EXPLANATORY MEMORANDUM TO THE TRIBUNAL REPORT

The Executive Counsel to the Financial Reporting Council ("FRC") and (1) Deloitte LLP ("Deloitte") and (2) John Clennett

The FRC has published the report of the Disciplinary Tribunal appointed under paragraph 9(2) of the Accountancy Scheme to hear the Formal Complaint brought by the FRC's Executive Counsel against Deloitte and Mr John Clennett concerning their conduct in relation to the audit of the financial statements of Aero Inventory Plc ("Aero") and its subsidiary Aero Inventory (UK) Limited ("AI") for the financial years ended 30 June 2006, 2007 and 2008, and to make determinations in relation to Adverse Findings against Deloitte and Mr Clennett, sanctions and costs ("the Tribunal Report").

The Tribunal Report follows a public hearing. No individual director or member of management at Aero or AI was a party to the Tribunal hearing. The Tribunal did not invite or receive any witness evidence from any director or member of management at Aero or AI, and no such individual was represented at or in attendance at the Tribunal's hearings. Further, the Tribunal did not invite or receive comments or representations on the terms of the Tribunal Report from any such individuals prior to the Tribunal Report being finalised.

The sole purpose of the Tribunal was to hear and determine the Formal Complaint made against Deloitte and Mr Clennett and brought by the FRC's Executive Counsel, and to do so on the basis of the evidence and arguments relied on by those parties.

The Tribunal has not made, and should not be taken to have made, any findings against any individual or entity other than Deloitte and Mr Clennett (including any individual director and/or member of management at Aero and/or AI).

It would not be fair to treat any part of the Tribunal's findings, including any part(s) of the Tribunal Report, as constituting or evidencing findings against anyone other than Deloitte and/or Mr Clennett.

IN THE MATTER OF:

THE EXECUTIVE COUNSEL TO THE FINANCIAL REPORTING COUNCIL

Complainant

and

(1) DELOITTE LLP

(2) JOHN CLENNETT

Respondents

Before the Disciplinary Tribunal:

Terence Mowschenson QC (Chairman)
J. Gordon Jack
Ms Tania Brisby

Hearing on 9, 10, 11, 12, 13, 16, 17, 18, 19, 20, 23, 24, 25 26 May, 6, 13, 14, 16 17 June and 11 October 2016.

Timothy Dutton QC, Henry King and Rebecca Loveridge instructed by Herbert Smith Freehills for the Executive Counsel

Ian Croxford QC and Jamie Smith QC instructed by Clyde & Co for the Respondents

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REPORT OF THE TRIBUNAL

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1. This is the report of the Tribunal appointed under paragraph 9 (2) of the Accountancy Scheme of 8 December 2014 ("the Scheme") created by the Financial Reporting Council ("the FRC") which is the independent disciplinary body for the accountancy and actuarial professions in the United Kingdom into the Formal Complaint brought against

   1.1. The First Respondent, Deloitte LLP ("Deloitte") which is, and was at all material times, a member firm of the Institute of Chartered Accountants in England and Wales ("the ICAEW"); and

   1.2. The Second Respondent, Mr John Clennett ("Mr Clennett"), who is, and was at all material times, a partner of Deloitte and a member of the ICAEW,

   concerning Deloitte's and Mr Clennett's conduct in relation to the audit of the financial statements of Aero Inventory Plc ("Aero") and its subsidiary Aero Inventory (UK) Limited ("AI") for the financial years ended 30 June 2006 ("FY2006"), 2007 ("FY2007"), and 2008 ("FY2008").

The Background

2. Aero, incorporated in 1994, was originally a company which provided simple parts to a range of small customers from various industries. It was quoted on the Alternative Investment Market from about May 2000. Its board comprised a number of directors with some considerable experience including Mr Nigel McCorkell ("Mr McCorkell") who had previously been a director of Meggitt PLC amongst other companies and a vice chairman of St Mary's Hospital Paddington NHS Trust and Mr Frank Turner ("Mr Turner") who had been a director of Rolls Royce, Lucas Industries PLC and British Midland PLC. Messrs McCorkell and Turner were also members of the audit committee at all material times albeit joined by additional members as time went on. Rupert Lewin ("Mr Lewin"), the Chief Executive, had a career which included being an analyst and being a director of Robert Fleming Securities Limited and for a time Head of Corporate Broking. The Finance Director Hugh Bevan ("Mr Bevan") was a chartered accountant and had worked for Robert Fleming and Jardine Fleming and had been the Chief Operating Officer of Jardine Fleming's Asian Corporate Finance business and in 1999 returned to London from Hong Kong as Head of Equity Capital Markets Execution.

3. By 2004 its business model involved becoming the exclusive supplier to a customer (an airline) of aircraft parts on the basis of a long term contract. The business involved acquiring a customer's existing inventory and thereafter charging the customer on the basis of usage. Aero expected the customer to pay no more for its parts than in the past but to enjoy significant savings in operating and capital costs. In its Chief Executive's statement in the FY2005 accounts, the Chief Executive wrote that Aero's "profit comes primarily from optimising procurement". For the FY2005 and following years Deloitte was the auditor and Mr Clennett was the audit engagement partner of Aero. The audit

reports from FY2005 to FY2008 were unqualified, and the financial statements of Aero showed increasing turnover, profits and levels of stock.

Year ended 30 June	**2005** (US$ m)	**2006** (US$ m)	**2007** (US$ m)	**2008** (US$ m)
Turnover	81.1	113	247	440
Gross Profit	30.4	37.9	82.8	161.8
Operating Profit	14.6	20.5	52.9	93.3
Stocks	120.6	188.5	390.9	690.1

4. Aero's expansion was financed by a rights issue in March 2006 which raised a net £87.3m and by increasing bank borrowings in FY2007 and FY2008, negotiations for which were underway in 2006. The increased profits were largely the result of (a) Aero reportedly entering into bulk purchase contracts in each of the relevant years, (b) allocating the price paid for these bulk purchases to individual stock items using a straight line discount method ("SLD") and (c) earning significant profits in the early periods of these contracts as a consequence of using the SLD methodology. A fourth factor (d) was that the size of the inventory and the book value of Aero's stocks were also apparently increasing significantly. Each of these areas was therefore of importance to whether Aero was able to continue trading and was making the profits set out in its financial statements. They were known to be matters of importance for the audit.

5. In the course of the audit of FY2006, in August 2006, Aero claimed to have concluded a contract with PT Garuda Indonesia (Persero) ("Garuda") the flag carrier of Indonesia, for the purchase of its aircraft parts inventory, for a purchase price of US$34 million on 29 June 2006 and on the same day sold to GMF AeroAsia ("GMF") part of that inventory for US$23 million. GMF was a 99 per cent owned subsidiary of Garuda and operated an aircraft maintenance business. One of its clients was Garuda. These two transactions were referred to as "the Garuda Transaction" during the hearing and we adopt that terminology.

6. In FY2007 Aero purchased an aircraft parts inventory from Qantas Airways Limited ("Qantas") for US$114.6 million and agreed to service Qantas' stock requirements for a period of 10 years.

7. In FY2008 Aero purchased

7.1. An aircraft parts inventory from ACTS Aero Technical Support and Services ("ACTS") for US$75.7 million and an inventory from Aeromantenimiento Sociedad Anonima ("Aeroman") for US$4.5 million and agreed to service ACTS's and Aeroman's stock requirements for 10 years; and

7.2. An aircraft parts inventory from All Nippon Airways Co Limited ("ANA") for US$22.5 million and agreed to service ANA's requirements for 5 years.

8. The contracts for the purchase of inventory are referred to as "Bulk Purchase Contracts". After acquisition the stock in the Bulk Purchase Contracts remained at the sellers' premises and would be used to service their requirements supplemented by Aero purchasing other parts as and when required.

9. The Garuda Transaction, which was the bulk purchase contract accounted for by Aero in FY2006, was different from Aero's subsequent bulk purchase contracts in that it did not provide for a long term supply agreement with the airline following the purchase of its inventory and there was therefore no 'truck stock period'. Aero was therefore left holding stock which Garuda did not require for its current fleet, and in respect of which Aero had no supply agreement. As noted above in FY2007 and FY2008 Aero concluded further bulk purchase contracts with Qantas, ACTS, Aeroman and ANA. Aside from the aforementioned difference, the bulk purchase contracts had the following features in common:

9.1. Aero agreed to buy all the stock held by the customer. This involved buying tens of thousands of inventory lines in a single bulk acquisition.

9.2. Aero and the customer would agree upon a date at which a listing of all stock to be purchased (the "Truck Stock") would be provided to Aero by the customer. This date is referred to as the "Truck Stock Date".

9.3. There would then be a period of negotiation where Aero and its customer would agree upon a purchase price for the Truck Stock. The process of evaluation of the price took several months, so there was a period of time between the Truck Stock Date and the actual contract signing.

9.4. In the intervening period (variously referred to as the "Truck Stock Period", "period 1" / "P1" and the "Pre-Contract Period") parts were used and purchased by the airline. Parts used were billed to the airline by Aero at contracted prices (based on OEM) and parts purchased were billed to Aero. Thus, by the time the contract was concluded, the composition of the stock actually sold had changed due to consumption, purchases and returns in the Truck Stock Period and the overall purchase price payable by Aero fell to be adjusted accordingly.

9.5. The stock acquired under the bulk purchase contracts did not move physically at the date of sale to Aero, but remained at the same premises until sold to the relevant customer or transferred elsewhere by Aero.

9.6. The price Aero agreed to pay for the Truck Stock (which fell to be adjusted for consumption, purchases and returns in the Truck Stock Period, as described above), was a single total price: for example, for the Qantas bulk purchase, it was $114.6 million.

9.7. As part of the contractual package, Aero would agree to service the seller's/customer's stock replacement requirements for a fixed term, frequently on terms that Aero would deliver benchmarked costs savings. The seller's/customer's requirements would be supplied initially by Aero from the bulk purchase stock and then from items purchased by Aero from the market once the bulk purchase stock had been exhausted. Deloitte and Mr Clennett noted that Aero had a "prospective" ability to 'pool' stock parts which it held worldwide and supply new customers. However, this was not a significant element in Aero's business and in FY2007 and FY2008 was respectively less than 1 and 1.2 per cent of sales.

10. When Aero entered into Bulk Purchase Contracts a number of issues arose:

10.1. first the calculation of the total cost of the inventory acquired;

10.2. secondly the calculation of the effect of the seller consuming or disposing of stock between the Truck Stock Date and the date of the contract;

10.3. thirdly, the allocation of the total cost of inventory to individual parts to allow calculations of cost of sales for items sold prior to the accounts date and the inventory value remaining at the accounts date.

11. In agreeing a purchase price Aero and the seller would take into account a number of factors. Aero would take into account the manufacturers' list price ("OEM") and investigate the rate at which the seller would consume the stock. The seller on the other hand might have a desire to convert its stock into cash, might no longer require the parts if it no longer operated a particular type of aircraft, might be influenced by the cost savings of transferring the stock and the risk of future obsolescence, or the realisation of considerable stock on its books, and the level of service and cost savings offered by Aero. However when calculating the cost of Bulk Purchase Stock for accounting purposes Aero calculated the percentage difference between the aggregate value of all the items in the inventory at their manufacturers' list price ("OEM") and the purchase price under the Bulk Purchase Contract. The resulting percentage was applied to all items of each Bulk Purchase Contract as a discount from its OEM price. Typically the discount was said to be in the region of 50 per cent against OEM prices. This discount was a straight line discount ("the SLD"). The effect of the SLD was that the marginal profit of each item in a bulk sale was treated as being the same. The consequence of that, if Aero was paying more for fast moving items than slower moving items, was to attribute a lower cost to fast moving items, and consequently increase the profit made on the faster moving items (and accelerate the recognition of profit) and to attribute a higher cost to slower moving items which might have been to cause their value to be

reflected in the accounts at a higher value, rather than being the lower of cost or net realisable value.

12. Aero claimed that it could sell slow moving or obsolescent stock to consumers other than the entity from which it had purchased the stock and so realisation was merely a matter of timing.

13. In summary the Amended Formal Complaint ("the Formal Complaint") alleges that the Respondents committed an act of Misconduct (as defined in the Scheme) in relation to the audit of:

    13.1. The appropriateness of the accounting and disclosure in Aero's FY2006 financial statements of the Garuda Transaction;

    13.2. the costs of sales and stock valuation in the 2006, 2007 and 2008 financial statements; and

    13.3. stock existence in the FY2007 and FY2008 financial statements.

14. Deloitte is of course responsible for the actions of all the members of the team involved in the audit of Aero. Mr Clennett is only responsible for his own actions. This was common ground.

15. The Formal Complaint was originally brought against an additional respondent, Mr Bevan, who had been the finance director of Aero at all material times. He admitted the two allegations made against him which related to the same issues in the financial statements as allegations 1 and 2 against the first two Respondents, and entered into a Settlement Agreement under the Scheme approved by the Tribunal whereby he was excluded from membership of the ICAEW for 3 years and required to pay £170,000 towards the Executive Counsel's costs.

16. We express our sincere appreciation to counsel and the solicitors respectively acting for the Executive Counsel and for the Respondents for the assistance given to the Tribunal which sat for many days. We would also like to thank those in the "back room" who prepared the voluminous bundles of documents placed before us which made a very difficult task much easier.

17. The Tribunal's task, under Paragraph 9(7) of the Scheme is to determine whether to make an Adverse Finding in respect of some or all of the Misconduct alleged by the Executive Counsel in the Formal Complaint.

18. An 'Adverse Finding' is defined in Paragraph 2(1) of the Scheme, so far as is relevant, as:

> "a finding by a Disciplinary Tribunal that a Member or Member Firm has committed Misconduct."

The meaning of Misconduct

19. 'Misconduct' is defined in the same paragraph of the scheme as:

> "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."

20. It was common ground that there can be no question of Misconduct unless the respondent to disciplinary proceedings has been found to have fallen below the standards reasonably to be expected of a Member or Member Firm. In the course of the hearing this was referred to as the negligence threshold, as the failure to reach that threshold is a component of the tort of negligence. We were not concerned with discreditable conduct.

21. However there appeared to be some difference between the parties as to the requirement that the conduct fall significantly short of the negligence threshold albeit that difference appeared to be more apparent than real. The Executive Counsel accepted that the expression "significantly" meant that the extent to which the conduct has to fall short had to be serious and relied on an extract from the decision in FRC Executive Counsel v Deloitte and Einollahi [Tribunal 2 September 2013, Appeal 2014/15]. The Tribunal in that case at paragraph 18 onwards gave the following summary of the test:

> "18. 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.
>
> 24. 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."

22. The Respondents contended that the inclusion of the expression "significantly" imported more than a "quantitative" test as to the extent to which a respondent's conduct fell short of the negligence threshold. The expression "significantly" should be given its ordinary meaning as "important" or "notable" and in the context of the Scheme, conduct must be of significance to the purpose of the Scheme namely "to protect the public, maintain public confidence in the accounting profession and uphold proper standards of conduct": paragraph 1(2) of the Scheme. Furthermore the expression should be construed in its context where the alternative limb of the definition of Misconduct refers to conduct which is "likely to bring discredit to the Member or the Member Firm or to the accountancy profession".

23. We do not consider that the Respondents' contention assists the construction of the first limb of Misconduct. The purpose of the Scheme is to protect the public, maintain public confidence in the accountancy profession and uphold proper standards of conduct. A finding that a respondent has fallen significantly short of the negligence threshold will inevitably assist in protecting the public, maintaining public confidence in the accounting profession and upholding proper standards of conduct. We have difficulty in envisaging a situation in which a tribunal could conclude that conduct had fallen significantly short of the negligence threshold but was not Misconduct because it had no impact on the purposes described in paragraph 1(2) of the Scheme.

24. We consider that paragraphs 18 and 24 of the decision in FRC Executive Counsel v Deloitte and Einollahi do assist in characterising the task for the Tribunal. We do not consider that the final sentence of paragraph 18, when read in the context of the decision, was suggesting that "mere" negligence without the significant departure from the negligence threshold would suffice and we accept the Respondents' submission that the extent to which the conduct has to fall short of the negligence threshold is that the extent to which it has to fall short has to be serious, or to bedevil this issue by using another expression, substantial.

25. In this report the expression "significantly short of the standards" means "significantly short of the standards reasonably to be expected of a Member or Member Firm".

26. The Tribunal is conscious, as we apprehend was the draftsman of the Scheme, that a finding of Misconduct may have serious consequences for a respondent and that the interest of the public is not likely to be protected by a scheme which concerned itself with insignificant or trivial departures from the negligence threshold.

27. It was common ground that the burden of proof is on the Executive Counsel to satisfy the Tribunal that the facts and matters relied on by him amount to Misconduct and that the standard of proof is the civil standard, i.e., the balance of probabilities: paragraph 12 of the Scheme.

The witnesses of fact

28. In the course of the hearing which lasted some 19 days the Tribunal had the advantage of hearing the evidence of:

28.1. Mr Clennett: Mr Clennett qualified as a Chartered Accountant in 1985, became a partner of Deloitte in 1990 and has had experience in the audit of substantial public companies including companies involved in the aerospace and defence industry which gave him a considerable amount of technical and commercial expertise. He has recently acted as the engagement quality control partner on the audit of an airline company. He has led or been involved as the Independent Quality Assurance Partner on a large number of publicly listed companies including SEC registrants and is a National Risk partner for Deloitte's corporate finance business. He continues to be accredited to lead PCAOB audits which involve in excess of 50 hours of CPE per year. Until 2013 he was in charge of Quality for the South East region Audit Executive which holds responsibility for overseeing the audit practice in that region. Mr Clennett's recollection of many of the important events was not clear. For example, in his oral evidence he repeatedly said that he could not remember all the conversations that were going on in relation to Garuda in 2006 or remember what discussions he might have had with Mr Lewin about the documents received from the Shangri-La and GMF by fax on 4 October 2006 (the "Faxed Documents") or when they were supplied to him. In relation to discussion of the GMF letter contained within the Faxed Documents, Mr Clennett said that "[T]his is where it's quite hard to remember all the conversations, you know, or whether I'm reconstructing or recollecting." He was in a difficult position in relation to various issues because records were not maintained on the audit file which should have been. Nonetheless we are satisfied that he tried to assist the tribunal albeit he was prone to suggest in the course of his evidence that certain discussions must have taken place although he could not remember them.

28.2. Mr Daniel Baker ("Mr Baker"): Mr Baker joined Deloitte (then Deloitte & Touche) in August 2002. He qualified as a chartered accountant in September 2004 and thereafter worked in Deloitte's audit department until the end of October 2013. He was promoted to Manager on 1 July 2005 and Senior Manager on 1 July 2007. On 1 July 2010 he was appointed audit Director. Mr Baker first became involved in Deloitte's audit work on Aero when he reviewed Aero's interim results for the six month period ended 31 December 2005. Aero was just one of a number of audits he worked on and these involved some substantial companies with large inventories and included a company with a full listing as well as a number of companies listed on AIM. Mr Baker gave evidence to the effect that he could recall the Aero audits and issues which arose and had some quite clear memories, though his recall of the detail was less good after so many years. In addition his recollection of a particular year's audit was affected by the fact that he had worked on a number of audits and had some difficulty in distinguishing the events of the various years. As he frankly stated, he had difficulty at times in identifying what was reconstruction after reviewing papers from what was recollection. Matters of which he had little or no

recollection included discussions of the Faxed Documents, the Garuda Transaction, or the principle of the SLD in FY2006 or FY2007.

28.3. Ms Georgina Dowding ("Ms Dowding"): Ms Dowding joined Deloitte in 2002 and qualified as a chartered accountant in September 2005. By the time of the Aero audit in 2006 she had worked on the audit of several companies. She is now a Director, a position between a Manager and partner. Ms Dowding worked on the audits of FY2006 to FY2008 but had some involvement in the FY2005 audit. Her memory had also faded over the years and she had almost no recollection of anything material and could barely recall the detail of the Garuda Transaction.

28.4. Mr Mark Mullins ("Mr Mullins"): Mr Mullins qualified as a chartered accountant in 1989, joined Deloitte's predecessor firm on qualifying and became a partner in 1996. He currently leads Deloitte's UK audit practice and is a member of the Audit and Risk Advisory Executive and of Deloitte's Board of Partners. He did not hold these positions in 2006 to 2009 but was the Independent Review Partner ("IRP") in relation to the Audits for FY2006 to FY2009 as well as for the interim reviews of half year results. Mr Mullins' recollection of the audits was indistinct due to the passage of time. His recollection was also not good in relation to the Garuda Transaction. He also found it difficult to recall matters that one might have expected to be the subject of contemporaneous notes.

The Expert Witnesses

29. The duties and responsibilities of expert witnesses were summarised by Cresswell J in the Ikarian Reefer [1993] 2 Ll Rep 68. They have been elaborated on since then in subsequent cases but it might assist matters in the future if the rules are once again summarised here:

> 1. Expert evidence presented to the court should be, and should be seen to be, the independent product of the expert uninfluenced as to form or content by the exigencies of litigation.
>
> 2. An expert witness should provide independent assistance to the court by way of objective, unbiased opinion in relation to matters within his expertise. An expert witness in the High Court should never assume the role of an advocate.
>
> 3. An expert witness should state the facts or assumptions upon which his opinion is based. He should not omit to consider material facts which could detract from his concluded opinion.
>
> 4. An expert witness should make it clear when a particular question or issue falls outside his expertise.

5. If an expert's opinion is not properly researched because he considers that insufficient data is available, then this must be stated with an indication that the opinion is no more than a provisional one. In cases where an expert witness, who has prepared a report, could not assert that the report contained the truth, the whole truth and nothing but the truth without some qualification, that qualification should be stated in the report.

6. If, after exchange of reports, an expert witness changes his view on a material matter having read the other side's expert's report or for any other reason, such change of view should be communicated (through legal representatives) to the other side without delay and when appropriate to the court.

7. Where expert evidence refers to . . . calculations, analyses, . . . or other similar documents, these must be provided to the opposite party at the same time as the exchange of reports.

30. In our view it would be good practice for expert reports prepared for the Tribunal to set out at length a declaration that the practice or code relied on has been adhered to. Setting out the code at length will concentrate the minds of all concerned with the preparation of the report as to what the duties are. We had some sympathy with certain of the criticisms made in relation to the reports of both expert witnesses, Mr Nigel Meredith ("Mr Meredith") for the Executive Counsel and Mr Nicholas Allen ("Mr Allen") for the Respondents.

31. Mr Meredith was called by Executive Counsel. He is an audit partner with Ernst & Young LLP and has been a partner for 15 years. He has a degree in economics and qualified as a chartered accountant in 1986. He is a member of the Institute of Chartered Accountants for England and Wales ("ICAEW") and the Institute of Chartered Accountants of Scotland ("ICAS"). He has extensive experience in audits including companies in the aerospace industry and holding substantial inventory including Goodrich (now part of UTC Aerospace Systems), GKN PLC (including GKN Westland) and Bombardier. Mr Meredith had a tendency when giving oral evidence to try to give evidence as to what he himself would have done in the FY2006 to FY2008 audits but he prepared a very detailed report which the Tribunal found of considerable assistance.

32. Mr Meredith's report was the subject of sustained criticism by the Respondents on a number of grounds and the principles set out in the Ikarian Reefer.

32.1. It was difficult at times to find one's way round the report and it appeared at times to be repetitious and not follow the scheme of the allegations.

32.2. It did not deal with aspects of the case which it might have been expected to deal with such as collusive fraud and whether it had any bearing on the matter.

32.3. It did not deal with the paper prepared by Horwath Clark Whitehill or two occasions when Ernst & Young had been retained by Aero (one in relation to

the accounting treatment of Garuda and in relation to IFRS conversion work) and arguably (both firms) might have been alerted to issues arising upon the application of SLD.

32.4. It used as evidence relating to the identification of types of aircraft parts in Garuda's stock a valuation of Garuda stock prepared by AIMS about June 2006. The Respondents contended that this evidence was not supplied to the Respondents in good time to enable them to consider it and furthermore, there was evidence to suggest that the valuation might have been prepared by AIMS in collusion with Aero to assist Aero in paying as little as possible for the Garuda stock.

32.5. Mr Meredith had only read part of the interview transcripts of interviews with relevant individuals interviewed by the FRC.

32.6. Mr Meredith stuck to his opinions even when doing so was, so it was contended on a number of occasions, absurd.

33. We agree that it would have been appropriate that the matters outlined above in paragraphs 32.2 to 32.4 should have been dealt with in the report. Mr Meredith was, of course, responsible for his own report and had no doubt had assistance from Executive Counsel's legal team. It may well be that the potential significance of these documents to the discharge of the duty was overlooked in light of the volume of documentation. We do not attribute any untoward motive to him or indeed Executive Counsel's legal team for the omissions.

34. Mr Allen gave expert evidence on behalf of the Respondents. He is a Fellow of the ICAEW and a member of the Hong Kong Institute of Certified Public Accountants. He joined Coopers & Lybrand in London in 1977 and transferred to Coopers & Lybrand in Hong Kong in 1983. He became a partner there in 1988. He retired from the merged firm of PricewaterhouseCoopers in June 2007. He was the engagement partner of a number of substantial companies including Swire Pacific and was partner in charge of the PwC Hong Kong and China Assurance Practice (audit) comprising 3,000 staff and partners in 20 offices. Mr Allen's report was subjected to serious criticism by Executive Counsel. Mr Allen sought to assist the Tribunal in relation to the concept of Misconduct by "making some remarks about whether the shortcomings that I saw would have been a disciplinary issue from a PwC point of view" and commenting on how he would have overseen someone's work at PwC. He said in cross examination that he had not considered in his report what the test was for a finding of Misconduct (under the Scheme).

34.1. In paragraph 2.2.4 of his report he had said that "section 8 [was intended to] assist the Tribunal, as best I can, as to whether any shortcoming or combination of shortcomings by Deloitte or Mr Clennett was of such as a nature as to merit a disciplinary finding."

34.2. In conclusion, in section 8 of his report, he made a surprising statement to find in an expert's report in this context:

> "In so far as I have disagreed with the Allegations, even if my own opinions are found to be in error by the Tribunal, I would similarly not expect the shortcomings thereby identified to result in a disciplinary finding. I pay regard to the facts that a suitably qualified and diligent auditor has identified the pertinent audit risks and has sought to address them in consultation with senior or well qualified colleagues".

Furthermore in providing evidence to the Tribunal on the question of stock existence, Mr. Allen appeared to justify placing reliance on uncompleted statistical sample tests and contractual warehousing terms, which, under cross examination, he admitted did not provide sufficient evidence of stock existence. That was an instance of Mr Allen trying too hard for his client.

35. Despite the criticisms made by the Respondents of Mr Meredith, and those made by Executive Counsel of Mr Allen, the Tribunal found both experts of assistance in reaching its conclusion. As with any Tribunal dealing with contested expert evidence (or indeed the evidence of a joint expert) the Tribunal has evaluated the evidence carefully and with some circumspection.

GENERAL POINTS

Hindsight

36. We have borne in mind the dangers of hindsight, which include analysing each conversation or note line by line, and attributing greater significance to such matters in the light of subsequent events, instead of considering matters as participants saw them as they occurred, or assuming that what happened subsequently was bound to happen.

Approach to the evidence

37. Our approach to the evidence will be that summarised by Mr Justice Leggatt in Gestmin SGPS S.A. v Credit Suisse [2013] EWHC 3560 (Comm). A similar and shorter summary of the appropriate approach to assessing evidence is to be found in the dissenting speech of Lord Pearce in the House of Lords in Onassis v Vergottis [1968] 2 Lloyds Rep 403 at p 431:

> "'Credibility' involves wider problems than mere 'demeanour' which is mostly concerned with whether the witness appears to be telling the truth as he now believes it to be. Credibility covers the following problems. First, is the witness a truthful or untruthful person? Secondly, is he, though a truthful person, telling something less than the truth on this issue, or, though an untruthful person, telling the truth on

this issue? Thirdly, though he is a truthful person telling the truth as he sees it, did he register the intentions of the conversation correctly and, if so, has his memory correctly retained them? Also, has his recollection been subsequently altered by unconscious bias or wishful thinking or by overmuch discussion of it with others? Witnesses, especially those who are emotional, who think that they are morally in the right, tend very easily and unconsciously to conjure up a legal right that did not exist. It is a truism, often used in accident cases, that with every day that passes the memory becomes fainter and the imagination becomes more active. For that reason a witness, however honest, rarely persuades a Judge that his present recollection is preferable to that which was taken down in writing immediately after the accident occurred. Therefore, contemporary documents are always of the utmost importance. And lastly, although the honest witness believes he heard or saw this or that, is it so improbable that it is on balance more likely that he was mistaken? On this point it is essential that the balance of probability is put correctly into the scales in weighing the credibility of a witness. And motive is one aspect of probability. All these problems compendiously are entailed when a Judge assesses the credibility of a witness; they are all part of one judicial process. And in the process contemporary documents and admitted or incontrovertible facts and probabilities must play their proper part."

Collusive Fraud

38. The Executive Counsel and the Respondents differ as to the relevance of any collusive fraud by certain members of the management of Aero. The Respondents referred the Tribunal to ISA 240 Paras 18 – 19 as it prevailed at the relevant time, an extract from which provided:

> "18 The risk of not detecting a material misstatement resulting from fraud is higher than the risk of not detecting a material misstatement resulting from error because fraud may involve sophisticated and carefully organized schemes designed to conceal it, such as forgery, deliberate failure to record transactions, or intentional misrepresentations being made to the auditor. Such attempts at concealment may be even more difficult to detect when accompanied by collusion. Collusion may cause the auditor to believe that audit evidence is persuasive when it is, in fact, false. The auditor's ability to detect a fraud depends on factors such as the skilfulness of the perpetrator, the frequency and extent of manipulation, the degree of collusion involved, the relative size of individual amounts manipulated, and the seniority of those individuals involved. While the auditor may be able to identify potential opportunities for fraud to be perpetrated, it is difficult for the auditor to determine whether misstatements in judgment areas such as accounting estimates are caused by fraud or error.

> 19. Furthermore, the risk of the auditor not detecting a material misstatement resulting from management fraud is greater than for employee fraud, because management is frequently in a position to directly or indirectly manipulate accounting records and present fraudulent financial information. Certain levels of management may be in a position to override control procedures designed to prevent similar frauds by other employees ...".

39. Paragraph 20 of ISA 240 emphasised that the discovery of a material misstatement of the financial results resulting from fraud does not, of itself, indicate failure to comply with ISAs and that this is particularly the case for certain kinds of material misstatements, since audit procedures may be ineffective for detecting an intentional misstatement that is concealed through collusion. Whether an audit is performed in accordance with ISAs is determined by the audit procedure performed in the circumstances, the appropriateness of the audit evidence obtained as a result thereof and the suitability of the auditor's report based on an evaluation of that evidence. Executive Counsel's contention was consistent with the tenor of paragraph 20 to the effect that his case was directed to what Deloitte and Mr Clennett should have done, and did not do, in each of the relevant years by reference to what was known or should have been apparent to them as a member firm and member of the ICAEW applying the relevant standards at that time. His contention was that they failed to obtain sufficient appropriate audit evidence in relation to the matters alleged and failed to exercise sufficient professional scepticism in respect of the evidence presented by Aero. Thus, he contended whether or not there was a collusive fraud and, if there was, the extent and details of the same are, in the end, not material to the outcome of this Formal Complaint. We deal further with collusive fraud in the appropriate context below.

Absence of audit documentation

40. The Executive Counsel referred to Deloitte's Combined DTT and UK Audit Approach Manual ("the Manual") which provides guidance as to what audit working papers should include and which reflects some of the contents of ISA 230 (Audit Documentation) as it prevailed at the relevant time. Amongst the matters which should be recorded are descriptions in reasonable detail of the work performed, the conclusions reached and the basis for them as well as recording discussions with management in relation to significant matters identifying with whom and where the discussions took place. In addition the working papers should address information which contradicts a conclusion reached. 25.10c of the Manual notes that the quality of documentation is increasingly important and that "regulators assume that "if it is not recorded it wasn't done"" and that "a court of law will draw adverse inferences from missing documentation." So far as the Tribunal is concerned we have formed our conclusions on all the evidence placed before us which must include having regard to the contents of contemporaneous documentation as well as the evidence adduced before the Tribunal and we have not simply assumed that if it was "not recorded it wasn't done".

41. However, we do observe that there appeared to be a substantial failure to record matters arising during the course of the audit including discussions with management. That coupled with the lack of recall of all the witnesses called on behalf of Deloitte and Mr Clennett increased the burden of the task on the Tribunal to a substantial extent. Albeit we conclude that all the witnesses (and Mr Clennett) did their best to give truthful evidence we were concerned at the lack of recall of events which may have taken place between 8 to 10 years ago but in the light of Aero's collapse into administration in 2009 might have been expected to remain in the minds of those who participated in the audit.

ALLEGATION 1 – THE GARUDA TRANSACTION

42. The Executive Counsel's first complaint relates to the Garuda Transaction and is as follows:

> "In relation to the audit of Aero's financial statements for the financial year ended 30 June 2006, the conduct of Deloitte and Mr Clennett fell significantly short of the standards reasonably to be expected of, respectively, a Member Firm and a Member in that: -
>
> 1.1. Deloitte and Mr Clennett issued an unqualified audit opinion having failed to obtain sufficient appropriate audit evidence from which to draw a reasonable conclusion (a) that it was appropriate to recognise the Garuda Transaction in the FY2006 financial statements and/or (b) as to the terms and substance of the Garuda Transaction, and failed thereby to act in accordance with Fundamental Principle 4 'Performance' in the Guide to Professional Ethics.
>
> 1.2. Having failed to obtain sufficient appropriate audit evidence to enable them to draw a reasonable conclusion to recognise the Garuda Transaction in the FY2006 financial statements and/or as to the terms and substance of the Transaction, Deloitte and Mr Clennett failed to report to Aero that the Garuda Transaction should be removed from the FY2006 financial statements and/or to qualify their audit opinion, and failed thereby to act in accordance with Fundamental Principle 4 'Performance' in the Guide to Professional Ethics.
>
> 1.3. Deloitte and Mr Clennett failed to exercise sufficient professional scepticism when assessing and following up information concerning the Garuda Transaction which was made available to them by Aero's management, and failed thereby to act in accordance with Fundamental Principle 4 'Performance' in the Guide to Professional Ethics.
>
> 1.4. [Having taken the view that the Garuda Transaction could be recognised in the FY2006 financial statements,] Deloitte and Mr Clennett failed to report to Aero's management that the Garuda Transaction should be reported as an exceptional item and/or to qualify their audit opinion, and

failed thereby to act in accordance with Fundamental Principle 4 'Performance' in the Guide to Professional Ethics.

1.5 As a result of the above, Deloitte and Mr Clennett failed to comply with the requirements of ISA 200 and ISA 500."

The Standards

43. Fundamental Principle 4 ("Performance") of the ICAEW Guide to Professional Ethics applicable in 2006 provided that:

> "A member should carry out his professional work with due skill, care, diligence and expedition and with proper regard for the technical and professional standards expected of him as a member".

44. ISA 200, as it applied in 2006, provided, at paragraph 6, that:

> "**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.** An attitude of professional scepticism means the auditor makes a critical assessment, with a questioning mind, of the validity of audit evidence obtained and is alert to audit evidence that contradicts or brings into question the reliability of documents or management representations. For example, an attitude of professional scepticism is necessary throughout the audit process for the auditor to reduce the risk of overlooking suspicious circumstances, of over generalizing when drawing conclusions from audit observations, and of using faulty assumptions in determining the nature, timing, and extent of the audit procedures and evaluating the results thereof. In planning and performing an audit, the auditor neither assumes that management is dishonest nor assumes unquestioned honesty. Accordingly, representations from management are not a substitute for obtaining sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the audit opinion".

ISA 500 as it prevailed at the relevant time, provided, at paragraph 7, in relation to sufficient appropriate audit evidence that:

> "Sufficiency is the measure of the quantity of audit evidence. Appropriateness is the measure of the quality of evidence; that is, its relevance and its reliability in providing support for, or detecting misstatements in, the classes of transactions, account balances, and disclosures and related assertions. The quantity of audit evidence needed is affected by the risk of misstatement (the greater the risk, the more audit evidence is likely to be required) and also by the quality of such audit evidence (the higher the quality, the less may be required). Accordingly, the sufficiency and appropriateness of audit evidence are

interrelated. However, merely obtaining more audit evidence may not compensate for its poor quality".

45. As noted above, in the course of the FY2006 audit Aero claimed to have entered into the Garuda Transaction on 29 June 2006. The inclusion of the Garuda Transaction had a substantial effect on the FY2006 results. As a result of the accounting treatment afforded to the Garuda Transaction it resulted in profits initially thought to be going to be of £8.8 million being recognised in FY2006, equivalent to 73 per cent of Aero's gross profit (and in the event put at £9.9 million, equivalent to 81 per cent of Aero's operating profit). Absent the profit from the Garuda Transaction Aero's profit in FY2006 would have been some £2.2 million. It is now clear that the Garuda Transactions occurred sometime after that date and probably in the first week of October 2006 and should have formed part of the financial statements for FY2007. We are satisfied that Deloitte and Mr Clennett were misled by Aero's management including two directors.

