have come to their attention – either directly from their own review or at least indirectly once it became clear that Mr [...] was not picking up significant errors in the work of other members of the engagement team.

7.189 Accordingly, we find that in relation to this issue both Mr King and Mr Railton failed to ensure that Baker Tilly and they themselves complied with the ISAs and the fundamental principle referenced in this Allegation (1) and in this respect their conduct of the audit fell short of the standards reasonably to be expected of them.

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[196] [T6/223 T7/187]

[197] [G2/25]

Other Variances

Other variances – the Issues

7.190 This heading refers to the complaint in sub-allegation 1.2(a)(iii) that there was no explanation on the audit file for any of the other discrepancies – i.e. those discrepancies which could not reasonably be explained on the basis of freight charges, namely the 23 items in the sample of 38 which were tested in relation to which the differences were neither 10% or 20%, one striking discrepancy being the X32 CE MACH (line 47).

7.191 In fact two of the 23 were the "***isolated errors***" referred to above, in ten cases the differences were less than 5%, and four of the remainder were recorded on the stock list at less than their invoiced price.

7.192 In the Respondents' oral closing submission[198] it was simply contended that this issue is out with Allegation 1.2(a). We do not consider that it is – see paragraph 7.137 above.

7.193 Executive Counsel submitted that Baker Tilly had not attempted to follow up these 23 variances, which could not be explained by the 10% or 20% freight charges, that Baker Tilly had no explanation for them and that accordingly in this respect sufficient appropriate audit evidence had not been obtained.

7.194 The fact that there was no explicit evidence that these variances were investigated by Baker Tilly is not disputed. However, Mr Main's opinion was that that whilst, ideally, more tests would have been performed[199] this was if you were going to "***gold plate***" the exercise and that he did not think that a reasonable auditor would have done them – Baker Tilly had got a reasonable level of assurance from the work which had been done.

Other Variances - Executive Counsel's Case

7.195 Executive Counsel submitted that any suggestion that there was sufficient evidence on the audit file and that Baker Tilly had addressed this issue was speculation on Mr Main's part: no analysis and no audit tests were performed at the time by the Engagement Team. Mr Main was forced to acknowledge this.

"Q. You have to speculate about how to explain those differences, because you just don't know. Look at 7.4.14: "Having reviewed the findings from the audit

[198] [T11/ 70]

[199] [Joint Statement paragraph 67;D2/5/447]

procedures, I consider it is likely that the differences highlighted were explained by the factors highlighted above, i.e. use of the average cost basis, movements in currency exchange rates, and the correct inclusion of freight charges." But you don't know that, do you? You can't tell.

A. I would find it surprising if all they agreed.

Q. But you can't tell.

A. If they didn't include those factors, then I would be surprised, because you would expect those differences, you would expect some small variances as shown on here because of things such as that, because of these factors. So no, I haven't gone back and verified that that was the case, but I would be surprised if it wasn't.

Q. I'm not saying to you that the differences didn't include some element for those factors.

A. Yes.

Q. What I am saying to you is that you cannot say whether there were other factors that may have also explained the differences.

A No, no, agree.

Q. Because the auditor just hadn't done any work around whether there were other reasons for those differences.

A. No.

Q. Correct?

A. Yes.

The Chairman: Does it really boil down to this: the only explanation you can find is the one which you've advanced, therefore you assume that must have been the reason?

A. I would be amazed if part of those differences weren't for those reasons. You would not expect them to all agree because you're comparing apples and pears. You're comparing the latest purchase invoice to some -- some of the items will be on an average cost basis and some of those may vary a little bit, which, as you can see, you have some small fluctuations there on a number of the items, and it could

be items such as that causing that. But there could be other reasons, I agree. But then when I've done my extrapolation -- I accept the extrapolation on the file is wrong, but when I've done my extrapolation it shows that it was within a reasonable tolerance from the evidence you'd expect from a test such as this.

The Chairman: In fact, you have done your own audit.

A. Yes, I have audited the audit, yes."[200]

Other Variances - The Respondents' Case

7.196 Mr Main described the allegation as "***somewhat illogical as there was actually no attempt to conclude that all the variances identified related to freight charges (indeed there was very little attempt to explain the variances at all), the suggestion that the remaining variances related to freight charges appearing to be an assumption made by Mr Leech, rather than being based on any explicit comment on the audit file.***"[201]. Mr Main considered it likely that they were explained by one or more of a number of factors: for example, the use of the average costs basis or movements of currency exchange rates or the combination of these factors plus the freight charge.[202]

Other Variances - Falling Short - Conclusions in Relation to Baker Tilly

7.197 These variances were small, but these items formed part of a sample which Baker Tilly had chosen to test. We are satisfied and find as a fact that Baker Tilly did not seek or obtain any explanation for them; in our judgment no reasonably competent auditor acting with reasonable care and skill, having embarked on such an exercise, would fail to complete it. We consider that the complaint of a failure to comply with paragraph 2 of ISA 500 and the fundamental principle of professional competence and due care is made out and in this respect Baker Tilly's conduct of the audit fell short of the standards reasonably to be expected of a Member Firm.

[200] [T9/224 – 226]]

[201] [paragraph 7.4.13; D2/3/295].

[202] [paragraph 7.4.14: D2/3/295]

Other Variances - Falling Short - Conclusions in Relation to the Engagement Partners

7.198 For like reasons to those set out in paragraphs 7.44 – 7.46 above, we consider and find that in relation to this issue Mr King's and Mr Railton's conduct of the audits fell short of the standards reasonably to be expected of them.

Allegation 1.2(b) – Valuation of TES inventories – Inventory Obsolescence

The Allegation

7.199 Sub-Allegation 1.2(b) is that:

> ***"(a) in relation to the audit of TES, the Respondents failed to obtain sufficient appropriate audit evidence of the valuation of inventories in that (b) Despite recognising in the Final Audit Findings document that inventory levels needed to be monitored against forecast demand to ensure stock levels were appropriate and despite a significant increase in inventory levels, the Respondents failed to carry out testing designed to identify whether there were any issues with slow moving or obsolete inventory."***

Inventory Obsolescence - The Issues

7.200 In the Audit Findings Report[203] Baker Tilly recorded that the Group was carrying a significant amount of stock at year end, stock levels having increased from £14m in 2006 to £60m in 2007, £24m of which was attributable to the acquisition of Snorkel. It was common ground that the bulk of the £60m, after deduction of the £24m, would be found in TES.[204] Hence the increase in the stock in TES since the previous year would have been of the order of £22m.

7.201 As already stated, in addition to assessing inventories as a significant risk in the KIT, Baker Tilly's Audit Plan[205], presented to the Tanfield Audit Committee on 6 December 2007, identified "***Stock holding***" at TES as a "***key area of audit focus/risk***" and also recorded: "***Stock is expected to be a highly significant figure within the group Balance Sheet at 31 December 2007. A risk associated with this high stock holding is the risk of damage and obsolescence.***" Similar observations were made in the Audit

[203] [F2/49/330-333]

[204] .[T3/109]

[205] [G1/1/13]

Review Programme, in which Stock holding was identified as a "***potential problem***"[206]. Ms [...] and Mr [...] prepared the KITs[207] showing that they considered this area to be an area of "***significant risk***", and in their evidence they confirmed that that was their view.

7.202 Again, as already noted but of less significance, both the "***Assembly of Audit Confidence***"[208] and the "***Working Assembly of Audit Confidence***"[209] audit work papers record that Baker Tilly assessed inventories as "***high risk***".

7.203 It is not in dispute that the Respondents planned to carry out a substantive test of detail to address the risk of obsolescence:

"***We will also review the stock listings as at the year end and ensure that all damaged stock items are separately identified. Further, we will ensure that all stock lines which are of "significant age" have been adequately provided against.***" (Planning Memorandum[210]).

7.204 Again, it is common ground that this test though planned was not carried out - the Joint Memorandum at Paragraph 72[211] records that the experts agreed that the Audit Plan[212] "***identified a procedure to consider the adequacy of stock lines of significant age provided against"*** and that this specific ageing test was not carried out.

7.205 It appears that neither Mr King nor Mr Railton checked that the planned test had been carried out. Mr King stated that he "***was not aware that***" the planned test had been carried out, and that he did not check whether it had[213]. Mr Railton stated that he did not know that that test had not been carried out[214].

7.206 As appears from paragraphs 7.207 – 7.213 below, the audit documentation undoubtedly indicates that Baker Tilly gave some consideration to the risks of obsolescence.

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[206] [G1/8/91].

[207] [C/4/114 and C/5/125]

[208] [G1/7/79]

[209] [G1/11/162]

[210] [G1/8/91]

[211] [D2/5/447]

[212] [F/1/13] and G1/8/91]

[213] [T6/196]

[214] [T7/155]

7.207 A working paper entitled "***Review_ of_ stock _lists***"[215], a part of the Analytical Review, includes a note recording that "***The stock listings as at 31 December 2007 have been compared to those on 31 December 2006. All significant stock lines added or removed and all stock lines which do not appear to have moved during the period have been discussed with the client as detailed below***". The various listings, six in all, are recorded as having been reviewed and each is accompanied by a short comment, which, it is to be inferred, reflect the discussions with Tanfield.

7.208 Another paper from the Analytical Review, the "***Review of detailed listings***" working paper[216], includes annotations which were substantially the same as those in the working paper referred to in the last paragraph, but with an additional comment (relating to SEV stock) that the vehicles in question had "***long service lives so that obsolescence was not considered a significant risk***", and a note at lines 137 and 138 that "***Due to the significant increase in Upright Operations throughout the year and the significant lead times preventing a reduction in stock quantities being delivered the RM's holdings are significantly higher than in the prior year.***" Both papers included a note referring to "***lead times preventing a reduction in stock quantities.***"

7.209 The "***Stock turn unit costs***" paper[217], again a part of the Analytical Review, included a review of the Stock turn at TES and SEV.

7.210 In respect of the Tanfield Lea site, a working paper[218] prepared by Ms [...] for the stocktake includes a note that Tanfield had informed her that there was no obsolete stock, and that the client was not aware of any slow moving lines. In her oral evidence she stated that she did no detailed testing in relation to obsolescence, though she looked for damaged items on site.[219] In short, she relied on what management had told her, as recorded in her note.

7.211 A working paper entitled "***Increase of Inventories***"[220] and headed "***SIGNIFICANCE IN INCREASE IN INVENTORY LEVELS***" refers to the increase from £14m to £60m, an increase of 326%, and records:

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[215] [G1/19/202]

[216] [F1/32/250]

[217] [F1/33/253]

[218] [G2/26/224 @ 226]

[219] [T5/63].

[220] [F1/29/217]

"*This represents a significant increase, however it is considered that this is reasonable in line with the overall growth in operations of the group….The stocktakes were attended as planned with no significant differences noted…. No obsolescence issues were identified requiring further stock provision."*

7.212 A note entitled VIGO AVANTE STOCK SYSTEM PROCEDURES[221], which is stated to have been updated ***"per discussion with [...] (Stores manager) on 20 December 2007"***, addressing the procedures applied at the Vigo site included a heading "***Damaged/Obsolete stock***". The paper discussed, at lines 58 – 69, Tanfield's processes for dealing with obsolete parts, noted the role in the process performed by the store manager, and included the comment:

"***Parts for obsolete machines are likely to still have value as spares are required. These are therefore transferred to the spare parts store and will then be written down if there is no movement over a prolonged period of time, Similarly if there are large quantities which are unlikely to be sold they will be written down. This is in the discretion of the stores manager***".

7.213 A working paper "***Group_AR_-_Inventories***"[222] includes the following note:

"***RMs totalling £6.7m .. were rec'd in the last two months of the year which could not be cancelled due to late production decisions being made. These RMs will be used although failure to communicate the decisions regarding 08 production plans has lead to significant overstocking.***

TES is overstocked on the RMs …because the sales forecasts for 2008 reflected a change in priorities compared to those of 2007. As a result the RMs were ordered in incorrect quantities and could not be stopped due to the significant lead times with suppliers.."

7.214 Mr [...]'s evidence at paragraph 171 of his witness statement[223] was that whilst the overall level of stock at TES increased between the end of 2006 and the end of 2007, this was due to a deliberate increase in stock as a result of growth that was forecast for 2008, and partly also due to a change in priorities which meant that TES was overstocked for raw materials for some Upright lines***.***

[221] [E1/295]

[222] [F1/31/225 @ 230]

[223] [C/1/35]

7.215 The Final Audit Findings document[224], presented to the Audit Committee on 28 February 2008, records that Baker Tilly had not identified any stock obsolescence issues and includes advice that stock levels should be monitored against forecast demand to ensure stock levels were appropriate.

7.216 The Executive Counsel submitted, on the basis of the evidence of Mr Leech, that:

(a) the consideration of whether there were any obsolescence issues should have involved, for example, reviewing stock ageing reports, reviewing recent dispatches, looking for evidence of parts held for models either no longer in production or outsourced[225];

(b) in fact no substantive tests in relation to obsolescence were carried out; and

(c) In the premises no sufficient appropriate audit evidence had been obtained.

7.217 On the basis of the evidence of Mr Main, the Respondents submitted that :

(a) The risk of inventory obsolescence had been overstated by both Mr Leech and Executive Counsel – the risk was low;

(b) It was to be inferred that Baker Tilly had made an audit judgment that valuation and obsolescence was not considered a significant issue at the year end; and

(c) Baker Tilly, whilst not carrying out the planned test, had in fact assembled other sufficient appropriate audit evidence upon which it was entitled reasonably to conclude that the valuation of inventories was not affected by slow moving or obsolete inventory holdings.

7.218 They further submitted that as the gist of the allegation 1.2(b) related to whether a reasonable auditor would have carried out further testing, it did not matter whether or not Baker Tilly in fact took into account the evidence relied upon by Mr Main, but it was evident that they had.

Inventory Obsolescence - Executive Counsel's Case

7.219 In addition to the submission set out in paragraph 7.216 above, Executive Counsel also referred to the comments in the "***resolution***" column of the Final Audit Findings Report,

[224] [F2/49/339]

[225] [D1/1/76 paragraph 4.3.94]

presented to the Audit Committee on 28 February 2008, in response to the risk of obsolescence, that:

"The remainder increase is due to group stocking up in order to meet forecast demands for the forthcoming year.

The stocktakes were attended as planned with no significant differences noted

No obsolescence issues were identified requiring further stock provision"

7.220 These comments, it was submitted, were incomplete, inaccurate and misleading in that:

(a) No reference was made to the fact that the planned tests of detail had not been performed.

(b) The reference to obsolescence issues not being identified was misleading, as it suggested that tests of detail had been performed, although none were.

(c) There was little audit evidence of the Group *"**stocking up in order to meet forecast demands**".*

(d) No reference was made to the reasons for "***overstocking***" referred to in the Vigo analytical review discussed below (i.e. issues of "***late cancellation***" and "***changes in priorities***", etc.).

(e) The assertion that no significant differences were noted in the stocktakes was inaccurate. Differences were noted. It was also misleading. The stocktakes were not designed to, and did not, address obsolescence.

7.221 The assertion that the FAF was misleading does not fall within the terms of the Allegation. The comments within the FAF are relevant but only as evidence relating to the Allegation. The comment "***no obsolescence issues etc"*** appears to have been lifted from a note made by Mr [...] on the work paper entitled "***Increase in Inventories***"[226]. In relation to that note Mr [...] explained[227]:

"***The gist of what I was trying to say was it's not intended, obviously, looking at it -- it's not audit evidence to support a particular number, it's not corroborating***

[226] [F1/29/217]

[227] [T6/120]

anything, it's not saying this is proving that something's right. It was -- brainstorm was the best way I could think to describe it, to be honest."

7.222 Mr [...] explained that the reference to ***"no obsolescence issues were identified requiring further stock provision***" was a reference to his understanding that the client had a procedure in place which would have identified obsolete or damaged goods and he and Mr [...] did not see anything ***"to the contrary or any issues that hadn't been dealt with by the client's process."***[228]

Inventory Obsolescence - The Respondents' Case

7.223 The Respondents referred to the fact that the allegation itself alleges specifically that they had "***failed to obtain sufficient appropriate audit evidence of the valuation of inventories in that … [they] failed to carry out testing designed to identify whether there were any issues with slow moving or obsolete inventory***", and submitted that this allegation was demonstrably wrong.

7.224 Mr Main's position was set out in paragraph 76 of the Joint Memorandum:[229]

"***Mr Main's view is that the auditors had implicitly and reasonably made an audit judgment that valuation and obsolescence was not considered a significant issue at the year-end based on enquiries made of management, the continued strong performance of the Tanfield Group at 31 December [2007], the fact that the increase in inventory values had been rationalised through their analytical procedures (including a specific consideration of movements in higher value inventory lines on working paper TES 02.10.00.3a/1 and the fact that the auditors identified that the inventory ratio to cost of sales at TES had fallen from 47.3% in 2006 to 45.64% in 2007), and evidence obtained from observations at their stocktake attendance.***"

7.225 As noted at paragraph 7.207 above, the paper referred to in the last paragraph[230] includes the note that ***"The stock listings as at 31 December 2007 have been compared to those at 31 December 2006. All significant stock lines added or removed and all stock lines which do not appear to have moved during the period have been discussed with the client …"***

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[228] [T6/122/3]

[229] [D2/5/448]

[230] [G1/19/202]

7.226 In relation to Executive Counsel's submission that there was no evidence that the Respondents made any such judgment, and no evidence that they considered the factors identified by Mr Main, and that this was another example of Mr Main seeking to fill in the gaps in the audit file, whilst Mr Main acknowledged as much in evidence he confirmed that the evidence to which he referred was on the on file[231]:

"Q. But just coming back to the point about your use of the word "implicitly" –

A. Yes.

Q. -- you have had to reconstruct after the event what you think the judgment must have been by reference to documents that you've identified?

A. The judgment wasn't written down.

Q. No.

A. I've accumulated the evidence myself –

Q. Yes.

A. -- and looked on the file myself to see what the evidence was that might have supported the opinion that is given in the report to the audit committee. But, yes, I can say that I've seen nothing that pulls it all together in the audit file.

Q. So you have put together the evidence yourself that you believe would justify a judgment in circumstances where, however, the judgment is not identified on the file?

A. Yes, yes, it's not documented on the file.

Q. No.

A. But the evidence is there on the file."

7.227 In relation to the fact that Baker Tilly had not carried out the planned test, Mr Main said in his oral evidence[232]:

[231] [T10/21-22]

[232] [T10/18-19]

"If they could do the test then I don't know why they didn't do the test. It would have been a good test to identify all the stock. But they did do an alternative test, I think, as we've identified in the joint statement, in that they looked at the stock at the end of the previous year and at the end of the current year to identify if there were any items on there within the higher value lines which hadn't moved, which goes part of the way, I think towards addressing the existence of slow-moving stock, because it identifies those that hadn't moved".

7.228 In paragraph 7.10.1 of his report, Mr Main stated that *"**Baker Tilly reasonably concluded that the potential for obsolete, damaged or old inventory was low, especially given that a lot of new stock had recently been acquired to meet predicted increased sales and until June 2008 post year-end sales continued to be very healthy. On this basis, the audit enquiries made at the date the Tanfield financial statements were signed on 21 April 2008 were sufficient to allay concerns that significant provision against slow moving inventory was required at that date.**"*

The level of risk

7.229 The Respondents submitted that there were many objective indications which – at a high level – would contradict any basis for believing that the risk of obsolescence might be high. By way of example:

(a) In the file note[233] which he sent to Mr King on 3 October 2007[234], the preceding group engagement partner, Mr […], concluded[235] that:

"Lower of cost and NRV was tested by reference to obsolete stock – risk is reduced because Tanfield generally make to order. One issue arose where an order fell through. However Tanfield were able to subsequently sell this stock through at an amount above costs. Components of raw materials can generally be used on many stock items and therefore the risk of obsolescence on RM is low. In addition, because Tanfield sell significant service and maintenance contracts, a lot of older component parts can be used through this work …"

[233] [E1/66]

[234] [E1/65]

[235] [E1/68]

(b) The inventory ratio to cost of sales had decreased – see the quotation from the Joint Statement at paragraph 7.224 above.

(c) The ratio of stock to turnover had actually decreased slightly for TES and Mr Leech in his evidence[236] had commented that a significant increase in the ratio would be an indicator of obsolescence.

(d) The period in which, on average, all the stock held is used up ("***stock turn***") had reduced.[237] Mr Leech accepted that there had been a 25% reduction in the raw materials stock turn period at TES; and that a much more modest perceived reduction for the stock turn period at SEV ***"[contra-indicated] the existence of a significant risk in relation to obsolescence"***.[238] (In fact there was no such reduction in relation to SEV)[239].

7.230 The Respondents further relied on:

(a) the evidence of Mr, [...] referred to in paragraph 7.214 above.

(b) The minutes[240] of the Audit Committee meeting which note that: ***"The significance of the value of stock was also discussed although no audit evidence was identified with regard to stock obsoletion [sic] issues. The Audit Committee were happy with the levels of stock based on the ramp up of production to meet expected future demand"***.

(c) The interview of Mr [...] by the AADB, in which he gave evidence[241] that TES had stocked up deliberately to meet on-going demand – as it was considered that a lack of available inventory was constraining the business.

The Evidence on the Audit File.

7.231 The appropriate starting point, it was submitted, was to consider the overall evidence on the audit file relating to this issue. As to this:

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[236] [T3/142-143]

[237] [F1/33/253]

[238] [T3/126]

[239] [T3/126,7]

[240] [F2/52/395]

[241] [J2/6/574/5]

(a) The audit planning documents included comments which show consideration at the planning stage of the level of risk of inventory obsolescence occurring – see paragraph 7.201 above.

(b) Mr Main in Paragraph 7.9.1 of his report[242] stated that the detailed analytical review gave reasoned explanation for changes in the overall inventory levels, and that therefore the increase in inventory levels in itself did not give rise to concerns about slow moving or obsolete inventory, a large part of the increase having arisen from an overstocking issue as a result of over order of raw materials in December 2007 – which clearly did not represent slow moving stock. As indicated above, Mr Main particularly referenced the working paper entitled Review of detailed listings[243].

(c) Whilst the working paper, part of the Analytical Review, "***Group_AR – Inventories***"[244] in respect of TES (see paragraph 7.213 above) recorded a variance of 36% between the audit team's expectations of value and the actual value at the year end, in Mr [...]'s witness statement, at paragraph 110, it was stated that the audit team considered the explanations for those variances and obtained corroboration for those explanations.[245]

(d) The analytical review procedures were supported by the stock turn working paper referred to at paragraph 7.209 above[246]. It was common ground and was accepted by Mr Leech that the stock turn was relevant to the consideration of the risk of obsolescence.[247] Mr King's evidence was that he was specifically aware of the stock turn work that supported the analytical review, and that this was part of the overall material he took into account.[248]

(e) The working paper describing the stock system procedures[249] (see paragraph 7.212 above) concluded (for the reasons explained in the body of the text) that *"**the total damaged stock included in the listing is negligible**"*. Paragraph 172

[242] [D2/3/299]

[243] [F1/32/250]

[244] [F1/31/225]

[245] [F1/31/225 and A/2/44 paragraph 63]

[246] [F1/33/0253]

[247] [T3/117].

[248] [T6/192]

[249] [E1/295]

of Mr [...]'s witness statement[250] referred to this note and records that ***"This was supported by discussions with the client that indicated that the total damaged stock was negligible."***

(f) In respect of the Tanfield Lea site, the working paper for the stocktake (prepared by Ms [...] and referred to in paragraph 7.212 above) recorded that:

"***The client informed me that there was no obsolete stock and no stock damaged beyond repair included in the stock holding area and hence on the system. Due to the nature of the stock… damage is rare. If an item is damaged, and it is Tanfield's fault, the items are scrapped and written off. If an item is damaged on delivery it is returned to the supplier***".[251]

(g) The TES "***review of detailed inventory listings***" working paper[252] (referred to at paragraph 7.208 above), a key working paper in the context of stock obsolescence, included detailed review notes on specific items of stock. Mr Leech accepted that, although he had not referred to this paper, anyone who read the paper would have appreciated that it was relevant to the issue of potentially slow-moving stock or obsolescence.[253]

(h) The TES "***Increase in inventories***" working paper[254] referred to at paragraph 7.211 above, provided evidence as to obsolescence. The paper considers the increases in stock, and records that no stock obsolescence issues were identified requiring further stock provision. Mr Leech accepted that this paper, although in part relating to the issue of going concern, was also relevant to the issue of stock obsolescence.[255]

7.232 The evidence of Mr Leech and the case against the Respondents were criticised on the ground that his reports had been developed without regard to ***"many of the key documents on* the *audit file"*** (presumably those referred to in the last paragraph) which relate to the consideration of obsolescence, and that to address the flaws in Mr Leech's reports, and thus in the case advanced, both the Executive Counsel and Mr Leech had

[250] [C/1/35]

[251] [G2/26/226]

[252] [F1/32/250]

[253] [T3/121]

[254] [F1/29/217]

[255] [T3/129]

sought belatedly to focus their case on an assertion that a planned test for obsolescence was not performed.

7.233 The Respondents also drew attention to the fact that, on its face the "***Review of detailed listings***" work paper[256] (paragraph 7.208 above) includes the note *"**discussed with the client as detailed below***[257]. The reference on that work paper shows that it was prepared to address an aud-IT test (referred to as "***test 3***") specifically directed to the issue of stock obsolescence.

7.234 Reference was also made to the fact that in his re-examination Mr Main was handed the controls of aud-IT and then taken to a test[258], which he explained:

"Q. So test 3 is what?

A. "Review the schedules of inventory and obtain, record and check management explanations for:

"Inventory lines added or removed during the period;

"Inventory lines which do not appear to have moved during the period;

"Inventories not in current use."

Q. …Could you see if there's any document associated under those tests.

A. Inventories -- it's the one we've just referred to,

"Inventories AR review of stock lists", which is the reference 02.10.00.3.A-1.

….

Q. What would you understand the purpose of such test to be?

A. To identify obsolete stock.

Q Could you just look at the information tabs in relation to those three subtests of test 3, to see whether those tests were recorded as being completed or not.

[256] [F1/32/250]

[257] [F1/32/250 lines 8-10]

[258] [T10/171-173]

A. Completed by [...] and approved by [...].

Q. That's for 3A. Could you look at 3B, please.

A. Completed by [...] and approved by [...].

Q. And 3C?

A. Completed by [...] and approved by [...]. "

7.235 The Respondents submitted that in light of the evidence as a whole, the allegation of a failure to obtain sufficient appropriate audit evidence of inventory valuation by failing to carry out relevant tests designed to address stock obsolescence issues must be rejected: overall, the enquiries undertaken were more than adequate.

Was the Evidence Taken Into Account

7.236 That that evidence was taken into account by Baker Tilly is, it was submitted, evident from:

(a) the factual evidence, for example:

(i) Mr King's evidence was that his views on obsolescence derived from a number of work papers and his understanding of the business and that he took everything into account in reaching a view;[259] and

(ii) Mr Railton's evidence in his witness statement at paragraph 111 that the stock was new so that "***obsolescence was unlikely to be a risk"***[260]*.*

(b) The aud-IT system itself (as was clear from the passage of re-examination referred to in paragraph above).

Inventory Obsolescence – Falling Short - The Tribunal's Conclusions in Relation to Baker Tilly

The Correct Approach

7.237 As appears from paragraph 7.218 above, the Respondents again contended that if during the audit sufficient appropriate audit evidence had been gathered by Baker Tilly it did not

[259] [T6 194]

[260] [C/2/71]

matter if Baker Tilly did not in fact take it into account. We addressed and rejected this contention in paragraphs 2.24 to 2.26 above.

The Level of Risk

7.238 Mr [...] in his witness statement at paragraph 76[261] stated that he was not aware of any heightened risk of damage or obsolescence – "***The increased stock reflected the expected demand for products in 2008; the stock was new and it was expected that it would be turned over quickly."*** Mr Railton in his witness statement[262] whilst acknowledging that with stock there was always a risk of obsolescence ("***that is that the product becomes unsaleable due to technical changes"),*** stated that it was not a significant risk for the group: the increase in stock represented a gearing up for and delivering growth: the stock was new so obsolescence was unlikely to be a risk. In oral evidence he stated that the recognition of obsolescence in the audit plan as an area for audit attention was because the increase in inventories was "***a big number****."*[263].

7.239 In our opinion any reasonably competent auditor discharging its duties with reasonable care would have shared Mr Railton's view that the increase in inventories was a large number which needed to be considered with particular care, but would regard his reasoning for concluding that obsolescence was unlikely to be a risk as incomplete, in failing to encompass the risks of overstocking and of slow moving stock.

7.240 As noted at paragraph 7.229 above, the Respondents advanced various reasons as to why, as Mr Main asserted, Baker Tilly might reasonably have regarded the relevant risk as being low.

7.241 As to the views which a reasonably competent auditor exercising reasonable care would have taken of those reasons, we consider that:

(a) Management's explanation (see paragraph 7.213 above) that the enormous growth in stock between the ends of 2006 and 2007 was the deliberate consequence of purchases to meet forecast growth in 2008 would not by itself, and even with corroboration, be a justification for regarding the risk of obsolescence as low. The reference to overstocking for raw materials on some

[261] [C/1/15]

[262] [Paragraph 111 : C/2/71]

[263] [T7/155]

Upright lines is evidence of slow moving stock and would signal a potential area of risk of obsolescence.

(b) Mr [...] evidence, referred to at paragraph 7.230(c) above, given many years later, is merely corroborative of, as being consistent with, Baker Tilly's evidence that that is what they were told by Tanfield in 2007/8**.**

(c) In the light of the enormous growth in stock between the end of 2006 and 2007 we do not consider that any reasonably competent auditor exercising reasonable care and skill would have regarded Mr […]'s file note (see paragraph 7.229(a) above) as having any significant bearing on the risk of obsolescence issues at the end of 2007.

(d) The decrease in the inventory ratio to sales, (see paragraphs 7.224 and 7.229(b) above) which was a decrease from 47.3% in 2006 to 45.64% in 2007[264] would have been regarded by the reasonably competent auditor as little more than a straw in the wind.

(e) Whilst a significant decrease in the ratio of stock to turnover might signal a possible decrease in the risk of obsolescence, the evidence here was of merely a slight decrease at TES.

(f) The reduction in the average period in which stock was used up (stock turn)[265] was of 25%. Mr Leech stated that that was a significant reduction but the turnover periods (219 days for raw materials and 26 for finished goods at TES) were still high. In fact the inventory turn at SEV had increased between 2006 and 2007.[266]

7.242 In any event, as already stated, inventories was regarded as a significant risk, and within inventories obsolescence was singled out by Baker Tilly as a key area of audit/focus – see paragraphs 7.201 – 7.203 above. Having regard to the fact that inventories in the Group Financial Statements had increased very substantially from the previous year, we consider it likely that this would have been the starting point of every reasonably competent auditor exercising ordinary care.

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[264] [E5/1001TES, E5/1032 SEV]

[265] [F1/33/253:T3/125,6]

[266] [T3/126,7]

The Evidence on the Audit File

7.243 In paragraph 4.3.90[267] of his first report, Mr Leech stated that with the exception of a comment in the Final Audit Findings document[268] and a single document in the post balance sheet event meeting note[269], he had seen no further evidence of consideration in the audit files of slow moving stock or obsolescence, suggesting that these documents reflected the sum total of Baker Tilly's work in relation to obsolescence. In the light of the documentation referred to in paragraphs 7.207 – 7.213 above that suggestion is plainly unsustainable – though Mr Leech, in cross-examination[270] explained that he had been looking for some test of obsolescence – he had looked at the other documentation referred to by Mr Main but he regarded it as high level. We accept this evidence. It follows that whilst the criticism of this paragraph of Mr Leech's report is justified, it is a point that goes to Mr Leech's credit rather than to the substance of the Allegation.

7.244 As appear from paragraph 7.231(g) above, Mr Main was of the view that the analytical review provided a reasoned explanation (that it was deliberate but that there had been some over-ordering of raw materials) for changes in the overall inventory levels, and that therefore the increase in inventory levels did not by itself give reasons for concerns about obsolete inventory.

7.245 Executive Counsel pointed out that in relation to Mr Leech's suggestion that additional procedures should have been carried out by Baker Tilly (for example, reviewing stock ageing reports, reviewing recent dispatches, looking for evidence of parts held for models either no longer in production or outsourced)[271] Mr Main had contemplated in his report[272] that such procedures "***might have been carried out if other procedures, including the analytical review, had suggested a heightened risk of slow moving or obsolete inventory***".

7.246 Mr King's evidence was that, so far as he is aware, the Engagement Team did not pursue any further enquiries arising from this analytical review. He did not see the need for it to be followed up[273].

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[267] [D1/1/75]

[268] [F2/49/333]

[269] [(G1/13/168]

[270] [T3/112]

[271] [paragraph 4.3.9 : D1/1/54]

[272] [Paragraph 7.9.5: D2/3/300]

[273] [T6/184-185]

7.247 Executive Counsel submitted that the relevant section of the Tanfield file[274] (in particular the passage at lines 180 – 195 referred to in paragraph 7.213 above) dealing with raw materials at Vigo, where the bulk of the stock was held, far from providing comfort that there was no obsolescence, raised alarm bells in relation to it.

7.248 In cross-examination, Mr Main agreed[275] that, in light of these references, there was a gap in the audit evidence. Baker Tilly needed to make further enquiries:

Q. But what you have now accepted is that further enquiries needed to be made, both following on from the Vigo stock count and the analytical review exercise.

A. I think the enquiry that I suggested was the point that you noted, that the change in production priorities, you might have asked -- and I don't know whether they did ask -- the question, "Does that mean you've bought a load of stock that you're not going to use?" I think that might have been the enquiry that I would fill the gap with.

Q. And the reasonable auditor would have followed up on the system at Vigo to see whether there was obsolete stock in that system, tested the system.

A. They gained an understanding of the system -- yes, you might have done that test.

Q. Yes. And the reasonable auditor would have followed up on the information in the analytical review and at least enquired about that information.

A. That's the answer I've just given.

Q. Yes.

7.249 As to the assertion (see paragraph 7.231(d) above) that the analytical review paper was supported by the stock turn working paper Mr Leech's evidence was that stock turn was relevant to obsolescence but only as a high level indicator[276]. Mr Main referred to the ratio of inventory to turnover for TES[277]. However, he accepted in evidence that one could not regard it as a test for obsolescence, not on its own, albeit combined with other

[274] [F1/31/230]

[275] [T10/42-43]

[276] [T3/117]

[277] [F1/33/253]

evidence it might be helpful: "***but you couldn't just say, "Well, it's exactly the same, therefore I'm not going to do any further work***"[278]. Mr King's evidence was that the test was an indicator of whether there was an obsolescence issue but he acknowledged that it "***can't per se give you direct comfort over obsolescence***"[279].

7.250 The Respondents' references to damaged stock (see paragraph 7.231(e) above) are of no relevance – the Allegation does not include any criticism of the audit in relation to damaged stock.

7.251 In relation to the point referred to in paragraph 7.231(f) above, and the information recorded in the Tanfield Lea stocktake note viz: "***The client informed me that there was no obsolete stock and no stock damage beyond repair included in the stockholding area and hence the system***", Executive Counsel submitted that this was simply a comment from the client (most likely a junior store manager) on site to which little weight could be attached: it was not a test for obsolescence, and Ms [...] stated in evidence that she did not do any further work on obsolescence[280]. Mr Main agreed in cross-examination that the stocktake was not a test for obsolete stock[281]. We do not consider that any reasonably competent auditor exercising ordinary care would have been content with the information provided by the client as reported by Ms [...] without some further investigation.

7.252 Executive Counsel submitted that on analysis the detailed inventory listings paper referred to in paragraph 7.231(g) above, provided no comfort in relation to obsolescence. Mr Main acknowledged[282] that this document told one nothing about movements between 2006 and 2007 at Vigo, where the vast majority of the raw material were held, and that the reference at lines 137 – 138 in the "***Review of Detailed Listings***" paper[283] was indicative of an obsolescence problem (see paragraph 7.208 above). Mr King's evidence was that this was not a specific test for obsolescence[284]. Mr [...] referred to this document in his witness statement, but did not appear to rely on it as a test for obsolescence.[285] We accept these submissions.

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[278] [T10/50]

[279] [T6/199]

[280] [T5/63]

[281] [T10/28]

[282] [T10/44]

[283] [F1/32/251]

[284] [T6/201]

[285] [Paragraph 106: C/1/22]

7.253 Mr Main relied on the paper describing the Vigo Avante System Procedure[286] – see paragraph 7.212 above. Executive Counsel submitted that this paper provided no audit evidence; it was simply evidence of a procedure to deal with obsolete stock; and there was no evidence that this procedure was tested. Mr Main agreed in cross-examination that the auditor had identified a system but had not tested it[287].

7.254 In relation to the aud-IT test referred to in Mr Main's re-examination (see paragraph 7.234 above), we understand that the Respondents submit that the Tribunal should infer that a test was carried out to identify obsolete stock and that this was carried out by Ms [...] and approved by Mr [...]. The difficulty with this is that Ms [...]'s evidence (see paragraph 7.211 above) was that she did no further work following the Tanfield Lea stocktake, and Mr King when asked to explain what this test was, and after being given overnight to investigate what it was, was unable to explain it.[288] We are not satisfied that any meaningful test of the nature suggested in order to identify obsolete stock was in fact carried out.

7.255 Whilst the working papers[289] include a note that the excessive raw materials ***"will be used"*** there is no record of any investigation as to when that was forecast to come about. Mr [...], at paragraph 171 of his witness statement[290] simply comments that the increased stock levels at TES was ***"due to increased stocking due to forecast growth in demand in 2008. Our work on going concern also showed the increases in forecast revenue. This was not an unreasonable assessment by the Group – particularly as, historically, forecast revenue had been exceeded."***

7.256 A paper[291] recording discussion on Going Concern with Mr [...] on 22 February 2008 does support Mr [...]'s statement as to past and forecast growth, but it contains no reference to obsolescence and no information which would enable any assessment to be made as to when excess stock was likely to be "***moved***". If Mr [...] was also referring to the Going Concern paper[292], as Mr King did at paragraph 125 of his witness statement[293], we are bound to state that there is within that document nothing to support Mr [...]'s statement, and nothing to throw any light on when the excess stock was forecast to be used up.

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[286] [E1/295]

[287] [T10/31]

[288] [T6 /205,6 :T7/ 4 – 6.]

[289] [see paragraph 7.7.15 above]

[290] [C/1/35]

[291] [F1/28]

[292] [F2/59/429]

[293] [C/3/107]

7.257 Mr Leech characterised the documentation relied upon by Mr Main in relation to this sub-allegation as "***high level***". We agree with that characterisation. The work done by Baker Tilly in this area of the audit was deficient in its failure to investigate in greater depth the increase in inventories at TES between the year ends for 2006 and 2007 and, within that investigation, to dig down into the implications of the admitted overstocking.

7.258 For the reasons given above, therefore, we do not accept Mr Main's view that without the planned test there was sufficient appropriate audit evidence for a reasonably competent auditor exercising reasonable care to be satisfied that there were no issues with slow moving or obsolete inventory at TES. Even if that hypothetical auditor had initially approached obsolescence and slow moving stock as a low risk area, the combination of the substantial increase in inventories since the prior year and the existence of overstocking would have resulted in a recognition that this was an area of particular concern. Further, in our judgment every reasonably competent auditor having planned a test for obsolescence would have carried it out – unless on a re-assessment it had concluded that there were sound reasons for adopting some other plan and it had documented the cancellation of the test and reasons for doing so.

Was the Evidence Taken into Account

7.259 As stated above, Mr Main, who was aware that the planned test for obsolescence had not been carried out, considered that nevertheless there was sufficient other evidence to allay concerns that significant provision against slow moving inventory was required as at 21 April 2008, and he suggested that it was to be inferred that Baker Tilly at some stage post-planning had ***"implicitly and reasonably"*** made an audit judgment that valuation and obsolescence was not a significant issue. We have rejected Mr Main's opinion that there was in fact sufficient appropriate audit evidence to satisfy a reasonably competent auditor exercising reasonable care and skill that there were no material issues of slow moving or obsolete inventory. In case we are wrong in rejecting that opinion, it is appropriate to consider whether, even if there was a sufficiency of such evidence, Baker Tilly took that evidence into account and made the judgments which Mr Main suggests they "did".

7.260 The Executive Counsel submitted that against the background of the initial assessment (see paragraphs 7.201 and 7.202 above), the decision not to perform the only planned test of obsolescence was obviously an important one, and that Mr Main's evidence was that he would have expected to see a record on the audit file recording why the planned

test had not been carried out and what replacement tests were proposed; or if no additional tests were proposed, the reasons why.[294]

7.261 There is no record on the audit file explaining the reasoning of the Engagement Team (and Mr Main confirmed he had not seen any such record).[295]

7.262 As appears from paragraph 7.205 above, Mr Railton did not know that the planned test had not been carried out, and it is more likely than not that Mr King, too, was unaware that this was the case. It follows that the planned test remained an intended feature of the audit, and was not considered to be unnecessary. Nor was there any *"**replacement test**".*

7.263 As to the question of whether or not as a matter of fact Baker Tilly took into account the evidence and adopted the approach which Mr Main did:-

(a) Mr Railton at paragraph 113[296] of his witness statement, referring to the Group Audit plan[297] and the expressed intent to ***"ensure all stock lines which are of significant age have been adequately provided against"***, stated ***"It was anticipated that this would be done in part by attendance at the stocktake and partly through work undertaken through the work programme set out on the step "Inventories" in the analytical review section of the audit files."***[298].

(b) In his oral evidence Mr King stated that he considered Baker Tilly had sufficient evidence in relation to obsolescence[299]. In his witness statement he asserted at paragraph 117[300] that he reviewed the substantive analytical review papers which included Group AR - Inventories[301], the review of detailed listings[302], and Stock turn, Unit costs[303], and that he also reviewed the issues noted in the Resolution

[294] [T10/19-20]

[295] [T10/20]

[296] [C/2/71]

[297] [G1/1/13]

[298] [*G1/1/13, H/1/13*]

[299] [T6/191]

[300] [C/3/105]

[301] [F1/31/225]

[302] [F1/32/250]

[303] [F1/33/253 et seq]

of Issues Schedule[304] and Adjusted and Unadjusted Errors[305]. His review notes[306] record that the stock level increase was to be a key point in the Final Audit Findings.

(c) In Mr King's oral evidence,[307] when it was put to him that the statement in the FAF that the stocktake had been attended as planned etc[308] was something which he took as read without checking, he insisted he was aware of the work done during the analytical review and took account of everything learned during the audit. He disagreed that as an analytical review document the Stock turn Unit costs document[309] was highly deficient. He repeated that he had taken into account the documents referred to in (b) above[310]. He stated that he was not saying that ***"he drew a specific correlation between any one work paper and the conclusion that there were no obsolescence issues. It would have been a number of work papers including my understanding of the business….one takes into account everything"***. He referred to evidence that three tests had been carried out on aud-IT to check every inventory item over £50000 to see whether they were in use or not: the Test has been planned and signed off but he could not say precisely what tests had been done.[311]

7.264 On balance we are of the view that Baker Tilly did substantially take account of the evidence relied upon by Mr Main. However, as we have found, given that the planned test had not been carried out and the errors had not been followed up with management that was insufficient.

Inventory Obsolescence - Falling Short – Overall Conclusions in Relation to Baker Tilly

7.265 Our conclusions, therefore, are that in relation to this sub-allegation 1.2(b):-

(a) No reasonably competent auditor who had planned the test as Baker Tilly would have concluded that sufficient appropriate evidence had been obtained and that enough had been done; and, in any event -

[304] [F2/57/407]

[305] [F2/58/422]

[306] [F2/48/329]

[307] [T6/192-193]

[308] [F2/49/339]

[309] [F1/33]

[310] [T6/194]

[311] [T7/4 to 7]

(b) Contrary to the contention of Mr Main, absent the planned test, there was not sufficient appropriate audit evidence to show that there were no issues with slow moving or obsolete inventory at TES.

7.266 Accordingly, we find that the complaint of failure to comply with paragraph 2 of ISA and the fundamental principle of professional competence and due care is made out in relation to this issue, and in this respect Baker Tilly's conduct of the audit fell short of the standards reasonably to be expected of a Member Firm.

Inventory Obsolescence – Falling Short - Conclusions In Relation to the Engagement Partners

7.267 It is striking that neither Mr King nor Mr Railton were aware that the planned test had not been carried out. Mr [...] should have seen that it was implemented as planned. For like reasons to those set out at paragraphs 7.44 to 7.46 above, we consider that Mr King's and Mr Railton's conduct of the audits fell short of that reasonably to be expected of a Member.

