

Semple Cochrane - Excalibur within a Scottish setting or the limitations of audit?

Abstract

The paper outlines accounting irregularities which led to the near collapse of Semple Cochrane, one of last cases brought before a Tribunal under the aegis of the United Kingdom's Joint Disciplinary Scheme. The accounting issues at stake provide a backdrop to an exploration of the role of the external auditors within corporate governance, the notion of expertise within the accounting profession, and possible limitations on what auditors can, and cannot, achieve, issues which remain at the centre of discussion on the role and value of audit.

Introduction and Background

Semple Cochrane was one of the last cases brought before a Tribunal under the aegis of the Joint Disciplinary Scheme (JDS)¹ of the professional accounting bodies. Although the complaints made related to activities in the final years of the last century – the company all but collapsed in early 2000 – the judgments of the Tribunal were not finally given until 2008. As compared with other more high profile later JDS cases, most notably that relating to Ernst & Young's role in the audit of Equitable Life, Semple Cochrane has attracted very little attention in professional literature or the media more widely (and almost none at all outside Scotland) – but it is an interesting case and one which is worth further examination on a number of levels. One reason for its relative lack of exposure might be that it is a case relating to a medium sized Scottish firm primarily engaged in electrical engineering and therefore does not have the immediacy of interest amongst wider stakeholders which JDS cases such as Equitable Life, or earlier those relating to Maxwell and Polly Peck, had. Another might be that it is a complicated case with a *dramatis personae* of which Shakespeare would have been proud and one, where again in many respects similar to Shakespearean plays, it is often difficult to ascertain the underlying motivations of the various actors involved.

The judgments² and associated material relating to the various complaints run to more than 650 pages, and it is therefore an impossible task to do justice to all the various issues and nuances which arose and were considered by the Tribunal within the confines of a short article such as this one. The variety of themes which could be developed from the underlying

¹ A review of the role of the Joint Disciplinary Scheme can be found in M Chance (1993) *The Accountants' Joint Disciplinary Scheme*, JFRC, 2(1), pp.22 – 30. Equitable Life and Semple Cochrane were the JDS' last cases, both concluded in 2010. From 2005, the JDS was effectively replaced by the Accounting and Actuarial Disciplinary Board (AADB), a body within the Financial Reporting Council (FRC). The AADB, in turn, was replaced in November 2012 by the FRC's Conduct Committee.

² There were two separate judgments. The first, in relation to complaints against past and present members of Deloitte and Touche and the firm itself, is the main focus for examination in this article and is referenced as TR1 (and the relevant appendix to the report as TR1A). Joint Disciplinary Tribunal (2008). Complaint against John (Ian) Durie, David John Crawford and Marshall William Miller, and Deloitte & Touche (TR1). The second, which relates to complaints against a member of the Semple Cochrane board who was a member of the Institute of Chartered Accounts of Scotland, is not considered in detail here, although there is some use of background material contained in the Tribunal report. All the complaints against this individual were dismissed. This report is referenced as TR2 (and the relevant appendix to the report as TR2A). Joint Disciplinary Tribunal (2008). Complaint against Mr William Wilson Evans (TR2). Access to these reports is not that straightforward as, following the cessation of activity of the JDS, its website on which they were available electronically was taken down; however, they should be available in hard copy on application to ICAS or ICAEW, or at their respective libraries.

material is diverse and includes, inter alia, more specific accounting issues as to the manner in which notions expressed in terms such as ‘reasonable certainty’ should be interpreted within the accounting framework and wider issues as to the nature and purpose of corporate governance. Semple Cochrane was arguably one of the few documented cases where non-executive directors tried to make a difference, but were in fact foiled by a combination of dominant executive management and an unfortunate alliance, no doubt completely inadvertent, of outside consultants and the company’s professional advisers.³ These themes are explored in a forthcoming, related article, but here the focus is confined to a straightforward consideration of the accounting issues at stake, the role of the external auditors, and a brief discussion of the notion of expertise within the accounting and auditing profession and of possible limitations on what auditors can, and cannot, achieve.⁴

Semple Cochrane was a medium sized firm providing engineering and building services and was headquartered in Paisley south west of Glasgow. In late 1996 it made a placing of shares and was then admitted to the official list of the London Stock Exchange. At that point in time it was valued in the market at approximately £14 million. It continued to expand and the share price more than doubled within two years. However, in March 2000 the chairman, Dr Tom Clark, who had been a dominant presence in the company for twenty years or so, resigned,⁵ and the share price plunged⁶ as questions were raised about the quality of the company’s accounting practices and the extent of its debt levels; as noted above, the company came very close to complete collapse. In the meantime, a reshaped board had commissioned an investigation by Ernst & Young into the company’s finances, and a restated set of interim accounts for the six months ending 31 December 1999 portrayed significant write offs virtually across the board.

In December 2000, following a complaint made to ICAS by a previous non-executive director of Semple Cochrane, the JDS began an investigation. This resulted in June 2004 in Executive Counsel for the JDS laying a number of complaints against both individuals with

³ And arguably, but without any fault on its part, by the Institute of Chartered Accountants of Scotland.

⁴ D Gwilliam and O Marnet (2015). Semple Cochrane – When Non-Executive Directors try to make a difference, does anybody listen? Working Paper.

⁵ For many years he had combined the roles of chairman and chief executive but had stood down as chief executive in late 1999.

