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Carillion: building on shaky ground

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Carillion: Building on Shaky Ground

Carillion plc's (Carillion) rapid and unexpected collapse led to it filing for bankruptcy in January 2018. Its failure raised uncomfortable questions about the role of those expected to adopt a more critical stance, including the Board, the auditors, the Regulators and the government[1].

The company went from a clean audit opinion and proposing a record dividend of £79.3m (FY 2016) in March 2017 to announcing a provision of £845m on contracts by July[2]? And then, the provision was increased further to £1,045m in September[3] 2017, just two months later.

At the time of its bankruptcy, Carillion owed around £2bn to its 30,000 suppliers and others who had traded with it. In addition, it had around 43,000 employees and many more were dependent upon it through its supply chains and pension schemes.

Many of its approximately 27,000 pension scheme members face an uncertain future as the government Pension Protection Fund was forced to take over the schemes. They will not receive their expected pensions.

The government, one of its main customers was caught unaware and had to commit £150m to ensure continuity of public services.

> '*Investors seemed to know, people who worked for the company seemed to know, the only people who didn't see what was happening were those who were paid to– the directors and the auditors of the company*.'[4] Rachel Reeves MP Chair of Business, Energy and Industrial Strategy Committee. *(Oral evidence 22 February 2018)*

Were clues present in the company's financial statements (Case Exhibit 1) or was the mounting crisis hidden from analysts and the public?

Is it the case that corporate financial reporting is no longer a useful basis for decision-making (Lev, 2018)?

Background

Carillion came into existence via a demerger from Tarmac in 1999. The split left the heavy building materials business within the Tarmac company, transferring construction services to the newly formed Carillion. Over the ensuing years Carillion expanded into the facilities management sector, growing through acquisition, purchasing its rivals including Mowlem (£350m 2006), Alfred McAlpine (£565m 2008) and Eaga (£298m 2011) at a premium (Case Exhibit 2). Following a change in government policy related to feed in tariffs, the Eaga business was rationalised almost immediately. In 2014 the proposed takeover of its nearest rival Balfour Beatty failed. Many of the UK acquisitions also involved taking on the legacy defined benefit pension schemes of those companies, thereby adding the cost of servicing the pension scheme obligations to the overall cost of acquisition.

In 2016 the company's work for the UK government represented 38% of its revenues[5]. Carillion focused on providing maintenance, facilities management, and energy services to buildings and large property estates, in public and private sectors; infrastructure services for roads, railways, and utility

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[1] Intro to case FT.com (2.06 minutes) https://youtu.be/8vb3Cp1AH04

[2] Carillion plc, 2017, first-half trading update 10 July 2017

[3] Carillion plc, Financial results for the six months to 30 June 2017, 29 September 2017

[4] Q977 https://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/work-and-pensions-committee/carillion/oral/79121.pdf

[5] https://publications.parliament.uk/pa/cm201719/cmselect/cmworpen/769/769.pdf p.8

networks, with contracts including road and hospital construction and many strategic service contracts e.g. free school meals.

Carillion reported its results through four business segments: support services, Public Private Projects (PPP), Middle East construction services, and construction services (excluding the Middle East). Divisional performance for 2015 and 2016 is shown in Case Exhibit 3. Support services comprised 52% of revenue in 2016 and include facilities management, facilities services, energy services, rail services, road maintenance services, utilities services, remote site accommodation services and consultancy businesses in the UK, Canada and the Middle East. PPP comprised 6% of revenue (2016) and includes returns on investments in PPP contracts in the UK and Canada and the sale of investments in those projects. The increase in revenues related to the construction phases of a number of projects, including the Midland Metropolitan Hospital, Aberdeen Western Peripheral Route and Midlands Priority Schools Building Programme. The reduction in profit experienced in 2016 was reported as being expected to decline again in 2017 due to fewer sales of equity in PPP projects. Middle East construction services comprised 13% of revenues in 2016 and 2% of operating profit with the company reporting a competitive market and low level of contracts available. Finally, construction services outside of the Middle East grew to 29% of revenues yet only yielded 3% operating profit. This segment includes the results of the UK building, civil engineering and developments business along with construction activities in Canada.

Triggering Carillion's decline

Events were set in motion when Emma Mercer, at the time group finance officer, questioned the revenue recognition on construction contracts in March/April 2017. She had recently returned from time at the Canadian operation.