Allegation 1.3 – The SEV Stocktake – Existence of Inventories

The Allegation

7.268 Allegation 1.3 is that:

"In relation to the SEV stocktake in December 2007 the Respondents failed to obtain sufficient appropriate audit evidence of the existence of inventories in the roll forward testing in that

1. ***differences between listing on the day of the stocktake and the year-end inventory listing were found in 7 out of 20 items originally sampled. However, the Respondents only checked two of these variances to corroborative evidence in order to verify the movements between the count and the year end; and***

2. ***the Respondents failed to obtain sufficient appropriate audit evidence regarding the other five discrepancies, relying instead on uncorroborated management representations, the evidence of which was not retained on the audit file".***

7.269 Allegation 1.3 is the only allegation in relation to inventories which concerns SEV. No complaint is made regarding the SEV stocktake generally - the allegation being limited to the adequacy of the roll forward testing that was conducted. As already indicated, this allegation is no longer pursued against Mr King, The total value of the SEV inventories (£1.3m) was such that the risk of there being an error which might be material to Tanfield's financial statements was sufficiently low to render it unnecessary for Mr King to consider in detail the procedures relating to the SEV stocktake for the purposes of the Tanfield audit.

Existence of SEV Inventories - The Issues

7.270 SEV's largest stockholding was at a warehouse in Sheffield. At this warehouse the stock comprised a large number of low value parts, the majority of which were parts for Dairy Crest milk floats. Mr [...], an audit junior from Baker Tilly's Leeds Office, carried out the stocktake on 20 December 2007. Mr [...]'s evidence is that he reviewed it and signed off on it.

7.271 After the year end, Baker Tilly carried out some roll-forward testing, reviewing stock movements between the time of the sample count (on 20 December) and the year end date. This is the subject of the allegation. The relevant audit work paper is: SEV: Agreement of physical sample counts to final sheets.[312]

7.272 Differences between the stocktake listing and the year end listing were identified in the case of 7 out of the 20 sampled. Baker Tilly obtained explanations from […] of Tanfield in respect of 3 of the largest items[313]), and the explanations were noted in summary form on the working paper. The Executive Counsel accepts that the explanation provided by Mr […] in respect of those three discrepancies was sufficient. However Executive Counsel maintained the criticism of the four (not five, as pleaded) remaining differences.

7.273 The working paper records the differences between the stocktake and year-end inventory as:

(a) Contact Kit 1 item out of 34;

(b) Front Spring 1 item out of 18;

(c) Front Axle King Pin 3 items out of 104; and

[312] [H/21/143]

[313] [E2/335 - 336]

(d) Cork Chaincase Gasket 2 items out of 14.

7.274 It is common ground that these four remaining differences were not investigated further, and so they remained unexplained. Mr [...] was involved in the email chain but had little recollection of this issue. The Executive Counsel submitted that Baker Tilly should have investigated all seven differences and should have obtained evidence to corroborate the explanations provided by the client (e.g. received notes, production records or dispatch notes), and referred to the fact that the BT Manual required them to follow up all errors, individually and cumulatively.

7.275 The Respondents submitted that at best this allegation amounted to no more than a "***best practice***" criticism rather than representing a "***falling short***" from the standards, let alone an allegation of Misconduct.

Existence of SEV Inventories – Executive Counsel's Case

7.276 In his oral evidence T3/160 Mr Leech explained:

" ***.. we're left with four which nobody's checked that the difference is what the difference is. So even though the difference is small, once you check you could of course find out the difference is very large. You just don't know. So unless you complete the test, you don't know whether there is an error there or not. So you know once you've picked your sample you have to follow that through to the end and then if there is an error you project that over the whole population because you've just picked a sample, and at that point you decide, having projected that error, whether it is material or not***".

Existence of SEV Inventories -The Respondents' Case

7.277 They submitted that this allegation could not survive another passage in Mr Leech's oral evidence[314] in relation to these differences, the effect of which was that Mr Leech accepted that this was at best a matter he regarded as raising a "***review point***" for his junior:

MR TURNER: Each -- That's Mr Leech's evidence. In relation to the steering box, you said you were comfortable with the way it was dealt with which was an explanation provided within the email from […]?

[314] [T3/162-163]

A. Yes. I mean, it would have been nicer to have seen the despatch notes but I think, you know, on balance –

Q. Really what this complaint amounts to is there was a failure to obtain a similarly detailed explanation in relation to the four remaining items where there were variances?

A. Yes.

Q. So a failure to obtain similarly detailed explanation as to a difference of one out of 34 on the contact kits; is that right?

A. Yes.

Q. One out of 17 front springs and four out of ten steering boxes?

A. Yes.

Q. So it is a failure to send one further email?

A. Well, depending on the response.

Q. And to get a response. Would this be a review point for your audit junior?

A. Yes.

Q. It's not a report to the beak [this] time, is it?

A. No.

7.278 In essence, Mr Main's view was that not all reasonably competent auditors would have regarded the differences as sufficiently serious to require them to be followed up: a reasonable auditor could have taken the decision not to further investigate these remaining differences.[315]

"A. … In view of the small differences then I think many auditors wouldn't take that any further. We're talking about something with a low level of overall stock, I think it was 1.1 million at SEV, and they were small differences and they were differences we would expect. So I can understand why they didn't follow through those items.

[315] [T10/76]

Q. So the auditor is relying on the size of the difference to say, well, there's no need to follow it through, rather than relying on the fact that those differences are for the same reason as the items they have followed through?

A. Yes. And the fact that they were expecting the differences.

Q. When you say "some auditors' --

A. Would a reasonable auditor? I think a reasonable auditor would take a similar view, that this wasn't a problem area. This is something that was expected.

It's just not a significant issue.

The Existence of SEV Inventories – Falling Short – Conclusions in Relation to Baker Tilly

7.279 In relation to this issue our conclusion is that the view expressed by Mr Leech in the passage from his evidence which we have set out at paragraph 7.276 above is one which would be shared and applied by every competent auditor performing its duties with reasonable skill and care. Baker Tilly, albeit not through its senior personnel, failed to complete the substantive test which they had embarked upon. We consider that in relation to this issue the complaint of a failure to comply with paragraph 2 of ISA 500 and with the fundamental principle of professional competence and due care is made out and that that in this respect Baker Tilly's conduct of the audit fell short of the standards reasonably to be expected of a Member Firm.

Existence of SEV Inventories - Conclusions In Relation to Mr Railton

7.280 Mr Leech accepted that the work paper with which this allegation is concerned is not one which he would expect the audit partner of a reasonable auditor to refer to unless some issue was specifically drawn to his or her attention,[316] and there is no evidence to suggest that this was the case. Nor do we consider that a check on Mr [...]'s work triggered by concerns arising from the review of other more significant areas of the audits would necessarily have resulted in Mr Railton discovering the deficiency in this area of the audit. Accordingly, we find that this allegation is not proven against him.

[316] [T3/152-153]

8. PART 8 – ALLEGATION 2 – INADEQUATE REVIEW OF AUDIT DOCUMENTATION (INVENTORIES)

Between 26 November 2007 and 22 July 2008, in relation to the engagement of Baker Tilly to act as auditor of the financial statements of Tanfield Group, TES and SEV for the year ending 31 December 2007 the Respondents failed adequately to review the audit documentation and to discuss the audit evidence with the engagement teams for TES and Tanfield Group so as to be satisfied that sufficient appropriate audit evidence had been obtained to support the conclusions reached in relation to the existence and valuation of inventories, and for the auditor's report to be issued, thereby

(a) ***failing to comply with the requirements of paragraph 26 of ISA 220 and the guidance thereto in paragraph 27; and/or***

(b) ***failing to act in accordance with the Fundamental Principle of Professional Competence and Due Care of the Code of Ethics of ICAS, ICAEW and ACCA.***

Particulars

1. In relation to the existence of inventories, which comprised a "critical area of judgment" and/or "a difficult or contentious matter" for TES and Tanfield Group and had been identified by the Respondents as a "significant risk" for TES and Tanfield Group when planning the audit in December 2007, the Respondents failed:

(a) to conduct timely reviews at appropriate stages of the engagement;

(b) ***to document the extent and timing of the reviews; and***

(c) ***to resolve any issues arising.***

2. In relation to the valuation of inventories which comprised a "critical area of judgment" and/or "a difficult or contentious matter" for TES and Tanfield Group and had been identified by the Respondents as a "significant risk" for TES and consequently Tanfield Group when planning the audit in December 2007, the Respondents failed

(a) to conduct timely reviews at appropriate stages of the engagement;

(b) ***to document the extent and timing of the reviews; and***

(c) ***to resolve any issues arising.***

In so far as they reviewed the audit documentation and discussed the audit evidence with the engagement teams, the Respondents failed to identify the shortcomings identified above in Allegation 1 and/or identified them but failed to resolve them.

The Respondents failed to obtain sufficient appropriate audit evidence in relation to Inventories in order to express an unqualified audit opinion on the financial statements in accordance with ISA 700, paragraph 36a"

8.2 Paragraphs 26 and 27 of ISA 220 and paragraph 36a of ISA 700 relate to the duties of engagement partners, and this allegation is directed principally at Mr King and Mr Railton. However, since Baker Tilly is vicariously responsible for their conduct in relations to these audits, this allegation is directed against all the Respondents.

Inadequate Review of Audit Documentation - Inventories

The Issues

8.3 The requirements referenced in the allegation are:

(a) that "***Before the auditor's report is issued, the engagement partner, through review of the audit documentation and discussion with the engagement team, should be satisfied that sufficient appropriate audit evidence has been obtained to support the conclusions reached and for the auditor's report to be issued***" (ISA 220 paragraph 26) and

(b) that "***The engagement partner conducts timely reviews at appropriate stages during the engagement. This allows significant matters to be resolved on a timely basis to the engagement partner's satisfaction before the auditor's report is issued. The reviews cover critical areas of judgment, especially those relating to difficult or contentious matters identified during the course of the engagement, significant risks, and other areas the engagement partner considers important. The engagement partner need not review all audit documentation. However, the partner documents the extent and timing of the reviews. Issues arising from the reviews are***

resolved to the satisfaction of the engagement partner." (ISA 220 paragraph 27)

8.4 In the Tanfield Audit Plan prepared by Baker Tilly on 27th November 2007 for presentation to the Audit Committee on 6th December 2007[317], Baker Tilly identified the valuation of inventories as a key risk: "***Stock is expected to be a highly significant figure within the group Balance Sheet at 31 December 2007. A risk associated with this high stock holding is the risk of damage and obsolescence"***.

8.5 The KIT prepared by [...] dated 14th December 2007 lists inventories at TES as a Significant Risk, however only the accounting treatment of US inventories is mentioned under the risks identified for Tanfield. With respect to TES inventories the planned audit response in the Key Issues Tracker was "***Stocktake attendance planned to gain assurance re. existence*"** and **"*Test counts on a sample basis are planned to obtain assurance as to the completeness of stock and accuracy in relation to quantities"***[318].

8.6 The Final Audit Findings report dated 27th February 2008 for presentation to the Audit Committee on 28th February[319], reports "***The inventories figure in the group financial statements has increased significantly from the prior year to £60m (2006: £14m). £24m of this increase relates to the Snorkel operations. The remainder increase is due to the group stocking up in order to meet forecast demand for the forthcoming year. The stocktakes were attended as planned with no significant differences notes. No obsolescence issues were identified requiring further stock provision. See stock pricing issue identified for £825k (section 6) and further adjusted and unadjusted errors (section 9) for specific differences identified.***"

8.7 Besides the formal documents referred to above, Baker Tilly's files include a number of file notes documenting discussions with Tanfield and reports and notes filed on the aud-IT system.

8.8 In Paragraph 83 of the Joint Memorandum between Mr Main and Mr Leech dated 10 October 2017, it is noted that the experts "***agree that significant matters identified during the audit ought to have been recorded"*** but ***"disagree on the extent to which***

[317] [F1/1/F-0013]

[318] [1/11/F-0088-9]

[319] [F2/49/F-0339]

Mr King and Mr Railton ought to have recorded internal discussions on inventory"[320].

8.9 The stock counts at TES and SEV threw up a number of discrepancies which were apparently resolved in discussions with management, but without further evidence, substantive testing or full documentation of the judgments made in relation to discrepancies there is no way of knowing the potential impact they may or may not have had on the Financial Statements, with the result that there is not a full paper trail to prove that judgments made were based on informed consideration of the issues, and there is no documentary evidence to prove that any of the discrepancies and errors relating to inventories were brought to the attention of either Mr. King or Mr. Railton.

8.10 At issue is the question of whether Mr. King and Mr. Railton, respectively Engagement Partners for Tanfield and TES and SEV audits, having identified inventories as an area of significant risk and audit focus, should have proactively interrogated the stocktake work papers irrespective of whether or not any issues had been escalated to them.

8.11 This allegation relates to the requirement to provide evidence of the work, discussions and thought processes that underpin the assurance the auditors take, and give, when issuing an audit opinion. This allegation does not include any claim that failures in documentation of audit judgments led to any misstatement of the Financial Statements.

8.12 A further issue for consideration under this Allegation is whether or not any failure to meet the required standards, if such there was, crosses the threshold of seriousness into Misconduct, which issue is addressed at the conclusion of this Report.

Inadequate Review of Audit Documentation –Inventories - Executive Counsel's Case

8.13 Executive Counsel contended that while the standards require the Audit Engagement partner to review the audit work in greater detail than was done by the Respondents, the nature and extent of the review will depend on a number of factors including the assessment of risk at item and assertion level, the results of any analytical review and the result of substantive tests of detail (and the extent to which they have revealed problems). Areas where the partner will need to have a close level of involvement will be critical areas of judgment, including significant risk, and other areas that the partner considers to be important (i.e., key areas of audit focus or risk). The partner is required to be proactive. The review must be in sufficient detail to enable the partner: (a) to be

[320] [D2/5/D-449]

satisfied that all staff have discharged their responsibilities adequately; and (b) to be satisfied that sufficient appropriate audit evidence has been obtained (Written Closing Submission paragraph 285).

8.14 Executive Counsel further argued in paragraph 286 that "***whether or not they were identified as significant risk, Mr King and Mr Railton acknowledged that existence and valuation of inventories and were*** "***key areas of audit focus/ risk with a heightened level of focus***"", the expectation being that they should have reviewed the working papers more closely, identified the errors in them and required further testing or inquiry to assemble sufficient appropriate audit evidence.

8.15 Executive Counsel's case is that the fact that Mr. King and Mr. Railton failed to identify the discrepancies or errors in the paperwork from the stocktakes when seeking assurance about the existence and valuation of inventories "***admits of (sic) only two explanations. Either (a) they failed adequately to review the audit documentation and to discuss the audit evidence with the engagement team or (b) they reviewed the audit evidence but failed, incompetently, to identify that the audit was deficient***". (EC Closings paragraph 289.)

Inadequate Review of Audit Documentation – Inventories – Respondents' Case

8.16 The Respondents argued that neither the applicable standards nor the BT Manual prescribe any specific form of review during an audit by which the audit engagement partner should satisfy himself about the sufficiency and appropriateness of audit evidence. (These standards are set out above at paragraphs 5.11 to 5.13 above, but for ease of reference are also referred to below.) In paragraphs 289 and 290 of the Respondents' Closing Submissions they cite the BT Audit Manual as follows: ***"The firm's standard procedures are designed to minimise the cost of expensive review time by recognising the concept of the "review pyramid" and tailoring documentation to fit into that concept".*** **(Chapter 4.K. paragraph 5.1[321])** and continuing**:** ***"The idea behind the review pyramid is that, as responsibility increases, the need for detailed knowledge reduces. In other words, whilst the reporting partner has overall responsibility for the conduct of the audit assignment, it is not necessary for him to know every detail of what testing we have done. He must, however, know what our standard procedures require us to do and that we have complied with those***

[321] [M1/M-0204]

procedures*".* (Chapter 4.K. paragraph 5.2)[322]. The Respondents go on to cite paragraph 5.3(c): "***it is not necessary for the reporting partner to review the working papers in detail, provided that the assignment manager has completed all the checklists and conclusions for which he is responsible. All that the reporting partner need do is to review those conclusions (including the points for partner schedule) and the file dividers to see if there are any areas of the financial statements about which he is particularly concerned. The way that the current audit file is organised, and the proper completion of the points for partner (see paragraph 5.4 below), will assist the reporting partner in this process. Provided he is satisfied with the evidence of completion provided by these standard documents, the reporting partner can complete his own review checklist and conclusion form****".* (Chapter 4.K. paragraph 5.3(c))[323]

8.17 The Respondents argue and both experts agreed that it is not normal or required for the partner to review working papers such as stocktakes in detail unless a specific concern was escalated to them. The Respondents argued that the existence and valuation of inventories was not a significant risk: *"**The only risk identified by Mr King as a significant risk from the perspective of the Group audit was the accounting for the acquisition of Snorkel. The only risk identified by Mr Railton as a significant risk from the perspective of the TES and SEV audits was the valuation/recoverability (but not the existence) of the W[...] debt in the context of the SEV audit**"* (Respondents' Closing Submissions paragraph 291(a)).

8.18 In any event, the Respondents argued that no issue of concern was brought to the attention of Mr. King or Mr. Railton relating to the stocktakes and the existence and valuation of inventories.

8.19 The Respondents argue that Mr [...] was an experienced manager and Mr. King had taken steps to assure himself of the quality of the team. Indeed this is documented in Mr. King's Acceptance File Note dated 28th November 2018 setting out his reasons for accepting to act as audit engagement partner: "***I also considered whether it was appropriate for me personally to accept the role. Factors affecting my decision included the use of an experienced senior manager ([...]) with good knowledge of the client, a strong audit team, and my personal experience of large listed groups****"*.[324]

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[322] [M1/M-0204]

[323] [M1/M-0205]

[324] [F1/4/F-0068]

8.20 The audit file on aud-IT indicates that a number of reviews were signed off by Mr. King and Mr. Railton, (though the aud-IT file was often completed and updated after events) and the witness statements of both partners are corroborated by Mr. [...] in terms of a number of meetings and discussions about the Tanfield audit.

8.21 In the Joint Memorandum between Mr Main and Mr Leech dated 10 October 2017[325] at paragraph 86 it is recorded that: "***Mr Main's view is that key issues arising from the audit were summarised in the Final Audit Findings report to the extent that Mr King and Mr Railton felt it necessary to have a record. There is also documentation of all issues raised during the audit and their resolution on a document described as "Resolution of Issues Schedule."*** This document is filed at F2/57.

Inadequate Review of Audit Documentation – Inventories - Falling Short -The Engagement Partners - Conclusions

8.22 The Tribunal accepts and have found that Baker Tilly considered there to be a number of significant/ key risks in the Tanfield audit, such as the Snorkel acquisition and inventories on which the auditors focused – at least at the planning stage. We consider that they were right to do so - inventories were clearly an area for close review having increased for Tanfield from £14.1m at 31 December 2006 to £60.3m at 31 December 2007 and at TES from £11.5m at 31 December 2006 to £30.7m by 31st December 2007.

8.23 We note Mr. Leech's evidence under cross-examination that the partners should have reviewed the work papers relating to key risk areas: *MR LEECH*: "***I do believe it's a matter for the engagement partner to use his judgment to determine which work papers he should review. So I don't think -- because it's a significant risk he has to review every single work paper but in my experience an engagement partner would review work papers -- significant work papers with judgment and estimates in it within a significant risk area. But I also think an engagement partner would go beyond that as well and a reasonable engagement partner would look anywhere in the file where there have been difficult or contentious matters with the client, where there have been other judgments and estimates that maybe didn't quite reach significant risk level but he was concerned that in the aggregate if they -- you know, there's lots of judgments and estimates and in the aggregate if these get to a material issue, then, you know, that's a potential qualification****." THE CHAIRMAN: "**Let me make sure I understand this. Assuming that in this case the engagement*

[325] [D2/5/D-0449-50]

partners were not specifically alerted by their subordinates to a particular area, are you saying that even if there was no specific alert, the engagement partners in this case should have been looking at or delving into the working papers in relation to this valuation of inventories?" *MR LEECH: "**I am**".* (Transcript Day 3, pages 96-97)

8.24 We note Mr. Main's evidence in his report dated 28th July 2017 at paragraph 14.3.13: "***It is also important to note that paragraph 4(c) of ISA 220 Quality Control states that partners...are entitled to rely on the firm's systems (for example in relation to the capabilities and competence of personnel through their recruitment and formal training*)".** Then at paragraph 14.3.14: *"**The approach taken by Mr King and Mr Railton is not dissimilar to the approach taken by many audit engagement partners in documenting the extent of their review. It is clear that the ISAs do not require the engagement partner to document which individual papers were reviewed; but rather to show which "elements" were reviewed. The Audit Manual reflects the requirement in the ISA and does not require the partner to review working papers in detail."*** Continuing at paragraph 14.3.15 ***"In line with ISA 220, Mr King and Mr Railton were entitled to rely on Mr [...], the qualified audit seniors and the trainees to have performed their tasks competently and have brought relevant matters to their attention. I note that aud-IT does not allow a task to be undertaken by a staff member below the level assigned. Any review of the detailed working papers is primarily carried out to ensure that the planned audit procedures are properly performed and that any issues arising from these procedures are reported up the review pyramid to the audit partner. It is common for the audit engagement partner to rely on a competent manager to carry out this detailed work. It would appear that Mr [...] was competent in his role and in particular I note Mr [...] comment in his interview with the AADB that '[...] is dynamite. He really is. His attention to detail and knowledge of technical issues is dynamite for me' Mr [...] also made positive comments about oth**er **more junior members of the audit team."*** (Main Report of 28th July 2017.[326])

8.25 We accept the evidence, so far as it goes, in the various witness statements referring to review meetings and discussions on the audit team and we further accept that review signed off on aud-IT happened. We also note that in respect of inventories, the files clearly show that a great deal of stocktake work was done, notwithstanding the errors in that work.

[326] [D2/3/D-0348]

8.26 In terms of review, Mr. Main's report states at paragraph 14.3.5: "***Mr King confirms that (A) he met with Mr [...] prior to an audit planning meeting with Mr [...] on 24 October 2007 to discuss the planning of the audit (paragraph 85 of his witness statement); (B) he attended the audit committee planning meeting on 6 December 2007 accompanied by Mr Railton and Mr [...] (paragraph 87 of his witness statement); (C) he discussed the group audit plan and key issues tracker with Mr [...] at a meeting on 14 January 2008 (paragraph 94 of his witness statement); (D). he met with Mr [...] on 18 February 2008 in Baker Tilly's Newcastle office to carry out an initial review of the Tanfield file (paragraph 100 of his witness statement); and (E) he also attended the audit committee meeting on 28 February along with Mr [...] and Mr Railton when the audit issues were discussed (paragraph 102 of his witness statement)***". (Main Report of 28th July 2017), [327] and at paragraph 14.3.7 Mr Main points out that: "***Mr [...] also makes several references in his witness statement to discussions taking place during the course of the audit with the audit partners. This included: the attendance at meetings with Mr King and Mr Railton on 24 October 2007 when they met with Mr [...] to discuss audit planning, on 21 November 2007 when Mr Railton and Mr [...] attended a further meeting with Mr [...] and a meeting on 6 December 2007 when Mr [...], Mr King and Mr Railton attended a meeting with the Tanfield audit committee. In paragraphs 86 to 89 of his witness statement[328], Mr [...] sets out further discussions which took place with Mr King and Mr Railton during the audit planning process. He confirms in paragraph 107[329] that he discussed the outcome of the analytical procedures performed with the audit partners, including analytical procedures carried out in respect of inventories. In paragraph 226,[330] Mr [...] confirms that he discussed the trading statement released by Tanfield in July 2008 with Mr Railton. Mr [...] then confirms in paragraph 222[331] that he and Mr Railton discussed how any outstanding issues relating to the audit had been resolved before the audit opinion was signed on 21 July 2008***."

8.27 We consider that in respect of inventories, Mr. King and Mr. Railton would in general be entitled to rely on the experienced audit manager to escalate any problem issues to them arising on the stocktakes. However, they were also obliged to carry out a sufficient review

[327] [D2/3/D-0346]

[328] [C/1/18]

[329] [C/1/22 @ 23]

[330] [C/1/48]

[331] [C/1/47]

of detail, certainly in areas of significant risk, to be able to establish whether or not Mr [...] was discharging his duties adequately, and we have already found, at paragraphs 7.42 to 7.46 above, that it is clear that he was not and that his work was not adequately reviewed. Such a review must necessarily involve looking at some working papers.

8.28 We consider that Mr. King and Mr. Railton should have asked more questions of their team given the significant increase in inventories over the year, and their own assessments of risk at the planning stage. Had they asked more questions and reviewed some work papers in the key areas they would have noticed the errors. Any competent auditor conducting the audits with reasonable care and skill would have carried out reviews which involved looking at least at some of the working documents in key areas. Not having carried out any reviews at this level they were not in a position to express any unqualified opinion – see paragraph 36a of ISA 700.

8.29 It follows from the findings which we have set out above that we consider that the complaint that Mr King and Mr Railton failed to comply with paragraphs 26 and 27 of ISA 220 and failed to comply with the fundamental principle of professional competence and due care in the respects asserted in this Allegation 2 is proven and that in these respects Mr King's and Mr Railton's conduct of these three audits fell short of the standards reasonably to be expected of Members.

Inadequate Review of Audit Documentation – Inventories - Falling Short – Baker Tilly

8.30 It follows from Baker Tilly's vicarious responsibility for the Engagement Partners' conduct of the audits that the findings made in the last paragraph apply also to Baker Tilly.

9. PART 9 – ALLEGATION 3 – POST BALANCE SHEET EVENTS (INVENTORIES)

The Allegation

Between 1 January and 22 July 2008, in relation to the audit procedures to consider all events from the balance sheet date up to the date of the auditor's report, in particular in relation to Inventories, the First and Third Respondents failed:

(a) ***to perform adequate audit procedures to obtain sufficient appropriate audit evidence that all events up to the date of the signing of the auditor's reports for TES and SEV for the year ended 31 December 2007 that may have required adjustment of, or disclosure in, their financial statements had been identified; and***

(b) ***to prepare work papers which were a sufficient and appropriate record that demonstrated that all events up to the date of the auditor's report that may have required adjustment or disclosure in the financial statements of TES and SEV had been identified and considered by the Respondents,***

thereby

(i) failing to comply with the requirements of paragraph 4 of ISA 560, paragraphs 2, and 9 of ISA 230 (Revised) and paragraph 21 of ISA 220; and/or

(ii) failing to act in accordance with the Fundamental Principle of Professional Competence and Due Care of the Code of Ethics of ICAS, ICAEW and ACCA.

Particulars

1. The Respondents noted in the Tanfield Group Audit Findings Report, presented to the Tanfield Group Audit Committee on 28 February 2008 that one of the key areas of audit focus was the risk of damage and obsolescence associated with Tanfield Group's high stock holding and that stock levels should be monitored by management against forecast demand to ensure the appropriateness of stock levels.

2. On 1 July 2008, Tanfield Group issued a trading statement which referred to a "marked slowing in our markets …experienced throughout June", and an article in the Financial Times of the same date with the headline "Tanfield shares plunge 83% on warning".

3. From 1 January 2008, until the Auditor's report was signed for the TES and SEV 31 December 2007 financial statements on 21 July 2008, the First and Third Respondents failed to perform any or any sufficient appropriate procedures to consider inventory obsolescence and a potential reduction in the realisable value of inventory that might require discussion with management or adjustment of, or disclosure in, the said financial statements; neither did they demonstrate by the preparation of documentation in the audit file that they had considered whether adjustment or disclosure was necessary.

9.2 The allegation is, of course, advanced only against Mr Railton and Baker Tilly (Mr King having signed the audit opinion on the Group financial statements on 21 April 2008).

Post Balance Sheet Events (Inventories) - Issues

9.3 In paragraph 186 of their written closing submissions the Respondents submitted that Allegation 3(b) was not in play, because Executive Counsel had confirmed that no "***documentation***" complaint was being pursued. Reliance was placed on statements made by Executive Counsel in the oral opening of the case[332] and in the course of the hearing on day 10[333]. We reject that submission. In paragraph 10(c) of Executive Counsel's written opening it was indicated that complaint was made in relation to Allegations 3(b) and 6(b) of failure to carry out and document audit procedures, and we did not understand the general statements of Executive Counsel referred to by the Respondents as reflecting any intention to withdraw the specific allegations advanced in those specific allegations. That this was the case was spelled out in Executive Counsel's oral closing submissions on Day 11[334].

9.4 ISA 560 paragraph 4 is concerned with post balance sheet events reviews undertaken by an auditor to bridge the period between the entity's accounting year end and the date that the audit report and financial statements are signed. It provides:

"***The auditor should perform audit procedures designed to obtain sufficient appropriate audit evidence that all events up to the date of the auditor's report that may require adjustment of, or disclosure in, the financial statements have been identified***."

The guidance within this paragraph includes the statement that "***the auditor is not, however, expected to conduct a continuing review of all matters to which previously applied audit procedures have provided satisfactory conclusions.***"

9.5 The following paragraph, paragraph 5, in relation to audit procedures to identify events that may require adjustments to or disclosure in the financial statements, includes the guidance that such procedures should be performed as near as is practicable to the date of the auditor's report, should take account of the auditor's risk assessment and "***ordinarily***" include, for example:

(a) Reviewing management's procedures for identifying subsequent events;

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[332] [T1/128]

[333] [T10/113]

[334] [T11/ 8]

(b) Reviewing minutes of board meetings held after year end;

(c) Reviewing management accounts, interim statements, budgets, forecasts and other related management reports; and

(d) Inquiring of management as to whether subsequent events have occurred, including whether any unusual accounting adjustments have been made or are contemplated.

9.6 The terms of paragraphs 2 and 9 of ISA 230 are set out in paragraph 2.20 above. Paragraph 21 of ISA 220 allocates to engagement partners responsibility for ensuring that audit engagements comply with professional standards and regulations and for *"**the auditor's report that is issued to be appropriate in the circumstances**"*

9.7 Paragraph 3 of IAS 10 "***Events after the Balance Sheet Date***" identifies two types of post balance sheet events:

"***Events after the balance sheet date are those events, favourable and unfavourable, that occur between the balance sheet date and the date when the financial statements are authorised for issue. Two types of events can be identified:***

(a) ***those that provide evidence of conditions that existed at the balance sheet date (adjusting events after the balance sheet date); and***

(b) ***those that are indicative of conditions that arose after the balance sheet date (non adjusting events after the balance sheet date).***"

9.8 Paragraph 2 of ISA 560 applies to both adjusting and non-adjusting events. It requires the auditor to *"**consider the effect of subsequent events on the financial statements and on the auditor's report**".*

9.9 *A*s regards non-adjusting events, IAS 10, paragraph 21 provides:

"***If non-adjusting events after the balance sheet date are material, non-disclosure could influence the economic decisions that users make on the basis of the financial statements. Accordingly, an entity shall disclose the following for each material category of non-adjusting event after the balance sheet date:***

(a) ***the nature of the event; and***

(b) ***be an estimate of its financial effect, or a statement that such an estimate cannot be made.***"

9.10 This allegation focuses on the period between 28 February 2008, when the Final Audit Findings Report was presented to the Tanfield Audit Committee and the 21 July 2008 when Mr Railton signed the audit reports for TES and SEV, the context including the issue of a profit warning in Tanfield's trading statement on 1 July 2008, the immediate fall in the Group's share value as a consequence, and the impairments of £75m, including £15.3m on the grounds of obsolescence, announced on 30 September 2008.

9.11 The relevant background is largely set out above in the context of Allegation 1.2(b) (Valuation of inventory – slow moving or obsolete inventory). By way of summary:--

(a) The Respondents planned to carry out substantive tests of detail to address the risk of obsolescence: ***"Further, we will ensure that all stock lines which are of "significant age" have been adequately provided against."*** (Planning Memorandum[335].) Whilst this test had been planned it was not carried out (Joint Memorandum paragraph 66)[336], and in fact, no detailed substantive tests in relation to obsolescence were carried out.

(b) In the course of the analytical review of raw materials held at Vigo, the Engagement Team became aware of potential obsolescence issues - see paragraph 7.208 above and line 137 – 138 on the working paper ***32.02.10.00.3 and review of detailed listings***[337]. These issues were not followed up.

(c) On 28 February 2008, the FAF was presented to the Audit Committee. The FAF included the following recommendation: "***From our audit work we not identified any stock obsolescence issues. However, stock levels should be monitored against forecast demand to ensure stock levels are appropriate"***[338].

9.12 In his witness statement, at paragraph 224[339], Mr [...] asserted that following the completion of the Group audit, the audit team pressed Tanfield's management for the financial statements for TES and SEV to allow the audit of those entities to be finalised,

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[335] [G1/8/91]

[336] [D2/5/447]

[337] [F1/32/251]

[338] [F2/49/333]

[339] [C/1/48]

that the first drafts of the financial statements were provided on 20 May 2008, that discussions then followed between the audit team and management, and further work was undertaken on the drafts, the final versions of those drafts being produced on 21 July 2008. There is no reason to doubt this evidence.

9.13 On 1 July 2008, and prior to Mr Railton signing his audit opinion, Tanfield issued the Trading Statement[340] referred to above. Negative statements in that document included, "***a marked slowing in our markets … throughout June***" and ***"the deteriorating wider macro-economic outlook***", and there was reference to "***significant levels of inventory which will take time to erode.***" An article in the Financial Times also dated 1 July 2008 carried the headline, "***Tanfield shares plunge 83% on warning***"[341] However, the trading statement also recorded that "***trading in the first five months of 2008 was relatively strong and in line with management's expectations***" and that the outlook was still "***one of year on year growth",*** but at a significantly lower level than previously forecast. Customer rescheduling of orders was stated to be first experienced in June 2008.

9.14 The evidence given by Mr Railton in his witness statement[342] was:

"156. I was surprised by the tone of the trading statement. Given that the Group had seen strong growth for the first five months of the year, it seemed unusual to me that the Group should decide to realign its growth strategy because of one month of poorer than expected sales. However, I was not concerned by the trading statement or the possibility of it impacting the figures in the accounts as at the 2007 year end. The Group had had relatively strong trading for the first five months of the year and it was still expected that there would be further growth, albeit at a lower level than previously forecast.

157. Given the passage of time between the completion of the detailed execution work and finalising the financial statements for TES and SEV, and the content of the 1 July 2008 trading statement, I thought it important to meet with management to discuss the up to date position in relation to post balance sheet events and going concern before signing the audit opinions. I therefore asked (Mr [...]) to set up a meeting with [...]."

Again, there is no reason to doubt these assertions.

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[340] [E5/965]

[341] [D1/1/148]

[342] [C/2/79-80]

9.15 On 21 July 2008 Mr [...] met with Mr [...]. The Baker Tilly file note[343] of that meeting records that it was an audit committee meeting (though only Mr [...] and Mr [...] were present), the purpose of which was: "***to discuss the updated position with regards to post balance sheet events and going concern following the sign of Tanfield Group plc ….and recent Stock Market announcements regarding the Group company…****".* The file note records that, "***The Group hit its budget up to May, however, the June actuals were half of what was forecast. The Group still has approximately £12m cash balance and significant net assets. The main issue is with regards to the slow moving stock however this was not envisaged as a significant problem with regards to obsolescence****."* Management accounts were not available but Mr [...], at paragraph 228[344] of his witness statement, explained that he was able to review the latest financial data on the screen and later that day he was emailed[345] confirmation of the figures. The subject of the email was stated to be "***management account numbers****"* and were described as *"**YTD numbers at 30.06.08 per [...] board reports**".* These figures were very high level*.*

9.16 In his evidence about the meeting Mr [...], in his witness statement, stated at paragraph 226,[346] amongst other things, that "***During the meeting, we discussed …. the update on trading that had been issued by Tanfield on 1 July 2008 in advance of its interim results for the six months ending 30 June 2008. Our key takeaway from the update was that while the Group did not now expect to hit the growth targets it had set for the year, growth was still expected*** ", and, at paragraph 227, "***I asked [...] if there was a risk of stock becoming obsolete if growth was not expected to be at the same levels as forecast earlier in the year. [...] explained to me that obsolescence would not be a significant problem. The stock of the business consisted mainly of raw materials. [...] did not consider that there would be any issues with clearing the stock held at that point at a later date****".*

9.17 Mr Railton's evidence is that he met with Mr [...] after the meeting on 21 July 2008 to discuss the conversation and reviewed Mr [...]'s note of the meeting. The note of the meeting on the audit file is not however signed by him. His evidence was[347] that in the light of the information provided by Mr [...] he was satisfied that TES and SEV would

[343] [G1/13/168]

[344] [C/1/48]

[345] [E5/989]

[346] [C/1/48]

[347] [Paragraph 158: C/2/80]

continue on a going concern basis for the next 12 months and that there was no need for a note in the financial statements to provide any post balance sheet disclosures. His view in light of his reading of the trading statement and the conversation between Mr [...] and Mr [...] was that there were not going to be any significant stock obsolescence issues.[348]

9.18 It is common ground that (a) there was no further audit work in this area and that (b) no evidence was obtained to corroborate Mr [...] statement that there was no obsolescence problem.[349]

9.19 On 21 July 2008, the financial statements for TES and SEV were finalised and Mr Railton signed the audit opinions for both companies. The aud-IT files for TES and SEV were then completed on 23 July 2008. In Mr [...]'s witness statement, at paragraph 229,[350] and Mr Railton's witness statement, at paragraph 159,[351] it was stated that before releasing the audit opinions:

(a) A signed letter of representation was required from the directors of each of TES and SEV[352]. Both letters included a representation that there had been ***"no events since the balance sheet date which necessitate revision of the figures in the financial statements or inclusion of a note thereto"***.

(b) Mr [...] was also asked to provide certain specific confirmations regarding post balance sheet events. To this end, Mr [...] signed a fax which confirmed, amongst other things, that Baker Tilly had been informed of ***"any other event which may affect the amounts included or disclosed in the financial statements"***.[353]

9.20 23 July 2008, two days after the finalisation of the TES and SEV audits, a Tanfield board meeting took place. Mr [...] account, in his interview with the AADB, was that this meeting was the first time that impairments were discussed within the business.[354] As Mr Railton stated in his own AADB interview, Mr [...] evidence suggests that the 23 July 2008 board meeting indicated the start of an exercise of considering the need for impairments, rather than suggesting that such an exercise was already actively ongoing[355].

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[348] [T8/24/9]

[349] [Main paragraph 9.3.3: D2/3/307]

[350] [C/1/49]

[351] [C/2/80]

[352] [G2/39 and H/32]

[353] [G2/40 & H/33]

[354] [J2/6/582]

[355] [J3/7/661]

Post Balance Sheet Events (Inventories) - Executive Counsel's Case

9.21 Executive Counsel's case is that there was a serious failure on the part of Baker Tilly to conduct post balance sheet audit procedures and obtain sufficient appropriate audit evidence:

(a) As appears from the chronology and history relating to obsolescence set out in paragraphs 7.200 to 7.215 above Baker Tilly and Mr Railton appreciated that there were potential stock obsolescence issues – "***Stock is expected to be a highly significant figure within the group Balance Sheet at 31 December 2007. A risk associated with this high stock holding is the risk of damage and obsolescence.***" Stock holding was identified as a "***potential problem"*** and as a "***key area of audit focus/risk***", and they had noted in the Audit Findings Report that:-

(i) the Group was carrying a significant amount of stock at the year end; and

(ii) whilst they had not identified stock obsolescence issues, the stock levels should be monitored by management against forecast demand to ensure the appropriateness of stock levels.

(b) Baker Tilly and Mr Railton ought to have had in mind that the Engagement Team: (a) had planned to carry out substantive tests of detail to address the risk of obsolescence in the Planning Memorandum[356], but (b) had not performed those tests nor indeed any detailed substantive tests in relation to obsolescence. Mr Railton's evidence was that he was unaware that the test had not been carried out – see paragraph 7.205 above.

(c) Baker Tilly and Mr Railton understood that the accounting policy for obsolete or slow moving stock was for it to be identified and written off.

(d) The issues raised in the trading update and the press coverage were not confined to "***one month of poor sales"***. They included: (a) the deteriorating macro-economic outlook; (b) "***anticipated radical changes in the global markets in which [Tanfield] operate***"; (c) the company's net cash position falling from £26.1m to £11.1m during the first half of the year; and (d) "***increased inventory***

[356] [G1/8/91]

levels". They were sufficiently serious for Baker Tilly and Mr Railton to consider whether the subsidiaries would continue as a going concern. Moreover, they were sufficiently serious that Mr Railton and Baker Tilly should, in Mr Main's opinion, have carried out post balance sheet events procedures in relation to Trade Receivables[357].

(e) No corroboration was sought for Mr [...] assertions to Mr [...]. This was contrary to ISA 580 paragraph 6.

(f) It was to be inferred that Mr Railton failed adequately to address his mind to the issue given the absence of any record showing that Mr Railton (or anyone else at Baker Tilly) had considered whether: (a) to perform detailed post balance sheet event procedures (and if not, why not); and (b) an adjustment or disclosure was necessary. The file note records the discussion between Mr [...] and Mr [...]. There is no reference to any judgment being made by Mr Railton (or indeed by Mr [...]) in relation to post balance sheets.

(g) In light of the severity and pace of the deterioration in trading, Mr Leech's opinion is that Mr Railton and Baker Tilly should have performed detailed post balance sheet event procedures in order to consider stock obsolescence and realisable value – e.g., reviewing sales reports, stock turn reports, or management financial statement and reviewing minutes of board meetings[358]. It was not enough to rely upon the statements of Mr [...].

(h) In his oral evidence, Mr Main accepted that the trading statement was a "***red alert***"[359]. He accepted that he personally probably would have asked more questions than Baker Tilly had[360] and he thought that a reasonable auditor might also have done so.

(i) As regards the sufficiency and appropriateness of the Letter of Representation[361] ("***There have been no events since the balance sheet date….***"), Mr Main accepted that he personally would have dug down and asked more questions before regarding management's representations as sufficient[362] and that the

[357] [Main paragraph 10.5.2: D2/3/327]

[358] [Leech 1 paragraph 4.4.12: D1/1/80]

[359] [T10/63]

[360] [T10/70]

[361] [G2/39/359]

[362] [T10/69 – 70]

representation was by itself insufficient[363]. The following exchange sets out Mr Main's final position on this issue:

MS SMITH: - without any evidence that the auditor has asked questions from which he could be satisfied as to the basis for the making of these representations, it not enough simply to accept these representations is it?

A The representations are appropriate, but the auditor would have asked more questions. …

MS SMITH : And there's no evidence that any further questions were asked beforehand?

A I've not seen that, no.

Q. Right. So absent further questions being asked, these representations would not by themselves be sufficient evidence.

A. Just a representation? No, probably not.

(j) Based on the fact that at around the time of the trading statement, or at least prior to 30 September 2008, management carried out an impairment review and concluded that at 30 June 2008 the carrying value of inventories was impaired by £15.3m on the ground of obsolescence, the basis for the impairment being recorded as: "***Models no longer manufactured; Reengineering of certain models resulting in obsolete parts; Models no longer supported for the provisions of spare parts; Damaged inventories due to physical movement; Raw material used for the engineering of parts now outsourced to third party suppliers***", it was to be inferred that, had Baker Tilly and Mr Railton performed appropriate audit procedures, they would have identified very significant obsolescence issues such that any adjustment or disclosure would have had a material impact on the reported results for TES and SEV as at 31 December 2007.

Post Balance Sheet Events (Inventories) - The Respondents' Case

9.22 In summary, the Respondents submitted that the evidence in respect of this issue showed that:

[363] [10/72 - 73]

(a) Baker Tilly were pro-active in light of the trading statement in raising the issue of stock obsolescence with management.

(b) The decision to accept management's explanation was a reasonable one in light of the evidence as a whole, and was fully consistent with the approach required by the ISAs.

9.23 Overall, the evidence in relation to this Allegation shows that:

(a) the trading statement recorded that, despite the problems in June, during the first five months of the year growth had been strong and in line with management's expectations and, moreover, that further growth was expected; These points were emphasised by the factual witnesses during the course of their cross-examination.[364]

(b) Mr Railton responded to the trading statement by requesting that Mr [...] meet with Mr [...];

(c) the key "***takeaway***" from this meeting was that, notwithstanding the recent downturn, growth was still expected;

(d) Mr [...] also explained during the course of the meeting that slow moving inventory or obsolescence were not regarded as being significant concerns; and

(e) the Tanfield Board then subsequently provided a representation that there were in fact no disclosable or adjustable post balance sheet events.

9.24 Mr Leech agreed in cross-examination that it is clear from ISA 560 that the accepted procedures which might be followed in relation to obsolescence included enquiries with management[365], (the point, we understand, being that it is submitted that ISA 560 does not in terms require other evidence as corroboration).

9.25 It was submitted that Mr Main's evidence on this issue, which was characterised as compelling, was that a reasonable auditor would not necessarily have undertaken further procedures.[366] The following exchange took place in relation to the statement made by Mr [...] to Mr [...] at their meeting on 21 July 2008:-

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[364] [T7/190,T8/23 T8/187]

[365] [T3/164/12] – [T3/166/5]

[366] [T10/59-60]

Q. Before that statement made by management was accepted, further work should have been done to corroborate the statements made in the file note, shouldn't it, Mr Main?

A. Yes. Sorry can you --

Q. Yes. Before sign-off following that meeting --

A. Yes.

Q. -- further work and evidence to obtain corroboration in relation to the statements made should have been done and should have been obtained.

