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 and Pensions Committees of Session 2017–19

Tenth Report of the Business, Energy and Industrial Strategy Committee of Session 2017–19

Twelfth Report of the Work and Pensions Committee of Session 2017–19

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Business, Energy and Industrial Strategy Committee

The Business, Energy and Industrial Strategy Committee is appointed by the House of Commons to examine the expenditure, administration, and policy of the Department for Business, Energy and Industrial Strategy.

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The Work and Pensions Committee is appointed by the House of Commons to examine the expenditure, administration, and policy of the Department for Work and Pensions and its associated public bodies.

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Summary

Carillion's rise and spectacular fall was a story of recklessness, hubris and greed. Its business model was a relentless dash for cash, driven by acquisitions, rising debt, expansion into new markets and exploitation of suppliers. It presented accounts that misrepresented the reality of the business, and increased its dividend every year, come what may. Long term obligations, such as adequately funding its pension schemes, were treated with contempt. Even as the company very publicly began to unravel, the board was concerned with increasing and protecting generous executive bonuses. Carillion was unsustainable. The mystery is not that it collapsed, but that it lasted so long.

Carillion and its collapse

Carillion was an important company. Its collapse will have significant and as yet uncertain consequences, not least for public service provision:

- It had around 43,000 employees, including 19,000 in the UK. Many more people were employed in its extensive supply chains. So far, over 2,000 people have lost their jobs.
- Carillion left a pension liability of around £2.6 billion. The 27,000 members of its defined benefit pension schemes will now be paid reduced pensions by the Pension Protection Fund, which faces its largest ever hit.
- It also owed around £2 billion to its 30,000 suppliers, sub-contractors and other short-term creditors, of whom it was a notorious late payer. Like the pension schemes, they will get little back from the liquidation.
- Carillion was a major strategic supplier to the UK public sector, its work spanning from building roads and hospitals to providing school meals and defence accommodation. The Government has already committed £150 million of taxpayers' money to keeping essential services running.
- Carillion's collapse was sudden and from a publicly-stated position of strength. The company's 2016 accounts, published on 1 March 2017, presented a rosy picture. On the back of those results, it paid a record dividend of £79 million—£55 million of which was paid on 10 June 2017. It also awarded large performance bonuses to senior executives. On 10 July 2017, just four months after the accounts were published, the company announced a reduction of £845 million in the value of its contracts in a profit warning. This was increased to £1,045 million in September 2017, the company's previous seven years' profits combined. Carillion went into liquidation in January 2018 with liabilities of nearly £7 billion and just £29 million in cash.

Carillion's board

Carillion's board are both responsible and culpable for the company's failure. They presented to us as self-pitying victims of a maelstrom of coincidental and unforeseeable mishaps. Chiefly, they pointed to difficulties in a few key contracts in the Middle East.

But the problems that caused the collapse of Carillion were long in the making, as too was the rotten corporate culture that allowed them to occur. We are particularly critical of three key figures:

- Richard Adam was Carillion's Finance Director for 10 years. He was the architect of Carillion's aggressive accounting policies and resolutely refused to make adequate contributions to the company's pension schemes, which he considered a "waste of money". His voluntary departure at the end of 2016 and subsequent sale of all his shares were the actions of a man who knew where the company was heading.
- Richard Howson, Chief Executive from 2012 to 2017, was the figurehead for a business that careered progressively out of control under his misguidedly self-assured leadership.
- Philip Green joined the board in 2011 and became Chairman in 2014. He was an unquestioning optimist when his role was to challenge. Remarkably, to the end he thought he was the man to head a "new leadership team".

We recommend that the Insolvency Service, in its investigation into the conduct of former directors of Carillion, includes careful consideration of potential breaches of duties under the Companies Act, as part of their assessment of whether to take action for those breaches or to recommend to the Secretary of State action for disqualification as a director.

Checks and balances

A system of internal and external checks and balances are supposed to prevent board failures of the degree evident in Carillion. These all failed:

- The company's non-executive directors failed to scrutinise or challenge reckless executives.
- Carillion's accounts were systematically manipulated to make optimistic assessments of revenue, in defiance of internal controls. Despite being signatories of the Prompt Payment Code, Carillion treated suppliers with contempt, enforcing standard payment terms of 120 days. Suppliers could be paid earlier in return for a fee, a wheeze that Carillion used to effectively borrow more, under the radar.
- KMPG was paid £29 million to act as Carillion's auditor for 19 years. It did not once qualify its audit opinion, complacently signing off the directors' increasingly fantastical figures. In failing to exercise professional scepticism towards Carillion's accounting judgements over the course of its tenure as Carilion's auditor, KPMG was complicit in them.
- Carillion paid other big-name firms as badges of credibility in return for lucrative fees. Deloitte, paid over £10 million by the company to act as its internal auditor, failed in its risk management and financial controls role. EY was paid £10.8 million for six months of failed turnaround advice.

- The company's shareholders suffered from an absence of reliable information and were ill-equipped to influence board decision-making. In the main, they sold their shares instead.
- The key regulators, the Financial Reporting Council (FRC) and the Pensions Regulator (TPR), were united in their feebleness and timidity. The FRC identified concerns in the Carillion accounts in 2015 but failed to follow them up. TPR threatened on seven occasions to use a power to enforce pension contributions that it has never used. These were empty threats; the Carillion directors knew it and got their way.
- The Government's Crown Representative system provided little warning of risks in a key strategic supplier. We recommend an immediate review of that system.
- It is far from apparent that the potential for legal action for wrongful trading or failure to exercise directors' duties acted as a restraint on the behaviour of the board.

The lessons of Carillion

Most companies are not run with Carillion's reckless short-termism, and most company directors are far more concerned by the wider consequences of their actions than the Carillion board. But that should not obscure the fact that Carillion became a giant and unsustainable corporate time bomb in a regulatory and legal environment still in existence today. The individuals who failed in their responsibilities, in running Carillion and in challenging, advising or regulating it, were often acting entirely in line with their personal incentives. Carillion could happen again, and soon.

The economic system is predicated on strong investor engagement, yet the mechanisms and incentives to support engagement are weak. This makes regulators such as the FRC and TPR more important. The Government has recognised the regulatory weaknesses exposed by this and other corporate failures, but its responses have been cautious, largely technical, and characterised by seemingly endless consultation. It has lacked the decisiveness or bravery to pursue bold measures recommended by our select committees that could make a significant difference. That must change. That does not just mean giving the FRC and TPR greater powers. Chronically passive, they do not seek to influence corporate decision-making with the realistic threat of intervention. Action is part of their brief. They require cultural change as well.

There is a danger of a crisis of confidence in the audit profession. KPMG's audits of Carillion were not isolated failures, but symptomatic of a market which works for the Big Four firms but fails the wider economy. There are conflicts of interest at every turn. KPMG were Carillion's external auditors, Deloitte were internal auditors and EY were tasked with turning the company around. Though PwC had variously advised the company, its pension schemes and the Government on Carillion contracts, it was the least conflicted of the Four and could name its price as Special Manager of the liquidation. Waiting for a more competitive market that promotes quality and trust in audits has failed. It is time for a radically different approach. 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.

Correcting the systemic flaws exposed by the Carillion case is a huge challenge. But it can serve as an opportunity for the Government. It can grasp the initiative with an ambitious and wide-ranging set of reforms that reset our systems of corporate accountability in the long-term public interest. It would have our support in doing so.

Introduction

Our inquiry

1. Companies collapse. It is a standard part of the business life cycle. The demise of a major company does not in itself warrant a parliamentary inquiry. Carillion, a major UK multinational construction and facilities management company which entered compulsory liquidation in January 2018, was, however, a very unusual case:

- Carillion's collapse was sudden and from a publicly-stated position of strength. It went into liquidation in January 2018 with liabilities of nearly £7 billion and just £29 million in cash. Yet it had paid a record dividend of £79 million and large bonuses to senior executives for performance in 2016.
- The company's 2016 accounts, published in March 2017, were certified true and fair by its auditor, KPMG. In July 2017, the company issued a profit warning which announced a reduction of £845 million in the value of its contracts. This was increased to £1,045 million in September 2017, the exact value of the previous seven years' profits combined.
- Carillion left a pensions liability of around £2.6 billion and its schemes are set to be the largest ever hit on the Pension Protection Fund (PPF), which is partfunded by a levy on other pension schemes.
- Carillion also owed around £2 billion to its 30,000 suppliers, sub-contractors and other short-term creditors, of whom it was a notorious late payer. Like the pension schemes, they will get little back from the liquidation.
- Carillion was a major strategic supplier to the UK public sector and had around 450 construction and service contracts across government.
- The Government has committed an initial £150 million of public funds to ensure continuity of public services provided by Carillion.

Carillion was no ordinary company, and no ordinary collapse.

2. We chose to work together on Carillion, as our predecessor Committees did on BHS, because it is impossible to consider the management of the pension schemes without considering that of their sponsor company. Our inquiry did not consider Government decisions to award major contracts to Carillion. Those matters will be considered by the National Audit Office, the Public Accounts Committee and the Public Administration and Constitutional Affairs Committee in subsequent reports. We have also taken steps to ensure that we have not interfered with official investigations being undertaken by the Insolvency Service (IS), Financial Reporting Council (FRC), Financial Conduct Authority (FCA) and the Pensions Regulator (TPR). Our inquiry enabled the reasons for the collapse of Carillion, and its lessons for Government policy, to be considered in public. This report sets out our findings from that work. It is split into two parts. First, we consider the business and the reasons for its failure, together with the failure of various checks and balances on corporate conduct. Second, we consider the wider policy implications of the case.

3. Over the course of the inquiry, we took evidence from Carillion's regulators, its investors, its advisors, its pension trustees, and from Carillion's directors during its final years. We also heard from the Secretary of State for Work and Pensions and the Secretary of State for Business, Energy and Industrial Strategy to examine the Government's long-term response to the collapse of the company. In addition to oral evidence and correspondence with Carillion's stakeholders, we sought and received minutes and papers of Carillion's board and its committees from the Official Receiver, many of which we have published as part of the inquiry. We are grateful to the Official Receiver and his staff for their work in providing these documents to aid our scrutiny. Similarly, the pension scheme trustees were particularly forthcoming in response to our requests for documents. Our work was aided by Gabriel Moss QC and Hannah Thornley, both of South Square Chambers, and Professor Prem Sikka, who have acted as our Specialist Advisers. We are very grateful for their work.

The company and timeline

4. Before its collapse, Carillion was the second largest construction company in the UK. It had around 43,000 employees, including 19,000 in the UK. Many more people were employed in its extensive supply chains. It had pension obligations to around 27,000 members of its defined benefit (DB) pension schemes. Carillion's work spanned the public and private sector and extended beyond the UK, with notable contracts in the Middle East and Canada. Its work for the UK government accounted for 38% of its reported 2016 revenues and spanned from building roads and hospitals to providing school meals and defence accommodation.[1]

Timeline of key events

Date	Event
February 2006	Acquisition of Mowlem for £350 million.[2]
April 2007	Richard Adam appointed to board as Finance Director.[3]
February 2008	Acquisition of Alfred McAlpine for £565 million.[4]
December 2008	Pension valuation.
December 2009	Richard Howson appointed to board as Executive Director.[5]
March 2010	2008 pension valuation 15-month deadline.
September 2010	Richard Howson appointed Chief Operating Officer, remaining on the board.[6]
October 2010	2008 pension valuation agreed.
April 2011	Acquisition of Eaga for £298 million.[7]
June 2011	Philip Green appointed to board as Senior Non-Executive Director.[8]
December 2011	Pension valuation.
January 2012	Richard Howson appointed Chief Executive.[9]
March 2013	2011 pension valuation 15-month deadline.
December 2013	Pension valuation.[10] Alison Horner appointed to board as Non-Executive Director.[11]
May 2014	Philip Green appointed Chairman.[12]

1 Department for Work and Pensions and the Insolvency Service, Carillion declares insolvency: information for employees, creditors and suppliers, published 15 January 2018, updated 16 January 2018

Date	Event
June 2014	2011 pension valuation agreed.[13]
December 2014	2013 pension valuation agreed.[14]
July 2015	Keith Cochrane appointed to board as Senior Independent Non-Executive Director.[15]
December 2016	Richard Adam retired as Finance Director.[16]
2017	
1 January	Zafar Khan appointed to board as Finance Director.[17]
1 March	2016 Annual Report and Accounts signed and published.[18] Richard Adam sold entire existing shareholding for £534,000.[19]
~End March–15 April	Emma Mercer returned to UK as Finance Director of Construction Services and brought to the attention of Richard Howson and Zafar Khan "some issues with which she was not comfortable".[20]
8 May	Richard Adam's long-term incentive plan awards for 2014 vested. He sold the total amount for £242,000.[21]
May	The board conducted a review of accounting treatment for receivables following Ms Mercer's concerns. This was reviewed by KPMG. The review concluded that assets had been misclassified but there had been no misstatement of revenue. Acted as a trigger for wider review of contract positions.
7 June	The board held a "lessons learned" exercise which considered cultural, managerial and operational shortcomings.[22]
8 June	The board considered a presentation on a possible equity issue.[23]
9 June	Final dividend for 2016 paid worth £55 million.
4–5 July	The Chairman, and board the following day, were informed that their brokers were not able to underwrite the proposed equity issue and were advised that a trading update should be made on 10 July. Philip Green remained hopeful for a "positive and upbeat" announcement to the market.[24]
9 July	Richard Howson stepped down as Chief Executive. Replaced by Keith Cochrane as Interim Chief Executive. The board agrees a contract provision of £845 million to be included in their interim 2017 financial results.[25]
10 July	Carillion announced the £845m contract provision and comprehensive review of the Group's business and capital structure.[26]
12 July	Carillion's share value fell 70% from 10 July.[27]
14 July	EY appointed to support its strategic review with a focus on cost reduction and cash collection. HSBC appointed as new broker.[28]
August	The board identified a need to put in place further short term committed bank facilities.[29]
3 September	Zafar Khan "spooked" the board with a financial update.[30]
11 September	Zafar Khan sacked as Finance Director and Emma Mercer appointed as his replacement. New non-executive directors appointed and Transformation Officer seconded in from EY.[31]
29 September	Half-year results included a further £200m profit write down.[32]
24 October	Deferral of pension deficit contributions agreed, releasing £100 million unsecured and £40 million secured new bank finance.[33]

Date	Event
17 November	Third profit warning issued, alongside announcement that the company was heading towards a breach of its debt covenants.[34]
First week of December	Changed assumptions in weekly cashflow materially reduced the company's short-term cashflow forecasts.[35]
11 December	Kiltearn Partners, the largest shareholder in Carillion, halved its stake.[36]
22 December	Cashflow forecast delivered to finance creditors showed the company would have less than £20 million of available cash in March 2018. As a result, it was unable to make further drawings under its £100 million unsecured facility without further waivers being granted by each of them.[37]
Late December	New lenders informed the company that a further waiver would not be given unless an approach was made by the company to Government.[38]
31 December	The company submitted a formal request for support to Government.[39]
2018	
3 January	FCA notified Carillion that it had commenced an investigation into the timeliness of announcements made by the company between 7 December 2016 and 10 July 2017.[40]
4 January	The Company met Government officials to discuss status of restructuring efforts and the need for short and long-term funding.[41]
9 January	The Company met with HMRC to explore the possibility of deferred payment to in respect of tax liabilities, which were otherwise due in January, February, March and April 2018. The outcome was inconclusive.[42]
12 January	Carillion paid £6.4 million to a series of advisors and lawyers, including KPMG (£78,000), FTI Consulting (£1m), EY (£2.5m), Slaughter and May (£1.2m).[43]
13 January	The company sent a letter to Cabinet Office making a final request of £160 million, including an immediate £10 million.[44]
14 January	Cabinet Office informed the company that it would not be willing to provide such support to the company. The board concluded that the company was insolvent.[45]
15 January	Directors presented a petition to the Court for the compulsory winding up of the company on the grounds it was unable to pay its debts.[46] Accepted by the Courts and Official Receiver appointed as liquidator, with PwC appointed as Special Managers to assist with the liquidation. Government announced they were making £150 million available to support the liquidation and laying a contingent liability to indemnify the Official Receiver.[47]
16 January	Greg Clark MP, Business Secretary, wrote to the Insolvency Service and the Official Receiver asking them to fast-track their investigation into the causes of Carillion's failure and the conduct of the directors.[48]
18 January	TPR announced they were launching an anti-avoidance investigation into Carillion's funding of their pension schemes.[49]

Date	Event
24 January	Work and Pensions and Business, Energy and Industrial Strategy Committees launched a joint inquiry into the management and governance of Carillion, its sponsorship of its pension schemes and wider implications for company and pension scheme law, regulation and policy.
29 January	FRC announced investigations into the 2014, 2015 and 2016 KPMG audits of Carillion.[50]
19 March	FRC announced investigation into the preparation and approval of Carillion's financial statements by Richard Adam and Zafar Khan.[51]

2 Carillion plc, Annual Report and Accounts 2006, p 74
3 Companies House, Carillion plc Officers, accessed 1 May 2018
4 Carillion plc, Annual Report and Accounts 2008, p 101
5 Companies House, Carillion plc Officers, accessed 1 May 2018
6 Carillion plc, Annual Report and Accounts 2010, p 37
7 Carillion plc, Annual Report and Accounts 2011, p 93
8 Companies House, Carillion plc Officers, accessed 1 May 2018
9 Carillion plc, Annual Report and Accounts 2012, p 40
10 Brought forward from December 2014 and based on same assumptions used for previous valuation.
11 Companies House, Carillion plc Officers, accessed 1 May 2018
12 Carillion plc, Annual Report and Accounts 2014
13 Mercer, Carillion (DB) pension trustee limited scheme funding report actuarial valuations as at 31 December 2013, p 1
14 *As above*.
15 Companies House, Carillion plc Officers, accessed 1 May 2018
16 *As above*.
17 *As above*.
18 Carillion plc, Annual Report and Accounts 2016
19 Letter from Richard Adam to the Chairs, 20 February 2018
20 Carillion plc, Minutes of a meeting of the Board of Directors, 9 May 2017
21 Letter from Richard Adam to the Chairs, 20 February 2018
22 Lessons learned Board pack and minutes, 7 June 2017
23 Carillion plc, Minutes of a meeting of the Board of Directors, 8 June 2017
24 Carillion plc, Minutes of a meeting of the Board of Directors, 5 July 2017
25 Carillion plc, Minutes of a meeting of the Board of Directors, 9 July 2017
26 Carillion plc, H1 2017 Trading Update, 10 July 2017, accessed 1 May 2018
27 London Stock Exchange, Carillion share price, accessed 1 May 2018
28 High Court of Justice, In the matter of Carillion plc and in the matter of the Insolvency Act 1986, Exhibit: KC1 - First witness statement of Keith Robertson Cochrane, Dated: 15 January 2018 (Not published)
29 *As above*.
30 Q314; Letter from Philip Green to the Chairs, 20 February 2018
31 London Stock Exchange, Carillion plc Directorate Change, 11 September 2017
32 Carillion plc, Financial results for the six months ended 30 June 2017, 29 September 2017
33 High Court of Justice, In the matter of Carillion plc and in the matter of the Insolvency Act 1986, Exhibit: KC1 - First witness statement of Keith Robertson Cochrane, Dated: 15 January 2018 (Not published)
34 Update on discussions with stakeholders, trading and financial covenants deferral, 17 November 2017
35 High Court of Justice, In the matter of Carillion plc and in the matter of the Insolvency Act 1986, Exhibit: KC1 - First Witness Statement of Keith Robertson Cochrane, Dated: 15 January 2018 (Not published)
36 London Stock Exchange, Carillion plc Notification of major holdings, 11 December 2017
37 High Court of Justice, In the matter of Carillion plc and in the matter of the Insolvency Act 1986, Exhibit: KC1 - First witness statement of Keith Robertson Cochrane, Dated: 15 January 2018 (Not published)
38 *As above*.
39 *As above*
40 London Stock Exchange, Carillon plc Regulatory investigation announcement, 3 January 2018
41 High Court of Justice, In the matter of Carillion plc and in the matter of the Insolvency Act 1986, Exhibit: KC1 - First witness statement of Keith Robertson Cochrane, Dated: 15 January 2018 (Not published)
42 As above

43 . Business, Energy and Industrial Strategy Committee and Work and Pensions Committee, Carillion paid out £6.4 million to advisors before £10 million taxpayer bailout, 12 March 2018

44 Summary of short term funding proposal, and status update, 13 January 2018 and letter from Carillion to Cabinet Office, 13 January 2018

45 High Court of Justice, In the matter of Carillion plc and in the matter of the Insolvency Act 1986, Exhibit: KC1 - First witness statement of Keith Robertson Cochrane, Dated: 15 January 2018 (Not published)

46 *As above*

47 . HMT, Central Government supply estimates 2017-18, Supplementary estimates, February 2018

48 *The collapse of Carillion, Briefing Paper 8206, House of Commons Library, March 2018*

49 Letter from The Pensions Regulator to the Chair regarding Carillion, 12 February 2018

50 Financial Reporting Council, Investigation into the audit of the financial statements of Carillion plc, 29 January 2018

51 Financial Reporting Council, Investigation into the preparation and approval of the financial statements of Carillion plc, 19 March 2018

1 Carillion plc

Business approach

Dash for cash

Acquisitions

5. Carillion demerged from Tarmac in 1999. Highly ambitious, it grew quickly and expanded beyond its roots in the construction sector into facilities management. Much of this growth was driven by acquisitions. By purchasing rivals such as Mowlem and Alfred McAlpine, Carillion removed competitors for major contracts. Already the second biggest construction firm in the UK,[52] Carillion attempted to become the biggest in 2014 by merging with the only larger firm, Balfour Beatty.[53] This move was, however, rejected after the Balfour Beatty board dismissed Carillion's claims that the merger would generate cost-savings of £175 million a year in "synergies", the benefits of working together.[54]

6. Given Carillion's record in achieving cost savings through mergers and acquisitions, Balfour Beatty was right to be sceptical. For example, in 2011, Carillion purchased Eaga, a supplier of heating and renewable energy services.[55] Prior to the purchase, Eaga had made accumulated profits of £31 million.[56] Five consecutive years of losses followed, totalling £260 million at the end of 2016.[57] The disastrous purchase cost Carillion £298 million.[58] This came at a time Carillion was refusing to commit further funds to addressing a pension deficit of £605 million. That problem itself was largely attributable to acquisitions: when Carillion bought Mowlem for £350 million in 2006 and Alfred McAlpine for £565 million in 2008 it also bought responsibility for their pension scheme deficits.[59] It was storing up problems for the future.

7. Carillion's spending spree also enabled one of the more questionable accounting practices which featured in its eventual demise. Carillion purchased Mowlem, Alfred McAlpine and Eaga for substantially more than their tangible net assets. The difference between the net assets and the amount paid is accounted as "goodwill". Goodwill is the intangible assets of the company being purchased. These might include the skills and experience of the workforce, the company brand, and synergies with the purchasing company. The value of the goodwill recorded on Carillion's balance sheet for each of those purchases was higher than the purchase prices themselves. Carillion acquired £431 million of goodwill from Mowlem, £615 million from Alfred McAlpine and £329 million from Eaga.[60] As those figures are simply the arithmetic difference between the purchase price and the net tangible assets of the company, their accuracy as an assessment of the

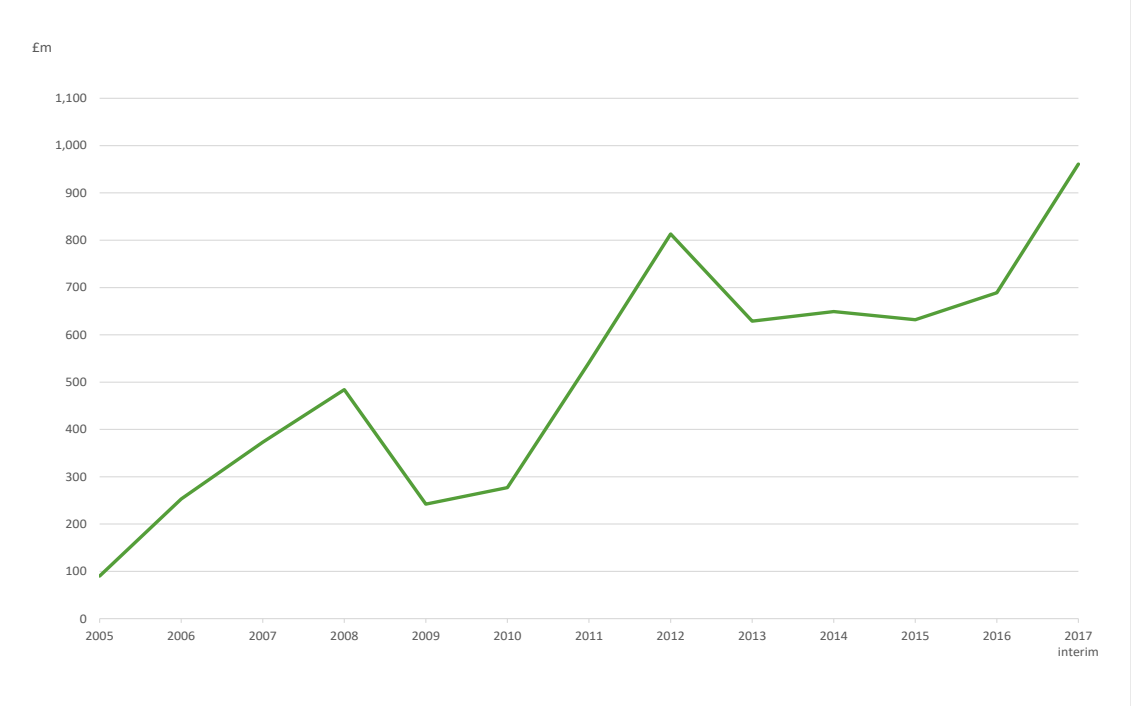
52 The Construction Index, Top 100 construction companies 2014, accessed 1 May 2018
53 Carillion retained its position as the second largest UK construction firm between 2009 and 2017, behind Balfour Beatty in each year.
54 "Balfour Beatty: five reasons why the Carillion merger won't work", Daily Telegraph, 15 August 2014
55 Eaga was renamed Carillion Energy Services.
56 Carillion Energy Services Ltd, Directors' report and financial statements for the period ended 31 December 2012, p 9
57 Carillion Energy Services Ltd, Annual report and financial statements, 2011–2016
58 Carillion plc, Annual Report and Accounts 2011, p 92
59 Carillion plc, Annual Report and Accounts 2006, p 74; Carillion plc, Annual Report and Accounts 2008, p 101
60 Carillion plc, Annual Report and Accounts 2006, p 74; Carillion plc, Annual Report and Accounts 2008, p 101; Carillion plc, Annual Report and Accounts 2011, p 92

intangible assets purchased is entirely dependent on the appropriateness of the price paid. As we consider later in this report, these large and uncertain intangible assets also continued to prop up Carillion's balance sheet for the remainder of its existence.

Debt

8. Carillion rejected opportunities to inject equity into the growing company and instead funded its spending spree through debt. Borrowing increased substantially between 2006 and 2008 as Mowlem and Alfred McAlpine were bought.[61] It then almost trebled between 2010 and 2012 to help fund the Eaga purchase. The accumulation of debt, and inability to reduce it, caused concerns among Carillion's investors. Standard Life Investments began selling its shares in the company from December 2015 onwards,[62] citing a high debt burden that was unlikely to reduce in the near term due to acquisitions and a high dividend pay-out.[63] As we discuss later in this chapter, in early 2015 UBS claimed total debt was higher than Carillion were publicly stating, triggering a big increase in investors short selling, or betting against, Carillion's shares.[64]

Figure 1: Carillion's total borrowing



Source: Carillion plc Annual Report and Accounts 2005–2017

9. Carillion's growing net debt appeared to be of little concern to the board until the company was in dire straits. Keith Cochrane, non-executive director from July 2015 until becoming interim Chief Executive in July 2017, described net debt and the pension deficit as "lesser concerns" in 2015.[65] Looking back, however, company directors acknowledged

61 Mowlem cost £350 million - Carillion plc, Annual Report and Accounts 2006, p 74 and Alfred McAlpine £565 million, Carillion plc, Annual Report and Accounts 2008, p 101

62 Standard Life Investments merged with Aberdeen Asset Management in August 2017 to form Standard Life Aberdeen

63 Letter from Standard Life Aberdeen to the Chairs, 2 February 2018

64 Carillion plc, Minutes of a meeting of the Board of Directors, 2 April 2015

65 Q233 [Keith Cochrane]

that their position was unsustainable. Philip Green, non-executive director from June 2011 and Chairman since May 2014,[66] told us that he regretted the board "did not reduce net debt sooner" and conceded that they were too slow to explore the opportunity of raising equity rather than relying on debt.[67]

Expansion

10. While Carillion's acquisitions had enabled it to purchase rivals for its home turf, in Mowlem and Alfred McAlpine, and expand into the new market of energy efficiency services, in the case of Eaga, they had not delivered the returns the company had projected. Richard Howson, Chief Executive from January 2012 to July 2017, explained that the company turned its attention to bidding aggressively on contracts to generate cash:

> We did not have any money to buy competitors, as we had done in the past. We had to win our work organically. We had to bid and we had to win […][68]

Expansion into new markets was a key part of Carillion's strategy, and led to ventures into Canada, the Caribbean and the Middle East as it sought opportunities for growth.

11. Carillion's forays overseas were largely disastrous. The most notorious example was a 2011 contract with Msheireb Properties, a Qatari company, to build residential, hotel and office buildings in Doha. The project was due to complete in 2014, but remains unfinished.[69] We heard claim and counter-claim from Carillion's directors and Msheireb Properties, who each said the other owed them £200 million.[70] Regardless of the true picture—and we are baffled that neither the internal nor external auditors could tell us—it is abundantly clear that the contract was not well-managed by Carillion. A July 2017 Carillion board "lessons learned" pack conceded as much, citing the company's weak supply chain, poor planning and failure to understand the design requirements up front.[71] Carillion also had difficulty adapting to local business practices. Richard Howson, who after being sacked as Chief Executive in July 2017 was retained in a new role to maintain morale and negotiate payment in key failing contracts,[72] explained, "working in the Middle East is very different to working anywhere else in the world".[73]

12. Carillion's directors attempted to ascribe the company's collapse to unforeseeable failings in a few rogue contracts. But, responding to difficulties in UK construction, Carillion knowingly entered risky new markets.[74] A 2009 board strategy paper rated the Dubai market outlook as 3/10,[75] but Carillion's 2010 annual report said it would "target new work selectively" in the City.[76] With reference to Carillion's problems with Msheireb, Richard Howson told us "we only won, thankfully, one construction project in Qatar".[77]

66 Philip Green is not to be confused with Sir Philip Green of Arcadia and, previously, BHS.
67 Letter from Philip Green to the Chairs, 21 February 2018
68 Q606 [Richard Howson]
69 Letter from Msheireb Properties to the Chairs, 27 February 2018
70 Q482 [Richard Howson]; Letter from Msheireb Properties to the Chairs, 27 February 2018
71 Carillion plc, Minutes of a meeting of the Board of Directors, 7 June 2017 (not published)
72 Letter from Richard Howson to the Chairs, 21 February 2018
73 Q428 [Richard Howson]
74 Q526 [Richard Howson]
75 Carillion plc, November Board meeting Board Strategy Session, November 2009
76 Carillion plc, Annual Report and Accounts 2010, p 10
77 Q526 [Richard Howson]

Yet Carillion bid for 13 construction contracts in that country between 2010 and 2014.[78] The overriding impression is that Carillion's overseas contract problems lay not in a few rogue deals, but in a deliberate, naïve and hubristic strategy.

13. The July 2017 lessons learned pack highlighted the breadth of problems in Carillion's contract management.[79] Andrew Dougal, Chair of the audit committee, noted there appeared to be a "push for cash at period end", which would reflect well in published results, and "inadequate reviews on operational contracts".[80] As a large company and competitive bidder, Carillion was well-placed to win contracts. Its failings in subsequently managing them to generate profit was masked for a long time by a continuing stream of new work and, as considered later in this chapter, accounting practices that precluded an accurate assessment of the state of contracts.

