Carillion Bankruptcy:
A Nightmare That Challenged the Foundations of the U.K. Accounting Profession

Motivated by several corporate scandals in which auditors failed to warn of disaster, professional accounting in the United Kingdom was under investigation for failing to act in the public interest. Then Carillion went bankrupt, and the role, function, and structure of professional accounting in the United Kingdom was severely challenged.

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Until its bankruptcy in January 2018, Carillion was the second-largest construction company in the United Kingdom with 43,000 employees worldwide, of whom 19,000 were in the United Kingdom. It also had a significant presence in the Middle East and Canada. It constructed the Tate Modern in London, the Grand Mosque in Oman, and the revitalization of Union Station in Toronto.[1]

The company benefited from the outsourcing of public services to private companies. Carillion had 450 contracts with the U.K. government, including managing lunch programs at 900 schools, maintaining prisons, providing maintenance and facilities management services at hospitals, and constructing and maintaining homes for Ministry of Defense personnel. At the time of its collapse, three major uncompleted U.K. infrastructure projects were the HS2 highspeed rail link (£1.4 billion contract), the Aberdeen bypass in Scotland (£745 million contract), and the Royal Liverpool University Hospital (£335 million contract).[2]

Unfortunately, Carillion suffered from poor management combined with disclosures that did not reveal the true financial problems of the company.

On March 31, 2017, KPMG, the auditors of Carillion, issued a clean audit opinion on the financial statements for the year ended December 31, 2016. Four months later, the company issued profit warnings and recorded a £845 million write-down on its construction contracts, that increased to £1,045 million in September. In January 2018, the company declared bankruptcy with £7 billion in liabilities and only £28 million in cash. The parliamentary investigation of Carillion attributed the bankruptcy to "recklessness, hubris and greed."[3]

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[1] Hallie Detrick, "What You Need to Know about the Collapse of Carillion, a U.K. Construction Giant," *Fortune*, January 15, 2008, https://fortune.com/2018/01/15/what-you-need-to-know-about-the-collapse-of-carillion-a-u-k-construction-giant.
[2] BBC News, "Carillion: Six Charts That Explain What Happened," *BBC News*, January 19, 2018, https://www.bbc.com/news/uk-42731762.
[3] House of Commons, Business, Energy and Industrial Strategy and Work and Pensions Committees: Carillion, *Second Joint Report from the Business, Energy and Industrial Strategy and Work Pensions Committees of Session 2017–19*, https://publications.parliament.uk/pa/cm201719/cmselect/cmworpen/769/769.pdf.

Devastating Aftermath

The contagion effect of Carillion's bankruptcy was huge.

- Suddenly, Carillion's workforce became unemployed.
- Infrastructure services provided by Carillon stopped. The government committed £150 million to keeping these essential services operating.[4]
- The numerous unfinished construction contracts employed 30,000 smaller firms. They were owed £2 billion and probably will receive only £1 for every £100 owed to them.[5]
- The company had thirteen defined benefit pension plans with 27,000 members and an unfunded pension liability was £2.6 billion. The U.K. government assumed part of this liability through the Pension Protection Fund, but pensioners will not receive their full benefits.[6]

Business Model

Carillion expanded rapidly. In order to eliminate competition, it bought its competitors, often creating goodwill by paying much more than the book value of the net assets acquired. As a result, Carillion had sizable goodwill and debt on its balance sheet. Goodwill amounted to £1.6 billion, or 35% of the company's gross assets, but there was no provision for goodwill impairment until the company went bankrupt and the value of its goodwill was demonstrably zero.

The company paid for this expansion through debt financing. In December 2016, the company's debt was £689 million, and its debt-to-equity ratio was 5.3 to 1.[7] However, the board did not see the growing debt as problematic, nor did it consider recording a provision for potential goodwill impairment.

The company used its cash to pay dividends and management bonuses. The 2016 dividend of £79 million was higher than the previous year's. Senior managers received large cash bonuses despite failing to meet easily obtainable financial targets. At the same time, the company curtailed payments to its pension plan.[8]

There were inadequate controls of senior management. Richard Adam, the director finance for ten years, was the designer of Carillion's aggressive accounting policies. He considered payments to the pension plans as a "waste of money." Richard Howson, CEO from 2012 to 2017, provided "misguided and self-assured leadership." Inadequate oversight by the board exacerbated the company's poor governance structure. Philip Green, chair of the board of

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[4] Ibid., Summary.
[5] Rob Davies, "'Recklessness, Hubris and Greed'—Carillion Slammed by MPs," *The Guardian*, May 16, 2018, https://www.theguardian.com/business/2018/may/16/recklessness-hubris-and-greed-carillion-slammed-by-mps.
[6] House of Commons, Business, Energy and Industrial Strategy and Work and Pensions Committees: Carillion, paras. 140 and 143.
[7] Ibid., para. 78.
[8] Ibid., para, 66.