> Emma Mercer: *Having a number of construction projects means that you have to exercise judgment over all sorts of things: when the contract is going to get finished; how much we are going to receive; if we are claiming against anybody; what entitlement we may have. What I saw when I returned to the UK is that both the number of contracts we were taking judgment on and the size of those judgments had increased. What that meant is that when we saw the deterioration in the first part of 2017 and into the second—when we saw those huge deteriorations on those contracts—because we were already at a more aggressive position, it was very difficult to withstand those deteriorations on those projects.*[6] *(Oral evidence 6 Feb 2018)*

On 10 July 2017 a £845m impairment was reported in the construction services division, of which £375m[7] related to three loss making UK PPP contracts including the Royal Liverpool hospital, the Sandwell Midland Metropolitan hospital, the Aberdeen bypass and £470m to overseas markets. The Chief Executive Richard Howson resigned on release of the news. A further profit warning in September 2017 led to another £200m impairment to support services contracts[8] and yet another profit warning in November 2017 indicated that Carillion was set to breach its bank covenants with expected average debt for the year to be between £875m and £925m[9]. A recapitalisation was planned for early 2018 to shore up the balance sheet, however the company entered liquidation on 15 January 2018. A significant proportion of the company's income was derived from long term contracts which involves significant reliance on the forecast costs by the company[10]. Under the accounting standard in

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[6] Q272 http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/work-and-pensions-committee/carillion/oral/78103.pdf
[7] Carillion plc, 2017 first half trading update, 10 July 2017
[8] Carillion plc, Financial results for the six months ended 30 June 2017, 29 September 2017
[9] Carillion plc, Update on discussions with stakeholders, trading and financial covenants deferral, 17 November 2017
[10] Carillion plc, 2016 Annual Report, Accounting policies p.95

operation at the time (IAS 11 Construction Contracts)[11] contract revenues and costs were recognised by reference to the stage of completion where the outcome could be reliably estimated. This estimation of the final outcome involved significant judgement and was noted as a key audit risk in the 2016 auditor report (Case Exhibit 4). Contract revenue for 2016 amounted to £1,939.2m (37% annual revenues).

Contract accounting processes were monitored internally in two ways by Carillion:

- Monthly review meetings where management reviewed the position reported
- Peer review process to challenge all aspects of the contract operation and reporting process

The Parliamentary Joint Committee reported that when Deloitte examined peer reviews undertaken between January 2015 and July 2017 of the contracts that comprised the £845m provision that they had found that management had used higher expected margins than the peer review had advised in 42% of cases. For example, the difference on the Royal Liverpool University Hospital contract meant that the 2016 accounts recognised £53m more than was recommended by the peer review[12]. In contrast, in just 14% of cases a higher margin was recommended as part of the exercise.

It was later found that Carillion had also recognised revenues classed as 'traded not certified'. This means that the clients had not yet agreed the costs e.g. in the case of claims or variations and therefore that there was significant uncertainty whether payment would be received. This figure was not publicly disclosed but was uncovered in the audit committee papers accessed by the joint committee[13]. The Parliamentary Joint Committee found that in December 2016 there was £294m of traded not certified revenue or 15% of contract revenues.

The legacy of Carillion's acquisitive strategy

The acquisition spree led to a significant level of goodwill on the balance sheet (£431m from Mowlem acquisition, £615m from Alfred McAlpine acquisition and £329m from Eaga acquisition) comprising around 31% of total assets (2016). This goodwill exceeded the purchase price for these entities.[14] The audit report identifies goodwill as a key area of judgement where small changes to the valuation assumptions could result in a significant reduction in the valuation of goodwill (Case Exhibit 4).

Accounting for goodwill on acquisition is an accounting technique which can lead to significant intangible assets reported by acquisitive companies. The accounting rules have varied over time as various drawbacks of each approach have been identified (Amel-Zadeh, et al., 2016). The current accounting standard (IFRS3) involves significant assumptions applied by management in relation to the future cash generation of the assets. In 2020 the International Accounts Standards Board (IASB) reopened the discussion by issuing a consultation paper[15]indicating that the discussion regarding the utility of the current accounting disclosures continues.

The Parliamentary joint committee (Peter Kyle MP) questioned investors (Murdo Murchison Chairman Kiltearn Partners) about their treatment of goodwill in their analysis of the company.