14. **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 pensions problems for the future. Similarly, expansions into overseas markets were driven by optimism rather than any strategic expertise. Carillion's directors blamed a few rogue contracts in alien business environments, such as with Msheireb Properties in Qatar, for the company's demise. But if they had had their way, they would have won 13 contracts in that country. The truth is that, in acquisitions, debt and international expansion, Carillion became increasingly reckless in the pursuit of growth. In doing so, it had scant regard for long-term sustainability or the impact on employees, pensioners and suppliers.**

Dividends

15. Carillion's final annual report, *Making tomorrow a better place*, published in March 2017, noted proudly "the board has increased the dividend in each of the 16 years since the formation of the Company in 1999".[81] This progressive dividend policy was intended to "increase the full-year dividend broadly in line with the growth in underlying earnings per share".[82] The board, most of whom were shareholders themselves,[83] were expected to take into account factors including:

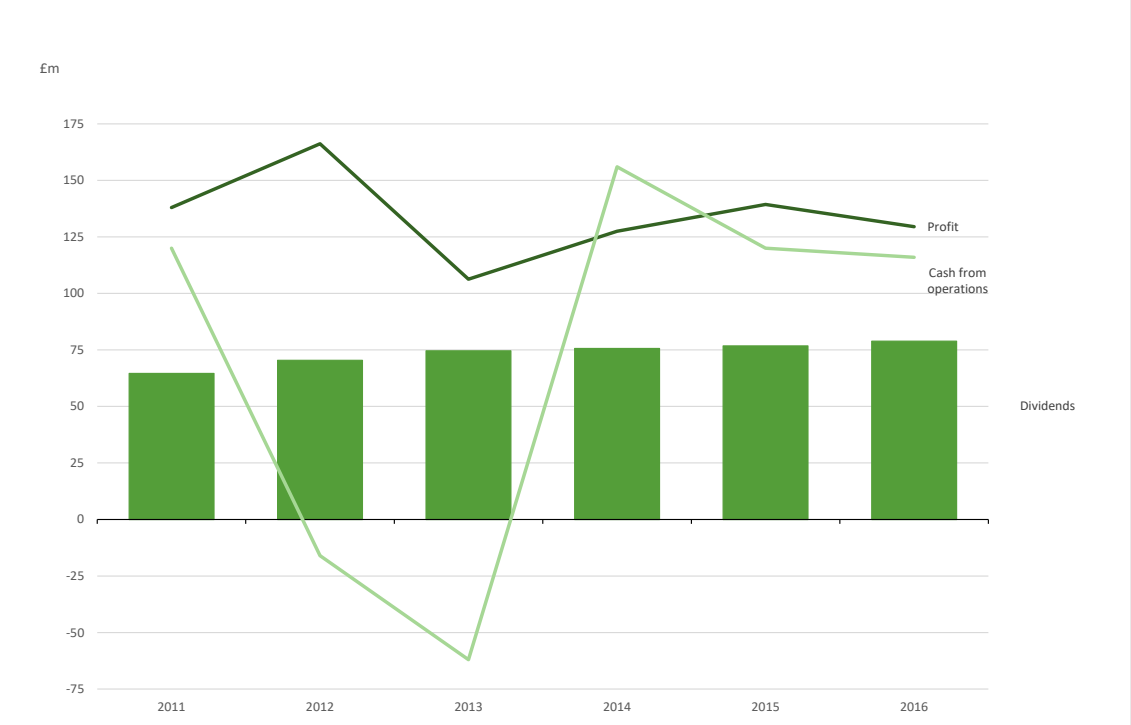
- the level of available distributable reserves;
- future cash commitments and investment needs to sustain the long-term growth prospects of the business; and
- net profits, to provide "dividend cover",

when determining dividend payments.[84]

78 Letter from Richard Howson to the Chairs, 21 February 2018
79 Carillion plc, Meeting of the Board of Directors, 7 June 2017 (not published)
80 *As above.*
81 Carillion plc, Annual Report and Accounts 2016, p 43
82 Carillion plc, Annual Report and Accounts 2016, p 7
83 In the Annual Report and Accounts 2016, p 71, Philip Green, Richard Howson, Zafar Khan, Richard Adam, Andrew Dougal and Alison Horner are listed as shareholders. Keith Cochrane and Ceri Powell are not.
84 Carillion plc, Annual Report and Accounts 2016, p 43

16. In reality, Carillion's dividend payments bore little relation to its volatile corporate performance. In the years preceding its collapse, Carillion's profits did not grow at a steady rate, and its cash from operations varied significantly. In 2012 and 2013, the company had an overall cash outflow as its construction volumes decreased.[85] But in these years the board decided not only to continue to pay dividends, but to increase them, even though they did not have the cash-flow to cover them.[86]

Figure 2: Carillion's dividend payments



Source: Carillion plc annual reports and accounts 2011–2016

17. Remarkably, the policy continued right up until dividends were suspended entirely as part of the July 2017 profit warning.[87] The final dividend for 2016, of £55 million, was paid just one month before on 9 June 2017.[88] Former members of Carillion's board told us that there was a "wide ranging discussion"[89] and "lengthy debate" in January and February 2017 on whether to confirm that dividend.[90] January 2017 board minutes show that Zafar Khan, then Finance Director, proposed withholding it to conserve cash and reduce debt. However, he faced opposition from Andrew Dougal, the Chair of the audit committee,[91] and Keith Cochrane, then the Senior Independent Non-Executive Director and later interim Chief Executive. Both men expressed concerns about the message holding dividends would have sent to the market. Mr Cochrane suggested "it may be appropriate to send a message to the market about debt reduction at the right time".[92] He

85 Q603 [Richard Adam]
86 Q602 [Richard Adam]
87 Carillion plc, H1 2017 Trading Update, 10 July 2017
88 This payment was the final dividend payment for 2016, announced in May and paid on 9 June 2017. Stockopedia, Carillion, accessed 1 May 2018
89 Q383 [Keith Cochrane]
90 Q292 [Zafar Khan]
91 Mr Dougal held 5,000 shares in the company. Carillion plc, Annual Report and Accounts 2016, p 71
92 Carillion plc, Minutes of a meeting of the Board of Directors, 26 January 2017

told us that "management were committed to reducing average net debt after paying the dividend".[93] It is clear, however, that all other considerations, including addressing the company's ballooning debt burden, were over-ridden. The minutes of the February 2017 board meeting provide no detail of any further discussion of the dividend, but simply confirm that the board recommended a dividend of 18.45p per share.[94] The right time to "send a message to the market" did not appear to come until the board issued its profit warning just over four months later.

18. Richard Adam, Finance Director from April 2007 to December 2016, told us that Carillion's objective in dividend payments was "balancing the needs of many stakeholders", including pensioners, staff and shareholders.[95] We saw little evidence of balance when it came to pensioners' needs. Over the six years from 2011–2016, the company paid out £441 million in dividends compared to £246 million in pension scheme deficit recovery payments.[96] Despite dividend payments being nearly twice the value of pension payments, Keith Cochrane denied that dividends were given priority.[97] When offered the analogy of a mother offering one child twice as much pocket money as the other, he merely noted that was an "interesting perspective".[98] Richard Adam's defence was that from 2012–2016, dividends increased by only 12% whereas pension payments increased by 50%.[99] He omitted to mention that, across his ten year stint as Finance Director, deficit recovery payments increased by 1% whereas dividends increased by 199%.[100] Setting aside selective choosing of dates, there is a simpler point: funding pension schemes is an obligation.[101] Paying out dividends is not. We are pleased that the Business Secretary has confirmed that his Department's review into insolvency and corporate governance will include considering "whether companies ought to provide for company pension liabilities, before distributing profits" through dividends.[102]

19. Nor was it clear that shareholders agreed that Carillion achieved Richard Adam's balance. Some investors, such as BlackRock, invested passively in Carillion because it was included in tracking indices. For them, the suspension of dividends, as with significant falls in the share prices, could lead to a company being removed from indices and trigger an automatic obligation to sell shares.[103] Active investors took a more nuanced view. Standard Life Aberdeen told us that while "the dividend payment is an important part of the return to shareholders from the earnings" it was not in the investor's interests to encourage the payment of "unsustainable dividends."[104] In December 2015, Standard Life Investments (as it then was) took the decision to begin divesting from Carillion in part because they realised Carillion's insistence on high dividends meant it was neglecting

93 Q383 [Keith Cochrane]
94 Carillion plc, Minutes of a meeting of the Board of Directors, 28 February 2017
95 Q604 [Richard Adam]
96 Analysis of Carillion plc's Annual Report and Accounts cashflow statements 2011–2016
97 Q388 [Keith Cochrane]
98 Q390 [Keith Cochrane]
99 Q605 [Richard Adam]
100 Analysis of Carillion plc's annual report and accounts cashflow statements 2007–2016
101 Pensions are deferred pay and pension deficits are responsibilities of the employer. See TPR, Annual funding statement for defined benefit pension scheme, April 2018, p 11.
102 Letter from the Secretary of State for Business, Energy and Industrial Strategy to the Chairs, 30 April 2018
103 Letter from BlackRock to the Chairs, 8 February 2018, Q1118 [Amra Balic]
104 Q1115 [Euan Stirling]

rising debt levels.[105] Murdo Murchison, Chief Executive of Kiltearn Partners, another active investor, said dividend payments that were "not sustainable" was a factor in his company choosing to divest Carillion shares:

> In our analysis we baked in a dividend cut. When the market is telling you a dividend is not sustainable the market is usually right and, again, it is quite interesting in this context as to why the management were so optimistic about the business they were prepared to take a different view.[106]

Ultimately, any investors who held on to their shares found them worthless.

20. Mr Murchison said that, while dividends should be "a residual", payable once liabilities had been met, there was a problem with "corporate cultures where a lot of management teams believe dividends are their priority".[107] Carillion's board was a classic such case, showing:

> desire to present to investors a company that was very cash generative and capable of paying out high sustainable dividends. They took a lot of pride in their dividend paying track record.[108]

Such an approach was inconsistent with the long-term sustainability of the company.

21. **The perception of Carillion as a healthy and successful company was in no small part due to its directors' determination to increase the dividend paid each year, come what may. Amid a jutting mountain range of volatile financial performance charts, dividend payments stand out as a generous, reliable and steady incline. In the company's final years, directors rewarded themselves and other shareholders by choosing to pay out more in dividends than the company generated in cash, despite increased borrowing, low levels of investment and a growing pension deficit. Active investors have expressed surprise and disappointment that Carillion's directors chose short-term gains over the long-term sustainability of the company. We too can find no justification for this reckless approach.**

Pension schemes

Pension obligations

22. Carillion operated two main defined benefit (DB) pension schemes for its employees, the Carillion Staff and Carillion 'B' schemes.[109] In April 2009, Carillion closed the schemes to further accruals and from that point employees could instead join a defined contribution plan.[110] Carillion still retained its obligation to honour DB pension entitlements accumulated before that date. The schemes had combined deficits, the difference between their assets and liabilities, of £48 million in 2008, £165 million in 2011 and £86 million in 2013.[111]

105 Letter from Standard Life to the Chairs, 2 February 2018
106 Q1116 [Murdo Murchison]
107 Q1115 [Murdo Murchison]
108 *As above.*
109 The Carillion 'B' scheme was only available to executive directors and other senior employees.
110 Carillion plc, Annual Report and Accounts 2009, p 102
111 Analysis of scheme annual report and accounts.

23. Those deficits, while undesirable, were not unusually high by DB standards and may well have been manageable. Through its acquisitions policy, however, Carillion took on responsibility for several additional DB schemes in deficit. When the company entered liquidation in 2018, it had responsibility for funding 13 UK DB pension schemes.[112] All but two of those are likely to enter the Pension Protection Fund (PPF), which pays reduced benefits to members of schemes that are unable to meet pension promises owing to the insolvency of the sponsoring employer.[113] The PPF, which is part-funded by a levy on other pension schemes, will take on responsibility for both the assets of the schemes and the liability of paying the reduced pensions. The PPF estimates the aggregate deficit for PPF purposes will be around £800 million, making it the largest ever hit on its resources.[114]

Box 1: The Pension Protection Fund (PPF)

The PPF protects the pensions of members of DB pension schemes. If the sponsoring employer of a scheme becomes insolvent, and the schemes cannot afford to pay pensions at least equal to PPF compensation, the PPF compensates them financially for the money they have lost. PPF benefits are generally lower than in the failed scheme: if someone had already reached pension age when the company went bust, they would be paid their full pension, but will usually have lower annual indexation. Schemes members yet to reach pension age face a 10% haircut to their pensions as well. There is also a cap on annual compensation.

As well as taking on liabilities for paying reduced pensions, the PPF takes on the assets of the failed schemes. To fund pension payments, it invests those assets, seeks to recover money and other assets from the insolvent sponsors, and charges a levy on pension schemes eligible for the PPF. The levy is risk-based and acts as an insurance premium. In March 2017, the schemes insured by the PPF had a combined deficit on a PPF basis of £295 billion.

In 2018–19, the PPF expects to collect £550 million of levy in total across all eligible schemes. The hit from the Carillion schemes will be larger than that. However, the PPF has a reserve of £6.1 billion, making it "well-placed" to absorb the Carillion schemes. The PPF projects a 93% probability of being fully-funded by 2030.[115]

24. The most significant of the additional schemes acquired were sponsored by Mowlem and Alfred McAlpine. Mowlem was purchased in 2006, when it had a year-end pension deficit of £33 million.[116] Alfred McAlpine was purchased in 2008, when it had a year-end deficit of £123 million.[117] By the end of 2011, the combined deficit on these two schemes had grown to £424 million.[118] On 6 April 2011, a single trustee board, Carillion (DB) Pension Trustee Ltd, was formed to act for the two main Carillion schemes, Alfred McAlpine,

112 Carillion Group Section; Permarock Products Pension Scheme; Carillion "B" Pension Scheme; The Carillion Staff Pension Scheme; Alfred McAlpine Pension Plan; Mowlem Staff Pension and Life Assurance Scheme; Planned Maintenance Engineering Limited Staff Pension And Assurance Scheme; Bower Group Retirement Benefits Scheme; The Carillion Public Sector Scheme; The Mowlem (1993) Pension Scheme; Prudential Platinum Carillion Integrated Services Limited Section; Carillion Rail (Centrac) Section; Carillion Rail (GTRM) Section. Carillion also had DB pension obligations in Canada following acquisitions there.

113 Letter from PPF to the Chair, 20 February 2018

114 Letter from PPF to the Chair, 3 April 2018

115 Letter from PPF to Chairs, 20 February 2018 and PPF Annual Report and Accounts 2016–17

116 Mowlem Staff Pension and Life Assurance Scheme, Report and financial accounts 2007, p 8

117 Alfred McAlpine Pension Plan, Actuarial Valuation as at 31 December 2008, p 2

118 Mercer, Carillion (DB) pension trustee limited scheme funding report actuarial valuations as at 31 December 2013, p 3

Mowlem and two additional schemes: Bower and the Planned Maintenance Engineering Staff schemes.[119] These schemes together accounted for the large majority of both the total Carillion deficit and total pension membership.[120] We focus in this report on those schemes and the negotiations between Carillion and Carillion (DB) Pension Trustee Ltd (the Trustee).

Scheme funding

25. DB pension schemes are subject to a statutory funding objective of having sufficient and appropriate assets to make provision for their liabilities.[121] Actuarial valuations must be carried out at least once every three years to assess whether this statutory funding objective is met.[122] If it is not, the Trustee and sponsor company are required to agree a recovery plan for how and when the scheme will be returned to full funding, including deficit recovery payments to be made by the sponsor.[123] The agreed valuation and recovery plan, schedule of contributions and valuation must be submitted to The Pensions Regulator (TPR) within 15 months of the valuation.[124]

26. The main Carillion schemes had combined deficits of:

- £327 million on 31 December 2008;
- £617 million on 31 December 2011; and
- £439 million on 31 December 2013.[125]

27. Carillion and the Trustee therefore needed to agree three recovery plans over the past decade. The 31 December 2016 valuation was, Keith Cochrane told us, "somewhat overtaken by events"[126] as the company unravelled, but the Trustee expected the total deficit to be around £990 million.[127]

28. The 2008 valuation was a warning of things to come. Carillion and the Trustee failed to agree a valuation within 15 months, mainly because of a disagreement over the assumptions used to calculate the deficit. Carillion pushed for more optimistic assumptions of future investment returns than the Trustee considered prudent.[128] Additionally, while the Trustee believed that contributions of £35 million per annum were both necessary and affordable as a minimum, Carillion said they could not afford contributions above £23 million.[129] Carillion also wanted the recovery plan to be 15 years, which the Trustee noted "exceeds the 10 year maximum which the Regulator suggests is appropriate".[130] The

119 Letter from Carillion (DB) Pension Trustee Ltd to the Chair, 26 January 2018
120 Trustee data shows that at the end of 2013, total membership across these schemes was 20,587. Carillion plc Annual Report and Accounts 2013 show that total membership across all schemes was 28,785 at the end of 2013.
121 Pensions Act 2004, section 222
122 Pensions Act 2004, section 224
123 Pensions Act 2004, section 226
124 The Pensions Regulator, Code of practice no.3 Funding defined benefits, July 2014, p44
125 Analysis of scheme valuation reports. The Bower pension scheme operated on a different valuation cycle and is therefore not included here.
126 Q362 [Keith Cochrane]
127 Letter from Carillion (DB) Trustee Limited to the Chair, 26 January 2018
128 Letter from Robin Herzberg to the Pensions Regulator, 25 March 2010
129 *As above.*
130 *As above.*

valuation and recovery plans were eventually agreed in October 2010, seven months late, with payments averaging £26 million over a 16 year period.[131] The company largely got its way.

29. The 2011 valuation reached an impasse on the same issues:

- The Trustee calculated the deficit at £770 million and requested annual deficit recovery payments of £65 million for 14 years to address it.[132]
- Carillion, using more optimistic assumptions, said the deficit was £620 million. They presented annual deficit recovery contributions of £33.4 million for 15 years as a take it or leave it offer.[133]

30. The Trustee's position was supported by independent covenant advice from their advisors, Gazelle Corporate Finance. Based on the financial reports available to it, Gazelle said Carillion could increase annual contributions to above £64 million without a significant impact on available cashflow.[134] It also noted Carillion had "historically prioritised other demands on capital ahead of deficit reduction in order to grow earnings and support the share price".[135] Despite the continued increases in dividends every year, the company had refused requests from the Trustee to establish a formal link between the level of dividends and pension contributions.[136]

31. Richard Adam, as Finance Director, argued the company could not afford such high contributions. Gazelle was sceptical of this: his pessimistic corporate projections presented to the Trustee were certainly at odds with the upbeat assessments offered to the City to attract investment.[137] In retrospect, the gloomy outlook may have been more accurate. But if that was so, Carillion should not have been paying such generous dividends. Gazelle concluded that Richard Adam had an "aversion to pension scheme deficit repair funding".[138] The scheme actuary, Edwin Topper from Mercer, said Carillion's "primary objective was to minimise the cash payments to the schemes".[139] Robin Ellison, Chair of the Trustee, observed at the time that Richard Adam viewed funding pension schemes as a "waste of money".[140]

32. Despite TPR writing to both sides in June 2013 to indicate contributions in the range of £33 million - £39 million would not be "acceptable based on the evidence we have seen" - Carillion refused to increase its offer.[141] In early 2014, however, a compromise was reached based on a new valuation date of 31 January 2013. Improved market conditions between those two dates had reduced the deficit to £605 million. The Trustee reluctantly

131 The recovery plans across the five different schemes were all 16 years in length, with the exception of Alfred McAlpine, which was 14 years in length. The Alfred McAlpine Pension Plan Annual report for the year ended 31 December 2010, p 28
132 Letter from the Trustee to the Pensions Regulator, 9 April 2013
133 *As above.*
134 Letter from Gazelle Director to Carillion Trustees, 23 February 2012
135 *As above.*
136 Carillion single Trustee - meeting between Trustee representatives and the Pensions Regulator regarding failure to agree the 2011 valuation, 29 April 2013
137 Letter from the Trustee to the Pensions Regulator, 9 April 2013
138 Letter from Simon Willes, Gazelle Executive Chairman, to the Chair, 29 March 2018
139 Mercer, Meeting note with Carillion single trustee schemes and TPR, 19 December 2012
140 Sacker and Partners LLP, Carillion single Trustee - meeting between Trustee representatives and the Pensions Regulator regarding failure to agree the 2011 valuation, 29 April 2013
141 Letter from TPR to Robin Ellison and Janet Dawson, 27 June 2013

accepted initial annual contributions of £33 million, in line with Carillion's original offer and £30 million less than the Trustee originally requested. While recovery contributions were scheduled to rise to £42 million from 2022, there would be new negotiations in the meantime.[142] The Carillion group would also only guarantee payments due up to end of 2017.[143] Beyond then, schemes would only have recourse to individual sponsor companies within the group. It was also agreed that the next valuation, based on the position at 31 December 2013, would be based on the same assumptions and would not consider the total level of contributions.[144] It is difficult to interpret this result as anything other than a victory for Carillion in its objective of minimising its contributions to the scheme. We consider the role of TPR in this outcome later in this report.

33. Following the July 2017 profit warning, Carillion was desperate to cut costs. The pension schemes were one of their main targets. The Trustee agreed to defer pension contributions worth £25.3 million due between September 2017 and April 2018, on the basis that the sponsor would otherwise have been insolvent.[145] Carillion also sought to offload its pension schemes into the PPF in a bespoke deal, though it had far from sufficient funding to produce a proposal that would have been attractive to the Trustee, TPR or the PPF.[146]

34. Though most of them were shareholders, Carillion's former directors were not members of the DB pension schemes. Instead, they received generous employer contributions to a defined contribution scheme. For example, Richard Howson and Richard Adam received employer contributions of £231,000 and £163,000 respectively for their work in 2016.[147] The performance indicators used to determine bonus payments did not include managing the risk of pension deficits. The directors rejected accusations, however, that they did not care about funding the pension schemes. They repeatedly referred to meeting their pension obligations, meaning fulfilling the deficit recovery plan, without any regard to the lopsided negotiation that led to its agreement.[148] The company ultimately reneged on that agreement, asking the Trustee to forgo payments due in a desperate effort to save the company. Fundamentally, those directors did not meet their obligations. TPR makes clear that "pensions are deferred pay and pension deficits are responsibilities of the employer".[149] Carillion failed in its obligations to honour its pension promises and to take adequate steps to address its pension deficits.

35. **Honouring pension obligations over decades to come was of little interest to a myopic board who thought of little beyond their next market statement. Their cash-chasing acquisitions policy meant they acquired pension scheme deficits alongside companies. Their proposals for funding those deficits were consistently and resolutely derisory as they blamed financial constraints unrecognisable from their optimistic market announcements. Meeting the pension promises they had made to their rank**

142 Mercer, Carillion (DB) pension trustee limited scheme funding report actuarial valuations as at 31 December 2013, p 5

143 Gazelle, Carillion plc Paper for the trustee board, 7 February 2012, p 3

144 Mercer, Carillion (DB) pension trustee limited scheme funding report actuarial valuations as at 31 December 2013, p 1. Consequently, there was no great scope for disagreement over this valuation and it was agreed in December 2014.

145 Letter from Carillion (DB) Trustee Limited to the Chair, 26 January 2018

146 High Court of Justice, In the matter of Carillion plc and in the matter of the Insolvency Act 1986, Exhibit: KC1 - First witness statement of Keith Robertson Cochrane, Dated: 15 January 2018 (Not published); Q757 [Mike Birch]

147 Carillion plc, 2016 Annual Report and Accounts, p 66

148 For example, Q381, Q384 [Keith Cochrane], Q571 [Philip Green]

149 The Pensions Regulator, Annual funding statement for defined benefit pension scheme, April 2018, p 11

and file staff was far down their list of priorities. This outlook was epitomised by Richard Adam who, as Finance Director, considered funding the pension schemes a "waste of money".

Suppliers

36. Carillion relied on an extensive network of suppliers to deliver materials, services and support across its work.[150] At the point of the company's collapse, the construction trade body Build UK estimated that Carillion's supply chain spanned 30,000 companies.[151] These businesses included direct subcontractors, indirect subcontractors, and suppliers who may have been unaware that they formed part of Carillion's supply chain until the insolvency prevented them from receiving payments owed. The Federation of Small Business (FSB) said that small suppliers had been placed in a "perilous" situation.[152] The jeopardy suppliers faced at the hands of Carillion was not, however, limited to the point when the company ceased trading. We heard that the company had long been abusing its dominant market position by making small suppliers wait for payment.[153] Suppliers told us that Carillion subjected them to extended delays across reporting periods and was notable for quibbling with invoices to avoid prompt payment.[154]

37. Carillion signed the Government's Prompt Payment Code in 2013.[155] Signatories are expected to pay suppliers on time, give clear guidance to suppliers and encourage good practice. They should pay 95% of invoices within 60 days unless there are exceptional circumstances,[156] undertake to work towards 30 day payment terms, and avoid practices that adversely affect the supply chain.[157]

38. Despite signing the Code, Carillion had a reputation as a notorious late payer.[158] In 2016, the FSB protested to the company on behalf of suppliers waiting up to 126 days to receive the payments they were owed.[159] The Rt Hon Greg Clark MP, Secretary of State for Business, Energy and Industrial Strategy, said that "it is obvious that those payment terms were too long".[160] Carillion's former directors were, however, either unaware of the use of this business practice, or unwilling to admit to it. Richard Adam, Richard Howson and Philip Green all claimed not to recognise cases of people waiting 120 to 126 days for payment.[161] Emma Mercer, Carillion's final Finance Director, told us of "a few outliers" of "about five per cent" of the supply chain were paid over 120 days and "less than ten per cent" waited 60 days.[162]

150 The Construction Index, Top 100 construction companies 2017, accessed 22 April 2018
151 BuildUK, Mitigating Impact of Carillion's Liquidation, accessed 22 April 2018
152 Letter from FSB to the Chairs, 31 January 2018
153 Letter from FSB to the Chairs, 31 January 2018
154 Letter from Vaughan Engineering Ltd to the Chair, 30 March 2018; we also received confidential information from other Carillion suppliers on payment delays.
155 Letter from FSB to the Chairs, 31 January 2018
156 The Government and Chartered Institute of Credit Management do not set criteria for exceptional circumstance, but suggest the example of instances where a company is able to demonstrate that they apply different terms to the benefit of their smaller suppliers.
157 Department for Business, Energy and Industrial Strategy and Chartered Institute of Credit Management, Prompt Payment Code, accessed 24 April 2018
158 Letter from FSB to the Chairs, 31 January 2018
159 *As above.*
160 Q1236 [Greg Clark]
161 Q546 [Richard Howson]; Q547 [Richard Adam]; Q548 [Philip Green]
162 Qq356–8 [Emma Mercer]

39. Emma Mercer's evidence exhibited greater frankness than Carillion's other former directors. While she accepted that suppliers were asked to sign up to 120 day payment terms, she explained that the company offered an early payment facility (EPF) option.[163] She called this practice "supply chain factoring", which is also known as "reverse factoring" or "supply chain financing". In such an arrangement, suppliers can receive payments from a bank ahead of standard timescales, at a discounted rate. Supply chain financing has won support from industry bodies, including the FSB, and Government. In 2012, the then Prime Minister announced the Supply Chain Finance Scheme as an "innovative way for large companies to help their supply chain access credit, improve cash-flow and at a much lower cost".[164] Carillion was a founding participant in this well-intentioned initiative.

40. Carillion's use of supply chain finance was unusual in both the harshness of the alternative standard payment terms and the extent to which the company relied on it. Shortly after the launch of the Supply Chain Finance Scheme, Carillion changed its standard payment terms to 120 days.[165] Suppliers could sell their invoices at a discount to Carillion's bank to receive their payment after 45 days. Carillion, however, would not be expected to reimburse the bank until the standard payment terms had expired, providing them with a generous repayment period. Emma Mercer told us that this was a deliberate strategy: Carillion explicitly used its EPF to avoid "damaging our working capital" and because it was vulnerable to its own customers not paying within 45 days.[166] This only serves to highlight the fragility of Carillion's business model.

Box 2: Vaughan Engineering

The collapse of Carillion will inevitably have a ripple effect through the UK construction industry and the wider economy. One of the first companies to be hit was Vaughan Engineering Ltd, which filed for administration on 28 March 2018.[167] The company employed around 200 people and provided mechanical and electrical building services on large commercial building projects. They had worked extensively with Carillion over the past decade.[168]

Vaughan Engineering described Carillion's collapse as the principal factor in their own downfall, though they also cited contract disputes with other contractors and inadequate Government support following Carillion's insolvency.[169] Their complaints against Carillion echo those of other suppliers who had to deal with them: standard payment terms of 120 days that could only be circumvented by use of the early payment facility, delays in the certification of payments and unsubstantiated counter claims. The company believe they were owed £830,000 by Carillion, which left them unable to cover their liabilities.[170]

41. At the point the company collapsed, Carillion had access to credit of up to £500 million for the "early" payment of suppliers, and was drawing around £350 million.[171] That Carillion was using supply chain financing to prop itself up would be of grave concern to

163 Qq352–3 [Emma Mercer]
164 'Prime Minister announces Supply Chain Finance Scheme' Prime Minister's Office, 23 October 2012
165 Carillion was still expected to pay within 30 days on its public sector contracts.
166 Qq354–5 [Emma Mercer]
167 BBC News, Former Carillion sub-contractor in administration, accessed 27 April 2018
168 Letter from Vaughan Engineering Ltd to the Chair, 30 March 2018
169 *As above*.
170 *As above*.
171 Carillion plc, Group short term cash flow forecast, 22 December 2017 (not published)

investors. But S&P Global, a credit ratings agency, told us that "the lack of transparency concerning Carillion's reverse factoring practices likely obscured its weak balance sheet and cash flow position."[172] The accounting impact of this approach is considered later in this report. In the dying days of the company, Carillion considered a proposal by its restructuring consultants, EY, to extend standard payment terms to 126 days as an untapped "cash generative opportunity".[173]

42. **Carillion relied on its suppliers to provide materials, services and support across its contracts, but treated them with contempt. Late payments, the routine quibbling of invoices, and extended delays across reporting periods were company policy. Carillion was a signatory of the Government's Prompt Payment Code, but its standard payment terms were an extraordinary 120 days. Suppliers could be paid in 45 days, but had to take a cut for the privilege. This arrangement opened a line of credit for Carillion, which it used systematically to shore up its fragile balance sheet, without a care for the balance sheets of its suppliers.**

43. We welcome that as part of Carillion's insolvency, the Official Receiver has sought to improve payment terms for goods and services provided during and for the benefit of the liquidation. They have reduced terms to "there or thereabouts, within 30 days of invoice rather than the 120 days that [we] have heard".[174]This does not, however, benefit those suppliers who remain unpaid for goods and services before the collapse of the company. The vast majority of those were uninsured and have joined the long list of creditors unlikely to see anything they were owed.[175]

Corporate governance

44. Corporate governance is the process by which a company is directed and controlled.[176] Its purpose is "to facilitate effective, entrepreneurial and prudent management that can deliver the long-term success of the company".[177] The UK Corporate Governance Code, held by the Financial Reporting Council (FRC), states that the "underlying principles of good governance [are] accountability, transparency, probity and a focus on the sustainable success of an entity over the longer term".[178] Philip Green told us that Carillion's board upheld these standards, describing a culture of "honesty, openness, transparency and challenging management robustly, but in a supportive way".[179]

45. The documents we saw, however, showed a very different picture:

- A June 2017 lessons learned exercise following an accounting review found the need for a "cultural audit" and "review of values", which should make changes "where necessary such that staff fully understand that behaving with transparency, honest[y] and integrity is as important as achieving, improving and delivering".[180]

172 Letter from S&P Global to the Chairs, 23 March 2018
173 Carillion plc, Weekly reporting pack for week ending 26 November Actuals, 8 December 2017 (not published)
174 Q1380 [David Kelly]
175 "Most UK suppliers uninsured against Carillion's collapse", Daily Telegraph, 25 January 2018
176 Institute of Chartered Accountants of England and Wales, What Is Corporate Governance?, accessed 1 May 2018
177 Financial Reporting Council, UK Corporate Governance Code, para 1
178 *As above*, para 4
179 Q418 [Philip Green]
180 Carillion plc, Lessons Learned Board Pack, June 2017, p 66

- EY, appointed on 14 July to support a strategic review of the company, quickly identified a "lack of accountability […] professionalisation and expertise", an "inward looking culture" and a "culture of non-compliance".[181]

- Minutes from a Carillion board discussion of strategy in August 2017 identify "a culture of making the numbers" (hitting targets at all costs) and "wilful blindness" among long-serving staff as to what was occurring in the business. The board concluded that the culture of the organisation required "radical change".[182]

- Carillion's January 2018 turnaround business plan stated that the group had "become too complex with an overly short-term focus, weak operational risk management and too many distractions outside of our 'core'".[183]

46. Carillion's management lacked basic financial information to do their job. A January 2018 review by FTI Consulting for Carillion's lenders found the "presentation and availability of robust historical financial information", such as cash flows and profitability, to be "extremely weak".[184] This accorded with a presentation by Keith Cochrane to the board on 22 August 2017 which identified "continued challenges in quality, accessibility and integrity of data, particularly profitability at contract level".[185] For a major contracting company, these are damning failings.