46. As part of the background against which the FY2006 audit was carried out, as Mr Clennett knew, Aero financed its purchases of bulk stock by way of a rights issue and bank borrowing and a lending bank would have regard to Aero's accounts. Deloitte was aware (through Mr Baker) that Aero had signed a new bank facility with Barclays and AIB on Thursday 5 October 2006. Accordingly there were reasons to believe that it would be especially important to Aero not to produce disappointing results and Mr Allen agreed the obvious, that if an auditor perceives that a company might be under pressure with its shareholders to achieve a particular result that might alert an auditor to the possibility that management might be pressurised into reporting results which were not justified. In its 2005 interim accounts Aero informed the market that it expected its accounts to be significantly weighted in the second half of the FY2006 financial year and that its directors were confident of Aero's growth prospects. As Mr Allen said in the course of cross examination evidence:

> "You have taken me through a series of documents that show that [the Garuda Transaction] is a large unusual transaction at the end of the year and that management had announced that profits would be weighted towards the second half of the year. So within the context of audit planning for management override, yes, there would be a focus on this transaction to make sure that there was sufficient, adequate, persuasive evidence that it should be booked."

That answer appears to be consistent with the risk identified by Deloitte in the Strategic Audit Plan for FY2006 as described below.

47. Deloitte and Mr Clennett recognised certain of the risks and described them in the Strategic Audit Plan for the FY2006 Audit. Thus under the heading of considerations which affected the strategic audit plan it was recorded that:

> "[Aero] is AIM listed therefore there are market expectation [sic] which the company will be under pressure to meet. These will relate to turnover and profit after tax therefore these are key performance indicators.
>
> In relation to the business model there is risk associated with the end of contracts or the decommissioning of aircraft. Stock is maintained at an appropriate level throughout the contract to ensure service levels however if a contract ends and is not renewed Aero will end up with a large quantity of surplus stock. This could theoretically be sold, or used to service other contracts; however the process has not yet been tested ... ".

Under the note relating to critical judgment areas it is noted that ISA 240, as it prevailed at the relevant time, requires Deloitte to presume that there is a risk of fraud in revenue recognition and that the audit engagement partner (i.e., Mr Clennett) should set out which types of revenue, revenue transactions or assertions may give rise to such risks. Deloitte identified "revenue recognition on large "one-off" transactions, typically made at the start of new contracts" as a Significant Identified Risk ("SIR").

Under the heading "current period matters" there was inserted on about 19 June 2006:

> "There has been a large share placing and options issue during the year to raise funds to expand the business. This will mean there will be increased pressure from investors to provide improved performance for their investment."

And on about 7 September 2006:

> "Towards year end, the Company entered into an outright transaction with SRT. Also there was a significant transaction with Garuda and [GMF]. We have performed additional testing necessary to ensure it is fairly stated. To be disclosed in the financial statements."

Under the heading "going concern" it was provided that

> "to ensure the company remains a going concern there are a range of covenants that need to [be] met in relation to the loan agreement with the Royal Bank of Scotland."

And finally it was noted that no other SIRs other than the SIRs recorded had been identified.

48. The Strategic Audit Plan also recorded that Mr Clennett had prior year experience of Aero and Mr Baker had experience from the interim financial statements. Gina Clark (i.e., Ms Dowding) was also recorded as having prior year experience.

49. There were other factors which should have made Deloitte and Mr Clennett additionally wary of the possibility of management override:

49.1. The perception that management interpreted accounting standards aggressively, as recorded in Deloitte workpaper 1210. Mr Allen agreed that such a perception would be relevant to the auditor's assessment of the risks present in Aero.

49.2. Aero's management informed Deloitte that each of Aero's two most profitable transactions for the year (Garuda and SRT (as to the latter see below)) had occurred at or very close to the year end. Mr Allen agreed that this was "part and parcel of addressing the risk of management override".

49.3. The way in which events unfolded in relation to the SRT Transaction described below.

49.4. The length of time taken by Aero to produce documentation which had been requested. Deloitte and Mr Clennett repeatedly requested documentation in support of the Garuda Transaction from 16 August up to early October.

49.5. The fact that no contract for the Garuda Transaction was ever produced when initially there had been no suggestion that there was no written contract and subsequently no adequate explanation was given as to why such a substantial transaction should not have been fully documented.

50. The sequence of events in the audit relating to the Garuda Transaction appears to be as set out below. Deloitte and Mr Clennett would have been aware of the possibility of transactions from the Chief Executive's statement in the 2005 interim results which referred to the possibility of new contracts towards the end of FY2006 and the unamended Strategic Audit Plan also referred to "New contracts in Indonesia and with Qantas are also in discussion". That appears to have been written on or about 19 June 2006.

51. W/p 1411 was reviewed by Mr Baker and Mr Clennett respectively on the 11 and 18 August. It was prepared by Ms Dowding (then called Clark) on 13 June 2006 and records "Stock purchase from Garuda and sale to GMF" as a "Significant Event/Unusual Transaction".

52. Neither Mr Clennett nor Mr Baker is able to pinpoint from recollection when exactly they were first told of the Garuda Transaction, but it is clear that by 16 August 2006 Deloitte had been told about it as Tiara Kok (one of the audit team) was aware of it as she emailed Martin Webster, Aero's company secretary (copied to Sarah Pardington, also of Aero) seeking a copy of sales contracts for GMF and Garuda and thanking him for minutes of both Aero PLC and Aero UK board minutes and as noted above on 7 September 2006 the Strategic Audit Plan (w/p 1130) was amended to add reference to "a significant transaction with Garuda and [GMF]".

53. The paper version of w/p 1210 (marked as reviewed by Mr Baker on 11 August 2006 and by Mr Clennett on 18 August 2006 and bearing Mr Mullins' manuscript "29/8/06")

refers to the Garuda Transaction as having taken place "In June 2006" and states that "a si[g]nificant purchase and sale took place – " in response to the question under Engagement Risk "[D]oes the entity engage in unique, complex and material transactions that pose difficult "substance over form" questions ?". The AS/2 electronic version reveals extra narrative (cut off from the paper copy, when printed): "– to be audited substantively. This large 'one-off' transaction is included within the SIR identified on 1130".

54. It is clear that in August 2006 the Respondents had been led to understand that the Garuda Transaction had taken place in FY2006 and did so because that was what they were informed by personnel at Aero. The audit team had classified the Garuda Transaction as a 'Significant Event/Unusual Transaction' and included it as an SIR (Specific Identified Risk) in w/p 1130.

55. By 18 August 2006 the audit team had carried out work on Aero's purchase accruals and accrued income and had identified that the amounts due on the purchase and sale elements of the Garuda Transaction had at that time been accounted for by Aero as accruals. Mr Clennett's evidence was that this signified to the Respondents that both a purchase and a sale had been made by the year end, but that invoices had not been posted prior to that date. Mr Baker had this understanding too. We do not understand that Executive Counsel contended that it was unreasonable of the Respondents to reach that conclusion from the presence of an accrual in Aero's accounting systems provided that the accrual was properly included in Aero's systems. The work papers need to be approached with some care as certain of them refer to Garuda when from the context the reference should have been to GMF, for example W/p 5570M. W/p 5570 was provided by Aero from its accounting systems and represented that the income accrual related to FY2006. Mr Meredith agreed to that. The fact that there was confusion in nomenclature is not altogether surprising. The "G" in GMF stands for "Garuda".

56. Mr Baker reviewed various board minutes on 1 September 2006. Included was a copy of Aero UK's board minute of 4 July 2006 in which Mr Bevan was recorded as referring to stock purchases and sales to Garuda and to Garuda's lack of credit standing. The reference to "Garuda" was probably intended to be a reference to GMF. The minute afforded no evidence as to the date of the Garuda Transaction and we do not take the Respondents as referring to it as such. A minute of an Aero board meeting held on 27 June 2006 contained Mr Lewin's overview of his Chief Executive's report. That recorded him as saying with "with regard to Garuda, the proposed stock purchases and sales had been agreed between Rupert Lewin and the President of Garuda. The transaction settlement documentation was in the course of preparation". In addition Mr Bevan was quoted as stating (at paragraph 2.5) that part of the Garuda Transaction has been "included in the May management accounts. The remaining element of the Garuda transaction would be recorded in the June accounts; it was noted that ongoing trading with Garuda should be undertaken only after their credit situation had been carefully considered". Minutes of a board meeting of Aero recorded that "settlement arrangements in relation to the Garuda Transaction were noted". No further details

were recorded in the minute. The board minute review noted that the "Garuda contract was expected to make [sic] substantial contribution to 2006/2007".

57. The Board Minutes in themselves provide some evidence that the Garuda transaction had taken place in FY2006, in particular the passage cited from paragraph 2.5 of the board minute of 27 June 2006. However, that is on the basis that one might expect the content of the minute to be accurate and that one would normally expect a Chartered Accountant and director such as Mr Bevan to be giving his fellow directors correct information.

58. In the course of the audit between 16 August and 11 September 2006 Deloitte and Mr Clennett chased for information relating to the Garuda Transaction:

58.1. On 10 August 2006 Ms Kok emailed Mr Bevan, copied to Sarah Pardington, relating to a number of share option scheme contracts required and added that she had "spoken to Sarah [Pardington] on the new customer contracts and the contract that is currently with Rupert [Lewin] is the Garuda contract which I forgot to mention". Mr Bevan forwarded the email to Mr Webster and Ms Pardington asking them to provide copies of the Haeco and Taeco contracts. He did not reply to Ms Kok saying that there was no Garuda written contract.

58.2. On 16 August 2006 Ms Kok emailed Martin Webster, cc Sarah Pardington, saying "would appreciate if I could get a copy of the sales contracts for Haeco (revised contract in Jan), TAECO, GMF (Indonesia), Garuda (Indonesia) and any other major sales and purchase contracts entered into in the current financial year 30 June 2006 and until to date".

58.3. On 17 August 2006 Ms Kok emailed Mr Bevan (and others) attaching the latest list of outstanding audit queries. This included requests for supporting documents for the Garuda stock purchase of £18.384m and for the 'Garuda' income accrual of £12.4m.

58.4. On 21 August 2006 Ms Kok emailed Mr Nathan and Ms Pardington (cc Mr Bevan and various members of the Deloitte audit team) attaching the then latest list of outstanding audit queries. Her email stated "would appreciate if you could revert to us as soon as possible on the outstanding matters". The attachment again included requests for supporting documents for the Garuda stock purchase of £18.384m and the 'Garuda' income accrual of £12.4m.

58.5. On 25 August 2006 Ms Kok emailed Ms Pardington (cc Mr Webster, Mr Bevan, Mr Nathan and various members of the Deloitte audit team) attaching the then latest list of outstanding queries and again stating "would appreciate if you could revert to us on the outstanding matters as soon as possible". The attachment included requests for "Purchase invoice/contract for the Garuda Stock purchase – £18.384 million", "Supporting documents for the following GMF - £12.4 million – Confirmation from GMF on the total sale value of stock and agree the listing of stocks purchased with total sales value of £12.4 million

(cost based on calculation of £3.7 million)" as well as a list of queries for Martin Dodge regarding the Garuda Transaction, including a request for a stock listing of the stocks being sold to GMF.

58.6. On 7 September 2006 Mr Baker emailed Mr Bevan stating:

> "Quick note to remind you of the main things we are waiting on:
> SRT info following John's note
> Garuda info
> … I've got time in John's diary for Thursday am to come out for a close meeting – we'll be going through the above …".

58.7. On 11 September 2006 Ms Kok emailed Ms Pardington, Loye Akinyele and Mr Bevan (cc Mr Baker and Ms Clark) attaching the then latest outstanding list and stating "Would appreciate if we could obtain the information as soon as possible preferably by today or latest tomorrow in order for us to complete the audit by the agreed time line". The attached list included requests for the Garuda Purchase Invoice/Contract and Confirmation and the GMF Sales Invoice/Contract and Confirmation.

58.8. Shortly afterwards, also on 11 September 2006, Mr Clennett emailed Mr Bevan (cc Mr Lewin) asking "Please can you call me as we need to resolve the outstanding and major issues: We are still waiting to see documentation in connection with Garuda and GMF – we haven't even seen a purchase order from GMF let alone any contract."

59. Mr Baker explained the repeated requests for information as part of Deloitte seeking to "project manage" the obtaining of information so "that the client could keep track of what remained outstanding and we could be sure that requests would not be forgotten about ... The fact of repetition from one schedule to another does not signify that we were becoming increasingly anxious about particular requests. We found Aero to be less organised than many clients of a similar standing...". If Deloitte were not becoming increasingly anxious about the delay in receiving information as to the Garuda Transaction, they should have been. It had, so they were being told, just been entered into before the end of FY2006, i.e., shortly before the request. The transaction was one of considerable importance to Aero and they had been told that Mr Lewin had negotiated the transaction with the President of Garuda. They could have legitimately expected any documentation to be readily to hand and to the extent that there was none, that that would be communicated to them in response to their request. Ms Dowding's evidence that chasing documentation was a routine matter linked to the charging structure missed the point that the requests for information in relation to the Garuda Transaction were genuine requests. They were no less important because they were made in the context of other, possibly, more mundane information. Deloitte was awaiting the further information requested. For example, the Income Accrual Breakdown (w/p 5571), prepared on 22 August 2006 and showing accruals as of 30 June 2006, shows an accrual of £12,436,465 in respect of Garuda with a note "*awaiting

backup". Aero had originally announced that its results for FY2006 would be announced on 25 September 2006. On about 18 September 2006 it issued an announcement to the effect that the results for FY2006 would be published on 6 October 2006.

60. By 24 August 2006 Ms Kok had spoken to Mr Bevan on the subject of the Garuda Transaction and recorded his answers at w/p 5560B (the "Garuda Sale Memo"). Mr Bevan informed her that:

60.1. both contracts making up the Garuda Transaction had, save in respect of settlement, been concluded on 30 June 2006;

60.2. Aero had purchased $32 million (£18.4 million) of inventory from Garuda. That represented all of the inventory then owned by Garuda;

60.3. Aero had "concurrently" sold part of the stock to GMF for £12.4 million "at a very good margin";

60.4. Garuda and GMF were Government-related (with GMF being a subsidiary of Garuda), but with separate management; and

60.5. Garuda wished to sell all its bulk stock, whilst GMF desired to buy only a part of that stock and this had given Aero the opportunity to enter into a deal with both parties. Mr Bevan stated that: "GMF provide maintenance to a variety of airlines in Indonesia, including ... Garuda". The memo also recorded that Deloitte had also seen copies of the stock sold to GMF.

61. The listings were designated w/ps 5470, 5561 and 5460C. W/p 5470 was in two sheets and was split between parts with alphabetical prefixes, on the one hand, and those with numeric prefixes, on the other hand. W/p 5470 itemised the details (over 1,520 pages) of the stock bought but there has been added at the top of the first page of each sheet a figure showing the "stock purchase price paid" which was the total allocated cost for that sheet which resulted from allocating the $34m agreed price proportionately across the various lines of parts listed within it.

62. Following her preparation of the Garuda Sale Memo, Ms Kok spoke to Mr Bevan and Ms Pardington about certain queries arising and on 25 August 2006 and sent an email to Mr Dodge. Ms Pardington was by then a Director of AI. In any event, she responded by three emails: two on 25 August 2006 and one on 4 September 2006. In answer to Ms Kok's enquiry as to how the stock sold to GMF was determined, Ms Pardington answered that "The parts sold to GMF were the parts that the customer wanted to buy". This answer was consistent with the Garuda Sale Memo ("[GMF] wanted to purchase only certain parts") and Mr Baker's understanding was that GMF had identified stock they needed in the short term. Ms Pardington's responses were in the circumstances further additional client representations that the Garuda Transaction had already taken place and, moreover, prior to the FY2006 year end.

63. Aero provided to the audit team Mr Bevan's Garuda Explanatory Memo ("the Garuda Explanatory Memorandum"). It was provided on about 7 September 2006 prior to the preparation of the first draft of Deloitte's Report to the Audit Committee. Mr Clennett's recollection is that he had asked Mr Bevan for a paper of this kind to be put before the Board; and he understood that both Mr Bevan and Mr Lewin had been involved in its preparation, as they had been. In any event the document was drafted and provided so as to be audit evidence given to the auditors and upon which they could place reliance; it was intended to assist in persuading them that there was sufficient audit evidence to show that the Garuda Transaction had taken place as Mr Bevan (and others) falsely claimed and should be accounted for on a gross not net basis. It was intended by its authors to be and was deceitful. It was reviewed by both Mr Baker and Mr Clennett.

64. The Garuda Explanatory Memorandum emphasised that Aero had entered into two separate transactions with Garuda and GMF "a separately managed maintenance company" and the "commercial rationale for such transactions particularly in the light of [Aero's] concern as to the credit risks associated with GMF." Total sales by Aero to GMF in FY2006 amounted to $1.3 million of which $1.1 million had been paid. The memorandum went on:

> "Aero Inventory have been in discussions with Garuda for a considerable time concerning a larger conventional Aero Inventory contract whereby Aero Inventory buys all Garuda's consumables and expendable parts and then contracts to sell GMF parts as required. A stock acquisition was agreed in June 2006. The value to be paid for the stocks has been arrived at after considerable analysis, including an assessment of the likelihood of stock items being consumed in a reasonable time frame."

The Garuda Explanatory Memorandum went on to record that Aero had agreed to buy Garuda's entire inventory of stock as at 29 June 2006 for $34 million. Title to the stock "passed" by way of delivery at the premises where the stock was held. Aero had analysed the stock to be purchased and its value at OEM list price and in accordance with past practice had allocated the cost of the parts acquired over the total in proportion to OEM list price. Following the normal business model Aero would sell consumable parts to GMF to satisfy their anticipated short term needs and these items of stock had been invoiced at prices approximating to OEM list price. In aggregate that stock "requested by Garuda and invoiced on 29th June 2006 is US$23 million". The stock represented just under 20 per cent of the stock "to be acquired" at OEM list price.

65. The Garuda Explanatory Memorandum also recorded that "given the risk in extending credit to GMF, [Aero] is now negotiating to settle the purchase of stocks and the sale of stocks referred to above by a net payment by [Aero] to Garuda of US$11 million".

66. Mr Clennett had a number of discussions with Mr Lewin and Mr Bevan during the course of the audit. He wished to be satisfied that the Garuda Transaction involved bona fide transactions, and as to the circumstances surrounding the transactions, their

form and the timing relative to the year end. The discussions included a rationale as to the reason for the interposition of Aero into the transaction and why Garuda had sold the stock to Aero at a substantial discount to Aero which claimed to have made a substantial margin on the sale on to GMF. Mr Clennett's evidence was that he stressed that he wished to see all the contractual documentation. Apparently Mr Lewin informed Mr Clennett in the course of one of these conversations that there were no contractual documents but Mr Clennett stated that he emphasised that he wanted to see confirmation from GMF that it owed Aero the purchase price for the stock sold on to it by 30 June 2006. Mr Lewin gave a detailed explanation of the commercial rationale for the two elements including that: (a) Garuda and GMF were separately managed; (b) relations between them had broken down; (c) GMF was short of inventory and trading balances between the two companies were not being settled; (d) Garuda wished to sell the entirety of its stock holding in one transaction to raise funds and outsource its supply; (e) GMF was not in a position to buy the whole of the stock. It was in these circumstances, Mr Lewin explained, that Aero had the opportunity to acquire stock from Garuda cheaply and sell part of it at a profit to GMF. Mr Lewin said that the sale and purchase had been under negotiation for some while before the end of June 2006. He also told Mr Clennett that Aero's concerns about credit risk were complicated and were delaying settlement of both the purchase and sale.

67. The Deloitte audit team had seen by mid-August 2006 documents relating to a bid bond which Aero posted in support of its tender for the Garuda stock purchase and, in particular, had seen the SWIFT message of 29 June 2006 concerning that bid bond which was included in the audit files as workpaper 5168M and which provides:

> "060629
>
> ...
>
> BEHALF AERO INVENTORY (UK) LIMITED ... OUR RESPONSIBILITY PLEASE ISSUE YOUR STANDARD BID BOND FOR USD 310,000.00 ... IN FAVOUR OF THE CHAIRMAN OF THE COMMITTEE, SPARE PARTS SALES COMMITTEE, MANAGEMENT BUILDING, 2ND FLOOR, R 209 GARUDA MAINTENANCE FACILITY, SOEKARNO – HATTA INTERNATIONAL AIRPORT, CENGKARENG, INDONESIA, SUPPORTING TENDER REFERENCE ADVERTISEMENT IN KOMPAS, 26 JUNE 2006 FOR THE GARUDA INDONESIA SPARE PARTS SALES TENDER. GUARANTEE TO REMAIN VALID UNTIL 04 AUGUST, 2006 FROM DATE OF ISSUE.
>
> ...
>
> IN CONSIDERATION OF YOUR ISSUING YOUR GUARANTEE AS ABOVE WE THE ROYAL BANK OF SCOTLAND PLC ... HEREBY ISSUE IN YOUR FAVOUR OUR IRREVOCABLE STANDBY LETTER OF CREDIT NUMBER G111192 DATED 29 JUNE 2006 FOR USD 310,000.00 ... EXPIRING ON 18

SEPTEMBER 2006 AT THE COUNTERS OF OUR ABOVE-MENTIONED DEPARTMENT IN LEEDS FOR PAYMENT."

68. The document produced to the Tribunal was highlighted in yellow text and was so highlighted in the copy in Deloitte's audit file; it appears to have been highlighted by one of the Deloitte audit team as the same highlighting appears in Deloitte's reconciliation workings at the foot of the page.

69. Mr Croxford referred to the SWIFT message which had been attached to an email dated 29 June 2006 from Mr Bevan to a contact in Indonesia, forwarding a copy of the SWIFT message of that day, received by him from RBS. Mr Croxford referred to the email as strong evidence that Mr Bevan had misled Mr Clennett as to the date upon which he represented that the Garuda Transaction had occurred because on that date he was forwarded a copy of the SWIFT message referring to the bid bond in terms which were inconsistent with the Garuda Transaction occurring on 29 June 2006. We accept that submission.

70. As is clear from the passages from the SWIFT message which Deloitte had highlighted, the tender advertisement for the Garuda Indonesia spare parts tender had been placed in Kompas, the Indonesian national newspaper, on 26 June 2006. The bid bond was issued on 29 June 2006, and was to remain valid until 4 August 2006 (facts also highlighted by Deloitte in the SWIFT message on the audit file). That was inconsistent with the Garuda Transaction occurring in FY2006.

71. In the audit file, the SWIFT message is page 2 of a two page workpaper, 5158M, shown as reviewed by Mike Chidothe on 14 August 2006, by Tiara Kok on 14 August 2006 and by Dan Baker on 26 September 2006.

72. The first page of the workpaper is a fax from Mr Bevan and Mr Nathan to RBS dated 28 June 2006, subject "Bid Bond/Letter of Credit", saying:

> "With regard to the standby letter of credit, please accept this letter as authority to debit our US Dollar account No. AERINV-USD1, with the amount of US$310,000 today 28.06.06."

72.1. The highlighting on that page was as shown in the quotation above. The cross-reference appended to the highlighted figure of $310,000 referred to w/p 5190-2, the RBS Bank confirmation, which said:

> "Bonds, Guarantees, Indemnities or other undertakings given in favour of third party:
>
> See attached"

and then in the attached list of three items showed the bid bond as the third item.

72.2. Mr Baker reviewed that RBS Bank confirmation, w/p 5190/2, on 5 October 2006.

73. The second page of workpaper 5148M was the SWIFT message. By manuscript annotation to that page the $310,000 was converted to its sterling equivalent at the rate used by Aero at 30 June 2006 ($1.87/£) and an "RMI" rate used by Deloitte for the same date, which produced a difference described as "Trifling". The sterling equivalent at the Aero rate, £165,775, was highlighted and a cross-reference given to the "cash at bank and in hand" leadsheet, w/p 5101.

74. The 'cash at bank and in hand' leadsheet (workpaper 5101) was reviewed by Mr Baker on 1 September 2006, by Ms Dowding on 15 August 2006 and by Mr Clennett on 18 August 2006. Row 14 of the spreadsheet is an entry for the RBS Letter of Credit at £165,775 which has been cross-referenced to workpaper 5168M (i.e. the workpaper showing conversion of the bid bond from USD to sterling and to which the SWIFT message was attached). Ms Dowding confirmed that it was "quite likely" that, when reviewing this leadsheet, she would have reviewed the tie back to the underlying worksheets.

75. Further, the 'Review of Balance' workpaper, again reviewed by Mr Baker on 1 September 2006 and Mr Clennett on 18 August 2006, contained an entry for the sterling amount of the bid bond (£165,775) and also an explanation that "The RBS letter of credit deposit or Bid Bond is effectively a security deposit obtained by AI UK [as] a condition of the Garuda contract in Indonesia. Garuda wanted assurances from RBS that AI had sufficient funds to fulfil the terms of the contract. A copy of the document is filed at W/p 5168M. Deloitte has tested the foreign currency conversion, recalculated the balance using AI's internally generated USD foreign exchange rates. This calculation has been compared to Deloitte's RMI". The reference to a contract was inconsistent with the information given to Deloitte and Mr Clennett by Mr Bevan and Mr Lewin that there was no Garuda contract. Mr Allen confirmed that he would expect an auditor to request the contractual documentation and to bottom out the inconsistency. Mr Clennett should have ensured that a copy of the contract referred to was produced and asked to see a copy of the Bid Bond.

76. Mr Baker confirmed that, when he was signing audit working papers or reconciliations with two or three sheets on the hard copy file, it was his habit generally to read the documents and then sign the top sheet. Consistently with this practice, Mr Baker's initials (together with the initials of Mike Chidothe and Tiara Kok) appear on the top sheet of workpaper 5168M together with the date of his review, 26 September 2006. Mr Baker confirmed that he would "certainly have seen" this document and also that he did his best to read documents carefully.

77. Ms Dowding also confirmed that she believes that the 'squiggle' which appears with the other initials at the top of the front sheet of workpaper 5168M is hers so she must have reviewed this document.

78. Mr Baker's evidence was that he does not recall any specific discussion within the audit team about the bid bond but that, to the extent there was a piece of evidence that was important or related to another transaction, he would have expected the team to discuss

it with Mr Clennett. He explained that "[T]he way this would have worked in practice would – there would have been an audit room when I would have been on site and given the date of 26 September, we were still on site and I can't tell, but I suspect I probably was at the client's site. I used to review the paper copy with the team live, so I'd discuss it with them."

79. Ms Dowding also confirmed that the audit team talked freely with each other in the audit room at Aero, as appropriate, and that there was generally quite a degree of discussion in an audit room. Executive Counsel submitted that Mr Baker must have read at least the highlighted text contained in the SWIFT message when reviewing workpaper 5168M on 26 September 2006 and that he would have had well in mind at this stage (3 days before the Report to the Audit Committee was provided to Aero) the need for evidence as to the date of conclusion of the Garuda Transaction. Mr Allen suggested during the course of cross examination that the audit team would have reviewed this document only in the context of seeking support for the entry in the lead schedule for cash at bank so that they could reasonably have failed to notice the significance of the timing of the tender advertisement. We do not consider that that is a justification for not picking up the significance in the reference to the timing of the bond as at the same time the same members of the audit team were repeatedly chasing Aero for documentation to support the alleged timing of the Garuda Transaction.

80. Mr Clennett and Mr Baker had reviewed workpapers which referred to the bid bond and which cross referred to workpaper 5168M containing the SWIFT message referring to Garuda's tender advertisement of 26 June 2006 and to the bid bond being posted by Aero on 29 June 2006. Mr Clennett's evidence was that he did not recall there being any bid bond and that he was pretty certain that he did not see the SWIFT message but that he would have wanted to ask more questions if he had been aware of it. As to whether it would have been discussed within the audit team, he said that "It's highly likely that the team would have been aware – we all would have been talking about the Garuda transaction, so I don't know whether somebody gave [Mike Chidothe] some explanation or whatever. I don't know but it's - hopefully, one would have had some discussion about it."

81. Executive Counsel submitted that it is to be inferred that Mr Baker (or others within the Deloitte audit team who reviewed the SWIFT message) would have discussed its contents with Mr Clennett, given that the team had been chasing Aero for documentation of the Garuda Transaction since at least 16 August 2006 and must, as appears from the highlighting of relevant text, have realised the relevance of the SWIFT message to the recognition of the Garuda Transaction. We do not make that inference since we consider that if the terms of the bid bond had been discussed with Mr Clennett he would have appreciated the significance of the inconsistency and would have raised the matter with Aero. Mr Clennett had seen a reference to the bid bond and examined an audit file relating to the bank account in which a copy of the bid bond was to be found. However he did not turn it up. He should have done in light of the dearth of evidence relating to the Garuda Transaction.

82. One of the factors which should have alerted Deloitte and Mr Clennett as to possible risks in the audit was an episode involving SRT. In the course of the FY2006 audit Aero's directors represented to Deloitte that a sale to SRT had been concluded and that the transaction should be recognised as a $10 million sale in Aero's FY2006 financial statements. Deloitte were provided with 3 invoices from Aero to SRT dated 29 June 2006 which contained the description "Sale of parts as agreed with Martin Dodge" and altogether totalled $10 million. However, in evidence Mr Clennett confirmed that Deloitte knew "long before the audit committee [meeting on 4 October 2006] that on the face of [the SRT contract], SRT was not a sale but a form of consignment arrangement". That was apparent from the terms of the contract which are workpaper 5589 reviewed by Tiara Kok and Mr Clennett on 24 August 2006. A comment was recorded in relation to SRT in the Audit Summary Memorandum to the effect that "John [Clennett] currently in discussion with client on the validity of the sale transaction."

83. Notwithstanding the clear wording of the SRT contract the Aero directors continued to contend that the $10 million should be included. It was not until on or around 4 October 2006 that Deloitte and Mr Clennett received confirmation, by way of an email sent on 3 October 2006 email from Mr Sorensen of SRT, that "the AEI once-off sale of moving stock agreement signed 30 June 2006 is a consignment agreement and that SRT has not taken ownership of the parts related to this consignment stock at the date of the agreement. SRT will take ownership of the parts and accept the risk on the parts when these are issued from stock subject to the conditions in our general agreement." The email went on to volunteer, somewhat opaquely, that "we can confirm that we have not taken the credit notes to the Profit and Loss. We also confirm that we have not booked the stock or the invoices on the Balance Sheet. I should stress that as previously stated SRT UK have by mistake booked the credit note to the Balance Sheet and allocated that to another invoice. That is a clerical error that will be corrected."

84. This was entirely at odds with the position that Aero's directors and management had been forcefully taking since at least 16 August 2006. Indeed, Mr Turner (who was on the board of SRT) had been saying that the transaction had been booked as a sale in SRT's accounts. As Mr Baker said in evidence "A number of directors attempted to persuade John Clennett that the agreement with SRT must be recorded as a sale in the 2006 year. The most challenging directors were the non-executives, Nigel McCorkell and Frank Turner. ... In particular, I remember that Frank Turner told John that he was surprised at our stance because SRT had to his knowledge already booked the transaction in its own accounts." Mr Clennett suggested in cross examination that Messrs Lewin, Bevan, Dodge, McCorkell and Turner were all simply labouring under a misunderstanding as to what they had agreed with SRT and that the Aero directors had been open and honest about the transaction. Messrs Bevan and McCorkell were accountants, Mr Turner was on the board of SRT and they were all able to review the clear terms of the SRT contract. Whether or not that suggestion was correct does not matter. Their approach to the SRT incident should have led to an increased awareness of the possibility of management override and that was indeed Deloitte's perception of

the episode. The minutes of the FY2008 engagement team discussion on fraud and error refer to the client having previously "attempted to advance sales but this was reversed during the audit". Mr Clennett and Mr Baker both confirmed in the course of cross examination that the reference was to the episode relating to SRT in the course of the FY2006 audit. Furthermore the "Aero Planning Meeting/Fraud Briefing Notes" dated 22 May 2008 recorded: "Revenue recognition – tried to include advance sales in the prior year but this was reversed following the audit." As Mr Allen said in evidence "if SRT had been an attempt by management to wrongly put forward transactions and they had not provided the other documentation and reacted in the way they did, then, yes, if you discover that your client is deliberately trying to put through invoices that aren't valid or aren't appropriate, then that would heighten your risk, absolutely".

85. On 14 September 2006 Deloitte emailed to Mr Bevan a draft of its audit report to the audit committee which was then scheduled to take place on 4 October 2006. The draft stated that included amongst the matters outstanding were reviews of documentation and conclusions on accounting for the Garuda Transaction and SRT Transaction, and that they "await confirmation from GMF of their liability at 30 June 2006 and final confirmation of settlement details". The Garuda Transaction and SRT sale were referred to as key judgment areas. The report noted that Deloitte had asked for confirmation from SRT that payment for the sale of the goods to SRT was not conditional on usage.

86. On 29 September 2006 Deloitte issued its report to Aero's audit committee. It noted that certain matters need to be finalised before the audit could be finalised and that on a satisfactory resolution of the matters an unqualified report could be issued. The matters included the Garuda Transaction and the SRT Transaction which were also key judgment areas. The report repeated the point that Deloitte had asked for confirmation from SRT that payment for the sale of the goods to SRT was not conditional on usage. It also stated that Deloitte did not have sufficient documentation to support the Garuda Transaction, that Deloitte understood it was due to be settled on 29 September 2006 and that Deloitte would be provided with copies of all relevant documentation. The contribution of the Garuda Transaction (£8.8 million) and the SRT transaction (£2.6 million) were described as significant contributors to gross profits. The effect of the withdrawal of the gross profits from the Garuda and SRT transactions was illustrated at Appendix 2 of the report as an audit adjustment by way of reduction in gross profits of £11.455 million "pending resolution of these transactions". The report also recorded Deloitte's understanding that Aero was in the process of negotiating an increased debt facility from £32 million to £80 million with Barclays Bank plc. The opinions expressed in the Report were the product of Mr Clennett's review of the audit working papers, a discussion as to the issues raised with Mr Baker, Ms Dowding and Ms Kok and a discussion with Mr Bevan in relation to the factual issues in the Report. The Report was reviewed by Mr Mullins in his role as Engagement Quality Assurance Review Partner ("EQAR") and Independent Review Partner ("IRP") and Mr Altoft in his role as Professional Services Reviewer ("PSR").

87. Accordingly, prior to the meeting with the audit committee Deloitte did not consider that it had sufficient audit evidence to justify the inclusion of the gross profit of the Garuda and SRT Transactions. The SRT Transaction was removed as a result of the email sent on 3 October 2006 from Mr Sorensen of SRT.

88. So far as the Garuda Transaction is concerned, Deloitte had some audit evidence as to the existence of the Garuda Transaction in the form of oral and written representations from the directors (including the Garuda Sale Memo and the Garuda Explanatory Memorandum) and evidence of the accruals. It had no written or oral evidence from any independent third party. Deloitte, as Mr Clennett said in evidence, was looking for additional independent evidence that the transaction occurred and that it had occurred prior to the end of FY2006.

89. Aero's accounts were due to be released on 6 October 2006.

90. On 4 October 2006 Mr Clennett attended a meeting with Aero's Audit Committee and on that date seven documents ("the Faxed Documents") were given to Mr Clennett. They were (i) a letter ("the Garuda letter") dated 3 October 2006 from Garuda to AI, (ii) an invoice dated 29 September 2006 ("the GMF invoice") from GMF to AI for $2,500, (iii) an AI invoice numbered 82987 ("the Aero invoice") in the sum of $32 million addressed to GMF, (iv) a letter dated 30 Juni (sic) 2006 from GMF to AI ("the GMF letter") confirming that an AI invoice numbered 82987 dated 29 June 2006 for $32 million "has received and outstanding on June 30th, 2006", (v) a payment instruction from GMF to Citibank N.A. Jakarta to make a payment of $23 million to AI, and (vi) two payment instructions dated 4 October 2006 from Garuda to Citibank to make payments of $6,764,235.66 and $25,195,518.82 respectively to GMF. Items (i) to (iv) were faxed from the Shangri La Jakarta Business Centre and items (v) and (vi) were apparently faxed directly from GMF.

91. Albeit it was odd that items (i) to (iv) were faxed from the Business Centre we do not consider that that issue should have led Deloitte to suspect that the documents were forgeries or had been tampered with. Aero needed to obtain third party confirmation from GMF and it would not have been extraordinary if Mr Lewin had asked for the documents and wanted to ensure that they were sent to Aero in time for the board meetings as so far as Deloitte was concerned Mr Lewin was in Indonesia and moving on to Sydney.

92. An issue which divided the parties was as to the time when Mr Clennett and Mr Baker were supplied with the documents. The Audit Committee meeting was due to start at 9 a.m. at Aero's offices in New Barnet. The time stamps on those of the Faxed Documents sent from the Shangri-La Business Centre show that they were sent at 14:18 and 14:19 which (assuming these signified Indonesian time) equates to 08:18 and 08:19 London time on 4 October 2006. Those sent from GMF have time stamps of 3.33pm and 3:25pm, indicating that they were received by Aero at around 9.33am and 9:25am London time on 4 October 2006. Mr Clennett in the course of cross examination said

that he had a recollection of being supplied with some documentation which could have been the Faxed Documents during the course of the meeting.

93. The minutes of the audit committee (attended by Mr Clennett, Mr Baker, Mr Bevan and Mr Webster, Mr Lewin (by telephone), Messrs Turner (by telephone) and McCorkell) record that "The representation letter would be finalised now that the SRT and the Garuda/GMF issues had been resolved; an updated report confirming satisfactory resolution of the outstanding issues would be circulated by [Deloitte].". The minutes of the Aero board meeting which was held shortly after the Audit Committee Meeting recorded that the 4 October 2006 Documents had been received and copied to Deloitte. Mr Clennett and Mr Baker both gave evidence to the effect that they considered and discussed the Faxed Documents. Mr Clennett's evidence was that he could recall discussing the letter from GMF with Mr Baker as constituting third party evidence and he said that he spoke to Mr Mullins (the EQAR and IRP) and Mr Altoft (the PSR reviewer). In cross examination he emphasised that he could not have signed the audit off alone. There is no written record of any of these conversations.