> *Peter Kyle: Did not the huge amounts of goodwill give you cause for concern?*
>
> *Murdo Murchison: We always look at goodwill. We invest globally and our typical approach to goodwill is to basically discount it quite heavily. Goodwill is typically the result of past*

[11] IFRS15 Revenue from Contracts with Customers replaced IAS 11 for periods starting on or after 1 January 2018

[12] https://publications.parliament.uk/pa/cm201719/cmselect/cmworpen/769/769.pdf

[13] https://publications.parliament.uk/pa/cm201719/cmselect/cmworpen/769/769.pdf

[14] https://publications.parliament.uk/pa/cm201719/cmselect/cmworpen/769/769.pdf

[15] https://www.ifrs.org/projects/work-plan/goodwill-and-impairment/#current-stage

management actions to overpay for assets and we saw that clearly here with McAlpine, for example. The question then is: is the market paying up for that goodwill? Again, it was discounted in the valuation. This is not a capital-heavy business. The goodwill in this case was not something we put a lot of weight on. In fact we discounted it very heavily'[16]*(Oral Evidence 7 March 2018)*

As part of the quest to eliminate competitors from the market through acquisition Carillion had also acquired a number of defined benefit pension schemes. These schemes typically pay pensioners an amount linked to their salary and service over their period of retirement rather than being linked to their payments into the scheme. It is the employer, who bears the risk of changes in valuation and longevity of members. Whilst the schemes in question were closed to new members they have a long run off period and the liability must be valued and accounted for appropriately.

By law, in the UK, defined benefit schemes must have sufficient assets to meet their liabilities[17] and actuarial valuations should be conducted every three years to determine whether this is the case. Where it is not the case a deficit recovery plan must be agreed with the Pensions Regulator within 15 months of the valuation which is expected to enable the sponsoring company to balance its operational cash requirements with its obligations to make good the pension scheme deficit.

None of Carillion's directors were members of these schemes, but they were shareholders and arguably prioritised their own interests (Case Exhibit 5) ahead of the scheme members and the legal responsibility to pensioners. Whilst the valuation risk was acknowledged the directors were not incentivised to reduce the liability. Ultimately the Pension Protection Fund covered the approximately £800-900m required to cover the reduced pay out threshold to pensioners of the schemes. This will be borne by levy payers over future years[18]. The Chair of the Joint committee questioned Carillion's interim Chief Executive (Keith Cochrane):

Chair: The point […] is that you are saying that it is all being paid out of cash, and yet the cash left in 2016 is minus £117 million. When it all went under, just a couple of weeks ago, you had at least a £587 million deficit—probably £800 million or £900 million—in the pension fund. Over a seven-year period, 2009 to 2016, you have paid out dividends of £554 million. You have said very warm words about what an important stakeholder the pension fund was and how it really mattered, and you have talked about all of these conversations you had with the trustees, and yet—this was just a matter of fact—you were paying out much more in dividends, were you not, than you were paying into the pension fund?

Keith Cochrane: Certainly the quantum of dividends versus pension fund payments, absolutely. That is a statement of fact. I accept that.[19] *(Oral evidence 6 Feb 2018)*

Evidence of stress – using payables as a source of funding

In addition, there was significant market evidence that Carillion was using its suppliers as a source of cash flow. It did so via an Early Payment Facility (EPF) through which it encouraged suppliers to take a discount on the payable in return for earlier payment (45 days) rather than its standard 120 days terms. This was despite the company signing the prompt payment code committing to 60 days payment terms moving towards 30 days.

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[16]Q1032 http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/work-and-pensions-committee/carillion/oral/79969.pdf

[17] The Pensions Act, 2004.

[18] https://www.ppf.co.uk/

[19] Q 378 http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/work-and-pensions-committee/carillion/oral/78103.pdf

'signatories undertake to pay suppliers within a maximum of 60 days (in line with late payment legislation requirements), to work towards adopting 30 days as the norm, and to avoid any practices that adversely affect the supply chain.'* [20]

This practice of using payables as a source of funding was reported in the trade press as early as 2013 (Case Exhibit 6). The 2016 annual report's only disclosure related to the EPF put a decidedly positive slant on the arrangement.

'The use of Carillion's sector leading supply chain finance offering, our Early Payment Facility, allows our supply chain partners access to their payments ahead of their contractual terms, reducing their need for working capital and helping them grow and sustain local communities.' [21]

The Joint committee inquiry (Heidi Allen MP) questioned Emma Mercer who was Finance Director at the time of the collapse about the scheme.

Emma Mercer 'Effectively, we give suppliers the choices of being on either. With those that go on to the supply chain factoring, we do ask them to sign up to terms of 120 days, but they have the ability to be able to draw down a payment within 45 days—which I will come back to in a second—or anything above 45 days is not at their charge. We get the benefit of the working capital facility associated with that up to 120 days.