⁶ In 1999 the share price had touched £5, in June 2002 it was around 9p. Investors Chronicle (07/06/2002). Semple share. Available at: <http://www.investorschronicle.co.uk/2012/03/07/semple-share-SdiEkoM2bysK7vWUGEs4SO/article.html>.

then present or past association with Deloitte & Touche and against Deloitte & Touche itself. The nature of the complaints varied as they related to both individuals and the firm but their primary direction was in relation to the audit of Semple Cochrane's accounts for the years ending June 1996 through to June 1999 and the work of Rutherford Manson and Dowds (RMD) as reporting accountants in relation to the November 1996 Stock Exchange flotation. RMD had been the auditors of Semple Cochrane for a number of years,⁷ but in July 1999 their practice was absorbed into that of Deloitte & Touche (now Deloitte)⁸ and the 1999 audit was signed off in the name of Deloitte & Touche. In the outcome all the complaints against individuals and Deloitte & Touche were dismissed with the exception of one made against RMD for not maintaining adequate audit records, although no penalty was levied in respect of this.

Accounting and Audit Issues

As noted above, the accounting and audit issues were many and by no means homogenous in their nature, but the great majority lay in respect of the valuation of contracts, both long and short term, entered into by Semple Cochrane. Perhaps the central and best known issue related to the valuation of a long term contract entered into in connection with the refitting of a ship, the Sir Bedivere,⁹ which had been extensively damaged during the Falklands war and was being rebuilt and refitted in a Scottish dockyard. Semple Cochrane was not the main contractor on the project, but it was responsible for the supply and installation of electrical systems on board and acted as a sub-contractor accordingly.

Accountants and auditors have, traditionally at least, been seen as cautious in terms of the recognition of profit before its amount can be ascertained appropriately.¹⁰ However, it has long been recognised that if some element of the profit on long term contracts is not 'booked' during the lifetime of that project then a misleading picture as to the activities of the entity during any one accounting period is likely to be presented to the shareholders and other stakeholders, and also that if it is not so booked, then management are provided with

⁷ Their first audit was for the year ended June 1995.

⁸ Strictly speaking the ultimate parent body is apparently Deloitte Touche Tomhatsu, a UK private company limited by guarantee, but today they normally term themselves and are referred to as Deloitte.

⁹ Bedivere was the Arthurian knight responsible for returning Excalibur to the Lady of the Lake.

¹⁰ Here again because of considerations of space and immediate relevance a very simplified version of the wide range of issues associated with 'profit' recognition is presented.

considerable discretion as to when they do in fact choose to finally book the full profit amount in terms of decisions as to when a project has finally been completed. Consequently SSAP 9¹¹ (first issued in 1975 and revised in 1988 and 2001) required that:

*'Where it is considered that the out-come of a long term contract can be assessed with reasonable certainty before its conclusion, the prudently calculated attributable profit should be reported in the profit and loss account as the difference between the reported turnover and related costs for that project.'*¹²

However, it also provided that:

*'...if it is expected that there will be a loss on a contract as a whole, all of the loss should be recognised as soon as it is foreseen...'*¹³

and in an Appendix which was strictly speaking not part of the standard but only general guidance, reference was made to the issue of variations and claims:

*'Where approved variations have been made to a contract ...and the amount to be received in respect of those variations has not yet been settled and is likely to be a material figure in the outcome it is necessary to make a conservative estimate of the amount likely to be received...'*¹⁴

*'The settlement of claims arising from circumstances not envisaged in the contract...is subject to a high level of uncertainty...it is generally prudent to recognise receipts in respect of such claims only when negotiations have reached an advanced stage and there is sufficient evidence of the acceptability of the claim in principle to the purchaser, with an indication of the amount involved also being available.'*¹⁵

Sample Cochrane's published accounting policy was consistent with the requirements of SSAP 9 although there was a change of emphasis between 1996 and 1997 when the policies stated that 'Revenues derived from variations on contracts are recognised only when they have been accepted by the customer,' and 1998 and 1999 when the wording was 'Revenues derived from variations on contracts are recognised only when the final outcome can be assessed with reasonable certainty.'¹⁶

Although the principle underlying the standard and its successors has the support of almost all practising accountants and users of accounting information, there are formidable practical problems in determining what the outcome of a long term contract is likely to be and also of the appropriate means to allocate that profit over time. Put simply, the gist of the JDS

¹¹ Accounting Standards Board (1975). Statement of Standard Accounting Practice 9 (SSAP 9). Stocks and Long Term Contracts. (First issued in 1975, revised 1988 and 2001). FRC: London.

¹² TR1 pp 22-23.

¹³ Ibid., p 23.

¹⁴ SSAP 9 Appendix 1 para 26 quoted at TR2 p 27.

¹⁵ Ibid., Appendix 1 para 27 quoted at TR2 p 27.

¹⁶ TR1 p 25.

complaint in this particular instance was that Semple Cochrane booked profit (or failed to make an appropriate write-off) on the Sir Bedivere contract in 1996, 1997, 1998 and 1999 when in fact there was not 'reasonable certainty' as to a profitable outcome. In 1996 Semple Cochrane according to the JDS complaint recognised £582,000 profit, and the accumulated amount had risen to £623,000 by 1997 and £671,000 by 1998.¹⁷ In respect to the accounting treatment the JDS asserted that the auditors were, or should have been, aware that there was not sufficient evidence to support the estimates in relation to costs to completion that the company was making, or as to expected further revenue attributable to anticipated variations in the terms of the contract.

