Edited for publication

IN THE MATTER OF

THE EXECUTIVE COUNSEL TO THE FINANCIAL REPORTING COUNCIL

and

(1) KPMG LLP

(2) PETER NOEL MEEHAN

FINAL SETTLEMENT DECISION NOTICE

PURSUANT TO RULE 108 OF THE AUDIT ENFORCEMENT PROCEDURE

This Final Settlement Decision Notice is a document prepared by Executive Counsel following an investigation relating to, and admissions made by, the Respondents. It does not make findings against any persons other than the Respondents and it would not be fair to treat any part of this document as constituting or evidencing findings against any other persons or entities since they are not parties to the proceedings.

Amendments were made to this document for publication in line with the FRC's Publication Policy (Audit Enforcement Procedure).

3 AUGUST 2023

PART A

1. INTRODUCTION

A. Nature of this *Final Settlement Decision Notice*

1. The Financial Reporting Council (the "**FRC**") is the competent authority for Statutory Audit in the UK and operates the Audit Enforcement Procedure (June 2023) (the "**AEP**"). The AEP sets out the rules and procedure for the investigation, prosecution and sanctioning of breaches of *Relevant Requirements*. References to the AEP in this *Final Settlement Decision Notice* are to the version dated June 2023 unless otherwise stated.

2. The AEP contains a number of defined terms and, for convenience, those defined terms are also used within this document. Where defined terms are used, they appear in italics.

3. This *Final Settlement Decision Notice* also uses the following definitions:

    3.1 "**Carillion**" means Carillion plc and its group companies;

    3.2 the "**2014 audit**" means the audit of the financial statements of Carillion for the financial year 2014;

    3.3 the "**2015 audit**" means the audit of the financial statements of Carillion for the financial year 2015; and

    3.4 the "**2016 audit**" means the audit of the financial statements of Carillion for the financial year 2016;

    3.5 the "**Respondents**" means:

        3.5.1 KPMG LLP ("**KPMG**") which was the *Statutory Audit Firm* for the 2014, 2015, and 2016 audits; and

        3.5.2 Peter Noel Meehan ("**Mr Meehan**") who was the *Statutory Auditor* for Carillion for the 2014, 2015, and 2016 audits.

4. In accordance with Rule 102 of the AEP, Executive Counsel entered into settlement discussions with the Respondents.

5. A *Proposed Settlement Decision Notice* was issued by Executive Counsel on 29 June 2023 pursuant to Rule 103 of the AEP in relation to the conduct of the Respondents in respect of the 2014 audit, 2015 audit and 2016 audit. The Respondents provided written agreement to the *Proposed Settlement Decision Notice*, pursuant to Rule 105 of the AEP, on 14 July 2023. The *Convener* subsequently appointed an *Independent Reviewer*, pursuant to Rule 106 of the AEP, to consider the *Proposed Settlement Decision Notice.*

6. On 26 July 2023, the *Independent Reviewer* approved the issuance of a *Final Settlement Decision Notice* pursuant to Rule 107(a) of the AEP.

7. In accordance with Rule 108 of the AEP this *Final Settlement Decision Notice* sets out:

   7.1 the breaches of *Relevant Requirements*, with reasons;

   7.2 the *Sanctions* imposed on the Respondents with reasons; and

   7.3 the amount payable in respect of the Executive Counsel's costs of the matter.

8. KPMG audited the financial statements of Carillion for the financial years 2014, 2015, and 2016. In each of these years, KPMG provided an unqualified audit opinion that the financial statements gave a true and fair view of Carillion's affairs. KPMG's audit opinion for the financial year 2016 was dated 1 March 2017. In July and September 2017 Carillion announced expected provisions totalling £1.045 billion, primarily arising from expected losses on a number of its contracts, and a goodwill impairment charge of £134 million. In January 2018, Carillion plc entered into compulsory liquidation.

9. Carillion was required to prepare its 2014, 2015 and 2016 financial statements in accordance with International Financial Reporting Standards ("**IFRS**"), also referred to as "*accounting standards*".

10. In carrying out the 2014, 2015 and 2016 audits, the Respondents were required to act in accordance with the International Standards on Auditing (UK and Ireland) ("**ISAs**") and the Ethical Standards issued by the Auditing Practices Board ("**ESs**"). The provisions of the ISAs and the ESs were all "*Relevant Requirements*" within the meaning of the AEP. Each breach found in this *Final Settlement Decision Notice* is a finding by the Executive Counsel that one or more of the Respondents breached one or more of those *Relevant Requirements.*

11. References to the ISAs and ESs in this *Final Settlement Decision Notice* are to the versions in force and applicable at the time of the relevant audits.

B. Structure of this *Final Settlement Decision Notice*

12. This *Final Settlement Decision Notice* is divided into five parts: A to E. Part A contains introductory chapters as follows:

12.1 Chapter 1 sets out this introduction.

12.2 Chapter 2 sets out factual background on:

12.2.1 Carillion and the events leading up to its liquidation;

12.2.2 KPMG; and

12.2.3 a summary of the most important *Relevant Requirements* relating to the issues considered in this *Final Settlement Decision Notice* and the Respondents' approach to these requirements.

12.3 Chapter 3 sets out factual background on:

12.3.1 nine of Carillion's most significant contracts, being eight UK contracts and one overseas contract, selected by the Executive Counsel to consider the Respondents' audit work in relation to contracts; and

12.3.2 how the performance on these contracts was reported in Carillion's financial statements, including details of the relevant accounting standards and Carillion's approach.

12.4 Chapter 4 provides a summary of the breaches found and the key facts supporting those findings.

12.5 Chapter 5 sets out the *Sanctions* imposed and the amount payable in respect of costs.

13. Part B of this *Final Settlement Decision Notice* sets out breaches of *Relevant Requirements* in relation to the Respondents' audit work in respect of UK construction and services contracts. In this part of the *Final Settlement Decision Notice*:

13.1 Chapters 6 and 7 set out breaches of *Relevant Requirements* in respect of two elements of the Respondents' audit of Carillion's portfolio of contracts generally.

13.2 Chapters 8 to 12 set out breaches of *Relevant Requirements* in respect of the Respondents' audit of a number of elements of eight of Carillion's most significant UK contracts.

13.3 Chapter 13 sets out breaches of *Relevant Requirements* in respect of the Respondents' assessment of the risk of material misstatement in relation to Carillion's portfolio of contracts overall.

14. Part C of this *Final Settlement Decision Notice* sets out breaches of *Relevant Requirements* in relation to the Respondents' audit work in respect of debt and going concern. In this part of the *Final Settlement Decision Notice*:

14.1 Chapters 14 to 16 set out breaches of *Relevant Requirements* in relation to the Respondents' treatment of three significant matters that had an effect on Carillion's reported debt.

14.2 Chapter 17 sets out breaches of *Relevant Requirements* in relation to the Respondents' work on Carillion's reported debt specifically.

14.3 Chapter 18 sets out breaches of *Relevant Requirements* in relation to the Respondents' audit of management's going concern assessment.

15. Part D of this *Final Settlement Decision Notice* is made up of Chapters 19 to 21, which set out breaches of *Relevant Requirements* in relation to the Respondents' work in three further areas, relating to the valuation of pension scheme liabilities, valuation of goodwill and aspects of Carillion overseas components.

16. Part E of this *Final Settlement Decision Notice* comprises Chapter 22, which sets out breaches of *Relevant Requirements* in relation to the Respondents' management, supervision and review of the audits.

C. Scope of this Final Settlement Decision Notice

17. On 26 January 2018, the FRC's Conduct Committee referred potential allegations for investigation under the AEP. The scope of the investigation is as follows:

> *"Whether there have been breaches of Relevant Requirements in relation to the Statutory Audits of the financial statements of Carillion plc for the years ended 31 December 2014 to 2016 and audit work conducted in 2017."*

18. The investigation considered issues arising in the 2014 audit, the 2015 audit, and the 2016 audit, focussing primarily on the 2016 audit. As a consequence, most of the breaches of *Relevant Requirements* cited in this *Final Settlement Decision Notice* are from the 2016 audit. A number of other breaches of *Relevant Requirements* are found in relation to the other audits (some but not all of which are related to those made in relation to the 2016 audit). The Executive Counsel has taken a proportionate and risk-focused approach, such that by necessity, the Executive Counsel's investigation has focused on certain areas of the Respondents' work, and has not purported to examine and conclude on all areas, in order that this *Final Settlement Decision Notice* is kept to a tolerable length and level of complexity. As such, the findings made in this *Final Settlement Decision Notice* do not represent an exhaustive commentary on the conduct of the relevant audits.

19. Quotations from correspondence, documents or transcripts are verbatim, with any grammatical, spelling or other errors remaining as the original. The term "sic" is not used.

D. ISA breaches and liability of the Respondents

(1) ISA breaches

20. The nature of ISAs is that they naturally overlap with one another, with the result that a single deficiency can often involve a breach of multiple ISAs. In this *Final Settlement Decision Notice*, the Executive Counsel has not sought to identify every ISA that has been breached by each deficiency, but instead has identified the ISAs that are most directly relevant to the issue in question.

(2) References to breaches of Relevant Requirements

21. For ease of identification, breaches of *Relevant Requirements* are set out in paragraphs using bold underlined text (like **<u>this</u>**).

(3) KPMG's liability

22. As the Statutory Audit Firm responsible for the 2014, 2015 and 2016 audits, KPMG is responsible for any established breaches of *Relevant Requirements* on the part of its partners or employees. As such, references to "KPMG" throughout this *Final Settlement Decision Notice* refer to the relevant KPMG audit team members who conducted the audit and, as applicable, the firm. Where a breach of ESs is found and attributed to KPMG, the relevant individual/s involved is/are identified in the paragraphs setting out the breaches of *Relevant Requirements*.

(4) Mr Meehan's liability

23. Mr Meehan was the engagement partner on all three audits covered in this *Final Settlement Decision Notice*. He was responsible for the overall quality of the audits and the direction, supervision, and performance of the audits in compliance with the professional standards and applicable legal and regulatory requirements. Accordingly, Mr Meehan is responsible for any established breaches of ISAs in relation to the audits.

E. Carillion's conduct

24. The breaches of *Relevant Requirements* in this *Final Settlement Decision Notice* do not depend on fraud or any other form of misconduct on the part of Carillion's management or staff being established. Therefore:

    24.1 This *Final Settlement Decision Notice* does not seek to make any finding about the conduct of Carillion or its management or staff.

    24.2 Although this *Final Settlement Decision Notice* may refer to the risk of manipulation, risks arising from fraud, the risk of management seeking to manage earnings, and other similar concepts, this *Final Settlement Decision Notice* does not allege that manipulation or fraud actually took place.

2. BACKGROUND

A. Carillion and the events leading up to its liquidation.

25. Carillion supplied services in three core areas:

25.1 construction (building and infrastructure projects for public and private sector customers);

25.2 property and facilities management and infrastructure services (which are generally referred to in this *Final Settlement Decision Notice* as simply "*services*"); and

25.3 project finance for public-private partnerships.

26. The bulk of Carillion's business was in the UK. However, it also operated in Canada and in the Middle East and North Africa.

27. Carillion's results for the financial years 2014, 2015, and 2016 and the half-year to 30 June 2017 were as follows:

	FY2014	FY2015	FY2016	HY2017
Group revenue	£4,072m	£4,587m	£5,214m	£2,498m
Profit after tax	£128m	£139m	£130m	£44m
Proposed dividends	£76m	£79m	£79m	-
Cash from operations	£124m	£73m	£73m	(£290m)
Net assets	£895m	£1,017m	£730m	(£405m)
Intangible assets (largely goodwill)	£1,614m	£1,634m	£1,669m	£1,551m
Pension deficit	£510m	£394m	£805m	£711m
Net debt (or net borrowing)	£177m	£170m	£219m	£571m
Average net debt over the period	£451m	£539m	£587m	£694m

28. Each of Carillion's 2014, 2015 and 2016 annual reports reported the group's "*net borrowing*" (also referred to as "*net debt*"), defined as total borrowing less net cash and cash equivalents. This amount was referred to repeatedly in the annual reports which described it as "*the most appropriate measure of liquidity for the Group*". It was also an important indicator of Carillion's ability to continue as a going concern.

29. During the 2016 audit, KPMG recorded that Carillion was "*becoming the most popular share for hedge funds to sell short*", potentially indicating the sellers' view that its share price overvalued the business. In April 2017, it was reported that "*Carillion…has been the most popular stock for hedge funds to sell "short" on the UK market for 18 months*", identifying potential areas of concern, including:

    29.1 Amounts recognised for revenue on Carillion's long-term contracts, which were dependent on management's estimates of the overall outcome of those contracts and so at risk of manipulation or error. This concern was heightened due to the increasing amount of revenue that had been recognised but not yet paid by Carillion's customers, even as sales declined.

    29.2 "*Aggressive management of payments terms with suppliers*", suggesting problems with generating cash flow.

30. On 23 February 2017, KPMG's "*Year end Audit Memorandum*" for Carillion's audit committee (the "**2016 Year-End Audit Memorandum**"), identified a number of contracts, over which there was "*the highest degree of judgement, estimate and challenge*" and, in relation to these contracts, highlighted assumptions made by management in relation to amounts totalling more than £600 million, which underpinned the reported results.

31. On 1 March 2017, Carillion announced its results for the year end 31 December 2016.

32. In mid-2017, with KPMG's assistance, Carillion's management performed an "*enhanced*" review of the group's material construction contracts. The decision to perform this review was largely driven by deterioration in cash flows in relation to a number of Carillion's construction contracts.

33. The outcome of this review was a provision of £695 million against construction contracts as at 30 June 2017. KPMG's report to Carillion's audit committee in connection with that review and that level of provision was dated 9 July 2017 and confirmed:

> *"Overall, our assessment is that the post-provision position traded on the claims reviewed in respect of these contracts is reasonable*
>
> *…*
>
> *Management has considered each of the major contract positions in turn to assess whether the enhanced contract review has uncovered evidence that should have been obtained and taken into account in preparing the Group's 2016 annual report and accounts.*
>
> *…*

… management does not believe there was a fundamental error in the positions traded in the Group's 2016 annual reporting and accounts.

Overall we agree with management's assessment."

34. One day later, on 10 July 2017, Carillion issued a profit warning and announced a provision against its construction contracts of approximately £845 million. Following this, Carillion's share price fell by 70% over a matter of days.

35. On 29 September 2017, Carillion published its interim financial statements for the six months to 30 June 2017. These were reviewed but not audited by KPMG and reported losses of nearly £1.2 billion, primarily arising from the £845 million provision against construction contracts, a further provision of approximately £200 million against its service contracts and a goodwill impairment charge of approximately £134 million.

36. These interim financial statements stated that the total provisions of £1,045.5 million were treated as relating to the current period and did not arise from errors in financial statements for 2016 and earlier periods.

37. On 17 November 2017, Carillion issued another profit warning, and indicated that it would breach its banking covenants the following month.

38. On 15 January 2018 Carillion was placed into compulsory liquidation.

B. KPMG

39. KPMG (or its predecessor firm[1]) was appointed as Carillion's auditor for the year ended 31 December in 1999.

40. On 4 March 2015, KPMG signed its 2014 audit report, in which it gave an unmodified audit opinion on Carillion's financial statements for the year to 31 December 2014.

41. On 3 March 2016, KPMG signed its 2015 audit report, in which it gave an unmodified audit opinion on Carillion's financial statements for the year to 31 December 2015.

42. On 1 March 2017, KPMG signed its 2016 audit report, in which it gave an unmodified audit opinion on Carillion's financial statements for the year to 31 December 2016.

43. In each of the three audits:

    43.1 Mr Meehan was the engagement partner and "*Group Audit Partner*", and signed the audit report (as "*Senior Statutory Auditor*").

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[1] KPMG Audit Plc was auditor for the 1999-2013 audits.

43.2 Mr Meehan's audit opinion was unqualified.

44. The engagement team included the following personnel, in order of seniority:

44.1 the Group Senior Manager for the 2016 audit ("**KPMG Senior Manager A**");

44.2 the UK Construction and Group Senior Manager for the 2016 audit ("**KPMG Senior Manager B**");

44.3 the UK Services Senior Manager for the 2016 audit ("**KPMG Senior Manager C**");

44.4 the UK Construction Assistant Manager for the 2016 audit;

44.5 the UK Services and Group "*In charge*" for the 2016 audit; and

45. Another KPMG partner, who was the Engagement Quality Control Reviewer ("**EQCR**").

46. Carillion was a very important client for all key members of the audit team. In particular:

46.1 Mr Meehan was the lead audit engagement partner for the 2014, 2015, and 2016 audits of Carillion. He was also the component partner for UK construction and UK services in 2015 and 2016. Before that, he had "*little recent big-ticket construction experience*". In interview, Mr Meehan stated that the "*vast majority*" of his client time was spent on Carillion, estimating it to be about 40-50% of his time overall.

46.2 KPMG Senior Manager A had worked on the Carillion audit each year since they joined KPMG in 2007. For the 2014, 2015, and 2016 audits they were the Group Audit Senior Manager. In interview, KPMG Senior Manager A explained that Carillion had been their primary client over this period and that they had spent "*probably a third or about half*" of their time on Carillion.

46.3 KPMG Senior Manager B's first significant involvement with Carillion was in 2011. They had worked on the Carillion audit each year thereafter. For the 2016 audit, KPMG Senior Manager B was promoted to Senior Manager. They performed this role for the audit of the UK Construction component and, in KPMG Senior Manager A's absence in January 2017, for the group audit. Carillion was KPMG Senior Manager B's primary client. In interview, KPMG Senior Manager B estimated that they spent roughly 35% to 40% of their time on the Carillion audits overall, increasing to 70-75% during the year-end work on the 2016 audit. They explained that they did not have any other clients "*of the same scale or breadth as Carillion*".

46.4 KPMG Senior Manager C was a manager on the 2014 and 2015 audits of UK Services and Senior Manager on the 2016 audit. In interview, they said that they thought that Carillion was their third-largest client.

C. Requirements for the audits and KPMG's approach

(1) Overall approach

47. ISA 200 set out requirements relating to the overall objectives and conducts of audit.

48. It required KPMG to apply "*professional skepticism*" in planning and performing the audit, where professional scepticism was defined as:

> *"An attitude that includes a questioning mind being alert to conditions which may indicate possible misstatement due to error or fraud and a critical assessment of audit evidence."*

49. Guidance in ISA 200 provided further description, stating:

> *"Professional skepticism is necessary to the critical assessment of audit evidence. This includes questioning contradictory audit evidence and the reliability of documents and responses to inquiries and other information obtained from management and those charged with governance. It also includes consideration of the sufficiency and appropriateness of audit evidence obtained in the light of the circumstances, for example in the case where fraud risk factors exist and a single document, of a nature that is susceptible to fraud, is the sole supporting evidence for a material financial statement amount."*

50. A lack of scepticism would therefore be where this "*critical assessment*" was insufficient such that the ensuing audit procedures performed were inadequate.

51. These requirements were repeated in other ISAs considering different stages or aspects of the audit, including in ISA 240, ISA 330 and ISA 500.

52. ISA 200 also required KPMG to comply with relevant ethical requirements, set out in Ethical Standard 1 ("**ES 1**"), which provided that:

> *"Auditors shall conduct the audit of the financial statements of an entity with integrity, objectivity and independence"*

53. ES 1 described each of these characteristics as follows:

53.1 Integrity

"requires not only honesty but a broad range of related qualities such as fairness, candour, courage, intellectual honesty and confidentiality."

Integrity therefore required candour and honesty in the acquisition, analysis and transmission of information and judgements.

53.2 Objectivity

"a state of mind that excludes bias, prejudice and compromise and that gives fair and impartial consideration to all matters that are relevant to the task in hand, disregarding those that are not."

ES 1 noted that the preparation of financial statements required judgements to be made and that if these were affected by bias, then the financial statements may be misstated or misleading. In this context, ES 1 went on to state:

"The auditor's objectivity requires that an impartial opinion is expressed in the light of all the available audit evidence and the auditor's professional judgment. Objectivity also requires that the auditor adopts a rigorous and robust approach and is prepared to disagree, where necessary, with the directors' judgments."

Objectivity therefore related to the factors considered in making a judgement and included being prepared to disregard, where necessary, management's preference for a certain approach to be taken.

53.3 Independence

"freedom from situations and relationships which make it probable that a reasonable and informed third party would conclude that objectivity either is impaired or could be impaired. Independence is related to and underpins objectivity."

ES 1 noted that independence related to the circumstances of the audit rather than the auditor's state of mind and related to the financial, employment, business and personal relationships between the auditor and the audited entity and its connected parties.

(2) Risks of material misstatements

54. ISA 315 required KPMG to identify and assess risks of material misstatements in the financial statements.

55. ISA 315 also required KPMG to determine whether any of these risks were "*significant risks*", defined as:

> *"An identified and assessed risk of material misstatement that, in the auditor's judgment, requires special audit consideration."*

56. KPMG identified the following significant risks in the 2014, 2015, and 2016 audits:

 56.1 the carrying value of goodwill;

 56.2 the recognition of contract revenue, margin, and related receivables and liabilities (this risk is sometimes referred as relating to "*contracts*");

 56.3 the recognition of deferred tax assets;

 56.4 the valuation of retirement benefit obligations; and

 56.5 management override of controls.

57. In addition, KPMG also identified the "[…] *outsourcing transition*" as a significant risk for the 2014 audit and "*Other revenue judgments*" relating to revenue from a licensing agreement as a significant risk in the 2016 audit.

58. ISA 240 expands on how ISA 315 is to be applied in relation to risks of material misstatement due to fraud. This ISA required that the risk of fraud from management override of controls be treated as a significant risk.

(3) Materiality

59. ISA 320 set out requirements relating to materiality, describing materiality in the context of an audit as follows:

> *"Misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements.*
>
> *…*
>
> *The auditor's determination of materiality is a matter of professional judgment, and is affected by the auditor's perception of the financial information needs of users of the financial statements."*

60. ISA 320 paragraph 9 defined "*performance materiality*" as:

> *"the amount or amounts set by the auditor at less than the materiality level or levels for particular classes of transactions, account balances or disclosures."*

61. ISA 450 paragraph 5 required KPMG to:

> *"accumulate misstatements identified during the audit, other than those that [we]re clearly trivial."*

62. KPMG set a figure that it called the "*Audit Misstatement posting threshold*" as the threshold below which amounts could be regarded as "*clearly trivial*" for this purpose.

63. KPMG set the quantitative thresholds for materiality as follows:

	2014 audit	2015 audit	2016 audit
Materiality	£9.0m	£8.0m	£8.0m
Performance materiality	£6.7m	£6.0m	£6.0m
Audit misstatement posting threshold	£0.4m	£0.4m	£0.4m

(4) Audit documentation

64. ISA 230 required KPMG to:

> *"prepare audit documentation that is sufficient to enable an experienced auditor, having no previous connection with the audit, to understand:*
>
> *(a) The nature, timing and extent of the audit procedures performed to comply with the ISAs (UK and Ireland) and applicable legal and regulatory requirements;*
>
> *(b) The results of the audit procedures performed, and the audit evidence obtained; and*
>
> *(c) Significant matters arising during the audit, the conclusions reached thereon, and significant professional judgments made in reaching those conclusions."*

65. KPMG's audit files include documents prepared by the audit team and documents obtained from Carillion and other sources, some of which are then annotated or otherwise amended by the audit team. This *Final Settlement Decision Notice* refers to all documents in the audit file as "**working papers**" and uses the financial year in respect of which they were prepared. For example, the term "*2016 working paper*" means a working paper prepared in connection with the 2016 audit, but not necessarily prepared in whole or in part in 2016.

66. KPMG working papers included "**position papers**", which were prepared by Carillion and provided to KPMG for the audits. These position papers set out a description of specific contracts, including the relevant amounts reported, along with explanations and support for these amounts.

(5) Audit procedures and evaluation

67. Various ISAs set out requirements relating to audit procedures and audit evidence addressing the risks identified, including the significant risks identified above. These ISAs included:

67.1 ISA 330 on the design and implementation of audit procedures to address the risks identified, including certain specific requirements in respect of significant risks.

67.2 ISA 240 expands on how ISA 330 is to be applied in relation to risks of material misstatement due to fraud, including the risk of fraudulent financial reporting arising from efforts by management to manage earnings.

67.3 ISA 500 on the nature and evaluation of audit evidence and the audit procedures to obtain sufficient appropriate audit evidence.

67.4 ISA 540 on the evaluation of accounting estimates made by management and indicators of possible management bias which might impact these.

67.5 ISA 700 on the evaluation of the conclusions drawn from audit evidence obtained and the expression of an opinion on whether the financial statements provide a "*true and fair view*".

3. CARILLION'S CONTRACTS AND CONTRACT REPORTING

A. Contracts considered in this Final Settlement Decision Notice

(1) Introduction

68. As noted above, two of Carillion's core business areas were construction and services. In 2017 Carillion announced provisions totalling £1,045 million against a number of contracts in these areas. KPMG's working paper *"HY.7.1.1.5.0.01.0 PROVISIONS BREAKDOWN*" provided the following analysis:

68.1 £392 million relating to UK construction contracts;

68.2 £133 million relating to UK services contracts; and

68.3 £520 million relating to construction and services contracts overseas.

69. Part B of this *Final Settlement Decision Notice* sets out findings in relation to KPMG's audit work on contracts. Chapters 6, 7 and 13 consider elements of KPMG's audit work on Carillion's portfolio of contracts generally. Chapters 8 to 12 consider KPMG's audit work on eight of Carillion's most significant UK contracts and Chapter 21, in Part D, considers KPMG's audit work on Carillion's overseas components including, in particular, one overseas contract.

70. These nine contracts referred to above were some of the largest, most critical contracts for Carillion's financial performance 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*". They also accounted for some of the largest components of the provisions announced by Carillion in 2017 as follows:

Contract	Provision
UK Construction:	
Aberdeen	£86.0m
Battersea	£38.2m
Liverpool	£67.5m
Southmead	£14.3m
UK Services:	
Nottingham	£22.0m
Oxford	£10.0m
Portsmouth	£17.1m
Services Contract A	£20.1m
Overseas	
Msheireb	£110.0m

71. Background details for these contracts are set out below. Each of these contracts are referred to as defined terms in this *Final Settlement Decision Notice*.

(2) The Aberdeen Contract

72. The Aberdeen Contract was a contract between:

72.1 a special purpose vehicle constituting a joint venture among three equal partners (Carillion, Joint Venture Partner 1 and Joint Venture Partner 2); and

72.2 the customer;

for the construction of the new Aberdeen Western Peripheral Route.

73. The Aberdeen Contract commenced in December 2014, and was originally (or at least in 2016) scheduled to be completed in late 2017.

74. In 2015, it was estimated that the Aberdeen Contract would generate (for Carillion) approximately £178 million in revenue and £165 million in costs, giving a profit of approximately £13 million.

75. There were significant delays on the Aberdeen Contract, and as at 31 July 2017, the road was not yet finished, and Carillion's estimated total costs had increased to over £300 million.

(3) The Battersea Contract

76. The Battersea Contract was a contract for the construction of apartments and associated amenities in or around the site of the old Battersea power station in London.

77. The Battersea Contract commenced on 11 November 2013 and was originally scheduled to be completed on 24 March 2017.

78. At commencement, it was estimated that the Battersea Contract would generate £443.7 million in revenue and £438.3 million in costs,[2] giving a profit of £5.4 million.

79. There were significant delays and a significant increase in costs on the Battersea Contract. This led to a "*Reset deal*" in late 2015, whereby Carillion's customer agreed to increase the contract sum by £20 million and to grant Carillion an extension of time. By late 2016, however, Carillion was seeking a "*second reset*", targeting an additional £28.6 million from its client in order to achieve the expected profit on the contract.

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[2] This assumes a margin of 1.25%.

(4) The Liverpool Contract

80. The Liverpool Contract was a contract for the construction of a new hospital in three phases on the existing Royal Liverpool University Hospital site. Phase 1 involved the construction of the new hospital and support building; phase 2 involved asbestos removal and the demolition of the existing hospital; and phase 3 involved the construction of an underground car park and "*central plaza*".

81. The Liverpool Contract commenced on 3 February 2014, and phase 1 was originally scheduled to be completed on 31 March 2017.

82. At commencement, it was estimated that the Liverpool Contract would generate £286.1 million in revenue and £271.2 million in costs,[3] giving a profit of £15.8 million.

83. There were significant issues on the Liverpool Contract related to asbestos, and there were also difficulties with the design of the hospital. Later, structural problems led to delays in the project and to claims being made against Carillion.

(5) The Southmead Contract

84. The Southmead Contract was a contract for the construction of a hospital at Southmead in North Bristol in two phases.

85. The Southmead Contract commenced in 2009; phase 1 was completed on 28 September 2015 and phase 2 was completed on 29 July 2016. At around that time, the project's scope was extended, so that the project overall was then scheduled to be completed on 29 September 2017.

86. At commencement, it was estimated that the Southmead Contract would generate revenue of £431 million and costs of £396.6 million, giving a profit of £34.5 million.

(6) The Nottingham Contract

87. The Nottingham Contract was a contract for the provision of cleaning, catering, logistics, laundry, waste management, security, and administrative services to the customer.

88. The Nottingham Contract commenced in July 2014, and was originally due to terminate on 30 June 2019.

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[3] This assumes a margin of 5.5%.

89. However, in November 2016, Carillion's customer indicated that it "*wanted a managed exit*" from the Nottingham Contract, with services transferred back to the customer. Accordingly, on 6 February 2017, Carillion and its customer entered into a so-called "*exit agreement*", whereby the Nottingham Contract would terminate on 1 April 2017, but Carillion would provide car parking and traffic management services until 30 June 2022.

(7) The Portsmouth Contract

90. The Portsmouth Contract was a contract for the provision of housekeeping, catering, portering, laundry, waste management, groundskeeping, administrative, and similar services to the customer.

91. Carillion had also built the hospital, completing it and transferring it to the customer in three phases from 2006 to 2010. The Portsmouth Contract was signed on 1 January 2006, but had a "*Commencement Date*" of 15 June 2009, and was due to terminate in 2039.

92. As is developed later in this *Final Settlement Decision Notice*, Carillion received revenue from the car park at the Portsmouth site and treated this revenue as attributable to the Portsmouth Contract until 2016.

(8) Services Contract A

93. Services Contract A was a contract for the provision of maintenance, repair, management, and other services to the customer.

94. Services Contract A commenced on 1 May 2014 and was due to terminate on 31 May 2019.

95. From an early stage, Carillion experienced difficulties recovering its costs on the contract, leading to increasing debtors and work in progress. This was partly because the customer audited and challenged Carillion's bills, as it was entitled to do under the contract, but also because the contractual terms included a Guaranteed Maximum Price ("**GMP**") clause, which capped Carillion's revenue at a fixed amount which reduced each year.

(9) The Oxford Contract

96. The Oxford Contract was a contract for the provision of catering, cleaning, portering, and other similar services to the customer.

97. The Oxford Contract commenced in or around 2003 and was due to terminate on 15 December 2036.

98. This contract was not one of those identified by KPMG as having a higher risk of material misstatement and so was not selected for detailed testing. For this reason, it does not feature in Chapter 10, dealing with service contracts. However, KPMG was aware that Carillion and its customer were in dispute about the portering services provided under this contract and KPMG's role and audit work relating to this is considered in Chapter 11.

(10) The Msheireb Contract

99. As has already been noted, Carillion had a presence in Qatar, which had a highly material impact on Carillion's reported results. The Qatar component of Carillion's business was involved in a contract for the construction of a housing complex in Doha. The Msheireb Contract was performed by a joint venture in which Carillion had an 80% stake.

B. Reporting the performance of contracts in Carillion's financial statements

(1) Introduction

100. Carillion's construction and service contracts spanned a number of years. This meant that reporting the performance of these contracts in each year was not straightforward. The requirements of accounting standards for long-term contracts and Carillion's approach are set out below.

(2) Accounting standards

(a) IAS 11 "Construction Contracts"

101. The stated objective of IAS 11 was to "*prescribe the accounting treatment of revenue and costs associated with construction contracts.*"

102. In relation to revenue to be recognised on the contract overall, IAS 11 paragraph 11 provided as follows:

> *"Contract revenue shall comprise:*
>
> *(a) the initial amount of revenue agreed in the contract; and*
>
> *(b) variations in contract work, claims and incentive payments:*
>
> *(i) to the extent that it is probable that they will result in revenue; and*
>
> *(ii) they are capable of being reliably measured."*

103. In relation to revenue from variations, IAS 11 paragraph 13 provided the following:

> *"A variation is an instruction by the customer for a change in the scope of the work to be performed under the contract. A variation may lead to an increase or a decrease in contract revenue. Examples of variations are changes in the specifications or design of the asset and changes in the duration of the contract. A variation is included in contract revenue when:*
>
> *(a) it is probable that the customer will approve the variation and the amount of revenue arising from the variation; and*
>
> *(b) the amount of revenue can be reliably measured."*

104. In relation to revenue from claims, IAS 11 paragraph 14 provided the following:

> *"A claim is an amount that the contractor seeks to collect from the customer or another party as reimbursement for costs not included in the contract price. A claim may arise from, for example, customer caused delays, errors in specifications or design, and disputed variations in contract work. The measurement of the amounts of revenue arising from claims is subject to a high level of uncertainty and often depends on the outcome of negotiations. Therefore, claims are included in contract revenue only when:*
>
> *(a) negotiations have reached an advanced stage such that it is probable that the customer will accept the claim; and*
>
> *(b) the amount that it is probable will be accepted by the customer can be measured reliably."*

105. IAS 11 therefore provided that variations and claims relating to construction contracts could only be included in revenue where the amounts could be reliably measured and the following conditions were met:

105.1 for variations, it was probable that the customer would approve the variation and the amount of revenue arising from the variation; and

105.2 for claims, negotiations have reached an advanced stage such that it is probable that the customer will accept the claim.

106. In relation to revenue to be recognised in each reporting period, IAS 11 paragraph 22 provided as follows:

> *"When the outcome of a construction contract can be estimated reliably, contract revenue and contract costs associated with the construction contract shall be recognised as revenue and expenses respectively by reference to the stage of completion of the contract activity at the end of the reporting period."*

107. IAS 11 paragraph 25 continued as follows:

> *"The recognition of revenue and expenses by reference to the stage of completion of a contract is often referred to as the percentage of completion method. Under this method, contract revenue is matched with the contract costs incurred in reaching the stage of completion, resulting in the reporting of revenue, expenses and profit which can be attributed to the proportion of work completed. This method provides useful information on the extent of contract activity and performance during a period."*

108. On the subject of the "*stage of completion*", IAS 11 paragraph 30 provided as follows:

> *"The stage of completion of a contract may be determined in a variety of ways. The entity uses the method that measures reliably the work performed. Depending on the nature of the contract, the methods may include:*
>
> *(a) the proportion that contract costs incurred for work performed to date bear to the estimated total contract costs;*
>
> *(b) surveys of work performed; or*
>
> *(c) completion of a physical proportion of the contract work."*

109. Where the outcome of a contract cannot be estimated reliably, IAS 11 paragraph 32 provided as follows:

> *"(a) revenue shall be recognised only to the extent of contract costs incurred that it is probable will be recoverable; and*
>
> *(b) contract costs shall be recognised as an expense in the period in which they are incurred."*

110. Where contracts are expected to make an overall loss, IAS 11 paragraph 36 provided as follows:

> *"When it is probable that the total contract costs will exceed total contract revenue, the expected loss shall be recognised as an expense immediately."*

111. IAS 11 therefore provided:

111.1 where the outcome of a construction contract could be estimated reliably and the contract was expected to be profitable, the amount of revenue recognised in each reporting period should be in line with the stage of completion of the contract. The stage of completion can be measured in a number of ways, including the proportion of estimated total costs that has been incurred by the end of the reported period;

111.2 where the outcome of a contract could not be estimated reliably, revenue could be recognised to the extent of costs incurred that could be recovered, that is, no profit could be recognised; and

111.3 where the contract was expected to result in an overall loss, the entire expected loss for the contract needed to be recognised immediately.

(b) *IAS 18 "Revenue"*

112. The stated objective of IAS 18 was to "*prescribe the accounting treatment of revenue arising from certain types of transactions and events*". IAS 18 paragraph 1 stated that this included (*inter alia*) revenue arising from "*the rendering of services*".

113. In relation to "*the rendering of services*", IAS 18 paragraph 20 provided as follows:

> *"When the outcome of a transaction involving the rendering of services can be estimated reliably, revenue associated with the transaction shall be recognised by reference to the stage of completion of the transaction at the end of the reporting period."*

114. IAS 18 paragraph 21 continued as follows:

> *"The recognition of revenue by reference to the stage of completion of a transaction is often referred to as the percentage of completion method. Under this method, revenue is recognised in the accounting periods in which the services are rendered. The recognition of revenue on this basis provides useful information on the extent of service activity and performance during a period. IAS 11 also requires the recognition of revenue on this basis. The requirements of that Standard are generally applicable to the recognition of revenue and the associated expenses for a transaction involving the rendering of services."*

115. On the subject of the "*stage of completion*", IAS 18 paragraph 24 provided as follows:

> *"The stage of completion of a transaction may be determined by a variety of methods. An entity uses the method that measures reliably the services performed. Depending on the nature of the transaction, the methods may include:*
>
> *(a) surveys of work performed;*
>
> *(b) services performed to date as a percentage of total services to be performed; or*
>
> *(c) the proportion that costs incurred to date bear to the estimated total costs of the transaction. Only costs that reflect services performed to date are included in costs incurred to date. Only costs that reflect services performed or to be performed are included in the estimated total costs of the transaction."*

116. IAS 18 paragraph 25 then continued as follows:

> *"For practical purposes, when services are performed by an indeterminate number of acts over a specified period of time, revenue is recognised on a straight-line basis over the specified period unless there is evidence that some other method better represents the stage of completion. When a specific act is much more significant than any other acts, the recognition of revenue is postponed until the significant act is executed."*

117. Thus, IAS 18 provided that for service contracts:

117.1 where the outcome of contracts could be reliably estimated, revenue should be recognised according to the stage of completion of the contract;

117.2 the stage of completion could be determined by a variety of methods; and

117.3 a "*straight-line*" basis, where revenue was recognised evenly over the period of the contract, could be applied where certain conditions were met, including that there was no evidence that another basis better represented the stage of completion.

(c) *IAS 37 "Onerous Contracts"*

118. IAS 37 paragraph 10 provided as follows:

> *"An onerous contract is a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it."*

119. IAS 37 paragraph 66 provided as follows:

> *"If an entity has a contract that is onerous, the present obligation under the contract shall be recognised and measured as a provision."*

120. This is similar to the requirement of IAS 11 on construction contracts, requiring that, where the contract was expected to result in an overall loss, then the entire expected loss for the contract was recognised immediately.

(3) Carillion's approach

(a) *Construction contracts*

121. Carillion's 2016 financial statements disclosed that, in relation to construction contracts, where the outcome of a contract could be estimated reliably, revenue was recognised by reference to the contract's stage of completion, as measured by the proportion of total costs at the balance sheet date to the estimated total cost of the contract.

122. This was consistent with the provisions of accounting standards set out above. Carillion's policy in relation to construction contracts was substantially the same in 2015 and 2014.

123. Consistent with this, Carillion's approach to calculating revenue from a construction contract was as follows:

  123.1 It would first prepare estimates or forecasts of:

    123.1.1 Total revenue from the contract over its whole life.

    This would be the total value of the contract stated in the contract itself, together with the value of any claims, variations and any other adjustments.

    123.1.2 Total costs to be incurred over the whole life of the contract.

  123.2 It would then calculate the stage of completion by comparing the costs already incurred on the contract with the forecast of costs to be incurred over the whole life of the contract.

  123.3 Finally, it would multiply the estimate of total contract revenue by the stage of completion to arrive at a figure for revenue to be recognised to date.

124. The assessment of the variations and claims included in forecast revenue and of forecast costs, used to determine the stage of completion and the amount of revenue to recognise on specific construction contracts, are considered in Chapters 8 and 9.

125. The assessment of the overall position taken on specific construction contracts and their accounting treatment, including whether the outcome of the contract could be estimated reliably or might have been loss-making, is considered in Chapter 12.

(b) *Service contracts*

126. Carillion's 2014, 2015 and 2016 financial statements disclosed the following in relation to service contracts:

  126.1 2014:

  "Revenue from service contracts is recognised by reference to services performed to date as a percentage of total services to be performed."

  126.2 2015:

  "Revenue from service contracts is recognised over the period the services are delivered to the customer."

  126.3 2016:

> *"Revenue from service contracts is recognised by reference to services performed to date as a percentage of total services to be performed. In the event that the services are delivered evenly across the contract period, the revenue is recognised on a straight-line basis over the period the services are delivered."*

127. It is understood that the changes to the wording in each of these three years was to clarify Carillion's approach, rather than to indicate a change to the underlying policy.

128. Carillion's stated approach to recognising revenue from service contracts was therefore by reference to the contracts' stage of completion and, where the services were delivered evenly over the life of the contract, the straight-line basis was used. Where services were delivered evenly across the contract period, the straight-line approach was likely to reflect the contracts' stage of completion. Carillion's stated approach therefore complied with the requirements of IAS 18.

129. The assessment of the accounting treatment of various elements of specific service contract is considered in Chapter 10.

130. The assessment of the overall position taken on specific service contracts and their accounting treatment, including whether they might have been loss-making, is considered in Chapter 12.

(4) Risks of misstatement in financial reporting

131. These approaches meant that revenue recognised depended on judgements and estimates used to assess the contract's overall revenue and its stage of completion.

132. Accordingly, as set out above, KPMG identified a significant risk of material misstatement in each of the 2014, 2015 and 2016 audits relating to the recognition of contract revenue, margin, and related receivables and liabilities.

133. Accurate and reliable reporting of the contracts' performance depended on:

    133.1 applying appropriate approaches to assessing total revenue and the stage of completion;

    133.2 reliable and accurate estimates of variations and claims to arrive at forecasts for total revenue for construction contracts;

    133.3 reliable and accurate estimates of total costs as a basis to assess the stage of completion for construction contracts;

    133.4 recognising all costs incurred on service contracts;

    133.5 identifying and recognising all relevant liabilities for contracts; and

133.6 assessing the overall risk relating to contracts and the reliability with which their overall outcomes could be estimated.

134. The reliance on judgements and estimates gave rise to a risk that Carillion's management could manage reported earnings and thus influence the perceptions of Carillion's performance and profitability.

135. Chapter 13 considers KPMG's overall assessment of the risk of material misstatement relating to Carillion's portfolio of contracts overall and whether the amount set aside by Carillion to address this risk was reasonable and appropriate.

4. SUMMARY

A. Overview

136. Carillion was a major listed company, which suffered financial distress in 2017 and entered compulsory liquidation in January 2018. As the findings of this *Final Settlement Decision Notice* demonstrates, its financial statements had not been subject to rigorous, comprehensive, and reliable audits in the three years leading up to its demise.[4]

137. In relation to the 2016 audit:

137.1 In a wide range of areas, and in respect of a wide variety of items, KPMG failed to gather sufficient appropriate audit evidence to enable them to conclude that the financial statements were true and fair, and failed to consider (adequately or at all) the implications for the audit of evidence suggesting that Carillion's accounting was incorrect or unreliable.

137.2 These failings were not confined to poor performance by particular individuals or specific difficult issues, but occurred over many different areas of KPMG's audit work involving all the key members of the audit team. Many of the failings occurred in connection with the audits of the largest, most critical contracts for Carillion, which had been identified by KPMG as containing "*the highest degree of judgement, estimate and challenge*" and therefore gave rise to a significant risk of material misstatement.

137.3 KPMG failed to conduct its audit work with an adequate degree of professional scepticism. Instead of consistently challenging and scrutinising the audit evidence it gathered, KPMG failed to subject Carillion's management's judgements and estimates to effective scrutiny, even where those judgements and estimates appeared unreasonable and/or appeared to be inconsistent with accounting standards and suggested management bias.

[4] Carillion entered liquidation before KPMG had concluded its 2017 audit and that audit has not featured in this investigation.

137.4 As noted in paragraph 46 above, Carillion was a very important client for both KPMG and key members of the audit team during the relevant years. This created a risk to their objectivity. In a number of instances Mr Meehan and other members of the audit team failed to adopt a rigorous and robust approach and agreed the presentation of financial information that suited Carillion's management where there were clear indicators that management's judgements had been affected by bias.

137.5 Further, 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. Audit procedures in a range of areas of the 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. Records of the fact and timing of the preparation and review of working papers were unreliable and, in some cases, misleading. As a result, the final audit file does not provide a reliable record of the evidence that in fact formed the basis for the audit report. 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.

138. The findings in this *Final Settlement Decision Notice* are necessarily based on the audit procedures that are recorded on the final audit file. In view of the deficiencies in the 2016 audit file identified at paragraph 137.5 above, the findings for the 2016 audit may not reflect the extent to which audit procedures recorded on the 2016 audit file may not have been completed by the date of the audit report.

139. As noted in paragraph 18 of Chapter 1, the investigation has focused primarily on the 2016 audit. However, similar failings in the 2014 and 2015 audits have also been found, demonstrating many of the features identified above.

B. Summary of breaches

140. The breaches of *Relevant Requirements* in this *Final Settlement Decision Notice* fall into the following four categories:

140.1 those related to Carillion's contracts (covered in Part B);

140.2 those related to Carillion's reported debt and its status as a going concern (covered in Part C);

140.3 those related to a number of other areas (covered in Part D); and

140.4 those related to the management, supervision and review of the audits generally (covered in Part E).

141. The breaches of *Relevant Requirements* in each of these four categories are summarised below.

C. Part B: contracts

(1) Introduction

142. Part B of this *Final Settlement Decision Notice* sets out findings in relation to KPMG's audit work on contracts. Chapters 6 to 7 and chapter 13 consider elements of KPMG's audit work on Carillion's portfolio of contracts generally. Chapters 8 to 12 consider KPMG's audit work on eight of Carillion's most significant UK contracts.

143. These 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.

144. These eight contracts also accounted for some of the largest components of the provisions announced by Carillion in 2017.

145. This *Final Settlement Decision Notice* does not make express findings on breaches in relation to other individual contracts.

(2) Selection of contracts for audit testing (chapter 6)

146. 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 amounts it identified as the most risky or significant, and carried out only very limited audit work on the remaining population.

147. As a result, KPMG carried out no substantive audit procedures, and hence obtained very little evidence, over a residual population of contracts that accounted for very substantial amounts of revenue, margin, receivables and liabilities. For example, in 2015 and 2016 these contracts represented over £1.6 billion and £1.4 billion respectively of Carillion's revenue.

(3) Controls related to contracts (chapter 7)

148. KPMG was required to identify and evaluate Carillion's controls over its accounting for its contracts, gaining an understanding of the controls, evaluating their design and determining whether they had been implemented. In addition, where it relied on these controls to provide assurance over amounts in the financial statements, KPMG was required to test whether they were operating effectively and so did, in fact, provide that assurance.

149. However, in the 2016 audit, in relation to "*higher-level*" controls, which related to Carillion's central oversight of contracts, and "*site-level*" controls, in place at the relevant contract sites, KPMG failed to adequately evaluate the design of the controls or to determine whether they had been implemented.

150. Further, KPMG's testing of many of the controls they relied on was deficient and did not confirm whether they were operating effectively.

(4) Construction revenue: variations and claims (chapter 8)

151. Forecasting total contract revenue 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. Forecast revenue included amounts from any agreed variations made to the contract and from any claims made against the customer. However, these could only be included where certain criteria required by accounting standards were met, which in turn depended on judgements and estimates made by Carillion's management.

152. During the 2016 audit, KPMG was aware that Carillion's approach to recognising revenue from claims departed from its internal policy and should have identified that in consequence the criteria required by accounting standards were in some cases unlikely to be met, thus risking inappropriate recognition of revenue.

153. In 2016, the amounts for claims and variations included in forecast revenue on four of Carillion's most significant and critical contracts were substantial, totalling over £100 million. The inclusion of these amounts enabled Carillion to either record profits for the contracts or (where they were loss-making) minimise any provisions. 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.

154. Despite this, KPMG did not obtain sufficient appropriate audit evidence to provide assurance that the necessary criteria for these 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, and also failed to consider whether, in aggregate, they indicated possible management bias that represented a risk of material misstatement overall.

(5) Construction revenue: forecast costs (chapter 9)

155. Carillion was required to forecast costs on its construction contracts to determine the amount of revenue and profit to be recognised in a period and also whether or not a contract should be treated as loss making overall. These forecasts relied on judgements and estimates by Carillion's management, which were often highly subjective, and had a very significant impact on Carillion's overall reported profit. There was therefore a heightened risk from management bias.

156. Despite this, on some of Carillion's most significant contracts, 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 any detail or evidence and were inconsistent with both the contract's track record and other evidence relevant to costs that were likely to be incurred. KPMG failed to consider the judgements and estimates made by management with sufficient professional scepticism, and whether, in aggregate, they indicated a possible management bias that represented a risk of material misstatement overall.

(6) Assets on selected service contracts (chapter 10)

157. During 2014, 2015 and 2016, Carillion recognised significant amounts as assets on some of Carillion's most significant service contracts. Accounting standards provided that assets could only be recognised where they represented "*economic benefits*" that Carillion would recover in future periods. The accounting treatment adopted thus depended on judgements by Carillion's management on whether the amounts were likely to be recoverable. Recognising these assets either increased profit or reduced or eliminated losses. The judgements made relating to these amounts were often subjective and had a significant impact on Carillion's overall reported profit, and there was therefore a heightened risk from management bias.

158. However, for a number of these assets, KPMG did not verify that the accounting treatment adopted by Carillion was appropriate. KPMG 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.

159. The amounts in question were substantial. The amounts considered in this chapter over just three service contracts amounted to over £40 million in 2016 and the accounting treatment adopted enabled Carillion to avoid providing for significant losses on the contracts.

(7) The Oxford Contract dispute (chapter 11)

160. The Oxford Contract was not selected by KPMG for detailed testing in 2016. However, KPMG was aware that Carillion's customer was making a substantial claim arising from allegations that Carillion had falsified records in relation to portering services provided by Carillion under this contract. KPMG was required to assess the likely outcome of this claim and whether its impact was properly reflected in the financial statements.

161. KPMG was also aware that the allegations against Carillion were underpinned by work performed by another KPMG team, which had been engaged by Carillion's customer to assist in the investigation of the allegations. KPMG's assessment of the likely outcome of the claim potentially required consideration of the firm's own work, which presented a threat to the audit team's independence.

162. 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 to adequately address the threat to its independence.

(8) Overall assessment (chapter 12)

163. 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. This required consideration of whether the forecasted overall outcome of the contract was reasonable, including whether it was probable that the contract would make an overall loss.

164. On construction contracts, KPMG's detailed work in the 2016 audit identified several of Carillion's most significant construction contracts as being "*high risk*", identifying uncertainty over amounts totalling over £120 million on just three contracts. However, KPMG did not properly consider the implications of this level of uncertainty on each contract and did not adequately respond to evidence of potential liabilities on the contracts which had not been incorporated into forecasts. Overall, it did not properly evaluate whether overall positions taken on the contracts were appropriate and reasonable.

165. 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. In each case, KPMG failed to approach management's justification for not recognising the extent of the likely losses with appropriate scepticism.

(9) Group provisions for contract risks (chapter 13)

166. Chapters 8 to 12 consider several of Carillion's most significant contracts and in particular, how KPMG addressed the risk arising from the reliance on estimates and judgements made by Carillion's management when accounting for these contracts.

167. There was also a risk over Carillion's portfolio of contracts as a whole that, even if the estimates and judgements made on individual contracts were reasonable, not all contracts would perform in line with the positions taken in Carillion's financial statements. KPMG was required to assess whether provisions in Carillion's financial statements to address this risk were reasonable and appropriate in light of the specific risks identified across the portfolio.

168. In 2016, the audit work performed on the reasonableness of the provisions was minimal and did not properly address the very significant risks identified in KPMG's detailed work on specific contracts. In its reporting to the Audit Committee, 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. In the same report, KPMG also identified a significant number of "*other notable contracts*" where similar risks arose but were not included in the downside scenario. Overall, the report set out specific amounts, relating to these "*higher risk*" and "*notable*" contracts, which depended on estimates and judgments and 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.

D. Part C: debt and going concern.

(1) Introduction

169. As explained above, Part B of this *Final Settlement Decision Notice* considers certain elements of KPMG's audit work on Carillion's contracts, that is, Carillion's core business.

170. Part C of this *Final Settlement Decision Notice* considers elements of KPMG's audit work on what Carillion presented as one of the most important financial indicators of its overall financial performance: net debt or net borrowing.

171. Net borrowing was considered to be an important indicator of Carillion's liquidity, and hence its ability to pay its debts when due, and there was a clear incentive for management to understate it. There was evidence 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. Overall, KPMG failed to consider whether the financial statements gave a true and fair view of net borrowing.

172. The first three chapters in Part C of this *Final Settlement Decision Notice* consider KPMG's audit work on certain items that had a significant impact on Carillion's net borrowing. The fourth chapter then considers KPMG's audit work on Carillion's net debt/borrowing directly. Finally, the last chapter in Part C of this *Final Settlement Decision Notice* considers KPMG's audit work on an area that was both closely related to Carillion's financial performance and of critical importance – Carillion's assumption that it was a going concern (that is, its assumption that it would stay in business for the foreseeable future).

(2) The EPF (chapter 14 and Part C)

173. The Early Payment Facility ("**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 from £35 million as at 31 December 2012 to £472 million as at 31 December 2016.

174. As well as providing Carillion's suppliers with payments for their invoices within a shorter time, the EPF also provided Carillion with additional time to make its payments for these invoices. This 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. In January 2017, Carillion Director A estimated the impact on reported borrowing of the EPF as approximately half of the value of the invoices on the platform, indicating that Carillion's reported net borrowing was reduced by around £236 million at December 2016. However, the nature and scale of these arrangements, and their effect as an additional form of financing, were not disclosed in the financial statements.