directors, was considered “an unquestioning optimist.” Overall, there were inadequate checks and balances in place:[9]

> Carillion’s business model was an unsustainable dash for cash. The mystery is not that it collapsed, but how it kept going for so long. Carillion’s acquisitions lacked a coherent strategy beyond removing competitors from the market, yet failed to generate higher margins. Purchases were funded through rising debt and stored up pension problems for the future. Similarly, expansions into overseas markets were driven by optimism rather than any strategic expertise.[10]

Accounting Policies

Carillion had some aggressive accounting policies. It recorded revenue on construction projects that were not signed off by Carillion’s customers. Consequently, there was uncertainty about whether the company would collect the cash. These contracts amounted to £294 million, or 10% of total construction revenue.[11]

The company used the percentage of completion method on its long-term contracts, whereby each reporting period it would record a percentage of the gross profit on the project based on the actual costs incurred as a percentage of the estimated total costs of completing the project. In November 2016, cracks appeared in the beams of the Royal Liverpool University Hospital. The additional costs for repairing the cracks meant that this project would report a loss of 12.7%. The company chose to ignore these additional costs. Instead, it recorded a 4.9% profit margin on the project, amounting to £53 million net revenue in 2016. The July profit warning revised this to be a £53 million loss.[12]

Carillion had reverse-factoring agreements with some of its bankers. The company normally waited 120 days before paying its suppliers. If a supplier wanted prompt payment, it could receive it from the bank but at a reduced amount. The bank would then collect that amount from Carillion. Carillion recorded the amounts owed to the bankers not as bank indebtedness but as an “other creditor” within “trade and other payables.” This disguised the actual cost of bank financing. This classification also made the working capital ratio appear better than it was. An investigation by Moody’s estimated the hidden bank indebtedness at £498 million.[13]

The investigating parliamentary committee was highly critical:

> Carillion used aggressive accounting policies to present a rosy picture to the markets. Maintaining stated contract margins in the face of evidence that showed they were optimistic, and accounting for revenue for work that had not even been agreed, enabled

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[9] Ibid., Summary.
[10] Ibid., para. 14.
[11] Ibid., para. 88.
[12] Ibid., paras. 83 and 86.
[13] Ibid., paras. 40, 41, and 91.

> it to maintain apparently healthy revenue flows. It used its early payment facility for suppliers as a credit card, but did not account for it as borrowing. The only cash supporting its profits was that banked by denying money to suppliers. Whether or not all this was within the letter of accountancy law, it was intended to deceive lenders and investors. It was also entirely unsustainable: eventually, Carillion would need to get the cash in.[14]

Accountants

Part of the purpose of the parliamentary inquiry was to discover how KPMG could issue a clean audit opinion and then four months later Carillion recorded a mammoth write-down and issued profit warnings, only to collapse six months later.

KPMG was the external auditor for nineteen years, receiving £29 million in fees. Each year, KPMG gave Carillion a clean audit opinion. Peter Meehan was the partner in charge of the audit.

When queried about Carillion's revenue recognition policy, Meehan said that he did not personally consider the policies as aggressive but conceded that the company tended toward optimism when it came to assessing the riskier construction contacts.[15]

Nor did Meehan think that there should be a provision for goodwill impairment. Michelle Hinchcliffe, head of audit at KPMG, pointed out to the parliamentary committee that it is not the auditors' responsibility to calculate goodwill. Instead, the auditor assesses management judgment. Management decided there should be no goodwill impairment, and KPMG did not challenge that assessment.[16] Ten months after it received a clean audit opinion, the goodwill account went from £1.6 billion to zero.

Overseas, Carillion had a substantial contract with Msheireb Properties in Qatar related to the 2022 FIFA World Cup. The Qatar project doubled in size, stretching from three years to six. Carillion received no payment for eighteen months on this project. The parliamentary committee found that both Msheireb and Carillion claimed that they each had a £200 million receivable related to the Qatar contract. Member of Parliament Peter Kyle queried Meehan over this, asking incredulously, "You don't know whether your client was owed £200m or it owed £200m?… I wouldn't hire you to do an audit of my fridge."[17]

Meehan knew that Carillion was the most shorted stock on the London Stock Exchange, indicating that many investors thought that Carillion's shares were overvalued. He also

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[14] Ibid., para. 96.

[15] Alia Shoaib, "Carillion Inquiry: Missed Red Flags, Aggressive Accounting and the Pension Deficit," *Accountancy Age*, February 26, 2018, https://www.accountancyage.com/2018/02/26/carillion-inquiry-missed-red-lights-aggressive-accounting-pension-deficit/

[16] Ibid.