The JDS complaint in respect to the 1996 audit was couched as follows:

*'In particular the auditors failed properly to review the Sir Bedivere contract which had been substantially delayed and was still in progress on 30 June 1996....Semple Cochrane recognised a profit of £582,000 on this contract, which was accepted by the auditors, although there was inadequate evidence to do so either in accordance with the company's stated accounting policy...or with the requirements of SSAP 9. The outcome of this contract could not be assessed with reasonable certainty, as there was no audit evidence to support the value attributed to variations of £550,000 or the costs to complete the contract of £1,277,000 (£2,500,000 less £1,223,000 incurred). The auditors themselves noted the absence of any records to support the total cost estimate of £2,500,000. Moreover only a small element of the labour cost had actually been incurred indicating the outcome of the contract was uncertain. The profit of £582,000 was approximately double the level anticipated in the company's original tender for the contract...'*¹⁸

There is some suggestion in the Tribunal report that in that year the auditors had advocated writing down this profit recognition by £290,000 – but it does not appear that this write down actually took place.¹⁹

Without rehearsing in detail the complaints relating to subsequent years, it is clear that over this period of time the auditors became aware that Semple Cochrane was in dispute with the main contractors over the fulfilment of the contract, and it was suggested by the JDS that this should have made them even more cautious as to profit recognition ahead of the completion. For example, in respect to the complaint in relation to the 1997 audit:

¹⁷ The actual amounts recognised in the profit and loss statement were to an extent disputed in evidence before the Tribunal but there was agreement that there was profit recognition which was material in the context of the Semple Cochrane accounts – and in fact in the outcome the Financial Director did appear to accept the JDS figures as accurate (TR2 p 130).

¹⁸ TR1 p 35.

¹⁹ TR2 p 130.

“Furthermore the working papers in respect of the Sir Bedivere contract contained a note indicating a substantial claim, which would have further called into question the attribution of profits to that contract, but the team did not follow up that issue.”²⁰

In the final outcome Semple Cochrane was unable to pursue successfully its ambitions to renegotiate the contract in accordance with the terms it considered appropriate and had to settle for a much reduced final sum; in consequence, the interim figures for the six months ending 31 December 1999 showed an exceptional charge of £1.67m in respect of the Sir Bedivere contract.

Similar, although not identical, issues arose in respect to two contracts to provide lighting on the M8 motorway. These contracts were entered into with the Scottish Office (via Renfrewshire Council acting as agents) and were carried out and completed in 1997 and were not therefore long-term contracts per se.²¹ However, the final financial outcome was still in dispute in 1998 and 1999, and there was extensive debate as to entitlements for early completion and responsibilities for delay. In this regard, the first JDS complaint was made in respect of the 1998 audit:

‘The auditors’ review of other contracts was inadequate, as there was insufficient evidence to show that their outcome could be assessed with reasonable certainty. Examples of such inadequate review include the M8 contract, the Redford Barracks, Edinburgh contract, the M77 contract (which in their planning document, the audit team recognised would require extensive field work along with the Sir Bedivere contract) and the A1(M) Alconbury contract’,²²

and in respect of the 1999 audit the complaint was stronger:

‘The auditors reviewed the two M8 contracts which although carried out in 1997, were still in dispute in 1999. The outcome of the contracts could not be assessed with reasonable certainty and no attributable profit should have been recognised on them. Mr Miller appears to have reached a view on the prospects of the company’s claim on the balance of probability. SSAP 9 gives no sanction for this approach. Mr Miller should have called for a reduction in turnover and profit of at least £200,000. He did not do so.’²³

²⁰ TR1 p 49.

²¹ Not that Semple Cochrane appear to have made a very clear distinction between short and long term contracts – the JDS complaint stated that: ‘The majority by number of Semple Cochrane’s contracts were of a short term nature, but were accounted for on the same basis as long term contract.’ TR1A p 5.

²² TR1A p 16.

²³ Ibid, p 18.

Other contracts where significant issues arose lay in relation to Redford Barracks in Edinburgh where, yet again, there were disputes with the main contractor. The 1998 complaint is detailed above; again by 1999 it had become stronger:

‘The auditors reviewed only one of the three contracts which the company had in relation to Redford Barracks, Edinburgh and discovered that the company had improperly accounted for a disputed claim. They correctly realised that this increased the loss shown on the contract. The auditors did not review the other two contracts, although they were aware that there were disputes with the main contractor on each and that the company’s method of accounting enabled claims to be recognised prematurely. Nor did they visit the company’s Edinburgh office where the relevant contract files were held. Had they done so, they might have discovered the substantial overvaluation of the Edinburgh contracts which was disclosed to the board in April 2000.’²⁴

The evidence relating to the manner in which these contracts were accounted for as discussed by the Tribunal report²⁵ is not that easy to follow, either as to the extent to which an actual provision was made or how that related to the auditors’ awareness that there had been internal discussion as to the possible need for a provision of £190,000 against the three contracts, but in the outcome substantial losses were booked on these contracts in the subsequently revised figures.