A. I think you need to go back to what the post balance sheet events standard says, and it says if there's inconclusive evidence arising from the work you carried out at the time you carried out the detailed fieldwork then you need to follow it up, or if there are new circumstances then you might need to carry out further detailed procedures. But I think you can make a judgment as to whether those circumstances were such that you needed to go back and actually revisit the work that you carried out originally, and they hadn't got any indications originally that they felt there was an obsolescence provision, so they made a judgment that they didn't need to follow it up again just on the results of the trading statement.

Now, that's a judgment that they've made and this was obviously -- you know, it's difficult to know what was then going to happen with the economy, because I think we're all in a similar situation at that point in time.

Q. But I apprehend, Mr Main, that that's not a judgment you would have made in those circumstances.

A. I think I probably could have come to that same conclusion, because if I'd been happy with the situation when I carried out the year-end review, and the trading statement wasn't saying, "We're falling off a cliff here", it was saying, "We're rowing back, it's not going to be as good as we thought, but we're still going", then that alone wouldn't have led me into a wholesale re-performance of all the obsolescence review considerations.

9.26 In his re-examination, Mr Main was also taken to the "***Group analytical review on inventories***" working paper[367] which shows the value of WIP could reasonably be expected to be lower - based on the Q1 2008 requirements. In light of the turnaround time for stock, Mr Main's evidence was that he would not himself have dug deeper into inventory holdings as at 31 December, since he would have expected stock from December to have been sold before July and so any impairment as of that date would not affect the positon as of the balance sheet date:[368]

Q. And we've had the trading statement. Having seen the trading statement, would you have dug deeper in relation to the inventory holdings as at 31 December to seek further assurance as to whether any of the inventory holdings as at that date were impaired before signing off the audit report for the subsidiary accounts?

A. No, I don't think I would, because -- I think because of the stock turn that we had, you'd have expected most of the stock from December to have been sold by the time we got to 31 July, and therefore any impairment would relate to what was in the books at that point in time and not to the position as at 31 December.

THE CHAIRMAN: What was the stock turn that you had in mind?

A. It's in the reports somewhere. I think it's in the joint statement. (Pause).

The inventory ratio to cost of sales was 45.64 in 2007, which implies it was turning it over more than twice a year.

That's in paragraph 76 of the joint statement.

(Pause).

THE CHAIRMAN: That means the whole of the stock as an average is turned over twice a year, does it?

A. Yes. No, to -- yes, twice a year.

9.27 The Respondents submitted that in fact, in the evidence set out in the last paragraph, Mr Main understated the position: the re-examination was directed to certain raw material holdings for Upright which had been the focus of his cross-examination on this issue. The

[367] [F1/31/0225]

[368] [T10/179]

contemporaneous evidence (as revealed by the "***Analytical review***" working paper) was that 13 weeks-worth of that stock was held[369]. Accordingly, it would likely have turned over four times a year (or twice between the balance sheet date and the time the trading statement was issued).

Post Balance Sheet Events (Inventories) - Falling Short - Conclusion in Relation to Baker Tilly

Allegation 3(a)

9.28 We consider that Baker Tilly's assessment at the planning stage of the audit that the high level of stockholding posed a risk of obsolescence and should be an area of key audit focus was one which would have been shared by all reasonably competent auditors exercising due care and skill. Further, in our judgment that hypothetical auditor, notwithstanding that it had carried out a substantive test for obsolescence (as Baker Tilly had planned) and adequately followed up any differences found, would not have modified that original risk assessment – having regard not only to the level of stock but also the information of overstocking provided during the course of the audit.

9.29 The trading statement issued on 1 July 2008 was described by Mr Leech in his oral evidence[370] as ***"a major red flag",*** and Mr Main accepted the suggested characterisation as "***a red alert"***. In the context, we understood them to mean that it raised concerns, amongst other things, as to whether or not there had been post balance sheet events which might require disclosure in the accounts, including in relation to obsolescence. Without referring in terms to obsolescence, the statement did refer to "***significant levels of inventory which will take time to erode"*** – albeit, of course, as at the 1 July 2008. We consider that any competent auditor exercising reasonable skill and care would also have regarded the trading statement as a red alert.

9.30 Mr Railton's evidence was that the trading statement did not raise concerns with him – see paragraph 9.14 above - and Mr [...]'s evidence was that he specifically raised the issue of obsolescence with Mr [...] - see paragraph 9.15 above. The note[371] of his meeting with Mr [...] refers to post balance sheet events, going concern, and obsolescence. However, Mr Railton also made it clear that his judgment was that there were not going to be any significant stock obsolescence issues and the effect of the evidence of both Mr

[369] [F1/31/228 lines 145-6]

[370] [T3/172]

[371] [G1/13/168]

Railton and Mr [...][372] was that in the light of Mr [...] statement there was no need for the issue to be investigated further. As already stated, we accept this evidence as to their thinking, and therefore do not accept Executive Counsel's suggestion, based on the lack of any supporting record, that Mr Railton and Mr [...] did not make any judgment on this topic. We are not overlooking the fact that Mr [...]'s note of his meeting provided a designated space for it to be, and was not, signed off by Mr Railton, but we do not infer from that that Mr Railton did not see or consider that note and did not make a judgment in relation to the response required on Baker Tilly's part to the implications of the trading statement.

9.31 Whilst Mr [...] explained that management accounts as such were not available, there was no evidence that, for example, board minutes, interim statements, forecasts or other related management reports such as stock turn reports, would not have been available if he had asked to see them.

9.32 It is not clear whether any reliance was placed by Mr Railton and Mr [...] on Mr [...] assertion that the stock consisted mainly of raw materials (see paragraph 9.16 above) but it appears to us to be of little or no materiality, since in principle all stock could be at risk of obsolescence, and although some items might be less exposed than others (eg uncut metal sheets might be more easily disposable than manufactured components), the raw materials at TES included manufactured components.

9.33 Mr Railton, Mr [...], and Mr Main, all relied heavily on the fact that growth in the first five months of 2008 was reported to be strong and that further, though slower, growth was still forecast, and they contended that the stock turnover was such that stock held at the 31 December 2007 would all have been used and disposed of by June 2008. However, the premise for this contention would be that all items of stock were used up at the same rate and that the rate of turnover which applied to the ordinary levels of stock held throughout 2007 also applied to the items which were reported at the year end to be overstocked**.**

9.34 Mr [...] in his oral evidence stated[373] that Tanfield was "***on budget for the first five months of the year, no designs of machinery had been changed, no machines had been withdrawn, and as a result it was a reasonable assumption that the stock was not obsolete***". It is not clear on what basis Mr [...] made this assertion, as this information

[372] [T8/188]

[373] [T8/187]

is not reflected in his witness statement, is not recorded in the note of his meeting with Mr [...], and is not reported in the trading statement. Indeed, that note may be read as indicating the contrary – "***The product mix and level of stock had also changed and reduced in order to reduce current stock levels.***" In any event, changes in designs or the withdrawal of machines are not the only potential causes of slow moving stock or obsolescence.

9.35 In his oral evidence Mr [...] also stated that Baker Tilly based their assumption (that stock was not obsolete) on their "***knowledge of the business***"[374], and Mr Railton's oral evidence was to the same effect. They both referred to their pre-existing knowledge of the Tanfield business as a reason for not carrying out any procedures in addition to the enquiry with Mr [...]. They did not explain what aspect of the business they had in mind, but it is clear from the fact and content of the Trading Statement that something a-typical (ie new) was going on, and it is difficult to see that their pre-existing knowledge would be of great assistance in this context.

9.36 Whilst we of course acknowledge the guidance in paragraph 4 of ISA 560 (see paragraph 9.4 above) we consider that, following the issue of the trading statement, every competent auditor exercising reasonable care and skill, would have concluded that it should do more than make enquiries with management, and should adopt other procedures as suggested in the guidance which would at the same time have corroborated what it was being told by management:

(a) ISA 580 provides, in the guidance in paragraph 6, that where management representations relate to matters which are material to the financial statements the auditor will need, amongst other things, to seek corroborative audit evidence. Paragraph 7 recites that "***Representations from management cannot be a substitute for other audit evidence that the auditor could reasonably expect to be available****".*

(b) In his oral evidence[375] Mr Main accepted that the matters under consideration in this allegation related to matters which were material.

(c) We do not accept, as was submitted by the Respondents, that the principle in the guidance in ISA 580 paragraph 6 [see sub-paragraph (a) above], is in some way

[374] [T8/188]

[375] [T10/64-5]

qualified by, or inapplicable to, the guidance in ISA 560 paragraph 4, and Mr Main's evidence did not go so far as to suggest that it did.

(d) None of the procedures suggested in ISA 560 paragraph 4 would have been onerous.

(e) Mr Main agreed that he personally would have asked more questions than Baker Tilly had done – see paragraph 9.21(i) above - and he effectively accepted that the representation in Tanfield's Letter of Representation (***"there have been no events since the balance sheet date"***) should not without further enquiries have been accepted as sufficient evidence of the facts represented. The evidence relied upon by the Respondents and referred to in paragraph 9.25 above preceded the further cross-examination of Mr Main referred to in paragraph 9.21(i) above – the latter effectively "***trumped***" the former.

9.37 The conclusion expressed in the opening of the last paragraph is based on the assumption that the hypothetical competent auditor had in fact carried out an effective substantive test for obsolescence and followed up any differences found. But on the facts of this case Baker Tilly had done neither of these things. Mr Railton was unaware that the planned substantive test had not been carried out, but the hypothetical competent auditor must be assumed to be aware of the shortcomings of the earlier work on obsolescence, and this case, therefore is a fortiori.

9.38 In the earlier part of Mr Main's cross-examination, referred to in paragraph 9.26 above, it was put to Mr Main that before the sign-off following the meeting between Mr [...] and Mr [...] on 21 July 2008 further work should have been done to corroborate the statements made in the file note. Mr Main, in apparent reference to guidance given in ISA 560, agreed that that would be the case where the data which had been collected during the fieldwork in relation to obsolescence was "***inconclusive***", or there were "***new circumstances***". In our judgment, both those conditions were fulfilled here. In any event, as we have already stated, Mr Main made further concessions after this passage of evidence.

9.39 Our conclusion therefore is that sub-allegation 3(a) is proven as against Baker Tilly, and that in this respect Baker Tilly failed to comply with the requirements of paragraph 4 of ISA 560 and paragraph 21 of ISA 220 and failed to act in accordance with the fundamental principle of professional competence and due care, and accordingly the conduct of the audit in these respects fell short of the standards reasonably to be expected of a Member Firm.

9.40 For the sake of completeness we should add that we do not consider that the evidence establishes on the balance of probabilities that the conclusion, contended for by Executive Counsel[376], that if Baker Tilly "***had performed appropriate audit procedures they would have identified very significant obsolescence issues ..."***. There is no basis for concluding that Mr [...] did not honestly believe his statement, made on 21 July 2008, that management did not envisage obsolescence as being a significant problem. There is no evidence as to when Tanfield first appreciated that there was in fact a substantial problem with obsolescence. All that the evidence establishes is that the impairments announced on 30 September 2008 included a very substantial sum for obsolescence.

Allegation 3 (b)

9.41 As noted in paragraph 9.17 above, Mr [...] and Mr Railton stated that they did consider whether the issue of obsolescence needed to be addressed further, and concluded that it did not. We have accepted that evidence. Executive Counsel submitted that this judgment should have been recorded on the audit file, Executive Counsel's case, supported by the evidence of Mr Leech's first report, paragraph 44.4.15, being that such documentation was required by paragraphs 2 and 9 of ISA 230. This issue was raised in cross-examination with Mr Main.[377] His initial response was that the judgment was recorded in the file note, then that it was implicit in what was recorded in the file note, and then that there was nothing in the file note to make a judgment on because the file note said that there weren't any issues to be considered and hence there was no "***conclusion to be documented because it was in the file note***."

9.42 We cannot accept Mr Main's reasoning. According to Mr Railton and Mr [...], they did address the issue and make a judgment. The file note was not a record of Baker Tilly's judgment but of the judgment of the Tanfield management. Whilst an auditor reviewing Baker Tilly's work might infer from the file note and the fact that no further procedures had been carried out that Baker Tilly had concluded that no further procedures were required, there was no record of why that conclusion had been reached – though that auditor might infer that it was based on such matters as those relied upon in their evidence by Mr Railton, Mr [...], and Mr Main.

[376] [see paragraph 9.21(j) above]

[377] [T10/57]

9.43 In our judgment the allegation of non-compliance with paragraphs 2 and 9 of ISA 230 is plainly made out. The further question is whether any competent auditor acting with reasonable care and skill would have acted as Baker Tilly did in relation to the issue of documenting the reasoning behind Baker Tilly's judgment. We have concluded that the answer to that question is a negative one. The trading statement had been a red alert. There had been a dramatic fall in the value of Tanfield's shares. We consider that every competent auditor exercising reasonable care and skill would have wanted to document, and would have documented, the reasons for the judgments it made in deciding how it should respond (and had responded) to that alert. It follows that we are also of the view that in the respects alleged in this allegation 3(b) Baker Tilly failed to act in accordance with the fundamental principle of professional competence and due care, and that in the respects alleged Baker Tilly's conduct of the audit fell short of the standards reasonably to be expected of a Member Firm.

Post balance Sheet Events (Inventories) – Falling Short - Conclusion in Relation to Mr Railton.

9.44 It was Mr Railton's responsibility to decide and direct what, if anything, needed to be done further in the particular circumstances of the long delay following the presentation of the balance sheets and the issue of the trading statement. We have held that the competent auditor acting with reasonable care and skill would have investigated further management's assertions that it was not envisaged that obsolescence was a significant problem, and we have found that this would have been the case even if, as was not the case here, the earlier audit work undertaken in relation to obsolescence had been completed satisfactorily. Mr Railton was directly involved in Baker Tilly's decision not to carry out any such further investigations.

9.45 We have also held that a case where, as here, earlier work had not been completed satisfactorily, was a fortiori. Mr Railton was unaware that the planned substantive test had not been carried out, but it seems to us that once the trading statement came to his notice any competent auditor exercising reasonable care and skill would have sought some assurance (by checking with subordinates and/or looking at working papers) that the earlier work on obsolescence was reliable, and if that had been done, it is more than likely that the fact that the substantive test had not been carried out, and the other deficiencies in the earlier work, would have come to his or her notice. Mr Railton did not seek any such assurance, and we do not consider that he is in any way exculpated by the fact that he was unaware of the deficiencies of the earlier work on obsolescence.

9.46 Our conclusions are, therefore, that the case advanced in sub-allegation 3(a) is made out against Mr Railton, and that in this respect he failed to comply with the requirements of paragraph 4 of ISA 560, and also failed to act in accordance with the Fundamental principle of Professional Competence and Due Care.

9.47 It follows from Mr Railton's personal involvement in the post balance sheet events concerned that he too was personally involved in Baker Tilly's failure to comply with paragraphs 2 and 9 of ISA 230. It also follows that Mr Railton failed to effectively discharge his responsibility under paragraph 21 of ISA 220 as engagement partner for ensuring that the audit engagement complied with professional standards and regulations.

9.48 Our conclusion therefore is that in the respects alleged in Allegation 3, Mr Railton's conduct of the audit fell short of the standards reasonably to be expected of a Member.

10. PART 10 – ALLEGATION 4 – INADEQUATE EVIDENCE OF THE EXISTENCE / VALUATION OF TRADE RECEIVABLES

Between 26 November 2007 and 22 July 2008, in relation to the engagement of Baker Tilly to act as auditor of the financial statements of Tanfield Group, TES and SEV for the year ended 31 December 2007 the Respondents failed to obtain sufficient appropriate audit evidence of the existence and valuation of trade receivables to be able to draw reasonable conclusions on which to base the audit opinion, thereby:

(a) ***failing to comply with the requirements of paragraph 2 of ISA 500 and paragraph 21 of ISA 220; and/or***

(b) ***failing to act in accordance with the Fundamental Principle of Professional Competence and Due Care of the Code of Ethics of ICAS, ICAEW and ACCA.***

Particulars

1. The Respondents failed to obtain sufficient appropriate audit evidence in relation to two debts which were individually material to the audits of both TES and the Tanfield Group, namely

(i) the valuation of the £7.3 million odd debt owed to TES by [...] ("IPS"), and

(ii) the valuation of the £9.2 million odd debt owed to TES by [...] ("PSE");

2. Despite having identified it in the Key Issues Tracker as a significant risk for SEV regarding existence, valuation and overstatement, the Respondents failed to obtain sufficient appropriate audit evidence concerning the valuation and the recoverability of a debt of £500,000 owed since 2005 by W[...] to SEV as at 31 December 2007 ("the W[...] Debt").

3. Despite having planned to do so, the Respondents failed to obtain evidence by any other testing that would have given comfort over the existence of the debtor balances, such as confirmation or correspondence from the third party itself or a sufficient review of after date cash receipts.

4. The Respondents used an analytical test for the existence of trade receivables but did not obtain sufficient appropriate evidence to substantiate their conclusions.

5. The Respondents' substantive testing of the valuation of receivables in the TES audit files was insufficient in that they placed reliance on enquiries of management when alternative evidence could reasonably have been expected to exist. In particular, the Respondents' analytical procedures for receivables considered breaches in debtors' credit terms to assess the recoverability and appropriateness of the value of the individual debts. For five debtors identified as being in breach of their credit terms, neither written representations nor evidence of follow up of the management representations was obtained.

6. The Respondents failed to obtain any, or any sufficient, evidence of the basis of management's decision for making provisions against specific bad or doubtful debts.

10.2 As can be seen, the period between 26 November 2007 and 22 July 2008 includes both the pre- and post- balance sheet periods. However, so far as Mr King is concerned the period during which the relevant acts and omissions occurred is narrower. Mr King signed the audit opinion for Tanfield's financial statements on 21 April 2008. The relevant period in relation to Mr King, therefore, is from 26 November 2007 to 22 April 2008. The Respondents admit that Baker Tilly failed to make adequate enquiries in the post balance sheet period between 21 April 2008 and 22 July 2008, and that in this respect Baker Tilly fell short, but not significantly short, of the standards reasonably to be expected – see

paragraphs 10.11(d) and 10.66 below. This, of course, was the responsibility of Mr Railton and not Mr King.

Allegation 4.1 – The IPS and PSE Debts Owed To TES (Recoverability)

The Allegation

10.3 Sub-allegation 4.1 is;

"The Respondents failed to obtain sufficient appropriate audit evidence in relation to two debts which were individually material to the audits of both TES and Tanfield Group, namely

a. the valuation of the £7.3 million odd debts owed to TES by [...] ("IPS"), and

b. the valuation of the £9.2 million odd debt owed to TES by [...] ("PSE").

The IPS And PSE Debts (Recoverability) - Issues

10.4 As presented, the allegation is not that there was insufficient appropriate audit evidence that the debts had ever accrued. In relation to both the IPS and PSE debts the issues are as to the adequacy of the evidence obtained by Baker Tilly to enable them to determine the recoverability and hence the valuation of those debts.

10.5 Of course, any assessment as to the recoverability or valuation of a debt involves a consideration of the terms applicable to it, especially the terms of payment, and a consideration of whether or not the debt is paid up in accordance with those terms. It was alleged by the Executive Counsel that Baker Tilly failed to obtain sufficient appropriate evidence of those terms, in the case of the IPS debt, but no such complaint is advanced in respect of the PSE debt.

10.6 Baker Tilly's fieldwork established that the net trade receivables for TES at 31 December 2007 amounted to £30.1m and that this sum included:

(a) a £7.3m odd debt owed to TES by IPS i.e. 23.3% of TES's trade receivables – an increase from £4.4m as at 31 December 2006; and

(b) a £9.2m debt owed to TES by PSE i.e. 29.4% of TES's trade receivables – an increase from £0.2m as at 31 December 2006.

10.7 Not all of these debts were due for payment by 31 December 2007. In essence, the issues are whether Baker Tilly obtained sufficient appropriate audit evidence:

(a) as to the terms of payment of the IPS debt, and of the record of IPS's payments of that debt, to provide sufficient confidence in its recoverability; and

(b) as to the extent to which payments due in respect of the PSE debt were ***"in terms***", and of the record of PSE's payments of that debt, to provide sufficient confidence of its recoverability.

10.8 It is plain that the TES audit was completed on the basis of the understanding that the whole of the IPS debt was on 365 day credit returns. Executive Counsel challenged the correctness of this understanding, the challenge stemming from evidence given by Mr [...] in his interview with the AADB to the effect that the 365 day credit terms for IPS applied only to the provision of spare parts, and that the bulk of the debt was ***"probably"*** on 90 day terms.[378] Mr Leech considered that Baker Tilly did not obtain sufficient corroboration as to the applicability of these credit terms.[379] There is no dispute that Baker Tilly did not actually seek or obtain any documentary evidence substantiating the 365 day terms, although Mr [...] thought he may have been shown an invoice which was indicative of those terms.

10.9 In relation to the PSE debt there is no issue as to the credit terms applicable, the criticism being that the evidence of PSE's payment record which Baker Tilly obtained was insufficient to provide confidence in the recoverability of that debt. Mr Leech's opinion was that in the light of evidence that a substantial sum was overdue, additional procedures should have been undertaken to address the question of the debt's recoverability.[380] A similar criticism is advanced by Executive Counsel in respect of the IPS debt.

10.10 These criticisms are advanced in relation to the fieldwork in the period to 4 March 2008 (immediately after the Group balance sheet date of 28 February 2008), in relation to the period between that date and the date of the signature by Mr King of the Tanfield audit report on 21 April 2008, and in relation to the further period ending with the signature of the TES audit report by Mr Railton on 21 July 2008.

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[378] [J2/6/562]

[379] [Joint Memorandum paragraph 95: D2/5/451]

[380] [Joint Memorandum paragraph 100 – D2/5/452.]

10.11 Mr Main's opinion was that:-

(a) The failure to obtain documentary evidence to verify the 365 day credit terms for the IPS debt was a judgment the auditor was entitled to make, and not a failing[381];

(b) Baker Tilly concluded from details of payments provided by the client on 4 March 2008 that the IPS and PSE balances were in terms, and decided that no further work was required: whilst many auditors would have done more work (and he personally would have done), others might reasonably have concluded it was not necessary to do so[382];

(c) The failure to make further enquiries between 4 March 2008 and the date of the signature of the Group audit report on 21 April 2008 was not ***"best practice***" but was "***within the range of reasonable audit judgments as to the evidence required in the circumstances."***[383]; and

(d) The omission to make such further enquiries in July 2008 was outside the range of reasonable judgments and fell short of that required by ISA 560 Subsequent Events[384] but did not fall significantly short of the standards reasonably to be expected.

The IPS and PSE Debts (Recoverability) - Background/Facts

10.12 There was no reference to receivables in the Audit Plan.[385] However, receivables were identified as a high risk item in the "***Assembly of Audit Confidence***"[386] and the "***Working Assembly of Audit Confidence***"[387] planning sections of the audit file. Nevertheless, as noted above, according to Mr [...], "***high risk***" actually meant "***normal risk***"[388].

10.13 As stated, Mr Railton's and Mr King's evidence was that, save for recoverability of the W[...] debt, they did not consider Trade Receivables to be an area of "***significant risk***" at the planning stage, or indeed at all. This evidence contrasts with that of Mr [...]. Mr [...]

[381] [Paragraph 10.4.15 – D2/3/323]

[382] [Paragraph 10.4.23 – D2/3/325]

[383] [Para 10.5.1 - D2/3/327]

[384] [Paragraph 10.5.2 – D2/3/327]

[385] [F1/1]

[386] [G1/11]

[387] [F1/20]

[388] [[...] Witness Statement paragraph 188: C/1/38-39]

considered the IPS debt to be a significant risk (in the ISA 315 sense)[389]. Mr King did acknowledge, however, that Trade Receivables were the subject of more focus.[390]

10.14 Baker Tilly planned (see the Assembly of Audit Confidence)[391] to, and did, perform substantive analytical reviews and substantive testing of trade receivables. According to Mr [...][392] the analytical work for trade receivables on the Tanfield audit was completed by Mr [...] on 24 February 2008, and checked by himself on the following day. The analytical review paper, TES: Receivables AR – Trade[393], includes, amongst other things, the following notes:

"Trade Receivables

Andy advised that receivable days of approximately 60 would be reasonable to use in the expectations due to the fact that UK customers tend to operate on 30 days and push to around 40 and foreign customers operate on 60 days but push to around 80….estimated receivables based on average of approximately 60 days would be reasonable to use…

IPS

Credit terms for the customer are 12 mths and therefore the total debt due to TES at y/e represents full trade for 2007 plus an element relating to 2006 trade which has just become overdue and therefore shows in the current – 30 days overdue and the greater than 30 days overdue columns …… Major recoverability concern to be considered in relation to this balance . Consider separate disclosure.

[...]

This poses less of an issue as recoverability has been evidenced during the year. Also as expected above days credit are often pushed to 80 days therefore to have Oct debtors o/s at the y/e is reasonable."

10.15 In relation to the IPS debt, the "***Analytical review***" working paper also records the following:

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[389] [T6/128]

[390] [T7/9]

[391] [F1/15/121 and G1/7]

[392] [Witness Statement paragraph 193: C/1/40]]

[393] [G2/22/211-215]

"***Received £831k post-year-end which covers all of the older debt and contributes to the current debt. No recoverability issue deemed to exist***"[394]. This comprised the first three 2008 payments shown on the payment profile[395].

10.16 Similarly, that paper includes the following note in relation to the PSE debt:

"***Rec'd 2,496,203 euros post y/e which covers all the older debt and contributes partially to the 30 day debt (approximately £ equivalent = 1.710k). No recoverability issues deemed to exist***."

10.17 A further working paper[396] indicates in relation to IPS that the credit terms were 365 days and that the 171,521 Euros due at the year-end had since been received, and records "***PFM noted***" – which Mr Main inferred meant "***Point for Manager".*** Importantly, the paper also records[397] how credit terms were embedded into the ledger sales system, showing all items within terms as "***current***". Mr Main[398] stated that the IPS balance was ***"largely shown as current as payment terms were set on the system as 365 days***": (one cannot see from the spreadsheet itself what credit terms were embedded in relation to each customer, and hence Mr Main's conclusion appears to be based on the Respondents' witness statements.)

10.18 In her witness statement[399] Ms. [...] stated that she was involved in the audit work relating to TES trade receivables and that the client had informed them that the IPS debt was on 365 days credit terms: she was fairly certain that the informant was [...], who had also stated that Tanfield were not aware of any bad debt concerns other than those for which provision had been made: she remembered questioning the IPS debt at the time and discussing it with [...]. She stated that she was the author of the note that the IPS debt was "***a major recoverability concern raised by the audit team..".***

10.19 In her oral evidence[400] Ms [...] stated that although she did not see any underlying documents corroborating the 365 credit terms, [...] demonstrated to her that these terms were reflected in the TES accounting system.

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[394] [see lines 246 – 249 of G2/22/214]

[395] [E3/488]

[396] [G2/30/256]

[397] [lines 29 – 32]

[398] [paragraph 10.3.13:D2/3/315]

[399] [Paragraphs 26 – 28:C/5/127]

[400] [T5/84 - 88]

10.20 Mr [...] in his witness statement[401] asserted that he had a good recollection of the IPS debt because the 365 day payment terms were particularly unusual. In his oral evidence[402] he stated that he was told of the 365 day payment terms for the IPS debt by a lady who looked after credit control. In paragraph 38 of his witness statement, he asserted that, although he could not recall with certainty, he believed he saw the 365 day term stated either on the TES system or on a copy invoice. Also in his witness statement, at paragraph 39, Mr [...] stated that he had discussed the 365 day term with Mr [...], who had told him that Tanfield had come to an arrangement with IPS to take a bulk purchase of spare parts stock, which had been acquired with Snorkel, on 365 day terms, IPS being a supplier of spare parts to the industry, and that ***"after that the issue was raised up the review chain"***. In this statement he did not say what proportion of the IPS balance he understood to relate to the Snorkel spare parts. (As a matter of detail, the note of Mr [...] interview records him as having referred to Upright rather than Snorkel, though nothing turns upon this discrepancy.)

10.21 Mr Railton's evidence is that Mr [...] had raised with him issues in respect of the debt due from IPS. In his witness statement, Mr Railton explained that the audit team had discussed the debt with management and had been informed that IPS had credit terms of 365 days. He stated, at paragraph 141 of his witness statement, "***365 days credit terms afforded to IPS were unusually generous but the team's audit work had not identified any issues regarding the recoverability of the amounts."***[403] Mr Railton did not state who, in the audit team, discussed the debt with management.

10.22 Mr [...], in his witness statement[404], referred to the variances which emerged during the analytical review of trade receivables. These included £3.38m attributable to the fact that Baker Tilly had been unaware of the 365 day credit terms for IPS, and a variance attributable to the fact that PSE credit terms were normally 80 days and not 60 as originally assumed. Mr [...] went on[405] to state that he raised the IPS and PSE issues with Mr King and Mr Railton and that they "***discussed the matter with Mr [...], and "the issues were then addressed" in the FAF***". Mr [...] did not state which IPS and PSE issues were discussed with Mr [...]. In our judgment it is unlikely that these discussions with Mr [...] focused on the credit terms. It is more likely that discussion of the credit terms

[401] [Paragraphs 37 – 39: C/4/119]

[402] [T6/130]

[403] [C/2/77]

[404] [Paragraph 194:C/1/40]

[405] [paragraph 195]

took place at a lower level when the variances were first observed and that what was discussed at a more senior level was the fact that the balances were substantially unpaid at that time and that Baker Tilly would be requesting specific representations from directors in relation to that issue – this would be consistent with the note in the FAF to this effect (see paragraph 10.23 below). Again, if these discussions with Mr [...] had been about the credit terms one would have expected Mr [...] to say so. Instead he stressed[406] that no one at Tanfield had demurred upon or after the receipt of the FAF, annotated as set out in the next paragraph.

10.23 Both debts featured in the Final Audit Findings reports presented to the Audit Committee on 28 February 2008[407]. The report notes (so far as relevant):

"Of the total trade receivables of £30.1 million at 31 December 2007, £9.2 million is due from [...] (2006: £0.2 million) and £7.3 million is due from [...] (2006: £4.4 million).

Our audit work has not highlighted any issues with regards to recoverability of the amount due from [...] although this balance increases the exposure of the group.

It has been noted from our audit work that the credit terms for sales to [...] are 12 months from the date of invoice. These are exceptional terms which have resulted in the year end receivable balance exceeding sales to this customer for the 2007 financial year"

10.24 The "***Resolution column***" of the FAF contains the following[408]:

"At the time of our audit fieldwork these balances remained substantially unpaid.

Specific representations are to be obtained from the directors in relation to this issue.

Awaiting confirmation of receipts during the year and post year end" *(*This line emphasised in the original)***.**

10.25 Both Mr King and Mr Railton made the point that, as can be seen from the penultimate paragraph in the quotation referred to in paragraph 10.23 above, the 365 day payment

[406] [Paragraph 198; C/1/42]

[407] [F2/49/355]

[408] [F2/49/355]

terms for the IPS debt had been raised in the FAF and nobody on the Audit Committee had corrected the position. Mr [...]'s evidence was to the same effect - see paragraph 198 of his witness statement[409]. There is no evidence to contradict this testimony, and we accept it.

10.26 In his witness statement, at paragraph 140[410], Mr King stated that the recoverability of the IPS and PSE balances was discussed at the audit committee meeting at which the FAF was reviewed. This evidence needs to be addressed with caution. A number of issues raised in the FAF (including an issue of potential over-reliance on key customers identified as IPS and PSE) are annotated "***This issue has been discussed with directors'***, and the issue of recoverability of receivables, which was annotated as set out in paragraphs 10.15 and 10.16 above was not recorded as having been discussed. There is a note of an Audit Committee Follow Up Discussion, dated 18 March 2008,[411] between Mr King and Mr […], the Chairman of that committee and a Mr […], but this contains no reference to any aspect of trade receivables. Furthermore, if there had been any such discussion between Mr King or Mr Railton with senior management or the audit committee which touched on the terms of payment of the IPS debt neither of them would have been at such pains to draw attention to Tanfield's silence on the issue after receipt of the FAF. The fact that the "***Resolution***" section of the FAF refers to the provision of specific representations in relation to unpaid balances is consistent with some discussion of recoverability at the meeting with the audit committee (though the discussion may have been later) but it does not support any suggestion that any question as to the terms of credit was raised at that meeting.

10.27 Our conclusion, therefore is that in spite of the fact that Mr [...] raised this up the review chain, neither Mr King nor Mr Railton (nor anyone else on the Engagement Team) pursued this with Mr [...] or sought corroboration of these payment terms. It appears that the only person who made any enquiry with senior management about the 365 day term was Mr [...], and that it was after his conversation with Mr [...] that he passed the matter up the chain.

10.28 On 4 March 2008, Mr [...] received an email from [...], to which "***Payment profiles***" for IPS and [...] were attached[412]. This provided evidence of:

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[409] [C/1/42]

[410] [C/3/110]

[411] [F2/51/392]

[412] [E3/488]

(a) payments by both IPS and PSE throughout 2007; and

(b) the following post-year end receipts –

IPS

Jan 4 £ 237,213.82

Jan 14 £ 222,339.59

Feb 1 £ 371,127.99

Feb 27 £ 22,385.13

£ 853,066.53

PSE

Jan 9 €2,496,203.07 .

10.29 Mr Main at paragraph 10.4.18 of his report[413] described the payments as "***regular***", but in fact there is nothing in the email to show that each one represented the full amount due at the time when it was made, or that the payment was on time.

10.30 It is apparent that at least some of the engagement team[414] mistakenly assumed that the payment from PSE was in Sterling, whereas in fact the Sterling equivalent was actually only some £1.7m. Initially, Mr Main was under the same misapprehension, and served a "*corrective statement*" once he appreciated the error – see paragraph 10.62 below.

10.31 The work paper dealing with cash received by TES after the balance sheet date[415] recorded

"Upon further discussion with the client noted that […] amount is on 365 day credit terms .Noted that there is no history of significant bad debts however due to the size of the balance and the 1 year credit terms. Noted as PFM.

Noted that further consideration of [...] balance is also required – refer to PFM"

[413] [D2/3/324]

[414] [[...]'s witness statement paragraph 197(d):C/1/42]

[415] [F1/27/214]

("PFM" appears to be an abbreviation for "Point For manager".)

10.32 In the present context, what Mr [...] said to Baker Tilly in 2007/8 is more important than what he said to the AADB some years later**.** In a supplemental statement[416] served shortly before the hearing, Mr [...] stated that from his discussion with Mr [...] his understanding was that most, if not all, of the debt was on 365 day terms:

"9. In paragraph 39 of my witness statement, I explain that I had a discussion with [...] in relation to the payment terms of IPS. Paragraph 159(a) of the EC's Opening Submissions states that, in interview with the AADB, [...] explained that the 365 day terms related to only a small part of the balance of the IPS debt, and the IPS's usual payment terms (probably 90 days) applied to the vast majority of the balance.

10. I was surprised to read this. I recall this discussion with Mr [...] very clearly, and it was my understanding from this discussion that the overwhelming majority, if not all of the IPS debt was on 365 day terms. To the extent that these payment terms may have only related to spare parts sales, I recall that spare parts sales made up the vast majority of the IPS debt, and so the vast majority of the balance would have been on 365 day payment terms. This is consistent with my recollection of the 365 day terms being specified on a copy invoice, or the accounting system, or possibly both (as noted in paragraph 38 of my witness statement)".

10.33 In his oral evidence, Mr [...] again stated[417] that the credit control lady had shown him either an invoice or an entry on a screen which confirmed 365 day credit applied to it. He stated[418] that Mr [...] had told him there was a one-off arrangement with IPS re stock, and he (Mr [...]) understood that the 365 days commenced on the date of the arrangement, though he did not know when that was, other than that it was sometime between the summer of 2007 and the year end. He also stated that he did not know whether the arrangement applied to all of the stock or certain amounts of it, but the arrangement was to take *"**significant amounts***" of this stock. He subsequently stated that he understood "***the balance***" was on 365 day terms, and referred to "***the bulk of that year-end balance***". [419]He confirmed that whilst the evidence he was shown by the credit controller

[416] [C1/7/135]

[417] [T6/130 – 132]

[418] [T6/135]

[419] [T6/140]

might have showed that there was 365 day terms in relation to one aspect of the debt it could not provide any corroboration as to the overall debt[420].

10.34 It is apparent that at the planning stage Baker Tilly were given to understand by the client that on average it took customers 60 days to pay their debts. According to Mr [...],[421] the substantive analytical review work for trade receivables relied upon expectations for trade receivables that had been developed at the planning stage, which were set by Ms [...] and Mr [...] following discussions with […] at Tanfield: […] advised that 60 days was a reasonable assumption for them to make for the purposes of their planned review - on the basis that UK customers' terms were 30 days (often stretched to 40) and foreign customers it was 60 days (often stretched to 90). The substantive analytical review revealed a difference of 26% between Baker Tilly's expectations and the actual figures at year end, which equated to around £8m – some evidence of the need for information provided by Tanfield to be regarded with caution.

10.35 It was in the follow up to this result that Baker Tilly were informed that the IPS debt was on 365 day payment terms[422]. Hence, it is apparent that the information provided to Ms [...] and Mr [...] as to the IPS 365 payment terms was not provided to them at the outset of their work in relation to TES trade receivables – at a time when they were plainly enquiring about the customers' credit terms, and when it should have been apparent to Mr […] that if the whole or any substantial part of the IPS debt was on 365 day payment terms it might be relevant for Baker Tilly to know that for the purposes of setting their expectations for the purposes of the proposed analytical review.

10.36 As appears from paragraphs 10.14 above, the PSE business was understood to be on 60 day payment terms, although these was often extended to 80 days. In his oral evidence Mr Railton stated that he had had a conversation with Mr [...] as a result of which he understood a payment of €2.5m after the year end had put the December balance in terms[423]:

"***The conversation I'd had with [...] and – and from recollection what's documented on the trade debtors analytical review confirms that on receipt of the 2.5 million euros on 9 January, that put the December 2007 balance in terms***".

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[420] [T6/141]

[421] [Paragraph 190:C/1/39]

[422] [[...] witness statement paragraph 194.1 (b): C/1/40]

[423] [T7/172-173]

10.37 The evidence given by Mr King in paragraph 142 of his witness statement[424] was that "***There was no objective evidence at the time that the balances from IPS and PSE were impaired"***. In his oral evidence[425] he stated that he could not recall what at the time he understood as to whether or not the PSE debt was in terms, but PSE was a customer with a record of slow payment, and had made significant payments post-year-end, and so ***"he was satisfied with that."***

10.38 Mr Main, at paragraph 10.1.1 of his report,[426] accepted that it was possible that a significant part of these debts remained unpaid both when the Tanfield audit report was signed on 21 April 2008 and the TES audit report was signed on 21 July 2008, though he stated that the amount unpaid was not clear.

10.39 In fact, as stated at paragraph 10.6 above and as recorded in the analytical review papers, at the 2007 year end, the PSE balance (owed but not necessarily due) was £9.2m. On the basis of Ms [...]'s payment profiles (paragraph 10.28 above), £6.1m was attributable to sales in November and December 2007 (Lines 172 – 175[427]) leaving £3m odd which related to sales in October 2007 (or earlier) and therefore due for payment on 21 January 2008. As has been seen, a payment of just under €2.5m (equivalent to roughly £1.7m) was received by TES from [...] after the year end - on 9 January 2008 (referred to at line 251 in the working paper "***Receivables AR***"[428]. Nothing further was received before 22 January 2008.

10.40 On the basis of this evidence, therefore, even assuming PSE enjoyed extended payment terms of 80 days, the €2.5m payment did not put the December 2007 balance "***in terms***". On any view, at least £1.3m would be due by 21 January 2008 (if not before), Under cross-examination[429], Mr Railton accepted this. Mr King[430] also accepted that: (a) the €2.5m payment did not put the December 2007 balance "***in terms***", and that at least £1.3m would be due by 21 January 2008 (if not before); and (b) £6m would be out of term and due by 21 March 2008 at the latest: however, he did not accept that this indicated that there was a serious issue with recoverability:-

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[424] [C/3/111]

[425] [T7/15]

[426] [D2/3/311]

[427] [G2/22/213]

[428] [G2/22/214]

[429] [T8/1 – 15]

[430] [T7/14]

Q. Yes. So just looking at this analytical review, you already have a situation where the difference between the 3 million and the 1.7 is outside terms, and you've got a 6 million figure that will be outside terms at the latest as of 21 March.

A. Yes.

Q. So that means that there is a very serious issue around recoverability that needs to be further investigated, doesn't it, Mr King?

A. I mean, it means they hadn't settled. It doesn't mean necessarily that there was a serious issue about recoverability at that time."

10.41 However, the Resolution of Issues Schedule[431] included a note in the following terms:-

"<u>Recoverability of trade receivables</u>

There is no evidence of credit limits in operation on the sales ledger. This is particularly important in relation to the two very significant balances with [...] (£7.3m) and [...] (£9.2m).

No history of issues re recoverability of debts from these customers.

To be considered re going concern impact."

10.42 Mr [...] explained that this Schedule was uploaded onto the Senior Review Checklist of the Group aud-IT (but not the TES audit file) on 28 March 2008; it was uploaded onto the TES aud-IT file on 22 July 2008.

10.43 Mr King and Mr Railton both accepted that they did not perform any follow-up work prior to the signing off (by Mr King) on 21 April 2008 of the Tanfield audit report, or the signing off (by Mr Railton) of the TES audit report on the 21 July:

(a) Mr Railton agreed in cross-examination that he never went back to check the position after the Final Audit Findings Report on 28 February 2008; he never checked to see if payments had been made in relation to this debt[432].

[431] [F2/57/415]

[432] [T8/16]

(b) Mr King did not think it necessary to look at the underlying information which the Engagement Team had seen about the payment history post-year end. He was satisfied with the evidence the team had at the time of execution[433].

10.44 It is common ground that the management representation envisaged in the FAF (see paragraph 10.24 above) was never obtained and also that there is no record on the audit file to explain why this was so. When the AIU asked why this was, Baker Tilly replied: "***we concluded that because [...] and […] were within terms and no further evidence of non-recovery existed, no specific representation was required***."[434]

10.45 Mr Railton stated in his witness statement (paragraph 148)[435], "***I cannot recall why that was the case, but the audit team did receive confirmation of payments received from IPS and PSE after the year end***". However, in his oral testimony he acknowledged that he was not aware what confirmation the audit team had received in relation to these payments; he did not consider it necessary to check what information they had received to confirm receipts both during the year and post-end prior to signing the audit – although he was "***aware of broadly what receipts had been received …because (he) knew how much activity there had been with these two important customers. So (he) was aware of the activity and the interaction with [...] and IPS***"[436]. He also stated that he was not aware of the email from [...]; and he did not look to see whether any further evidence had been obtained over and beyond what was on the analytical review prior to 21 July 2008.[437]

10.46 Mr King's evidence was that this was not an oversight. In cross-examination it was suggested to him that it appeared that he had just overlooked the fact that Baker Tilly had planned to seek a representation from management in relation to these two debts:

"Q. It rather appears that that was just simply overlooked, doesn't it?

A. No, I think that was because we were satisfied that we'd had sufficient evidence of the payments post-year-end.

Q. Well, I don't understand how you could have been satisfied of that, Mr King, you hadn't seen any evidence over and above the analytical review.

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[433] [T7/19, T 7/25 , T7/ 30 – 31]

[434] [Main paragraph 3.2.8: D2/3/251]

[435] [C/2/78]

[436] [T7/172]

[437] [T7/186]

A. Other than the payments that they had already made, no

Q. No, and the analytical review already showed that, in relation to PSE, it was outside its terms.

A. By -- yes, it would have been, yes.

Q. Yes. So how could you possibly have been satisfied as at 21 April if you had taken all of that into account?

A. I was satisfied."

The IPS and PSE Debts (Recoverability) - Executive Counsel's Case

10.47 The Executive Counsel submitted that the Respondents failed to obtain sufficient appropriate audit evidence in relation to the valuation of the IPS and [...] debts, and that this was a serious failure:

(a) The IPS and PSE debts were individually material to TES and Tanfield (it would be recalled that "***M***" for TES was £429,000 and for Tanfield, £1.128m): they accounted for over half the year end receivables balance (£31.22m) for TES.

(b) These debts should have been treated as "***significant risks***". Mr [...] considered the IPS debt to be a significant risk (in the ISA 315 sense)[438]: Mr King and Mr Railton acknowledged that they were the subject of heightened focus[439].

10.48 The thrust of the Executive Counsel's case was that during the audit no sufficient appropriate evidence was obtained:

(a) to conclude that the IPS debt was in fact on 365 day payment terms (and there was evidence to suggest that some or all of it was or may not have been on those terms), and there were no issues as to its recoverability;

(b) to conclude that there were no recoverability issues in relation to the PSE debt.

10.49 In relation to the IPS debt, Executive Counsel referred to :-

[438] [T6/129]

[439] [T7/9]

(a) The fact that in the analytical review it was identified as a "***major recoverability concern***"[440].

