**Business, Energy and Industrial Strategy and Work and Pensions Committees, 2018**

# 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*

*Report, together with formal minutes relating to the report*

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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.