SUMMARY OF FINDINGS IN DECISION 1

This summary of findings concerns the outcomes of investigations into the relevant Statutory Auditor(s). No part of this summary of findings should be treated as making any findings in respect of the conduct of any other persons or entities.

As exemplified below, audit failings have been found in numerous areas of the audits across the relevant years (financial years ended 2014, 2015 and 2016), including in many cases in areas which had been identified as presenting significant risk of misstatement.

Contracts

The breaches relate to KPMG's audit work on eight of Carillion's most significant UK contracts and certain elements of KPMG's audit work on Carillion's portfolio of contracts generally.

UK construction and services contracts were at the core of Carillion's business, accounting for nearly three quarters of total of group revenue. Many of the contracts related to the construction, operation and maintenance of key elements of UK infrastructure, most notably a number of hospitals and significant road and railway projects.

The eight contracts were some of the largest, most critical contracts for Carillion at the time of the audits considered. All but one of these contracts were identified by KPMG during its 2016 audit as containing "*the highest degree of judgement, estimate and challenge*". It would therefore be expected that they would attract the most care from KPMG, applying high standards of critical analysis and professional judgement and a rigorous and robust approach. These eight contracts also accounted for some of the largest components of the provisions announced by Carillion in 2017.

Selecting contracts for testing

KPMG identified that there was a significant risk of material misstatement in relation to revenue, margin, receivables and liabilities relating to contracts. However, KPMG performed detailed audit testing only on specific contracts and carried out only very limited audit work on the remaining population. As a result, KPMG obtained very little evidence over a residual population of contracts that accounted for very substantial amounts of revenue, amounting to over £1.6 billion in 2015 and £1.4 billion in 2016.

Controls

KPMG was required to identify and evaluate Carillion's controls over its accounting for its contracts. However, in the 2016 audit KPMG failed to adequately evaluate the design of the controls or to determine whether they had been implemented and the testing of many of the controls they relied on was deficient and did not confirm whether they were operating effectively.

Forecasts of claims, variations and costs to determine revenue

For construction contracts, forecasting total contract revenue and costs was necessary to determine the amount of revenue and profit to be recognised in a period for an ongoing contract, and also whether or not a contract should be treated as loss-making overall. The judgements made relating to these amounts were highly subjective and had a very significant impact on Carillion's overall reported profit and there was therefore a heightened risk from management bias.

Forecast revenue included amounts from any agreed variations made to the contract and from any claims made against the customer but these could only be included where criteria required by accounting standards were met. For certain significant contracts KPMG did not obtain sufficient appropriate audit evidence to provide assurance that the necessary criteria for claims and variations to be included within revenue were met, and in a number of cases had evidence suggesting that they were not. KPMG failed to consider the judgements and estimates made by management on each of these claims and variations with sufficient professional scepticism.

KPMG's approach in relation to costs on some of Carillion's most significant contracts similarly lacked sufficient scepticism; KPMG did not subject Carillion's forecasts to any effective challenge or scrutiny to ensure that they were reasonable. The forecasts were often unsupported by evidence, and inconsistent with both the contract's track record and other evidence relevant to costs that were likely to be incurred.

For both forecast revenue and forecast costs in respect of these contracts, KPMG also failed to consider whether, in aggregate, they indicated possible management bias that represented a risk of material misstatement overall.

Contract assets

On some of Carillion's most significant service contracts substantial amounts were recognised as assets during 2014, 2015 and 2016. Recognising these assets either increased profit or reduced or eliminated losses and depended on judgements by Carillion's management on whether the amounts were likely to be recoverable. KPMG did not approach this area with an adequate degree of professional scepticism. It failed to challenge inconsistencies and a lack of clarity generally in the justifications provided by management for the recognition of the assets and did not respond to indications that the accounting treatment might overstate reported profit. In relation to two contracts audit team members failed to maintain their objectivity in relation to judgements made by Carillion's management.

Audit work relating to a claim against Carillion and KPMG's independence

In relation to one significant contract, KPMG was aware that the customer was making a substantial claim against Carillion, alleging that records relating to services provided under the contract had been falsified. The KPMG audit team was also aware that the allegations were supported by work performed by a separate KPMG team. In the 2016 audit, KPMG failed to obtain sufficient appropriate audit evidence to assess whether a potential liability arising from the claim was properly reflected in the financial statements and failed adequately to address the threat to its independence from the involvement of another KPMG team.

Potentially loss-making contracts and provisions

In addition to assessing the individual components of amounts recognised on each contract, KPMG was required to evaluate and reach a conclusion as to whether the overall position taken by Carillion on each contract in the financial statements, was appropriate and supported by the evidence obtained. On construction contracts, KPMG's detailed work in the 2016 audit identified several of Carillion's most significant construction contracts as being "high risk" but did not properly evaluate whether overall positions taken on the contracts were appropriate and reasonable. On service contracts, KPMG identified a risk in the 2014, 2015 and 2016 audits that several of Carillion's most significant contracts would make a loss overall but failed properly to evaluate this risk and failed to approach management's justification for not recognising the extent of the likely losses with appropriate scepticism.