(b) The explanation given by Mr [...] in interview with the AADB that the 365 day terms related to only a small part of the balance. IPS's usual payment terms (which Mr [...] recalls were probably 90 days) applied to the "***vast majority***" of the balance[441].

(c) The fact that it was apparent from the FAF, that at least some of the Engagement Team understood that IPS were on exceptionally generous 365 day payment terms – and that this applied to the whole debt: Mr King and Mr Railton confirmed that this was their understanding.

10.50 Executive Counsel submitted that:

(a) Mr Railton and Mr King, and those other members of the Engagement Team who believed that IPS were on 365 day payment terms, were almost certainly mistaken.

(b) As a result of his conversation with Mr [...], Mr [...], who it appeared had had the greatest involvement with this issue, had an appreciation that not all of the debt was necessarily on such payment terms.[442]

(c) IPS's 365 day payment terms (as some of the Engagement Team understood them to be) were unusually long: that called for an explanation and evidence. Mr [...] had specifically raised this issue up the review chain for the attention of Messrs [...], Railton and King.

(d) Furthermore, there was disconfirming evidence on the audit file which should have alerted the Respondents to the fact that their understanding of these payment terms may have been wrong:-

(i) Firstly, IPS had paid an invoice dated 30 November 2007 on 1 February 2008 (i.e. 10 months early if the 365 payment terms were in place)[443].

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[440] [G2/22/213]

[441] [J2/6/561]

[442] [witness statement paragraph 39:C/4/119]

[443] [G2/23/216.]

Both Mr [...] and Mr Main agreed in evidence that this should have prompted enquiries[444].

(ii) Secondly, […] (an accountant in Tanfield's finance team) had advised that 60 day payment terms was a reasonable estimate for the purpose of setting expectation in the analytical review. It seemed unlikely that Andy would have advised this if such a significant client had payment terms of 365 days (see lines 50 – 57 of "***TES Receivables AR – Trade***" referred at paragraph 10.14 above[445]). In the circumstances, management should have been questioned and corroboration sought.

(e) There is no record on the audit file of the additional information provided by Ms [...] on 4th March 2008, nor of the impact it had on the Respondents' assessment of the recoverability of these debts. Neither Mr King nor Mr Railton appear to have seen it.

(f) This additional information, had it been properly considered by the Respondents should have raised serious concerns:

(i) The payment from IPS of £22,385 on 27 February was minor given the size of the debt.

(ii) Further, the payment profile for PSE Sales showed that only a single payment had been received from [...] in 2008. The fact that no payment was received from [...] between 9 January 2008 and 4 March 2008 ought to have prompted the Respondents to consider whether further follow up procedures were necessary before the audit reports were signed.

(g) On the assumption that PSE had 80 day payment terms, then by no later than 21 January 2008, the [...] debt was not within terms, and some £1.3m was due. This should have prompted further investigation. In re-examination, Mr Main was taken to another working paper[446] which, it was suggested, showed that something different from the £1.3m would have been due on 21 January 2008[447]. Insofar as there was confusion, or inaccuracies and inconsistencies, in the audit

[444] [T8/159:T9/117]

[445] [G2/22/211]

[446] [G1/12/16 lines 13/14]

[447] [T10/155]

documents around this issue, this does not assist the Respondents. These discrepancies should have been picked up by the Engagement Team, and in particular by Mr [...]. As Mr Main acknowledged in evidence, it is something that the Engagement Team should clearly have identified[448].

(h) By 21 April 2008, the date when Mr King signed the auditor's report for Tanfield, a further £6m was due to be paid by IPS. The last payment from PSE was (so far as the Respondents were aware) 9 January 2008; and the last payment from IPS was 27 February 2008. This ought to have prompted Baker Tilly and Mr King to make further enquiries prior to signing the Report. Testing was not, but should have been, extended to cover cash receipts up to when the Group Accounts were signed.[449] The non-receipt of any payments between those dates would be an indicator of impairment.

(i) Testing was not, but should have been, extended to cover cash receipts up to when the accounts for TES and SEV were signed. By 21 July 2008, over 6 months had elapsed since the last known payment from PSE; and nearly 5 months since the last known payment from IPS.

(j) Despite resolving to do so in the FAF[450], the Respondents did not obtain specific representations from the directors.

(k) There is no evidence on the audit file that the Respondents made a judgment that further evidence was not required to assess whether the IPS and PSE balances should have been impaired. It is to be inferred that no, or no proper consideration was given to this issue.

(l) Mr Main acknowledged that many auditors would have done more work and made further enquiries in respect of the IPS and PSE debts and that he, personally, would have done so before signing the report on 21 April 2008. It is telling that he would not, however, express an opinion on whether any reasonable auditor would have done so[451].

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[448] [T9/52]

[449] [Leech 1 paragraph 5.2.17:D1/1/96]

[450] [F2/49/355]

[451] [T9/63]

The IPS and PSE Debts (Recoverability) - The Respondents' Case

General

10.51 In relation to the contested allegations it was submitted that:

(a) The real issue addressed during the course of the hearing in respect of allegation 4.1 concerned the recoverability of the balances. Mr King's evidence was that he considered the evidence in relation to these two balances and exercised a judgment that he was satisfied as to recoverability.

(b) In respect of IPS, at the date of the analytical review the balance was within payment terms and the analytical review recorded specifically that £831,000 had been received post the year-end. There was therefore good evidence as to recoverability[452].

(c) In respect of PSE, Mr King's evidence was that, although he could not recall whether he knew whether PSE was within terms at the time of his review, he was nonetheless satisfied, given that PSE was a customer with a record of making payments, albeit slow payments, and had made significant payments post the year-end.[453]

(d) So far as the position up to the signature of the Group audit opinion (i.e. 21 April 2008) is concerned Baker Tilly obtained sufficient appropriate audit evidence to allow a reasonable auditor to be satisfied as to the valuation of the IPS and PSE debts.

(e) While there was an accepted "***falling short***" in relation to Post Balance Sheet Events work performed prior to signature of the TES audit opinion (ie 22 July 2008) that ***"falling short"*** was not so serious as to cross the threshold into significance

10.52 Mr Main's evidence was, in effect, that, in light of all of the evidence suggesting that the payment terms were 365 days, it was a reasonable judgment not to seek further corroborative evidence in respect of this issue.[454] It was submitted that Mr Main's view

[452] [Main – D1/2/324]

[453] [T7/15]

[454] [Paragraph 10.4.15:D2/3/323]

reflected the approach that a reasonable auditor might have taken in respect of this issue, and that there has plainly not been any "***falling short***".

10.53 Mr Main's opinion was that if the Tanfield audit report had been finalised on or shortly before 4 March 2008 Baker Tilly had sufficient appropriate audit evidence in respect of the valuation of the IPS and PSE trade receivables to support their audit opinion[455], though the fact that no payment had been received from PSE since 9 January 2008 ought to have prompted them to consider that further follow-up procedures might be necessary before the audit report was signed on 21 April 2008[456].

10.54 The opinion referred to in the last paragraph appears to have been based on the observations in an earlier paragraph of his report, paragraph 10.4.19[457] where he stated:

"It is clear from the witness statements that Baker Tilly made a judgment that further evidence was not required to assess whether these balances should have been impaired and they relied upon a number of matters as follows:

A. £2,5 million had been received from PSE in January 2008 and £831,000 had been received from IPS. Payments of this magnitude, (which in accordance with Baker Tilly's understanding, maintained those receivables within normal payment terms) provided evidence of recoverability.

B. The debts were discussed with both the finance director, who would have seen the audit findings report, and the Audit Committee, and neither gave any indication that the debts should be impaired and for this reason specific representations were not sought.

C. The balances would appear to have been brought back within payment terms by 4 March 2008, when [...] provided details of payment patterns of each account (based upon the common understanding of Baker Tilly and Tanfield's accounts department of the IPS payment terms).

Both of these balances were with major customers who had a good track record of paying balances on time as evidenced by the schedule of historical payment patterns supplied by [...] on 4 March 2008."

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[455] [Paragraph 10.4.21 of his report D2/3/325]

[456] [Paragraph 10.4.20]

[457] [D2/3/324]

10.55 The only reference given by Mr Main in this paragraph of his report was to Ms [...]'s list of historical payments. However, it is to be noted that in his witness statement Mr King asserted that the "***recoverability issues of these balances were discussed at the audit committee meeting***"[458]*.*

10.56 In relation to the issue arising from the lack of further investigation as to the payment patterns after 4 March 2008 Mr Main, in his report, at paragraph 10.4.22[459], referred to the fact that the AIU in the course of a routine monitoring, in October 2008, of Baker Tilly's procedures questioned why these balances had not after all been included in the letter of representation which was obtained from Tanfield, and Baker Tilly had responded to the effect that no representations were considered necessary as the balances were within terms and no further evidence of non-recovery existed. Mr Main commented that the AIU appeared to be satisfied as it was not raised in the report subsequently made to Baker Tilly.

10.57 Mr Main then expressed the following opinion in relation to this issue[460]:

"***10.4.23 It is clear that Baker Tilly concluded after receiving details of payments on 4 March that those PSE and IPS balances were back in terms. This was explained in their response to AIU. On this basis they considered no further enquiry of management was required before the audit opinion was signed on 21 April 2008. I believe that many auditors would have done more work and made further enquiries in respect of the IPS and PSE balances, and I personally would have done so. However, as the AIU's apparent acceptance of Baker Tilly's approach suggests, others might reasonably have concluded it was not necessary to do so.***"

10.58 As appears from paragraph 10.11(c) above, Mr Main concluded that though not best practice Baker Tilly's judgment in relation to this issue was within the range of reasonable audit judgments.

The IPS 365 Day Credit Issue

10.59 The Respondents referred to the facts that:-

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[458] .[Paragraph 140 C/3/110]

[459] [D2/3/325]

[460] [D2/3/325]

(a) The substantive analytical review identified issues with amounts relating to the IPS and PSE balances. Mr [...] raised these issues with Mr King and Mr Railton (who in turn raised the issues with Mr [...]).[461] However, the work papers also indicated – and Baker Tilly plainly believed – that the non-current part of both the PSE and IPS debts as at the year-end had been paid by the time at which Baker Tilly completed its audit fieldwork.

(b) The *"**Receivables Substantive Testing**"* working paper[462] recorded that the IPS debt was on 365 day terms and that the sum of €171,521 due for payment at the year-end had since been received. In respect of the PSE debt, the working paper recorded that €20,000 was outstanding but that *"**payments [are] regularly received from [the] customer, therefore not considered doubtful**"*.

(c) Further post balance sheet event procedures were also recorded in the aud-IT file, which included consideration of the IPS and PSE debt balances. There was a summary of these procedures at paragraphs 10.3.24 – 10.3.29 of Mr Main's Report[463].

(d) The issue of the IPS and PSE debts was recorded in the Final Audit Findings Report (see paragraph 10.24 above) which also noted that the auditors were awaiting confirmation of receipts during the year and post year-end. The confirmation of these receipts was then later supplied by [...] on 4 March (see paragraph 10.28 above).

10.60 It was submitted that:-

(a) The suggestion that the IPS terms might not have been on 365 day terms was based solely on a few lines in the transcript of Mr [...] interview with the AADB. The Executive Counsel could have exercised his powers under the Scheme to require Mr [...] to attend to give evidence before the Tribunal on this issue, but has chosen not to expose him to the Tribunal's gaze.

(b) As Mr Main stated at paragraph 10.4.14 of his report[464], the evidence obtained by Baker Tilly to indicate that the payment terms were 365 days was compelling:

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[461] [[...] paragraphs 190 – 195: C/1/39-41; Main paragraphs 10.3.19 to 10.3.23 : D2/3/317-318]

[462] [G2/30/256]

[463] [D2/3/0318-0320]

[464] [D2/3/322-323]

(i) The TES accounting system (Avante), which was programmed with the credit terms of all debts, had been set up so that only debts from IPS of over 365 days were shown as overdue. Ms [...] explained when questioned that she had a clear recollection of being shown this within TES's software systems.[465] This was also clearly documented within the "***Receivables analytical review***" working paper.[466] (In fact Ms [...]'s evidence was not very clear and that working paper does not appear to record anything about the software. Moreover, the working papers refer to 365 days from invoice and [...] thought it was 365 days from "***the arrangement***").

(ii) [...], the financial controller for the Group, informed Baker Tilly that there were no unusual levels of bad debt or slow payment problems.

(c) The audit team were told that the payment terms for IPS were 365 days, as is set out in the work paper dealing with cash received into TES after the balance sheet date.

(d) The Final Audit Findings Report was sent to Mr [...] in advance of the Final Audit Committee meeting, and drew attention explicitly to the fact that the payment terms for IPS were 365 days – yet at no stage was this assumption corrected (either by Mr [...] or by Mr […]).

(e) In his oral evidence Mr [...] confirmed the account of his discussion with Mr [...] which he had given in his witness statements.[467]

(f) Mr Railton later emphasised when questioned that he had flagged the point specifically in the report for the audit committee meeting (a copy of which was sent to [...] in advance) and that, from his perspective, Baker Tilly had received a consistent message from the financial controller, the credit controller, the financial director and the audit committee, as well as from the Avante system, all of which suggested that the credit terms were in fact on 365 days.[468]

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[465] [T5/88]

[466] [F1/34/259 line 270 – 276]

[467] [T6/139]

[468] [T7/167]

(g) It was put to Mr Main on the penultimate day of the hearing that there had been evidence of one IPS invoice dated 30 November 2007 being paid on 1 February 2007 (i.e. before payment was required if IPS had a year to pay). There were many possible reasons why an invoice might on occasion be paid within its term and/or (as here) out of sequence. Mr Main's evidence was that he could see how any implication that payment terms were shorter might be overlooked,[469] not least because this work paper was not prepared for the purpose of corroborating an expectation as to payment periods.[470]

Both Debts –The Other Issues

10.61 The Respondents relied upon the evidence of Mr Main referred to in paragraphs 10.52 to 10.55 above.

10.62 As appears from paragraph 10.52, in his initial report Mr Main referred to the balances having been brought back within payment terms. It is clear that this was based on the misunderstanding that the payment made by PSE in the new year was in Sterling, because in a sheet of corrections to his report Mr Main referred to the evidence that the payment was in Euros and that the Sterling equivalent was £1,710,000. In the sheet he acknowledged that, as a consequence, the PSE debt may not have been brought back within payment terms, but he referred to a TES Receivables Substantive audit working paper[471] in which it was noted in relation to the PSE debt that "***20,000 Euros of older year end debtor still outstanding at time of fieldwork. To be included in next payment (payments regularly received from customer, therefore not considered doubtful)"***, and he stated that it suggested that the PSE balance had been brought within normal terms "***subject to a trivial amount of €20,000"***. He also stated: ***"If Baker Tilly understood the full sum had been repaid by reason of a clerical error in relation to the currency, that would of course amount to an error in the detailed fieldwork but, even if the PSE balance had not been brought back within payment terms, this does not affect my conclusion in paragraph 10.5.1"***. (See paragraph 10.11(c) above.)

10.63 In relation to the suggestion that elements of the PSE debt were outside terms as at 21 January and that he personally might have followed up some later payments, reference

[469] [T9/116]

[470] [cf T4/70]

[471] [G2/30/255]

was made to Mr Main's evidence that he considered that a reasonable auditor could have been satisfied with the position in respect of PSE on the basis of the evidence available.[472]

Q. Because that would not fall within the range of reasonable audit judgments not to carry out further enquiries.

A. I think it would. Even if I knew that only 1.7 had been paid, you've still got, as I said, a very substantial payment coming in from this customer, who'd also paid continuously through the year. I personally would have followed up some later payments to see what had happened since that point in time, but I can see that other partners might have said, "Well, there's nothing to indicate here that they're not continuing to make payments. They're a very important customer. I'm not going to follow it up further."

10.64 Again, in relation to the evidence that no payments had been received from PSE in December 2007 and only one in January 2008 and then none in February, the Respondents referred to the evidence of Mr Main that he did not consider the payment pattern in respect of the PSE debt as shown by the schedule attached to [...]'s email to Mr [...] dated 4 March 2008[473] to give rise to any particular concern, not least as missing payments were not unusual during the Christmas period, and in light of the fact that there had since been a substantial catch up payment:[474]

Q. When you rely on the payment pattern -- can we just have a quick look at the 4 March email. It's in E3 at 487. (Pause).

There's no confidence to be gained from the payment pattern that we see here, in the sense that, whilst there have been regular payments throughout the year from January through to November, there weren't any payments in December, there was one payment in January, which one might say is a balancing payment in relation to the December payments, perhaps, but then there's nothing beyond 9 January. So that's not consistent with the pattern that's up until then been the case, is it?

A. Yes, I can see why the -- as you say, there's no payment in December. That's not unusual because you've got Christmas shutdown, so often purchaser departments use it as a good excuse to delay a payment, and it came in in January

[472] [T9/55 – Leech at T9/54-55]

[473] [E3/487]

[474] [T9/55 – 71]

and it was 2.5 million euros, and if you look at the payment on 23 November, That's 899,000 euros. So looking at the past pattern, it is nearly three times the payment in November, so it is covering December and January and I think there's a bit of a catch-up there as well. So it's a catch-up payment.

Q. Well, we don't know that.

A. No.

Q. All we can see is that the last payment is 9 January and nothing after that.

A. Yes. But the December missing payment I think is quite understandable.

10.65 In relation to the signing of the Tanfield audit report on 21 April 2008, it was submitted that whilst Mr Leech's opinion was that Baker Tilly did not undertake sufficient work to determine whether any recoverability issues existed before the Tanfield audit report was signed[475], Mr Main's evidence on this issue was more compelling - in particular, Mr Main's evidence was that as of 21 April 2008 other auditors could reasonably have concluded that no further work was required[476]. Mr Main explained that:

(a) The auditor's focus would be as to whether there was evidence of impairment as at 31 December 2007.[477]

(b) The receipts of £831,000 from IPS and €2.5m from PSE after the year-end provided evidence of recoverability, as did the fact that the balances appear to have been brought back within payment terms by 3 March 2008 (when [...] provided details of payment patterns on each account). Mr Leech accepted that the payment of the E2.5m by PSE, though not paying off the entire sum due, would provide evidence towards valuation and provide reassurance for the auditor.[478]

(c) The balances were both discussed with Tanfield's finance director, [...], and were raised explicitly in the Audit Findings Report prepared for the Audit Committee, yet no indication was given of any possibility that the debts might be impaired.

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[475] [Leech at 10.5: D2/4/415]

[476] [Main 10.4.23: D2/3/325]

[477] [T/9/60]

[478] [T/9/60]

(d) IPS and PSE were both major customers who had a good track record of paying on time (as evidenced by the payment patterns supplied by [...] after the year end on 4 March[479]) – IAS 39 required "***objective evidence***" of impairment.

10.66 In relation to the issue of the signing of the audit report (by Mr Railton) for TES on 21 July 2008, the Respondents referred to:

(a) A note in aud-IT covering post balance sheet event work[480] which provided:

"The following tests must cover the period between the end of the financial year and the end of on-site audit work. Where a significant time is expected to elapse between the completion of on-site work and the date of the audit report, these tests must be re-performed, or their findings reconfirmed via a documented closing meeting with the client".

(b) The evidence that:

(i) it was decided (as was permitted) that these procedures could be satisfied through the re-confirmation of the position with management and a documented closing meeting[481] given by Mr [...] in his oral testimony;

(ii) to that end, on 21 July 2008 Mr [...] met with [...] and subsequently prepared a note of that meeting[482];

(iii) at that meeting Mr [...] discussed with Mr [...] the updated position with regards to post balance sheet events and going concern following the signing of the Group audit opinion[483];

(iv) Baker Tilly obtained a faxed confirmation from Mr [...] in which they requested information about, amongst other things, ***"any other event which may affect the amounts included or disclosures within the financial statements"***;[484] and

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[479] [E3/487-488]

[480] [F1/25/0192]

[481] [T8/180]

[482] [G1/13/168]

[483] [[...] witness statement paragraphs 226 – 227 : C/1/ 48]

[484] [G2/40/363]

(v) a written letter of representation was obtained from the Board of TES which confirmed that: "***there have been no events since the balance sheet date which necessitate a revision of the figures in the financial statements or inclusion of a note thereto***".[485]

(c) Mr Railton's evidence that he discussed Mr [...]'s proposed meeting with Mr [...] in advance of the meeting itself, and then discussed the contents and the detail of the meeting after Mr [...] came back[486]: in light of all of the evidence, including the trading update and the enquiries made of management by Mr [...], Mr Railton did not accept that there had been a serious dereliction of his duty.[487]

(d) The statement by Mr Main in his Report that, although he could understand in the circumstances how Baker Tilly could have made a judgment that no further work in respect of the IPS and PSE balances was required ahead of the signing of the TES audit opinion on 21 July 2008, this fell short of the standards required by ISA 560. However it was not Mr Main's view that this was a significant falling short from the standards,[488] and he remained firm on this when the position was explored in cross-examination.[489]

The IPS And PSE Debts (Recoverability) – Falling Short - Conclusions in Relation to Baker Tilly

Significant Risk

10.67 Because of the significant sums involved, and the increases in the balances since the previous year's end, we consider that many competent auditors would have treated them as significant risks, but given that Baker Tilly had knowledge of these customers from previous years, we consider that there would be some competent auditors with that knowledge who might properly take the view that Mr King and Mr Railton did – which was that though not significant risks, these debts did need to be the subject of heightened focus.

[485] [G2/39/359]

[486] [T8/17]

[487] [T8/38]

[488] [Main paragraph 10.5]: D2/3/327]

[489] [T9/83]

Recoverability of The IPS Debt – Credit Terms

10.68 As appears from paragraph 10.21 above, Mr Railton stated that "***the audit team***" discussed this debt with management. We accept that, but we have found that the evidence does not establish that anyone on that team other than Mr [...] and Ms [...] were involved in any discussions about the credit terms applying to it. The team, therefore, proceeded solely on the basis of the information given by Tanfield to those two members of the audit team and upon their observations. Mr [...]'s evidence was that he thought he *might* have been shown an invoice referring to those credit terms, but there is no record of this in the audit papers. There is no suggestion that Baker Tilly saw or attempted to see or obtain any other documentary evidence substantiating that the IPS debt or any particular part of it was on 365 day credit terms.

10.69 Whilst Ms [...] confirmed that Tanfield's accounting system was programmed on the basis that IPS debts were on 365 day credit terms, Mr [...] was on notice that these terms did not apply to the entirety of the balance. Whilst his understanding was that these terms arose from an arrangement whereby IPS was to take a bulk purchase of the spare parts which had been acquired with Snorkel, [In fact Mr [...] evidence to the AIU was that the parts had been acquired with Upright] with time running from the date of the arrangement, and that this constituted the bulk of the year end balance, he did not suggest that he had sought any corroboration of this information or any evidence or further information as to the actual amount of the balance attributable to the arrangement. Whilst he was shown an invoice or entry in the accounting system of an IPS item on 365 day credit terms, he was still in the position that he did not know to how much of the IPS balance this applied. Further, whilst he understood that the 365 days ran from the date of the arrangement, the notes on the FAF Report reflect an understanding that time for sales to IPS ran from ***"the date of invoice"***,[490] and there is no suggestion that any clarity was sought as to whether IPS's liability in respect of Snorkel spares was treated as having arisen from a one-off purchase of the spares in their entirety or from a series of purchases in which spares were drawn down and invoiced in batches.

10.70 Outside the context of consumer contracts, credit terms of 365 days are extremely unusual. This was recognised by all the audit team, and in our judgment would have been regarded by any competent auditor exercising reasonable care and skill as calling for the IPS balance to be the focus of particular attention. Further, the advice given to Baker

[490] [See paragraph 10.23 above]

Tilly at the planning stage of the audit that it was reasonable to assume credit terms of an average of 60 days was not consistent with the bulk of the IPS debt being on 365 day credit terms, and further still, there was evidence that an IPS invoice had been paid in 62 days – see paragraph 10.50(d)(i) above. Whilst Mr Main stated that he could see why the implications of this could be overlooked, the fact of this payment, together with the invoice number, surfaced in a record of "***payment period testing***" carried out as part of Baker Tilly's analytical review. Furthermore, Baker Tilly's understanding that the IPS debt was on 365 day credit terms appeared on a number of the documents on the audit file and so those terms were or should have been known to every member of the audit team.

10.71 In our judgment, given the size of the IPS balance and the fact that it was material to both the TES and Tanfield Group audits, any and every competent auditor would, once alerted to the fact that some of the IPS balance might not be on the 365 credit terms – whether alerted to that possibility by the information given to Mr [...], or by the inconsistency of the advice given by Tanfield, or by the test result referred to in the last paragraph – would have wanted to obtain reasonable assurance as to what if any amount of the IPS balance was subject to 365 day credit terms, would not have regarded the evidence assembled by Baker Tilly as providing that assurance, and would not only have sought a detailed clarification by Tanfield of what the position was, but also substantiation in the form of documentary or other objective evidence.

10.72 Our conclusion, therefore is that in this respect this-sub-allegation 4.1 is proven against Baker Tilly: Baker Tilly's conduct of the audit was not in compliance with paragraph 2 of ISA 500 or the fundamental principle of professional competence and due care, and, in the premises, fell short of the standards reasonably to be expected of a Member Firm.

10.73 In reaching this conclusion we have taken account of all the Respondent's submissions and the evidence of Mr Main. As stated at paragraph 10.2.9 above, his conclusion in relation to this issue was that the failure to obtain documentary evidence to verify the 365 day credit terms was a judgment which Baker Tilly was entitled to make and not a failing. This conclusion, which appears in his report, was initially reached at a date prior to the service of Mr [...]'s supplemental witness statement, and hence in ignorance of the fact that Mr [...] acknowledged that he was aware that at least a part of the IPS debt was not on those terms, and accordingly at a time when Mr Main was under the impression that "***there was a lot of persuasive internal evidence that was all consistent***" which justified the judgment which he supported, and he cited the set up of the accounting software, [...]'s advice that there were no unusual levels of bad debt etc, the notes on the

audit papers recording the 365 credit terms, and the fact that Tanfield did not dissent from the reference in those credit terms in the FAF.

10.74 In fact, in the light of Mr [...]'s supplemental statement and oral evidence, and of the evidence of an IPS invoice being paid in 62 days, it cannot be stated that all the internal evidence was consistent, and it is unclear whether the set up on the software applied to all or only some of the IPS debt. The inference drawn by Baker Tilly from the lack of response by Mr [...] or members of the audit committee (see paragraph 10.2.58 (d)) to the statement in the notes in the FAF as to the credit terms applying to IPS sales is not the only possible inference, and in any event it could not provide corroboration. Further, if, in the context of an audit, "***silence***" qualifies as evidence at all, the evidence provided by an inference drawn from silence is an extremely weak form of audit evidence.

10.75 It is not clear what conclusions if any the Respondents submit should be drawn from the fact that the Executive Counsel could have, but did not, require Mr [...] to give evidence before the Tribunal. His evidence might have strengthened or weakened the criticisms made of the Respondents, but the Tribunal is concerned with what he said at the time, and he did not, in his evidence to the AADB, give any evidence as to that - ie as to what he told Mr [...] during the audit. The only evidence of that has been provided by Mr [...], and we have accepted that evidence and reached our conclusions on the basis of it.

Recoverability of the IPS/PSE Debts –Other Issues

10.76 The IPS debt was a material amount for both TES and Tanfield. As we have found, the terms of payment applicable to this balance remain unclear, but whatever those terms it appears, from the analytical review paper, that as at the 2007 year end the balance was not within the payment terms, and it was initially noted on that paper that the debt was a major recoverability concern – it is to be inferred that this was because the debt was said to be 30 to over 60 days overdue. By 21 April 2008 nearly two months had elapsed since the last payment by IPS - the payment of £22,385 on 27 February 2008. There was no evidence of the receipt of any money from IPS during this period, although there had been two in each of January and February. In the context of the scale of the balance that last payment was minor.

10.77 So far as the PSE debt is concerned, this, too, was not within its payment terms as at the 2007 year end. Even on the basis of the evidence in Mr Main's correction sheet (see paragraph 10.62 above) it was not within terms, and on a worst case scenario at least £1.3m was outstanding after 21 January 2008 and £6m would have been out of term by 21 March 2008, there being no evidence of any payment since 9 January.

10.78 Mr Main's initial conclusion, namely that he and many other but not necessarily all auditors would have done more work to gain confidence in the recoverability of these debts was based upon four factors and the inferences he drew from communications made between Baker Tilly and the AIU in 2008. The four factors were[491] the understanding that £2.5m had been received from PSE in January 2008 and £831,000 had been received from IPS, and that these payments had maintained the debt within normal payment terms, the understanding that the debts had been flagged in the FAF and discussed with the finance director and the Audit Committee without any indication that the debts might be impaired, the understanding that the balance was back within payment terms by 4 March 2008, and that the balances were with major customers with a good track record of paying balances on time.

10.79 As it transpired, the sum received from PSE was not £2.5m but only £1.7m, there was no sufficient evidence that either debt was maintained within terms, the only discussion with the finance director established in evidence is that between him and Mr [...], and there is no evidence to substantiate the belief that the credit terms were discussed with the Audit Committee. As appears from the evidence quoted in paragraph 10.70 above, Mr Main indicated that the fact that the receipt from PSE in January 2008 was £800,000 less than he had originally understood did not alter his opinion, but there is no gainsaying the fact that a payment of £2.5m is better evidence of recoverability than a payment of £1.7m. Whilst the two debts were flagged up in the FAF, we are satisfied that their recoverability was not discussed in any detail at the Audit Committee meeting either with Mr [...] or the Audit Committee prior to 21 April 2008. As it has transpired, there was no satisfactory evidence that either of the two debts was back within payment terms by 4 March 2008 – in the case of the IPS debt, principally because there was no clear evidence as to what those terms were. Apart from the evidence that Ms [...] advised that there was no problem with bad or slow moving debts except those for which provision was being made, we were not taken to any evidence to demonstrate that that IPS and PSE had good track records for paying on time. Mr Main's evidence that the delay in payments reflected in Ms [...]'s payment profiles might be due to the Christmas break was mere speculation, not being supported by evidence of any information to that effect being provided to Baker Tilly. The fact that IPS and PSE were major customers (to the extent that Baker Tilly did raise in the FAF the issue of potential over-reliance) was, in our judgment, a reason for greater vigilance, and not vice versa.

[491] [see paragraph 562 above]

10.80 As stated at paragraphs 4.11 to 4.13 above, our approach has been not to take account of the AIU report. However, even if we had done so we would not have been prepared to make the inference which Mr Main did from the AIU's lack of response to Baker Tilly's explanation for their decision not to require the two balances to be incorporated in the letter of representation. We do not consider that such an inference could be drawn without knowing more about the AIU's understanding of the facts. For example, the AIU may not have been aware that no documentary corroboration had been obtained as to the payment terms applicable to the IPS balance, and may have inferred from Baker Tilly's assertion that *"**no further evidence of non-recovery existed**"* that Baker Tilly had looked for such evidence and found none.

10.81 In our judgment, again in the light of the sizes of these balances and their materiality to both the TES and Tanfield audits, and in the circumstances described in paragraphs 10.50(e) and 10.50(f) above, our conclusion is that any and every competent auditor exercising reasonable care and skill would have wanted to obtain and would have obtained further evidence of their payment history to substantiate the recoverability of these two balances. In relation to the PSE debt, further investigation was required as at 4 March 2008 and such further investigation was required in relation to both balances prior to the signing of the TES audit on 21 July 2008. We are satisfied that no competent auditor exercising reasonable care and skill would have considered that Baker Tilly had obtained sufficient appropriate audit evidence in relation to these trade receivables upon which to draw reasonable conclusions on which to base their audit opinion. Further, we are satisfied that any competent auditor in Baker Tilly's position would have obtained corroborative evidence of the payment histories – particularly in the light of the fact that they had been given inconsistent information by Tanfield as to the appropriate credit terms applicable to the IPS balance.

10.82 Our conclusion, therefore, is that in relation to these issues Baker Tilly's conduct of the audit was not in compliance with paragraph 2 of ISA 500 or with the fundamental principle of professional competence and due care and fell short of the standards reasonably to be expected of a Member Firm.

10.83 As stated, Mr Main's opinion (see paragraph 10.11 above) was and the Respondents conceded (paragraphs 10.2 and 10.51(e) above) that the omission, in July 2008, to make further enquiries as to the payment history of these debts was outside the range of reasonable judgments and fell short of that required by ISA Subsequent Events. These concessions were rightly made.

Letter of Representation

10.84 As noted above, Baker Tilly planned to obtain from directors the "***specific representations***" referred to in the FAF – see paragraph 10.24 above. The explanation related to the AIU is noted in paragraph 10.44 above. Mr Railton had no explanation as to why this plan was not carried through. Mr King's explanation (see paragraph 10.46 above) was that Baker Tilly's view was that they were satisfied with the evidence as it stood at 4 March 2008. We have already rejected that view. We consider that absent assurance from further investigation of the recoverability of these very large balances every competent auditor acting with reasonable care and skill would have requested and obtained the letters of representation which Baker Tilly had in fact planned to do. We consider that Baker Tilly were further at fault in abandoning the plan to obtain the representations. In our judgment no competent auditor acting with reasonable care and skill would have changed course in this fashion without having a good reason to do so and without recording that reason on the audit file. Baker Tilly did not document any reason and we could discern no good reason for this volte face.

10.85 In relation to this issue, therefore, we have reached the conclusion that Baker Tilly's conduct of the audit was not in compliance with paragraph 2 of ISA 500 or with the fundamental principle of professional competence and due care and fell short of the standards reasonably to be expected of a Member Firm.

Recoverability of the IPS and PSE Debts - Falling Short - Conclusions in Relation to the Engagement Partners

Recoverability of the IPS Debt – 365 Day Credit Terms

10.86 Mr [...] did not say in terms that he made any of his superiors aware of the fact that the 365 day terms did not apply to the entirety of the balance. There is no evidence that Mr [...], Mr Railton or Mr King were made aware of this at the time. They would have appreciated that such credit terms were very unusual, and they would have been aware that they had not been disclosed to the audit team at the planning stage. However, not without some hesitation, we have come to the conclusion that not every competent engagement partner, having only that limited knowledge, would have considered it necessary to probe further into the validity of the supposed credit terms.

Recoverability of the IPS/PSE Debts – Other Issues

10.87 In our judgment, Mr Railton and Mr King were entitled to rely upon their subordinates to ascertain the IPS and PSE payment histories, and to analyse correctly the information which they received: it was not for them to analyse the payment profiles provided on 4 March 2008, and they had no reason to question the information that as at that date both debts were within payment terms.

10.88 Nevertheless, Mr King was aware that no evidence had been obtained of the payment history between 4 March and 21 April 2008 - this follows from his evidence that his judgment was that it was not needed. Again with some hesitation, we have concluded that other competent auditors would share Mr Main's view, namely that though not best practice it was within the range of reasonable audit judgments as to the evidence required in the circumstances.

10.89 As is set out below, Mr Railton cannot escape personal responsibility for the fact that no evidence was obtained as to the payment history of either IPS or PSE for the period to 21 July 2008 when he signed the audit report for TES.

Letter of Representation

10.90 We have already found that Baker Tilly was at fault in not pursuing this issue. As Engagement partners both Mr King and Mr Railton have a personal responsibility for this failure and it follows that the allegations in this sub-allegation 4.1 are made out against them on this ground as well – in relation to this issue their conduct of the audits fell below the standards reasonably to be expected of Members.

Allegation 4.2 – The W[...] Debt Owed To SEV: Recoverability

The Allegation

10.91 Sub-allegation 4.2 is:

> "***Despite having identified it in the Key Issues Tracker as a significant risk for SEV regarding existence, valuation, and overstatement, the Respondents failed to obtain sufficient appropriate audit evidence concerning the valuation and recoverability of a debt of £500,000 owed since 2005 by W[...] to SEV as at 31 December 2007 ("the W[...] Debt")***".

The W[...] Debt (Recoverability) - Issues

10.92 In 2005, SEV had sold the Asian manufacturing and selling rights to a type of aerial access equipment to W[...], a Chinese equipment manufacturer.[492] The original agreement was that W[...] would pay £500,000 *upfront* for the right to manufacture and sell vehicles.

10.93 During the 2006 audit the debt was identified by Baker Tilly as a problem. The Final Audit Findings for Tanfield[493] included, in the "resolution" column, the comment (the last line was emphasised in the original):

"The original sale was of a license for the sale of Tanfield Aerial Access products in China.

Tanfield will not allow W[...] to trade under the licence until paid. As W[...] has invested substantially in the project the company is confident they will pay.

"In addition, W[...] are in the process of selling land which will partly be used to pay Tanfield.

[Awaiting correspondence from company.]"

10.94 The debt remained outstanding in 2007. The Audit Findings Report explained the problem (in the "***issue***" column): "***Due to delays in the setting up of operations and cashflow difficulties this agreement was recently updated to allow W[...] to pay the outstanding balance at an amount per unit sold once production begins (expected to be 2008) however production has not commenced as at the year end***."[494]

10.95 Mr Railton stated in his witness statement that, by the time of the 2007 audit, the audit team already had evidence of the existence of the debt from previous audit work in 2005 and 2006. There was no challenge to this statement. The issue in relation to the 2007 Tanfield and SEV audits, therefore was simply whether the debt was likely to be repaid.[495]

10.96 During the execution phase of the audit, the W[...] debt was identified as part of the substantive analytical review, and the working papers record that the debt was discussed

[492] [Mr Railton's witness statement paragraph 132:C/2/75]

[493] [E1/17]

[494] [F2/49/354]

[495] [Railton paragraph 133; C/2/75]

with Mr [...] and that it was "***still considered it as fully recoverable***" (though it was noted there was no documentary evidence available to support this conclusion).[496] Mr [...] explained the position at paragraph 209 of his witness statement:

"During the audit fieldwork, we followed up on this issue with management. I raised W[...] with [...] who said that I should discuss the issue with the Group sales director, […]. […] explained to me that W[...] had not been able to set up its operations yet and so was not generating revenue from which to pay the outstanding balance. SEV had agreed to allow W[...] to pay the outstanding balance at an amount per unit sold once production began (which was expected to be 2008). […] could not provide me with any written evidence to support the further agreement however. After my discussion with […], I raised the issue with Steve. We agreed that we should seek a management representation in relation to recoverability of the debt. We reported the position to the audit committee in our Audit Findings Report and the representations letter obtained from the Group audit and the SEV audit both contained representations from directors confirming that they believed that the debt would be paid".[497]

10.97 Mr Railton accepted that the recoverability (but not the existence) of the W[...] debt was a significant risk for the purposes of the SEV audit.[498] This was reflected in the KIT[499] prepared by Mr [...], and was also accepted by Mr [...][500] – ***"because of its size and the fact that it remained unrecovered"***.

10.98 Executive Counsel contended that the recoverability of the debt was also a significant risk for Tanfield, but this was vigorously contested by the Respondents.[501]

10.99 Baker Tilly did in fact obtain the management representation envisaged, but Executive Counsel contended that they failed to obtain sufficient appropriate audit evidence concerning the recoverability of the W[...] debt and should have done more to obtain confirmation of the applicable terms and its likely recoverability.

10.100 The Respondents submitted that:

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[496] [H/18/135]

[497] [C/1/44]

[498] [T7/134]

[499] [H/5/75-76]

[500] [T8/168]

[501] [King T6/209]

(a) Whilst the W[...] debt *was* material to SEV's financial statements, there was no "***falling short***" in relation to the valuation of the debt for the purposes of the SEV audit opinion, still less a "***falling short***" which crossed the threshold into significance.

(b) Given its size (and Mr Leech's oral evidence), there was no sustainable basis for complaint in relation to the valuation of the W[...] debt for the purposes of the Tanfield audit opinion.

The W[...] Debt (Recoverability) - The Background/Facts

10.101 The debt was identified as a significant risk in the Tanfield KIT[502], which included the comment, "***Risk being that the balance is no longer recoverable as a result of changed circumstances/ongoing relationship- with W[...]***". Mr [...], who prepared the KIT, confirmed that he considered that the debt was a significant risk.[503]

10.102 At the planning stage the Respondents determined that "***further investigation considered to be required via operations directors […]. Detailed documented support will be required on the CAF to support the recoverability of this balance should it remain on the ledger at the year end.***"[504]

10.103 It was Mr [...]'s expectation that the Engagement Team would obtain that detailed documentary support[505]. Mr [...] understood that the operations director at Tanfield had been out to China for discussions with W[...].[506] These discussions took place at around the time of the execution/fieldwork phase in January/February 2008.

10.104 However in the FAF, presented to the Audit Committee Meeting on 28 February 2008, it was noted: ***"…as at the date of this report there is no documentary evidence to support the updated agreement as described or any evidence to support the updated agreement as described or any evidence to support the proposed timescale. It is proposed that specific representations are to be obtained from the directors in relation to the recoverability of this balance.***"[507]

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[502] [F1/11/91]

[503] [T6/21]

[504] [H/11/117]

[505] [T6/153]

[506] [Witness statement paragraph 44:T6/154]

[507] [F2/49/354]

10.105 The Tanfield Resolution of Issues schedule (updated to 11 March 2008)[508], produced prior to the sign off of the Group's financial statements on 21 April 2008, included a note in the following terms;

"W[...] £500k trade receivables balance remains on the ledger. This relates to an agreement entered into with "W[...]" (Chinese company) in 2005. The original agreement was that WF would pay £500k upfront for the right to manufacture and sell AL 22 vehicles in China. Due to delays in setting up the operation and cashflow issues this agreement was recently updated to allow WF to pay a fee per unit basis once production begins (expected to be 2008) however production had not commenced at year end. Per [...] (FD) it is expected that production will commence in 2008 with volumes being such that the £500k will be recovered by the 2008 year end. However at the time of writing there is no documentary evidence to support the updated agreement per above or any evidence to support timescale.

Propose that specific representations are obtained from the directors in relation to this point (recoverability) & noted for inclusion in final audit findings."

Mr [...] explained that this document reflected the discussions that had been had around the subject of the debt with the directors of Tanfield[509].

10.106 The Resolution of Issues Schedule for SEV's financial statements[510] produced by Mr [...][511], included an entry in respect of the W[...] debt identical to the entry in Tanfield's Resolution of Issues Schedule – as set out in the last paragraph above. It was uploaded to the SEV aud-IT system on 22 July 2008 and reflected the discussion Mr [...] had had in January/February 2008[512].

10.107 The Tanfield representation letter,[513] at paragraph 10 stated, in bold terms: "***We believe that the balance due from W[...] at the year end of £500,000 is recoverable and will be repaid***". The SEV representation letter[514] dealt with the W[...] debt at paragraph 9 in the same bold terms.

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[508] [F2/57/421]

[509] [T6/155]

[510] [H/29/230]

[511] [T6/156]

[512] [T6/157]

[513] [F2/62/462-470]

[514] [H/32/253]

10.108 A further fax was also obtained from Mr [...] on 21 July 2008 confirming that there had been no other event that might affect the amounts included or disclosures within the SEV financial statements[515].

The W[...] Debt (Recoverability) - Executive Counsel's Case

10.109 It was submitted that:

(a) There should have been significant concerns about recoverability of the W[...] debt: it was old debt; it had been identified as a problem in 2006; the promises in the past had proved to be empty ("***W[...] are in the process of selling land which will partly be used to pay Tanfield****");* there had been a change of payment terms; there was an absence of documentary support.

(b) The debt was a "***significant risk***" to SEV. Materiality for sampling purposes was set at £34,000. SEV's Income Statement recorded a loss before tax of £372,000 in 2007.

(c) In the absence of any sufficient records on file documenting the Respondents' thinking, it was reasonably to be inferred that they failed adequately to address their minds to this issue.

(d) There was no proper basis for the Respondents to conclude that *other* evidence (i.e. other than management's written representation) could not reasonably be expected to exist (ISA 580 paragraph 4[516]). Insofar as management represented that they were unable to provide such evidence, the Respondents failed to apply sufficient professional scepticism. Common sense would suggest that there would be records including emails and notes of meetings. In any event, in the absence of such material, the Chinese company should have been approached or checks made on open sources (to ascertain, for example, when production was due to begin).

10.110 As indicated above, the Executive Counsel contends that the debt was objectively a significant risk within the meaning of ISA 315 paragraph 6.3.3 for Tanfield, on the grounds that:

(a) this was a non-routine transaction (Mr [...] described it as a "***one-off***");

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[515] [H/33/255]

[516] [B2/15/485]

(b) an assessment of its value required judgment and assumptions about the effects of future events; and

(c) the Engagement Team treated the W[...] debt as a significant risk - see paragraph 6.11 above.