175. Despite its significance, KPMG carried out minimal audit work on the EPF in 2014, 2015 and 2016. KPMG did not obtain a clear understanding of how the EPF operated and of its impact on Carillion's cash flows and reported net borrowing. KPMG could not, therefore, properly assess whether, in light of these matters, Carillion's financial statements gave a true and fair view of its financial position overall.

(3) The 2016 Outsourcing Transactions (chapter 15)

176. At the end of 2016, Carillion entered into a group of contracts with Provider A, its provider of outsourced services. These included provision for payments totalling £40 million by Provider A to Carillion for the purchase of various intellectual property rights, as well as payments by Carillion to Provider A for an expanded range of outsourced services for an extended period. The accounting treatment for the initial payment by Provider A to Carillion increased the profit reported by Carillion in the 2016 financial statements by £34.2 million, and thus materially improved Carillion's position.

177. KPMG identified a significant risk that the contracts were dependent on each other, and that as a result, the income from the sale of the intellectual property rights should be spread over the life of the outsourcing contract. However, KPMG failed to audit the accounting treatment of the contracts properly, and failed to respond appropriately to evidence that suggested the treatment adopted was inappropriate and that no profit at all should have been recognised. KPMG showed a lack of scepticism and objectivity in relation to judgments made by Carillion's management.

(4) Revenue from the Portsmouth car park (chapter 16)

178. Carillion recognised £16.7 million in revenue in its 2016 financial statements representing a number of years' future income in relation to the Portsmouth car park, based on a change in the accounting treatment adopted. KPMG did not give proper consideration to whether this change was appropriate and accepted, without sufficient analysis or evidence, that the recognition of this revenue was appropriate.

179. Carillion also entered into a contract at the end of 2016, whereby it received a cash payment of £9.4 million in return for paying monthly amounts over the subsequent five years, based on the level of the car park income at the time of agreement. Despite indications that this arrangement was a loan, Carillion did not recognise the transaction as borrowing but instead recognised it as deferred income, a different treatment that meant the amount was not included in Carillion's reported debt. KPMG accepted this treatment despite having received advice from its own technical experts that the balance should be treated as borrowing.

180. Both transactions involved significant judgements by management and each had a substantial positive impact on Carillion's reported performance. There was therefore a heightened risk of management bias and KPMG should have treated these judgements with particular scepticism.

(5) Net borrowing (chapter 17)

181. Net borrowing at year end featured prominently in Carillion's 2016 annual report. It was presented as "*the most appropriate measure of liquidity*", including all sources of financing, and was described as "*providing further clarity on the Group's underlying performance*". KPMG understood that borrowing was an important metric for users of the financial statements. However, KPMG had evidence suggesting that the reported net borrowing figure at year end did not provide a fair and accurate picture of the group's actual underlying borrowing requirements.

182. In this regard, KPMG failed to assess adequately whether the financial statements provided a true and fair view of Carillion's financial position and failed to assess whether the presentation of net borrowing in the annual report was consistent with KPMG's knowledge acquired during the audit.

(6) Going concern (chapter 18)

183. 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.

184. However, KPMG 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.

E. Part D: other accounting and auditing areas

(1) Pensions (Part D)

185. The 2016 financial statements reported an increase of over £400 million in Carillion's net liability in respect of its employee pension schemes, taking the total to over £800 million. This increase was mainly driven by an increase in the valuation of Carillion's future obligations under the schemes and in particular by changes to a number of financial and actuarial assumptions on which this valuation was based.

186. However, even with this increase, KPMG's actuaries regarded the assumptions used in the 2016 audit as likely to result in a valuation of liabilities "*at the extreme weak limit*" of acceptability, so minimising the amount reported. KPMG identified that moving some of these assumptions to the centre of its benchmark range would have increased the reported liability by at least a further £200 million. KPMG failed to respond to this and other indications of management bias relating to these assumptions.

187. In addition, KPMG's actuaries identified a number of elements of Carillion's valuations which required further audit work to ensure the accounting treatment was appropriate. KPMG failed to perform this further audit work adequately or at all.

(2) Goodwill (chapter 20)

188. The financial statements for each of the years 2014 to 2016 reported goodwill balances totalling in excess of £1.5 billion. These amounts represented future economic benefits that Carillion expected to arise from acquisitions that it had made.

189. Carillion was required to assess the value of its goodwill annually by determining whether these economic benefits were likely to be recovered. If not, the financial statements needed to reflect an impairment to the value of goodwill. The process relied on judgements and estimates made by Carillion and the result had the potential to significantly impact reported assets and profits.

190. KPMG identified goodwill as a significant risk, noting the size of the amounts and the inherent uncertainty involved. However, KPMG's audit work failed to ensure that the 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 cash flows. Despite the risk of management bias, KPMG did not respond to evidence indicating that some of the assumptions were not reasonable, calling into question the reliability of those forecasts.

(3) Overseas components (chapter 21)

191. One of Carillion's overseas components, Qatar, included the Msheireb Contract, which was estimated to have a final value of over £600 million. In 2016 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.

192. However, KPMG did not identify the Qatar component as significant and planned to perform only "*limited desktop review procedures*" for the component. Despite evidence of significant risks relating to the contract, KPMG did not revisit its approach throughout the 2016 audit. The limited procedures planned were poorly executed and overall KPMG's audit work provided insufficient evidence to support the very large amounts recognised.

193. Additionally, in its 2016 audit of the Canada component, KPMG failed to evaluate information provided by the component auditor adequately and failed to respond appropriately to indications of possible management bias and risks that revenue in relation to claims had been recognised inappropriately.

F. Part E: management, supervision and review (chapter 22)

194. In the 2016 audit, Mr Meehan and KPMG failed in their duties to ensure that the audit engagement was properly managed and supervised, and that a reliable means of ensuring that audit work was correctly recorded and properly reviewed, was in place.

195. 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. Audit procedures in a range of areas of the 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. The final audit file does not provide a reliable record of the evidence that in fact formed the basis for the audit report.

196. 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.

197. In 2015 audit procedures were also performed after the date of the audit report, but nonetheless recorded on the audit file as if they had been performed before that date. Additionally, in both 2014 and 2016 the audit files were not finalised until long after the date mandated by KPMG's audit manual or recommended in auditing standards.

5. *SANCTIONS* AND COSTS

A. *Sanctions*

198. The Executive Counsel imposed the following *Sanctions*:

198.1 **KPMG:**

198.1.1 A financial sanction of £26,500,000 (taking into account aggravating and mitigating factors) and reduced by 30% for admissions and early disposal, so that the financial sanction payable is £18,550,000.

198.1.2 A published statement in the form of a severe reprimand.

198.1.3 A declaration that the 2014, 2015, and 2016 Statutory Audit Reports did not satisfy the *Relevant Requirements*.

198.1.4 An order pursuant to rule 136(c) of the AEP, requiring KPMG to take action to mitigate the effect and/or prevent the recurrence of the breaches of the *Relevant Requirements* set out in the *Final Settlement Decision Notice* (the "**Breaches**"). The order requires KPMG:

A. to identify the causes of the Breaches and the measures since taken that have the objective or effect of helping to prevent the recurrence of such Breaches, and to evaluate and report on the effectiveness of those measures;

B. to evaluate and report on the effectiveness of current firm wide processes for identifying and responding to engagement risks relating to acceptance and continuance of PIE audits; and

C. to implement such further remedial action identified as necessary by the FRC in light of the findings of A and B above.

198.2 **Mr Meehan:**

198.2.1 A financial sanction of £500,000 (taking into account aggravating and mitigating factors) and reduced by 30% for admissions and early disposal, so that the financial sanction payable is £350,000.

198.2.2 A published statement in the form of a severe reprimand.

198.2.3 Exclusion from membership of the ICAEW for 10 years. This will run concurrently with the period of exclusion already imposed on his practice.

B. Reasoning

(1) Introduction

199. Paragraph 10 of the FRC's Sanctions Policy (Audit Enforcement Procedure) (the "**Policy**") provides that *Sanctions* are intended to be effective, proportionate and dissuasive. The reasons for imposing *Sanctions* are identified in paragraph 11 of the Policy as the following:

199.1 to declare and uphold proper standards of conduct amongst auditors and to maintain and enhance the quality and reliability of future audits;

199.2 to maintain and promote public and market confidence in auditors and the quality of their audits and in the regulation of the accountancy profession;

199.3 to protect the public from auditors whose conduct has fallen short of the *Relevant Requirements*; and

199.4 to deter auditors from breaching the *Relevant Requirements* relating to statutory audit.

200. Paragraph 12 of the Policy provides that the primary purpose of imposing *Sanctions* for breaches of the *Relevant Requirements* is not to punish, but to protect the public and wider public interest. Accordingly, *Sanctions* will normally be intended to:

200.1 improve the behaviour or performance of the auditors concerned;

200.2 reflect the facts of the particular case and take into account the nature of the breaches of *Relevant Requirements* and the circumstances of the auditors concerned;

200.3 be proportionate to the nature of the breaches of *Relevant Requirements* and the harm or potential harm caused;

200.4 eliminate any financial gain or benefit derived as a result of the breach of the *Relevant Requirements*; and

200.5 deter breaches of the *Relevant Requirements* by the auditors concerned and others.

201. In considering *Sanctions* in this case, the Executive Counsel has had regard to the principles set out above and the following additional factors:

201.1 the full circumstances of the case;

201.2 the seriousness of the breaches;

201.3 proportionality;

201.4 the Respondents' levels of responsibility for the breaches found;

201.5 the loss to Carillion and/or its investors, and the other financial detriment or harm, actually or potentially caused by the breaches found;

201.6 the harm to investor, market, and public confidence in the truth and fairness of financial statements actually or potentially caused by the breaches found; and

201.7 Mr Meehan's state of mind (insofar as that can reasonably be inferred from the evidence).

(2) Approach

(a) <u>Overview</u>

202. In determining the *Sanctions* to be imposed in this case, the Executive Counsel has:

202.1 assessed the nature and seriousness, gravity and duration of the breaches and the degree of responsibility of the Respondents for the breaches;

202.2 identified the *Sanctions* that are potentially appropriate having regard to the breaches;

202.3 considered the relevant aggravating and mitigating circumstances and how those affect the level, nature, and combination of *Sanctions*;

202.4 considered further adjustments to achieve an appropriate deterrent effect; and

202.5 considered discounts for admissions and early disposal.

203. Each of those steps is now detailed in turn.

(b) *Nature, seriousness, gravity, duration, and responsibility*

204. In assessing the nature, seriousness, and gravity of the breaches, the Executive Counsel in summary makes the following observations:

204.1 There are numerous and widespread breaches identified in each of the 2014, 2015, and 2016 audits. There are a very large number of breaches of *Relevant Requirements* over the three years across many different areas of audit work.

204.2 Many of the breaches involve the same *Relevant Requirements* in each year. There were thus repeated, similar failures in multiple areas of the audits.

204.3 Many of the breaches of *Relevant Requirements* in this *Final Settlement Decision Notice* concern failures by the Respondents to act with professional scepticism and to obtain sufficient appropriate audit evidence. There were also breaches of the ES, including several relating to objectivity, one to independence and one to integrity. These requirements lie at the heart of proper auditing, and failures to comply with them thus represent failures to adhere to the most basic and fundamental audit concepts.

204.4 Many of the audit failings relate to areas identified as significant risks by the Respondents (the recognition of contract revenue, margin, and related receivables and liabilities; the carrying value of goodwill; the valuation of retirement benefit obligations; and elements relating to the 2016 Outsourcing Transactions). Accounting for long term contracts was the most significant issue facing the audit team throughout the period, but the Respondents nevertheless failed to perform the audit competently in relation to each element of the process for deriving the relevant amounts in the financial statements.

204.5 Other areas that were not identified as significant risks nevertheless had a very significant impact on the financial statements, for example the EPF and going concern, where KPMG failed 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.

204.6 The Respondents' breaches all contributed to the outcome that a very large public company, which had multiple large contracts with public authorities, was not subject to rigorous, comprehensive, and reliable audits in the three years leading up to its demise. In particular, in 2016 the Respondents' work in respect of going concern and Carillion's financial position generally was seriously deficient. The Respondents failed to respond to numerous indicators that Carillion's core operations were lossmaking and that it was reliant on short term and unsustainable measures to support its cash flows.

204.7 The breaches found in this *Final Settlement Decision Notice* were not dishonest and in the majority of cases were not intentional, deliberate or reckless. However, there is a finding of a lack of integrity in respect of Mr Meehan's record of his review of the 2016 audit. There are also some findings against the Respondents of a lack of objectivity in respect of service assets, the 2016 Outsourcing Transactions and the Portsmouth Car Park. In respect of the Oxford Contract, there are findings of a failing to adequately assess a threat to independence. These breaches of ESs are particularly serious because of their impact on the credibility of the opinions and reports issued by the auditor.

204.8 Aside from the audit fees charged to Carillion, the Respondents did not derive or intend to derive any specific financial benefit from the breaches.

204.9 The breaches found in this *Final Settlement Decision Notice* reveal persistently low-quality work over a broad range of areas that was and is apt to undermine public confidence in auditors and audits.

204.10 As regards the duration of the breaches, the Executive Counsel observes that the breaches of *Relevant Requirements* relate to three consecutive annual audits rather than being confined to a single year. Further, the number and seriousness of breaches increased and often repeated as time went by.

204.11 Mr Meehan's failings relate to duties specifically assigned to him under the ISAs as engagement partner. Over the three audits, and in 2016 in particular, Mr Meehan failed in that role. In 2016 no effective process was implemented to ensure that audit procedures had been completed, documented and reviewed satisfactorily and in accordance with *Relevant Requirements* before the audit report was issued, and they were not. He did not have a proper basis to be satisfied that the opinion given in the 2016 audit report was appropriate.

204.12 KPMG is a firm of considerable size and financial means. In 2022, it had 781 partners across all functions. Its UK fee income in the year to 30 September 2022 was £2,723 million and its audit fee income was £695 million.

204.13 KPMG has been the subject of sanctions in 12 cases in the last four years under both the FRC's Accountancy Scheme and the AEP.

204.13.1 In February 2023, a financial sanction of £1.75 million (reduced to £1.023 million on settlement) and a severe reprimand were agreed for breaches of *Relevant Requirements*.

204.13.2 In January 2023, a financial sanction of £1.25 million (reduced to £875,000 on settlement) and a severe reprimand were agreed for breaches of *Relevant Requirement*s.

204.13.3 In May 2022, a financial sanction of £20 million (reduced to £14.4 million to reflect KPMG's self-reporting, co-operation and admissions) and a severe reprimand were imposed for Misconduct in relation to the provision of false and misleading information and documents to the FRC's Audit Quality Reviews of two audits carried out by KPMG.

204.13.4 In December 2021, a financial sanction of £4.5 million (reduced to £3.375 million on settlement) and a severe reprimand were agreed for breaches of *Relevant Requirements*.

204.13.5 In December 2021, a financial sanction of £1.25 million (reduced to £875,000 on settlement) and a severe reprimand were agreed for breaches of *Relevant Requirements*.

204.13.6 In December 2021, a financial sanction of £4.3 million (reduced to £3.1 million on settlement) and a severe reprimand were agreed for breaches of *Relevant Requirements*.

204.13.7 In July 2021, a financial sanction of £13 million and a severe reprimand were imposed for Misconduct in relation to breaches of the fundamental principles of Objectivity and Integrity.

204.13.8 In March 2020, a reprimand was agreed for breaches of *Relevant Requirements*.

204.13.9 In December 2019, a financial sanction of £700,000 (reduced to £455,000 on settlement) and a reprimand were agreed for breaches of *Relevant Requirements*.

204.13.10 In June 2019, a financial sanction of £5 million (reduced to £3.5 million for admissions) and a severe reprimand were imposed for Misconduct.

204.13.11 In March 2019, a financial sanction of £5 million (reduced to £4 million on settlement) and a severe reprimand were agreed for Misconduct.

204.13.12 In February 2019, a financial sanction of £6 million and a severe reprimand were imposed for Misconduct.

204.14 In July 2022, Mr Meehan was sanctioned by a Disciplinary Tribunal for his role in providing false and misleading information and documents to the FRC in connection with the FRC's Audit Quality Review of the 2016 audit.

(c) *Identification of Sanctions*

205. Having assessed the nature, seriousness, gravity and duration of the breaches, the Executive Counsel has identified the combination of *Sanctions* set out at paragraph 198 above as appropriate:

206. The Executive Counsel has then taken into account any aggravating and mitigating factors that exist (to the extent that they have not already been taken into account in relation to the seriousness of the breaches).

(d) *Aggravating and Mitigating factors*

207. The disciplinary records of both KPMG and Mr Meehan have been considered above in determining the seriousness of the breaches. There are no other aggravating factors.

208. The Respondents have provided good co-operation during the investigation (as they are required to do) but not the exceptional level of co-operation which would amount to a positive mitigating factor. There are no other mitigating factors.

209. The Executive Counsel does not consider there to be any aggravating or mitigating factors that have not already been taken into account which would require adjustment of the sanctions for KPMG and Mr Meehan.

(e) *Adjustments for deterrence*

210. Having considered the matters set out at paragraphs 72 and 73 of the Policy, the Executive Counsel considers that the financial sanctions described above are already set at a level which is sufficient to achieve the appropriate deterrent effect and no further adjustment is necessary.

(f) *Discounts for Admissions and Settlement*

211. Having taken into account the admissions made by the Respondents and the stage at which those admissions were made, Executive Counsel has determined that a reduction of 30% to the financial sanctions is appropriate, such that the financial sanction for KPMG is reduced to £18,550,000 and that for Mr Meehan is reduced to £350,000.

(g) *Other considerations*

In accordance with paragraph 47(c) and (d) of the Policy, Executive Counsel has taken into account the size of KPMG, and the financial resources of the Respondents, and the effect of a financial sanction and whether the financial sanction is likely to be covered by insurance.

C. Costs

212. The Respondents have agreed to pay Executive Counsel's costs in full in this matter, being £5,324,365.68.[5] Such costs shall be paid no later than 28 days after the date of this *Final Settlement Decision Notice*.

[5] These costs include the Executive Counsel's costs arising from the investigation into KPMG's audit of certain transactions relating to the financial statements of Carillion for the financial year ended 31 December 2013, and which is the subject of a separate *Final Settlement Decision Notice*.

PART B

6. SELECTION OF CONTRACTS FOR AUDIT 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 amounts it identified as the most risky or significant, and carried out only very limited audit work on the remaining population.

As a result, KPMG carried out no substantive audit procedures, and hence obtained very little evidence, over a residual population of contracts that accounted for very substantial amounts of revenue, margin, receivables and liabilities. For example, in 2015 and 2016 these contracts represented over £1.6 billion and £1.4 billion respectively of Carillion's revenue.

A. Overview

213. In the 2014, 2015, and 2016 audits, KPMG identified a significant risk of material misstatement in relation to the recognition of contract revenue, margin, and related receivables and liabilities. Misstatements exceeding £9 million in 2014 and £8 million in 2015 and 2016 were considered to be material.

214. KPMG was required to perform procedures responsive to this risk, that is, designed to detect material misstatements.

215. KPMG performed substantive audit procedures on revenue, margin, receivables and liabilities in relation to selected contracts considered to contain the greatest risk of misstatement. Chapters 7 to 12 consider the performance of these audit procedures.

216. However, these audit procedures did not provide any evidence in relation to contracts which were not selected for testing. These represented a significant proportion of Carillion's revenue, as set out in the following table:

	2015 audit	**2016 audit**
Revenue attributable to untested construction contracts	£1.1 bn	£1.0 bn
Proportion of total construction contract revenue untested	48%	41%
Revenue attributable to untested service contracts	£0.5 bn	£0.4 bn
Proportion of total service contract revenue untested	36%	27%

217. In addition, even for contracts which were selected, KPMG did not test all amounts recognised relating to these contracts. Amounts below a certain threshold were not tested with the result that, in aggregate, a substantial and material amount across these selected contracts was also not tested.

218. KPMG was required to consider whether there was a risk that the amounts not tested could contain a material misstatement, either individually or in aggregate. If there was such a risk, further audit procedures were required to ensure that sufficient appropriate audit evidence was obtained (both in relation to contracts which were not selected, and in relation to untested amounts relating to contracts which had been selected).

219. There is no evidence that KPMG properly considered this issue, and there was in any event no basis for concluding that the untested contracts and amounts could not contain a material misstatement. The limited audit procedures performed on the untested contracts and amounts could not provide sufficient audit evidence in relation to those contracts and amounts.

B. KPMG's approach

(1) Introduction

220. KPMG was required to perform procedures responsive to the significant risk it had identified in relation to contract revenue, margin, and related receivables and liabilities. In particular, KPMG was required to perform substantive testing, and, unless controls testing was also performed, the substantive testing needed to include tests of detail.[6]

221. As explained in Chapter 7, KPMG's controls testing did not provide any assurance over amounts recognised for contracts and balances which had not been selected for substantive testing.

222. KPMG's approach to selecting construction and service contracts for testing in 2016 is described below. KPMG's approach to contract selection in 2014 and 2015 was not materially different.

[6] ISA 330 paragraphs 5 to 7 and 21.

(2) Selection of construction contracts

223. KPMG tested revenue, margin, and related receivables and liabilities only in relation to construction contracts that it identified as representing a higher risk of material misstatement. KPMG gave a narrative description of the planned approach in working paper "*TOD 1 Contract Selection*":

> *"Obtain the contract summary schedules used by the entity to record monitor and report the financial performance and position of individual contracts and use to select contracts for review. The selection should be based on our understanding of the entity and for example should identify contracts that:*
>
> *(1) are identified through inquiry of management as being high risk and or which are being reported on individually to the Board or Audit Committee.*
>
> *(2) have had significant changes in forecast total revenue and or forecast margin compared to prior period.*
>
> *(3) have large and unusual items including (a) high margins (b) low margins (close to breakeven) (c) contracts forecast to be significantly loss making (d) have a significant contract work in progress balance (e) have significant payments on account . (f) contracts that have recognized or are forecast to recognize significant profits during the period.*
>
> *(4) were reviewed during the previous audit and where there is significant continuing contract activity or risk of significant misstatement to current period results.*
>
> *Document the selection criteria applied.*
>
> *For all contracts selected in stage 1 stratify based on size and risk and determine which should be subject to (1) site visit (2) full contract review (3) desktop contract review. Plan and perform appropriate procedures on each category of contract."*

224. KPMG provided the following details of the criteria applied to identify such contracts in working paper "*AP050.3.4CCS SUBSTANTIVE APPROACH*":[7]

Quantitative criteria	*Qualitative criteria*
- FY16 Margin > 3% of CCS gross profit	*- Listed on HY16 clearance meeting*
- FY16 Margin < £(2.5)m	*- Identified as a 'risk' contract from BUR*
- Contract debtors > 2% of CCS total contract debtors	
- Movement between FY15 v FY16 yearly margin <2% or >2%	
- Movement between FY15 v FY16 EoL margin <2% or >2%	

225. The same criteria were also set out in working paper "*TOD 1.0010 CCS CONTRACT SCOPING 2016*", accompanied by additional explanatory notes.

226. The tab titled "*Coverage*" in working paper "*TOD 1.0010 CCS CONTRACT SCOPING 2016*" indicated that 33 construction contracts, out of nearly four hundred active contracts, were selected for testing and that, of these 33, 17 were to be tested through the provision of a position paper by Carillion, and the remaining 16 were to be tested through a "*verbal update*" from Carillion's management.

227. KPMG then calculated that the proportion of the construction component's total revenue and gross profit attributable to the 33 contracts selected for testing was 14% and 6% respectively. That calculation was incorrect because of various errors in the relevant spreadsheet. After the audit, KPMG calculated that the correct figures were 59.4% and 65.2% respectively.

228. Whilst the selection process was intended to identify individual contracts and balances that contained the highest risk of misstatement, it was not capable of providing any assurance, or any audit evidence, over the risk of misstatement in the remainder of the population.[8] KPMG did not consider the risk of material misstatement relating to revenue, margin, and related receivables and liabilities in relation to the construction contracts not selected for testing or identify that it had obtained no evidence relating to these contracts and consequently that further audit procedures were required.

[7] "*CCS*" stands for "*Carillion Construction Services*", and refers to Carillion's construction component. "*BUR*" stands for "*Business Unit Review*" meetings. "*EOL*" stands for "*end of life*", and refers to the forecasts of a contract's performance over its life.

[8] ISA 500 paragraph A55.

(3) Selection of service contracts

229. Similarly, KPMG tested revenue, margin, and related receivables and liabilities only in relation to service contracts that it identified as representing a higher risk of material misstatement. The criteria applied to identify such contracts were set out in working paper "*TOD 01.0010 CONTRACT SELECTION*" as follows:

> *"Criteria 1: High margin (greater than 18%) or low margin (less or equal to 1%) and contract value is above 3 times statutory performance materiality. Contracts with a high margin will generate material profits in the Group and in Services and those making less or equal to 1% margin are at risk of becoming loss making and this is a risk as any lossess would need to be provided up front for the life of the contract.*
>
> *Criteria 2: Contract work in progress balance In excess of statutory performance materiality.*
>
> *Criteria 3: Contract debtor balance in excess of statutory performance materiality.*
>
> *Criteria 4: Prepayment balance in excess of statutory performance materiality.*
>
> *Criteria 5: Mobilisation balance in excess of 1/3 statutory performance materiality.*
>
> *Criteria 6: Contracts that are forecast to recognise profits in excess of statutory performance materiality during the year.*
>
> *Criteria 7: Contracts that have a contract value in excess of 15 times statutory performance materiality.*
>
> *Criteria 8: New contracts that have greater than £10m revenue. £10m revenue is deemed a suitable threshold as the MPC[9] has to approve all new services contracts >£10m p.a as detailed in <2.5.1.D>*
>
> *Criteria 9: Contracts with zero or less margin and revenue in excess of £5m. Contracts making zero or less margin are a risk as any future losses need to be provided up front over the life of the contract.*
>
> *Criteria 10: Qualitatively, any contract in the audit teams judgement which should be selected on the basis of other factors not already liseted above (e.g. review of internal audit reports, board minutes, inquiries with management and KPMG's audit knowledge of the client):*

[9] Carillion's Major Projects Committee.

> *A contract: Contract is being renegotiated before year end and a large deferred income balance is expected and this contract has not been looked at since 2013. Furthermore, there is some aged WIP and profit has increased a little."*

230. In the same working paper, in the tab titled "*Contracts Selected*", KPMG recorded that 35 service contracts, out of over two hundred active contracts, met one or more of the criteria and that, of these, 17 were selected for testing, of which seven (including the Nottingham Contract and Services Contract A) were also selected for site visits. The decision whether to perform a site visit was stated to have been made in light of the following factors:

> *"(a) sites that were not visited in the prior year(s); (b) were material to their relevant statutory entity; (c) cover a cross section of statutory entities and (d) cover a number of divisions within the Services Business Unit".*

231. In the same working paper, in the tab titled "*December Summary*", KPMG recorded that the proportion of the services component's total revenue and gross profit attributable to the contracts selected for testing was 73% and 61% respectively.

232. KPMG also performed some "*supplementary testing*" on certain specific amounts relating to some of the contracts not selected. The criteria for amounts subjected to this "*supplementary testing*" were described in the working paper as follows:

> *"The threshold for further testing are the largest balances in the untested population which are deemed to have a potential material misstatement. From this scoping it is determined that the untested population is unlikely to be materially misstated"*

233. It did not explain:

    233.1 how large a balance had to be before being considered "*the largest*";

    233.2 how KPMG determined which balances were "*deemed to have a potential material misstatement*"; or

    233.3 the basis for KPMG concluding that the "*scoping*" meant that "*the untested population [wa]s unlikely to be materially misstated*".

234. KPMG thus did not explain how the significant risk relating to revenue, margin, receivables and liabilities for the service contracts not selected was addressed, or identify that it had obtained no evidence relating to these contracts from its substantive testing, and consequently that further audit procedures were required.

235. KPMG did carry out an audit procedure relating to the population of service contracts, set out in working paper "*SAP1.0010 DEFERRED INCOME ANALYTIC*". That working paper set out a comparison of the total amount for deferred income balances as at December 2016 for all group entities holding service contracts to "*expected*" deferred income, being the corresponding deferred income as at December 2015, adjusted for movements in deferred income related to contracts selected for testing during 2016. The working paper recorded that the difference between the actual deferred income and "*expected*" deferred income was below performance materiality and that KPMG concluded that deferred income was "*within KPMG's expectations*", with the result that no further work was required.

236. This procedure was deficient. In particular:

236.1 The threshold of performance materiality (which was used as a measure of the acceptable variance between the 2016 figures and the adjusted 2015 figures) was applied separately to each "*Entity*". Thus, KPMG failed to consider whether the total of the variances might exceed performance materiality in aggregate.

236.2 The total deferred income as at December 2016 was stated to be £32.7 million, and the "*expected*" deferred income was stated to be £44.9 million.[10] Thus, the overall variance in fact was £12.2 million, which was far in excess of performance materiality.

237. This procedure could not, and did not, provide sufficient appropriate audit evidence to address the risk of material misstatement in the untested population of contracts.

[10] This does not take into account an adjustment made in the working paper in respect of two contracts within Carillion Integrated Services division which had experienced decreases in deferred income during the year. However, the explanation for these decreases, and for the adjustment to expected deferred income, was inadequate and unsupported by evidence.

(4) Selection of items

238. In its working paper "*TOD 01.0020 APPROACH PAPER*", titled "*Contract Reviews: Audit Approach*", KPMG set out its approach to the audit of service contracts selected for testing. KPMG recorded that, for balance sheet items, that is, receivables and liabilities relating to contracts:

238.1 at the interim stage, it would investigate amounts greater than one third of performance materiality; and

238.2 at the final stage of the audit, it would investigate:

238.2.1 amounts that had changed by greater than one third of performance materiality since the interim stage; and

238.2.2 amounts that had not been tested at the interim stage but which were now above one third of performance materiality.

239. As stated in Chapter 2, misstatements exceeding £8 million were considered to be material in the 2015 and 2016 audits with performance materiality being around £6 million. In the 2014 audit these amounts were slightly higher with materiality of £9 million. KPMG's stated approach therefore was that amounts below approximately £2 million would not be tested on the service contracts selected for substantive testing.

240. That approach, which was stated to apply generally, is illustrated in the following examples:

240.1 In its 2016 working paper "*AP060.3.0020 NOTTINGHAM 2016*", KPMG stated that its approach to testing balance sheet items in relation to the Nottingham Contract was to "*investigate balances greater than 1/3PM*". The result was that KPMG left untested balances that amounted in total to £1.556 million.

240.2 In its 2016 working paper, "*AP060.3.0070 PORTSMOUTH CONTRACT REVIEW 201*", KPMG stated that its approach to testing balance sheet items in relation to the Portsmouth Contract was to "*investigate amounts that have changed by an amount greater than 1/3PM*" between October 2016 and December 2016. The result was that KPMG left untested balances that amounted in total to £0.893 million.

240.3 In its 2016 working paper, "*AP060.3.0060* [Services Contract A] *2016*", KPMG stated that its approach to testing balance sheet items in relation to Services Contract A was to "*investigate balances which are greater than 1/3PM*". The result was that KPMG left untested balances that amounted in total to £0.979 million.

240.4 In its 2015 working paper "*AP060.3.0070 NOTTINGHAM*", KPMG stated:

> *"KPMG will investigate Dec-15 balances greater than 1/3PM (>£1,625,000). 1/3PM was chosen as an appropriate level in order to reduce the occurrence of aggregation risk across contracts within a particular statutory entity."*

The result was that KPMG left untested balances that amounted in total to £1.461 million in debtors and prepayments.

240.5 In its 2014 working paper "*TOD 3.00105 NOTTINGHAM WORKBOOK*", KPMG stated, "*Balances will be deemed not significant if they are less than 1/3rd PM, £1,314k*". The result was that £0.531 million in work in progress and debtor assets and £1.216 million of accruals were not tested.

240.6 In its 2014 working paper "*TOD 2.00140* [Services Contract A] *Workbook*", KPMG stated that it would "*investigate amounts which are greater than 1/3PM (>£1,315,000)*" at the interim audit. The result was that £0.860 million in debtors and £0.451 million deferred income were not tested.

241. These examples show that KPMG's approach to testing balance sheet items in relation to just three service contracts in 2016 left untested amounts amounting to £3.4 million in total. The aggregate amount of untested items across the 35 service contracts selected for testing in 2016 would clearly be significantly higher.

242. KPMG was required to assess the risk that, in aggregate, these untested items might contain a material misstatement and, if so, to ensure that sufficient appropriate audit evidence was obtained. In the 2015 audit, KPMG recorded that:

> *"1/3PM was chosen as an appropriate level in order to reduce the occurrence of aggregation risk across contracts"*

243. But there was no explanation for this conclusion. KPMG did not give proper consideration to the risk, in circumstances where the aggregate amount not tested was evidently material, and its substantive testing provided no evidence in relation to items not selected.

(5) Summary

244. To address the risk of material misstatement in amounts recognised relating to contracts, KPMG tested only certain items in relation to certain contracts.

245. KPMG therefore needed to assess whether the amounts recognised relating to the contracts and balances which were not tested might contain a material misstatement, either individually or in the aggregate, and if so ensure that sufficient appropriate audit evidence was obtained.

246. There is no evidence that KPMG carried out any proper assessment of this risk and no effective audit procedures were performed in relation to any contract or any amount of contract revenue, margin, or related receivables or liabilities which had not been selected for testing.

C. Conclusion

247. There were thus breaches by **the Respondents** in the **2014, 2015 and 2016 audits** of:

247.1 **ISA 330 paragraphs 5, 6, 7(b) and 21,** in that the Respondents did not adequately design or perform audit procedures in response to the significant risk in relation to contract revenue, margin, receivables and liabilities in relation to the contracts and items it had not selected for testing. In particular, the Respondents did not:

247.1.1 perform substantive tests of detail or controls testing in relation to any of the contracts or items they had not selected for testing; or

247.1.2 obtain any audit evidence that balances they had not selected for testing were not materially misstated, whether individually or in aggregate; and

247.2 **ISA 500 paragraph 6**, in that the Respondents failed to design and perform appropriate audit procedures to enable them to obtain sufficient appropriate audit evidence in relation to any of the contracts or items they had not selected for testing.

7. CONTROLS RELATED TO CONTRACTS

KPMG was required to identify and evaluate Carillion's controls over its accounting for its contracts, gaining an understanding of the controls, evaluating their design and determining whether they had been implemented. In addition, where it relied on these controls to provide assurance over amounts in the financial statements, KPMG was required to test whether they were operating effectively and so did, in fact, provide that assurance.

However, in the 2016 audit, in relation to "*higher-level*" controls, which related to Carillion's central oversight of contracts, and "*site-level*" controls, in place at the relevant contract sites, KPMG failed to adequately evaluate the design of the controls or to determine whether they had been implemented.

Further, KPMG's testing of many of the controls they relied on was deficient and did not confirm whether they were operating effectively.

A. Overview

248. For the 2016 audit KPMG identified a significant risk in relation to contract revenue, margin, and related receivables and liabilities, and identified that the risk related in particular to estimates of revenue from variations and claims, and of forecasts of costs.

249. KPMG was required to identify and evaluate controls which were relevant to this risk and determine whether they had been implemented. Further, where KPMG relied on controls as providing assurance over amounts in the financial statements, it was required to test those controls to confirm they were operating effectively.

250. KPMG told the Audit Committee that, as part of its response to the significant risk, it would evaluate controls over forecast costs, the contract approval process, and a number of other oversight processes in place at the business unit or group level. It also planned to test the operating effectiveness of a number of these controls, including site-level controls on certain selected contracts.

251. However, KPMG's evaluation of Carillion's higher-level controls, and how they mitigated the significant risk relating to contracts, was inadequate. KPMG obtained insufficient evidence to conclude that the controls provided audit assurance over any amounts in the financial statements.

252. KPMG identified a number of site-level controls as providing assurance but the audit work on these controls was deficient. In particular:

   252.1 Some of the processes, as described in the working papers, did not mitigate any risk in relation to the financial statements and consequently were not relevant controls.

   252.2 KPMG's descriptions of many controls revealed a lack of understanding of how the relevant control process was performed and documented, and so there was no proper basis on which to conclude that the control provided the supposed assurance.

   252.3 The controls as described in the working papers did not provide assurance over some or all of the specific audit assertions identified by KPMG.

253. KPMG thus did not evaluate the design of the controls adequately. KPMG also did not perform audit procedures to establish that the controls were implemented, recording that they relied on unspecified prior year work or management representations.

254. KPMG's testing to confirm whether the controls on which it intended to rely were operating effectively was also deficient. In many cases the testing provided no evidence that the control was operating effectively, and in some cases it indicated that the control was not operating as expected, or at all.

255. Further, despite identifying that the significant risk related in particular to estimates of revenue from variations and claims, KPMG did not identify any controls over the recognition of revenue relating specifically to claims.

B. Background: Role of controls in the audit

(1) Explanation of assertions and controls

256. ISA 315 required the auditor to identify and assess the risks of material misstatement in the financial statements at two levels:

   256.1 first, risks at the financial statement level, described as relating pervasively to the financial statements as a whole; and

   256.2 second, risks at the assertion level, described as relating to specific classes of transactions, account balances, or disclosures.

257. ISA 315 paragraph 4(a) defined "*assertions*" as:

> *"Representations by management [or those charged with governance], explicit or otherwise, that are embodied in the financial statements, as used by the auditor to consider the different types of potential misstatements that may occur".*

258. A single representation could contain a number of assertions. For example, the statement, "*receivables were £1 million*" contains the following assertions:[11]

 258.1 an existence assertion, that is, that the asset described as "*receivables*" existed at the relevant date;

 258.2 a completeness assertion, that is, that the amount of £1 million includes all receivables that existed at the relevant date; and

 258.3 a valuation assertion, that is, that the amount of £1 million is the correct valuation of the receivables at the relevant date.

259. ISA 315 paragraph 4(c) defined "*controls*" as:

> *"any aspects of one or more of the components of internal control"*

and defined "*Internal control*" as:

> *"The process designed, implemented and maintained by those charged with governance, management and other personnel to provide reasonable assurance about the achievement of an entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations."*

260. A single control process might address the risk of misstatement relating to one or a number of assertions. In the above example (the statement "*receivables were £1 million*"), a control to ensure that all relevant invoices were included in receivables could provide assurance over the existence and completeness assertions but might provide little or no assurance over the valuation assertion.

[11] See ISA 315 paragraph A124(b).

(2) The required approach to controls

261. ISA 315 paragraphs 12 and 13 required the auditor to "*obtain an understanding of internal control relevant to the audit*" and specifically to:

> *"evaluate the design of those controls and determine whether they have been implemented, by performing procedures in addition to inquiry of the entity's personnel."*

262. ISA 315 paragraph 29 specifically required the auditor to obtain an understanding of controls relevant to significant risks.

263. Separately, ISA 330 paragraph 8, which set out requirements on designing and implementing appropriate responses to the risks identified, set out the following requirements:

> *"design and perform tests of controls to obtain sufficient appropriate audit evidence as to the operating effectiveness of relevant controls if:*
>
> *(a) The auditor's assessment of risks of material misstatement at the assertion level includes an expectation that the controls are operating effectively (that is, the auditor intends to rely on the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures); or*
>
> *(b) Substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level."*

264. Consequently, KPMG was required to:

264.1 identify and obtain an understanding of controls relevant to the significant risk relating to contracts, that is, controls which addressed the risk of misstatement relating to one or a number of assertions relating to amounts recognised for contracts; and

264.2 perform procedures to evaluate the design of those controls and determine whether they had been implemented.

265. Further, where KPMG's assessment of the risk incorporated an expectation that certain relevant controls were operating effectively, KPMG was required to design and perform tests of those controls to confirm that they were in fact operating effectively and as expected to mitigate the assessed risk.

(3) KPMG's planned approach

266. As noted above, in the 2016 audit, "*recognition of contract revenue, margin, and related receivables and liabilities*" was classified as a significant risk.

267. In a meeting on 9 June 2016, recorded in working paper "*2.5.2.0010 AUDIT STRATEGY MEETING*", KPMG told Carillion's management that in relation to "*Contracts*", there would be a "*controls focus*" to the 2016 audit.

268. This approach was set out in detail in the 2016 Audit Strategy Memorandum in which KPMG told the Audit Committee that the significant risk related in particular to estimates of revenue from variations and claims and to forecast costs.

269. KPMG went on to state that, in response to the risk, its audit work on controls would comprise the following (emphasis added):

> *"Evaluate the **controls** designed and implemented by the Group to give us <u>assurance that the estimates used in assessing the final out-turn of costs on each contract are appropriate</u> […]*
>
> *Consider the operation of **controls** at the Board level, such as the <u>major projects approval process</u> […]*
>
> *Evaluate the contract **oversight process** within each business unit, for example, through the <u>peer review process</u>, <u>Business Unit Reviews</u> ('BURs') and the <u>'tone at the top' and culture</u> that this drives throughout the business.*
>
> *'Health check' the **control** environment at each contract we visit and closely liaise with Internal Audit with regard to their work in this area.*

270. KPMG therefore communicated to Carillion:

270.1 that the significant risk arising from the recognition of contract revenue related in particular to estimates of revenue from variations and claims and to forecast costs;

270.2 its response to the significant risk would include evaluating:

270.2.1 controls relating to forecast costs;

270.2.2 controls at board level, including the major projects approval process;

270.2.3 "*oversight*" controls, including:

270.2.3.1 "*Business Unit Reviews*" ("**BURs**");

270.2.3.2 the peer review process; and

270.2.3.3 Carillion's "*tone at the top*" and the culture of the organisation; and

270.2.4 controls in place at a number of contract sites.

271. KPMG's audit work fell into two broad categories:

271.1 procedures concerned with higher-level controls, which were supposed to be in place above the contract level, at the business unit and group level respectively; and

271.2 site-level controls, at the contract level, which were tested on site visits.

272. KPMG's work on higher-level controls is considered in the next section, Section C. KPMG's work on the site-level controls is considered in Sections D and E below.

C. Higher-level controls

(1) Introduction

273. This section considers KPMG's work in the 2016 audit on higher-level controls in place at the business unit or group level relating to the significant risk on contracts. It considers KPMG's audit work in relation to the following:

273.1 the major projects approval process or the Major Project Committee ("**MPC**");

273.2 BURs;

273.3 the peer review process;

273.4 the "*tone at the top*" and culture of the organisation;

273.5 controls over estimates of revenue from variations and claims; and

273.6 controls over forecast costs.

(2) Major projects approval process or MPC

274. KPMG identified the MPC meetings as a relevant higher-level control that KPMG would both evaluate and test for its operating effectiveness.

275. In its 2016 working paper "*HLC.1 Business Unit Reporting Meetings-Hlc Control Description And D I*", KPMG wrote as follows:

> *"Our assessment of the "recognition of contract revenue, margin and related receivables and liabilities" risk is an aggregation of key elements of audit procedures and evidence. In particular we: - attend Major Projects Committee ('MPC') meetings which we find to be a robust control over contract tendering and inception, and therefore outturn margin. Further, followed up on conditions imposed to ensure live contracts are acting in accordance with those conditions"*

276. Similar remarks appeared in the "*Engagement continuance report*" dated 7 March 2017.

277. However, there was no explanation of how the MPC meetings operated as a control over any financial reporting assertions. The MPC process was concerned exclusively with "*contract tendering and inception*" and involved scrutinising significant contracts that Carillion was proposing to bid for and considering the attendant risks. Whilst the MPC did consider *expected* margins when deciding whether to approve a tender, there was no evidence that it could operate as a control over revenue recognition after the tender was won and work on the contract had started, and therefore no evidence that it operated as a control over "*outturn margin*", that is, the margin reflected in the financial statements. There was also no evidence that anyone "*followed up*" to ensure that "*live contracts [we]re acting in accordance with*" any conditions imposed.

278. KPMG's audit work in relation to the MPC, which consisted solely of reviewing minutes of meetings where various bids were discussed, provided no assurance in relation to any assertion and there was no basis for the conclusion that the MPC meetings constituted a "*robust control over* […] *outturn margin*".

(3) Business Unit Reviews

279. KPMG identified the BUR meetings as a relevant higher-level control that KPMG would both evaluate and test for its operating effectiveness.

280. The BURs were monthly meetings in which "*key developments, risks and opportunities"* on selected contracts were discussed. KPMG recorded that:

> *"findings of these meetings are then written up and consolidated into a group wide Performance Review Memorandum (PRM) that is circulated throughout senior management,"*

and that KPMG planned to:

> *"place reliance on these as a control over contract management and monitoring of revenue, margin and related receivables and liabilities."*

281. However, KPMG did not explain *how* these meetings operated as a control in mitigating risks relating to any element of financial reporting in relation to contracts, and the minutes of KPMG's attendance do not provide any evidence that the BURs were effective in mitigating these risks in practice. For example, the minute from the Construction BUR on 13 and 15 December 2016 simply recorded:

> *"Throughout the day the central team challenged the sector personnel on their results and forecast results for the year. Particular attention was paid to WIP, cash collection and profitability."*

282. There was no evidence of the outcome of the "*challenge*", or whether and how that outcome was reflected in reported results for the relevant contracts. There was no explanation of how, in light of these matters, the process provided assurance over the reliability of Carillion's financial reporting.

(4) Peer review process

283. The peer review process was described in the 2016 financial statements as follows:

> *"Independent peer reviews of contracts are conducted by experienced colleagues from other parts of the business with outputs reported to the Audit Committee"*

284. KPMG had stated to the Audit Committee that it would evaluate controls relating to Carillion's oversight processes including this peer review process. However, there is no evidence that KPMG carried out any evaluation or identified any link between the peer reviews and any specific assertions relating to financial reporting.

285. KPMG did not obtain any information about the peer review process other than the number of peer reviews performed and the number of recommendations. KPMG did not identify what the peer reviewers found, the significance of those findings in the context of financial reporting, or any response to those findings, and did not assess the implications of those findings or any responses. KPMG therefore obtained no evidence as to whether the peer review process represented a control over any risks relating to financial reporting.

(5) The "tone at the top" and culture

286. KPMG also stated that it would evaluate Carillion's "tone at the top" and culture as part of its work on controls relating to oversight processes. KPMG recorded consideration of these matters as part of the assessment of Carillion's overall control environment but the work did not refer to or address the significant risk in relation to contracts that had been identified. KPMG obtained no evidence that the "*tone at the top*" or culture contributed to contract oversight processes or acted as a relevant control. KPMG consequently obtained no evidence that either the "tone at the top" or culture provided any assurance relating to the identified risks.

(6) Estimates of revenue from variations and claims

287. KPMG had communicated to Carillion that the significant risk relating to contracts related in particular to estimates of revenue from variations and claims. KPMG recorded that the BURs, described above, would be relied on as a control over various elements of contract accounting. However, as set out above, how this was achieved was not explained, and the evidence obtained did not provide any assurance over this risk. No other relevant controls were identified.

(7) Forecast costs

288. KPMG had communicated to Carillion that the significant risk relating to contracts related in particular to forecast costs. KPMG stated that it would:

> *"Evaluate the controls designed and implemented by the Group to give us assurance that the estimates used in assessing the final out-turn of costs on each contract are appropriate"*

289. KPMG recorded that the BURs operated as a control over forecast costs, but, similarly, as set out above, how this was achieved was not explained, and the evidence obtained did not provide any assurance over this risk. No other relevant controls were identified.

(8) Conclusion on higher-level controls

290. KPMG was required to identify and obtain an understanding of controls which addressed the risk of misstatement relating to the significant risks that it had identified, and to perform procedures to evaluate the design of those controls and determine whether they had been implemented. In addition, since KPMG relied on the operating effectiveness of certain controls, it was required to test those controls to confirm that they were, in fact, operating effectively to mitigate the assessed risk.

291. KPMG identified that the significant risk relating to contracts arose in particular in connection with estimates of revenue from variations and claims and with forecast costs, and planned a "*controls focus*", which was to include evaluating and testing a number of "*higher-level*" controls.

292. However, KPMG's understanding of higher-level controls, and how they might provide audit assurance, was inadequate, with the result that KPMG was not in a position to properly determine whether any of the controls identified in fact operated (or were even intended to operate) as controls over the reliability of Carillion's financial reporting. KPMG's testing was inadequate and did not provide evidence that the controls were operating effectively.

293. There were thus breaches by **the Respondents** in the **2016 audit** of:

 293.1 **ISA 315 paragraphs 13 and 29**, in that the Respondents did not obtain an adequate understanding of how controls were relevant to the audit and to the identified significant risk and did not design or perform sufficient procedures to evaluate the design of controls they had identified as relevant and determine whether they had been implemented;

 293.2 **ISA 330 paragraphs 5, 6 and 8**, in that the Respondents did not adequately design or perform audit procedures in response to the risks they had identified and in particular did not adequately test controls they relied on; and

293.3 **<u>ISA 500 paragraphs 6 and 7</u>**, in that the Respondents:

293.3.1 failed to design and perform appropriate audit procedures to enable them to obtain sufficient appropriate audit evidence to support the conclusion that any of the identified processes were operating effectively as controls over the recognition of contract revenue, margin, or related receivables and liabilities; and

293.3.2 did not adequately assess whether the evidence obtained was relevant and reliable.

D. Identification and evaluation of site-level controls

294. As set out above, KPMG was required:

294.1 to obtain an understanding of controls relevant to the significant risk that it had identified, that is, the risk of misstatement relating to accounting for Carillion's contracts;

294.2 to perform procedures to evaluate the design of those controls and to determine whether they had been implemented; and

294.3 where its risk assessment incorporated an expectation that certain relevant controls were operating effectively, KPMG was required to test these controls to confirm their operating effectiveness.

295. The first two of these requirements for site-level controls are considered in this section and the third requirement for site-level controls is considered in Section E.

296. The "*Risk assessment*" section of the audit file identified eleven "*relevant controls*" relating to construction contracts and five "*relevant controls*" relating to service contracts. A working paper for each of these controls recorded KPMG's understanding of the control and the specific assertions over which the control was said to provide assurance, including:

296.1 a description of the "*Risk of what could go wrong mitigated by the control*";

296.2 a description of how the control was performed and documented; and

296.3 the "*Significant Accounts*" and assertions addressed by the control.

297. However, the details provided in these working papers did not adequately explain how the control addressed risks relating to the accounts and assertions identified or, in many cases, how the controls operated in relation to financial reporting at all. Consequently, there was no evidence that KPMG had properly understood how each control operated in relation to the significant risk.

298. For example, in relation to construction contracts:

298.1 Working paper "*01 Signed Contract*" described the risk mitigated by the control as:

"Work started on contract before contract is signed. Costs incurred may be irrecoverable"

And how the control was performed and documented as:

"The project contract is signed by the client before work commenced"

The accounts and assertions that were identified as being addressed by the control were completeness, existence and accuracy of Total Revenue and existence of retentions.

Although it was obviously important that work did not commence before a contract was signed the description did not identify a control process to ensure that this did not happen or how assurance was obtained over the specific assertions identified.

298.2 Working paper "*03 Procurement Program Monitoring*" described the risk mitigated by the control as:

"*Not a detailed understanding of costs to complete leading to incorrect EoL margin being traded."*

And how the control was performed and documented as:

"The procurement programme and/or schedule is updated and monitored."

The accounts and assertions that were identified as being addressed by the control were completeness and accuracy of Cost of Sales and Amounts owed to customers on construction contracts. However, there was no explanation of what the "*procurement programme*" comprised or how it was "*monitored"*, or how this related to Carillion's financial reporting for construction contracts.

298.3 Working paper "*06 Subcontractor Notice To Start*" described the risk mitigated by the control as:

"If reconciliations are not performed for all subcontractors could lead to understated costs"

And described how the control was performed and documented as follows:

"A notice to start (or commence) is issued to the subcontractor a specific time in advance as defined by the contract. A copy of this notice to start is kept on file. The order (subcontract) is not a notice to start. The order states the terms. A simple email or letter asking to start is required."

The accounts and assertions that were identified as being addressed by the control were completeness and accuracy of Cost of Sales and Amounts owed to customers on construction contracts. However, there was no obvious connection between the risk described and the control, and no clear explanation of how the control was intended to operate, or how it related to Carillion's financial reporting for construction contracts.

299. In relation to Service contracts:

299.1 Working paper "*01 Contractual Kpi Reporting*" described the risk mitigated by the control as:

"*Carillion may be unable to support KPI performance due to insufficient KPI reporting*"

And described how the control was performed and documented as follows:

"The control is performed is by management whereby they have to report the KPIs on each contract to the client on a monthly basis. KPMG check that these reports are being prepared but do not rely on the contents of these reports. A potential misstatement is that KPIs are not reported on and therefore the company suffers fines for these."

The accounts and assertions that were identified as being addressed by the control included completeness and accuracy of Cost of Sales, completeness, existence and accuracy of Total Revenue and existence, accuracy and valuation of Other Receivables – Services WIP. However, there was no clear explanation of how the control was intended to operate or how it related to Carillion's financial reporting for service contracts.

299.2 Working paper "*05 Manual Journals Authorisation*" described the risk mitigated by the control as:

"*Without the necessary authorisation, inappropriate manual journals can be posted by individuals*"

And described how the control was performed and documented as follows:

"The control is performed by management whereby manual journals posted should be approved by a superior. A potential misstatement would occur if authorisation was not obtained from a superior for the posting of a manual journal and this would lead to the misstatements if the manual journals posted were inappropriate."

The accounts and assertions that were identified as being addressed by the control included completeness and accuracy of Cost of Sales, completeness, existence and accuracy of Total Revenue and existence, accuracy and valuation of Other Receivables – Services WIP. However, there was no explanation of how the control was intended to operate to ensure that manual journals were in fact approved.

300. In relation to both construction and service contracts, KPMG had concluded that the controls described in the work papers were relevant to the audit and operating in relation to a significant risk so it was required to perform procedures to both evaluate the design of those controls and to determine whether they had been implemented. Each of the working papers included the following question:

"Has the design and implementation of the control been tested as part of a walkthrough?"