[17] Ibid.

admitted that the company had a host of problems. But he thought that it "had the reserves to deal with those challenges." Furthermore, he defended issuing a clean audit opinion on the 2016 financial statements. "I think that me and my team all did the best we could and I stand by the decision we gave on the 31 December 16 accounts."[18]

Cochair of the parliamentary committee, Rachel Reeves, had a different opinion. She said that the auditors were "mere spectators—commentators at best, certainly not referees—at the mercy of reckless and self-interested directors.… [The audits] appear to be a colossal waste of time and money, fit only to provide false assurance to investors, workers and the public."[19]

Overall, the parliamentary report was highly critical of KMPG, saying,

> had KPMG been prepared to challenge management, the warning signs were there in highly questionable assumptions about construction contract revenue and the intangible asset of goodwill accumulated in historic acquisitions. These assumptions were fundamental to the picture of corporate health presented in audited annual accounts. In failing to exercise—and voice—professional scepticism towards Carillion's aggressive accounting judgments, KPMG was complicit in them.[20]

The members of Parliament asked whether KPMG, especially Meehan, had a conflict of interest auditing Carillion, SLA (a major investor with a 10% interest in Carillion), and the pension plan. "Meehan said that this was not unusual."[21]

The committee was also critical of Deloitte and E&Y. For providing internal audit services to Carillion, Deloitte received £775,000 annually since 2010. Although the accounting firm identified issues, it rarely noted them as high priority. Deloitte was also responsible for advising on debt recovery yet was unaware of the dispute with Msheireb about who was owed the £200 million. "Deloitte were either unable to identify effectively to the board the risks associated with their business practices, unwilling to do so, or too readily ignored them."[22]

E&Y was paid £10.8 million for six months' work to provide advice on cost savings, none of which occurred. One of its recommendations was for Carillion to wait 126 days before paying its suppliers. Yet E&Y collected its fee three days before the company declared bankruptcy:

> The panoply of auditors and other advisors who looked the other way or who were offered an opportunity for consultancy fees from a floundering company have been

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[18] Ibid.
[19] Ibid.
[20] House of Commons, Business, Energy and Industrial Strategy and Work and Pensions Committees: Carillion, para. 124.

[21] Shoaib, "Carillion Inquiry."
[22] House of Commons, Business, Energy and Industrial Strategy and Work and Pensions Committees: Carillion, para. 125.

> richly compensated. In some cases, they continue to profit from Carillion after its death.[23]

The Big Four accounting firms form an oligopoly auditing 99% of the 100 largest companies on the London Stock Exchange (FTSE) and 97% of the largest 250 companies. There are huge barriers of entry for other accounting firms to enter this market, and in 2018, Grant Thornton, the sixth-largest U.K. accounting firm, stopped auditing any of the FTSE 350. The committee viewed the Big Four as a "cozy club" where there is a lack of meaningful competition. Furthermore, accounting firms will often use an audit as a loss leader in order to sell higher-margin consulting services. This creates further potential conflicts of interest.[24]

The report concluded that it is now time for action. The current system works in favor of the Big Four oligopoly and not in the public interest. Consequently, among the many recommendations resulting from the Carillion bankruptcy, the parliamentary committee called for a breakup of the Big Four and restricting accounting firms from providing management consulting services:

> We recommend that the Government refers the statutory audit market to the Competition and Markets Authority. The terms of reference of that review should explicitly include consideration of both breaking up the Big Four into more audit firms, and detaching audit arms from those providing other professional services.[25]

Questions:

1. Why did Carillion go bankrupt?
2. What aspects of Carillion should have raised the professional skepticism concerns of the corporation's auditors, KPMG? Why? Which aspects were the most important?
3. Why didn't the aspects identified in Question 2 raise the professional skepticism concerns of the auditors?
4. Should the professional accountants working as employees for Carillion have done anything to bring the aspects referred to in Question 2 to the attention of those interested in the governance of Carillion and/or the those who should have been protecting the public interest? If so, what should they have done? If not, why not?
5. If the NOCLAR rules had been in force when Carillion was instituting the aspects referred to in Question 2, what should the professional accountants have done if they had learned about them 2?
6. What are the key lessons to be learned from the Carillion Case by investors, auditors, and other employed professional accountants who are expected to demonstrate professional skepticism?

[23] Ibid., para. 167.
[24] Ibid., paras. 202 and 204.
[25] Ibid., para. 213.

Additional questions are available in the source publication: *Business & Professional Ethics for Directors, Executives & Accountants*, 9e, Leonard J. Brooks & Paul Dunn, published by Cengage Learning, Inc., ©2021, ISBN: 978-0-357-44188-6

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