Another contract where the possibility of further auditor caution and scepticism might have arisen lay in what was known as the Acton Bridge painting contract which had been entered into only four months before the 1999 year-end at a contract price of £289,000. However, by the year-end variation claims of £661,000 were accounted for giving rise to a company valuation of the contract of £950,000, which Deloitte & Touche suggested adjusting down to £900,000. At the 1999 year-end only £70,000 had been paid to the relevant Semple Cochrane subsidiary. Here the JDS complaint asserted that:

‘The outcome of the contract could not be assessed with reasonable certainty. The auditors were aware that the accounting value included large unresolved claims and that they needed to obtain full documentation, but they did not obtain independent evidence and did not ask to see essential contract documents including correspondence with the main contractors. In the event, the contract had still not been resolved when the revised interim accounts for the six months ended 31 December 1999 were announced on 20 June 2000. The loss on the contract incorporated into these accounts amounted to £1.14 million of which £600,000 was treated as a prior year adjustment at 30 June 1999.’

²⁴ TR1A pp 18-19.

²⁵ TR1 pp 280-287.

Again there was evidence that the auditors were aware of problems relating to this contract. A file note prepared by the audit manager dated 14 September 1999 stated:

‘WIP

*The major issue on the job is the Acton Bridge contract which is currently in dispute. This contract has been reviewed in detail and a potential adjustment of £200k reduction in profit exists based on the audit work performed to date. This is because a potential loss of £145k exists and the client has taken a £48k profit to 30/6/1999.*²⁶

But in the outcome a provision of only £50,000 was made.

A final interrelated, but separate, issue which was discussed in detail related to the audit of what are termed ‘Account Holding Numbers’. These appear to have been nine ‘suspense’ accounts amounting in total to slightly more than £681,000 and were treated in the accounts as work in progress. Again the nature of the complaint relating to the 1999 audit was direct:

*‘[These were] not contract accounts but suspense accounts for costs which had not been attributed to particular contracts.... These sums should not have been treated as work in progress but should have been written off. The auditors accepted a false oral explanation of the one account which they found when they could easily have checked it but did not do so. The auditors knew from previous audits, and from a warning about suspense accounts in an internal audit report, that such accounts might exist. Moreover the auditors failed to comply with their firm’s standard procedures for suspense accounts. As a result of this failure the company’s assets and profits were materially overstated in the 1999 accounts’*²⁷

Beyond this there was a whole string of issues raised in the JDS complaints relating to the 1999 accounts which do not appear to have been addressed in great detail by the Tribunal. These included the following:

*‘The auditors’ assessment of several other contracts was inappropriate. The outcome of the Braehead gantry contract could not be assessed with reasonable certainty and the auditors should not have accepted the forecast profit of £220,000 without obtaining more evidence. The auditors gave no reason for their recommended uplift of £40,000 on the profit on the Marchbanks contract, amounting to almost all the predicted profit on the contract when it was only fifty per cent completed. The provision for the dispute on the P&O Cruises (MV Victoria) contract in which the customer was refusing to pay £100,000, should have been about £60,000 not the £30,000 which the auditors recommended...’*²⁸

²⁶ TR1 p 297.

²⁷ TR2 pp 28-29.

²⁸ TR1A p 18.

*'The auditors noted a potential uplift of £52,000 profit on the company's West Dunbartonshire contract, although there was no documentary evidence to support the amounts relating to the outcome of the contract, which was not completed at the year end. The auditors also understated the provision on the MV Global Snipe contract entered into by the subsidiary, Midland Ship Repairs Limited. The work on this contract was originally assessed at £10,000, then purportedly increased to £206,000 by oral agreement. That sum had been invoiced but not paid, the customer agreeing to pay £60,000. The auditors noted an adjustment of £73,000, being fifty per cent of the difference. The group's solicitors expressed serious doubt to the auditors about the outcome of the claim and the ability to recover sums due from the customer which had sold the ship. In these circumstances prudence dictated writing the debt down to £60,000.'*²⁹

*"The auditors did not carry out any recorded audit work on the joint venture company Semple DHE Limited, a seventy-five per cent subsidiary of Semple Cochrane and signed an unqualified auditors' report on its accounts for the period from 8 June 1998 to 30 June 1999, stating, inter alia, that an audit had been performed. This was untrue. Had a competent audit been performed, the auditors would have ascertained that a disputed delay and disruption claim of £416,000 had been wrongly accounted for and that a provision should have been made.'*³⁰

And in terms of summary:

*'In the event the auditors' presentation to the audit committee showed potential adjustments with a net effect of a reduction in profit of £52,000. Had the audit team acted with due competence they would have identified overstatements of profit of at least £3.4m....The overstatements probably applied to many other contracts making the appropriate write down much greater.'*³¹

It is not immediately obvious why none of these issues appear to have been discussed in any detail; they all lay under complaint 5, that in relation to the Deloitte & Touche 1999 audit, but it is not clear that the JDS had withdrawn their concerns as to these matters, or that they had in any sense been struck out, and neither scenario is referred to in the Tribunal Report.

Although as is clear from the above the complaints against the auditors were extensive, none of those detailed above were upheld by the Tribunal. Based on their own consideration of the documentary evidence, including that of expert witnesses, and the oral evidence given by the parties against whom the complaints had been made and also that of other witnesses, the Tribunal was of the view that in each and every circumstance that they discussed the auditors had come to a suitable judgment based on appropriately gathered evidence or that the complaint had not been established. Why they did so is an interesting question, although examination of the detailed evidence for each and every issue referred to above is a task which is not possible within the scope of this paper.

²⁹ Ibid, p 19

³⁰ TR1A p 20.

³¹ Ibid, p 20.