94. The Executive Counsel contended that on the face of the Audit Committee meetings there was no time for any extensive consideration by Mr Clennett and Mr Baker, let alone Mr Mullins and Mr Altoft. The latter did not attend the Audit Committee meeting. What probably happened is that the Faxed Documents were handed to Messrs Baker and Clennett at the Audit Committee meeting. They expressed a preliminary opinion and then confirmed that view later that day so that the Audit Committee minutes could be settled in the form in which they were.

95. Mr Baker also gave evidence which was unchallenged that he asked one of the members of the audit team to check that the funds from GMF had been received and that was successfully done.

96. At the Audit Committee meeting directors of Aero repeated their representations that the Garuda Transaction had been entered into on 29 June 2006. However oral and written representations in the past had not provided the assurance which Deloitte and Mr Clennett required particularly where Mr Clennett was seeking "third party confirmation" – in his words – that the transaction had occurred and its date. The Faxed Documents were intended to supply that evidence.

The Garuda letter (dated 3 October 2006):

96.1. The Garuda letter refers to Aero's offer stating that

> "I am writing to inform you that your offer for the Garuda consumer spares inventory . . . had [sic] been accepted with reference to the pricing date of 29th of June 2006 can now be settled between us in the manner agreed.

> Please be inform [sic] that the settlement of this transaction involves the payment today of the entire sum of $34 million to [Garuda] and that any separate arrangement you may have at any other organisation is not linked to this transaction in any way and does not make a precondition to this transaction.
>
> Your signature to this letter signifies your acceptance to these conditions in full. Please also be accept that [Garuda] offered no warranties or guarantees to this material which by signing this letter you confirm that you have inspected the material in June and accepted the condition at the pricing date of the 29th of June above."

The letter was signed by Mr Rupert Lewin for Aero and Mr Djatmiko for Garuda.

96.1.1. The Garuda letter does not provide confirmation that the purchase of the Garuda inventory took place on 29 June 2006. We do not consider that the fact that the letter may have been written by a person whose first language was not English enables one to treat the letter as confirmation that a contract had been concluded on 29 June 2006. The letter is expressed to "inform" not to "confirm". The reference to a pricing date of 29 June 2006 is not confirmation, i.e., audit assurance, of the date the Garuda contract was made. If the contract was made on 29 June 2006 one would have expected to find a reference not to "pricing date" but a reference to "the contract date"; the reference to the offer having been accepted "with reference to the pricing date" makes little sense if an offer had been accepted on 29 June 2006 as Mr Clennett was being told by the Aero directors. A common use of the expression "pricing date" (as opposed to a reference to a contract date) is that the pricing date is a different date to the contract date. The third paragraph of the letter refers to signature by Aero signifying Aero's acceptance of the conditions in the letter "in full" including the fact that no warranties or guarantees were being given in relation to the inventory. That also raised questions as to when the contract with Garuda had been agreed.

96.1.2. Mr Clennett's evidence in cross examination as to how he gained comfort in relation to the date of the transaction from Garuda's letter was elliptical.

> "Q. If I have understood what you are saying, you had been told there was no documentation. The first item you receive in the sequence is the letter of 3 October. Do you see that?
>
> A. Yes.
>
> Q. And it refers to:

"Our electronic inventory entitled 'Group A and group B' that had been accepted with reference to the pricing date of the 29 June 2006, can now be settled between us, in the manner now agreed."

Q. Do you see that?

A. Yes.

Q. You were told that documentation or somebody in the team told you documentation would arrive on settlement. This is actually referring to a pricing date, isn't it, of 29 June?

A. That's what the letter says, yes.

Q. Which Mr Baker told us was truck stock date. In other words, a pre-contract date at which you price goods; is that right?

A. Well there wasn't a truck stock period in this one, so it is not a strictly straight analogy.

Q. But the pricing date isn't actually referring to a concluded contract, is it?

A. No, and it's our understanding there wasn't a concluded contract.

Q. So you can't have understood that to mean that there was a contract concluded on 29 June?

A. Well, as I said, there was no -- as far as we knew, there wasn't a contract.

Q. Well, if there wasn't a contract, it must have been an oral arrangement agreed by Mr Lewin in Indonesia, so in order for you to recognise this in the accounts, you can only recognise it if there has in fact been a passing of risk and rewards which means there needs to have been an agreement of some kind, concluded on 29 June, doesn't it?

A. Yes, oral or otherwise.

Q. But this can't have been referring to a concluded agreement. It is referring to a pricing date, isn't it?

A. I wouldn't accept that. "Your offer had been accepted". You know, we took this to mean that it had been accepted on 29 June. "Pricing date" could be additional wording.

Q. At best --

A. If you scrub the word "pricing", then it -- you know with reference to the date but --

Q. You can scrub anything from evidence in order to proceed, but the problem with this is, it is at best, something which requires further enquiry, doesn't it? Did you have any idea what this first paragraph was supposed to mean?

A. I mean, we took this to be confirmation of -- as it was explained to us by management, that confirmation of the transaction if there was a purchase in advance of the sale to Garuda, to GMF.

Q. Who from management gave you that explanation about this paragraph?

A. I can't recall whether we were speaking to Rupert Lewin, Hugh Bevan or who at this time. "

96.1.3. The Garuda letter did not provide third party confirmation as to the date of the contract or its terms. The conversation referred to by Mr Clennett with Mr Lewin (who was in Indonesia or Australia on 4 October 2006) or Mr Bevan which supposedly cast some light on the meaning of the letter and the terms of which he could not recollect was not the third party confirmation which he required. Mr Clennett's suggestion that one could read the letter as confirmation if one ignored the reference to "pricing" was an unacceptable approach to reading a letter supposed to serve the important function which the Garuda letter was intended to do particularly in the light of the effect of the Garuda Transaction on the financial statements for FY2006. There is no written record of the discussion with management and Mr Clennett ultimately said he could not recall what was said. Mr Baker's evidence was that pricing date referred to the truck stock date. The fact that there was no truck stock period in the Garuda Transaction does not detract from his point that the pricing date may have referred to a date prior to the entry into the contract with Garuda and would normally be understood to be so doing.

96.1.4. Deloitte and Mr Clennett should not simply have ignored the word "pricing", if that is what they did, as Mr Clennett sought to do in evidence. The letter clearly called for explanation and, in the

circumstances in which it was produced, long after requests for written confirmation had been made, and at the very last minute, should have raised concerns. Mr Clennett said (for the first time) in the evidence quoted above that the letter was explained to Deloitte by "management" but there is no contemporaneous evidence of such discussion. In any event, Mr Clennett, when giving evidence, had no clear recollection of that alleged discussion given that he could not remember whether it had been with Mr Lewin (who was probably in Indonesia) or Mr Bevan and ultimately accepted that he could not recall exactly what discussions there had been.

96.1.5. As for the reference in the letter to the Garuda sale to Aero being "not linked" to any separate arrangement with any other organisation, it was unlikely, as Mr Allen accepted, that Garuda would have inserted this wording of its own initiative. It pointed to Aero having been involved in the preparation of the letter, further undermining the assurance that could be taken from it. However, more importantly the statement was not correct as Mr Clennett knew or should have concluded for reasons set out below. Mr Clennett accepted that GMF required inventory in order to service Garuda's requirements and he knew from the Garuda Sale Memo that the sales were concurrent; in evidence he said:

> "Q. You knew that the GMF arrangement, Garuda maintenance facility, was part, it was linked to this transaction, you knew that, because GMF needed to have stocks to service Garuda; isn't that right?
>
> A. Yes, but that doesn't mean that this is linked to that.
>
> Q. It must do. The $34 million that Aero is paying Garuda enables it, assuming for the moment there are separate transactions, to supply to GMF, $23 million of those parts, so that GMF can service Garuda?
>
> A. Yes, but it didn't have to sell to GMF on that day or at that time.
>
> Q. But it was doing?
>
> A. It did, I know, but it didn't have to. It could have sold them the day after, a month after or whenever. It could have sold them the following period."

We deal further below with the question of linkage of the Garuda and GMF contracts but the assertion in the Garuda letter that the two

contracts were not linked in the light of the evidence available to Deloitte and Mr Clennett should have been a source of concern.

96.1.6. Further, the reference in the letter to there being "no warranties or guarantees" in respect of the inventory sold ought to have caused some concern to Deloitte and Mr Clennett. If the transaction had concluded prior to the FY2006 year end, there was no good reason for the Garuda letter dated 3 October 2006 to be setting out Garuda's position as to the warranties or guarantees on offer. The reference to payment being due "today" does not provide confirmation that the date of the sale was 29 June 2006. The same point can be made in relation to the fact that no warranties "had been offered". That could refer to no warranties being offered in pre contract negotiations or in relation to an agreement made at some unspecified date prior to 3 October 2006.

96.1.7. If Deloitte and Mr Clennett had been giving proper consideration to whether the Garuda letter supported the alleged transaction date, they would have required explanations of the matters set out above. A letter about which so many questions could be raised did not provide the third party evidence required as to the Garuda Transaction having occurred in FY2006.

The GMF invoice:

96.2. The GMF invoice purported to charge Aero for

> "Material Services (ex GA parts) from 29 June 06 till 29 Sept 06 for Spare part insurance; Warehouse loan space; Electricity and water; security Building cleaning service; Building maintenance; Manpower".

Mr Clennett confirmed that the warehousing, insurance, electricity and water and security referred to in the invoice were all the sorts of things which he would have hoped there to be contractual documentation for but said Deloitte were told there was no contract. Asked whether he had asked to see the contract of insurance he said no because "I wouldn't be second guessing whose insurance it was and what arrangements there were. It just looks like a payment for services over a period of time". Mr Clennett said:

> "We would want to know what the agreement was, but you know, we asked for an agreement, there wasn't one and they said it was a straight purchase. So you know, if they have paid $33 million for some inventory and there are no terms, and they have told you there are no terms and they have told you they've given

> you all the relevant documentation, then we have to assume that there isn't (sic) further agreements."

Deloitte and Mr Clennett did not ask to see any documentation evidencing an agreement to supply the services described in the GMF invoice. They should have inquired further as other documents might have existed (albeit not a sale contract) which might have provided some independent evidence as to the date of the contract.

96.3. The GMF invoice was consistent with the Garuda Transaction occurring on 29 June 2006 but was sent with the GMF and Garuda letters which raised many questions. We do not consider that when read in the context of these letters it provided appropriate third party evidence.

The GMF letter:

96.4. The GMF letter supposedly dated "30 Juni [sic] 2006": This letter was entitled "Confirmed Invoice Received" and stated that

> "This letter to confirm that Aero Inventory Invoice Number: 82987, dated June 29th, 2006 for sum of USD 23 Million has (sic) received and outstanding on June 30th, 2006".

Mr Clennett recalled that he may have discussed what this letter needed to say before it was received. However, one thing Deloitte and Mr Clennett certainly knew was not true was that there had been an invoice received by GMF on 30 June 2006 because they knew that no invoice had been issued at that stage as they had examined Aero's records in relation to the cut-off date of 30 June 2006 and the invoice numbered 82987 had not been issued in June 2006. Furthermore, the GMF "debt" appeared as an accrual. The letter was therefore, on its face, making a representation known to Deloitte and Mr Clennett to be false.

96.5. Mr Clennett's response was to say that he "took this to be that was their way of locking down the $23 million that was due to them". This approach involves ignoring the actual wording and contents of the document itself and instead giving it an interpretation consistent with what Aero management had been saying. He also said

> "And the fact that they put 30 June on the letter was sort of further confirmation to us because obviously we asked for this, this hasn't come by accident. You know, we asked for this through the company to get this confirmation and it was signed and stamped by the CEO",

and

> "and the fact that it was dated 30 June to us was just additional comfort that that was the intention; that was when they said that they had committed to this transaction, that they had bought this inventory".

Mr Allen supports that view in his evidence.

A letter which is known to be back dated and which refers to an invoice as issued on a date on which it was known not to have been issued raises more questions than it answers and did not provide appropriate third party evidence as to the date of the Garuda Transaction.

96.6. Aero's invoice to GMF: This had been backdated to 29 June 2006. Mr Clennett was asked "You must have thought: why haven't I seen this invoice before?" and answered "I don't recall thinking much about this invoice because I knew it was an accrual". The fact that it was an accrual, and that Deloitte and Mr Clennett therefore expected it to have been raised after the end of the financial year, did not explain why it was back dated, why Aero had not produced the document until 4 October 2006 in circumstances where Deloitte had been specifically requesting it since at least 16 August 2006, nor why it ultimately came from Indonesia when Aero could be expected have had a copy of the same invoice in its own records.

97. The payment instructions received from GMF: These showed that Garuda was transferring $31m to GMF on 4 October 2006 and, on the same day, GMF had given instructions for payment of $23m to Aero. Mr Clennett could not recall why Deloitte were being shown documents demonstrating that Garuda was paying $31m to GMF. These documents were consistent with a link between the Garuda and GMF transactions.

98. Mr Lewin's statement as Chief Executive in the FY2006 Report and Accounts, in the context of a reference to the Garuda Transaction, stated that Aero had signed a "Memorandum of Understanding with [GMF] to expand our ongoing level of business with them. ". Mr Clennett could not recall specifically asking for or seeing the Memorandum of Understanding and in cross examination appears to have assumed that it was "a simple reference to ongoing business" and therefore irrelevant. He should have asked to see it.

99. On 6 October Deloitte signed off on the audit of the financial statements for FY2006.

100. The first two issues which arise in relation to the accounting treatment of the Garuda Transactions are:

100.1. Did the audit evidence obtained by Deloitte and Mr Clennett in relation to the Garuda Transaction constitute sufficient appropriate evidence for them reasonably to conclude that it supported (a) the recognition of and (b) the profit attributed to the Garuda Transaction in Aero's FY2006 financial statements?

100.2. If not, did (i) Deloitte and (ii) Mr Clennett fail to act competently with due care and skill in concluding that Deloitte had obtained sufficient appropriate audit evidence in relation to the Garuda Transaction in that regard? If either (i) Deloitte or (ii) Mr Clennett did so fail, in what respects did each fail?

101. We deal with SLD in relation to the Garuda Transaction in the context of Allegation 2.

102. For the reasons stated above we do not consider that the audit evidence obtained by Deloitte and Mr Clennett in relation to the Garuda Transaction constituted sufficient appropriate evidence for them reasonably to conclude that it supported the recognition of the Garuda Transaction in FY2006.

103. We consider that Deloitte and Mr Clennett fell significantly short of the standards in accepting that the Garuda Transaction could be included in the FY2006 financial statements.

104. For the reasons set out above we consider that the evidence obtained by Deloitte and Mr Clennett fell far short of appropriate evidence, in the context in which it was reviewed, to justify the inclusion of the Garuda Transaction, whether as two transactions or one transaction (in the case of the latter just as stock acquisition), in FY2006. Deloitte and Mr Clennett were entitled to treat the written and oral representations of the directors as some audit evidence but they were clear on 29 September 2006 that they required independent evidence from a third party. In summary, they were well aware: (i) that the Garuda Transaction supposedly generated an important element of Aero's profit for FY2006, (ii) of the risk of management override, (iii) of the SIR on large one off transactions and the fact that the Garuda Transaction had itself been identified as a SIR in W/p1130, (iv) of the proximity to the year end of the Garuda Transaction, (v) of the delay in producing any written evidence that the Garuda Transaction occurred in FY2006 (even if it did not amount to a written contract), (vi) that Deloitte (through Mr Baker and others) (but not Mr Clennett) was aware of the terms of the Bid Bond, (vii) of the impression Deloitte and Mr Clennett formed as to the attempt by management to create a profit in FY2006 out of the SRT Transaction, (viii) of the fact that the Garuda Transaction had been under negotiation for several months and yet, apart from stock lists, Aero had produced no written evidence even of emails between Aero and Garuda (or GMF), and (ix) albeit they were told there was no written contract, Deloitte and Mr Clennett were aware that a Bid Bond had supposedly been granted as a security deposit by AI as a condition of the Garuda Transaction and did not ask to see the document which made it a condition of the Garuda Transaction that a Bid Bond be issued as a security deposit or any evidence that that was the reason for the issue of the Bid Bond. Deloitte and Mr Clennett failed to examine the aspects of the letters described above with a critical and sceptical eye.

Furthermore there was a signed Memorandum of Understanding with GMF referred to in the Chief Executive's Statement to the 2006 Aero accounts which Mr Clennett did not ask to see.

105. Furthermore, for the reasons described above, in accepting that the Garuda Transaction could be included in FY2006 Deloitte and Mr Clennett failed to exercise sufficient professional scepticism when following up the information supplied to them by Aero and thereby failed to act in accordance with Fundamental Principle 4 "Performance" in the Guide to Professional Ethics.

106. We do not consider that collusive fraud can be relied on by Deloitte and Mr Clennett in relation to the Faxed Documents. On their face the documents did not supply the appropriate third party evidence for which they were required. If and to the extent that any deficiency in the documents was allayed by oral explanations (as to the nature of which there is no evidence or contemporaneous note) by the directors, those explanations could not remedy the need for independent third party evidence. Rather they emphasised the lack of it.

107. In order to be satisfied that it was appropriate to recognise any profit from the Garuda Transaction in the FY2006 accounts, Deloitte and Mr Clennett needed sufficient appropriate audit evidence both as to the fact that the transaction had occurred in FY2006 and as to whether it was appropriate to recognise the two contracts as separate and distinct purchase and sale contracts.

The Garuda Transaction – linkage

108. If the Garuda Transaction was to be regarded as a single transaction, it would be properly accounted for as a purchase of $11m of stock, with the only impact on Aero's FY2006 financial statements being an increase in stock of $11m with an offsetting reduction in cash (or increase in creditors). It is clear from the Garuda Explanatory Memo, provided by Aero to Deloitte on or around 7 September 2006, that it was envisaged at this stage that the transaction would be settled by a net payment from Aero to Garuda. This was an indication that the purchase and sale were (at least) closely linked. Mr Allen said, when asked whether the prospect of net settlement might indicate that this was a single transaction:

> "I think clearly based on the advice that [Aero] got, my view would be that if it was a net payment, then you probably would have had to account for it as a single transaction, yes. That's why it was, with hindsight, separated out into two transactions – two amounts."

109. On this basis, certainly at the time they received the Garuda Explanatory Memo, Deloitte and Mr Clennett should have been taking the view that the Garuda Transaction should probably be accounted for as one transaction but there is no evidence that they did so. The fact that in the end the settlement was not done on a net basis did not necessarily negate the linkage. In light of this, Mr Clennett's response to the prospect

of net settlement in evidence, that "Well, there were two separate transactions" is plainly inadequate.

110. Moreover, the contemporaneous documents show that the transaction was repeatedly presented to Deloitte as being one transaction (albeit with two limbs) and Deloitte and Mr Clennett also repeatedly referred to it in the singular as that was how they understood it. For example:

110.1. The board minutes reviewed by Mr Baker on 1 September 2006 included notes that:

110.1.1. "The potential transaction with Garuda was also discussed. It was noted that the proposed transaction involved the purchase of stock for c. $32m and the sale, shortly thereafter, of parts for $21m at OEM list price (potentially to include parts from Aero Inventory's existing stock), being settled by a net payment by Aero Inventory of c. $11m. The structure of the transaction was driven by Garuda's lack of credit worthiness as well as Garuda's need to maintain security of supply during its re-structuring."

110.1.2. "With regard to Garuda, the proposed stock purchases and sales had been agreed between Rupert Lewin and the President of Garuda."

110.1.3. "Settlement arrangements: Developments in relation to the Garuda transaction were noted. A written summary of the transaction would be circulated."

110.2. The draft Board minute of 4 October 2006 sent to Mr Baker at his request on 5 October 2006 stated that "Hugh Bevan outlined the details of the Garuda/GMF transaction. ... The report on the transaction would be completed to record the final outcome ... The board confirmed its approval of the transaction".

110.3. Aero's responses to queries raised by Tiara Kok on the sale and purchase were contained in an email with the subject "Garuda queries - Understanding the transaction".

110.4. Deloitte stated in workpaper 1210 "In June 2006 a significant purchase and sale took place – to be audited substantively. This large 'one-off' transaction is included within the SIR identified on [w/p] 1130".

110.5. In the "Determine Planning Materiality" workpaper Deloitte stated that "Revenue has been used as the critical factor, not PAT as recommended for public entities and as used for PY. The rationale for this is a one-off transaction to 'Garuda' which distorts the overall pattern for the period under review."

110.6. In the FY2006 Strategic Audit Plan Deloitte recorded that "Towards year end, the Company entered into an outright transaction with SRT. Also there was a significant transaction with Garuda and GMF Aero-Asia. We have performed

additional testing necessary to ensure it is fairly stated. To be disclosed in the financial statements."

110.7. In the Audit Summary Memorandum Deloitte recorded that "During the end of the year, the Company managed to secure a bulk sale to GMF Aero-Asia of approximately £12 million. The Company had bulk purchased stocks from Garuda Airlines and concurrently resold the stocks to GMF Aero-Asia, the maintenance arm of Garuda Airlines."

110.8. In the "Evaluation of Misstatements" workpaper Deloitte referred to "Delay in receipt of documentation for SRT transaction, and GMF/Garuda transaction. … GMF/Garuda transaction supported by documentation so no adjustment raised."

111. In the Garuda Sale Memo Mr Bevan confirmed that Aero had "concurrently" sold part of the stock to GMF for £12.4 million "at a very good margin". Mr Bevan also told Ms Kok as recorded in the Garuda Sale Memo that

> "the two companies are government related [but] have separate management. [GMF] wanted to purchase only certain parts but [Garuda] would only be willing to sell all the stocks at a good price. Thus, [AI] had entered into the deal with both parties to purchase the bulk of stocks from [Garuda] at a very good price and resell the certain part of the stock to [GMF] at an attractive price, in line with the business model of [AI]".

112. Deloitte and Mr Clennett were aware that the parts sold to GMF were in the main intended for use by Garuda. That can be seen from the passage of Mr Clennett's evidence set out at paragraph 96.1.5 above. The parts retained by Aero were not of any immediate interest to Garuda.

113. Deloitte and Mr Clennett were also aware that ultimately the settlement of the transaction involved money going round in a loop so that (i) Aero paid $34m to Garuda; (ii) Garuda paid around $31m to GMF; (iii) GMF paid $23m to Aero. Mr Clennett agreed that it was Aero's $34m paid to Garuda which enabled GMF to pay $23m back to Aero. The substance of the transaction from Aero's perspective as Deloitte and Mr Clennett understood or should have understood was that it was acquiring for $11m stock which Garuda did not want its 99% subsidiary to buy. In the process, because the settlement involved it in parting with $34m before receiving $23m back, it had a brief credit risk. The assumption by Aero of a brief credit risk does not alter the substance of the transaction.

114. Deloitte and Mr Clennett relied heavily on the management representation letter which they obtained from Aero by which management represented that "GMF AeroAsia and Garuda are independently managed entities and <u>therefore</u> that the bulk sale to GMF Aero Asia and the purchase from Garuda should be recorded as separate transactions." The representation contained a non sequitur. The fact, if it was the case, that Garuda and GMF were separately managed did not necessarily lead to the conclusion that the

transactions were not linked. It is particularly notable that this was not something confirmed by the Faxed Documentation despite the separate management point being something that Garuda and GMF were well positioned to comment on and despite the Garuda letter purporting to confirm (presumably in response to a request from Aero for such confirmation) that the Garuda sale to Aero was not linked to any other transaction. Mr Clennett could not recall any discussion concerning the issue of linkage other than the representation as to independent management.

115. Mr Clennett accepted in evidence that independent management (had it existed) was not enough to show that the transactions were not linked. Mr Clennett's evidence was that the transactions would be linked if the transactions were contractually conditional on each other. This placed an incorrect emphasis on legal form, which is not what should drive the presentation of financial statements, as FRS 5 makes clear.

116. FRS 5 provides:

> "**OBJECTIVE**
>
> 1. The commercial effect of the entity's transactions, and any resulting assets, liabilities, gains or losses, should be faithfully represented in its financial statements.
>
> ...
>
> **GENERAL**
>
> **The substance of transactions**
>
> 14. A reporting entity's financial statements should report the substance of the transactions into which it has entered. ... A ... series of transactions that achieves ... an overall commercial effect should be viewed as a whole.
>
> ...
>
> **THE SUBSTANCE OF TRANSACTIONS**
>
> **General principles**
>
> 46. Paragraph 14 of the FRS sets out general principles for reporting the substance of a transaction. Particularly for more complex transactions, it will not be sufficient merely to record the transaction's legal form, as to do so may not adequately express the commercial effect of the arrangements. ...
>
> ...
>
> **Assessing commercial effect by considering the position of other parties**
>
> 51. Whatever the substance of a transaction, it will normally have commercial logic for each of the parties to it. If a transaction appears to

> lack such logic from the point of view of one or more parties, this may indicate that not all related parts of the transaction have been identified or that the commercial effect of some element of the transaction has been incorrectly assessed. "

117. Whilst there is no specific definition of linkage of transactions in the Accounting Standards, Application Note G on Revenue Recognition, issued as an amendment to FRS 5 in November 2003, provides some assistance as an analogy. Under the section on 'Separation and Linking of Contractual Arrangements', Application Note G provides at G22, in relation to a single contractual arrangement requiring a seller to provide a number of different goods and services (or 'components') to its customers, that these components may be unrelated and capable of being sold individually or they may be so closely related that their individual sale is not commercially feasible from either the seller's or the customer's perspective. At G25-G26 the Application Note provides that a contractual arrangement should be accounted for as two or more separate transactions where the commercial substance is that the individual components operate independently of each other (i.e. each component represents a separable good or service that the seller can provide to customers) but that, conversely, the commercial substance of two or more separate contracts may require them to be accounted for as a single transaction. The key concepts are commercial substance and an analysis of whether purportedly separate components are genuinely independent from one another.

118. Mr Clennett accepted that the commercial rationale for the transaction meant that GMF needed some of Garuda's stock to service Garuda and others. It is also clear Aero would not have bought the inventory if GMF had not indicated it wished to buy some of it and Aero did not wish to take a substantial credit risk on GMF. Deloitte's Report to the Audit Committee of 29 September 2006 summarises Deloitte's "understand[ing] from management that cash settlement for the transaction has yet to be agreed as the group wishes to avoid the credit risk with GMF by ensuring that payment for the Garuda parts does not happen until GMF have paid for the inventory they require". Aero did not want to be left holding the stock that it intended to sell to GMF.

119. Mr Allen's evidence was that "I certainly feel that if the transactions were deemed to be linked and one would only take place if the other one took place as well, then I think that's certainly relevant for the consideration". He went on to say:

> "Well, I think if I'm a middleman in a transaction and I do a transaction with you to buy some inventory and I've already got my buyer lined up, then that's a transaction which takes place and I make a profit on that transaction. If you are not prepared to sell to me unless I sell it to this party, i.e. the transactions are linked, you can't separate the two, then you get into the area where you can't probably treat it as two transactions."

120. The reality is that the two transactions were linked in this way and were not genuinely independent. It is unrealistic to suppose that Garuda would have sold all of its stock to

Aero without knowing that the stock which GMF needed to continue maintaining Garuda's fleet would immediately be sold back to GMF. That would have put its whole business in jeopardy. Mr Allen's suggestion that this problem was overcome by the representation that there was no linkage in the fax from Garuda is to elevate form over substance and we reject it.

121. Mr Allen agreed that "Garuda must be comfortable having – when they dispose of stock in this way that they are going to get – have a source of inventory to keep their planes flying." As Deloitte and Mr Clennett understood, the reason Garuda was comfortable in this instance was that they knew the necessary parts would immediately be sold to GMF: hence the transactions were linked. In the circumstances it is an obvious inference that Garuda would not have sold its inventory to Aero but for the agreement by Aero to sell the inventory which GMF required to service its fleet of aircraft. The inventory remained in the same warehouse where it had always been under the immediate control of GMF. Furthermore Garuda ensured that GMF would be in funds to settle its obligation to pay Aero for the stock acquired by it.

122. Deloitte and Mr Clennett relied on having been told by Mr Lewin that Garuda and GMF did not get on and that GMF was being prepared to be disposed of or otherwise separated from the group. That in itself did not go anywhere near showing that the transactions were not linked. Mr Clennett accepted when giving evidence that it was possible that his recollection about Mr Lewin telling him that GMF was to be disposed of could have come about through things he had learnt separately. Aero's board minutes, which were reviewed by Mr Baker on 1 September 2006, did not support any representation that Garuda and GMF did not get on. The minutes of the board meeting of 27 June 2006 record that "the proposed stock purchases and sales had been agreed between Rupert Lewin and the President of Garuda". "This was yet further evidence that the transactions were linked.

123. The commercial substance of the Garuda Transaction was clearly that GMF would acquire $23m of the Garuda stock and the remainder of the stock would be purchased by Aero for $11m. It should have been accounted for in accordance with its commercial substance. There is no evidence on the audit file to show that Deloitte weighed up the various features of the Garuda Transaction in order to reach a judgment as to whether it should be accounted for as one transaction or two – something which Mr Allen confirmed that he would expect to see being done on the audit file. Instead, the transaction was accounted for in accordance with an artificial legal form which had the result that when the straight line discount was used, it enabled Aero to recognise more than $18m of profit on the deal in its FY2006 accounts. We consider that Deloitte and Mr Clennett did not have sufficient appropriate audit evidence to allow them to take this approach.

124. The issues in relation to the treatment of the Garuda Transaction as two transactions or a single transaction are as follows:

124.1. Did the audit evidence obtained by Deloitte and Mr Clennett in relation to the

Garuda Transaction constitute sufficient appropriate evidence upon which reasonably to draw conclusions as to whether it was appropriate to recognise the two limbs as separate and distinct transactions or as a single transaction? We answer this issue in the negative.

124.2. If not, did (i) Deloitte and (ii) Mr Clennett fail to act competently with due care and skill in concluding that Deloitte had obtained sufficient appropriate audit evidence in that regard? If either (i) Deloitte or (ii) Mr Clennett did so, in what respects did each fail?

125. Deloitte and Mr Clennett's conduct in accepting the treatment of the Garuda Transaction as two separate transactions as opposed to a single transaction fell significantly short of the standards.

126. Furthermore, for the reasons described above, in accepting that the Garuda Transaction was two unlinked transactions, for the reasons set out above, Deloitte and Mr Clennett failed to exercise sufficient professional scepticism when following up the information supplied to them by Aero and thereby failed to act in accordance with Fundamental Principle 4 "Performance" in the Guide to Professional Ethics.

Adequacy of disclosure of the Garuda Transaction in the FY2006 accounts

127. If, contrary to Executive Counsel's primary case, it was appropriate for Aero to recognise some profit from the Garuda Transaction in the FY2006 accounts, he contended that Deloitte and Mr Clennett ought to have ensured that the transaction was disclosed in such a way as to enable a user of the financial statements to understand its commercial effect.

128. FRS 5 provides that:

> "[Paragraph 1] The objective of this FRS is to ensure that the substance of an entity's transactions is reported in its financial statements. The commercial effect of the entity's transactions, and any resulting assets, liabilities, gains or losses, should be faithfully represented in its financial statements.
>
> [Paragraph 30] Disclosure of a transaction in the financial statements, whether or not it has resulted in assets or liabilities being recognised or ceasing to be recognised, should be sufficient to enable the user of the financial statements to understand its commercial effect".

129. Paragraph 11 of the standard provides that, subject to paragraph 12, (which is not relevant for present purposes), FRS 5 applies to "all transactions of a reporting entity whose financial statements are intended to give a true and fair view of its financial position and profit or loss (or income and expenditure) for a period". The expression "transaction" includes both a single transaction or arrangement and also a group of transactions.

130. On 15 September 2006 Mr Bevan provided Aero management with a draft of the financial statements which included some wording on the Garuda stock purchase as well as the SRT discounted sale. He was proposing within the Operational Review – Indonesia section of the Chief Executive's Statement to state that "During the financial year we made a significant stock purchase from Garuda and the overall level of our sales rose significantly year-on-year. In particular we made a US$23 million sale to GMF AeroAsia…".

131. Mr Baker provided Aero with Mr Clennett's comments on the draft statements on 21 September 2006. This included a suggestion that Aero insert what was described as 'Note A' being an insertion in the turnover note (Note 2 of the accounts) stating "On 30 June, as part of ongoing negotiations [Explain further] with GMF Aero Asia and Garuda Airlines, the group purchased from Garuda $33m inventory and on the same day sold [$7m] of this inventory to GMF Aero Asia at a selling price of $23m." Mr Clennett was clearly attempting to ensure that the accounts referred to a same-day transaction at the year end with $7m of inventory being sold to GMF for $23m.

132. There were some exchanges between Deloitte and Aero as to the wording of the statements, with Mr Bevan resisting Mr Clennett's attempt to have the detail of Note A included in the statements. Ultimately, the wording in relation to the Garuda Transaction which was included in the FY2006 financial statements was as follows:

> [In the Chief Executive's Statement]
>
> "During the year ... our efforts to develop our business in Indonesia resulted in a US$23 million sale of parts to GMF AeroAsia in June 2006.
>
> Operating profit rose by 54 per cent to £12.1 million (2005: £7.9 million) with the main contributions arising from sales to SR Technics, GMF AeroAsia and HAECO. These contributions included significant profits arising from our US$23 million stocks sale in Indonesia…
>
> …
>
> Indonesia – As indicated in previous reports we have been developing our business in Indonesia, putting in place the necessary infrastructure to support an expansion of our operations. Although this business has taken longer to develop than originally anticipated, we did increase our overall level of sales considerably, as we had budgeted at the beginning of the year. This was largely due to the purchase of Garuda's engineering consumable and expendable stocks for US$34 million and the subsequent sale in June 2006, for US$23 million, of some of these stocks to GMF AeroAsia to satisfy their requirements".
>
> [In Note 2 concerning Turnover in place of the contents of Note A] "In June the Group made a significant stock purchase amounting to US$34

million from Garuda and sold US$23 million of parts to GMF AeroAsia."

133. This was substantially different to Mr Clennett's proposed 'Note 2' and its suggested disclosure of the same-day, year-end nature of the transaction as well as the profit made on the sale to GMF.

134. Deloitte's audit opinion for FY2006 confirmed that "The information given in the directors' report is consistent with the financial statements". When it was suggested to him that the phrase "subsequently in June" in the Chief Executive's statement was misleading and gave an impression which was quite different from what had actually happened (i.e. a purchase and sale on the same day with some $18m gross profit being generated on that single transaction) so that the information provided by the Chief Executive was not consistent with the financial statements, Mr Clennett said:

> "Yes, we're confirming that it's consistent. We're not confirming that every word and every nuance is entirely accurate. I mean, the word "subsequent" – I mean in his mind it was subsequent. We bought it and then we sold it. It did happen in June, it was $23 million and it was some of the stocks. So, you know, I don't think you could say that therefore our opinion is invalid."

135. The reasonably well informed reader of the financial statements would not have interpreted "subsequently in June" as meaning that the transactions happened "concurrently" as had been described in the Garuda Sale Memo. Neither would they have understood, from the limited disclosure made, the scale of the profit made on this back-to-back transaction on the last but one day of the financial year. This information would have been considered by such a reader to be significant to an understanding of Aero's performance for the year.

136. It was common ground, between Messrs Meredith and Allen, and also on the part of Mr Clennett, that the Garuda Transaction, if it was to be recognised in the FY2006 accounts, was an exceptional item and needed to be disclosed in a manner consistent with this.

137. FRS 3 paragraph 19 provides that:

> "All exceptional items, other than those included in the items listed in paragraph 20, should be credited or charged in arriving at the profit or loss on ordinary activities by inclusion under the statutory format headings to which they relate. They should be attributed to continuing or discontinued operations as appropriate. The amount of each exceptional item, either individually or as an aggregate of items of a similar type, should be disclosed separately by way of note, or on the face of the profit and loss account if that degree of prominence is necessary in order to give a true and fair view. An adequate description of each exceptional item should be given to enable its nature to be understood."

138. 'Exceptional items' are defined by Paragraph 5 FRS 3 as:

> "Material items which derive from events or transactions that fall within the ordinary activities of the reporting entity and which individually or, if of a similar type, in aggregate, need to be disclosed by virtue of their size or incidence if the financial statements are to give a true and fair view".

139. Paragraph 46 of the Explanatory section of FRS 3 provides that exceptional items are:

> "an inherent part of the normal activities of a reporting entity and are included in the computation of profit and loss on ordinary activities but, because of their exceptional size or incidence, require separate disclosure to explain the performance of a period."

140. Paragraph 30 of FRS 5 is in these terms:

> "Disclosure of a transaction in the financial statements, whether or not it has resulted in assets or liabilities being recognised or ceasing to be recognised, should be sufficient to enable the user of the financial statements to understand its commercial effect." =

141. Paragraph 92 of FRS 5 (under the 'Explanation' section) provides that:

> "For the vast majority of transactions [30] involves no more than those disclosures currently required. However, this may not be sufficient to portray fully the commercial effect of more complex transactions, in which case further information will need to be disclosed."

142. Mr Clennett explained that "The thing that makes it exceptional is the impact on the results, so it is the sale which is the exceptional item." However, the full impact on the results was not disclosed as it could have been if Mr Clennett had insisted on the inclusion of his 'Note A'. That was because the sale was the result of a concurrent purchase.