47. Such problems were not restricted to financial information. When it collapsed in January 2018, the total group structure consisted of 326 companies, 199 based in the UK,[186] of which 27 are now in compulsory liquidation.[187] Sarah Albon, Chief Executive of the Insolvency Service, told us that the company's "incredibly poor standards" made it difficult to identify information that should have been "absolutely, straightforwardly available", such as a list of directors.[188] Responsibility for ensuring the company is run professionally is the responsibility of the board. Stephen Haddrill, Chief Executive of the FRC, said "there must be enormous cause for concern about how the company was governed".[189]

48. **Corporate culture does not emerge overnight. The chronic lack of accountability and professionalism now evident in Carillion's governance were failures years in the making. The board was either negligently ignorant of the rotten culture at Carillion or complicit in it.**

Key board figures

49. Carillion was governed by a seven-member board, comprising the company's Chief Executive, Finance Director and five non-executive directors.[190] Immediately prior to the company's profit warning in July 2017, the members were Richard Howson (Chief

181 Carillion plc, EY presentation to Board, 22 August 2017
182 Carillion plc, Minutes of a meeting of the Board of Directors, 22 August 2017
183 Carillion plc , Group Business Plan, January 2018, p 6
184 Carillion plc, FTI Consulting, Independent Business Review, Januaury 2018
185 Carillion plc, Strategy Proposition Board Presentation, 22 August 2017
186 Q17 [Sarah Albon]
187 PwC, Carillion Group website, accessed 23 April 2018
188 Q110 [Sarah Albon]
189 Q17 [Stephen Haddrill]
190 Carillion plc, 2016 Annual Report and Accounts, pp 50–51

Executive), Zafar Khan (Finance Director), Philip Green (non-executive Chairman), and Keith Cochrane, Andrew Dougal, Alison Horner and Baroness Morgan of Huyton as non-executive directors. By the collapse of the company Mr Howson and Mr Khan were no longer in post, replaced by Keith Cochrane and Emma Mercer respectively.[191] Over the course of the inquiry, we have sought evidence from and about Carillion's board and their central role in the collapse of the company.

Richard Howson

50. Richard Howson joined the Carillion board in December 2009 and was Chief Executive from 1 January 2012 until his sacking as the company issued its profit warning on 10 July 2017. He stayed on in a lesser role before leaving in September 2017, though he continued to receive his full, contractual salary until the company entered liquidation.[192] Mr Howson had been at the company since its formation in 1999, and the 2016 annual report highlighted his "detailed knowledge of key business units".[193] In evidence to us, however, he sought to distance himself from problems in the company that were "from the long term and from a long time ago".[194] He joined the board after the acquisitions of Mowlem and Alfred McAlpine (but before Eaga) and stressed that he had moved from a role responsible for Middle East construction when Carillion signed its contract with Msheireb.[195]

51. Mr Howson demonstrated little grasp of the unsustainability of Carillion's business model or the basic failings of governance that lay at the root of its problems. He opened his evidence by stating that "but for a few very challenging contracts, predominantly in the Oman and one in Qatar, I believe Carillion would have survived".[196] He even seemed surprised to have been removed as Chief Executive following the profit warning, arguing "the business was in a sustainable position" based on support it was receiving from banks.[197] In his world, Carillion was a healthy business that fell victim to a series of unforeseeable events over which it had no control.

52. In fact, Mr Howson had a responsibility to ensure he was well informed about performance and risk, and to act on areas of weakness. Rather than make the fundamental changes needed, however, he spent much of his time chasing down the consequences of the company's mistakes. As Chief Executive, he told us "probably 60% of my time was either on cash calls or, a lot of time, out and about around contracts collecting".[198] He said he "felt like a bailiff" as he visited Qatar ten times a year for six years, "just to try to collect cash" from a single contract.[199] He was retained after his sacking with responsibilities for collecting cash on key contracts and boosting morale in the UK construction business.[200] We do not doubt that Mr Howson could be an effective cheerleader: he clearly had great

191 Companies House, Carillion plc Officers, accessed 1 May 2018
192 Carillion plc, Remuneration Committee Minutes, 7 September 2017
193 Carillion plc, Annual Report and Accounts 2016, pp 50–51; Carillion plc, Annual Report and Accounts 2016, p 50
194 Q609 [Richard Howson]
195 Q425 [Richard Howson]
196 Q413 [Richard Howson]
197 Q475 [Richard Howson]
198 Q534 [Richard Howson]
199 Q426 [Richard Howson]
200 Letter from Richard Howson to the Chairs, 21 February 2018

affection for what he told us was "a great business".[201] However, as the leader of the company, he was either unaware of the significant, long-term problems it was facing, or chose not to act on them.

53. **Richard Howson, Carillion's Chief Executive from 2012 until July 2017, was the figurehead for a business model that was doomed to fail. As the leader of the company, he may have been confident of his abilities and of the success of the company, but under him it careered progressively out of control. His misguided self-assurance obscured an apparent lack of interest in, or understanding of, essential detail, or any recognition that Carillion was a business crying out for challenge and reform. Right to the end, he remained confident that he could have saved the company had the board not finally decided to remove him. Instead, Mr Howson should accept that, as the longstanding leader who took Carillion to the brink, he was part of the problem rather than part of the solution.**

Keith Cochrane

54. Keith Cochrane was appointed to the Carillion board as Senior Independent Non-Executive Director (NED) on 2 July 2016.[202] He came with extensive board-level experience, yet quickly succumbed to the dysfunctionality prevalent on the board.[203] He, and the board, were aware of concerns from shareholders about the company's net debt and its pensions deficit. The board minutes, however, show little sign of these positions being properly challenged and there was no general change of approach until the profit warning.[204] Mr Cochrane said that he sought to challenge executives, "in an appropriate manner",[205] but also believed there was "no basis" in 2016 for "not accepting the view that management put forward".[206] In evidence to us, Mr Cochrane asked himself "should the board have been asking further, more probing questions?" but, even aware of the fate of the company and with hindsight, he could only respond "perhaps."[207]

55. When Richard Howson was sacked as Chief Executive in July 2017, the board on which Mr Cochrane already served asked him to step into the role on an interim basis. He began to recognise some problems the company faced, extending the size of the provision made in the profit warning, and admitting—to the board at least—that the company had cultural problems. Mr Cochrane told us that Carillion was "a business worth fighting for",[208] but in giving investors "limited and vague" answers to "fairly fundamental questions" about the company, he reinforced their concerns and contributed to a continued sell-off of shares.[209] In October 2017, Carillion appointed a permanent successor as Chief Executive from outside the company. His start date was brought forward to 22 January 2018 "to ensure the long-term sustainability of UK industry". By then, the company was already in liquidation.[210]

201 Q413 [Richard Howson]
202 Carillion plc, Annual Report and Accounts 2016, p 54
203 Carillion plc, Annual Report and Accounts 2016, p 50. He held executive roles at The Weir Group, Stagecoach plc and Scottish Power plc, and continued to be lead non-executive director for the Scotland Office and Office of the Advocate General.
204 Qq229 – 237 [Keith Cochrane]; Carillion plc, Minutes of a meeting of the Board of Directors, 26 January 2017
205 Q244 [Keith Cochrane]
206 Q242 [Keith Cochrane]
207 Q242 [Keith Cochrane]
208 Letter from Kiltearn Partners to the Chairs, 2 February 2018
209 *As above.*
210 "Carillion brings start date forward for new CEO", Financial Times, 20 December 2017

56. **Keith Cochrane was an inside appointment as interim Chief Executive, having served as a non-executive on the board that exhibited little challenge or insight. He was unable to convince investors of his ability to lead and rebuild the company. Action to appoint new leadership from outside Carillion came far too late to have any chance of saving the company.**

Non-executive directors

57. Carillion's five NEDs had the same legal duties, responsibilities and potential liabilities under the Companies Act 2006 as their executive counterparts.[211] The distinction is that NEDs are responsible for constructively challenging the executives responsible for the day-to-day running of a company, and develop proposals for strategy. The Corporate Governance Code states:

> Non-executive directors should scrutinise the performance of management in meeting agreed goals and objectives and monitor the reporting of performance. They should satisfy themselves on the integrity of financial information and that financial controls and systems of risk management are robust and defensible.[212]

58. The Carillion NEDs who gave evidence to us told us they performed well in this role. Alison Horner, a NED from December 2013 until the company's collapse, said "we were there to provide oversight and challenge, and we were able to do that effectively".[213] Philip Green, a NED since June 2011 and non-executive Chairman since May 2014, agreed, saying "we challenged; we probed; we asked".[214] When we asked him for a concrete example of this challenge, he cited the company's level of debt in 2016 and 2017, stating "the board consistently challenged management on debt, and management then developed a so-called self-help plan to reduce debt".[215] Yet debt rose from £689 million to £961 million over that period.[216] Mr Green also pointed to board scrutiny of how executives were managing large, failing contracts:

> Some people challenged by sending questions in advance by email; some people challenged in the meeting. I would say that it was a board that constructively challenged management.[217]

However, Mr Green later cited those same contracts as a "very significant factor" in the company's collapse.[218] Murdo Murchison, of former Carillion shareholder Kiltearn Partners, doubted whether the non-executive directors had been able "to exercise any effective check on the executive management team. It appears that they were hoodwinked as much as anybody else".[219]

211 The five NEDs in place at the end of 2016 were: Philip Green, Andrew Dougal, Alison Horner, Ceri Powell and Keith Cochrane. As Chairman, Philip Green was paid £215,000 per year. All the others were paid £61,000. Carillion plc, Annual Report and Accounts 2016, p 66
212 Financial Reporting Council, UK Corporate Governance Code, para A.4
213 Q417 [Alison Horner]
214 Q423 [Philip Green]
215 Q420 [Philip Green]
216 *The collapse of Carillion*, Briefing Paper 8206, House of Commons Library, March 2018
217 Q423 [Philip Green]
218 Q537 [Philip Green]
219 Q1036 [Murdo Murchison]

59. **Non-executives are there to scrutinise executive management. They have a particularly vital role in challenging risk management and strategy and should act as a bulwark against reckless executives. Carillion's NEDs were, however, unable to provide any remotely convincing evidence of their effective impact.**

Philip Green

60. Philip Green joined the Carillion board as Senior Independent NED in June 2011 and became Chairman in May 2014. He was an experienced member of corporate boards.[220] He also had experience of failing companies: he was Managing Director of Coloroll before it went into receivership in June 1990, following which, in 1994, the Pensions Ombudsman made a finding of breach of trust and maladministration against him.[221] In 2011 he was appointed as a corporate responsibility adviser to the then Prime Minister, a role he left in 2016.[222]

61. The UK Corporate Governance Code says that a company's Chairman is "responsible for leadership of the board and ensuring its effectiveness on all aspects of its role".[223] In this position, Philip Green oversaw low levels of investment, declining cash flow, rising debt and a growing pension deficit. Yet his board agreed year-on-year dividend increases and a rise in remuneration for his executive board colleagues from £1.8 million to £3.0 million.[224] Mr Green was still at the helm when the company crashed in January 2018.

62. Mr Green appears to have interpreted his role as Chairman as that of cheerleader-in-chief. His statement in the 2016 Annual Report and Accounts, signed on 1 March 2017, just four months before the profit warning, concluded:

> Given the size and quality of our order book and pipeline of contract opportunities, our customer-focused culture and integrated business model, we have a good platform from which to develop the business in 2017.[225]

Even more remarkably, on Wednesday 5 July 2017, a few days before the Monday 10 July profit warning, Carillion board minutes recorded:

> In conclusion, the Chairman noted that work continued toward a positive and upbeat announcement for Monday, focusing on the strength of the business as a compelling and attractive proposition […][226]

The Monday announcement comprised a £845 million write-down. It is difficult to believe the Chairman of the company was not aware of the seriousness of its position, but equally difficult to comprehend his assessment if he was.

220 At the time of his appointment as Carillion's Chairman he was also Chairman of BakerCorp and Chairman Designate of Williams and Glyn Bank Limited and had previously been Chairman of Clarkson plc.

221 'Carillion boss Philip Green has previously been found guilty of a breach of trust over pensions', City A.M., 16 January 2018

222 City A.M., Carillion chairman Philip Green was a number 10 adviser , City A.M., 15 January 2018

223 Financial Reporting Council, UK Corporate Governance Code, para A.3

224 2014–2016. Executive directors were Richard Howson and Richard Adam. Total remuneration includes salary/fees, benefits, bonus, long-term incentives and pension.

225 Carillion plc, Annual Report and Accounts 2016, p 7

226 Carillion plc, Minutes of a meeting of the Board of Directors, 5 July 2017

63. In his evidence to us, Philip Green accepted, as Chairman, "full and complete" responsibility for the collapse of the company.[227] He clarified, however, that he did "not necessarily" accept culpability,[228] and that it was not for him to say who was culpable.[229] His company, however, assigned culpability in sacking Richard Howson, Zafar Khan, and "several other members of senior management".[230] Subsequent market announcements and the group's January 2018 business plan referred optimistically to the "new leadership team", a "refreshed" executive team and a "bolstered" board. Indeed, in a letter to the Cabinet Office on 13 January 2018, Mr Green reassured the Government that "the previous senior management team have all exited the business".[231] He, however, was to remain at the head of the proposed new board.[232]

64. **Philip Green was Carillion's Chairman from 2014 until its liquidation. He interpreted his role as to be an unquestioning optimist, an outlook he maintained in a delusional, upbeat assessment of the company's prospects only days before it began its public decline. While the company's senior executives were fired, Mr Green continued to insist that he was the man to lead a turnaround of the company as head of a "new leadership team". Mr Green told us he accepted responsibility for the consequences of Carillion's collapse, but that it was not for him to assign culpability. As leader of the board he was both responsible and culpable.**

Remuneration committee

65. Carillion's board and its remuneration committee (RemCo) attempted to present its remuneration policy as unremarkable. RemCo Chair, Alison Horner, told us that its policy was for executive pay to be "mid-table", the industry median.[233] Benchmarking analysis commissioned from Deloitte by the RemCo in 2015 showed Carillion paid relatively low total Chief Executive remuneration.[234] As a result of this benchmarking, Richard Howson's basic salary was increased by 8% in 2015 and 9% in 2016.[235] His total remuneration jumped from what he recalled to us as "something like £1.1 million or £1.2 million" to £1.5 million in 2016.[236] Philip Green was awarded a 10% increase in his fees as Chairman in 2016, from £193,000 to £215,000, again based on benchmarking.[237] Carillion's wider comparable workforce received just a 2% pay rise in 2016.[238]

66. Remuneration based on industry medians generates a ratchet effect: by raising their pay to the median, companies increase the median itself. This method of reward can also detach pay from the performance of both the individual and the company. The generous increases paid to Mr Howson, Mr Green and other senior staff in 2015 and

227 Q470 [Philip Green]
228 *As above.*
229 Letter from Philip Green to the Chairs, 20 February 2018
230 High Court of Justice, In the matter of Carillion plc and in the matter of the Insolvency Act 1986, Exhibit KC1: First Witness Statement of Keith Robertson Cochrane, dated: 15 January 2018 (Not published)
231 Letter from Philip Green to John Manzoni, 13 January 2018
232 Alison Horner, NED and Chair of the Remuneration Committee, was the only other proposed board member whose appointment pre-dated the July 2017 profit warning.
233 Q618 [Alison Horner]
234 Carillion plc, Review of Current Incentive Plans, 7 October 2015
235 Q618 [Alison Horner]
236 Qq 613–4 [Richard Howson] Qq 613–4 [Alison Howson]
237 Qq 637–8 [Alison Horner]
238 Carillion plc, Annual Report and Accounts 2016, p 73

2016 came despite declines in the company's share price.[239] Remuneration for Carillion's senior leaders included the potential for an annual bonus of up to 100% of basic pay, split evenly between financial and other objectives.[240] In 2016, Mr Howson received a bonus of £245,000 (37% of his salary) despite meeting none of his financial performance targets.[241] Murdo Murchison of Kiltearn Partners described this as a "complete disconnect" between financial performance and pay. He said the policy gave the board "a great deal of freedom to pay what they want to pay" to directors who failed to meet "fairly easy" financial targets.[242]

67. The RemCo told Carillion's shareholders in December 2016 that it intended to increase the maximum bonus available to 150% of salary, to "attract and retain Executive Directors of the calibre required".[243] Investors such as BlackRock protested in private about these changes,[244] and the RemCo was forced to abandon its plans in March 2017.[245] Nonetheless, at Carillion's 2017 Annual General Meeting, around 20% of investors voted against the motion to approve the board's remuneration report. Kiltearn noted the continued growth of Richard Howson's pay as a cause.[246] In the RemCo and board papers we have seen, there is no evidence that the sizeable opposition to the remuneration policy prompted any reassessment of their general approach.

68. This was evidenced by the RemCo's remarkable decisions at the time crisis publicly struck the company. Amra Balic, Managing Director at BlackRock, told us that, at the time of the 10 July 2017 profit warning, Carillion's board was "thinking again how to remunerate executives rather than what was going on with the business".[247] RemCo papers from 9 July 2017, the day before the first profit warning, show it agreed to offer retention payments to five senior employees to remain with the company until 30 June 2018, and salary increases of between 25 and 30% "in the light of the very considerable burden likely to fall on certain roles".[248] It also took the decision to pay the new interim Chief Executive (and former member of the RemCo) Keith Cochrane a fee of £750,000 for the role, notably higher than his predecessor's basic pay.[249]

69. An effective board remuneration policy should have the long-term success of the company as its only goal. Carillion's RemCo was responsible for a policy of short-term largesse. **In the years leading up to the company's collapse, Carillion's remuneration committee paid substantially higher salaries and bonuses to senior staff while financial performance declined. It was the opposite of payment by results. Only months before the company was forced to admit it was in crisis, the RemCo was attempting to give executives the chance for bigger bonuses, abandoned only after pressure from institutional investors. As the company collapsed, the RemCo's priority was salary boosts and extra payments to senior leaders in the hope they wouldn't flee the company,**

239 Q620 [Alison Horner]
240 Carillion plc, Annual Report and Accounts 2016, p 73
241 *As above.*
242 Qq1092–3 [Murdo Murchison]
243 Letter from Carillion to BlackRock, 12 December 2016
244 Qq1074–5 [Amra Balic]; Letter from BlackRock to the Chairs, 8 February 2018
245 Letter from Carillion to BlackRock, 7 March 2017
246 Letter from Kiltearn Partners to the Chairs, 2 February 2018
247 Q1076 [Amra Balic]
248 Carillion plc, Remuneration Committee minutes, 9 July 2017. Names and job titles of Carillion employees below board level have been redacted.
249 Carillion plc, Remuneration Committee minutes, 23 October 2017

continuing to ensure those at the top of Carillion would suffer less from its collapse than the workers and other stakeholders to whom they had responsibility. The BEIS Committee is considering some of these issues as part of its current inquiry into fair pay.[250]

Clawback

70. In 2014, the Financial Reporting Council's UK Corporate Governance Code introduced a requirement for performance-related remuneration policies for executive directors to include "clawback" provisions. These enable bonuses to be recovered,[251] in circumstances set individually by companies.[252] In February 2015, in response to this change, the Carillion RemCo agreed a policy that enabled clawback if the company's accounts needed to be restated, or if the director was guilty of gross misconduct.[253] It set the RemCo as the arbiter of whether, and the extent to which, clawback applied.

71. Following the collapse of Carillion, the company was criticised for having overly restrictive clawback terms.[254] Alison Horner, Chair of the RemCo, denied this accusation and said the terms made it easier to claw back bonuses.[255] Ms Horner also told us that misstatement and misconduct were used as clawback terms are used by "80% of the FTSE".[256] However, a sample of clawback terms from 2015 shows that many companies, including those on which Carillion directors were also board members, also included "serious reputational damage" as a criteria for clawback.[257] It is unclear why Carillion did not include reputational damage in its terms, and unlikely Ms Horner was unaware of its use elsewhere, including for executives at Tesco plc, where she is Chief People Officer.[258] Furthermore, the RemCo considered new clawback terms recommended by Deloitte, "to reflect current best practice", in September 2017 as part of its search for a new Chief Executive.[259] Minutes of that meeting show the RemCo agreed new triggers for clawback, including reputational damage, failures of risk management, errors in performance assessments and information, and any other circumstances in which the RemCo believed to be similar.[260]

72. These new terms were too late to affect the bonuses given to directors in previous years, who remained on the weak original terms. In the same meeting as the new terms were agreed, the RemCo considered asking directors to return their 2016 bonuses, but concluded "that could not be enforced and would be very difficult to achieve at this stage".[261] We regret that the RemCo had neither set terms that could have made clawback possible, nor shown a willingness to challenge directors on their pay-outs. We agree with

250 Business, Energy and Industrial Strategy Committee, Corporate Governance: delivering on fair pay inquiry.
251 Financial Reporting Council, UK Corporate Governance Code, para D1.1. The terms also specify 'malus' provisions, which prevent non-cash aspects earned but not yet paid out from vesting.
252 "Bank of England tightens bonus rules", Financial Times, 13 January 2016
253 Carillion plc, Annual Report and Accounts 2016, p 78; Carillion plc, Remuneration Committee: Clawback, 26 February 2018; Q640 [Alison Horner]. The first provision did not apply if the restatement is due to a change in accounting standards, policies or practices adopted by the Company
254 "Carillion questions over exec bonuses", Financial Times, 16 January 2018
255 Qq640–1 [Alison Horner]
256 Q640 [Alison Horner]
257 Wood Group, Annual Report and Accounts 2015, p 50; United Utilities, Annual Report and Accounts 2015, p 89; Shell, Annual Report and Accounts 2015, p 90
258 Tesco plc, Annual Report and Accounts 2016, p 64
259 Deloitte, Paper for the Remuneration Committee, 7 September 2017, p 1
260 Carillion plc, Remuneration Committee Minutes, 7 September 2017
261 *As above.*

the suggestion by Amra Balic of BlackRock to us that standard legal language around clawbacks applicable to every company would make enforcement more likely.[262] Of course, the Carillion directors could have returned their bonuses voluntarily.

73. **Nowhere was the remuneration committee's lack of challenge more apparent than in its weak approach to how bonuses could be clawed back in the event of corporate failures. Not only were the company paying bonuses for poor performance, they made sure they couldn't be taken back, feathering the nests of their colleagues on the board. The clawback terms agreed in 2015 were so narrow they ruled out a penny being returned, even when the massive failures that led to the £845 million write-down were revealed. In September 2017, the remuneration committee briefly considered asking directors to return their bonuses, but in the system they built such a move was unenforceable. If they were unable to make a legal case, it is deeply regrettable that they did not seek to make the moral case for their return. There is merit in Government and regulators considering a minimum standard for bonus clawback for all public companies, to promote long-term accountability.**

Alison Horner

74. Alison Horner presided over those remuneration and clawback policies. She joined the Carillion board as a NED in December 2013, and was appointed Chair of the RemCo in May 2014.[263] She is also Chief People Officer at Tesco plc, where she has responsibilities for over 500,000 members of staff.[264] When we challenged Ms Horner about the RemCo's decisions under her leadership, she stressed that shareholders were consulted on remuneration. She did not, however, mention to us any of the concerns that shareholders told us they had expressed.[265] When we asked Ms Horner about large pay increases, she pointed to a decision to offer median pay, but did not offer any justification for further detaching pay from performance.[266] When we sought Ms Horner's explanation for the company's weak clawback terms, she dismissed the concerns of the Institute of Directors and the FRC.[267] She also showed no indication that she believed she had made any mistakes. Other than being "sorry for what has happened," she accepted no culpability as a long-serving member of the board.[268]

75. **A non-executive director and chair of Carillion's remuneration committee for four years, Alison Horner presided over growing salaries and bonuses at the top of the company as its performance faltered. In her evidence to us, she sought to justify her approach by pointing to industry standards, the guidance of advisors, and conversations with shareholders. She failed to demonstrate to us any sense of challenge to the advice she was given, any concern about the views of stakeholders, or any regret at the largesse at the top of Carillion. Ms Horner continues to hold the role of Chief People Officer of Tesco, where she has responsibilities to more than half a million employees. We hope that, in that post, she will reflect on the lessons learned from Carillion and her role in its collapse.**

262 Q1102 [Amra Balic]
263 Carillion plc, Annual Report and Accounts 2014, p 37
264 Tesco plc, Executive committee, accessed 1 May 2018
265 Q618 [Alison Horner]; Q622 [Alison Horner]; Q625 [Alison Horner]
266 Q618 [Alison Horner]
267 Q641 [Alison Horner]
268 Q413 [Alison Horner]

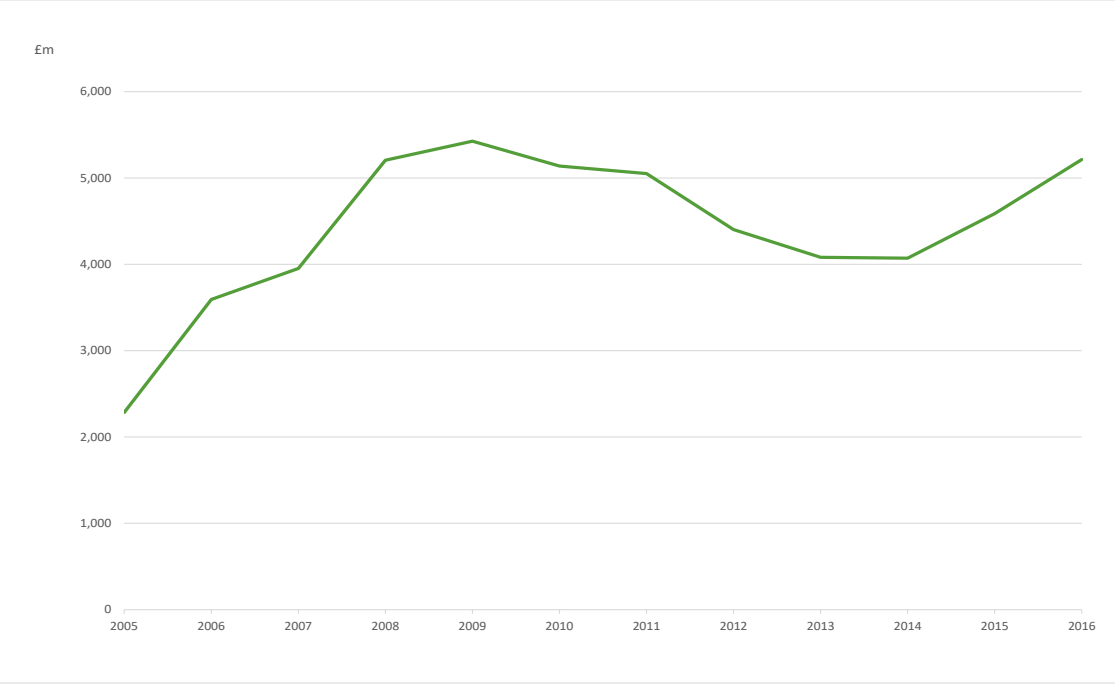
Financial reports

76. Accurate and timely financial reports and accounts of companies are essential to the functioning of the economy. They are relied upon by lenders, investors and all other stakeholders in a business. One of the fundamental concepts of accounting is that accounts are prepared on a true and fair basis. The Companies Act 2006 states that company directors must not approve accounts unless they are satisfied they give a true and fair view of the assets, liabilities, financial position and profit or loss of the company.[269] In turn, the auditor gives an opinion as to whether the accounts are true and fair and free from material misstatement.

Financial performance up to July 2017

77. Until July 2017, there was little public information to suggest that Carillion's accounts, which were signed off with an unmodified opinion each year by KPMG as auditor, presented anything other than a true and fair picture of the company's finances. They showed a profitable company. After a sustained fall following the financial crisis in 2008, revenue had grown strongly. Earnings per share had also increased steadily since 2014. Carillion's profit margins, while unspectacular at around 5–6%, were still "attractive relative to peers".[270]

Figure 3: Carillion's total revenue



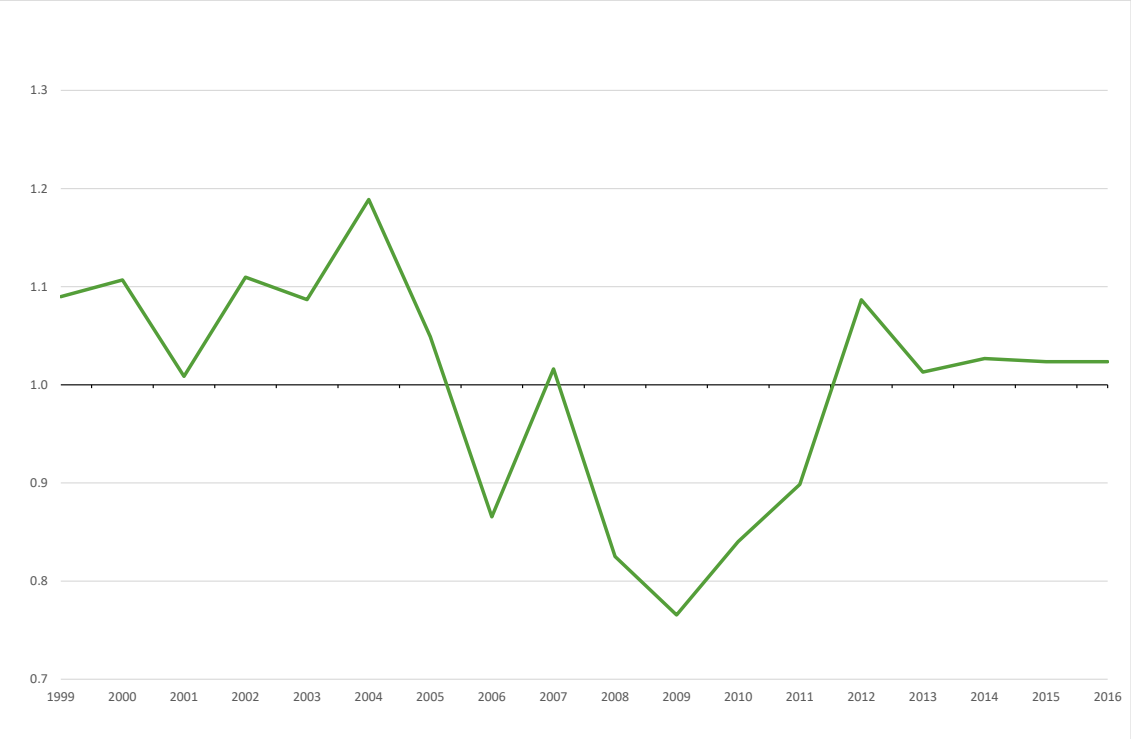
Source: Carillion plc Annual Report and Accounts 2005–2016

78. There were, however, indicators of underlying problems. Most notably, borrowing had increased rapidly, from £242 million in December 2009 to £689 million in December 2016.[271] This contributed to a big spike in the company's debt to equity ratio, which reached

269 Companies Act 2006, section 393
270 Q1026 [Murdo Murchinson]
271 *The collapse of Carillion*, Briefing Paper 8206, House of Commons Library, March 2018

5.3 by December 2016, considerably above the ratio of 2 widely considered acceptable.[272] The company also had a low level of working capital: its ratio of current assets to current liabilities remained static at around 1.0 between 2013 and 2016. Anything lower than 1.2 is potentially indicative of a company in financial difficulty.[273]

Figure 4: Carllion's working capital ratio



Source: Analysis of Carillion plc's Annual Report and Accounts 1999–2016

July 2017 trading update

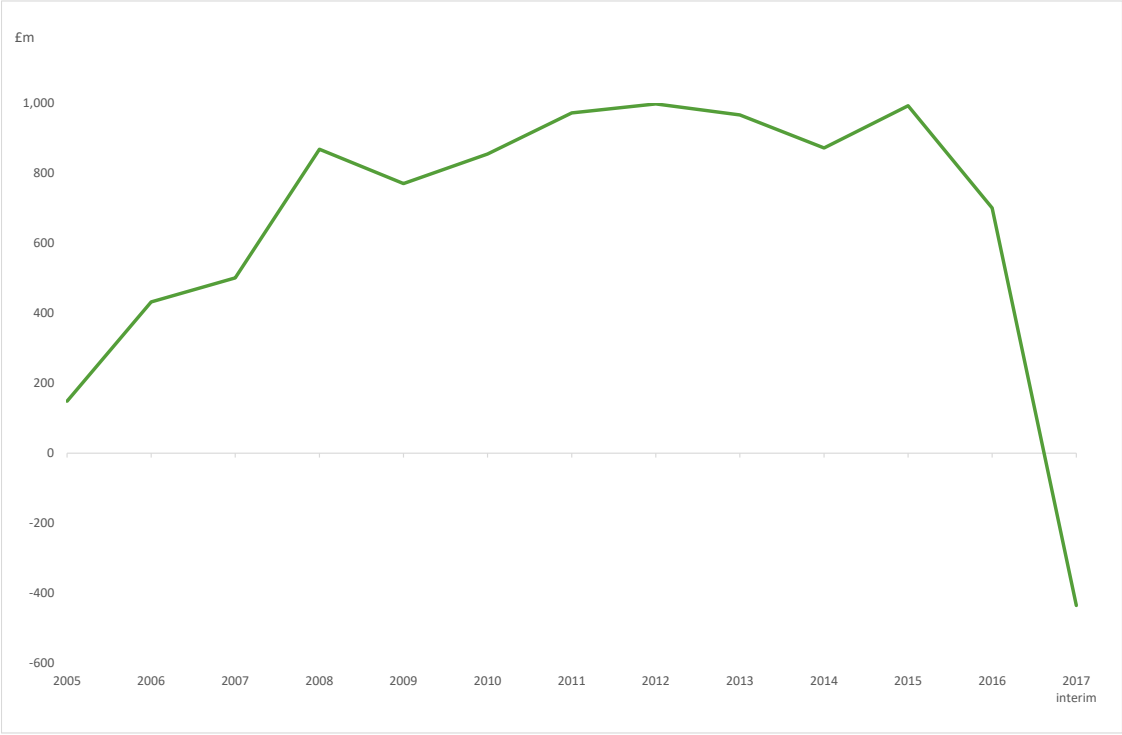
79. On 10 July 2017, Carillion issued a sudden profit warning. It announced that it would reduce the value of several major contracts by a total of £845 million in its interim financial results, due in September.[274] When those results were published, the write-down went further: £200 million extra was added, completely wiping out the company's last seven years of profits and leaving it with net liabilities of £405 million. Borrowing had risen dramatically again, to £961 million. The goodwill recognised on the balance sheet was reduced by £134 million and the company's working capital ratio fell to 0.74.[275] The announcement was an extraordinary reassessment of Carillion's financial health.