It is difficult reading the Tribunal report at face value not to believe that in some instances at least the decisions were perverse. It is certainly true that the revised interim accounts for the six months to 31 December 1999, which were presumably subject to detailed review by Ernst & Young as the auditors who had replaced Deloitte & Touche, showed a very different picture to those that had gone before. Provisions/losses were shown in respect to all the contracts referred to above, although some of them, including the £1.67m exceptional charge on the Sir Bedivere contract referred to above, were now treated as a prior year adjustment. In total there were asset value write downs of approximately £10m in the revised interim accounts, and without the support of the Bank of Scotland the company would almost certainly have collapsed completely. The final audited accounts for the year ended June 2000 showed prior year adjustments of £10.4m, £4.7m of which related to 1999 and £5.7m to the earlier years. These prior year adjustments significantly exceeded the aggregate pre-tax profit of £7.7m recognised by Semple Cochrane in the five years between 1995 and 1999.³²

If there is an explanation for the decisions of the Tribunal at the technical level it probably lies in the nature of the issues under examination. As discussed further below, contracts of the nature entered into by Semple Cochrane are complicated. Issues as to the responsibility for non-performance often arise, claim and counter claim frequently ensue, and major contractual revisions are by no means unknown; in fact, they are commonplace. In such circumstances, provided that Semple Cochrane could adduce evidence, whether internal (including that pointing to a previously good track record for delivering contracts on time and to budget), or provided by independent specialist consultants,³³ or on occasion letters from the company's lawyers as to the likelihood of success if contractual disputes went to arbitration/the courts, then the 'noise' around the issues may have convinced the auditors that they could 'live with' the differences between the manner in which they might have wished the company to account and the manner in which it did in fact do so. Similar considerations may have persuaded the Tribunal that to hold the auditors to have been negligent in such circumstances would be inappropriate.

³² TR2A pp 18-19.

³³ Albeit consultants engaged by and paid for by Semple Cochrane rather than consultants engaged directly by RMD or Deloitte and Touche. There was questioning by the JDS of how independent at the least one of these consultants was but the Tribunal found no evidence that there was a genuine lack of independence.

Beyond the immediate technical level, one could also surmise and speculate as to wider institutional and sociological influences which might have led the Tribunal to come to the decisions that it did perhaps in the manner of perceptions and unconscious biases, issues which are briefly touched upon in an earlier paper by one of the authors (Gwilliam, D., 2006)³⁴ but that would be beyond the scope of this paper, although it might be worth exploration in future papers.

Whilst it is true that the firm was absolved from blame on every count, it is difficult indeed to read the Tribunal report (and the associated one relating to the role of the finance director) without coming to the conclusion that this was not Deloitte & Touche's finest hour, and of course they resigned as auditors in late 1999. Given the number of issues that were identified, and known to the auditors, where there was potential for overstatement of assets and profits which were highly material in the context of Semple Cochrane's numbers, it is surprising that an overall audit perspective which would have reflected the total potential downside risk was not adopted and in consequence would have led to more detailed and intensive questioning of the accounting numbers. There is also the issue of going concern:³⁵ auditors are required to form an opinion as to whether the company will continue as a going concern for a period of twelve months after the date of the financial statements. Given that Semple Cochrane was effectively on life support within not much more than six months of the signing off of the 1999 year end accounts, one would have to question the suitability of the auditors' judgment in this respect, but this is an aspect of the audit role which is not referred to at all in the Tribunal report.

When Deloitte & Touche took over the 1999 audit they must have been aware of enough 'red flags', as they are termed in the audit literature.³⁶ to have supported a May Day parade. This was a new audit for them and they would, or should, necessarily have been cautious as to the quality of the audit work carried out by the previous firm of auditors which they had now taken over. The audit team knew that in June 1998 a non-executive director Dan Wright had taken over from Dr Clark as managing director, and that within a month he

³⁴ D Gwilliam, Audit quality and audit liability: a musical vignette, PN, vol. 22(1), 2006 pp 37-52.

³⁵ The definition of 'going concern' in the standards is quite general. The current standard ISA (UK&I) 570 defines 'going concern' as: 'Under the going concern assumption, an entity is viewed as continuing in business for the foreseeable future.'

³⁶ A 'red flag' is seen as an indicator that issues and problems associated with the financial statements might arise during the course of the audit.

had resigned³⁷ and Dr Clark had resumed his joint role as chairman and chief executive officer, a combination of posts explicitly frowned upon by the UK Corporate Governance Code. They knew that two non-executive directors in post at the 1999 year-end, both of whom had questioned aspects of accounting and governance within Semple Cochrane, had resigned in July 1999.³⁸ They knew that one of these non-executive directors, an ICAS member, had previously sought the advice of ICAS as to the propriety of Semple Cochrane's accounting treatment in respect to the Sir Bedivere contract.³⁹ They knew that Semple Cochrane was a very rapidly growing listed company – turnover rose from £20.7m in 1996 to £57.3m in 1999 – and that in the past at least, questions had been asked about the number of qualified accounting staff in post. They were aware, or became aware of, internal audit reports which questioned the accuracy of Semple Cochrane's contracting accounting system to predict costs to completion with any accuracy and therefore to predict profit on a contract with any certainty,⁴⁰ and as the evidence before the Tribunal shows, they were aware, or became aware, during the course of the 1999 audit of a whole range of accounting and audit issues which needed to be addressed. It should be noted that the senior audit team had effectively been the same as that of the previous year (and in fact as for the previous four years) and there is limited evidence in the Tribunal reports as to the extent that Deloitte & Touche sought to address the issues raised by the 'red flags' described above.