143. Deloitte's Report to the Audit Committee dated 29 September 2006 reported that Aero should "disclose the impact on the results of the GMF and SRT transactions as they are not representative of underlying performance" and should ensure that commentary in the financial statements "clearly discloses the results from sales from long term contracts based on usage and other significant sales to contract customers".

144. There was substantial discussion between Mr Bevan, Mr Baker and Mr Clennett as to the form of disclosure. At the Audit Committee Meeting on 4 October 2006, Mr Clennett informed the attendees that Deloitte's preference was for the individual profit arising from Aero's sale of stock to GMF to be disclosed in the Accounts but that "Aero ... did not wish to make this disclosure" because they were concerned that it would reveal market-sensitive information. It was Deloitte's and Mr Clennett's case that:

144.1. This concern was legitimate and consistent with Note 2 to the draft Accounts, where Aero had elected not to discuss the result of each geographical segment on the grounds that to do so would be seriously prejudicial to the company;

144.2. There was other disclosure to be made in the Accounts concerning the Garuda Transaction, including the fact that the transactions were both said to have taken place in June 2006, the respective value of each transaction and the fact that "significant profits" had arisen from the stock sale to GMF;

144.3. Mr Clennett conferred with Mr Baker, Mr Mullins and Mr Altoft on the disclosure issue.

145. The statement that the transaction occurred in June did not alert the reader to the fact that the sale was on 29 June, the penultimate day of the Aero financial year.

146. The reference to "significant profits" in Mr Lewin's "Review of Results" was inadequate as a means of discharging the duty that "[T]he amount of each exceptional item, either individually or as an aggregate of items of a similar type, should be disclosed separately by way of a note, or on the face of the profit and loss account if that degree of prominence is necessary to give a true and fair view." In that review, Mr Lewin wrote:

> "Operating profit rose by 54 per cent to £12.1 million (2005: £7.9 million) with the main contributions arising from sales to SR Technics, GMF AeroAsia and HAECO. These contributions included significant profits arising from our $23 million stocks sale in Indonesia."

Aero mentioned (although in a different currency, US dollars) the Garuda Transaction's impact on the first heading on the face of its Profit and Loss Account, namely Turnover, and said that it was one of the main contributors to the next heading on the face of the Profit and Loss Account, Operating Profit (being Turnover less Operating expenses). This did not enable the reader to understand the scale of the contribution of the GMF sale (purportedly on the penultimate day of the reporting period) to Operating Profit for the year: the alleged profit of £9.9 million (the size of which was not disclosed) was 81 per cent of the Operating Profit for the year - it more than quintupled what would otherwise have been Aero's operating profits - and more than 100 per cent of second-half operating profits for the year, and without this sale profits for the year would have fallen significantly. Mr Allen said in his second report that the sale:

> "constitutes 46% of gross margin and, in that context, the description in the financial statements that the GMF transaction generated a significant element of the profits is acceptable disclosure"

What was required was disclosure of the quantum of the impact on Operating Profit of the sale to GMF or that a significant percentage of the Operating Profit was attributable to a back to back transaction and Note 2 to the accounts did not disclose that the sale to GMF was from the stock purchased from Garuda which it should have done. Without

such disclosure the commercial effect of the Garuda Transaction could not be understood by a user of the financial statements and a user would not get a true and fair view. The disclosure should have brought to the attention of the user the substantial impact on operating profit of the sale to GMF, the fact that the stock sold to GMF was acquired from Garuda and that the two transactions were back to back.

147. Deloitte and Mr Clennett ought to have applied professional scepticism when considering Aero's apparent concerns in respect of what constituted commercially sensitive information. In any event, whether or not the information was commercially sensitive, the accounts were required to show a true and fair view; in order to do so it was necessary for the impact on the company's overall profits to be disclosed. It was one thing not to quantify the amount of profit attributed to the sale to GMF in the Operating Profit but more needed to be revealed as to the special circumstances in which the profit had arisen.

148. The effect of this was that the disclosure given in the financial statements was not sufficient to enable a user to understand the commercial effect of the Garuda Transaction.

149. Separately disclosing the sales value, cost of sales and profits arising from the transaction would have enabled a user of the financial statements to have made an assessment of the quality of earnings, as described by Deloitte in their report to the Audit Committee.

150. It is noteworthy that Mr Leahy of Hermes Pension Management Limited asked questions in relation to the Garuda Transaction in an email sent on 13 December 2006 including the question whether it was a coincidence that the Garuda Transaction was just before the year end, why did Garuda sell its inventory, and why did GMF need to acquire it in FY2006 and what was the margin for Aero. That was after a visit to Aero's Stansted and Barnet premises in the course of which he must have acquired some additional information. The Respondents contended that the Hermes email was evidence that the disclosures in the financial statements had been sufficient to alert users of accounts to the unusual nature of the transaction; however we consider that the standards do not pre-suppose that of users of accounts, including financial market participants, would have the same level expertise in assessing financial statements or the same level of access to management as Hermes. Moreover, had the disclosure note been adequate, Mr Leahy of Hermes would not have had to ask all those questions.

151. The disclosure of the Garuda Transaction in Aero's FY2006 financial statements was the subject of consideration and discussion not only by Messrs Clennett and Baker, but also by Mr Mullins (in his capacity as EQAR partner and IRP) and Mr Altoft (the PSR). Both Mr Mullins and Mr Altoft signed off their approval to the financial statements and Deloitte's clean audit opinion. The audit files do not contain a record of such discussions or a reason why Deloitte and Mr Clennett acquiesced in the approach Aero wished to adopt.

152. The issues in relation to disclosure are as follows:

152.1. By reference to the requirements for disclosure of exceptional items, was the disclosure contained in Aero's FY2006 financial statements in relation to the Garuda Transaction sufficient for the financial statements to show a true and fair view? We answer that in the negative.

152.2. If not, did (i) Deloitte and (ii) Mr Clennett fail to act competently with due care and skill in concluding that the disclosure was sufficient for the financial statements to show a true and fair view? If either (i) Deloitte or (ii) Mr Clennett did so fail, in what respects did each fail?

153. Deloitte and Mr Clennett should have advised Aero's management that the Garuda Transaction should be reported in the FY2006 financial statements as an exceptional item incorporating the required disclosures set out above and/or qualified their opinion.

154. We consider that Deloitte and Mr Clennett's conduct in relation to the issue of disclosure fell significantly short of the standards. Accordingly for the reasons set out above we find Allegation 1 proved in relation to the matters pleaded in paragraphs 1.1 to 1.5 of Allegation 1.

ALLEGATION 2 — COST OF SALES AND STOCK VALUATION

155. Allegation 2 provides that in relation to the audit of Aero's financial statements for FY2006 to FY2008, the conduct of Deloitte and Mr Clennett fell significantly short of the standards reasonably to be expected of, respectively, a Member Firm and a Member in that: -

> "2.1 Deloitte and Mr Clennett issued an unqualified audit opinion in each financial year having failed to obtain sufficient appropriate audit evidence from which to draw a reasonable conclusion that Aero's accounting treatment in relation to the stock acquired under the Bulk Purchase Contracts was appropriate, and in particular, that it did not overvalue profits from the re-sale of the stock and/or the stock held at the year end, and failed thereby to act in accordance with Fundamental Principle 4 'Performance' in the Guide to Professional Ethics and (in respect of the audits for the financial years ended 30 June 2007 and 30 June 2008) Fundamental Principle C 'Professional Competence and Due Care' in the Code of Ethics and the Guidance in Section 130 (Paragraphs 130.1(b) and 130.2).
>
> 2.2 Alternatively, if, contrary to the above and to Executive Counsel's primary case, it could reasonably have been expected that a Member or Member Firm would have accepted that a "straight line discount" could be applied in Aero's financial statements to the stocks acquired under the Bulk Purchase Contracts, it could not reasonably have been expected that a Member or Member Firm

would have accepted that Aero's financial statements gave a true and fair view in the absence of a clear statement in them that the policy on acquisition of bulk purchase stock was to allocate the cost across all lines based on a uniform discount from the OEM price of the item, and that consequently Aero reported higher margins in the period following a Bulk Purchase Contract than in the later stages. In so doing, Deloitte and Mr Clennett failed to act in accordance with Fundamental Principle 4 'Performance' in the Guide to Professional Ethics and (in respect of the audits for the financial years ended 30 June 2007 and 30 June 2008) Fundamental Principle C 'Professional Competence and Due Care' in the Code of Ethics and the Guidance in Section 130 (Paragraphs 130.1(b) and 130.2).

2.3 Deloitte and Mr Clennett failed to show sufficient professional scepticism when assessing and following up information which was made available to them by Aero's management and the results of their own audit testing in relation to Aero's accounting treatment of the stock acquired under the Bulk Purchase Contracts, and failed thereby to act in accordance with Fundamental Principle 4 'Performance' in the Guide to Professional Ethics and (in respect of the audits for the financial years ended 30 June 2007 and 30 June 2008) Fundamental Principle C 'Professional Competence and Due Care' in the Code of Ethics and the Guidance in Section 130 (Paragraphs 130.1(b) and 130.2).

2.4 As a result of the above, Deloitte and Mr Clennett failed to comply with the requirements of ISA 200, ISA 500 and ISA 580."

The Standards

156. Relevant parts of Fundamental Principle 4 in the Guide to Professional Ethics and of ISAs 200 and 500 have been set out at paragraphs 43 and 44 above.

157. Fundamental Principle C (applicable to the FY2007 and FY2008 audits) provides that:

> "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."

158. ISA 580, as it prevailed at the relevant time, provided:

> "4. **The auditor should obtain written representations from management on matters material to the financial statements when other sufficient appropriate audit evidence cannot reasonably be**

expected to exist. The possibility of misunderstandings between the auditor and management is reduced when oral representations are confirmed by management in writing...

6. During the course of an audit, management makes many representations to the auditor, either unsolicited or in response to specific inquiries. When such representations relate to matters which are material to the financial statements the auditor will need to:

(a) Seek corroborative audit evidence from sources inside or outside the entity;

(b) Evaluate whether the representations made by management appear reasonable and consistent with other audit evidence obtained, including other representations; and

(c) Consider whether the individuals making the representations can be expected to be well informed on particular matters.

7. Representations by management cannot be a substitute for other audit evidence that the auditor could reasonably expect to be available. For example, a representation by management as to the cost of an asset is not a substitute for the audit evidence of such cost that an auditor would ordinarily expect to obtain. If the auditor is unable to obtain sufficient appropriate audit evidence regarding a matter which has, or may have, a material effect on the financial statements and such evidence is expected to be available, this will constitute a limitation in the scope of the audit, even if a representation from management has been received on the matter.

9. **If a representation by management is contradicted by other audit evidence, the auditor should investigate the circumstances and, when necessary, reconsider the reliability of other representations made by management.**"

The Bulk Purchase Contracts

159. As described in paragraph 9 above the Garuda Transaction, which was the Bulk Purchase Contract accounted for by Aero in FY2006 was different from Aero's subsequent Bulk Purchase Contracts in that in the Garuda Transaction there was a "concurrent" sale of a substantial amount of stock to GMF and there was no long term supply agreement with Garuda following the purchase of its inventory and there was therefore no 'truck stock period'. In the case of the Garuda Transaction, Aero was left holding stock which Garuda did not require for its current fleet, and in respect of which Aero had no supply agreement. As noted in paragraph 9, in FY2007 and FY2008 Aero

concluded further bulk purchase contracts with Qantas, ACTS, Aeroman and ANA. We have described the features of bulk purchase contracts in paragraph 9 above.

SLD as an estimation technique

160. SSAP 9 (applicable in FY2006 and FY2007) provides, at paragraph 4, that:

> "The methods used in allocating costs to stocks need to be selected with a view to providing the fairest possible approximation to the expenditure actually incurred in bringing the product to its present location and condition. For example, in the case of retail stores holding a large number of rapidly changing individual items, stock on the shelves has often been stated at current selling prices less the normal gross profit margin. In these particular circumstances this may be acceptable as being the only practical method of arriving at a figure which approximates to cost."

Paragraph 16 provides that:

> "Cost is defined . . . as being that expenditure which has been incurred in the normal course of business in bringing the product. . . . to its present location."

Paragraph 16 goes on to provide that:

> "*Cost of purchase* comprises purchase price . . . and any other directly attributable costs."

Paragraph 26 provides that:

> "The amount at which stocks are stated in periodic financial statements should be the total of the lower of cost and net realisable value of the separate items of stock or of groups of similar items."

In the Appendix, under the heading "Methods of Costing"

> "11. It is frequently not practicable to relate expenditure to specific units of stocks . . . The ascertainment of the nearest approximation to cost gives rise to two problems:
>
> (a) The selection of an appropriate method for relating costs to stocks and long term contracts.
>
> (b) The selection of an appropriate method for calculating the related costs where a number of identical items have been purchased... at different times (e.g., unit cost, average cost or FIFO).

12. In selecting the methods referred to in paragraphs 11 (a) and (b) above, management must exercise judgement to ensure that the methods chosen provide the fairest practicable approximation to cost."

161. Part of the complaint in Allegation 2 is that Deloitte issued an unqualified audit opinion in each financial year having failed to obtain sufficient appropriate audit evidence from which to draw a reasonable conclusion that Aero's accounting treatment in relation to the stock acquired under the Bulk Purchase Contracts was appropriate, and in particular, that it did not overstate profits from the re-sale of the stock and/or the value of the remaining stock. Executive Counsel contended that Deloitte and Mr Clennett omitted during each of the relevant audits to test the appropriateness of the application and impact of SLD, particularly with respect to Aero's reported profits.

162. Central to the criticism of Deloitte and Mr Clennett was that they did not consider whether SLD provided the "fairest possible approximation" of the cost of bringing the items within each bulk purchase contract to their present location and condition because it did not reflect the fact that Aero might have paid proportionately more of the OEM price for faster moving items than for slower moving items, thus generating very large margins when faster moving items were sold in the early stages of a contract but then recognising reducing margins as Aero had to replace the sold (faster moving) stock with that purchased at near to OEM price whilst the slower moving stock remained on its books. Thus, if the commercial substance of the Bulk Purchase Contracts was that fast moving items were purchased by Aero at a smaller discount from the list or OEM price than the slower moving items, and the effect of SLD was that it applied a larger discount to the faster moving items which did not accord with the commercial reality of the purchase transaction, when Aero calculated its cost of sales and profit on fast moving items, the costs allocated to the fast moving parts should have been higher and the resulting profit lower than that shown in the financial statements. It follows that had higher costs of sales been allocated to fast moving items, the value of stock retained at the year-end would have been reduced.

163. Thus in the Formal Complaint the Executive Counsel asserted:

"36. Aero prepared its FY2006 and FY2007 financial statements under UK GAAP. Accordingly, FRS 5 and SSAP 9 were the relevant standards for the consideration of the substance of transactions and stock valuation:-

(1) FRS 5 states that financial reporting must ensure that the substance of an entity's transactions is reported in its financial statements. The commercial effect of the entity's transactions, and any resulting assets, liabilities, gains or losses should be faithfully represented in its financial statements.

...

37. In FY08, Aero prepared its financial statements under IFRS. ...

> (1) IAS 1 [as it prevailed at the relevant time] states that financial statements shall present fairly the financial position [and] financial performance ... of an entity.
>
> ...
>
> (3) The IASB Framework document [as it prevailed at the relevant time] provided at paragraph 35, that in order to faithfully represent transactions, "it is necessary that they are accounted for and presented in accordance with their substance and economic reality and not merely with their legal form."

164. Deloitte and Mr Clennett recognised the importance to Aero's FY2006 Accounts of revenue recognition deriving from the bulk purchase contracts. The Strategic Audit Plan (workpaper 1130) (which was reviewed by Mr Clennett) identified such revenue recognition as a "Specific Identified Risk" under the heading "CONSIDERATION FACTORS THAT AFFECT THE STRATEGIC AUDIT PLAN" and sub heading "Critical judgment areas".

165. It was the application of the SLD methodology which enabled Aero to post a large profit on the Garuda Transaction.

166. Deloitte appreciated that the cost of £3.6m initially allocated to the stock being bought from Garuda and concurrently sold to Garuda's 99% subsidiary for £12.4m was calculated by applying SLD. The Audit Summary Memorandum recorded:

> "Garuda: At the end of the year, the Company entered into an agreement to purchase approximately $34 million (circa £18.3 million) stocks from Garuda of which approximately £3.6 was subsequently sold to GMF resulting in a balance of £14.7 million parts in inventories. The Company had performed a bulk allocation of the cost for each of the parts based on the OEM price.
>
> Summary of calculation:
>
> 1) The OEM price for each of the stocks was obtained.
>
> 2) Total cost of the stocks was divided by the total value of the stocks based on the OEM Price to obtain an estimated margin.
>
> 3) Subsequently, the cost value is pro-rated amongst each of the parts based on the OEM price less the estimated margin.

> We have reviewed the calculation and are reasonably assured the allocation method is fairly reasonably [sic]. We have also obtained a confirmation from GMF and Garuda on the amount outstanding from each parties."

167. Mr Baker annotated the reference to "£3.6", on 4 September 2006:

> "Is this right? Seems like a low number"

In response to Mr Baker's question, someone wrote "Yes based on calculation" and Tiara Kok wrote: "Pending supporting to verify the cost allocation and also the stock listing on the sale of goods to GMF".

168. The Respondents submitted that there is a distinction between (a) allocation of cost and (b) making a provision and contended that the rates of saleability of individual items of inventory play no part in cost allocation. They contended that the accountancy principle is that the cost of stock is not adjusted to reflect rate of sale or the carrying cost of capital tied up in stock. Cost is only adjusted where necessary to ensure that it is brought into a balance sheet at the lower of cost or market value and if obsolescence needs to be addressed. They criticised Mr Meredith's approach which took into account the rate of usage of stock on the grounds that, as they contended (i) he looked at costs from the perspective of some subjective evaluation process undertaken by Aero and not from the objective terms of the agreement between (in the case of the Garuda Transaction) Aero and Garuda and (ii) his evaluation process involved some estimation of the likelihood, timing and result of future transactions.

169. In summary, the Respondents' contention was that the process of allocating the cost does not concern the revenue producing characteristics of the stock item in separate, future transactions. It does not concern post-acquisition actual or potential changes in the inherent saleability of the stock item or its potential sale price. Instead, it asks a single, simple question of principle: how much was paid to buy this item of stock? For Aero, the preparers of the financial statements were thus obliged to determine the historic cost (or the nearest approximation to such cost) of each and every item of stock acquired as a bulk package from each of Garuda and Qantas (for FY2006 and FY2007); the same is true for the later bulk acquisitions from ACTS, Aeroman and ANA (in FY2008). That, the Respondents contended, was what SLD did.

170. Implicit in the Respondents' submission is that the cost of an item is the cost of the item as evidenced by the agreement under which the item was acquired. However the cost of an item cannot always be ascertained from the terms of the agreement under which it was acquired. Hence the provision under Method of Costing in SSAP 9 set out above.

171. In answering the question how much was paid to buy this item of stock one may have to examine the intentions of the buyer. As SSAP 9 provides:

> "The methods used in allocating costs to stocks need to be selected with a view to providing the fairest possible approximation to the expenditure

> actually incurred in bringing the product to its present location and condition."

In the case of a bulk purchase of stock, some of which might be of immediate use to a purchaser, for example, by way of immediate resale, and other stock might have to be retained by the buyer for a considerable time, a buyer might well be willing to pay a higher proportion of OEM price for that stock which he can immediately sell on. That is how one would expect a businessman to act. That accords with the evidence of Mr Allen who said in the course of cross examination:

> "if I'm an auditor, I would expect the client to have done a considerable amount of analysis before they spend $34 million to buy stock. So when I get a note [i.e. the Garuda Explanatory Memo] that says they have done a considerable amount of analysis, that is what I would expect them to have done ... The analysis would be done – would be from a commercial point of view, "How much do I think I want to pay for this stock?", and they would do a lot of analysis. They said that they did. One of the assessments that they did, because they say [in the Garuda Explanatory Memo] "included", is the likelihood of stock being consumed in a reasonable timeframe."

172. That contrasted with the understanding of Deloitte and Mr Clennett as a result of representations from management which was to the effect that the basis upon which Aero would seek to agree the price for a bulk purchase of stock was "a complete list of the parts that they're buying and then a valuation of those parts" and that Aero would then seek to obtain a discount of 50% or more on that valuation. Deloitte's and Mr Clennett's understanding appears counter-intuitive in the light of the approach one would expect a commercial buyer of bulk stock to take and in the light of the Garuda Transaction which highlighted the consequences of applying SLD by producing a substantial profit and raised the question whether the acceleration of profit was excessive.

173. The Respondents contended that a factor in favour of the application of SLD was that it removed subjective judgment of the directors as to what they had paid for the stock and thus reduced the scope for manipulation. Thus, they contended that subjective considerations of worth, obsolescence, the rate of usage and the cost of financing should not be taken into account. But SSAP 9 itself provides that judgement was required by providing that management must exercise judgement to ensure that the method chosen to allocate expenditure to specific units of stock provided the fairest practicable approximation to costs. Thus the fact that a method of allocating costs requires the exercise of judgement by management does not invalidate it. SSAP 9 requires such an exercise. Secondly, insofar as the Respondents sought to contend that SLD avoided the exercise of management judgement that was incorrect. If SLD was used it involved the inference that management considered that SLD gave the fairest approximation to costs; that was the exercise of management judgement. Mr Allen accepted that SLD required

an assumption that all the stock would eventually sell. That is but one example of a subjective assessment by management involved in the adoption of SLD. Another is that SLD provided the fairest possible approximation to the expenditure actually incurred.

174. Deloitte and Mr Clennett were aware that SLD could have the effect of accelerating profit and that earnings could be distorted if Aero purchased inventory it could not sell. Furthermore, they knew that the Garuda stock being sold on by Aero to GMF was the stock Garuda required to service its aircraft. The draft board minute of the 4 October 2006 board meeting sent to Mr Baker the following morning (5 October 2006) said "The material purchased by GMF all represented parts for current Garuda aircraft types." Deloitte and Mr Clennett should have asked to see the analysis referred to in the Garuda Explanatory Memorandum prepared by Aero in calculating the price it wished to pay for the Garuda stock and checked that the inventory retained by Aero in the Garuda Transaction would sell as Aero was telling Deloitte it would do as part of its business of supplying other airlines. However there was no evidence that any analysis was carried out by Deloitte or Mr Clennett as to the possible usage of the Garuda inventory retained by Aero. Subsequently Mr Meredith did analyse the inventory retained by Aero and his analysis confirmed that of the parts retained by Aero the majority, both by number of lines and OEM value, related to aircraft no longer operated by Garuda. Had Deloitte carried out such an analysis in the course of the audit it would have led to an understanding of the possible problem Aero might face in disposing of stock and also called into question the profit attributed to the sale to GMF which depended on the SLD attribution of cost. Mr Meredith used material prepared by AIMS (an entity which might not have been entirely reputable) as providing information as to the identity of the Garuda fleet of aircraft. No evidence was produced to show that part of the AIMS data was not correct. In not asking for the analysis carried out by Aero of the Garuda stock or questioning Aero management as to the basis upon which Aero fixed the purchase price of the Garuda stock Deloitte and Mr Clennett fell significantly short of the standards and demonstrated a lack of scepticism.

175. Mr Baker and Mr Clennett each said on a number of occasions that the making of large margins on fast selling items at the beginning of a contract was not a problem because, once the whole of the stock had been sold, the same margin would have been made regardless of which cost estimation technique had been used. This is correct in the long run and assuming that all the stock could be sold at the same profit margin. However, the consequence was that Aero was apparently generating unusually large profits at the outset of a contract, as it sold back to the customer for a price close to OEM which in its accounts it claimed it had just bought from the customer for a substantial discount from the OEM price. These ostensible profits at the outset of the contract quickly tailed off: for example gross profit on Qantas in the first year (FY2007): 61 per cent. Gross profit on that contract in the second year (FY2008): 29 per cent. That was the reason why in order to sustain its reported profit margins over the period in question Aero had to enter a new and bigger bulk purchase contract each year and keep accounting in the

same way for the cost of the items bought in that contract. Aero could not repeat this in 2009 as the banks were not prepared to lend yet more money (to fund another bulk purchase), and Aero having not sold the large quantities of slow moving stock which it held went into administration. Accounts are prepared on an annual basis and are intended to "aid users in understanding the performance achieved by a reporting entity in a period and to assist them in forming a basis for their assessment of future results and cash flows": FRS3 under the heading "objective". Accordingly the Tribunal was surprised at the assertion that so long as the total profits were realised under a contract at some time, the acceleration of profit into "year 1" was not a matter of concern. If profit was being accelerated and there was a fairer way of allocating costs so that the financial statements presented a fairer view one would expect that course to be followed; otherwise the financial statements would not be true and fair for the period.

176. The Garuda Transaction illustrated the effect of Aero's application of SLD. The application of SLD to the stock purportedly purchased for $34m depended on it being fair to allocate cost uniformly over the OEMs of (a) parts sold to GMF and (b) parts retained by Aero. The concurrent bulk sale by Aero to GMF was evidence of the fair value of the stock sold to GMF: $23m. Aero's taking of a profit initially anticipated to be $16.3m (subsequently increased to $18.2m on 3 October 2006, by revision of the OEMs so that the cost allocated to the parts sold to GMF was revised downwards from $6.7m to $4.8m on that sale) depended on an allocation of cost under which it said that it had concurrently bought that stock for $6.7m (with the rest of the stock, for aircraft not in Garuda's fleet, being allocated the rest of the purchase price, i.e. $27.3m). That "straight line" allocation of cost implied that just as the stock sold to GMF had been bought for $6.7m and sold for $23m, the remainder of the stock, bought for $27.3m, could itself be sold for some $94m.

177. Mr Allen agreed that "the [SLD] accounting policy leads to an acceleration of profit". However his evidence was that in selecting an accounting policy for bulk stock acquired in a single purchase transaction at a global price Aero would be looking for a justifiable method to allocate its expenditure on any one bulk item. The evidence of Messrs Dodge and Pabari (former Aero employees) was to the effect that when preparing to negotiate with a prospective seller of bulk stock Aero classified the stock into "fast moving" and "slow moving" categories and assessed the value in the light of the classification with fast moving stock having a value closer to OEM than slow moving stock. Having assessed an overall value to the stock it then embarked on negotiation putting forward an aggregate price without revealing how it had reached that price and how it reached the price it eventually agreed to pay. Notwithstanding that approach, and assuming that Deloitte and Mr Clennett were told of that approach, Mr Allen concluded that SLD was the appropriate method of allocating the price paid for the stock. He was concerned that an approach that took into account the timing of the sale of stock appears to be taking into account the worth of the stock which was only relevant when considering the value of inventory for the purpose of a company's financial statements. In his view the auditor did not need to consider how the bulk purchase contract was negotiated or

the likely usage of the stocks held. Neither, in Mr Allen's view, did the auditor need to consider the impact of the policy on reported profit, even as an indicator of whether the accounting treatment is according with the commercial substance of the transaction.

178. We do not accept Mr Allen's evidence. If Aero was assessing the value of the stock to ascertain the price to pay by reference to different lines' rates of usage, then that valuation (taking into account an assessment of rate of usage) was a factor to take into account in assessing what Aero paid for it.

179. For the same reasons we do not accept Mr Allen's reservations as to the use of a Differential Discount Method ("DDM"), i.e., a different discount linked to the rate of usage. There is no question of the value being "locked in" for a future assessment of Net Realisable Value as suggested by Mr Allen at paragraph 6.3.8 of his first report. So far as Mr Allen's concerns as to objectivity of the exercise are concerned, DDM is not inherently less objective than SLD because the adoption of SLD involves the exercise of judgement as described above. The price which Aero agreed to pay for the bulk stock was the result of a number of subjective assessments by Aero.

180. Mr Meredith stated in his Second Report that had the cost of bulk purchase stock been allocated to individual items purchased consistently with the way Aero had assessed the market value and thus the purchase price it would, in his opinion, have reflected the commercial substance of the transaction and complied with the requirements of Accounting Standards. Mr Allen criticised Mr Meredith's approach in his Second Report at paragraph 4.1.1 where he wrote "Mr Meredith refers to a concept of 'commercial reality'. He appears to be suggesting that this is a concept identified by Accounting Standards (and see also the similar suggestion at paragraphs 1.24 and 1.26 (second bullet point) of his second report). There is no such concept recognised in Accounting Standards".

181. Mr Allen recognised in paragraph 6.3.12 of his first report that accounting policies should choose substance over form but stated that that principle "is directed to avoiding the use of contrived legal terms to misrepresent the substance of a transaction. It does not endorse the selection of accounting policies based on management's subjective view of commercial substance". Mr Allen's view of the concept of substance over form was overly narrow.

182. The concept of commercial reality is at the heart of accounting standards. For example, paragraphs 33 to 35 of the IASB's Framework for the Preparation and Presentation of Financial Statements (as it prevailed at the relevant time) serve as a useful reminder of the principles:

> "**Faithful Representation**
>
> 33. **To be reliable, information must represent faithfully the transactions and other events it** either **purports to represent** or could reasonably be expected to represent. Thus, for example, a balance sheet

should represent faithfully the transactions and other events that result in assets, liabilities and equity of the entity at the reporting date which meet the recognition criteria.

34. Most financial information is subject to some risk of being less than a faithful representation of that which it purports to portray. This is not due to bias, but rather to **inherent difficulties** either in identifying the transactions and other events to be measured or **in devising and applying measurement and presentation techniques that can convey messages that correspond with those transactions and events**. In certain cases, the measurement of the financial effects of items could be so uncertain that entities generally would not recognise them in the financial statements; for example, although most enterprises generate goodwill internally over time, it is usually difficult to identify or measure that goodwill reliably. In other cases, however, it may be relevant to recognise items and to disclose the risk of error surrounding their recognition and measurement.

Substance Over Form

35. If information is to represent faithfully the transactions and other events that it purports to represent, it is necessary that they are **accounted for and presented in accordance with their substance and economic reality** and not merely their legal form. The substance of transactions or other events is not always consistent with that which is apparent from their legal or contrived form. For example, ..."

183. In his oral evidence Mr Allen said that:

> "Commercial reality is when you ... it's when management have their view as to the substance of a transaction and accounting standards don't allow management to just choose their own subjective view of commercial substance, which might differ from management to management, when they come to accounting for common transactions or common balance sheet items.
>
> The concept of substance over form I think is a readily identifiable subject which says that you should not contrive to misrepresent a transaction by avoiding recording a transaction or creating an asset when you haven't actually transferred an asset. It is that substance over form concept that I recognise, but I don't believe that substance over form concept means that there is this idea of commercial reality which says that, "If I, as management, have a subjective view about something, then I'm perfectly entitled to account for it that way". "

And that:

> "I disagree [that there is nothing wrong with Meredith II paragraph 1.24] because that paragraph is making reference to this particular spreadsheet and the fact that the spreadsheets were the management's view of usage and the fact that they might apply a certain value to some kind of fast-moving items than to items which didn't move as fast. So that was their commercial view as to how much they were prepared to pay. That's my point."

184. Mr Clennett himself appeared to accept that the financial statements should reflect commercial reality when he said in relation to SLD:

> "It was well-known and an inevitable consequence of the fact that Aero achieved greater discounts from OEM on bulk purchases than it did when buying individual parts from suppliers that, over the course of time as bulk purchase stock was consumed and replacement parts had to be acquired from suppliers at a lesser discount, Aero's margins on individual part lines would fall. However, that does not demonstrate that the straight-line discount methodology of allocating cost across bulk purchase stock did not reflect the commercial substance of those bulk purchase transactions."

185. Mr Allen's opinion as to commercial substance appears to be inconsistent with the Respondents' defence which pleads that:

> "They recognised the need to explore ... whether another accounting treatment, in place of SLD, might better reflect the commercial substance of the Bulk Purchase Contracts": Defence paragraph 15.2

and that Deloitte and Mr Clennett "did explore [that] with Aero's senior management". They say that they:

> "formed the view that ... [t]he application of the SLD accounting method to derive the cost of acquisition of the Qantas Truck Stock was consistent with the commercial substance of the transaction": Defence paragraph 190.1.

and, in relation to the Qantas bulk purchase in FY2007, that:

> "Deloitte and Mr Clennett reasonably and appropriately formed the view that the SLD accounting method reflected the commercial effect of the transaction": Defence paragraph 218.

and, in relation to the ACTS bulk purchase in FY2008, that:

> "Deloitte and Mr Clennett formed the view that ... [t]he application of the SLD accounting method to derive the cost of acquisition of the ACTS Truck Stock was consistent with the commercial substance of the transaction.": Defence paragraph 218.1.

and, in relation to Aeroman in FY2008, that:

> "Deloitte and Mr Clennett ... had sufficient audit evidence to consider that the SLD method did appropriately reflect the commercial effect of that contract as they reasonable *[sic]* perceived it to be.": Defence paragraph 209.1.

186. We consider that Mr Allen's opinion misses the point. Aero's basis for assessing the market value and hence the price it was willing to pay represented commercial reality. The purchases were at arm's length. If the commercial reality was that Aero's management had fixed the price they were willing to pay for stock by reference to considerations of worth, rate of usage, obsolescence and the cost of finance, the product of those deliberations represented the substance and economic reality of the transaction. Any purchase by a purchaser requires the purchaser to assess what it is worth to him even if he uses "objective" data such as OEM as part of the process. If management's considerations as to how to fix the price are taken into account that ought to lead to more accurate financial statements not less. The objective versus subjective issue is not determinative of the appropriate accounting policy and is illusory because any price fixed by a buyer and seller depends on their subjective assessments of the price at which they are prepared to buy and sell. To the extent that an auditor has to rely upon management's assessment of how it arrived at a price as opposed to third party audit evidence, so the auditor needs to be on guard against management override. However management's negotiating position is a question of fact which in the ordinary course of events should accord with the substance and commercial reality of the transaction which is under review. If necessary the auditor can examine any written material produced by management for calculating the price it wishes to pay.

187. IFRS 3, as it prevailed at the relevant time, requires that:

> "4. When an entity acquires a group of assets or net assets that does not constitute a business, it shall allocate the cost of the group between the individual identifiable assets and liabilities in the group based on their relative fair values at the date of acquisition".

That appears to be consistent with the approach adopted by Mr Meredith particularly when one takes into account the definition of "fair value" as

> "The amount for which an asset could be exchanged or a liability settled, between knowledgeable, willing parties in an arm's length transaction".

188. The evidence showed that, not surprisingly, Aero did take into account the rate of usage in calculating the price it was prepared to pay for a bulk purchase of stock and that the level of discount increased the longer the stock was likely to take to sell.

189. On or about 7 September 2006 Deloitte was provided with the Garuda Explanatory Memo which stated, among other things, that, "The value to be paid for the stocks has

been arrived at after considerable analysis, including an assessment of the likelihood of stock items being consumed in a reasonable timeframe." This was inconsistent with the Garuda Stock Allocation Memo (w/p 5490) which recorded that the same margin had been "used across the board due to limited information from the initial purchase [which] is consistent with the method used with the allocations performed for the previous customers". When asked whether he asked to see the analysis referred to in Mr Bevan's Memo, Mr Clennett's response was:

> "I thought – well I don't recall the detail of this one sentence, but when we asked for the analysis of cost of the inventory budget and were given detailed spreadsheets and an OEM list, I don't – I wouldn't necessarily read into this what you can read into it with the benefit of hindsight, but we thought that — and certainly if you're identifying all the parts, then they are therefore current and therefore consumable.
>
> If there is a suggestion that says there's something we should have asked for that we didn't ask for – and we asked for things all the time. I can't remember exactly what we asked for all the time, but when you're told that: you've got it, this is the list, this is our analysis, and then you're probably going to take that at face value unless you believe they're being dishonest.".

190. The stock lists did not provide any analysis of the likelihood of stock items being consumed in a reasonable timeframe and therefore could not have been what Mr Bevan was referring to in his memo. Mr Allen accepted this.

191. Mr Lewin had told Mr Clennett that Aero could not identify precisely which items of Garuda retained stock would sell and when they would sell. Mr Clennett said that, if he had been told before receipt of this memo that Aero could not undertake an assessment of the likelihood of stock items being consumed in a reasonable time frame and had then received the Garuda Explanatory Memorandum then "that would definitely have rung alarm bells". There is no reason why the position should be any different whether the representation by Aero as to whether it could undertake the relevant assessment was made before or after provision of the Garuda Explanatory Memo.

192. The reference to an analysis involving an analysis of usage accorded with what Mr Allen expected as he said in evidence in the passage quoted at paragraph 171 above. There was other evidence to the effect that Aero took into account that usage was relevant including the reference in a Due Diligence Report prepared by BDO dated 28 December 2007 which Mr Bevan confirmed was correct, the evidence of Messrs Dodge and Pabari in the course of interviews with the Accountancy and Actuarial Disciplinary Board and in various emails in relation to a prospective purchase from Cathay Pacific sent between various Aero personnel such as Graham Air's email of 5 July 2006 to Martin Dodge, Andrew Pye's email dated 10 July 2006 to Mr Bevan and Andrew Pye's email dated 11 July 2006. There was also other evidence to similar effect in relation to

a proposal to United Airlines. In a contract between AI and ACTS retained on Deloitte's 2008 Audit File, section 38 provided that AI was to purchase additional inventory. The price was to be fixed by reference to a formula to be paid by ACTS. One of the components of the formula was "years usage of stock".