301. KPMG recorded the following response*s* to this question:

301.1 In relation to construction contracts:

"KPMG have tested this control in previous years. No changes have been made to this process"

No further details were provided regarding the testing performed or the outcome.

301.2 In relation to service contracts:

"… we enquired with [senior management of the Carillion Services finance team] *as to whether the control existed. We then inspected and observed the documents and reports when out on site visits"*

302. Site visits are addressed in Section E below. KPMG otherwise obtained no evidence that the controls identified had been implemented.

303. In its evaluation of site level controls KPMG thus failed:

303.1 to adequately identify or understand the controls which operated to provide assurance over the relevant risks;

303.2 to evaluate their design; and

303.3 to determine whether they had been implemented.

304. Further, despite noting that the significant risk relating to contracts related in particular to estimates of revenue from variations and claims and to forecasts of costs, KPMG:

304.1 did not identify any contract level "*process*" controls that mitigated risks relating to estimates of revenue from claims; and

304.2 identified certain controls related to "*the final out-turn of costs*" and "*EoL margin*",[12] but provided no explanation of how these controls mitigated risks relating to forecast costs; and

304.3 did not test the implementation of the controls, relying on unspecified prior year testing.

305. There were thus breaches by **the Respondents** in the **2016 audit** of:

305.1 **ISA 315 paragraphs 13 and 29**, in that the Respondents did not perform procedures properly to evaluate the design of controls they had identified as relevant to the audit and determine whether they had been implemented. Further, they did not adequately identify the controls relevant to the assessed risks and related assertions; and

305.2 **ISA 500 paragraphs 6 and 7**, in that the Respondents failed to design and perform appropriate audit procedures to enable them to obtain sufficient appropriate audit evidence that the controls identified had been implemented.

E. Testing of site-level controls

(1) Introduction

306. As set out above, where KPMG's risk assessment incorporated an expectation that certain relevant controls were operating effectively, KPMG was required to design and perform tests of those controls to confirm that they were in fact operating effectively as expected to mitigate the assessed risk.

307. This section sets out KPMG's 2016 audit work performed to test the identified site-level controls for the contracts considered in detail in this *Final Settlement Decision Notice.*

[12] For example, working papers "*03 Procurement Program Monitoring*" and "*09 Monthly Reporting Packs*" referred to risks relating to end of life margin and costs to complete processes relating to the final out-turn of costs and referred to assertions.

(2) Construction contracts

(a) <u>*Introduction*</u>

308. In its working paper "*TOD 4.1 CCS SITE VISIT SUMMARY*", KPMG set out the following twelve controls to be tested during its site visits for construction contracts in the 2016 audit:

308.1 "*The project contract is signed by the client before work commenced*"

308.2 "*Client contract changes are documented and approved in line with the change terms. These changes are logged on a contract changes register or schedule.*"

308.3 "*The procurement programme and/or schedule is updated and monitored.*"

308.4 "*Recommendation for awards (RFAs), in the updated format, are approved prior to subcontracting*"

308.5 "*A signed contract is in place for a subcontractor before work commences.*"

308.6 "*All subcontractors are issued a notice to start in line with the notice provision in the contract.*"

308.7 "*Subcontract changes are instructed on a pro-forma document and logged. All instructions are linked to the subcontract account.*"

308.8 "*Formal instructions are issued for day work. Day work sheets are approved and linked to the formal instructions.*"

308.9 "*Unless the exact applied figure is being paid to a subcontractor, payment and withholding notices (contracts pre-October 2011) or payment and pay less notices are issued in a timely manner in line with the contract terms.*"

308.10 "*Monthly contract reports are prepared. All reports include a contract appraisal; building contracts also include a progress dashboard.*"

308.11 "*A risk and opportunities schedule is kept and regularly updated.*"

308.12 "*Inspection and test plans are in place for work activities.*"

309. Of the construction contracts considered in this *Final Settlement Decision Notice*, the Aberdeen Contract had a site visit with "*full*" controls testing and the Battersea and Liverpool Contracts had site visits with "*review*" or "*limited*" controls testing. The controls tested broadly matched the control processes discussed in section D above. As set out below, the testing performed on the site visits was defective, and did not provide evidence that the controls were operating effectively to address the risks and assertions it had identified.

(b) *The Aberdeen Contract*

(1) *Test 1*

310. Working paper "*TOD 4.B.4 ABERDEEN SITE VISIT*" stated that the relevant control required that a contract be signed by the client before the work started. It also described KPMG's test of this control as follows:

> *"Obtain a copy of the main contract and check it has been signed by at least the client.*
>
> *NOTE: A memo from legal stating the contract has been signed is sufficient"*

311. KPMG's test, to confirm that a signed contract existed, did not provide any audit evidence that work had not commenced before the contract was signed (which was the risk it had identified) and so provided no evidence that the control was effective to address that risk. It also did not provide any evidence that risks relating to amounts recognised for revenue or retentions were mitigated.

(2) *Test 2*

312. Working paper "*TOD 4.B.4 ABERDEEN SITE VISIT*" described the relevant control as follows:

> *"Client contract changes are documented and approved in line with the change terms. These changes are logged on a contract changes register or schedule".*

313. Working paper "*02 Contract Changes*" stated that this control mitigated the following risk:

> *"the client and Carillion have not agreed to contract variations before commencement then this may lead to recoverability issues"*

314. The working paper then recorded that the relevant assertions addressed by the control included completeness, existence and accuracy of Total Revenue.

315. Working paper "*TOD 4.B.4 ABERDEEN SITE VISIT*" described KPMG's test of this control as follows:

> *"A) Obtain a copy of the schedule of client changes.*
>
> *B) TS2 - For a sample of 5 of these changes, evidence that the site has retained an audit trail of the instruction."*

316. This test did not verify that the schedule from which KPMG drew its sample included *all* contract changes, or that it accurately recorded agreed amounts for the changes, and consequently the test did not provide evidence in relation to completeness or accuracy of amounts included in revenue for variations. KPMG therefore failed to establish that the control was operational and effective in mitigating the risks relating to the assertions it had identified.

(3) Test 3

317. Working paper "*TOD 4.B.4 ABERDEEN SITE VISIT*" described the relevant control as follows:

> *"The procurement programme and/or schedule is updated and monitored."*

318. Working paper "*03 Procurement Program Monitoring*" stated that this control mitigated the following risk:

> *"not a detailed understanding of costs to complete leading to incorrect EoL margin being traded"*

319. Working paper "*TOD 4.B.4 ABERDEEN SITE VISIT*" described KPMG's test of this control as follows:

> *"A) Obtain a copy of the procurement programme/schedule. Obtain evidence that this is being monitored and regularly updated. To do this:*
>
> *B) request meeting minutes where the programme was discussed; (For small contracts this can be evidenced by Day Books/Emails)*
>
> *C) review the programme to sense check whether the information is up to date. (e.g. by version control/dates)*
>
> *D) TS1 - Confirm that the procurement programme has been discussed internally for the relevant package for the five subcontractors in control 5, below. (This may not be minuted for small contracts)."*

320. These tests did not address Carillion's recording and reporting of the *amounts* of costs or the calculation of costs to complete and consequently could not provide assurance that the control mitigated the risk identified.

321. Further:

321.1 KPMG did not in any event obtain copies of the "*meeting minutes*" and "*Confirm that the procurement programme has been discussed internally*", as planned, but instead stated, "*the schedule will be satisfactory evidence*"; and

321.2 KPMG recorded that "*Carillion ensure that all aspects of each package have specific dates attributed, to remain on schedule*" and "*the relevant sections are discussed with the subcontractors*" but did not explain how this had been tested or how it established that the control described was operating effectively.

322. KPMG therefore failed to establish that the control was operating effectively in mitigating the risks relating to the assertions it had identified.

(4) Test 6

323. Working paper "*TOD 4.B.4 ABERDEEN SITE VISIT*" described the relevant control as follows:

> *"All subcontractors are issued a notice to start in line with the notice provision in the contract"*

324. The working paper described KPMG's test of this control as follows:

> *"TS1 - For the sample of five subcontractors:*
>
> *A) check the site has evidence that a notice to start has been issued.*
>
> *B) Check the subcontract to identify the point at which the notice to start should be issued and confirm the notice to start was issued in a timely manner."*

325. However, KPMG did not perform part "*B*" of the test.

326. Working paper "*06 Subcontractor Notice To Start*" indicated that this control addressed various assertions, including completeness and accuracy of subcontractor costs in cost of sales.

327. However, the existence of a notice to start for sub-contractors recorded as working on the contract, whether or not it had been issued "*in a timely manner*", did not provide audit evidence that risks relating to those assertions were mitigated. KPMG therefore failed to establish that the control was operational and effective in mitigating the risks relating to the assertions it had identified.

(5) *Test 7*

328. Working paper "*TOD 4.B.4 ABERDEEN SITE VISIT*" described the relevant control as follows:

> *"Subcontract changes are instructed on a pro-forma document and logged. All instructions are linked to the subcontract account."*

329. The working paper described KPMG's test of this control as follows:

> *"A) TS1 – Confirm that subcontract changes are being tracked and monitored. Do this by asking the contract manager for each of the sampled subcontractors for recent applications for payment and check to see if variations have occurred and ensure these are approved and logged."*

330. Tab "*TS1*" of the working paper indicated that there were no "*changes/variations to the contract evidenced in the payment notice valuations*" in relation to any of the sampled sub-contractors. However, in response to the question "*Can we evidence these variations monited and applied for?*", the working paper recorded "*Yes, application log kept alongside variations list and value agreed on payment notice*", for five of the six sub-contractors sampled, and "*n/a*" for the sixth. These findings were, on their face, inconsistent.

331. The test did not provide evidence that changes were either "*instructed on a pro-forma document"* or "*logged*" or "*linked to the subcontract account*" and thus did not provide assurance that the control as described was operating effectively. In fact, the results suggested that the process adopted differed materially from the control as described in KPMG's work paper, and that KPMG's understanding of the control was incorrect.

(6) *Test 8*

332. Working paper "*TOD 4.B.4 ABERDEEN SITE VISIT*" described the relevant control as follows:

> *"Unless the exact applied figure is being paid to a subcontractor, payment and withholding notices (contracts pre-October 2011) or payment and pay less notices are issued in a timely manner in line with the contract terms."*

333. The working paper described KPMG's test of this control as follows:

> *"TS1 – For the sample of five subcontractors, identify the date on which payment notices are required to be issued as per the contract.*
>
> *A) Obtain copies of the last payment notices and check if they have been issued in line with the date defined in the contract.*

> *B) Confirm that the payment notices are supported by a breakdown and a payment certificate.*
>
> *Where there is a difference between the payment notice and the subcontractor's application:*
>
> *C) confirm a withholding or pay-less notice has been issued*
>
> *D) Is it in line with the deadline defined in the contract."*

334. However:

334.1 KPMG did not perform part "*A*" of the test, but simply recorded that the "*Payment notice timeframe*" was "*Not specified*" in any of the contracts sampled.

334.2 KPMG did not perform part "*B*" of the test.

334.3 KPMG did not properly perform part "*C*" of the test, in that (i) in relation to three of the items that KPMG tested, the "*withholding or pay-less*" notices were dated October 2015, and therefore not relevant to the 2016 audit, and (ii) in relation to the three remaining items that KPMG tested, the dates of the "*withholding or pay-less*" notices were recorded as "*N/A*".

334.4 KPMG did not properly perform part "*D*" of the test, in that, in answer to the question "*The notices were issued within the required timeframes after the application for payment deadline?*", it answered "*Yes*" in relation to all six sub-contractors sampled, despite the fact that it had previously recorded in Part "A" of the test that no such "*timeframe*" existed.

335. KPMG therefore failed to establish that the control was operating effectively in mitigating the risks relating to the assertions it had identified.

(7) Test 9

336. Working paper "*TOD 4.B.4 ABERDEEN SITE VISIT*" described the relevant control as follows:

> *"Monthly contract reports are prepared. All reports include a contract appraisal; building contracts also include a progress dashboard."*

337. The working paper described KPMG's test of this control as follows:

> *"A) Obtain a copy of the contract reports for the last three months.*
>
> *Perform a review to determine whether there is any missing information:*
>
> *B) Is the standard form completed including a contract appraisal (terminology: or contract report/CVR)?*

C) For building contracts only, is there a progress/quality dashboard?

D) Is it sent to the Operational/Commercial Pairing ([…]*)?"*

338. The working paper then recorded as the results for this testing:

"No issues to note from review"

339. KPMG recorded no other evidence that it had performed the test it set out to perform and provided no response to any of the specific questions in the test. There was no explanation for how any assurance was obtained. KPMG thus failed to confirm that the control was operating effectively in mitigating the risks relating to the assertions it had identified.

(8) Test 10

340. Working paper "*TOD 4.B.4 ABERDEEN SITE VISIT*" described the relevant control as follows:

"A risk and opportunities schedule is kept and regularly updated."

341. The working paper described KPMG's test of this control as follows:

"A) Obtain a copy of the latest risk and opportunities register and review the document from the last three months to check it is being updated regularly.

B) Do the risks makes sense based on the stage of the project (e.g. If building: Groundwork risks such as difficulty laying foundations should not be on the list if the building is in the final fit-out stage)

C) Check there are documented actions for the risks"

342. The working paper recorded as the results for this testing:

"A risk register is being mainained and updated n a monthly basis. This is oversean by [senior management of the Carillion Construction commercial team]*."*

343. KPMG again recorded no other evidence that it had performed the test it set out to perform and provided no response to the specific questions in the test, and there was no explanation for how any assurance was obtained. KPMG thus failed to confirm that the control was operating effectively in mitigating the risks relating to the assertions it had identified.

(9) Test 11

344. Working paper "*TOD 4.B.4 ABERDEEN SITE VISIT*" described the relevant control as follows:

"Inspection and test plans are in place for work activities"

345. The working paper described KPMG's test of this control as follows:

> *"A) TS1 - For the sample of subcontractors, check that inspection and test plans are in place for the activities they are performing."*

346. For each of the six samples, working paper "*TOD 4.B.4 ABERDEEN SITE VISIT*" recorded the results of this testing as follows:

> *"N/A - all covered within task briefing stage at start"*

347. KPMG recorded no other details or evidence that it had performed the test and appears therefore to have relied on uncorroborated management representations. KPMG thus failed to confirm that the control was operating effectively in mitigating the risks relating to the assertions it had identified.

(c) *The Battersea Contract*

(1) *Test 2*

348. Working paper "*TOD 4.A.3 BATTERSEA SITE VISIT*" recorded controls testing, including the following:

> *"2. Understanding of how variations have or will be approved*
>
> *KPMG reviewed the variation register for Battersea. There are some large items within this resgister and this covers variations agreed, variations not agreed and variations not submitted. The variations resigter is updated as and when needed but usually this would be at least once monthly. A number of the variations in 2016 have been wrapped up and are being submitted to the client as a claim above and beyond cover costs incurred. There has not been a formal submission of these variations yet. In general variations appear well recorded, are being updated regularly and being submitted to the client in batches over and above the incurred amount in order to ensure costs are covered. The variation approval process and change log is well established and the process and controls continue to appear to be performing appropriately."*

349. The working paper did not identify which control was being tested but it is assumed to be the control described in working paper "*02 Contract Changes*", which described the control as follows:

> *"Client contract changes are documented and approved in line with the change terms. These changes are logged on a contract changes register or schedule."*

350. Working paper "*02 Contract Changes*" stated that this control mitigated the risk that:

> *"the client and Carillion have not agreed to contract variations before commencement then this may lead to recoverability issues"*

351. The narrative in working paper "*TOD 4.A.3 BATTERSEA SITE VISIT*" indicated that the register included variations that had not been agreed and furthermore that some of those variations had not even been submitted, but that Carillion was incurring costs implementing them. The results of the test therefore showed that "*Client contract changes*" were not being properly "*documented and approved*", meaning that the control was not operating effectively; and the risk that "*the client and Carillion ha[d] not agreed to contract variations before commencement*" was not being mitigated.

(2) Test 4

352. Working paper "*TOD 4.A.3 BATTERSEA SITE VISIT*" recorded controls testing, including the following:

> *"4. Understanding of how subcontractor contracts are approved*
>
> *Prior to raising an order with a subcontractor, a recommendation for award form will be approved by the Originator, the Project Manager, the ommericial Manager and thje Supply Chain manager for all RFAs. RFAs over specific amounts will also require approval from other levels of seniority (see example of RFA on the righ hand column which shows these levels).*
>
> *All sub-contractors will have an appropriately approved sub-contract order (i.e. contract) before work commences. A site will create a sub-contract order, which is usually sent to a central team (central supply Chain / regional office) before being sent to the supplier for signing. (This does not have to be signed by Carillion, only the subcontractor). A copy of the signed contract is retained on site.*
>
> *A notice to start (or commence) is issued to the subcontractor a specific time in advance as defined by the contract. A copy of this notice to start is kept on file.*
>
> *Battersea were able to show an example of a notice to start however this is not always communicated formally. As the main subcontractors have mostly already started their work plans, notices to start are no longer being issued as often as they were in the previous years of the contract."*

353. The working paper did not identify which control was being tested but it is assumed to relate to the control described in working paper "*04 Rfa Approvals*" which described the control as follows:

> *"Recommendation for awards (RFAs), in the updated format, are approved prior to subcontracting"*

354. Working paper "*04 Rfa Approvals*" stated that this control mitigated the following risk:

> *"Work being completed by unapproved subcontractors effecting the quality of the work and effecting the probability of recovering full retention from the customer"*

355. Working paper "*04 Rfa Approvals*" then indicated that this control addressed assertions about the completeness and accuracy of subcontractor costs in cost of sales and of amounts owed to customers. The working paper did not explain how risks relating to these assertions were mitigated by the control and in particular how the control gave further assurance over the completeness or accuracy of amounts.

356. Further, the narrative in working paper "*TOD 4.A.3 BATTERSEA SITE VISIT*", set out above, only provided a description of how the control operated, not a test of whether it was operating effectively. Carillion's selection of a single item did not provide sufficient evidence that the control in question was operational and effective.

(3) Service contracts in the 2016 audit

357. Of the service contracts considered in this *Final Settlement Decision Notice*, the Nottingham Contract and Services Contract A were selected by KPMG for a site visit in the 2016 audit.

358. In its working paper "*TOD 01.0020 APPROACH PAPER*", KPMG described what it intended to do during its site visits relating to service contracts in the 2016 audit as follows:

> *"KPMG will be testing controls whilst out at site and these will include: contractual KPI reporting, contract variations, credit note approvals, manual journals, bad debt write off approvals and subcontractor reconciliations".*

359. In its working paper "*01.0010 SERVICES CONTROLS MATRIX*", KPMG stated that it planned to test a sample of at least 25 for each control across the contracts selected for site visits.

360. However:

360.1 KPMG's testing of controls over credit note approvals did not assess whether or not credit notes had been approved, only whether they had been appropriately processed;

360.2 KPMG did not perform any test of controls over bad debt write-off approvals;

360.3 the relevant working paper for the site visit for the Nottingham Contract, "*AP060.3.00290 NOTTINGHAM SITE VISIT*", recorded no controls testing other than "*Manual journals posted by the FM were approved by* [a more senior individual within the Carillion Construction finance team] *and KPMG tested a sample of 5*"; and

360.4 KPMG failed to test a sample of 25 for manual journals and subcontractor reconciliations across the contracts for which site visits were to be performed.[13]

(4) Conclusion

361. There were thus breaches by **<u>the Respondents</u>** in the **<u>2016 audit</u>** of:

361.1 **<u>ISA 330 paragraphs 8, 9, and 17</u>**, in that the Respondents did not:

361.1.1 design or perform tests of controls adequately in response to the risks they had identified in relation to contracts;

361.1.2 obtain a sufficient understanding of deviations from controls on which they relied and the potential consequences; and

361.1.3 consider all audit evidence irrespective of whether they appeared to corroborate or to contradict the assertions in the financial statements, and so did not respond as they should have done to indications that Carillion's controls over revenue from variations were not operating effectively; and

361.2 **<u>ISA 500 paragraphs 6 and 7</u>**, in that the Respondents:

361.2.1 failed to design and perform appropriate audit procedures to enable them to obtain sufficient appropriate audit evidence to confirm that reliance could be placed on Carillion's controls relevant to the significant risk relating to contract revenue, margin, and related receivables and liabilities; and

361.2.2 did not adequately assess whether the evidence obtained was relevant and reliable.

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[13] The working paper records that samples of 30 and 25 were tested for manual journals authorisation and subcontractor reconciliations respectively, including five each in relation to Services Contract A, and another two contracts. However, the working paper for the Services Contract A site visit provides no evidence that any manual journals or supplier reconciliations were tested; the working paper for one of the two other contract's site visit provides no evidence any manual journals were tested; and the working paper for the other of the two contract's site visit indicates that a sample of seven, not five, manual journals was tested.

8. REVENUE ON CONSTRUCTION CONTRACTS: CLAIMS AND VARIATIONS

Forecasting total contract revenue 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. Forecast revenue included amounts from any agreed variations made to the contract and from any claims made against the customer. However, these could only be included where certain criteria required by accounting standards were met, which in turn depended on judgements and estimates made by Carillion's management.

During the 2016 audit, KPMG was aware that Carillion's approach to recognising revenue from claims departed from its internal policy, and should have identified that in consequence the criteria required by accounting standards were in some cases unlikely to be met, thus risking inappropriate recognition of revenue.

In 2016, the amounts for claims and variations included in forecast revenue on four of Carillion's most significant and critical contracts were substantial, totalling over £100 million. The inclusion of these amounts enabled Carillion to either record profits for the contracts or (where they were loss-making) minimise any provisions. 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.

Despite this, KPMG did not obtain sufficient appropriate audit evidence to provide assurance that the necessary criteria for these 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, and also failed to consider whether, in aggregate, they indicated possible management bias that represented a risk of material misstatement overall.

A. Overview

362. As explained in Chapter 3, Carillion used the "*stage of completion*" approach to calculate revenue from construction contracts, as follows:

362.1 It would first prepare estimates or forecasts of:

362.1.1 Total revenue from the contract over its whole life.

This would be the total value of the contract stated in the contract itself, together with the value of any claims, variations and any other adjustments. Estimates needed to be made of the amounts to be included for claims and variations not yet agreed with the customer. Such amounts need to be probable and capable of reliable measurement.

362.1.2 Total costs to be incurred over the whole life of the contract.

362.2 It would then calculate the stage of completion by comparing the costs already incurred on the contract with the forecast total costs to be incurred over the whole life of the contract.

362.3 Finally, it would multiply the estimate of total contract revenue by the stage of completion to arrive at a figure for revenue to be recognised to date.

363. Accounting standards[14] provided that this approach could be used unless:

363.1 it was not possible to estimate the outcome of the contract reliably, in which case revenue could only be recognised to the extent that it was recoverable and did not exceed costs; or

363.2 it was probable that the contract would make an overall loss, in which case the estimated loss for the whole contract needed to be recognised immediately.

364. Accounting standards also provided that specific criteria needed to be met for amounts from claims and variations to be included in revenue. These criteria included that it was "*probable*" that revenue would result from the claim or variation, and that the revenue could be "*reliably measured*".[15]

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[14] IAS 11.

[15] IAS 11 paragraph 11. See also IAS 11 paragraphs 13 and 14.

365. The amount of revenue recognised in each period for the four construction contracts introduced in Chapter 3, and considered in this chapter, was therefore determined by the contract's forecast overall profit or loss over the contract's life, which in turn was determined by:

365.1 the total forecast revenue, including from claims and variations, which are considered in this chapter; and

365.2 the total forecast costs, which are considered in the next chapter.[16]

366. In relation to claims and variations, KPMG identified that there was "*a high degree of management judgement required in: assessing the level of these contingencies; recognising variations and claims; and estimating the revenue recognised by the Group with respect to the final out-turn on contracts*" and identified a significant risk of material misstatement in each of the 2014, 2015 and 2016 audits relating to the recognition of contract revenue, margin, and related receivables and liabilities.

[16] Where an amount from a claim or variation was included in forecast revenue to determine the amount of revenue to recognise, Carillion described that amount as "*traded*".

367. For the four contracts considered in this chapter, where claims or variations had not yet been agreed, Carillion identified a potential value for the claim or variation, and an estimated recoverable amount to be included in forecast revenue. The potential values of some of the largest claims and variations on these contracts, together with the corresponding amounts included in forecast revenue, are as follows:

Contract	Claim / variation	2014		2015		2016	
		Potential value	Forecast revenue	Potential value	Forecast revenue	Potential value	Forecast revenue
Aberdeen	Claim: [Customer][17]					£55.3m	£23.3m
Aberdeen	Claim: Insurance					£13.3m	£6.7m
Battersea	Variation	£17.2m	£3.0m	£29.2m	£15.8m	£18.0m	£9.1m
Battersea	Claim: "*reset*"			£31.5m	£31.5m	£55.0m	£28.6m
Liverpool	Claim: Ground asbestos	£12.0m	£3.9m	£9.4m	£3.0m	£9.4m	£3.0m
Liverpool	Claim: [Consultant 1] design					£7.1m	£7.0m
Liverpool	Claim: [Consultant 2] asbestos					£10.0m	£4.5m
Liverpool	Claim: [Customer] asbestos			£6.0m	£2.4m	£6.0m	£4.0m
Liverpool	Claim: Power on delay					£11.3m	£5.9m
Liverpool	Claim: Beam[18]					£0.0m	£1.0m
Southmead	Various claims					£10.0m	£10.0m

[17] Working paper "*AP050.3.2.3 INFRASTRUCTURE CONTRACT YE16*" refers to a "*£160m claim submitted to* [the customer]" and contains embedded document "*AWPR-WMc-SC-LH-4790 Delay and Additional Cost Notice per Clauses 19,3…*" which sets out a schedule of costs totalling £165.9 million, together with a number of costs marked as "*TBC*". Carillion's share of the claim is taken to be one third of that total.

[18] Working paper "AP050.3.1 DEC 2016 BUILDINGS" shows the "Total Potential" for "Beam" as £15.9 million, based on a summary provided by Carillion, however, the working paper also indicates that the "Requested" amount was £0.0 million.

368. These amounts were highly subjective, and their size meant that their inclusion within forecast revenue had a significant impact on Carillion's reported profit. Further, where but for inclusion of these amounts the contract would otherwise be forecast to make an overall loss, the inclusion of these amounts in forecast revenue avoided the need to recognise large provisions. There was therefore a heightened risk of significant misstatement from management bias in relation to these claims and variations.

369. KPMG was required to obtain sufficient appropriate audit evidence to support Carillion's judgement that it was appropriate to include these amounts in revenue from these claims and variations. It was also required to approach each of the amounts in question with scepticism, recognising that they involved significant judgements by management and a heightened risk of bias.

370. However, there were significant deficiencies in KPMG's audit work on these claims and variations. Examples of shortcomings included the following:

370.1 a lack of evidence that a claim or variation had been quantified, drafted or submitted to the relevant counterparty;

370.2 a lack of explanation and/or supporting evidence for the amount or proportion of a claim or variation treated as part of total contract revenue, or the process by which the estimate had been arrived at;

370.3 a lack of expert or legal opinions supporting a claim, despite references to the availability of such evidence and an intention to obtain it;

370.4 a lack of third-party evidence, in particular relevant correspondence from counterparties;

370.5 an absence of explanation for the apparent lack of progress in a claim or agreement to a variation, and a failure to consider the impact of that lack of progress on the assessment of recoverability;

370.6 an insufficient response to evidence that an amount was disputed, and a failure to consider the impact of that evidence on the assessment of recoverability;

370.7 inconsistencies between evidence in position papers produced at year end for the audit and in other documents in KPMG's possession, including earlier position papers and Carillion's legal disputes register; and

370.8 a general failure to evaluate whether and how the requirements of IAS 11 were met and, in particular, to respond to evidence suggesting that the required criteria had not in fact been met.

371. KPMG also failed to evaluate whether the judgements and decisions made by management in preparing these estimates, even if individually were within a reasonable range, tended to take an optimistic view of the recovery of claims and variations and so in aggregate indicated possible bias that represented a risk of material misstatement overall.

372. More generally, KPMG was aware that Carillion's approach to recognising revenue from claims departed from its internal policy, and should have identified that in consequence the criteria required by accounting standards were in some cases unlikely to be met.

373. KPMG also took significant comfort from the inclusion of only a proportion of the potential value of claims and variations in total contract revenue (often around 50% for claims) on the basis of "*accumulated knowledge*" or an assumption that there was a level of recovery that Carillion generally achieved.

374. For example, in working paper "*AP050.3.2.3 Infrastructure Contract YE16*", KPMG stated as follows:

> *"KPMG know from historical experience and site visits undertaken that the process for agreeing variations can be unclear and complex to resolve. Even though the nature of a variation is undertaken through request of the client, Carillion can often carry out work and incur increased costs without agreeing on a price of the variation with the client. KPMG had to rely on management representation in this instance and the use of managements own professional knowledge that they will exercise prudency when trading variation values. KPMG found that in sampled contracts, traded*[19] *variation values fell between 40-55% of submitted variation value, based on* [senior management of Carillion Construction finance team's] *representation that Carillion expects to recover between 80-100% of variation values on all contracts this gives comfort that management are exercising prudency."*

375. However, KPMG did not refer to any evidence supporting its statement that "*in sampled contracts, traded variation values fell between 40-55% of submitted variation value*" or to any audit procedure to compare amounts for variations included in forecast revenue with submitted variation values. It also did not record any evidence corroborating either the representation that Carillion expected to recover over 80% of "*variation values*" or that that expectation was reasonable.

[19] Where an amount from a claim or variation was included in forecast revenue to determine the amount of revenue to recognise, Carillion described that amount as "*traded*".

376. Further, it was not appropriate to rely solely on management representations in circumstances where more reliable audit evidence would be expected to be available. It was also inappropriate to rely on management's "*professional knowledge*" to conclude that they would "*exercise prudency when trading variation values*".

B. Accounting standards

377. As set out in Chapter 3 and above, revenue from construction contracts was recognised in proportion to the stage of completion and derived from forecast revenue and forecast costs.

378. Deriving forecast revenue involved adding together several different elements. In this regard, IAS 11 paragraph 11 provided as follows:

> *"Contract revenue shall comprise:*
>
> *(a) the initial amount of revenue agreed in the contract; and*
>
> *(b) variations in contract work, claims and incentive payments:*
>
> > *(i) to the extent that it is probable that they will result in revenue; and*
> >
> > *(ii) they are capable of being reliably measured."*

379. Carillion's accounting policy as disclosed in each of its 2014, 2015, and 2016 financial statements, provided, "*revenue represents the fair value of consideration receivable* […] *for services supplied to external customers*". No policy specifically for recognising revenue from claims and variations was disclosed.

380. IAS 11 paragraph 13 established the following rules relating to revenue from variations:

> *"A variation is an instruction by the customer for a change in the scope of the work to be performed under the contract. A variation may lead to an increase or a decrease in contract revenue. Examples of variations are changes in the specifications or design of the asset and changes in the duration of the contract. A variation is included in contract revenue when:*
>
> *(a) it is probable that the customer will approve the variation and the amount of revenue arising from the variation; and*
>
> *(b) the amount of revenue can be reliably measured."*

381. IAS 11 paragraph 14 established the following rules relating to revenue from claims:

> *"A claim is an amount that the contractor seeks to collect from the customer or another party as reimbursement for costs not included in the contract price. A claim may arise from, for example, customer caused delays, errors in specifications or design, and disputed variations in contract work. The measurement of the amounts of revenue arising from claims is subject to a high level of uncertainty and often depends on the outcome of negotiations. Therefore, claims are included in contract revenue only when:*
>
> *(a) negotiations have reached an advanced stage such that it is probable that the customer will accept the claim; and*
>
> *(b) the amount that it is probable will be accepted by the customer can be measured reliably."*

C. Carillion's approach to recognising revenue from claims

382. As set out above, paragraphs 13 and 14 of IAS 11 provided that the revenue from variations and claims could be included where they met certain criteria.

383. KPMG needed to evaluate and conclude on whether the approach taken by Carillion to recognising revenue from both was consistent with accounting standards and ensured that these criteria were met.

384. However, on 26 January 2017, a member of the audit team sent KPMG Senior Manager C an email to which there were four attachments, titled "*Pre-contract bid costs*", "*Mobilisation costs*", "*Profit recognition*", and "*Revenue recognition*". In the email, the member of the audit team wrote:

> *"The attachments are policies I have pulled off from Carillion's intranet".*

385. Later on 26 January 2017, KPMG Senior Manager C forwarded the email to Mr Meehan. The attachment "*Profit recognition*" was headed "*Carillion plc - Profit Recognition Policy*". This set out the following in relation to claims:

> *"Uncertified claims may only be included in the final forecast where the value of such claims have been carefully considered with a good draft of the claim completed. It must be reasonably certain that the client will agree to the claim and the client must have the ability to pay. All claims included within end forecasts must be approved by the relevant Business Unit Commercial and Finance Director and reviewed by the Business Group Commercial and Finance Director".*

386. On 30 January 2017, Mr Meehan responded to various members of the audit team, stating as follows:

> *"Rev rec services just looks wrong*

> *Copy* [KPMG Senior Manager A] *as don't the accounts say somewhere, or worse we do, that "the accounts are prepared in accordance with GAAP and Carillion's policies"?*
>
> *If so we need to get these changed. They should speed up the 2017 review.*
>
> *Should the need to update these go in the AC Paper as a control type point?"*

387. Shortly after this email on 30 January 2017, Mr Meehan forwarded KPMG Senior Manager C's email of 26 January 2017, including the four attachments, to various members of the team, stating as follows:

> *"Did you bother to read this at all before you sent it????*
>
> *Look at claims on the construction profit rec one and it a complete joke to say they have applied this.*
>
> *You should have read this"*

388. Later on 30 January 2017, KPMG Senior Manager B responded to Mr Meehan's email stating as follows:

> *"Key areas of their current policy that diverges from what actually happens:*
>
> *Claims*
>
> ● *good draft of the claim completed*
>
> ● *reasonably certain that the client will agree to the claim*
>
> ● *client must have the ability to pay."*

389. It follows that the audit team was aware that Carillion's approach ("*what actually happens*") was to recognise revenue from claims in circumstances where:

389.1 a "*good draft of the claim*" had <u>not</u> been completed; and/or

389.2 it was <u>not</u> "*reasonably certain that the client w*[ould] *agree the claim*"; and/or

389.3 the client might <u>not</u> "*have the ability to pay*".

390. In these circumstances it was likely that in some cases revenue was being recognised for claims where:

390.1 negotiations had not "*reached an advanced stage*"; and/or

390.2 it was not "*probable that the customer w*[ould] *accept the claim*"; and/or

390.3 "*the amount that it* [wa]*s probable w*[ould] *be accepted by the customer*" could not be measured reliably.

And thus that the criteria required by IAS 11 (see above) were not met. KPMG should have identified this and concluded that Carillion's approach was inappropriate.

391. There were thus breaches by **the Respondents** in the **2016 audit** of **ISA 315 paragraph 11(c)** and **ISA 700 paragraphs 8(d) and 9(c)**, in that the Respondents failed to evaluate whether the policy in fact applied on construction contracts was consistent with accounting standards and appropriate.

D. The Aberdeen Contract

(1) The 2016 audit

392. The Aberdeen Contract commenced in December 2014. By 2016, the costs on the project had over-run and the joint venture (in which Carillion had a one-third stake) was seeking substantial additional payments. KPMG's working paper indicated that forecast revenue on the contract included £23.3 million in respect of a claim against its customer and £6.7 million in respect of an insurance claim.

393. KPMG was aware during the course of its 2016 audit that such negotiations as had taken place between the joint venture and its customer had not made substantial progress:

393.1 In an email dated 11 July 2016 and reporting on the "*Half Year 2016 UK Construction Update Meeting*", KPMG Senior Manager B wrote:

"• Aberdeen

- *Currently sitting on PoA of £6m*
- *£25m claim to trade in future to maintain EoL margin*
- *£20m from* [the customer] *for delay in start and £5m from insures for bad weather*
- *Main risk = early discussions on agreeing claims do not go well"*

393.2 The *"Infrastructure PRM Pack – November 2016"*, provided to KPMG in December 2016, stated as follows:

"The major operational focus continues to be Aberdeen and in particular the adjudication with Scottish Ministers (TS) moving to a "facilitated mediation". The Winter 17 completion will not be achieved and we had been forecasting March 2018 but further delay to […] *approvals and poor outputs on CRCP are creating tension that pushes the date towards end of May. We have commissioned additional planning resource to support the project alongside a revised CTC* […]*"*

393.3 Carillion's legal disputes register as at 30 September 2016 recorded that:

393.3.1 The customer had made an application seeking declarations that the main contractor (in effect the joint venture) had no entitlement to any relief or compensation above the contractual payments;

393.3.2 that application had not been granted, but this did not mean that the joint venture's claims were accepted as good, and it was *"still left to* [the joint venture] *to prove entitlement"* to further payments;

393.3.3 following the adjudication, the parties had *"recommenced dialogue",* but the customer had not yet agreed to enter into a *"facilitated negotiation"* process;

393.3.4 the current state of affairs was that the joint venture was *"continu*[ing] *to work up its claims"*; and

393.3.5 there had been no "*strategic legal advice*".

393.4 By an email dated 30 January 2017, Carillion provided KPMG with both the adjudication itself and a note dated 3 September 2016 from its lawyers ("**Solicitor Firm A**") commenting on the adjudication. Both the adjudication and the note confirmed the points contained in the register, with Solicitor Firm A stating:

> *"You will see that the Adjudicator does not decide that the claims are good; only that they are not necessarily bad."*

393.5 Carillion's legal disputes register as at 28 February 2017 added the following information:[20]

393.5.1 The "*extent*" of the dispute was now £150 million.[21]

393.5.2 On 9 December 2016, the customer had issued a pre-action protocol letter: the joint venture had argued that court proceedings would be premature but both Carillion and counsel thought that the prospects of this argument succeeding were "*slim*".

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[20] Received by KPMG after the date of the audit report but then reviewed and added to the file.

[21] This was an increase of £45 million in five months (in fact, an increase of over £60 million, because the joint venture's letter of 13 September 2016 stated that the value had increased from £105 million to over £165 million)

393.5.3 The joint venture was awaiting the customer's next steps but meanwhile was "*proceeding to compile the delay & disruption case with all haste*".

393.5.4 Carillion's litigation plan was made up of nine "*work streams/ actions*", which included:

393.5.4.1 work by quantum experts;

393.5.4.2 costs budgeting;

393.5.4.3 pursuit of a "*Loss of revenue claim*";

393.5.4.4 the possible pursuit of claims against third parties;

393.5.4.5 the need to take *"advice on whether limits on liability c*[ould] *be circumvented*"; and

393.5.4.6 "*a review of all potential claims that might lead to financial recovery*".

394. It was clear from the above material that there was no agreement between the joint venture and the customer about these claims and that any process to resolve them was at a very early stage. Despite this, it was evident from KPMG's main audit working paper, "*AP050.3.2.3 INFRASTRUCTURE CONTRACT YE16*", that, as at December 2016, Carillion had included £23.3 million in forecast total revenue[22] in respect of the claim against the customer, on the basis of its one-third participation in the joint venture. A further £6.7 million in respect of an insurance claim was also included.

395. The working paper contained a number of embedded documents. However, none of these provided sufficient evidence that the amounts above should have been included in contract revenue.

[22] The figures quoted here represent Carillion's one-third share of (a) the JV's claim against the customer (of which £70 million was "*deemed recoverable*") and (b) its claim against insurers for £20 million.

396. The embedded documents included two relating to the claim against the customer. The first was described as "*£160m claim submitted to* [the customer]". The document was a letter dated 13 September 2016, giving notice of the claim and setting out details of the additional costs incurred. It referred to other correspondence and included an appendix setting out a schedule of costs totalling £165.880 million, together with a number of costs marked as "*TBC*". KPMG commented on this document, "*This supports the fact that the claim position is greater than the clients traded position*". However, whilst this material confirmed that the total amount of the claim was more than the amount Carillion had included in revenue, it gave no assurance over whether it was probable that the amount treated as revenue would be recovered.

397. The second document was described as "*Copy of the adjudication findings in Carillions favour*". KPMG commented on this document:

> *"The attached document is confirmation from the JV's lawyers that the adjudication found against Scottish ministers, adding support to Carillions position on this contract."*

398. The document, which was an email from Solicitor Firm A to which a copy of the adjudication decision was attached, includes the following comments:

> *"You will see that the Adjudicator does not decide that the claims are good; only that they are not necessarily bad. That is to say –* [they have] *rejected the Ministers' invitation to negate all of the claims, but it is still left to ARL, in due course, to prove entitlement.*
>
> *[…]*
>
> *We have previously discussed the risk that - even if we win - the Ministers will follow up with a second adjudication, inviting the adjudicator to value the EoT and compensation at nil (which would put the onus on us to prove entitlement in a very short timescale).*
>
> *There is nothing in this decision to stop that."*

399. The advice from Solicitor Firm A was that the joint venture ought "*to press afresh the suggestion of mediation*", but added, "*How to do that will require careful thought*". This document gave no assurance over whether the amount included in revenue would be recovered nor provided a basis for KPMG to conclude that this would, or probably would be the case.

400. The embedded documents also included two relating to the insurance claim. The first was described as "*£40m claim submitted to the insurers*". KPMG commented on this document as follows:

> *"Claim submitted September 16 sets out the increase of 'New works costs' from £105m to £165.8m and the subsequent submission for £40m of cost recovery from the insurers. Of which, £4m has been received to date".*

401. The document is a duplicate of the letter of 13 September 2016 referred to above, which made no reference to any insurance claim, other than the remark "*the direct cost of the damage* […] *being covered by the project insurance policies* […] *but <u>the release of which the CA has thus far refused to sanction</u>*" (emphasis added).

402. The second of the two documents relating to the insurance claim was described as "*Bank statement and backings for £4m payment from insurers*". KPMG commented on this document as follows:

> *"Bank statement extracted from* [Carillion's online bank] *terminal shows receipt of £4m in relation to Aberdeen. KPMG have obtained management representation that this payment is not 'full and final' and therefore there are further payments to come."*

403. The document is a bank statement showing that £4 million had been received during December 2016, with the reference "*CTLA/ABERDEEN RD * 296467*REF ABL407/* TFR*". It contained no evidence that the payment related to a successful insurance claim.

404. These two documents did not provide sufficient appropriate audit evidence that a payment of £4 million had been made in relation to the insurance claim or that a further payment of at least £2.7 million would be made; in relation to the latter KPMG relied solely on a management representation.

405. KPMG's evaluation of the evidence obtained in the working paper was minimal. In particular:

405.1 In relation to the (identified) risk "*Valuation and Recoverability of Variations and Claims*", beneath the heading "*How KPMG applied professional judgement to this area*", KPMG recorded various matters relating to variations, but made no reference at all to claims.

405.2 The section titled "*Conclusion over risk*" did not include any reference to either of the two claims or KPMG's conclusions on them, despite the fact that their combined value was £30 million.

405.3 KPMG did not evaluate in respect of either claim whether the criteria in the applicable accounting standards had been met so as to permit any amount to be included in revenue, or obtain any explanation as to how the specific sums included by Carillion had been derived. In respect of the claim against the customer, the evidence showed that the claim was strongly disputed, and the expert legal advice did not provide any assurance that any amount was likely to be recovered. In respect of the insurance claim KPMG did not critically consider the evidence it had obtained and in relation to the additional £2.7 million relied on an uncorroborated management representation.

406. KPMG should have been sceptical about the inclusion in revenue of any amount in respect of these claims. KPMG failed to consider the requirements of IAS 11 or to obtain sufficient appropriate audit evidence to support including the relevant amounts in total contract revenue. The evidence in its possession suggested that, as at December 2016, it was *not* probable that the customer would accept the claim against it, nor was it possible to estimate reliably an amount that it was probable would be accepted, and that therefore the criteria required by accounting standards were not met.

407. There were thus breaches by **the Respondents** in the **2016 audit** of:

407.1 **ISA 200 paragraph 15**, in that the Respondents did not approach management's judgement with an adequate degree of professional scepticism and so did not critically assess the accumulated evidence relating to the likely recovery of the claims;

407.2 **ISA 330 paragraphs 5, 6 and 26**, in that the Respondents did not adequately design or perform audit procedures in response to the risks they had identified relating to estimates of contract revenue and did not adequately consider all audit evidence irrespective of whether it appeared to corroborate or to contradict the assertions in the financial statements;

407.3 **ISA 500 paragraphs 6, 7 and 9**, in that the Respondents:

407.3.1 failed to design and perform appropriate audit procedures to enable them to obtain sufficient appropriate audit evidence to support Carillion's recognition of revenue from claims; and

407.3.2 did not adequately assess whether the evidence obtained, particularly that prepared by Carillion, was relevant and reliable;

407.4 **ISA 540 paragraphs 12, 13, 15 and 18**, in that the Respondents did not adequately assess whether Carillion's estimates of revenue from claims, assumptions relevant to those estimates, and processes for deriving those estimates and assumptions, were appropriate and reasonable.

E. The Battersea Contract

(1) The 2014 audit

408. In its 2014 audit working paper "*AP050.3.0080 BUILDINGS FINAL CONTRACT REVIE*", KPMG indicated that forecast revenue on the Battersea Contract included £3.9 million in respect of a claim against Carillion's customer.

409. The working paper contained the following passage:

> *"From Sept margin decreased by 1.4% after a detailed Cost to complete review was performed by Carillion. Contract at site level at present is break even with a route map inplace to achieve the EOL margin as at 31 dec, this is detailed below, but is predominantly made up of margin on variations and extention of time claim.*
>
> *The margin has been traded back from that taken in Septmeber to 3.1%, this is agaisnt a revised EOL margin of 3.5%. At the site level the margin is at present roughly at 0% margin with a routemap in plance to achieve the EOL margin, this is detailed below, but is predominantly made up of margin on variations and extention of time claim."*

410. The table below this text in the working paper included a figure of £30.4 million for "*Variations*". There is no evidence that KPMG performed any audit procedure on this balance.

411. The minutes of a meeting between Carillion and KPMG on 14 January 2015 record the following:

> *"Battersea (£16.0m margin route-map)*
>
> *Contract has experienced delays caused by a client request to construct an energy centre within the basement. Carillion need to recover claims and variations that are primarily related to the energy centre totalling £17.2 million to achieve the final traded margin. As only £3.0 million has been traded to date for YE14 the risk is not significant however,* [Carillion Construction management] *understood the potential risk and confirmed that discussions were planned with the client to recover the monies due."*

412. KPMG performed no audit procedures in relation to the £17.2 million referred to, seemingly on the basis that this was not necessary because only £3.0 million was being "*traded*" by Carillion. Consequently, KPMG did not consider whether the requirements of IAS 11 were satisfied, or obtain further audit evidence. There was no explanation for how this amount related to the £30.4 million amount recorded in working paper "*AP050.3.0080 BUILDINGS FINAL CONTRACT REVIE*" above.

413. £3.0 million was significantly higher than the threshold for recording audit misstatements, and thus the fact that this was all that Carillion was "*trading*" should not have led to the conclusion that there was no need to investigate further. Further, the comment "*Contract at site level at present is break even"* indicated a risk that, if the amount was not recovered, the contract would be loss-making, meaning that the conclusion on this amount was particularly significant. However, KPMG did not consider these points or make any further enquiries.

414. There were thus breaches by **the Respondents** in the **2014 audit** of:

414.1 **ISA 200 paragraph 15**, in that the Respondents did not approach management's judgement with an adequate degree of professional scepticism and so did not critically assess the accumulated evidence relating to the likely recovery of the claims and variations;

414.2 **ISA 330 paragraphs 5 and 6**, in that the Respondents did not adequately design or perform audit procedures in response to the risks they had identified relating to estimates of contract revenue;

414.3 **ISA 500 paragraphs 6, 7 and 9**, in that the Respondents failed to design and perform appropriate audit procedures to enable them to obtain sufficient appropriate audit evidence to support Carillion's recognition of revenue from claims and variations and failed to properly consider whether the evidence obtained, particularly that prepared by Carillion, was relevant and reliable; and

414.4 **ISA 540 paragraphs 12, 13, 15, and 18**, in that the Respondents did not adequately assess whether Carillion's estimates of revenue from claims and variations, assumptions relevant to those estimates, and processes for deriving those estimates and assumptions, were appropriate and reasonable.

(2) The 2015 audit

(a) *Variations*

415. In its 2015 working paper "*AP050.3.1.2 DEC 2015 BUILDINGS CONTRACT WP(1)*", under the heading "*Variations*", KPMG recorded that, in relation to the Battersea Contract, the "*Variations traded*" had a value of £15.8 million and the "*Variations submitted to client*" had a value of £29.2 million.

416. Under the same heading, KPMG wrote as follows:

> *"Variations in Dec 2015 have reduced to zero from £958k in Sept 2015. This is due to payment received regarding these variations, claims of £14,782,392 as at Sept and measured works of £16,262,491. This accounts for £32,002,501 of the increase in cash received since Sept 2015. £15,000,000 of this cash is related to the advance payment which is discussed in section 4 of the WP. The remaining £45,637,139 is for additional measured works, variations and claims incurred and approved between Sept 2015 and Dec 2015.*
>
> *For EOL variations of £15,807,151 a total of £29,244,777 has been submitted - of this total amount £12,782,705 have been agreed so far, therefore leaving £3,024,446 to be recovered from a remaining submitted amount of £16,462,072 (recovery rate of 18.4%) therefore this seems reasonable."*

417. Later in the same working paper, under the heading "*Professional judgement*", KPMG wrote as follows:

> *"The main issues [include] the £15,807,151 of EOL variations which are not confirmed. […]*
>
> *[…] for £15m of variations a total amounts of £29m has been submitted which is in line with the usual level of acceptance. The KPMG team also performed a site visit at Battersea and viewed the variations and opportunities schedule at this point. Many of these variations are for end customers in terms of modifications to the original plans e.g. in order personalise flats or to combine a number of flats into one. Therefore as these variations are well documented and are for the end user it seems likely that there will be some agreement for the variations although the quantum is currently undetermined. Also as all variations to date have been paid it would indicate that they are no current issues with any of the variations submitted."*

418. This audit work was deficient in that:

418.1 The figures of £12,782,705, £16,462,072 and £29,244,777 appear to have been derived from an embedded spreadsheet provided by Carillion, which recorded that the first figure had been agreed. There is no evidence that KPMG performed any audit work to check the accuracy of the figures or obtained any evidence that variations totalling c.£12 million had in fact been agreed. KPMG performed controls testing which confirmed customer agreement to a sample of variations but recorded no evidence of the amounts involved.

418.2 KPMG relied on approximately 50% of the stated value of the variations being "*in line with the usual level of acceptance*" but did not record any evidence in support of this and did not consider whether "*the usual level of acceptance*" (even if accurate) made it probable that the unagreed variations in question here would in fact be accepted.

418.3 KPMG also relied on the variations being "*well documented*" and "*for the end user*" but did not provide any evidence of these facts or any explanation why they made recovery of the specific amounts probable.

419. The forecast profit for the contract over its life was £15.1 million. If the £15.8 million in variations was not recovered, then there was a risk that the contract was in fact loss-making. This would have meant that a different accounting treatment for the contact would be required, such that the estimated loss for the whole contract would be recognised in the period.

(b) *Claims*

420. In its 2015 working paper "*AP050.3.1.2 DEC 2015 BUILDINGS CONTRACT WP(1)*", KPMG indicated that £31.5 million was included in forecast revenue in respect of a claim against Carillion's customer.

421. In its 2015 working paper "2*.5.1.00130 JULY BOARD MEETING MINUTES*", under the heading "*CEO report 08 July 2015*", KPMG noted the following in relation to the Battersea Contract:

> *"Construction works 31 weeks behind programme, primarily around blocks F & G. 10-12 weeks of formal extension expected in next period. Cost and time implications have been submitted to client – negotiations ongoing to re-base contract sum."*

422. In its 2015 working paper "*2.6.9.0010 MATERIAL DISPUTES DEC 2015*", Carillion's legal disputes register, as reviewed and annotated by KPMG, Carillion included the following text in relation to the Battersea Contract:

422.1 Under the heading "*Name and Details*":

> *"The project is c30 weeks late and to date there has been no EoT and/or loss and expense granted by the Employer.* [Carillion] *considers this is primarily due to change in location of Energy Centre and knock on effects that that change had.*
>
> *Employer is saying culpable delay on the basis that we are in delay for our own reasons as well as any reasons of the Employer."*

422.2 Under the heading "*Comments and Progress in the month*":

> *"Major investigations are ongoing to understand the impacts that the Employer changes have had. At same time there are extensive discussions going on with the Employer to try and resolve the differences between us* – [Carillion Construction management and Carillion Construction commercial team] *are all heavily engaged.*
>
> *A deal has been agreed for the impact of changes and delays to the project with the Employer to date. This has resulted in a settlement and deed of variation which gives CCL the time it sought together with an additional £20m.*
>
> *Now need to understand the financial impact that that leaves with the supply chain and determine how we seek recovery from those that caused the losses that we will still suffer."*

423. It therefore appeared that, as at December 2015:

423.1 Carillion's customer had been disputing responsibility for all or part of the delay suffered;

423.2 an agreement had nevertheless been reached for payment to Carillion of an additional £20 million and an extension of the contract period; and

423.3 despite this payment, Carillion would still suffer losses, and it was not clear how or whether those losses could be recovered.