Indeed, at the commencement of the 1999 audit, Semple Cochrane was classified as 'normal risk' for audit purposes when in reality it was anything but.⁴¹ Perhaps the one significant contribution that Deloitte & Touche did make was to insist on the inclusion in the final accounts of a disclosure note as to the uncertainty of the outcome as to the Sir Bedivere contract, and they drew attention to this disclosure note in their audit report. The JDS thought that they should have done much more; they should have advised that 'in order to comply with

³⁷ Ex post the Scottish media referred to this passage of time in the following terms: 'The source, who has been extremely close to Semple Cochrane, said Wright and Clark had had a "ferocious fight" over the recognition of profits from this contract. He added that Wright had instigated an investigation into the contract immediately after he took up the chief executive post and had wanted to make provisions at that stage.' Herald Scotland 7 March 2000 available at:

<http://www.heraldscotland.com/sport/spl/aberdeen/semple-wrong-on-wright-issue-1.246176>.

³⁸ TR1 p 215.

³⁹ Ibid, p 215.

⁴⁰ TR1A p19. The JDS complaint also claimed that they failed to comply with SAS 500 by failing to review all internal audit reports and thereby failed to pick up on reports of various contract overvaluations and the existence of suspense accounts within the contract accounting system. As for SAS 500, see: Auditing Practice Board (1995). Statements of Auditing Standards 500 (SAS 500). Considering the work of internal audit (Issued March 1995). FRC: London.

⁴¹ TR1A p 16. In previous years RMD had also classified the Semple Cochrane audit as normal risk.

SSAP 9 and the company's accounting policies, it was necessary for between £1m and £1.7m to be written off.' They considered that in this context Deloitte & Touche had failed to adequately consider in the context of SAS 600⁴² whether the company's accounting treatment had led to a material misstatement in the company's accounts.⁴³

Why should this have come to pass? Here we shall focus on just two issues, the more specific one being the nature of the audit dynamics between Semple Cochrane, RMD and Deloitte & Touche, and the wider one relating to the notion of professional expertise within the accounting profession. Rutherford Manson and Dowds was an Edinburgh firm of recent origin: it was founded in 1986 apparently by three college associates. It had developed a niche market in the financial sector and as we have seen was subsequently taken over by Deloitte & Touche. For a relatively small firm it had a significant external profile, but it is likely that Semple Cochrane was its only listed client in the industrial sector. Indeed, there is reference in the Tribunal report to the fact that Semple Cochrane was the only listed company brought into the client portfolio of Deloitte & Touche's Glasgow office as a result of the acquisition of RMD.

Whether this made it less likely to question the accounting practices at a company which was perceived to be successful and expanding is a difficult question to answer, but it is possible. The takeover by Deloitte & Touche may have been triggered by a desire to add to its own practice in the financial sector or perhaps to acquire the talent within the firm.⁴⁴ Whatever the reason it is unlikely that the audit of Semple Cochrane was in itself a key driver. There is some evidence in the Tribunal Reports that Deloitte & Touche were conscious of a need to ensure that auditing standards on the 1999 audit were in accordance with their own, and as we have seen they brought in one of their own partners to act as the Quality Control partner, but, as has been noted, the senior audit team on the 1999 audit consisted of the same individuals as had conducted the 1998 and earlier audits on behalf of RMD.

These issues of specific expertise and possible desire to maintain the relationship with a listed client were, ex post, tangentially referred to in the Scottish print media:

⁴² Auditing Practice Board (1993). Statements of Auditing Standards 600 (SAS 600). Auditors' reports on financial statements (Issued May 1993). FRC: London.

⁴³ Ibid, p 17.

⁴⁴ One of the founders Cahal Dowds became the youngest ever ICAS president in 2002 ahead of taking over as senior partner at Deloitte and Touche Scotland in 2003. Another ex RMD alumnus Roger Baird replaced him as head of Deloitte in Scotland in 2008.

*'One accountant with knowledge of the matter said: "Semple Cochrane was not a major account for Deloitte & Touche but in the case of RMD it was. What you had there was auditing work being done by a firm whose specialism lay elsewhere. Is there the possibility that what was done was not a great audit? Probably.'*⁴⁵

The Nature of Audit Expertise

Since the late nineteenth century expectations of the level of expertise to be provided by professional auditors has been defined in terms of the need for them to exhibit 'reasonable skill and care' in the conduct of their work, a duty which in this case was interpreted by the Tribunal as the level and skill of care to be expected of a competent professional accountant. However, when confronted with actual audit and accounting situations the translation of this essentially high level concept to relate to the day to day practicalities has not proved an easy task for the courts or for other entities with quasi-legal jurisdiction. Clearly standards change over time. In a world in which there have been enormous changes in the nature and size of business, the educational and training requirements of professional accountants and the quality of internal control systems within companies, dramatic developments in information processing and IT more generally, and the introduction of codified accounting and auditing standards,⁴⁶ one would hardly expect the standard of care required of Mr Theobald, the auditor in the London and General Bank case,⁴⁷ to be the same as that which Deloitte & Touche were expected to exercise in their audit of Semple Cochrane, anymore that anyone visiting a general practitioner today would expect to receive the same care as would have been provided by a nineteenth century medical practitioner.