Heidi Allen: Does that mean that you were using suppliers like a loan? You were borrowing.

Emma Mercer: The reason we introduced it is because when we went back to the Prompt Payment Code, and we went back to discussions on government contracts—and also on other contracts with our other customers as well—what we found was that we were being pushed to drive supplier days, obviously, down to 45 days, but our customers were not necessarily paying us on 45 days.' [22] *(Oral evidence 6 Feb 2018)*

The Usefulness of Financial Reporting

The Carillion case has highlighted the seeming disconnect between the financial reports and the underlying performance of the company. The reporting did not provide insight into the aggressive accounting policies adopted nor the practices designed to grow revenues at the expense of profitability.

Investors made their own adjustments for the purposes of analysis e.g. to goodwill on acquisition[23]. The Joint committee report also found that the company's

'board minutes in April 2015 refer to 'disappointing' UBS analysis that had factored both the pension deficit and the EPF into 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'' [24]

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[20] http://www.promptpaymentcode.org.uk/
[21] Carillion plc, 2016 Annual Report, p.13
[22] Q353/354 http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/work-and-pensions-committee/carillion/oral/78103.pdf
[23] Q 1093 http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/work-and-pensions-committee/carillion/oral/79969.pdf
[24] https://publications.parliament.uk/pa/cm201719/cmselect/cmworpen/769/769.pdf p.16

Investor adjustments to Carillion's debt to take into account the EPF had started from as early as 2013 (Case Exhibit 7), despite the company's superficial disclosures on the matter (Case Exhibit 6).

Whilst ignoring the mounting debt within the company and the large unfunded pension liability, the Board increased the dividends to shareholders to record levels maintaining a veneer of normality. The dividend policy led to investors purchasing the company's shares on the promise of continued and increasing dividends rather than because of the long term value within the company.

The board were heavily criticised by the Joint committee report for the lack of challenge by the non-executive directors and the overly optimistic outlook of the Chairman, Philip Green.

> *'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.'*[25]

[25] https://publications.parliament.uk/pa/cm201719/cmselect/cmworpen/769/769.pdf p.47

Case Exhibit 1: Carillion Accounts (extracts from Annual Reports)

Consolidated income statement

£m	**2012**	**2013**	**2014**	**2015**	**2016**
Revenue	4,402.8	4,080.9	4,071.9	4,586.9	5,214.2
less share of JV	-736.6	-748.3	-578	-636.2	-819.3
Group revenue	3,666.2	3,332.6	3,493.9	3,950.7	4,394.9
Cost of sales	-3,279.4	-2,984.6	-3,166.4	-3,609.8	-4,044.2
Gross profit	386.8	348	327.5	340.9	350.7
Admin expenses	-240.4	-268.2	-166.4	-195.2	-217.8
Profit on disposal of PPP equity investments	13.2	44.6	13.9	37.7	12.7
Group operating profit	159.6	124.4	175	183.4	145.6
Share of results of JVs	34.3	26.5	25.1	26	36.3
Profit from ops	193.9	150.9	200.1	209.4	181.9
Non operating items	-1.2	-0.7	-9.9	-2.5	-1.1
Net financial expense	-27.9	-39.6	-47.6	-51.8	-34.1
Profit before tax	164.8	110.6	142.6	155.1	146.7
Tax	-9.9	-4.3	-15.1	-15.7	-17.2
Profit after tax	154.9	106.3	127.5	139.4	129.5
Amortisation (note 3)	35.1	22.8	20.3	23	20
Depreciation (note 3)	27.1	21.5	24.5	22.4	25

Consolidated balance sheet

£m	**2012**	**2013**	**2014**	**2015**	**2016**
Non current assets					
Property, plant and equipment	125.8	128.2	140.9	140.8	144.1
Intangible assets	1,536.6	1,552.8	1,610.8	1,633.9	1,669.3
Retirement benefit assets	0.7	3.8	6.1	12.7	5.8
Investments in JVs	176.4	152	130.6	161.4	174.9
Other investments	61.5	7.3	9.3	4.7	5.4
Deferred tax assets	123.8	112.6	142.6	103.8	163.8
Total non current assets	2,024.8	1,956.7	2,040.3	2,057.3	2,163.3
Current assets					
Inventories	55.3	48.6	50.1	64.3	78.8
Trade and other receivables	1111.5	1212.3	1325.4	1270.5	1664
Cash and cash equivalents	657.1	413.7	472	462.2	469.8
Derivative financial instruments	0.4	2.2	0	14.6	46.4
Current asset investments	2.5	2.4	1.9		
Income tax receivable	10.8	4	0.7	1.2	10.8
Assets classified as held for sale					
Total current assets	1837.6	1683.2	1850.1	1812.8	2269.8
Total assets	3862.4	3639.9	3890.4	3870.1	4433.1