10.111 It was submitted that:

(a) The transaction was highly relevant to the Group's consolidated accounts and an issue which Mr King, as Tanfield auditor, should have considered. Had the W[...] debt been written off it would have more than doubled SEV's loss;

(b) The Respondents evidently considered the debt to be relevant to the Tanfield audit. The debt was listed on the 2007 audit Resolution of Issues Schedule ("***Schedule of Group Issues***")[517]; it was specifically included in the Group Final Audit Findings Report[518] and it was a matter about which specific representations were sought by Tanfield Group Plc[519];

(c) Mr Main surmised that the Respondents "***would have taken into account materiality in the context of both the Tanfield and SEV subsidiary financial statements***" and **"might *reasonably have concluded that they were prepared to accept a lower standard of audit evidence in respect of W[...] debt"*** (Main paragraphs 11.4.3 – 11.4.12)[520]. The difficulty with Mr Main's evidence on this point was that it was speculation. There was no evidence on the audit file to suggest that this was the Respondents' state of mind or chain of reasoning at the time; and

(d) It appeared that there was no attempt to obtain any further information after 28 February 2008 (save for the specific representation from the directors). And hence that there was no evidence as to the recoverability of the debt save for the Letters of Representation. Mr King acknowledged that it was not something he focussed on at the time ***"not massively, no"***[521].

[517] [F2/57/421]

[518] [F2/49/354]

[519] [F2/62/462-470]

[520] [D2/3/331-332]

[521] [T6/227]

10.112 In his first report[522] at paragraph 5.2.52 Mr Leech stated that, in his opinion, in the light of management's inability to provide documentation substantiating the new terms of the debt, a reasonable auditor would have sought third party evidence over its existence and valuation, and he suggested by way of examples, circularising the customer, seeking correspondence and looking for evidence of the plans for manufacturing in China. In his second report[523] he stated that a reasonable auditor would have sought evidence of correspondence with the Chinese company and whether it intended, or had the ability, to start production. In his third report[524] he stated that he considered that the audit work in relation to SEV fell short of the sufficiency of evidence requirement and that the audit of the Tanfield Group also fell short of that requirement ***"as the subsidiaries make up a significant of the Group number."***

The W[...] Debt (Recoverability) – Respondents' Case

10.113 The debt was not material to Tanfield's accounts[525] and so the issue principally related to the SEV audit opinion.

10.114 Although the Executive Counsel submitted that further evidence should have been obtained to corroborate the position relating to the debt, the difficulty, however, was, as was recorded on the audit file, that the audit team had already made enquiries and been told that no documentary evidence was available. In these circumstances, it was difficult to see what further steps the audit team should have taken.

10.115 Mr [...] confirmed that he had personally asked Tanfield's management for documentation surrounding the debt but had been informed no such documentation existed, and that the agreement to pay once production began was agreed at a meeting in China attended by […][526]:

"A. I -- I was initially involved in a meeting with [...], the finance director. He then passed us on to […] who is another director at Tanfield. He was involved with W[...]. He'd been out to China to discuss the situation with W[...]. It was Darren who we'd asked for the correspondence -- whether there was any correspondence that they'd had between -- between W[...] and Tanfield with regard to the debt and

[522] [D1/1/104]

[523] [D1/2/230-231]

[524] [Paragraph 11.4: D2/4/420]

[525] [Main 11.4.8 – 11.4.12 : D2/3/332]

[526] [T8/171:T7/57 line 13]

we were informed there wasn't any. It was all done through a meeting that Darren had."

10.116 Mr Railton likewise confirmed in his own evidence that Mr [...] had pressed management ***"as hard as he could professionally"*** to try to obtain any paperwork.[527]

10.117 Baker Tilly's reasoning and the steps taken to obtain appropriate audit evidence were recorded in the ***"Resolution of Issues Schedule"*** and in the Audit Findings Report to the Audit Committee.[528] Ultimately:

(a) A specific representation letter was obtained from management confirming the recoverability of the debt stating: ***"We believe that the balance due from W[...] at the year-end of £500,000 is recoverable and will be paid*****;** [529]and

(b) A further fax was also obtained from Mr [...] on 21 July 2008 confirming that there had been no other event that may affect the financial statements.[530]

10.118 Mr Main's evidence was that the decision not to take further steps to investigate the position, but to rely on the written representation from management, was a reasonable one, both from the perspective of the Tanfield and the SEV audits. Mr Main drew attention in his evidence to the steps that had been taken by the audit team to obtain documentary evidence, as well as to the responsibilities on a director making a representation that no documentary evidence exists:[531]

Q. And a reasonable auditor, Mr Main, would want to at least try to find more evidence about that before accepting a written representation from management.

A. Yes, and they asked Mr […] if he'd got any written evidence and he said that he hadn't……..which is important, because a director signs a statement in the directors' report, and it goes with the accounts, acknowledging their legal responsibility to provide all the information that they have available that would be of relevance to the auditor. So if a director has said there isn't any evidence when there is, that's quite a serious issue for the director.

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[527] [T8/50]

[528] [F2/57/421: F2/49/354]

[529] [F2/62/470 – Tanfield: H/32/253 – SEV]

[530] [H/3/255-256]

[531] [T9/89]

10.119 Mr Main also pointed out that, not only would it be difficult to obtain information from a Chinese company, but even if the audit team had managed to obtain further evidence, there would remain a question mark as to its quality:[532]

10.120 The point was explored with Mr Main at some length, yet Mr Main's overall view, which it was submitted was compelling, was that the written representation obtained from management was possibly ***"as good as they were going to get, realistically"***.[533]

10.121 Mr Leech accepted that: i) a letter of representation puts a director on the spot and so represents a higher level of audit evidence than simply the discussions with management; and ii) it would have been appropriate for Baker Tilly to have taken into account when assessing the weight that could properly be placed on such a letter that the risk of fraud had been assessed as low (a point about which no complaint has been made).[534]

10.122 In rejecting the allegations against Baker Tilly and Mr Railton in relation to this aspect of the SEV audit, Mr Main, in his report,[535] referred again to SEV's status as a wholly- owned subsidiary, and stated that it was unlikely that writing off the £500,000 debt would have materially influenced an economic decision of a user of the financial statements, and continued :-

"11.4.12 The fact that SEV was a wholly owned subsidiary and that the W[...] debt was not material at group level is not of course a licence for the auditor to ignore material balances. Where however the user of the financial statements would not be influenced by the treatment of this receivable in the financial statements, Baker Tilly might reasonably have concluded that they were prepared to accept a lower standard of audit evidence in respect of the W[...] debt. A trade creditor is unlikely to have been influenced by the writing off of this balance as it was already clear that SEV relied on group support."

10.123 As to the position at the Tanfield level, the point appeared to be pursued by Executive Counsel but without much specificity, that the recoverability of the debt should have been investigated further prior to the finalisation of the Tanfield audit. It was put to Mr King that while this debt was not close to being material at group level, it could, if it were a bad debt, become material if aggregated with other bad debts. Mr King accepted this truism

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[532] [T9/91]

[533] [T9/95]

[534] [T4/24-27]

[535] [paragraph 11.4.11 at D2/3/332]

but it was clear that there were no other bad debts with which to aggregate this small (at group level) debt and that the IPS and PSE debts were considered separately. As was plainly reasonable, Mr King was content not to seek further evidence in circumstances where the debt itself was significantly below sampling materiality and in light of the fact that a specific representation had been obtained from management.[536]

10.124 The focus throughout Mr Leech's reports has been on the position at SEV. In cross-examination, Mr Leech accepted that his focus had been on the SEV audit, and his criticisms of the position at Tanfield level appeared to raise primarily an issue regarding the documentation of the auditor's thought process:[537]

Q. So why haven't you made any specific complaint about Mr King's work in any of your reports in relation to the W[...] debt?

A. Well, I think the point that I make in the report is that more evidence should have been sought.

Q. You don't say that about Mr King, do you?

A. No.

Q. And why not?

A. Well, I'm making the points essentially in relation to the TES -- sorry, to the SEV audit because the debt arose in the SEV audit, it was clearly material as we've already discussed. In terms of the group level, I think it was -- to start out in principle if the directors had formulated a reasonable basis for the recovery in the representation letter, then I think that would have been more acceptable.

Q. This is a debt which is well below the materiality or sampling materiality for the group?

A. It is.

Q. It is well below the sampling interval for the group?

A. It is.

[536] [T6/209-210]

[537] [T4/15-17]

Q. And my suggestion is that it was not unreasonable for an auditor in those circumstances at group level not to do any additional work or seek additional corroboration in respect of the W[...] debt?

A. Well, I think a reasonable auditor would have provided more rationale as to why that was an acceptable judgment.

Q. So is it the thought process is not sufficiently explicitly stated on the audit file?

A. Well, the thought process as to why that 500,000 wasn't taken to the summary of unadjusted audit differences or that audit evidence to support the recoverability was sufficient and appropriate.

10.125 It was submitted that ultimately, Mr Leech accepted that there was no serious or significant criticism to be made of Baker Tilly's and/or Mr King's approach in the context of the Tanfield audit.[538]

10.126 The Respondents submitted that plainly there has been no "*falling short*" in relation to either of the audits in respect of this issue, let alone a basis for a finding of Misconduct.

The W[...] Debt (Recoverability) - Falling Short - Conclusions in Relation to Baker Tilly

10.127 We do not consider that the evidence supports any submission to suggest that the Respondents did not address their minds to this issue. The documentation shows that they were conscious of the need to single it out for attention and also records the reasoning behind the decision to accept a management representation as sufficient evidence. This issue concerns that judgment.

10.128 As Executive Counsel submitted, the debt was material to SEV, its recoverability was accepted as being a significant risk, and the record of past unfulfilled statements and reports of cash flow issues were all reasons for concern. There is substance in the contention that one would expect management to be able to produce some emails or notes of meetings to confirm the terms now said to be applicable to the payment of the debt. However, we also consider that many competent auditors would have regarded an attempt to obtain confirmatory evidence from the company in China as likely to be futile. Mr. King stated that in his experience such requests were futile - by which we think he

[538] [T4/19]

meant generally futile, and not specifically requests to China, and we have no reason to doubt that evidence[539].

10.129 As Mr Main pointed out (see paragraph 10.122 above) the fact that SEV was a wholly owned subsidiary did not provide a licence to ignore balances. Nor in our view does it provide a licence to depart from the applicable auditing standards. The other evidence which Mr Main referred to in the last sentence of the quotation in paragraph 10.122 above seems to us to be off the point, since the scenario being addressed would not be that the £500,000 had been impaired in the statements, but a scenario in which it had not been so impaired when it should have been. We also note that there was no evidence that Tanfield was a guarantor of any of SEV's trade debts. We consider that many auditors, as exemplified by Mr Leech, would have regarded it as inadmissible (under the terms of ISA 560 paragraph 4) to rely upon a management representation without having first been provided with, and recorded, plausible explanations as to why there was not a single email or note or board or other minute evidencing the terms now stated to be applicable to the debt. Mr Railton asserted that Mr […] was pressed by Mr [...] as hard as he could be professionally. The source of this information is unclear, but in any event there is no explanation as to why the questioning was left to Mr [...], who did not have the status enjoyed by Mr Railton. We do not consider that the faxed representation relied upon by the Respondents, which makes no reference to the W[...] debt is of any materiality to this issue.

10.130 However, it was said that it was Mr […] who had negotiated the terms in question. Mr […] was not only a director, but also the CEO of Tanfield. Although not without hesitation, we have concluded that some competent auditors exercising reasonable care and skill may have made the judgment which Baker Tilly did, namely to accept the management representation as sufficient appropriate audit evidence of the recoverability of the debt. Accordingly, we find that in relation to this issue Baker Tilly's conduct of the audit did not fall short of the standards reasonably to be expected of it.

10.131 The conclusion expressed in the last paragraph was reached in the context of the SEV audit. As stated in paragraph 10.124 above, the Respondents assert that Mr Leech in effect conceded that there was no case against Mr King in respect of the Tanfield Group audit. In fact, Mr Leech did not go so far, as appears from the transcript[540]:

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[539] [T6/226]

[540] [T4/19]

"Q. you didn't spell out any specific criticisms of Mr King in your reports, did you?

A. No.

Q. And that's because you do not regard this as being a serious or significant falling short by him, did you?

A. No, because it's below materiality."

10.132 Nevertheless, because of the immateriality of the debt to the statements in Tanfield, and our conclusion on this issue in relation to the SEV audit, it follows that in our judgment Baker Tilly's conduct of the audit in relation to the same issue in relation to the Tanfield audit also did not fall short of the standards reasonably to be expected of it.

The W[...] Debt (Recoverability) - Conclusions in Relation to the Engagement Partners.

10.133 It follows from our conclusions in relation to Baker Tilly that there is no basis for any finding of "*falling short*" by either Mr King or Mr Railton's allegations relating to the W[...] debt.

Allegation 4.3 – Testing the Existence of Debtor Balances

The Allegation

10.134 Sub-Allegation 4.3 is:

"Despite having planned to do so, the Respondents failed to obtain evidence by any other testing that would have given comfort over the existence of the debtor balances, such as confirmation or correspondence from the third party itself or a sufficient review of after date cash receipts."

Testing the Existence of Debtor Balances - Issues

10.135 This sub-allegation relates primarily to the Respondents' substantive test of detail of trade receivables. The substantive testing performed for TES and SEV involved selecting a sample of customers for testing. The relevant workpaper is TES – 21.30.00.1a1: Receivables Substantive Testing.[541]

[541] [The same workpaper appears in both the TES and Tanfield Files at G2/30/255 and F2/44/305]

10.136 The initial planned tests included *inter alia* (a) debtors' circularisation and (b) verifying the existence of receivable balances by reference to a sample of delivery notes and remittance advices. It is common ground that these tests would have provided good evidence as to the completeness, existence, accuracy and valuation of the receivables balances.

10.137 However, these tests (the tests marked in columns J, K and O) were replaced[542] by the following test:

"Replacement test:

To check completeness of year end balances, the last invoice posted in 2007 and first in 2008 have been checked to ensure they are in the correct period (and also checked to packing lists to ensure cut off is correct)"

In the work papers the description of the Replacement test is followed by the note:

"Further confidence in cut off is obtained from post balance sheet events ."

10.138 It is not disputed that there is no explanation in the working paper as to why the planned tests were modified or the basis on which the Respondents considered the replacement to be adequate.

10.139 In the Joint Memorandum, paragraph 111[543], the experts agreed that "***the replacement test to test the existence of Trade Receivables, instead of the planned test, was not satisfactory***".

10.140 However, in Mr Main's opinion[544], whilst the replacement test was less satisfactory than that which it replaced, it did provide some audit evidence of the existence of trade receivables (and their original amount) and there were other tests which, together with the replacement test, cumulatively[545] provided sufficient appropriate audit evidence of the existence of inventories, and he concluded that Baker Tilly had made a judgment to this effect.[546]

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[542] [F2/44/306] [G2/30/256]

[543] [D2/5455]

[544] [Paragraph 13.4.1 – D2/3/341]

[545] [Paragraph 10.4.11 and T9/166]

[546] [Paragraph 13.4.1 – D2/3/341].

10.141 This opinion was recorded in the following terms in paragraph 115 of the Joint Memorandum[547]:

> ***"… the after date cash test undertaken in TES cash received after the balance sheet date for the 5 largest debtors at TES[548] was sufficient to provide evidence in respect of the existence assertion when combined with the other strands of audit evidence described in his report, including analytical procedures and substantive verification of 99 debit entries (sales) to the receivables ledger."***

10.142 Executive Counsel took issue with the assertion that the Respondents made the judgment suggested by Mr Main (there was no evidence on the audit file to support it – "***this was another example of Mr Main filling in the gaps on the audit file****.")* and submitted that the evidence obtained as a result of the replacement test did not cover the assertions the original procedures were designed to test, and nor did the other planned tests of detail sufficiently address those assertions.

10.143 On the basis of Mr Main's conclusion, in section 13.3 of his report[549] that the work carried out in respect of the existence of trade receivables was reasonable to support the audit opinions for Tanfield, TES and SEV, it was submitted on behalf of the Respondents that they had not fallen short of the relevant standards.

Testing the Existence of debtor Balances - Background/Facts

10.144 The test originally planned and the replacement test are identified in paragraphs 10.136 and 10.137 above. Mr King, at paragraphs 133 – 135 of his witness statement[550] expressed the view that tests on sales and analytical review procedures on trade receivables provided assurance with regard to trade receivables. Baker Tilly did test the existence of sales, the results being recorded in a working paper entitled "***Sales substantive testing***"[551], and also performed cash after date testing on overdue balances[552] - particularly relied on by Mr Main. The parties also referred to the "***Post balance sheet events (TES transaction review)***" working paper[553].

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[547] [D2/5/455]

[548] [F1/27/214]

[549] [D2/3/343]

[550] [C/3/109]

[551] [F2/47/326]

[552] [F1/27/214]

[553] [F1/23/190]

10.145 The recoverability of debts was considered by testing cash after the year end date in both TES and SEV[554]. In relation to this testing Mr [...] stated at paragraphs 205 and 206 of his witness statement[555] that:

(a) In the case of TES, 48% of year-end debtors were tested. The results showed that 99% of "***non-current***" debts (i.e. those outside their payment terms) had been paid.

(b) In the case of SEV, the equivalent recovery percentage was 81%. The working paper considered that although credit terms were usually 30 days, certain customers were allowed (or routinely took) 60 days.

(c) In light of both these results, and the fact that it was confirmed that staff were continually following up on invoices, it was concluded that the evidence of recoverability appeared reasonable.

Testing the Existence of Debtor balances - Executive Counsel's Case

10.146 Mr Leech's opinion was that the overall testing, taking into account all the other "***strands of audit evidence***" to which Mr Main refers, at paragraphs 115 and 116 of the Joint Memorandum,[556] fell short of the requirements of ISA 500:

(a) The sample size taken in the "***Cash received after the balance sheet date***" working paper was insufficient as it only considered 6% of the total year end balance for TES (Joint Memorandum paragraph 114).[557]

(b) The work paper recording the results of the test for sales made during 2007 did not provide sufficient appropriate evidence of the existence of Trade receivables at the year end as it did not include information to establish whether any of the sales items tested were actually in Trade receivables at the end of the year. (Joint Memorandum paragraph 118.)[558]

(c) The testing of debtors who were within their current payment terms ,recorded in the test transaction review, only considered cash receipts up to 29 January 2008,

[554] [F1/27/214:F1/26/213]

[555] [C/1/143]

[556] [D2/5/455]

[557] [D2/5/455]

[558] [D2/5/455]

and further corroboration should have been obtained before the auditor's report for Tanfield Group and TES were signed (on, respectively, 21 April and 21 July 2008).[559]

10.147 Executive Counsel submitted that the short point was that there was no evidence on the audit file to suggest that Baker Tilly made the judgment inferred and suggested by Mr Main, and it was "***tempting to leave the matter there***", but in any event:

(a) The replacement test provided less strong evidence than the tests it replaced; the reason for the change should have been drawn to the attention of more senior members of the team, and approved by the partners.

(b) There were a number of tests which the Respondents could have performed, but did not perform, in order to get comfort over the existence of debtor balances, such as confirmation or correspondence from the third party itself or a sufficient review of after date cash receipts in order to confirm year end receivables were paid post the balance sheet date, thereby confirming their existence and valuation at the year end.

(c) The *cash received after the balance sheet*[560] test referred to at paragraph 10.145 above involved the consideration of only 5 of TES' debtors – the five largest receivable balances. It did not address any potentially overdue balances on other receivables. The Respondents evidently intended to test £20.3m (line 7) but in fact only tested the older element of the debt (items which are, at the balance sheet date, in default) comprising just £2.598m. The 5 items, comprised just 8% of the total TES Trade Receivables balance at the year end (£31.2m): this was insufficient a sample.

(d) The *Sales substantive testing*[561] identified sales recorded in the sales ledger. This was just a test of sales and showed that there have been some valid sales. It was not a test in relation to receivables, and did not include sufficient information to establish whether any of the sale items tested had matured into Trade receivables at the year end, and, hence, did not provide sufficient appropriate evidence of the existence of Trade Receivables.

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[559] [Paragraph 117 of the Joint Memorandum – D2/5455]

[560] [F1/27/214]

[561] [F2/47/326]

(e) The *post balance sheet events*[562] work paper was wholly insufficient in terms of audit evidence in relation to receivables. It showed cash receipts from two customers only (TNT and PSE), and recorded cash receipts only up to 29 January 2008. Mr Main agreed that this was insufficient[563].

10.148 Executive Counsel submitted that these tests, individually or cumulatively, provided insufficient audit evidence: there were a number of conventional, straightforward tests which should have been performed in order to get comfort over the existence of debtor balances (such as confirmation or correspondence from the third party itself or a sufficient review of after date cash receipts in order to confirm year end receivables were paid post the balance sheet date thereby confirming their existence and valuation at the year end). The Respondents' failure to perform these tests was inexplicable.

Testing Existence of Debtor Balances - The Respondents Case

10.149 The Respondents submitted that Mr Main's evidence that the work performed was reasonable to support the audit opinions for Tanfield, TES and SEV, was plainly correct and should be accepted. There was nothing intrinsically inappropriate in altering a planned audit procedure provided that, at the end of the day, sufficient appropriate evidence has been obtained in the round. Mr Leech in cross-examination was taken to the "***TES receivables substantive***" working paper[564] and accepted that the tests conducted, considered in conjunction with the replacement test actually conducted, actually provided, at various stages of the testing, further appropriate audit evidence.[565]

10.150 Reference was made to the witness statement of Mr King, at paragraphs 133 to 136[566], where he referred to "***the cumulative nature"*** of paragraph 3 of ISA 500 and continued:

"For example, when forming a conclusion over existence of debtors one would take into account the results of a specific test designed to address the objective such as vouching debtor balance sheets to sales invoices and despatch notes, but one would also consider the results of other tests that provided evidence over the existence of debtors such as cash received after the year end, trade receivables analytical review, and turnover analytical review (if the turnover exists, the debtor

[562] [F1/23/190]

[563] [T9/154-155]

[564] [F2/44/0305]

[565] [T4/39-42]

[566] [C/3/109 – 110]

must also have existed). The cumulative nature of evidence means that whilst the individual test designed to provide evidence of existence of debtors might fail, sufficient evidence could still be obtained from other tests …..Therefore when considering trade receivables it is also important to consider work carried out in relation to sales … The analytical sampling procedures to identify material balances …"review for trade receivables[567] shows that the audit team carried out appropriate sampling procedures to identify material balances.."

10.151 The Respondents submitted that:

(a) The audit evidence relating to receivables included the analytical review work for sales transactions: in particular, the ***"Group AR – Turnover"*** working paper showed a sample of sales (including IPS and PSE) being traced to invoices and to orders, thereby providing evidence of the existence of those sales[568] and therefore of the existence of receivables;

(b) The recoverability of debts was considered by testing the after cash date – see paragraph 10.145 above; and

(c) There was a technical disagreement between the experts as to the evidence provided by the ***"TES Sales Substantive"*** paper[569], which featured on a number of occasions during the course of the questioning[570] Mr Main's evidence that this provided further evidence in respect of the receivables balances was compelling: [571]

Q. Now, the document at F2/47, Mr Main, page 326, that is a document dealing with substantive testing in relation to sales, isn't it?

A. It is.

Q. It is not a test in relation to receivables.

A. It provides evidence in respect of receivables, definitely. The receivables balance, it's what left at the end of the year on the ledger as a result of the sales

[567] [F1/34/254]

[568] [F1/30/218]

[569] [F2/47/0326]

[570] [Mr Leech T4/48-50]

[571] [T9/122-123]

that have been recorded in the system and the receipts that have been made against those sales.

So if you've got confidence that all of the sales that are recorded in the receivables ledger are valid, then that gives you some confidence that the balances at the end of the year are also valid. Whether or not those have been paid or not -- and they've checked on this test as well, they've actually checked that the invoice has either been paid or the balance is in debtors, so that's again further helpful evidence. The fact that you've got sales that are valid being recorded in the ledger gives you direct evidence that the ledger is reliable and it's a substantive test. They've actually verified that the transactions being recorded in the ledger are valid transactions. And what we're looking at here is not recoverability, we're looking at: was that sales ledger correct in the first place? And this test does give you direct substantive evidence that the debit items going on to the sales ledger are valid transactions, so it does give you substantive evidence on existence.

10.152 So far as the after date cash testing was concerned, Mr Main was taken to the document[572]. The line of questioning put to Mr Main appeared to be based on the unrealistic assumption that the testing should have been carried out on at least the majority of the balances. The questioning also appeared to misunderstand the nature of the test and, in any event, Mr Main was clear that he considered that the test conducted in fact provided sufficient appropriate audit evidence of trade receivables:[573]

Q. So of the 30 million trade receivables, this shows that they have agreed 2.5 million to bank statements.

A. Yes, they've gone for the riskier ones because they've looked at the overdue ones and looked at which of the overdue ones have actually been paid.

Q. Yes.

A. So they've done a sample. You would never do a 100 per cent test on trade receivables, so they've done a sample and they've looked at the higher risk items.

Q. Yes. Well, they've only tested less than 10 per cent through to the bank statement, haven't they, of the overall population?

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[572] [F1/27/0214]

[573] [T9/136-137]

A. On that test, yes.

Q. Yes. And the reasonable auditor, Mr Main, wouldn't consider that to be sufficient appropriate audit evidence in relation to trade receivables.

A. Wouldn't they? I think they probably would, actually.

Q. You think they probably would?

A. Yes. (Pause).

Q. Mr Main, it is right to say, isn't it, that generally an after date cash analysis would involve checking sums that fall due after the balance sheet date? That's why it has its name.

A. Yes.

Q. And that's not what this is doing.

A. Yes, it is.

10.153 Mr Main was also taken to the section in the trade receivables analytical review[574] dealing with bad debt provisioning. It was put to Mr Main that there was nothing on the audit file to show that the auditors tested whether provision needed to be made except in respect of the items identified by management. This, however, misunderstood the test. As Mr Main explained, the test identified older balances and considered what management had done about them.[575] Although, it was suggested the point might be returned to[576] it never was – and no further points in relation to this issue were put to Mr Main. It would be reasonable to assume therefore that no allegation relating to this testing either is or could fairly be pursued.

10.154 Even if, contrary to the Respondents' submissions, the Tribunal reached the view in relation to any particular test that the test itself was lacking in some respect, or did not itself provide a high degree of assurance, it did not follow that there has been a "*falling short*" from the applicable standards. For the reasons above, there was no requirement that the Respondents obtain a high degree of assurance from every test; nor does a specific failing in a test conducted give rise to a "***falling short***".

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[574] [G2/22/0211]

[575] [T9/184]

[576] [T9/185]

10.155 Overall, the Respondents obtained sufficient appropriate evidence in relation to trade receivables balances. In circumstances in which audit evidence must be considered cumulatively, the more narrowly focussed allegations advanced by the Executive Counsel had no merit.

Testing The Existence of Debtor Balances - Falling Short – Conclusions in Relation to Baker Tilly

10.156 The note relating to the Replacement test, referred to in paragraph 10.137 above, does indicate that Baker Tilly did plan to obtain additional evidence to support the assertion as to the existence of receivables, and that it adopted the approach reflected in the evidence of Mr King which we have quoted at paragraphs 10.144 and 10.150 above. On balance, we have concluded that Baker Tilly did make a judgment along the lines suggested by Mr Main. In the light of the lamentable standard of documentation throughout these audits, the absence of any record on the audit file of the judgment is not a strong indication to the contrary.

10.157 The Respondents submission that Mr Leech accepted that the tests recorded in the "***TES receivables substantive***" working paper[577] did provide further appropriate audit evidence is correct, but it fails to reflect the totality of his evidence. In his cross-examination Mr Leech stated that:

(a) He had no criticism of the execution of the Replacement "***cut off***" test, and that it did provide some confidence in the accuracy of TES's accounting records[578], and evidence over the existence of receivables[579].

(b) The "***Receivables substantive***" working paper[580] did show that Baker Tilly had looked at, understood, and tested aged listing.[581]

(c) The "***TES sales substantive***" working paper[582] recorded detailed testing of 99 samples; this was a substantive test not a test of controls, and was unclear as to whether any of the receivables were present at 31 December 2007. It provided evidence on the population of sales, but if these were not receivables there was

[577] [F2/44/305]

[578] [T4/42 - 43]

[579] [T4/88]

[580] [F2/44]

[581] [T4/44 – 45]

[582] [F2/47]

no evidence that could be drawn from this as this was not a test of controls[583]: it was possible that some of the invoices which were agreed to despatch notes were actually in the trade receivable balance at the year-end but one could not tell.[584]

(d) The after date cash test is the most important test when considering valuation risk - by finding that the debts have been paid after the year end provides good evidence that they were of that value at the year end.[585] The "***Cash received***" working paper[586] showed that Baker Tilly tested a total of just under £2.6m non-current year end debtors and that 99% of these had been paid since the year end having been agreed to bank statements[587] but he considered that the cash testing should have been more comprehensive[588] – a fuller test of after date cash[589], since one would usually look to vouch more than £2.5m out of a larger balance of 42m (this was in Euros – 29m in Sterling)[590]. There should have been after date cash procedures on the current portion of the debt and these should have been carried through to the date the audit reports were signed.[591]

(e) He did not disagree with the principle of Mr Main's approach to this allegation[592] but he did not agree that the working papers in the round provided sufficient evidence on the audit file of the existence of receivables.[593]

10.158 In oral closing submissions it was suggested on the part of the Respondents[594] that Executive Counsel's submissions (paragraph 10.147(c) above) in relation to the cash received after balance sheet test, that Baker Tilly intended to test £20.3m of the debt was demonstrably absurd and had not been put to any witness. However, this submission was mistaken, as this interpretation of the document was put to Mr Main[595] and he agreed with

[583] [T4/48 – 49]

[584] [T4/61]

[585] [T4/130]

[586] [F1/27/214]

[587] [T4/77]

[588] [T4/79]

[589] [T4/84]

[590] [T4/85]

[591] [T4/135]

[592] [T4/88]

[593] [T4/110]

[594] [T11/157]

[595] [T9/143 – 144]

it. The other factual submissions in that paragraph are also correct, and as indicated in the last paragraph, Mr Leech did regard the sample as insufficient.

10.159 Under cross-examination Mr Main stood his ground, stating that:

(a) Whilst Mr Leech was right in saying that the paper did not include information to establish whether any of the items tested were actually trade receivables at the year end[596], the "***TES sales substantive***" working paper did provide direct substantive evidence that the debit items going on to the sales ledger were valid transactions, and hence of existence[597]; it confirmed there was a valid sale and a valid debtor balance at the end of the year[598]; 99 samples had been tested which was quite a big value[599]; the sample would definitely have some towards the end of the year[600]; it was quite a good test, verifying sales and giving some assurance in respect of receivables[601].

(b) In relation to the cash received after the balance sheet date paper[602], as had been suggested to Mr Leech (see paragraph 10.157(d) above), he considered that the sample of overdue items which was tested, although it represented less than 10% of the overall population, would be considered by the reasonable auditor to be sufficient: it was a reasonable sample[603] as to existence when combined with the other tests and the analytical review[604]; notwithstanding that the remainder of the 20m figure was not tested and as at the sign off date of 21 April was concerned, everything in the current column could be due[605].

(c) The evidence from the substantive testing, the post balance sheet testing, and the sales ledger provided "***quite strong evidence combined***"[606].

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[596] [T9/130]

[597] [T9/123]

[598] [T9/124]

[599] [T9/125]

[600] [T9/127]

[601] [T9/129]

[602] [F1/27/214]

[603] [T9/146]

[604] [T9/146–147]

[605] [T9/148]

[606] [T9/157]

(d) The analytical review provided another strand in the evidence[607] giving a general guide as to what they think the receivables figure was and was reasonable, although there were a couple of smaller balances which ideally might have been verified you could take a view not to do so because of their low value[608]; whilst the analytical review procedure would not have been sufficient by itself, looking at it overall, whether the receivables were fairly stated, there was sufficient appropriate evidence to conclude that they were.[609]

10.160 Not without some hesitation we have concluded that, on balance, not every competent auditor exercising reasonable care and skill would share the opinion of Mr Leech – though undoubtedly many would. Accordingly our conclusion is that Baker Tilly's conduct of the testing of the existence of the debtor balances did not fall short of the standards reasonably to be expected.

Testing Existence of Debtor Balances - Falling Short – Conclusions in Relation to the Engagement Partners

10.161 In the light of the conclusion expressed in the last paragraph, this issue does not arise.

Allegation 4.4 – Analytical Testing For The Existence Of Trade Receivables

The Allegation

10.162 Sub-Allegation 4.4 is:

"***The Respondents used an analytical test for the existence of trade receivables but did not obtain sufficient appropriate evidence to substantiate their conclusions.***"

Analytical Testing (Trade Receivables) - The Issues

10.163 The analytical review for trade and other receivables is recorded in the following work papers:

(a) TES - 02.13.00.1.A/2: Receivables AR – Trade[610].

[607] [T9/157]

[608] [T9/163]

[609] [T9/165]

[610] [G2/22/211-215]

(b) TES - 02.13.00.1.a/3: Receivables AR – Payment period testing[611].

10.164 Baker Tilly used assumptions, calculated at the planning stage, to estimate what the receivables balance would be and then looked for explanations to explain the difference between the assumed and actual figures. This analytical review showed a variance of £8m (26%): the estimated 2007 balance was calculated to be £22m based on November and December sales (i.e., assuming all debtors were on 60 day terms); the actual 2007 balance was around £30m.

10.165 Mr [...]'s witness statement provides an account of how the variances which had been identified were explained by the audit team.[612] A large part of the variance (£3.338m) arose from the fact that it had been assumed that the IPS balance was repayable on 60 day credit terms, whereas on further investigation the audit team concluded that the balance was repayable on 365 day credit terms.

10.166 Executive Counsel submitted that the Respondents over-relied upon the analytical review to make up for deficiencies in their testing to verify the existence of trade receivables in that:

(a) Their approach, advanced in the Respondents' defence by Mr Main in cross-examination,[613] resulted in the analytical review being "***double-counted***" within in the framework of the Baker Tilly "***points-based***" approach to audit confidence, and this was inconsistent with the BT Audit Manual and wrong as a matter of principle; and

(b) Further, and in any event, the analytical review was deficient in that:

(i) The explanation for the contribution of the IPS debt to the variance referred to in paragraph 10.164 above was Baker Tilly's new understanding that that debt was on 365 day credit terms (rather than the 60 days previously advised) and Baker Tilly failed to obtain any corroboration for those terms.

[611] [G2/23/216

[612] .[Paragraphs 193 and 194. C/1/40]

[613] [Defence paragraph 109; T9/165 et seq]

(ii) The analytical review was carried out at an excessively high level[614] and was based on sales figures taken from Tanfield's internal systems and management explanations which had not been corroborated.

10.167 The Respondents submitted that:

(a) The analytical procedures must be viewed as part of a suite of audit evidence obtained to verify the existence of trade receivables;

(b) The assertion of double counting appeared to end up with the different suggestion that the analytical review itself could not justify the award of four audit confidence points: the problem with this submission was that the Complaint was ultimately one as to compliance with professional standards as defined by the ISAs, which require a judgment to be made based on the evidence in the round;

(c) The issue as to the IPS credit terms had already been addressed; and

(d) Overall, the analytical procedure was helpful in predicting the expected level of receivables and confirming that the actual balance was in line with expectations, and that this process (sometimes referred to as "***predictive analytical review***") provided strong audit evidence.[615]

10.168 Our conclusions in respect of the criticism that Baker Tilly failed to obtain corroboration for its conclusion that the IPS balance was repayable on 365 day credit terms are set out at paragraph 10.81 above.

Analytical Testing (Trade Receivables) - Executive Counsel's Case

10.169 In relation to the "***over-reliance***" alleged Executive Counsel submitted that in cross-examination Mr Main accepted that it would not by itself be sufficient evidence of the existence of Trade receivables[616].

10.170 In relation to the alleged deficiencies in the analytical review, the Executive Counsel:

(a) Referred to Mr Leech's opinion that the analytical review was carried out at an excessively high level, and was based on sales figures and management explanations which had not been corroborated sufficiently or at all and submitted

[614] [Mr Leech's opinion first report paragraph 5.2.6 :D1/1/92]

[615] [Main paragraph 12.4.5: D2/3/338]

[616] [Defence paragraph 109:T9/165]

that Mr Main acknowledged in cross-examination that the explanations provided for the variance between the actual and expected figures in the analytical review were not all corroborated[617];

(b) Returned again to the IPS 365 day credit issue: Baker Tilly relied on its new understanding of IPS's payment terms to reconcile the variance; this was a misunderstanding, or at the very least, it was unsupported by corroborative evidence; this assumption about payment terms infected the analytical review; the expectation of receivables balances, and how much debt was overdue, was based on this flawed understanding of payment terms; and Mr Main accepted that if Baker Tilly's assumption as to the 365 day term was wrong it would have skewed the analytical review[618]; and

(c) Re-iterated the reference to the fact that the audit file included disconfirming evidence as to the 365 day terms. The relevant workpaper[619] suggested that an invoice issued to IPS in November 2007 had been paid in February 2008. This invoice information (albeit without naming IPS as the debtor) was included in the analytical review workpaper[620], at lines 53 - 67. Further, lines 50 – 57 of that page provided evidence that Tanfield had not suggested that any customer was on terms other than the 40 days for UK customers and 60 - 80 days for foreign customers. Mr Main accepted this in cross-examination[621].

Analytical Testing (Trade Receivables) - The Respondents' Case

10.171 The Respondents' principal submissions were that:

(a) The allegation (like many others) suffered from the vice that it implicitly invites the Tribunal to focus on just one aspect (rather than the totality) of Baker Tilly's work in relation to receivables. The analytical review was but one component of the evidence to support Baker Tilly's audit opinions and had real value. Viewed overall, sufficient appropriate audit evidence was obtained.

[617] [T9/162]

[618] [T9/114-115]

[619] [G2/23/216]

[620] [G2/22/211]

[621] [T9/118-119]

(b) The analytical review was conducted in conjunction with detailed substantive testing of trade receivable balances.[622] It was artificial to focus on the evidence provided by a single test in isolation, not least because, as provided for by paragraph 3 of ISA 500, audit evidence is cumulative in nature and requires that a conclusion be reached after taking into account all the evidence in totality rather than by considering the results of each test in isolation.[623] Indeed, the allegation in the Formal Complaint required the Tribunal to be satisfied that there was an overall failure to obtain sufficient appropriate audit evidence.

(c) Mr Main's overall opinion was that the analytical procedure was helpful and provided strong audit evidence.

(d) When considered in the round, there was no basis for finding that Baker Tilly had fallen short of the standards in relation to the evidence that was obtained as to the recoverability of trade receivables at the year-end.

10.172 In paragraph 12.4.6 of his report Mr Main stated that he agreed with Mr Leech that in isolation the analytical test on its own did not provide sufficient evidence of the existence of trade receivables, but that "***the existence of trade receivables was … further audited by a combination of detailed substantive tests on receivables and tests to verify the validity of sales (audit working paper 21.30.00.1/3 on the Tanfield aud-IT file and 21.30.00/1/1 on the TES aud-IT file) which provide substantive evidence of the debits to the receivables ledger in addition to the analytical procedures performed***." [624]

10.173 In support of the first two of their principal submissions, and in response to the Executive Counsel's allegation of non-compliance with Baker Tilly's "***confidence points system***", the Respondents submitted that after first putting to Mr Main that the analytical review did not itself appear to justify four confidence points, Counsel for the Executive Counsel then later appeared to accept that it was in fact the broader question of the sufficiency of the overall evidence obtained that was the appropriate question for the Tribunal:[625]

Q. So I suggest that that couldn't possibly have been an analytical review that Baker Tilly could accord four confidence points to.

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[622] [Main paragraph 12.4.6; D2/3/338]

[623] [See Mr King's witness statement paragraph 133 C/3/109]

[624] [F2/47/326: G2/31/257]

[625] [T9/166-167]

A. I think this whole concept of confidence points, you can take it to ridiculous levels. Audit isn't a science, it is about collecting sufficient appropriate audit evidence, and to try and put a specific number of points on each area is only a general guide to what evidence you need. Sitting back, I would say that the combined evidence that they had obtained, it wasn't unreasonable to draw a conclusion as to the existence of trade receivables. So it's the whole suite of evidence. You can put four points or five points, that's all a matter of the auditor's judgment. At the end of the day, whatever you do with assurance points, the partner has to draw an opinion as to, "I've got this evidence, is that enough?" And that is what they've done.

Q. I think you referred just now to the analytical review being only a general guide, Mr Main?

A. A general guide? I think the words I use in 12.5.1: "The analytical review performed provided valuable substantive evidence as one part of the overall suite of audit evidence obtained in respect of trade receivables."

Q. Yes, and you go on:

"There were some explanations that were not independently corroborated, but given the other evidence obtained I do not see this as to be a significant failing in the audit process."

A. Yes.

Q. So the question for the Tribunal here will be whether the evidence obtained in the round is sufficient.

A. Yes.

10.174 In relation to the utility of the analytical review, the Respondents:

(a) Referred to Mr Leech's evidence relating to the analytical review test in which he accepted that: i) the procedure followed was a permissible one; ii) the tests included investigations by the auditor by reference to the aged debt listings; and iii) the tests constituted *"**helpful audit evidence**"* in the context of valuation**.**[626]:

[626] [G2/22/0211;T4/50 – T4/62]

(b) Submitted that overall, it was unclear whether Mr Leech ultimately was advancing serious criticisms as to this test beyond certain "***review point***" criticisms such as whether or not more could have been done to corroborate specific items and balances.

(c) Relied on evidence given by Mr Main in paragraph 12.4.6 of his report[627] and in his in cross-examination:[628]

Q. Yes.

In 12.4.6 on page 338 you have said that you agree with paragraph 4.4.1 of Mr Leech's first report that, in isolation, analytical procedures such as this do not on their own provide sufficient evidence of the existence of trade receivables. So you wouldn't be suggesting that this analytical procedure by itself would be sufficient?

A. No, no, I think you put everything into the bank together, look at it overall, and form an opinion as to whether the receivables is fairly stated, and we've gone through all the of that evidence and that's what they drew their conclusion on.

Q. Well, my suggestion, Mr Main, is having gone through the various aspects of the evidence on which you rely, there was not sufficient appropriate evidence on which to draw any conclusion as to the recoverability of trade receivables as at the year-end?

A. Obviously I disagree, as stated in my conclusion.

10.175 In relation to Mr Main's acceptance that there had been elements which had not been corroborated, the Respondents submitted that the Tribunal should have regard to his evidence that the items not corroborated were of low value, and that he considered the test overall as ***"pretty good"***:[629]

Q. Nevertheless, you're accepting there were uncorroborated elements and they should have been corroborated, shouldn't they, Mr Main?

A. I think you've got to take materiality into account, and this is an analytical review test giving us a general guide as to what we think the receivables figure is,

[627] [D2/3/338]

[628] [T9/165]

[629] [T9/162-163]

is it reasonable, and a couple of smaller balances we've not verified -- ideally you might have done, but, you know, you could take a view that in fact they are relatively low amounts and we don't need to corroborate something of that kind of value.

Q. Well, you're relying on the analytical review, aren't you, to put together with all the other testing that by itself is not sufficient, so the analytical review needs be pretty good in order to ensure that you've got the evidence that you require.

A. Yes, it was pretty good and there's a couple of items we've not followed through.

10.176 The Respondents concluded with the submission that taken in the round, and for all the reasons given by Mr Main, Baker Tilly obtained sufficient evidence in relation to the recoverability of receivables. Alternatively, to the extent there was any falling short of the standards, it plainly was not a significant one.

Analytical Testing (Existence of Receivables) - Falling Short – Conclusions in Relation to Baker Tilly

10.177 In essence, Executive Counsel's criticisms were that the analytical test was:

(a) "***skewed***" because of Baker Tilly's erroneous belief that the IPS debt was on 365 days credit terms;

(b) deficient because Baker Tilly had failed to obtain corroboration of what they were told by management; and

(c) involved double–counting for the purposes of Baker Tilly's points-based approach to audit confidence.

10.178 We have already expressed our conclusions in relation to the issues arising relating to the IPS debt, and therefore leave it out of account for present purposes.

10.179 Although Mr Main refused to concede that this was a failed test which should not have earned the 4 confidence points contemplated under the Baker Tilly audit approach, we consider that there is substance in that criticism, but accept that the issue before us in Allegation 4 is whether overall Baker Tilly's opinion was supported by sufficient appropriate audit evidence of the existence and valuation of trade receivables, and we note that the Particulars do not in fact advance the criticism of "double-counting".

10.180 It is clear that the analytical test was carried out by Baker Tilly with a view to obtaining evidence to support appropriate conclusions as to the existence and valuation of trade receivables. Mr Main did not dispute that it lacked corroboration, and in that respect it was in our judgment deficient and poorly executed. Baker Tilly, however, plainly considered it as providing some helpful supportive evidence and that it was unnecessary to obtain corroboration of the explanations provided to them. The answer to the question as to whether it provided any evidence to support conclusions as to the existence of trade receivables must be in the affirmative – but as Mr Leech put it, only at a "***high level***". As Mr Main pointed out (paragraph 10.175 above), leaving aside questions of corroboration, there were only relatively low amounts which were not verified. We do not think we can conclude that no competent auditor exercising reasonable care and skill would have adopted the same course as Baker Tilly did.