272 Investopedia, What is considered a good net debt-to-equity ratio?, accessed 27 April 2018
273 Investopedia, What does a low working capital ratio show about a company's working capital management, accessed 27 April 2018
274 Carillion plc, H1 trading update, 10 July 2017
275 Carillion plc, Financial results for the six months ended 30 June 2017, 29 September 2017

Figure 5: Carillion's last 7 years' profits wiped out by 2017 provision

Source: Analysis of Carillion plc's annual report and accounts 2010–2017

Figure 6: Carillion's total equity



Source: Carillion plc's Annual Report and Accounts 2005-2017

80. The stock market did not wait for the full interim results to pass judgement; the share price fell by 70% from 192p on Friday 7 July to 57p by Wednesday 12 July. The share price never recovered, falling to 14p by the time the company eventually filed for liquidation on 15 January 2018.[276]

Aggressive accounting

81. As the dust settled, many analysts and investors began to question whether it had all been too good to be true in the first place. The August 2017 Carillion audit committee papers show that, as investors shied away from offering further equity to the company, a common question was emerging:

> Many have questioned the timing of the provision. Surely management had known these contracts had been problematic for a while?[277]

Kiltearn Partners, which owned over 10% of Carillion's shares at the time the provision was announced, was very critical of the timing of the profit warning. They argued that changes of that magnitude do not generally materialise "overnight" and that there are "clear grounds for an investigation into whether Carillion's management knew, or should have known, about the need for a £845 million provision".[278] Euan Stirling, of Aberdeen Standard Investments,[279] concurred, saying "these things do not happen over a short period of time".[280]

82. The provision conceded that £729 million in revenue that Carillion had previously recognised would not be obtainable.[281] This led to accusations that Carillion was engaged in "aggressive accounting", stretching what is reasonably allowed by accounting standards to recognise as much revenue upfront as possible. Sir Amyas Morse, Comptroller and Auditor General (C&AG), told the Liaison Committee that "when all the drains have been pulled up on Carillion we will see some pretty aggressive accounting practices".[282]

Revenue accounting

83. What would aggressive accounting look like for a company like Carillion? Much of Carillion's revenue came from construction contracts that are inherently difficult to account for. Accruals accounting dictates revenue should be recognised when it is earned, not when it is received. For construction projects spanning several years, this means companies must assess how far to completion their projects are. This is usually done by reference to the costs incurred to date as a percentage of the total forecast costs of the project.[283] Applying that percentage to the initially agreed contract price produces the

276 London Stock Exchange, Carillion share price, accessed 1 May 2018
277 This was a question from a joint presentation by Morgan and Stanley and HSBC to the Carillion audit committee, 22 August 2017,
278 Letter from Kiltearn Partners to the Chairs, 2 February 2018
279 Aberdeen Standard Investments is the investment arm of Standard Life Aberdeen plc, which was formed as a merger of Standard Life plc and Aberdeen Asset Management plc in August 2017. It was Standard Life who held shares in Carillion in 2015 and 2016.
280 Q1029 [Euan Stirling]
281 Carillion's group business plan shows that of the £1,045 million provision, £729 million went against trade receivables, with the rest being added to future costs. Carillion's Group Business Plan, January 2018, p 41
282 Oral evidence taken before the Liaison Committee on 7 February 2018, HC 770 (2017–19), Q5 [Sir Amyas Morse]
283 Carillion's notes to their financial statements confirm that this is the method that they were using, Carillion plc Annual Report and Accounts, p 96

revenue recognised.[284] This puts a great emphasis on total estimated costs of a project. As KPMG's audit report on Carillion's 2016 annual report notes, "changes to these estimates could give rise to material variances in the amount of revenue and margin recognised".[285] A company wanting to indulge in aggressive accounting would make every effort to minimise the estimates of total final costs to ensure that margins on contracts are maintained and greater amounts of revenue are recognised up front.

84. Deloitte, Carillion's internal auditors, explained that the company had two processes to review margins reported by site teams:[286]

i) monthly Project Review Meetings (PRMs) at which a management contract appraisal could adjust the site team's position; and

ii) peer reviews to "provide challenge to the financial, operational and commercial performance of contracts".

85. In July and August 2017, Deloitte examined peer reviews conducted between January 2015 and July 2017 of the contracts which made up the £845 million provision. They found that management contract appraisals tended to report higher profit margins than peer reviews.[287] In 14% of cases, the peer review recommended a higher margin. In 42% of cases, three times as many, management used higher margins than recommended by the peer reviews.[288]

86. Deloitte noted that the differences between the two assessments were far from trivial: in more than half the cases where the peer review recommended a lower margin, the difference exceeded £5 million.[289] A November 2016 peer review of the Royal Liverpool University Hospital contract suggested a loss of 12.7%, compared with the contract appraisal margin of 4.9% profit.[290] The result was that the annual accounts published in March 2017 recognised approximately £53 million in revenue in excess of what would have appeared had the peer review estimate been used.[291] The July 2017 profit warning included a provision of £53 million against that contract.[292]

284 Further complexity is added to this equation by the potential inclusion of insurance claims, incentive payments and variations arising on the initial contract. Carillion plc's Annual Report and Accounts 2016, p 96, stated that these are only recognised as revenue "where it is probable that they will be recovered and are capable of being reliably measured".

285 KPMG, independent auditor's report, included in Carillion plc's Annual Report and Accounts 2016, p 86

286 Letter from Deloitte to the Chairs, 13 March 2018

287 *As above.*

288 Letter from Deloitte to the Chairs, 27 March 2018

289 Letter from Deloitte to the Chairs, 13 March 2018

290 *As above.*

291 Deloitte quoted a difference of £53.9 million between those figures. Those figures were based on November reviews. The audit committee papers show that the year-end position recorded in the financial statements was based on a profit margin of 4.44%, which would equate to £52.5 million.

292 This figure was part of the initial provision figure of £695m that was presented to the Board on 7th July (August 2017 Audit Committee papers - not published). This was subsequently increased to £845m by July 9th, with a corresponding increase in the provision against Royal Liverpool of £15m (September 2017 Audit Committee papers - not published). Keith Cochrane explained that he personally took the decision to increase the provision over that weekend, Q240 [Keith Cochrane]

Box 3: Case study: the Royal Liverpool Hospital contract

A private finance initiative contract for the design and construction of the Royal Liverpool Hospital was agreed by The Hospital Company (Liverpool) Ltd and The Royal Broadgreen University Hospitals NHS Trust on 13 December 2013. On the same date, The Hospital Company (Liverpool) Ltd awarded Carillion Construction Ltd (CCL) a five year, £235 million contract for design and construction.[293]

CCL began construction work in February 2014, with phase 1 due to be completed by 31 March 2017. As early as May 2015, however, delays were reported due to asbestos, pushing back expected completion to 30 June 2017.[294] Carillion's Major Project Status Report in October 2015 acknowledged this delay but estimated a final profit margin of 5.5%, 2% more than their initial bid estimate.[295]

In November 2016, two cracks were discovered in concrete beams at the hospital. Following a review commissioned by CCL, less significant cracks were discovered in six further beams. Richard Howson told us that Carillion deserved credit for their actions, because "we did not just cover it up. We properly rectified, even though it cost, and those beams would probably never fail in their cracked state".[296] However, Charles McLeod, Director of the Hospital Company, told us that five of the eight defective beams could have failed under the load of a fully operational hospital. He said failure to remedy the defects "could have resulted in at best, unsafe working conditions and at worst, injury and loss of life".[297]

Richard Howson said that the costs associated with rectifying the cracked beams occurred in the second quarter of 2017 and added "over £20 million of cost to our completion".[298]That may tally with Carillion's public unravelling but it does not accord with Carillion's own review process. A November 2016 peer review of the contract concluded that additional costs meant it was making a loss of 12.7%. Senior management disagreed, despite having evidence of the cracked beams alongside continued issues with asbestos, and recorded an expected profit margin of 4.9%. That led to approximately £53 million in additional revenue being recognised in the 2016 accounts, the same amount that the company eventually made a provision for on that contract in July 2017.

Carillion's insolvency has significantly delayed completion of the hospital. The Hospital Company has entered negotiations with alternative contractors and is working to agree a revised timetable for completion.[299]

87. Andrew Dougal, Chair of Carillion's audit committee, said he was unaware of these variances and first heard of them when Michael Jones, the Deloitte Partner responsible

293 The Hospital Company (Liverpool) Ltd Annual report and financial statements, December 2014
294 *As above.*
295 Carillion Major Projects Status Report, October 2015 (not published)
296 Q447 [Richard Howson]
297 Letter from Charles McLeod, CBE, on behalf of the Hospital Company (Liverpool) Ltd, to the Chairs, 21 February 2018, p 3
298 Q445 [Richard Howson]
299 Letter from Charles McLeod, CBE, on behalf of the Hospital Company (Liverpool) Ltd, to the Chairs, 21 February 2018, p 3

for Carillion's internal audit, raised them with him in September 2017.[300] Michael Jones confirmed this and said Andrew Dougal was "concerned that these differences did not appear to have been followed up by management".[301] Andrew Dougal conceded that "in hindsight, it would have been helpful for the audit committee to have this information so it could have factored it into its challenge of management's judgements".[302]

88. Carillion also recognised considerable amounts of construction revenue that was "traded not certified". This was revenue that clients had not yet signed off, such as for claims and variations, and therefore it was inherently uncertain whether payment would be received. In December 2016, the company was recognising £294 million of traded not certified revenue, an increase of over £60 million since June 2014, and accounting for over 10% of total revenue from construction contracts.[303] The amount of revenue that was traded not certified was never publicly disclosed in financial statements, but was included in papers reviewed quarterly by the audit committee.

89. Zafar Khan, who signed off the 2016 accounts, said he did "not agree that there was a concerted effort to adopt aggressive accounting as such" and that the numbers reported "were appropriate, based on the information that was available at that point in time".[304] As part of a contract review that led to the July 2017 provision, management were asked by KMPG to consider whether the results indicated that the 2016 accounts had been misstated due to either fraud or error. The position the board chose to adopt publicly was that there was no misstatement and that the provisions all related to the sudden deterioration of positions on key contracts between March and June 2017.[305]

90. Carillion's problems were not, however, restricted to just a few contracts: September 2017 audit committee papers showed that at least 18 contracts suffered losses over the March-June period.[306] Internal board minutes show the board were aware of concerns about aggressive accounting methods. A June 2017 lessons learned board meeting minute noted that "management need to be aware that high-level instructions such as that to 'hold the position' (i.e. maintain the traded margin) may, if crudely implemented, have unintended consequences".[307] Those minutes show that Andrew Dougal identified a "hold back of bad news", with regard to one major contract.[308] He subsequently told us the contract in question was the Royal Liverpool Hospital.[309] A board minute from August 2017 notes concerns from Keith Cochrane that long-serving staff in the business had a tendency to turn a blind eye to such practices. While there were corporate incentives to present a hugely optimistic picture, there were also individual incentives for staff rewarded on the basis of published results. March 2015 board minutes show the board was concerned that potential clawback of their bonuses should not include "retrospective judgements on views taken on contracts in good faith".[310]

300 Letter from Andrew Dougal to the Chairs, 5 April 2018
301 Letter from Deloitte to the Chairs, 13 March 2018
302 Letter from Andrew Dougal to the Chairs, 5 April 2018
303 February 2017 audit committee papers (not published)
304 Q273 [Zafar Khan]
305 KPMG, Enhanced contracts review and half year update, 9 July 2017 (not published)
306 Carillion Audit Committee papers, September 2017 (not published)
307 Carillion plc, Lessons Learned Board Pack, June 2017, p 66
308 Carillion plc, Lessons Learned 7 June Minutes (not published)
309 Letter from Andrew Dougal to the Chairs, 5 April 2018
310 Carillion plc, Minutes of a meeting of the Board of Directors, 3 March 2015

Accounting for the early payment facility

91. It is not only Carillion's revenue accounting that has been called into question since the company collapsed. Two major credit ratings agencies, Moody's and Standard & Poor's, claimed that Carillion's accounting for their early payment facility (EPF) concealed its true level of borrowing from financial creditors.[311] They argue the EPF structure meant Carillion had a financial liability to the banks that should have been presented in the annual account as "borrowing". Instead Carillion choose to present these as liabilities to "other creditors". Moody's claim that as much as £498 million was misclassified as a result, though Carillion's audit committee papers show the actual figure drawn was slightly lower at £472 million.[312]

92. The Financial Reporting Council (FRC) would not confirm whether they agreed with this assessment.[313] They set out the relevant accounting standards and noted that the precise terms of any supply chain financing arrangement will dictate how it is accounted for. They did write, however, that they "encourage disclosure of complex supply chain arrangements".[314] Carillion's financial statements did not highlight the EPF.[315] Some analysts, however, spotted it.[316] Carillion's board minutes in April 2015 refer to "disappointing" UBS analysis that had factored both the pension deficit and the EPF in Carillion's total debt position. The May 2015 minutes state that the shorting (betting against) Carillion shares was up significantly and that the "bulk had followed the UBS note in March".[317]

93. Carillion's classification of the EPF was advantageous to its presentation of its finances in two main ways. First, presenting drawing on the EPF as "other creditors" excluded it from total debt. It was consequently not incorporated in a debt to earnings ratio which was a key covenant test between Carillion and its lenders.[318] Carillion announced in its third profit warning on 17 November 2017 that it was likely to breach that covenant.[319] Had £472 million been classified as debt, it would most likely have breached this covenant test far earlier.

94. Second, Carillion's EPF treatment helped hide its failure to generate enough cash to support the revenues it was recognising. Carillion had a target of 100% cash conversion: for cash inflows from operating activities to at least equal underlying profit from operations. It consistently reported that it was meeting this target.[320] It could do this because the EPF classification allowed it, in cashflow statements, to present bank borrowing as cash

311 Moody's, Carillion's collapse exposes flaws in the accounting for supply-chain finance, 13 March 2018; S&P Global Ratings, Carillion's Demise: What's at stake?, 23 March 2018
312 Moody's, Carillion's collapse exposes flaws in the accounting for supply-chain finance, 13 March 2018; Carillion, Group short term cash flow forecast, 22 December 2017 (not published)
313 Letter from the FRC to the Chairs, 21 March 2018
314 *As above.*
315 There is one reference to the early payment facility in the 2016 Annual Report and Accounts within the strategic report section, but nothing in the financial statements. Carillion plc, Annual Report and Accounts 2016, p 13
316 Carillion plc, Minutes of a meeting of the Board of Directors, 2 April 2015
317 Carillion plc, Minutes of a meeting of the Board of Directors, 6 May 2015
318 The ratio was net debt to EBITDA (earnings before interest, taxes, depreciation and amortisation).
319 BBC News, HS2 contractor Carillion's shares hit by profit alert, 17 November 2017
320 Carillion plc, Annual Report and Accounts 2016, p 18

inflow from operations, rather than from financing activities.[321] Moody's found that between 2013 and 2016, Carillion reported cash inflows from operations of £509 million, a conversion rate of over 100% on group operating profit of £501 million.[322] But reclassifying EPF inflows of £472 million as financing activities would mean out of an operating profit of £501 million, only £37 million was cash-backed, a conversion rate of 7%. This exposes Carillion's accounting revenue practices: revenue will at times correctly be recognised before the cash comes in, but as the C&AG said, "if your cash never really comes in, that may be a sign that you need to look about how you have been accounting for these businesses".[323]

95. **The Carillion board have maintained that the £845 million provision made in 2017 was the unfortunate result of sudden deteriorations in key contracts between March and June that year. Such an argument might hold some sway if it was restricted to one or two main contracts. But their audit committee papers show that at least 18 different contracts had provisions made against them. Problems of this size and scale do not form overnight. A November 2016 internal peer review of Carillion's Royal Liverpool Hospital contract reported it was making a loss. Carillion's management overrode that assessment and insisted on a healthy profit margin being assumed in the 2016 accounts. The difference between those two assessments was around £53 million, the same loss included for the hospital contract in the July 2017 profit warning.**

96. **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 not even been agreed, enabled 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.**

Carillion's finance directors

97. Responsibility for the preparation of the accounts lies collectively with the board, which may delegate that task to the Finance Director. Richard Adam was Carillion's Finance Director from 2007 until he retired at the end of 2016. He was replaced by Zafar Khan, previously the Group Financial Controller, who only lasted nine months before being sacked. Mr Khan was replaced in September 2017 by Emma Mercer, who remained in post until the company collapsed.[324]

321 Cashflow statements break down how cash is generated within a company. The cash flows from operating activities is essentially the cash that been generated through trading, whereas the financing cash flows show the cash generated through borrowing and equity. By presenting money borrowed under the early payment facility as "other creditors", it's classification within the cashflow can be seen as part of the company's operating activity rather than a financing activity.

322 Moody's, Carillion's collapse exposes flaws in the accounting for supply-chain finance, 13 March 2018

323 Oral evidence taken before the Liaison Committee on 7 February 2018, HC 770 (2017–19), Q7 [Sir Amyas Morse]

324 Emma Mercer did not join Carillion plc's board.

Emma Mercer

98. Emma Mercer was the only director prepared to concede that Carillion were engaged in aggressive accounting. She told us that when she returned to the UK in April 2017, having spent three years in the Canadian part of the business, there was a "slightly more aggressive trading of the contracts than I had previously experienced in the UK".[325] In further correspondence, she elaborated this could be seen in the "number and size of contracts where significant judgements were being made in relation to the recognition of uncertified revenue in construction contracts".[326]

99. Ms Mercer appeared to bring a level of discipline and accuracy to Carillion's accounting policies that had been severely lacking. On her return, she quickly spotted an anomaly in the way the company was classifying receivable balances on construction contracts,[327] calling it "sloppy accounting".[328] The board agreed that her concerns should be investigated, but shied away from a full independent review. Instead, the board invited the company's auditor, KPMG, to review work that it had previously audited and approved. KPMG agreed with the board's conclusion that although Carillion had misclassified assets, it had not misstated revenue. That review did, however, act as the trigger for the wider contract review that led to the £845 million provision in July 2017.[329]

100. **Emma Mercer is the only Carillion director to emerge from the collapse with any credit. She demonstrated a willingness to speak the truth and challenge the status quo, fundamental qualities in a director that were not evident in any of her colleagues. Her individual actions should be taken into account by official investigations of the collapse of the company. We hope that her association with Carillion does not unfairly colour her future career.**

Zafar Khan

101. Emma Mercer was in post because the board lost faith in Zafar Khan after only nine months as Finance Director. Mr Khan told us that he "spooked" the Carillion board in September 2017 with a presentation he felt gave nothing more than an honest assessment of the company's position.[330] Philip Green told us, however, that the board concluded collectively that he was "not close enough to the underlying business unit numbers" and not the "right person" to participate in negotiations with the company's banks.[331] Our evidence certainly supports the board's view. In oral evidence, he claimed success in his top priority of reducing the company's debt, before eventually admitting "debt increased through 2017".[332] Board minutes from May 2017 show that, when Emma Mercer raised concerns about accounting irregularities, Mr Khan suggested that they showed "incompetence and laziness in the accounting review of the contract".[333] As the then

325 Q264 [Emma Mercer]
326 Letter from Emma Mercer to the Chairs, 5 March 2018
327 Emma Mercer's concern was that Carillion were using "negative accruals", which were netting off payables and receivables balances. Whilst KPMG confirmed this was permitted under international accounting standards on construction contracts, Carillion had a "golden rule" not to do so.
328 Carillion plc, minutes of a meeting of the Board of Directors, 15 May 2017, p 4
329 *As above.*
330 Q314 [Zafar Khan]; Letter from Zafar Khan to the Chairs, 21 February 2018
331 Letter from Philip Green to the Chairs, 20 February 2018
332 Qq342–44 [Zafar Khan]
333 Carillion plc, Minutes of a meeting of the Board of Directors, 9 May 2017, p 4

Finance Director, this charge lay ultimately at his door. Although he may not have been the architect of those policies, his previous role as group financial controller hardly meant this was a man lacking in experience of how the company operated.

102. **Zafar Khan failed to get a grip on Carillion's aggressive accounting policies or make any progress in reducing the company's debt. He took on the role of Finance Director when the company was already in deep trouble, but he should not be absolved of responsibility. He signed off the 2016 accounts that presented an extraordinarily optimistic view of the company's health, and were soon exposed as such.**

Richard Adam

103. The dominant personality in Carillion's finance department was Richard Adam. He was in charge for most of the last decade, and received a final pay package of £1.1 million in December 2016.[334] Andrew Dougal said Mr Adam "exercised tight control over the entire finance function, had extensive influence through the Group" and "was defensive in relation to some challenges in board meetings".[335] His approach to negotiating with the pension Trustee similarly suggested someone who exerted control and refused to compromise. It is impossible to imagine that any significant accounting policy decisions were made without his prior approval.

104. Mr Adam got out at the right time. He told us that he could do no more than speculate as to what went wrong with the company, as in his view he had left it in December 2016 in a healthy state.[336] Despite that assessment, he was quick to offload all the shares he had acquired over his years in the business. He sold his entire holding on the day the rosy 2016 accounts were published, and then his 2014 long term performance award shares on the day they vested in May 2017. He told us he does not hold shares because of the risks involved.[337] In total, he sold shares worth a total of £776,000 between March and May 2017, at an average price of 212p.[338] The share price fell to 57p by mid-July.

105. **Richard Adam, as Finance Director between 2007 and 2016, was the architect of Carillion's aggressive accounting policies. He, more than anyone else, would have been aware of the unsustainability of the company's approach. His voluntary departure at the end of 2016 was, for him, perfectly timed. He then sold all his Carillion shares for £776,000 just before the wheels began very publicly coming off and their value plummeted. These were the actions of a man who knew exactly where the company was heading once it was no longer propped up by his accounting tricks.**

Conclusions on Carillion's board

106. In their evidence to us, Carillion's directors gave no indication that they accepted any blame for their decisions that ultimately led to the collapse of the company. They sought to point the finger at anyone or anything else they could find. Rather than a failure of management, the collapse of Carillion was, to them, the fault of their advisers, the Bank of England, the foreign exchange markets, Brexit, the snap 2017 General Election,

334 Carillion plc, Annual Report and Accounts 2016, p 66
335 Letter from Andrew Dougal to the Chairs, 5 April 2018
336 Letter from Richard Adam to the Chairs, 20 February 2018
337 Q467 [Richard Adam]
338 Letter from Richard Adam to the Chairs, 20 February 2018

Carillion's investors, Carillion's suppliers, the entire UK construction industry, Middle Eastern business culture, the construction market of Canada, and professional designers of concrete beams.[339]

107. **Carillion's directors, both executive and non-executive, were optimistic until the very end of the company. They had built a culture of ever-growing reward behind the façade of an ever-growing company, focused on their personal profit and success. Even after the company became insolvent, directors seemed surprised the business had not survived.**

108. **Once the business had completely collapsed, Carillion's directors sought to blame everyone but themselves for the destruction they caused. Their expressions of regret offer no comfort for employees, former employees and suppliers who have suffered because of their failure of leadership.**

339 Q234 [Keith Cochrane]; Qq238–9 [Keith Cochrane]; Q282 [Zafar Khan]; Q298 [Zafar Khan]; Qq305–6 [Zafar Khan]; Q381 [Keith Cochrane]; Q385 [Keith Cochrane]; Q445 [Richard Howson]; Qq448–452 [Philip Green]; Q462 [Philip Green]

2 External checks and balances

Investors

109. While ultimate responsibility for the success of a company rests with the board, shareholders have an important role in holding the board to account for its performance. Under the principles set out in the FRC's Stewardship Code, investors monitor the performance of companies in which they invest, including by checking on the effectiveness of leadership and the quality of reporting.[340] The Code sets out a menu of options for escalating stewardship activities where there are concerns, from private meetings with board members to public statements and voting against resolutions at annual general meetings. It states that investors should be willing to act collectively with other investors when there are risks that threaten to destroy shareholder value or at times of "significant corporate stress".[341]

110. The stewardship activities of some of the major shareholders in Carillion in March 2017 are set out in the table below. The different approaches adopted in the final months of trading are in part a reflection of the different investment strategies of the investors and the preferences of their clients. For BlackRock, most of their investments were through passively managed funds which were sold automatically as Carillion shares fell out of the tracked indexes. The Canadian investor, Letko, Brosseau & Associates, on the other hand, continued to see Carillion as a long-term investment and were willing to consider offering additional support even after the initial profit warnings. Shareholders, including BlackRock, did push back successfully on proposals by the remuneration committee to increase the maximum bonus opportunity from 100% to 150%, but these objections were a protest against the pay proposals rather than a proxy for discontent with the company's performance.[342]

Table 1: Investor engagement

Company	Shareholding on 1 March 2017 (%)	Engagement activities
BlackRock Inc.	8.81	Discussions with board prior to March 2017, including in February on remuneration arrangements. Voted in favour following changes to maximum bonus proposals. Long and short positions held for clients. No engagement after March 2017. Majority of shares held in passive funds, sold in line with changes to indexes arising from profit warnings.
Brewin Dolphin Ltd	5.00	Met CEO and FD on 9 March 2017 for routine shareholder meeting and options for improving financial position discussed. Shareholdings reduced during 2017 in the light of changing assessment of the investment, accelerated after July profit warning.

340 Financial Reporting Council, Stewardship Code, Principle 3
341 Financial Reporting Council, Stewardship Code, Principle 4
342 Q1076 [Amra Balic]; Letter from Alison Horner to BlackRock, 7 March 2017

Company	Shareholding on 1 March 2017 (%)	Engagement activities
Deutsche Bank AG	5.82	Not proprietary investments. Shares held on behalf of clients and for hedging purposes. No engagement with Carillion management.
Kiltearn Partners LLP	5.01*	Continued to buy Carillion shares on behalf of clients until early July 2017. Kiltearn voted all its shares against the Remuneration Report in May 2017 due to "excessive" pay award to the CEO and concerns about debt and working capital levels. Met CEO on 17 July to discuss funding gap. Concluded that recovery was "unlikely" and that no effective assessment could be made of its finances due to unreliability of published financial information. Began selling shares on 3 August 2017. Kiltearn met CEO on 13 October and, unconvinced by his answers to questions, sold all shares by 4 January 2018.
Letko, Brosseau & Associates Inc.	4.97	No change in plans or engagement after March 2017 until July profit warning, although a routine review call, requested on 13 June, was not met. After an urgent call on 10 July, shares held on basis that there was a "fair chance" of Carillion remaining a going concern; a further injection of capital considered. Further engagement around September profit warning. After November profit warning, view was taken that recovery was "unlikely" and all shares sold rapidly.
Standard Life Aberdeen	4.96**	Standard Life[1] began to gradually divest in December 2015 owing to concerns about financial management, strategy and corporate governance. Bi-annual meetings with Carillion board from 2014, at which concerns were raised about widening pension deficit, high levels of debt, weak cash generation an unwillingness of board to change strategic direction. Meeting with CEO on 17 July, by which time shareholding was minimal. All shares sold by end of 2017.

Source: Letters from investors and oral evidence. Shareholding figures from Carillion Annual Report 2016.

* According to Kiltearn, this figure should be 10%. ** According to Standard Life Aberdeen, this figure should be 0.56% at this date.

1 Standard Life merged with Aberdeen Asset Management in in August 2017. Aberdeen held limited shares in Carillion during this period, mainly in passive funds, and had little direct engagement with the board.

111. Effective stewardship by investors depends in large part on the availability of trustworthy financial reporting and on honest engagement with board members in response to the raising of concerns. The Carillion board failed on both these counts. In private meetings with the board, the Standard Life representative, Euan Stirling, referred to the fact that "the financial statements have been made to reflect a much more

optimistic outlook for the company",[343] and that there was "a gloss to the presentations that we felt did not reflect the true business circumstances".[344] BlackRock shared the view that management teams were "overly optimistic" and retained its position of not actively investing in a company it did not view as an "attractive investment proposition".[345] For Standard Life, direct engagement was an important element of their investment strategy, and they began to divest as those meetings revealed that the board was not going to change direction in the face of their concerns.[346] Other investors, with less resources to devote to direct engagement, relied heavily on the published financial information. Murdo Murchison, Chief Executive of Kiltearn Partners, told us that, in the light of the July 2017 profit warning, that information "could no longer be considered reliable":[347]

> What was brought to the table in July last year was evidence of misstatement of profits over a prolonged period of time, evidence of aggressive accounting and evidence of extremely poor operational management, which was completely at odds with the way the business was presented to the marketplace.[348]

Following the July 2017 profit warning, Kiltearn met Keith Cochrane, by then interim Chief Executive of Carillion, on 17 July and 13 October. Unimpressed by his inability to offer "any meaningful information" about how the company proposed to address its financial problems or "give answers that Kiltearn considered satisfactory to relatively straightforward questions", they determined they could only continue to sell shares.[349]

112. Representatives of the institutional investors were, at best, frustrated by the behaviour and performance of the Carillion board.[350] Kiltearn, unhappy with the level and timeliness of financial disclosures, were considering legal action in respect of what they considered could be "dishonest concealment" of information in the 2016 annual report.[351] In spite of these significant concerns on the part of some major investors, as a group these owners of the company did not manage to act in a co-ordinated manner to exert effective influence on the board of Carillion.

113. **Major investors in Carillion were unable to exercise sufficient influence on the board to change its direction of travel. For this the board itself must shoulder most responsibility. They failed to publish the trustworthy information necessary for investors who relied on public statements to assess the strength of the company. Investors who sought to discuss their concerns about management failings with the board were met with unconvincing and incompetent responses. Investors were left with little option other than to divest.**

114. **It is not surprising that the board failed to attract the large injection of capital required from investors; we are aware of only one who even considered this possibility. In the absence of strong incentives to intervene, institutional investors acted in a rational manner, based on the information they had available to them. Resistance to**

343 Q1033 [Euan Sterling]
344 Q1030 [Euan Stirling]
345 Q1008 [Amra Balic]
346 Q1002 [Euan Stirling]
347 Letter from Kiltearn Partners to the Chairs, 2 February 2018
348 Q1125 [Murdo Murchison]
349 Letter from Kiltearn Partners to the Chairs, 2 February 2018
350 Q1041 [Amra Balic]
351 Letter from Kiltearn Partners to the Chairs, 2 February 2018

an increase in bonus opportunities, regrettably, did not extend to direct challenges to board members. Carillion may have held on to investors temporarily by presenting its financial situation in an unrealistically rosy hue; had it been more receptive to the advice of key investors at an earlier stage it may have been able to avert the darkening clouds that subsequently presaged its collapse.