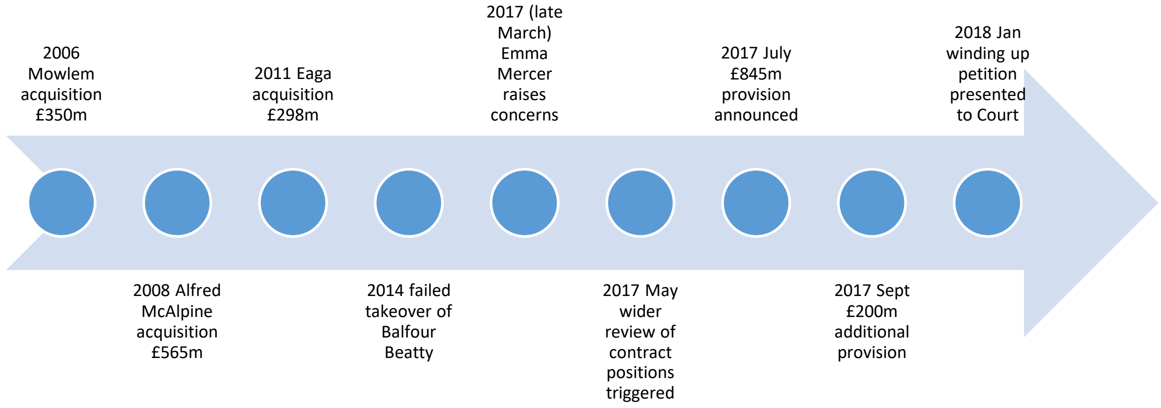
	2012	2013	2014	2015	2016
Current liabilities					
Borrowing	-35.3	-22.5	-35.3	-33.5	-96.7
Derivative financial instruments	-7.1	-13.2	-22.6	-11.6	-10.6
Trade and other payables	-1,614.6	-1,588.5	-1,727.1	-1,713.8	-2,090.1
Provisions	-27	-32.7	-8.6	-5	-7.8
Income tax payable	-3.8	-4.7	-8.3	-7.2	-12.2
Total current liabilities	-1,687.8	-1,661.6	-1,801.9	-1,771.1	-2,217.4
Non-current liabilities					
Borrowing	-777.6	-606.4	-614	-598.5	-592
Other payables	-9.1		-48.7	-64.4	-67.3
Retirement benefit liabilities	-351.7	-373.9	-515.8	-406.2	-810.6
Deferred tax liabilities	-16.3	-10.2	-11.3	-10.5	-15.4
Provisions	-9.2	-4.2	-4.2	-2.1	-0.5
Total non current liabilities	-1,163.9	-994.7	-1194	-1,081.7	-1,485.8
Total liabilities	-2,851.7	-2,656.3	-2,995.9	-2,852.8	-3,703.2
Net assets	1,010.7	983.6	894.5	1,017.3	729.9
Equity					
Share capital	215.1	215.1	215.1	215.1	215.1
Share premium	21.2	21.2	21.2	21.2	21.2
Translation reserve	-23.8	-36.4	-33.3	-38.9	-0.9
Hedging reserve	-21.5	-5.6	-11.2	-8.2	-16.5
Fair value reserve	15.8	0.2	0.3	0.3	0.5
Merger reserve	433.2	414.6	400.9	393.7	389
Retained earnings	358.9	358.1	279.7	410.3	92.7
Equity attributable to shareholders of the parent	998.9	967.2	872.7	993.5	701.1
Non-controlling interests	11.8	16.4	21.8	23.1	28.8
Total equity	1,010.7	983.6	894.5	1,016.6	729.9
Further data from the notes to the accounts					
Bank overdrafts	-4.9	-3.3	-6.2	-6.4	-2.1
Trade payables	643.3	541.9	611.6	591.4	749.2
Trade receivables	236.1	219.7	242.1	252.8	229.5
Average net borrowings	344.1	490.6	450.7	538.9	586.5
Other creditors	263.1	404.6	509.5	561.2	760.5
Proposed dividend per share (p)	18.45	18.25	17.75	18.25	18.45