10.181 It follows that we do not consider that this sub-allegation 4.4 is proven against Baker Tilly.

Analytical Testing (Existence Receivables) – Falling Short – Engagement Partners

10.182 In the light of the conclusion expressed in the last paragraph that there is no basis for any finding of a "*falling short*" by Mr King or Mr Railton in relation to this sub-allegation 4.4.

Allegation 4.5 – Substantive Testing Of The Valuation Of TES Receivables

The Allegation

10.183 Sub-Allegation 4.5 is:

> "***The Respondents' substantive testing of the valuation of receivables in the TES audit files was insufficient in that they placed reliance on enquiries of management when alternative evidence could reasonably have been expected to exist. In particular, the Respondents' analytical procedures for receivables considered breaches in debtors' credit terms to assess the recoverability and appropriateness of the value of the individual debts. For five debtors identified as being in breach of their credit terms, neither written representations nor evidence of follow up of the management representations was obtained***".

Substantive Testing - Valuation of Receivables – Issues

10.184 In the context of Sub-Allegation 4.3. it was alleged that, for the reasons addressed above, the Respondents' substantive testing of TES receivables was inadequate. In this Sub-allegation the same criticism is advanced but on further grounds.

10.185 The work paper for TES receivables substantive[630] identified five overdue balances and recorded Baker Tilly's comments:

[…] - £8305 – Long outstanding balance at year end of £439 – paid since year end.

[…] - £490.246: Older balance of 1359 euros still due. Made up of small invoices. Being chased and not considered doubtful.

[…] – £591,180: 90-120 days 65,020 Euros due. Customer missed a payment – will include next payment run.

[…] – £ 7,288,992: 365 days: 171,521 Euros due at year end. Received since year end.

[...]: - £9,190,774: 20,000 of older year and debtor balance still outstanding at time of fieldwork. To be included in next payment (payments regularly received from customer, therefore not considered doubtful.

10.186 Executive Counsel contended that the engagement team appeared to have relied on oral representations from management, and that checks should have been made to ascertain whether cash was subsequently received or whether other evidence could be expected to be available, but few if any steps were taken to do this.

10.187 The Respondents submitted that reliance, in relation to these debtors, on management's explanations and representations was not unusual, that even if direct contact had been made by Baker Tilly with the specific debtors it was unlikely that they would have disclosed any financial difficulties that they were facing,[631] and that the debts were small.

Substantive Testing - Valuation of Receivables- Executive Counsel's Case

10.188 Baker Tilly were unduly passive. Mr Leech considered that an altogether more proactive approach is appropriate: engaging with credit controllers and obtaining corroboration by reference to bank statements, correspondence and credit checks.

10.189 In his first report Mr Leech stated:

[630] [F2/44/305:G2/30/255]

[631] [Main 13.4.4 : D2/3/342]

"5.2.20 Based on the evidence on file it appears that the Auditor satisfied itself as to valuation of these five debts through the oral representations of management, with only two of the five possibly checked to corroborative evidence.

5.2.21 The explanations provided for certain of these debts actually indicate possible issues. For example, the explanation for the overdue debt from Powerlift …..

5.2.23 In the absence of further follow up as part of post balance sheet events … this does not … give sufficient appropriate valuation as to debt, falling short of the requirements of ISA 500 ...

5.2.24 According to ISA 580 (Management Representations) written representation from management should be obtained on matters when other sufficient appropriate audit evidence cannot reasonably be expected to exist. However, it would be reasonable to expect other evidence to be available or other work to be documented around valuation of receivables for example after date cash, reviewing correspondence with customers, tests of control, third party credit reports, corroboration with other members of staff".

Substantive Testing – Valuation of Receivables - The Respondents' Case

10.190 This is outlined at paragraph 10.187 above. In oral closing submissions the Respondents stated that the IPS and PSE debts had been corroborated to bank statements[632]. It was submitted that the three other balances were absolutely tiny amounts: although the Powerlift balance was £44500, in the overall scheme of things this was a tiny amount, being 10% of TES materiality and 2% of Tanfield's materiality, and it was "***followed up and paid the following year****",* as evidenced by the work paper Group AR Trade Receivables[633] at line 363.

Substantive Testing – Valuation of Receivables - Falling Short – Conclusion in Relation to Baker Tilly

10.191 Our conclusion is that Mr Leech's view represents best practice, but that a good many competent auditors exercising reasonable care and skill would share Mr Main's view of this issue, We do not consider this sub-allegation 4.5 to have been made out.

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[632] [T11/160]

[633] [F1/34/261]

Substantive Testing - Valuation of Inventories - Falling Short – Conclusions in Relation to the Engagement Partners

10.192 In the light of the conclusion expressed in the last paragraph there is no basis for any finding of "*falling short*" by Mr King and Mr Railton in relation to this sub-allegation 4.5.

11. PART 11 – ALLEGATION 5 – INADEQUATE REVIEW OF AUDIT DOCUMENTATION (TRADE RECEIVABLES)

The Respondents failed adequately to review the audit documentation and to discuss the audit evidence with the engagement teams so as to be satisfied that sufficient appropriate audit evidence had been obtained to support the conclusions reached in relation to the existence and valuation of trade receivables and for the auditor's report to be issued, thereby

(a) failing to comply with the requirements in ISA 220 paragraph 26 and the guidance thereto in paragraph 27; and/or

(b) failing to act in accordance with the Fundamental Principle of Professional Competence and Due Care of the Code of Ethics of ICAS, ICAEW and ACCA.

Particulars

1. In relation to the existence and valuation of trade receivables, namely the W[...] Debt, which comprised a "critical area of judgment" and/or "a difficult or contentious matter" for SEV and Tanfield Group and which had been identified by the Respondents as "a significant risk" for SEV when planning the audit in December 2007, the First and Third Respondents failed:

(a) to conduct timely reviews at appropriate stages of the engagement;

(b) to document the extent and timing of the reviews; and

(c) to resolve any issues arising.

2. In relation to the matters referred to in paragraphs 1 and 3-6 of the Particulars to Allegation 4, the Respondents failed adequately by discussion with members of the engagement team to satisfy themselves that sufficient appropriate audit evidence had been obtained

(a) to support the conclusions reached in relation to the existence and valuation of trade receivables; and

(b) for the auditor's report to be issued.

3. Insofar as the Respondents reviewed the documentation and discussed the audit evidence with the engagement teams, they failed to identify the shortcomings identified in Allegation 4 and/or identified them but failed to resolve them.

4. The Respondents failed to obtain sufficient appropriate audit evidence in relation to Trade Receivables in order to express an unqualified audit opinion on the financial statements in accordance with ISA 700 paragraph 36a.

11.1 This allegation is specifically concerned with the conduct of Mr King and Mr Railton, and indirectly with Baker Tilly, on the basis of its vicarious responsibility for their conduct as the engagement partners of the audits.

Inadequate Review (Receivables) – The Issues

11.2 ISA 220, paragraphs 26 and 27 (set out at Annex B at page 273 below), relate to the duties of engagement partners, prior to the issue of the auditor's report, through review of the audit documentation and discussion with the engagement team, to be satisfied that sufficient appropriate audit evidence has been obtained to support the conclusions reached.

11.3 In paragraph 36(a) of ISA 700 it is stated:

"***An auditor may not be able to express an unqualified opinion when either of the following circumstances exist and, in the auditor's judgment, the effect of the matter is or may be material to the financial statements***

(a)There is a limitation on the scope of the auditor's work"

11.4 As can be seen this Allegation focuses on the role of the engagement partners in relation to specified sub-allegations in Allegation 4:

(a) Sub-allegation 1 – valuation of the IPS and PSE debts;

(b) Sub- allegation 3 – testing of the existence of debtor balances;

(c) Sub-allegation 4 – analytical testing for trade receivables;

(d) Sub-allegation 5 – substantive testing valuation of trade receivables; and

(e) Sub-allegation 6 - not pursued.

Conclusion

11.5 We have in fact already addressed these allegations against Mr King and Mr Railton when dealing with the matters referred to in sub-paragraphs (a), (b), (c) and (d) above, and accordingly we make no separate findings in respect of this Allegation. Although ISA 700 is not referenced in the earlier Allegations, the express reference to it in this Allegation 5 does not affect any of our conclusions.

12. PART 12 – ALLEGATION 6 – POST BALANCE SHEET EVENTS (TRADE RECEIVABLES)

Between 1 January and 22 July 2008 the First and Third Respondent failed in relation to the audit procedures to consider all events from the balance sheet date up to the date of the auditor's report, in particular in relation to trade receivables:

(a) to perform adequate audit procedures to obtain sufficient appropriate audit evidence that all events up to the date of the signing of the auditors' reports for TES and SEV for the year ended 31 December 2007 that may have required adjustment of, or disclosure in, their financial statements had been identified, and

(b) failed to prepare work papers which were a sufficient and appropriate record that demonstrated that all events up to the date of the auditor's report that may have required adjustment or disclosure in the financial statements of TES and SEV had been identified and considered by the Respondents,

thereby

(i) failing to comply with the requirements of paragraph 4 of ISA 560, paragraphs 2 and 9 of ISA 230 (Revised) and paragraph 21 of ISA 220; and/or

(i) failing to act in accordance with the Fundamental Principle of Professional Competence and Due Care of the Code of Ethics of ICAS, ICAEW and ACCA.

Particulars

1. The Respondents noted in the Tanfield Group Audit Findings Report document, presented to the Tanfield Audit Committee on 28 February 2008, that:

(a) the year-end debts owed to TES of £7.3 million by IPS and £9.2 million by PSE "At the time of our audit fieldwork …remained substantially unpaid. Specific representations are to be obtained from the directors in relation to this issue"; and

(b) that "specific representations are to be obtained from the directors in relation to the recoverability of [the W[...] Debt]" and "no provision has been made against this amount".

2. The Respondents noted in the planning section of the audit file for SEV that the W[...] Debt was a "significant risk" regarding existence, valuation and overstatement, and in another planning document relating to the SEV audit from around December 2007 that detailed documentation would be needed on file to support its valuation.

3. On 1 July 2008, the Tanfield Group issued a trading statement referring to "a deterioration of customer payment profiles" throughout June, which was followed by an immediate drop in the share price of the Tanfield Group of about 83%.

4. Between 1 January 2008, until the Auditor's report was signed for the TES and SEV 31 December 2007 financial statements on 21 July 2008, the First and Third Respondents nevertheless:

(a) failed to perform any or any sufficient appropriate procedures to obtain evidence of the recoverability of the material debts owed to TES and SEV (including IPS, PSE and the W[...] Debt), including third party confirmations, written representations from management and evidence of post year-end cash collection; and

(b) failed sufficiently to consider the rationale for their opinion that the debts referred to in Allegation 4 above of certain customers should not be impaired in the absence of sufficient appropriate evidence of recoverability in the TES or SEV 31 December 2007 financial statements."

Post Balance Sheet Events (Trade Receivables) - Issues

12.1 This allegation relates to Baker Tilly and Mr. Railton, the audit engagement partner on the TES and SEV audits. As stated above, while financial information for TES and SEV was incorporated in the Tanfield financial statements for the year ended 31st December 2007, for which a clean audit opinion was signed on 21st April 2008, the audit opinion for the 2007 financial statements of TES and SEV was not signed until 21st July 2008.

12.2 The particulars of the allegation point to post balance sheet events relating to the recoverability of outstanding debts as at 31st December 2007 of £7.3m owed to TES by IPS, £9.2m owed to TES by PSE, and a debt of £500,000 owed to SEV by W[...] relating to an agreement made in 2005 whereby W[...] would pay £500k upfront for the right to manufacture and sell AL22 vehicles in China. All three debts had been identified as issues in the Final Audit Findings report for the Tanfield Group dated 27th February 2008 (F2/49/F-0354 and F-0355).

12.3 The TES and SEV audit opinion was signed after the public trading update statement ("***the Trading Statement***") was issued by Tanfield on 1st July 2008, announcing that although trading for the first five months of 2008 had been relatively strong and in line with management's expectations, there had been a "***marked slowing in our markets***" in June. The Trading Statement sparked a single day fall of 83% in the Tanfield Group share price.

12.4 Between the Trading Statement and signature of the TES and SEV audit opinions, Mr. Railton did not meet Tanfield management to discuss the performance of the business or the accounts. However Mr. [...], the audit manager for the Tanfield Group and TES and SEV audits, met Mr. [...], Tanfield Group and TES and SEV's Finance Director to discuss the going concern status of the business and post balance sheet events for TES and SEV, a note of this meeting was prepared by Mr [...][634]. The chronology of events is set out in some detail at paragraphs 9.11– 9.18 above.

12.5 On 21st July, Baker Tilly received a Letter of Representation from the Board covering the W[...] debt signed by Mr. [...][635] as well as faxed confirmation in respect of SEV that there had been no events "***which may affect the amount included or disclosures within the Financial Statements***"[636]. Similarly in respect of TES, on 21st July a Letter of

[634] [G/13/G0168-9]

[635] [H/32/H-0253]

[636] [H/33]

Representation[637] confirmed "***there have been no events since the balance sheet date which necessitate a revision of the figures in the financial statements or inclusion of a note thereto***" and a fax[638] confirmed there had been no post balance sheet events affecting the amounts or disclosures in the financial statements.

12.6 The requirements under ISA 560 – Subsequent Events cover the auditor's obligations to deal with events which become known after the balance sheet date or after the auditors' report (on this allegation, issued on 21st July 2008), whether they have a subsequent adjusting or non-adjusting impact on the accounts and the appropriate approach to reflecting such events in the financial statements.

12.7 As described by Executive Counsel (EC Opening Submissions paragraph 198) "***The relevant events were (a) the (continued) failure by IPS, PSE and W[...] to discharge their liabilities and (b) the deteriorating wider macro- economic outlook***".

12.8 In the letter of Taylor Wessing dated 22nd September 2017[639] Baker Tilly and Mr. Railton accept that in relation to debts owed to TES by IPS and PSE they "***omitted to act in accordance with ISA 560 when considering post balance sheet events relating to trade receivables in TES"*** . In the same letter, Baker Tilly and Mr. Railton clarify that they do not accept that the admitted omission amounts to Misconduct. Nor did they accept an omission to act in accordance with the standards for the W[...] debt, which was covered under paragraph 9 of the Letter of Representation from the Tanfield board dated 21st April 2008[640].

12.9 In the Joint Memorandum between Mr Main and Mr Leech dated 10 October 2017 at paragraph 124[641] the experts agreed that "***there is not enough information available on the audit file to make a current assessment of whether the IPS and PSE balances subsequently treated as impaired included balances outstanding at 31 December 2007. Mr Leech notes that it appears that £6 million of the £9.2 million PSE balance at 31 December 2007 was subsequently written off when the impairment calculations were undertaken in September 2008, however, the Experts agree that when the impairment was booked by management in 2008 it was charged to current year results without any prior year adjustment***".

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[637] [G/39/G-0359]

[638] [G/40]

[639] [A/4/A-0071.2]

[640] [H/32/H-0253]

[641] [D2/5/457]

12.10 Given that the allegations concerning post balance sheet events, allegations 3 and 6, refer only to TES and SEV and not Tanfield , and that the audit opinion for Tanfield was signed on 21st April 2008, the alleged failings of Baker Tilly and Mr. Railton to investigate post balance sheet events relate to actions or omissions between 21st April and 21st July when the audit opinions for SEV and TES were signed.

Post balance Sheet Events (Trade Receivables) - Executive Counsel's Case

12.11 Executive Counsel's case is that having identified recoverability of receivables, and specifically amounts due from IPS, PSE and W[...] as an issue in their Final Audit Findings report dated 27th February 2008 (F2/49/F-0354 and F-0355), Baker Tilly and Mr Railton failed to perform any further checks to satisfy themselves as to the status of these receivables before signing the audit report on 21st July 2008, and failed to obtain directors' representations in respect of the IPS and PSE debts as planned in the Final Audit Findings report (F-0355).

12.12 Executive Counsel further infers that had further procedures been undertaken to assess the status of these debts prior to signing off the accounts on 21st July, it is likely, given the subsequent impairments, that Baker Tilly and Mr Railton:

(a) "***would have identified the issues surrounding the recoverability of the IPS and PSE debt. As noted earlier in these submissions the impairments made at the 2008 year end £6 million owed by IPS and £6 million owed by PSE[642]. This must have comprised in large part 2007 year end debts since the 2008 sales for PSE and IPS were relatively modest (£1.3 million and £1.2 million respectively***" (Executive Counsel Closing Submissions paragraph 298f); and

(b) would have uncovered relevant information on W[...], given Executive Counsel's contention that:

"***It is revealing that the W[...] debt was written off entirely as at June 2008, making up £500,000 of the £568,000 2008 SEV impairment. The relevant entry in audit working paper in the 2008 accounts states, "Balance has been on the debtor ledger for 4 years. Baker Tilly has raised concerns in prior audits re the recoverability of the balance but client has argued previously that the amount would eventually be recovered. There has been***

[642] [I/7/71]

no indicators (sic) in current year to suggest that the amount may become recoverable. The client now regards the balance as irrecoverable" (Executive Counsel Closing Submissions paragraph 299c).

Post balance Sheet Events (Trade Receivables) -The Respondents' Case

12.13 The Respondents note that the TES and SEV accounts were signed on 21st July 2008 after receipt of confirmation from the directors in Letters of Representation and post balance sheet events faxes that there had been no events since the balance sheet date warranting any change to the figures or notes to the accounts. In the case of the W[...] debt, the directors specifically attested to its recoverability in their Letter of Representation dated 21st July.[643]

12.14 The Respondents contend that they took account of the Trading Statement issued on 1st July by arranging the meeting referred to in paragraph 12.4 above between Mr. [...] and Mr. [...] to discuss going concern issues and post balance sheet events.[644]

12.15 With respect to TES, the Respondents contend that "***although it is accepted that there was a partial falling short with respect to receivables that falling short comes nowhere close to crossing the threshold into significance.***"[645].

12.16 In relation to the TES Financial Statements, in his expert report dated 28th July 2017 at paragraph 10.4.27 Mr Main wrote "***I have seen no evidence to suggest that Baker Tilly should have concluded that the value of either of these receivables was impaired at 31 December 2007. Any provision for impairment is likely to have arisen as a result of the economic crisis in 2008. Even if part of that debt had been considered irrecoverable on 21 July 2008, this would at most have required disclosure as a non-adjusting post balance sheet event***." [646]

12.17 Mr Main admitted at paragraph 10.5.2 [647] of the same report that:

"***The delay until the signing of the TES opinions (to 21 July 2008) was more substantial and there had been the 1 July 2008 trading statement. In those circumstances, in my opinion the omission to make any further enquiries in July***

[643] [Respondents' Closing Submissions paragraphs 233 and 257]

[644] [Respondents' Closing Submissions paragraphs 196, 197,198, 199 and 233]

[645] [Respondents' Closing Submissions paragraph 89]

[646] [D2/3/D-0326]

[647] [D2/3/327]

2008 fell outside the range of reasonable judgments and the work in this area fell short of that required by ISA 560 Subsequent Events." But he goes on to comment at paragraph 10.5.3: "***That said, there were limited practical consequences that any omission in this regard would have on TES's financial statements. TES's financial statements had already been incorporated in the consolidated group financial statements. The addressee of the opinion, Tanfield Group was already aware, of course, of any facts they might have been asked to disclose to the auditors relating to the recoverability of these loans. Any evidence of impairment would, at most, have required disclosure as a non-adjusting post balance sheet event and it is unlikely that anyone would have relied upon such a note. Furthermore Baker Tilly were satisfied when they gave their audit opinion on Tanfield on 21 April 2008 they had not highlighted any issues regarding recoverability as they had concluded the balances were within terms and hence there were no flags to require them to re visit their assessment of the recovery of these balances. I can therefore understand how Baker Tilly might have made a judgment that no further work was required in July 2008, albeit I do not agree with their conclusion. All auditors have to make many judgments in the course of an audit and I see this as a matter of misjudgment. On balance, therefore, I do not consider that the audit of the IPS and PSE trade receivables is a matter where the Baker Tilly or Mr Railton fell significantly short of the standards reasonably to be expected of a member or member firm.***" Main Report, 28th July 2017.[648]

12.18 In relation to the SEV Financial Statements the Respondents do not accept that it would have been possible to conduct further procedures to assess the recoverability of the W[...] debt and do not believe they fell short of the standards reasonably to be expected of members or member firms. Addressing the Respondents' reliance on directors' representations Mr. Main stated at paragraph 11.4.4 of his 28th July 2017 report, ***"….Baker Tilly had a difficult audit judgment to make - i.e. could they accept the representations of the board with regard to the potential impairment or was the absence of other substantive evidence of such significance that they should qualify their audit opinion? They had made enquiries and had been told there was no written evidence available. Direct correspondence with a customer in China would have been unlikely, in my experience, to elicit a response and, even if the debtor had replied, that response would not necessarily have provided additional evidence that the debt was recoverable. The crux of the recoverability issue***

[648] [paragraph 10.5.2-3 :D2/3/D-0327]

surrounded, in this case, whether or not manufacturing of the product was to commence or not. It is even more unlikely that a reply would have been received to such a question upon which any weight could have been placed. In my experience it is difficult to receive replies to any form of third party confirmation and even when received these are often unreliable as they tend to be delegated to junior staff. In my view, practically, there was little more that could be done here to obtain further evidence of recoverability.[649]

12.19 The Respondents and Mr. Main further referred to the fact that (a) the W[...] debt, at £500,000 was not material to the Tanfield Group's financial position and (b) that SEV *was* a wholly owned subsidiary of the Group, and that it was unlikely that writing off the £500,000 in respect of the W[...] balance would have materially influenced an economic decision of a user of the financial statements, asserting that clearly it would have not influenced Tanfield at all, who were well aware of the situation, that SEV had no third party debt and its only other creditors were trade payables and the tax authorities, and that a trade creditor was unlikely to have been influenced by the writing off of this balance as it was already clear that SEV relied on group support. (Main Report, 28th July 2017, paragraph 11.4.11*)*.[650]

Post Balance Sheet Events (Trade Receivables) – Falling Short – Conclusions

12.20 The Tribunal notes again that there is no allegation that the TES and SEV accounts were misstated and accepts that the accounts of the wholly owned subsidiaries reliant on parental support might well not be relied upon by third party users of accounts, but as Mr Main pointed out, the fact that those companies were wholly-owned subsidiaries did not provide a licence to ignore the balances (see paragraph 10.129 above) or in our opinion to depart from proper auditing standards.

12.21 The Tribunal accepts Executive Counsel's submission that, having identified the recoverability of the IPS, PSE and W[...] debts as an issue in their Final Audit Findings report of 27th February 2008, Baker Tilly and Mr. Railton failed specifically to follow up the status of these debts with any third party validation or other tests despite (a) worsening global economic conditions and (b) the Trading Statement of 1st July pointing to a deterioration in Tanfield's markets. These were circumstances in which reasonable auditors would be expected to be particularly alert to the pressures on directors of listed

[649] [D2/3/D-0331]

[650] [*D2/3*/D-0332]

companies and perhaps approach management representations with more scepticism and identify appropriate third party validation of the recoverability of debts that had been identified as a potential problem.

12.22 The Tribunal considers that in respect of TES, every competent auditor exercising reasonable care and skill would have questioned the payment performance of key customers, especially given that the Final Audit Findings report of 27th February had raised not only the recoverability of the IPS and PSE debts[651] but also pointed to the reliance on key customers: "***Sales to [...] (PSE) and [...] (IPS) make up £22.3 million (33%) of Tanfield Engineering Systems Limited's turnover for the year ended 31 December 2007"***.[652] That Baker Tilly and Mr Railton failed to obtain further evidence regarding the performance of these debts before signing their audit report and further failed to follow the Final Audit Finding report's conclusion that: "***specific representations are to be obtained from directors in relation to this issue"***[653] leads the Tribunal to the conclusion that they fell short of the required standards.

12.23 For the avoidance of doubt, the Tribunal finds that Baker Tilly and Mr. Railton were both careless and incompetent in failing to raise specifically the performance of the IPS and PSE debts with Tanfield after the 1st July Trading Statement and in failing to raise with their client the potential impact on the company of, among other things, the share price collapse and in failing to anticipate that the seriousness of the company's troubles after the share price collapse warranted a far greater attention to detail, record keeping and documentation of judgments made.

12.24 The Tribunal is struck by the fact that despite the cataclysmic share price fall of 1st July and the warnings given in the Trading Statement, Mr. Railton did not feel that as Engagement Partner on the SEV and TES audits and the key relationship manager for Tanfield at Baker Tilly he should have met the client in person to discuss both the subsidiary financial statements and current trading performance of the Group. Indeed, we understand from Mr Railton's witness statement at paragraphs 11, 18 and 21 that he was Client Services Engagement partner ("***CSE***") "***for a number of audit clients in Baker Tilly's Newcastle office. The role of the CSE is to be responsible for the client relationship and understanding the client and identifying how Baker Tilly services***

[651] [G2/32/G-0285]

[652] [G2/32/G-0284]

[653] [G2/32/G-0285]

could assist. The CSE is also responsible for managing financial and risk exposure including monitoring engagement performance.".[654]

12.25 In respect of SEV, the Tribunal accepts the evidence of Mr. Main cited above that the nature of the debt with W[...], its performance dependent upon on a decision to start manufacturing, and the fact that the counterparty was a Chinese company made it improbable that further enquiry by Baker Tilly and Mr. Railton for third party validation would have yielded results. Given this view, notwithstanding the length of time this debt had been outstanding, the Tribunal allows that it was reasonable for Baker Tilly and Mr. Railton to accept directors' representations as evidence for the recoverability of this debt, particularly as the amount was immaterial in the context of the financial statements of TES and Tanfield

12.26 In respect of Allegation 6(a), therefore, (that Baker Tilly and Mr Railton failed: "***to perform adequate audit procedures to obtain sufficient appropriate audit evidence that all events up to the date of the signing of the auditors' reports for TES and SEV for the year ended 31 December 2007 that may have required adjustment of, or disclosure in, their financial statements had been identified***") the Tribunal finds the allegations of non-compliance with paragraph 4 of ISA 560, of paragraph 21 of ISA 220, and the fundamental principle of professional competence and due care proven in relation to both Baker Tilly and Mr Railton with respect to TES and the IPS and PSE debts but not with respect to SEV and the W[...] debt.

12.27 In respect of Allegation 6(b), (that Baker Tilly and Mr Railton: "***failed to prepare work papers which were a sufficient and appropriate record that demonstrated that all events up to the date of the auditor's report that may have required adjustment or disclosure in the financial statements of TES and SEV had been identified and considered by the Respondents"***) the Tribunal notes that there is no contemporaneous evidence of the discussions or considerations which may have led the Respondents to make the judgments they made in relation to post balance sheet events as both the audit sign off records on aud-IT [655] and the note of the meeting between Mr [...] and Mr [...] (G/13/G-0168-9) are dated 21st July 2008, i.e. after the audit opinion was signed, and in any event the note was not a record of any judgment made by Mr Railton or Mr [...] – see paragraph 9.42 above. We therefore consider the omissions in Allegation 6(b) proven

[654] [C/2/C-0053-4]

[655] [for TES at G/13/G-0168 and for SEV at H/31/H-0240]

and that the conduct of Mr Railton and Baker Tilly fell short of the standards reasonably to be expected of a Member and Member Firm.

13. PART 13 – MISCONDUCT

Allegation 1

Baker Tilly

13.1 We have found that Baker Tilly fell short of the standards reasonably to be expected of a Member Firm in relation to Allegation 1.1 (a) - paragraph 7.43, 1.2(a) -paragraph 7.186, 1.2(b) - paragraph 7.266, and 1.3 - paragraph 7.279). The deficiencies in the audit identified in the first three of these sub-allegations were all serious and in our opinion crossed the "***threshold of "significance"***", and that in each of these respects Baker Tilly's conduct of the audit fell significantly below the standards reasonably to be expected of a Member Firm and amounted to misconduct. The deficiencies in respect of sub-allegation 1.3 did not cross that threshold.

The Engagement Partners

13.2 We have found that Mr King and Mr Railton fell short of the standards reasonably to be expected of Members in relation to Allegation 1.1(a) – (paragraphs 7.44 to 7.47), 1.2(a) – (paragraphs 7.187 to 7.189 and 7.198), 1.2(b) – (paragraph 7.267). These all related to an area of the audit which they had identified as posing significant risks. The errors and uncertainties which they failed to "***identify through the lack of appropriate review***" were significant – as we have found in the last paragraph. In our opinion in each of these respects their conduct of the audit fell significantly below the standards reasonably to be expected of Members, and amounted to misconduct.

Allegation 2

The Engagement Partners

13.3 We have found that Mr King and Mr Railton fell short of the standards reasonably to be expected of a Member in relation to this allegation – see paragraphs 8.29, and we have already found that in failing through appropriate review to identify significant errors and uncertainties Mr King and Mr Railton's conduct fell significantly below the standards reasonably to be expected of Members and amounted to misconduct. It is to be noted however that this allegation overlaps with the more detailed allegations referred to in paragraph 13.2.

Baker Tilly

13.4 Baker Tilly is responsible vicariously for the Misconduct of the engagement partners referred to in the last paragraph.

Allegation 3 (a)

13.5 We have found (at paragraph 9.39) that in the respects alleged in Allegation 3 Baker Tilly's and Mr Railton's omissions in the conduct of the audit of TES fell short of the standards reasonably expected from a Member Firm or a Member. The Executive Counsel submitted that that conduct fell significantly short of those standards.

13.6 The Respondents submitted, principally in relation to Allegation 3(a), that if, contrary to their primary contentions, it is determined that there has been a falling short from the applicable standards, any such falling short plainly cannot have been significant. In particular:

(a) Any disclosure would have been of a "***non-adjusting***" post balance sheet event, that is that there is no adjustment to the values in the 2007 financial statements but the reader might wish to note an event occurring after the balance sheet which might indicate a future adjustment, since:

(i) IAS 2 states that events occurring after the balance sheet date are only taken into account to the extent that they confirm conditions existing at the end of the period.[656]

(ii) Market conditions at the balance sheet date were favourable, as Mr Leech accepted.[657]

(iii) The subsequent down-turn in TES's fortunes took place long after the balance sheet date.

(iv) Accordingly, the downturn could not have affected the carrying value of any assets as at 31 December 2007.

(v) Mr Leech accepted that his instructions encompassed the timing of the 2008 impairments,[658] but he has never suggested that they should have

[656] [B2/17/525]

[657] [Leech no I 4.2.35 D1/1/51]

[658] [T2/72/8]

been made in 2007. Mr Main's unchallenged evidence was to the effect that the decisions made in mid-2008 would not raise the spectre of a prior-year adjustment.[659]

(b) TES and SEV were 100% subsidiaries of Tanfield – and so the addressee of the audit reports (i.e. Tanfield's management) would have been fully aware of any matters disclosed in any such note.

(c) Finally, the Tanfield trading statement was itself a matter of public record which would have been available to any wider user of the TES and SEV financial statements. Indeed, this is a factor which Mr Leech – at least in the past – considered relevant to the significance of any "***falling short***" by Baker Tilly.[660]

13.7 They further submitted that the position of TES and SEV and the fact that Tanfield's management were the addressees of the report was analogous in material respects to the position addressed in the decision of the Disciplinary Tribunal (chaired by Sir Stanley Burnton) dated 12 April 2017 in **Connaught**.[661] It was submitted that the Tribunal should follow the approach reflected in particular, at paragraph 137 of that Decision, in which the Tribunal held that the financial statements of CPL, a subsidiary of Connaught, did not give a true and fair view and indeed gave a misleading view of the profits and assets of CPL. Nevertheless, given that CPL was solely owned by Connaught, which was therefore well aware of the true position, this falling short was held to not have been a significant one[662].

"CPL was a contracting company, and its financial statements were relevant to its clients and potential clients. However, its financial statements were primarily intended for its sole shareholder, Connaught itself, which was of course well aware of its accounting policies and their application. In these circumstances, while we regard the conduct of the Respondents in relation to disclosure to have been below the standard reasonably to be expected of them, we do not consider it to have been significantly so".

13.8 In relation to the submissions referred to in paragraph 13.6(a) above, we comment:

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[659] [T10/61 – 62]

[660] [T3/192 – 194]

[661] [N2/12/0451]

[662] [N2/12/504]

(a) The reference to IAS 2 appears to be an error.

(b) The evidence of Mr Leech to which reference was made related to the date when the audits were being planned.

(c) The balance sheet date was 31 December 2007 and the apparent downturn was after the end of May.

(d) It was put to Mr Railton[663] that it was theoretically possible that the change in the market meant that stock which had been thought not to be obsolete as at 31 December 2007 had become obsolete by the following July: he did not dissent but stated that Baker Tilly had a broad feel, based on the 13 week stock turnover, that Tanfield would have used a lot of the parts it had had in stock at 31 December 2007.

(e) The summary given in sub-paragraph (v) of the evidence of Mr Leech and Mr Main is correct, but Mr Leech's evidence only goes to the issue of whether in fact there was any undiscovered obsolescence, and Mr. Main's evidence is limited to obsolescence arising from **decisions** taken in 2008 not to manufacture products.

13.9 In retrospect, it can be stated not only that any disclosure would have been of a non-adjusting post balance sheet event, but also that there were not any adjusting post-balance sheet events, but the whole purpose of the procedures prescribed in paragraph 4 of ISA 560 is to obtain sufficient appropriate audit evidence that there were no post balance-sheet events to disclose.

13.10 It is correct to state that there are some similarities between the company structures in **Connaught** and in the present case. TES and SEV were trading companies and their financial statements would have been relevant to their existing and potential customers and suppliers, but this plainly is a case in which those principally interested in the TES and SEV financial statements were the management and shareholders, and there was only one shareholder, namely Tanfield. Executive Counsel made the point that **Connaught** was concerned with the non-disclosure of a capitalisation and amortising costs policy and submitted that this was different from a situation in which one was concerned with inventories and receivables. In our judgment **Connaught** is distinguishable. In that case the accounts of the subsidiary did not include any note to explain that mobilisation costs had been capitalised and treated as an asset. However

[663] [T8/27]

the accounts of the holding company did include such an explanatory note. Though the terms of the note were subject to criticism, it did provide a basis for the contention that the intelligent and informed reader of the holding company's accounts would have realised that the policy must have been applied to the subsidiary's accounts.

13.11 We do consider that the potential prejudice to others which an auditor may reasonably foresee as a possible consequence of a breach of duty on the part of the auditor is relevant to any assessment of the seriousness of that breach. However, the fact that persons whether directly or not directly connected with a company might have sources of information about that company other than its published accounts, in our opinion, cannot alter an auditor's duties in respect of an audit. As the Appeal Tribunal stated in **Connaught,** [664] the financial statements of a company must give a true and fair view, and whether they do so "***must be determined on the basis of the financial statements standing alone***".

13.12 Whilst we accept that Mr Railton/Baker Tilly did have "***a broad feel***" that there was no post balance sheet obsolescence problem, we have held that it was a breach of duty not to have sought further evidence to support this judgment. We consider that the omission of further procedures (as predicated by paragraph 4 of ISA 560) fell significantly short of the standards reasonably to be expected and amounted to Misconduct.

Allegation 3(b)

13.13 Since the Executive Counsel has not advanced a case of wholesale non-compliance with paragraphs 2 and/or 9 of ISA 230, it must be treated as if it were a "***stand-alone***". On that basis, the deficiency, though relating to an important topic, in our opinion cannot be regarded as crossing the threshold of significance. The (audit) file note made by Mr [...] following his meeting with Mr [...] on 21 July 2008 did provide a partial record of Baker Tilly's considerations as to whether there were any post balance sheet events relevant to obsolescence. It was possible for Mr Main to understand what had been done and also to infer what the judgments had been made. There was no wholesale disregard for ISA 230. Accordingly we do not consider that the omissions established in respect of this Allegation fell significantly short of the standards reasonably to be expected.

[664] [N2/12/503-504]

Allegation 4

Baker Tilly

13.14 We have found that Baker Tilly fell short of the standards reasonably to be expected of a Member Firm in relation to allegations 4.1 – paragraphs 10.72, 10.82, and 10.85. These deficiencies relate to an area of the audit perceived as needing particular focus (see paragraph 10.33 above). Taking account of the factors summarised in paragraphs 10.71, 10.81, and 10.84 we are of the opinion that in relation to these issues Baker Tilly's conduct of the audit fell significantly below the standards reasonably to be expected of a Member Firm, and amounted to Misconduct.

The Engagement Partners

13.15 We have found (paragraph 10.90) that Mr King and Mr Railton in failing to ensure that the planned representations were actually obtained fell below the standards reasonably to be expected of Members, but that otherwise the allegations in 4.1 were not established against them. We consider that the abandonment of the plan to obtain the representations from management without any sound reason for so doing fell significantly below the standards reasonably to be expected of Members, and amounted to Misconduct.

Allegation 5

13.16 As appears from paragraph 11.4 above, these allegations, which are directed at the Engagement Partners, overlap with earlier allegations, and it is not appropriate to make additional findings in relation to them.

Allegation 6

Baker Tilly

13.17 We have found that Baker Tilly fell short of the standards reasonably to be expected of them in relation to Allegations 6(a) and 6(b) – see paragraphs 12.26 and 12.27 above,

13.18 Allegation 6(b) overlaps with Allegation 3(b) and therefore does not merit separate consideration. For the reasons stated in relation to Allegation 3(b), we do not consider that the conduct of Mr Railton and Baker Tilly fell significantly short of the standard reasonably to be expected of a Member or Member Firm.

13.19 In relation to the allegation in 6(a) the Respondents, whilst admitting that there was "***a falling short***" in respect of the omission to carry out any follow up procedures in

relation to the IPS and PSE debts in July 2008 prior to the signature by Mr Railton of the TES on 21 July of the audit opinion, submitted that taking the evidence as a whole, it would be wrong to regard such a failing as amounting to Misconduct:

(a) First, because there was sufficient evidence of the IPS and PSE balances as at the date on which the Tanfield audit opinion was signed on 21 April 2008. The issue, therefore, simply concerns the lack of further work in the period leading to the finalisation of the TES and SEV opinions in July.

(b) Second, whilst there was a further delay before the signing of the TES audit opinion (caused by a delay in Tanfield's management providing finalised financial statements) Baker Tilly did not simply rely on the position as of 21 April 2008 but instead took positive steps to obtain further evidence ahead of finalisation of the TES audit opinion, including arranging the meeting with Mr [...] that was attended by Mr [...]. The procedures that were followed also complied fully with the requirements for post balance sheet event work reflected on aud-IT.

(c) Third, at most, any evidence of impairment would have required disclosure as a non-adjusting post balance sheet event rather than as an adjustment to the 2007 accounts. That is, the subsidiary accounts would record the same sum for receivables in the balance sheet but there would be a note to the accounts stating that events occurring during 2008 might be relevant to recovery of some of those debts.

(d) Fourth, TES itself was a 100% subsidiary of Tanfield, Tanfield's management themselves had expressly confirmed through a management representation given on the date that the audit opinion was signed that there were in fact no relevant post balance sheet events, and in these circumstances, the Tribunal should take account of and follow the approach that was taken in **Connaught**.

(e) Fifth, the trading statement [665] (which referred in terms to the existence of *"**customer payment delays**"*) was in the public domain.

(f) Sixth, the Tribunal should take account of the fact that, for the reasons already referred to above, the AIU cannot have regarded this issue as having the significance which is now suggested.

[665] [E5/965]

13.20 As to those submissions:-

(a) We have rejected the submission that there was sufficient evidence of the IPS and PSE balances as at the date the Tanfield Group audit opinion was signed on 21 April 2008.

(b) The Respondents' second submission appears to us not to affect the fact that their follow up work was deficient. It is not suggested that Mr [...], when he met Mr [...] on 21 July 2008 made any request for an updating in respect of the IPS and PSE debts payment histories. In his oral evidence [666] Mr Main stated that the discussions between Mr [...] and Mr [...] on 21 July 2008 specifically referred to recoverability of debts. This was not in Mr [...]'s witness statement and it is not reflected in his note of those discussions.[667] However, in his oral evidence[668] he did state that he would have asked a general question about the recoverability of debt, whilst accepting that he had not asked Mr [...] specifically about either the IPS or PSE debts.

(c) The submission that any evidence of impairment would not have required an adjustment of the 2007 accounts appears to be based on the understanding that the IPS and PSE debts were brought within terms by the payments made in January and February 2008 – which, on the evidence, remains unclear. Further, even if correct, the point remains that the impairment would have needed to be disclosed in a note in the accounts.

(d) We have already expressed our view that this case is not analogous to the situation in **Connaught.** In ISA 500 paragraph 34 it is recognised that auditors may rely upon management representations where "***other sufficient appropriate audit evidence cannot reasonably be expected to exist or when the other audit evidence obtained is of a lower quality.***" Here there was no basis for thinking that appropriate audit evidence could not have been obtained.

(e) Whilst we accept that the Trading Statement was in the public domain after 1 June 2008, that it referred to customer payment delays, and that this could not have any impact prior to that date, in our judgment the effect of that statement

[666] [T9/82]

[667] [G1/13/168]

[668] [T8/178]

and the ensuing collapse in the Tanfield share price should have been an incentive for greater punctiliousness rather than less.

(f) The Respondents' sixth point is a reiteration of the view which was expressed by Mr Main and which we do not accept.

13.21 In his report at paragraph 10.5.3 Mr Main set out a number of reasons why he did not consider that the audit of the IPS and PSE trade receivables fell significantly short of the standards to be expected. These were substantially reiterated in the submissions referred to in paragraph 13.19 above and we have already expressed our conclusions in relation to them. However, it is worth noting that in cross-examination [669] Mr Main:

(a) was referred to the "***Framework for the preparation and presentation of financial statements***" in which users are identified as including employees, lenders, suppliers and trade creditors, customers, government agencies and the general public.

(b) agreed that he could not be sure that no-one would want to rely upon any note disclosing an impairment, and that the fact that it might be unlikely that it would be relied upon was not a reason for not providing an appropriate disclosure.

13.22 In our opinion in failing to ensure that further procedures were carried out before the TES audit report was signed on 21 July 2008 Baker Tilly's conduct of the audit fell significantly below the standards reasonably to have been expected of a Member Firm, and amounted to Misconduct.

Mr Railton

13.23 It appears to be the case that Mr Railton, like Mr King, had been led to believe that the IPS and PSE debts were within payment terms as at (effectively) the date of the Tanfield balance sheet. However, in the circumstances which we have referred to above, which include the fact that some five months had since elapsed, and Tanfield had issued a Trading Statement which included a profits warning and referred to a deterioration of "customer payment profiles" (albeit that that was stated to be "***throughout June***"), we consider that in the respects alleged in Allegation 6(a) Mr Railton's conduct of the audit fell significantly short of the standards reasonably to have been expected of a Member, and amounted to Misconduct. For the reasons stated in relation to Allegation 3(b), we do

[669] [T9/ 80]

not consider that Mr Railton's conduct fell significantly short of the standard reasonably to be expected of a Member in the respects alleged in Allegation 6(c).

Aggregation

13.24 As can be seen we have concluded that the Respondents "***fell significantly short***" in relation to each of the allegations referred to in paragraph 13.1 above, and that the Engagement Partner did so in relation to each of the allegations referred to in paragraph 13.2 above. In the event of this being judged too harsh a judgment on each of those deficiencies taken on their own, it would be our view that taken together and on a cumulative basis (which would be permissible as they all fall within the ambit of Allegation 1), they would together cross the threshold of significance and would together amount to Misconduct. As it is, our primary findings of Misconduct as set out above, have been made on the basis of a consideration of each deficiency on its own.

14. PART 14 - SANCTIONS

14.1 In the light of the conclusions set out above it is necessary to determine what sanctions if any should be imposed on the Respondents.

Available Sanctions

14.2 The available sanctions (which may be imposed in combination) are prescribed in Appendix 1 to the Scheme. In the case of Member Firms, the available sanctions are a Reprimand, a Severe Reprimand, a Condition (a direction, such as, for example, that the Firm is to make administrative changes), a Fine, an Order for the waiver or repayment of client fees, an Order proscribing, for a specified period, the Firm's eligibility for authorization to carry out a particular activity, or an Order that any such authorization be withdrawn, together with a recommendation as to a period during which it should not be reinstated. The same sanctions are available in relation to Members, together with the additional sanction of exclusion from membership for a recommended period of time.

Guidance

14.3 Guidance is provided in a document entitled "**Accountancy Scheme Sanctions Guidance**" ("**the Sanctions Guidance**" - "**SG**" for short), issued by the Conduct Committee of the Financial Reporting Council under the power conferred in paragraph 3(ii) of the Scheme, and effective on 1 June 2018.

14.4 The guidance is expressed[670] to be advisory, but it is also stated that if a Tribunal decides to depart from the guidance "***it should explain its reasons for the departure***".

14.5 Paragraph 7 of the Sanctions Guidance provides that Tribunals "***may have regard to sanctions imposed in other cases***", but that Tribunals must "***determine the sanction which they think appropriate on the facts and circumstances of the case before them.***"[671].