424. KPMG highlighted the relevant entry in yellow, which, according to the key at the top of KPMG's working paper meant the following:

> *"Dispute has been covered by Construction/Services component testing. See 4.7.2.0010 for Services Clearance Meeting Minutes and 4.7.2.00100 for Construction Clearance Meeting Minutes which discuss some of these further".*

425. The "*Construction Clearance Meeting Minutes*" recorded the following:

> *"Battersea – EoL; recovery of £11.5m claims, £15.8m variations and cost savings of £25 .7m– Significant cash receipt before year end, reducing the risk. However, KPMG will continue to watch as even though good traded position at present plenty of challenges to overcome.* […] *is a good project director so programme wise they are doing well. Battersea struggling to get people in for other phases so Battersea are keen to get Carillion on board – but CCS will not talk about agreeing to another phase until this one is completely resolved."*

426. In its 2015 working paper, "*AP050.3.1.2 DEC 2015 BUILDINGS CONTRACT WP(1)*" KPMG noted that the £20 million payment left £11.5 million of claims outstanding and that these were "*yet to be formalised*". Under the heading *"Professional Judgement"* KPMG then concluded as follows:

> *"The main issues involving subjective balances within the Battersea contract are the £11,500,000 of claims not yet agreed and the £15,807,151 of EOL variations which are not confirmed. During the site visit it was discussed with on site managers that Battersea are struggling to attract new contractors to tender for later phases of the build after issues with* [another contractor] *during phase 1, therefore they are reliant on* [Carillion] *to give a good review of the project and relationship and also potentially to bid for another phase. KPMG challenged whether Carillion were reliant on winning another phase of work with Battersea as this is a major contract and is in the first phase of 8 phases. However as Carillion have another key contracts coming through in the year including* [two new contracts]*, which have been seen in the year review of pipeline contracts, this would indicate that Carillion are not reliant and therefore have more power in the relationship. Indsutry knowledge from Peter Meehan has indicated that there have been issues with* [another contractor] *in the market. This In terms of the £11.5m of claims KPMG have considered the likelihood of an agreement on this balance. KPMG challenged this number with the client given that as the contract is approximately 75% complete and there is a remaining 36% of the total claims not yet agreed. Therefore there is a possibility that if the claims are moving in line when raised with management they disagreed that the claims value might be in line with progress and therefore with progress that there could be shortfall of circa £3.6m (25% of total contracts length remaining 31.5m vs. 36% of total 31.5m claims remaining). The Buildings management team did not agree that there was a link between contract progress and potential claims agreed as many of there contracts do not attracts claims requests until late on in the process. In response to this KPMG raised that given the time left to completion and the usual length of agreeing such claims that the project may have finished in this time and that the claim may become hard to agree once building was completed by Carillion. However Carillion also disagreed with this on the grounds that the relationship between both parties was good and that there was potential for new work on further phases of the Battersea contracts.*

> *This was in line with KPMG understanding gained from the site visit (see above) KPMG therefore raised the point that there would need to be careful consideration when taking on any further contracts if there was no agreement reached on this claim at the time of negotiations. Given that Battersea have already confirmed £20m of the future claim and there has been no change in the forecast figure since Sept it would appear that there was reasonable ground for* [Carillion] *to consider that they would be able to confirm a further portion. Taking into account these additional market factors it would seem reasonable that a further portion of claim will be agreed."*

427. KPMG therefore concluded that it was reasonable for Carillion to include in revenue a further £11.5 million for claims in addition to the £20 million which had been agreed, relying on representations made by Carillion management, including that:

427.1 the customer was "*reliant on* [Carillion] *to give a good review of the project and relationship and also potentially to bid for another phase*", whereas "*Carillion* [was] *not reliant and therefore ha*[d] *more power in the relationship"*; and

427.2 "*the relationship between both parties was good and* […] *there was potential for new work on further phases of the Battersea contracts*".

428. KPMG referred to no other evidence to support either of these representations.

429. KPMG also relied on the fact that the customer had "*already confirmed £20m of the future claim*" to conclude that "*there was reasonable ground for* [Carillion] *to consider that they would be able to confirm a further portion*".

430. However, the deed of variation embedded in the working paper stated, "*this Deed is made in full and final settlement of all Claims either Party, has or may have against the other*". KPMG did not check whether the matters giving rise to the claims totalling £11.5 million were included in the settlement. The settlement had been agreed in December 2015, and it was therefore likely that all or part of the £11.5 million was included in the "*full and final settlement"*, and that Carillion would therefore have no right either to make an additional claim or to receive any further amount under the settlement.

431. KPMG's 2015 working paper "*4.6.3.0020 MATERIAL DISPUTES FEB-2016*", which was an updated version of Carillion's legal disputes register referred to above, included the following from Carillion regarding the Battersea Contract:

> *"A Reset deal was concluded with the Employer at the end of last year. It provided for a further variation to the contract sum of £20m and a full EoT for the delay.*
>
> *As a result of the Reset deal, Carillion has suffered significant loss and expense. There are also major claims from the supply chain that will need to be concluded.*

[…]

E[xtent] – £30m+

[…]

Investigations to understand the financial impact that the Reset deal leaves with the supply chain and to determine how we seek recovery from those that caused the losses that we have suffered are underway. This will be a complex and difficult exercise due to the scale of the sums in dispute and number of parties involved."

432. It therefore appeared that, contrary to the position advanced in the clearance meeting and on the site visits, Carillion had accepted a loss as the result of the full and final settlement agreement it had reached with its customer and was now dependent on the "*complex and difficult exercise*" of recovering the amounts from others. The evidence obtained therefore raised a significant doubt as to whether Carillion could recover any further sum *via* a claim against its customer, and that any route to recovering that sum from any other party (expected to be a "*complex and difficult exercise"*) had not even been clearly identified, let alone reached the stage of a claim that had advanced sufficiently to justify it being included in revenue.

433. KPMG should therefore have been sceptical about the recovery of this amount but did not consider or critically assess the evidence it had obtained, instead relying on the management representations described above.

(c) *Conclusion*

434. The forecast profit for the contract over its life was £15.1 million. If the £15.8 million in variations and £11.5 million claim were not recovered then, particularly in light of the "*major claims from the supply chain*", there was an obvious risk that the contract was in fact loss-making. This meant that the conclusions on these amounts were particularly significant. However, KPMG did not consider these points or make any further enquiries.

435. There were thus breaches by **the Respondents** in the **2015 audit** of:

435.1 **ISA 200 paragraph 15**, in that the Respondents did not approach management's judgement with an adequate degree of professional scepticism and so did not critically assess the accumulated evidence relating to the likely recovery of the claims and variations;

435.2 **<u>ISA 330 paragraphs 5, 6 and 26</u>**, in that the Respondents did not adequately design or perform audit procedures in response to the risks they had identified relating to estimates of contract revenue and did not adequately consider all audit evidence irrespective of whether it appeared to corroborate or to contradict the assertions in the financial statements;

435.3 **<u>ISA 500 paragraphs 6, 7, 9 and 11</u>**, in that the Respondents:

435.3.1 failed to design and perform appropriate audit procedures to enable them to obtain sufficient appropriate audit evidence to support Carillion's recognition of revenue from claims and variations;

435.3.2 did not adequately assess whether this evidence, particularly that prepared by Carillion, was relevant and reliable; and

435.3.3 did not adequately consider or respond to inconsistencies in the evidence obtained on whether the amount met the criteria for being included in revenue; and

435.4 **<u>ISA 540 paragraphs 12, 13, 15, and 18</u>**, in that the Respondents did not adequately assess whether Carillion's estimates of revenue from claims and variations, assumptions relevant to those estimates, and processes for deriving those estimates and assumptions, were appropriate and reasonable.

(3) The 2016 audit

(a) <u>Variations</u>

436. By an email dated 11 July 2016, KPMG Senior Manager B sent what they called "*a brief summary of the significant contracts at HY16*" to Mr Meehan. In relation to Battersea, the email stated as follows:

"Battersea

- *No margin traded in H1, effectively losing £2.4m margin*
- *Need to agree £11.5m increase in contract value*
- *Need to agree £15.8m in variations*
- *As well as require £19.3m in cost savings to reach EoL margin*
- *Main risk = total risk is £46.6m"*

437. In its 2016 working paper "*TOD 4.A.3 BATTERSEA SITE VISIT*", KPMG recorded the following:

> *"KPMG inspected the signed version of the contract in the P[rior] Y[ear] controls testing site visit. There were no issues noted at this point. There have been no ammendments to the contract. All other variations to the contract are looged in the change register and there was a previous reset in relation to the energy centre for which the final agreement was signed off separately. There is a second reset in negotiations currently but this has not yet been agreed and only the heads of terms have been discussed so far. KPMG will request the signed version of this when it is completed but this is not expected until early in 2017."*

438. In its working paper "*AP050.3.1 DEC 2016 BUILDINGS*", KPMG recorded the following in relation to "*variations*" to the Battersea Contract:

> *"KPMG reviewed the change register during the site visit with no issues to note in Carillion being able to support the requests made. Note to the end of 2016 Carillion had successful increased the value of the contract to £488m per agreement from the client, see CERT. Aside from the claim mentioned below, Carillion need to obtain a further £9m in variations from £19m, which is within the percentage normally achieved by Carillion. Carillion have recovered a significant number of variations with the challenge made by KPMG is that easier items were agreed first leaving more difficult to the end, however from a review of the change register it appears in the round that changes have been dealt with in chronological order therefore most recent ones to settle now."*

Agreed contract value	*487*
Contract value requested with variations	*505*
Ask	*(18)*
Traded	*(9)*
Percentage	*50%*

439. It appears that KPMG relied on the proposition that 50% of the stated value of the variations as submitted was "*within the percentage normally achieved by Carillion*", but KPMG had no evidence to support that proposition, and did not consider whether "*the percentage normally achieved*" (even if accurate) in fact made it probable that the unagreed variations in question would be accepted.

440. The details given above from working paper "*AP050.3.1 DEC 2016 BUILDINGS*" were from the version of this working paper included on the 2016 audit file, which was finalised on 3 July 2017. However, an earlier version of this working paper, from a version of the audit file at 15 April 2017, approximately six weeks after the date of the audit report but before the audit file was finalised, did not include the narrative quoted above or any reference to the £19 million variations, the £18 million "*Ask*", or to the £9 million "*traded*". Instead it stated in relation to variations, "*All variations are included in the claim to be recovered*".

441. Both versions of the working paper included an amount of £524.4 million for the total forecast revenue for the contract, but each provided a different "*Summary*" of the components of this amount, as follows:

	April 2017 version		**Final version**
"Total agreed contract sum"	£486.7m	*"Total agreed contract sum"*	£486.7m
"Unagreed claims"	£28.6m	*"Unagreed variations"*	£9.1m
	£515.3m	*"Unagreed claims"*	£28.6m
"Add margin of 1.8%"	£524.6m		£524.4m

442. The calculation in the April 2017 version included "*Add margin of 1.8%*", applied to the total revenue from the agreed contract and the unagreed claims. There was no explanation in the April 2017 version for the line item called "*Add margin of 1.8%*"and there was no proper basis for adding a further "*margin*" to either the agreed contract sum or the unagreed claims.

443. In April 2017 KPMG's working paper did not record any reference to the £9.1 million "*Unagreed variations*" referred to in the final version of the working paper. It is therefore to be inferred that by the date of the audit report no audit work had been performed on the £9.1 million "*Unagreed variations*" included in the final version of the working paper. This is discussed in Chapter Part E below.

(b) <u>*Claims*</u>

444. In 2016 Carillion included £28.6 million in total revenue from claims on the Battersea Contract. There was correspondence between KPMG and Carillion in respect of the claims, including the following:

444.1 On 30 November 2016, KPMG requested "*Draft heads of terms for reset covering/explaining claims figure of £28m*".

444.2 On 11 January 2017, Carillion sent KPMG *"Position Paper – December 2016"* in relation to Battersea. Under the heading "*Recovery Strategy*", this included a figure for "*Claims*" of £28.6 million.

444.3 On 13 January 2017, Carillion sent KPMG an email stating, *"Heads of claim as discussed with Battersea in support of the reset. Values need to be discussed further"*. Attached to the email was a document marked "*HoT – draft for Discussion*" and "*Without Prejudice*". This was a two-page document that proposed revised completion dates for a number of specific items of work but included no monetary amounts for those items individually or for the "*total Contract Sum adjustment*".

444.4 On 20 February 2017, KPMG emailed Carillion asking, *"has there been an update to Battersea heads of terms yet to get an idea of the value of claims you will be submitting?"* There is no evidence that Carillion ever answered this question nor any record of KPMG taking any action about the lack of a response.

444.5 Carillion's legal disputes register as updated in September 2016 contained the same text on this issue as had been set out in the version from February 2016, suggesting that there had been no progress in the intervening six months. The register as at 28 February 2017[23] still contained the same text from February 2016, suggesting that there had been no progress in a year.

445. KPMG's 2016 working paper on construction contracts *"AP050.3.1 DEC 2016 BUILDINGS"* stated as follows in relation to the Battersea Contract:

> *"The main issues involving subjective balances within the Battersea contract are the £28,590,980 of EOL claims not yet agreed. KPMG have not yet received confirmation of the total claims value submitted to the client - though from discussions with management this is expected to be in the region of £55m - £60m, which is inline with Carillion normally obtaining 50%. This was followed up in the year end meeting with* [senior management of Carillion Construction's management team, finance team and commercial team], *due to no submitted value able to support the claims value. Carillion management believe that due to the success of the previous reset, for which £20m of a total submission of £27m was recovered, the second reset will follow a similar path. There are discussions ongoing for future works at Battersea and Carillion are a favoured contractor which they believe will give them leverage to settle reset successfully. This is aide by the fact other subcontractors are turning down work on this site as well as this being phase 1 the customer needs to release the profit to fund future phases. KPMG challenged this view indicating that this could also result in a settlement and below the necessary value in order to secure future works. Carillion informed KPMG that all contracts would be treated separately, which has been*

[23] Received by KPMG after the date of the audit report but then reviewed and added to the file.

> *the case on other contracts in the past. KPMG though remain sceptical about full recovery of the £28.6m. Using a recovery rate (£20m/£27m) of 74% similar to the previous reset then £20m/£27m = 74%) then claims of £37.7m would need to be submitted. This would however appear low in line with general recovery rates across all contracts of around 50% (as discussed above). KPMG will continue to monitor this contract and have raised with management the importance of receiving the full heads of terms with values once confirmed."*

446. KPMG was therefore aware that no claim had been submitted to the customer that set out the total sum sought, and Carillion itself had not calculated a final value for the claim. KPMG had been told that there had been discussions with the customer, but there was no indication that any amount of the claim had been agreed, which was unsurprising in circumstances where all the relevant amounts remained unknown to both parties.

447. KPMG relied on Carillion's representations that "*due to the success of the previous reset …the second reset will follow a similar path"* and that Carillion's supposed "*leverage*" would enable it to achieve a successful settlement. This ignored the fact that the result of the previous reset had been that Carillion "*suffered significant loss and expense*", despite it having similarly claimed at the time that it had "*more power in the relationship*".

448. KPMG also relied on "*general recovery rates across all contracts of around 50%*", without any evidence in support of that proposition or any explanation why the "*general recovery rates*" (if accurate) should be a guide to the probable recovery of these unagreed amounts.

449. KPMG was also aware that in 2015 there had been substantial amounts of unagreed claims and variations pre-dating the previous reset agreement, which was expressed to be in "*full and final settlement of all Claims either Party, has or may have against the other"*. There was an obvious risk that at least some of the 2016 claims related to matters that were covered by the previous reset agreement and in respect of which Carillion could therefore not expect any further payment from the customer. KPMG did not consider this point at all.

(c) <u>Conclusion</u>

450. The evidence obtained by KPMG was insufficient to support including the amounts it did in respect of claims and variations in total forecast contract revenue. The evidence in KPMG's possession suggested that, as at December 2016, it was not probable that the customer would agree to pay the amount sought, nor was it possible to estimate reliably any amount that it was probable would be paid, and therefore that the criteria prescribed by accounting standards were not met.

451. The forecast profit for the contract over its life was £9.4 million. If the £9.1 million variation and £28.6 million claim were not recovered then there was a risk that contract would have made a substantial overall loss, which would have been required to be recognised in 2016. This meant that the conclusion on this amount was particularly significant but KPMG did not consider these points or make any further enquiries.

452. There were thus breaches by **the Respondents** in the **2016 audit** of:

452.1 **ISA 200 paragraph 15**, in that the Respondents did not approach management's judgement with an adequate degree of professional scepticism and so did not critically assess the accumulated evidence relating to the likely recovery of the claims and variations;

452.2 **ISA 330 paragraphs 5, 6 and 26**, in that the Respondents did not adequately design or perform audit procedures in response to the risks they had identified relating to estimates of contract revenue and did not adequately consider all audit evidence irrespective of whether it appeared to corroborate or to contradict the assertions in the financial statements;

452.3 **ISA 500 paragraphs 6, 7 and 9**, in that the Respondents:

452.3.1 failed to design and perform appropriate audit procedures to enable them to obtain sufficient appropriate audit evidence to support Carillion's recognition of revenue from claims and variations; and

452.3.2 did not adequately assess whether this evidence, particularly that prepared by Carillion, was relevant and reliable; and

452.4 **ISA 540 paragraphs 12, 13, 15, and 18**, in that the Respondents did not adequately assess whether Carillion's estimates of revenue from claims and variations, assumptions relevant to those estimates, and processes for deriving those estimates and assumptions, were reasonable and appropriate.

F. The Liverpool Contract

(1) The 2014 audit

453. In its 2014 working paper "*AP050.3.0080 BUILDINGS FINAL CONTRACT REVIE*", KPMG noted that Carillion was including £3.9 million as revenue arising from a claim on the Liverpool Contract. The claim related to costs incurred in dealing with asbestos discovered on the site.

454. Under "*Interim Update*", KPMG noted as follows:

> *"Additional asbestos discovered in the ground across the Phase 1 Work Site.*
>
> *Additional sampling & detailed remediation strategy carried out to meet requirements of* [the Local Authority] *Planning Condition 21 – Contamination. Costs impact to date £5.5m."*

455. Under "*Final Update*", KPMG noted as follows:

> *"In terms of the claim for the additional asbestos there has been no significant progress since interim, discussions are continuing with the* [customer] *with the next meeting taking place on the 16th January 2015. KPMG obtianed a breakdown of the asbestos claims and agreed paymnts made to subbies* [subcontractors] *greater than 1/6PM, providing comfort over the quantum of the claim. Carillion are currently trading £3.9m of the total claimed amount of c£12m. In addition there are visible contingencies on the project that Carillion could utilise inorder to hit the traded margin should the claim fail."*

456. KPMG then recorded the following as the justification for including an amount in revenue from the claim:

> *"The current traded margin at 5.2% is some 0.3% lower than the final EOL margin of 5.5%. The claim should the asbestos claim not be traded would be circa 4%. The varince of 1.5% equates to £4.3m over the life of the contract. This worst-case scenario does not result in a material error and is highly unlikely given Carillion's strong position on the claim. Using our cumulative audit knowledge and experience we generally expect Carillion to receive circa 50% of the total claimed amount on average, however given the strong contractual and legal case that Carillion have on this claim we would expect the recoverable amount to be somewhat higher than this average."*

457. Similarly, in a document titled "*RLUH Asbestos Claim*", which indicated that its purpose was "*to examine the relevant parts of the contract entered into between Carillion Construction Ltd and* [the customer]*, with regards to liability regarding asbestos*", KPMG stated as follows:

> *"In Summary given the lack of any explicit statement of liability regarding asbestos in phase 1 it is reasonable for Carillion to be pursuing a claim and for them to be trading a percentage of the claimed value. The matter is likely to be resolved via a commercial agreement and from reviewing the contract it would appear unlikely that Carillion would not receive some form of compensation."*

458. There was no evidence to support the assertion "*we generally expect Carillion to receive circa 50% of the total claimed*" or to explain why that expectation should hold good for this particular claim. There was similarly no evidence to support the conclusions that Carillion had a "*strong contractual and legal case*" and that it was "*unlikely that Carillion would not receive some form of compensation*". In fact, KPMG had obtained Carillion's legal disputes register as at 31 October 2014, which recorded the following statement to the contrary:

> *"Meetings were held on 16 October with both* [QCs] *to ascertain whether there are any merits in a formal claim against the* [customer]*. Both QCs struggled to find any significant legal arguments."*

459. It appeared that discussions with the customer were ongoing, but there had evidently been little progress between September 2014 and January 2015. The evidence obtained by KPMG suggested that, as at December 2014, it was not probable that the customer would agree to pay the amount sought, nor was it possible to estimate reliably any amount that it was probable would be paid, and therefore that the criteria prescribed by accounting standards for the inclusion of the claim in revenue were not met.

460. There were thus breaches by **the Respondents** in the **2014 audit** of:

460.1 **ISA 200 paragraph 15**, in that the Respondents did not approach management's judgement with an adequate degree of professional scepticism and so did not critically assess the accumulated evidence relating to the likely recovery of the claim;

460.2 **ISA 330 paragraphs 5, 6 and 26**, in that the Respondents did not adequately design or perform audit procedures in response to the risks they had identified relating to estimates of contract revenue and did not adequately consider all audit evidence irrespective of whether it appeared to corroborate or to contradict the assertions in the financial statements;

460.3 **<u>ISA 500 paragraphs 6, 7, 9 and 11</u>**, in that the Respondents:

460.3.1 failed to design and perform appropriate audit procedures to enable them to obtain sufficient appropriate audit evidence to support Carillion's recognition of revenue from claims;

460.3.2 did not adequately assess whether this evidence, particularly that prepared by Carillion, was relevant and reliable; and

460.3.3 did not adequately consider or respond to inconsistencies in evidence obtained on whether the amount met the criteria for being included in revenue; and

460.4 **<u>ISA 540 paragraphs 12, 13, 15, and 18</u>**, in that the Respondents did not adequately assess whether Carillion's estimates of revenue from claims, assumptions relevant to those estimates, and processes for deriving those estimates and assumptions, were appropriate and reasonable.

(2) The 2015 audit

461. During the 2015 audit it became clear that (i) despite a further year having elapsed, little, if any, progress had been made in resolving Carillion's initial claim relating to asbestos in the ground, and (ii) discovery of further asbestos in a different part of the site had resulted in a further claim. KPMG's working paper *"AP050.3.1.2 DEC 2015 BUILDINGS CONTRACT WP"* indicated that forecast revenue included a total of £5.4 million in respect of these two claims.

462. In its working paper *"AP050.3.1.2 DEC 2015 BUILDINGS CONTRACT WP"* under the heading "*Claims*" and the sub-heading "*Explain the following; why there are claims on contract, whether there has been any initial communication from the client, when expect to settle*", KPMG recorded the following:

> *"Total claims of £5,368,483 are recorded in the December 2015 traded position. These are related to asbestos found both in the ground and in the energy centre. The energy centre asbestos claim is more clear cut due to the wording the the contract, therefore the main issue lies in the claim for asbestos found in the car park in phase 1.*
>
> *KPMG prepared a paper in 2014 regarding this matter and will obtain the latest legal view on the asbestos car park."*

463. The working paper then described a series of meetings in 2015, attended by representatives of Carillion and the customer, and recorded the following:

> *"As can be demonstrated above, regular meetings are taking place between* [Carillion] *& the* [customer] *to try & resolve the EoT's* [extensions of time] *without the use of the Dispute Resolution Procedure."*

464. The working paper also included a number of embedded documents, including letters from Carillion setting out the basis for the claims. KPMG did not obtain copies of any responses to these letters, although it was apparent from later letters that there had been responses. In particular, KPMG did not obtain or review a copy of the customer's letter dated 20 August 2015, in which - as Carillion's letter of 2 October 2015 made clear - Carillion's customer had denied any liability for the asbestos found in the ground.

465. In the relevant section of the working paper, KPMG commented:

> *"The legal position on the asbestos in the ground is that the* [customer has] *failed to comply with 'Law' as required by the Construction Contract & the Project Agreement, please see the attached letter & attachment regarding the legislation we say the* [customer]*is in breach of."*

466. Later in the same working paper, under the heading "*Professional judgement*", KPMG concluded as follows:

> *"The main issues for the* [Liverpool] *contract are the claims relating to asbestos of £5,368,483.*
>
> *The final amount able to be regained is influenced somewhat by external factors due to* [the customer] *fighting against the Carillion claim. There are therefore 3 possible outcomes: 1) nothing is received in regards to the cliam, 2) part of the claim is received, 3) all of the claim value is received.*
>
> *KPMG have reviewed a number of documents discussing this matter and CCL have established a view on their claim and have communicated this fully with the* [customer]*. Given that the position on the asbestos in the energy centre seems clear it is unlikely that none of the claim value will be received. However given that no official deal has been reached it would seem more reasonable that part of the full claim has been*[24] *received."*

[24] It is assumed that in the working paper KPMG meant to state "*it would seem more reasonable that part of the full claim will be received*", not "*it would seem more reasonable that part of the full claim has been received*".

467. KPMG also received and annotated Carillion's legal disputes register as at 31 December 2015. The section on the Liverpool Contract indicated that Carillion had appointed Solicitor Firm A and had the following text under the heading "*Comments and Progress*":

> *"Ongoing discussions held with the* [customer]. *Delay Event notices issued to Project Co recording 13 week impact on Completion Date. Letter issued in response to the request from Project Co/* [customer] *for further information. The* [customer has] *responded to Project Co that our claim is rejected and asking for further substantiation. Further details of the regulations/laws we contend the* [customer is] *in breach of have been issued to Project Co. Meeting held with the* [customer] *on 16 November to discuss asbestos in the ground and in the energy centre and the programme implications and their potential culpability. The* [customer] *asked us to withdraw the claim re the ground but agreed to review the detail re the energy centre. The* [customer's] *external planner* […] *has advised the* [customer] *that we are not entitled to an EOT for the asbestos in the Energy Centre as we were already in delay by 21 weeks in August 2015. There are implications for the* [customer] *of causing delay to the* [another] *project. Further discussions to be held to try to settle all claims.*
>
> [An individual] *engaged to act as asbestos expert to advise in relation to issues with the* [customer] *and in a potential claim against* [Consultant 2].[25] *Outline draft report issued which concludes that* [Consultant 2] *were negligent and that the sampling was not robust enough."*

468. In light of the above, KPMG was aware that no agreement had been reached on any aspect of either claim against the customer, and that any claim against Consultant 2 was at an early stage. There was insufficient evidence to conclude that it was probable that any amount of either claim would be accepted.

469. Further, there was no explanation or evidence regarding the basis on which Carillion had determined that £5.4 million was an appropriate figure, and no proper evaluation of whether the criteria set out in the applicable accounting standards were met in order for any amount attributable to the claim to be treated as revenue.

470. There were thus breaches by **the Respondents** in the **2015 audit** of:

470.1 **ISA 200 paragraph 15**, in that the Respondents did not approach management's judgement with an adequate degree of professional scepticism and so did not critically assess the inadequate and conflicting evidence relating to the likely recovery of the claims;

[25] KPMG's working paper described Consultant 2 as consultants for the asbestos in the ground.

470.2 **<u>ISA 330 paragraphs 5, 6 and 26</u>**, in that the Respondents did not adequately design or perform audit procedures in response to the risks they had identified relating to estimates of contract revenue and did not adequately consider all audit evidence irrespective of whether it appeared to corroborate or to contradict the assertions in the financial statements;

470.3 **<u>ISA 500 paragraphs 6, 7 and 9</u>**, in that the Respondents failed to design and perform appropriate audit procedures to enable them to obtain sufficient appropriate audit evidence to support Carillion's recognition of revenue from claims and failed to properly consider whether this evidence, particularly that prepared by Carillion, was relevant and reliable; and

470.4 **<u>ISA 540 paragraphs 12, 13, 15, and 18</u>**, in that the Respondents did not adequately assess whether Carillion's estimates of revenue from claims, assumptions relevant to those estimates, and processes for deriving those estimates and assumptions, were appropriate and reasonable.

(3) The 2016 audit

(a) <u>Introduction</u>

471. In 2016 it was evident that the claims relating to asbestos, one of which had been pending since 2014, had still not been resolved, and that Carillion was still including a significant amount in revenue in respect of the claims. Carillion was also including recoveries from a number of other claims that had arisen in the course of the year with the result that, overall, a total of £25.5 million from claims was included in forecast revenue.

472. In its main 2016 working paper on construction contracts, "*AP050.3.1 DEC 2016 BUILDINGS*", KPMG stated, "*To maintain the traded margin on* [the Liverpool Contract] *Carillion need to recover an additional £25.5 million* [by way of claims]". KPMG summarised the claims position as follows:

> *"£13.0 million is to be recovered from the* [customer] *for asbestos and "power-on" delay, £7.0 million from* [Consultant 1]*, £4.5 million from* [Consultant 2] […]*, and £1.0 million from the insurers for a cracked beam. Due to these issues the contract is currently seven months behind schedule with no extension of time yet agreed resulting in an additional liquidated damages exposure of £10.5 million. This exposure has not been factored into the traded margin as discussions are ongoing with all parties, with management remaining confident of full recovery due to the number of routes available."*

473. The working paper also included amounts from a December 2016 position paper supplied by Carillion, indicating that the total revenue forecast by Carillion included a total of £25.4 million from claims as follows:

	Included in forecast	**"*Requested*"**
Claims – [Customer] *(Asbestos)*	£3.0m	£9.4m
Claims – [Customer] *(Asbestos in Energy Centre)*	£4.0m	£6.0m
Claims – Delay Event (Power On)	£5.9m	£11.3m
Claims – [Consultant 1] *(Design Negligence)*	£7.0m	£7.1m
Claims – [Consultant 2]	£4.5m	£9.9m
Beam	£1.0m	£0.0m
Total	**£25.4m**	**£43.6m**

474. For each of the claims identified, the working paper included an embedded document in a column headed "*Submission*". In each case, the relevant document was correspondence from Carillion to the relevant party, setting out the basis for the claim and the value ascribed to it by Carillion.

475. The working paper also included a column headed "*Latest correspondence*". In the case of the "[Customer] *(Asbestos)*" claim only, the working paper also included an embedded document in that column. It is to be inferred that KPMG intended to obtain the "*Latest correspondence*" in respect of each of the claims but did not do so. The letters in the "*Submission*" column were dated May 2016 in respect of the Consultant 1 claim and March 2016 in respect of the Consultant 2 claim, and it was to be expected that responses to those letters would have been received before the year end. It was also to be expected that such response would provide important evidence as to whether it was probable that the claims would be accepted and in what amount. KPMG ought therefore to have obtained and reviewed the "*Latest correspondence*" (and, as noted above, apparently intended to do so), but did not.

(b) <u>*Claim for asbestos in the ground*</u>

476. In relation to the claim for asbestos in the ground, the embedded "*Latest correspondence*" (a letter from Carillion dated 24 November 2016) included the following passages:

> *"At today's date, the* [customer] *and Project Co are on the brink of a formal dispute* […]
>
> […] *by continuing with its attempts to obtain an adjudicator's decision on the Asbestos Claim at this premature stage, all that the* [customer] *will achieve will be an expensive and time-consuming legal battle* […]

> […] *the* [customer's] *approach to date has been to demand that the Asbestos Claim be withdrawn, failing which the* [customer] *would seek a decision from an adjudicator* […] *on 15 November 2016, the* [customer] *issued a purported Notice of Adjudication in respect of the Asbestos Claim* […] *Steps are now being taken to seek to appoint an adjudicator.*
>
> […] *CCL is strongly of the view that the time and money which would otherwise be spent on adjudication proceedings would be much better invested in mediating the Asbestos Claim* […]"

477. It therefore must have been apparent to KPMG that this claim continued to be disputed, and that there was no evidence that liability for any sum would be accepted by the customer. Nevertheless, Carillion's December 2016 position paper recorded that Carillion had included £3.0 million in forecast revenue from the claim and KPMG did not challenge the treatment as inappropriate.

(c) *Claim against Consultant 2*

478. In relation to the claim against Consultant 2 (which had delivered the original survey), the embedded "*Submission*" was a copy of a without prejudice letter from Carillion dated 31 March 2016. This letter summarised Carillion's perspective, culminating in the assertion, "*there are two categories of costs incurred by* [Carillion] *for which* [Consultant 2] *is responsible",* namely direct costs and costs arising from delays, totalling £6.8 million, together with a further £3.1 million of indicative liquidated and ascertained damages.

479. KPMG had not seen any response to the claim and consequently had obtained no evidence that Consultant 2 was likely to accept the claim or that negotiations were advanced. Nevertheless, Carillion's December 2016 position paper recorded that Carillion had included £4.5 million in forecast revenue from the claim against Consultant 2, and KPMG did not challenge the treatment as inappropriate.

(d) *Claim against Consultant 1*

480. In relation to the claim against Consultant 1 which had prepared the design for the new hospital, the embedded "*latest correspondence*" document was a copy of a letter dated 9 May 2016 from Carillion. This letter asserted the following:

> "[Consultant 1] *is* […] *liable to* [Carillion] *for the current estimated sum of £7,075,000 plus any additional costs associated with the impact on the programme, plus* [Carillion] *overheads and profit. Further details of these losses will be supplied when available.* [Consultant 1's] *liability to* [Carillion] *may not be limited to the examples referred to* [earlier in the letter]. [Carillion] *reserves its rights in respect of any additional cost increases incurred as a result of a breach by* [Consultant 1]*."*

481. KPMG had not seen any response to the claim and consequently had obtained no evidence that Consultant 1 was likely to accept the claim or that negotiations were advanced; in fact, the claim was obviously at an early stage. Nevertheless, Carillion's December 2016 position paper recorded that Carillion had included £7.0 million (99% of the claim) in forecast revenue from the claim against Consultant 1, and KPMG did not challenge the treatment as inappropriate.

(e) *KPMG's overall assessment*

482. Later in the same working paper, under the heading "*Professional Judgment*", KPMG concluded as follows:

> *"The main issues for the* [Liverpool] *contract are the claims relating to asbestos,* [Consultant 1 and Consultant 2]*. The claims submitted to* [Consultant 1] *per the supporting letter do not give sufficient scope to regain the full amount traded.*
>
> *The final amount able to be regained is influenced somewhat by external factors due to* [the customer] *fighting against the Carillion claim. There are therefore 3 possible outcomes: 1) nothing is received in regards to the claim, 2) part of the claim is received, 3) all of the claim value is received. At present 55% of total submitted claims need to be received in order to achieve the current traded margin.*
>
> *While overall this seems reasonable - if the claims are treated individually then the* [Consultant 1] *submission is significantly below the expectation to achieve the £7m traded. KPMG would expect around £14m of claims to have been submitted. The number of routes to reovery gives a more broad chance of recovery to get back to the traded value."*

483. Finally, under the heading "*Conclusion over risk*", KPMG wrote as follows:

> *"KPMG have highlighted this as a high risk ongoing contract. KPMG have gained comfort over the completeness of the claims and have flagged the gap to the Group Audit Team* […]*"*

484. There is no evidence that KPMG considered the criteria in the applicable accounting standards in determining whether, in respect of each claim, it was appropriate for Carillion to include any amount as revenue, or the specific amount that Carillion actually included.

485. There was no explanation why the position was deemed "*reasonable*", or what evidence (other than management representations) had been relied on to reach that conclusion. KPMG appears to have taken some comfort from the fact that "*55% of total submitted claims need*[ed] *to be received*", but there was no evidence to support the proposition that any particular level of recovery could be expected.

486. In fact, KPMG had evidence that, following adjudication, the claim relating to asbestos in the ground had been unsuccessful. Carillion's legal disputes register as at 30 September 2016 recorded the following in relation to the claim:

> *"Ongoing discussions with the* [customer] *resulted in an initial offer from the* [the customer] *of 13 weeks plus £2m although this appears now to have been withdrawn* […] *The* [customer's] *position seems to be hardening."*

487. The version of the register as at 28 February 2017 then stated as follows:

> *"The* [customer] *referred the delay claim re asbestos in the ground to adjudication.* [The Adjudicator] *determined that Project Co (and thereby* [Carillion]*) were solely responsible for the asbestos in the ground and that no Delay Event has occurred.* [Carillion] *to focus on the other delay claims and the claim against* [Consultant 2] *re recovery for asbestos."*

488. Further, in relation to the claim against the customer for the delay event, in respect of which Carillion had included £5.92 million in revenue, the February 2017 register stated as follows:

> *"Discussions are ongoing with the* [customer] *re power on delay claims. The* [customer] *have intimated they feel the delay is Carillion FM's responsibility.* [Solicitor Firm A's] *advice is that the outcome of any formal dispute would be uncertain so to pursue all commercial settlement angles. Carillion are to discuss further at another workshop with the* [customer]*."*

489. This provided no assurance that any amount would be recovered.

490. In relation to the claim against Consultant 2, the September 2016 register referred to "*a potential claim against* [Consultant 2]", an "*Outline draft report*", "*initial advice*", and an "*initial opinion*", and indicated that the claim had not progressed beyond the sending of a letter to Consultant 2. Similarly, the February 2017 register stated that a "*Draft claim ha*[d] *been prepared which w*[ould] *be issued to* [Consultant 2] *along with* [an expert's] *report by the end of Feb 2017.*"

491. KPMG did not identify or address any of these points, each of which suggested that the inclusion of amounts in revenue for each of these claims was not appropriate.

492. The forecast profit for the contract over its life was £13.2 million. If less than half of the £25.4 million amount for claims was recovered, then there was a risk that the contract was in fact loss-making. This would have meant that a different accounting treatment for the contract would be required, such that the estimated loss for the whole contract would be recognised in the period. This meant that the conclusion on these claims was particularly significant but KPMG did not consider these points or make any further enquiries.

(f) *Conclusion*

493. KPMG thus failed to consider the requirements of IAS 11 or to obtain sufficient appropriate audit evidence to support including the relevant amounts in total contract revenue. The evidence in KPMG's possession suggested that it was not probable that the customer would agree to pay the amount sought, nor was it possible to estimate reliably any amount that it was probable would be paid, and therefore that the criteria prescribed by accounting standards were not met.

494. There were thus breaches by **the Respondents** in the **2016 audit** of:

494.1 **ISA 200 paragraph 15**, in that the Respondents did not approach management's judgement with an adequate degree of professional scepticism and so did not critically assess the accumulated evidence relating to the likely recovery of the claims;

494.2 **ISA 330 paragraphs 5, 6 and 26**, in that the Respondents did not adequately design or perform audit procedures in response to the risks they had identified relating to estimates of contract revenue and did not adequately consider all audit evidence irrespective of whether it appeared to corroborate or to contradict the assertions in the financial statements;

494.3 **ISA 500 paragraphs 6, 7 and 9**, in that the Respondents failed to design and perform appropriate audit procedures to enable them to obtain sufficient appropriate audit evidence to support Carillion's recognition of revenue from claims and failed to properly consider whether this evidence, particularly that prepared by Carillion, was relevant and reliable; and

494.4 **ISA 540 paragraphs 12, 13, 15, and 18**, in that the Respondents did not adequately assess whether Carillion's estimates of revenue from claims, assumptions relevant to those estimates, and processes for deriving those estimates and assumptions, were appropriate and reasonable.

G. The Southmead Contract

(1) The 2016 audit

495. In its 2016 audit working paper "*AP050.3.1 DEC 2016 BUILDINGS*", KPMG recorded the following background information in relation to the Southmead Contract:

> *"The original contract was for the construction of an 800-bed acute hospital on a site at Southmead in North Bristol* […]. *Construction is being undertaken by Carillion Construction in two phases. construction of the Southmead Hospital in Bristol. The project started in 2009 with an original contract value of £430m which has increased to £450m at Dec 2016. Issues were identified in Phase two of the project resulting in the project running behind schedule. There were also a number of significant compensation events throughout the contract as a result of asbestos being found throughout the site. Phase 1 of the project was completed in 2015 and Carillion disposed of their share of Southmead on 30 June 2015. Phase 2, the build of the car park was completed in 2016."*

496. It then recorded the following in relation to claims:

> *"At the interim review stage there were £7.6m of claims to recover relating to disputes in relation to phase 1 of the contract. In Dec 2016 this was traded back to £3.5m claims to recover form [a submission of £10m related to drainage, ductwork and door issues."*

497. After that, the working paper set out a breakdown of claim amounts, with a "*total claims value submitted*" of £10.0 million, "*total claims value traded*" of £3.5 million, and "*percentage required*" of 34%. A second breakdown showed a lower "*total claims value submitted*" of £8.7 million, but the same "*total claims value traded*" of £3.5 million, and consequently a higher "*percentage required*" of 40%. KPMG commented on this percentage, "*This still appears a reasonable recovery rate*".

498. The second breakdown was derived from an embedded document: a draft report from a quantity surveyor, commissioned by lawyers acting for Carillion. The report ascribed values to potential claims being considered by Carillion; it did not comment on the merits of any of the claims and was clearly an incomplete draft.

499. The working paper included a section titled "*Ongoing steps towards settlement*", which stated as follows:

> *"Draft letters of claim are being prepared and will be finalised upon receipt of expert reports. There is no final copy of these yet so KPMG will continue to minitor this contract in to HY2017. Independent technical experts have been appointed. See expert views which support Carillion position"*

500. Next to this passage were two further embedded documents but, contrary to the text quoted above, they were only letters of instruction to experts: they did not contain "*expert views*", supporting Carillion's position or otherwise, notwithstanding that both had been instructed to provide initial views by 28 October 2016.

501. KPMG then recorded the following:

> *"Finalise and submit claims late 2016/early 2017*
>
> *Potential mediations early / mid 2017 with* [Contractor A] *and* [Contractor B]
>
> *Reach a negotiated settlement with* [an insurer] *- no yet reached.*
>
> *KPMG have raised this contract with management,* [senior management of the Carillion Construction finance team] *gave the below statement in regards to the position:*
>
> *'We currently have an exposure of just under £9.9m on the CCS Southmead* […] *contract (being WIP of £10.0m less unpaid certificates/timing of £0.1m), this position is post finalisation costs from both phase 1 and 2. The undermeasure has been supressed by retention monies of £6.4m, hence the reported December under certified position is £3.5m. This doesn't alter the requirement to secure value in excess of £9.9m to support the current traded position.*
>
> *Against the exposure of £9.9m, we are seeking to recover remedial costs that CCL and CCS have incurred from the supply chain. The third parties responsible have been identified as* [Contractor A] *(Drainage and Theatre Ductwork*), [Contractor B] *(*[a subcontractor] *in Administration and claim lodged with their Insurers) and* [a subcontractor] *(M&E construction manager). The current recoverable claims breakdown as follows; drainage £6.0m* ([Contractor A]*), theatre ductwork £2.4m (*[Contractor A]*) and doors £1.6m (*[Contractor B]*). £10m in total. This is not exhaustive.*
>
> [Solicitor Firm B] *have been appointed.*
>
> - *Draft letters of claim have been prepared and will be finalised upon validation of expert reports*
> - *Draft quantum has been prepared and to be finalised upon receipt of expert reports and adding management, legal and overhead and profit values*
> - *Independent technical experts have been appointed*
>
> *We are aiming to finalise and submit claims early 2017 with potential mediations early / mid 2017 with* [Contractor A and Contractor B]*. We are stepping up intensity.'"*

502. It was therefore clear that at the year end, no claims had been finalised or submitted, and no evidence had been provided to KPMG to support the merits of any of the planned claims. This appears to have remained the position until the conclusion of KPMG's audit. KPMG obtained neither evidence that any of the counterparties had provided any response to the intended claims nor evidence of any negotiations having taken place or any acceptance of any liability for any sum by any party. Moreover, commentary from the senior management of the Carillion Construction finance team recorded in the working paper made clear that the amount required to be recovered to support Carillion's "*traded position*" was £9.9 million, not the £3.5 million recorded by KPMG. This discrepancy was explained by the senior management of Carillion Construction's finance team as follows:

> *"The undermeasure[26] has been supressed by retention monies of £6.4m, hence the reported December under certified position is £3.5m."*

503. KPMG concluded with these comments:

> *"Carillion have submitted claims of £10m to cover the £3.5m balances traded per the year end 2016 CAVs. This requires a 35% /40% recovery rate which is lower than the general 50% recovery rate applied by Carillion. The claims submitted are spread between two parties –* [Contractor A] *(£8.3m claim) and* [Contractor B] *(£1.6m claim) which treating these separately and assuming a 50% recovery rate from each would result in a receipt of £4.8m to cover the £3.5m under measure. KPMG have raised this contract with management and will continue to monitor this particulary the WIP and retentain balances."*

504. These comments were inconsistent with the evidence recorded in the working paper, which indicated that no claims had been finalised or submitted and referred to no evidence to support a conclusion that any amount of any claim could properly be included in revenue. KPMG referred to 50% as the "*general* […] *recovery rate*" but there was no evidence to support the proposition that that was in fact Carillion's "*general* […] *recovery rate*" or the proposition that that rate could be used as a guide to assess probable recovery in this instance.

[26] "*Undermeasure*" is understood to mean the amount of revenue recognised that has not been certified by the customer.

505. On the '*Summary*' tab of the same working paper KPMG recorded the following in relation to the contract:

> *"Since Southmead hospital was sold in H1 2015, Carillion has incurred £9.9 million of costs from undertaking remedial work. As at 31 December 2016 the entire £9.9 million is held on balance sheet to be recovered. Management has appointed an independent technical expert to draft the claim papers to both the consultant engineers and insurers, with the intention to submit them in H1 2017."*

506. This more accurately captured the position at year end, but similarly referred to no evidence to support a conclusion that any amount of any claim could properly be included in revenue.

507. There were thus breaches by **the Respondents** in the **2016 audit** of:

507.1 **ISA 200 paragraph 15**, in that the Respondents did not approach management's judgement with an adequate degree of professional scepticism and so did not critically assess the accumulated evidence relating to the likely recovery of the claims;

507.2 **ISA 330 paragraphs 5, 6 and 26**, in that the Respondents did not adequately design or perform audit procedures in response to the risks they had identified relating to estimates of contract revenue and did not adequately consider all audit evidence irrespective of whether it appeared to corroborate or to contradict the assertions in the financial statements;

507.3 **ISA 500 paragraphs 6, 7 and 9**, in that the Respondents failed to design and perform appropriate audit procedures to enable them to obtain sufficient appropriate audit evidence to support Carillion's recognition of revenue from the claim and failed to properly consider whether this evidence, particularly that prepared by Carillion, was relevant and reliable; and

507.4 **ISA 540 paragraphs 12, 13, 15, and 18**, in that the Respondents did not adequately assess whether Carillion's estimates of revenue from the claim, assumptions relevant to those estimates, and processes for deriving those estimates and assumptions, were appropriate and reasonable.

H. Review of accounting estimates for management bias

508. Under ISA 240 paragraph 32(b) and ISA 540 paragraph 21, KPMG was required to review the specific judgments and decisions made by management in making accounting estimates for indicators of possible bias. Such bias may be intentional, for example, arising from a motivation to report a desired result, and may therefore be fraudulent in nature.[27] KPMG was also required to identify whether, regardless of whether the individual estimates might be individually reasonable, they indicated possible bias that might represent a risk of material misstatement overall. If so, KPMG was required to re-evaluate the estimates.

509. In its 2016 working paper "*4.5.1 Management bias*", KPMG stated, in relation to "*Contract Judgment (revenues, amounts owed under construction contracts, trade receivables)*":

> *"We have considered possible management bias in regards to judgment on key contracts and are comfortable that there is no intentional management bias in regards to contract judgment because we have: assessed the competence of those individuals making the key judgments; discussed the key contracts with a wide variety of individuals; considered the regular challenge of forecasts; and noted the significant involvement of executive management in the major contracts. As auditors we have had the opportunity to observe the approach adopted by management over a number of years and, as set out in the Executive Summary to our Audit Committee Document, we consider that management has maintained a balanced approach in assessing the level of provisions required, even though the potential range of outcomes is, as always, uncertain and the approach to those judgements is consistent with the prior year. We can conclude that our assessment of Services and Construction contracts are neutral."*

510. The equivalent working papers in the 2015 audit contained identical wording (other than the final sentence), and the equivalent working papers in the 2014 audit contained similar wording.

511. As set out above, evidence obtained by KPMG on the claims and variations in relation to four significant contracts considered in this chapter indicated that in a number of instances amounts were included in total forecast revenue where:

    511.1 there was no agreement between Carillion and its customer on either liability or amount and any negotiations were at an early stage;

[27] ISA 540 guidance paragraph A9 states "*Accounting estimates are imprecise, however, and can be influenced by management judgment. Such judgment may involve unintentional or intentional management bias (for example, as a result of motivation to achieve a desired result).*" and ISA 240 paragraph 11 providing a definition of fraud.

511.2 legal advice did not indicate that any amount would be recovered;

511.3 the claim had not yet been drafted or quantified;

511.4 the claim had remained un-agreed for a number of years;

511.5 KPMG's requests for further supporting evidence were unsuccessful, in particular where evidence obtained did not include responses from the counterparties;

511.6 support for recoverability of the amount was limited to Carillion's "*power" or "leverage"* in its relationship with its customer and the success of previous claims with the customer;

511.7 Carillion's estimate of the "*probable*" amount that would be recovered, in relation to the amount claimed, was not explained; and/or

511.8 the amount recognised often ensured that the percentage margin recognised on the contract remained consistent and/or that no loss would need to be recognised on the contract.

512. These factors indicated that Carillion's estimates might be consistently over-optimistic or aggressive in relation to the inclusion in revenue of claims and variations, such that they were not neutral. However, other than the audit work described in this chapter, the audit files for all three audits contained no record of any further review of the estimates in relation to claims and variations for indicators of possible management bias representing a risk of material misstatement overall.

513. There were thus breaches by **the Respondents** in the **2014, 2015 and 2016 audits** of **ISA 240 paragraph 32(b)(i)** and **ISA 540 paragraph 21** in that the Respondents did not identify indicators of possible management bias and did not respond adequately to the risks arising from the potential for management to manage earnings through the artificial inflation of revenue from claims and variations.

I. Evidence obtained in relation to litigation and disputes

(1) Introduction

514. ISA 501 identified the need for specific consideration to be given by the auditor to the risks arising from litigation and claims. In particular:

514.1 ISA 501 paragraph 3 stated that the auditor's objective was to obtain:

"sufficient appropriate audit evidence regarding the [...] *Completeness of litigation and claims involving the entity".*

514.2 ISA 501 paragraph 9 stated as follows:

"The auditor shall design and perform audit procedures in order to identify litigation and claims involving the entity which may give rise to a risk of material misstatement, including:

a) Inquiry of management and, where applicable, others within the entity, including in-house legal counsel;

b) Reviewing minutes of meetings of those charged with governance and correspondence between the entity and its external legal counsel; and

c) Reviewing legal expense accounts."

514.3 ISA 501 paragraph 10 stated as follows:

"If the auditor assesses a risk of material misstatement regarding litigation or claims that have been identified…the auditor shall, in addition to the procedures required by other ISAs (UK and Ireland), seek direct communication with the entity's external legal counsel. The auditor shall do so through a letter of inquiry, prepared by management and sent by the auditor, requesting the entity's external legal counsel to communicate directly with the auditor..."

515. KPMG was thus required to design and perform audit procedures to identify litigation and claims involving Carillion which may give rise to a risk of material misstatement, including the procedures specified in ISA 501 paragraph 9. KPMG had identified the recognition of contract revenue (which included revenue from claims) as a significant risk in all three audits and thus it was also required to communicate directly with Carillion's external legal counsel. Overall KPMG was required to obtain sufficient appropriate audit evidence as to whether all potentially material litigation and claims had been identified, and that management's estimates of the financial implications were reasonable.

(2) KPMG's approach in the 2016 audit

516. Separately from the audit work on individual contracts, in the 2016 audit KPMG performed the following procedures:

516.1 making enquiries of Carillion's group legal team and reviewing Carillion's "*legal disputes register*" for September 2016;

516.2 making enquiries of Carillion's external lawyers;

516.3 reviewing a spreadsheet prepared by Carillion of legal expenses in 2015 and 2016; and

516.4 reviewing Carillion's board minutes for evidence of any new legal disputes since September 2016.

517. Each of these is considered below.

(3) Enquiries of Carillion's group legal team and the legal disputes register

518. KPMG's audit work involved examining the legal disputes register prepared by the group legal team, noting any claims recorded as having a value exceeding £3 million, and making further enquiries in relation to any such claims. KPMG prepared a spreadsheet listing:

518.1 "*disputes for which the extent was disclosed as higher than £3m*"; and

518.2 the external solicitors acting for Carillion in those disputes, as recorded in the legal disputes register as at 30 September 2016.

519. KPMG then used this list as a basis for contacting Carillion's external solicitors. KPMG recorded that it had reviewed the register for February 2017 to confirm that no additional claims had been identified, but the February 2017 register was not in fact received until after the audit report had been signed.

520. KPMG relied on both the completeness of the legal disputes register as at September 2016 and its initial and ongoing accuracy as to the amounts recorded for the disputes, in order to identify all claims that, individually or collectively, may have given rise to a risk of material misstatement. However, KPMG obtained insufficient audit evidence regarding the register as set out in more detail below.

521. KPMG had requested potentially relevant information by interviewing two members of Carillion's senior management, asking:

> *"What policies, procedures and controls has management established for identifying, evaluating, accounting for and disclosing litigation, claims and assessments?"*

against which KPMG recorded:

> *"The Group's legal team assesses each claim on its own merit and works with the business units to identify claims".*

522. Against further enquiries about (i) Carillion's involvement in litigation and claims, (ii) management's assessment of them, and (iii) which of them might be material to the financial statements, KPMG recorded the following comment:

> *"The Group is involved in a large number of litigations and claims which are documented in the Group's legal register. Management's assessment is included in the register. The vast majority relate to contracts where we consider the claim on a contract by contract basis as part of our component audit work. None of the residual claims are deemed significant (or likely) enough in the current year to warrant individual disclosure."*

523. The information recorded did not provide any assurance over the completeness of the register, or the accuracy of the amounts involved.

(4) Enquiries of Carillion's external lawyers

(a) *Introduction*

524. Paragraph A21 of ISA 501 provided:

> *"Direct communication with the entity's external legal counsel assists the auditor in obtaining sufficient appropriate audit evidence as to whether potentially material litigation and claims are known and management's estimates of the financial implications, including costs, are reasonable."*

525. KPMG prepared letters to be sent by Carillion to its external solicitors about disputes appearing in the legal disputes register. The bulk of these were sent on 11 January 2017.