Consolidated cash flow statement

£m	2012	2013	2014	2015	2016
Cash flow from operating activities					
Group operating profit	164.1	124.4	175	183.4	145.6
Depreciation and amortisation	62.2	44.3	44.8	45.4	45
Loss on disposal of property, plant and equipment	1.6	2.3	0.3	-14.4	-6.4
Profit on disposal of PPP Equity investments	-13.2	-44.6	-13.9	-37.7	-12.7
Other non cash movements	-10	-6.1	-1.7	-0.3	1.9
Non-recurring operating items	2.6	44.2		5	40.2
Operating profit before changes in working capital	**207.3**	**164.5**	**204.5**	**181.4**	**213.6**
Decrease in inventories	15.2	-1.1	-1.4	-14.3	-6.3
(Increase)/decrease in trade and other receivables	-36.6	-123.8	-40.1	48	-290.6
Decrease in trade and other payables	-143.5	-40.6	50.5	-41.1	301.5
Cash generated from operations before pension recovery payments, rationalisation costs and Eaga related charges	42.4	-1	213.5	174	218.2
Deficit recovery payments to pension scheme	-30.2	-39.2	-46	-47.4	-34.6
Rationalisation costs	-28.6	-22	-11.5	-6.3	-46.6
Eaga Partnership Trusts related charges	0				-21.5
Cash (used in)/generated from operations	**-16.4**	**-62.2**	**156**	**120.3**	**115.5**
Financial income received	15.8	11.1	2.9	2.4	2.5
Financial expense paid	-27.3	-30.9	-29.6	-35.3	-39.6
Acquisition costs	-0.6	-1	-1.2	-6.6	-0.9
Taxation receipts/(payments)	2.9	4.6	-4.3	-7.5	-4.2
Net cash flows from operating activities	**-25.6**	**-78.4**	**123.8**	**73.3**	**73.3**
Cash flows from investing activities					
Disposal of property, plant and equipment	2.7	0.9	6.4	17.6	13.8
Disposal of jointly controlled and other investments	45.9	143.7	36	54.1	47.1
Dividends from jointly controlled entities	13.6	18.2	9.1	16.8	11.8
Loan advance/repayments received from jointly controlled entities		2.9	15.9	7.2	2.1
Disposal and closure of businesses	-3.8	-0.3			
Decrease in current asset investments	1.8	0.1	0.5		
Acquisition of subsidiaries (net of cash acquired)	-4.9	-20.3	-26.3	-10.6	-32.5
Acquisition of non-controlling interests			-3.1		
Acquisition of intangible assets	-3.7	-6.5	-3	-1.2	
Acquisition of property, plant and equipment	-14.6	-21.6	-25.8	-29.2	-37.3
Acquisition of equity in and net loan advances to jointly controlled entities	-19.7	-6.1	-7.7	-28.3	-4.8
Acquisition of other non-current asset investments	-3	-3.8	-1.2	-0.4	
Net cash flows from investing activities	**14.3**	**107.2**	**0.8**	**26**	**0.2**

Cash flows from financing activities					
Draw down of bank and other loans	277.2	-171	14.7	-19	6.7
Payment of finance lease liabilities	-16.8	-16.7	-9.2	-6	-7.4
Acquisition of own shares	-3	-2.2	-0.5	-0.4	-1
Payment to employees in settlement of share options	-0.8	-0.3			
Dividends paid to equity holders of parent	-70.4	-74.6	-75.7	-76.8	-78.9
Dividends paid to non-controlling interests	-8.2	-1.1	-1	-3.2	-3.8
Net cash flows from financing activities	**178**	**-265.9**	**-71.7**	**-105.4**	**-84.4**
Increase in net cash and cash equivalents	166.7	-237.1	52.9	-6.1	-10.9
Net cash and cash equivalents at 1 January	487.7	652.2	410.4	465.8	455.8
Effect of exchange rate movements	-2.2	-4.7	2.5	-3.9	22.8
Net cash and cash equivalents at 31 December	**652.2**	**410.4**	**465.8**	**455.8**	**467.7**

Case Exhibit 2 – Timeline



Source: Prepared by author from Joint Committee Report p.8
https://publications.parliament.uk/pa/cm201719/cmselect/cmworpen/769/769.pdf

Case Exhibit 3 – Divisional performance

Revenue	**2015**	**2015**	**2016**	**2016**
	£m	**% of revenues**	**£m**	**% of revenues**
Support services	2,534.2	55%	2,712.7	52%
PPP projects	192.8	4%	313.0	6%
Middle East construction services	601.6	13%	668.3	13%
Construction services (Excluding Middle East)	1,258.3	27%	1,520.2	29%
Total	**4,586.9**		**5,214.2**	

Underlying operating profit	**£m**	**% profit**	**£m**	**% profit**
Support services	146.6	6%	182.7	7%
PPP projects	49.3	26%	28.3	9%
Middle East construction services	25.3	4%	16.1	2%
Construction services (Excluding Middle East)	37.8	3%	41.3	3%
Total	**259.0**	**6%**	**268.4**	**5%**

Source: Carillion plc, 2016 Annual Report, p.38.