193. There was no contemporaneous evidence on the audit files that Deloitte and Mr Clennett asked Aero how it valued the stock it was buying for such very material sums, or considered whether SLD was an appropriate method. Mr Clennett gave evidence that Mr Lewin had told him in the context of the Garuda Transaction that "Mr Lewin said it was one agreed price. I asked him how the price was determined and he said "We evaluate the parts at OEM and attempt to get whatever discount. Typically, we would like to get at least 50 per cent discount across the whole OEM price"". He also said he had no recollection of any discussion as to the relevance of fast or slow moving parts and had no such discussion with Mr Dodge in relation to purchases such as those from Qantas, ACTS or ANA. Mr Clennett's view was that the relevance of the speed at which parts might be disposed of was resolved by considering whether the "parts are valid parts".

> "Q. When it comes to SLD, the straight line discount, is this a fair conclusion, Mr Clennett: that based on what you say you were told by Mr Lewin, you didn't think to test, carry out audit tests on the appropriateness of straight line discount. Rather, what you tested was, or sought to test, was the consistency of its application. Is that fair?
>
> A. Well, the appropriateness, the test of appropriateness is: does it comply with the accounting standard?, in the first instance and on the basis of the data we had, it seemed to me a pretty, you know, logical basis, you know, on which to apply inventory over a very large project.
>
> So to test, to do some alternative test on reasonableness, you need some data to test it against, which we didn't have, and so there appeared to be no other basis.
>
> Q. All right. You didn't have it –
>
> A. And we did know it was – well you know, it was obviously, we were told that it was their past practice as well and we've now seen the Horwath Clark Whitehill which confirms that.
>
> Q. You didn't have data but, as I said at the start of this sequence of questions, we don't find you actually making a specific request for the data that was used at the point of negotiation of these contracts?
>
> A. Well, we did ask for the data. We were given inventory, we were given the cost listings and we were told that was how it was achieved. That's what we were told. If you're making a reference to, can we ask

for some other data which we don't know exists, when you ask for all the data, you would expect to be told it. I mean we are talking about a public company here and, you know, if there's relevant audit evidence or if there's something else out there, then we would expect to be given it. "

194. There is no written contemporaneous evidence of a request for "data" used as a basis for calculating the amount to offer for a bulk purchase. No such request was made in writing to Aero and no evidence of a request or follow up request appears in the audit file. Mr Clennett did not refer to such a request in his witness statement. Mr Baker did not refer to such a request in his witness statement and when asked if he could remember any discussion on the possibility that SLD would accelerate profit or on the relevance of the speed with which stock might sell could not recall any such discussion. Indeed, it appeared that he still considered that the issue was of peripheral relevance as he emphasised that "over the life of the contract the absolute profit in dollar terms will not change" which overlooked the fact that companies account on an annual basis. Mr Clennett appeared to support that view when in response to a question as to whether Deloitte would need to understand something about rate of usage of the parts in seeking to allocate cost to those parts, Mr Clennett stated that:

> "if you are buying the inventory from an airline, you will have a whole mix of inventory. You have some fast one [year], you have some fast another. The key point was making sure that it was all current, so it was all going to be usable and therefore it could be fed into the contract at some point in the future."

195. In response to a question from the Tribunal, in the context of FY2008, whether the large margins in the early stages of bulk purchase contracts prompted him to think about whether the SLD method was correct, if it was having this result, Mr Clennett answered:

> "A. Well, that then relates into – that then relates into whether you will have inventory that you can't sell, so you've obviously got to allocate your cost. If you end up with items, I think even – as you can see from the Horwath Clark Whitehill memo, if you end up with items that you can't sell or that are slow moving, that won't be sold, then potentially, you need a provision and those were the sorts of discussions that I was having with Rupert Lewin, saying: why don't we apply a bigger discount, for example, on the opening stock and build up a bigger provision? And that was one method of doing it. So those are the kind of discussions we were having. Not that straight line discount was not an appropriate methodology over –
>
> THE CHAIRMAN: So your answer to my question is: no, it didn't prompt you to think about the straight line discount in itself, the amount of the discount or anything like that?

A. No. As I said, that was – it seemed a fairly logical way of assessing a pot of inventory, when you don't know exactly what's going to happen with bits of it. "

However from the context of his reply to Executive Counsel's counsel he made it plain that the question of early substantial profits was an issue Deloitte and he had had to face in FY2006 and FY2007 and that

"... the conclusion we reached was that the accounting policy adopted by Aero, the fact that they were buying inventory cheaply and selling it upfront, there was no sort of accounting mechanism for saying: that's not a profit. It should be spread over the life of the contract..."

196. Almost no audit work was done on the issue whether all the stock would eventually be used. Two of the questions on "Understanding of the transaction" which Tiara Kok, as field manager of the audit, raised with Martin Dodge on 25 August 2006 (and which Mr Allen lists as "requests [including] material that is of relevance to the Garuda/GMF transactions") were:

"Understanding of the transaction

1) What customers are to be serviced in the future for the Garuda stocks?

2) What types of aircrafts are these parts servicing?"

197. Sarah Pardington's answer on 4 September 2006, in which she renumbered the questions as part of answering the "remaining audit outstanding questions" and gave her answers in red text, was:

"5. What customers are to be serviced in the future for the Garuda stocks?

5a. All customers where parts are common and required as well as ad-hoc demands, and general sales.

6. What types of aircrafts are these parts servicing?

6a. B-747-400, A-330-300, B-737-800, B-737-400, B-737-300, B-737-500"

198. Those answers were filed as workpaper 5490C and transferred into the Garuda Stock Allocation Memo, workpaper 5490:

"According to the client, the parts purchased are consumed in B-747-400, A-330-300, B-737-800, B-737-400, B-737-300, B-737-500 which

is thus transferable to other customers which demand common parts and also ad-hoc sales to other smaller customers."

199. However, aside from recording the client's statement, there is no evidence that Deloitte and Mr Clennett tested what they were being told. Unlike in relation to the later Bulk Purchase Contracts, where the whole of an airline's inventory was acquired and a long term agreement entered into to provide inventory services to that airline, the Garuda Transaction was notable in that Aero acquired stock from Garuda which was not the subject of any ongoing servicing agreement and was stock which GMF (who serviced Garuda) and Garuda did not want. Aero attributed a cost of only $4.8m to the parts acquired from Garuda which related to Garuda's current aircraft, which it concurrently sold to Garuda's 99% subsidiary for $23m, and attributed the balance of the $34m it paid to Garuda (i.e. $29.2m) to the parts for aircraft not flown by Garuda, none of which Deloitte had sampled or seen or tested for traceability to ascertain whether they could realistically be sold elsewhere. An analysis of the stock retained by Aero was clearly material to whether it was a credible proposition that it could be sold for some $94m (as described in paragraph 176 above (let alone the higher figure which was inherent in the reallocation of the cost on 3 October 2006)). Mr Meredith gave evidence to the effect that the fact that Garuda no longer wanted some of the stock and was willing to sell the entirety of its stock at a 70 per cent discount to OEM was an indication that the stock it did not wish GMF to acquire was slow moving stock or possibly obsolescent stock which might relate to aircraft no longer in service (at least with Garuda). That was the sort of consideration which should have occurred to Deloitte and Mr Clennett and was not considered by them.

200. Mr Meredith did further work to investigate the relationship between the parts sold to GMF and the Garuda stock retained by Aero and the aircraft in service with Garuda and concluded that the parts sold to GMF did relate to aircraft in service with Garuda and the parts retained by Aero did not, raising the question of where Aero would sell these parts. Albeit that he was subjected to a sustained attack in the course of cross examination as to the sources he had relied on (material from a document produced by AIMS) no evidence was adduced to contradict his conclusions.

201. Furthermore, stocks for aircraft need a certificate to identify the manufacturer and its age. No audit work was done on retained stock to ascertain whether certificates were available. The fact that a process might be implemented to obtain replacement certificates does not answer the point.

202. The 'data' with which Mr Clennett says Deloitte was provided upon request comprised "cost listings" (i.e. lists of OEM prices) together with an explanation that Aero attempted to negotiate a discount of around 50 per cent off the list price. There is no suggestion, or contemporaneous evidence, that Deloitte and Mr Clennett pressed Aero's management to explain how they could negotiate the pricing for such substantial contracts without performing some analysis of the likely usage and saleability of the stock to be purchased. Deloitte and Mr Clennett appear to have accepted that there was

no other data since they did not make further efforts to obtain it despite the fact it should have appeared probable that such data existed. This is consistent with Mr Clennett's evidence, set out above, that "That's what we were told ... when you ask for all the data, you expect to be told it. I mean we are talking about a public company here and, you know, if there's relevant audit evidence or if there's something else out there, then we would expect to be given it".

203. Deloitte's and Mr Clennett's acceptance of the apparent lack of data is to be contrasted with the evidence of Mr Allen quoted at paragraph 171 above and in his Second Report at paragraph 4.1.17 which stated he was:

> "not surprised to learn that Aero produced spreadsheets such as those now referred to by Mr Meredith [produced by Aero in the context of the ACTS Transaction]. Such spreadsheets were a reasonable exercise for Aero to perform as part of its preparation for negotiations with the sellers of bulk stock and its internal assessment of the price it might be prepared to pay, and possibly as a negotiating tool for disclosure to the seller. Indeed, in interview Mr Dodge and Mr Pabari seem to describe such a process."

He then added that that type of assessment is directed towards "worth" rather than cost which we do not accept for the reasons set out in paragraphs 177-178 and 186 above.

204. On this basis, Deloitte and Mr Clennett, like Mr Allen and Mr Meredith, should have been expecting there to be usage analysis spreadsheets produced by Aero in relation to their bulk purchase negotiations and should have asked to be supplied with copies of them.

205. It is clear that Deloitte and Mr Clennett were misled by Mr Lewin as to the manner in which Aero fixed the price at which it was prepared to purchase stock. However this was an area where Deloitte and Mr Clennett should have expected there to be more documentation and the explanation proffered by Mr Lewin did not, on its face, appear to accord with commercial reality. They should have asked to see the data that they were told existed such as the analysis of the Garuda Stock and the historical usage data acquired from Qantas and ACTS. Historical data can provide information as to future use particularly in the case of planes if the planes continue to be used by the customer. Certain parts will be required at regular intervals. In not asking for it Deloitte and Mr Clennett fell significantly short of the standards and demonstrated a lack of scepticism consistently with their failure to explore in detail with Aero management the manner in which Aero calculated the price which it was prepared it was prepared to pay for stock in a bulk purchase.

206. The Respondents submitted that the tribunal had to be satisfied that no reasonably competent auditor could have held the opinion that Aero's use of SLD in FY2006-FY2008 to allocate the cost of stock acquired in a bulk purchase was acceptable. In that regard they refer to the Horwath Clark Whitehill ("HCW") memorandum in 2004,

the work of Mr Mucai and Ernst & Young's technical team in the summer of 2006, and Ernst & Young's technical work in 2006 and 2007 as showing that reasonably competent auditors could have shared the Respondents' opinion. We deal with this argument below; however we note that Deloitte and Mr Clennett did not consider whether SLD was an appropriate accounting treatment.

207. The HCW Memorandum provided (emphasis added below):

> "[Aero's] accounting policy is:
>
> Stocks are valued at the lower of cost . . . and net realisable value after making due allowance for obsolete and slow-moving stocks. Cost is calculated by averaging purchase prices and by reference to supplier list prices adjusted to reflect discounts obtained where appropriate. The company regards stock as slow-moving where it is unlikely to be sold within the periods of its various long-term inventory management contracts.
>
> This was refined last year as follows:
>
> . . .
>
> [Aero] expects to carry two main categories of stock in their balance sheet at 30 June 2004. Firstly, the company will continue to carry the stock required to meet to meet their obligations under the various contracts they have with HAECO . . . Secondly they will be carrying stock required under their new contract signed on 1 December 2003 with SR Technics . . . The company also carries other stock for its UK customers at standard costs.
>
> As part of the valuation of stock, management need to consider not only the method employed to arrive at the cost of stock items, but also the level of overheads carried in stock, the treatment of "bulk" purchases during the year, and the need for provisions against slow-moving, obsolete or surplus stock.
>
> We consider that the matters outlined in this paper comply with current accounting principles and provide a suitable basis for [Aero] to report its results. Given, however, that the company is expanding rapidly and enters into individual contracts, <u>its stock valuation procedures should be regularly reviewed to confirm that these remain appropriate.</u>
>
> ...
>
> 4.1 Allocation of contract price

During the six months ended 31 December 2003, the company purchased stock in bulk from SRT as part of its new contract with that company. This stock was purchased at about a 50% discount to its selling price.

Conceptually, the preferred method of accounting for such a bulk purchase would be to allocate the total cost across the stock purchased on a line by line basis. In such a case, total cost would be spread over those lines which are re-sellable, with a nil cost allocated to obsolete or unsellable lines or those which are surplus to requirements.

Due to the lack of relevant data, in this instance and all previous instances of "bulk" purchase, Aero Inventory has allocated cost across all the bulk purchased stock on a pro rata basis. This has the effect of allocating a lower cost to sellable stock lines than would be the case under the preferred method (noted above), and a cost (where none is allocated under the preferred method) to obsolete or slow moving stock.

The result of the adopted methodology is to produce a higher margin on sold items than would be the case if cost had been allocated on a line by line basis. It also has the effect of including surplus stock in the balance sheet at a value, when it should be carried at nil. In the long term, the level of overstatement of gross margin is equal to the overstatement of surplus stock.

The adopted treatment remains acceptable as long as the higher margin produced by the sale of these lines does not distort reported earnings. This means that appropriate provisions for surplus or obsolete stock need to be made (see paragraph 5.1) unless it can be demonstrated that no provisions are required.

[Hugh Bevan] does not believe that the SRT bulk purchase includes any obsolete or slow-moving stock. If this is demonstrated to be true, and the parts purchased are all sellable at above the price at which they are included in stock, then no provision is necessary.

...

5.1 Provisions

In previous years the company has not made any provision against the cost value of stock on the following grounds:

(i) the various sales contracts were expected to continue beyond their initial term,

(ii) the company expected its customers to buy back certain stocks once the sales contract reached its term (if not renewed),

(iii) the company is able to sell parts to alternative customers, outside of the main sales contracts.

In addition, it was deemed too early in the HAECO contract to be able to estimate the level of potential excess stock carried by the company (because usage patterns and statistics had not been sufficiently long established to make long term supply need projections). "

208. The Respondents rely upon this memorandum as showing that another accountant had considered SLD and not rejected the use of SLD as a matter of principle. They submit HCW expressly approved it in the case of Aero with the caveat that SLD had "the effect of allocating a lower cost to sellable stock than would be the case under the preferred method . . . and a cost (where none is allocated under the preferred method) to obsolete or slow moving stock."

209. It is unclear whether the Respondents saw this memorandum as it may not have been in HCW's audit files as it may not have been produced in the course of an audit as opposed to being a note of advice. Mr Clennett's evidence (which we accept) was that he had not seen it.

210. There are a number of matters to note on the HCW Memorandum.

210.1. First, it is clear that HCW had recognised the risk that applying SLD to estimate the cost of items within a bulk purchase would have the effect of allocating a lower cost to sellable stock lines than would be the case under the preferred, line by line, method. They concluded that SLD was acceptable as long as the higher margin produced by the sale of sellable lines did not distort reported earnings;

210.2. Secondly, it is predicated on the basis that there was a lack of relevant data, i.e., data that would differentiate the cost of the various lines; but for the lack of data, the preferred method of accounting for such a bulk purchase would be to allocate the total cost across the stock purchased on a line by line basis;

210.3. Thirdly, it warned that given that the company was expanding rapidly and entered into individual contracts, its stock valuation procedures should be regularly reviewed to confirm that these remain appropriate. The reference to stock valuation was not merely the method employed to arrive at the cost of stock items, but also the level of overheads carried in stock, the treatment of "bulk" purchases during the year, and the need for provisions against slow-moving, obsolete or surplus stock.

210.4. Fourthly, the transaction referred to by HCW was different to the Garuda Transaction; in the Garuda Transaction there was a concurrent sale of a

substantial part of the stock to GMF being that stock which was required by Garuda to service its fleet of aircraft and Deloitte and Mr Clennett had grounds to believe there was data relevant to the allocation of cost; there was no service contract applying to the stock retained by Aero; and

210.5. Fifthly,it stated that the basis for the lack of provisioning in paragraph 5.1 of the HCW Memorandum needed to be reviewed as time went on.

211. Deloitte and Mr Clennett did not carry out a review of stock valuation procedures as HCW had advised would be necessary. As noted above, the reference to a review was not confined to stock valuation but also referred to the method to allocate the cost of stock.

212. The Respondents contended that the HCW Memorandum approved the use of SLD without any relevant caveat as the provisioning referred to was in respect of obsolete, unsellable or surplus stock and not to slow moving but sellable stock and therefore SLD remained acceptable so long as the appropriate provision was made. We do not read the paragraph as stating that the only factor which could lead to distorted earnings was the lack of provisioning in the sense referred to above. The lack of provisioning could be one factor which led to distorted earnings. Furthermore, we do not accept that the HCW Memorandum, written with reference to the situation in FY2004 and the transactions carried out in that period, can necessarily be relied upon as showing what HCW would have advised in FY2006 as a competent auditor, particularly in the light of the Garuda Transaction and the reference to there being an analysis of the Garuda stock. Mr Meredith's evidence was to the effect that if "you are making big bulk purchases of parts in this industry, it is highly likely you're going to have slow moving and fast moving stock and therefore the application of the straight line discount is going to give exactly the distortion of earnings that is described here". If the HCW Memorandum is interpreted as saying anything else we do not accept it.

213. Mr Meredith's opinion on the HCW Memorandum was that it was consistent with his opinion on the assumption that it is read as requiring a provision for "surplus, slow moving stock". That "provision" was required to be made in allocating the cost price of stock so as not to attribute too high a cost to slow moving items.

214. Mr Clennett accepted, in relation to the Garuda Transaction, that if the cost allocated to what was sold to GMF was understated then Aero would be posting too high a profit. It was Executive Counsel's case that the risk of a distortion of reported earnings, as a result of the application of SLD, was precisely what materialised in relation to the Garuda Transaction and the recognition, in that transaction, of a profit of more than $18m on the sale of $23m of stock to GMF.

215. As Aero's business developed and the bulk purchase contracts became more material to Aero's results from FY2006 onwards, the appropriateness of SLD as a cost estimating technique required review and that was starkly shown by the consequences

of applying SLD to the Garuda Transaction. The principle of the application of SLD was not reviewed.

216. The Respondents also relied upon the work of E&Y's technical team in the summer of 2006 to evidence another reasonably competent auditor accepting Aero's use of SLD when (unknown to the Respondents) Mr Bevan engaged E&Y to provide advice on the accounting treatment of the Garuda Transaction and Qantas bulk acquisition and long term supply agreement. On 31 July 2006 and 4 August 2006 Mr Bevan emailed Mr Mucai and in relation to the Garuda Transaction informed him that Aero had applied SLD in order to allocate cost and also sent him an early draft of the Garuda Explanatory Memorandum. There was also a reference to SLD in relation to the Qantas agreement as one way of accounting for that transaction. E&Y was also informed by Aero, in response to a question, that some stock moved quickly and other stock moved slowly. However E&Y appear not to have advised on the application of SLD. In relation to the Garuda Transaction, the advice was that the transactions were linked and that the correct accounting treatment was to recognise the Garuda Transaction as an acquisition of stock at the net amount of the transaction. In relation to the Qantas contract, Mr Mucai appears to have concentrated on stock consumed in the truck stock period, i.e., prior to the contract being entered into and then on the relationship between the contract to acquire stock from Qantas and the supply contract. There is no express acceptance by E&Y of SLD in Mr Mucai's advice given on 15 August 2006 just as there is no expression of dissent from the use of SLD. However we do not consider on the material available that E&Y can be taken to have approved the use of SLD let alone expressed a considered view of its use.

217. In March 2006 E&Y were engaged by Aero to undertake an assessment of the impact that a move from the UK GAAP to IFRS accounting framework would have on Aero. A draft report was produced on 28 June 2006. Mr Mucai and Ms Lai Leng were members of the E&Y team. It is clear that in the draft Impact Assessment Report E&Y addressed an aspect of the manner in which Aero addressed the costs of its stock. However the references appear to be limited to carrying stock at the lower of cost and net realisable value, the need for the functional currency of Aero to change from sterling to dollars for the purposes of the IFRS conversion which required some consideration of the date of acquisition of inventory and its original cost, the use of FIFO, the use of average cost and the fact that there was no original cost for 50 per cent of the Parts Central inventory. There is no reference to SLD in the assessment and we do not consider that the report shows that E&Y considered or approved the use of SLD.

218. E&Y carried out further work in relation to IRFS in April 2007. Once again there is no reference to SLD in connection with that work. Accordingly we do not consider that E&Y's work in connection with IFRS supports a contention that E&Y approved of the use of SLD.

219. Finally the Respondents relied upon a PowerPoint presentation prepared by E&Y relating to Aero's acquisition of the ACTS bulk purchase. The proposed work included

a review of the stated accounting policy around the valuation of inventory and the allocation of the purchase price of the ACTS inventory which would have required E&Y to consider SLD. To that end, the presentation sets out various alternative methods of allocation of the purchase price across the bulk stock. Mr Meredith considered, although he was not sure, that these were the allocation methods put to E&Y as potential alternatives which they would then have gone away and considered and that "I think this is a proposal to consider these questions which if it had been completed, presumably would have then raised further questions about age and usability of stock and stock provisioning". It was suggested on behalf of Deloitte and Mr Clennett, that the alternatives set out in the presentation amounted to E&Y's draft advice to answer the question posed by Aero. We do not consider that the presentation reflected E&Y's concluded advice as opposed to posing alternative methods of valuing stock acquired in a bulk purchase contract under the heading "How should the company allocate the purchase price of inventory acquired from AVEOS?" followed by the next slide asking the questions "How should the financial reporting consequences of this be calculated and confirmed?" In that slide there was a reference to identification of slow moving stock and provision in the same context of accounting for the sale to Air Canada and accounting for the Qantas contract. The fact is that without a commentary to accompany the slides it is not possible to conclude that E&Y were giving advice approving the use of SLD.

220. We now deal with allegation 2 in relation to each of the years 2006 to 2008.

FY2006

221. The results of FY2006 were heavily impacted by the inclusion of the apparent profits from the Garuda Transaction. These were included on the basis that the Garuda Transaction was properly to be treated as two transactions and both occurred in FY2006. We have dealt with these matters in the context of allegation 1. Allegation 2, in relation to FY2006 assumes that even if the Garuda Transaction was properly to be treated as two transactions falling within FY2006, Deloitte and Mr Clennett had insufficient audit evidence to draw a conclusion that SLD was appropriate, or should have ensured its application was disclosed in the accounts and demonstrated more professional scepticism in relation to information supplied to them by Aero's management.

222. The Strategic Audit Plan for FY2006 identified revenue recognition as a Specific Identified Risk and the Audit Summary Memorandum described the apparent profit on the Garuda Transaction. Mr Baker appeared to question whether the cost of the stocks sold to Garuda was low and Tiara Kok wrote on the Audit Summary Memorandum that that was the figure "pending supporting" to verify the cost allocation and stock listing on the stock sold to GMF.

223. Mr Baker could not recall what investigations had been made to verify the low cost attributed to the stock sold to GMF. As described above, it appears that the appropriateness of SLD was not considered in any detail because Mr Clennett appears

to have accepted Mr Lewin's explanation as to how Aero calculated the price it was prepared to pay for the stock. In the light of the fact that Aero informed Deloitte and Mr Clennett in the Garuda Sale Memo that the purchase of stock from Garuda and the sale to GMF were "concurrent" it is surprising that Deloitte and Mr Clennett did not investigate with Aero how the price had been fixed and consider whether SLD was the appropriate method of allocating cost. In circumstances where Aero was acquiring stock (at a substantial discount to OEM) and selling some of it on for a price substantially closer to OEM, and at almost two thirds of the price it was paying for the entirety of the stock, to the subsidiary of the airline which would utilise the stock sold, it was a striking feature of the transaction, that in effect the accounting treatment would record Aero as acquiring stock from Garuda at a low price and selling it on to its subsidiary at a substantially higher price. Deloitte and Mr Clennett were also informed that the stock sold to GMF was that stock which Garuda would require to service its fleet of aircraft. The manner in which Aero proposed to deal with the transaction should have brought home to Deloitte and Mr Clennett that they needed to consider the appropriateness of SLD in FY2006 as they should have required some assurance that Aero in calculating the price for the acquisition of stock from Garuda had taken into account the fact that some of the stock would be the subject of a simultaneous sale. On the face of the information provided to Deloitte and Mr Clennett it was counter intuitive that Aero would have applied the same discount to the stock to be sold onto GMF as to the stock retained. Insofar as it is relevant, Garuda in deciding on what price to sell its stock is unlikely to have applied the same discount to stock it wished GMF to acquire (i.e., the stock required to service its fleet of aircraft) as it did to stock it no longer required as it could not be used on its then fleet of aircraft.

224. Mr Clennett accepted that earnings would be distorted if Aero purchased inventory which it could not sell and allocated cost to that inventory and confirmed that Deloitte was relying on Aero telling it that Aero could sell all of the stock which it acquired and that this needed to be tested. Mr Clennett claimed that this was tested through checking that there were valid OEMs for the items that were purchased but such checking could not tell Deloitte when or whether the items were going to sell. In addition, even if such checking could give any assurance as to whether the stock was sellable, it is to be noted that around 25 per cent of the parts purchased from Garuda had dummy prices.

225. Mr Allen's evidence was that, in assessing whether stock was fast or slow moving, one needed to "look at maintenance programmes" because "when one deals with machines that need maintenance, one knows that periodically they require certain parts". However, there is also no evidence that Deloitte examined maintenance programmes or performed any analysis to determine whether the parts which were acquired by Aero were likely to be used as part of the maintenance programmes of Aero's customers. That was fundamental to any suggestion that the effect of SLD in accelerating profit was tempered by the fact that all the profit would be realised in due course.

226. As noted above Mr Clennett's evidence is that Deloitte understood that the basis upon which Aero would seek to agree the price for a bulk purchase of stock was "a complete

list of the parts that they're buying and then a valuation of those parts" and that Aero would then seek to obtain a discount of 50 per cent or more on that valuation. This is a surprising proposition as a matter of common sense – that a business would be prepared to pay $34m for stock without having conducted some analysis into how quickly it could sell that stock. It was also inconsistent with the way Mr Clennett must have understood Mr Lewin to run the business – he explained in evidence that when he first went to see Mr Lewin (i.e. before Deloitte took over the audit from HCW) "Rupert Lewin presented us with a mathematical model done by a professor which showed a sort of Gaussian distribution as to how much inventory you needed to be able to satisfy a 95 per cent pick rate". This detailed mathematical approach to the profitability of the business would have been entirely at odds with negotiating a price for stock without having conducted a thorough analysis of the value which could actually be released from that stock.

227. Mr Allen also said that he would have expected Aero to have carried out a considerable amount of analysis before committing itself to a bulk purchase of stock and Deloitte and Mr Clennett knew there had been an analysis.

228. In support of the allegation of lack of professional scepticism the Executive Counsel relied upon Deloitte's and Mr Clennett's conduct in relation to an adjustment made on 3 October 2006 by way of increase to profit of £1,057,000 to the profit on the sale to GMF. The adjustment was made at about the time that Aero was told by Deloitte and Mr Clennett that the £2 million profit attributed to the SRT transaction would have to be removed from the accounts. That adjustment was generated by increasing the cost of stock purchased from Garuda and retained by Aero. Mr Clennett and Mr Baker said in evidence that they were aware that an incentive to make the profit adjustment was the removal of the profit attributable to the SRT Transaction.

229. The mechanics of the adjustment were illustrated by a spreadsheet prepared by Aero which showed the replacement of various dummy prices by actual OEM prices. Mr Meredith was concerned that the revision of dummy prices by actual prices undermined the methodology of dummy prices which were intended to represent an average price of a range of similar items (wire, bolt, bushing, cable, washer, bearing, connector, terminal, and clamp) and to provide a price where the OEM could not readily be ascertained. Provided the calculated dummy prices were revised prior to the finalisation of the year end accounts and fairly we see no objection to the revision. The calculated dummy price was achieved by taking all parts which matched the description, the quantities of each part and the OEM price where available. Once the data was collated for the specific description a calculation was performed by taking the total extended value for parts which did have an OEM price and dividing the figure by the total number of individual items. That resultant figure was then applied to those parts which did not have an OEM price.

230. Mr Allen agreed that where a client brings forward a new profit calculation on an alleged existing transaction close to the year end it merits close attention and that

Deloitte and Mr Clennett did not enquire sufficiently into the justification for the price adjustment.

231. It was common ground that incorrect or inappropriate use of dummy prices had the potential to understate the cost of stock and overstate the profit on its sale. Mr Clennett accepted, for example, that if the reality of the position was that the cost being allocated to the stock sold to GMF through dummy items was understated then there would be an overstatement of profit.

232. The use of such dummy prices had the potential to result in a material misstatement of Aero's financial performance in FY2006 because (i) 41 per cent of the line items acquired by Aero from Garuda (i.e. including both the retained stock and the stock sold to GMF) had originally been costed using 'dummy prices' of US$32.51 or US$5.76; (ii) 26 per cent of the stock lines sold to GMF had originally been costed using those same 'dummy prices'. The 'dummy price' had been applied to a wide range of items.

233. However, Deloitte and Mr Clennett failed to ensure that a sufficient number of dummy prices were tested. In FY2006, Deloitte selected 22 items to test the cost allocation of the stock purchased from Garuda; this contained only 3 dummy prices (which in the course of the audit showed a relatively minor discrepancy). Whilst Deloitte selected the sample of 22 items through use of CMA (cumulative monetary amount) sampling, this sampling method did not take account of the need to identify and test dummy prices in particular because of the specific risk to which they gave rise. Deloitte and Mr Clennett carried out no testing to ensure that the parts which were grouped together and averaged in order to create a dummy price did have a reasonably similar cost. It was clear from the 24 items from Aero's revised Garuda allocation which Deloitte selected for testing in October 2006 that dummy prices had been applied to parts with a wide range of descriptions. Deloitte and Mr Clennett should have ensured that the testing was carried out.

234. Deloitte's testing of the revised allocation involved selecting a sample of 24 items from that allocation and requesting OEM price proofs for those 24 items. The 24 items chosen for testing were those with the largest increases in OEM value. 23 of these 24 items previously had dummy prices of $5.76 or $32.51. Deloitte did not enquire into how there had been such large adjustments to the dummy prices and consider whether this called into question the dummy price methodology as a whole. They should have done.

235. 26 per cent of the items sold to GMF used dummy prices but only 6 of the 24 items sampled by Deloitte were within the stock sold to GMF; the remainder were within the stock retained by Aero. The effect of the revision was that it reduced the allocated costs of what was sold to GMF and it increased the allocated cost of stock retained by Aero. However, Deloitte and Mr Clennett carried out no testing to ensure that Aero had approached even-handedly whether the dummy prices it revised were from the goods sold to GMF as opposed to the goods which were retained. Mr Allen's explanation was that "a sample of the most egregious changes has been picked out in order to check

through to make sure that they're valid. That's what that looks like to me, which is a reasonable approach to have adopted". However, it was not reasonable to test only the most egregious changes in circumstances where it may have suited Aero to inflate the apparent cost of the stock retained by it (so that the value of the stock in its books was inflated) whilst deflating the apparent cost of the stock sold to GMF (thereby increasing its profit on that transaction). In those circumstances, Deloitte and Mr Clennett should have investigated whether the revised allocation was even-handed as between the retained and the sold stock but they did not do so.

236. Deloitte and Mr Clennett also carried out no audit work to review or verify Aero's calculation of the dummy price, even though Aero's revised Garuda allocation presented to them on 3 October 2006 showed that there had been dramatic revisions to dummy prices (in one case going from $5.76 to $326,542 for a single item). This called into question the reliability of Aero's methodology for calculating dummy prices. We do not consider that it is an answer to the allegation to say that the sampling was reasonable in the light of the fact that Deloitte had to deal with over 26,000 lines of stock or that the source of OEM pricing might reveal different results. Deloitte and Mr Clennett should have carried out further audit work in relation to these matters.

237. The price adjustment illustrated how SLD could be the subject of manipulation by the use of OEM prices and dummy pricing. Mr Allen and Mr Meredith agreed that Deloitte and Mr Clennett should have enquired of Aero's management as to what had given rise to such a large adjustment and designed tests to gain reasonable assurance that the explanation provided was justifiable.

FY2007

238. In FY2007 Aero entered into a bulk purchase contract with Qantas. The Qantas contract was signed on 6 October 2006 with the truck stock date being 1 June 2006. The truck stock purchased was valued at $114 million which Aero said represented a 51 per cent discount to OEM value. The proportion of Aero's turnover, gross profits for FY2007 and stocks at 30 June 2007 attributed to the Qantas contract was:

> Turnover: $113. 9 million equating to £58.9 million or 46 per cent;
>
> Gross profits: £36.2 million or 77 per cent of total gross profit;
>
> Stocks: Stocks at 30 June 2007 were £90.4 million or 42 per cent of total stocks

In addition to stock Aero acquired Qantas historical inventory usage data for $26.4 million.

239. In FY2007 Aero continued to apply SLD. Just as Deloitte and Mr Clennett had not tested its appropriateness in FY2006 in the light of the Garuda Transaction, so they did not carry out any audit tests to consider whether it provided an appropriate method of allocating costs in FY2007 despite the fact that they were aware that Aero had paid a considerable sum for Qantas historical inventory usage data of $26.4 million; nor did they ask to see any data which Aero had created in the course of calculating the price it

was prepared to pay for the Qantas stock. The reason they should have done so was that the information might have assisted them in considering the appropriateness of the use of SLD. The tests which Deloitte carried out were intended to ascertain whether SLD was being implemented, i.e. whether the formula inherent in SLD was being consistently applied. Deloitte and Mr Clennett did not ask to see the historical usage profile. An inference from the fact that Aero purchased the historical usage profile is that it might have given some indication as to the rate of usage in the future.

240. Mr Meredith's opinion was that he would have expected the historical usage profile to have been obtained by Deloitte and Mr Clennett and to have been applied in the valuation of closing stock and also in ascertaining the allocation of cost of stock sold to Qantas in FY2007. There was no evidence that Deloitte and Mr Clennett asked for any data relating to the calculation but Mr Meredith considered that inquiries should have been made as to how Aero had ascertained the cost of the stock to be obtained and that if told that it had been carried out in a similar manner to the acquisition from Garuda should have challenged that. This was, after all, the second time that Deloitte and Mr Clennett were aware that there might be documentation available which could cast light on the manner in which the purchase price of stock was calculated by Aero. The Respondents contend that there was a consistency in the explanation put forward by Aero as to the use of SLD. But the Garuda Transaction should have caused Deloitte and Mr Clennett to raise questions as to its utilisation, and the reference to the historical usage profile in relation to the Qantas bulk purchase was yet another instance where Deloitte and Mr Clennett could have investigated the principle of the application of SLD. In failing to ask to see the historical usage data Deloitte and Mr Clennett fell significantly short of the standards and also demonstrated a lack of appropriate scepticism.

241. Certain of the tests applied should have alerted Deloitte and Mr Clennett to the fact that certain lines were selling substantially faster than others.

242. In w/p 5441 Deloitte conducted testing on Aero's inventory listing for Qantas stock as of 30 May 2007 to verify that the book value for the 120 items selected as the testing sample was not greater than recent purchase costs or net realisable value. The testing showed that there had been recent purchases by Aero for only 30 of the 120 lines since the inception of the bulk purchase contract - as Mr Clennett explained, this meant that there was "obviously a lot of value in the 75 per cent still to sell". Of those 30 lines, in 14 cases the book value was higher than the purchase price.

243. The testing should have alerted Deloitte and Mr Clennett to the fact that certain stock lines were moving very quickly. Meanwhile it appeared that 75 per cent of lines had not moved at all (or not moved to a sufficient extent that there had been any recent purchases). This ought to have been a warning sign that there was some very fast moving stock in the bulk purchase contract which made SLD inappropriate.

244. The combination of having some very fast moving stock and needing to replenish this stock with stock purchased very close to OEM resulted in a dramatic diminution in

margin after the initial stage of a bulk purchase contract. The testing on workpaper 8152 ("Qantas Testing") recorded that Aero's margin on sales to Qantas had decreased over the course of FY2007 from 71.8 per cent in Q1 to 58.1 per cent in Q2 to 52 per cent in Q3 and it was noted that "falling margins due to the consumption of higher value items at the [beginning] of the contract that were purchased from Qantas at discounted [prices]." Again this ought to have alerted Deloitte and Mr Clennett to the possibility that the very high margins being attributed to items which were selling in a relatively short space of time (and which stock then had to be replenished at OEM price) may have been wrong. The commercial reality was that Aero would have attributed greater value to fast moving parts and would have been prepared to pay a higher proportion of OEM value for them compared to slower moving parts.

245. Deloitte considered only whether SLD was being applied evenly. What was not being considered was whether the methodology was itself appropriate, even when the results of the testing showed that stock from only 25 per cent of lines had moved in the period under consideration (i.e. October 2006 to May 2007).

246. Deloitte's audit papers do not contain, in respect of either the FY2007 audit or the preceding interim review, a spreadsheet or other data from Aero containing the underlying calculations showing the derivation of the straight line discount for the Qantas Truck Stock or its application to the OEM price on a line-by-line basis; nor do the audit papers for the FY2007 audit contain a full list of the allocated Truck Stock cost, line by line, following the process of what is referred to in paragraph 194 of the Defence as "refinement" of some OEMs. Deloitte and Mr Clennett do not recall, but believe that a final allocation was seen by the audit team, and rely upon workpaper 5425 in support of that belief (Defence 194.2).