In addition to the risks relating to specific contracts, there was also a risk over the performance of Carillion's portfolio of contracts as a whole. KPMG was required to assess whether provisions in Carillion's financial statements to address this risk were reasonable. In 2016, the audit work performed on the reasonableness of the provisions was minimal. KPMG identified a "downside scenario" relating to a number of "higher risk" contracts over which there was "the highest degree of judgement, estimate and challenge" with an aggregate "exposure" of more than £250 million and a significant number of "other notable contracts" where similar risks arose. Amounts relating to these "higher risk" and "notable" contracts totalled more than £600 million. However, KPMG concluded that provisions of just £50.1 million were reasonable and that Carillion's reported position on contracts overall was appropriate. These conclusions were not supported by the evidence obtained and KPMG did not approach this area with an adequate degree of professional scepticism.

Debt

Net borrowing was considered to be an important indicator of Carillion's liquidity, and hence its ability to pay its debts when due. In 2016 there was evidence available to KPMG that the amount reported as net borrowing and the accompanying disclosures may not have given a true picture of the underlying borrowing of the group. The evidence related in particular to the Early Payment Facility ("EPF") operated by Carillion and to certain 'one off' transactions entered into in late 2016.

The EPF was a reverse factoring facility under which invoices raised by Carillion's suppliers were paid by participating banks, in advance of the suppliers' payment terms, with Carillion repaying the banks at a later date. The total value of invoices on the EPF platform at any one time was substantial and rose to £472 million as at 31 December 2016. The EPF provided represented, in effect, an additional source of working capital for Carillion and so reduced its reliance on other forms of financing that were included in reported borrowing but the nature and scale of the arrangements, and their effect as an additional form of financing, were not disclosed in the financial statements. KPMG should have considered the treatment adopted with scepticism but, despite its significance, KPMG, carried out minimal audit work on the EPF in 2014, 2015 and 2016 and did not obtain a clear understanding of how the EPF operated or its impact on Carillion's reported net borrowing.

In late 2016 Carillion entered into a number of contracts (described as 'one offs') that had a material impact on both reported revenue and profit, and year end cash, and consequently the reported level of net debt. KPMG failed to audit the accounting treatment of certain of these the contracts properly and failed to respond appropriately to evidence that suggested the treatment adopted in each case was inappropriate. KPMG showed a lack of scepticism and audit team members failed to maintain their objectivity in relation to judgements made by Carillion's management in respect of these contracts.

In addition, large movements in amounts for net borrowing around the 2016 year end strongly suggested manipulation of borrowing at year end – for example, by delaying payments to creditors. Overall, in relation to debt, KPMG failed to assess adequately whether the 2016 financial statements provided a true and fair view of Carillion's financial position and failed, in particular, to assess whether the presentation of net borrowing in the 2016 annual report was consistent with KPMG's knowledge acquired during the audit.

Going concern

KPMG was required to conclude whether it was appropriate for Carillion's financial statements to be prepared on a going concern basis, and, even if it was appropriate, whether there was a material uncertainty about Carillion's ability to continue as a going concern which should be disclosed in the financial statements. However, in the 2016 audit KPMG's approach lacked sufficient scepticism and failed to properly evaluate and challenge management's assessment of going concern, and to identify and respond to events or conditions that collectively might have cast significant doubt over Carillion's ability to continue as a going concern and which required further audit procedures to be performed.

<u>Other accounting and auditing areas</u>

There were serious breaches of Relevant Requirements arising from KPMG's audits of Carillion's pensions liabilities, of the amounts reported for goodwill, and of the treatment of certain of Carillion's overseas contracts.

Pension liabilities

KPMG's actuaries regarded the assumptions used in the 2016 valuation of pensions liabilities as likely to result in a valuation of liabilities "at the extreme weak limit" and identified that moving some of these assumptions to the centre of its benchmark range would have increased the reported liability by at least £200 million. KPMG lacked sufficient scepticism and failed to respond to this and other indications of management bias relating to these assumptions.

Goodwill

Carillion's financial statements for each of the years 2014 to 2016 reported goodwill balances totalling in excess of £1.5 billion. KPMG identified goodwill as a significant risk, noting the size of the amounts and the inherent uncertainty involved. However, the audit work failed to ensure that Carilion's assessment of goodwill was performed appropriately and failed to obtain sufficient evidence to support a number of important assumptions that underpinned Carillion's forecasts of future cashflows. KPMG did not approach this area with an adequate degree of professional scepticism.

Overseas contracts

One of Carillion's overseas components, Qatar, included a contract which was estimated to have a final value of over £600 million. In the 2016 audit, KPMG was aware of significant problems with this contract and that Carillion's reported performance of the contract incorporated over £100 million in claims and variations which had not yet been agreed with the client. KPMG's audit work was limited and provided insufficient evidence to support the very large amounts recognised. Additionally, in its audit of the Canada component, KPMG failed to respond appropriately to indications of possible management bias and risks that revenue in relation to claims had been recognised inappropriately.

<u>Management, supervision and review</u>

In the 2016 audit Mr Meehan and KPMG failed in their duties to ensure that the audit engagement was properly managed and supervised. Records of the preparation and review of working papers were unreliable and, in some cases, misleading. On occasions Mr Meehan instructed the audit team to record his review of working papers without ensuring that he had in fact performed such a review and so failed to act with integrity. Audit procedures in a range of areas of the 2016 audit were not completed until more than six weeks after the date of the audit report but were nonetheless recorded on the final audit file as if they had been performed before that date. Overall, no effective process was implemented to ensure that all the audit procedures underpinning the 2016 audit report had been completed, documented and reviewed satisfactorily before the audit report was issued. In light of these deficiencies, Mr Meehan did not have a proper basis to be satisfied that the opinion given in the 2016 audit report was appropriate.