Case Exhibit 4 – Principal audit risks (Audit Report extracts)

'The risk – The Group recognises revenue based on the stage of completion of construction contracts by reference to the proportion of costs incurred to the balance sheet date compared with the final costs of the contract at completion and therefore relies on estimates in relation to the final out-turn of costs on each contract. Changes to these estimates could give rise to material variances in the amount of revenue and margin recognised. Contingencies may also be included in these estimates of cost to take account of specific risks, or claims against the Group, arising within each contact. These contingencies are reviewed by the Group on a regular basis throughout the contract life and adjusted where appropriate. Finally, variations and claims are recognised on a contract-by-contract basis, both on service and construction contracts, where the Group believes the rights and obligations exist given the progress of negotiations. There is therefore a high degree of judgement in: recognising variations and claims; and estimating the revenue recognised by the Group based on the projected final out-turn on contracts.'

'The risk – The Group's balance sheet includes goodwill, principally arising from historical acquisition in the UK. The risk is that the goodwill allocated to cash generating units ('CGU') is not recoverable and should be impaired. Due to inherent uncertainty involved in forecasting an discounting future cash flows, which are the basis of the assessment of recoverability, this is one of the key judgemental areas for our audit.

The Group annually carries out an impairment assessment of goodwill using a value-in-use model which is based on the net present value of the forecast earnings of the cash-generating-unit ('value-in-use'). This is calculated using certain assumptions around discount rates, growth rates and cash flow forecasts.

Given the relative size of the goodwill in the Group balance sheet, particularly in the UK Services CGU, relatively small changes in these assumptions could give rise to material changes in the assessment of the carrying value of goodwill.'

Source: Carillion plc, 2016 Annual Report, p.86.

Case Exhibit 5 – Extracts from Carillion plc 2016 Annual Report

Extract from dividend policy

‘The Group has a progressive dividend policy which aims to increase the dividend each year in line with the growth in underlying earnings per share. The Board has adopted this policy in order to align shareholder returns with the underlying performance of the business. The Board has increased the dividend in each of the 16 years since the formation of the company in 1999.’

Extract form Carillion five-year review

Underlying earnings per share (pence)

2012 40.4p

2013 34.7p

2104 33.7p

2015 35.0p

2016 35.3p

Source: Carillion plc, 2016 Annual Report, p.38 and p.151.

Case Exhibit 6 – Early payment facility (extract from Annual Report)

‘As indicated above, our category management supply chain system is also helping us to create long-term partnerships with our suppliers, as this system means we buy in greater volumes from our chosen suppliers who also get good visibility of our future requirements for the goods and services that they sell to Carillion. The introduction of Carillion’s Early Payment Facility (EPF) at the beginning of 2013 has also proved to be extremely popular with suppliers and is also helping us to build long-term relationships with our suppliers. Under the EPF, we are paying all suppliers on at least the same terms as they were on prior to joining the EPF and in many cases we are paying suppliers up to 20 days earlier, at no cost to suppliers. Also suppliers can choose when they take payments in respect of approved invoices and if they wish to take them even earlier, they can do so at minimal cost, which is far less than their typical cost of borrowing.’

Source: Carillion plc, 2014 Annual Report, p.15

Case Exhibit 7 – Carillion to double maximum payment terms to 120 days

By Vern Pitt, Iain Withers, 21 March 2013

Exclusive: Subcontractors will have to pay fee to get money before 120 days as part of new payment system

Carillion is nearly doubling its maximum payment terms to suppliers to 120 days in a new payment system.

Under Carillion's Early Payment Facility, payment terms will rise from a maximum of 65 days to 120 days and subcontractors will be paid directly by a bank instead of Carillion, through a controversial financial mechanism known as "reverse factoring".