One issue which has a bearing on this case is the manner in which auditors are expected to develop their skills and judgment beyond what is conventionally seen as their area of expertise in terms of their knowledge of accounting records and control systems and the suitability of the technical construction of published accounts into the areas of judgment

⁴⁵ The Scotsman (20/01/2002). UK auditors under fire in wake of Enron. Available at: <http://www.scotsman.com/business/finance/uk-auditors-under-fire-in-wake-of-enron-1-1359328>.

⁴⁶ As has been noted in previous articles in PN, e.g. D Gwilliam 'Audit quality and audit liability: a musical vignette' PN, 22(1), 2006 pp 37-52, the courts and related quasi-judicial bodies seem to exhibit a certain reluctance to engage with auditing standards. It is true that the only complaint upheld against RMD related to their failure to maintain proper audit working papers as required by SAS 230 for the years 1996-1998 the JDS complaints contained reference to possible breaches of at least two other auditing standards neither of which were discussed at all in the Tribunal report. As for SAS 230, see: Auditing Practice Board (1995). Statements of Auditing Standards 230 (SAS 230). Working papers (Issued March 1995). FRC: London.

⁴⁷ *Re London and General Bank (No2)* [1895].

which underlie those accounts. At the end of the nineteenth century, in *Re Kingston Cotton Mill Co. (No.2)*,⁴⁸ it was accepted by the Court of Appeal that absent of any indications of untoward activity it was appropriate for the auditor to accept a management certificate as to the value of stock.⁴⁹ Whilst it is very likely that in practice in the twentieth century auditors did make more exhaustive investigation of the nature of the numbers constituting stock, this ruling was not challenged directly in the courts until *Re Thomas Gerrard*,⁵⁰ and even there Pennyquick J, side-stepped delicately around the issue of seeking to overturn the Kingston Cotton Mill decision by means of holding that there was evidence of untoward activity which the auditor was, or should have been, aware of.⁵¹ Today the development of practice and the introduction of codified standards make it quite clear that the auditor has to bring the value of stock within the ambit of conventional audit enquiry.

A shift to a requirement for an auditor to obtain evidence either by themselves or from other independent parties in areas where significant judgment calls are made has been seen across a range of audit activities. To take one other example, in the past the auditors of insurance companies and similar financial institutions would accept the certificate of the designated Independent Actuary virtually without question; today they conduct a much more searching examination of the underlying assumptions and valuations and may indeed employ their own actuaries for that purpose. Here there are analogies with the issues surrounding the RMD, and then Deloitte & Touche, audits of Semple Cochrane. Few auditors are trained in either electrical engineering or the cut-throat business of contracting in the construction and engineering industries, in which variation orders frequently arise,⁵² and as has been noted above RMD was a firm which specialised primarily in the financial sector. In such circumstances it would have been difficult for the auditors to have questioned management assertions as to the likely outcome of contracts or the validity of claims made against Semple Cochrane.

Given that the auditors were all but impotent to form their own independent view as to the likely outcomes of the wide range of problem contracts it is not at all surprising that

⁴⁸ *In Re Kingston Cotton Mill Company (No. 2) [1892]*

⁴⁹ *Ibid.*, 2 Ch. 279.

⁵⁰ *In Re Thomas Gerrard and Son Ltd [1967]*.

⁵¹ *Ibid.* 2 All ER 525 at 536.

⁵² There were 85 variation orders on the Sir Bedivere contract in the year ending 1996 and an estimated further 150 to 200 orders in the following year. TR2 p 136. TR1 p 77 states that there were nearly 1,500 specific variations on the contract.

they would have sought refuge in internally prepared company documentation and explanation, reports prepared by independent outside consultants (albeit consultants engaged by Semple Cochrane not RMD or Deloitte & Touche) and the opinions offered by Semple Cochrane's legal advisers, opinions which at times had a flavour of the oracle at Delphi in terms of their ability to be interpreted by the various parties in the manner in which they chose to interpret them. The legal opinions and reports, of which Semple Cochrane obtained many, would on occasion vary in nuances of emphasis, sometimes quite significantly, depending on to which party they were to be presented.

Whilst one might have some sympathy for the difficulties which would have confronted RMD and Deloitte & Touche as they conducted their audit work, others more critical of the audit profession would suggest that members of the audit profession, and particularly the large firms, hold themselves out as offering expertise across the entire range of industry, and they ought to have ensured that individuals with relevant expertise were allocated to the particular client.⁵³ Furthermore, at an overall level they should have displayed a far more critical and sceptical attitude than they actually did.⁵⁴ Again, those critical of the audit profession might say that the audits of Semple Cochrane which came under examination in this case bore a resemblance to the description of audit provided many years ago by John Stonehouse (the Labour minister and disgraced businessman who faked his own suicide after the collapse of the British Bangladesh Trust in 1974). Stonehouse considered audit to be a ritual gavotte in which the auditors asked questions, one provided them with the answers that they wanted to hear, they mulled over these answers for a time, and then signed off on the accounts and collected their fee. Those who would seek to defend the audit profession, and the individuals and firms associated with the audit of Semple Cochrane, would point out that faced with very wide range of complaints against them brought before a Tribunal headed by a retired Lord Advocate (the chief legal officer of state in Scotland) only one relatively minor complaint was upheld.