526. Each letter included the following request:

> *"In connection with the preparation and audit of the financial statements for the year ended 31 December 2016, the directors of Carillion Plc have made estimates of the amounts of the ultimate liabilities (including costs) which might be incurred, and are regarded as material, in relation to the following matters on which you have been consulted. We should be obliged if you would confirm that in your opinion these estimates, which follow, are reasonable."*

527. Each letter then set out a list of the "*estimated liabilities*" for each matter on which that solicitor was recorded as being instructed, as well as the following request:

> *"If there are any further potential liabilities over c. £3m which we have not listed above please could you note these in your return"*

528. However, KPMG's letter referred only to "*liabilities*", and so on its face did not request responses relating to claims made by Carillion that had been included in revenue.

529. As set out below, the responses received indicated confusion as to how 'liabilities' had been interpreted, as well as raising questions about the reliability of the legal disputes register.

(b) *Solicitor Firm A*

530. The legal disputes register examined by KPMG as at September 2016 recorded more than 20 disputes being handled by Solicitor Firm A on Carillion's behalf.

531. Carillion sent an amended version of KPMG's enquiry letter to Solicitor Firm A on 28 February 2017, the day before KPMG was due to sign its audit opinion. The enquiry letter listed 14 disputes being handled by Solicitor Firm A for Carillion, totalling about £570 million (using the currency conversion rates from the time).

532. Solicitor Firm A responded to Carillion by email timed at 16:50 on 1 March 2017, the date of the 2016 audit report and after Carillion announced KPMG's unqualified audit report that morning. Carillion forwarded the email to KPMG at 08:13 on 2 March 2017.

533. The response noted that Solicitor Firm A was in fact no longer acting for Carillion on two of the disputes listed in the enquiry letter. It is unclear when Solicitor Firm A had ceased to act but this was evidence that the register was not up to date. The two disputes in relation to which Solicitor Firm A was no longer acting were listed as having an "*estimated liability*" of just over £200 million at the relevant exchange rates.[28] Consequently KPMG obtained no audit evidence from external lawyers in relation to those matters.

534. The substance of Solicitor Firm A's response was a single sentence:

> *"I have had discussions with the relevant lawyers responsible for the day to day running of those matters and based upon their own work with members of your team and those of your joint venture partners, it is thought that your estimates of the liabilities involved are reasonable."*

(c) *Solicitor Firm C*

535. Solicitor Firm C was sent an enquiry letter dated 11 January 2017 seeking comments on six disputes and responded by letter to Carillion dated 14 February 2017.

[28] One dispute involved an "*estimated liability*" of AED500m, but the September register explained that there was an AED100m claim and a "*circa AED400m counterclaim*". It was unclear why these were added together for the purpose of estimating Carillion's liability.

536. In respect of one dispute, referred to as *CESP*, Solicitor Firm C wrote, "*we have no reason to regard the estimate provided as unreasonable*". However, in respect of the other five disputes (all of which related to Carillion's Middle East and North Africa ("**MENA**") components), Solicitor Firm C wrote:

> *"we have not yet provided advice to the Company on the merits or value of the claims and, therefore, are not able to comment on the estimates provided by the directors".*

537. Solicitor Firm C added:

> *"As you will know, we are instructed by Carillion on a range of matters, various of which are not referred to in your letter. We do not seek to comment upon any specific matters upon which we are instructed which are not set out in your email irrespective of quantum […]".*

538. Consequently, the response provided no assurance over the five identified claims and also confirmed to KPMG that the request in the enquiry letter to note "*any further potential liabilities over c. £3m*" had been expressly rejected by the firm, and thus further enquiries should have been made.

(d) *Solicitor Firm B*

539. Solicitor Firm B was sent an enquiry letter dated 11 January 2017 about seven disputes and gave its final response by letter dated 23 February 2017.

540. The enquiry letter asked whether the "*estimates of the amounts of the ultimate liabilities (including costs) which might be incurred*" were "*reasonable*".

541. On 11 January 2017 Solicitor Firm B responded to KPMG seeking clarification on the meaning of "*ultimate liabilities*", and asking by way of example, "*what does the figure of £10m for* [a named project] *connote?*"[29]

542. On 10 February 2017, KPMG attempted to clarify this issue by stating as follows:

> *"The £10m figure in relation to* [a named project] *would be the ultimate net profit or loss that the company might expect to record on the project.*
>
> *It does not necessarily correspond to a provision as the likelihood of this amount actually being paid may not be high and therefore there could be a figure for £10m recorded as the extent but £0 recorded as a provision."*

[29] The "*£10m for* [a named project]" was the figure of £10m stated in the letter to be the "*Estimated liability including costs*" in relation to a "*Matter*" called "[a named project]".

543. However, Solicitor Firm B could not reasonably be expected to comment on "*the ultimate net profit or loss that the company might expect to record on the project*".

544. In its letter of 23 February 2017, Solicitor Firm B stated as follows:

> *"In your email of 10 February you clarified that these figures represent the ultimate net profit or loss the company might expect to record on the project. They represent the extent but not the likelihood of the outcome occurring. We have no knowledge of the company's underlying accounting. However based on our knowledge of the sums in dispute and the likely costs being incurred we confirm that the figures appear to us to be reasonable."*

545. There was no further correspondence and thus Solicitor Firm B's response remained unclear. Solicitor Firm B had been asked whether the "*figures*" were "reasonable" estimates of:

545.1 Carillion's "*ultimate liabilities (including costs)*" in relation to the disputes in question (as *per* the original letter of 11 January 2017); and

545.2 "*the ultimate net profit or loss that the company might expect to record on the project*" (as *per* KPMG's email of 10 February 2017 and Solicitor Firm B's letter of 23 February 2017)

but the response did not address either.

(e) *Solicitor Firm D*

546. Solicitor Firm D was sent an enquiry letter dated 11 January 2017 and responded by an email dated 13 January 2017. Solicitor Firm D had been listed in the legal disputes register as handling two disputes above KPMG's materiality threshold for enquiries of £3 million. However, Solicitor Firm D's email stated that it was no longer acting on the two disputes to which KPMG referred, and that both matters were now being handled by another firm, Solicitor Firm E. This was further evidence that the legal disputes register maintained by the group legal team was not up to date.

(f) *Solicitor Firm E*

547. On 10 February 2017, KPMG contacted Solicitor Firm E in relation to the two disputes which it had wrongly understood were being handled by Solicitor Firm D and sent its enquiry for confirmation of the "*estimated liabilities*".

548. By email of 24 February 2017, Solicitor Firm E responded as follows:

> *"The figures provided are roughly the amounts claimed by Carillion in each matter rather than prospective liabilities or costs. Any liabilities or costs will be significantly lower than the figures mentioned. If no recovery or a lower recovery was made then no doubt this would represent a loss to Carillion but I am not in a position to comment on how Carillion has accounted for these matters in that regard."*

549. The response from Solicitor Firm E did not offer any opinion on whether management's estimates were reasonable, which was the main purpose of the enquiry. KPMG did not identify this and made no further enquiry.

(5) Review of Carillion's legal expenses spreadsheet

550. KPMG was provided with a spreadsheet (an embedded document within working paper "*2.6.9.D LITIGATION AND CLAIMS*")[30] which showed that cumulatively Carillion had spent £63.1 million on legal fees in 2015 and £42.1 million in 2016.

551. There is no evidence that KPMG performed any audit procedures on the spreadsheet to verify its accuracy and completeness or to link it with other working papers produced by KPMG. Rather, KPMG's work on this spreadsheet appears only to have consisted of a high-level comparison between the two figures for 2015 and 2016. In this regard, KPMG stated as follows:[31]

> *"The decrease in legal expenses going through the P&L is in line with the movement in costs incurred to date from the prior year legal disputes register to the current year legal disputes register. Therefore, this is in line with KPMG's expectations."*

552. Neither the spreadsheet nor the procedure performed was capable of providing any evidence "*to identify litigation and claims involving the entity which may] give rise to a risk of material misstatement*" for the purpose of ISA 501 paragraph 9. In particular, the spreadsheet showed legal expenses by entity, and so provided no information about the underlying claims, and therefore no evidence about the completeness of the claims known to KPMG.

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[30] This workpaper appears to have been created after the date of the audit report (see Chapter 22Part E).

[31] This workpaper appears to have been created after the date of the audit report (see Chapter 22Part E).

(6) Review of Carillion's board minutes

553. The final component of KPMG's audit work on Carillion's legal disputes was to review Carillion's board minutes. KPMG stated that the purpose of this exercise was "*to test completeness of the litigation and disputes register*". KPMG recorded:

> *"no further claims have been identified in these minutes than are already included in the litigation and claims report".*

554. However, as might be expected, KPMG's recorded review of the board minutes referred to only a very small percentage of the claims noted by KPMG: they contained brief references to only 10 of the 93 contracts on KPMG's "*Legal Letters List 2016*" and contained (for example) no references at all to any contracts from Canada or MENA. The review was highly unlikely to identify previously undisclosed claims and provided no evidence that the legal disputes register was complete.

555. Further, the board minutes examined by KPMG only went up to October 2016 and therefore could not provide evidence regarding the completeness of the register after this date.

(7) Conclusion

556. KPMG planned a series of audit procedures intended to identify litigation and claims involving Carillion which might give rise to a risk of material misstatement, and to obtain evidence of whether management's estimates of the financial implications were reasonable. However:

    556.1 The procedures relied largely on the accuracy and completeness of the register maintained by Carillion, but KPMG had insufficient evidence supporting the reliability of the register, and some evidence suggesting that the register was unreliable.

    556.2 Enquiry letters sent to external lawyers were unclear and the responses provided little if any evidence of the reasonableness of Carillion's estimates.

    556.3 The other procedures intended to identify material disputes and/or provide evidence over the completeness of the register were not appropriate for that purpose and did not provide the requisite assurance.

557. There were thus breaches by **the Respondents** in the **2016 audit** of:

    557.1 **ISA 330 paragraphs 5 and 6**, in that the Respondents did not adequately design or perform audit procedures in response to the risks of misstatement relating to litigation and claims; and

557.2 **ISA 500 paragraphs 6, 7 and 9**, in that the Respondents failed to design and perform appropriate audit procedures to enable them to obtain sufficient appropriate audit evidence to address the risks of misstatement relating to litigation and claims and failed to properly consider whether this evidence was relevant and reliable.

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9. REVENUE ON CONSTRUCTION CONTRACTS: FORECAST COSTS

Carillion was required to forecast costs on its construction contracts to determine the amount of revenue and profit to be recognised in a period and also whether or not a contract should be treated as loss-making overall. These forecasts relied on judgements and estimates by Carillion's management, which were often highly subjective, and had a very significant impact on Carillion's overall reported profit. There was therefore a heightened risk from management bias.

Despite this, on some of Carillion's most significant contracts, 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 any detail or evidence, and inconsistent with both the contract's track record and other evidence relevant to costs that were likely to be incurred. KPMG failed to consider the judgements and estimates made by management with sufficient professional scepticism, and whether, in aggregate, they indicated a possible management bias that represented a risk of material misstatement overall.

A. Overview

558. As explained in Chapter 3, Carillion used the "*stage of completion*" approach to calculate revenue from construction contracts, as follows:

558.1 It would first prepare estimates or forecasts of:

558.1.1 Total revenue from the contract over its whole life.

This would be the total value of the contract stated in the contract itself, together with the value of any claims, variations and any other adjustments.

558.1.2 Total costs to be incurred over the whole life of the contract.

558.2 It would then calculate the stage of completion by comparing the costs already incurred on the contract with the forecast total costs to be incurred over the whole life of the contract.

558.3 Finally, it would multiply the estimate of total contract revenue by the stage of completion to arrive at a figure for revenue to be recognised to date.

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559. Accounting standards provided that this approach could be used unless:

559.1 it was not possible to estimate the outcome of the contract reliably, in which case revenue could only be recognised to the extent that it was recoverable and did not exceed costs; or

559.2 it was probable that the contract would make an overall loss, in which case the estimated loss for the whole contract needed to be recognised immediately.

560. The amount of revenue recognised in each period for the four construction contracts introduced in Chapter 3, and considered in this chapter, was determined by the contract's forecast overall profit or loss over the contract's life, which in turn was determined by:

560.1 the total forecast revenue over the life of that contract, including from claims and variations, which were considered in the previous chapter; and

560.2 the total forecast costs, which are considered in this chapter.

561. In respect of these forecasts, KPMG identified that "*Changes to these estimates could give rise to material variances in the amount of revenue and margin recognised*" and identified a significant risk of material misstatement in each of the 2014, 2015 and 2016 audits relating to the recognition of contract revenue, margin, and related receivables and liabilities.

562. These amounts were highly subjective and the size of the four contracts considered in this chapter meant that changes to their forecast costs had a significant impact on Carillion's reported profit. In particular, reductions in forecast costs could avoid the contract being forecast to make an overall loss, and so avoid the need to recognise large provisions. There was therefore a heightened risk of misstatement from management bias in relation to these forecast costs.

563. KPMG's planned audit work in relation to forecast costs on contracts selected for detailed review in the 2014, 2015 and 2016 audits was recorded as follows:

> *"Costs to complete and cost overruns compare to latest forecast costs and total costs to date (based on segment of work underway) and compare to prior period forecasts, make enquiries of management where significant changes have occurred, consider costs to be incurred over the remaining forecast life, corroborate to supporting evidence such as subcontractor quotes, cost estimates etc, and assess any potential cost overruns through discussion with management and consider whether any contingencies are appropriate"*

564. However, despite the critical role played by forecast costs, in its work on the significant contracts introduced in Chapter 3, KPMG:

564.1 failed to perform its planned audit procedures set out above or to perform audit procedures which adequately responded to the risks identified, to assess the reasonableness of the costs forecasts;

564.2 failed to obtain a breakdown of the total forecast costs, an appropriate understanding of how Carillion's management had made those forecasts, or the data upon which those forecasts were based, and, in many cases, failed to obtain any supporting evidence of the total forecast costs;

564.3 did not adequately assess whether the evidence obtained was sufficient and appropriate to support the reasonableness of the forecasts; and

564.4 failed to evaluate properly whether, in light of the audit evidence, the costs forecasts were reasonable.

565. Further, despite the level of judgement required for the forecasts, and the risk of management bias, KPMG failed to scrutinise and challenge management's costs estimates properly. In particular:

565.1 KPMG failed to identify that the rate at which costs were forecast to be incurred to complete the contracts was often markedly lower than the rate at which costs had been incurred on the contract to date;

565.2 KPMG failed to identify or respond adequately to evidence of costs that were likely to be incurred but which were not included in forecasts;

565.3 KPMG failed to respond adequately to forecasts of costs incorporating "*savings*", or reductions on previous forecasts, with no or insufficient evidence to support the change; and

565.4 KPMG did not consider whether inconsistencies in forecasting on contracts raised questions about the reliability of Carillion's cost estimates more generally.

566. KPMG also failed to evaluate whether the judgements and decisions made by management in preparing these estimates, even if individually reasonable, tended to take a consistently optimistic view of the costs likely to be incurred and so in aggregate indicated a possible bias that represented a risk of material misstatement overall.

B. Audit: The Aberdeen Contract in the 2016 audit

(1) The 2016 audit

567. KPMG recorded planned audit work in relation to forecast costs was:

> *"compare to latest forecast costs and total costs to date (based on segment of work underway) and compare to prior period forecasts, make enquiries of management where significant changes have occurred, consider costs to be incurred over the remaining forecast life, corroborate to supporting evidence such as subcontractor quotes, cost estimates etc, and assess any potential cost overruns through discussion with management and consider whether any contingencies are appropriate."*

568. The Aberdeen Contract commenced in December 2014. KPMG's working paper "*AP050.3.2.3 INFRASTRUCTURE CONTRACT YE16*" set out the following amounts:

	December 2015	October 2016	December 2016
Costs to date	£47.9m	£126.9m	£152.9m
Estimated costs to complete	£117.3m	£90.7m	£64.7m
"*End of life*" forecast costs	£165.2m	£217.6m	£217.6m
Margin	£12.4m	- £10.0m	- £10.0m
Total forecast revenue	£177.6m	£207.6m	£207.6m

569. In 2016 therefore, the contract was treated as loss-making and the entire expected loss of £10 million was recognised in the financial statements.

570. The working paper did not include or refer to any detailed breakdown or analysis of, or supporting evidence for, the total amounts of forecast costs.

571. The "*Costs to date*" figures showed that the costs being incurred on the contract had increased substantially during 2016, with an average monthly spend of approximately £8.75 million in 2016 as a whole, increasing to £13 million in November and December 2016. The expected completion date was now delayed until May 2018, 16 months from the year end. If costs continued to be incurred at the same rate as previously (i.e., between £8.75 million and £13 million *per* month), instead of £64.7 million, costs to complete the contract would fall somewhere in the range of £140 million [32] to £221 million.[33]

[32] 16 months (2016 year end to the beginning of May 2018) x £8.75 million.

[33] 17 months (2016 year end to the end of May 2018) x £13 million.

572. Position papers provided by Carillion stated that a cost reduction plan had been drawn up and implemented, and that the estimated costs to complete the contract were approximately £64.7 million as at December 2016. This equated to a monthly spend of approximately £3.9 million, less than half the average monthly costs incurred during 2016, and only 30% of the average monthly costs incurred in November and December 2016.

573. In its working paper "*AP050.3.2.3 INFRASTRUCTURE CONTRACT YE16*", KPMG calculated that the estimated cost savings represented an approximate reduction of 20% on previous forecasts of costs to complete, stating:

> *"Risk on this contract is obviously achieving ambitious cost savings of £22m on £84m of remaining costs (£65m + 19m) c20%[34]. Client is has provided cost saving schedule provide backing for the savings and the fact it has been agreed at JV level by other JV members gives a certain level of comfort. However, initiative was only implemented at site level recently, therefore assessment of the achievability of the plan cannot yet be made. KPMG will have to revisit and assess progress at the half year stage however for the year end position, this contract has been badged as high risk and will therefore be discussed with Carillion Group in relation to the need for provisions."*

574. In the working paper, KPMG referred to a schedule titled "*Aberdeen WPR Cost Control & Cost Reduction Plan*" (the "**Cost Saving Schedule**"). The Cost Saving Schedule was embedded in the working paper and listed the proposed cost savings measures. KPMG commented on the Cost Saving Schedule in the following terms:

> *"The strategy document prepared at JV level shows all the cost saving initiatives taking place by all board members in order to reduce the cost, and therefore losses made by each. This has not yet been quantified on a line by line basis, but through discussions with* [Carillion Construction commercial team]*, preliminary estimates are of £22m savings to Carillion."*

575. KPMG should have been sceptical about the achievability of these cost savings. As noted above, the rate at which costs had been incurred on the contract had increased considerably during 2016, but the estimate of costs to complete assumed that this rate would drop to less than half of the average seen throughout 2016. This was a striking reduction, and (at minimum) invited additional investigation. Further, only a small proportion of this reduction was accounted for by the Cost Saving Schedule.

[34] KPMG's calculation was based on £19 million out of Carillion's estimated costs savings of approximately £22 million being already accounted for in the reduced estimate of costs to complete of £65 million in the position paper as at December 2016, meaning that the costs to complete before any cost savings were £65 million + £19 million = £84 million.

576. KPMG requested (but did not receive) a breakdown of the expected impact on costs of the various items listed in the Cost Saving Schedule. It was necessary to obtain this, together with evidence as to how the estimates had been calculated, in order to determine whether the estimated costs to complete were reasonable. This was particularly important where a number of the items appeared to be intended to <u>control</u> costs (which had increased significantly from the original tender amount) but had no obvious potential to <u>reduce</u> costs.

577. Further, most of the items in the Cost Saving Schedule were actions due to be commenced some time before the year end. To determine the impact of these items, KPMG should have obtained evidence as to (i) whether they had been implemented by that time, and (ii) if implemented, their actual effect on costs in the period since implementation. The evidence in KPMG's possession indicated that monthly costs had in fact increased in the last two months of 2016.

578. Finally, KPMG referred to no evidence to confirm that the costs saving schedule had been "*agreed at JV level*" and did not explain why any such agreement would provide "*a certain level of comfort*" over the reasonableness of the estimated cost reduction that could be achieved.

579. KPMG identified that the cost savings were "*ambitious*" and represented a "*risk on this contract*". If the cost savings had not been incorporated into the forecast, then Carillion would have had to recognise additional losses of around £19 million. It was therefore important to determine whether the cost savings were reasonable. Despite this, KPMG did not carry out its planned procedures to compare the "*latest forecast costs and the total costs to date* to *prior period forecasts*" and to obtain corroborating evidence. KPMG approached the suggested costs savings with insufficient scepticism and without considering the risk of management bias.

580. There were thus breaches by **<u>the Respondents</u>** in the **<u>2016 audit</u>** of:

580.1 **<u>ISA 200 paragraph 15</u>**, in that the Respondents did not approach this area with an adequate degree of professional scepticism, and so did not critically assess the inadequate and conflicting evidence in relation to Carillion's forecasts;

580.2 **<u>ISA 330 paragraphs 5 and 6</u>**, in that the Respondents did not perform adequate audit procedures to respond to the assessed risks, in particular to obtain a clear understanding of the forecasts and whether they were reasonable and accurate;

580.3 **<u>ISA 500 paragraphs 6, 7, 9 and 11</u>**, in that the Respondents:

580.3.1 failed to design and perform appropriate audit procedures to enable them to obtain sufficient appropriate audit evidence to support the forecasts and their use in the calculation of revenue;

580.3.2 did not adequately assess whether this evidence was relevant and reliable; and

580.3.3 did not adequately consider or respond to indications that Carillion's forecasts were inconsistent with other evidence and/or unreasonable; and

580.4 **<u>ISA 540 paragraphs 12, 13, 15 and 18</u>**, in that the Respondents did not adequately assess whether Carillion's estimates of forecast costs, assumptions relevant to those estimates, and processes for deriving those estimates and assumptions, were appropriate and reasonable.

C. Audit: The Battersea Contract in the 2014, 2015 and 2016 audits

(1) Introduction

581. The Battersea Contract commenced in November 2013 and was originally scheduled to be completed on 24 March 2017.

582. KPMG's working papers and position papers provided to KPMG set out the following amounts:

	Tender	**December 2014**	**December 2015**	**December 2016**
Costs to date		£91.6m	£244.3m	£440.1m
Estimated costs to complete		<u>£353.2m</u>	<u>£232.2m</u>	<u>£76.2m</u>
Total "*End of life*" forecast costs	£438.3m or £430.5m	£444.8m	£476.5m	£516.4m
Margin		<u>£16.1m</u>	<u>£15.1m</u>	<u>£8.0m</u>
Total forecast revenue	£443.7m	£460.9m	£491.6m	£524.4m

583. KPMG's planned audit work in relation to forecast costs for contracts selected for detailed review in the 2014, 2015 and 2016 audits included:

> *"compare to latest forecast costs and total costs to date (based on segment of work underway) and compare to prior period forecasts, make enquiries of management where significant changes have occurred, consider costs to be incurred over the remaining forecast life, corroborate to supporting evidence such as subcontractor quotes, cost estimates etc, and assess any potential cost overruns through discussion with management and consider whether any contingencies are appropriate."*

584. In each of 2014, 2015 and 2016, KPMG's working papers did not include any detailed breakdown or analysis of, or supporting evidence for, the total amounts of forecast costs.

(2) The 2014 audit

585. During the 2014 audit, the contract had been in progress for just over a year.

586. Carillion's position paper as at December 2014 provided inconsistent information on the original estimate of costs at the contract tender stage. The position paper calculated "*tendered margin*" on costs of £430.5 million, but also recorded the tender value as being £443.7 million and the tendered margin as £5.4 million, implying tendered costs of £438.3 million.[35] There was therefore an unexplained difference of £7.8 million between the two amounts for forecast costs in the tender within the position paper.

587. The position paper recorded that by December 2014 the total forecast costs of the contract had increased to approximately £444.8 million, an increase of either £14.3 million or £6.5 million on the amounts above. There was also an increase in contract value of £17.2 million relating to variations.

[35] The working paper states that the tender value was £443.7 million, and that the tendered margin was £5.4 million, indicating that the original estimate of costs to complete was £443.7 million – £5.4 million = £438.3 million. However, the working paper indicates that the original estimate of costs to complete was £430.5 million.

588. It was therefore important for KPMG to understand what the original estimate of costs was at the inception of the contract and how Carillion had calculated the cost to complete figure at December 2014. In particular, KPMG should have established whether Carillion was expecting to receive value of £17.2 million for the additional work it would perform whilst incurring costs of only £6.5 million. This would indicate a profit of £10.7 million, a margin of 62% for this work, which was, without any explanation, unlikely. Even if the increase in costs was £14.3 million, the expected margin appeared to be 17%, far in excess of the margin otherwise expected to be achieved on the contract.

589. KPMG should therefore have approached the forecast costs to complete with an adequate degree of professional scepticism. However, it did not investigate these issues at all, recording in its final work paper:

> *"From Sept margin decreased by 1.4% after a detailed Cost to complete review was performed by Carillion. Contract at site level at present is break even with a route map inplace to achieve the EOL margin as at 31 dec, this is detailed below, but is predominantly made up of margin on variations and extention of time claim."*

(3) The 2015 audit

590. KPMG's working paper "*AP050.3.1.2 DEC 2015 BUILDINGS CONTRACT WP (1)*" set out the following amounts for forecast costs as at September 2015 and December 2015:

	September 2015	**December 2015**
Costs to date	£201.9m	£244.3m
Estimated costs to complete	£274.6m	£232.2m
Total "*End of life*" forecast costs	£476.5m	£476.5m

591. Carillion's position paper as at September 2015 identified a "*Cost Appraisal*" amount of £502.2 million to which a number of reductions, totalling £25.7 million, were applied to arrive at the estimated total forecast of £476.5 million. £24.2 million of the reductions related to cost savings, approximately 5% of the initial "*Cost Appraisal*" amount. Carillion's position paper as at December 2015 contained an identical calculation but with no indication of whether any of the costs reductions had been successfully implemented in the intervening period.

592. KPMG did not obtain any further details on these reductions or any further evidence regarding whether they could reasonably be achieved. In particular, KPMG obtained no evidence relating to:

592.1 the "*Cost Appraisal*" process, when, how and by whom it had been prepared, or any assumptions used or calculations performed;

592.2 similar information regarding the process by which the cost reductions were then identified, or an explanation why the output of this exercise was considered more reliable than the original appraisal; or

592.3 whether, between September and December, any cost reduction measures had been implemented or whether they had been successful in reducing costs.

593. KPMG in fact had further evidence relevant to the forecast costs. Carillion's legal disputes register as at February 2016, obtained by KPMG for the 2015 audit, stated in relation to the Battersea Contract:

> *"A Reset deal was concluded with the Employer at the end of last year. It provided for a further variation to the contract sum of £20m and a full E[xtension]o[f]T[ime] for the delay.*
>
> *As a result of the Reset deal, Carillion has suffered significant loss and expense. There are also major claims from the supply chain that will need to be concluded."*

594. KPMG did not consider whether the "*claims from the supply chain*" against Carillion, which were likely to result in significant additional costs, had been included in forecast costs on the contract.

595. The contract was forecast to make a profit of £15.1 million over its life. Based on this forecast, a failure to achieve the cost reductions of £24.2 million would have meant the contract would make an overall loss over its life of around £9.1 million. If the reductions were not reasonably achievable the accounting treatment for the contract would need to change, and the entirety of the forecast loss would have needed to be recognised in 2015.

(4) The 2016 audit

596. KPMG's working paper "*AP050.3.1 DEC 2016 BUILDINGS*" set out the following amounts for the prior year, December 2015, and for December 2016:

	December 2015	**December 2016**
Costs to date	£244.3m	£440.1m
Estimated costs to complete	£232.2m	£76.2m
Total "*End of life*" forecast costs	£476.5m	£516.4m
Margin	£15.1m	£8.0m
Total forecast revenue	£491.6m	£524.4m

597. In its working paper "*AP050.3.1 DEC 2016 BUILDINGS*", KPMG wrote the following:

> *"Since December 2015 Carillion have revised their position on claims and now expect to receive a total of £28,590,980 in claims value. This increase in expected claims has negated the requirement for £26m of costs saving to be found over the life of the contract. Although removal of the cost saving initiative reduces the risk in this respect, as in general large cost savings are not usually made on projects despite the relative size as well as being near completion, the risk has now moved to the form of client recoveries. This is more in line with Carillion's usual method of clawing back money but presents its own downside as it is also dependent on third parties and usually only a proportion of the total claim submission is actually recovered."*

598. In other words, the reductions in forecast costs considered in the 2015 audit were now no longer incorporated into the forecast costs, and the requirement for these reductions had been "*negated*" by a claim against Carillion's customer.

599. The working paper did not consider or explain:

599.1 why, if in 2015 the cost savings of £26 million had been considered achievable (see paragraph 591 above), in 2016 Carillion no longer expected to make them;

599.2 why, if "*cost savings are not usually made on projects*", they had been incorporated into forecasts in the previous year; or

599.3 whether this change in approach indicated that the forecasting process on the contract might not be reliable.

600. Further, the fact that the "*increase in expected claims*" had "*negated the requirement for £26m of costs saving*" should have alerted KPMG to the risk of management bias in these forecasts. There was no reason why the amount of cost savings planned during the 2015 audit should be similar to the amount of the claim arising from unanticipated events. As noted above, if the cost reductions relied on in 2015 could not be achieved (which would have been evident by December 2016) and there was no additional revenue from claims, then the contract would have been loss-making. The change in management's approach raised a question as to whether its forecasts of costs and revenue were tailored to ensure that the contract could still be treated as profitable, rather than being, in each case, objective estimates. KPMG did not identify this issue or perform any audit procedures in response to it.

601. In any event, the amounts in KPMG's working paper "*AP050.3.1 DEC 2016 BUILDINGS*" were inconsistent with the amounts in document "*CAV2 Report by Region/Pairings*" provided by Carillion to KPMG as follows:

	KPMG's working paper	**"*CAV2 Report*"**
Total "*End of life*" forecast costs[36]	£516.4m	£494.8m
Margin	£8.0m	£8.0m
Total forecast revenue	£524.4m	£502.8m

602. This was a significant difference and warranted further investigation, but KPMG did not detect this issue or perform any audit procedures in response to it.

(5) Conclusion

603. There was a risk that Carillion's management could manage reported earnings through manipulation of cost forecasts. KPMG identified that "*Changes to these estimates could give rise to material variances in the amount of revenue and margin recognised*".

[36] For the "CAV2 Report" this is the difference between the amounts given in the "CAV2 Report" for total forecast revenue and margin.

604. In each of the 2014, 2015 and 2016 audits, KPMG's working papers did not include any detailed breakdown or analysis of, or supporting evidence for, the total amounts of forecast costs. KPMG did not respond to inconsistencies in these estimates and indications that the forecasts did not include all costs to be incurred on the contract. These potential underestimates of forecast costs were substantial, such that the contract may in fact have been loss-making and may therefore have required a different accounting treatment, which would have meant that substantial losses should have been recognised.

605. Further, in the 2016 audit, KPMG did not respond to evidence that the forecasts on the Battersea contract might be subject to management bias.

606. There were thus breaches by **the Respondents** in the **2014, 2015 and 2016 audits** of:

606.1 **ISA 200 paragraph 15**, in that the Respondents did not approach this area with an adequate degree of professional scepticism, and so did not critically assess the inadequate evidence in relation to Carillion's forecasts and in particular in relation to the inclusion and then exclusion of material reductions in the costs forecasts;

606.2 **ISA 330 paragraphs 5 and 6**, in that the Respondents did not perform adequate audit procedures to respond to the assessed risks, in particular to obtain a clear understanding of the forecasts and whether they were reasonable and accurate;

606.3 **ISA 500 paragraphs 6, 7, 9 and 11**, in that the Respondents:

606.3.1 failed to design and perform appropriate audit procedures to enable them to obtain sufficient appropriate audit evidence to support the forecasts and their use in the calculation of revenue;

606.3.2 did not adequately assess whether this evidence was relevant and reliable; and

606.3.3 did not adequately consider or respond to indications that Carillion's forecasts were inconsistent with other evidence; and

606.4 **ISA 540 paragraphs 12, 13, 15 and 18**, in that the Respondents did not adequately assess whether Carillion's estimates of forecast costs, assumptions relevant to those estimates, and processes for deriving those estimates and assumptions, were appropriate and reasonable.

D. Audit: The Liverpool Contract in the 2014, 2015 and 2016 audits

(1) Introduction

607. The Liverpool Contract commenced on 3 February 2014 and was originally scheduled to be completed on 31 March 2017.

608. KPMG's working papers set out the following amounts:

	December 2014	December 2015	December 2016
Costs to date	£55.1m	£135.0m	£239.8m
Estimated costs to complete	£216.9m	£137.3m	£46.4m
Total "*End of life*" forecast costs	£272.0m	£272.3m	£286.1m
Margin	£15.8m	£15.8m	£13.2m
Total forecast revenue	£287.8m	£288.2m	£299.4m

609. KPMG recorded planned audit work in relation to forecast costs for contracts selected for detailed review in the 2014, 2015 and 2016 audits included:

> *"Costs to complete and cost overruns compare to latest forecast costs and total costs to date (based on segment of work underway) and compare to prior period forecasts, make enquiries of management where significant changes have occurred, consider costs to be incurred over the remaining forecast life, corroborate to supporting evidence such as subcontractor quotes, cost estimates etc, and assess any potential cost overruns through discussion with management and consider whether any contingencies are appropriate."*

610. In each of 2014, 2015 and 2016, KPMG's working papers did not include any detailed breakdown or analysis of, or supporting evidence for, the total amounts of forecast costs.

(2) The 2014 audit

611. At the 2014 year end, the contract had been in progress for just under a year.

612. Carillion's position paper as at December 2014 stated:

> *"Additional asbestos discovered in the ground across the Phase 1 Work Site.*
>
> *Additional sampling & detailed remediation strategy carried out to meet requirements of* [the Local Authority] *Planning Condition 21 – Contamination. Costs impact to date £5.83m. This has been balanced by a credit for the bid costs of £4.93m & the remainder from contingency.*

At the end of December 2014 the project was 16 weeks behind the internal programme. The delay to the programme is mainly due to the additional asbestos, but also due to co-ordination issues on site between the sub-structure contractor & the concrete frame contractor.

A new programme to completion has been agreed internally that achieves the Phase 1 Completion Date.

Acceleration measures are being instructed to the concrete frame contractor, including 24 hour working to the concrete cores & 12 hour working to the slabs.

Liability for the additional asbestos is being discussed with the [customer]*, the next meeting is taking place on 16 January 2015."*

613. This revealed a number of matters relevant to the costs incurred or likely to be incurred on the contract:

613.1 Asbestos had been discovered at the site and had resulted in both additional costs and delay (see Chapter 8).

613.2 The "*costs impact to date*" relating to the asbestos was £5.8 million.

613.3 The effect of these additional costs on the overall forecasts had been mitigated by "*a credit for the bid costs of £4.93m & the remainder from contingency*". The position paper indicated that the £4.9 million for "*Bid Cost Capitalisation*" was deducted from forecast costs but provided no further explanation for the deduction.

613.4 The contract was delayed by 16 weeks, due in part to "*co-ordination issues*" between contractors.

614. In its working paper "*AP050.3.0080 BUILDINGS FINAL CONTRACT REVIE*", KPMG recorded that Carillion was pursuing a claim relating to the discovery of asbestos of approximately £12 million, of which £3.9 million was included in forecast revenue.

615. KPMG's working paper did not record any consideration of, or evidence relating to:

615.1 whether the "*costs impact to date*" amount of £5.8 million, referred to in Carillion's position paper, was a reliable valuation of the additional costs that had been incurred in relation to asbestos;

615.2 whether further costs were expected to be incurred in relation to the asbestos, and the amount;

615.3 whether the "*co-ordination issues*" between contractors, referred to in Carillion's position paper, had resulted in additional costs and, if so, whether these had been reflected in the costs forecast;

615.4 whether the 16 weeks of delay had resulted or would result in additional costs to complete the contract and, if so, whether these additional costs had been reflected in the "*costs impact to date*" of £5.8 million or incorporated into the costs forecast. The costs of such a delay could be significant given:

615.4.1 the average weekly 'costs already incurred' on the contract was £1.2 million;[37] and

615.4.2 the average weekly rate for estimated costs to complete the contract was £1.9 million,[38]

suggesting that additional costs incurred for the 16-week delay might be between £19.2 million and £30.4 million, significantly more than £5.8 million;

615.5 whether the "*acceleration measures*", apparently intended to ensure that Carillion met the completion date, would result in additional costs, and whether these had been reflected in the costs forecast; or

615.6 what the credit of £4.9 million in respect of "*Bid Cost Capitalisation*" represented or whether the corresponding deduction from forecast costs was appropriate.

616. KPMG failed to investigate and/or failed to obtain sufficient evidence in relation to these matters, and thus failed to obtain sufficient appropriate audit evidence that the costs forecast for the contract was reasonable.

617. The forecast profit for the contract over its life was £15.8 million. The potential additional costs arising from the asbestos issues (already valued at £12 million for the purpose of the claim) and the period of delay raised a question as to whether the contract would make an overall loss over its life. This would have meant that a different accounting treatment for the contract would be required. KPMG did not identify this issue and performed no audit procedures in response to it.

[37] The average weekly rate at which costs had so far been incurred £55.1m divided by 47 weeks = £1.2m.

[38] The estimated costs to complete the contract £216.9m divided by 117 weeks = £1.9m.

(3) The 2015 audit

618. KPMG's working paper "*AP050.3.1.2 DEC 2015 BUILDINGS CONTRACT WP*" indicated that as at December 2015 the total forecast costs on the contract were £272.3 million, an increase of £0.3 million compared to the previous year, and comprised costs to date of approximately £135.0 million and costs to complete of approximately £137.3 million.

619. In this working paper KPMG referred to a summary provided by Carillion showing additional costs relating to asbestos of approximately £21.8 million comprising:

619.1 £9.4 million relating to "*Asbestos in the ground*";

619.2 £6.2 million relating to "*Energy Centre Asbestos*", which was an additional issue identified during 2015; and

619.3 £6.2 million relating to "*funding costs*" on the 17-week delay arising out of asbestos.

620. This was a substantial increase on the "*Costs impact to date*" amount of £5.8 million which had been considered in the previous year. Despite this, the total forecast costs only increased by £0.3 million. This ought to have prompted KPMG to consider whether the additional costs had been properly incorporated in the forecast costs, but KPMG did not consider this or obtain any evidence relating to it.

621. Further, the forecast profit for the contract over its life was £15.8 million. The additional costs arising from the asbestos issues again raised a question as to whether the contract would have been forecast to make an overall loss over its life. This would have meant that a different accounting treatment for the contract would be required. KPMG did not identify this issue and performed no audit procedures in response to it.

(4) The 2016 audit

622. Position papers provided by Carillion at various points during 2016 were included in KPMG's working paper "*AP050.3.1 DEC 2016 BUILDINGS*" and set out the following amounts:

	December 2015	May 2016	October 2016	December 2016
Costs to date	£135.0m	£193.0m	£230.0m	£239.8m
Estimated costs to complete	£137.3m	£108.3m	£72.0m	£46.4m
Total "*End of life*" forecast costs	£272.3m	£301.3m	£302.0m	£286.1m
Margin	£15.8m	£15.1m	£14.0m	£13.2m
Total forecast revenue	£288.2m	£316.4m	£316.1m	£299.4m

623. From December 2015, total forecast costs increased by approximately £29.0 million in May 2016, before reducing by £15.9 million to £286.1 million in December 2016. Changes in forecast revenue meant that the overall forecast margin on the contract varied by just £2.6 million over the year.

624. KPMG did not identify this and did not obtain any explanation for the large movements in total forecast costs over the year, and in particular for the reduction of £15.9 million in the forecast from October to December 2016.

625. Further, the Carillion position paper for December 2016 stated that the contract was 33 weeks behind schedule and recorded an increase in the period of the contract from 165 weeks to 193 weeks. This indicated that as at December 2016, the contract had 41 weeks to run during which it was expected to incur further costs of £46.4 million. This equated to weekly average costs of approximately £1.1 million. Up to that point, the weekly average costs had been approximately £1.6 million, increasing to £2.0 million during 2016.[39] Thus, Carillion was suggesting that a significant decrease in the weekly rate of costs was expected, but there was no explanation or analysis to support this.

[39] Costs incurred of £239.8m over 152 weeks from commencement to December 2016 and costs incurred of £104.8m over the 53 weeks in 2016 only.

626. The reduction in forecast costs at the year end, the relatively consistent level of the forecast margin and the unexplained reduction in the weekly rate of costs estimated to complete the contract indicated possible management bias and raised a question as to whether forecasts of costs and revenue were tailored to ensure that the contract could still be treated as profitable, rather than being, in each case, objective estimates. KPMG did not identify this issue or perform any audit procedures in response to it.

627. In December 2016 the forecast profit for the contract over its life was £13.2 million. If the forecast reduction in costs was not achieved the contract would have been forecast to make an overall loss over its life. This would have meant that a different accounting treatment for the contract would be required. KPMG again did not identify this issue and performed no audit procedures in response to it.

(5) Conclusion

628. There was a risk that Carillion's management could manage reported earnings through manipulation of cost forecasts. KPMG identified that "*Changes to these estimates could give rise to material variances in the amount of revenue and margin recognised*".

629. In each of the 2014, 2015 and 2016 audits, KPMG did not obtain evidence to enable it to conclude that Carillion's estimates of forecast costs were reasonable and did not respond to a number of indications that forecast costs might be unreliable and susceptible to management bias. The potential underestimates of forecast costs were so substantial that the contract may have been loss-making and may therefore have required a different accounting treatment which would have meant that substantial losses should have been recognised.

630. In the 2016 audit in particular, KPMG did not respond to large inconsistencies in total forecast costs and did not consider whether, along with other inconsistencies in forecasting on the Battersea Contract, these raised questions about the reliability of Carillion's cost estimates more generally.

631. There were thus breaches by **the Respondents** in the **2014, 2015 and 2016 audits** of:

631.1 **ISA 200 paragraph 15**, in that the Respondents did not approach this with an adequate degree of professional scepticism, and so did not critically assess the inadequate evidence in relation to Carillion's forecasts;

631.2 **ISA 330 paragraphs 5 and 6**, in that the Respondents did not perform adequate audit procedures to respond to the assessed risks, in particular to obtain a clear understanding of the forecasts and whether they were reasonable and accurate;

631.3 **ISA 500 paragraphs 6, 7, 9 and 11**, in that the Respondents:

631.3.1 failed to design and perform appropriate audit procedures to enable them to obtain sufficient appropriate audit evidence to support the forecasts and their use in the calculation of revenue;

631.3.2 did not adequately assess whether this evidence was relevant and reliable; and

631.3.3 did not adequately consider or respond to indications that Carillion's forecasts were inconsistent with other evidence; and

631.4 **ISA 540 paragraphs 12, 13, 15 and 18**, in that the Respondents did not adequately assess whether Carillion's estimates of forecast costs, assumptions relevant to those estimates, and processes for deriving those estimates and assumptions, were appropriate and reasonable.

E. Review of accounting estimates for management bias

632. Under ISA 240 paragraph 32(b)(i) and ISA 540 paragraph 21, KPMG was required to review the judgments and decisions made by management in making accounting estimates for indicators of possible bias. Such bias could be intentional, for example, arising from a motivation to report a desired result, and might therefore be fraudulent in nature.[40] KPMG was required to identify whether, even if accounting estimates were individually reasonable, they indicated a possible bias that might represent a risk of material misstatement overall. If so, KPMG was required to re-evaluate the estimates.

[40] ISA 540 guidance paragraph A9 states "Accounting estimates are imprecise, however, and can be influenced by management judgment. Such judgment may involve unintentional or intentional management bias (for example, as a result of motivation to achieve a desired result)." and ISA 240 paragraph 11 providing a definition of fraud.

633. In its 2016 working paper "*4.5.1 Management bias*", KPMG stated in relation to "*Contract Judgment (revenues, amounts owed under construction contracts, trade receivables)*":

> *"We have considered possible management bias in regards to judgment on key contracts and are comfortable that there is no intentional management bias in regards to contract judgment because we have: assessed the competence of those individuals making the key judgments; discussed the key contracts with a wide variety of individuals; considered the regular challenge of forecasts; and noted the significant involvement of executive management in the major contracts. As auditors we have had the opportunity to observe the approach adopted by management over a number of years and, as set out in the Executive Summary to our Audit Committee Document, we consider that management has maintained a balanced approach in assessing the level of provisions required, even though the potential range of outcomes is, as always, uncertain and the approach to those judgements is consistent with the prior year. We can conclude that our assessment of Services and Construction contracts are neutral."*

634. The equivalent working papers in the 2015 audit contained identical wording (other than the final sentence) and the equivalent working papers in the 2014 audit contained similar wording.

635. As set out above, evidence obtained by KPMG on the forecast costs in relation to the three significant contracts considered in this chapter indicated that in a number of instances amounts for forecast costs were used in the calculation of revenue where:

635.1 no detailed breakdown of the costs was provided;

635.2 KPMG's requests for further supporting evidence were unsuccessful;

635.3 forecasts assumed that the rate at which costs were incurred on the contract would decrease substantially, with no explanation;

635.4 forecasts changed substantially, or incorporated savings, compared to forecasts made in prior periods with no credible explanation;

635.5 forecasts did not appear to incorporate additional costs relating to additional revenue recognised on contracts; and/or

635.6 changes to the forecasts ensured that the percentage margin recognised on the contract remained consistent and/or that no loss would need to be recognised on the contract.

636. However, other than the audit work described in the sections above, the audit files for all three audits contain no record of any further review of the estimates in relation to forecast costs for indicators of possible management bias such that, even if individually reasonable, might in aggregate represent a risk of material misstatement overall.

637. There were thus breaches by **the Respondents** in the **2014, 2015 and 2016 audits** of **ISA 240 paragraph 32(b)(i)** and **ISA 540 paragraph 21** in that the Respondents did not identify indicators of possible management bias and did not respond adequately to the risks arising from the potential for management to manage earnings through the artificial inflation of revenue through underestimating forecast costs.

10. ASSETS ON SERVICE CONTRACTS

During 2014, 2015 and 2016, Carillion recognised significant amounts as assets on some of Carillion's most significant service contracts. Accounting standards provided that assets could only be recognised where they represented "*economic benefits*" that Carillion would recover in future periods. The accounting treatment adopted thus depended on judgements by Carillion's management on whether the amounts were likely to be recoverable. Recognising these assets either increased profit or reduced or eliminated losses. The judgements made relating to these amounts were often subjective and had a significant impact on Carillion's overall reported profit, and there was therefore a heightened risk from management bias.

However, for a number of these assets, KPMG did not verify that the accounting treatment adopted by Carillion was appropriate. KPMG 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.

The amounts in question were substantial. The amounts considered in this chapter over just three service contracts amounted to over £40 million in 2016 and the accounting treatment adopted enabled Carillion to avoid providing for significant losses on the contracts.

A. Overview

638. Assets represent "economic benefits" that will be recovered in future periods. The assets considered in this chapter did not relate to amounts due to Carillion for the core services provided under the contracts. They were described in KPMG's working papers as follows:

638.1 "*Mobilisation*"

These were described in the 2016 financial statements as "*non-recurring set up costs incurred to facilitate performance obligations*". The 2014 and 2015 financial statements did not refer to them, but working papers indicated an understanding consistent with this description.

In the instances considered in this chapter, working papers indicated that these amounts were initially included as prepayment assets and "*amortised*", that is, treated as expenses in the income statement gradually over the life of the contract, and so not entirely in the period in which the costs were actually incurred.

638.2 "*Transition*"

These were not referred to in any of the 2014, 2015 or 2016 financial statements but, according to descriptions in working papers, were similar in nature to "*mobilisation"* costs.

In the instances considered in this chapter, working papers indicated that these "*transition*" amounts were treated as expenses in the period, but that corresponding amounts were included as additional income and related assets, on the basis that the costs would be recovered from the customer. The additional income recognised therefore meant that the costs incurred did not impact on the profit recognised on the contract in the relevant period.

638.3 "*Claims*"

KPMG's working papers and correspondence described these as relating to costs incurred on contracts and treated as additional income recoverable from the customer via a claim, separately from the routine invoicing processes for services performed.

639. In recognising these assets, therefore, either the related costs were not treated as expenses in the period, or they were expensed but an identical amount was recorded as additional income. In either case the profit margin recognised on contracts, and the overall profit reported by Carillion was higher than if the costs had simply been expensed. The recognition of these assets therefore engaged the significant risk of material misstatement identified by KPMG relating to the "*recognition of contract revenue, margin, and related receivables and liabilities*".

640. This chapter sets out an analysis of the audit work on these assets in relation to three of Carillion's most significant service contracts, introduced in Chapter 3:

	2014	2015	2016
Nottingham Contract			
Mobilisation costs	£1.8m	£2.5m	£3.1m
Transition costs	£2.6m		
Claim		£14.9m	£24.0m
Services Contract A			
Mobilisation costs	£2.3m	£1.6m	£1.2m
Transition costs, later described as a claim		£2.4m	£2.0m
Claims			£5.8m
Portsmouth Contract			
Claim			£9.0m

641. These contracts were selected by KPMG for detailed testing in each of the 2014, 2015 and 2016 audits on the basis that (with others) they were the most risky or significant.

642. The contracts considered were reported by Carillion as being either loss-making, or close to loss-making in each of the years considered, and the inclusion of the amounts treated as assets increased their reported profitability significantly. If any of the contracts had been determined to be loss-making over its whole life, significant provisions would have had to be recognised. There was therefore a heightened risk of misstatement from management bias in relation to these amounts.

643. The identification of the appropriate accounting treatment for these amounts often required judgement on the part of management. In assessing these judgements KPMG was required act with objectivity, which included (i) giving "*fair and impartial consideration*" to all matters that were relevant, disregarding those that were not, and (ii) adopting a "*rigorous and robust approach*" and being prepared to disagree, where necessary, with the judgments made.[41]

[41] ES 1.

644. Despite this, and despite the significant risk relating to profit margins recognised on contracts identified by KPMG, the audit work in respect of the contracts and assets considered in this chapter was inadequate, in that KPMG:

644.1 did not plan and perform audit procedures, in response to the risks identified, to assess whether it was probable that Carillion would recover any future economic benefit from them;

644.2 did not adequately assess whether the evidence obtained was sufficient and appropriate to support the accounting treatment of the assets and related costs or whether the treatment complied with accounting standards;

644.3 did not respond to, or address sufficiently, a lack of clarity and consistency in information provided by management; and

644.4 did not respond to a number of instances where evidence indicated that the amount recoverable on "*Claim*" assets was lower than the amount recognised or where doubts were raised about whether the claim existed at all.

645. In relation to the Nottingham Contract in the 2016 audit, KPMG also provided an inadequate and misleading account in its reporting to the Audit Committee of the likely recovery of various amounts recorded as assets.

B. Accounting standards

646. Accounting standards provided that an asset represented "*future economic benefits*" and could be recognised when it was probable that those benefits would be recovered and when the cost or value of the asset could be measured reliably.[42]

647. Accounting standards further provided:[43]

647.1 a cost incurred in a period had to be recognised as an expense in the income statement for that period unless it produced an asset which met the above criteria for being recognised; and

647.2 income could be recognised in a period only when it related to an increase in an asset or a decrease in a liability that could be measured reliably.

[42] The Conceptual Framework for Financial Reporting (part of IFRS), at paragraph 4.44.

[43] The Conceptual Framework for Financial Reporting (part of IFRS), at paragraphs 4.52 and 4.47.

648. For example, where costs were incurred in performing services in the current period and those costs would be recovered from the customer in a later period, the amount could be treated as an asset in the current period and then treated as expenses in that later period, so long as it was probable that the amount would be received from the customer and could be measured reliably.

649. Specific accounting standards, such as IAS 2 on inventories, IAS 16 on property plant and equipment, and IAS 38 on intangible assets, provided further criteria for recognition of specific types of assets.

650. The contracts considered in this chapter were either loss-making or close to being so, such that the overall costs incurred on the contract would or might exceed the overall income. KPMG was therefore required to consider carefully whether costs incurred in performing services under these contracts in fact produced any probable future economic benefit.

C. The Nottingham Contract in the 2014, 2015 and 2016 audits

(1) The contract in 2014

651. Carillion's work on the Nottingham Contract started in July 2014, and so, by the 2014 year-end, the contract had been operating for around six months.

652. In its 2014 working paper "*TOD 3.00105 NOTTINGHAM WORKBOOK*", KPMG recorded the following:

652.1 assets at the year-end were £4.9 million, and included:

652.1.1 £1.8 million, described as "*mobilisation"* costs and included as a prepayment asset; and

652.1.2 £2.6 million, described as "*transition*" costs and treated as an expense but offset by a corresponding amount in revenue and an accrued income asset.

652.2 revenue was £16.9 million.

652.3 the contract had been reported as making a loss in 2014 of £1.1 million.

653. The audit work performed on the amounts for "*mobilisation*" and "*transition*" costs is considered below.

(2) Mobilisation costs in 2014

654. In its working paper "*TOD 3.00105 NOTTINGHAM WORKBOOK*", KPMG identified that £1.8 million was included in "*Prepayments*" on the basis that the costs in question were mobilisation costs. KPMG then wrote as follows:

> *"Per breakdown provided by the client, at year-end this included some £1,777k of mobilisation costs at year end, which are to be amortised over the life of the 5 year contract, in line with Carillion plc group policy. This amortisation is included within the calculation of the profit figures (at a margin of 2.8%) detailed in the "Overview – PL" tab. KPMG has not sampled within this balance, as the total balance of £1,777k is below 1/2 PM, and the largest individual entry is £360k is below 1/10 PM, thus giving a risk of material misstatement owing to the overstatement of these balances low."*

655. KPMG therefore performed no audit procedures in relation to this amount on the basis that the amount was below half materiality and was accounted for "*in line with Carillion plc group policy*". However, KPMG did not:

655.1 identify the accounting treatment required by "*Carillion plc group policy*" and whether this was compliant with relevant accounting standards; or

655.2 assess whether any asset at all should have been recognised, that is, whether the recovery of any future economic benefit obtained through the costs was probable and could be measured reliably, particularly in view of the contract being loss-making in the period.