Under the scheme, subcontractors will have to pay a charge to the bank if they want to be paid earlier than 120 days. The charge is set out on a sliding scale that increases to up to 0.67% of the value of the invoice, depending on how early the subcontractor wishes to be paid.

A Carillion spokesman said the scheme was voluntary and Carillion would reimburse the cost of bank charges for payments made to subcontractors in line with their current payment terms, leaving them no worse off. He also said suppliers could negotiate with Carillion to cover a proportion of the fees for payment earlier than their current terms.

But a Carillion subcontractor, who did not wish to be named, told Building he had serious concerns about the scheme and feared that the charges would not be covered by Carillion. "The subcontracting industry can't afford it. This would mean that we wouldn't be able to do business with Carillion - it's that serious," he said.

He added that the scheme was too complicated to be properly understood - especially by smaller suppliers. "A lot of people will sign up for this out of desperation and later regret it, especially smaller contractors who don't have commercial teams to advise them."

In a letter to suppliers, seen by Building, Carillion group finance director Richard Adam said the move was "in support" of the government's Supply Chain Finance scheme - a form of reverse factoring - which was launched by David Cameron in October, primarily to support the cash flow of smaller firms within the supply chain.

In documents alongside the letter, Carillion said it was a "mutually beneficial arrangement that provides earlier access to funds for our suppliers and a strong balance sheet for Carillion".

But Suzannah Nichol, chief executive of the National Specialist Contractors Council, said it was "in no way acceptable" to extend payment terms to 120 days, while the government put so much emphasis on prompt payment.

She said although the scheme was voluntary, suppliers would feel pressured to accept new terms for fear of losing future work. "Many suppliers, certainly at this moment in time, find it difficult to stand up to main contractors," she said.

Rudi Klein, chief executive of the Specialist Engineering Contractors Group, advised firms to be careful before entering into such an arrangement. He pointed out that suppliers would still be left chasing Carillion for reimbursement of the bank charges.

“This doesn’t improve supply chain finance, it underwrites the major fault line in UK construction, which is the under capitalisation of the largest firms that let out most of the work,” he added.

In its accounts for the year to 31 December 2012 Carillion reported that its net debt - the balance of its cash in the bank minus its borrowings - increased by nearly 50% the previous year to £156m, with average debt through the year increasing by £125m to £344m. It also reported that it owed trade creditors £1.6bn.

Kevin Cammack, analyst at Cenkos, who downgraded his share price expectation for Carillion this month, in part due to the firm’s low cash reserves, said that extending payment terms to 120 days would allow Carillion to move up to a month’s worth of debt off its balance sheet.

Source: https://www.building.co.uk/news/carillion-to-double-maximum-payment-terms-to-120-days/5052077.article

Case Exhibit 8 – Accounting policy for construction contracts

When the outcome of a construction contract can be estimated reliably, contract revenue and costs are recognised by reference to the degree of completion of each contract, as measured by the proportion of total costs at the balance sheet date to the estimated total cost of the contract. Insurance claims, incentive payments, and variations arising from construction contracts are included in revenue where it is probable that they will be recovered and are capable of being reliably measured.

When the outcome of a construction contract cannot be estimated reliably, contract revenue is recognised to the extent of contract costs incurred where it is probable those costs will be recoverable.

The principal estimation technique used by the Group in attributing profit on contracts to a particular period is the preparation of forecasts on a contract by contract basis. These focus on revenues and costs to complete and enable an assessment to be made of the final out-turn of each contract.

Consistent contract review procedures are in place in respect of contract forecasting. When it is probable that total contract costs will exceed total contract revenue, the expected loss is recognised immediately. Contract costs are recognised as expenses in the period in which they are incurred.

Where costs incurred plus recognised profits less recognised losses exceed progress billings, the balance is shown as amounts owed by customers on construction contracts within trade and other receivables. Where progress billings exceed costs incurred plus recognised profits less recognised losses, the balance is shown as amounts owed to customers on construction contracts within trade and other payables.

Pre-contract costs Pre-contract costs are expensed as incurred until the Group is appointed preferred bidder or formal notification of the intention to appoint is received. Provided the contract is expected to generate sufficient net cash inflows to enable recovery and the award of the contract is probable, pre-contract costs incurred post the appointment as preferred bidder are included in amounts owed by customers on construction contracts.

Where pre-contract bid costs are reimbursed at financial close, the proceeds are initially applied against the asset included in amounts owed by customers on construction contracts. Any excess recoveries are carried forward as deferred income and released to profit over the period of the contract.

Source: Carillion plc, 2016 Annual Report, p.96.

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