⁵³ Although the engagement partner did in fact claim to have substantial experience of the audit of manufacturing companies and of contract work in progress. TR2 p 58.

⁵⁴ One example which might support this perspective is the fact that at the onset of the 1999 audit the engagement partner drafted a memo analysing Semple Cochrane's system for accounting for contract work in progress. Inter alia this noted that: 'The managers are in general prudent and do not take money up front on project. Instead the profit is taken on a pro rata basis for length of contract.' TR2 p 95.

Concluding Reflections

If it were not for the seriousness of the issues as they affected shareholders, and other stakeholders including creditors and perhaps most importantly employees, one would have to say that on occasion there were elements of near farce in some of the matters reported by the Tribunal. Semple Cochrane was a company which existed almost solely on the basis of contracts – it may have had as many as 1,000 of them open at any one time – yet the finance director for much of the period under consideration, a qualified Scottish accountant, appears not to have been comfortable with his knowledge of SSAP 9.⁵⁵ A non-executive director, himself a qualified Scottish accountant, raised issues with the finance director and came to the conclusion that the finance director knew nothing about SSAP 9, at which juncture he contacted ICAS to obtain a copy of the standard so as to refresh himself as to his own knowledge. Ernst & Young were asked to review the financial position in early 2000, and thereon followed very significant write downs and provisions, but in 1995 a report commissioned from Ernst & Young had reported that the accounting systems were of a good standard.⁵⁶ At one stage the Tribunal appeared to support the perspective of the finance director that he could obtain significant comfort as to the quality of the internal systems from an ISO 9002 accreditation in 1992 and subsequent reaccreditation early in 1997.⁵⁷ Views as to the value of such accreditation differ widely, but one would hope that the finance director would have been able to form his own perspective on the quality of systems in a company which was hardly a multi-national giant. John Ian Durie moved on to become finance director of Simclar – another West Scottish company with an entrepreneurial managing director – which subsequently experienced both financial setbacks and litigation as to the legality of certain of its dividend payments.⁵⁸ The Deloitte response to the Tribunal findings was a

⁵⁵ In giving evidence to the Tribunal he stated that he was: ‘never very comfortable with SSAP 9, not least when complex issues arose’. TR2 p 116.

⁵⁶ ‘The Tribunal agreed with the perspective of the RMD engagement partner that the 1995 E&Y report ‘portrayed Semple as a growing and profitable business with good accounting controls and systems, and did not identify any areas of concern.’ TR2 p 45. However it is also true that there were some specific criticisms in the E&Y report – although their overall perspective seems to have been that the contracts were conservatively managed – it is possible that this had been the case previously - 1995 saw the arrival of a new finance director and new auditors and after the flotation there was evidence given to the Tribunal of greater emphasis on positive earnings management within the company.

⁵⁷ Per the finance director ‘We were driven by an ISO 9000 philosophy and system’ TR2 p 64 and p 108

⁵⁸ Simclar entered administration in June 2011 owing over £40 million pounds. See The Herald Scotland (10/08/2012). Simclar fall from grace is laid bare in report. Available at: <http://www.heraldscotland.com/business/company-news/simclar-fall-from-grace-is-laid-bare-in-report.18555728>. The liquidators of Simclar Ayrshire launched a commercial action against John Ian Durie, Sam Russell and Stephen Donnelly. In April 2012, founder Sam Russel agreed to an out of court settlement re

predictable, if understandable, one, as reported in Accountancy Age on the 30th of October 2008. Vince Niblett, head of audit at Deloitte, said:

'Today's JDS report provides long overdue confirmation that there were no grounds to the complaints against Deloitte. Deloitte has maintained from day one that this disciplinary action was unmerited and we are pleased to have been fully exonerated.'

However, it is regrettable that it has taken almost eight years to conclude this enquiry since the matter was referred to the JDS in November 2000. The careers of a number of innocent individuals have been unfairly prejudiced by this enquiry hanging over them for so long.

*We take our audit responsibilities extremely seriously and the tribunal's finding is testament to our robust approach.*⁵⁹

Whilst one might sympathise with Mr Niblett's views as to the delay which overcame the process (to which the fact that Deloitte & Touche sought and obtained a hearing seeking to strike out the complaints at a preliminary stage contributed to a degree, although it was not the major cause of the delay), not everyone would agree with his substantive point as to the quality of the audit undertaken. An alternative perspective delivered with the benefit of some inside knowledge would be that of Dan Wright, a director and, as we have seen, briefly CEO of Semple Cochrane:

*'I think so much of the auditing profession is a waste of time which does nothing to stop businesses going bust or people being stitched up' ... 'The disclaimer that all auditors use contains so many weasel words that you really have to ask what the value of their function is. Semple Cochrane was audited and it was audited again. The board asked them [the auditors] to carry out further investigations and it still ended up as a complete shambles.'*⁶⁰

the payment of £3m dividends, after which a 'Proof Before Answer' was discharged, and associated scheduled hearing adjourned. The Herald Scotland. (15/04/2012). Director in court deal after row over £3m payments. Available at: <http://www.heraldscotland.com/news/home-news/director-in-court-deal-after-row-over-3m-payments.17243493>.

⁵⁹ <http://www.accountancyage.com/aa/news/1779852/semple-cochrane-accountants-cleared#ixzz1Zo7mSELY>

⁶⁰ 20 January 2002 available at <http://business.scotsman.com/wallstreetfraud/UK-auditors-under-fire-in.2295651.jp>.