Auditors

115. It is the responsibility of the board of directors to prepare and approve the company's financial accounts.[352] The role of the auditor is to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement.[353] If they are unable to obtain sufficient appropriate audit evidence to support that assessment, they should issue a modified opinion on the accounts, noting the areas of the accounts that are the cause of that modification.[354]

116. KPMG were Carillion's auditors for all 19 years of the company's existence from 1999. Such a long tenure inevitably calls into question whether they could provide the independence and objectivity that is crucial to high-quality audit. Legislation passed in 2014 requires listed companies to change their audit firm after a maximum of 20 years.[355] Transitional arrangements, however, meant that Carillion would not have had to replace KPMG until 2024.[356] KPMG said that its independence was not impaired after 19 years auditing Carillion. Michelle Hinchliffe, KPMG's Head of Audit, said she did not believe this was "too long to be impartial" and that "independence for me is a mindset. For myself and all my fellow partners, independence and integrity are absolutely critical to our profession".[357]

117. Over 19 years, KPMG charged Carillion £29 million in audit fees, alongside additional charges for taxation and other assurance services. Carillion's financial statements show that over that period, KPMG never found reason to offer a qualified audit opinion on the accounts. On 29 January 2018, shortly after Carillion collapsed, the FRC announced an inquiry into the 2014, 2015 and 2016 audits, with particular focus on the "company's use and disclosure of the going concern basis of accounting, estimates and recognition of revenue on significant contracts, and accounting for pensions".[358] KPMG welcomed the investigation, stating "it is important that regulators acting in the public interest review the audit work related to high profile cases such as Carillion".[359]

KPMG's enhanced contract review

118. When we questioned KPMG about the provision Carillion made in July 2017, KPMG's responses mirrored those of Carillion's directors: the causes all related to events that took place after the publication of the accounts on 1 March 2017. They listed factors

352 Companies Act 2006, section 394 and section 414
353 Financial Reporting Council, International Standard on Auditing (UK) 200 (revised June 2016), p 4
354 Financial Reporting Council, International Standard on Auditing (UK) 705 (revised June 2016), p 3
355 Financial Reporting Council, Audit tender notes on best practice, February 2017, p 4
356 Carillion plc, Annual Report and Accounts 2016, p 63
357 Qq944–45 [Michelle Hinchliffe]
358 Financial Reporting Council, Investigation into the audit of the financial statements of Carillion plc, 29 January 2018
359 Letter from KPMG to the Chairs, 2 February 2018

including "worsening delays leading to forecast reassessments", "unexpected site-specific developments" and "the developing political and economic situation in the Middle East, particularly events in Qatar", as being responsible for the contract provision.[360]

119. Those conclusions followed an enhanced management review of key contracts in May 2017, which was audited by KPMG. KPMG noted that the review was a "deep dive", and "beyond the level of detail that would typically be completed by the audit team".[361] They also highlighted some of Carillion's aggressive accountancy practices, including that "claims are booked earlier in the Group than would be by certain others in the industry" and that there was "a lack of consistency and guidance around the Group in when to recognise value on claims".[362] That these findings only became apparent after "deep dives" raises questions over the adequacy of KPMG's core audit work. Peter Meehan, the KMPG Audit Partner who signed off the accounts, told us that his company's previous work was extensive, citing large numbers of site visits.[363] Yet KPMG neither identified nor challenged Carillion's aggressive approach to revenue accounting on specific contracts.

120. KPMG was aware that recognition of contract revenue was the most significant risk in Carillion's accounts: it is acknowledged as such in its 2016 audit report.[364] The report narrative, however, merely described in general terms the inherent risks around accounting for construction contracts and described generic audit procedures carried out to mitigate that risk. KPMG did not in any way allude to Carillion's unusually optimistic outlook. Murdo Murchison told us that his investment company relied on audited financial results, but they were "clearly not a good guide" to the state of Carillion.[365] More valuable information was included in KPMG's February 2017 presentation to the Carillion audit committee, which noted that "overall the traded position on contracts is challenging, but when considered in conjunction with the provisions […] is reasonable".[366] That conclusion too was flawed, but it did at least admit to contract challenges. This concern was not, however, deemed worthy of inclusion in KPMG's published audit report.

KPMG failings and goodwill

121. KPMG's blind spots with regard to Carillion were not isolated to its audits of that company. The FRC examines a sample of audits for each major audit firm operating in the UK in annual audit quality reviews (AQR). Though Carillion was not part of the FRC's 2016–17 KPMG sample, the report of that review called on KPMG to "re-assess [its] approach to the audit of revenue and the related training provided" and found that "insufficient revenue testing was performed on certain audits".[367]

122. The AQR report also noted weaknesses in KPMG's testing for impairments to goodwill, stating that there was sometimes "insufficient challenge of management's assumptions".[368] Carillion's balance sheet was propped up by goodwill. In the 2016 accounts it was recorded as £1.6 billion, 35% of the company's gross assets and more

360 Letter from KPMG to the Chairs, 2 February 2018
361 KPMG, Enhanced contracts review and half year update, 9 July 2017 (not published)
362 *As above.*
363 Q789 [Peter Meehan]
364 Carillion plc, Annual Report and Accounts 2016, p 86
365 Q1004 [Murdo Murchison]
366 Carillion plc, February 2017 Audit Committee papers (not published)
367 Financial Reporting Council, KPMG LLP KPMG Audit plc Audit quality inspection, June 2017
368 Financial Reporting Council, KPMG LLP KPMG audit plc Audit quality inspection, June 2017

than double its net assets of £730 million.[369] This goodwill was accumulated through acquisitions, as the difference between the book value of the company purchased and the price Carillion paid. It accounts for intangible assets of the purchased companies, such as the workforce, brand, and synergies with Carillion. It is reasonable to posit that these assets might decline over time, particularly if, like Eaga for example, the purchased business proved to be loss-making. Accounting standards require the assumptions used to estimate goodwill to be tested each year to evaluate whether it should be impaired, or reduced in value, in the accounts.[370]

123. Carillion's goodwill was never impaired in its annual accounts.[371] This indicates the company remained confident that the amount it paid for each acquisition was justified due to the continued economic benefits it expected to derive from them. This is difficult to justify for some of Carillion's purchases. £330 million of goodwill was recorded when Eaga was purchased in 2011,[372] yet after five consecutive years of substantial losses, that figure remained unchanged, despite Philip Green admitting the purchase was a "mistake".[373] KPMG's 2017 half-year update to the board indicates the flimsiness of Carillion's calculations that justified not impairing any of their goodwill. They found that "historically at least 80% of the Group's net present value has been derived from the perpetuity calculation".[374] This means that 80% of the value of cash flows Carillion hoped to achieve through acquisitions was predicated on the assumption that those cash flows would continue in perpetuity. Such assumptions were not disclosed by the company or its auditor. The Secretary of State for Business, Energy and Industrial Strategy has confirmed that the FRC are looking at Carillion's treatment of goodwill as part of their investigation.[375]

124. **KPMG audited Carillion for 19 years, pocketing £29 million in the process. Not once during that time did they qualify their audit opinion on the financial statements, instead signing off the figures put in front of them by the company's directors. Yet, 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 judgements, KPMG was complicit in them. It should take its own share of responsibility for the consequences.**

Advisors

125. Carillion's board were supported by an assortment of companies offering a range of professional services. Among these were Deloitte, who alongside KPMG, EY and PwC comprise the "Big Four" audit and professional services firms. Deloitte acted as Carillion's

369 Carillion plc, Annual Report and Accounts 2016, p 93 and p 109

370 International Financial Reporting Standards, IAS 36 Impairment of Assets, accessed 1 May 2018. Up until 2004, the reporting standards allowed for goodwill to be amortised rather than tested annually for an impairment. Amortisation reduces the value of an intangible asset annually so if this accounting treatment had still been in force, Carillion would have had to report substantially lower levels of goodwill in their accounts.

371 An impairment of £134 million was included in the interim financial statements for 2017. Carillion plc, Financial results for the six months ended 30 June 2017, p 1

372 Carillion plc, Annual Report and Accounts 2011, p 92

373 Letter from Philip Green to the Chairs, 20 February 2018

374 KPMG, Enhanced contracts review and half year update, 9 July 2017 (not published)

375 Letter from the Secretary of State for Business, Energy and Industrial Strategy to the Chairs, 30 April 2018

internal auditors, charging on average £775,000 a year since 2010.[376] The role of internal audit is to "provide independent assurance that an organisation's risk management, governance and internal control processes are operating effectively".[377] Although Deloitte made a number of recommendations through their internal audit reports, they rarely identified issues as high priority. Only 15 out of 309 recommendations between 2012 and 2016 were deemed as such.[378] Likewise, across 61 internal audit reports in 2015 and 2016, only a single report in 2016 found inadequate controls.[379] They were responsible for advising on financial controls such as debt recovery,[380] yet were unaware of the dispute with Msheireb over who owed whom £200 million. They also did not appear to have expressed concern over the high risk to the business of a small number of contracts not being met.[381] **Deloitte were responsible for advising Carillion's board on risk management and financial controls, failings in the business that proved terminal. 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.**

126. Deloitte's role with Carillion was not confined to internal audit. Among other roles, they acted as advisors to the remuneration committee, offered due diligence on the disastrous takeover of Eaga in 2011 and then received £730k for attempting a subsequent transformation programme at Eaga.[382] Such widespread involvement in Carillion was simply par for the course for the Big Four accountancy firms. Over the course of the last decade, they collectively received £51.2 million for services to Carillion, a further £1.7 million for work for the company's pension schemes and £14.3 million from Government for work relating to contracts with Carillion.[383]

127. EY, another member of the Big Four, were particularly heavily involved with Carillion after the profits warning in July 2017. They were appointed to oversee "Project Ray", a transformation programme designed to reset the business.[384] Carillion paid them £10.8 million over a six-month period,[385] in part to identify up to £123 million of cost savings, mainly to be met through a 1,720 reduction in full-time UK employees.[386] Those savings were not achieved before the company collapsed. EY also helped negotiate the agreement with the pension Trustee to defer £25 million in deficit recovery contributions and a "time to pay" arrangement with HMRC in October 2017 that deferred £22 million of tax obligations.[387] As we noted earlier, EY even suggested extending standard payment terms to suppliers to 126 days.[388] Their own fees, however, were not deferred. On Friday 12 January 2018, three days before the company was declared insolvent and one day before

376 Letter from Deloitte to the Chairs, 2 February 2018
377 Chartered Institute of Internal Auditors, About Us, accessed 1 May 2018
378 Analysis of Deloitte's internal audit reports to the audit committee.
379 *As above.*
380 Q811 [Michael Jones]
381 Q807 [Michael Jones]
382 Letter from Deloitte to the Chairs, 2 February 2018
383 Work and Pensions Committee, Committees publish responses from Big Four on Carillion, 13 February 2018. Note that the original total quoted here for pension scheme work was £6.1 million. PwC subsequently informed us that out of a total of £4.6 million that they gave us for work done on the Electric Supply Pension Scheme, only £200,000 related to Carillion. Letter from PwC to the Chairs, 23 February 2018
384 Letter from EY to the Chairs, 25 January 2018
385 *As above.*
386 EY Project Ray Board meeting, Carillion audit committee papers, 22 August 2017 (not published)
387 Carillion plc, Weekly reporting pack, 27 October 2017 (not published)
388 Carillion plc, Weekly reporting pack for week ending 26 November actuals, 8 December 2017 (not published)

Philip Green wrote to the Government pleading for taxpayer funding to keep the company going, Carillion paid EY £2.5 million. On the same day, it paid out a further £3.9 million to a raft of City law firms and other members of the BigFour.[389]

Table 2: Carillion's payments to advisers on 12 January 2018

Advisor name	Amount paid (£)
KPMG	78,000
Willkie Farr & Gallagher UK	164,016
Sacker & Partners	37,211
Mills & Reeve	20,621
Lazard & Co	551,716
FTI Consulting	1,018,666
Freshfields Bruckhaus Deringer	91,165
Ernst & Young	2,508,000
Clifford Chance	149,104
PricewaterhouseCoopers	276,000
Akin Gump	305,549
Slaughter and May	1,196,093
Total	**6,396,141**

128. Philip Green told us that Carillion "took advice every step of the way" from a range of big name advisers:[390]

> We sought very strongly at Carillion to make sure that we had quality advice, whether it was Slaughter & May as our lawyers, Lazard as our bankers or Morgan Stanley as our brokers. We believed we had high quality advice in the Carillion situation […].[391]

Though Philip Green listed Morgan Stanley above, his board marginalised them as brokers in July 2017. This decision was taken after Morgan Stanley told the Carillion board that it would not underwrite a proposal to raise further equity.[392] This was because it had concluded that "Carillion's senior management could neither produce nor deliver an investment proposition that would convince shareholders and new investors to support the potential rights issue".[393] After Morgan Stanley's representatives left that board meeting, the board concluded the broker's position was "not credible" and that while it would be necessary to "continue to work with them as brokers in the short term that would clearly change in the future".[394] Morgan Stanley confirmed that HSBC were appointed as joint corporate broker on 14 July and that thereafter "Carillion sought our advice less frequently".[395]

129. **Carillion's directors were supported by an array of illustrious advisory firms. Names such as Slaughter and May, Lazard, Morgan Stanley and EY were brandished**

389 Business, Energy and Industrial Strategy Committee and Work and Pensions Committee, Carillion paid out £6.4 million to advisors before £10 million taxpayer bailout, 12 March 2018
390 Q462 [Philip Green]
391 Q461 [Philip Green]
392 Carillion plc, Minutes of a meeting of the Board of Directors, 5 July 2017
393 *As above.*
394 Letter from Morgan Stanley to the Chairs, 21 February 2018
395 *As above.*

by the board as a badge of credibility. But the appearance of prominent advisors proves nothing other than the willingness of the board to throw money at a problem and the willingness of advisory firms to accept generous fees.

130. **Advisory firms are not incentivised to act as a check on recklessly run businesses. A long and lucrative relationship is not secured by unduly rocking the boat. As Carillion unravelled, some firms gave unwelcome advice. Morgan Stanley explained that the opportunity to raise equity to keep the company afloat had passed. Carillion simply marginalised them and sought a second opinion. By the end, a whole suite of advisors, including an array of law firms, were squeezing fee income out of what remained of the company. £6.4 million disappeared on the last working day alone as the directors pleaded for a taxpayer bailout. Chief among the beneficiaries was EY, paid £10.8 million for its six months of failed turnaround advice as Carillion moved inexorably towards collapse.**

Pension trustees

131. Trustees invest the assets of a pension scheme and are responsible for ensuring it is run properly and that members' benefits are secure.[396] In this role, trustees negotiate with the sponsoring employer on behalf of the scheme members. As we noted earlier in this report, a single trustee board (the Trustee) represented the large majority of Carillion's DB scheme members.[397]

132. Gazelle, who acted as covenant advisors to the Trustee, told us that Carillion may have set out to "manage" the Trustee so that it "did not present an effective negotiating counterparty" to the company.[398] This was done in part through the "dominating influence" of Carillion employees, who faced an inherent conflict of interest, on the Trustee board.[399] Robin Ellison, the Trustee Chair, disagreed stating that "all the directors of the trust company were independently-minded".[400] Gazelle also cited Carillion's budgetary control over the Trustee that "may have limited the ability of the Trustee to itself obtain detailed advice on more complex issues", and pressure exerted on the scheme actuary by Carillion at trustee meetings.[401]

133. Despite these limitations, and as we considered earlier in this report, the Trustee pushed Carillion hard to secure additional contributions to fund the pension deficits. They also consistently acted on advice from The Pensions Regulator on their approach to dealing with company.[402] Both the 2008 and 2011 valuations were agreed well outside the statutory 15-month deadline as the Trustee sought to obtain a better deal. Although agreements were eventually signed by the Trustee and Carillion on these valuations, Robin Ellison argued that they were effectively "imposed".[403] As Mr Ellison noted, "the

396 The Pensions Regulatory, Guidance for Trustees, accessed 22 April 2018

397 Trustee data shows that at the end of 2013, total membership across the six schemes under the trusteeship of Carillion (DB) Pension Trustee Ltd was 20,587 - Carillion plc's Annual Report and Accounts 2013 show that total membership across all schemes was 28,785 at the end of 2013.

398 Letter from Simon Willes, Gazelle Executive Chairman, to the Chair, 29 March 2018

399 *As above.* Trustees who are employees of the sponsor are a common feature of Trustee boards.

400 Q151 [Robin Ellison]

401 Letter from Simon Willes, Gazelle Executive Chairman, to the Chair, 29 March 2018

402 Letter from TPR to Robin Ellison and Janet Dawson 27 June 2013; Letter from TPR to the Trustees, 27 July 2011; Letter from the Trustee to the Pensions Regulator, 9 April 2013

403 Q189 [Robin Ellison]

powers of pension fund trustees are limited and we cannot enforce a demand for money".[404] TPR does have a power to impose contributions, and the Trustee wrote to TPR requesting "formal intervention" on behalf of scheme members with regard to the 2013 valuation and recovery plan.[405]

134. **The pension trustees were outgunned in negotiations with directors intent on paying as little as possible into the pension schemes. Largely powerless, they took a conciliatory approach with a sponsor who was their only hope of additional money and, for some of them, their own employer. When it was clear that the company was refusing to budge an inch, they turned to the Pensions Regulator to intervene.**

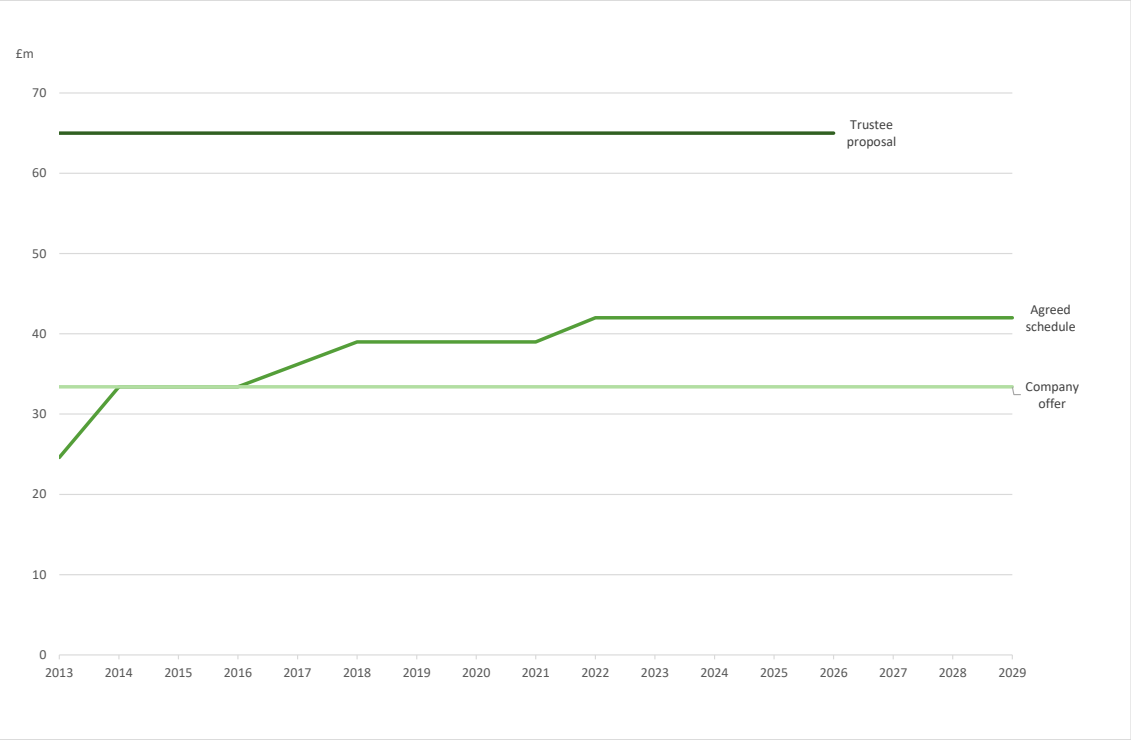
The Pensions Regulator

135. The Pensions Regulator had an active interest in the Carillion pension schemes for the last decade of the company's life. While it was involved in negotiations between Carillion and the Trustee over the 2008 valuation and recovery plan, this involvement was "less intense" than its "proactive engagement" on the 2011 valuation.[406] Following the July 2017 profit warning, TPR participated in a series of meetings to discuss the company's deferral of pension contributions.[407]

136. Earlier in this report, we found that, having adopted an intransigent approach to negotiation, Carillion largely got its way in resisting making adequate deficit recovery contributions following the 2011 valuation. TPR argued, however, that its involvement led to an increase of £85 million in contributions by Carillion across the recovery period.[408] This figure is derived by comparing Carillion's initial offer of £33.4 million for 16 years with the final agreed plan, which had contributions rising from £25 million in 2013 to £42 million by 2022. To what extent TPR were responsible for that increase is unclear. What is not, though, is that the £85 million was a long way short of the additional £342 million the Trustee was seeking through annual contributions of £65 million. The agreed plan was also heavily backloaded, with initial contributions of £33 million matching the company's offer and steps up in contributions only occurring in later years, when it would regardless be superseded by a new valuation and recovery plan. Gazelle described the TPR's intervention as "disappointing" and expressed bafflement at how Richard Adam "managed to persuade the Pensions Regulator not to press for a better recovery plan".[409]

404 Q151 [Robin Ellison]
405 Letter from Robin Ellison to TPR, 9 April 2013
406 Qq653–4 [Mike Birch]
407 Letter from Chief Executive of TPR to the Chair, 26 January 2018
408 Q689 [Mike Birch], Q693, Q711, Q774 [Lesley Titcomb]
409 Letter from Simon Willes, Executive Chairman Gazelle, to the Chair, 29 March 2018, p 7

Figure 7: 2013 pension deficit recovery plans



Source: Analysis of Trustee minutes and scheme annual reports

137. If a company is failing to honour its obligations to fund a pension scheme, TPR has powers, under section 231 of the Pensions Act 2004, to impose a schedule of pension contributions.[410] In 13 years, however, TPR has not used that power once with regard to any of the thousands of schemes it regulates.[411] During the course of the 2011 negotiations, TPR repeatedly threatened to use its section 231 powers, making reference to them in correspondence on seven different occasions between June 2013 and March 2014.[412] Carillion correctly interpreted these as empty threats. That is no surprise, given TPR's evident aversion to actually using its powers to impose a contribution schedule.

138. TPR were also willing to accept recovery plans in the Carillion schemes that were significantly longer than the average of 7.5 years.[413] Carillion and the Trustee's agreed recovery plans averaged 16 years in both 2008 and 2011. TPR told us they do not want their approach to be "perceived as focused too heavily on the length of the recovery plan" and that longer plans may be appropriate where the trustees and employer have agreed higher liabilities based on "prudent assumptions".[414] Carillion, however, explicitly rejected more prudent assumptions, but was still allowed lengthy recovery plans.

139. There is also little evidence that TPR offered any serious challenge to Carillion over their dividend policy, despite their guidance acknowledging that dividend policy should be considered as part of a recovery plan.[415] In April 2013, TPR confirmed to both the company and Trustee that they were "not comfortable with recovery plans

410 Pensions Act 2004, section 231
411 Letter from the Pensions Regulator to the Chair, 12 March 2018. Over 5,500 schemes are eligible for the PPF.
412 *As above.*
413 The Pensions Regulator, Scheme funding statistics, June 2017, p 7
414 Letter from the Pensions Regulator to the Chair, 12 March 2018
415 The Pensions Regulator, Code of practice no.3, Funding defined benefits, June 2014, p 3

increasing whilst dividends are being increased".[416] When questioned about Carillion's dividend policy, however, TPR argued Carillion's ratio of dividend payments to pension contributions was better than other FTSE companies and that they "cannot and should not prevent companies paying dividends, if that is the right thing to do".[417] TPR argued this approach to dividends is in keeping with their statutory objective to minimise any adverse impact upon the sustainable growth of sponsoring employers in its regulation of DB funding. This objective, however, only came into force in 2014, after both the 2008 and 2011 valuations. Carillion's growth did, of course, not transpire to be sustainable.

140. TPR also has statutory objectives to reduce the risk of schemes ending up in the PPF and to protect member's benefits. The PPF expects to take on 11 of Carillion's 13 UK schemes, meaning the members of those schemes will receive lower pensions than they were promised. Even paying out lower benefits, the schemes will have a funding shortfall of around £800 million, which will be absorbed by the PPF and its levy-payers.[418] TPR clearly failed in those objectives.

141. Following Carillion's liquidation, TPR announced an investigation into the company which would allow them to seek funding from Carillion and individual board members for actions which constituted the avoidance of their pension obligations.[419] We await the outcome of that investigation with interest but question the timing. TPR had concerns about schemes for many years without taking action. There are also no valuable assets left in the company, and while individual directors were paid handsomely for running the company into the ground, recouping their bonuses is unlikely to make much of a dent in an estimated pension liability of £2.6 billion.[420] The Work and Pensions Committee's 2016 report on defined benefit pension schemes found that TPR intervention tended to be "concentrated at stages when a scheme is in severe stress or has already collapsed".[421] Carillion is the epitome of that.

142. **The Pensions Regulator's feeble response to the underfunding of Carillion's pension schemes was a threat to impose a contribution schedule, a power it had never—and has still never—used. The Regulator congratulated itself on a final agreement which was exactly what the company asked for the first few years and only incorporated a small uptick in recovery plan contributions after the next negotiation was due. In reality, this intervention only served to highlight to both sides quite how unequal the contest would continue to be.**

143. **The Pensions Regulator failed in all its objectives regarding the Carillion pension scheme. Scheme members will receive reduced pensions. The Pension Protection Fund and its levy payers will pick up their biggest bill ever. Any growth in the company that resulted from scrimping on pension contributions can hardly be described as sustainable. Carillion was run so irresponsibly that its pension schemes may well have ended up in the PPF regardless, but the Regulator should not be spared blame for**

416 Carillion single Trustee, Meeting between Trustee representatives and the Pensions Regulator regarding failure to agree the 2011 valuation, 29 April 2013

417 Q777 [Lesley Titcomb]

418 PPF letter to the Chair, 20 February 2018

419 Letter from Chief Executive of TPR to the Chair, 26 January 2018

420 £2.6 billion is the provisional estimate being made as to the deficit of the schemes on a section 75 basis, which is the size of the deficit according to how much would be paid to an insurance company to buy-out the liabilities. Although the section 75 debt will not be met as there are insufficient assets left in the company, that is the figure that becomes due on insolvency.

421 Work and Pensions Committee, Sixth Report of Session 2016–17, Defined benefit pension schemes, HC 55, p 4

allowing years of underfunding by the company. Carillion collapsed with net pension liabilities of around £2.6 billion and little prospect of anything being salvaged from the wreckage to offset them. Without any sense of irony, the Regulator chose this moment to launch an investigation to see if Carillion should contribute more money to its schemes. No action now by TPR will in any way protect pensioners from being consigned to the PPF.

Financial Reporting Council

144. The Financial Reporting Council (FRC) is the regulator of accountants, auditors and actuaries. It has a responsibility for maintaining high standards of financial reporting and auditing, and for pursuing sanctions against those who fall below established professional standards. It also has a wider mission to promote the integrity of UK business through its Codes on Corporate Governance and Stewardship. To this end, it seeks to "encourage companies to produce timely, relevant and trustworthy information about their performance, prospects and board behaviour".[422] While it can go to the courts to require revisions to accounts or reports, it generally operates by agreement with the companies concerned.

145. The FRC can also take legal action in respect of misconduct and breaches of professional standards, but the UK Corporate Governance Code operates on a "comply or explain" basis. Directors of companies are not subject to legal action for non-compliance with the Code and the FRC only has powers of persuasion in promoting adherence to its principles and guidance. It is principally a matter for shareholders to ensure that the board complies with the Code and runs the company effectively. Whilst the FRC has no business in intervening in the day-to-day management of companies to prevent them failing, it is responsible for maintaining confidence in the system of checks and balances which underpins the UK business environment by actively pursuing any failings in a timely manner, not least to act as a deterrent against future poor performance or misconduct.

146. In respect of Carillion, the FRC identified some concerns relating to disclosure of information as early as 2015. It reviewed the company's accounts as part of its regular cycle of corporate reporting reviews, the subject of which are determined by risk profiling and the identification of priority sectors.[423] It contacted the company in relation to twelve issues, ranging from a lack of clarity in goodwill assumptions to inadequate explanation of a significant decline in the book to bill ratio.[424] Carillion made the requisite disclosures in subsequent accounts,[425] but crucially, the FRC did not follow up by reviewing Carillion's accounts the following year, nor by investigating further. The Chief Executive of the FRC, Stephen Haddrill, told us that, "with hindsight, clearly it would have been better to have had a further look",[426] but that "we did not think that the lack of disclosure was symptomatic of something more serious".[427] The FRC had not reviewed the auditing of the Carillion accounts by KPMG since 2013.[428] In spite of subsequent reports of aggressive

422 Financial Reporting Council, About Us, accessed 23 April 2018
423 Letter from FRC to the Chairs, 2 February 2018
424 Letter from FRC to the Chairs, 2 February 2018. The book to bill ratio is the ratio of the number of orders received to the number billed for.
425 Q31 & Q39 [Stephen Haddrill]
426 Q33 [Stephen Haddrill]
427 Q50 [Stephen Haddrill]
428 Q35 [Stephen Haddrill]

accounting practices and evidence of the extensive shorting of Carillion stock, the FRC did not choose to take a closer look at the accounts of Carillion, nor the auditing of them, until after the first profit warning in July 2017.

147. Shortly after the collapse of Carillion in January 2018, the FRC announced that it had been "actively monitoring this situation for some time in close consultation with other relevant regulatory bodies".[429] This was not, however, active monitoring of the accuracy of disclosure of information by the company; it was instead a review of the previous audit begun in July 2017.[430] The fact that this review was underway could not be made public until after the company's collapse due to confidentiality requirements, which Stephen Haddrill told us he had been trying to get around in some respects and were in need of review.[431]

148. On January 29 2018 the FRC announced an investigation into the auditing by KPMG of Carillion's financial statements from 2014 onwards under its audit enforcement procedure.[432] On 19 March 2018 it announced specific investigations into the conduct of Richard Adam and Zafar Khan, in relation to the preparation and approval of Carillion's financial statements during this period.[433] Under its existing powers, the FRC can only take action against those with accounting qualifications. Stephen Haddrill told us that the FRC would conduct these inquiries "as fast as possible" but could not estimate any timescale.[434] The FRC routinely aims to complete such investigations in around two years.[435] Mr Haddrill told us that the FRC's enforcement team had been increased from 20 to 29 since January 2016, with further expansion planned. **While we welcome the swift announcement of investigations into the audit of Carillion and the conduct of the Finance Directors responsible for the accounts, we have little faith in the ability of the FRC to complete important investigations in a timely manner. *We recommend changes to ensure that all directors who exert influence over financial statements can be investigated and punished as part of the same investigation, not just those with accounting qualifications.***

149. **The FRC was far too passive in relation to Carillion's financial reporting. It should have followed up its identification of several failings in Carillion's 2015 accounts with subsequent monitoring. Its limited intervention in July 2017 clearly failed to deter the company in persisting with its over-optimistic presentation of financial information. The FRC was instead happy to walk away after securing box-ticking disclosures of information. It was timid in challenging Carillion on the inadequate and questionable nature of the financial information it provided and wholly ineffective in taking to task the auditors who had responsibility for ensuring their veracity.**

429 Financial Reporting Council Statement Regarding Carillion, 15 January 2018
430 Q34 & Q59 [Stephen Haddrill]
431 Qq64–65 [Stephen Haddrill]
432 Financial Reporting Council, Investigation into the audit of the financial statements of Carillion plc, 29 January 2018
433 Financial Reporting Council, Investigation into the preparation and approval of the financial statements of Carillion plc, 19 March 2018
434 Q3 [Stephen Haddrill]
435 Letter from FRC to the Chairs, 6 July 2016. We note that this period has almost expired in relation to the investigation into the audit by PwC of the BHS accounts.