(3) Transition costs in 2014

656. In its working paper "*TOD 3.00105 NOTTINGHAM WORKBOOK*", KPMG identified that a further £2.6 million was included in "*Prepayments*", and that this amount related to costs incurred in "*restructuring and delivering a transition from in-house to outsourced*". KPMG also recorded that Carillion had not invoiced its customer for these costs because of "*fixed revenue in the contract*" and because the customer worked on "*a fixed budget basis*".

657. KPMG requested further information in relation to these costs (which had been described by Carillion as "*BAU trading and mobilisation*"), and, in response, Carillion stated that the costs had arisen from delays in reaching its "*Target operating model*". KPMG Senior Manager C replied informing Carillion that the costs had to be treated as "*operating losses*", that is, as an expense in the income statement and not as a prepayment asset. KPMG Senior Manager C wrote to KPMG colleagues, including KPMG Senior Manager A, later the same day, stating:

> *"They bid for the contract on a non-allowable accounting treatment, doesn't mean it is okay now".*

658. The following day, however, KPMG Senior Manager C suggested to their colleagues:

> *"Maybe we can build an argument that they have performed more services in year one and therefore should recognise more revenue (and the corresponding WIP instead of a prepayment)?"*

659. Working paper "*TOD 3.00105 NOTTINGHAM WORKBOOK*" then set out the audit team's conclusion, in line with KPMG Senior Manager C's suggestion, that the costs should be recognised as an expense in the current period but that a corresponding amount should be recognised as revenue in the current period.

660. KPMG did not give proper consideration to whether the recovery of the amount from the customer was probable and could be measured reliably, particularly given that the contract apparently provided for "*fixed revenue*", the customer was working on "*a fixed budget basis*" and the contract was loss-making in the period.

(4) The contract in 2015

661. In its 2015 working paper "*AP060.3.0070 NOTTINGHAM*", KPMG recorded the following:

661.1 assets at the year-end were £21.2 million and included:

661.1.1 £11.5 million in work in progress described as "*Claim related WIP 2015*";

661.1.2 £3.4 million in work in progress described as "*Claim related WIP 2014*";

661.1.3 £2.3 million in work in progress described as "*Contract WIP*"; and

661.1.4 £2.5 million in prepayments described as "*Prepayments (Mobilisation)*".

661.2 revenue was £46.3 million, comprising:

661.2.1 £30.1 million described as "*Core Contract Income*";

661.2.2 £11.6 million described as "*Claim 2016*";

661.2.3 £3.4 million described as "*Claim 2015 Transition*"; and

661.2.4 £1.6 million described as "*Minor new works*";

It is assumed that the descriptions should have been "*Claim 2015*" and "*Claim* 2014 *Transition*", in line with the descriptions of the corresponding assets.

662. The working paper recorded an "*Underlying Margin*" loss on the contract of £11.6 million, which excluded the "*Claim 2016*" income of £11.6 million. The reported margin for 2015, which included this income, was £0. Recognition of the "*Claim*" income therefore had the effect of cancelling out the underlying loss.

663. The audit work performed on this "*Claim related WIP*" and also on "*Prepayments (Mobilisation)*" costs is considered below.

(5) Claim in 2015

664. Working paper headed "*Nottingham contract - half year file note*" set out the following details obtained in a meeting with Carillion on 9 July 2015:

> *"the contract has been traded[44] at zero margin. This has led to the following balances on the balance sheet …"*

665. The working paper "*Nottingham contract - half year file note"* then set out amounts totalling £11.6 million recorded as assets relating to claims, mobilisation costs and transition costs. The working paper then stated that £11.2 million was to be claimed from the customer, representing *"£7.2m per annum increased fee and £4m one-off claims*".

666. Thus, the working paper recorded that at half year the contract's performance was reported at a zero margin but that included substantial amounts of additional income being treated as recoverable from claims.

667. For the year end audit, in working paper *"AP060.3.0070 NOTTINGHAM*", KPMG stated that two "*claim*" amounts, now totalling £14.9 million and described as "*Claim related WIP*", were analysed in more detail in the working paper "*AP060.3.00330 NOTTINGHAM POSITION PAPER*".

[44] The term "*traded*" here is understood to refer to how the contract has been reported.

668. Working paper "*AP060.3.00330 NOTTINGHAM POSITION PAPER*" provided the following details:

> *"To date the contract is losing c£964k a month. Over the remaining contractual life of 54 months the total loss would equate to c£52m with £1.1m of the loss having already been traded in 2014. The reasons for the losses are:*
>
> *1) Carillion believe the* [customer] *misrepresented the size and condition of the estate.*
>
> *2) Carillion believe the* [customer] *misstated the required specification to the extent that it didn't meet building regulations, health and safety, care quality commission and NHS rules.*
>
> *3) Carillion have not been able to introduce planned efficiency savings due to resistance from the* [customer].
>
> *In October 2015, Carillion entered the first round of mediation with the* [customer] *in respect to the above claims. The* [customer has] *offered £17,075,000 to settle Carillion's claims spread over five years and Carillion have made a counter offer of £31,200,000 spread over five years.*
>
> *In January 2016, Carillion entered the second round of mediation with the* [customer] *in respect to the above claims. The* [customer] *revised their original offer of £17,075,000 to £16,101,000 over five years. In addition to this, the* [customer] *included cost avoidance opportunities with a value of £11,095,000 over the five years."*

669. Carillion was therefore claiming that the loss it was making on the contract was the result of misrepresentations by the customer and "*resistance*" preventing Carilion from introducing efficiency savings. Mediation had commenced relating to these claims and was still in progress in January 2016.

670. The same working paper also recorded amounts offered by the customer and provided an analysis of the amounts over the contract's life, which indicated that:

670.1 the current offer from customer totalled £27.2 million - £16.1 million additional payments and £11.1 million cost savings - was significantly lower than the loss of around £52 million the contract was expected to make over its life; and

670.2 only £7.5 million of this offer related to the period up to the 2015 year end with the remainder relating to future periods.[45] Only approximately 50% of the £14.9 million therefore related to periods up to December 2015.

[45] The contract had commenced in July 2014 so the total was made up of the amounts for year one plus half the amounts for year two.

671. This evidently called into question whether recognition of an asset in respect of the claim, and related income, of £14.9 million at December 2015 was appropriate. However, there is no evidence that KPMG identified or considered this issue.

(6) Mobilisation costs in 2015

672. In its 2015 working paper *"AP060.3.0070 NOTTINGHAM*", KPMG stated that it had received a "*high level breakdown*" of the £2.5 million in prepayments described as "*Prepayments (Mobilisation)*", that it had "*reviewed qualitatively to assess that there were no classifications of costs that were not capitalisable under IAS 38*".

673. The breakdown is shown in a document called "*Mobilisation Costs 2015 Summary*", which was obtained by the audit team and which provided an analysis of the £2.5 million as follows:

673.1 £1.8 million costs from 2014 (considered above);

673.2 plus £2.2 million additional costs for 2015;

673.3 less £1.5 million adjustments described as "*Amortisation*" and "*Revenue*".

674. The document provided an analysis of the additional costs incurred in 2015, placing them into categories such as "*Agency Labour*", "*IT hardware – Int Charges*", "*Legal & Prof incl Consultants*", and "*Recoveries*". The document contained no other details about the nature of the costs or how, when, or why they were incurred.

675. There is no further explanation of KPMG's review of the "*high level breakdown*" or any evidence that it sought to obtain any further information or queried how costs incurred in 2015, at least six months after the Nottingham Contract had commenced, could be classified as mobilisation costs[46]. The information provided in "*Mobilisation Costs 2015 Summary*" did not enable such an assessment to be made.

676. KPMG did not assess whether any future economic benefit obtained through the costs was probable and could be measured reliably, despite the contract being loss-making in the period.

[46] Understood to be "*non-recurring set up costs*".

(7) The contract in 2016

677. As set out above, in 2014 and 2015 KPMG recorded that the Nottingham Contract had "*underlying*" losses which were offset by additional income that Carillion was seeking to recover from claims against its customer. As a result, a reduced loss was recognised on the contract of £1.1 million in 2014 and no loss was recognised on the contract in 2015.

678. In its 2016 working paper "*AP060.3.0020 Nottingham 2016*", KPMG recorded the following:

678.1 assets at the year end were £28.1 million and included:

678.1.1 £24.0 million of work in progress; and

678.1.2 £3.1 million of "*Prepayments (Mobilisation)*".

678.2 revenue was £38.2 million, comprising:

678.2.1 £29.4 million described as "*Core Contract Income*";

678.2.2 £8.0 million described as "*Claim*"; and

678.2.3 £0.9 million described as "*Minor new works*".

678.3 the contract had made an "*Underlying*" loss in 2016 of £7.3 million.

678.4 the working paper identified £7.3 million of the "*Claim*" revenue as relating to claims recognised in 2016, which again had the effect of cancelling out the "*Underlying*" loss.

679. The contract's reported margin was £0. The working paper stated that the amount of the "*Underlying*" loss "*relates to the claim related revenue*".

680. Details in the working paper indicated that the £24.0 million of work in progress comprised the following:

"*Claim related WIP 2014*"	£3.4m
"*Claim related WIP 2015*"	£11.7m
"*Transition 2014/2015*"	£0.6m
"*Claim Jan-16 - Oct-16*" Also described as "*claim related WIP between January 2016 - October 2016 agrees to the underlying loss in the December contract pack*"	£6.0m
"*Contract WIP*" >60 days"	£0.9m
"WIP < *60 days*" This includes £1.3m described as "*Underlying loss in November and December*"	£1.4m
	£24.0m

681. The "*Transition*", "*Claim*", and "*Mobilisation*" assets recognised in 2014 and 2015 remained within work in progress, indicating that none of the amounts had been recovered from the customer.

682. As in 2015, there was no explanation of how the amounts described as "*claim*" related to the matters forming the basis of a claim against Carillion's customer or how they were quantified, other than the description "*underlying loss*". As in 2015, the inclusion of these amounts in reported revenue meant that no loss was reported on the Nottingham Contract.

683. On 6 February 2017, an exit agreement setting out the terms on which Carillion and its customer agreed to terminate the contract was finalised. Carillion relied on the terms of this agreement to demonstrate that £26.2 million of assets were recoverable. The £26.2 million comprised the £24.0 million work in progress and £3.1 million of "*Prepayments (Mobilisation)*", less £0.9 million of deferred income.

684. The audit work relating to the amounts included within work in progress described either as "*claims*" or "*underlying loss*" and the "mobilisation" costs, including the assessment of the recoverability of these assets through the exit agreement are considered below.

(8) Claims in 2016

685. In its working paper "*AP060.3.0020 NOTTINGHAM 2016*", KPMG recorded work in progress of £24.0 million, including £22.4 million described either as "*claims*" or "*underlying loss*" (see table above).

686. The working paper referred to working paper "*AP060.3.00480 NOTTINGHAM POSITION PAPER*" for further analysis of the work in progress. That working paper set out an analysis of whether the terms of the exit agreement were likely to result in recovery of £26.1 million "*in line with the balance sheet exposure*" relating to work in progress, mobilisation and deferred income.[47]

687. However, it provided no more details on how the amounts described as "*claims*" or "*underlying loss*" had been calculated or how they related to the matters forming the basis of a claim. As in previous years, KPMG did not adequately assess whether or how any future economic benefit was obtained through incurring the related costs.

(9) Mobilisation costs in 2016

688. In its working paper "*AP060.3.0020 NOTTINGHAM 2016*", KPMG recorded that, in 2016, Carillion treated a further £0.7 million of costs as prepayments, described as "*mobilisation*", in addition to costs of £2.5 million costs incurred in previous years. The total value of mobilisation costs as 31 December 2016 was £3.1 million.

689. In the working paper, KPMG stated that, as in 2015, it had received a "*high level breakdown*" of the £0.7 million of "*newly mobilised costs in 2016*" in prepayments, that it had "*reviewed qualitatively*". The high-level breakdown was not included in the working paper.

690. There is no further explanation or detail of the amounts or any evidence that KPMG sought to clarify the nature of the costs, or how, when, or why they were incurred, or how the further costs of £0.7 million incurred in 2016, at least eighteen months after the Nottingham Contract had commenced, could be classified as mobilisation costs.

691. Again, therefore, KPMG did not assess whether any future economic benefit was obtained through incurring these costs.

[47] The £0.1m difference between this and the £26.2m in the previous version of the position paper is not explained and is assumed to be a rounding difference.

692. Further, unlike its 2014 and 2015 financial statements, Carillion's 2016 financial statements disclosed an accounting policy for "*Mobilisation costs*", which stated the following:

> *"Mobilisation costs are non-recurring set up costs incurred to facilitate performance obligations under customer contracts. Mobilisation costs are expensed as incurred unless: a) they are capital in nature, in which case they are capitalised in accordance with the relevant accounting standard; or b) there is a contractual entitlement to recover such costs from the customer in the event of early termination, in which case the costs are capitalised and amortised to the income statement over the contract period. Costs are only capitalised under b) if the contract is expected to be profitable going forward and the costs capitalised relate to future services under the contract".*

693. KPMG did not verify that there was a contractual entitlement for Carillion to recover the "*mobilisation*" costs, and so failed to obtain evidence that the disclosed policy had been applied in this case.

(10) Claim and mobilisation costs in 2016 – recovery through the exit agreement

694. As set out above, working paper "*AP060.3.00480 NOTTINGHAM POSITION PAPER*" set out an analysis of whether the terms of the exit agreement were likely to result in recovery of £26.1 million "*in line with the balance sheet exposure*" relating to work in progress, mobilisation and deferred income. The explanations and evidence obtained by KPMG in relation to this during the 2016 audit are set out below.

695. On 17 January 2017, prior to the exit agreement being finalised, Carillion sent KPMG a position paper for the contract as at 31 December 2016. This referred to the proposed agreement, stating:

> *"… we intend under any outcome to recover the outstanding balance sheet items (see below) through negotiations"*

696. The position paper included a table under the heading "*Carillion Claims Position*" showing the expected recovery from a list of items in the agreement, totalling £26.2 million. The table included the following items:

696.1 £13.3 million described as "*Contract Payments*";

696.2 £2.2 million described as "*Guaranteed Income*"; and

696.3 £5.1 million described as "*Service Change savings*",

which together gave a "*Subtotal*" described as "*£20.6m settlement*". A number of additional items brought the total to £26.2 million.

697. On 31 January 2017, senior management of the Carillion Construction finance team circulated a new position paper internally, stating that they had "*updated*" the paper following internal discussion and "*in response to Peter's call today*"; and they suggested that Carillion "*should test this with Peter offline and then craft rework the position to suit*". The reference to "*Peter*" is understood to refer to Mr Meehan.

698. On 2 February 2017 at 16:26, senior management of the Carillion Construction finance team sent KPMG a document headed "*Value recovery against current balance sheet exposure*". Like the earlier position paper described above, this new document showed that Carillion expected to recover £26.1 million.[48] However, this new version of the position paper divided the £26.1 million into the following categories (which were substantially different from those in the earlier position paper):

698.1 £6.9 million from "*Cash Consideration*";

698.2 £11.1 million from "*Operating benefit*", comprising:

698.2.1 £8.4 million forecast income relating to the car park;

698.2.2 £2.2 million forecast income from "*Managed technology service*"; and

698.2.3 £0.5 million forecast income from "*Further Services complimentary Services*";

698.3 £5.7 million from "*Asset Value/Investment*"; and

698.4 £2.4 million from "*Claims and Recoveries*".

699. Recovery of £11.1 million thus depended on forecasts of "*Operating benefit*", that is, forecasts of income from certain services which Carillion would continue to provide after termination of the Nottingham Contract.

700. Also on 2 February 2017, Mr Meehan had a call with Carillion Director A and, following the call, emailed the audit team and the Carillion Group finance team stating:

> *"Spoke to* [Carillion director A]*.* [They don't] *want to book more on the* [Portsmouth] *car park as it was discussed at last board at 17 or whatever it is, and* [a Carillion director] *was very confused on this vs the 9 so all messy. Not helped as* [Carillion Director B] *had previously quoted different numbers.*

[48] The £0.1m difference between this and the £26.2m in the previous version of the position paper is not explained and is assumed to be a rounding difference.

> *So* [Carillion Director A] *says* [a Carillion director] *will just think they are peeing about if* [they] [*change*] *the number again.*
>
> *So,* [senior management of the Carillion Construction finance team and Carillion Services finance team] *to come up with better paper around 1&2 on their list to get to £25. Said be more ambitious on numbers to get there, and we will say aggressive but, with extra on car park , taken in round, it looks balanced in Services overall."*

701. KPMG Senior Manager A replied the same day:

> *"Ok - would have preferred write off and car park as we discussed but there we go. Can net off in our files at least?"*

702. The next day, on 3 February 2017, Mr Meehan replied to the Carillion Construction finance team's email of 2 February 2017 described above, as follows:

> *"*[Carillion Director A] *called last night and as you probably know* [they are] *not keen on changing the car park number as the board have already seen 2 or 3 versions and to change it again will get a lot of attention.*
>
> *I accept that sensitivity.*
>
> *I said to* [Carillion Director A] *I prefer a paper that justifies the 26m based on points 1&2, with more ambition / stretch in those numbers, rather than get into 3&4 which appear to be "very challengable" from an accounting perspective.*
>
> *E.g. Car park run very badly at present, poor layout, revenue leakage thro failed barriers etc. Portsmouth rev experience shows x per space pa, Notts should be higher given criticality of parking provision there- both utilisation and (lesser extent) rates, can be higher.....*
>
> *I suspect this paper will be more Mills & Boon than Shakespeare but hopefully it will get us there*
>
> *By all means leave bits of 3&4 in if you feel strongly that they are ok, but on principle things like capitalising previously w/off mobilisation doesn't do it for me.*
>
> *Hope that makes sense"*

703. The references to the "*car park*" and related "*numbers*" in both these emails appear to be to the £16.7 million revenue recognised in 2016 in relation to income from the Portsmouth car park, discussed in Chapter 16.

704. It appears from the emails above that:

704.1 a "*write off*" of some of the assets on the Nottingham Contract had been discussed and it had been suggested that this would be offset by more revenue being recognised in relation to income from the Portsmouth car park;

704.2 Carillion Director A had conveyed to Mr Meehan that they were reluctant to recognise more revenue from the Portsmouth car park, referring to issues with communicating changes in the amount to Carillion's non-executive directors;

704.3 as a result, a "*better paper*" on the Nottingham Contract would be produced to justify the recoverability of the assets and so avoid a "*write off*";

704.4 Mr Meehan stated that he would prefer the paper to:

704.4.1 focus on "*points 1&2*", (understood to be the first two elements in the senior management of Carillion Construction finance team's document "*Value recovery against current balance sheet exposure*") that is, "*cash consideration"* and "*operating benefit*"; and

704.4.2 incorporate "*more ambition / stretch*" in the forecasts of income from services provided by Carillion,

and suggested ways that an increase in forecast income might be justified; and

704.5 as set out at paragraphs 700 and 702, Mr Meehan had also communicated to Carillion that the paper "*hopefully [it] will get us there*", and that KPMG:

> *"…will say aggressive but, with extra on car park , taken in round, it looks balanced in Services overall"*

705. On 5 February 2017, senior management of the Carillion Construction finance team circulated a revised version of the position paper internally, stating:

> *"I have updated the* [Nottingham] *paper post the discussion with KPMG and receiving guidance that the balance sheet recovery areas must be limited cash consideration and operating income (not investment, Lot 3 or post agreement claims)".*

706. On 7, 9 and 15 February 2017, Carillion provided three further versions of the position paper to KPMG. These incorporated only minor amendments from the version the senior management of Carillion Construction finance team had circulated on 5 February 2017. Each of these versions recorded that Carillion expected to recover £26.1 million, divided as follows:

706.1 £8.9 million from "*Cash Consideration*";

706.2 £16.2 million from "*Operating benefit*", comprising:

706.2.1 £11.4 million for "*operating benefit from the car park*"; and

706.2.2 £4.8 million for "*Manged Technology*";

706.3 £0.5 million as the value of the car-parking asset; and

706.4 £0.5 million from "*Additional Services*".

707. From 2 February the position paper had changed as follows:

707.1 amounts for the third and fourth elements, which had previously been described as "*Asset Value/Investment*" and "*Claims and Recoveries*" totalling £8.1 million, and which had been described by Mr Meehan to Carillion as "*very challengable*", were now reduced to £1.0 million in total; and

707.2 amounts for the first and second elements, about which Mr Meehan had suggested there could be "*more ambition/stretch*", were increased as follows:

707.2.1 "*Cash Consideration*" had increased by £2.0 million; and

707.2.2 "*Operating benefit*" had increased by £5.6 million, comprising:

707.2.2.1 an increase of £3.0 million increase in "*operating benefit from the car park*"; and

707.2.2.2 an increased of £2.6 million in forecast income from the managed technology service.

708. The exit agreement had been finalised on 6 February 2017. Under that agreement, all services provided by Carillion were to terminate by 1 April 2017, save for car-parking, traffic-management and "*Lot 3*" services. The agreement also provided for potential future opportunities for Carillion to provide a managed technology service and for amendment to "*Lot 3*" services but did not give Carillion any right to any amount of income for either. The amounts given in the agreement can be summarised as follows:

Commercial settlement cash payment Referred to as a payment "*in settlement of all claims and counterclaims between the parties*". Of this, £3 million had been paid to Carillion in July 2016	£4.5m
Continuation of the car parking and traffic management services This conferred a net benefit to Carillion of circa £0.8 million per annum	£4.4m
Transfer of fixed assets	£0.6m

709. As noted above, in its working paper "*AP060.3.00480 NOTTINGHAM POSITION PAPER*", KPMG considered management's assessment that assets of £26.1 million, including claims in work in progress and "*mobilisation*" costs in prepayments, were recoverable through the terms of the exit agreement. In that working paper, KPMG stated that the agreement "*contained the following components*":

709.1 £8.9 million "*Cash consideration*";

709.2 £11.4 million "*Car park management*";

709.3 £4.8 million "*Managed technology service*";

709.4 £0.5 million attributed to "*the value of the car park's assets*"; and

709.5 £0.5 million in "*other consideration*".

710. These amounts matched those given in Carillion's position papers of 7, 9 and 15 February 2017 set out above.

711. However, KPMG failed to verify that these amounts were supported by the terms of the agreement or that there was evidence that provided assurance over the recovery of the £26.2 million assets recognised in relation to the Nottingham Contract. In particular:

711.1 The exit agreement provided for Carillion to continue to operate the car park for five years, with net income projected to total £4.4 million over the entire period. The £11.4 million for "*Car park management*" was arrived at by adding sums reflecting costs savings and tariff increases planned by Carillion management, but this was based on uncorroborated management assertions and failed to take into account various contractual limitations which were likely to affect the level of income that could be achieved.

711.2 £3.8 million of the "*Cash consideration*" was "*Payment for Work in Progress, under normal course*", and so would have related, at least in part, to trading in 2017, with the costs of delivering those services still to be incurred. Given that the contract was loss-making, these costs were likely to have exceeded the £3.8 million, resulting in a net cash outflow, not inflow.

711.3 £0.6 million of the "*Cash consideration*" related to the "*transfer of assets*", assumed to relate to separate assets held by Carillion which would transfer to its customer when the contract terminated, and so could not be viewed as the recovery of the work in progress or prepayments.

711.4 The £4.8 million from the "*Managed technology service*" was not supported by the terms of the exit agreement at all, which only provided that the parties might enter into an agreement in relation to these at some unspecified future point.

711.5 Neither the £0.5 million attributed to "*the value of the car park's assets*" nor the £0.5 million in "*other consideration*" was supported by any obligation in the agreement to purchase anything from Carillion.

712. Overall, therefore, recovery of £17.2 million of the £26.2 million was not supported by the terms of the exit agreement and relied in large part on Carillion forecasting a very significant increase in income from operating the car park.

713. The 2016 Year-End Audit Memorandum prepared for Carillion's Audit Committee included the following paragraph in relation to Nottingham:

> *"During 2016* [the customer] *announced their intention to end their contract with the Group. An agreement was reached with the* [customer] *in February 2017 to recover the £26.1 million balance sheet position, consisting of £8.9 million of cash, £16.2 million of future income from car parking and managed technology services and £1.0 million of other assets sales. The £16.2 million has been recognised against the balance sheet position as the* [customer] *agreed to give the Group these highly lucrative services to compensate for the historic claim. The amount recognised relies on assumptions made around this income. If these are not achieved an impairment may be needed to the balance in future periods."*

714. This was an inadequate and misleading account of the agreement between Carillion and the customer and of the evidence in KPMG's possession. The references to "*highly lucrative services*" and to "*£16.2 million of future income from car parking and managed technology services*" which "*the* [customer] *agreed to give*" did not reflect the contents of the agreement, which provided illustrative amounts of only £4.4 million for the car park and no obligations at all for the managed technology services. Whilst the narrative went on to state that the £16.2 million income relied on assumptions, it did not provide any indication of the details of or basis for those assumptions, and did not disclose that the amount was more than three times the estimated future income set out in the agreement. As a result, the paragraph did not adequately describe the risks regarding the recoverability of this amount.

(11) Conclusion

715. Carillion's work on the Nottingham Contract started in July 2014.

716. The performance of the Nottingham Contract, as recorded in KPMG's working papers, together with the assets considered above, is as follows:

	2014	**2015**	**2016**
"*Underlying*" loss	Not given	£11.6m	£7.3m
Claim recognised as additional revenue	None	£11.6m	£7.3m
Reported loss	£1.1m	£0.0m	£0.0m
Included as assets:			
- Mobilisation costs	£1.8m	£2.5m	£3.1m
- Transition costs	£2.6m		
- Claims		£14.9m	£24.0m

717. In 2014, 2015 and 2016, KPMG recorded that the Nottingham Contract was loss-making in the period, that is, that costs incurred on the contract exceeded its income. However, these excess costs were either accounted for as having produced various assets, and not as expenses relating to the period, or offset by additional income corresponding to assets described as "*Claims*".

718. For all of the amounts included as assets in the table above, KPMG relied on representations by management and/or failed to question whether recognition of the assets was appropriate. KPMG did not obtain a clear understanding of the related costs and did not assess whether it was probable that Carillion would recover any future economic benefit from these assets, particularly in view of the contract being loss-making.

719. In 2015, evidence obtained by KPMG indicated that the justification for a large part of the £14.9 million recognised in assets related to potential increases in income and cost savings in future periods, and that the amount which related to the period to December 2015 was approximately £7.5 million. KPMG therefore did not have evidence to support the recognition of the higher amount of £14.9 million.

720. In February 2017, the Nottingham Contract was terminated and Carillion relied on the exit agreement to show that £26.1 million of assets were recoverable. Earlier position papers provided to KPMG by Carillion management put forward a range of options as to how this might be achieved, although KPMG had preferred "*writing off*" some part of the amount. The final position paper reflected Mr Meehan's preference for the approach KPMG would find most acceptable as justifying the accounting treatment, which, as he said, "*hopefully … will get us there*".

721. The forecasts of income from future services were increased significantly. However, the terms of the exit agreement provided for only a small proportion of the total amount, and overall only supported recovery of £9 million of the £26.1 million asset.

722. Further, the description provided in KPMG's reporting to Carillion's Audit Committee gave an inadequate and misleading account of the agreement and the recoverability of the amounts.

723. There were thus breaches by **the Respondents** in the **2014, 2015 and 2016 audits** of:

723.1 **ISA 200 paragraph 15**, in that the Respondents did not approach this area with an adequate degree of professional scepticism, and so did not critically assess information obtained from management and the adequacy of the evidence supporting the recognition of the assets and treatment of the related costs;

723.2 **ISA 240 paragraphs 28 to 33**, in that the Respondents did not respond adequately to risks arising from the potential for management to try to manage reported earnings through treating costs incurred on the contract as giving rise to a future economic benefit and so not recognising them as expenses in the income statement;

723.3 **ISA 330 paragraphs 5 and 6**, in that the Respondents did not design or perform audit procedures to respond to the assessed risks, in particular to obtain a clear understanding of the assets and whether it was probable that any future economic benefit would be recovered; and

723.4 **ISA 500 paragraphs 6 and 7**, in that the Respondents failed to design and perform appropriate audit procedures to enable them to obtain sufficient appropriate audit evidence to support the accounting treatment of the assets and related costs, and failed to properly consider whether this evidence was relevant and reliable.

724. There were also further breaches by **the Respondents** in the **2015 and 2016 audits** of **ISA 500 paragraphs 9 and 11**, in that they did not adequately consider whether information produced by Carillion was reliable or respond to inconsistencies in evidence supporting the recoverability of the assets.

725. There were also further breaches by **the Respondents** in the **2016 audit** of **ISA 260 paragraph 16**, in that the description provided in KPMG's reporting to Carillion's Audit Committee gave an inadequate and misleading account of the agreement and the recoverability of the assets.

726. In addition:

726.1 As set out above, for the 2016 financial statements, Carillion's management estimated that Carillion would recover £16.2 million from operating the car park and from providing the managed technology service. Any part of this that was not considered to be recoverable would need to be treated as an expense in the period and so reduce profit by, potentially, a significant amount.

726.2 KPMG was aware therefore that the amount recognised as an asset required judgement on the part of Carillion's management and had a significant impact on reported profit.

726.3 ES 1 required KPMG to conduct its audit work with objectivity. It specifically required KPMG:

726.3.1 to give "*fair and impartial consideration to all matters that are relevant to the task in hand, disregarding those that are not*";

726.3.2 to express an "*impartial opinion … in the light of all the available audit evidence and the auditor's professional judgment*";

726.3.3 to adopt "*a rigorous and robust approach*"; and

726.3.4 to be "*prepared to disagree, where necessary, with the directors' judgments"*.

726.4 A "*write off*" of some of the amounts recognised, offset by increasing the amount recognised relating to the Portsmouth car park, was preferred by KPMG but Carillion's management was reluctant to pursue this course. Mr Meehan told management that he preferred "*more ambition / stretch*" in the forecasts of income from services provided by Carillion. He also signalled that KPMG would accept that treatment stating, *"…will say aggressive but, with extra on car park , taken in round, it looks balanced in Services overall*".

726.5 Subsequently, Carillion's management provided a position paper with estimates of £16.2 million for this income. This was higher than earlier versions of the position papers, reflecting Mr Meehan's advice, and included:

726.5.1 £7.0 million derived from costs savings and tariff increases relating to the car park, the potential for which was uncorroborated and failed to account for various contractual limitations; and

726.5.2 £4.8 million from managed technology services, despite the exit agreement containing no obligations concerning such services and only providing that the parties might enter into an agreement in relation to such services at some unspecified future point.

727. Mr Meehan thus failed to challenge management's judgments or have regard to the evidence in his possession, but rather actively assisted Carillion to achieve its desired result.

728. There was also therefore a further breach by **the Respondents** in the **2016 audit** of **ES 1 paragraphs 6, 10 and 12** in that they failed both to give fair and impartial consideration and to adopt a rigorous and robust approach in assessing whether management's estimates were appropriate and reasonable, and thereby failed to act with objectivity.

D. Services Contract A in the 2014, 2015 and 2016 audits

(1) The contract in 2014

729. Carillion's work on Services Contract A started in May 2014.

730. In its 2014 working paper "*TOD 2.00140* [Services Contract A] *Workbook*", KPMG recorded the following in relation to Services Contract A:

730.1 assets at the year end were £8.0 million and included:

730.1.1 £4.8 million of work in progress;

730.1.2 £0.9 million of debtors; and

730.1.3 £2.3 million of "*Prepayments*" described as "*mobilisation costs*".

730.2 revenue was £22.6 million comprising:

730.2.1 £16.3 million of core revenue; and

730.2.2 £6.3 million of variable revenue.

730.3 the contract had made a loss in 2014 of £0.3 million.

731. Audit work on the £2.3 million of mobilisation costs is considered below.

(2) Mobilisation costs in 2014

732. In its working paper "*TOD 2.00140* [Services Contract A] *WORKBOOK*", KPMG recorded during the interim audit that, as at September 2014, Carillion treated £2.2 million of costs incurred as a prepayment and provided the following explanation:

> *"The prepayments consist of the mobilisation costs incurred by Carillion prior to the commencement of* [Services Contract A] *and these costs are being amortised over the length of the contract (5 years). KPMG obtained the breakdown of the mobilisation costs and they consisted of staff costs, training costs and ICT costs.*
>
> *Per IAS 38.69-70, capitalisation of staff training costs is not permitted as the nature of the investment is in staff rather then fixed assets directly, such expenditure should always be treated as a revenue expense. Carillion included £244k of staff training costs which were capitalised and amortised. This figure is below AMPT[49] and therefore KPMG will not be raising an audit adjustment however this will be brought up in the clearance meeting for future reference.*
>
> *The remaining prepayments meet the definition of Carillion's contract costs which are capitalised and amortised over the length of the contract and given the amount is <PM then no further work is proposed"*

733. The working paper recorded that no further work was performed during the final stage of the audit to consider the amount at the year end, because the increase in the balance from the interim stage to the year end was less than one third of performance materiality.

734. But for the recognition of these amounts as prepayments, Carillion would have reported a loss on the contract, of approximately £2.6 million.

735. KPMG's audit procedures on these costs were inadequate. In particular:

735.1 KPMG obtained a breakdown of the costs but did not obtain or record an understanding of the basis on which they had been treated as prepayments.

735.2 KPMG referred to IAS 38 but did not explain why it was relevant in circumstances where the asset recognised was a prepayment rather than an intangible asset.

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[49] Audit misstatement posting threshold.

735.3 KPMG did not assess whether any asset at all should have been recognised, that is, whether any future economic benefit obtained through the costs was probable and could be measured reliably, particularly given that the contract was loss-making in the period.

(3) The contract in 2015

736. In its 2015 working paper "*AP060.3.0060* [Services Contract A]", KPMG recorded the following in relation to Services Contract A:

736.1 assets at the year end were £22.2 million, and included:

736.1.1 £2.9 million of debtors;

736.1.2 £17.5 million of work in progress, including £2.4 million costs relating to "*transition*"; and

736.1.3 £1.8 million of prepayments, including £1.6 million described as *"Mobilisation*".

736.2 revenue was £61.8 million, comprising:

736.2.1 £25.4 million of core revenue; and

736.2.2 £36.4 million of variable revenue.

736.3 the contract had made a profit in 2015 of £0.5 million.

737. The working paper recorded losses of between £0.02 million and £0.2 million in each month except May and June, which had profits of £1.4 million and £0.5 million respectively. KPMG noted that the profits recorded in May and June were the results of "*manual adjustments*" relating to "*transition costs*".

738. The £1.6 million amount in prepayments described as "*Mobilisation*" is assumed to be the remaining balance of the £2.3 million "*mobilisation costs*" recognised in 2014 considered above. The audit work in relation to the £2.4 million "*transition*" costs is considered below.

(4) Transition costs / claim in 2015

739. As set out above, KPMG recorded that the contract made a loss in each month except May and June, which had profits resulting from "*manual adjustments*" relating to "*transition costs*".

740. KPMG provided further details of these "*transition costs*" in working paper "*AP060.3.00350* [Services Contract A] *TRANSITION COSTS*" which described the £2.4 million in the following terms:

> *"the asset capitalised in* [Services Contract A] *forms part of a claim which is in the process of being drawn up. The claim relates to costs incurred to 31st December 2015 in excess of the contract value, such as TUPE, operational overpayments and other costs during the transition which were arguably recoverable from the client."*

741. The costs in question had therefore been recognised as an expense in the current period and a corresponding amount recognised as revenue and an asset deriving from a claim to be made to recover these costs.

742. The working paper referred to a further paper prepared by management said to explain the asset. KPMG received four versions of this paper during the audit:

742.1 On 8 December 2015, KPMG was provided with an initial version of the paper, which proposed that £2.4 million be included as an accrued revenue asset. The amount was derived from costs of £3.0 million, incurred "*as a result of transitioning transferred activities and staff into a sustainable model*", which figure was then reduced to £2.4 million by the application of an unexplained "*Senstitivity factor*".

742.2 KPMG challenged the treatment of these costs as accrued revenue, referring to "*strict criteria*" for this treatment, including that the costs needed to be recoverable.

742.3 On 19 and 27 January 2016, Carillion provided second and third versions of the paper to KPMG, both of which continued to propose that £2.4 million be treated as accrued revenue. These newer versions showed a different way of deriving of the amount, which was based on higher costs of £4.0 million, reduced by a higher "*sensitivity factor*" to arrive at the same final amount of £2.4 million. Both these versions stated "*we are not regarding this treatment as claim recovery*".

742.4 On 27 January 2016, KPMG Senior Manager C emailed the senior management of the Carillion Construction finance team, and, referring to the latest version of the paper, stated:

> "[…] *it still doesn't cover off any of the points in my email below. (In fact it has been made worse by including training costs – the cardinal sin as we discussed last year!). As it stands this paper does not support the recognition and therefore we would have an audit adjustment to derecognise the profit."*

742.5 On 29 January 2016, KPMG Senior Manager A emailed a senior manager of the Carillion Services finance team referring to an earlier telephone conversation and requesting a further version of the paper, stating:

> *"It was helpful that you were able to articulate that the asset capitalised in* [Services Contract A] *in fact formed part of a claim which was in the process of being drawn up."*

742.6 KPMG Senior Manager A's email then requested that the paper was updated to reflect both the discussion between KPMG Senior Manager A and the senior manager of the Carillion Services finance team, and a number of concerns on the paper previously raised by KPMG Senior Manager C with the senior manager Carillion Services finance team, including that the amount should not include "*future efficiency savings*" and "*internal/non-incremental*" costs, and that there was a lack of clarity over how the amount would be claimed from Carillion's customer.

742.7 On 2 February 2016, a fourth version of the paper was then provided to KPMG. That fourth version stated that the £2.4 million represented a claim against the customer to Services Contract A for "*TUPE, operational overpayments and transition costs*" and added, "*we are currently in the process of drawing up that claim*". There was, however, no evidence of the basis on which Carillion proposed to recover the relevant costs and, whilst the paper set out a summary of expenditure incurred prior to 31 December 2015, analysed into broad categories such as "*Poor Audit results impacting Valuations*", "*AP Training– one off costs*" and "*Reactive Supply chain strategy*", it contained no further explanation of these categories nor any further detail.

743. The final version of the paper prepared by management was embedded in working paper "*AP060.3.00350* [Services Contract A] *TRANSITION COSTS*". In the working paper, KPMG stated:

> *"Per managements paper the impact of year 1 profitability and thus the pending claim is £2,420,000. Given that the claim with* [the customer] *has not been filed as at 31st December 2015 or the date of this paper (10/02/2016) then there is no correspondence for KPMG to obtain to assess whether the claim is likely to be successful."*

744. There was thus no consideration of, and no supporting evidence for, whether the claim was likely to result in the amounts recognised being recovered. There was no explanation for why the customer would be liable to compensate Carillion for the costs it had incurred and no consideration was given to the impact of the "*GMP*" clause in Carillion's contract with the customer, which set a maximum level for payments due to Carillion "*irrespective of the actual costs incurred by the supplier*", and which provided that the maximum level would reduce each year.

745. KPMG Senior Manager C and KPMG Senior Manager A evidently had reservations about whether there was a proper basis for this claim:

745.1 In an email of 2 February 2016 to KPMG Senior Manager A, KPMG Senior Manager C wrote:

> *"Very very tenuous is my view – what do they do next year when they don't get a claim?* […] *But on the plus side it is now a judgement and not material so we can't say wrong. We can't say right in ACD* [KPMG's report to the Audit Committee] *though? What did you agree with* [the senior manager in the Carillion Services finance team]*?"*

745.2 KPMG Senior Manager A replied:

> *"I agreed not a lot with* [the senior manager in the Carillion Services finance team] *–* [they] *basically* [don't] *get it. I wrote* [them] *that email which basically gave* [them] *what to write. Hopeless."*

745.3 KPMG Senior Manager C then replied:

> *"Okay - I don't understand the claim argument full stop, it falls down as soon as they don't make a claim, but could get us there this year end I guess".*

745.4 KPMG Senior Manager A then replied:

> *"Better to discuss offline".*

746. The following day, on 3 February 2016, KPMG Senior Manager A sent the Carillion Construction finance team and Carillion Director A an email, copied to Mr Meehan, in which they wrote the following:

> "[It] *gets us over the line for FY15 on the basis that we assume there is some basis of claim – otherwise this is an audit adjustment.*
>
> *If, in due course, no claim is made then we will still have a problem in FY16 unless some substantial progress is made or some of the asset is written off.*
>
> *One to watch please."*

747. In summary:

747.1 But for the treatment of £2.4 million as an asset relating to a claim, Carillion would have reported a loss on Services Contract A in 2015 of approximately £1.9 million. The accounting treatment adopted was therefore significant.

747.2 Carillion's initial justification for treating the £2.4 million as an asset did not envisage a claim being made. The treatment ultimately adopted was contradicted by Carillion's statement "*we are not regarding this treatment as claim recovery*".

747.3 KPMG Senior Manager C and KPMG Senior Manager A had each concluded that the basis on which Carillion had originally proposed accounting for the costs was inappropriate and suspected that the accounting treatment ultimately applied was also inappropriate. In particular:

747.3.1 Correspondence between KPMG Senior Manager A and KPMG Senior Manager C demonstrated their reservations, in particular KPMG Senior Manager C's comment that the treatment was "*Very very tenuous is my view – what do they do next year when they don't get a claim? But on the plus side it is now a judgment and no material so we can't say wrong.*"

747.3.2 KPMG Senior Manager A described assisting Carillion on how to present the new accounting treatment, stating "[The senior manager in Carillion Services finance team] *basically doesn't get it. I wrote* [them] *that email which basically gave* [them] *what to write. Hopeless.*"

748. They nevertheless accepted management's treatment of the claim to "*get us there this year end*", despite their doubts and the lack of any evidence to support the probable recovery of the amount.

(5) The contract in 2016

749. In its 2016 working paper "*AP060.3.0060* [Services Contract A] *2016*", KPMG recorded the following in relation to Services Contract A:

749.1 assets at the year end were £23.6 million, comprising:

749.1.1 £21.1 million of work in progress, including £5.8 million relating to *"other claims"* and £2.0 million relating to *"transitional claims*";

749.1.2 £0.5 million of debtors; and

749.1.3 £2.0 million of prepayments, including £1.2 million described as "*mobilisation*" which is assumed to be the remaining balance of the £2.3 million "*mobilisation costs*" in 2014 considered above.

749.2 revenue was £51.9 million, comprising:

749.2.1 £24.4 million of core revenue; and

749.2.2 £27.5 million of variable revenue.

749.3 Carillion had recorded that the contract had made a loss in 2016 of £6.1 million.

750. The audit work on the "*other claims*" of £5.8 million and the "*transitional claims*" of £2.0 million is considered below.

(6) Claim in 2016

751. In its working paper "*AP060.3.0060* [Services Contract A] *2016*", KPMG indicated that the £21.1 million of work in progress included £5.8 million related to "*other claims*" and referred to working paper "*AP060.3.00460* [Services Contract A] *POSITION PAPER-KPMG*" for further consideration of these amounts.

752. Working paper "*AP060.3.00460* [Services Contract A] *POSITION PAPER-KPMG*" referred to a "*position paper*" prepared by management which was included in the audit file as working paper "*AP060.3.00430* [Services Contract A] *Position Paper*" and which included the following analysis of the £21.1 million of work in progress:

"WIP, Live and Collectable	*13.3*
Transition costs claims	*2.0*
Claims SW Paper	*2.6*
Claims Start Year	*1.2*
Claims In Year	*1.2*
Projects Prelims WIP	*0.8"*

753. There is no further explanation for these items but it is assumed that the amount of £5.8 million referred to in KPMG's working paper as "*other claims*" comprised the "*Claims SW Paper*", "*Claims Start Year*", "*Claims in Year*", and "*Projects Prelims WIP*".

754. In its working paper "*AP060.3.00460* [Services Contract A] *POSITION PAPER-KPMG*", KPMG described the "*Claims*" as:

> *"These costs which are being claimed relate to historical costs incurred prior to 31st December 2015 and is in excess of the contract value that should have been recovered from* [the customer] *in respect of the TUPE, operational overpayments, transition costs and stringent KPI demands by* [the customer]*.*
>
> […]
>
> *Carillion aims to recover these costs from* [the customer] *by holding senior discussions with the* [director of the customer] *and Banking Relationship Manager as noted above. Next meeting is on 27th Jan 2017. KPMG have asked* [the Carillion Services finance team] *on the outcome of this meeting and have included their response below."*

755. The working paper included an email from the Carillion Services finance team to the audit team dated 20 February 2017. This email set out dates of and attendees at Carillion's meetings with the customer and included a brief description of the purpose of the meetings. KPMG then stated in the working paper:

> *"KPMG will continue to discuss the position of the WIP Balance as discussions between* [the customer] *and Carillion take place in Feb 2017 in order to assess whether the WIP balance will be recoverable."*

756. Whilst working paper "*AP060.3.00460* [Services Contract A] *POSITION PAPER-KPMG*" purported to consider "*Whether the WIP on the Balance Sheet is recoverable*", it did not include:

756.1 any evidence that any claims had been submitted; or

756.2 any basis for or assessment of the recoverability of these amounts, or any evidence supporting the validity of the claim.

757. The fact that there had been meetings between Carillion and the customer did not provide any evidence supporting the accounting treatment of the amounts. The working paper did not refer to any evidence as to whether further discussions in fact took place in February between Carillion and the customer or if discussions were held, what their outcome was.

(7) Transition costs in 2016

758. In its working paper "*AP060.3.0060* [Services Contract A] *2016*", KPMG indicated that the £21.1 million of work in progress included £2.0 million related to "*transitional claims*". As set out above, KPMG referred to a "*position paper*" prepared by management which set out further details of this amount and which was included in the audit file as working paper "*AP060.3.00430* [Services Contract A] *Position Paper*".

759. As in the previous year's audit, KPMG received a number of different versions of this paper from Carillion:

759.1 On 17 January 2017, a first version of the paper was emailed to KPMG. This referred to £2.0 million for "*Transition Accounting WIP*" and provided a list of related costs totalling £4.0 million, reduced to a £3.4 million "*Transition value*" by the application of an unexplained "*Sensitivity factor*". The paper did not explain:

759.1.1 the relationship between the £2.0 million included in work in progress and the £4.0 million costs listed;

759.1.2 the reason for the application of the "*Sensitivity factor*" and how the factor had been derived; or

759.1.3 on what basis the amounts could be recovered.

759.2 On 17 January 2017, following receipt of this paper, KPMG Senior Manager C reminded Carillion that in 2015 it had been agreed that:

"this treatment for transition costs was inappropriate"

759.3 Later that day, in response, Carillion provided second and third versions of its position paper in which the description of the £2.0 million included in work in progress was changed to "*Transition costs claims*".

760. In its working paper "*AP060.3.00460* [Services Contract A] *POSITION PAPER-KPMG*", KPMG referred to the "*claim for transitions*" and stated, "*There is risk regarding the recoverability of £2m*".

761. As in the 2015 audit, Carillion's initial justification for including £2.0 million as an asset did not envisage a claim being made.

762. Again, despite recording concerns over the recoverability of the amount, KPMG did not obtain any evidence explaining why the customer was liable to compensate Carillion for the losses suffered, or how Carillion had concluded that it was likely to succeed.

763. As noted at above, during the 2015 audit, KPMG Senior Manager A had stated in an email, copied to Mr Meehan:

> *"If, in due course, no claim is made then we still have a problem in FY16 unless some substantial progress is made or some of the asset is written off. One to watch please"*

This had echoed KPMG Senior Manager C's comment to KPMG Senior Manager A:

> *"I don't understand the claim argument full stop, it falls down as soon as they don't make a claim".*

764. Nearly a year later, there was still no evidence of any progress having been made in recovering these amounts, or even of a formal claim having been prepared.

765. In January 2017, KPMG Senior Manager C sent an email to another member of KPMG's audit team, copying Mr Meehan with a summary of seven issues on service contracts, for consideration before a meeting the next day. This included reference to the £2 million transition costs, acknowledging that Carillion's accounting treatment was not appropriate, stating:

> *"Transition (£2m) explained as claim now. To tell* [senior management of the Carillion Services finance team] *offline this is not acceptable. Loss making?"*

766. In February 2017, KPMG Senior Manager C sent an email to other members of the audit team (not including Mr Meehan), referring to a review of audit working papers relating to Services Contract A, and stating:

> *"it is not a good example of how we audit judgements in contracts. And we know £2m is wrong!"*

767. Mr Meehan had been copied on KPMG Senior Manager A's "*One to watch*" email in the 2015 audit; and in the 2016 audit, he was copied in on, and responded to, KPMG Senior Manager C's email to another member of the audit team ("*To tell* [senior management of the Carillion Services finance team] *offline this is not acceptable*"). Mr Meehan was therefore aware of the issue in 2016. Despite this, KPMG accepted management's treatment of this amount as an asset relating to a claim.

(8) Conclusion

768. Carillion's work on Services Contract A started in May 2014.

769. The reported performance of Services Contract A together with the assets considered above, is as follows:

	2014	2015	2016
Reported profit / loss	£0.3m loss	£0.5m profit	£6.1m loss
Included as assets:			
- Mobilisation costs	£2.3m	£1.6m	£1.2m
- Claim			£5.8m
- Transition costs / claim		£2.4m	£2.0m

770. In 2015, Carillion reported a small profit from the contract. If the amounts considered above had not been treated as recoverable, and so recognised as assets, the contract would have reported a loss.

771. Despite the significant risk identified relating to contracts, for all of the amounts included as assets in the table above, KPMG did not obtain a clear understanding of the related costs and did not obtain sufficient evidence to conclude that it was probable that Carillion would recover any future economic benefit.

772. In both 2015 and 2016 Carillion's initial justification for recognising assets in relation to "*transition*" did not envisage a claim being made until KPMG challenged whether the recognition of these assets was appropriate. This raised questions over the reliability of information provided to KPMG and whether there was a proper basis for the claim. In both years KPMG identified that the initial treatment was inappropriate and queried whether a claim would be brought at all, but obtained no audit evidence other than management representations.

773. There were thus breaches by **the Respondents** in the **2014, 2015 and 2016 audits** of:

773.1 **ISA 200 paragraph 15**, in that the Respondents did not approach this area with an adequate degree of professional scepticism, and so did not critically assess information obtained from management and the adequacy of the evidence supporting the recognition of the assets and treatment of the related costs;

773.2 **ISA 240 paragraphs 28 to 33**, in that the Respondents did not respond adequately to risks arising from the potential for management to try to manage earnings through treating costs incurred on the contract as giving rise to a future economic benefit and so not recognising them as expenses in the income statement;

773.3 **ISA 330 paragraphs 5 and 6**, in that the Respondents did not design or perform adequate audit procedures to respond to the assessed risks, in particular to obtain a clear understanding of the assets and whether it was probable that any future economic benefit would be recovered where the contract was loss-making, or close to being loss-making; and

773.4 **ISA 500 paragraphs 6 and 7**, in that the Respondents failed to design and perform appropriate audit procedures to enable them to obtain sufficient appropriate audit evidence to support the accounting treatment of the assets and related costs, and failed to properly consider whether this evidence was relevant and reliable.

774. There were also further breaches by **the Respondents** in the **2015 and 2016 audits** of **ISA 500 paragraphs 9 and 11**, in that they did not adequately consider or respond to inconsistencies in, and doubts over the reliability of, evidence produced by Carillion supporting the recoverability of the "*transition*" amounts.

775. In addition:

775.1 In the 2015 and 2016 financial statements, Carillion treated £2.4 million and £2.0 million respectively as an asset relating to a purported claim against Carillion's customer for costs described as "*Transition*". In 2015, Services Contract A was reported as making a profit of £0.5 million so without this £2.4 million claim, the contract would have been reported as loss-making. In 2016 the contract was already reported as loss-making.

775.2 In both the 2015 and 2016 audits, KPMG was aware that the accounting treatment of this amount required judgement on the part of Carillion's management relating to the recoverability of the claim and had a significant impact on reported profit.

775.3 ES 1 required KPMG to conduct its audit work with objectivity. It specifically required KPMG:

775.3.1 to give "*fair and impartial consideration to all matters that are relevant to the task in hand, disregarding those that are not*";

775.3.2 to express an "*impartial opinion … in the light of all the available audit evidence and the auditor's professional judgment*";

775.3.3 to adopt "*a rigorous and robust approach*"; and

775.3.4 to be "*prepared to disagree, where necessary, with the directors' judgments*".

775.4 In the 2015 audit, KPMG Senior Manager A and KPMG Senior Manager C each concluded that the basis on which Carillion had originally proposed accounting for the costs was inappropriate and were doubtful as to whether the accounting treatment ultimately applied was also inappropriate. KPMG Senior Manager C in particular queried whether a claim would even be made. Despite these concerns, neither KPMG Senior Manager A nor KPMG Senior Manager C made any attempt to obtain further evidence for existence of the claim, for the basis of the claim or for the prospects of its success.

775.5 Again, in the 2016 audit, KPMG received a number of different explanations for how the amount would be recovered. KPMG Senior Manager C again concluded that the treatment ultimately adopted was inappropriate ("*we know £2m is wrong*"). The issue had been highlighted to Mr Meehan first by KPMG Senior Manager A during the 2015 audit as "*One to watch*" in the 2016 audit and then again during the 2016 audit by KPMG Senior Manager C. Despite these concerns, neither Mr Meehan nor KPMG Senior Manager C made any attempt to obtain further evidence for existence of the claim, for the basis of the claim, or for the prospects of its success.