247. The Stock Lead Memo states as follows, in full, in relation to the allocation of Qantas stock:

> "b) Stock – Qantas
>
> - The allocation of the original Qantas bulk purchase is a Specific Identified Risk.
>
> When the company purchase a bulk of stock for [sic] at inception of a contract the cost is allocated across the stock listing. This allocation determines subsequent margin and resulting stock valuation.
>
> We have tested the Qantas allocation through a combination of substantive tests and control (through understanding of the process) at [5425].
>
> These tests include:
>
> - agreeing a final allocation to amounts paid for inventory

- review of implicit margin on allocated values to recorded margin and ongoing cost margin

- cost/NRV testing on year end values

- recalculation of year end line valuation by reference to initial allocation, subsequent consumption and subsequent purchases.

Testing was performed satisfactorily [5426]."

248. Two workpapers were there referenced: W/p5425 and W/p5426. There is no workpaper referenced W/p5426 in the audit file, and the reference should have been to 5425. Mr Allen agreed to that. The workpaper, prepared by Andrew Ilett and reviewed by Mr Clennett, describes its "Objective/Method" as being "To gain assurance over the Qantas Allocation". This was done by first testing the "full audit trail of 10 items checking purchases/consumption since allocation. Allocated price will [sic] agreed to the allocation. The selling price will be agreed to OEM prices which in turn are the contracted prices" and secondly "when this is done a margin analysis will be performed on a judgmental sample of items between their allocated cost and there [sic] NRV". The conclusion was that

> "Margin analysis on sheet performed indicated that the margin in total made on items purchased at allocation is reasonable. Satisfactory."

249. The "margin in total" there referred to is a margin of 55 per cent. However, as Mr Croxford put to Mr Meredith, and as Mr Meredith agreed, it "leaps off the page at the reader" that there are all sorts of percentage margins being shown in the workpaper. They range from 5 per cent to 100 per cent. There is no explanation in the workpaper for that variation. It is also apparent that for items where the quantity sold back to Qantas exceeded the quantity acquired under the bulk purchase contract (47 of 163 items) there was a much higher profit margin than for the other items. The Formal Complaint in paragraph 74(2) notes that:

> "a high profit margin (averaging 75%) had been applied to 'fast moving' items (where at least all of the items of that type acquired under the Bulk Purchase Contract had been re-sold to Qantas) whereas much lower margins (averaging 48%) had been applied to 'slow moving' items."

250. Mr Allen's opinion on the allegation made in paragraph 74(2) was that the allegation was very subtle and relied upon hindsight and that the pattern shown in W/p 5425 "was not one that should have been evident to Deloitte and Mr Clennett at the time that they performed the audit (and their factual evidence is that it was not evident to them)." However the variations in the percentage margins were obvious on the face of the workpaper and the possibility of manipulation of profit had been identified as a SIR.

251. The manipulation of OEMs would be one way of manipulating the profit margin:

> "The client has the opportunity to manipulate the profit margin by allocating unreasonably low costs to items that have been sold – thus recognising too much profit up front. Prices that have changed since the initial allocation should be reviewed. May be possible to get the IT department to produce a listing of items that have had their cost changed. Price Allocation will need to be obtained from Martin Dodge."

The minutes of the audit team's discussion of fraud and error provided:

> "The main risk will relate to financial misreporting, especially inventory valuation. This is key to the costs of sale recognised.
>
> . . .
>
> Margin made on items of inventory was also discussed. This is a key issue i.e. check they are not claiming a 50% margin when the evidence suggests it should be a 30% margin."

252. Deloitte and Mr Clennett contend in paragraph 211.1 of their Defence that one of the tests in w/p 5425 was relevant to the risk that Aero might be manipulating the allocation of cost of the Qantas Truck Stock. The test was that in relation to 4 of the 10 items non-statistically sampled, the sale or contract price with Qantas was checked against OEM data.

253. Mr Meredith's opinion was that in the event that Deloitte and Mr Clennett considered it was appropriate to test a judgemental sample, he would expect the justification to have been documented in the audit working papers (which it was not) and the sample to have contained at least 20 to 25 items.

254. Mr Allen's opinion was that given that (a) the total amount paid for the Truck Stock per the agreement with Qantas agreed to the total of the Truck Stock per the spreadsheet (as to which he said "There is no overt record in the audit files of this test being performed, but I consider it reasonable to infer that it was carried out"), and (b) he infers that Deloitte determined that the discount between the total value of the Truck Stock on an OEM basis per the spreadsheet total had been applied in determining the allocation cost (as to which he says "It is not explicitly stated that this step was performed, however, in view of the fact that the Interim Review file makes reference to the three spreadsheets prepared by the client and the testing of samples to allocation workings, I consider it reasonable to assume that the audit team identified that an overall discount had been applied across all the lines of inventory"); and absent collusive fraud (which Deloitte and Mr Clennett did not have reason to believe was taking place), adequate comfort would have been derived from the conclusion that on the 4 items tested the sale or contract price was within 10 per cent of the OEM price.

255. We do not consider that a non-statistical sample of 4 items constituted an adequate basis on which to derive assurance over an issue as to the possible manipulation of OEMs (with a consequent impact on cost and its allocation), which had been identified as a SIR.

FY2008

256. In FY2008 Aero entered into three contracts to acquire truck stock, with ACTS (on 16 November 2007 for $75.5 million), ANA (on 31 March 2008 for $22.5 million) and Aeroman (on 27 April 2008 for $4.5 million).

257. The minutes of the 2008 engagement team discussion on fraud and error record:

> "Obsolescence – the client do not write hardly anything off, under the assumption that almost every part is useable/sellable at some point or another. There are very few items that have an expiry date. As long as a plane flies, it will need parts – and often once a plane retires from a fleet it will be used in third world countries.
>
> Margins – the client are immediately recognising large margins made from goods bought in bulk at the beginning of contracts. These margins should be evened out across the contract. This is a key issue to be dealt with at year end.
>
> Valuation – prices are estimated on initial bulk purchase and then updated as more accurate information is obtained. This is open to estimation and can be manipulated".

258. At the audit planning stage Deloitte and Mr Clennett identified as SIRs:-

> "3. Allocation of purchase price across the total purchase. When [AI] purchase a large amount of stock for a set price than [sic] they will have to allocate this cost across the stock listing. The reasoning behind this will have to be tested. In addition we will need to ensure that the allocation has not changed at year end. The client has the opportunity to manipulate the profit margin by allocating unreasonably low costs to items that have been sold – thus recognising too much profit up front...
>
> 6. Stock provisioning. The client have historically made minimal provisions on the basis that all stock will be useable at some point in time, other than minimal items that have expiry dates. In the current year, the stock value is much higher than previous years. Need to ensure adequate provisioning is in place."

An additional SIR was documented in W/p 1810 and provided:

> "[Risk:] Pre-contract profits- accounting for margins on new contracts

[Response:] Review client calculations relation to truck stock in the pre-contract period i.e., consumption records, purchase and returns data."

259. There was some testing of the allocation of cost in relation to the ACTS contract in workpaper 5466E. W/p 5466E contained a summary of the data contained in the spreadsheets at w/p 5466Y, comprising the total allocated cost, P1 (truck stock period) cost of sales, consumption value, contribution and pre contract profit allowable. Calculating the P1 consumption from the figures contained in the spreadsheet shows contribution margins varying from 43.8 per cent to 65.1 per cent. This variation in margin should have been an indication to Deloitte and Mr Clennett that SLD did not represent a fair allocation of cost – margins would have fallen as Aero depleted the fast moving stock within the original truck stock and had to purchase replacement stock at a much smaller discount from OEM.

260. The audit testing work performed by Deloitte and Mr Clennett in relation to the Aeroman cost allocation was recorded in workpaper 5466C. Deloitte selected a sample of 5 line items for testing and sought OEM price proofs for those items. The audit papers do not reveal a rationale for the sample size. Of the 5 items tested, 1 had a difference of 410% between the recorded OEM and the price proof. The workpaper recorded, in respect of this, that "Differences in OEM are expected to change as market conditions change. The only risk in relation to cost allocation is that lower OEMs are being allocated to faster moving product lines. This does not appear to be the case examining pre and post contract consumption on a line-by-line basis. It is thus concluded these differences do not occur for financial benefit. Satisfactory." This conclusion was reached despite Deloitte receiving no proper explanation from Aero as to the discrepancy – Mr Pabari had simply stated that "This was an opening allocation issue, the OEM of $578.50 was the price available at the time of allocation". In respect of this testing:

260.1. The sample of 5 items was inadequate. It should have been based on a statistical sampling method and should have included items that had not moved from the truck stock date;

260.2. There is no evidence of any audit work to verify that the significant difference in price in 1 of the 5 items tested was due to "market conditions". The testing was inadequate to allow Deloitte and Mr Clennett to draw the conclusion recorded in the workpaper and set out above.

261. The audit testing work performed by Deloitte and Mr Clennett in relation to the ANA contract was recorded in workpaper 5467E. Deloitte selected a sample of 15 items for testing and sought OEM price proofs for these items. They concluded that "Differences in OEM are expected to change as market conditions change. The only risk in relation to the cost allocation is that lower OEM's are being allocated to faster moving product lines. This does not appear to the case examining post contract consumption on a line-

by-line basis. It is thus concluded these differences are satisfactory." In respect of this testing:

261.1. Deloitte and Mr Clennett failed to record the basis on which the 15 items were selected. The sample ought to have been based on a statistical sampling method and should have included items that had not moved from the truck stock date;

261.2. 14 of the 15 items in the sample appeared between lines 3 and 212 of the 40,000 items in Aero's cost allocation schedule which was arranged so that items for which there had been consumption since the commencement of the contract were at the top. The sample therefore contained a disproportionate number of fast moving items and could not test whether Aero was manipulating its profit margins by applying low OEM prices to fast moving items and vice versa.

261.3. The OEM price proofs for 4 of the 15 items suggested that Aero had used too low an OEM value when allocating cost to these items and for 1 of the 15 items the price proof suggested that Aero's OEM had been too high. It was potentially significant that the item in respect of which Aero's OEM value may have been too high was one for which consumption had been lower than purchases in the pre-contract period, unlike 3 of the 4 items for which the OEM may have been too low.

262. The flaws in the design of the test and the results of the test itself meant that Deloitte and Mr Clennett had not obtained sufficient appropriate audit evidence from which to draw the conclusion that they did.

263. As noted at paragraph 195 above, in response to a question from the Tribunal in relation to large margins, Mr Clennett, as it became increasingly apparent that the SLD methodology was producing large profits in the early years of the contract and that this needed to be "evened out", did not give consideration to the question whether SLD itself was appropriate as opposed to considering whether there was a need for some provisioning.

264. Mr Clennett gave evidence to the effect that he did give independent consideration to the appropriateness of the application of the SLD methodology for the FY2008 bulk purchases, and considered it in relation to the transition to IFRS in 2007/2008 in relation to the applicability of IAS 2 to Aero. Mr Clennett also gave evidence to the effect that

> "The discussions with Rupert Lewin that I have described . . . [as to the nature of the bulk purchase contracts, the SLD methodology and the possible application of other estimation techniques] took place over the course of the 2007 through 2009 financial years; I do not recall it as being only one discussion; instead it was a topic that recurred during our audits and was referred to on different occasions in meetings and calls between us."

We find that insofar as Mr Clennett did have discussions with Mr Lewin as to SLD it was not about the appropriateness of SLD in itself but more directed to whether the effect on profits of SLD suggested more provisioning was required to deal with items which could not be sold or were slow moving. What Deloitte and Mr Clennett did not consider was whether SLD was appropriate in principle. The fact that the two issues were not different sides of the same coin and that Deloitte and Mr Clennett understood that, is illustrated by the two items recognised as SIRs set out above.

265. Deloitte and Mr Clennett should have sought to follow up whatever documentation was available as to the manner in which Aero calculated or allocated the total price it wished to offer for bulk stock.

Manipulation of profit margin

266. Executive Counsel alleges in paragraph 62(3) of the Formal Complaint that although Deloitte and Mr Clennett identified the risk that Aero could further inflate profits by manipulating the profit margin on the Bulk Purchase Contracts, audit evidence that the risk had materialised was not properly considered and not followed up by further testing.

267. In relation to FY2006 Deloitte and Mr Clennett were aware that Aero was under pressure to meet market expectations as to profit and turnover. For FY2007 Deloitte and Mr Clennett had identified as a SIR the possibility of manipulating the profit margin by allocating unreasonably low costs to items that had been sold and that the level of margin was a "key issue". Similar issues were recognised for the FY2008 audit.

268. Mr Clennett said in his evidence that the identification of the risk was not generated by any particular concern but was the result of the product of imaginative thinking around the subject of the conceptual risk of fraud at the planning stage.

269. Mr Allen considered that the risk of manipulation of profit by inflating the profit margin on Bulk Purchase Profits was addressed in three ways:

(a) ensuring the adoption of an acceptable accounting policy (the SLD method);

(b) being satisfied that if any revisions were made to the original stock cost allocation, the revisions were justified; and

(c) being aware that it was not possible to change costs allocated to individual stock lines in respect of a bulk purchase, because any single change would change every other line item and so would be evident.

270. However:

270.1. Even if the SLD method was an acceptable accounting policy that in itself did not deal with the risk since SLD itself was open to abuse by manipulation of OEMs and dummy prices.

270.2. Deloitte did not take proper steps to satisfy themselves that if any revisions were made to the original stock cost allocation, the revisions were justified. Mr Allen himself considers that there were "shortcomings" in that there was:

> "no evidence of enquiry as to the reasons why the revision in allocation of costs in respect of the inventory purchased from Garuda resulted in a £1.057 million increase in profit earned on the sale of stock to GMF in FY2006 ...
>
> ... no evidence of consideration and testing of the justification for any material change in profit arising from the revision in allocation of costs in respect of the inventory purchased from ACTS which resulted in an increase in Pre-Contract Profit calculated by Aero from $32.8 million (at 31.12.2007) to $48 million (at 30.06.2008)."

270.3. It is not the case that any change to a stock line would require a change to every other stock line. Furthermore manipulation could have taken place as the costs were inserted into a stock line in the first instance.

271. Further, the 2008 audit papers do not contain a spreadsheet or other data from Aero containing the underlying calculations showing the derivation of the SLD percentage of the ACTS stock and its application to the stock to calculate a cost of each part line. Mr Allen inferred that a version of an allocation and pre-contract profit calculation for ACTS must have been given to Deloitte by the time of emails referring to it that were sent by Sam Chapman of Deloitte on 19 and 22 August 2008 and he relies on an exchange of emails between Mr Dodge and Mr Pabari of Aero on 14 and 15 August 2008 to identify what he says were cost allocations for the ACTS, ANA and Aeroman contracts which, it appears to Mr Allen, were each burned to disk and provided to Deloitte. However as Mr Allen said in cross examination the spreadsheet which Mr Allen infers was attached to an email dated 14 August 2008 and purporting to attach a "ACTS Allocation and Pre Contract Profit" schedule in relation to the cost allocation for ACTS in 2008 was not a stock allocation spreadsheet. Albeit that Mr Allen then suggested that stock allocation had been examined in the course of a test of costs against NRV in the FY2008 interim review that was not a review of the reason for an increase in profit due to the ACTS contract.

Pre contract profit (FY2008)

272. As described at paragraphs 9.3 to 9.6 above during the Truck Stock Period (when Aero was still negotiating the purchase of the stock), Aero would invoice the customer for stock which the customer consumed, with payment being made by the customer on contract signature. The value of the invoice was based on terms set out in the contract which was being negotiated, but was close to OEM value. Given the way Aero allocated the discounts applicable to the Truck Stock, i.e. uniformly without differentiation between fast moving or slow moving stock, a significant 'profit' was

recognised by Aero in the Truck Stock Period. For example, if the overall price paid was equal to 50 per cent of the aggregate OEM value for the entire Truck Stock, Aero would value each item at 50 per cent of its OEM value. Since it was invoicing the stock back to the customer at close to OEM value, the 'profit' it booked was about 50 per cent on fast moving inventory which would make up the majority of the sales in this period.

273. "Pre-Contract Profit" was the subject of debate between Aero's management and Deloitte. Management's position was that they should recognise this consumption during the Truck Stock Period as revenue and profits similar to normal sales transactions. Deloitte's position, which both Mr Allen and Executive Counsel agree was correct, was that Aero could not recognise revenue and profits before the contract was signed (because the risks and rewards of ownership did not pass to Aero until the contract was signed) and that any 'profit' arising from consumption in the Truck Stock Period should be treated as a further discount to the cost of the stock which was acquired on contract signature.

274. Since Aero had prepared its accounting books and records on the basis that sales and profits were recognised in the Truck Stock Period, some complicated adjustments were required. In order to restate the year end figures to reflect the position that any profits arising in the Truck Stock Period should be accounted for as a further discount to the cost of stock acquired by Aero, it was necessary to adjust the value of the stock and hence the profits arising in the period up to the accounting year end. In addition to removing sales and profits in the Truck Stock Period, it was necessary to restate the profits on sales recorded by Aero after the contract had been signed (i.e. after the Truck Stock Period): these profits had been computed on the basis of a cost of stock which assumed that trading had taken place in the Truck Stock Period. Mr Meredith described the adjustments:

274.1. The first step was:

> "An assessment was made of any 'profits' arising in the 'truck stock period' and these were deducted from the year end value of stocks in the financial statements thereby reducing profits (Debit: Cost of goods sold, Credit: Stocks)."

274.2. The second step was:

> "An estimate was made of profits from trading in the 'truck stock period' that had been realised through trading in the period from the date of contract signature to the financial year end, by assessing whether items acquired at the contract signature date had been sold. A further adjustment was made to cost of goods sold and stocks to reflect this, thereby increasing profits (Debit: Stocks, Credit: Cost of goods sold)."

274.3. And the intended result was:

> "The net result of these two adjustments was intended to reflect the fact that no trading had taken place prior to contract signature and the stock at year end was stated at the correct value."

275. Aero made those adjustments for ANA and Aeroman. It did not, however, as is common ground, make any adjustment for them for ACTS, on which, as was also common ground, it had recognised $35 million of "Pre-Contract Profits". This does not flow through directly as an adjustment to year end profit: although the pre-contract profit should have been removed from year end profit (step 1 above), step 2 above would partially offset that. As Mr Meredith explained:

> ". . . AI accounted for trading in the 'truck stock period' as sales which were subsequently reversed in the financial statements. Any 'profits' arising in the 'truck stock period', which had been calculated based on the straight line application of the bulk purchase discount, were offset against stock at the contract signature date. These 'profits' were intended to be realised as stock acquired on contract signature was consumed. The impact of these 'profits' should not have been fully realised until the stock acquired at the start of the contract was sold . . . ".

276. The same point is explained in Deloitte's workpaper 5466A (in a paragraph in relation to Aeroman), but the paper goes on to explain on the next page that the basis of the calculation of pre-contract profit for ACTS is the same as for Aeroman:

> "During period 1 (the date from inception to contract signing – 30/6/07 – 27/4/08) AI bills ACTS for all usage at OEM (original equipment manufacturer) price and pays for all purchases and returns. The trading profits generated during this pre-contract period are released to the income statement over an appropriate period of time."

277. One key question was what was "an appropriate period of time" over which the Pre-Contract Profit should be released.

278. In relation to Qantas in FY2007, Deloitte considered that an average stock holding period might be two years, based on average stock turn. Aero however released the pre-contract profits over a nine-month period (i.e. fully released by 30 June 2007). Deloitte (as they have subsequently explained in a letter dated 17 April 2013):

> "understood from discussion with Aero's management that they believed that 9 months was a reasonable stock holding period given that the pre contract contribution had arisen in respect of stock consumed within 3 months of the truck stock date. We considered that an average stock holding period might be 2 years based on average stock turn but accepted that the pre contract contribution could be allocated, as a means of estimation, to the inventory on which it arose, that is the faster moving lines. We concluded that the adoption of 9 months as an estimate of the stock turn on the items to which the pre contract contribution related was

not unreasonable or likely to give rise to material error in the financial statements."

279. In relation to ACTS in FY2008, Deloitte received from Aero calculations in 4 large spreadsheets. In these, Aero calculated the pre-contract margin on each part consumed before the contract date by deducting the consumption value for that part from its cost, and then adding up the total 'margin' or 'contribution' from pre contract consumption of each part line. Aero then calculated the proportion of that contribution which could be recognised at the reporting date by reference to the value of stock which had been consumed. As Mr Baker noted, this was in principle more accurate than the approach taken the previous year for Qantas stock which (he says) "involved a high level assumption about the stock turn of items that had been the subject of pre-contract consumption". That assumption was, as set out at paragraph 278, that those lines would be faster-moving.

280. Thus, in both years, Aero was allocating to the faster-moving stock lines the (considerable) pre-contract profit which was already the result of applying a uniform 'straight line discount' to all stock. The faster moving stock was already being booked at a cost which was possibly unrealistically low. By reducing that cost still further by applying the 'pre-contract profit' to the faster-moving lines, Aero was increasing the acceleration of profit.

281. Deloitte's workpaper 5466A went on to provide:

> "The basis of cost allocation and pre-contract profits calculation is same as for Aeroman.
>
> The calculation indicated a total pre-contract profit of $48.0m of which $42.4m could be recognised. To date [Aero] have recognised ~$35m. It is thus concluded [Aero] have not released excess profit in what they are entitled to. [Aero] calculated the pre-contract profit release at the point of signing the contract on the most accurate data available at that time. The calculation detailed above [5466Y] was carried out by the client to prove there was not over recognition of profit."

282. Deloitte's workpapers for the FY2008 interim audit show a pre-contract profit of $32.8 million. Mr Allen says it is evident that the stock allocation for the ACTS purchase used for the purpose of preparing the 31 December 2007 Interim financial statements was subsequently updated before the 2008 year end, and that the impact of this revision was to increase the Pre-Contract Profit (as calculated by Aero) from $32.8m to $48m, which would also have increased the margin on sales after the contract date. Mr Allen considers that:

> "The proper response of the auditor to this situation would have been to assess the materiality of the change on profit and/or inventory and, if

material, design appropriate tests to be satisfied that those material movements were reasonable."

Mr Allen stated that "[T]here is no evidence of consideration and testing of the justification for any material change in profit arising from the revision in allocation of costs in respect of [this increase]." Mr Allen's conclusion was that was a 'shortcoming'.

283. The Respondents concede that if there was an under recognition of profit they ought to have informed the Board that the profit being recognised in the FY2008 accounts was understated and required an adjustment of $7.4 million to the profit and an adjustment the effect of which was to reduce the year end stock balance by $5.6 million. However they refer to the complexity of the calculation in ascertaining the profit as a reason for not appreciating that there was an understatement. However Deloitte's W/p 5466A recognised a pre contract profit of $48 million, so despite the complexity of the calculation, Deloitte was aware of the matter. Without any doubt the calculation of pre contract profit was a complex exercise.

284. Furthermore Mr Allen agreed that there was no evidence of audit work being carried out in relation to the $35 million albeit that a profit of $32.8 million had been considered in the course of Deloitte's Interim Review. Mr Meredith's evidence was to the effect that there was no evidence or explanation on file to justify the recognition of pre contract profit of $35 million or why the accounting treatment differed from the other contracts where adjustments were made to the year end stock adjustment nor were there any calculations of the amount in the audit file. What appears to have happened is that Deloitte and Mr Clennett accepted calculations prepared by Aero albeit they were considered by Mr Chapman of Deloitte. Deloitte and Mr Clennett should have sought the explanations in respect of the matters described by Mr Meredith.

285. In relation to Aeroman, Deloitte's testing of pre-contract profit was described in w/p 5466A as follows:

> "The total cost allocated by the client is $14.26m. The basis of allocation is OEM. It should be noted purchases are not allocated on a line-by-line basis. It is fair to assume purchases will generally relate to faster moving product lines. This will thus have the effect of reducing the cost of faster moving product lines and thus pushing forward contributions. The effect of this will not be material as the Aeroman contract is small in size."

286. In relation to the Aeroman contract Aero allocated the net purchase price of $14.3 million for the Aeroman Bulk Purchase Stock across all items. No adjustment was made to reduce the value of stock for consumption in the pre contract period. This resulted in the stock acquired upon contract signature being valued at 70 per cent of the estimated OEM value.

287. Pre contract "profit" was calculated by applying the figure of 70 per cent to the value of sales in the pre contract period to obtain a Pre-Contract "profit" figure of $4.6 million. A line by line assessment was made of pre contract sales and this resulted in a "profit" of $2.2 million which could be released.

288. However, there is no evidence of any audit testing performed to confirm that the impact of that methodology did not exceed materiality. Mr Allen agreed that the audit work papers do not quantify the impact to support the view that the impact was not material.

289. The Respondents admit that no audit testing was performed to confirm that the impact of that methodology did not exceed materiality. The Respondents contend that that was a matter on which they were entitled to form a judgment to the effect that no testing for materiality was required as the amounts involved were so small in comparison to the ACTS and ANA contracts.

290. In relation to ANA, Aero treated the ANA bulk purchase stock as having been acquired at a discount of 83 per cent to its OEM price and reported a gross profit margin of 134 per cent during the first three months of the contract. Certain of the items in the bulk purchase stock which ANA had agreed to sell Aero had been entirely consumed in the pre-contract period but there had been no purchases. These items were allocated a negative cost of US$4.5m as of 31 March 2008 and this was recognised by Aero as 'day 1 profit' generated by the ANA bulk purchase contract by way of additional margin on turnover in the period from the contract date to the FY2008 year end.

291. The Executive Counsel contended that there is no recorded evidence in the audit file of any audit work performed by Deloitte and Mr Clennett in relation to whether Aero's accounting treatment of the ANA bulk purchase stock reflected the substance of the transaction and was in accordance with the applicable financial reporting standard; therefore it is to be inferred that no such audit work took place. In particular he alleged the audit file does not record whether any consideration was given to whether Aero's treatment of day 1 profit meant that Aero was recognising profit on items which it had never owned, and had not therefore sold to ANA. W/p 5467A (prepared by Mr Chapman and signed off by Mr Clennett) does refer to product lines which had a negative cost and notes that the negative cost (where total purchase price is less than the consumption value during the precontract period) is allocated across the quantity of stock as at 31 March 2008. Where a negative cost exists and there are no items in stock at 31 March 2008 (the date of the contract) (as they were consumed during the pre-contract period) this is recognised in the period to the end of FY2008. Much of the W/p is concerned with the treatment of pre contract "sales".

292. We do not consider that Deloitte and Mr Clennett failed to consider whether Aero was recognising profit (by treating it as a negative cost) on items it had never owned in the context of this transaction. It had dealt with that issue previously when it persuaded Aero to treat the "profit" as a reduction in cost. We also reject Executive Counsel's submission that Deloitte should have investigated the reason why ANA's high demand for certain items had ceased once the original inventory had been consumed.

293. The issues relating to the use of SLD are as follows:

293.1. With regard to the bulk stock acquired by Aero from Garuda (FY2006), Qantas (FY2007), ACTS (FY2008), ANA (FY2008) and Aeroman (FY2008), did Deloitte and Mr Clennett obtain sufficient appropriate audit evidence from which to conclude that Aero's accounting treatment (i.e. SLD used by Aero to allocate the cost of bulk stock purchases to individual items of stock) was appropriate?

293.2. If not, did (i) Deloitte and (ii) Mr Clennett fail to act competently with due care and skill in concluding that Deloitte had obtained sufficient appropriate audit evidence in that regard? If either (i) Deloitte or (ii) Mr Clennett did so fail, in what respects did each fail?

294. We do not consider that Deloitte and Mr Clennett obtained sufficient appropriate audit evidence from which to conclude that Aero's accounting treatment (i.e. SLD) was appropriate in FY2006 to FY2008.

295. For the reasons set out above Deloitte and Mr Clennett were aware from the nature of the Garuda Transaction and material that Aero prepared an analysis of stock before entering a Bulk Stock Purchase contract and purchased information as to historical usage from sellers of bulk stock. Furthermore, in the light of the apparent profit thrown up by the Garuda Transaction they should have questioned the Aero management far more closely as to the manner in which Aero calculated the price which it was prepared to pay for the stock and asked to see the analysis which Aero management said had been carried out and the historical usage documentation acquired by Aero. In FY2006 to FY2008 they failed to consider the principle of the application of SLD, failed to investigate whether the financial statements reflected the substance of the Bulk Purchase Contracts and whether it was realistic to treat Aero as paying the same proportion of an OEM price for a fast moving item as for a slow moving item. Further Deloitte and Mr Clennett failed:

In FY2006:

295.1. in the respects described in paragraphs 233 to 237 above in relation to the use and application of dummy prices;

295.2. to enquire of Aero's management as what had given rise to the large adjustment of cost giving rise to an additional profit of £1.057 million: paragraphs 228 to 237 above;

In FY2007:

295.3. to seek a copy of Qantas's historical usage analysis;

295.4. to ensure that an appropriate statistical or non statistical sample of items was selected to test whether price allocation had been manipulated;

In FY2008:

295.5. to obtain copies of and examine the historical usage information acquired by Aero from ACTS, Aeroman and ANA;

295.6. to consider and test the justification for the revision in the allocation of costs which resulted in a pre-contract profit increase from $32.8 million (at 31 December 2007) to $48 million (to 39 June 2008);

295.7. in relation to the stock acquired from Aeroman in the respects described in paragraph 260 to ensure that a sufficiently large sample of items was checked to ensure that cost was being properly allocated or to investigate why the price in relation to one item had a difference of 410 per cent between the recorded OEM and the price proof;

295.8. in relation to stock acquired from ANA in relation to the respects described in paragraph 261 to 265 to ensure that the items of stock tested were fairly allocated between items sold and retained so that the possibility of manipulation could be tested and to use an appropriate test;

Manipulation of profit margin:

295.9. to give adequate consideration to the risk that profits might be being artificially manipulated by artificially manipulating the original stock cost allocation by revising prices or dummy pricing and the possibility that the risk might have materialised was not properly considered and followed up as described in paragraphs 267 to 271;

Pre contract profit:

295.10.in the respects described in paragraphs 282 to 284 above.

In relation to these failings Deloitte and Mr Clennett's conduct fell significantly short of the standards and failed to show sufficient professional scepticism.

Disclosure of the SLD methodology

296. It is Executive Counsel's alternative case that if, contrary to the above, Deloitte and Mr Clennett could reasonably have accepted the application of SLD to the bulk purchase stock, they could not reasonably have accepted that Aero's financial statements gave a true and fair view in the absence of a clear statement in them that "(i) the policy on acquisition of bulk purchase stock was to allocate the cost across all lines based on a uniform discount from the OEM price of the item, and that consequently (ii) Aero reported higher margins in the period following a bulk purchase contract than in the later stages." The disclosure which Executive Counsel contended was required is that in inverted commas in this paragraph. No such disclosure was in the accounts for

FY2006 to FY2008. Albeit the accounts for FY2008 accounts contained a disclosure in relation to pre-contract profit in the following terms:

> "Where the Group purchases bulk stock at the commencement of a new contract, the price paid is determined based on physical inventory extant at a date which is typically several months before contract signing date. This allows the Group to evaluate the material in advance of purchase. The cost of the bulk purchase is allocated across all lines based on selling price. The consumption of any of this inventory by the customer in advance of contract signing is billed to the customer at contract prices."

Executive Counsel contended that did not disclose SLD. The Respondents did not contend that it did.

297. Mr Allen said in relation to the first element of the disclosure that it would not in his experience be normal practice to go into this level of detail when cost is allocated on a specific contract. Instead, as was done in Aero's financial statements for FY2006 to FY2008, the usual and acceptable approach was to describe the accounting policy as to the calculation of cost of stock at a higher level by which we presume he meant the usual disclosure of the lower of cost or net realisable value. Accordingly he considered that the accounts disclosed a true and fair view and no further disclosure was required.

298. As to the second element (the higher margin) he said the application of the SLD method to allocate cost does not itself give rise to higher margins. The application of the SLD method to bulk purchase inventory means that the same profit margin is earned on each piece of inventory as it is sold. However, albeit that the application of SLD gave rise to a constant margin, he also accepted that it "accelerated profit" if the effect of SLD was to attribute a lower cost to fast moving stock than to slower moving stock on the basis that Aero in calculating the price for a bulk stock purchase was prepared to pay a higher price (i.e., a higher percentage of OEM) for fast moving stock than slow moving stock. Thus SLD attributed a constant margin which did not accord with the substance of a bulk purchase transaction because in the period immediately following a bulk purchase profit was being recognised earlier than might otherwise have been the case. Accounts are intended to give a true and fair view over a period.

299. FRS 5 provides under the heading "Disclosure of the substance of transactions" that disclosure of a transaction "should be sufficient to enable the user of the financial statements to understand its commercial effect" and paragraph 14 of FRS 5 provides that financial statements should report the substance of a transaction into which the reporting entity has entered. The Respondents emphasise that notes in the explanation section of FRS 5 provide that

> ". . for the vast majority of transactions [the disclosure required by para 30] involves no more than those disclosures currently required. However, this may not be sufficient to portray fully the commercial

effect of more complex transactions, in which case further information will need to be disclosed".

300. The Respondents contend that Mr Meredith's opinion, reflected in Complaint paragraph 2.2, that the estimation technique (i.e., SLD) should have been disclosed was incorrect and involved a confusion of accounting policies and estimation techniques. Thus paragraph 51 of FRS 18 requires an entity to select whichever estimation technique is judged to be most appropriate in the particular circumstances "for the purpose of giving a true and fair view". Paragraph 55(b) requires disclosure of a technique that is significant as explained in paragraph 57 of FRS 18. Paragraph 57 provides:

> ". . . Although many estimation techniques are used in preparing financial statements, most do not require disclosure because, in most instances, the monetary amounts which might reasonably be ascribed to an item will fall within a relatively narrow range. An estimation technique is significant for the purposes of para 55 (b) only if the range of reasonable monetary amounts is so large that the use of a different amount from within that range could materially affect the view shown by the entity's financial statements. To judge whether the disclosures are required in respect of a particular estimation technique, an entity will consider the impact of varying the assumptions underlying that technique. The description of a significant estimation technique will include details of those underlying assumptions to which the monetary amount is particularly sensitive".

301. The Respondents referred to Appendix IV of FRS 18 and paras 37 to 40 which they contended rejected the concept that an estimation technique was required to be disclosed because another available technique exists which might produce another result, which they contend was what Mr Meredith was advocating. However the conclusion reached, as set out in paragraph 40, is that:

> ". . . the FRS instead focuses on the degree to which judgment is needed in applying whichever estimation technique has been chosen, and the sensitivity of the resulting amounts to such judgment."

302. We consider that the use of SLD fell within paragraph 57 as the estimation technique was significant since the monetary amounts which might fall to be ascribed to an item of stock fell within a wide range which could materially affect the view shown in Aero's financial statements. In considering whether disclosure was required of the use of SLD one needs to vary the assumptions underlying SLD as it was applied and consider whether that produces different results. We do not accept that the use of SLD avoided assumptions. One assumption was that Aero assessed the price of an item of stock regardless of whether it was fast or slow moving. Those assumptions could be altered so as to take into account (a) 'years usage' bands; and (b) the ascription of a different percentage discount to each band. If one altered the discount applied to parts based on different rates of usage and differential prices paid the result could materially affect the

financial statements. We do not consider that altering the assumptions as described produced a different estimation technique within the meaning of paragraph 57 of FRS 18, rather that it would have been an appropriate way to assess the impact of varying the assumptions underlying the technique and inform an appropriate disclosure as required by the standard.

303. Accordingly, if SLD was properly to be applied, we consider that the use of SLD should have been disclosed with the underlying assumptions described that the price paid for each item of stock was the same regardless of its speed of usage.

304. The issues in relation to disclosure are as follows:

304.1. Alternatively (contrary to Executive Counsel's primary case that a Member or Member Firm could not reasonably have been expected to accept the application of a "straight line discount" to the allocation of the cost of bulk stock purchases) was the disclosure of the basis of accounting for the cost of bulk purchase stock sufficient for the financial statements to show a true and fair view?

304.2. If not, did (i) Deloitte and (ii) Mr Clennett fail to act competently with due care and skill in concluding that the disclosure was sufficient for the financial statements to show a true and fair view? If either (i) Deloitte or (ii) Mr Clennett did so fail, in what respects did each fail?

305. For the reasons set out above we do not consider that disclosure was sufficient.

306. Deloitte and Mr Clennett should not have certified the accounts as showing a true and fair view in the absence of disclosure as described above and should have pressed management to disclose that cost was allocated by the use of SLD. In so failing Deloitte and Mr Clennett fell significantly short of the standards.

Stock obsolescence FY2007/FY2008

307. Stock was by far the most significant asset on Aero's balance sheet; it was a stock-holding business. It was Executive Counsel's case that Deloitte and Mr Clennett omitted during each of the relevant audits to test the appropriateness of the application of Aero's 0.5% obsolescence provision. SSAP 9 provides that provisions are amounts:

> "retained as reasonably necessary for the purpose of providing for any liability or loss which is either likely to be incurred, or certain to be incurred but uncertain as to amount or as to the date on which it will arise".

308. It was common ground between the experts that if stock would ultimately be sold there was no question of providing for obsolescence; however a provision would have to be made if stock might not be sold at a price in excess of its cost. Mr Clennett agreed with that, stating that "slow-moving stock was not a defined term in accounting standards but was a term commonly used in the context of a provision to denote stock that

ultimately would not be sold (or would only be sold in the future at a price below present book value). Stock that was consumed at a slow rate would not require a provision merely because of its rate of consumption". As we have noted above, a feature of SLD is that stock retained might have been allocated a cost higher than was appropriate and that was another aspect which needed to be borne in mind when considering a need to make a provision.