Role of Government

Crown Representative

150. Crown Representatives were introduced in 2011 to "manage the relationship between Government and each of its strategic suppliers", and act as a focal point of for their contact with Government.[436] Carillion easily met the definition of a strategic supplier.[437] Philip Green described Carillion's relationship with its Crown representative as "transparent" and the "key relationship" it had with Government.[438] Richard Howson said he met with the Crown Representative each quarter and on an ad hoc basis in between.[439]

151. As part of its management of key strategic suppliers, the Cabinet Office is responsible for monitoring "publicly available sources for financial information […] including in particular information about "trigger events" that could potentially lead to the invocation of financial distress measures in Government contracts".[440] Such information is expected to be shared with the Crown Representative to discuss with the supplier. A profit warning is one such trigger event.[441] Carillion issued three profit warnings between July and November 2017, yet between August and November 2017 there was no Crown Representative in place for Carillion, owing to "normal staff turnover".[442] The Government have conceded that this was a "longer-than-usual delay" as they sought someone with experience of corporate restructuring rather than company finances.[443] Officials maintained that the July profit warning was a complete surprise to them, but that contact was subsequently stepped up, and 25 meetings between the Government and Carillion were held between July and January.[444]

152. **The assignment of a Crown Representative to Carillion served no noticeable purpose in alerting the Government to potential issues in advance of company's July 2017 profit warning. The absence of one between August and November 2017 cannot have increased the Government's ability to keep itself informed of the direction of the company during a critical period before its collapse.**

Government support

153. Carillion formally approached the Government to ask for financial assistance on 31 December 2017, when it became clear that it was a prerequisite of discussions with existing lenders about further support.[445] Though the Government was by that stage involved in

436 Cabinet Office, Strategic supplier risk management policy, November 2012
437 The Strategic supplier risk management policy defines a strategic supplier as "those suppliers with contracts across a number of Departments whose revenue from Government according to Government data exceeds £100m per annum and/or who are deemed significant suppliers to Government in their sector."
438 Q7 [Philip Green]
439 Q9 [Richard Howson]
440 Cabinet Office, Strategic supplier risk management policy, November 2012
441 *As above.*
442 PQ 124135 [on Carillion], 7 March 2018
443 Letter from the Secretary of State for Business, Energy and Industrial Strategy to the Chairs, 30 April 2018
444 Oral evidence taken before the Liaison Committee on 7 February 2018, HC 770 (2017–19), Q44 [John Manzoni]
445 High Court of Justice, In the matter of Carillion plc and in the matter of the Insolvency Act 1986, Exhibit: KC1 - First witness statement of Keith Robertson Cochrane, Dated: 15 January 2018 (Not published).

discussions with Carillion, the only relief they had granted the company was a deferral of tax liabilities under a HMRC "time to pay arrangement" worth £22 million in October 2017.[446]

154. Discussions with the Government continued over the first two weeks of 2018. The company made a further request to HMRC to defer tax liabilities totalling £91 million across the first four months of 2018. HMRC refused to accept the request at that point, stating that it would have to be referred to their Commissioners.[447] On 13 January 2018, Philip Green wrote a final letter to the Cabinet Office making the case for Government to provide guarantees of up to £160 million to the company between January and April 2018.[448] Unless this money was provided, Mr Green noted the probability that they would have to file for insolvency. He claimed it was in Government's best interest to provide this funding because they did not have a viable contingency plan in place and allowing Carillion to fall into liquidation would "come with enormous cost to HM Government, far exceeding the costs of continued funding for the business". Mr Green argued that in such a scenario that there would be "no real ability to manage the widespread loss of employment, operational continuity, the impact on our customers and suppliers, or (in the extreme) the physical safety of Carillion employees and the members of the public they serve".[449]

155. The Government ignored these claims, aimed at propping up a failing business model, and rejected the request. Ministers rightly argued that "taxpayers should not, and will not, bail out a private company for private sector losses or allow rewards for failure".[450] £150 million was made available by the Government to support the insolvency in 2017–18, as well as an unquantified contingent liability to indemnify the Official Receiver.[451]

156. **In his last-minute ransom note, Philip Green clearly hoped that, faced with the imminent collapse of Carillion, Government would conclude it was too big to fail. But the Government was correct not to bail out Carillion. Taxpayer money should not be used to prop up companies run by such negligent directors. When a company holds 450 contracts with the Government, however, its collapse will inevitably have a signficant knock-on effects for the public purse. It is simply not possible to transfer all the risk from the public to the private sector. There is little chance that the £150 million of taxpayer money made available to support the insolvency will be fully recovered.**

Insolvency Service

157. The Minister for the Cabinet Office, the Rt Hon David Lidington MP, told the Liaison Committee that, in the absence of a Government bailout, there were only two options for the company:

- a "managed and orderly" liquidation supported by the Official Receiver, part of the Government's Insolvency Service; or

446 Carillion plc, Weekly reporting pack, 27 October 2017 (not published)
447 High Court of Justice, In the matter of Carillion plc and in the matter of the Insolvency Act 1986, Exhibit: KC1 - First witness statement of Keith Robertson Cochrane, Dated: 15 January 2018 (Not published).
448 Carillion plc, Summary of short term funding proposal and status update, 13 January 2018
449 Letter from Philip Green to Permanent Secretary to the Cabinet Office, 13 January 2018
450 HC Deb, 15 January 2018, col 624
451 HM Treasury, Central Government Supply Estimates 2017–18 Supplementary Estimates, February 2018, p 475 and p 496

- a "disorderly liquidation" that would have seen mass redundancies, contracts terminated and the potential loss of public services.[452]

Sarah Albon, Chief Executive of the Insolvency Service told us that private insolvency practitioners were unwilling to take on the administration because there was not "certainty that there was enough money left in the company to pay their costs".[453] At 6.40am on 15 January 2018, the High Court granted a winding-up order for Carillion plc and five subsidiaries,[454] appointing David Chapman, the Official Receiver, as liquidator.[455]

Box 4: Administration or liquidation

Administration provides for the potential rescue of the company or its business. Once an administration order is in place, a moratorium protects the company from legal actions whilst a survival plan or an orderly wind-down of the company's affairs is being achieved. Administration allows a company to continue to operate as the administrator attempts to find a buyer for all or part of the business.

Liquidation does not allow for a potential rescue of the company. The company stops trading, employees are made redundant, assets are collected and sold and the proceeds are used to pay company debts. At the end of the liquidation, creditors are paid as much as possible and the company ceases to exist.[456]

158. The Official Receiver took on two major roles. First, it had to act as liquidator with responsibility to sell Carillion's assets and distribute the returns to creditors.[457] Untangling Carillion's businesses and contracts required work at an unprecedented scale for the Insolvency Service.[458] This was not helped by the administrative chaos in which Carillion was left.[459] In particular, the Official Receiver found an absence of basic records.[460] Second, and far more unusually, the Official Receiver was required by Government to take over the running of the wide range of public services provided by Carillion. Given the unique scale of work required to both manage the insolvency and maintain services,[461] the Official Receiver applied to the High Court at the time of the winding-up petition to appoint Special Managers to assist him.[462] Since the liquidation process began, the Official Receiver has secured the employment of more than 11,000 former Carillion employees, ensured the continued operation of public services, and reduced payment times for suppliers from Carillion's 120 day terms to 30 days.[463] We welcome the work undertaken by the Official Receiver and his team since the insolvency, although we regret that more than 2,000 Carillion employees have been made redundant.[464] **The Official Receiver agreed to**

452 Oral evidence taken before the Liaison Committee on 7 February 2018, HC 770 (2017–19), Q104 [David Lidington]
453 Q115 [Sarah Albon]. Keith Cochrane confirmed that PwC and EY declined to act as administrators. See High Court of Justice, In the matter of Carillion plc and in the matter of the Insolvency Act 1986, Exhibit: KC1 - First witness statement of Keith Robertson Cochrane, Dated: 15 January 2018 (Not published).
454 Carillion Construction Limited, Carillion Services Limited, Planned Maintenance Engineering Limited, Carillion Integrated Services Limited, and Carillion Services 2006 Limited.
455 Letter from Official Receiver to the Chairs, 5 February 2018
456 *The collapse of Carillion*, Briefing Paper 8206, House of Commons Library, March 2018
457 HC Deb 15 January 2018, Col 624
458 Q1332 [David Kelly]
459 "Lack of political support doomed Carillion", Financial Times, 20 January 2018
460 Q110 [Sarah Albon]
461 The Official Receiver has been supported by around 3,200 retained Carillion staff (as at 1 May 2018).
462 Insolvency Service, Official Receiver's Update, 23 April 2018
463 Insolvency Service, Official Receiver's Update, 23 April 2018; Letter from Insolvency Service to the Chairs, 15 February 2018
464 Insolvency Service, Official Receiver's Update, 23 April 2018

support compulsory liquidation, and sought the appointment of Special Managers, in the best interests of the taxpayer and has sought to achieve the best possible outcome for employees, suppliers and other creditors.

Special Managers

159. In a letter to us, the Official Receiver explained that due to the speed of the final collapse of Carillion, he was unable to tender for the Special Managers he needed to support him. Instead, he made an immediate choice based on the criteria of "a firm that was not conflicted; which had sufficient resources to undertake this complex liquidation; and that had some existing knowledge of the Carillion group".[465] It is difficult to envisage how a company might have knowledge of Carillion and not be conflicted. However, the Official Receiver decided, and the High Court concurred, that PwC best met these criteria. PwC had undertaken a range of work for, or relating to Carillion, in the decade leading up to its collapse.[466] Most recently, it had supported the Cabinet Office in its cross-Government contingency planning for Carillion, up to and including advice on insolvency and the continuity of public services.[467] David Kelly, one of the PwC Special Managers, told us that he believed Carillion's work preparing Government for Carillion's insolvency did not represent a conflict.[468] This is questionable. But the requirement for "sufficient resources", which required large numbers of staff to start work on the insolvency within 12 hours of notification,[469] limited the options to the Big Four accountancy firms.[470] Despite PwC's extensive prior involvement in Carillion, given that KPMG was Carillion's external auditor, Deloitte its internal auditor and EY was responsible for its failed rescue plan, it was certainly credible for the Official Receiver to consider those other Big Four companies *more* conflicted. We consider competition and the Big Four in Chapter 3. **In applying to the Court to appoint PwC as Special Managers to the insolvency, the Official Receiver was seeking to resource a liquidation of exceptional size and complexity as quickly and effectively as possible from an extremely limited pool.**

160. The administrative costs of the liquidation, underwritten by the taxpayer, consist primarily of the work of the Official Receiver and his team, and of the Special Managers and other PwC staff that support them. In appointing the Special Managers, the High Court is also responsible for approving their remuneration by an application from the Official Receiver from time to time.[471] In March 2018 we took evidence from one of the Special Managers, David Kelly, and sought an update on the costs, and potential costs to the taxpayer of PwC's work. Mr Kelly, who is charged out at £865 per hour, told us that the cost of his firm's first eight weeks of work would be £20.4 million.[472] PwC's staff were working at an average hourly rate of £360 per hour, and they had 112 people working on Carillion in the week prior to their evidence. Mr Kelly was able to give no indication of the daily cost of the liquidation, no suggestion of the number of PwC staff that would be required even just a week into the future, and no estimate at all of what PwC's total fees would be at the conclusion of their work.[473] Across their 15 to 16 workstreams, PwC were

465 Letter from the Official Receiver to the Chairs, 5 February 2018
466 Letter from PwC to the Chairs, 2 February 2018
467 Q1329 [David Kelly]
468 Q1330 [David Kelly]
469 Q1332 [David Kelly]
470 PwC, KPMG, Deloitte and EY.
471 Letter from the Official Receiver to the Chairs, 5 February 2018
472 Q1333 and Q1367 [David Kelly]
473 Qq1332 – 65 [David Kelly]

unable to suggest any performance indicators for their success, beyond the underpinning priority of the maintenance of critical Government services.[474] While the Official Receiver and the High Court will be able to review and challenge PwC's fees,[475] we heard little evidence of challenge or scrutiny of the work of the Special Managers to date. The PPF told us that under normal insolvency procedures, their role as an unsecured creditor—when a company collapses with a pension deficit they are often the largest—gives them rights, which they take-up, to scrutinise the work and fees of the administrators or liquidators. They have no formal role, however, in scrutinising the work of the Special Managers.[476]

161. **We are concerned that the decision by the court not to set any clear remuneration terms for PwC's appointment as Special Managers, and the inability of the appointees to give any indication of the scale of the liquidation, displays a lack of oversight. We have seen no reliable estimates of the full administrative costs of the liquidation, and no evidence that Special Managers, the Official Receiver or the Government have made any attempt to calculate it. We have also seen no measures of success or accountability by which the Special Managers are being judged.**

162. **As advisors to Government and Carillion before its collapse, and as Special Managers after, PwC benefited regardless of the fate of the company. Without measurable targets and transparent costs, PwC are continuing to gain from Carillion, effectively writing their own pay cheque, without adequate scrutiny.** ***When the Official Receiver requires the support of Special Managers, these companies must not be given a blank cheque. In the interests of taxpayers and creditors, the Insolvency Service should set and regularly review spending and performance criteria and provide full transparency on costs incurred and expected future expense.***

Corporate law

Wrongful trading

163. From the tone of the letter sent to the Government on 13 January, it appears that the Carillion board expected the Government to provide the necessary guarantees to keep the company afloat. It states that "to date, the board has been able to conclude that, for so long as key stakeholders (including HM Government) continue to engage meaningfully in relation to the provision of short term funding and a longer term restructuring, it is appropriate to continue".[477] We do not have information on the substance of the conversations between the board and Cabinet Office officials during the preceding weeks, but it is difficult to believe that the Government would have given an indication that Carillion could expect long-term support, given the clear policy on private sector bailouts enunciated by the Minister. It must have been clear by the end of December, if not much earlier, that an injection of capital from another source was out of the question. Without Government support, insolvency or liquidation must have seemed inevitable. This calls into question whether the board was engaged in wrongful trading.

164. Under insolvency law, a director may be guilty of wrongful trading if they knew, or ought to have known, that there was "no realistic prospect" of the company avoiding

474 Q1345 [David Kelly, Marissa Thomas]
475 *As above.*
476 Letter from PPF to the Chair, 20 February 2018
477 Letter from Philip Green to Permanent Secretary to the Cabinet Office, 13 January 2018

liquidation or administration.[478] Once an insolvency process becomes inevitable, directors are obliged to seek to minimise the loss to the company's creditors. By January 2018, if not before, it must have been clear to the board that only a bailout from Government could save the company. It is of course up to the courts to determine, following any application from the liquidator, whether any offence was committed, and in respect of what period. **Given that, as far as we know, no indications had been given that a bailout would be forthcoming, and that the board apparently took no steps to minimise the potential loss to creditors, there must at least be a question as to whether individual directors could reasonably be accused of wrongful trading.**

Directors' duties

165. Under section 172 of the Companies Act 2006, a director is required to act "in a way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole". In doing so, directors are required to "have regard to" a wide range of considerations, including "the likely consequences of any decision in the long term", "the interests of the company's employees", the need to foster the company's business relationships with suppliers, customers and others", and "the desirability of the company maintaining a reputation for high standards of business conduct".[479] Board minutes from 15 December 2017, exactly one month before the liquidation, show that Philip Green specifically reminded the board of these duties, and of previous advice on them from legal advisors.[480] However, we have seen that, at the very least, there are questions to be asked about the extent to which Carillion's directors had regard to each of these considerations in running the company. Breaches of these duties can form the basis of proceedings brought by the Secretary of State for disqualification as a director under the Disqualification of Directors Act 1986.

166. In Chapter 1, we argued that the business model was based on generating new business rather than pursuing the long-term strategic interests of the company. We also argued that managers had little regard to the need to foster business relationships with suppliers: late payment practices took advantage of smaller suppliers as a matter of practice. This approach was at odds with any notion of maintaining a reputation for high standards of business conduct. We have also argued that the board failed to look after the interests of their employees and former employees by under-funding their pension schemes in favour of cash elsewhere. **In evidence to us, Carillion's board members did not give the impression that they were acutely conscious of the wide range of legal duties they had, nor of the prospect of any penalties arising from failure in this regard. It is difficult to conclude that they adequately took into account the interests of employees, their relationships with suppliers and customers, the need for high standards of conduct, or the long-term sustainability of the company as a whole. Any deterrent effects provided by section 172 of the Companies Act 2006 were in this case insufficient to affect the behaviour of directors when the company had a chance of survival.** ***We recommend that the Insolvency Service, as part of its investigation into the conduct of former directors of Carillion, includes careful consideration of potential breaches of duties under the Companies Act as part of their assessment of whether to take action for those breaches or to recommend to the Secretary of State action for disqualification as a director.***

478 Insolvency Act 1986, sections 214(2) and 246ZB(2)
479 Companies Act 2006, section 172(1)
480 Carillion plc, Minutes of the board of directors, 15 December 2017 (not published)

Box 5: Section 172 of the Companies Act 2006

172 Duty to promote the success of the company.

1. A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to—

a) the likely consequences of any decision in the long term,

b) the interests of the company's employees,

c) the need to foster the company's business relationships with suppliers, customers and others,

d) the impact of the company's operations on the community and the environment,

e) the desirability of the company maintaining a reputation for high standards of business conduct, and

f) the need to act fairly as between members of the company.

2. Where or to the extent that the purposes of the company consist of or include purposes other than the benefit of its members, subsection (1) has effect as if the reference to promoting the success of the company for the benefit of its members were to achieving those purposes.

3. The duty imposed by this section has effect subject to any enactment or rule of law requiring directors, in certain circumstances, to consider or act in the interests of creditors of the company.

Winners and losers

167. **The consequences of the collapse of Carillion are a familiar story. The company's employees, its suppliers, and their employees face at best an uncertain future. Pension scheme members will see their entitlements cut, their reduced pensions subsidised by levies on other pension schemes. Shareholders, deceived by public pronouncements of health, have lost their investments. The faltering reputation of business in the eyes of the public has taken another hit, to the dismay of business leaders. Meanwhile, the taxpayer is footing the bill for ensuring that essential public services continue to operate. But this sorry tale is not without winners. Carillion's directors took huge salaries and bonuses which, for all their professed contrition in evidence before us, they show no sign of relinquishing. 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 richly compensated. In some cases, they continue to profit from Carillion after its death. Carillion was not just a failure of a company; it was a failure of a system of corporate accountability which too often leaves those responsible at the top—and the ever-present firms that surround them—as winners, while everyone else loses out.** It is to the wider lessons of Carillion's collapse that we now turn.

3 Lessons

Government responsibilities

168. It will always be the case that even well-run companies will sometimes take poor decisions and be the authors of their own demise; no Government can prevent business failures. However, there are a number of lessons arising from the collapse of Carillion which may help to reduce the risks and impact of any future failures. These can be split into two categories. First, there are lessons for the Government on the way in which they manage the relationship with a company of such strategic importance. These are primarily matters for the Public Administration and Constitutional Affairs Committee. Second, the collapse of Carillion raises a series of questions about the wider business and pensions environment, for which the Government has ultimate responsibility, albeit much of it delegated to various regulators. The Government is responsible for ensuring that our current structure of stakeholder interests and incentives are balanced to best serve the public interest, and for ensuring that there is effective enforcement when things go wrong. Some of these issues are outlined below.

Government relationships with strategic suppliers

169. The wider implications of the collapse of Carillion for the way in which the Government outsources public services are currently the subject of an inquiry by the Public Administration and Constitutional Affairs Select Committee.[481] We therefore do not explore this whole business model here and look forward to their report. But it is clear that the role of the Crown Representative is particularly in need of review. We noted in Chapter 2 the unfortunate absence of a Crown Representative in Carillion at a critical period, but we question whether the role as it stands is suited to the task of ensuring that the Government's and the taxpayers' interests are being properly served. Where a company is providing so many key services for Government, it is essential that the Government can maintain confidence in that company's ability to deliver for the period it is contracted to do so. Carillion was a hugely complex company, it operated in the highly volatile construction and outsourcing services markets, and it entered into long contracts with uncertain returns. It seems inconceivable that a credible oversight function could be performed properly by an examination of published accounts and quarterly meetings with the board. Some individual Crown Representatives are responsible for three separate strategic suppliers: for example, the Crown Representative for Capita also covers Fujitsu and Motorola.[482] A deeper engagement with the business at all levels is required, to gain an understanding of the company's culture (for example, with regard to the timeliness of payments) and to enable any concerns affecting Government contracts to be detected and escalated early. While this may be a costlier system, that expenditure should be set against the actual costs now being incurred by the Government intervention to keep public services running following Carillion's collapse. ***We recommend that the Government immediately reviews the role and responsibilities of its Crown Representatives in the light of the Carillion case. This review should consider whether devoting more resources to liaison with strategic suppliers would offer better value for the taxpayer.***

481 Public Administration and Constitutional Affairs Select Committee, Sourcing public services: lessons learned from the collapse of Carillion inquiry

482 Cabinet Office and Crown Commercial Service, Transparency Data: Crown Representatives and Strategic Suppliers, accessed 1 May 2018

Prompt Payment Code

170. The issue of late payments is not limited to Carillion. Ahead of the 2018 Spring Statement, the FSB published research showing 84% of small firms report being paid late, with 37% finding that agreed payment terms have lengthened in the past two years, hampering cash flow. Only 4% see payment terms improving.[483] We welcome the Chancellor's subsequent call for evidence on late payments in his statement;[484] however, this is little comfort for Carillion's suppliers and for others whose businesses are put at risk by late payers. The BEIS Committee will be considering the effectiveness of the Prompt Payment Code and its enforcement as part of its ongoing inquiry into small businesses and productivity.[485]

Corporate Culture

171. Responsibility for the wider business environment and culture is shared among Government, regulators and, of course, business itself. Business culture is set primarily by board members, who must act in accordance with duties set out in section 172 of the Companies Act 2006. Whether or not this law turns out to have been breached by Carillion's directors, this case indicates that it is an inadequate influence on corporate behaviour. There is no realistic chance of shareholders bringing actions against board members for breach of their duties, given the impact such action would have on the share price.[486] In its report on Corporate Governance, the former BEIS Committee flagged up the ineffectiveness of section 172, but also recognised the difficulties of achieving sufficient legal clarity to influence decision making in the boardroom without presenting an unreasonable degree of legal exposure.[487] It advocated more specific and accurate reporting on the fulfilment of section 172 duties, combined with robust enforcement. The Government has accepted this recommendation but the necessary regulations required to implement the changes have still not been laid before Parliament.

172. Whilst the UK has in many respects an enviable system of corporate governance that helps to attract investment from around the world, too often the high-profile company failings exposed recently have arisen from rotten corporate cultures. We came across the systematic exploitation of workers, and inadequate rights that are meant to protect them, by some companies in our joint work on the Taylor Review of modern working practices.[488] Examples of unjustified executive pay are by no means confined to Carillion, nor is the poor treatment of suppliers. Effective corporate governance is required to ensure responsible business ownership and to protect workers: it should not be left to the courts to clear up the corporate mess.

483 Federation of Small Businesses, Small firms urge Chancellor to speak out on late payment crisis costing economy billions,accessed 23 April 2018

484 HC Deb, 13 March 2018, col 720

485 Business, Energy and Industrial Strategy Committee, Small businesses and productivity inquiry, accessed 25 April 2018

486 Kiltearn Partners report that they were interested in pursuing legal action against board members in respect of the liability of issuers in connection with published information, under section 90A and Schedule 10A, Part 2 of the Financial Services and Markets Act 2000.

487 Business, Energy and Industrial Strategy Committee, Third Report of Session 2016–17, Corporate Governance, HC 702, April 2017, para 25–31

488 Work and Pensions and Business, Energy and Industrial Strategy select committees, A framework for modern employment, HC 352, November 2017

173. The Government has already begun to respond to some of these lessons, through the amendments to directors' duties we have described, and to insolvency law. The White Paper on Insolvency and Corporate Governance published in March 2018 directly addresses some of the issues that our predecessor Committees raised in relation to BHS, and some relevant to the collapse of Carillion. These include proposals to:

a) Strengthen governance, accountability and internal controls within complex company structures;

b) Improve transparency around the payment of dividends and the circumstances in which they can be paid;

c) Improve the awareness of directors about the use of professional independent advisors;

d) Better protect supply chains and other creditors whilst preserving the primacy of the interests of shareholders.[489]

We welcome the Government's consultation on implementing some technical reforms arising from recent company collapses. However, we do not believe that these changes, even if successfully enacted, would have prevented the corporate failures we have seen, nor tackle some of the systemic weaknesses in our corporate frameworks that enable these periodic disasters to occur.

174. The BEIS Committee is currently looking at different aspects of corporate governance, starting with action to improve the gender pay gap and to curb unjustifiably high executive pay. It plans to revisit the implementation by Government and regulators of some of the major lessons arising from the demise of BHS, Carillion and other corporate failures and to look at the extent to which corporate law supports the Government's industrial strategy, not least in respect of takeovers.

Investors and stewardship

175. We set out in Chapter 2 the different approaches adopted by major shareholders and the collective failure of their combined stewardship responsibilities. Under the rules governing engagement, conversations between investor and company generally occur on a bilateral basis, other than in situations of corporate or economic stress.[490] There are also requirements preventing the release of information that is not available to other investors and constraints on acting in concert in the Takeover Code. The BEIS Committee explored in its report on corporate governance the potential for the UK Investor Forum to provide a basis for concerted action in limited cases, but noted also the challenges presented by the trends towards highly dispersed share ownership and passive rather than managed funds.[491] Proper engagement can be resource-intensive and—if the board is unreceptive—ineffectual, as with Carillion. In this scenario, it can make sense just to divest, or to stay in but rely on other institutional investors to engage effectively. There is also a strong financial

489 Department for Business, Energy and Industrial Strategy, Insolvency and Corporate Governance, March 2018, p 6
490 Financial Reporting Council, Stewardship Code, Principle 5
491 Business, Energy and Industrial Strategy Committee, Third Report of Session 2016–17, Corporate Governance, HC 702, April 2017, para 44 - 52

interest for shareholders not to say anything in public which may have an adverse impact on the share price. This might help to explain why the press and Parliament sometimes appear to do a better job of holding company boards to account than shareholders.

176. The potential consequences of what some have characterised "ownerless companies", subject to the whims of increasingly short-termist investors, have been subject to much debate and deserve consideration in the context of the Government's industrial strategy. Some of the issues were highlighted in the recent hostile takeover of the supplier GKN by the turnaround specialist, Melrose. They won the battle for ownership of the company with promises of higher returns to shareholders, with a business model that envisages relatively short-term ownership. They were up against a company with a long history of supplying parts to the automotive and aerospace sectors, including defence-related components, in the UK and US. Whatever the objectives of the Government's industrial strategy to support the development of productive sectors and supply chains in the UK, there is nothing in law or governance codes that requires investors to do anything other than look after their own interests. These may or may not align with those of the board, employees, or the long-term aspirations of the sector and government.

177. The Government has recognised that there is a problem. In its consultation on Insolvency and Corporate Governance, it includes a section on shareholder responsibilities in which it argues that "recent corporate failures make it right to ask whether a larger proportion of institutional investors could be more active and engaged stewards and whether more could be done to ensure that company directors and their investors engage constructively."[492] It asks for submissions on what changes could be made to the Stewardship Code to promote engaged stewardship, including the active monitoring of risk. It includes as possible options for reform:

- Amendments to the Stewardship Code to provide more detail on how investors should consider long-term sustainability;
- Promoting better reporting of stewardship outcomes by investors, as opposed to just reporting on process;
- Establishing a requirement in the Code for asset managers to monitor and engage on how directors have fulfilled their section 172 requirements;
- The establishment of an expert "stewardship oversight group" to review significant corporate failings and ensure that lessons are learnt.[493]

This last option is reactive and of questionable impact, although fully in line with the tone of regulatory intervention in the corporate realm. It is odd that the Government itself is inviting submissions on reforms to the Stewardship Code when the FRC is already committed to an overhaul of that Code later this year and the Government has previously referred recommendations relating to the Stewardship Code to the FRC review.[494]

178. In its report on Corporate Governance, the previous BEIS Committee called for the revised Stewardship Code to provide more explicit guidelines on high quality engagement,

492 Department for Business, Energy and Industrial Strategy, Insolvency and Corporate Governance, March 2018, p 26

493 *As above*, p 27

494 Business, Energy and Industrial Strategy Committee, Second Special Report of Session 2017–19, Government Response to Third Report on Corporate Governance, HC 338, September 2017

requirements for greater transparency in the voting records of asset managers and an undertaking to call out poor performance on an annual basis.[495] Following the Committee's report the Government asked the Investment Association to establish a public register of those companies experiencing a dissenting vote of more than 20% in any reporting year. This is now established and should help provide greater transparency on the effectiveness of company engagement with investors. The implementation of the EU Shareholder Rights Directive should also help to address short-termism and insufficient oversight of remuneration and related party transactions.[496]

179. The effective governance of companies and faith in our business culture relies upon the effective stewardship of major investors. They in turn rely upon accurate financial reporting and honest, constructive engagement with company boards. **The current Stewardship Code is insufficiently detailed to be effective and, as it exists on a comply or explain basis, completely unenforceable. It needs some teeth. Proposals for greater reporting and transparency in terms of investor engagement and voting records are very welcome and should be taken forward speedily. However, given the incentives governing shareholder behaviour, and the questionable quality of the financial information available to them, we are not convinced that these measures in themselves will be effective in improving engagement, still less in shifting incentives towards long-term investment and away from the focus on dividend delivery. A more active and interventionist approach is needed in the forthcoming revision of the Stewardship Code, including a more visible role for the regulators, principally the Financial Reporting Council.**

The Pensions Regulator

180. Carillion consistently refused to make adequate contributions to its pension schemes, favouring dividend payments and cash-chasing growth. It was a classic case for The Pension Regulator to use its powers proactively, under section 231 of the Pensions Act 2004, to enforce an adequate schedule of contributions. Rt Hon Esther McVey MP, the Secretary of State for Work and Pensions, concurred with this assessment, telling us that TPR should have used that power.[497] The other major corporate collapse the two Committees considered together, BHS, was also characterised by long-term underfunding of pension schemes. But the BHS case was different—the foremost concern in that case was the dumping of pensions liabilities through the sale of the company. The cases were, though, united by two key factors. First, a casual corporate disregard for pension obligations. And second, a pensions regulator unable and unwilling to take adequate steps to ensure that pensions promises made to staff were met.

181. The Work and Pensions Committee published a report on defined benefit (DB) pension schemes in December 2016.[498] This drew on the joint inquiry into BHS and subsequent work on the wider sector. The Committee recommended that TPR should regard deficit recovery plans of over ten years exceptional and that trustees should be given powers

495 Business, Energy and Industrial Strategy Committee, Third Report of Session 2016–17, Corporate Governance, HC 702, April 2017, para 55 and 60.

496 The Shareholder Rights Directive (EU) 2017/828 of the European Parliament and of the Council of 17 May 2017 came into force on 10 June 2017 and is due to be transposed into UK law by 10 June 2019.

497 Q1285 [Esther McVey]

498 Work and Pensions Committee, Sixth report of session 2016–17, Defined benefit pension schemes, HC 55, December 2016

to demand timely information from sponsors. It also recommended stronger powers for TPR in areas such as levying punitive fines to deter avoidance, intervening in major corporate transactions to ensure pensions are protected, and approving the consolidation and restructuring of schemes.[499] Many of the recommendations of that report were adopted by the Government in its March 2018 White Paper, *Protecting Defined Benefit Pension Schemes*. The Government now intends to consult on the details of the proposed additional TPR powers.

182. The Work and Pensions Committee has commenced an inquiry into the implementation of that White Paper.[500] The inquiry will be informed by the Committee's work on problematic major schemes, which has been primarily conducted through detailed correspondence and has considered:

- the long-term under-funding of pension schemes apparent in cases such as BHS, Palmer and Harvey, Monarch and Carillion;
- the suitability of buyers with short investment horizons, including some private equity firms, to assume responsibility for long term pensions liabilities, in cases such as GKN, Bernard Matthews and Toys R Us; and
- the potential risk to pension scheme covenants from corporate transactions, in cases such as Arcadia, Sainsbury's, Asda, Barclays, Trinity Mirror, Palmer & Harvey, and BHS.[501]

In the course of that work, it has become ever more apparent that, while some new powers are required, the problems in DB pensions regulation are primarily about the regulatory approach.