776. Thus in 2015 and 2016 they failed to challenge management's judgements and simply accepted the treatment adopted. There were therefore further breaches:

776.1 by **KPMG** (through KPMG Senior Manager A and KPMG Senior Manager C) in the **2015 audit** of **ES 1 paragraph 6, 10 and 12**, in that they failed both to give fair and impartial consideration and to adopt a rigorous and robust approach where the accounting treatment adopted was affected by management's preference to recognise an asset in respect of the "*Transition*" costs and thereby failed to act with objectivity; and

776.2 by **KPMG** (through Mr Meehan and KPMG Senior Manager C) and **Mr Meehan** in the **2016 audit** of **ES 1 paragraph 6, 10 and 12**, in that they failed both to give fair and impartial consideration and to adopt a rigorous and robust approach where the accounting treatment adopted was affected by management's bias and thereby failed to act with objectivity.

E. The Portsmouth Contract in the 2016 audit

(1) The contract in 2016

777. On 12 July 2016, KPMG Senior Manager C emailed Mr Meehan stating as follows in relation to the Portsmouth Contract:

> *"-Up for renegotiation this year and* [the customer] *wanted huge deduction*
>
> *-Contract pretty much break even, even if you include very profitable car parking (looks like maybe this is* [the customer] *buying them out of car park?)"*

778. In its working paper "*4.7.2.CM.2 SERVICES PRECLEARANCE MINUTES*", headed "*Carillion Services preclearance meeting*" and referring to a meeting between KPMG and Carillion on 16 January 2017, KPMG stated as follows:

> *"Excluding the £2.3m of income from the car park, the Portsmouth facilities management contract reported a loss of £1.6m. Future profitability is dependent on: efficiency improvements, reduced lifecycle costs, energy cost savings and reduction in overheads. Management are not intending to provide for this as an onerous contract*[50] *as it is believed these initiatives will move the contract to a more profitable position."*

779. In its 2016 working paper "*AP060.3.0070 PORTSMOUTH CONTRACT REVIEW 201*", KPMG recorded the following in relation to the Portsmouth Contract:

779.1 assets at the year end were £26.4 million and included:

779.1.1 £8.7 million of work in progress; and

779.1.2 £17.3 million of debtors.

779.2 revenue was £36.6 million.

779.3 the contract made a profit in 2016 of £0.5 million.

780. The working paper then recorded that £9.0 million of amounts included in assets related to "*Claim"*. The audit work performed on these amounts is considered below.

---

[50] This is assumed to refer to the provisions of IAS 37, which required that, where a contract was expected to result in an overall loss, then the entire expected loss for the contract was to be recognised immediately.

(2) Claim in 2016

(a) *Introduction*

781. Working paper "*AP060.3.0070 PORTSMOUTH CONTRACT REVIEW 201*" provided the following analysis of the assets on the Portsmouth Contract:

	Non-claim	**Claim**	**Total**
Work in progress	£5.6m	£3.1m	£8.7m
Debtors	£3.2m	£15.2m	£18.4m
Deferred Income	£0.0m	- £9.3m	- £9.3m
Extra accruals	- £0.5m	£0.0m	- £0.5m
Total	£8.3m	£9.0m	£17.3m

782. The working paper did not provide any source for this analysis or explain how the amounts had been allocated between the various assets, or how the amounts reconciled to the amounts for total assets given earlier in the working paper (see above). In relation to "*Claim*", the working paper then recorded the following:

> *"The net exposure on the claim has increased by £3.5m since interim from £5.5m to £9.0m.*
>
> *WIP and Debt net of the provision held in deferred income can be analysed as follows:*
>
> | | *£m* |
> |---|---|
> | *CCL recovery* | *2* |
> | *CHP upgrade and remediation works* | *1.4* |
> | *Asbestos removal* | *0.6* |
> | *Lifecycle and project works* | *0.8* |
> | *Commercial settlement* | *2.4* |
> | | *7.2* |
>
> *Taking VAT into consideration the total comes to £8.6m, leaving an immaterial variance of £0.4m"*

783. Again, the working paper did not indicate how these amounts were allocated between the various assets, that is, work in progress, debtors, and deferred income.

784. Further, £1.4 million was assumed, without any basis given, to relate to VAT on the above amounts and £0.4 million was not explained at all.

785. Audit work and evidence obtained for each of these amounts is considered below.

(b) *"CCL recovery" of £2 million*

786. In its working paper "*AP060.3.0070 PORTSMOUTH CONTRACT REVIEW 201*", KPMG noted that, at the interim stage (October 2016), £2 million was to be recovered from another component of the group, Carillion Construction Limited ("**CCL**").

787. On 16 January 2017, Carillion emailed KPMG a position paper which analysed "*WIP & Debt nett of Provisions and VAT > 60 days*" of £7.2 million into four items, including:

> *"£3.4m CHP [combined heat and power] upgrade and remediation works which are expected to deliver circa £0.7m of cost reduction per annum over the next 15 years, on completion of the project. Management believes the this is a prudent assumption"*

788. On 16 January 2017, KPMG Senior Manager C emailed the senior management of the Carillion Services finance team, blind copying Mr Meehan, querying the treatment of this £3.4 million and the absence of any reference to the £2 million, which during the interim audit was understood to be due from CCL.

789. The following day, on 17 January 2017, KPMG Senior Manager C sent an email to the Carillion Services finance team, referring to a call on the previous day and stating as follows:

> *"£1.4m is for the construction of CHP – we need a breakdown of the cost of this*
>
> *£2.0m is claim from construction […]*
>
> *[…] In summary my comments on this contract in the meeting tomorrow will be:*
>
> - *£2.0m needs to be recovered from construction. Concern here is it hasn't been passed to construction to deal with.*
> - *£1.4m to be reclassified to tangible fixed assets (ETB adjustment needed)"*

790. £2 million of the £3.4 million asset was therefore being treated as a receivable from CCL but it had not "*been passed to construction*".

791. On 20 February 2017, Carillion emailed KPMG a revised version of the position paper.

792. In its working paper "*AP060.3.0070 PORTSMOUTH CONTRACT REVIEW 201*", KPMG stated as follows in relation to the £2.0 million "*CCL Recovery*":

> "[Senior management of the Carillion Services finance team] *and* [the Carillion Construction commercial team] *are in discussions with moving this £2m to Construction's balance sheet as they will be claiming via insurance against a subcontractor for the £2m. These discussions are expected to be finalised in the first half of 2017."*

793. The working paper therefore explained that the amount might ultimately be recovered through insurance but that no claim had currently been made. It provided no further evidence for the recoverability of the amount.

794. In interview, KPMG Senior Manager C confirmed that whilst the asset had been recognised by Carillion services, no corresponding liability had been recognised by CCL.

(c) *“CHP upgrade and remediation works” of £1.4 million*

795. As set out above, costs of £1.4 million incurred for upgrade and remediation works, expected to result in future cost savings, were initially treated as an asset along with the £2 million described above.

796. As set out above, in their emails of 16 January 2017 to the senior management of the Carillion Services finance team, KPMG Senior Manager C queried this accounting treatment, stating it was “*clearly the wrong accounting*” and that the amount should instead be treated as a tangible fixed asset.

797. In its working paper “*AP060.3.0070 PORTSMOUTH CONTRACT REVIEW 201*”, KPMG stated as follows:

> *“The £1.4m in relation to CHP upgrade and remediation work has been reclassed to fixed assets by KPMG as documented in <3.2.AP060.3.CSL.30.00350>. No further work proposed to this balance in addition to the work carried out in the referenced workpaper.”*

798. The reference provided was to working paper “*AP060.3.00350 PORTSMOUTH CHP CAPITALISATION*”, in which KPMG set out a list of costs totalling £1.4 million, and, under the heading “*Objective*”, stated as follows:

> *“KPMG obtained a breakdown of invoices which formed part of the construction of CHP. KPMG reviewed these invoices to ensure the costs can be capitalised per IAS16. KPMG has agreed each line in the table below to invoices obtained from the client, and classified them based on their descriptions.”*

799. The working paper then stated under the heading “*IAS 16 Regulations*”:

> *“… Service works and costs related to the keeping the unit at it’s intended use should be included in the cost for capitalization […].*

> *Essential maintenance to the CHP (Combined Heat and Power) unit must be included in the capitalization costs, as these are necessary for the unit to function. Any costs that replace, service or maintain parts in a unit must be included, and spare parts can and should be included in capitalization, especially if having a contingent spare part is prudent. In this case, a CHP unit provides and generates energy for the Queen Alexandra Hospital, and having spare parts is a prudent choice in a hospital."*

800. That passage was inconsistent with paragraphs 12 and 13 of IAS 16, which required that replacement parts be capitalised, but not maintenance costs.

801. KPMG then went on to propose that £1.3 million (that is, all but £0.1 million) be reclassified from work in progress to tangible fixed assets.

802. However, KPMG did not:

    802.1 properly consider whether the costs fell within the criteria set out in IAS 16;

    802.2 perform any work in relation to whether Carillion owned or controlled the CHP unit (as opposed to the owners of the hospital) and could thus treat it as Carillion's asset at all; or

    802.3 properly consider how the total amount of £3.4 million, which all related to the construction and maintenance of the CHP, had been allocated between this item and the '*CCL recovery'* above.

(d) *"Asbestos removal" and "Lifecycle and project works" of £1.4 million*

803. During the interim audit, KPMG recorded in the working paper "*AP060.3.0070 PORTSMOUTH CONTRACT REVIEW 201*" that work in progress included £3.2 million, which it described as follows:

> *"lifecycle works which is not all invoiced on a monthly basis. KPMG reviewed 22 invoices relating to lifecycle works issued in November totalling £0.6m. The remaining other WIP and lifecycle WIP will be reviewed at year end for any material changes."*

804. However, in the same working paper, KPMG recorded that, at the final stage of the audit, it performed no audit work on either £0.6 million relating to "*Asbestos removal*" or £0.8 million relating to "*Lifecycle and project works*" on the basis that "*These are deemed not material individually as they are <1/3PM and the likelihood of a material misstatement is low.*"

805. KPMG therefore failed to obtain any evidence on the "*Asbestos removal*" amounts.

(e) *"Commercial settlement" of £2.4 million*

806. As described above, on 16 January 2017, Carillion emailed KPMG a position paper which analysed "*WIP & Debt nett of Provisions and VAT > 60 days*" of £7.2 million into four items. This included:

> *"£2.4m Commercial settlement balance which is to be billed to* [the customer] *once the final settlement is concluded"*

807. KPMG Senior Manager C requested further information on the amount, and on 17 January 2017, the Carillion Services finance team provided an invoice issued by Carillion to its customer which included two deductions totalling £2.427 million described as "*Without Prejudice – PMS Retro*" and "*Without Prejudice – Commercials*". The Carillion Services finance team also provided the following explanation:

> "[We] *confirm that the £2.4m deductions relate to undisputed retrospective Paymech adjustments that form part of the wider Commercial Settlement. Albeit the* [customer has] *a contractual right to deduct (Set Off) undisputed sums from our payments, in light of the* [customer's] *deficit position it was agreed that we would transact this element of the wider commercial settlement on a "without prejudice" basis prior to the end of 2016.*
>
> *The principle has been agreed that the* [customer] *contribution towards closing out other aspects of the commercial settlement including the Condition B element will be £2.5m. Negotiations continue to finalize the detail around these elements however they are yet to be finalised."*

808. The same day, KPMG Senior Manager C sent a further email to the Carillion Services finance team stating:

> *"£2.4m is a commercial settlement - need to know what this is? If it is the same as the invoice then why do you think recoverable if you have already given discount to the* [customer]*?*
>
> […]
>
> *£2.4m – need to be convinced this is recoverable – if we agreed with* [the customer] *to break even why have we given them a £2.4m credit?"*

809. On 18 January 2017, KPMG Senior Manager C emailed the senior management of the Carillion Services finance team stating:

> *"I am told that the payment (deduction from the invoice) made to Portsmouth was just to assist them with their cashflow and that the* [customer] *will repay the amount in 2017. Is this really the case? I am told that there is no written agreement of this. If it is I am very concerned with the control implications, firstly as the invoice says it is a payment of a claim and secondly because there is no written agreement."*

810. In summary, KPMG was informed by Carillion that the £2.4 million "*commercial settlement*" related to deductions from Carillion's invoice to its customer, which would be recovered. However, Carillion provided two conflicting explanations for these deductions:

810.1 first, that they were in line with agreed "*paymech*" adjustment, which the customer had a right to deduct; and

810.2 second, that they were "*to assist"* the customer *"with their cashflow*" and the amounts would be repaid to Carillion in 2017. KPMG understood that there was no written agreement for the repayment of such deductions by the customer.

811. In response to KPMG Senior Manager C's further request for clarification, the Carillion Services finance team replied stating:

> *"Carillion has made an interim "Without Prejudice Deduction" of £2.4m per the invoice* […] *emailed yesterday. The attached document, which is part of the overall commercial settlement, shows the £2.5m the* [customer] *will pay back once the settlement is agreed."*

812. Attached to the Carillion Services finance team's email was a document with the file name "*Commercials agreement in principle reached 29 Oct 2014*". The document was a single page comprising a number of bullet points, and was clearly an extract from a longer document. Other than the filename and covering email there was no information to establish what the document represented or its date. It included the following:

> *"*● [The customer] *to pay Carillion £2,008,000 (detailed as below)*
>
> ○ *The £2,500,000;*
>
> ○ *Less £219,000 (*[the customer] *CIL contribution under this agreement);*
>
> ○ *Less £273,000 (MRI 'infrastructure capacity' FPW works already paid on account by* [the customer]*)."*

813. KPMG received no explanation of what the £2.4 million represented or how it related to the amounts referred to in the document provided. There was also no explanation for why the extract, apparently from October 2014, represented what had supposedly been agreed with the customer over two years later.

814. On 20 February 2017, the Carillion Services finance team emailed KPMG a revised version of Carillion's position paper. In relation to the £2.4 million, this updated paper stated as follows:

> *"£2.4m Commercial settlement balance which is to be billed to* [the customer] *once the final settlement is concluded*
>
> *[…]*
>
> *The* [customer] *had wanted all the Commercial issues to be dealt with and transacted by the end of January 2017 if possible. All parties agreed that the Paymech deal was to be concluded by March 2017 and this date was also the long stop date for the Commercial issues.*
>
> *In December 2016 it was obvious that the original January 2017 date was not going to be met. During December it was agreed to pay the* [customer] *the £2.4M on a without prejudice basis knowing that the full Commercial Settlement would ultimately get settled in 2017"*

815. The explanation provided no further evidence nor did it make the overall position any clearer.

816. Carillion therefore had recognised an asset of £2.4 million in respect of an amount receivable from its customer but the various explanations for what the amount represented remained unclear, and the only other evidence obtained that recovery of the amount was probable was a single page extract from an "*agreement in principal*" from October 2014, and provided in January 2017. This referred to amounts of £2.008 million and £2.5 million and was obviously insufficient as evidence that the treatment of this amount was appropriate.

(3) Conclusion

817. During the 2016 audit, KPMG was aware that the Portsmouth Contract was only profitable due to income from the car park, that future profitability depended on cost reductions, and that the contract was being renegotiated, with the customer wanting a large deduction.

818. KPMG recorded assets described as "*Claim*" of £9.0 million at December 2016. This amount was split across in work in progress, debtors and deferred income but did not record any explanation of the basis for the allocation of the £9.0 million between these categories, nor any further analysis within these categories.

819. But for the recognition of these assets, Carillion would have reported a loss on the contract of approximately £8.5 million. The accounting treatment adopted was therefore particularly significant.

820. Despite this, and despite the significant risk identified relating to contracts, for each of the elements of the £9 million amount, KPMG's audit work was inadequate, and provided no proper basis to conclude that it was probable that the amounts would be recovered. KPMG did not obtain a clear understanding of the related costs and did not assess whether it was probable that Carillion would recover any future economic benefit from these assets.

821. Of the remainder of the £9 million, £1.4 million was assumed, without any basis given, to relate to VAT on the above amounts and £0.4 million was not explained at all.

822. There were thus breaches by **the Respondents** in the **2016 audit** of:

822.1 **ISA 200 paragraph 15**, in that the Respondents did not approach this area with an adequate degree of professional scepticism, and so did not critically assess information obtained from management and the adequacy of the evidence supporting the recognition of the assets and treatment of the related costs;

822.2 **ISA 240 paragraphs 28 to 33**, in that the Respondents did not respond adequately to risks arising from the potential for management to try to manage reported earnings through treating costs incurred on the contract as giving rise to a future economic benefit and so not recognising them as expenses in the income statement;

822.3 **ISA 330 paragraphs 5 and 6**, in that the Respondents did not design or perform adequate audit procedures to respond to the assessed risks, in particular to obtain a clear understanding of the assets and whether it was probable that any future economic benefit would be recovered where the contract was loss-making, or close to being loss-making; and

822.4 **ISA 500 paragraphs 6, 7, 9 and 11**, in that the Respondents failed to:

822.4.1 design and perform appropriate audit procedures to enable them to obtain sufficient appropriate audit evidence to support the accounting treatment of the assets and related costs;

822.4.2 properly consider whether the evidence obtained, particularly evidence produced by Carillion, was relevant and reliable; or

822.4.3 adequately consider or respond to inconsistencies in evidence supporting the recoverability of these amounts.

11. THE OXFORD CONTRACT DISPUTE

The Oxford Contract was not selected by KPMG for detailed testing in 2016. However, KPMG was aware that Carillion's customer was making a substantial claim arising from allegations that Carillion had falsified records in relation to portering services provided by Carillion under this contract. KPMG was required to assess the likely outcome of this claim and whether its impact was properly reflected in the financial statements.

KPMG was also aware that the allegations against Carillion were underpinned by work performed by another KPMG team which had been engaged by Carillion's customer to assist in the investigation of the allegations. KPMG's assessment of the likely outcome of the claim potentially required consideration of the firm's own work, which presented a threat to the audit team's independence.

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 to adequately address the threat to its independence.

A. Overview

823. As set out in Chapter 3, the Oxford Contract was a contract for the provision of catering, cleaning, portering and other services.

824. During the 2015 audit, KPMG was aware that a separate KPMG team had been engaged by Carillion's customer to assist in relation to an investigation into allegations of fraud involving Carillion's staff providing services under the contract, and that the customer was withholding payments to Carillion pending resolution of this dispute. KPMG identified a "*self-review threat*" to the independence and objectivity of the audit team and implemented safeguards accordingly.

825. During the 2016 audit, KPMG was aware that the customer was bringing a claim against Carillion in relation to these allegations, with a value of approximately £14 million, and that Carillion's strategy included "*rubbishing*" a report relating to the allegations, prepared by the separate KPMG team. However, KPMG obtained no evidence on the likely financial impact of the dispute other than uncorroborated representations from Carillion's management.

826. Further, despite the evidence recording that the dispute had led to a significant claim being made against Carillion, and the reliance by the customer on the work of KPMG's other team, its conclusion on whether the "*self-review threat*" was sufficiently mitigated was not revisited.

B. Dispute between Carillion and its customer

827. On 15 December 2015, KPMG Senior Manager C emailed a member of the KPMG data team, copying KPMG Senior Manager A, to ask about timescales and costs associated with payroll testing in the 2015 audit. On 16 December 2015, the member of the KPMG data team replied stating:

> *"On this particular client we feel we are conflicted out due to our involvement with 'Project Earth'. Over half of the DA team* […] *have had some involvement with this project and particularly given the sensitive nature of this payroll data we feel it is wise not to risk independence on either job!"*

828. Later in this correspondence, KPMG Senior Manager A replied to the member of the KPMG data team, stating:

> *"OK – surely if it is a piece of work involving an Audit client's data (irrespective of whether they are a contracting party or not) there should be a sentinel?*[51]
>
> *Given we are also extracting payroll data from an audit perspective I can easily see we could came a perceived independence threat."*

829. This email correspondence was sent on to a KPMG Partner, and later on 16 December 2015, the KPMG Partner replied stating:

> *"I spoke to the engagement partner of the carillion audit before this work started to clear issues."*

830. The following morning, on 17 December 2015 KPMG Senior Manager A forwarded this email correspondence to Mr Meehan, asking "*Did you?*". Mr Meehan replied, "*No*".

831. However, on 12 January 2016, in response to a further email from KPMG Senior Manager A on whether there was an "*independence risk*", Mr Meehan stated:

> *"I spoke to* [the KPMG Partner]. *I think they are supporting int audit for the* [customer][52] *on this as part of an ongoing contract.*
>
> *Don't think it gives us an independence issue. More a potential to upset Carillion if that Kpmg team identify lots of issues*
>
> *Sorry and thx*
>
> [They] *had a quick word with me pre xmas"*

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[51] "Sentinel" is understood to be KPMG's system for recording engagements and managing the risk of conflicts of interest.

[52] Understood to mean that the team was supporting the internal audit function of Carillion's customer.

832. A few minutes later, KPMG Senior Manager A replied to Mr Meehan as follows:

> *"That is correct – their concern is that if we get the data but they don't would be odd. I was just annoyed they didn't try to contact us (although recognise you may have spoken) & even more annoyed they ended up conflicting out the* […] *data team.*
>
> *Good news is they have now found someone who is not conflicted & can do our data work"*

833. The audit team therefore understood that another team within KPMG were involved in a significant engagement reviewing Carillion's payroll data for Carillion's client on the Oxford Contract. However, KPMG Senior Manager A and Mr Meehan did not consider there to be any conflict between this engagement and the audit of Carillion.

834. On 25 February 2016, a member of KPMG's Sentinel Team[53] emailed Mr Meehan requesting his confirmation that he was happy for an engagement with Carillion on the other side of a dispute to go ahead. The member of KPMG's Sentinel Team provided the following details:

> *"I believe* [the KPMG Partner] *has discussed with you, although I don't have much further information on the engagement itself in the Sentinel request it relates to a facilities management contract within* [the customer to the Oxford Contract].
>
> *We would be acting for the* [the customer] *and Carillion would be on the other side of the dispute."*

835. Mr Meehan confirmed that this was "*ok*".

C. The 2015 audit

836. During the 2015 audit, KPMG was provided with a position paper in relation to the Oxford Contract, working paper "*AP060.3.CSL.30.20 OXFORD POSITION PAPER DECEMBER*". In that position paper, Carillion recorded disputes with its customer over "*performance deductions*" from its payments to Carillion relating in particular to the portering service, stating:

> *"it is unlikely that a mutually acceptable position will be found quickly. To resolve the position it is expected we will need to also agree our benchmarking position and bring about closure on an investigation being lead by KPMG on behalf of the* [customer] *around our portering team and in particular alleged potential reporting issues around our portering KPI's...."*

[53] "Sentinel" is understood to be KPMG's system for recording engagements and managing the risk of conflicts of interest.

837. Later in the position paper, Carillion referred to £3.1 million trade debtors, which were much higher than budgeted, stating:

> *"Trade debtors both less than and greater than 60days relate to the current position around Portering performance and monies withheld by the* [customer] *relating to this - we continue to have dialogue about these deductions which we believe to be incorrect in line with previously adopted ways of working".*

838. In relation to the investigation involving the other KPMG team, the position paper prepared by Carillion's management recorded:

> *"we have now provided responses to all of the questions received and are presently awaiting feedback on the findings of the investigation initially brought about by a whistleblowing call in the summer of this year….*
>
> *Our internal view is that the findings will confirm in our favour where by our reporting has indeed been without any misrepresentation in our portering function and we look forward to this process being closed."*

839. KPMG considered the threat to its independence as an audit team arising from the ongoing work relating to the investigation in two working papers for the 2015 audit:

839.1 working paper "*AP060.3.CSL.30.10 OXFORD HOSPITAL*", in which KPMG stated:

> *"there is clearly a risk of self-review threat around this contract. As such, KPMG's method for gaining comfort over the investigation and its outcomes will ensure complete segregation of the investigation team (based in Data Analytics) and the Carillion plc/Carillion Services Audit engagement team."*

839.2 working paper "*1.1.1.0020 UK ETHICS_AND_IND CHECKLIST*", in which KPMG stated:

> *"KPMG has noted from work performed over the Oxford* […] *Services contract (3.2.AP60.3.CSL) that a small piece of investigative work has been provided during the year. The spend in relation to these is not material to either party when compared to the total audit/non-audit fees and there are no known disputes. Hence these two factors do not impact the firm's independence."*

840. On 4 March 2016, shortly after the 2015 audit report had been issued, the KPMG Partner emailed Mr Meehan with the subject line "*Project Earth - briefing as it relates to your audit client*" setting out further details of the work involved and consideration of any conflict as follows:

> *"We provide internal audit and counter fraud services to the* [customer to the Oxford Contract]*. …*

> *… I have been asked to email you to brief you on the work ahead of the impending release of the report to the* [customer] *given it may result in potential legal proceedings being taken by the* [customer]*, underpinned by work undertaken by KPMG. Pete, we have spoken about this again recently …*
>
> *… An allegation was received … that Carillion staff were deliberately amending data provided directly to the* [customer] *in order to avoid penalty fees identified within their contracting arrangements …*
>
> *… As internal audit partner lead to the* [the customer]*, I spoke to the lead audit partner for Carillion (Peter Meehan) before we commenced any work to check the perceived conflict issue at the outset where we concluded that we would be OK to do the investigation as the allegation related to Carillion's normal day to day operations / normal course of business. There was no allegation received against* [the customer] *and the work performed does not impact any dataset or governance arrangements that they may have with Carillion. …*
>
> *… As the work has proceeded, the* [customer] *is potentially looking to pursue a legal course given the performance issues identified – hence we engaged with risk management to ensure our engagement / report as drafted was appropriate given this potential legal avenue. At this stage (last week), we agreed to set up a specific Sentinel request to highlight this work (our existing engagement letter covered the general counter fraud service than this specific engagement)."*

841. Mr Meehan replied to the KPMG Partner stating:

> *"I had taken the view that this was akin to if our forensic team had been engaged to look at for example the number of licenses in use at an audit client. I had this many times at* [a previous client] *and it never caused any issue to me, so long as the client saw credibility in the findings of our forensic team, even if it did cost them money.*
>
> *A key difference here is that was work that Kpmg took on for* [another client] *(say) on a case by case basis- we had a choice. I think here* [the KPMG Partner] *is retained as the* [customer's] *advisor and has a lot less choice.*
>
> *In summary, may cause a difficult conversation with my client for me, but no more. If I am wrong* [a member of KPMG's audit risk team, who received the email] */ anyone and should have not permitted this work (which I can't see is in my remit) then please do let me know."*

842. By March 2016 therefore, KPMG was aware that Carillion's customer was investigating certain allegations of fraud relating to Carillion's portering service, and as a result was withholding payments to Carillion. The audit team was also aware that investigative work performed by KPMG's internal audit and counter fraud teams might be used to support legal proceedings to be brought against Carillion in relation these allegations.

D. The 2016 audit

843. By the time of the 2016 audit, a claim had been commenced by the customer against Carillion in relation to portering services. Working paper "*4.6.3.A SERVICES PBSES WP*" included the Carillion Services PRM Report, produced on or around 9 February 2017, which stated the following:

> "[Solicitor Firm C] *advising in connection with* [the customer's] *appointment of KPMG to undertake full audit of the portering service management system- "Portertrak".* [The customer] *sent heavily redacted KPMG report 30/6.* [The customer is] *making substantial claim for deductions (£14m) arising from deliberate manipulation of data. Carillion reviews suggest there are significant weaknesses in the report. Detailed rebuttals submitted.* [Carillion] *attended a meeting with* [the customer], [another party] *and KPMG in w/c 1 February for KPMG to explain methodology.* [Carillion] *to submit any questions by end February via* [Solicitor Firm C]*. Strategy is to keep the pressure on the* [customer] *by rubbishing the report while recognising there is potential exposure for* [Carillion] *so that a settlement on acceptable terms remains the aim."*

844. Details of this dispute were also provided in working paper "*2.6.9.A Material Disputes Sept 2016*" and the dispute was briefly referred to in working paper "*HLC.1.0020 CARILLION SERVICES BUR HY*".

845. KPMG had therefore obtained the following evidence in relation to the dispute:

    845.1 that the KPMG team acting for Carillion's customer was performing a "*full audit of the portering service management system*" and had prepared a report;

    845.2 that the customer was bringing a claim against Carillion for an amount of £14 million; and

    845.3 that Carillion was looking to settle the claim, whilst in the meantime "*rubbishing*" the report produced by the KPMG team acting for Carillion's customer.

846. However, no further evidence was obtained by KPMG on the likely impact of the dispute to establish whether a liability needed to be recognised or disclosed. There is no evidence that KPMG explored the issue with management, reviewed correspondence or made enquiries of Carillion's legal advisors. The dispute was not included in the enquiry letters to the legal advisors acting on either dispute.

847. KPMG also did not revisit its conclusions regarding the self-review threat it had previously identified, even though by the time of the 2016 audit the threat was particularly acute, in light of the claim now being pursued by Carillion's customer, and the evident importance of KPMG's work on the dispute to the potential liability.

E. Conclusion

848. During the 2016 audit KPMG was aware not only that another team at KPMG had been appointed to assist in relation to an investigation by Carillion's customer against Carillion in relation to Carillion's portering services but also that Carillion was facing a "*substantial claim for deductions (£14m) arising from deliberate manipulation of data*" in relation to the allegations.

849. However, KPMG performed no audit procedures to assess the likely impact of this dispute. The dispute was not included in the enquiries made to the legal advisors.

850. The claim made by Carillion's customer required the audit team to apply significant judgement over a potentially material amount. However, the claim relied on work performed and a report prepared by another KPMG team and Carillion's strategy for resisting the claim was described as being to "*keep the pressure on the* [customer] *by rubbishing*" KPMG's report. As part of its assessment of whether recognition or disclosure of a liability was required, the audit team needed to consider the likely outcome of this strategy and so potentially needed to assess the robustness of report produced by KPMG. In these circumstances there was an obvious risk that the audit team's judgement could be impaired.[54]

851. In the 2015 audit KPMG had identified this "*self-review threat*" and concluded that separation between the audit team and the team performing the work relating to the investigation mitigated this threat. In the 2016 audit, KPMG obtained evidence recording that the dispute had led to a significant claim being made against Carillion, but its conclusion on whether the "*self-review threat*" was sufficiently mitigated was not revisited.

852. There is no evidence that KPMG made the Audit Committee aware of the self-review threat it had identified in the 2016 audit or the safeguards purportedly put in place to defend against it.

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[54] See ES1 paragraphs 35 and 41.

853. There were thus breaches by **the Respondents** in the **2016 audit** of:

853.1 **ISA 260 paragraph 17(b) and ES 1 paragraph 63**, in that the Respondents did not adequately inform the Audit Committee of the relationships and other matters that might reasonably be thought to bear on the Respondents' objectivity and independence;

853.2 **ISA 500 paragraphs 6, 7 and 11**, in that the Respondents:

853.2.1 failed to design and perform appropriate audit procedures to enable them to obtain sufficient appropriate audit evidence in relation to the various disputes;

853.2.2 did not adequately consider whether the evidence obtained was relevant and reliable; and

853.2.3 did not respond to inconsistencies in the evidence obtained and in particular to indications that the potential liability was not reflected in Carillion's financial statements; and

853.3 **ES 1 paragraphs 6 and 30**, in that, in relation to the claim by Carillion's customer:

853.3.1 it was probable that "*a reasonable and informed third party"* would conclude that the Respondents' objectivity could be impaired in considering the conclusions of work performed by another KPMG team; and

853.3.2 the Respondents did not adequately address the identified threat to their independence in view of the likelihood of significant judgement over material amounts being required.

12. OVERALL ASSESSMENT OF CERTAIN CONTRACTS

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. This required consideration of whether the forecasted overall outcome of the contract was reasonable, including whether it was probable that the contract would make an overall loss.

On construction contracts, KPMG's detailed work in the 2016 audit identified several of Carillion's most significant construction contracts as being "*high risk*", identifying uncertainty over amounts totalling over £120 million on just three contracts. However, KPMG did not properly consider the implications of this level of uncertainty on each contract and did not adequately respond to evidence of potential liabilities on the contracts which had not been incorporated into forecasts. Overall, it 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. In each case, KPMG failed to approach management's justification for not recognising the extent of the likely losses with appropriate scepticism.

A. Overview

854. As explained in Chapter 3, accounting standards provided that, where the outcome of a construction contract could be estimated reliably, revenue, and consequently profit, could be recognised according to the stage of completion of the contract. However, if it was probable that the contract would make an overall loss the entire expected loss for the contract needed to be recognised immediately.[55] A conclusion that it was probable that a contract would make an overall loss could therefore have a significant impact on reported profit.

855. KPMG was required to assess both the reasonableness of the estimated outcome of the contract and whether it was probable that it would make an overall loss, to conclude that the accounting treatment of amounts recognised on the contract was appropriate.

[55] IAS 11 paragraphs 22, 32 and 36.

856. KPMG identified that estimates that determined the forecast outcome of the contracts required a "*high degree of management judgement*" and changes "*could give rise to material variances in the amount of revenue and margin recognised*". KPMG therefore identified a significant risk of material misstatement in each of the 2014, 2015 and 2016 audits relating to the recognition of contract revenue, margin, and related receivables and liabilities.

857. In addition, the judgement required in estimating the outcome of the contracts and assessing the reliability of such estimates, gave rise to a risk that Carillion's management might use these estimates to manage reported earnings and influence the presentation of Carillion's performance and profitability.

858. Chapters 8 and 9 above include consideration of KPMG's audit work in relation to estimates of revenue and costs for some of Carillion's most significant construction contracts.

859. In relation to three of these contracts KPMG's working papers categorised the contracts as "*High risk ongoing*", concluding the following:

859.1 for the Aberdeen Contract:

> *"this contract has been badged as high risk and will therefore be discussed with Carillion Group in relation to the need for provisions."*

859.2 for the Battersea Contract:

> *"this contract has been deemed high risk ongoing due to the need to track the acceptance of the claims and variations into 2017. It has been included in the ACD*[56] *and communicated to management as a contract to monitor."*

859.3 for the Liverpool Contract:

> *"KPMG have highlighted this as a high risk ongoing contract. KPMG have gained comfort over the completeness of the claims and have flagged the gap required to be recovered to the Group Audit Team to detemrine if a provision is held by Group or one is required as the potential exposure is signifcant."*

860. The audit team responsible for performing detailed audit work on construction contracts thus did not reach conclusions on whether the amounts recognised for these contracts were reasonable, but understood that further consideration would be given to the overall positions taken.

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[56] This refers to the "Audit Committee Document" or the 2016 Year-End Audit Memorandum.

861. There is no evidence of any further consideration of whether the overall position for each of these construction contracts was reasonable. Instead, in its 2016 Year-End Audit Memorandum KPMG highlighted the contracts as "*higher risk*" or "*notable*" and noted uncertainty over a number of elements impacting the contracts' profitability. In aggregate, these elements were significant, totalling £55 million on the Aberdeen Contract, £36 million on the Liverpool Contract and £28.6 million on the Battersea Contract, suggesting that each of these contracts could potentially make overall losses of tens of millions of pounds.

862. In relation to each of these construction contracts, KPMG therefore failed to properly evaluate whether:

862.1 the overall outcomes on these construction contracts had been estimated reasonably; and

862.2 the amount of revenue and profit (or loss) recognised on the contracts was appropriate and in accordance with the relevant accounting standards and in particular, whether the contracts should have been treated as loss-making overall and if so the amount of that loss.

863. In relation to several of Carillion's most significant service contracts, Chapter 10 above considers KPMG's audit work to assess the treatment of certain assets recognised on these contracts. The treatment impacted both the assessment of reported profit on the contract for the period but also the assessment of whether the contracts should have been treated as loss making overall.

864. There were indications that each of these service contracts would be loss-making overall but KPMG did not respond adequately to these indications and did not obtain sufficient appropriate audit evidence to be in a position properly to conclude that an overall profit would be achieved. In particular, KPMG did not approach Carillion's assessment of the overall outcome of the contracts with adequate professional scepticism.

B. Aberdeen Contract

865. By December 2016, Carillion forecast that the Aberdeen Contract would make an overall loss of £10 million and had recognised this loss. However:

865.1 As discussed in Chapter 8 above, the contract included £30 million from claims in forecast revenue and there was evidence that a claim valued at over £20 million was strongly disputed by the customer.

865.2 As discussed in Chapter 9 above, estimated costs to complete the contract incorporated savings of approximately £22 million on previous forecasts, described by KPMG as "*ambitious*".

866. Further, whilst the Aberdeen Contract was significantly delayed, KPMG's working paper "*AP050.3.2.3 INFRASTRUCTURE CONTRACT YE16*" Tab "*Aberdeen*" did not include any reference to or consideration of potential liabilities arising from these delays.

867. KPMG's working paper identified "*Valuation of End of Life Margin*" as a risk, stating:

> *"In order to gain comfort over the EOL margin, KPMG compared it to what was already being achieved on the contracts. If EOL margin was lower than what was already being achieved, this brings rise to future losses being incurred. Long term contract accounting standards (IAS 11) require any future losses to be recognised at the point they are identified. KPMG found no cases where possible future losses needed to be recognised during their audit testing."*

868. However, in relation to the Aberdeen Contract, the working paper did not reach a conclusion as to whether the EOL margin was reasonable; rather it categorised the contract as "*High risk ongoing*" and concluded the following:

> *"Risk on this contract is obviously achieving ambitious cost savings of £22m on £84m of remaining costs …*
>
> *… this contract has been badged as high risk and will therefore be discussed with Carillion Group in relation to the need for provisions."*

869. In interview Mr Meehan stated that he thought these cost savings were "*probably achievable*" but that:

> *"there was a degree of risk, such that an element of the provision needed to be allocated against it"*

870. Mr Meehan stated that concerns over the amount recognised on the contract "*drove*" the comments in the KPMG's 2016 Year-End Audit Memorandum. This document identified the Aberdeen Contract as a "*higher risk contract*" and provided the following narrative:

> *"Since half year, management has revised their cost to complete on Aberdeen resulting in an expected overall contract loss of £10.0 million (all figures reflect Carillion's share) that has been recognised in full. To achieve this expected loss a gap of £55.0 million needs to be achieved. A £30.0 million combined additional value is required from* [the customer] *due to delays in programme and the insurers for severe weather. Furthermore, £25.0 million of cost savings need to be made, which appears challenging when the contract is 69% complete and represents 22% savings on the works still required."*

871. KPMG was required to reach a conclusion as to whether the amounts recognised relating to the contract were appropriate and in accordance with the relevant accounting standards. However, KPMG reported to Carillion's Audit Committee that "*a gap of £55.0 million needs to be achieved*" but did not perform any proper evaluation, particularly in view of the risk identified, as to whether the amount of the loss recognised in 2016 was appropriate and in accordance with the relevant accounting standards.

872. There were thus breaches by **the Respondents** in the **2016 audit** of:

872.1 **ISA 200 paragraph 15**, in that the Respondents did not approach this area with an adequate degree of professional scepticism, and so did not critically assess whether, in view of the combined risks relating to the claim and the cost savings, and the impact of the ongoing delays and potential consequent disputes, the forecast outcome of the contract was reasonable;

872.2 **ISA 330 paragraphs 5 and 6**, in that the Respondents did not adequately design or perform audit procedures, in response to the risks identified relating to contracts, to ensure that the estimated outcome of the contract was reasonable, including whether the impact of the ongoing delays and disputes were appropriately incorporated; and

872.3 **ISA 700 paragraph 9(c)**, in that the Respondents did not adequately evaluate whether the accounting treatment of the contract was consistent with IFRS.

873. There were also breaches by **the Respondents** in the **2016 audit** of **ISA 220 paragraph 17** in that Mr Meehan did not ensure that sufficient appropriate audit evidence had been obtained to support the conclusions reached on the accounting treatment and the amount of the loss recognised in relation to the contract.

C. The Battersea Contract

874. By December 2016, Carillion had recognised a profit of approximately £8.0 million from the Battersea Contract. However, as discussed in Chapter 8 above, £28.6 million relating to claims and £9.1 million relating to variations were incorporated into calculations of revenue.

875. During the 2015 audit, KPMG obtained Carillion's document "*Construction Services PRM BOOK*" which stated as follows:

> *"During December, agreement was reached on a Deed of Variation to reset the Contract Programme and Contract Sum.*
>
> *Against the new Contract Programme (CP04a) current progress on the main residential block (RS1A) is assessed as being between 4 and 7 weeks late. The team are investigating mitigation measures to reduce this delay.*

[Solicitor Firm A] *continue to have an on-site presence and are providing the project team with legal/contractual advice in respect of both upstream and downstream commercial issues.*

The focus of activity for the Claims Review Team is now on defending and prosecuting downstream claims against our subcontractor's and designers.

Weekly management meetings continue with the Employer's cost consultant and Agent to progress the agreement of variation instructions.

The relationship with [Battersea Subcontractor A] *is strained as our payments are falling far short of the subcontractor's costs. We anticipate that further demands for 'on account' payments will be made.*

The performance of [Battersea Subcontractor B] *is now critical to timely completion of the project, however, this contractor has taken an extremely aggressive and potential litigious stance and we are concerned that the programme will deteriorate further. Meetings are being held at a high level within* [Battersea Subcontractor B] *but this does not appear to be having a positive impact.*

In the period, we were notified of the insolvency of [another subcontractor]*. This supplier is providing all ironmongery and some of the internal door sets. This will result in a delay to the internal joinery works and the team are investigating mitigation measures."*

876. KPMG's audit team was, or ought to have been, aware that, by January 2016:

876.1 the Battersea Contract was delayed;

876.2 Carillion was seeking legal advice from external advisors, Solicitor Firm A, in relation to potential claims against it; and

876.3 Carillion's relationship with one contractor was "*strained*"; another sub-contractor was seriously threatening legal action; and a third was insolvent.

877. Further, Carillion's legal disputes register, updated as at September 2016, stated in relation to the Battersea Contract:

"A Reset deal was concluded with the Employer at the end of last year. It provided for a further variation to the contract sum of £20m and a full EoT for the delay.

As a result of the Reset deal, Carillion has suffered significant loss and expense. There are also major claims from the supply chain that will need to be concluded."

878. There is no evidence that KPMG took steps to investigate the "*major claims from the supply chain*" made against Carillion, in order to assess whether any liabilities might need to be recognised. As set out in Section H of Chapter 8, evidence from Carillion's external legal advisors provided no additional assurance relating to the disputes and in any case was received by KPMG after the date of the audit report.

879. KPMG's 2016 working paper categorised the contract as "*High risk ongoing*", describing the issues on the contract under the heading "*Professional judgement*" as follows:

> *"The main issues involving subjective balances within the Battersea contract are the £28,590,980 of EOL claims not yet agreed. KPMG have not yet received confirmation of the total claims value submitted to the client - though from discussions with management this is expected to be in the region of £55m - £60m, which is inline with Carillion normally obtaining 50%. …*
>
> *… KPMG though remain sceptical about full recovery of the £28.6m. …*
>
> *… KPMG will continue to monitor this contract and have raised with management the importance of receiving the full heads of terms with values once confirmed."*

880. The working paper then set out the following conclusion:

> *"The project is progressing well from a cash perspective. However given the large value of claims unverified in the EOL forecast this contract has been deemed high risk ongoing due to the need to track the acceptance of the claims and variations into 2017. It has been included in the ACD and communicated to management as a contract to monitor."*

881. In interview, KPMG Senior Manager B, said in relation to the Battersea Contract:

> *"This £28 million, I'm not saying I'm happy with it, but it is being flagged up to the group team to make that decision. I'm not saying all of that £28 million is at risk, but it's a high-risk, ongoing contract: there's £28 million; the group team, Peter and* [KPMG Senior Manager A]*, need to determine what other risks are coming in from Canada, Services, Middle East and Oman as well, to then draw a conclusion on the level of provision."*

882. KPMG's 2016 Year-End Audit Memorandum included the Battersea Contract under the heading "*Other notable contracts*" and provided the following narrative:

> *"In H2 2016 the margin on the Battersea contract was traded back by a further 0.7% to 1.8% (a write off of £3.2 million). Following a change in strategy, Carillion no longer need to achieve £19.3 million in future cost savings, instead management is targeting an additional £28.6 million recovery from the client through a second reset."*

883. KPMG had identified that the profit recognised depended on success in achieving the £28.6 million claim over which there was considerable uncertainty. KPMG was also aware that forecast revenue also included a £9.1 million variation which had not yet been agreed, and there was in addition uncertainty relating to "*major claims from the supply chain*", which had not been incorporated into the forecast costs.

884. In interview, when asked about the recovery of the claim for £28.6 million, Mr Meehan stated:

> *"The same client, who was paying in advance, who had pre-sold all the apartments, and wants them finished quickly; there was -- yes, looking in the round rather than the -- you know, looking in the round, there was to me, sufficient evidence that this one, whilst high-risk ongoing, this wasn't quite as risky as the other ones that I'd seen. …*
>
> *… the recovery is probable, in my mind, albeit again, you know, you'd prefer you've got something in writing from the client or whatever, of course you do. But there would be some cases where you don't get that."*

885. When later asked about the process for reviewing the need for provisions on contracts, Mr Meehan stated:

> *"Battersea was a conscious decision. We did feel that, you know, the risks around Battersea were less than others because of the various reasons we talked about before. There was a conscious decision around that, it's not just it was left off"*

886. KPMG was required to reach a conclusion as to whether the amounts recognised relating to the contract were appropriate and in accordance with the relevant accounting standards. There is no record during the audit of a "*conscious decision*" being made that the overall position on the contract was reasonable, or on what evidence the conclusion was based. KPMG performed no proper evaluation of whether, in light of the uncertainties identified, the profit recognised was appropriate and in accordance with the relevant accounting standards.

887. There were thus breaches by **the Respondents** in the **2016 audit** of:

887.1 **ISA 200 paragraph 15**, in that the Respondents did not approach this area with an adequate degree of professional scepticism, and so did not critically assess:

887.1.1 the significance of the "*major claims from the supply chain*" and whether these represented additional liabilities and costs; and

887.1.2 whether, in view of the combined risks relating to the revenue from the claim and variation, and the ongoing delays and disputes relating to the contract, the forecast outcome of the contract was reasonable;

887.2 **ISA 330 paragraphs 5, 6 and 26**, in that the Respondents did not adequately design or perform audit procedures, in response to the risks identified relating to contracts, to ensure that the estimated outcome of the contract was reasonable and the impact of the ongoing delays and disputes were appropriately incorporated; and

887.3 **ISA 700 paragraph 9(c)**, in that the Respondents did not adequately evaluate whether the accounting treatment applied and disclosures made were consistent with IFRS.

888. There were also breaches by **the Respondents** in the **2016 audit** of **ISA 220 paragraph 17** in that Mr Meehan did not ensure that sufficient appropriate audit evidence had been obtained to support the conclusions reached on the accounting treatment and the amount of the profit recognised in relation to the contract.

D. The Liverpool Contract

889. By December 2016, Carillion had recognised a profit of approximately £11.7 million from the Liverpool Contract. However:

889.1 As discussed in Chapter 8 above, £25 million relating to various claims was included in revenue, but with little evidence that any amount of any of the claims had been accepted by either the customer or any other party.

889.2 As discussed in Chapter 9 above, forecast costs to complete the contract incorporated a decrease of over £15 million from previous estimates.

890. In addition, in its December 2016 position paper on the Liverpool Contract, Carillion wrote as follows:

> *"At the end of October 2016, Carillion are 33 weeks behind the Contract Programme".*

891. This raised the possibility that Carillion would be exposed to claims for liquidated damages or other liabilities. KPMG identified this in its 2016 Year-End Audit Memorandum, referring to a "*liquidated damages exposure of £10.5 million*" in relation to the contract.

892. However, there were no audit procedures to assess the impact of the potential liquidated damages, or other liabilities relating to the delay, on the overall profitability of the contract recorded in KPMG's workpaper "*AP050.3.1 DEC 2016 BUILDINGS.XLSX*", and no evidence that KPMG performed further work to ensure that this "*exposure*" had been reflected in assessing the overall profitability of the contract.

893. KPMG's working paper categorised the contract as "*High risk ongoing*" and concluded as follows:

> *"KPMG have highlighted this as a high risk ongoing contract. KPMG have gained comfort over the completeness of the claims and have flagged the gap required to be recovered to the Group Audit Team to detemrine if a provision is held by Group or one is required as the potential exposure is signifcant."*

894. In interview, KPMG Senior Manager B referred to this working paper stating:

> *"our paper is not stating that we agree with the traded amount. …*
>
> *… When we've gone through this; our conclusion is that this is high-risk, and that a decision needs to be made."*

895. KPMG Senior Manager B stated that they could not recollect any consideration of whether the contract should be treated as loss-making.

896. KPMG's 2016 Year-End Audit Memorandum identified the Liverpool Contract as a "*higher risk contract*" and provided the following narrative:

> *"To maintain the traded margin on* [the Liverpool Contract] *Carillion need to recover an additional £25.5 million. £13.0 million is to be recovered from the* [customer] *for asbestos and "power-on" delay, £7.0 million from* [Consultant 1]*, £4.5 million from* [Consultant 2] […]*, and £1.0 million from the insurers for a cracked beam. Due to these issues the contract is currently seven months behind schedule with no extension of time yet agreed resulting in an additional liquidated damages exposure of £10.5 million. This exposure has not been factored into the traded margin as discussions are ongoing with all parties, with management remaining confident of full recovery due to the number of routes available."*

897. KPMG identified that the profit recognised depended on success in achieving the £25.5 million in claims, over which there was considerable uncertainty, and that there was an additional "*exposure*" on the contract of £10.5 million which had not been accounted for in the reported position. There was therefore a risk that the forecast profit of £13.2 million was overstated by up to £36.0 million and that the contract might ultimately make a considerable loss.

898. Mr Meehan stated in interview:

> *"… there was challenges on that contract, such that some sort of provision was required against that exposure. …*
>
> *… There's a few big things here, that we need to make sure we've got adequately covered"*

899. KPMG was required to reach a conclusion as to whether the amounts recognised relating to the contract were appropriate and in accordance with the relevant accounting standards. However, KPMG performed no proper evaluation of whether, in light of the uncertainties identified, the amount of the profit recognised was appropriate and in accordance with the relevant accounting standards.

900. There were thus breaches by **the Respondents** in the **2016 audit** of:

900.1 **ISA 200 paragraph 15**, in that the Respondents did not approach this area with an adequate degree of professional scepticism, and so did not critically assess whether, in view of the combined risks relating to the revenue from the claims and the ongoing delays, the forecast outcome of the contract was reasonable;

900.2 **ISA 330 paragraphs 5, 6 and 26**, in that the Respondents did not adequately design or perform audit procedures, in response to the risks identified relating to contracts, to ensure that the estimated outcome of the contract was reasonable and the impact of the ongoing delays and disputes were appropriately incorporated; and

900.3 **ISA 700 paragraph 9(c)**, in that the Respondents did not adequately evaluate whether the accounting treatment applied was consistent with IFRS.

901. There were also breaches by **the Respondents** in the **2016 audit** of **ISA 220 paragraph 17** in that Mr Meehan did not ensure that sufficient appropriate audit evidence had been obtained to support the conclusions reached on the accounting treatment and the amount of the profit recognised in relation to the contract.

E. The Nottingham Contract

(1) The 2014 audit

902. In 2014, Carillion recognised a loss of approximately £1.1 million from the Nottingham Contract. However, as discussed at Chapter 10 above, costs of over £4.4 million incurred on the contract had not been recognised as expenses in the 2014 financial statements; otherwise, the loss reported on the contract would have been up to £5.5 million.

903. In its working paper "*TOD 3.00105 NOTTINGHAM WORKBOOK*" KPMG recorded:

> *"This contract is a first generation outsourcing for the* [customer] *and is saving the* [customer] *tens of millions of pounds over the five year life of the contract."*
>
> *…*
>
> *"the* [customer] *in this case works on a fixed budget basis, the supply chain managers cannot spend more in year one than over the life of the contract and they insist on fixed payments. For commercial reasons, and because it is very difficult for the* [customer] *to cancel the contract (agreed to section Schedule 2.16) meaning that with the fixed revenue in the contract a profit is guaranteed over the life of the contract, Carillion agreed to these terms."*

904. Neither the fact that it was "*very difficult for the* [customer] *to cancel the contract"* or that the contract provided for "*fixed revenue*" supported the conclusion that "*a profit is guaranteed over the life of the contract*". It was evident that if Carillion's costs over the life of the contract exceeded the fixed revenue provided for in the contract, as had in fact happened in 2014, the contract would be loss-making. The fact that Carillion's customer was saving "*tens of millions of pounds*" by outsourcing the relevant services indicated that making any profit would depend on Carillion being able to achieve substantial cost savings in delivering the outsourced services.

905. KPMG's working paper included indicators that there were problems with delivering the services, suggesting that the contract might continue to make losses:

905.1 The working paper recorded the following from Carillion's PRMs:

905.1.1 "*a number of gaps against KPIs*"

905.1.2 "*Technical compliance is an area of significant concern and being raised in writing to the* [customer]"

905.1.3 "*Technology remains an area of risk on all of the mobilisations with continuing delays at Nottingham*"

905.1.4 "*there remains a significant requirement for technology support for mobilisations at Nottingham*"

905.1.5 "*Generally, the recruitment of suitable calibre engineering managers and engineers remains a concern at Nottingham*"

However, KPMG did not investigate these further and in particular did not assess whether these might lead to the contract making a loss overall.

905.2 The working paper included a "*profile*" of the contract prepared by Carillion which set out forecasts of turnover and profit for the five-year period of the contract and indicated that the contract would be profitable overall. However, this "*profile*" was based on annual revenue of approximately £35.5 million, which was £1.7 million more than that indicated by the actual revenue for the first six months of the contract[57], and nearly £5 million higher than the 'fixed fee' for the first year of the contract, as recorded in the same workpaper. However, KPMG did not identify or investigate these discrepancies between the actual and forecast revenue.