14.6 In paragraph 9 it is stated that the primary purpose of imposing sanctions for acts of Misconduct is not to punish, but to protect the public and the wider public interest. Tribunals are enjoined, when considering what sanction or combination of sanctions[672] to impose to have regard to the reasons for imposing sanctions, the objectives being expressed[673] to be:

"***a. to declare and uphold proper standards of conduct .. and to maintain and enhance the quality and reliability of accountancy work;***

b. to maintain and promote public and market confidence in the accountancy profession .. the quality of corporate reporting and .. the regulation of the accountancy profession;

c. to protect the public from Members and Member Firms whose conduct has fallen significantly short of the standards reasonably to be expected…; and

d. to deter members of the accountancy profession from committing Misconduct."

14.7 The guidance is expressed[674] to be intended to assist Tribunals to fulfil those stated objectives by imposing sanctions which:

"***a. improve the behaviour of the Member or Member Firm concerned;***

b. are tailored to the facts of the particular case .... the nature of the Misconduct …. and the circumstances of the Member or Member Firm…;

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[670] [SG para.5]

[671] [In the event, the parties have not been able to identify cases which are broadly comparable, let alone "***on all fours***" with the present case]

[672] [SG para.12]

[673] [SG para. 9]

[674] [SG para.10]

c. are proportionate to the nature of the Misconduct and the harm or potential harm caused;

d. eliminate any financial gain or benefit derived as a result of the Misconduct; and

e. deter Misconduct by the Member, Member Firm or others."

14.8 In paragraph 12 it is stated:

"***There may be circumstances where the objectives can be achieved without a Fine.***"

14.9 In paragraph 11 it is stated that in connection with the guidance provided in paragraph 10(a), Tribunals should consider whether and if so to what extent a proposed sanction would be likely to lead to improvements in respect of the matters which gave rise to the proceedings and in the quality of work of the Member or Member Firm concerned.

14.10 The Tribunal is specifically required to "***consider the full circumstances of each case and the seriousness of the Misconduct involved before determining which sanction or combination of sanctions to impose***"[675]. Paragraph 15 provides that the seriousness of the Misconduct should be determined by reference to a number of factors which include the nature of the Misconduct, the level of responsibility of the Member or Member Firm, and the actual or potential loss or harm caused by the Misconduct. Paragraph 20 provides that in assessing the nature and seriousness of the Misconduct and in determining which sanctions might be appropriate the Tribunal will normally consider a list of factors summarized in the following paragraph, but it is emphasized that this is not exhaustive, and that there may be other factors to be taken into account.

14.11 In relation to the issue of proportionality, it is stated that "***a Tribunal should consider whether a particular sanction is commensurate with the circumstances of the case, including the seriousness of the Misconduct found and the circumstances of the Member or Member Firm concerned***"[676].

[675] [SG para. 13]

[676] [Para. 14]

14.12 In paragraph 33 it is stated that factors to be taken into account in determining whether a fine is appropriate "***will normally include whether:***

a. deterrence could be achieved by issuing a Reprimand or Severe Reprimand alone;

b. the Member or Member Firm has derived any financial gain or benefit (including avoidance of loss) as a result of the Misconduct;

c. the Misconduct involved or caused or put at risk the loss of significant sums of money; and

d. a Fine was ordered in similar previous cases."

The Stepped Approach

14.13 Paragraph 18 of the Guidance provides that "***the normal approach to determining the sanction to be imposed in a particular case should be to:***

a. assess the nature and seriousness of the Misconduct …(paragraphs 20 - 24);

b. identify the sanction or combination of sanctions that the Tribunal considers potentially appropriate having regard to the Misconduct …(paragraphs 25 to 55);

c. consider any … aggravating or mitigating circumstances and how those … affect the level of sanction under consideration (paragraphs 60 to 65);

d. consider any further adjustment necessary to achieve the appropriate deterrent effect (paragraphs 66 and 67);

e. consider whether a discount for admissions or settlement is appropriate (paragraphs 68 to 74); and

f. decide which sanction(s) to order and the level/duration of the sanctions where appropriate."

The Parties' Submissions as to the Appropriate Sanctions

14.14 Whilst recognising that the question of sanctions is entirely a matter for the Tribunal, the submissions of the Executive Counsel as to the sanctions which, after applying the

stepped approach, would be appropriate in the light of the Tribunal's findings, all of the facts and circumstances and the Sanctions Guidance, were:

(a) Baker Tilly - a Reprimand and a Fine in the region of £850,000.

(b) Mr King - a Reprimand and a Fine in the region of £60,000.

(c) Mr Railton - a Reprimand and a Fine in the region of £60,000.

14.15 The Respondents submitted that :

(a) They did not disagree with Executive Counsel's suggestion that each Respondent be issued with a Reprimand.

(b) They agreed with Executive Counsel's suggestion, in paragraph 18 of her submissions, that an additional non-financial penalty would not be appropriate.

(c) Whilst Baker Tilly accepted that it should be subjected to a Fine, a Fine of the level proposed by Executive Counsel was not warranted on the facts of the case.

(d) It was not necessary to impose a Fine (or impose a Fine as large as that proposed by Executive Counsel) on either Mr King or Mr Railton in order to achieve the objectives of the Scheme referred to in paragraph 14.7 above.

STEP 1: THE NATURE AND SERIOUSNESS OF THE MISCONDUCT

The Factors in Paragraph 21 of the Sanctions Guidance

14.16 As stated, paragraph 21 of the Sanctions Guidance lists 23 factors that the Tribunal will normally consider in assessing the nature and seriousness of the Misconduct (albeit these factors are not intended to be exhaustive). These are addressed and commented on below[677]:

21.a. Financial benefit derived or intended to be derived from the Misconduct.

14.17 It is common ground that the Respondents derived no financial benefit (beyond audit or other fees received from the client, which are not relevant) from the Misconduct.

21.b. The gravity and duration of the Misconduct.

[677] [Unless otherwise stated, the comments apply equally to each of the Respondents]

14.18 Since many of the 23 factors listed are relevant to the gravity of the Misconduct, Executive Counsel here addressed only *duration*, submitting that the Misconduct subsisted throughout the audit work, from October 2007 (when the audit work commenced) to 21 July 2008, when the audit opinions for TES and SEV were signed off by Mr Railton.

14.19 The Respondents submitted that the reference to *duration* was directed to misconduct persisting over a number of engagements, and that this factor had no application to the present case, and that in any event:

(a) The Misconduct was limited to a single audit year.

(b) Whilst Executive Counsel had submitted that the Misconduct "***subsisted throughout the audit work, from October 2007 to 21 July 2008***", a period of some 10 months, this submission did not take account of the different positions of the Respondents:

(i) Substantive audit work commenced with the stocktakes on 20 December 2007.

(ii) The earliest Misconduct found by the Tribunal related to the stocktake at Tanfield Lea.

(iii) Any Misconduct by Mr King had been completed by the time he signed the audit report for Tanfield, approximately four months after the stocktakes.

(iv) Although the audit reports for the subsidiaries were only signed in July 2008, there was something of a hiatus following the signing of the audit report for Tanfield on 21st April until the end of June 2008.

(v) Further, and whilst - in a literal sense – almost any audit failing might be said to subsist across the duration of a relevant audit, this took matters little further: the relevant point was that this is not a case where failings have been repeated across different years, in connection with multiple sets of financial statements.

14.20 We do not consider that this factor is limited to cases in which Misconduct persists over a number of engagements or, indeed, any particular kinds of cases, but otherwise we accept the submissions referred to in the last paragraph.

21.c. Whether the Misconduct caused or risked the loss of significant sums of money.

14.21 It is common ground that there was no allegation or evidence that the Misconduct caused any financial loss. However, Executive Counsel referred to Mr Leech's opinion that, given the insufficiency of audit evidence in relation to inventories and receivables, the Respondents should have qualified their opinions with a limitation in scope statement in the auditor's report in respect of these areas: on the basis of the evidence retained on the audit file, Mr Leech was of the view that it was not now possible to determine if the accounts were materially misstated (***Leech 1 paragraph 9.4***)[678]: there could not be certainty as to what would have happened to the share price if the audit and audit report had been free from Misconduct, but it was submitted that there was the **potential** for serious loss. Executive Counsel emphasized that :

(a) Inventories and trade receivables were the two most significant assets on the balance sheet for Tanfield Group.

(b) The users of financial statements include employees, lenders, suppliers and trade creditors, government agencies and the general public[679].

(c) Tanfield Group was a UK company listed on the Alternative Investment Market (AIM). Tanfield was one of the biggest companies on the AIM.

(d) The article in the Financial Times (FT) published on 1 July 2008, the date of the Trading Statement ("***Tanfield shares plunge 83% on warning***"), illustrates how the financial statements may have been of interest to, and relied on by, investors, employees, lenders, suppliers and other trade creditors as well as the general public.

(e) Whilst TES and SEV were 100% subsidiaries of Tanfield, as the Tribunal noted[680] their financial statements would have been relevant to their existing and potential customers and suppliers.

14.22 We reject the suggestion that we should place reliance on Mr Leech's evidence that in his opinion the auditor's reports should have been qualified. No such allegation was advanced in the Formal Complaint and, no doubt for that reason, that evidence was not

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[678] [**D1/0136**]

[679] **[para.13.21(a) above]**

[680] **[para 13.10 above]**

subject to cross-examination and this allegation was not put to the Respondents. It was not alleged in the Formal Complaint that the accounts contained any material misstatements. We reject the suggestion that we should take account of the possibility that there might have been. As the Respondents' counsel pointed out, Mr Leech accepted that his instructions required him to consider whether the impairments to inventories and receivables should have been recognised in 2008, but despite this, it was never a part of the Formal Complaint that the impairments should have been recognised in the 2007 financial statements or that there was insufficient appropriate audit evidence on the 2008 audit to justify recognising the impairments in 2008 rather than 2007. The qualification of an auditor's report has the potential to cause serious harm to the client company, and is not a step to be taken lightly. The alternative (and, we consider, the better) view to that expressed by Mr Leech is simply that more should have been done to gather the necessary evidence and that only after that had been done and the evidence had been found to be inadequate would it have been appropriate to consider qualifying the reports.

14.23 The article in the FT to which Executive Counsel refers provides no more than confirmation of the obvious, namely that the published accounts of the three companies would be of interest to users of financial statements and that trading statements affect share values. However, we accept the validity of the points set out in sub-paragraphs (a), (b), (c), and (e), in paragraph 14.21 above.

14.24 The absence of sufficient appropriate audit evidence predicates a risk of misstatements and this in turn means, in the context of the audits of these particular companies, and on the basis of our findings, that it gave rise to the risk of the loss of significant sums of money.

21.d. Whether the failures to comply with professional standards were intentional.

14.25 It is common ground that the failures were not intentional.

21.e. The nature, extent and importance of the standards breached.

14.26 The main standards breached included: the fundamental principle of professional competence and due care; ISA 500 (obtaining sufficient appropriate evidence); ISA 220 (role of the engagement partner); ISA 230 (audit documentation); and ISA 560 (post balance sheet events).

14.27 Executive Counsel submitted that: the breaches were of core standards at the heart of auditors' duties for the discharge of their role: as the Tribunal noted in **Connaught** (at para. 312): "***the importance of the standards themselves arises from the importance of audit in the economy and the financial system***": the breaches were not confined to a single area: some of them related to aspects of the audit (existence and valuation of inventories) which the Respondents had themselves identified as "**significant risks**" and which had been singled out as key areas of audit focus.

14.28 In our judgment paragraph 21.e. is not concerned with the nature, extent or importance of **the breaches** of the standards but with the nature, extent and importance of **the standards** which were breached. In this context it is immaterial that the breaches were not confined to a single area or related to aspects of the audits which the Respondents had identified as "***significant risks***". The quotation from **Connaught** is directed to the emphasis of the importance of the standards in general. However, the Respondents' breaches were of standards which are of fundamental importance to the adequate performance of any audit, and may be fairly categorized as "***core standards at the heart of auditors' duties.***"

21.f. Whether the Misconduct involved a failure to act or conduct business with integrity.

14.29 It is common ground that there was no such failure.

21.g. Whether the conduct was dishonest, deliberate or reckless.

14.30 It is common ground that it was not.

21.h. Whether the Member or Member Firm has been convicted of a related criminal offence.

14.31 It is common ground that the Misconduct did not constitute a criminal offence and none of the Respondents have been convicted of any offence.

21.i. Whether the Member or Member Firm has been convicted outside of the UK of a related criminal offence.

14.32 It is common ground that none of the Respondents have been convicted of any such offence.

21.j. Was the Misconduct isolated, or repeated or ongoing?

14.33 There is an overlap between this factor and that set out in paragraph 21.b. As appears from paragraph 14.18 above, the Executive Counsel submitted that the Misconduct subsisted during the period of the audit and was not confined to a single area.

14.34 In addition to the submissions referred to in paragraph 14.19 above, the Respondents reiterated that the Misconduct was isolated to a single audit year, and submitted that there was the additional factor that the subsequent audit year was specifically investigated by Executive Counsel but no allegations relating to this year were raised in the Formal Complaint: Executive Counsel's submission that the Misconduct "***subsisted during the period of the audit and was not confined to a single area***" missed the purpose of this criterion.

14.35 Since the Misconduct related to a single audit and there is no suggestion that it was repeated in subsequent audits or is ongoing, in our judgment it is fairly characterised as "***isolated***". The fact that errors in the audits occurred in different areas and at different "***levels***" and at various stages of the audits are, however, relevant, since they all fall within the overarching requirement that the Tribunal must consider all the circumstances.

21.k. If repeated or ongoing the length of time over which the Misconduct occurred.

14.36 It was not repeated or ongoing.

21.l. Was potential financial crime (such as fraud) facilitated or able to occur as a result of the Misconduct?

14.37 It is common ground that no financial crime was facilitated or able to occur.

21.m. Whether steps had been taken to address any similar Misconduct previously identified.

14.38 There is no suggestion that there had been any similar previous Misconduct. This factor is not applicable.

21.n. Whether the Misconduct adversely affected, or potentially adversely affected a significant number of people in the United Kingdom (such as the public, investors or other market users, consumers, clients, employees, pensioners or creditors).

14.39 The Executive Counsel reiterated the submission noted in paragraph 14.21 above, submitting that the Misconduct adversely affected, or potentially adversely affected, a

significant number of people. The Respondents submitted that in the absence of any suggestion of misstatement of the financial statements, it did not.

14.40 We have already addressed this issue – see paragraphs 14.22 to 14.24 above.

21.o. Whether there has been a failure to comply with any previous directions or other relevant sanction.

14.41 It is common ground that there has been no such failure.

21.p. Whether it is likely that the same type of Misconduct will recur.

14.42 The Respondents have provided little information as to the steps (if any) which have been, or are to be, taken to ensure that this type of Misconduct does not recur. However, Mr Randall, the solicitor acting on behalf of the Respondents in these proceedings, stated (at paragraph 11 of his witness statement) that: "***These findings of course relate to events over a decade ago and the firm's processes have undergone substantial changes since then***" but that nonetheless "***the firm will bear these findings firmly in mind in its continuous review of its practices, procedures and training***". The Respondents submitted that there can also be no question that the Tribunal's findings will be considered carefully by all Responsible Individuals at Baker Tilly, and it is plainly unlikely that the same type of Misconduct will recur. The point was also made that Mr Railton had ceased work as an audit engagement partner.

14.43 Executive Counsel acknowledged that our findings of Misconduct relate to events which took place over a decade ago and that the firm's processes will have undergone substantial changes since then.

14.44 The Misconduct in this case was principally due not so much to deficiencies in Baker Tilly's processes (as reflected in the BT Manual) as to the Respondents' laxity and failure to follow and apply them effectively. Nevertheless, there is no suggestion that there has been any repeat of laxity on a similar scale (or, indeed, at all) since 2008, and, whilst the risk of careless work in any profession or business can never be eliminated, we consider that we should proceed on the basis that it is unlikely that the same type of Misconduct will recur.

21.q. Whether the Misconduct undermines the purpose or effectiveness of the disciplinary arrangements, such as failure to comply with obligations under the Accountancy Scheme.

14.45 There is no suggestion that it does.

21.r. Whether the Misconduct could undermine confidence in the standards of conduct in general of Members and Member Firms / in financial reporting / corporate governance in the United Kingdom.

14.46 Executive Counsel referred to the statement of the Tribunal in **Connaught** (at paragraph 319) that any Misconduct in connection with an audit, particularly by a major firm such as Baker Tilly of a listed company, is liable to undermine confidence in financial reporting. We agree that would usually be the case, but the Executive Counsel acknowledged that the potential for confidence to be undermined in the present case is mitigated by the fact that the Misconduct occurred over 10 years ago. We consider that those in the public concerned with financial reporting and corporate governance will take the view that the world has moved on since 2008, and the fact that there were significant deficiencies in an audit which took place 10 years ago is not a reason for losing confidence in the standards of conduct of Members or Member Firms at the present time. Accordingly, we do not consider that the Misconduct could have the undermining effect referred to.

21.s. The effectiveness of Baker Tilly's procedures, systems or internal controls.

14.47 Executive Counsel did not advance any case that there were wide or systemic failings on the part of Baker Tilly, but submitted that a number of troubling matters emerged from the evidence specifically in relation to the audit of Tanfield, and that in this specific context, procedures and internal controls were ineffective in relation to the following areas:

(a) There was confusion within the Engagement Team as to risk;

(b) There was misunderstanding within the Engagement Team as to (a) the reliance they could place on analytical review procedures and (b) the Baker Tilly Audit Confidence points systems[681];

(c) There were failures to follow Baker Tilly's Audit Manual (eg. in relation to Tanfield Lea)[682];

[681] **[para.7.29 above]**

[682] **[para. 7.41 above]**

(d) There were fundamental misunderstandings of standard procedures (for example, on the part of Ms [...]. The flawed test actually performed was statistically valueless)[683];

(e) There was a lack of familiarity with aud-IT on the part of the Engagement Team;

(f) Documents were omitted from the audit file with the consequent danger that they may not have been properly reviewed; and

(g) Audit tests were not, or not adequately, documented, and key decisions were not recorded[684].

14.48 The Respondents submitted that the Formal Complaint made no allegation as to the general effectiveness of Baker Tilly's systems or internal controls at the relevant time and therefore no findings had been made in relation to these matters: whilst the comments made by the Tribunal referred to above related, in a general sense, to Baker Tilly's procedures and controls at the relevant times, these were not matters that went to the seriousness of the Misconduct, and, in any event, it would be wrong to place weight upon such remarks given that they were not raised by the Formal Complaint and were not the focus of factual and expert evidence: further, the relevant processes had, as explained above, undergone substantial changes since the material events.

14.49 Baker Tilly's procedures, systems, and internal controls were documented in the BT Manual. The adequacy of this document was not called into question by Executive Counsel and was not a subject of the Formal Complaint. The criticisms referred to in paragraph 14.47 above were factors already taken into account in the findings of Misconduct or were errors or omissions or general laxity which, not being subjects of the Formal Complaint, can only be treated as "***background***". Nevertheless, insofar as we have made findings that the audits were not carried out entirely in accordance with the BT Manual, Baker Tilly's procedures, systems and controls were not effective - they were not consistently and systematically applied.

21.t. When senior management became aware of the Misconduct and what action was taken at that point.

14.50 It is common ground that this is not applicable.

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[683] **[para. 7.41 above]**

[684] **[para. 8.8 above**]

21.u. Whether Mr King and Mr Railton caused or encouraged others to commit misconduct.

14.51 It is common ground that they did not.

21.v. Whether Mr King and Mr Railton held senior positions and supervisory responsibilities.

14.52 The Respondents submitted:

> "***They did not, beyond the fact that they were engagement partners. The Allegations themselves relate to Mr King and Mr Railton's performance as engagement partners for the Tanfield, TES and SEV audits. All audits should be conducted under the supervision of a partner. The fact that these audits were supervised by partners cannot be a factor that increases the seriousness <u>of the findings of Misconduct.</u>***"

14.53 We do not accept that submission. Mr King was the engagement partner for Tanfield's consolidated financial statements. Mr Railton was the engagement partner for the 2007 audits of TES and SEV. These were senior positions with supervisory responsibilities. In addition, Mr Railton was the partner at Baker Tilly responsible for the relationship with Tanfield, and between 2005 and 2007 (though we don't know the specific date in 2007) he was head of the business service department in Baker Tilly's Newcastle office. That department included the audit practice. From 2007 until 2009, he was head of the audit department. In those posts, he was responsible for managing and leading those departments, and his responsibilities included the development of the team, improving the financial performance of the department, risk management, business development, and the quality of overall performance. Accordingly, Mr Railton's responsibilities were in some respects wider than those of Mr King, which is a material consideration in the light of the overall laxity of Baker Tilly's approach to these audits.

21.w. Whether Mr King and Mr Railton were solely responsible for the Misconduct.

14.54 The Respondents submitted that they were not asserting that the findings of Misconduct related in large part to failings by audit juniors. Whilst we accept that it would be unfair to treat Mr King and Mr Railton as being solely responsible for the Misconduct relating, respectively, to Tanfield and to TES and SEV, the errors having initially arisen at more junior levels, they, as engagement partners were principally responsible for the audits and they both failed to perform their personal supervisory duties adequately.

Submissions as to the seriousness of the Misconduct generally

14.55 The Executive Counsel acknowledged that the Misconduct was not at the most serious end of the spectrum, but emphasized a number of points – which we set out in paragraphs 14.56, 14.59, 14.60, 14.62, 14.64, and 14.67 below and address in the ensuing paragraphs.

Public Interest.

14.56 Firstly, the Executive Counsel submitted that the public interest bears heavily on audit work, especially of a public company, given the importance of accounts to those who rely on them (and Tanfield Group was one of the biggest companies listed on the AIM. Tanfield reached its peak share price of 203.5p in July 2007. This gave it a market capitalisation of over £700m). Investors and creditors rely on those financial statements and the auditor's report in making their financial decision. Whilst TES and SEV were 100% subsidiaries of Tanfield, their financial statements, as the Tribunal noted at paragraph 13.10 above, would have been relevant to their existing and potential customers and suppliers. Auditors have statutory reporting obligations and audit serves the interests of society as well as those of clients.

14.57 The Respondents submitted that the reference to the market capitalisation of Tanfield in July 2007 was not relevant to the consequences of any error because there was no allegation that the accounts were misstated, that the market capitalization of Tanfield was not a factor going to the nature or seriousness of the Misconduct but a separate factor, as set out at paragraph 21.c. of the Sanctions Guidance, and that in any event the date appeared to have been selected only because it was the date on which Tanfield's share price reached its peak, preceding, by several months, any Misconduct on the part of the Respondents – the share price had fallen by the date of any Misconduct and by the time that the 2007 Tanfield audit report was signed by Mr King in April 2008, the share price had fallen from its peak by around 40%, if not more.

14.58 The market capitalization of Tanfield at a material time may be relevant to the level of any potential loss but the earliest date at which any loss could be sustained as a consequence of any misstatement would be the dates on which the signed audit reports were communicated to the relevant Boards. It is clear, as we have found at paragraph 14.24 above, that there was a risk of significant loss but the evidence does not support any finding as to the precise extent of that potential loss and there is no basis for a finding that any loss actually occurred. Having considered this factor 21.c. at paragraphs 14.21 to 14.24 above, it does not fall to be taken into account again.

Measure of Responsibility

14.59 Secondly, the Executive Counsel submitted that, as the Tribunal noted in **Connaught** (at para. 325), the responsibility of an auditor is to be measured less by the amount of the audit fee than by the scales of the balance sheet and profit and loss account that it audits and on which it reports. We accept this as an obvious point.

Significance of Inventories and Trade Receivables

14.60 Thirdly, the Executive Counsel submitted that inventories and trade receivables were the two most significant assets on the balance sheet for the Tanfield Group[685]. The aggregate value of these two assets across the Group was £105 million. The total value of all current assets across the Group was £137 million and of all assets (i.e. including long term assets) was £198 million.

14.61 We accept that this is relevant to the assessment of the seriousness of the Misconduct relating to inventories and trade receivables.

The Scale of TES's Business/Significance of IPS and PSE Debts

14.62 As the Tribunal noted[686] at the relevant time, the scale of TES's business was such that a material error in its financial statements could produce the same in the financial statements of the Group. The IPS and PSE debts were individually a material amount for both TES and Tanfield[687].

14.63 The Respondents submitted that the submission set out in the last paragraph, though literally true, was irrelevant in circumstances where Executive Counsel was disavowing any suggestion that there was in fact any material misstatement in the financial statements of TES, SEV or the Tanfield Group. We disagree with this submission – sub-standard work in relation to items which could have potentially significant consequences are plainly more serious than sub-standard work which is unlikely to have any significant consequences.

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[685] **[para 1.22** – **1.23** and **1.31 above]**

[686] **[para.1.21above]**

[687] **[paras.10.76 and10.81 above]**

Inventories as Significant Risks

14.64 Fourthly the Executive Counsel submitted that existence and valuation of inventories had been identified by the Respondents themselves as significant risks[688]. IPS and PSE debts had been identified by the Respondents as needing to be the subject of heightened focus[689]. The Respondents correctly identified that these areas were vulnerable to misstatement but did not then properly exercise their audit responsibility in relation to them.

14.65 The Respondents submitted that, on the Tribunal's findings, it is only ***because*** such matters were or ought to have been identified as significant risks, or as areas of particular concern, that the Tribunal has reached the view that many of the allegations of Misconduct have been substantiated: such matters cannot then be re-deployed to suggest ***heightened*** seriousness.[690]

14.66 In our view our finding that the Respondents recognized these areas of the audits as being, respectively, significant risks or as requiring particular focus, is confirmatory of the objective importance of the work in these areas, and is to their credit. We agree that this recognition cannot be deployed, when addressing the issue of Sanctions, to suggest a heightened seriousness, but there is no escaping the fact that a serious risk predicates the application of a level of care and skill which may not be required in relation to a less serious risk, and enhances the seriousness of any failure to adequately address the risk.

Reliance on Financial statements

14.67 Finally, the Executive Counsel submitted that the article in the FT published on 1 July 2008 illustrated how the Group's financial statements may have been of interest to, and relied on by, investors, employees, lenders, suppliers and other trade creditors as well as the general public. (The Executive Counsel does **not**, however, allege that there was any causal link between the financial or trading position of Tanfield at 31 December 2007 and the difficulties experienced in 2008 leading to the Trading Statement and share price collapse.)

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[688] **[paras, 6.21 and 6.22(a) above]**

[689] **[para. 10.67 above]**

[690] **[See paras 7.28, 8.10, 8.12, 10.57, and 13.2 above]**

14.68 This is merely a re-iteration of Executive Counsel's submissions in relation to the factor identified in paragraph 21.c. of the Sanctions Guidance, which we have addressed at paragraph 14.23 above.

Assessing the Seriousness of the Conduct of Each Respondent

14.69 In assessing seriousness, the conduct of each Respondent falls to be considered separately.

Conclusions as to the Seriousness of the Misconduct of Baker Tilly

14.70 Baker Tilly is vicariously responsible for all the Misconduct, including that which we have found to be attributable to the acts or omissions of personnel who were junior to Mr King and Mr Railton. In terms of Misconduct, plainly the upper end of the spectrum will be occupied by cases involving criminality, lack of integrity, dishonesty, deliberate or reckless breaches of the standards of conduct, all of which would be aggravated if the Member or Member Firm intended to derive a financial benefit from the conduct in question. None of these features are present in this case. In the context of cases not involving any intentional or reckless wrongdoing, cases giving rise to financial loss by others will generally be more serious than cases where no losses are sustained.

14.71 As stated at paragraph 14.55 above, the Executive Counsel accepted that this case is not at the most serious end of the spectrum of Misconduct. The Respondents submitted that the errors or omissions constituting the Misconduct in this case, as falling significantly short of the standards reasonably to be expected, occupy a place towards the bottom of that spectrum. Of the 23 factors referred to in paragraph 21 of the Sanctions Guidance, only 8 are of relevance and there is some overlap between some of them. The most serious of our findings in relation to the 23 factors relate to sub-paragraphs e, j, and v, of that paragraph, but in the light of the absence of any more serious features we consider that the classification suggested by the Respondents is objectively reasonable, and we adopt it.

Conclusions as to the Seriousness of the Misconduct on the part of Mr King and Mr Railton.

14.72 As the Executive Counsel pointed out, each was Engagement Partner; each had identified existence and valuation of inventories to be areas of significant risk which required particular attention[691]; each should have assessed valuation of trade receivables

[691] **[paras 6.21 and 6.22a above]**

as an area of particular concern which required particular attention[692]; each placed excessive reliance on Mr [...]; each failed to establish whether or not Mr [...] was discharging his duties adequately[693]; each failed adequately to review the work of his team[694]; each should have asked more questions and reviewed at least some of the key documents[695]; neither was aware that the planned test for obsolescence had not been carried out; each failed to obtain (and abandoned the plan to obtain) specific representations from management in respect of the very large IPS and PSE balances[696]**.**

14.73 The Respondents submitted, in relation to the criticism that Mr King and Mr Railton each failed to obtain specific representations from management in respect of the IPS and PSE balances (this being the only finding of Misconduct that has been made against Mr King and Mr Railton in connection with the various issues relating to receivables raised by Allegation 4) that it was to be noted that:

(a) This failing was not referred to expressly in the Formal Complaint with respect to Mr King.

(b) Mr Leech's first report did not make any express criticism of Mr King in this respect (see paragraph 5.3.5)[697].

(c) Although Mr Leech noted that Baker Tilly and Mr Railton had failed to obtain such representations, that failure did not feature in his summary of PSE failings relating to the audit of TES and SEV at section 5.5 of his first report [698]– indeed, it is somewhat ironic – in this context – that Mr Leech ***did*** complain about reliance on uncorroborated management representations (see paragraphs 5.5.6-7).

14.74 The Respondents further submitted that while the Tribunal has found them guilty of Misconduct in this respect, in the light of the matters set out in the last paragraph that this failing:

(a) Could only just have crossed the boundary into Misconduct.

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[692] **[para. 6.23 above]**

[693] **[para. 7.46,7.45,7.188, 7.198, 8.27 and 8.28 above]**

[694] **[para 8.28 above]**

[695] **[para. 8.28 above]**

[696] **[paras. 10.90 and 13.15 above]**

[697] **[D1/D0105]**

[698] **[D1/D0109ff]**

(b) Cannot provide any material support to Executive Counsel's case as to seriousness.

14.75 Although it was Mr Railton who was directly responsible for the audits of TES and SEV, they were subsidiaries of Tanfield, so Mr King had an over-arching responsibility for them. Whilst Mr Leech did complain of reliance on uncorroborated management representations, they do provide appropriate audit evidence, even if it is not always the best evidence. We do not accept that it is appropriate to disregard any of the acts or omissions which have been found to be evidence of Misconduct when assessing the seriousness of the Misconduct.

14.76 The Executive Counsel submitted that Mr King and Mr Railton, as the Engagement Partners, were principally responsible for the Misconduct: there was therefore broad parity between the conduct of Baker Tilly, on the one hand, and the conduct of the Engagement Partners on the other, but that in two respects, they may be seen to be less culpable than the Firm:

(a) Firstly, in respect of allegation 4.1 (the Respondents' failure to obtain sufficient appropriate audit evidence in order to determine whether the IPS and PSE debts owed to TES were recoverable) the Tribunal's findings against Baker Tilly are more wide-ranging than as against Messrs King and Railton, the findings against them being confined to failing to obtain (and abandoning the plan to obtain) specific representations from management[699], and the findings against Baker Tilly including, in addition: (a) failing to obtain sufficient appropriate audit evidence as to what, if any, amount of the IPS balance was subject to 365 day terms[700]; and (b) failing to obtain sufficient appropriate evidence (including corroborative evidence) of their payment history.[701]

(b) Secondly, the Firm is primarily responsible for the ineffective procedures and controls (referred to at paragraphs 14.47 to 14.49 above).

14.77 We do not accept the second of the distinctions suggested by Executive Counsel. For the reasons given at paragraph 14.49 above, we consider that the fact that Baker Tilly's procedures, systems and controls were ineffective was because they were not

[699] **[paras. 10.90 and 13.15 above]**

[700] **[paras.10.71 – 10.72 and 13.14 above]**

[701] **[paras. 10.81 – 10.82 and 13.14 above]**

systematically applied, and it was the responsibility of the Engagement Partners to ensure that they were.

14.78 The Executive Counsel further submitted, in relation to culpability, that there was no need to distinguish between Messrs Railton and King: there was one obvious point of distinction, namely that Mr Railton (but not Mr King) fell to be sanctioned for failing to carry out audit procedures relating to post-balance sheet events (allegations 3 and 6): however, another feature of the case elevated the seriousness of Mr King's Misconduct, in that Mr King held the necessary authorisation to conduct audits of publicly listed companies and was the Engagement Partner of the listed entity (Tanfield): the public interest therefore bore more heavily on Mr King's work, and, for these reasons, when looked at in the round, it was suggested that there was no need to distinguish between Mr King and Mr Railton's culpability.

14.79 We do not accept this suggestion. The failings in relation to the post-balance sheet events were a serious falling short on the part of Mr Railton. Despite the cataclysmic share price fall of 1 July 2008 and the warnings in the trading statement, Mr Railton did not feel that as Engagement Partner on the TES and SEV audits he should have met with the client in person to discuss the financial statements and the current trading of the Group. Instead, he once again delegated the task to Mr [...] and did not consider it necessary to do any more than Mr [...] had done. He stated in his first witness statement[702] that he was not concerned by the trading statement. Further, he was not just the Engagement Partner - see paragraph 14.53 above – and he had a long-standing relationship with Tanfield and its subsidiaries, and also with the personnel in the engagement team. Mr King did not.

STEP 2: POTENTIALLY APPROPRIATE SANCTIONS

Severe Reprimand/Reprimand

14.80 It is provided in paragraph 25 of the Sanctions Guidance that these sanctions signal the Tribunal's disapproval of the relevant conduct to the respondent/s and, through publication, to the wider public and profession, and will show on the respondents' disciplinary record.

14.81 In paragraph 27 of the Sanctions Guidance it is indicated that these sanctions either alone or in combination with a Fine may be appropriate where the Misconduct was unintended or does not cast doubt on the respondents' general competence, and is not so damaging

[702] [para 158: C/2/156]

to public/market confidence in the standards of the conduct of the profession and of corporate reporting that, in order to protect the public etc, practice authorisations should be withdrawn.

14.82 It is provided in paragraph 28 of the Sanctions Guidance that when considering whether a Reprimand or a Severe Reprimand is the appropriate sanction, a Tribunal should consider the seriousness of the Misconduct to determine whether a Severe Reprimand is the more appropriate censure for the particular conduct.

14.83 The Executive Counsel submitted that the conduct of each of the Respondents warranted a Reprimand. As stated at paragraph 14.15 above, this was not contested by the Respondents. We agree. The deficiencies and errors in the Respondents' work related to the audits of three related companies in a single year. They were not systemic and were unintended. They do not cast doubt on Baker Tilly's general competence now, and are not damaging to public or market confidence at the present time. We do not consider that the Misconduct calls for a Severe Reprimand.

Direction

14.84 The Executive Counsel referred us to the Review Panel Report of Sir Christopher Clarke, dated October 2007, in which, amongst other things, he recommended that greater attention be given to the use of non-financial penalties, including, for example, education and training programmes and requirements for improved systems, controls and procedures. The Executive Counsel stated that careful consideration had been given to the question of whether such a Direction would be appropriate in this case, but had concluded that having regard to the fact that these findings relate to events which took place over a decade ago and, as noted in the witness statement of the Respondents' solicitor, Mr Randall, the firm's processes will have undergone substantial changes since then, it was not appropriate to seek such a Direction in this case. We concur with that conclusion.

Fine

14.85 Paragraph 33 of the Sanctions Guidance identifies four factors, which amongst any others, should normally be considered in order to determine whether a Fine is an appropriate sanction. These are set out at paragraph 14.12 above. The Executive Counsel submitted that in the light of the seriousness of the Misconduct a fine would be an appropriate sanction because:

(a) Deterrence would not be achieved by issuing a Reprimand or Severe Reprimand alone;

(b) The Misconduct had put at risk the loss of significant sums of money; and

(c) Fines had been ordered in previous audit cases.

14.86 We have to take account of the guidance that the primary purpose of imposing sanctions for Misconduct is not to punish - as stated in paragraph 14.5 above –but to impose sanctions, intended to fulfil the stated objectives - also referred to in paragraph 14.5 above - which conform with the guidance set out at paragraph 14.6 above. The Respondents drew particular attention to the statement that the objectives may be achieved without a Fine – see paragraph 14.7 above.

14.87 In accordance with the guidance set out in paragraph 14.6 above any sanction must be tailored to the facts of the particular case, including the "***circumstances of the Member or Member Firm***"*.* As appears from the material set out in more detail below, we are satisfied that the circumstances of the Respondents are not such as to negate the imposition of a Fine on any of them. We do not consider that a Reprimand or a Severe Reprimand would act as a sufficient deterrent, and hence neither on their own would fulfill one of the most important objectives of the Scheme. We consider that Fines would be proportionate to the nature and seriousness of the Misconduct and the potential harm to which it gave rise, and will have the effect of deterring Misconduct by other Members or Member Firms.

Paragraph 11 of the Sanctions Guidance

14.88 As appears from paragraph 14.9 above, the Tribunal is enjoined to consider whether and the extent to which a proposed sanction would be likely to lead to improvements in respect of the matters which gave rise to the proceedings and to the quality of the work of the Member or Member Firm concerned.

14.89 Whilst there is no reason to suppose that the Respondents have not already learned lessons from the initiation of these proceedings, we consider that the imposition of Reprimands and Fines are likely to result in Baker Tilly checking further whether their procedures, systems, and internal controls could be improved and the quality of their work improved, and to effect any improvements which appear necessary. Further we consider

that these Sanctions are likely to have the effect of reinforcing Mr King's and Mr Railton's determination to ensure that in future their personal duties are discharged.[703]

Other Sanctions

14.90 In our judgment the circumstances of this case do not require or justify the imposition of any other sanction/s.

The Amounts of Any Fines

14.91 Paragraph 34 of the Sanctions Guidance provides that "***where a Tribunal considers that a Fine is appropriate it should aim to impose a Fine that:***

(a) is proportionate to the Misconduct and all the circumstances of the case;

(b) will act as an effective deterrent to future Misconduct; and

(c) will promote public confidence in the regulation of the accountancy profession and in the way in which Misconduct is addressed."

14.92 In paragraph 35 of the Sanctions Guidance it is provided "***that in undertaking its assessment, a Tribunal will normally take into consideration:***

(a) the seriousness of the Misconduct;

(b) in the case of a Member Firm, its size/financial resources and the effect of a Fine on its business;

(c) in the case of a Member, his financial resources and the effect of a Fine on that Member and his future employment;

(d) the factors set out in paragraph 21."

14.93 When considering the level of fine to impose, the Tribunal is further instructed to consider "***whether there are any arrangements that would result in part or all of any Fine being paid or indemnified by insurers, or by a Member's firm, partnership, company or employer***"[704]. In respect of this matter, Mr Randall, in his witness statement, confirmed that there are no such arrangements and that any fine imposed upon Mr King or Mr

[703] [We are aware, of course, that Mr Railton has not acted as an engagement partner since 2014].

[704] [S G para. 42.a.]

Railton would not be met by Baker Tilly. In paragraph 42.b. of the Sanctions Guidance it is provided that when deciding what level of fine to impose the Tribunal should disregard the possibility that a Respondent may be liable for the costs of the case.

Baker Tilly

14.94 Paragraph 36 of the Sanctions Guidance provides that

"***In the majority of cases involving the imposition of a Fine on a Member firm, the amount of revenue generated by the firm or the business unit(s) involved in the Misconduct will be a factor to be taken into account when assessing the size of the Fine which would be necessary, in the circumstances of the particular case, to act as a credible deterrent.***"

14.95 The Executive Counsel directed us to:

(a) The statement of the Court of Appeal, in relation to fines against companies (albeit in a very different factual context) in ***R v Balfour Beatty Rail Infrastructure Services Ltd [2006] EWCA Crim 1586*** at paragraph 42:

"***Knowledge that breach of this duty can result in a fine of sufficient size to impact on shareholders will provide a powerful incentive for management to comply with this duty. This is not to say that the fine must always be large enough to affect dividends or share price. But the fine must reflect both the degree of fault and the consequences so as to raise appropriate concern on the part of shareholders at what has occurred. Such an approach will satisfy the requirement that the sentence should act as a deterrent. It will also satisfy the requirement, which will rightly be reflected by public opinion, that a company should be punished for culpable failure to pay due regard for safety, and for the consequences of that failure***";

(b) Sentencing guidance issued by the Sentencing Council for corporate offenders etc. (effective from 1 October 2014):

"***The fine must be substantial enough to have a real economic impact which will bring home to both management and shareholders the need to operate within the law. Whether the fine will have the effect of putting the offender out of business will be relevant; in some bad cases this may be an acceptable consequence***"; and

(c) The statement made by Sir Christopher Clarke in the Review Panel Report at paragraph 5.21: "***At the same time fines must be one which have an impact on those on whom they are imposed*.**"

14.96 The Executive Counsel referred to the fact that, on 26 October 2015, Baker Tilly changed its name to "**RSM**", and that according to RSM UK's website: "***the firm adopted the name RSM and united under a single global brand with RSM audit, tax and consulting firms across the world***", and submitted that the Tribunal should have regard to the total fee income of RSM UK, and not only fee income from audit clients. Executive Counsel made the point that the Tribunal in **Connaught** recorded PwC's total revenue and profit as well as its revenue from audit work (see para 341 of the Tribunal's report in that case).

14.97 It was asserted that:

(a) For the year ended 2017, RSM UK had 346 principals, including 106 audit principals, that its total fee income was £319 million, and its fee income from audit work was £74 million; and

(b) According to financial statements for RSM UK **Audit** LLP for the year ended 31 March 2018 (JJR1), the turnover was £77.728 million and profit before members' remuneration and profit shares was £17.057 million.

14.98 In relation to the contention that the Tribunal should have regard to the wider financial position of "**RSM UK**", the Respondents submitted that:

(a) RSM UK is not a legal entity but is the shorthand title for the group of LLPs and limited companies trading as RSM in the UK.

(b) The figures referred to in paragraph 14.98(a) above were derived from the accounts of RSM UK Holdings Limited.

(c) The Sanctions Guidance directs the Tribunal to consider the size/financial resources of the **Member Firm**: the Member Firm in this case is RSM UK Audit LLP (i.e. the First Respondent).

(d) There was nothing in the Sanctions Guidance, or the Accountancy Scheme, to suggest that the Tribunal should have regard to the total fee income, across a range of disparate services provided by different legal entities, still less of the

various different RSM entities whose income is recorded in the accounts of RSM UK Holdings Limited.

(e) RSM UK Holdings Limited is not a "**Member Firm**" at all, as it is a holding company and does not provide accountancy services to clients for reward.

(f) Whilst the Tribunal in **Connaught** took account of PwC's total revenue and profit as well as its revenue from audit work, this was unsurprising since the "**Member Firm**" in **Connaught** was PwC, and in any event, in **Connaught** the Tribunal also took specific account (at paragraph 341) of the revenue generated within PwC by audit services.

(g) The approach in **Connaught** was consistent with paragraph 36 of the Sanctions Guidance, which refers to "***the amount of revenue generated by the firm or the business unit(s) involved in the Misconduct***"*:* in the present case that would require the Tribunal to focus on the fee income from audit work, such work being the relevant "***business unit***" in this context.

(h) The overall fee income reflected in the accounts of RSM UK Holdings Limited of £319 million related to both audit and non-audit services and therefore was not an appropriate measure: as required by the Sanctions Guidance, the relevant consideration was the audit-related turnover (this being in the region of £70 – 80 million, as compared – for example - with PwC's audit income in **Connaught** of £659 million).

14.99 We accept the Respondents' submissions in relation to this issue. We do not consider that it is appropriate to take into account the revenue of RSM UK Holdings Limited.

14.100 As noted at paragraph 14.14 above, the Executive Counsel suggested that an appropriate Fine imposed on Baker Tilly would be in the region of £850,000. The Respondents submitted that a Fine of around £500,000 would reflect the gravity of the Misconduct proved against Baker Tilly, and whilst there were many examples of higher fines being imposed in other cases, the Misconduct in those cases was markedly more serious. We consider that, subject to any adjustment in accordance with Steps 3, 4, or 5, the appropriate Fine for Baker Tilly is the sum of £750,000, which sum we consider to be sufficiently large to fulfill the objectives and purposes which we have referred to above.

Mr Railton and Mr King

14.101 Information as to the financial resources of Mr Railton and Mr King are set out in their second witness statements, providing detailed information about their remuneration, assets, liabilities and family circumstances.

14.102 We do not consider that it is necessary to recite this information in any detail, it being all of a personal nature. It is sufficient to state that both have dependent children, their principal assets are their homes, and their incomes and assets are such that a fine at a level which would act as an effective deterrent would be a significant imposition on both of them.