183. The Government and TPR recognise this concern and have pledged to act. The Secretary of State for Work and Pensions stressed that being " tougher, clearer, quicker" should be the "key focus" for a Pensions Regulator which would be "on the front foot".[502] TPR told us that, while it accepted that "over the last decade there have been times when the balance between employer and scheme may not always have been right", it was "a very different organisation from five years ago".[503] It is true that TPR has made changes:

- It has different leadership than at the height of its Carillion failings, Lesley Titcomb having been appointed Chief Executive in 2015;
- TPR has been given additional resources, including an additional £3.5 million in 2017–18 to support frontline casework;
- It has prioritised more proactive regulatory work and has set corporate performance indicators regarding quicker intervention in DB schemes that are underfunded or where avoidance is suspected;[504]

499 *As above.*
500 Work and Pensions Committee, Defined benefits white paper inquiry
501 Work and Pensions Committee, Defined Benefit Pensions
502 Q1285 and Q1304 [Esther McVey]
503 Letter from TPR to the Chairs, 16 March 2018
504 *As above.*

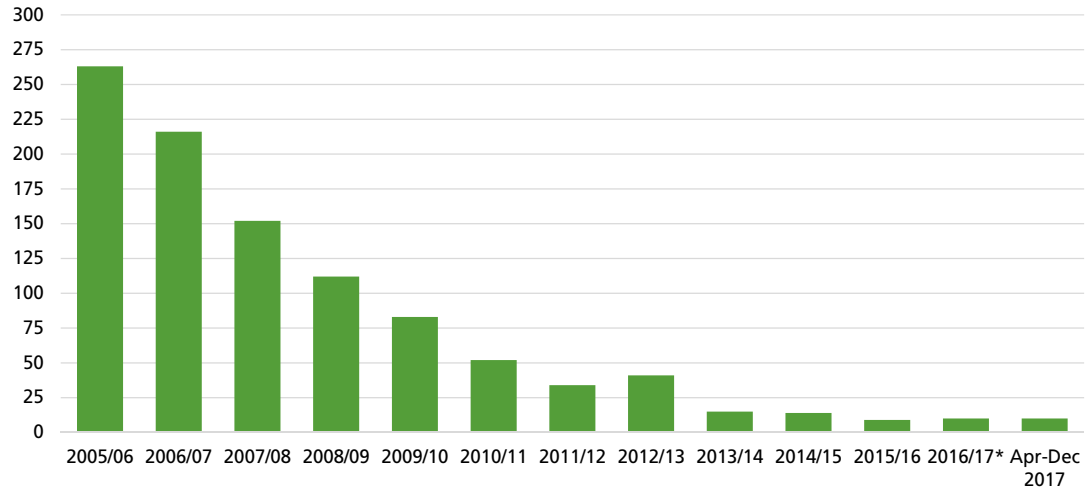
- Its performance measures now incorporate both the proportion of pension scheme members receiving reduced compensation and the extent to which schemes are adequately funded;[505]
- It has undertaken a period of self-analysis and change under the guise of the TPR Future programme;[506] and
- TPR is under more political pressure to focus on its core responsibility of protecting pensions.[507]

184. These are positive developments, but what has this meant in practice? We were deeply concerned by the evidence we received from TPR, which sought to defend the passive approach they and their predecessors had taken to the Carillion pension schemes. Lesley Titcomb told us that TPR had secured an improved recovery plan for the schemes having threatened the use of section 231 powers.[508] As we established in Chapter 2, the impact on the contributions received by the schemes was, at best, minimal. Mike Birch, said, with regard to section 231, "we do not threaten it when we do not think we would use it, so we were concerned".[509] However, in 13 years of DB scheme regulation, TPR has issued just three Warning Notices relating to its section 231 powers, and has not seen a single case through to imposing a schedule of contributions. In these circumstances, it is difficult to perceive a threat from TPR of using its section 231 powers as a credible deterrent. We have little doubt that the likes of Richard Adam took TPR's posturing with a pinch of salt; other finance directors with his dismissive approach to pensions obligations would do likewise.

185. The hollowness of TPR threats is not restricted to its powers to impose contributions. The Pensions Act 2004 established a process of voluntary clearance for corporate transactions such as sales or mergers. Under this process, TPR can confirm that it does not regard the transaction to be materially detrimental to the pension scheme.[510] It can therefore provide assurance that it will not subsequently use its powers to combat the avoidance of pension responsibilities, which could involve legal action and a requirement to contribute funds, in relation to the transaction.[511] Though clearance applications were common in the early years of TPR's existence, however, they soon fell rapidly into disuse:

505 The Pensions Regulator, Corporate Plan 2017–2020, April 2017
506 The Pensions Regulator, Protecting Workplace Pensions, accessed 1 May 2018
507 Letter from TPR to the Chair, 13 April 2018
508 Q731 [Lesley Titcomb]
509 Q671 [Mike Birch]
510 This calculation would incorporate any mitigatory measures such as the transfer of assets. It also takes into account the relative strength of the sponsor covenants before and after the transaction.
511 These are known as "anti-avoidance" or "moral hazard" powers.

Figure 8: Number of clearance cases handled by The Pensions Regulator



Sources: TPR freedom of information release 2016-02-10: "Numbers of cases of clearance relating to corporate transactions"; TPR Compliance and enforcement quarterly bulletins from April 2017 onwards; *Committee calculation based on the above.

TPR handled 263 clearance cases in 2005–06, but just 10 in 2016–17. This does not reflect a marked decline in corporate activity, but a realisation on the part of companies and their lawyers that threats from TPR are hollow: it is a paper tiger. There is little incentive to seek clearance to avoid being subject to powers that TPR has very rarely deployed with success.

186. The Government cited Sir Philip Green's settlement with the BHS pension schemes as evidence that TPR's anti-avoidance powers can be effective.[512] But that settlement was driven primarily by considerable public, press and parliamentary pressure. To stand independently in protection of pension promises, TPR needs to reset its reputation and demonstrate a marked break with hesitancy. Yet in evidence to us, TPR's current leadership defended its empty threats on Carillion, and displayed very little grasp of either which schemes were likely upcoming problem cases, or what TPR would do to protect the interests of members of those schemes.[513] It is difficult to imagine that any reluctant scheme sponsor watching would have been cowed by TPR's alleged new approach.

187. **The case of Carillion emphasised that the answer to the failings of pensions regulation is not simply new powers. The Pensions Regulator, and ultimately pensioners, would benefit from far harsher sanctions on sponsors who knowingly avoid their pension responsibilities through corporate transactions. But Carillion's pension schemes were not dumped as part of a sudden company sale; they were underfunded over an extended period in full view of TPR. TPR saw the wholly inadequate recovery plans and had the opportunity to impose a more appropriate schedule of contributions while the company was still solvent. Though it warned Carillion that it was prepared to do, it did not follow through with this ultimately hollow threat. TPR's bluff has been called too many times. It has said it will be quicker, bolder and more proactive. It certainly needs to be. But this will require substantial cultural change in an organisation where a tentative and apologetic approach is ingrained. We are far from convinced that TPR's current leadership is equipped to effect that change.** The Work and Pensions Committee will further consider TPR in its ongoing inquiry into the Defined Benefit Pensions White Paper.

512 Q1293 [Esther McVey]
513 Q707, Q712, Q718 [Lesley Titcomb]

Financial Reporting Council

188. The timid and reactive engagement by the Financial Reporting Council with Carillion underlines the conclusion of the previous BEIS Committee that enforcement of corporate governance responsibilities is not strong enough. The Committee's report recommended a more interventionist approach from an expanded and better-resourced FRC, including spot checks on companies to act as a deterrent against poor practice, and increased powers to allow it to initiate legal action against any director. The Government did not accept these ambitious recommendations. The Secretary of State for Business, Energy and Industrial Strategy, the Rt Hon Greg Clark MP, has consistently argued that the increased powers sought by the FRC are unnecessary. He told us that the powers that they need are there if they act jointly with the Insolvency Service and the Financial Conduct Authority.[514] To this end, these regulators have now signed a Memorandum of Understanding (MoU) to facilitate better use of their different powers when investigating the same company. Stephen Haddrill was not convinced that this was sufficient, telling us "as we saw before the financial crisis, regulators can collaborate and then they stop collaborating. I would like to see some structure around that".[515]

189. The present regulatory set up is convoluted and inconsistent. The FRC can pursue some directors, not others; monitor some reports but not others. There are too many regulators in the corporate kitchen, each with overlapping responsibilities but slightly different aims and agendas. Any government will know that it is hard enough to secure internal agreement, so to expect three or four regulators to cooperate seamlessly and harmoniously in pursuit of a common goal seems unrealistic and likely to slow down further already sluggish progress on investigations. Similar problems have been evident in pensions regulation. In its investigation into the British Steel Pension scheme, the Work and Pensions Committee found that steelworkers were gravely let down by two slow-moving and timid regulators—TPR and the FCA—who failed to co-ordinate to protect their pensions.[516]

190. The Government announced a review of the FRC on 17 March 2018, to be led by Sir John Kingman. The Government's stated objective of the review is to ensure that the FRC will remain "best in class" and the scope is wide: it aims to "ensure that its structures, culture and processes; oversight, accountability, and powers; and its impact, resources, and capacity are fit for the future."[517] It is not clear from the terms of reference or the evidence from the Secretary of State whether this review is an effort to revamp a body judged reluctant to throw its weight around, or a vehicle to re-examine the case for tougher regulation of company directors and further powers for the regulators.[518]

191. At present, the role of the FRC is confused. It is the professional regulator for accountants but also responsible for the voluntary codes that guide the behaviour of directors and investors. It has an apparently little-known role in investigating complaints

514 Q1251 [Greg Clark]
515 Q21 [Stephen Haddrill]
516 Work and Pensions Committee, British Steel Pension Scheme, Sixth Report of Session 2017–19, HC 828, February 2018
517 'Government launches review of audit regulator' Department for Business, Energy and Industrial Strategy Press Notice, 17 April 2018
518 Oral evidence taken before the Liaison Committee on 7 February 2018, HC 770 (2017–19), Q70 [David Lidington]

raised relating to its remit by whistle-blowers.[519] The quality of audits, as we have seen, is not of a consistently high standard. The FRC reports that 81% of FTSE 350 audits in 2016 required only limited improvement, meaning that 19% were significantly below standard: not a ringing endorsement of a high quality and competitive audit market.[520] Where standards fall below what is expected, the FRC is far too passive in demanding improvements and monitoring subsequent performance. It therefore offers no effective deterrent to sloppy auditing and accounting, and does nothing to dispel views that it is too sympathetic or close to the accountants and auditors it regulates.

192. The FRC does not appear to acknowledge a link, in terms of its responsibility, between adequate financial reporting, good corporate behaviour and the survival of companies. Stephen Haddrill told us that the FRC cannot see inside a company and does not oversee a system designed to stop companies collapsing. He argued against having powers to intervene in every company—there was a need for enterprise and must be room for failure—but advocated stronger powers to "be more transparent about the sorts of things we are finding."[521] This lack of transparency contributes to its inability to act as a credible threat to poor reporting practices. Companies can expect nothing more than a quiet word and encouragement to do better next time. There are signs that the FRC is beginning to adopt a more proactive approach.[522] In April 2018 it invited representatives from the investment community to form an Investors Advisory Group, to improve engagement between the FRC and the broad investor community. That month it also announced plans to enhance the monitoring of the six largest audit firms to, amongst other matters, "avoid systemic deficiencies within firms' networks".[523]

193. **This case is a test of the regulatory system. The Carillion collapse has exposed the toothlessness of the Financial Reporting Council and its reluctance to use aggressively the powers that it does have. There are four different regulators engaged, potentially pursuing action against different directors for related failings in discharging their duties. We have no confidence in the ability of these regulators, even with a new Memorandum of Understanding, to work together in a joined-up, rapid and coherent manner, to apportion blame and impose sanctions in high profile cases.**

194. **At present, the mindset of the FRC is to be content with apportioning blame once disaster has struck rather than to proactively challenge companies and flag issues of concern to avert avoidable business failures in the first place. We welcome the Government's review of the FRC's powers and effectiveness. We believe that the Government should provide the FRC with the necessary powers to be a much more aggressive and proactive regulator: one that can publicly question companies about dubious reporting, investigate allegations of poor practice from whistle-blowers and others, and can, through the judicious exercise of new powers, provide a sufficient deterrent against poor boardroom behaviour to drive up confidence in UK business standards over the long term. Such an approach will require a significant shift in culture at the FRC itself.**

519 According to the FRC's Annual Report for 2016–17, it received 12 such complaints that year and investigated further only two.

520 Financial Reporting Council, Developments in audit 2016–17, July 2017, p 5

521 Q78 [Stephen Haddrill]

522 Also, an independent review of the FRC's enforcement procedures sanctions in October 2017 made some technical recommendations but made no case for major change.

523 Financial Reporting Council, FRC to enhance monitoring of audit firms, 10 April 2018

The Big Four

195. Regulation should not be the sole driver of audit standards. As with other markets, competition between providers should place upwards pressure on the quality of services and downwards pressure on the price. KPMG's cursory approval of Carillion's annual accounts as external auditor for all 19 years of the company's existence bore none of the hallmarks of competition. This is far from an isolated problem: KPMG approved upbeat assessments of the state of HBOS months before the bank's spectacular 2008 collapse.

196. KPMG's close relationship with Carillion was not limited to its long tenure. Richard Adam, the longstanding Finance Director, and Emma Mercer, who took over that role, qualified as accountants at the firm.[524] This is far from unusual: the Competition Commission found that two-thirds of chief financial officers of large listed and private companies were Big Four alumni. Alongside regular audit fees, which averaged £1.5 million per year between 2008 and 2016, KPMG was paid £400,000 per year on average for additional taxation and assurance services.[525]

197. Unlike in other markets, incentives to enforce the quality of audit services are skewed. The primary users of the audited accounts are shareholders and potential shareholders, who rely on trusted information about public companies.[526] The audit is, however, paid for by the company, and directors can benefit from an auditor who is willing to turn a blind eye to sharp practice. This is particularly true when an established big-name brand brings credibility to financial statements. The auditor can expect a steady income for up to 20 consecutive years of audits. For example, in its report on KPMG audits of Pendragon, a motor retail group, the FRC found that the auditor operated with insufficient independence from the company.[527] The FRC is currently investigating KPMG's audits of the accounts of Rolls-Royce Group over a period when the engineering company admits it committed a series of bribery and corruption offences.[528] Murdo Murchison said he would write to the audit committee chairs of the two other UK listed companies Kiltearn Partners invests in audited by KPMG, seeking assurances about the quality of that work.[529] Euan Sterling, of Aberdeen Standard Investments, another company that invested in Carillion, said "reading a set of accounts is like reading a mystery novel".[530]

Reviews of competition in the audit market

198. Concerns about independence and audit quality are not restricted to KPMG. Together, the Big Four global accountancy firms, PwC, KPMG, Deloitte and EY, have dominated the audits of major UK companies since the implosion in 2002 of Arthur Andersen, the fifth member of what was then a Big Five. The Big Four oligopoly has been subject to two official UK competition inquiries:

524 Carillion plc, Annual Report and Accounts 2015, p 42; "Carillion, KPMG face Financial Reporting Council's biggest ever inquiry", Inside Business, 9 February 2018
525 Letter from KPMG to the Chairs, 2 February 2018
526 Competition Commission, Statutory audit services for large companies market investigation: summary of report, October 2013, para 6
527 Financial Reporting Council, Outcome of disciplinary case against KPMG Audit plc, a Member Firm of the ICAEW and Mr Greg Watts a partner of KPMG LLP, the parent of KPMG Audit plc, and a Member of the ICAEW, 3 February 2015
528 Financial Reporting Council, FRC launch investigation into KPMG in relation to the audit of the financial statements of Rolls-Royce Group, 4 May 2017
529 Q1128 [Euan Stirling]
530 Q1129 [Euan Stirling]

- in 2005, the Department for Trade and Industry and the FRC commissioned a study by Oxera, an economics consultancy, into competition and choice in the UK audit market, which reported in 2006;[531] and
- In 2011, following a recommendation by the House of Lords Economic Affairs Committee, the Office for Fair Trading referred the market for statutory audits of large companies to the Competition Commission (CC), which reported in 2013.[532]

199. Both studies found substantial barriers to effective competition. For example, the prospect of a new firm entering the market should loom as a healthy threat to incumbent firms. Oxera's report found that a rival to the Big Four was unlikely to emerge:

> Substantial entry is unlikely to be attractive, due to significant barriers, including the perception bias against mid-tier firms, high costs of entry, a long payback period for any potential investment, and significant business risks when competing against the incumbents in the market.[533]

It concluded that market entry by mid-market firms was only feasible if reputational bias against smaller firms was reduced and low rates of switching between auditors were increased.[534]

200. The Competition Commission found that systemic factors acted against switching. Tendering for audit was expensive and had uncertain benefits. The incumbent firm had the opportunity to respond to any dissatisfaction from the audited company. Furthermore, the incumbent auditors and the audited benefit from mutual understanding and continuity. The CC concluded that "companies are offered higher prices, lower quality (including less sceptical audits) and less innovation and differentiation of offering than would be the case in a well-functioning market".[535]

The audit market in 2018

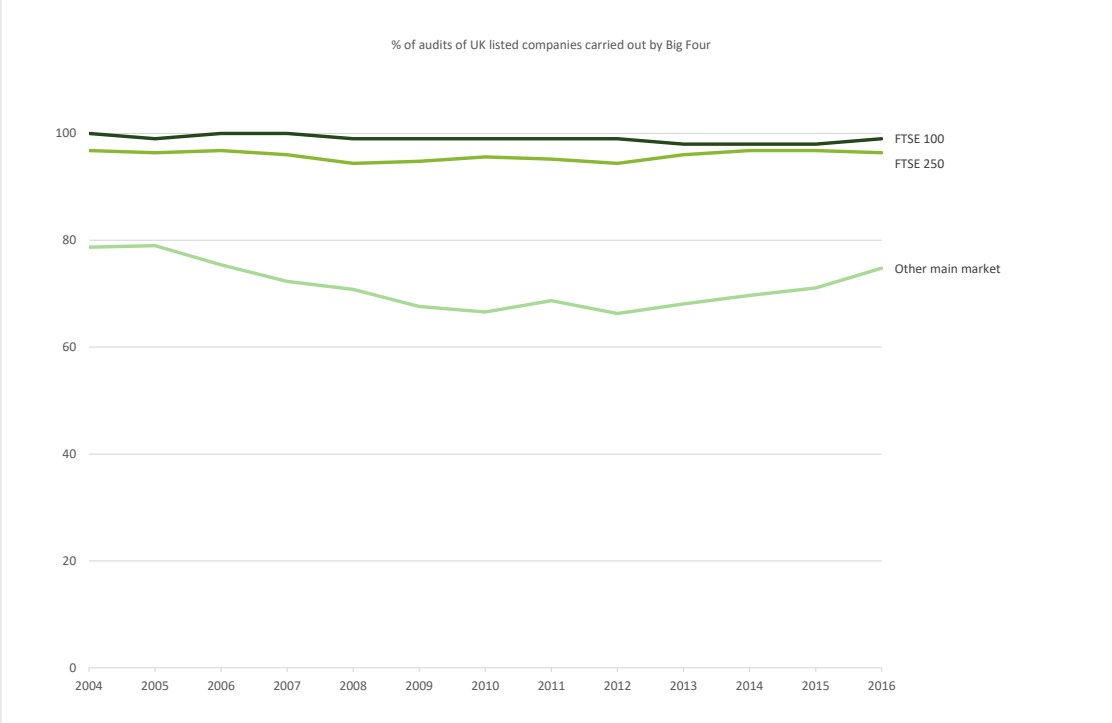
201. The Competition Commission recommended remedial measures to improve competition in the audit market. These were enacted by a 2014 Order by the Competition and Markets Authority (CMA), which replaced the Commission.[536] FTSE 350 companies must put their statutory audit out to tender at least every 10 years, and the maximum tenure is 20 years.[537] Measures were also taken to strengthen the accountability of the external auditor to a company's audit committee and reduce the influence of management.[538]

202. There is little sign, however, that those changes have had any substantial impact on the audit market. In 2016, the Big Four audited 99% of the FTSE 100 and 97% of the FTSE 250.[539] This dominance has been almost constant since the demise of Arthur Andersen.

531 Oxera, Competition and choice in the UK audit market, April 2006
532 Competition Commission, Statutory audit services for large companies market investigation, October 2013
533 Oxera, Competition and choice in the UK audit market, April 2006, executive summary page p i
534 *As above.*
535 Competition Commission, Statutory audit services for large companies market investigation, October 2013, para 34
536 Competition and Markets Authority, CMA finalises audit changes, 26 September 2014
537 Subject to transitional measures
538 Competition and Markets Authority, CMA finalises audit changes, 26 September 2014
539 Financial Reporting Council, Key Facts and Trends in the Accountancy Profession 2017, July 2017, p 45

If anything, the Big Four has further strengthened its grip. In 2016, it audited 75% of listed firms outside the FTSE 250 for the first time since 2006. The Secretary of State for Business, Energy and Industrial Strategy has argued that "increasing capacity in the FTSE 350 audit market would clearly be beneficial".[540]

Figure 9: Sustained market domination by the Big Four



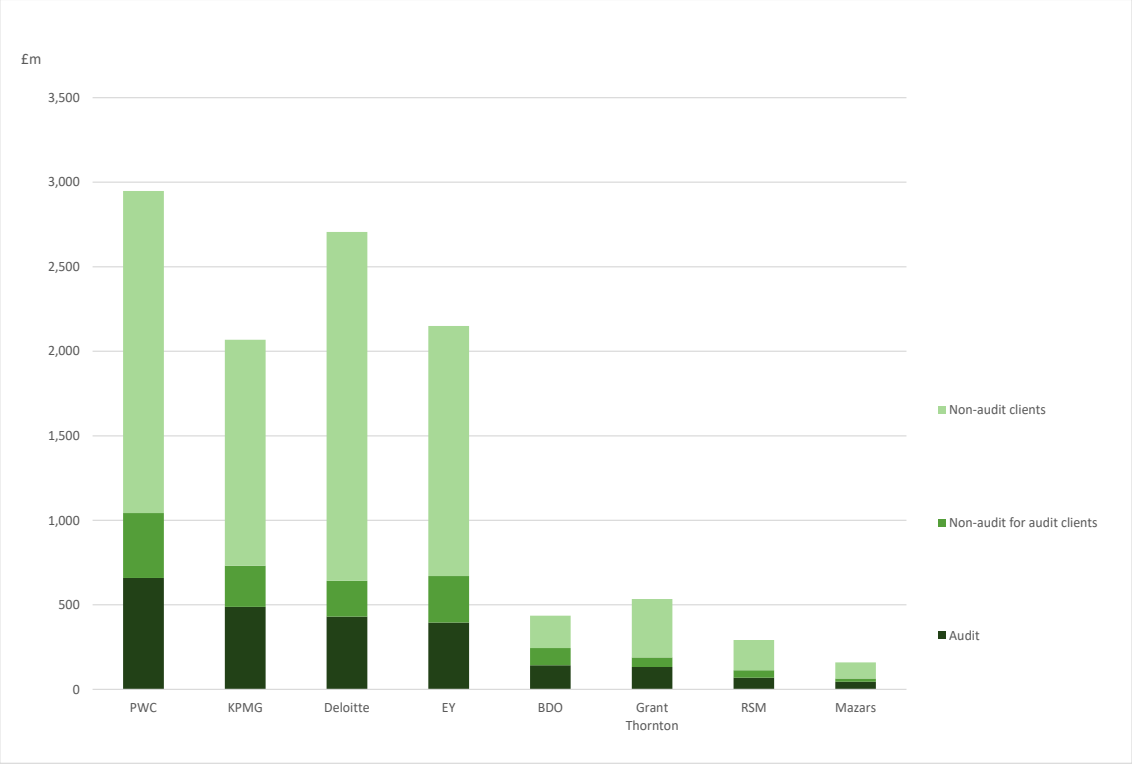
In March 2018, Grant Thornton, the sixth biggest UK firm in terms of audit fee income,[541] announced that it would no longer compete for FTSE 350 audit contracts.[542] Grant Thornton explained that "structures in the market" made it "impossible" for the company to succeed.[543]

Non-audit services

203. The Big Four offer a wide range of professional services in addition to audit. In 2016, combined Big Four income from audit services was £2 billion. Their income from non-audit services was £7.9 billion, four times as much. This included £1.1 billion of fees for non-audit services for audit clients.[544] When non-audit fee income is included, the difference between the Big Four and potential rivals is even more stark.

540 Letter from the Secretary of State for Business, Energy and Industrial Strategy to the Chairs, 30 April 2018
541 Behind the Big Four and BDO in 2016. Grant Thornton was the fifth biggest firm in terms of total fee income, incorporating non-audit services.
542 'Grant Thornton exits audit market for big UK companies.'Financial Times, March 29 2018
543 *As above*.
544 Financial Reporting Council RC, Key Facts and Trends in the Accountancy Profession, July 2017, p 37

Figure 10: The Big Four and the next four - 2016 fee income



204. It is often reported that audit services are used as a "loss-leader" by accountancy firms.[545] By bidding for audit work at relatively low rates, firms can establish contacts and reputation in a company or industry and increase their chances of winning lucrative non-audit consultancy work. This would act as a barrier to smaller and more audit-focused firms competing on audit pricing. Oxera found the ability to offer additional services on top of the audit gave the Big Four further advantages over smaller firms.[546] The Competition Commission considered the "bundling" of audit and non-audit services in its inquiry. It found it could not separately identify profit made from different services, partly because of the difficulty of attributing costs within broad corporate structures.[547] It did not find sufficient evidence to conclude that bundling harmed competition.[548]

205. There is, however, a simpler explanation of how the dominance of a few giant audit and professional services firms can inhibit competition. A company may be unable or unwilling to appoint one or more members of the Big Four as auditor for a variety of reasons. For example, a firm may:

- be providing substantial non-audit services to the firm, such as internal audit, or advice on corporate transactions or tax;

545 See, for example: "Does the big four alumni stifle competition?", ICAEW Economia, 11 October 2012; "Carillion's demise shines a light on an auditor expectation gulf", City A.M., 31 January 2018; "Audit Reform: The Conflict Minefield" AccountancyAge, 7 July 2016.

546 Oxera, Competition and choice in the UK audit market, April 2006, p i

547 Competition Commission, Statutory audit services for large companies market investigation, October 2013, para 10

548 Competition Commission, Statutory audit services for large companies market investigation, October 2013, para 29

- have conflicts of interest arising from close links to the finance director or audit committee chair;
- act as auditor to a major competitor; or
- in the opinion of the company, lack sufficient expertise or have a poor track record.

When there are only four options, the removal of one, two or even three firms from the equation leaves very few options left. In both the Oxera and Competition Commission reviews, financial services industry bodies reported that companies could have *no* effective choice of alternative auditor.[549]

206. This concern was very evident in Carillion. While KPMG provided external audit services, the company was similarly lucrative for the other Big Four firms. Deloitte provided internal audit services. EY was drafted in to try to restructure the company, and one of its partners was seconded onto the Carillion board. In other struggling companies, the names of the same giant companies appear, albeit often in different roles. As we set out in Chapter 2, when the Official Receiver needed a large firm to act as Special Manager to the liquidation of Carillion at short notice in January 2018, it sought a firm that was "not conflicted".[550] Despite having carried out more than £17 million of work on Carillion between 2008 and 2018, for the company, its pension schemes, and for government, PwC was the least conflicted Big Four firm.[551] It was appointed Special Manager as a monopoly supplier, underwritten by the taxpayer. Given that privileged position, it was perhaps unsurprising that PwC was unable or unwilling to provide an estimate of how long its work would take, or what the eventual bill would be.[552]

Time for action

207. Murdo Murchison of Kiltearn Partners said that "there appears to be a lack of competition in a key part of the financial system, which periodically causes a lot of other participants in that system a lot of trouble".[553] Stephen Haddrill, Chief Executive of the FRC, told us that the CMA would "need to review the effectiveness of what they recommended" regarding competition in the audit market, "and look at it again".[554] The Secretary of State for Business, Energy and Industrial Strategy, the Rt Hon Greg Clark MP, said he was "not averse" to reconsidering competition in audit market, as concentrated markets tended to act against the interests of consumers.[555] Similarly, Rt Hon Andrew Tyrie, incoming Chair of the CMA, said that "something needs to be done" about the audit market.[556]

549 Oxera, Competition and choice in the UK audit market, April 2006, p i; Competition Commission, Statutory audit services for large companies market investigation, October 2013, para 9.33–9.34
550 Letter from David Chapman, Official Receiver, to the Chairs, 5 February 2018
551 Work and Pensions Committee, Committees publish responses from Big Four on Carillion, 13 February 2018. Note that the original total quoted here for PwC work was £21.1 million. PwC subsequently informed us that out of a total of £4.6 million that they gave us for work done on the Electric Supply Pension Scheme, only £200,000 related to Carillion. Letter from PwC to the Chairs, 23 February 2018
552 Q1333 and Q1367 [David Kelly]
553 Q1046 [Murdo Murchison]
554 Q70 [Stephen Haddrill]
555 Qq 1258–9 [Greg Clark]
556 Oral evidence taken before the Business, Energy and Industrial Strategy Committee on 24 April 2018 HC 985 (2017–19), Q31 [Andrew Tyrie]

208. A range of potential policy options could generate more competition in audit. These include:

- more regular rotation of auditors and competitive tendering for audit contracts;
- breaking up the audit arms of the Big Four to create more firms and increase the chances of others being able to enter the market;
- splitting audit functions from non-audit services, reducing both the likelihood of associated conflicts of interest and the potential for cross-subsidisation.

209. The 2013 Competition Commission report considered how the interests of management and auditors could converge on matters of judgement, against the interests of shareholders. At times, management had "strong incentives to manage reported financial performance to accord with expectations and to portray performance in an unduly favourable light".[557] To maintain lucrative working relationships, auditors had incentives to "accommodate executive management" in this unwarranted optimism.[558] This is the story of Carillion's audits. But the weaknesses in regulation and competitive pressure which not only permitted those failures, but incentivised them to occur, are not restricted to one company. They are systemic in a market that has been stubbornly resistant to healthy competition, to the detriment of shareholders and the economy as a whole. That market is overdue shock treatment.

210. **The market for auditing major companies is neatly divvied up among the Big Four firms. It has long been thus and the prospect of an entrant firm or other competition shaking up that established order is becoming ever more distant. KPMG's long and complacent tenure auditing Carillion was not an isolated failure. It was symptomatic of a market which works for the members of the oligopoly but fails the wider economy. Waiting for a more competitive market that promotes quality and trust in audits has failed. It is time for a radically different approach.**

211. The dominant role of the Big Four stretches well beyond statutory audits. They have been prominent advisors to Governments of all colours and boast an extensive alumni network which dominates the ranks of regulators and finance directors. They provide a huge range of professional services to major companies, advising on internal audit, tax planning, risk, remuneration, corporate governance, controls, regulatory compliance, mergers and acquisitions, pensions restructuring, business turnaround and insolvency services. If one member of the oligopoly is a company's external auditor, the others can rely on providing other services, at all stages in a company's life cycle, and rack up substantial fees whatever the result. The Big Four collectively even benefit from mutual failure, as one of them will be invariably called in to advise on clearing up the mess left by the implementation of the previous advisors' proposed remedy.

212. **The lack of meaningful competition creates conflicts of interest at every turn. In the case of Carillion, KPMG were external auditors, Deloitte were internal auditors and EY were tasked with turning the company around. Though PwC had variously advised the company, its pension schemes and the Government on Carillion contracts,**

557 Competition Commission, Statutory audit services for large companies market investigation, October 2013, para 11.23

558 Competition Commission Statutory audit services for large companies market investigation, October 2013, para 26

it was the least conflicted of the Four. As the Official Receiver searched for a company to take on the job of Special Manager in the insolvency, the oligopoly had become a monopoly and PwC could name its price. The economy needs a competitive market for audit and professional services which engenders trust. Carillion betrayed the market's current state as a cosy club incapable of providing the degree of independent challenge needed.

213. ***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.***

Conclusions

214. **The collapse of Carillion has tested the adequacy of the system of checks and balances on corporate conduct. It has clearly exposed serious flaws, some well-known, some new. In tracing these, key themes emerge. We have no confidence in our regulators. FRC and TPR share a passive, reactive mindset and are too timid to make effective use of the powers they have. They do not seek to influence corporate decision-making with the realistic threat of intervention. The steps they are beginning to take now, and extra powers they may receive, will have little impact unless they are accompanied by a change of culture and outlook. That is what the Government should seek to achieve.**

215. **The Government has recognised the weaknesses in the regulatory regimes exposed by Carillion and other corporate failures, but its responses have been cautious, largely technical, and characterised by seemingly endless consultation. Our select committees have offered firm and bold recommendations based on exhaustive and compelling evidence but the Government has lacked the decisiveness or bravery to pursue measures that could make a significant difference, whether to defined benefit pension schemes, shareholder engagement, corporate governance or insolvency law. That must change. Other measures that the Government has taken to improve the business environment, such as the Prompt Payment Code, have proved wholly ineffective in protecting small suppliers from an aggressive company and need revisiting.**

216. **The directors of Carillion, not the Government, are responsible for the collapse of the company and its consequences. The Government has done a competent job in clearing up the mess. But successive Governments have nurtured a business environment and pursued a model of service delivery which made such a collapse, if not inevitable, then at least a distinct possibility. The Government's drive for cost savings can itself come at a price: the cheapest bid is not always the best. Yet companies have danced to the Government's tune, focussing on delivering on price, not service; volume not value. In these circumstances, when swathes of public services are affected, close monitoring of exposure to risks would seem essential. Yet we have a semi-professional part-time system that does not provide the necessary degree of insight for Government to manage risks around service provision and company behaviour. The consequences of this are clear in the taxpayer being left to foot so much of the bill for the Carillion clean-up operation.**

217. **Other issues raised are deep-seated and need much more work. The right alignment of incentives in the investment chain is a fiendishly difficult balance to strike. The**

economic system is predicated on strong investor engagement, yet the mechanisms and incentives to support engagement are weak and possibly weakening. The audit profession is in danger of suffering a crisis in confidence. The FRC and others have their work cut out to restore trust in the value, purpose and conduct of audits. Competition has the potential to drive improvements in quality and accountability, but it is currently severely lacking in a market carved up by four entrenched professional services giants. There are no easy solutions, but there are some bold ones.