309. In FY2006:

309.1. The risks to Aero of (a) a supply contract ending and leaving Aero with "a large quantity of surplus stock" and (b) decommissioning of aircraft were referred to in the Strategic Audit Plan for FY2006 (w/p 1130).

309.2. These risks were also analysed in the Report to the Audit Committee and the steps Aero was planning, mainly on the stock database/IT side, to enable it to analyse stock holdings against aircraft type and customer usage, were noted at the Audit Committee Meeting on 4 October 2006 (Minutes 1 and 2.1).

309.3. The Respondents received a 'Stock Provisioning Memo' and had discussions with Aero's senior management about this possible issue. The Stock Provisioning Memo emphasised that stocks held by Aero were unlike those held in most businesses. "They are held for aircraft with long product lines, have almost totally unlimited lives and may be used, as the business expands, for more than one customer". The Stock Provisioning Memo then went on to stress the potential significant development of cross selling opportunities between parts purchased from one fleet operator for aircraft operated by another operator. The provision recommended was 0.5 per cent of total stock albeit it was said that the calculations attached to the Stock Provisioning Memo suggested that no provisioning was required. Deloitte and Mr Clennett reviewed the Stock Provisioning Memo. Deloitte and Mr Clennett's Defence contends that this was:

> "a detailed 4-page rationale and precisely explained calculations, together supporting the maintenance of the historic 0.5% provision level."

310. In FY2007 Deloitte identified "Slow moving inventory including provisioning" as a "Key audit risk" in its Report to Aero's Audit Committee dated 31 August 2007. The Report said that there was a 0.5 per cent provision against stock and:

> "The year end stock balance amounted to £216 million, and the stock turn is low. Therefore this area is still an area of considerable focus."

And under "Deloitte response":

> "The group continues to build its inventories and customer base. Whilst the Group can identify obsolescence it has yet to determine a sound

methodology for identifying parts, if any, which may not sell over the life of the aircraft they support."

311. The adequacy of the stock obsolescence provision was identified as a SIR in the audit planning documentation for FY2008. The Strategic Audit Plan for the FY2008 audit said:

> "The Specific Identified Risks on this audit are:
>
> ...
>
> 6) Stock provisioning. The client have historically made minimal provisions on the basis that all stock will be useable at some point in time, other than minimal items that have expiry dates. In the current year, the stock value is much higher than previous years. Need to ensure adequate provisioning is in place."

312. Mr Clennett agreed that stock provisioning was an "important issue". By the time of the 2008 audit, as Deloitte reported to the Audit Committee, the gross stock balance had risen from $572.1m on 31 December 2007 to $693.7m on 30 June 2008. The provision had been 0.5 per cent throughout the period from 2006 to 2008 and Deloitte reported in its report to the Audit Committee dated 18 September 2008 that

> "Whilst the Group can identify obsolescence it has yet to determine a sound methodology for identifying parts, if any, which may not sell over the life of the aircraft they support. The risk of slow-moving stock associated with increasing inventories is however negated by a growing customer base.
>
> The directors should continue to review what is an appropriate level of provisioning for slow-moving inventory.
>
> ...Furthermore the group must consider the risk of any loss being incurred on the transfer or sale of inventory at the end of any particular contract, and provide for the loss over the life of the contract. In particular management should assess the value at which contract stock is likely to be sold at the end of a contract term and make provision for any shortfall below book value.
>
> Accounting guidance stipulates that aircraft components should be written off over the life of the aircraft. No specific provision has been made as management believe that aircraft inventory will be sold at above cost before the aircraft stop flying."

That report identified as a key risk slow moving inventory including provisioning.

313. The customer base had been growing over the period 2006-2008 but stock turn nevertheless remained low. Deloitte's 2008 Report to the Audit Committee stated that that "overall stock-turn is low". In a letter dated 17 April 2013 Clyde & Co stated that Deloitte considered an average stock holding period might be two years based on average stock turn. However the audit files do not contain an explanation of Deloitte's assessment of stock turn; it appears that no analysis was performed on stock turn and no consideration was given to the likelihood of all stock being sold by the end of a contract.

314. In each of FY2006, FY2007 and FY2008 Deloitte and Mr Clennett carried out no independent audit testing of the appropriateness of Aero's stock obsolescence provision of 0.5 per cent, even though the adequacy of the provision was an identified risk for the purposes of the FY2007 and FY2008 audits. Mr Clennett and Mr Baker both gave evidence to the effect that the issue of provisioning was much considered and debated and considered the risk that Aero was holding stock that it might have difficulty in selling. However they were satisfied by Aero's management maintaining that no provision was required and that 0.5 per cent provision was more than adequate and by internal discussions with the PSR reviewer and the IRP. Mr Clennett also had the benefit of discussions with Mr Hamilton who acted as the EQAR for an earlier audit and had considerable experience in the aviation industry. Mr Clennett was sure he would have had discussions with him but he did not suggest that any additional work should be performed in relation to provisioning. There is no documentation recording the substance of the discussion. Furthermore Mr Clennett was comforted by the fact that the risk of surplus stock attached more to bulk purchase contracts (as Aero did not make individual purchases of stock which it did not require) and bulk purchase stock was purchased at a substantial discount and that worked in favour of Aero as it reduced the likelihood of any provision which would be required for slow moving stock. However the degree of comfort which could be taken from the extent of the discount was reduced once one took into account the effect of SLD (in possibly increasing the cost of slow moving stock) and there is no evidence that this was considered by Deloitte or Mr Clennett. Mr Clennett also gave evidence that Deloitte was informed that Aero did not have data systems which would enable an examination of the ageing of inventory and that it is always difficult to come by hard evidence "that an item of stock will not sell in the future and we did not see such evidence in the case of Aero's provision" and that Mr Lewin had said to him that historical data was not necessarily an indicator as to future usage. Moreover, Mr Clennett recalled that usage data insofar as it existed would have related to particular customers whereas Aero's business model was to move towards a more unified approach to its holdings of stock which could be moved round the world to where it was needed by any particular customer. He did not think the data would be available for a particular line of parts regardless of which customer used stock in a particular line.

315. So far as sales (cross selling) made to customers by AI outside the main contracts is concerned, such sales amounted to £1.2 million in FY2006, £1 million in FY2007 and

£2.85 million in FY2006 (i.e., less than 1 per cent of total sales in FY2007 and FY2008). Those figures do not suggest that much comfort could be taken from the possibility of cross selling as a means of ascertaining whether the price of slow moving lines would not have to be reduced below cost in order to move them on.

316. The Respondents also made the point that as the value of stock rose in each year so the value of the 0.5 per cent provision rose. The corollary was however that the value of stock retained by Aero rose substantially over the years and it does not follow that sales or the potential market for sales by Aero was growing at the same rate. The evidence through the build-up of stock suggests that they were not. Albeit there was evidence that Aero reviewed stock acquired from SRT and allocated a nil value to stock that was thought to be worthless or of uncertain value, Mr Meredith found no evidence on the audit files that that process was followed in relation to stock acquired from Garuda, Qantas, ACTS, ANA and Aeroman. Mr Meredith also noted that the stock acquired from Garuda and not sold onto GMF was stock which related to planes Garuda no longer flew. 70 per cent of the total cost of the Garuda stock was allocated to that stock.

317. The Respondents submitted that given that aircraft required both planned repairs, in accordance with a scheduled maintenance programme, and ad hoc (often urgent) repairs, the fact that an item of stock might be 'slow moving' said nothing about its likely sale price when sold. There was some evidence that in certain cases once planes ceased to be in manufacture – and came to be passed on from carriers such as Qantas to carriers in the less developed/developing world – parts would probably become scarcer and more valuable. However we do not accept the submission that in general the fact that a line was slow moving said nothing about its eventual selling price. We consider that the fact that a line is slow moving should raise questions as to the price at which it might be sold.

318. That Stock Provisioning Memo was not updated for FY2007 or FY2008 (as Mr Allen agreed that it should have been). Mr Clennett's recollection is that Deloitte did not ask for a revised version of it for the years FY2007 and FY2008 because "Aero's core rationale for the level of stock provision did not change from one year to the next, and so the reasoning explained in the previous year's Stock Provisioning Memo remained valid and did not need to be restated for us."

319. Mr Clennett gave evidence that it was his view that the calculation (as distinct from the narrative) in the Stock Provision Memo:

> "had not added much to the arguments for and against a different provision; we thought that a more granular analysis of the stock holding so as to identify slow moving parts that were likely not to be sold would be a far more valuable exercise for Aero, which is the observation we made to the Audit Committee [in the Report to the Audit Committee on the 2007 Audit]".

320. That "rationale" was provided to Deloitte for the FY2006 audit. Deloitte identified provisioning as a key audit risk for the FY2007 audit and as a Specific Identified Risk in the FY2008 audit, but continued, without testing, to place central reliance on the Stock Provisioning Memo provided by Aero and on the specific management representations in the management representation letters, as to which Mr Clennett said:

> "We raised concerns as to the valuation of inventory, in particular with reference to the renewal of long term supply arrangements and at the end of the relevant aircraft lives. We sought representations from the Board on various matters of judgement. For example, on stock provisioning the Board were firmly of the view that provisions were not required as they expected supply agreements to be renewed or the inventory to be required by the replacement provider. They believed that parts tend to become more valuable as they are produced in lower quantities at the end of aircraft lives."

321. The management representations in question were:

321.1. for FY2006 (as per Defence 289):

> "We have reviewed inventory for obsolescence and requirements for a slow moving provision. We confirm that we are of the opinion that no material loss will occur from the disposal of stock at the end of the current contracts nor do we believe that any provision is required against inventory items that may be held at the end of the useful life of the aircraft."

321.2. for FY2007 (as per Baker 367):

> "We have reviewed inventory for obsolescence and requirements for a slow moving provision. We confirm that we do not believe that any provision is required against inventory items that may be held at the end of the useful life of the aircraft."

321.3. for FY2008 (as per Clennett 22.11 and Baker 372):

> "The Group has reviewed inventory for obsolescence and requirements for a slow moving provision, and confirm that we are of the opinion that no material loss will occur from the disposal of stock at the end of the current contracts nor do we believe that any provision is required against inventory items that may be held at the end of the useful life of the aircraft."

322. Mr Clennett answered in response to a question from the Tribunal, that although in each year management represented that they had "reviewed inventory for obsolescence", there was no evidence that management had actually carried out any detailed review. Mr Clennett gave evidence that Deloitte staff working on site during the course of the

audits had not found any evidence of scrappage or obsolescence. That accords with the work papers relating to the onsite visits. However, observation whilst on site would not deal with the question whether stock would be sold at an amount equal to or greater than its book value. The difficulty was that the work papers record the audit team reporting back on what they had been told by the Aero staff on the ground as to what Aero had done in relation to obsolescence including slow moving stock as opposed to Deloitte staff considering the matter independently. Deloitte and Mr Clennett relied on the acknowledgement by management that they had considered the issue. Deloitte and Mr Clennett also relied in part on Aero management's representation that, if a part stopped being manufactured, it became more valuable which accorded with the experience of some Deloitte personnel in relation to aircraft of particular note. When asked about the basis for this assertion, Ms Dowding said "This is what the client was saying was their basis for the discussion. I mean, this clearly hadn't been tested in practice because the contracts were relatively new and they hadn't experienced any decommissioning at that point".

323. Mr Clennett gave evidence to the effect that Mr Lewin informed him that Aero excluded obsolete items from the stock lists provided to Deloitte. However, when asked how he satisfied himself as to the exclusion of these obsolete items, Mr Clennett explained that he "wouldn't know" because Deloitte only saw the listings of the items which Aero said had a value. The stock listings were therefore of no use for checking whether Aero had properly reviewed the stock for obsolete items. Instead, Mr Clennett (and Deloitte) accepted at face value what Mr Lewin apparently told Mr Clennett – that the parts in the stock listing (i.e. those not purportedly excluded by Aero as being obsolete) were "parts that were usable on planes that were currently flying". Mr Clennett was not sure whether this meant currently flown by Garuda or just generally in use around the world. Mr Clennett gave evidence to the effect that Deloitte "pushed the board on many occasions to analyse its inventory for slow moving items or items that – and therefore items that may well not generate value in the future". However, Deloitte and Mr Clennett did not insist that this analysis was undertaken and therefore did not test the risk that Aero was allocating too high a cost to obsolete or slow moving stock. It was not suggested that they sought to see a list of parts treated as obsolete.

324. ISA 580 "Management representations", as it prevailed at the relevant time, stated that management representations should be obtained when other sufficient appropriate audit evidence cannot reasonably be expected to exist and cannot be a substitute for other audit evidence that the auditor could reasonably expect to be available. We would have expected Aero to have information relating to its customers' aircraft fleet and usage by that customer of parts. Furthermore we would expect there to have been some information available from third party sources as to the NRV of a sample of stock.

325. In response to the suggestion that the question as to whether you can or cannot sell a part is something that needs to be tested, Mr Clennett gave his view that "it's part testing and it's part judgment". Deloitte carried out no testing in relation to this aspect.

326. Mr Clennett said:

> "at one point I suggested to the audit committee that they increase the provision on bulk purchase inventories and build that into the overall costing and I can't remember his name but one of the non-execs, Roger—Davis, Roger Davis, I think, thought that was quite a good idea, but the board didn't think that they needed a further provision, beyond what they had already."

327. A particular matter affecting provisioning arose in relation to FY2007. The FY2007 Stock Lead Memo recorded in relation to Qantas stock:

> "Valuation was tested by comparing the carrying value against the cost and NRV for a CMA AS2 sample. Any discrepancies were investigated [5441]. The final variance was taken to [5470]."

328. In the course of the valuation Deloitte calculated that the value at which certain items were recorded was more than the latest purchase price. Of the 120 items tested there had only been purchases in respect of 30 lines and of those there was a price anomaly in respect of 14 lines. The aggregate error came to $10,828 or £5,160. Deloitte then extrapolated the error against the book value of the 120 lines and applied that percentage to the total book value of the Qantas stock. That produced a calculation error of £326,164. Had the extrapolation been against the total values of the 30 lines in respect of which there had been purchases then the resultant figure would have been ~£1.41 million (in excess of audit materiality). Both experts agreed that Deloitte's mathematical approach was wrong. Mr Allen considered that the difference should have been assessed by reference to the book value of the non Truck Stock items which would have required a great deal of work. As he considered the risk of material misstatement was low he considered Deloitte's approach was acceptable. Mr Meredith's opinion was that the correct approach was to calculate an error rate based on the variance noted divided by the population tested (being those items for which information was available).

329. Executive Counsel's submission was that when assessing whether the anomaly was material, Deloitte should have compared the monetary value of the anomaly detected to the monetary value of the stock ledger lines in which the test could have detected the anomaly (i.e. the 30 lines). Instead, and wrongly, Deloitte compared the monetary value of the anomaly to the monetary value of all 120 lines, even though the test would have been incapable of detecting an anomaly in 90 of those.

330. In any event the £326,164 was taken into account with other matters requiring a provision and formed part of a total extrapolated difference of £1,596,488. That amount was then set off against the 0.5 per cent provision of £1,043,000, leaving a "Remainder" of £553,488 (below audit materiality). As the "Conclusion" W/p 5470 provided:

> "The potential amount that is not covered by the Stock Provision has been taken to the 2340 as a likely misstatement. However as the

extrapolation is such a judgemental area it will not be put on the Management Representation letter."

331. The effect of that was that in FY2007 Aero had no provision for obsolescence. Mr Clennett agreed with that in his interview with the AADB. The provision had been applied in dealing with pricing differences and would not have been available to deal with obsolete stock.

332. Thus, despite the fact that (as noted at paragraph 310 above) Deloitte's Report to the Audit Committee for FY2007 said that there was a 0.5 per cent stock provision and that "The group continues to build its inventories and customer base. Whilst the Group can identify obsolescence it has yet to determine a sound methodology for identifying parts, if any, which may not sell over the life of the aircraft they support", there was in effect no provision for obsolescence in Aero's balance sheet, which was inappropriate.

333. With immaterial changes, and updating the year-end stock balance from £216 million to $693.7 million, Deloitte's Report to the Audit Committee for the 2008 audit repeated the same observations as FY2007.

334. At paragraph 6.11.5 of his report Mr Allen summarised from the witness evidence presented by Deloitte and Mr Clennett the basis for the auditor's acceptance of the 0.5 cent provision as follows:

"(a) The overall satisfactory results of the Cost and NRV testing each year.

(b) That Aero's books did not contain significant stock write-off balances.

(c) That, with the exception of the report for the Elsenham facility in the 2007 audit the feedback from the stock counts at various national/international Aero warehouse facilities was firmly to the effect that obsolescence was not a significant issue.

(d) The detailed and, in objective terms, commercially plausible reasons given by Aero as to why, given its business profile and niche market, the risk of stock obsolescence and of stock being sold in the future below book value was low. These reasons were set out in writing in the 2006 year in the Stock Provisioning Memo and were supported by calculations.

(e) That the Deloitte audit team and Mr Clennett had in-depth discussions with a number of members of Aero's senior management (including Mr Lewin and Mr Bevan) and the Board (including Non-Executive Directors having aerospace expertise).

(f) That the uniform message being given to the auditor by Aero's management and Board, namely that no or a small provision was justified, was backed up by a formal representation (given by successive Letters of Representation).

(g) That the Deloitte audit team consulted internally on the nature and justifiability of Aero's rationale for a 0.5% provision. In particular, Mr Clennett's evidence is that he consulted with Mr Gordon Hamilton, the EQAR partner at the early stages of Deloitte's relationship with Aero. Mr Hamilton is described by Mr Clennett as having "decades of experience in the aviation industry". Mr Clennett also states that he consulted with Mr Mullins and Mr Altoft on provisioning issues; and with Mr Baker of the audit team."

335. Mr Allen considered that Deloitte and Mr Clennett were entitled to take into account representations from Aero's management, on the basis that independent consideration was given to the reliability of the representations. The independent consideration referred to by Mr Allen was the comparison of cost to prices in manufacturers' OEMs. However that did not take into account the fact that the parts were not being sold by the original supplier and might require a discount to OEM for that reason or that there might be no market for the amount of particular lines held by Aero as a result of a bulk purchase. Aero obtained a substantial discount on a bulk purchase for amongst other reasons that the customer might not have been able to use slow moving or obsolete stock. That did raise an issue as to whether the stock was disposable and if so the price at which Aero could dispose of it. Deloitte and Mr Clennett took no independent steps to review the market for the parts relying on representations from Aero that parts did not become obsolete. They should have made their own enquiries.

336. Mr Meredith did not disagree with the statements made by Deloitte and Mr Clennett about the nature of the parts being purchased and sold by Aero (for example, that many parts would be capable of being sold over an extended period of time), but expected Deloitte and Mr Clennett to have sought to understand what steps had been taken to assess the expected future demand for the stock Aero held, to have sought to understand the aircraft types to which Aero's stock was applicable and to identify whether stocks were held for aircraft either not in service or expected to be withdrawn from service in the near future. These steps were not taken.

337. In the case of the stock obsolescence provision (including the implications of slow moving stock), Executive Counsel submitted that sufficient audit evidence could have been obtained, for example, by:

337.1. Comparing quantities of the year end stock with the parts usage data obtained from Qantas, ACTS/Aeroman and ANA as part of the Qantas, ACTS/Aeroman and ANA Bulk Purchase Contracts.

337.2. In the event parts were unlikely to be sold to the Bulk Purchase customers, reviewing other customers' fleets and stock holdings to determine whether stocks were potentially saleable elsewhere.

337.3. For items not expected to be sold in the short term, consideration should have been given to the risk of selling prices falling below cost or physical deterioration.

338. We consider that Deloitte should have attempted to obtain further independent audit evidence as to the appropriateness of the 0.5 per cent provision by taking the steps set out above for FY2007 and FY2008. We consider that Deloitte and Mr Clennett placed excessive reliance on discussions with Aero's management and management representations that the 0.5 per cent provision was adequate and to what they were told by Aero staff on the ground. They should have taken more independent steps to review the issue of provisioning as stock formed a particularly important aspect of Aero's financial statements.

339. The issues in relation to stock obsolescence are:

339.1. Did the audit work performed by Deloitte and Mr Clennett with regard to the adequacy of Aero's provision for stock obsolescence provide sufficient appropriate evidence to conclude that the level of stock provision in the FY2007 and FY2008 financial statements was reasonable?

339.2. If not, did (i) Deloitte and (ii) Mr Clennett fail to act competently with due care and skill in concluding that Deloitte had obtained sufficient appropriate audit evidence in that regard? If either (i) Deloitte or (ii) Mr Clennett did so fail, in what respects did each fail?

340. For the reasons set out above:

340.1. the audit evidence did not provide sufficient appropriate audit evidence;

340.2. Deloitte and Mr Clennett's conduct fell significantly short of the standards in the respects described above and they failed to exercise sufficient professional scepticism.

341. As to the general issue as to professional scepticism the issues are:

341.1. Did Deloitte and Mr Clennett exercise sufficient professional scepticism when assessing information made available by Aero's management and the results of their own audit testing?

341.2. If not, did (i) Deloitte and (ii) Mr Clennett fail to act competently with due care and skill in the exercise of professional scepticism in that regard? If either (i) Deloitte or (ii) Mr Clennett did so fail, in what respects did each fail?

342. For the reasons set out above Deloitte and Mr Clennett did not exercise sufficient professional scepticism when assessing information which was or could have been made available by Aero's management and the results of their own audit testing.

343. Accordingly we find paras 2.1 to 2.4 of Allegation 2 proved.

ALLEGATION 3 — STOCK EXISTENCE

344. Allegation 3 provides:

> "3.1 In relation to the audit of Aero's financial statements for the financial years ended 30 June 2007 and 30 June 2008, the conduct of Deloitte and Mr Clennett fell significantly short of the standards reasonably to be expected of, respectively, a Member Firm and a Member in that they failed to obtain sufficient appropriate audit evidence as to the existence of the stock which Aero's inventories recorded as being held at the premises of Qantas (in FY07) and ACTS (in 2008), and failed thereby to act in accordance with Fundamental Principle C in the Code of Ethics and the Guidance in Section 130 (Paragraphs 130.1(b) and 130.2).
>
> 3.2 As a result of the above, Deloitte and Mr Clennett failed to comply with the requirements of ISA 200, ISA 500 and ISA 501.

345. Allegation 3 concerns the audit of Qantas stock existence in FY2007 and ACTS stock existence in FY2008. In each case, the Allegation concerns the reconciliation of Qantas and ACTS's own records with Aero's records. The Qantas and ACTS stock was held in a number of locations. There are two steps to obtaining substantive assurance as to the existence of such stock:

345.1. Performing physical stock counts, to obtain assurance that the stock records (usually held at a site level) are consistent with the quantity of stock physically on hand.

345.2. Tie-in to year end listing, to obtain assurance that the stock records (at the site level) are consistent with the stock records in the accounting system.

346. ISA 501, as it prevailed at the relevant time, provided at paragraphs 11 and 17:

> "11. When inventory is situated in several locations, the auditor would consider at which locations attendance is appropriate, taking into account the materiality of the inventory and the risk of material misstatement at different locations."
>
> "17 The auditor performs audit procedures over the final inventory listing to determine whether it accurately reflects actual inventory counts."

This applies to both audit procedures outlined above. Mr Allen tried to suggest in evidence that it only applied to the first procedure outlined above but we consider it applies to both.

347. ISA 200, as it prevailed at the relevant time, contained certain provisions which we have summarised below:

> 8. The audit is designed to provide reasonable (not absolute) assurance that the financial statements taken as a whole are free from material misstatement.
>
> 10 (a). The work undertaken by the auditor to form his/her opinion is "permeated by judgment", in particular regarding (amongst other things) "The gathering of audit evidence, for example, in deciding the nature, timing, and extent of audit procedures".
>
> 15. The auditor addresses 'audit risk' by designing and performing audit procedures to obtain "sufficient appropriate audit evidence" to be able to "draw reasonable conclusions".
>
> 15. Reasonable assurance is obtained when the auditor has reduced audit risk to "an acceptably low level".

348. The procedure was set out by Mr Meredith in his second report and his description was

> "For companies where stock is held in multiple locations audit evidence is sought to reconcile the amount counted to the year end listing. This does not require the auditor to physically verify the amount in these other locations but the auditor should review a copy of the stock listing for the other locations. For example:
>
> - A company holds stock in three warehouses (Warehouse 1, Warehouse 2 and Warehouse 3). As part of the year end audit, the auditor determines that it will attend the stock count at Warehouse 2 as this gives sufficient coverage.
>
> - During the stock count, the auditor physically counts stocks of item ABC123 and agrees the 23 items counted to the Warehouse 2 stock records. This gives the auditor assurance over the Warehouse 2 stock records.
>
> - In performing the tie-in as part of the audit procedures the overall stock listing shows the company holding 35 ABC123s.

- The auditor obtains the year end stock listing for Warehouse 1 and Warehouse 3 and identifies that 12 ABC123s are held in Warehouse 1 and none in Warehouse 3. This gives the auditor assurance that the year end listing is reflective of the Warehouse 2 stock records and the quantities of stock on hand. Without performing the tie-in to the year end listing the auditor does not have assurance over the year end stock listing."

To the final sentence of the final bullet point one might add "absent other audit evidence".

FY2007

349. Aero's stock (measured by book value, as recorded in its accounts) more than doubled between the end of FY2006 and the end of FY2007. The driver of that doubling was the Qantas contract, which was signed on 6 October 2006 (with a truck stock date of 1 June 2006); at the year-end, Aero's stocks held at Qantas were two-fifths of its total stock, some £90 million out of £216 million. Deloitte and Mr Clennett were aware that the Qantas contract had led to significantly increased levels of stock, and noted this (as a Significant Event/Unusual Transaction) in the Audit Planning Memorandum. The Engagement Risk had been upgraded in FY2007 from "normal" to "greater than normal". A contemporaneous email from Mr Clennett to Mr Baker records the reason for the upgrade as being "The business is growing fast and has [in] place all its investment in commercial systems matters and the accounts function has lagged a little which they are addressing this year". The accounts function was also commented on by Mr Baker in his evidence who considered that Aero had a slightly "under par team". One reason it was growing fast was the Qantas contract but there was nothing special about the Qantas contract which led to the enhanced risk. However there was no Specific Identified Risk in relation to Qantas or ACTS stock.

350. Deloitte and Mr Clennett performed adequately the first of the two steps referred to at paragraph 345 above, doing physical counts at warehouses in Melbourne and in Sydney (which between them appeared to have held about 90% of the total value of Qantas' stock; the Sydney one holding more than twice as much by value as the Melbourne one). Executive Counsel makes no criticism of the manner in which the first procedure was performed.

351. Executive Counsel's criticism concerns the failure to perform the second procedure which involved the tie back of test counts counted in the warehouses (and which Deloitte had tallied with the warehouse's record) to Aero's accounting system's record of the number of parts it held, which would usually be greater, because the same part would often also be held in other warehouses.

352. In both FY2007 and FY2008, Deloitte took a statistical sampling approach to determining how many test counts it needed to tie in. It sought to obtain a specified

level of assurance, using professional judgment in the planning of the attainment of that level of assurance.

353. Deloitte's audit manual explained how it sought to obtain that specified level of overall assurance, using varying proportions of inherent assurance, control assurance and substantive assurance. The audit manual provided as follows:

> "13.25 In statistical terms, we ordinarily seek 95% overall assurance. The audit assurance model indicates how we obtain overall assurance. The formula for the audit assurance model is:
>
> OA = 100% - (100%-I) (100% -C) (100% -S)
>
> with OA, I, C, and S expressed as percentages and:
>
> - OA is the overall level of audit assurance required
> - I is inherent assurance
> - C is control assurance
> - S is substantive assurance
>
> 13.26 Another way of formulating the audit assurance model is to use reliability (R) factors, which are additive rather than multiplicative. In this formulation, OA = I + C + S, where OA, I, C, and S are expressed as R factors. R factors are equivalent to the confidence factors used to design or evaluate certain statistical procedures, such as CMA samples. There is an R factor corresponding to each level of assurance.
>
> 13.27 To achieve overall audit assurance of 95%, the individual R factors assigned to each of the three sources of assurance add up to 3.0. ...
>
> ...
>
> 13.29. The planning alternatives should be used strictly in accordance with the audit assurance model, as illustrated in Figure 13.1. ...
>
> 13.30 Set out below is a summary of the various combinations of inherent assurance, control assurance and substantive assurance that are possible in the audit assurance model"

Figure 13.1 – The Audit Assurance Model

Sources of Assurance	NO SPECIFIC IDENTIFIED RISK			SPECIFIC IDENTIFIED RISK		
Inherent Assurance	1.0 Maximum	1.0 Maximum	1.0 Maximum	0.0 None	0.0 None	0.0 None
Control Assurance	1.3 Maximum	0.3 Basic	0.0 None	1.3 Maximum	0.3 Basic	0.0 None
Substantive Assurance	0.7 Basic	1.7 Moderate	2.0 Intermediate	1.7 Moderate	2.7 Directed	3.0 Focused

354. The planned degree of substantive assurance varied between the FY2007 audit of Qantas stock existence and the FY2008 audit of stock existence (including ACTS stock). For the audit of Qantas stock existence for FY2007, the "planning alternative" adopted was to place no reliance on Control Assurance, and to place an "Intermediate" reliance (R=2.0) on Substantive Assurance. Deloitte Australia were instructed to use an R of 2 and calculated a sample size of 117 selections. They picked 30 at Melbourne and 87 at Sydney.

355. For the audit of stock existence in FY2008 (including the audit of the ACTS stock which represented 25% of the total stocks balance) Deloitte's audit approach was to take the "Maximum" Control Assurance (R=1.3) and "Basic" Substantive Assurance (R=0.7).

356. In FY2007 Deloitte Australia (instructed to use an R of 2.0) selected 117 test counts (30 at Melbourne, 87 at Sydney); they performed step 1 set out at paragraph 345.1 above but referred step 2 back to Mr Clennett for Deloitte UK to perform, and Deloitte UK set about trying to tie-in the 117 items selected in the sample.

357. In FY2008 the statistical calculation using R=0.7 determined that 151 test counts should be selected for tie-in. These were picked haphazardly but evenly over the sheet-to-floor and floor-to-sheet counts; 17 of the 151 were from ACTS (from the warehouse at Montreal).

358. In terms of the stock counts themselves, the Executive Counsel accepted that these were satisfactorily performed at Qantas' Melbourne and Sydney warehouses. The Melbourne warehouse alone held a significant percentage of the entirety of Aero's Qantas stock. The audit work on site was performed by representatives of Deloitte Australia (whose Siobhan Moynihan had formerly worked in Deloitte in the UK, and had been the audit manager on the FY2005 audit of Aero).

359. In principle agreeing the stock count results with Aero's own records should have been relatively simple as it was thought that Aero's database was generated from the Qantas inventory data. In fact the data on Aero's systems did not reconcile with the audit results produced by the first procedure. Once Deloitte UK was provided with Aero's year end stock listing of its parts held and managed by Qantas, it became apparent that that listing recorded higher quantities of stock for some part lines counted in the audit testing than set out in either the Sydney or Melbourne count sheets.

360. Aero's explanation to Mr Clennett for the discrepancy was that Qantas held stock at other sites. For the stock counted at Melbourne, the surplus was likely to be found (amongst other places) at Sydney and vice versa.

361. Deloitte therefore obtained the site-specific stock listings (in addition to the Sydney and Melbourne listings) and set about reconciling the differences, as its audit programme required. This involved, for each part line which had been physically checked, identifying that if there had been, for example, 5 of the parts in the Sydney warehouse, but Aero's records said it held 10 overall, going through the other warehouses' records to check that they showed a total of 5 of these parts.

362. Deloitte did this with a success rate of 89% by value of differences (98% by number of differences) for the 30 parts lines it had checked from the Melbourne warehouse. It was less successful with the Sydney warehouse, reconciling about 20% by number of the difference by the time of, or about the time of, the Audit Committee meeting on Monday 3 September 2007.

363. The timing of Mr Clennett's decision to discontinue tie-in of the Qantas test-counts in FY2007 is apparent from paragraphs 320 to 322 of the Defence.

364. Deloitte's Report to the Audit Committee was issued on Friday 31 August 2007, when Mr Clennett was aware that testing of Qantas' inventory existence was still in progress. The Report notes:

> "We have substantially completed our audit in accordance with our Audit Plan which was presented to you on 7 March 2007 subject to the satisfactory completion of the matters set out below:
>
> - Receipt of various supporting documents for stock, including a large sample relating to Qantas;
>
> ..."

365. Then at or about the time of the Audit Committee meeting on Monday 3 September 2007, and for reasons which were not documented, Mr Clennett and Mr Baker decided that Deloitte could justifiably give an unqualified opinion on the FY2007 Accounts without finishing the substantive testing. The timing was consistent with Mr Baker's email of Friday 31 August 2007 17:46 to Mr Dodge to the effect "we are aiming to get the accounts finalised by close of play Wednesday – so we should aim to have everything closed down by then".

366. The accounts were then finalised by close of play on Wednesday 5 September 2007.

367. In answer to a question from the Tribunal as to whether, under the provisions of statistical sampling, Deloitte was trying to get a particular confidence level and therefore, by abandoning the tests in Sydney, Deloitte did not get the same confidence level, Mr Clennett said (among other things) that:

> "We concluded the work on Melbourne as satisfactorily as we could in the time. We decided that we'd done enough when we got to 98 per cent by number on the existence test. There were a couple of items that we could have followed through further. And then on Sydney we just judged that was – that would have been a repeat exercise. It was a non-risk area. So that's why we concluded that we were probably not going to get any further evidence as to the existence"

and

> "So it's, you know, it's – would we have preferred to have finished it? Yes. But we were just forming a judgment that we'd done enough work, essentially, by the other counts that we'd done."

He was not there suggesting that the reconciliation could not be done but that he had sufficient audit evidence from the other counts which Deloitte had carried out.

368. There is an absence of a contemporary record of the reasons why Deloitte and Mr Clennett considered that they had sufficient audit evidence. However, as we have said above we have to decide the matter on all the evidence placed before us.

369. Mr Clennett said that he took into account:

369.1. The satisfactory evidence as to Aero's stock historically. We do not consider that Deloitte and Mr Clennett were entitled to place weight on the fact that in FY2006 the audit of stock had produced a satisfactory result. The amount of Qantas stock was very material and was the subject of different systems and controls which Deloitte had not previously audited. Aero's Parts Central system did not yet interface with the customer's inventory system, as it did with established contracts. Accordingly we find it difficult to see how Deloitte and Mr Clennett could have found any audit assurance as to the existence of Qantas stock by reference to the existence of non-Qantas stock. If anything the lack of the interface was something which should have given rise to more concerns in reconciling the Qantas stock as here was another feature which might have given rise to a discrepancy.

369.2. The fact that the audit evidence in relation to non-Qantas stock was satisfactory. We do not consider that reliance could be placed on the satisfactory audit of the non-Qantas stock for the reasons set out above.

369.3. The fact that the stock counts in Melbourne and Sydney had been satisfactory and indicated that the Qantas warehouse systems had a high degree of accuracy. There was no dispute as to the accuracy of the Qantas records as against the Qantas stock. The subject of the audit was the accuracy of the Aero records against the Qantas stock which was altogether different. Aero was the subject of the audit. The satisfactory result of the first procedure merely set the scene

for the second procedure. It gave no audit assurance in itself as to the second procedure.

369.4. That the audit team had reviewed the control of the stocks of parts Aero held for supply to customers under its contracts with them. The review was a walk through. The controls were not tested. The audit approach had been to place no reliance on control assurance and the review did not provide audit assurance. Mr Clennett in cross examination said that he had not relied on control assurance. In fact an intermediate approach had been taken on Qantas stock through a combination of design and implementation work and substantive work (R = 2). Control assurance the subject of W/p 4311 could not have given any comfort as to the reconciliation of Aero's stock records with those of Qantas. It was a review of how Qantas managed its warehouse and stock counts. Accordingly it was no substitute for the second procedure. Furthermore, the fact that Aero could not have functioned if it did not have tight controls on its stocks did not necessarily result in stock not being overstated.

369.5. That the tie in of the Melbourne stock count to Aero's year end Qantas stock listing had successfully traced 98 per cent of the items with differences to other locations. Only 2 per cent of the items (68 out of 2,941 (an overstatement of £13,381 out of £116,830)) were not reconciled but 2,873 out of 2,941 were. We consider that was some audit evidence which could be relied upon; however it does not necessarily follow that results from one location will be replicated in another location where the auditor has no prior experience in either location to draw from. However we do find that, as Mr Meredith said, it should have been possible to obtain a copy of the stock listing at the other locations similar to that which was on the audit file as at 30 May 2007. If that had been obtained that would have facilitated reconciliations of items held at different locations so as to reconcile the data obtained from Sydney with the data held by Aero. Alternatively the reconciliation could have been done by obtaining the listing of stock at the locations other than Sydney and, for each of the 24 part numbers in question, adding up how many parts there were at the other locations, as was done for Melbourne. Mr Clennett's evidence was not that the exercise could not be done but that he decided that Deloitte had enough evidence and made a judgment that they did not have to do more. The difficulty with that is that it negated the outcome of the determined audit strategy which they set out to achieve by doing the statistical sample and no other procedure was substituted for it.