14.103 The considerations referred to in paragraph 35 of the Sanctions Guidance (see paragraph 14.92 above) include "***the effect of a Fine on that Member and his future employment***". We accept that the findings of Misconduct could affect the future employment of both Mr King and Mr Railton, and that possibility is something to be taken into account at some stage (and we do so under Step 3), but we consider it unlikely that the imposition of a Fine would add significantly to that potential effect. Accordingly, in our considerations under this Step 2, we have not taken any account of this aspect of the case. We have already indicated that we do not regard Mr King and Mr Railton to be equally culpable.

STEP 3: AGGRAVATING AND MITIGATING FACTORS

14.104 Paragraph 60 of the Sanctions Guidance provides that:

> "***Having assessed the seriousness of the Misconduct and reached a view on the sanction that would be appropriate, a Tribunal considers whether to adjust that sanction to reflect any aggravating or mitigating factors that may exist (to the extent those factors have not already been taken into account in the Tribunal's assessment of the seriousness of the Misconduct).***"

14.105 Thirteen examples of aggravating and twelve examples of mitigating factors are set out in paragraphs 61 and 62 of the Sanctions Guidance.

14.106 The Executive Counsel suggested that in the case of Mr King and Mr Railton there was one aggravating factor, namely that each held a senior position with supervisory responsibilities. However, that is a factor already taken into account in Step 1.

14.107 In relation to mitigating factors, the Executive Counsel acknowledged that the Respondents did not stand to gain any profit or benefit from the Misconduct. However, this factor, too, has already been taken into account.

14.108 In the context of previous disciplinary records the Executive Counsel referred the Tribunal to the recent settlement of the ***Quindell*** case[705] in which Arrandco Audit Ltd (formerly RSM Tenon Audit Ltd) was sanctioned in relation to its audit work of Quindell Ltd and Quindell Plc in 2011. However, Arrandco Audit Ltd was, at the time of the ***Quindell*** audit, a separate entity unconnected to Baker Tilly (Baker Tilly acquired the audit practice of RSM Tenon in 2013) and the Quindell audit post-dated the Tanfield audit. For the sake of completeness, the Executive Counsel also drew to the Tribunal's attention the fact that ICAS has made two findings against Baker Tilly UK Audit LLP in 2011 and in 2013, but stated that, owing to their age and lack of similarity with the Misconduct in this matter, they were not regarded as amounting to a material aggravating factor.

14.109 The Respondents submitted that there were a number of the specific mitigating criteria listed at paragraph 62 of the Sanctions Guidance which needed to be taken into account:

(a) The Misconduct was an isolated event that is unlikely to be repeated.

(b) The Respondents did not stand to gain or profit from the Misconduct.

(c) The Respondents had a good compliance history and disciplinary record: the Tanfield audits were the only engagements Mr King or Mr Railton had been involved in in respect of which a regulator had raised any concerns, and neither Mr King nor Mr Railton have any previous disciplinary findings against them, by the FRC or their professional bodies.

(d) Baker Tilly had indicated that they had taken the Tribunal's findings seriously and had apologised for the Misconduct.

(e) Mr King and Mr Railton have similarly apologised for the omissions on their part that have given rise to the findings of Misconduct.

14.110 The factors referred to in sub-paragraphs (a) – (c) of the last paragraph have already been taken into account, but those referred to in sub-paragraphs (d) and (e) have not, and so it is appropriate to take them into account at this stage.

[705] The Executive Counsel of the FRC v Arrandco Audit Ltd and Jeremy Filley.

14.111 Additionally, it was submitted that there were important personal mitigating circumstances that apply in respect of Mr Railton and Mr King.

14.112 Mr Railton, in his second witness statement, referred to the long drawn-out nature of these proceedings, namely that the investigation was first announced in September 2009; that he was first interviewed by the FRC in February 2011; that it was only in October 2013 that the Respondents received the Proposed Formal Complaint from the FRC; it was only on May 2014 that the Formal Complaint was served; and it is only now that these proceedings have concluded, and stated:

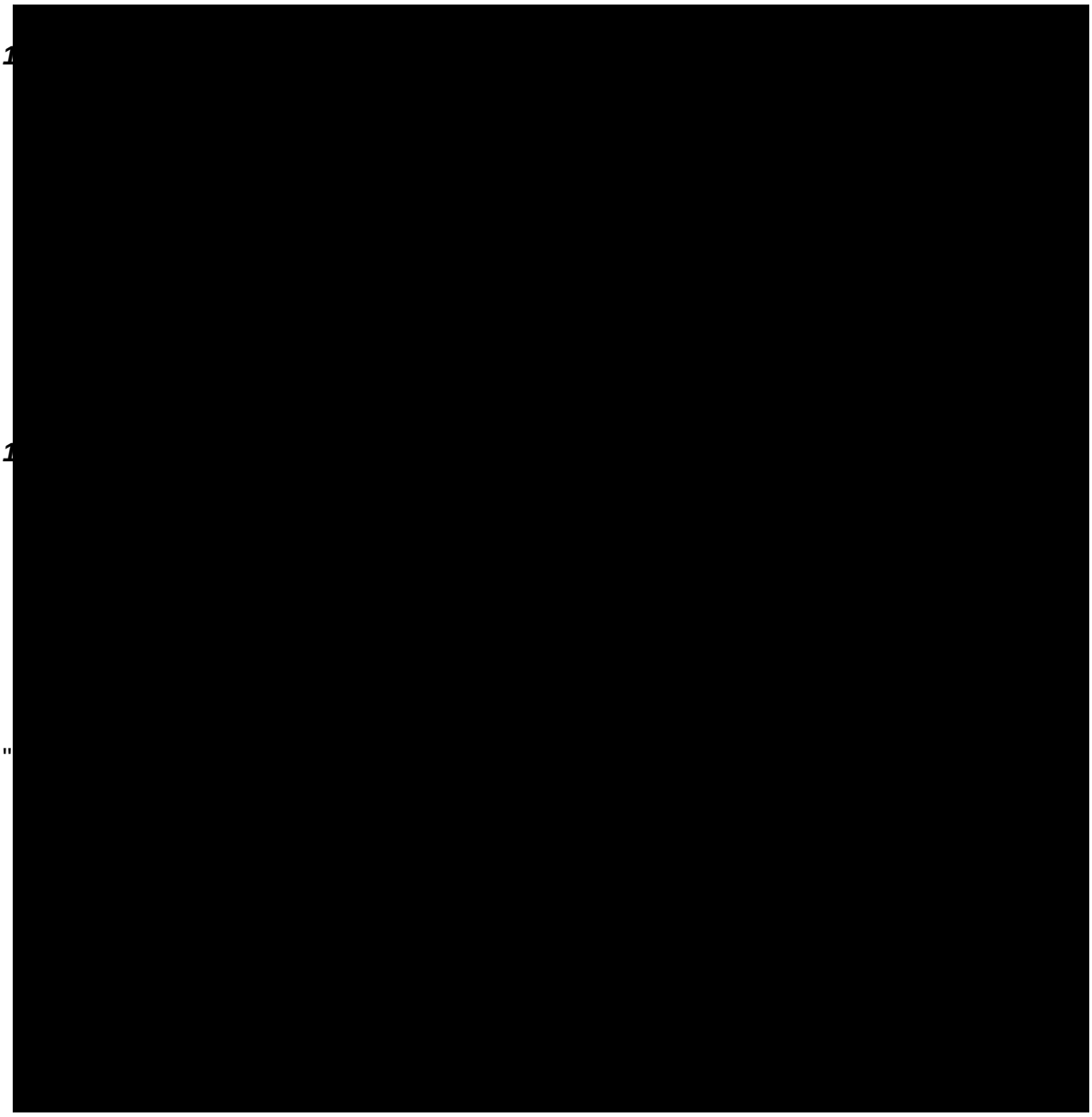
"***12.*** [redacted]

14.113 He also expressed concern about the future impact of the findings of Misconduct:

"***10.*** [redacted]

14.114 In his second witness statement Mr King explained that these proceedings had already impacted on his earnings and that the findings of Misconduct were likely to continue to do so:

"***14.*** [redacted]



14.115 He also referred to the stress of having these proceedings "***hanging over***" him:

14.116 There is no explicit reference in the Sanctions Guidance to personal mitigation of the nature described in 14.112 to 14.115 above, but Counsel for both parties agreed that it is appropriate for a Tribunal to take any such mitigation into account as falling within the words "**full circumstances of each case**" in paragraph 13 of the Sanctions Guidance. We were also referred to the fact that in the Sanctions Guidance it is provided, at paragraph 34.a. that in considering the amount of a Fine a Tribunal should consider "***all***

the circumstances of the case"[706] and that various parts of the Sanctions Guidance are stated, clearly or implicitly to be "***not exhaustive***".[707] They also pointed out that a broad approach was taken to matters of mitigation in **Connaught** and the **MG Rover Case.** We agree with this approach.

14.117 Mr Railton also referred in his second witness statement to the amount of time which he had had to dedicate to these proceedings:

> "***5. I have spent a significant amount of time dealing with the FRC's investigation since it was announced in September 2009, over nine years ago. As the proceedings have been drawn out over such a long period of time, it has been necessary for me to spend long periods of time reviewing the papers and refreshing my memory of the work carried out at each stage of the proceedings ….***
>
> ***…. Although it is not possible to calculate the exact amount of time I have spent on these proceedings, I am certain it will total many months.***"

14.118 One reason for the duration of these proceedings and the fact that they consumed an enormous amount of attention on the part of Mr Railton and Mr King is that the Respondents chose to defend them, and did so vigorously, going so far as to seek a judicial review of Executive Counsel's decision to pursue this matter, and, when they lost, to take the matter to the Court of Appeal, so to an extent both some of the stress and any loss resulting from their having been distracted from their ordinary work was self-inflicted. Nevertheless, there were elements in the delay (including delay on the part of the Tribunal), which could in no way be attributed to the Respondents, and we do consider that substantial periods of delay, anxiety, and stress, need to be taken into account as mitigation, particularly the five years between the beginning of the investigation and the service of the Formal Complaint and the period of delay by the Tribunal in its determination of the issues of Misconduct.

14.119 We accept the evidence that Mr King has already sustained measurable financial loss as a consequence of these proceedings. We also consider that it is likely that he and Mr Railton suffered some indirect loss as a result of their having limited their activities pending the resolution of these proceedings, thus affecting Baker Tilly's overall earnings

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[706] [See also para 17]

[707] [See paragraphs 13, 20, 21]

(and hence their own shares as partners), and we also accept that the findings of Misconduct may have a negative effect on their future employment and earnings, but none of these heads of loss can be quantified, and may, in the event, not be very significant.

14.120 In addition to the factors which have already been taken into account, both Mr Railton and Mr King request the Tribunal to take account of the fact that they have co-operated fully with the FRC's investigation since it commenced in September 2009. It was not suggested that they had not co-operated fully in the investigation, but it has to be stated that in so doing they were doing no more than complying with the obligations to co-operate with the Executive Counsel which is imposed by paragraph 14(i) of the Scheme.

14.121 Executive Counsel submitted, in relation to the personal mitigation relied on by Mr King and Mr Railton, that :

(a) it should, however, be borne in mind that the purpose of sanctions was not primarily punitive - as the Court of Appeal said in ***Bolton v Law Society [1994] 1 WLR 512 at 519B***:

"***Because orders made by the tribunal are not primarily punitive, it follows that considerations which would ordinarily weigh in mitigation of punishment have less effect on the exercise of this jurisdiction than on the ordinary run of sentences imposed in criminal cases.***"

(b) Thus, unlike a sentencing exercise in a criminal case, it would not be right in this context to place much weight as mitigation on personal hardship: the sanction is not imposed as punishment, but to protect the profession's most valuable asset, its collective reputation, and any apparent harshness is part of the price of membership of that profession (as Sir Thomas Bingham MR went on to comment in ***Bolton v Law Society***).

14.122 The Respondents submitted that the contention that it would not be right to place "***much weight***" on personal hardship as mitigation was incorrect - amongst other things, the Sanctions Guidance directly instructs the Tribunal to order sanctions that are tailored to the "***circumstances of the Member concerned***", as well as to consider the "***the full circumstances of each case***" (Sanctions Guidance, paras. 10(b) and 13).

14.123 We do not accept Executive Counsel's submission that at this stage we should not attach much weight to anything which would normally be regarded as mitigation. As appears

below, the provision in the Sanctions Guidance of Step 4 appears to us to be inconsistent with that approach.

14.124 In our judgment it would be fair to take account of the mitigation referred to in paragraph 14.119 above and we have done that in our deliberations in relation to this Step 3.

STEP 4: ADJUSTMENT FOR DETERRENCE

14.125 Paragraph 66 of the Sanctions Guidance provides for a Tribunal to make an upward adjustment to the proposed sanction if it considers, after making any adjustment for any mitigating and aggravating factors, that that adjusted sanction would be insufficient to ensure that the intended deterrent effect on the respondent and other Members or Member Firms would be achieved.

14.126 In paragraph 67 of the Sanctions Guidance it is suggested that the circumstances in which such an upward adjustment might be required could include cases where the Respondent already has a disciplinary record for Misconduct of a similar nature, a Respondent previously sanctioned has failed to improve its standards, and cases where the proposed sanction is too small to be a credible deterrent.

14.127 Since it is clear that "***deterrence***" has to be taken into account by the Tribunal before it ever reaches Step 4, superficially this Step might appear to be something of a duplication, but a requirement for the issue to be reviewed at this stage of the procedure is, we think, consistent with the principle that the primary purpose of imposing sanctions for Misconduct is not to punish but to protect the public and the wider public interest.

14.128 The Executive Counsel submitted that if the Tribunal adopts the level of Fines suggested by her, that there would be no need to make any upward adjustment to those figures for deterrence, or, put another way, a lower level of Fines would, in all the circumstances set out above, lack credibility as a significant deterrent to the Misconduct which has been found by the Tribunal.

14.129 We have carried out the review contemplated in Step 4. We have not adopted the suggestion made by Executive Counsel and do not accept that any lesser figures than those suggested by her would lack credibility as a significant deterrent.

STEP 5: DISCOUNT FOR ADMISSIONS OR SETTLEMENT

14.130 Paragraphs 68 to 74 of the Sanctions Guidance provides for the adjustment of the sanction proposed at the end of Step 4 to reflect the extent, significance and timing of

any admissions. It is common ground between the parties that these provisions do not apply in the present case.

STAGE 6 - DECIDE WHICH SANCTION(S) TO ORDER

14.131 We consider that in all the circumstances the appropriate sanctions to be imposed, and which we Order are:

(a) Baker Tilly - a Reprimand and a Fine of £750,000.

(b) Mr King - a Reprimand and a Fine of £30,000.

(c) Mr Railton - a Reprimand and a Fine of £35,000.

15. PART 15 - COSTS

15.1 As indicated at paragraph 75 of the Sanctions Guidance, having determined the sanction to be imposed, a Tribunal is required to consider whether to make any award in respect of the costs incurred by the FRC.

15.2 The Tribunal is empowered to make such a costs order by paragraph 9(8)(ii) of the Scheme, which provides that the Tribunal may include an order that the Member or Member Firm be required to pay the whole or part of the costs of, and incidental to, the investigation and the hearing of the Formal Complaint.

15.3 The Executive Counsel had provided a detailed Schedule of Costs to the Respondents with a view to the parties endeavouring to agree costs in advance of the hearing to address the issue of Sanctions. At the hearing the parties informed the Tribunal that they were still endeavouring to agree the issue of costs and invited us to make an order which adjourned the issue for 28 days, and accordingly we did so.

15.4 In a letter dated 17 December 2018, the Respondents' solicitors informed the Tribunal that the parties had agreed that the Respondents be ordered to pay 50% (fifty per cent) of the Executive Counsel's costs "*with the final sum to be agreed*", and accordingly we make an order in those terms.

15.5 The only further issue relates to the costs of the Tribunal. The amount of these costs can only be finally ascertained once this report has been completed.

15.6 In an email dated 6 December 2018, the Tribunal indicated that, subject to any submissions from the parties, it was minded to order the Respondents to pay the

Tribunal's costs, 75% (seventy-five per cent) of those costs be paid by Baker Tilly, and that responsibility for the remaining 25% (twenty-five per cent) be apportioned equally between Mr King and Mr Railton.

15.7 In the letter dated 17 December 2018, referred to in paragraph 15.4 above, the Respondents submitted that, having regard to the fact that the Executive Counsel had failed to establish many of the allegations of Misconduct, the Tribunal costs should be apportioned between the parties, that the Respondents should only be liable for the costs related to the allegations which had been proved, and that the balance should be covered by the Executive Counsel and/or the FRC itself. The Respondents further submitted that since only 18 of the 47 sub-allegations had been proved the Respondents should only be ordered to pay one third of the Tribunal's costs.

15.8 It was submitted on behalf of the FRC that in fact one "*failed*" sub-allegation (4.6) had not been proceeded with, and hence it occupied only a minimal amount of the Tribunal's time, and that there was a further sub-allegation (3(a)) which had succeeded and which had not been included in the Respondents' count of proven allegations. Accordingly, it was submitted that there were 45 effective sub-allegations and that 19 of these (42% - forty-two per cent) of them were proven.

15.9 The Respondents took the point that sub-allegation 4.6 was only abandoned during the hearing, but submitted that the amount of time spent in relation to it was essentially a matter for the Tribunal.

15.10 Sub-allegation 4.6 related to the debts owed to TES and SEV. A good deal of time was taken up with other sub-allegations relating to those debts, and we consider that the amount of time devoted to sub-allegation 4.6 in addition to the time devoted to the other sub-allegations in Allegation 4, was negligible.

15.11 We consider the FRC's approach to the Tribunal's costs to be fair and reasonable. Accordingly, the Tribunal's order is that the Respondents shall pay 42% (forty-two per cent) of the Tribunal's costs.

15.12 We understand that the costs which the Respondents are ordered to pay are covered by insurance, and that as a consequence there is no need to make any order apportioning the liability for costs as between the Respondents. However, in case that is a misunderstanding, we order that, of the Tribunal's costs to be paid by the Respondents, 75% (seventy-five per cent) of those costs be paid by Baker Tilly, and that the remaining 25% (twenty-five per cent) be paid in equal shares by Mr King and Mr Railton.

15.13 If there is any purpose in ordering the Executive Counsel or the FRC to pay any of the Tribunal's costs (we are not privy to their financial arrangements) we see no basis for doing so.

This is the unanimous report of the Tribunal.

…… ….

David Blunt QC

(Chairman)

14 January 2019

Annex A

Extracts from the Professional Bodies' Codes of Ethics

Note: Each of the three Respondents belongs to a different professional body (see Part 1 paragraph 3). Each of those bodies publishes a Code of Ethics which requires its members to comply with a set of "***fundamental principles***"; the principle relevant to this case is "***Professional Competence and Due Care***" (see Part 1, para.11 above). The definitions of this principle published by the ICAEW and the ICAS are identical. The definition published by the ACCA differs only slightly from that of the other two bodies. In each case "***Professional Competence and Due Care***" is the third Fundamental Principle. The definitions are reproduced, as relevant to this case, below.

Fundamental Principles - ICAEW[708] and ICAS[709]

Professional Competence and Due Care

"***A professional accountant has a continuing duty to maintain professional knowledge and skill at the level required to ensure that a client or employer receives competent professional service based on current developments in practice, legislation and techniques. A professional accountant should act diligently and in accordance with applicable technical and professional standards when providing professional services***."

Each of these fundamental principles is discussed in more detail in Sections 110-150.

Section 130: Professional competence and due care

130.1 "The principle of professional competence and due care imposes the following obligations on professional accountants:

(c) To maintain professional knowledge and skill at the level required to ensure that clients or employers receive competent professional service; and

(d) To act diligently in accordance with applicable technical and professional standards when providing professional services.

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[708] ICAEW"s Handbook 2007, effective from September 2006, p.194, section 100.4(c), and section 130.1- 130.5.

709 ICAS Code of Ethics, November 2008 (effective from 1 November 2006), section 100.4(c) and sections 130.1 -130.5.

130.3 The maintenance of professional competence requires a continuing awareness and an understanding of relevant technical, professional and business developments. Continuing professional development develops and maintains the capabilities that enable a professional account to perform competently within the professional environments.

130.4 Diligence encompasses the responsibility to act in accordance with the requirements of an assignment, carefully, thoroughly and on a timely basis.

130.5 A professional accountant shall take reasonable steps to ensure that those working under the professional accountant's authority in a professional capacity have appropriate training and supervision."

Fundamental Principles - ACCA[710]

Professional competence and due care

"7. Members have a continuing duty to maintain professional knowledge and skill at a level required to ensure that a client or employer receives competent professional service based on current developments in practice, legislation and techniques. Members should act diligently and in accordance with applicable technical and professional standards when providing professional services.

15. The principle of professional competence and due care imposes the following obligations on professional accountants:

(a) To maintain professional knowledge and skill at the level required to ensure that clients or employers receive competent professional service; and (b) To act diligently in accordance with the applicable technical and professional standards when providing professional services.

17. The maintenance of professional competence requires a continuing awareness and understanding of relevant technical, professional …developments…

19. Members should take steps to ensure that those working under their authority in a professional capacity have appropriate training and supervision."

[710] ACCA Rule Book 2007, Section 3, (Code of Ethics and Conduct) at part 3.2.

Annex B

Auditing Standards

ISA 200 - "*Objective and general principles governing an audit of financial statements*"

Paragraph 2

"***The objective of an audit of financial statements is to enable the auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework…The phrases used to express the auditor's opinion are "give a true and fair view" or "presents fairly, in all material respects," which are equivalent terms***."

Paragraph 5

"***The auditor should conduct an audit in accordance with ISAs (UK & Ireland).***"

Paragraph 6

"***The auditor should plan and perform an audit with an attitude of professional scepticism recognizing that circumstances may exist that cause the financial statements to be materially misstated***."

Paragraph 8

"***An audit in accordance with ISAs (UK & Ireland) is designed to provide reasonable assurance that the financial statements taken as a whole are free from material misstatement. Reasonable assurance is a concept relating to the accumulation of audit evidence necessary for the auditor to conclude that there are no material misstatements in the financial statements taken as a whole***."

Paragraph 15

"***The auditor should plan and perform the audit to reduce audit risk[711] to an acceptable low level that is consistent with the objective of an audit. The auditor reduces audit risk by***

[711] Defined in paragraph 14 as "*The auditor obtains and evaluates audit evidence to obtain reasonable assurance about whether the financial statements give a true and fair view (or are presented fairly, in all material respects) in accordance with the applicable financial reporting framework. The concept of reasonable assurance acknowledges that there is a risk the audit opinion is*

designing and performing audit procedures to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base an audit opinion."

ISA 220 – Audit Documentation

Paragraph 6

"***The engagement partner should take responsibility for the overall quality on each audit engagement to which that partner is assigned***."

Paragraph 21

"***The engagement partner should take responsibility for the direction, supervision and performance of the audit engagement in compliance with professional standards and regulatory and legal requirements, and for the auditor's report that is issued to be appropriate in the circumstances***."

Paragraphs 26 and 27

"***Before the auditor's report is issue, the engagement partner, through review of the audit documentation and discussion with the engagement team, should be satisfied that sufficient appropriate audit evidence has been obtained to support the conclusions reached and for the auditor's report to be issued.***"

The engagement partner conducts timely reviews at appropriate stages during the engagement. This allows significant matters to be resolved on a timely basis to the engagement partner's satisfaction before the auditor's report is issued. The reviews cover critical areas of judgment, especially those relating to difficult or contentious matters identified during the course of the engagement, significant risks, and other areas the engagement partner consider important. The engagement partner need not review all audit documentation. However, the partner documents the extent and timing of the reviews. Issues arising from the reviews are resolved to the satisfaction of the engagement partner."

ISA 230 (Revised) – Audit Documentation

Paragraph 2

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inappropriate. The risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated is known as audit risk."

"***The auditor should prepare, on a timely basis, audit documentation that provides:***

(a) A sufficient and appropriate record of the basis for the auditor's report; and

(b) Evidence that the audit was performed in accordance with ISAs (UK and Ireland) and applicable legal and regulatory requirements."

Paragraph 9

"***The auditor should prepare the audit documentation so as to enable an experienced auditor, having no previous connection with the audit, to understand:***

(b) The nature, timing, and extent of the audit procedures performed to comply with ISAs (UK and Ireland) and applicable legal and regulatory requirements;

(c) The results of the audit procedures and the audit evidence obtained; and

(d) Significant matters arising during the audit and the conclusions reached thereon."

Paragraph 16

*"**The auditor should document discussions of significant matters with management and others on a timely basis**."*

Paragraph 17

*"**The audit documentation includes records of the significant matters discussed and when and with whom the discussions took place**."*

Paragraph 18

"***If the auditor has identified information that contradicts or is inconsistent with the auditor's final conclusion regarding a significant matter, the auditor should document how the auditor addressed the contradiction or inconsistency in forming the final conclusion***."

ISA 315 – Obtaining an Understanding of the Entity and its Environment and Assessing Risks of Material Misstatement

Paragraph 2

"***The auditor should obtain understanding of the entity and its environment, including its internal control, sufficient to identify and assess the risks of material misstatement of the***

financial statements whether due to fraud or error, and sufficient to design and perform further audit procedures."

Paragraph 4

This includes "***identifying areas where special audit consideration may be necessary, for example ... the appropriateness of management's use of the going concern assumption***"

Paragraph 41

"***The auditor should obtain an understanding of internal control relevant to the audit. The auditor uses the understanding of internal control to identify types of potential misstatements, consider factors that affect the risks of misstatement, and design the nature, timing, and extent of further audit procedures. […]***".

Appendix 3 of ISA315 lists conditions that may indicate risks of material misstatement such as going concern and liquidity issues, including loss of significant customers, weaknesses in internal control (especially those not addressed by management), changes in the industry in which the entity operates, and constraints on the availability of capital and credit.

ISA 500 – Audit Evidence

Paragraph 2

"***The auditor should obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the audit opinion***."

Paragraph 16

"***The auditor should use assertions for classes of transactions, account balances, and presentation and disclosures in sufficient detail to form a basis for the assessment of risks of material misstatement and the design and performance of further audit procedures. The auditor uses assertions in assessing risks by considering the different types of potential misstatements that may occur, and thereby designing audit procedures that are responsive to the assessed risks***."

Paragraph 17

- *"**Completeness – [In relation to the period under audit] all transactions and events that should have been recorded have been recorded.***

- ***[In relation to account balances at the period end] all assets, liabilities and equity interests that should have been recorded have been recorded.***

- ***Existence – assets, liabilities and equity interests exist.***

- ***Accuracy – amounts and other data relating to recorded transactions and events have been recorded properly.***

- ***Valuation and allocation – assets, liabilities and equity interests are included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded.***

- ***Cut-off – transactions and events have been recorded in the correct accounting period***."

Paragraphs 26 to 38

ISA500 sets out several types of procedure which may be used, individually or in combination, to obtain audit evidence either in performing risk assessment, tests of control or substantive procedures. The types of procedure set out are:

- Inspection of records or documents;

- Inspection of tangible assets;

- Observation (i.e. looking at a process or procedure being performed by others);

- Inquiry (i.e. seeking information of knowledgeable persons);

- Confirmation (i.e. a specific type of inquiry, such as seeking confirmation of a balance from an independent source or third party);

- Recalculation (e.g. checking the mathematical accuracy of records or calculations);

- Re-performance (e.g. of internal controls which were originally performed as part of the entity's internal controls); and

- Analytical procedures (e.g. the evaluation of information made by studying the plausibility of relationships among financial and non-financial data).

Paragraph 32

"***The auditor performs audit procedures in addition to the use of inquiry to obtain sufficient appropriate audit evidence. Inquiry alone ordinarily does not provide sufficient audit evidence to detect a material misstatement at the assertion level***."

Paragraph 34

"***In respect of some matters, the auditor obtains written representations from management to confirm responses to oral inquiries. For example, the auditor ordinarily obtains written representations from management on material matters when other sufficient appropriate audit evidence cannot reasonably be expected to exist or when the other audit evidence obtained is of a lower quality***."

ISA 520 – Analytical procedures

Paragraph 2

"***The auditor should apply analytical procedures as risk assessment procedures to obtain an understanding of the entity and its environment and in the overall view at the end of the audit. Analytical procedures may also be applied as substantive procedures***."

ISA 530 – Audit Sampling and Other Means of Testing

Paragraph 2

"***When designing audit procedures, the auditor should determine appropriate means for selecting items for testing so as to gather sufficient appropriate audit evidence to meet the objectives of the audit procedures***."

Paragraph 50

"***Sometimes, the auditor may be able to establish that an error arises from an isolated event that has not recurred other than on specifically identifiable occasions and is therefore not representative of similar errors in the population (an anomalous error). To be considered an anomalous error, the auditor has to have a high degree of certainty that such error is not representative of the population. The auditor obtains this certainty by performing additional audit procedures. The additional audit procedures depend on the situation, but are adequate to provide the auditor with sufficient appropriate audit evidence that the error does not affect the remaining part of the population. One example is an error caused by a computer breakdown that is known to have occurred on only one day during the period. In that case, the auditor assesses the effect of the breakdown, for example by examining specific transactions processed on that day, and considers the effect of the cause of the breakdown on audit procedures and conclusions. Another example is an error that is found to be caused by use of an incorrect formula in calculating all inventory values at one particular branch. To establish that this is an anomalous error, the auditor needs to ensure the correct formula has been used at other branches***."

ISA 560 – Subsequent Events

Paragraph 4

"***The auditor should perform audit procedures designed to obtain sufficient appropriate audit evidence that all events up to the date of the auditor's report that may require adjustment of, or disclosure in, the financial statements have been identified***."

ISA 580 – Management Representations

Paragraph 4

"***The auditor should obtain written representation from management on matters material to the financial statements when other sufficient appropriate audit evidence cannot reasonably be expected to exist***."

ISA 700 – The Auditor's Report on Financial Statements

Para 36(a)

"***An auditor may not be able to express an unqualified opinion when either of the following circumstances exist and, in the auditor's judgment, the effect of the matter is or may be material to the financial statements*:**

(a) There is a limitation on the scope of the auditor's work."

Annex C

"***15 In respect of each of the allegations set out below, the conduct of the Respondents fell significantly short of the standards reasonably to be expected of a Member or Member Firm (as the case may be)***.

Allegation 1 – Inadequate Evidence of the Existence and Valuation of Inventories

Between 26 November 2007 and 22 July 2008, in relation to the engagement of Baker Tilly to act as auditor of the financial statements of Tanfield Group, TES and SEV for the year ended 31 December 2007 the Respondents failed to obtain sufficient appropriate audit evidence of the existence and valuation of Inventories, thereby:

(i) failing to comply with the requirements of paragraph 2 of ISA 500 and paragraph 21 of ISA 220; and/or

(ii) failing to act in accordance with the Fundamental Principle of Professional Competence and Due Care of the Code of Ethics of ICAS, ICAEW and ACCA.

Particulars

The TES Stocktake – Existence of Inventories

1. In relation to the TES stocktake on 20 December 2007 the Respondents failed to obtain sufficient appropriate audit evidence of the existence of Inventories in that:

   (a) no, or no sufficient, audit evidence was obtained for the existence of Work in Progress and Finished Goods;

   (b) at the Tanfield Lea Estate site the Respondents carried out a test for the existence of raw materials which was inadequate and insufficient in that they:

      (i) identified a sample size for testing without reference to their assessment at the planning stage, as recorded in the Key Issues Tracker, that there was a significant risk in respect of existence of Inventories;

      (ii) tested for the existence of raw materials on the basis of an insufficient sample size, namely a count of five line items from physical inventory to listing and a further count of five line items from listing to physical inventory;

(iii) identified errors in 7 out of 10 of the items tested and assessed a net error rate in the value of the items tested of 9% but failed sufficiently to evaluate and document whether the identified errors were isolated and therefore failed to consider whether it was appropriate to extrapolate using the net error rate of 9% revealed within the sample, over the entirety of the population being tested;

(iv) used the net error rate of 9% to extrapolate across the entirety of the population being tested despite it being inappropriate to do so;

(v) failed properly to consider their further actions and conclusions once they had identified the high level of errors in the sample tested.

(c) the tests undertaken at the Vigo site for the Upright, Electric Vehicles and Spares stocktake of raw materials demonstrated errors in many of the lines sampled, and:

(i) where there is evidence of discussions with management concerning the said errors, the Respondents failed to obtain sufficient appropriate follow up evidence or corroboration;

(ii) where there is no such evidence of discussion, the Respondents failed to obtain sufficient appropriate follow up evidence regarding the errors.

(d) no, or no appropriate audit evidence was obtained in respect of the roll forward testing, which showed differences in 21 out of 22 of the Upright, Spares and EV lines sampled.

TES – Valuation of Inventories

2. In relation to the audit of TES, the Respondents failed to obtain sufficient appropriate audit evidence of the valuation of Inventories in that:

(a) the Respondents found errors in the entire sample of 38 items tested in the comparison between the unit cost of the inventory items in the TES inventory system and the unit purchase price on the invoices. However despite the valuation assertion for Inventories being considered by the Respondent at the planning stage in the Key Issues Tracker as a significant risk:

(i) in respect of two of these items, the total variance was almost £103,000. The Respondent identified these errors as "isolated errors" from "discussions with the client" but failed to obtain sufficient evidence on which to conclude that they were isolated errors, contrary to the requirements of paragraph 50 of ISA 530;

(ii) in respect of all 38 items tested, the Respondent failed to obtain sufficient appropriate evidence of freight charges;

(iii) in respect of 23 of these items, the Respondents failed to obtain any, or any sufficient, appropriate audit evidence to explain why the cost of freight added was not either 10% (or 20% for US purchases).

(b) despite recognising in the Final Audit Findings document that inventory levels needed to be monitored against forecast demand to ensure stock levels were appropriate and despite a significant increase in inventory levels, the Respondents failed to carry out testing designed to identify whether there were any issues with slow moving or obsolete inventory.

The SEV Stocktake – Existence of Inventories

3. In relation to the SEV stocktake in December 2007 the Respondents failed to obtain sufficient appropriate audit evidence of the existence of Inventories in the roll forward testing in that

(a) differences between listing on the day of the stocktake and the year-end inventory listing were found in 7 out of 20 items originally sampled. However, the Respondents only checked two of these variances to corroborative evidence in order to verify the movements between the count and the year end; and

(b) the Respondents failed to obtain sufficient appropriate audit evidence regarding the other five discrepancies, relying instead on uncorroborated management representations, the evidence of which was not retained on the audit file.

Allegation 2 – Inadequate Review of Audit Documentation (Inventories)

Between 26 November 2007 and 22 July 2008, in relation to the engagement of Baker Tilly to act as auditor of the financial statements of Tanfield Group, TES and SEV for the year ending 31 December 2007 the Respondents failed adequately to review the audit documentation and to discuss the audit evidence with the engagement teams for TES and

Tanfield Group so as to be satisfied that sufficient appropriate audit evidence had been obtained to support the conclusions reached in relation to the existence and valuation of inventories, and for the auditor's report to be issued, thereby

(i) failing to comply with the requirements of paragraph 26 of ISA 220 and the guidance thereto in paragraph 27; and/or

(ii) failing to act in accordance with the Fundamental Principle of Professional Competence and Due Care of the Code of Ethics of ICAS, ICAEW and ACCA.

Particulars

1. In relation to the existence of inventories, which comprised a "*critical area of judgment*" and/or "*a difficult or contentious matter*" for TES and Tanfield Group and had been identified by the Respondents as a "*significant risk*" for TES and Tanfield Group when planning the audit in December 2007, the Respondents failed:

   (a) to conduct timely reviews at appropriate stages of the engagement;

   (b) to document the extent and timing of the reviews; and

   (c) to resolve any issues arising.

2. In relation to the valuation of inventories which comprised a "*critical area of judgment*" and/or "*a difficult or contentious matter*" for TES and Tanfield Group and had been identified by the Respondents as a "significant risk" for TES and consequently Tanfield Group when planning the audit in December 2007, the Respondents failed

   (a) to conduct timely reviews at appropriate stages of the engagement;

   (b) to document the extent and timing of the reviews; and

   (c) to resolve any issues arising.

3. In so far as they reviewed the audit documentation and discussed the audit evidence with the engagement teams, the Respondents failed to identify the shortcomings identified above in Allegation 1 and/or identified them but failed to resolve them.

4. The Respondents failed to obtain sufficient appropriate audit evidence in relation to Inventories in order to express an unqualified audit opinion on the financial statements in accordance with ISA 700, paragraph 36a.

Allegation 3 - Post balance sheet events (Inventories)

Between 1 January and 22 July 2008, in relation to the audit procedures to consider all events from the balance sheet date up to the date of the auditor's report, in particular in relation to Inventories, the First and Third Respondents failed:

to perform adequate audit procedures to obtain sufficient appropriate audit evidence that all events up to the date of the signing of the auditor's reports for TES and SEV for the year ended 31 December 2007 that may have required adjustment of, or disclosure in, their financial statements had been identified; and

to prepare work papers which were a sufficient and appropriate record that demonstrated that all events up to the date of the auditor's report that may have required adjustment or disclosure in the financial statements of TES and SEV had been identified and considered by the Respondents, thereby

> ***(i) failing to comply with the requirements of paragraph 4 of ISA 560, paragraphs 2, and 9 of ISA 230 (Revised) and paragraph 21 of ISA 220; and/or***
>
> ***(ii) failing to act in accordance with the Fundamental Principle of Professional Competence and Due Care of the Code of Ethics of ICAS, ICAEW and ACCA.***

Particulars

1. The Respondents noted in the Tanfield Group Audit Findings Report, presented to the Tanfield Group Audit Committee on 28 February 2008 that one of the key areas of audit focus was the risk of damage and obsolescence associated with Tanfield Group's high stock holding and that stock levels should be monitored by management against forecast demand to ensure the appropriateness of stock levels.

2. On 1 July 2008, Tanfield Group issued a trading statement which referred to a "marked slowing in our markets …experienced throughout June", and an article in the Financial Times of the same date with the headline "Tanfield shares plunge 83% on warning".

3. From 1 January 2008, until the Auditor's report was signed for the TES and SEV 31 December 2007 financial statements on 21 July 2008, the First and Third Respondents failed to perform any or any sufficient appropriate procedures to consider inventory obsolescence and a potential reduction in the realisable value of inventory that might require discussion with management or adjustment of, or disclosure in, the said financial

statements; neither did they demonstrate by the preparation of documentation in the audit file that they had considered whether adjustment or disclosure was necessary.

Allegation 4 - Inadequate Evidence of the Existence and Valuation of Trade Receivables

Between 26 November 2007 and 22 July 2008, in relation to the engagement of Baker Tilly to act as auditor of the financial statements of Tanfield Group, TES and SEV for the year ended 31 December 2007 the Respondents failed to obtain sufficient appropriate audit evidence of the existence and valuation of trade receivables to be able to draw reasonable conclusions on which to base the audit opinion, thereby:

(a) failing to comply with the requirements of paragraph 2 of ISA 500 and paragraph 21 of ISA 220; and/or

(b) failing to act in accordance with the Fundamental Principle of Professional Competence and Due Care of the Code of Ethics of ICAS, ICAEW and ACCA.

Particulars

1. The Respondents failed to obtain sufficient appropriate audit evidence in relation to two debts which were individually material to the audits of both TES and the Tanfield Group, namely

   (a) the valuation of the £7.3m odd debt owed to TES by [...] ("**IPS**"), and

   (b) the valuation of the £9.2m odd debt owed to TES by [...] ("**PSE**");

2. Despite having identified it in the Key Issues Tracker as a significant risk for SEV regarding existence, valuation and overstatement, the Respondents failed to obtain sufficient appropriate audit evidence concerning the valuation and the recoverability of a debt of £500,000 owed since 2005 by W[...] to SEV as at 31 December 2007 ("the W[...] Debt").

3. Despite having planned to do so, the Respondents failed to obtain evidence by any other testing that would have given comfort over the existence of the debtor balances, such as confirmation or correspondence from the third party itself or a sufficient review of after date cash receipts.

4. The Respondents used an analytical test for the existence of trade receivables but did not obtain sufficient appropriate evidence to substantiate their conclusions.

5. The Respondents' substantive testing of the valuation of receivables in the TES audit files was insufficient in that they placed reliance on enquiries of management when alternative evidence could reasonably have been expected to exist. In particular, the Respondents analytical procedures for receivables considered breaches in debtors' credit terms to assess the recoverability and appropriateness of the value of the individual debts. For five debtors identified as being in breach of their credit terms, neither written representations nor evidence of follow up of the management representations was obtained.

6. The Respondents failed to obtain any, or any sufficient, evidence of the basis of management's decision for making provisions against specific bad or doubtful debts.

Allegation 5 – Inadequate Review of Audit Documentation (Trade Receivables)

The Respondents failed adequately to review the audit documentation and to discuss the audit evidence with the engagement teams so as to be satisfied that sufficient appropriate audit evidence had been obtained to support the conclusions reached in relation to the existence and valuation of trade receivables and for the auditor's report to be issued, thereby

(a) failing to comply with the requirements in ISA 220 paragraph 26 and the guidance thereto in paragraph 27; and/or

(b) failing to act in accordance with the Fundamental Principle of Professional Competence and Due Care of the Code of Ethics of ICAS, ICAEW and ACCA.

Particulars

1. In relation to the existence and valuation of trade receivables, namely the W[...] Debt, which comprised a "*critical area of judgment*" and/or "*a difficult or contentious matter*" for SEV and Tanfield Group and which had been identified by the Respondents as "*a significant risk*" for SEV when planning the audit in December 2007, the First and Third Respondents failed:

(a) to conduct timely reviews at appropriate stages of the engagement;

(b) to document the extent and timing of the reviews; and

(c) to resolve any issues arising.

2. In relation to the matters referred to in paragraphs 1 and 3-6 of the Particulars to Allegation 4, the Respondents failed adequately by discussion with members of the engagement team to satisfy themselves that sufficient appropriate audit evidence had been obtained

(a) to support the conclusions reached in relation to the existence and valuation of trade receivables; and

(b) for the auditor''s report to be issued.

3. Insofar as the Respondents reviewed the documentation and discussed the audit evidence with the engagement teams, they failed to identify the shortcomings identified in Allegation 4 and/or identified them but failed to resolve them.

4. The Respondents failed to obtain sufficient appropriate audit evidence in relation to Trade Receivables in order to express an unqualified audit opinion on the financial statements in accordance with ISA 700 paragraph 36a.

Allegation 6 - Post Balance Sheet Events (Trade Receivables)

Between 1 January and 22 July 2008 the First and Third Respondent failed in relation to the audit procedures to consider all events from the balance sheet date up to the date of the auditor's report, in particular in relation to trade receivables:

(a) to perform adequate audit procedures to obtain sufficient appropriate audit evidence that all events up to the date of the signing of the auditors' reports for TES and SEV for the year ended 31 December 2007 that may have required adjustment of, or disclosure in, their financial statements had been identified, and

(b) failed to prepare work papers which were a sufficient and appropriate record that demonstrated that all events up to the date of the auditor's report that may have required adjustment or disclosure in the financial

statements of TES and SEV had been identified and considered by the Respondents, thereby

(i) failing to comply with the requirements of paragraph 4 of ISA 560, paragraphs 2 and 9 of ISA 230 (Revised) and paragraph 21 of ISA 220; and/or

(ii) failing to act in accordance with the Fundamental Principle of Professional Competence and Due Care of the Code of Ethics of ICAS, ICAEW and ACCA.

Particulars

1. The Respondents noted in the Tanfield Group Audit Findings Report document, presented to the Tanfield Audit Committee on 28 February 2008, that:

   (a) the year-end debts owed to TES of £7.3m by IPS and £9.2m by PSE "At the time of our audit fieldwork …remained substantially unpaid. Specific representations are to be obtained from the directors in relation to this issue"; and

   (b) that "specific representations are to be obtained from the directors in relation to the recoverability of [the W[...] Debt]" and "no provision has been made against this amount".

2. The Respondents noted in the planning section of the audit file for SEV that the W[...] Debt was a "significant risk" regarding existence, valuation and overstatement, and in another planning document relating to the SEV audit from around December 2007 that detailed documentation would be needed on file to support its valuation.

3. On 1 July 2008, the Tanfield Group issued a trading statement referring to "*a deterioration of customer payment profiles*" throughout June, which was followed by an immediate drop in the share price of the Tanfield Group of about 83%.

4. Between 1 January 2008, until the Auditor's report was signed for the TES and SEV 31 December 2007 financial statements on 21 July 2008, the First and Third Respondents nevertheless:

   (a) failed to perform any or any sufficient appropriate procedures to obtain evidence of the recoverability of the material debts owed to TES and SEV (including IPS, PSE and the W[...] Debt), including third party confirmations, written

representations from management and evidence of post year-end cash collection; and

(b) failed sufficiently to consider the rationale for their opinion that the debts referred to in Allegation 4 above of certain customers should not be impaired in the absence of sufficient appropriate evidence of recoverability in the TES or SEV 31 December 2007 financial statements.

Annex D