218. **Carillion was the most spectacular corporate collapse for some time. The price will be high, in jobs, businesses, trust and reputation. Most companies are not run with Carillion's reckless short-termism, and most company directors are far more concerned by the wider consequences of their actions than the Carillion board. But that should not obscure the fact that Carillion became a giant and unsustainable corporate time bomb in a regulatory and legal environment still in existence today. The individuals who failed in their responsibilities, in running Carillion and in challenging, advising or regulating it, were often acting entirely in line with their personal incentives. Carillion could happen again, and soon. Rather than a source of despair, that can be an opportunity. The Government can grasp the initiative with an ambitious and wide-ranging set of reforms that reset our systems of corporate accountability in the long-term public interest. It would have our support in doing so.**

Conclusions and recommendations

Carillion plc

1. 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 pensions problems for the future. Similarly, expansions into overseas markets were driven by optimism rather than any strategic expertise. Carillion's directors blamed a few rogue contracts in alien business environments, such as with Msheireb Properties in Qatar, for the company's demise. But if they had had their way, they would have won 13 contracts in that country. The truth is that, in acquisitions, debt and international expansion, Carillion became increasingly reckless in the pursuit of growth. In doing so, it had scant regard for long-term sustainability or the impact on employees, pensioners and suppliers. (Paragraph 14)

2. The perception of Carillion as a healthy and successful company was in no small part due to its directors' determination to increase the dividend paid each year, come what may. Amid a jutting mountain range of volatile financial performance charts, dividend payments stand out as a generous, reliable and steady incline. In the company's final years, directors rewarded themselves and other shareholders by choosing to pay out more in dividends than the company generated in cash, despite increased borrowing, low levels of investment and a growing pension deficit. Active investors have expressed surprise and disappointment that Carillion's directors chose short-term gains over the long-term sustainability of the company. We too can find no justification for this reckless approach. (Paragraph 21)

3. Honouring pension obligations over decades to come was of little interest to a myopic board who thought of little beyond their next market statement. Their cash-chasing acquisitions policy meant they acquired pension scheme deficits alongside companies. Their proposals for funding those deficits were consistently and resolutely derisory as they blamed financial constraints unrecognisable from their optimistic market announcements. Meeting the pension promises they had made to their rank and file staff was far down their list of priorities. This outlook was epitomised by Richard Adam who, as Finance Director, considered funding the pension schemes a "waste of money". (Paragraph 35)

4. Carillion relied on its suppliers to provide materials, services and support across its contracts, but treated them with contempt. Late payments, the routine quibbling of invoices, and extended delays across reporting periods were company policy. Carillion was a signatory of the Government's Prompt Payment Code, but its standard payment terms were an extraordinary 120 days. Suppliers could be paid in 45 days, but had to take a cut for the privilege. This arrangement opened a line of credit for Carillion, which it used systematically to shore up its fragile balance sheet, without a care for the balance sheets of its suppliers. (Paragraph 42)

5. Corporate culture does not emerge overnight. The chronic lack of accountability and professionalism now evident in Carillion's governance were failures years in the making. The board was either negligently ignorant of the rotten culture at Carillion or complicit in it. (Paragraph 48)

6. Richard Howson, Carillion's Chief Executive from 2012 until July 2017, was the figurehead for a business model that was doomed to fail. As the leader of the company, he may have been confident of his abilities and of the success of the company, but under him it careered progressively out of control. His misguided self-assurance obscured an apparent lack of interest in, or understanding of, essential detail, or any recognition that Carillion was a business crying out for challenge and reform. Right to the end, he remained confident that he could have saved the company had the board not finally decided to remove him. Instead, Mr Howson should accept that, as the longstanding leader who took Carillion to the brink, he was part of the problem rather than part of the solution. (Paragraph 53)

7. Keith Cochrane was an inside appointment as interim Chief Executive, having served as a non-executive on the board that exhibited little challenge or insight. He was unable to convince investors of his ability to lead and rebuild the company. Action to appoint new leadership from outside Carillion came far too late to have any chance of saving the company. (Paragraph 56)

8. Non-executives are there to scrutinise executive management. They have a particularly vital role in challenging risk management and strategy and should act as a bulwark against reckless executives. Carillion's NEDs were, however, unable to provide any remotely convincing evidence of their effective impact. (Paragraph 59)

9. Philip Green was Carillion's Chairman from 2014 until its liquidation. He interpreted his role as to be an unquestioning optimist, an outlook he maintained in a delusional, upbeat assessment of the company's prospects only days before it began its public decline. While the company's senior executives were fired, Mr Green continued to insist that he was the man to lead a turnaround of the company as head of a "new leadership team". Mr Green told us he accepted responsibility for the consequences of Carillion's collapse, but that it was not for him to assign culpability. As leader of the board he was both responsible and culpable. (Paragraph 64)

10. In the years leading up to the company's collapse, Carillion's remuneration committee paid substantially higher salaries and bonuses to senior staff while financial performance declined. It was the opposite of payment by results. Only months before the company was forced to admit it was in crisis, the RemCo was attempting to give executives the chance for bigger bonuses, abandoned only after pressure from institutional investors. As the company collapsed, the RemCo's priority was salary boosts and extra payments to senior leaders in the hope they wouldn't flee the company, continuing to ensure those at the top of Carillion would suffer less from its collapse than the workers and other stakeholders to whom they had responsibility. (Paragraph 69)

11. Nowhere was the remuneration committee's lack of challenge more apparent than in its weak approach to how bonuses could be clawed back in the event of corporate failures. Not only were the company paying bonuses for poor performance, they

made sure they couldn't be taken back, feathering the nests of their colleagues on the board. The clawback terms agreed in 2015 were so narrow they ruled out a penny being returned, even when the massive failures that led to the £845 million write-down were revealed. In September 2017, the remuneration committee briefly considered asking directors to return their bonuses, but in the system they built such a move was unenforceable. If they were unable to make a legal case, it is deeply regrettable that they did not seek to make the moral case for their return. There is merit in Government and regulators considering a minimum standard for bonus clawback for all public companies, to promote long-term accountability. (Paragraph 73)

12. A non-executive director and chair of Carillion's remuneration committee for four years, Alison Horner presided over growing salaries and bonuses at the top of the company as its performance faltered. In her evidence to us, she sought to justify her approach by pointing to industry standards, the guidance of advisors, and conversations with shareholders. She failed to demonstrate to us any sense of challenge to the advice she was given, any concern about the views of stakeholders, or any regret at the largesse at the top of Carillion. Ms Horner continues to hold the role of Chief People Officer of Tesco, where she has responsibilities to more than half a million employees. We hope that, in that post, she will reflect on the lessons learned from Carillion and her role in its collapse. (Paragraph 75)

13. The Carillion board have maintained that the £845 million provision made in 2017 was the unfortunate result of sudden deteriorations in key contracts between March and June that year. Such an argument might hold some sway if it was restricted to one or two main contracts. But their audit committee papers show that at least 18 different contracts had provisions made against them. Problems of this size and scale do not form overnight. A November 2016 internal peer review of Carillion's Royal Liverpool Hospital contract reported it was making a loss. Carillion's management overrode that assessment and insisted on a healthy profit margin being assumed in the 2016 accounts. The difference between those two assessments was around £53 million, the same loss included for the hospital contract in the July 2017 profit warning. (Paragraph 95)

14. 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 not even been agreed, enabled 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. (Paragraph 96)

15. Emma Mercer is the only Carillion director to emerge from the collapse with any credit. She demonstrated a willingness to speak the truth and challenge the status quo, fundamental qualities in a director that were not evident in any of her colleagues. Her individual actions should be taken into account by official investigations of the collapse of the company. We hope that her association with Carillion does not unfairly colour her future career. (Paragraph 100)

16. Zafar Khan failed to get a grip on Carillion's aggressive accounting policies or make any progress in reducing the company's debt. He took on the role of Finance Director when the company was already in deep trouble, but he should not be absolved of responsibility. He signed off the 2016 accounts that presented an extraordinarily optimistic view of the company's health, and were soon exposed as such. (Paragraph 102)

17. Richard Adam, as Finance Director between 2007 and 2016, was the architect of Carillion's aggressive accounting policies. He, more than anyone else, would have been aware of the unsustainability of the company's approach. His voluntary departure at the end of 2016 was, for him, perfectly timed. He then sold all his Carillion shares for £776,000 just before the wheels began very publicly coming off and their value plummeted. These were the actions of a man who knew exactly where the company was heading once it was no longer propped up by his accounting tricks. (Paragraph 105)

18. Carillion's directors, both executive and non-executive, were optimistic until the very end of the company. They had built a culture of ever-growing reward behind the façade of an ever-growing company, focused on their personal profit and success. Even after the company became insolvent, directors seemed surprised the business had not survived. (Paragraph 107)

19. Once the business had completely collapsed, Carillion's directors sought to blame everyone but themselves for the destruction they caused. Their expressions of regret offer no comfort for employees, former employees and suppliers who have suffered because of their failure of leadership. (Paragraph 108)

External checks and balances

20. Major investors in Carillion were unable to exercise sufficient influence on the board to change its direction of travel. For this the board itself must shoulder most responsibility. They failed to publish the trustworthy information necessary for investors who relied on public statements to assess the strength of the company. Investors who sought to discuss their concerns about management failings with the board were met with unconvincing and incompetent responses. Investors were left with little option other than to divest. (Paragraph 113)

21. It is not surprising that the board failed to attract the large injection of capital required from investors; we are aware of only one who even considered this possibility. In the absence of strong incentives to intervene, institutional investors acted in a rational manner, based on the information they had available to them. Resistance to an increase in bonus opportunities, regrettably, did not extend to direct challenges to board members. Carillion may have held on to investors temporarily by presenting its financial situation in an unrealistically rosy hue; had it been more receptive to the advice of key investors at an earlier stage it may have been able to avert the darkening clouds that subsequently presaged its collapse. (Paragraph 114)

22. KPMG audited Carillion for 19 years, pocketing £29 million in the process. Not once during that time did they qualify their audit opinion on the financial statements, instead signing off the figures put in front of them by the company's directors. Yet,

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 judgements, KPMG was complicit in them. It should take its own share of responsibility for the consequences. (Paragraph 124)

23. Deloitte were responsible for advising Carillion's board on risk management and financial controls, failings in the business that proved terminal. 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. (Paragraph 125)

24. Carillion's directors were supported by an array of illustrious advisory firms. Names such as Slaughter and May, Lazard, Morgan Stanley and EY were brandished by the board as a badge of credibility. But the appearance of prominent advisors proves nothing other than the willingness of the board to throw money at a problem and the willingness of advisory firms to accept generous fees. (Paragraph 129)

25. Advisory firms are not incentivised to act as a check on recklessly run businesses. A long and lucrative relationship is not secured by unduly rocking the boat. As Carillion unravelled, some firms gave unwelcome advice. Morgan Stanley explained that the opportunity to raise equity to keep the company afloat had passed. Carillion simply marginalised them and sought a second opinion. By the end, a whole suite of advisors, including an array of law firms, were squeezing fee income out of what remained of the company. £6.4 million disappeared on the last working day alone as the directors pleaded for a taxpayer bailout. Chief among the beneficiaries was EY, paid £10.8 million for its six months of failed turnaround advice as Carillion moved inexorably towards collapse. (Paragraph 130)

26. The pension trustees were outgunned in negotiations with directors intent on paying as little as possible into the pension schemes. Largely powerless, they took a conciliatory approach with a sponsor who was their only hope of additional money and, for some of them, their own employer. When it was clear that the company was refusing to budge an inch, they turned to the Pensions Regulator to intervene. (Paragraph 134)

27. The Pensions Regulator's feeble response to the underfunding of Carillion's pension schemes was a threat to impose a contribution schedule, a power it had never—and has still never—used. The Regulator congratulated itself on a final agreement which was exactly what the company asked for the first few years and only incorporated a small uptick in recovery plan contributions after the next negotiation was due. In reality, this intervention only served to highlight to both sides quite how unequal the contest would continue to be. (Paragraph 142)

28. The Pensions Regulator failed in all its objectives regarding the Carillion pension scheme. Scheme members will receive reduced pensions. The Pension Protection Fund and its levy payers will pick up their biggest bill ever. Any growth in the company that resulted from scrimping on pension contributions can hardly be described as sustainable. Carillion was run so irresponsibly that its pension

schemes may well have ended up in the PPF regardless, but the Regulator should not be spared blame for allowing years of underfunding by the company. Carillion collapsed with net pension liabilities of around £2.6 billion and little prospect of anything being salvaged from the wreckage to offset them. Without any sense of irony, the Regulator chose this moment to launch an investigation to see if Carillion should contribute more money to its schemes. No action now by TPR will in any way protect pensioners from being consigned to the PPF. (Paragraph 143)

29. While we welcome the swift announcement of investigations into the audit of Carillion and the conduct of the Finance Directors responsible for the accounts, we have little faith in the ability of the FRC to complete important investigations in a timely manner. *We recommend changes to ensure that all directors who exert influence over financial statements can be investigated and punished as part of the same investigation, not just those with accounting qualifications.* (Paragraph 148)

30. The FRC was far too passive in relation to Carillion's financial reporting. It should have followed up its identification of several failings in Carillion's 2015 accounts with subsequent monitoring. Its limited intervention in July 2017 clearly failed to deter the company in persisting with its over-optimistic presentation of financial information. The FRC was instead happy to walk away after securing box-ticking disclosures of information. It was timid in challenging Carillion on the inadequate and questionable nature of the financial information it provided and wholly ineffective in taking to task the auditors who had responsibility for ensuring their veracity. (Paragraph 149)

31. The assignment of a Crown Representative to Carillion served no noticeable purpose in alerting the Government to potential issues in advance of company's July 2017 profit warning. The absence of one between August and November 2017 cannot have increased the Government's ability to keep itself informed of the direction of the company during a critical period before its collapse. (Paragraph 152)

32. In his last-minute ransom note, Philip Green clearly hoped that, faced with the imminent collapse of Carillion, Government would conclude it was too big to fail. But the Government was correct not to bail out Carillion. Taxpayer money should not be used to prop up companies run by such negligent directors. When a company holds 450 contracts with the Government, however, its collapse will inevitably have a signficant knock-on effects for the public purse. It is simply not possible to transfer all the risk from the public to the private sector. There is little chance that the £150 million of taxpayer money made available to support the insolvency will be fully recovered. (Paragraph 156)

33. The Official Receiver agreed to support compulsory liquidation, and sought the appointment of Special Managers, in the best interests of the taxpayer and has sought to achieve the best possible outcome for employees, suppliers and other creditors. (Paragraph 158)

34. In applying to the Court to appoint PwC as Special Managers to the insolvency, the Official Receiver was seeking to resource a liquidation of exceptional size and complexity as quickly and effectively as possible from an extremely limited pool. (Paragraph 159)

35. We are concerned that the decision by the court not to set any clear remuneration terms for PwC's appointment as Special Managers, and the inability of the appointees to give any indication of the scale of the liquidation, displays a lack of oversight. We have seen no reliable estimates of the full administrative costs of the liquidation, and no evidence that Special Managers, the Official Receiver or the Government have made any attempt to calculate it. We have also seen no measures of success or accountability by which the Special Managers are being judged. (Paragraph 161)

36. As advisors to Government and Carillion before its collapse, and as Special Managers after, PwC benefited regardless of the fate of the company. Without measurable targets and transparent costs, PwC are continuing to gain from Carillion, effectively writing their own pay cheque, without adequate scrutiny. *When the Official Receiver requires the support of Special Managers, these companies must not be given a blank cheque. In the interests of taxpayers and creditors, the Insolvency Service should set and regularly review spending and performance criteria and provide full transparency on costs incurred and expected future expense.* (Paragraph 162)

37. Given that, as far as we know, no indications had been given that a bailout would be forthcoming, and that the board apparently took no steps to minimise the potential loss to creditors, there must at least be a question as to whether individual directors could reasonably be accused of wrongful trading. (Paragraph 164)

38. In evidence to us, Carillion's board members did not give the impression that they were acutely conscious of the wide range of legal duties they had, nor of the prospect of any penalties arising from failure in this regard. It is difficult to conclude that they adequately took into account the interests of employees, their relationships with suppliers and customers, the need for high standards of conduct, or the long-term sustainability of the company as a whole. Any deterrent effects provided by section 172 of the Companies Act 2006 were in this case insufficient to affect the behaviourof directors when the company had a chance of survival. *We recommend that the Insolvency Service, as part of its investigation into the conduct of former directors of Carillion, includes careful consideration of potential breaches of duties under the Companies Act as part of their assessment of whether to take action for those breaches or to recommend to the Secretary of State action for disqualification as a director.* (Paragraph 166)

39. The consequences of the collapse of Carillion are a familiar story. The company's employees, its suppliers, and their employees face at best an uncertain future. Pension scheme members will see their entitlements cut, their reduced pensions subsidised by levies on other pension schemes. Shareholders, deceived by public pronouncements of health, have lost their investments. The faltering reputation of business in the eyes of the public has taken another hit, to the dismay of business leaders. Meanwhile, the taxpayer is footing the bill for ensuring that essential public services continue to operate. But this sorry tale is not without winners. Carillion's directors took huge salaries and bonuses which, for all their professed contrition in evidence before us, they show no sign of relinquishing. 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 richly compensated. In some cases, they continue to profit from Carillion after its death. Carillion was not

just a failure of a company; it was a failure of a system of corporate accountability which too often leaves those responsible at the top—and the ever-present firms that surround them—as winners, while everyone else loses out. (Paragraph 167)

Lessons

40. *We recommend that the Government immediately reviews the role and responsibilities of its Crown Representatives in the light of the Carillion case. This review should consider whether devoting more resources to liaison with strategic suppliers would offer better value for the taxpayer.* (Paragraph 169)

41. The current Stewardship Code is insufficiently detailed to be effective and, as it exists on a comply or explain basis, completely unenforceable. It needs some teeth. Proposals for greater reporting and transparency in terms of investor engagement and voting records are very welcome and should be taken forward speedily. However, given the incentives governing shareholder behaviour, and the questionable quality of the financial information available to them, we are not convinced that these measures in themselves will be effective in improving engagement, still less in shifting incentives towards long-term investment and away from the focus on dividend delivery. A more active and interventionist approach is needed in the forthcoming revision of the Stewardship Code, including a more visible role for the regulators, principally the Financial Reporting Council. (Paragraph 179)

42. The case of Carillion emphasised that the answer to the failings of pensions regulation is not simply new powers. The Pensions Regulator, and ultimately pensioners, would benefit from far harsher sanctions on sponsors who knowingly avoid their pension responsibilities through corporate transactions. But Carillion's pension schemes were not dumped as part of a sudden company sale; they were underfunded over an extended period in full view of TPR. TPR saw the wholly inadequate recovery plans and had the opportunity to impose a more appropriate schedule of contributions while the company was still solvent. Though it warned Carillion that it was prepared to do, it did not follow through with this ultimately hollow threat. TPR's bluff has been called too many times. It has said it will be quicker, bolder and more proactive. It certainly needs to be. But this will require substantial cultural change in an organisation where a tentative and apologetic approach is ingrained. We are far from convinced that TPR's current leadership is equipped to effect that change. (Paragraph 187)

43. This case is a test of the regulatory system. The Carillion collapse has exposed the toothlessness of the Financial Reporting Council and its reluctance to use aggressively the powers that it does have. There are four different regulators engaged, potentially pursuing action against different directors for related failings in discharging their duties. We have no confidence in the ability of these regulators, even with a new Memorandum of Understanding, to work together in a joined-up, rapid and coherent manner, to apportion blame and impose sanctions in high profile cases. (Paragraph 193)

44. At present, the mindset of the FRC is to be content with apportioning blame once disaster has struck rather than to proactively challenge companies and flag issues of concern to avert avoidable business failures in the first place. We welcome the

Government's review of the FRC's powers and effectiveness. We believe that the Government should provide the FRC with the necessary powers to be a much more aggressive and proactive regulator: one that can publicly question companies about dubious reporting, investigate allegations of poor practice from whistle-blowers and others, and can, through the judicious exercise of new powers, provide a sufficient deterrent against poor boardroom behaviour to drive up confidence in UK business standards over the long term. Such an approach will require a significant shift in culture at the FRC itself. (Paragraph 194)

45. The market for auditing major companies is neatly divvied up among the Big Four firms. It has long been thus and the prospect of an entrant firm or other competition shaking up that established order is becoming ever more distant. KPMG's long and complacent tenure auditing Carillion was not an isolated failure. It was symptomatic of a market which works for the members of the oligopoly but fails the wider economy. Waiting for a more competitive market that promotes quality and trust in audits has failed. It is time for a radically different approach. (Paragraph 210)

46. The lack of meaningful competition creates conflicts of interest at every turn. In the case of Carillion, KPMG were external auditors, Deloitte were internal auditors and EY were tasked with turning the company around. Though PwC had variously advised the company, its pension schemes and the Government on Carillion contracts, it was the least conflicted of the Four. As the Official Receiver searched for a company to take on the job of Special Manager in the insolvency, the oligopoly had become a monopoly and PwC could name its price. The economy needs a competitive market for audit and professional services which engenders trust. Carillion betrayed the market's current state as a cosy club incapable of providing the degree of independent challenge needed. (Paragraph 212)

47. *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.* (Paragraph 213)

48. The collapse of Carillion has tested the adequacy of the system of checks and balances on corporate conduct. It has clearly exposed serious flaws, some well-known, some new. In tracing these, key themes emerge. We have no confidence in our regulators. FRC and TPR share a passive, reactive mindset and are too timid to make effective use of the powers they have. They do not seek to influence corporate decision-making with the realistic threat of intervention. The steps they are beginning to take now, and extra powers they may receive, will have little impact unless they are accompanied by a change of culture and outlook. That is what the Government should seek to achieve. (Paragraph 214)

49. The Government has recognised the weaknesses in the regulatory regimes exposed by Carillion and other corporate failures, but its responses have been cautious, largely technical, and characterised by seemingly endless consultation. Our select committees have offered firm and bold recommendations based on exhaustive and compelling evidence but the Government has lacked the decisiveness or bravery to pursue measures that could make a significant difference, whether to defined benefit

pension schemes, shareholder engagement, corporate governance or insolvency law. That must change. Other measures that the Government has taken to improve the business environment, such as the Prompt Payment Code, have proved wholly ineffective in protecting small suppliers from an aggressive company and need revisiting. (Paragraph 215)

50. The directors of Carillion, not the Government, are responsible for the collapse of the company and its consequences. The Government has done a competent job in clearing up the mess. But successive Governments have nurtured a business environment and pursued a model of service delivery which made such a collapse, if not inevitable, then at least a distinct possibility. The Government's drive for cost savings can itself come at a price: the cheapest bid is not always the best. Yet companies have danced to the Government's tune, focussing on delivering on price, not service; volume not value. In these circumstances, when swathes of public services are affected, close monitoring of exposure to risks would seem essential. Yet we have a semi-professional part-time system that does not provide the necessary degree of insight for Government to manage risks around service provision and company behaviour. The consequences of this are clear in the taxpayer being left to foot so much of the bill for the Carillion clean-up operation. (Paragraph 216)

51. Other issues raised are deep-seated and need much more work. The right alignment of incentives in the investment chain is a fiendishly difficult balance to strike. The economic system is predicated on strong investor engagement, yet the mechanisms and incentives to support engagement are weak and possibly weakening. The audit profession is in danger of suffering a crisis in confidence. The FRC and others have their work cut out to restore trust in the value, purpose and conduct of audits. Competition has the potential to drive improvements in quality and accountability, but it is currently severely lacking in a market carved up by four entrenched professional services giants. There are no easy solutions, but there are some bold ones. (Paragraph 217)

52. Carillion was the most spectacular corporate collapse for some time. The price will be high, in jobs, businesses, trust and reputation. Most companies are not run with Carillion's reckless short-termism, and most company directors are far more concerned by the wider consequences of their actions than the Carillion board. But that should not obscure the fact that Carillion became a giant and unsustainable corporate time bomb in a regulatory and legal environment still in existence today. The individuals who failed in their responsibilities, in running Carillion and in challenging, advising or regulating it, were often acting entirely in line with their personal incentives. Carillion could happen again, and soon. Rather than a source of despair, that can be an opportunity. The Government can grasp the initiative with an ambitious and wide-ranging set of reforms that reset our systems of corporate accountability in the long-term public interest. It would have our support in doing so. (Paragraph 218)

Formal minutes

Wednesday 9 May 2018

Business, Energy and Industrial Strategy Committee

Members present:

Rachel Reeves, in the Chair

Stephen Kerr Antoinette Sandbach
Peter Kyle

Draft Report (*Carillion*), proposed by the Chair, brought up and read.

Ordered, That the draft Report be read a second time, paragraph by paragraph.

Paragraphs 1 to 218 read and agreed to.

Summary agreed to.

Resolved, That the Report be the Tenth Report of the Committee to the House.

Ordered, That the Chair make the Report to the House.

Ordered, That embargoed copies of the Report be made available, in accordance with the provisions of Standing Order No. 134.

[Adjourned till Wednesday 9 May at 10.00 am

Work and Pensions Committee

Members present:

Heidi Allen, in the Chair

Ruth George Chris Stephens
Nigel Mills

Draft Report (*Carillion*), proposed by the Chair, brought up and read.

Ordered, That the draft Report be read a second time, paragraph by paragraph.

Paragraphs 1 to 218 read and agreed to.

Summary agreed to.

Resolved, That the Report be the Twelfth Report of the Committee to the House.

Ordered, That the Chair make the Report to the House.

Ordered, That embargoed copies of the Report be made available, in accordance with the provisions of Standing Order No. 134.

[Adjourned till Wednesday 9 May at 10.00 am

Witnesses

The following witnesses gave evidence. Transcripts can be viewed on the inquiry publications page of the Committee's website.

	Question numbers
Tuesday 30 January 2018	
Sarah Albon, Chief Executive Officer, The Insolvency Service and **Stephen Haddrill**, Chief Executive Officer, Financial Reporting Council.	Q1–144
Chris Martin, Managing Director, Independent Trustee Services Ltd and **Robin Ellison**, Chair, Carillion (DB) Pension Trustee Ltd.	Q145–217
Tuesday 6 February 2018	
Zafar Khan, former Finance Director, Carillion; **Keith Cochrane**, former Interim Chief Executive, Carillion; **Emma Mercer**, former Finance Director, Carillion.	Q218–412
Richard Howson, former Chief Executive, Carillion, **Philip Green CBE**, former Chairman, Carillion, **Richard Adam**, former Finance Director, Carillion, and **Alison Horner**, former Chair of Remuneration Committee, Carillion.	Q413–649
Thursday 22 February 2018	
Lesley Titcomb, Chief Executive, The Pensions Regulator; **Nicola Parish**, Executive Director of Frontline Regulation, The Pensions Regulator; **Mike Birch**, Director of Case Management, The Pensions Regulator.	Q650–778
Michael Jones, Internal Audit Partner, Deloitte; **Michelle Hinchliffe**, Head of Audit, KPMG; **Peter Meehan**, Audit Partner, KPMG.	Q779–997
Wednesday 7 March 2018	
Murdo Murchison, Chief Executive Officer, Kiltearn Partners, **Euan Stirling**, Global Head of Stewardship and ESG Investing, Aberdeen Standard Investments, and **Amra Balic**, Managing Director, Blackrock.	Q998–1130
Andrew Wollaston, Partner, Global Restructuring Leader and Global TAS Private Equity, Ernst & Young UK, **Alan Bloom**, Partner, Senior Restructuring, former UK Restructuring Leader and Global Restructuring Leader, Ernst & Young UK, and **Lee Watson**, Partner, Restructuring, Ernst & Young UK.	Q1131–1209
Wednesday 21 March 2018	
The Rt Hon Greg Clark MP, Secretary of State for Business, Energy and Industrial Strategy, **The Rt Hon Esther McVey MP**, Secretary of State for Work and Pensions, **Charlotte Clark**, Director, Private Pensions and Arm's Length Bodies, Department for Work and Pensions, and **Niall Mackenzie**, Director, Infrastructure and Materials, Department for Business, Energy and Industrial Strategy.	Q1210–1314
Marissa Thomas, Partner, Head of Deals, PwC, **David Kelly**, Partner and Special Manager, PwC, and **Gavin Stoner**, Partner, Restructuring and Pensions, PwC	Q1315–1395

List of Reports from the Business, Energy and Industrial Strategy Committee during the current Parliament

All publications from the Committee are available on the publications page of the Committee's website. The reference number of the Government's response to each Report is printed in brackets after the HC printing number.

Session 2017–19

First Report	A framework for modern employment	HC 352
Second Report	Leaving the EU: implications for the civil nuclear sector	HC 378
Third Report	The safety of Electrical Goods in the UK	HC 503
Fourth Report	Pre-legislative scrutiny of the draft Domestic Gas and Electricity (Tariff Cap) Bill	HC 517
Fifth Report	The impact of Brexit on the automotive sector	HC 379
Sixth Report	The impact of Brexit on the aerospace sector	HC 380
Seventh Report	The impact of Brexit on the processed food and drink sector	HC 381
Eighth Report	Pre-appointment hearing with the Government's preferred candidate for Chair of the Competition Markets Authority	HC 985
First Special Report	Industrial Strategy: First Review: Government Response to the Committee's Second Report of Session 2016–17	HC 337
Second Special Report	Corporate governance: Government Response to the Committee's Third Report of Session 2016–17	HC 338
Third Special Report	Apprenticeships: Government Response to the Second Joint Report of Session 2016–17	HC 450
Fourth Special Report	Leaving the EU: negotiation priorities for energy and climate change policy: Government Response to the Committee's Fourth Report of Session 2016–17	HC 550
Fifth Special Report	Pre-legislative scrutiny of the draft Domestic Gas and Electricity (Tariff Cap) Bill: Government Response to the Committee's Fourth Report	HC 865
Sixth Special Report	Leaving the EU: implications for the civil nuclear sector: Government response to the Committee's Second Report	HC 881
Seventh Special Report	The safety of Electrical Goods in the UK Government Response to the Committee's Third Report	HC 920
Eighth Special Report	A framework for modern employment: Government response to the Second Report of the Work and Pensions Committee and First Report of the Business, Energy and Industrial Strategy Committee of Session 2017–19	HC 966

List of Reports from the Work and Pensions Committee during the current Parliament

All publications from the Committee are available on the publications page of the Committee's website. The reference number of the Government's response to each Report is printed in brackets after the HC printing number.

Session 2017–19

First Report	Universal Credit: the six week wait	HC 336
Second Report	A framework for modern employment	HC 352
Third Report	Protecting pensions against scams: priorities for the Financial Guidance and Claims Bill	HC 404
Fourth Report	PIP and ESA assessments: claimant experiences	HC 355
Fifth Report	Universal Credit Project Assessment Reviews	HC 740
Sixth Report	British Steel Pension Scheme	HC 828
Seventh Report	PIP and ESA assessments	HC 829
Eighth Report	European Social Fund	HC 848
Ninth Report	Pensions freedoms	HC 917
Tenth Report	Assistive technology	HC 673
Eleventh Report	Universal Credit: supporting self-employment	HC 997
Fourteenth Report	Appointment of Professor Sir Ian Diamond as Chair of the Social Security Advisory Committee	HC 971
First Special Report	Child Maintenance Service: Government's Response to the Committee's Fourteenth Report of Session 2016–17	HC 354
Second Special Report	Self-employment and the gig economy: Government Response to the Committee's Thirteenth Report of Session 2016–17	HC 644
Third Special Report	Disability employment gap: Government Response to the Committee's Seventh Report of Session 2016–17	HC 652
Fourth Special Report	Victims of modern slavery: Government Response to the Committee's Twelfth Report of Session 2016–17	HC 672
Fifth Special Report	Employment Opportunities for Young People: Government response to the Committee's Ninth Report of Session 2016–17	HC 872

Sixth Special Report	Protecting pensions against scams: priorities for the Financial Guidance and Claims Bill: Government Response to the Committee's Third Report	HC 858
Seventh Special Report	A framework for modern employment: Government response to the Second Report of the Work and Pensions Committee and First Report of the Business, Energy and Industrial Strategy Committee	HC 966
Eight Special Report	PIP and ESA assessments: Government Response to the Committee's Seventh Report	HC 986
Ninth Special Report	British Steel Pension Scheme: The Pensions Regulator Response to the Committee's Sixth Report	HC 987