369.6. That in the light of the above there was no reason to doubt that if further work was done in respect of the differences between the Aero listing and the Sydney stock count a similar result would be achieved. First the Melbourne result did reveal a discrepancy which, if it had been satisfactory to test only Melbourne and the tests had been designed on that basis, might have given an appropriate degree of assurance despite the discrepancy of 11 per cent by value. But

secondly the Melbourne test had been designed as part of the test which required the stock at Sydney to be reconciled as well. That was not done. The statistical sample selected for testing was based on the total quantity of stock across all locations and it follows that, if Deloitte and Mr Clennett had chosen to count stock only at Melbourne, they would have needed to count more lines of stock at that location. Mr Clennett agreed that "If we had concluded that we didn't need to count at Sydney, we may well have done a more extensive sample at Melbourne, yes, there is a possibility." We would consider that that would have been probable. Accordingly we do not accept the submission that the testing at Melbourne gave sufficient assurance in relation to the stock held in the Sydney warehouse. It was not intended to do that on its own. We do not consider that "the 98 per cent tie-in was good audit evidence that Aero's listing correctly contained the stock held: (a) at Melbourne; (b) *at Sydney*; and (c) elsewhere" as submitted by the Respondents.

369.7. That Deloitte had been "repeatedly told by Aero that the cost of stock write offs or variances at the warehouse was borne by the customer". We accept that Deloitte and Mr Clennett had been told that any stock write-offs/variances occurring due to failures in stock management at the warehouse did not impact the Income Statement of Aero, as the cost was borne by Qantas. However, the audit was of Aero and its records. Had Aero's records wrongly recorded an excess amount of stock it is inconceivable that Qantas would have compensated Aero. That was accepted by the Respondents. Accordingly the need to carry out procedure 2 (or an appropriate substitute) was not negated by the possibility that if Aero's stock records correctly recorded an item or items of stock which in the event had been mislaid in the Qantas warehouse Qantas would compensate Aero.

370. Further points made by Mr Clennett were first, that the Qantas stock had been acquired recently. We do not consider that that obviated the requirement to complete the audit of the Qantas stock; secondly, that Deloitte and he were not aware of any disputes between Aero and Qantas in relation to the transmittal of data by Qantas WIMS system which was in turn fed into Aero's Parts Central System. But if there was an error in inputting data at Aero the error might not be identified by Aero and would not be known to Qantas unless an incident brought the error to light. He also said that there was no evidence of any billing errors but admitted that Deloitte and he had not taken any controls reliance from the absence of billing errors. In fact there was some evidence of billing errors.

371. In order to find the appropriate assurance Deloitte and Aero needed to rely upon some evidence which amounted to sufficient audit evidence as to the stock existence in FY2007 and which could replace the test which had not been completed even if Qantas stock itself was not a SIR. The point made by Mr Meredith was that once the determined audit strategy had not been completed, because the tie up was not done, that element of audit assurance was not obtained. Deloitte and Mr Clennett were entitled to

abandon a test which, if successful, would have supplied sufficient audit assurance. But if they did abandon the test they needed to be satisfied that they had other appropriate evidence sufficient to satisfy them as to the existence of the stock. We do not consider that Aero supplied sufficient evidence. Deloitte and Mr Clennett considered audit assurance of Aero's records of the Qantas stock was required and were correct to do so. The failure to tie in the Sydney stock resulted in there being inadequate audit evidence. We are concerned that Deloitte and Mr Clennett made the decision they did in order to certify the accounts on the date they did and so rushed their consideration of the matter.

FY2008

372. For FY2008 inventory was no longer treated as a SIR. Stocks held by Aero in relation to the ACTS Bulk Purchase Contract were valued at $172 million (i.e., 25% of the total stocks balance). Stock counts were carried out in Montreal (where over 80% of the ACTS stock was held) and at other sites where other stock was held.

373. The process of trying to audit the ACTS stock started on 30 July 2008 when Ms Gledhill emailed Mr Dodge outlining the audit process for stock as outlined above. The issue of resolving discrepancies between the ACTS records in Montreal and Aero's records continued right up to 12 September 2008 when Sam Chapman emailed Amar Pabari (copied to Mr Baker) asking if there had been any resolution on why ACTS year end stock listings did not tie in with Aero's own records. Mr Gregory replied to the effect that he was chasing an Aero manager in Canada for information from ACTS' IT System.

374. In relation to the FY2008 audit and the ACTS stock Deloitte had determined that it should tie in 151 of the 468 test counts it had done for the audit, and it evenly but haphazardly selected those 151, 17 of which were from the stock counts for ACTS stock (which was 25% by value of Aero's inventory and which had been counted at the Montreal warehouse). The sample size was based on an R factor of 0.7 (basic level of assurance) due to stock existence not being a significant risk and control reliance being taken.

375. However, in 13 of those 17 there were differences. Deloitte did not reconcile any of these differences.

376. On 16 September 2008 Deloitte issued its report to the Audit Committee for its meeting held on 18 September 2008. On that day (16 September) Ms Gledhill sent Mr Baker an outstanding items list. One of the items was a tie in of the ACTS stock. There were further exchanges on 17 September 2008 when Ms Gledhill sent Mr Tebbutt of Aero the outstanding list. Separately, Wayne Isenberg of Aero advised Mr Nathan, in a continuation of their email exchanges about whether all stock locations had been counted at the time of the audit, that ACTS had not been able to complete the count that day and that he would contact Mr Nathan the following day as soon as he got the results.

Internal exchanges within Aero the following day suggest that although Mr Nathan was pressing Wayne Isenberg in Canada for a drip feed of results, he was doubtful "about getting much helpful info. This week" and that he and Mark Gregory were pretty sanguine about the prospect that it would be a "Shame if the auditors had to go without resolution of this." It seems he did however chase Wayne Isenberg repeatedly.

377. On Thursday 18 September 2008 the Audit Committee met and Mr Baker presented Deloitte's report.

378. On the evening of Thursday 18 September 2008 Mr Chapman sent Aero (cc Mr Baker and Ms Dowding) a further list of stock-related items which he said:

> "remain outstanding and require resolution before Monday.
>
> ...
>
> **ACTS**
>
> - Stock count tie-in. Differences remain unresolved. I understand Amar will have explanations on Friday."

379. Mr Baker followed this up by forwarding the list to Martin Dodge saying that these:

> "... do need resolving before the numbers go out.
>
> To the extent we don't have the info (and then worked through it) by close of play tomorrow I think one or both of Mark [Gregory] & Amar [Pabari] will have to come in over the weekend and sort it out, as will my team.
>
> ... [Mr Clennett] & I will be in Barnet all day tomorrow if you want to talk through anything."

380. On Friday 19 September 2008 Mr Clennett reviewed the stock count tie-in work paper (w/p 5480.1). That paper showed that, as noted above, the stock counts did not tie in to Aero's records. Although Deloitte had repeatedly asked for an explanation, no work had been done to agree any of the differences to supporting audit evidence and the accounts were due to be released to the market on Monday morning. But having failed to obtain them before Friday 19 September 2008, with Aero's results due to be released to the market at 7 a.m. on Monday 22 September 2008, Deloitte then (on Mr Clennett's decision) did not tie-in any of those 13 lines, but recorded an explanation for why the ACTS stock counts did not tie in against tickmark (b), excluded the ACTS differences from the "Over/(under)statements", and calculated an "Extrapolated over/(under)statement" based only on the other 4 (non-ACTS) test counts which had not been reconciled, with the result that the extrapolated over/understatement was below the materiality threshold. The explanation recorded was that:

"ACTS stock counts do not tie for the following reasons:

1. ACTS store the same items at multiple locations. At the stock count only one location was counted.

2. The ACTS system is not sync'd with Parts Central [Aero's system] and although updates should happen, they don't properly.

3. Stock is posted against the incorrect parts due to the ACID no ref's used by ACTS – ACTS have many part numbers for the same part (ACID numbers).

   This does not represent over/under billing because all purchases/sales have been agreed since June 07."

381. Mr Clennett's evidence was that he thought that the explanation against tickmark (b) reflected discussions with Aero's management but he could not remember the substance of the discussion. Executive Counsel floated the idea that it might have been inferred by the audit team. We consider that the tickmark did reflect discussions with Aero management. Whether they did or not the fact is that the tie in was not carried out.

382. Deloitte quantified the value of all the differences found in the 151 test counts selected (which, besides the 13 ACTS test counts with differences, amounted to four other test counts, relating to non-ACTS stock: 3 at Zurich and 1 at Stansted) and recorded them in the "Over/ (under) statement" column of the "Test Counts Tie-In", computing the total net over/ (under) statement to be $22,211.61.

383. However, when extrapolating to the stock balance as a whole (ACTS and non-ACTS stock), rather than using that total net over/(under) statement to generate the extrapolation, which would have led to an extrapolated overstatement of some $13.2 million (when audit materiality was $3.8m), Deloitte excluded all the ACTS differences from the extrapolation. Consequently, the "Extrapolated over/ (under)statement" was shown as -$2,491,244, which was below audit materiality.

384. Mr Meredith commented in his report:

> "Although I do not consider that, without investigation, a simple extrapolation is appropriate in assessing the quantum of any potential error, extrapolating errors noted during the tie-through of all (ACTS and non-ACTS) count results suggests a total error of $13.2 million. When the errors are confined to ACTS stock only, the extrapolated overstatement was $53 million. Because the vast majority of errors identified by Deloitte arose from the ACTS Montreal warehouse, an extrapolation based solely on ACTS stock would have provided an indication of the potential impact on the final stock valuation of the errors identified."

385. The accounts were released on 22 September 2008 at 7 a.m..

386. Executive Counsel contended that Deloitte's decision to sign an unqualified audit opinion in FY2008 was wrong, and that the imminent publication date of the accounts was a factor in that wrong decision being taken.

387. The grounds put forward by Deloitte and Mr Clennett for justifying the decision not to tie in the ACTS stock in 2008 were very similar to the grounds relied upon as justifying the decision not to tie in the Qantas stock in FY2007.

387.1. Deloitte and Mr Clennett understood the business model and the importance of keeping accurate records so as to avoid difficulties when parts were not available for urgent maintenance issues and there had been no substantive stock existence issues in previous years. ACTS was a new contract and Aero and ACTS's data systems were not synchronised; that mitigated against assurance to be derived from previous audits.

387.2. The fact that stock counts in other locations had tied back satisfactorily. We do not consider that that could be relied upon as giving any substantial assurance. There was a different system operating at Aero from that applicable to established contracts: Aero's Parts Central system did not yet interface with the customer's inventory system, as it did with established contracts.

387.3. The fact that the stock count in Montreal reconciled with ACTS' ARTOS computer system. Aero and its systems were the subject of the audit. The fact that the first procedure led to a satisfactory conclusion could not give one assurance as to the results that the second procedure if carried out might produce.

387.4. Aero's management's explanations that the quantities of stock representing the differences between the Montreal count and the year-end ledger were stored at other locations was credible, as there were several other ACTS locations and Deloitte had not set out to count all of the bins which held the same part lines. We do not consider that Deloitte and Mr Clennett were entitled to rely upon management representations in this respect. On the representation there was other documentary evidence (or indeed real evidence) available to show where the "missing stock" was. That must have been the case if Aero were going to be in a position to service their customer efficiently.

387.5. Audit standards do not require an auditor to carry out a stock count at every location. That is correct but it does not answer the question whether Deloitte and Mr Clennett had obtained sufficient audit evidence and were correct in certifying the accounts without doing more to satisfy themselves as to the existence of stock.

387.6. The ACTS contract afforded protection in relation to missing stock. It would not do so if the "missing" stock arose out of an error in Aero's own records. In

any event the fact that Aero could be compensated for missing stock (assuming it was genuinely missing) does not result in the stock existing. It results in Aero having a collectable.

387.7. Mr Clennett said that that he believed a factor in his thinking was that Aero had been billing the client for inventory consumption, without apparent disagreement as to inventory existence, since the truck stock date "which indicated that Aero's stock records must have conformed reasonably well with those of ACTS". However, the ACTS invoices were prepared by ACTS itself and accordingly it is difficult to see how one can draw the inference from the lack of a dispute between Aero and ACTS that Aero's records were accurate. Furthermore, as Aero's IT system was not integrated the accuracy of Aero's sales ledger could not be relied upon as giving a level of assurance as to the existence of stock. If Aero's records inflated the volume of stock this would not be revealed by an invoice from ACTS.

388. The issues relating to Allegation 3 are as follows:

388.1. Did Deloitte and Mr Clennett obtain sufficient appropriate audit evidence as to the existence of the stock which Aero's inventories recorded as being held at the premises of Qantas (FY2007) and ACTS (FY2008)?

388.2. If not, did (i) Deloitte and (ii) Mr Clennett fail to act competently with due care and skill in concluding that Deloitte had obtained sufficient appropriate audit evidence in that regard? If either (i) Deloitte or (ii) Mr Clennett did so fail, in what respects did each fail?

389. For the reasons set out above Deloitte and Mr Clennett failed to obtain sufficient appropriate audit evidence as to the existence of the stock which Aero's inventories recorded as being held at the premises of Qantas (FY2007) and ACTS (FY2008).

390. For the reasons set out above, in concluding that Deloitte had obtained sufficient appropriate audit evidence in that regard Deloitte and Mr Clennett fell significantly short of the standards.

391. We conclude that the complaint in Allegation 3 is proved.

CONCLUSIONS

392. For the reasons set out above we make an Adverse Finding in relation to each of the 3 Allegations in the Amended Formal Complaint and make a finding of Misconduct against Deloitte and Mr Clennett.

SANCTIONS

393. In the light of the conclusions set out above we now turn to consider the nature of the sanctions which should be imposed on the Respondents.

The objectives of sanctions

394. The purpose of imposing sanctions is not to punish a respondent for an act of Misconduct but to protect the public and wider public interest and in doing so to seek to achieve whichever of the objectives of the Scheme are applicable. Paragraph 9 of the Sanctions Guidance ("the Guidance") provides four objectives for the imposition of sanctions The second objective (the protection of the public from a Member or Member Firm) does not arise, but the first, third and fourth are applicable. They are:

> "• to deter members of the accountancy profession from committing 'Misconduct';
>
> • to maintain and promote public and market confidence in the accountancy profession and the quality of corporate reporting; and
>
> • to declare and uphold proper standards of conduct amongst Members and Member Firms."

395. The third objective (the promotion of public and market confidence in the accountancy profession) and fourth objective (upholding proper standards of conduct) are particularly engaged due to the circumstances in which the Misconduct occurred. These are set out at some length above but are summarised below.

396. Aero was a publicly listed company, quoted on AIM. Deloitte and Mr Clennett recognised at the time of the FY2006 Audit that as a result of the AIM listing:

> "There are market expectations which the company will be under pressure to meet. These will relate to turnover and profit after tax therefore these are key performance indicators.".

397. The Garuda Transaction more than quintupled what would otherwise have been Aero's reported operating profits, represented more than 100 per cent of second-half operating profits for the year, and without the sale, profits for the year would have fallen significantly against a background of management having announced that profits would be weighted to the second half of the year. Aero made a last minute adjustment to book a further £1.057m of profit on the sale to GMF, in circumstances which Mr Allen agreed merited close attention which it had not received. Deloitte had categorised "revenue recognition on large 'one-off' transactions, typically made at the start of new contracts" as a SIR in the FY2006 Audit, considered that in the SRT Transaction in FY2006 Aero management had (as Deloitte subsequently recorded in the FY2008 audit file) "tried to include advance sales"

in the FY2006 accounts, and was aware that an incentive to make the £1.057m adjustment was the removal of the profit attributable to the SRT Transaction.

398. Despite the obvious importance of the Garuda Transaction to Aero's reported results, there was a serious failure by Deloitte and Mr Clennett to exercise professional scepticism in relation to it:

(a) as to whether it had happened in FY2006 at all (in following up the information provided to them about it);

(b) in any event, in accepting that it was two unlinked transactions;

(c) as to the application of SLD (which is what enabled the creation of the profit) and in failing to ask to see the data about it which they were told existed, such as the analysis of the Garuda Stock;

(d) in the disclosure of it, when considering Aero's apparent concerns about what constituted commercially sensitive information.

399. Aero's accounts showed increasing turnover, profits and levels of stock over the three years in question; each of these areas was of importance to whether Aero was able to continue trading and was making the profits set out in its financial statements; and they were known to be matters of importance for the audit. In FY2006 to FY2008, Aero's accounts consistently emphasised its growth and its growth was emphasised in numerous press articles. Aero's increased profits were largely the result of its reportedly entering into bulk purchase contracts in each of the relevant years and using SLD.

400. In the "AIM Awards" in 2008, Aero was shortlisted for

(i) "Best Use of AIM"
(ii) "AIM Transaction of the Year"
(iii)"Entrepreneur of the Year" (Rupert Lewin, Aero Inventory); and
(iv)"AIM Company of the Year 2008"

and won the second of these.

401. In the period from the month of publication of Aero's FY2006 accounts (October 2006) to the month of publication of Aero's interim results after FY2008 (i.e. March 2009)), almost £1 billion of Aero shares were bought and sold on AIM. The company posted consistently high profit margins on fast growing turnover by using, but not disclosing that it was using SLD. Deloitte was aware that the level of margin being reported over these years was (as it put it) a "key issue". Not only in the face of the Garuda Transaction, but also subsequently in FY2007 and FY2008 Deloitte and Mr Clennett displayed a lack of professional scepticism in relation to that, despite repeated warning signs. Investors would have been relying on profits being shown fairly in accounts audited by a firm of the size and prestige of Deloitte whether that reliance was directly from an examination of the accounts or by reliance on

press reports many of which would themselves be based in part on the results reported in the accounts.

402. In that period Aero also increased its bank borrowings to finance its expansion, negotiations for which were underway in 2006: the accounts recorded that banking facilities had been increased from £32m to £80m in FY2006; in FY2007 from £85 to £175m "permitting us to finance the next stage of our expansion without recourse to the equity market", and in 2008 to $500m (of which $411m had been drawn as at 30 June 2008). As Deloitte and Mr Clennett knew, a lending bank would have regard to and rely upon Aero's accounts.

403. Aero collapsed in 2009; the FY2008 accounts were its last annual accounts. The administrators' latest report suggests that there will be a shortfall to secured lenders and that unsecured lenders can be expected to recover 1.1 pence in the pound. Shareholders will receive nothing.

404. Deloitte - correctly - submitted to the Appeal Tribunal in MG Rover (when distinguishing the corporate finance advice which was in issue there) that the public interest bears heavily on audit work, especially of a large public company, given the importance of accounts to those who rely on them. As Deloitte emphasised to the MG Rover Appeal Tribunal, auditors have statutory reporting obligations and audit serves the interests of society as well as those of clients.

405. Aero was a stock-holding business (named "Aero Inventory") and stock was by far the most significant asset on its balance sheet. Deloitte noted at the time that Aero made "minimal provisions" (ostensibly 0.5 per cent) for stock obsolescence; identified provisioning as a key audit risk for the FY2007 audit and as a Specific Identified Risk in the FY2008 audit; but continued, without testing, to place central, and excessive, reliance on management representations that the provision was adequate. They did so even though:

(i) management's representation in each year that they had "reviewed inventory for obsolescence" was unsupported by any evidence that management had actually carried out any detailed review; and

(ii) in FY2007, there was in effect no provision for obsolescence at all, not even 0.5 per cent.

406. Aero's stock (measured by book value, as recorded in its accounts) more than doubled between the end of FY2006 and the end of FY2007; it then grew by over 75% between the end of FY2007 and the end of FY2008. Deloitte and Mr Clennett upgraded the Engagement Risk from Normal to "Greater than Normal" in FY2007 on the grounds that the business was growing fast and had put all its investment into commercial systems - and the accounts function had lagged a little, but then failed to obtain sufficient appropriate audit evidence in relation to stock, in both years.

407. We accept the Respondent's submission that the fact that the Misconduct occurs in circumstances where the public interest is engaged does not lead automatically to the conclusion that the Misconduct is towards the more serious end of the sanctions' spectrum. That depends on the nature of the Misconduct.

408. We now turn to the application of the 6 steps approach set out in paragraph 16 of the Guidance.

Step (1): Nature and seriousness of the Misconduct

409. A non-exhaustive list of factors to consider is set out at the Guidance paragraph 18.

Financial benefit derived or intended to be derived from the Misconduct.

410. As Deloitte submitted in the MG Rover appeal, "the fees earned by the Member Firm should not be the starting point when assessing the level of fine to be imposed", because (as Deloitte submitted, endorsing the FRC's own statement) such an approach is "unlikely to enhance public confidence in the profession". This was common ground.

Whether the Misconduct caused or risked the loss of significant sums of money.

411. We consider that it probably did. We refer to paragraphs. 401 to 402. The Respondents accept that (i) Aero was a substantial AIM company, (ii) its increases in profits were largely the result of the bulk purchase contracts and the application of SLD, (iii) the Garuda Transaction should not have been included in the FY2006 financial statements such that the profit of £9.9m should have been stripped out leaving a figure of £2m; and so a transaction representing 81% of Aero's operating profit and more than 100% of the operating profit in the second half of FY2006 was not properly recognisable and accordingly, Aero's reported profitability in FY2006 would have been very significantly lower; (iv) Aero significantly increased its bank borrowings in part due to the figures shown in the audited accounts for FY2006 to FY2008 and (v) on Aero's collapse both secured and unsecured credits (and shareholders) will receive little or nothing.

412. We do not consider that it is appropriate to speculate whether Aero would have taken steps to procure other false evidence had the Respondents applied the appropriate level of professional scepticism. Had the Faxed Documents produced on 4 October 2006 to show that the Garuda Transaction fell within FY2006 been rejected by the Respondents as supporting the date of the transaction, one would expect that the Respondents would have approached further documentation produced after the rejection with a very high degree of scepticism. Furthermore, the Respondents were in possession of sufficient information to deal with the issue of linkage in the Garuda Transaction and failed to consider the appropriateness of SLD. Had there been no Misconduct in relation to these matters the likelihood is that Aero's business would have followed a different course.

413. The Respondents – very properly - accept that the Misconduct risked the loss of significant sums of money. In addition, those who lent money on the strength of the accounts lost monies and many shareholders who were holding shares at the time of the

administration will also have lost money and many as a result of the false market created in part by the results shown in the accounts.

Whether the failures to comply with professional standards were intentional.

414. They were not.

The nature, extent and importance of the standards breached.

415. The breaches were extensive, over 3 years, and going to professional scepticism, which is at the heart of auditors' duties for the discharge of their role. They also related to the core of Aero's business.

Whether the Misconduct involved a failure to act or conduct business with integrity, was dishonest, deliberate or reckless, or had resulted in a criminal conviction of Mr Clennett / Deloitte.

416. It did not.

Was fraud able to occur as a result of the Misconduct?

417. We found that the Garuda Explanatory Memorandum and other documentation presented to Deloitte and Mr Clennett was (and was intended by its authors to be) deceitful. It was the Respondents' strongly argued case that the senior management of Aero were fundamentally and "shockingly" dishonest. However, the exercise of proper scepticism would have probably led to that dishonesty being uncovered or prevented it achieving its purpose: the result of the lack of professional scepticism meant that investors were left in the dark that their company was in the hands of fundamentally dishonest men. Mr Clennett's evidence was that his refusal to sign Aero's 2009 accounts "despite intense pressure from our client and poor behaviour by the client towards my team" "led the client into discussions with its bankers and ultimately administration". As Deloitte and Mr Clennett should not have signed the 2006, 2007 and 2008 accounts, and as it is unlikely that Aero could have continued its business in the same manner, the fraud perpetrated by management in inflating profits was facilitated by the Misconduct. Whether or not other ways of committing the fraud could have been devised is not in point.

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).

418. It did. Aero was quoted on AIM and a substantial number of shareholders lost money on its collapse as did the banks which lent monies. Those banks would in turn have had shareholders.

Whether the Misconduct undermines the purpose or effectiveness of the disciplinary arrangements.

419. It does not.

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

420. It was common ground that it could do so. Aero was AIM listed and its apparent great and growing profitability over FY2006, FY2007 and FY2008 and its subsequent failure were widely reported including (amongst other matters) because its suspension from AIM on 26 October 2009 came within a month of its having announced on 30 September 2009 that it had commenced preparation for a move from AIM to the main market of the London Stock Exchange. The facts of Aero's accounts having been so fundamentally wrong over a three-year period, and of its auditors having failed to obtain sufficient appropriate evidence as to the existence of its main asset, stock, could have seriously undermined confidence in the reliability of financial reporting of listed companies in the United Kingdom.

The effectiveness of Deloitte's relevant procedures, systems or controls.

421. There was a substantial failure to record matters arising during the course of the audit including discussions with management.

422. Deloitte's procedures were ineffective to stop the Misconduct. Mr Mullins had little useful evidence to give to the Tribunal (partly due to the failure to record matters) and whatever the review partner process involved it failed to identify discrete issues relating to the appropriateness of applying SLD, the date of the Garuda Transaction, or its linkage. Even without hindsight we would expect these matters to have been identified and the failures do cast doubt on the effectiveness of the review procedures. As Mr Clennett said, he did not sign off the accounts alone. Effectiveness of relevant procedures includes the effective implementation of procedures as well as the structure of the procedures and it is clear that the review procedure was not implemented in such a manner as to identify matters which were not overly difficult to identify.

When senior management of Deloitte became aware of the Misconduct and what action was taken at that point.

423. We do not criticise the senior management of Deloitte for defending the Complaint. They were entitled to do so and we have no reason to believe that that they acted other than in good faith in doing so. We know as a result of Mr Griggs' witness statement, served for the hearing on sanctions, what steps Deloitte is now taking as, in the light of this Report, and they now accept that there was Misconduct.

Whether Mr Clennett was in a senior position; whether he caused or encouraged other individuals to commit Misconduct; and whether he was solely responsible for the Misconduct.

424. Mr Clennett was in a senior position; until 2013 Mr Clennett was in charge of Quality for the South East region Audit Executive which holds responsibility for overseeing the

audit practice in that region. The Executive Counsel – properly - sought no order that Mr Clennett caused or encouraged other individuals to commit Misconduct. No such allegation was made and there was no evidence to that effect. Furthermore, Mr Clennett was not solely responsible for the Misconduct. He led a team of persons in the audits and the team's work was subject to review in each year. Mr Clennett accepted that as the leader of the team he bears the greatest responsibility for the Misconduct.

Step (2): Potential appropriate sanctions.

425. A number of sanctions are available. They are the issue of a reprimand or severe reprimand, the issue of a direction, the imposition of a fine, waiver or repayment of client fees, preclusion (in effect the withdrawal of a practising certificate for a period), exclusion of a member from a Participant for a specified period.

426. It was common ground that the appropriate sanction was a reprimand and the imposition of a fine. There was a dispute as to whether the reprimand should be a reprimand, as opposed to a severe reprimand, and the amount of the fine to be imposed on Mr Clennett and Deloitte.

427. We should say that but for the assurance by Deloitte's counsel that procedures had been implemented by Deloitte to deal with the lack of recording of matters referred to at paragraphs 40 and 41 above we would have made an order requiring additional training to be undertaken in relation to Deloitte's recording procedures.

Reprimand or severe reprimand.

428. A severe reprimand as opposed to a reprimand is appropriate where the Misconduct is at the more serious end of the spectrum. We consider that the Misconduct committed by Mr Clennett and Deloitte was sufficiently serious to merit the imposition of a severe reprimand. The failures in the audit went to central issues in the audit of a company which carried on a business of the nature carried on by Aero, i.e., the acquisition of stock in bulk, holding it and supplying it to third parties. One of the crucial issues in the audits was the attribution of cost to items of stock. Aero management contended that they applied SLD as described in this Report. Albeit revenue recognition in large one off transactions was identified as a SIR in the 2006 Strategic Audit Plan, the principle of the application of SLD was never questioned during the audit of the years FY2006 to FY2008. For the reasons set out above there was a lack of professional scepticism in a number of respects in relation to the Garuda Transaction which was put forward by Aero in the context of a need to meet expectations and in circumstances where management had to be persuaded to row back in the SRT transaction. There were other acts of misconduct in relation to the stock counts in subsequent years.

The level of fine

429. Paragraph 31 of the Guidance directs a Tribunal to aim to impose a fine (if it is appropriate to do so) 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.

430. In undertaking its assessment, paragraphs 32 and 33 of the Guidance state that a Tribunal will normally take into consideration the seriousness of the Misconduct, the size/financial resources of the Member Firm and the effect of a fine on its business, and the financial resources of the Member and the effect of a fine on him and his future employment.

431. As we have already stated we consider that the Misconduct was serious.

432. Deloitte LLP has UK revenues of £3.04 billion, distributable profits in the last financial year of £608 million and average profit per equity partner of £837,000. Its press release announcing those results also reports that it has had "significant success in the audit market, with four wins in the FTSE 100, taking our market share to 23%".

433. We are not concerned with Mr Clennett's resources as he has the benefit of an indemnity from Deloitte.

434. We have looked at other cases to consider the level of fines imposed in other cases in order to ensure that in a similar case the fine imposed by this Tribunal is not inconsistent without good reason. However, we are conscious that the primary purpose of sanctions is to deter others from committing acts of Misconduct, protect the public and the wider public interest and uphold the reputation of the Scheme: see the Guidance at paragraph 9 and by analogy Bolton v Law Society [1994] 1 WLR 512 at 519B-D and Fuglers v Solicitors Regulatory Authority [2014] EWCH 179 at paragraph 32. Not surprisingly we were not referred to cases where the circumstances and Misconduct are directly comparable. The Respondents did not contend that prior decisions set a precedent.

435. We were referred to three previous decisions by the Executive Counsel.

MG Rover

436. Deloitte failed adequately to consider potential conflicts of interest in corporate finance work concerning one transaction (which, as they emphasised, was not of the public significance of statutory audit work). Deloitte considered that it and the partner responsible merited no more than a Reprimand and a fine in each case, £250-500k for Deloitte and £20-30k for the partner. The Appeal Tribunal imposed Severe Reprimands and fines of £3m and £175k.

437. This case did not involve an audit but a conflict of interest in relation to one transaction. Save that the issue of a severe reprimand and a fine of £3 million illustrated that a previous tribunal did not shrink from imposing a relatively substantial fine the decision has no bearing on the circumstances of this case.

Manchester Building Society ("MBS"), settlement agreement

438. Failures in Grant Thornton's audit from FY2006 to FY2011 of the UK's 19th largest building society. The failures were solely in respect of MBS's fair value hedge accounting and failure to comply with the requirements of IAS 39 in documentation, designation, retrospective effectiveness testing and prospective effectiveness testing. No allegation of lack of professional scepticism. Severe Reprimand and base fine of £1.6m for Grant Thornton; Reprimand and base fine of £70k for one engagement partner, Severe Reprimand and base fine of £80k for the other engagement partner.

439. The Respondents make the point in relation to this decision that:

a. MBS, as the UK's 19th largest building society, had 22,000 savers and 3,750 borrowers.
b. The restatement necessary to MBS' FY2011 accounts (to correct Grant Thornton's Misconduct) resulted in a £28.712m reduction to retained earnings of £38.418m. This in turn meant that MBS had to take urgent action to raise sufficient capital to secure its existence and protect its members.
c. The Misconduct took place over 6 consecutive audit years.
d. There was no allegation of lack of professional scepticism, but Grant Thornton's audit planning was criticised.
e. Grant Thornton was a firm of substantial size with £471m fee income in FY2013. The base Fine against the Member Firm was £1.6m.

440. We note that the failure was as to one aspect of the MBS' accounts and not what might be considered a central aspect such as the attribution of cost of items of stock in the case of Aero. Furthermore, there was no allegation of a lack of professional scepticism as we have found in this matter.

Cattles, settlement agreement

441. Failures in the FY2007 audit by PwC of a FTSE 250 company. The audit failure was in a single year of audit. Insufficient evidence of adequacy of loan loss provision and failure to identify that impairment policy not adequately disclosed. PwC were deliberately misled by third parties and did not stand to gain any profit or benefit by the misconduct. Lack of professional scepticism. Severe Reprimand and base fine of £3.5m for PwC; Severe Reprimand and base fine of £120k for the engagement partner.

442. The Respondents submissions in relation to Cattles were as follows:

a. Cattles was a FTSE 250 company. Also, its Welcome division had over 500,000 customers to whom loans and HP facilities had been extended.
b. The Cattles group receivables were £2.8bn, giving a useful comparison to Aero's size.
c. Cattles' FY2007 financial statements, audited by PwC, showed profit before tax of £165.2m.
d. In April 2008, following publication of the FY2007 financial statements, Cattles undertook a rights issue which raised some £200m.
e. It was not until 20 February 2009 that an announcement was made to the market that publication of the 2008 Annual Report would be delayed. This led to a 74% drop in share price. Trading in Cattles shares was suspended on 23.04.09.
f. Restatement of the FY07 financial statements showed that Cattles' profit after tax had been overstated by £212m and net assets by £360.8m. As such, an originally reported pre-tax profit of £165.2m for FY07 was adjusted to a £96.5m pre-tax loss.
g. PwC failed to undertake sufficient investigations into Cattles' unimpaired loan book; they failed to gain an adequate understanding of Cattles' impairment policy and there was patent confusion within the audit team about that policy; the failures included inadequacies as to planning, conduct of the audit, professional scepticism and Cattles' disclosures in its financial statements. PwC accepted, without adequate challenge or enquiry, false management representations that impaired loans were properly transferred to a particular business unit (despite there being evidence to contrary) whereas in fact much of the impaired debt was being concealed in other business units.
h. Accordingly, the ascertainable financial impact of PwC's Misconduct was very significant and the balances under review (receivables) were an order of magnitude greater than Aero's stock balances. It is not accepted that the Respondents' lack of professional scepticism was more extensive than PwC's.

443. The Misconduct committed by the Respondents is more serious than that by the respondents in the case of PwC and Cattles. It was carried out in relation to three audit years and involved numerous acts of a lack of professional scepticism (see paragraphs 104, 105, 126, 147, 205, 295 and 340 of the Report) some of which went to a central issue in the accounts, the treatment of the Garuda Transaction, SLD, and the existence of stock in relation to a business which was a stock holding business. Although certain members of the board or senior management misled Deloitte and Mr Clennett, the failures to detect the respects in which they were being misled arose due to a lack of professional scepticism.

444. The Respondents also referred to the settlement agreement reached with Ernst & Young and Mr Flitcroft in relation to the FY2005 audit of Fairpack (and subsequent events) where the base fines were £850,000 and £60, 000 together with a reprimand. We regard the

Misconduct in the current matter to be altogether more serious and refer to our comments in relation to PwC and Cattles.

Step (3): aggravating and Mitigating Factors

445. Executive Counsel referred to the issue of a severe reprimand and fine of £3 million in the case of MG Rover. That Misconduct related to the provision of corporate finance advise by the predecessor unincorporated partnership. We do not consider that that fine is an aggravating factor.

446. We consider the fact that the Misconduct occurred over FY2006 to FY2008 as described in paragraph 428 as being an aggravating factor.

447. We do not consider that the fact the Respondents defended the proceedings or the vigorous manner in which they did to be aggravating factors. As the Respondents' counsel accepted, the consequence of defending the Complaint was to lose any discount in sanction due to admissions.

448. The Respondents cooperated fully with the FRC during the investigatory stages. Mr Clennett, for example, was interviewed twice. The Respondents provided lengthy answers to written questions and the Proposed Formal Complaint.

449. The Misconduct is historic (8 to 10 years ago) and very unlikely to be repeated. The former point is a regrettable incident of the formidable nature of the inquiry into the audits and the nature of the disciplinary process. We also note that Mr Clennett has had this matter hanging over him for many years.

450. The Respondents were deliberately and deceitfully misled by Aero, including by Mr Bevan, a fellow professional and the Finance Director and by certain of the Faxed Documents

451. Mr Clennett and his audit team took a firm stand with Aero during the FY2009 audit and this was an important factor in the chain of events that led to Aero's administration in November 2009.

452. Both Respondents have given their apologies for the Misconduct in the evidence served in advance of the hearing relating to sanctions.

453. Neither Respondent stood to gain any profit or benefit from the Misconduct.

454. Both Respondents have a good compliance and disciplinary record. Mr Clennett has no disciplinary record at all.

Step (4): Adjustment for deterrence

455. In the light of the sanctions we consider appropriate, we do not consider any further adjustment is required. We do not consider that the factors in paragraph 56 of the Guidance apply.

Step (5): Discount for admissions or settlement

456. This does not arise

Step (6): The appropriate level of sanctions

457. In the light of the above matters we consider that a severe reprimand should be issued to Deloitte and Mr Clennett;

458. Deloitte should pay a fine of £4 million; and

459. Mr Clennett should pay a fine of £150,000.

Costs

460. Pursuant to paragraph 9 (8) (ii) of the Scheme the Tribunal has power to order costs. We did not understand Deloitte to contend that we should not exercise that power.

461. The Executive Counsel's costs total approximately £3,251,298. We understand that this figure does not include costs attributable to the investigation of Mr Bevan; however Deloitte was anxious to preserve its position in relation to those costs.

462. We order that Deloitte should pay all the costs of the hearing to date.

463. We order that Deloitte should make an interim payment on account of costs of £2,275,000 (i.e., approximately 70 per cent of the total costs). If the balance of the costs cannot be agreed, then the parties may apply to the Tribunal to assess the costs due. For the avoidance of doubt, that assessment may include a review of costs attributable to Mr Bevan and included within the interim payment. In the event that the interim payment is too high, the excess will be repaid.

393. This is the unanimous decision of the Tribunal.

Terence Mowschenson QC

Chairman