906. In summary:

906.1 the contract had incurred an excess of £5.5 million costs over revenue during the six months to December 2014;

906.2 a loss of £1.1 million was reported on the contract, with £4.4 million costs not recognised as expenses in the income statement in 2014 (as set out in Chapter 10);

906.3 information obtained by KPMG suggested problems with the contract and a likely impact on costs; and

906.4 actual revenue achieved in the contract's first six months was less than the amount implied by Carillion's forecast, calling into question the reliability of the forecast and its conclusion that the contract would make an overall profit.

907. There were therefore indications that the contract might be loss-making overall which required further investigation.

(2) The 2015 audit

908. In 2015, Carillion did not recognise a profit or loss on the Nottingham Contract. KPMG recorded that the contract had made an "*Underlying*" loss of £11.6 million, calculated by excluding revenue recognised relating to a claim for £11.6 million.

909. As discussed in Chapter 10, above, the reported position depended on recovery of the £11.6 million claim and also the treatment of a further £2.5 million as "*mobilisation*" costs. If these amounts could not be recovered, the loss required to be included in the financial statements on the contract would have been £14.1 million.

[57] Based on revenue of £16.9 million in six months to December 2014, suggesting an annual revenue of £33.8 million.

910. In working paper "*AP060.3.00330 NOTTINGHAM POSITION PAPER*" KPMG noted the following:

> *"To date the contract is losing c£964k a month. Over the remaining contractual life of 54 months the total loss would equate to c£52m with £1.1m of the loss having already been traded in 2014. The reasons for the losses are:*
>
> *1) Carillion believe the* [customer] *misrepresented the size and condition of the estate.*
>
> *2) Carillion believe the* [customer] *misstated the required specification to the extent that it didn't meet building regulations, health and safety, care quality commission and NHS rules.*
>
> *3) Carillion have not been able to introduce planned efficiency savings due to resistance from the* [customer].
>
> *In October 2015, Carillion entered the first round of mediation with the* [customer] *in respect to the above claims. The* [customer has] *offered £17,075,000 to settle Carillion's claims spread over five years and Carillion have made a counter offer of £31,200,000 spread over five years.*
>
> *In January 2016, Carillion entered the second round of mediation with the* [customer] *in respect to the above claims. The* [customer] *revised their original offer of £17,075,000 to £16,101,000 over five years. In addition to this, the* [customer] *included cost avoidance opportunities with a value of £11,095,000 over the five years."*

911. The working paper included a spreadsheet titled "*Nottingham Numbers*" which showed the "*contract's projected outturn loss position*". This spreadsheet recorded that the "*Actual loss to date from the beginning of the contract*" was £12.7 million and a "*projected loss over the remaining life of the contract*" of £34.3 million. The latter amount was based on losses for the last three months of 2015 on the basis that the most recent three months were "*more representative over the contract's current position*". The spreadsheet then included the latest settlement offer, plus a further £7.9 million (on the basis that "*Carillion are not willing to settle for anything less*"), as well as a further £10.5 million for "*Estate condition*", to arrive at a forecast loss for the contract of £0.2 million.

912. Working paper "*AP060.3.00330 NOTTINGHAM POSITION PAPER*" concluded that this projected loss was "*not material … and therefore the total loss over the contractual life should not be provided for*".

913. However, as set out in Chapter Part E, the spreadsheet titled "*Nottingham Numbers*" was not prepared until after the date of the audit report in response to comments arising from a "*post signing review*" of the audit file performed by a KPMG reviewer during April and May 2016. The spreadsheet, and the conclusion on working paper "*AP060.3.00330 NOTTINGHAM POSITION PAPER*", could not therefore provide support for the conclusion reached and the audit opinion.

914. It is unclear what assessment of the need for any provision for the contract's loss had been performed as at the date of the audit report. However, the comments arising from the "*post signing review*" suggest that this was inadequate, stating:

> *"Perhaps I missed something but I didn't get a clear idea of what the Nottingham contract's projected outturn loss position would be absent the additional amounts claimed and expected cost savings – ie is the* [customer]*'s offer of £16m and costs savings of £11m (total c£27m) sufficient to cover the losses which would otherwise fall to be booked?*
>
> *There was little detail to support the envisaged cost savings.*
>
> *The additional construction works and/or re-development opportunities which might be available to mitigate the losses look quite speculative to include in the formal calculation of the projected loss. In any event they would seem to fall to be treated as separate contracts under IAS 11.36 rather than form part of this services contract?*
>
> *Apologies if I missed something but I didn't find the analysis very clear and the technical (as well as practical) basis for taking account of the speculative additional work opportunities of a different nature was not fully documented."*

915. In summary, KPMG recorded that the contract's loss over its remaining life would be either £52 million (per working paper "*AP060.3.00330 NOTTINGHAM POSITION PAPER*") or £34.3 million (per the Nottingham Numbers spreadsheet). The total sum offered in settlement was £16 million and "*costs savings*" of £11 million, with the former amount including £11.6 million "*claim*" recognised as revenue in 2015. Even with the inclusion of the "*cost savings*", therefore, this would leave a minimum loss of approximately £18.9 million over the remaining life of the contract. However, at the date of the audit report, KPMG apparently relied on "*speculative additional work opportunities*" to conclude that there was no need for a provision for future losses on the contract.

(3) Conclusion

916. In the 2014 audit KPMG failed to investigate sufficiently indications that the contract might be loss-making overall. By the 2015 audit the contract had made losses of £12.7 million over the eighteen months to December 2015, and KPMG failed to perform any, or any adequate, assessment of whether a provision for future losses was necessary.

917. There were thus breaches by **the Respondents** in the **2014 and 2015 audits** of:

917.1 **ISA 200 paragraph 15**, in that the Respondents did not approach this area with an adequate degree of professional scepticism, and so did not critically assess management's basis for why the contract should not be treated as loss-making overall;

917.2 **ISA 330 paragraphs 5 and 6,** in that the Respondents did not adequately design or perform audit procedures in response to indicators that the contract might be loss-making overall; and

917.3 **ISA 500 paragraphs 6, 7 and 11**, in that the Respondents:

917.3.1 failed to design and perform appropriate audit procedures to enable them to obtain sufficient appropriate audit evidence that the contract was not loss-making overall;

917.3.2 did not properly consider whether the evidence obtained was relevant and reliable; and

917.3.3 did not respond to inconsistencies in the evidence, in particular that the contract may in fact be loss-making overall and that a provision might be required.

F. Services Contract A

(1) The 2014 audit

918. Carillion's work on Services Contract A started in May 2014.

919. In 2014, Carillion recognised a loss of approximately £0.3 million from the contract. However, as discussed in Chapter 10 above, the reported position depended on the treatment of £2.3 million costs which were not treated as expenses in the income statement; otherwise the loss reported on the contract would have been up to £2.6 million for the eight months it had been operating.

920. KPMG's working paper "*TOD2.00140* [Services Contract A] *WORKBOOK*" recorded:

920.1 the variable element of revenue under the contract was £6.3 million, £2.8 million lower than a projection of £9.1 million;

920.2 the contract incorporated a GMP agreement providing that "*payments to the supplier in any year of the agreement shall not exceed the GMP, irrespective of the actual costs incurred by the supplier*";

920.3 according to "*discussions with management*", "*Carillion are still in the process of stabilising their costs*" and had incurred "*transition*" costs;

920.4 a "*backlog of outstanding billing*" had impacted the margin; and

920.5 again, according to "*discussions with management*", a "*15 point action plan*" had been designed to "*create more efficiencies*".

921. KPMG had also obtained a management forecast showing that the contract would make a profit of £0.7 million in 2015.

922. In its working paper, KPMG recognised that, since the contract had made a loss in the year, KPMG needed to "*assess whether a provision is required if the contract will continue to make a loss in the future*", that is, to assess whether the contract was expected to make an overall loss over its life, in which case the expected loss would need to be recognised immediately.

923. KPMG then concluded:

> *"Given it is a new contract it is in line with our cumulative audit knowledge and experience that contracts may make a small loss in the first year which is then rectified in subsequent years following a management action plan where further efficiencies are found in the contract.*
>
> *Therefore, taking the above into consideration KPMG do not propose that the contract requires a provision and the margin will be reviewed next year to see whether it was in line with Carillion's management forecast."*

924. KPMG:

924.1 did not obtain any explanation or evidence for the shortfall in variable revenue and whether this impacted the reliability of the forecast profit for 2015;

924.2 did not adequately consider the impact on the contract's likely profitability of the GMP agreement, which provided that the "*core fee*" payable to Carillion reduced in subsequent years;

924.3 performed no proper assessment of the "*transition*" costs referred to or whether the "*15 point action plan*" or a "*management action plan*" could reasonably be expected to achieve the forecast profit for 2015; and

924.4 did not obtain any explanation or evidence for how a "*backlog of outstanding billing*" could reduce margin, when delays in billing would not be expected to affect amounts recognised for either revenue or expenses in the period.

925. KPMG did not subject management's forecast to sufficient scrutiny, relying on "*cumulative audit knowledge and experience*" but without explaining why this provided any assurance over the outcome of this particular contract. The conclusion that the contract did not require a provision, despite the loss made during the year, was not adequately supported by evidence.

926. KPMG were required to treat with professional scepticism Carillion's assertion that the contract did not need to be treated as loss-making but failed to subject that assertion to effective scrutiny or challenge.

(2) The 2015 audit

927. In 2015, Carillion recognised a profit of approximately £0.5 million from the contract. However, as discussed in Chapter 10 above, the reported position depended on the treatment of £2.4 million included as an asset; otherwise the loss reported on the contract would have been up to £1.9 million.

928. KPMG's working paper "*AP060.3.0060* [Services Contract A]" recorded that the GMP agreement in the contract would reduce during the year. However, KPMG did not assess the impact of this on the profitability of the contract, in particular whether Carillion would be able to achieve costs savings to offset the reduction in revenue.

929. There were therefore indications that the contract might be loss-making overall and these required further investigation. Despite this KPMG did not address this issue at all.

(3) The 2016 audit

930. In 2016, Carillion recognised a loss of approximately £6.1 million from the contract. However, as discussed in Chapter 10 above, the reported position depended on the treatment of £5.8 million included as an asset; otherwise the loss reported on the contract would have been much larger, up to £11.9 million.

931. On 18 January 2017, a "*Carillion Services Clearance Meeting*" took place between Carillion and KPMG. KPMG's minutes of the meeting listed the contract as one of the "*Key audit areas*" and stated the following:

> "[Services Contract A] *is deemed to be a loss making contract and management believes that they should be able to break even in 2017.*
>
> - *There are many concerns regarding the* [customer] *owned helpdesk, as this discourages being able to talk in person, and it becomes highly improbable to go the helpdesk at all times*
> - *KPI demands placed by* [the customer] *on Carillion are very stringent, and are shown to be much stricter than market comparatives. The model is deemed inappropriate, and very difficult for Carillion to follow and implement, a fact that was raised during the KPMG site visit to* [the customer] *as well.*
> - *A £2m claim for transitions is present this year and is the same as last year. There is risk surrounding this claim regarding the recoverability of £2m. Some costs have been reduced in the higher levels, but the contract conversion is necessary to take place for even more recoverability.*
> - *The relationship between Carillion and* [the customer] *has shown to have escalated and improved, with* [Carillion Services management] *arranging to meet with* [the customer] *on the 13th of February.*
> - [A Carillion Director] *and* [a director of the customer] *have a relationship as well, as the group is a major customer.*
>
> *Some change is needed on* [the customer]*'s end as Carillion has cut costs to recover the £2m, but there is confidence that this can be done in 2017."*

932. In its working paper "*AP060.3.00460* [Services Contract A] *POSITION PAPER-KPMG*", KPMG stated it needed to consider:

> *"Whether* [Services Contract A] *is loss making going forwards*
>
> *… If a loss is expected going forwards in respect of* [Services Contract A]*, then the entire loss needs to be recognized immediately in the Income Statement"*

933. The working paper then referred to:

933.1 management's intention to change the contractual position and to "*secure additional variable works*";

933.2 the customer's supposed desire to resolve contractual issues; and

933.3 Carillion's supposed commercial advantage over the customer and ability to place pressure on the customer. KPMG noted:

> *"since Carillion is a bigger customer for* [the customer] *than what* [the customer] *is for Carillion, it is likely that this pressure may result in new favourable terms being renegotiated under this contract however KPMG will continue to challenge and monitor this situation"*

934. Carillion's PRM from January 2017 stated in relation to the contract that Carillion was expecting a loss of £9.4 million in 2017 and added:

> *"Current plan will not achieve breakeven in 2017, will reduce £9m loss by £4m […] Agreement of approach to resolve remaining loss and improvement in cash position required.*
>
> *[…]*
>
> *We cannot achieve breakeven without* [customer] *support. Need to establish* [customer] *desire to help resolve remaining loss and working capital lock-up."*

935. Thus, the contract was loss-making, with "*very stringent*" requirements of the services provided by Carillion, which were "*much stricter than market comparatives*" and "*very difficult for Carillion to follow and implement*". The contract was forecast to make further losses in 2017 and could not break even, let alone become profitable "*without* [customer] *support*".

936. Any improvement in Carillion's financial position under the contract was dependent upon the customer's agreement, and there was no evidence that this would be forthcoming, other than management's stated belief. KPMG did not obtain sufficient appropriate audit evidence that the necessary improvement in the contract would be forthcoming.

937. Accounting standards provided that the entirety of any expected loss over the contract's life needed to be recognised immediately. However, KPMG obtained no explanation for why even the loss expected to be made in 2017, forecast to be £9.4 million but possibly capable of being reduced by £4 million, was not provided for in 2016, although KPMG did not in any event properly assess the reasonableness of these forecasts.

(4) Conclusion

938. In the 2014 audit, KPMG noted that the contract might be loss making overall but then failed to obtain evidence to support its conclusion that a provision was not required. In the 2015 audit there were further indications that the contract might be loss-making overall, which required further investigation, but KPMG did not address the issue at all.

939. In the 2016 audit, the contract reported significant losses and forecast further substantial losses for the following year. KPMG therefore had evidence suggesting that the contract should be treated as loss-making and a provision for its overall losses should be made, but failed to subject Carillion's proposed treatment to effective scrutiny or challenge. KPMG relied on management's representations that the commercial relationship between Carillion and its customer would achieve the changes necessary for the contract to become profitable.

940. There were thus breaches by **the Respondents** in the **2014, 2015 and 2016 audits** of:

940.1 **ISA 200 paragraph 15**, in that the Respondents did not approach this area with an adequate degree of professional scepticism, and so did not critically assess the proposition that the contract should not be treated as loss-making overall and that in particular in 2016, no provision was required;

940.2 **ISA 330 paragraphs 5 and 6**, in that the Respondents did not adequately design or perform audit procedures in response to indicators that the contract might be loss-making overall; and

940.3 **ISA 500 paragraphs 6 and 7**, in that the Respondents:

940.3.1 failed to design and perform appropriate audit procedures to enable them to obtain sufficient appropriate audit evidence that the contract was not loss-making overall; and

940.3.2 did not properly consider whether the evidence obtained was relevant and reliable.

G. The Portsmouth Contract

(1) The 2014 audit

941. In 2014, Carillion recognised a loss of approximately £0.9 million from the Portsmouth Contract.

942. In its working paper "*TOD 3.0050 PORTSMOUTH WORKBOOK*", KPMG stated as follows:

> *"As the contract is currently a loss making contract then KPMG must assess whether a provision is required if the contract will continue to make a loss in the future. Therefore, KPMG have reviewed the 2015 RF1 prepared by Carillion (embedded for reference) where management estimate that the contract will make a c£375k loss in the first quarter and the overall profit in the year will be c£700k. Given it is a new contract it is in line with our cumulative audit knowledge and experience that contracts may make a small loss in the first year which is then rectified in subsequent years following a management action plan where further efficiencies are found in the contract.*
>
> *Therefore, taking the above into consideration KPMG do not propose that the contract requires a provision and the margin will be reviewed next year to see whether it was in line with Carillion's management forecast."*

943. However:

943.1 KPMG performed no further consideration or analysis of the forecasts of losses and profits referred to.

943.2 The working paper provided no details of the "*management action plan*" and the "*further efficiencies*" referred to, and did not refer to any evidence that it would improve the contract's profitability.

943.3 KPMG instead relied on "*cumulative audit knowledge and experience*" but did not explain why this provided any assurance over the outcome of this particular contract.

944. KPMG simply accepted management's assertion that the contract, whilst currently loss-making, would become profitable in the future.

(2) The 2016 audit

945. In 2016, Carillion recognised a profit of approximately £0.5 million from the Portsmouth Contract. However, the reported position depended on treating a total of £9 million, described as claims, as an asset; otherwise, a loss would have been reported on the contract.

946. The reported profit also Included £2.3 million in revenue from Portsmouth car park even though it was no longer considered to relate to the contract. This revenue would no longer be included on the contract in subsequent years.

947. Further, during the 2016 audit, KPMG was aware that the Portsmouth Contract was not profitable, that future profitability depended on cost reductions and that the contract was being renegotiated, with the customer wanting a large deduction. In particular:

947.1 on 12 July 2016, KPMG Senior Manager C emailed Mr Meehan stating as follows in relation to the Portsmouth Contract:

> *"-Up for renegotiation this year and* [the customer] *wanted huge deduction*
>
> *-Contract pretty much break even, even if you include very profitable car parking (looks like maybe this is* [the customer] *buying them out of car park?)"*

947.2 on 29 November 2016, KPMG Senior Manager C responded to an email from KPMG Senior Manager A referring to the income from Portsmouth car park, saying:

> *"Interesting it was sale of an asset last time for Portsmouth now an income stream. Are they disclosing as exceptional (haha)? It makes the Portsmouth contract loss making by c1m a year. We told them at HY they would need to provide at least some"*

947.3 working paper "*4.7.2.CM.2 SERVICES PRECLEARANCE MINUTES*", which was KPMG's record of the minutes of a meeting between KPMG and Carillion on 16 January 2017, stated as follows:

> *"Excluding the £2.3m of income from the car park, the Portsmouth facilities management contract reported a loss of £1.6m. Future profitability is dependent on: efficiency improvements, reduced lifecycle costs, energy cost savings and reduction in overheads. Management are not intending to provide for this as an onerous contract as it is believed these initiatives will move the contract to a more profitable position."*

947.4 on 17 January 2017, KPMG Senior Manager C emailed the Carillion Services finance team, stating as follows in relation to the Portsmouth Contract:

> *"[…] on the loss making side:*
>
> *Reported profit £0.5m – Car park profit £2.2m – depreciation of CHP £0.1m = (£1.8m)*
>
> *With £0.7m energy savings and other supply chain savings etc I can see this contract get to break even"*

948. Carillion produced a paper, working paper "*AP060.3.00310 MANAGEMENT PORTSMOUTH CAR PARK*", concerning the accounting treatment of the car park income, which included the following:

> *"In 2017, excluding the benefit of any income from the car parks, the facilities management contract is targeting an operating profit margin of 4.3% on revenue of approximately £37 million. This compares to an equivalent loss of 1.6% in 2016. The profit improvements include:*
>
> *- Reductions in service failure losses and general efficiency improvements of £781,000*
>
> *- Reduced life cycle costs of £333,000*
>
> *- Reductions from changes to patient services regarding housekeeping and cleaning of £302,000*
>
> *- Energy cost savings from the CHP becoming fully operational in the last quarter of 2016 of £479,000*
>
> *- Targeted reductions in overheads of £242,000"*

949. In relation to the "*Energy costs savings*" KPMG recorded the following:

> *"Per* [Carillion Services management]*, November was a break even month as the CHP replacement programme with not complete at this time, a loss of £45k for the month was incurred, this reduced to a loss of £18k in December as the running times of the CHP increased".*

950. KPMG performed insufficient audit procedures to determine whether it was probable that the "*profit improvements*" would be achieved and thus its assessment of whether the contract should be treated as loss-making was inadequate.

(3) Conclusion

951. In the 2014 audit KPMG knew that the contract was treated as loss-making and in both the 2014 and 2016 audits that its future profitability was dependent on cost savings being achieved by Carillion. KPMG failed to subject Carillion's assertion that the contract was not loss-making overall to effective scrutiny or challenge.

952. There were thus breaches by **the Respondents** in the **2014 and 2016 audits** of:

952.1 **ISA 200 paragraph 15**, in that the Respondents did not approach this area with an adequate degree of professional scepticism, and so did not critically assess the proposition that the contract should not be treated as loss-making overall;

952.2 **ISA 330 paragraphs 5 and 6,** in that the Respondents did not adequately design or perform audit procedures in response to indicators that the contract might be loss-making overall; and

952.3 **ISA 500 paragraphs 6 and 7** in that the Respondents failed to design and perform appropriate audit procedures to enable them to obtain sufficient appropriate audit evidence that the contract was not loss-making overall and did not properly consider whether the evidence obtained was relevant and reliable.

13. PROVISION FOR RISKS OVER CARILLION'S CONTRACT PORTFOLIO

Chapters 8 to 12 consider several of Carillion's most significant contracts and in particular, how KPMG addressed the risk arising from the reliance on estimates and judgements made by Carillion's management when accounting for these contracts.

There was also a risk over Carillion's portfolio of contracts as a whole that, even if the estimates and judgements made on individual contracts were reasonable, not all contracts would perform in line with the positions taken in Carillion's financial statements. KPMG was required to assess whether provisions in Carillion's financial statements to address this risk were reasonable and appropriate in light of the specific risks identified across the portfolio.

In 2016, the audit work performed on the reasonableness of the provisions was minimal and did not properly address the very significant risks identified in KPMG's detailed work on specific contracts. In its reporting to the Audit Committee, 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. In the same report KPMG also identified a significant number of "*other notable contracts*" where similar risks arose but were not included in the downside scenario. Overall, the report set out specific amounts, relating to these "*higher risk*" and "*notable*" contracts, that depended on estimates and judgments and 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.

A. Overview

953. As set out in previous chapters, the amounts recognised on individual contracts and the appropriate accounting treatment depended on judgements and estimates made by Carillion's management.

954. However, even if the estimates and judgements made on individual contracts were reasonable, there was still a risk that not all contracts would perform in line with forecasts which had determined the amounts recognised, particularly in a large and diverse portfolio of contracts such as Carillion's. KPMG understood that provisions of £50.1 million (the "**Group Provisions**") were intended to address this risk, stating in its working papers:

> *"Given the level of judgement involved and uncertainty over timing, success and quantum of any settlement, Carillion are aligned with other groups with long term contracts in maintaining central provisions. These provisions seek to ensure that the group presents a balanced view of the traded positions on a portfolio basis"*

955. KPMG also stated in its 2016 Year-End Audit Memorandum that its conclusion on the positions taken on contracts took into account the Group Provisions.

956. The significant risk relating to the recognition of contract revenue, margin and related receivables and liabilities was therefore partly addressed through assessing whether these provisions appropriately reflected the levels of uncertainty over Carillion's portfolio of contracts. It was therefore important for KPMG to determine that the provisions were adequate.

957. KPMG described its assessment of Group Provisions as follows:

> *"From an audit perspective, we seek to track the various contract risks identified through our fieldwork and group reporting into these group central provisions. We also consider the paper prepared by group management which sets out their views on the basis for and, allocation of, these provisions."*

958. It is not clear whether KPMG performed the first of these procedures, "*track[ing] the various contract risks identified through* [its] *fieldwork… into these group central provisions*", at all. Analysis recorded in KPMG's working papers was wholly inadequate and provided no assurance on whether the provisions were adequate.

959. As to the second of these procedures ("*consider*[ing] *the paper prepared by group management*"), KPMG's audit work was defective and provided minimal assurance over the adequacy of the Group Provisions.

960. KPMG therefore had no basis on which to conclude that Group Provisions appropriately reflected the risk identified on contracts and should not have relied on the provisions in concluding that the overall position taken on contracts was reasonable. Nonetheless, KPMG concluded that provisions of £50.1 million were adequate.

961. In fact, the contract risks identified by KPMG in its audit, and in particular those which it highlighted to Carillion's Audit Committee, suggested that the Group Provisions were likely to be insufficient. In its 2016 Year-End Audit Memorandum to Carillion's Audit Committee, KPMG provided details of contract risks it had identified through its audit work as follows:

961.1 KPMG reported on a number of specific contracts, stating:

"We comment on contracts by exception only, either as a result of scale, prior year commentary or as a result of a particular risk we want to bring to the attention of the Audit Committee."

961.2 The commentary for each contract highlighted certain significant risks or challenges, including the recovery of claims and the achievement of "*challenging*" costs savings, and noted that the reported position of the contract depended on the successful outcome of these. Overall, the commentaries for these selected contracts highlighted specific risks relating to amounts totalling over £600 million as set out below[58]:

[58] The commentaries included amounts for each risk identified on each contract but did not calculate an aggregate amount for all the risks.

Aberdeen	Unagreed claims and "*challenging*" cost savings	£55.0m
Liverpool	Unagreed claims and potential liquidated damages	£36.0m
[…]		
Southmead	Unagreed claims	£9.9m
Battersea	"*Second reset*" of the contract to be agreed	£28.6m
[…]		
Nottingham	Future income	£16.2m
[…]		
Services Contract A	"*Delayed invoices*" and unagreed claims	£7.8m
[…]		
Msheireb	Unagreed claims and variations	£106.2m
Canada Contract A	Uncertified revenue and unagreed claim	£43.3m
Canada Contract B	Unagreed claims	£35.9m
Canada Contract C	Unagreed claims	£3.8m
Canada Contract D	WIP on a contract currently lossmaking	£41.0m
	Less "*local provisions*" held for Abu Dhabi Joint Venture and Oman	- £18.8m
		£609.2m

961.3 Following these commentaries, at page 20, KPMG set out what it described as "*Illustrative net exposure on higher risk contracts*" (the "**Page 20 Analysis**"), explaining that it represented "*one view of how, under a downside scenario, the higher risk contracts are exposed in terms of traded position*". This was set out in a table that comprised thirteen contracts or business areas[59] together with an amount for each described as its "*exposure*".

961.4 The "*exposure*" amounts totalled £257.4 million. There was no explanation (either in the commentaries or the Page 20 Analysis itself) for why the particular contracts had been characterised as "*higher risk*" and selected for inclusion, nor for why any of the "*other notable contracts*" had not been included. There was no explanation for why the adequacy of the provisions was assessed by reference to the £257.4 million "*exposure*" rather than the £609.2 million total of the contract risks identified in the report.

961.5 KPMG noted that in some areas Carillion's reported position was "*challenging*" but confirmed that it considered that overall the reported position was reasonable, having regard to the Group Provisions held.

962. KPMG therefore relied on the adequacy of the Group Provisions in reaching its conclusions on contracts; but:

962.1 had no proper basis to support the adequacy of the Group Provisions; and

962.2 did not address indications that the Group Provisions were likely to be insufficient in light of the risks that KPMG had identified during its audit, let alone other risks.

B. Risks on specific contracts identified during the 2016 audit

963. Carillion's financial statements reported an increase of 59% in amounts "*Due from customers for contract work*" in relation to construction contracts, far exceeding the increase in revenue.[60] This suggested that amounts that had been recognised on construction contracts were not being recovered from customers and so that risks in relation to these contracts, in particular of recovering amounts due from customers, had increased.

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[59] Including the Nottingham Contract, Aberdeen Contract, Liverpool Contract, another contract, four "Legacy" contracts, two Canadian contracts and two elements of Carillion's business in the Middle East. The Portsmouth Contract was also included but was considered to have a negative "*exposure*" of £10 million deducted from the calculation of total "exposure", due to a "*cautious approach*" on that contract.

[60] From £386.8 million as at 31 December 2015 to £614.5 million at 31 December 2016.

964. KPMG's working papers show that KPMG placed construction contracts it selected for detailed audit testing into one of five risk categories[61], two of which were classed as "*High risk*": "*High risk ongoing*", and "*High risk claim*". These categories were not defined and the criteria for each category were not explained. The following contracts were allocated to the "*high risk*" categories:

964.1 The Aberdeen Contract was categorised as "*High risk ongoing*", at least partly because Carillion needed to achieve "*ambitious cost savings*", and therefore the contract needed to:

> *"be discussed with Carillion Group in relation to the need for provisions".*

964.2 The Battersea Contract was categorised as "*High risk ongoing*", at least partly because there was a "*large value of claims unverified in the EOL forecast*".

964.3 The Liverpool Contract was categorised as "*High risk ongoing*", the "*main issues*" being claims, with the result that KPMG had:

> *"flagged the gap required to be recovered to the Group Audit Team to determine if a provision is held by Group or one is required as the potential exposure is significant".*

964.4 The Southmead Contract was categorised as "*High risk claim*".

964.5 Another contract was categorised as "*High risk ongoing*", with a comment in the working paper stating:

> *"KPMG have badged this contract as high risk and the need for provisions will therefore be discussed with Carillion Group."*

964.6 Another contract was categorised as "*High risk claim*".

964.7 A further contract was categorised as "*High risk ongoing*".

964.8 A further contract was categorised as "*High risk claim*".

964.9 A further contract was categorised as "*High risk claim*".

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[61] High risk ongoing, Low risk ongoing, High risk claim, Low risk claim, Not significant.

965. KPMG did not place service contracts or overseas contracts into risk categories. Nonetheless, as explained in Chapter 10, KPMG's working papers show that the Nottingham Contract, the Portsmouth Contract, and Services Contract A had been reported as either loss-making or breaking even, and that their reported positions depended on the recovery of significant and contentious amounts. The potentially onerous nature of these contracts meant that they also presented a higher risk.

966. When asked in interview about how risks identified on specific contracts during the audit were considered, members of the audit team stated as follows:

966.1 When asked about Carillion's portfolio of contracts as a whole, KPMG Senior Manager B said:

> *"So, with regards to -- so, on the UK Construction, division where I was the Junior Senior Manager on, I'd be going through and challenging my team, challenging the position taken, formulating with the guidance of Peter exactly which ones then needed to go up to the clearance meeting at the Construction-level, and which ones then needed to go up into group.*
>
> *In regards to the provision portfolio side, I wouldn't be involved in those; in the work papers that we did, we would be flagging contracts that had risks and needed to be considered by the Group Audit Team."*

966.2 KPMG Senior Manager B later said in relation to amounts for claims on the Battersea Contract:

> *"This £28 million, I'm not saying I'm happy with it, but it is being flagged up to the group team to make that decision. I'm not saying all of that £28 million is at risk, but it's a high-risk, ongoing contract: there's £28 million; the group team, Peter and* [KPMG Senior Manager A]*, need to determine what other risks are coming in from Canada, Services, Middle East and Oman as well, to then draw a conclusion on the level of provision."*

966.3 KPMG Senior Manager C was asked about correspondence during 2016, prior to main audit work in early 2017, in which KPMG Senior Manager C referred to a potential £10 million write off on the Nottingham Contract. In relation to the final position taken on the contract, KPMG Senior Manager C stated:

> *"we need a £10 million provision against the Nottingham contract, which was my final assessment and Peter's assessment in the Services division …*
>
> *… we were very sceptical again, about this, and that's why the £10 million provision was communicated as needed, against this contract …*

… it [£10 million] *was a round number sum that was -- Peter and my view on where a reasonable outcome would be on this contract. In our view, it was more likely that they would recover £10 million less, so whatever it is, £12 or £13 or £14 million, rather than the £24 million"*

… It was our judgement of the provision needed, against the risks within this agreement"

KPMG Senior Manager C confirmed that they understood that there would be a specific provision of £10 million for the Nottingham Contract and stated:

"my understanding is, there's some kind of central provision, and that £10 million of the central provision was allocated to Nottingham contract. But that was dealt with by the Group Team, effectively I would report that £10 million provision was needed, and then the Group Team would deal with how that central provision was allocated, and whether there are any differences to how Carillion had allocated it, and KPMG had allocated it."

967. The senior managers responsible for the UK construction and UK service components therefore understood that risks identified through their work would be considered when assessing the sufficiency of Group Provisions. KPMG's assessment of the sufficiency of the Group Provisions is considered in the next sections.

C. KPMG's assessment of the Group Provisions

(1) Introduction

968. KPMG's working papers provided details of how Carillion's management allocated Group Provisions (amounting to £47.1 million) to various risks, as follows:

	2016
Audit Committee Provisions:	
"*Services – EPT provision*"	£4.0m
"*Construction - portfolio provision*"	£5.0m
"*Construction - Major Contract Risks*" Including £1.0 million relating to "DEAP"	£12.0m
"*CESP in Services*"	£6.1m
Subtotal:	**£27.1m**
Other Provisions/Contingency:	
Services	£15.7m
Construction	£0.9m
Middle East	£2.0m
PPP relating to "*any future transaction costs in relation to recently completed disposals*"	£0.5m
Head Office described as "*a number of risks including intercompany and consolidation rounding and review.*"	£0.9m
Subtotal:	**£20.0m**
Total:	**£47.1m**

969. An additional £3 million, included in the amount of £50.1 million in the 2016 Year-End Audit Memorandum, was not explained but is understood to relate to a local provision held in one of Carillion's overseas components.

970. The Group Provisions therefore included a total of £12.5 million[62] in respect of risks relating to specific issues, with the balance of £37.6 million allocated to contract risks generally.

[62] £4.0 million for "Services – EPT provision", £1.0 million relating to "DEAP", £6.1 million for "CESP in Services", £0.5 million for PPP and £0.9 million Head Office.

971. In its main working paper on Group Provisions, "*AP500.3.0010 PROVISIONS WORKBOOK*", KPMG referred to two procedures to assess the amount of the Group Provisions as follows:

> *"From an audit perspective, we seek to track the various contract risks identified through our fieldwork and group reporting into these group central provisions. We also consider the paper prepared by group management which sets out their views on the basis for and, allocation of, these provisions."*

972. KPMG's performance of these two procedures is considered below.

(2) First procedure - tracking contract risks identified through audit fieldwork

973. As set out in Section B above, KPMG identified through its audit work on specific contracts instances where there were particular risks over amounts recognised such that a provision might be required.

974. KPMG's working paper "*AP500.3.0010 PROVISIONS WORKBOOK*" did not explain how these identified risks were "*tracked*" into the Group Provisions, but included a copy of the Page 20 Analysis set out in the 2016 Year-End Audit Memorandum stating:

> *"As documented in our ACD, KPMG have listed out the potential exposures on the higher risk contracts in the business units. This is then comapred to the total Group provisions and we then assess whether the total contract provisions held are appropriate given the potential exposures"*

975. The Page 20 Analysis was described in the Year End Audit Memorandum itself as an "*illustrative analysis (which should be viewed with caution)"* which showed "*just one view of how, under a downside scenario, the higher risk contracts are exposed in terms of traded position…*"

976. It is not clear whether KPMG intended this analysis to record either the performance or outcome of the first audit procedure. Mr Meehan was asked in interview about this procedure and stated that the Page 20 Analysis was:

> *"the bulk of the consideration of the adequacy of the 50 million provision"*

977. When asked:

> *"is there any judgemental connection in terms of the process you went through which starts from contracts, or groups of contracts, or components, or types of risk which feeds through into the ultimate conclusion and says, well, 50 is enough?"*

Mr Meehan answered:

> *"There's no other work paper that does that, no …*
>
> *… I have to say page 20 seems to be the closest".*

978. The Page 20 Analysis set out amounts totalling £257.4 million described as "*exposure*" in relation to thirteen contracts or business areas[63], and compared this total to Group Provisions of £50.1 million. KPMG then concluded as follows:

> *"total contract provisions are some 20% of the above exposures. Although illustrative, we take some comfort that the Group is provided at this level.*
>
> *The above reflects the way we broadly justify the level of centrally held provisions against known risks. Whilst very subjective, we note that last year's comparative schedule[64] on our file showed a similar coverage of 20%. This is largely driven by higher risks this year in construction in the UK, offset by lower exposures in UK Services"*

979. However, the Page 20 Analysis was inadequate to provide any comfort over the sufficiency of the provisions, for the following reasons:

979.1 There was no explanation for the selection of the thirteen contracts or business areas included in the analysis, nor for how the "*exposure*" amounts had been calculated.

979.2 The "*exposure*" amounts largely related to amounts which might not be recovered from Carillion's customers. KPMG did not ensure that it had identified other risks arising from, for example, claims made against Carillion or unforeseen additional costs.

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[63] Including the Nottingham Contract, Aberdeen Contract, Liverpool Contract, another contract, four "Legacy" contracts, two Canadian contracts, Canada Contract B and Canada Contract A, and two elements of Carillion's business in the Middle East, an Abu Dhabi Joint Venture and Oman/Qatar. The Portsmouth Contract was also included but was considered to have a negative "*exposure*" of £10 million deducted from the calculation of total "exposure", due to a "*cautious approach*" on that contract.

[64] It is not clear what is referred to here. No similar analysis for 2015 has been identified.

979.3 The "*exposure*" amounts incorporated a reduction of £10 million in respect of "*Portsmouth Car Park (cautious approach)*", where KPMG considered that Carillion's decision to recognise only 7.5 years of future car park income in the 2016 financial statements represented a "*cautious*" approach, so mitigating risks on other contracts. There was no basis for this approach being considered "*cautious*" – as set out in Chapter 16 the accounting treatment of income from Portsmouth car park changed in 2016, resulting in a substantial amount of future revenue being recognised in 2016.

979.4 KPMG treated the entirety of the £50.1 million as "*contract provisions*" and did not, in this analysis, consider the specific risks to which £12.5 million of Group Provisions had been allocated.

979.5 KPMG provided no explanation for why it could "*take some comfort*" that Group Provisions were 20% of the total "*exposure*" amount; the 20% threshold appeared to be arbitrary.

980. In addition, as noted above, KPMG had reported amounts relating to specific contracts that all depended on estimates and judgments and that totalled more than £600 million. Group Provisions were just 8% of this amount.

981. Further, KPMG did not consider how or whether risks on Carillion's portfolio of contracts overall, other than the thirteen contracts or business areas included in the Page 20 Analysis, were provided for. In particular:

981.1 KPMG had identified uncertainty over significant amounts on a number of contracts that it described as "*high risk*" which did not form part of this assessment;

981.2 the Page 20 Analysis took no account of risks relating to contracts on which KPMG had performed detailed testing but had not identified as "*high risk*"; and

981.3 the Page 20 Analysis also took no account of risks relating to the large proportion of Carillion's contracts over which KPMG had performed no detailed testing. This included contracts in UK construction and UK services accounting for revenue of £1.4 billion.

(3) Second procedure - consideration of management's paper

982. KPMG's second procedure in relation to Group Provisions was to:

> *"consider the paper prepared by group management which sets out their views on the basis for and, allocation of, these provisions".*

983. This work was set out in:

983.1 working paper "*AP500.3.0020 MANAGEMENT PROVISIONS PAPER*", the paper prepared by Carillion group management, and annotated by KPMG; and

983.2 working paper "*AP500.3.0010 PROVISIONS WORKBOOK*".

984. The first of these working papers, "*AP500.3.0020 MANAGEMENT PROVISIONS PAPER*" did not provide any evidence that could support a conclusion on whether the Group Provisions were sufficient. In particular:

984.1 KPMG's annotations on the working paper included various references to working paper "*AP500.3.0010 PROVISIONS WORKBOOK*". However, for the reasons given below, that working paper provided no audit evidence on the sufficiency of the Group Provisions. The references to it therefore provided no audit evidence.

984.2 Some of the annotations simply recorded that the information was consistent either with other information in that document, or in a similar document previously provided by Carillion.

984.3 Other annotations recorded that the information was consistent with "*KPMG's understanding*" or "*KPMG's knowledge*". There was, however, no explanation of what "*KPMG's understanding*" or "*KPMG's knowledge*" was or how it was derived. The value of this exercise was therefore negligible and provided no audit evidence on the sufficiency of the Group Provisions.

985. The second working paper "*AP500.3.0010 PROVISIONS WORKBOOK*" did not provide evidence on whether the amount of the Group Provision was reasonable and contained a number of matters that warranted further investigation:

985.1 Tab "*Background*" of the working paper, describing Carillion's use of the Group Provisions, stated:

> *"These provisions … avoids misleading fluctuations in financial performance arising from settlement or historic contract positions caused simply by timing of those settlements."*

This was at least *prima facie* inconsistent with IAS 11, which required that the reported performance of a contract should reflect the probable outcome of the contract, including any settlement, at the relevant date. The reported performance of a contract therefore should not incorporate adjustments to avoid "*fluctuations*", which, if validly recorded, would reflect fairly the performance of the contract portfolio and so would not be "*misleading"*. Indeed, recording adjustments to conceal those real fluctuations could itself be misleading. Consequently, using provisions with the express aim of avoiding fluctuations was inappropriate.

985.2 Tab "*Risk Analysis*" provided narrative on risks in four of Carillion's components. In each case, this narrative provided no explanation of how the risks described related to the amount of the Group Provision and no evidence on whether the amount of the Group Provision was reasonable.

985.3 Tab "*Movements*" explained a £3.5 million increase in the "*Other Group Provisions*" as follows:

> *"General increase of £1.7m given that during 2016* [the customer to the Nottingham Contract] *announced their intention to end the contract with the Group early in 2017 and the finalisation of the price adjustment mechanism in* [another contract] *has taken longer than expected, with negotiations continuing with the client.*
>
> *General increase of £0.9m given the revised cost to complete on Aberdeen, the additional amounts Carillion require on* [the Liverpool Contract] *and the trading back of the Battersea contract margin.*
>
> *A £0.9m provision in Head Office to provide against a number of risks including intercompany and consolidation rounding and review.*

Summary of Findings

The increase of £3.5m compared to December 2015 and increase of £3.7m compared to June 2016 appears reasonable and in line with KPMG's expectations given the increase in revenue and the risk summarised above."

Again, this narrative provided no explanation of how the risks described related to the amount of the Group Provision and no audit evidence on whether the amount of the Group Provision was reasonable.

985.4 Tab "*Segments*" purported to:

"consider the allocation of Group level provisions to the IFRS 8 operating segments as identified by the Group"

The tab set out a comparison of allocations of the Group Provisions to each of five segments in 2016 and in 2015. The tab set out no consideration of this allocation or any evidence concerning whether the amount of the Group Provision was reasonable.

985.5 The working paper indicated throughout that the "*TOTAL PROVISIONS - AT GROUP*" amounted to £47.1 million. KPMG did not explain how this was consistent with the £50.1 million shown in the Page 20 Analysis, which was also reproduced in the last tab of the working paper.

986. In addition, there were specific risks to which £12.5 million of the Group Provisions had been allocated by management, identified in working paper "*AP500.3.0020 MANAGEMENT PROVISIONS PAPER*", comprising:

986.1 £4 million for "*EPT NHI*"

Working paper *"AP500.3.0030 EPT SUMMARY PAPER*" set out a calculation of the expected liability of £3.8 million and concluded that the £4 million included in the Group Provisions was therefore sufficient.

986.2 £1 million for "*DEAP*"

The working paper embedded a position paper prepared by management setting out a brief history of a claim and a summary of legal advice received.

986.3 £6.1 million "*CERT & CESP*", on which the working paper stated:

> *"This dispute relates to a £12.0 million claim from* [a claimant company] *in respect of a contract under the Community Energy Savings Programme. Efforts to resolve this dispute through mediation have not proved to be successful and although high level discussions remain ongoing this matter could be subject to court proceedings and is now expected to go to trial in March 2017. We continue to retain a provision of £6.1 million and expect this to provide adequate cover against our exposure"*

Working paper "*TOD 05 .0010 CERT CESP POSITION PAPER 2016*" set out further details of the claim and a conclusion that it was "*deemed unlikely that Carillion would lose both the claims given their strong case of arguments against* [the claimant company]" and that the £6.1 million included in the Group Provisions was therefore reasonable.

986.4 £0.5 million for "*PPP*"

986.5 £0.9 million for "*a number of risks including intercompany and consolidation rounding and review.*"

987. Other than in relation to the "*EPT NHI*", KPMG recorded minimal evidence that the amount of the provision allocated to the risk was reasonable. In particular, for "*CERT & CESP*" only narrative details of the claims were recorded, together with an opinion on the likely outcome of the cases, with no corroborating evidence.

988. Overall, the consideration of management's paper on the Group Provisions was recorded in two main working papers and comprised:

988.1 verification that information in the paper prepared by Carillion was consistent with other information in that document or equivalent documents previously provided by Carillion;

988.2 a record that information was consistent with KPMG's "*understanding*" or "*knowledge*", with no further details or reference; and

988.3 narrative descriptions of contract risks and of the Group Provisions with no supporting evidence and no explanation or analysis for how the amount of the Group Provisions related to the risks described (other than in relation to the "*EPT NHI*" above).

D. Overall assessment

989. In its 2016 Year-End Audit Memorandum, KPMG described the audit work that it had carried out to address the significant risk concerning "*Recognition of contract revenue, margin and related receivables and liabilities*" as follows:

> *"In respect of the "Recognition of contract revenue, margin and related receivables and liabilities" risk, we consider that there are a small number of significant contracts on which the Group has a material potential exposure. When taking account local and central provisions, on balance, we are satisfied with the Group's traded profit on contracts but draw the Committee's attention to the illustrative contract exposure summary on page 20, which we considered in drawing our conclusion"*

990. The senior managers responsible for the UK construction and UK service components understood that risks identified through their work on specific contracts would be considered when assessing the sufficiency of Group Provisions. KPMG's commentaries on specific contracts highlighted judgements and estimates made in relation to amounts totalling more than £600 million. KPMG then concluded that overall the position was reasonable, in some cases stating that this was "*in view of*" or "*in conjunction with*" the Group Provisions.

991. KPMG's commentaries suggested that the Group Provisions were likely to be insufficient to address the risk across Carillion's portfolio of contracts. Further, the amounts highlighted in these commentaries were unlikely to represent the total level of risk over Carillion's contract portfolio as it did not incorporate risks relating to contracts which KPMG had not subjected to detailed testing.

992. Mr Meehan was aware that the Group Provisions (and the relevant audit work performed) might be inadequate in relation to risks relating to Carillion's Canada business. In an email to KPMG Senior Manager A on 6 February 2017 he stated:

> *"To explain, we need to plan ahead to H1 and them possibly taking a big bath on Canada, wrapped around a withdrawal from construction there. We will look dicks if our paper just says challenging but ok. So I want to specifically reference central provs in a way that if our files get looked at we can say we had it covered as an issue, albeit perhaps not enough but the difference is the post y/e decision to withdraw."*

993. However, the Page 20 Analysis and KPMG's other consideration of the Group Provisions provided no evidence for whether risk over Carillion's portfolio of contracts was sufficiently addressed by the Group Provisions. In particular, there is no evidence that Mr Meehan sought to reflect his concerns relating to the Canadian component by causing Carillion to increase the amount of the Group Provisions, by raising the point with the Audit Committee, or in any other way.

994. There were thus breaches by **the Respondents** in the **2016 audit** of:

994.1 **ISA 200 paragraph 15**, in that the Respondents did not approach this area with an adequate degree of professional scepticism, and so did not critically assess the substantial risk relating to Carillion's portfolio of contracts overall;

994.2 **ISA 330 paragraphs 5, 6 and 26**, in that, in response to the risks they had identified in relation to contracts, the Respondents did not adequately design or perform audit procedures in connection with the Group Provisions and did not consider all audit evidence relating to risk relating to contracts;

994.3 **ISA 500 paragraphs 6, 7, 9 and 11**, in that the Respondents:

994.3.1 failed to design and perform appropriate audit procedures to enable them to obtain sufficient appropriate audit evidence to assess risk over the contract portfolio and the sufficiency of the Group Provisions;

994.3.2 did not properly consider whether the evidence obtained from Carillion on the Group Provisions and portfolio risk relating to contracts was relevant and reliable; and

994.3.3 did not consider or respond to inconsistencies in evidence, in particular that risks relating to the contract portfolio were substantial and that Group Provisions were likely to be insufficient to address this risk; and

994.4 **ISA 540 paragraphs 8(c), 12, 13, 15, and 18**, in that the Respondents:

994.4.1 did not obtain an understanding of how the estimates and assumptions relating to Group Provisions had been made and the data on which those estimates and assumptions were based; and

994.4.2 did not adequately assess whether Carillion's estimates on the Group Provisions, assumptions relevant to those estimates, and processes for deriving those estimates and assumptions were appropriate and reasonable.

PART C

14. THE EARLY PAYMENT FACILITY

The Early Payment Facility (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 from £35 million as at 31 December 2012 to £472 million as at 31 December 2016.

As well as providing Carillion's suppliers with payments for their invoices within a shorter time, the EPF also provided Carillion with additional time to make its payments for these invoices. This 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. In January 2017, Carillion Director A estimated the impact on reported borrowing of the EPF as approximately half of the value of the invoices on the platform, indicating that Carillion's reported net borrowing was reduced by around £236 million at December 2016. However, the nature and scale of these arrangements, and their effect as an additional form of financing, were not disclosed in the financial statements.

Despite its significance, KPMG carried out minimal audit work on the EPF in 2014, 2015 and 2016. KPMG did not obtain a clear understanding of how the EPF operated and of its impact on Carillion's cash flows and reported net borrowing. KPMG could not, therefore, properly assess whether, in light of these matters, Carillion's financial statements gave a true and fair view of its financial position overall.

A. Overview

995. The EPF commenced with pilot schemes in 2010 and had become fully operational by the end of 2012.

996. A number of banks participated in the EPF. The primary providers of the facilities were EPF Bank A, EPF Bank B and EPF Bank C, with other banks providing additional credit capacity (the "**Banks**").

997. The EPF enabled suppliers to receive payment from the Banks for their invoices earlier than the payment terms agreed with Carillion. Carillion repaid the Banks at a later point, usually according to the payment terms formally agreed between Carillion and the supplier.

998. Suppliers using the EPF were, in theory, liable to the Banks for charges if they chose to receive payment of their invoices earlier than their invoice payment terms. However, suppliers using the EPF were required by Carillion to extend their standard invoice payment terms, on the understanding that they could receive payment in accordance with their pre-existing payments terms - or, in many cases, earlier - at no cost to themselves. Carillion agreed to pay the charges arising over the period between the suppliers' pre-existing payments terms and the extended payment terms.

999. Therefore, through the operation of the EPF, Carillion benefited from the extended period to settle its suppliers' invoices. It was widely understood within Carillion (and reflected in evidence obtained by KPMG) that the EPF provided Carillion with a significant cash flow benefit and that this represented additional financing for which Carillion bore at least part of the cost.

1000. The determination of the appropriate accounting treatment of Carillion's liabilities to the Banks, where Carillion's suppliers had been paid but Carillion had not yet repaid the Banks (the "**EPF Amounts**"), depended on the terms between Carillion, its suppliers, and the Banks, and how these worked in practice (the "**Terms**"). In general, however, it would be expected that the EPF Amounts would be treated either as:

1000.1 "*trade payables*", that is, as amounts due to suppliers in payment for goods or services and agreed in line with normal trading payment terms; or

1000.2 in whole or in part as "*borrowing*", that is, as amounts owed under *all sources of financing used to fund the Group's operations* and for which finance charges would normally be incurred.

1001. In Carillion's 2014, 2015 and 2016 financial statements, the EPF Amounts were included within "*other creditors*" - a sub-set of "*trade and other payables*" - with no disclosure explaining this treatment. This meant that, whilst the EPF Amounts were included within liabilities generally, they were not included as part of the reported net borrowing, nor identified as amounts owed to banks, nor otherwise explained. The amounts were also not included in trade payables, which would otherwise have shown a very substantial increase during the relevant period. The impact of the EPF on Carillion's financial position was, therefore, not apparent from its financial statements.

1002. As set out at paragraph 1010 below, the total value of the invoices on the EPF platform was substantial, being approximately £235 million as at 31 December 2014, £342 million as at 31 December 2015 and £472 million as at 31 December 2016.

1003. Given the significance of these amounts, and their substantial year-on-year increase, it was particularly important for KPMG to assess whether Carillion's financial statements enabled a clear understanding of the impact of the EPF and so gave a true and fair view of Carillion's financial position.

1004. KPMG was, therefore, required to obtain a sufficient understanding of the Terms in place during each period in order to assess whether Carillion's treatment of the EPF Amounts was appropriate.

1005. Prior to the 2014 audit, KPMG had considered the accounting treatment of the EPF twice, as follows:

1005.1 in 2010, KPMG's audit team sought technical advice from KPMG's Department of Professional Practice about how the EPF Amounts should be accounted for; and

1005.2 in 2012, KPMG's audit team considered the matter again following certain changes to the EPF.

1006. On both of these occasions, the consideration included identifying potential characteristics of the EPF which would indicate that all or a part of the EPF Amounts should be accounted for as "*borrowing*". These included:

1006.1 whether the EPF provided a cash flow benefit to Carillion; and/or

1006.2 whether Carillion was required to pay interest charged by the Banks.

In both 2010 and 2012, KPMG concluded that the EPF did not have these characteristics of "*borrowing*" and that "*trade payables*" was the appropriate accounting treatment.

1007. However, evidence available to KPMG in subsequent years indicated that the EPF did have both of these characteristics during 2014, 2015 and 2016, suggesting that, on KPMG's own analysis, all or part of the EPF Amounts would more appropriately have been accounted for as "*borrowing*".

1008. In the 2014, 2015, and 2016 audits, KPMG failed to design and perform adequate substantive audit procedures in respect of the EPF Amounts, and specifically:

1008.1 failed to obtain an accurate understanding of how the EPF operated or the Terms;

1008.2 failed to consider whether, in light of its understanding of the Terms, its previous conclusions on the correct accounting treatment of the EPF Amounts required reconsideration;

1008.3 failed to assess the appropriateness of Carillion's treatment of the EPF Amounts as "*other creditors*", particularly where it was inconsistent with KPMG's previous conclusions that the appropriate treatment was as "*trade payables*";

1008.4 failed to consider specifically whether all or part of the EPF Amounts should have been included within "*borrowing*"; and

1008.5 failed to ensure that appropriate disclosure was made in Carillion's financial statements concerning the accounting treatment of the EPF Amounts.

1009. This chapter is structured as follows:

1009.1 Section B describes Carillion's use of the EPF.

1009.2 Section C concerns the appropriate accounting treatment of the EPF Amounts.

1009.3 Section D concerns Carillion's accounting treatment of the EPF Amounts.

1009.4 Section E concerns KPMG's consideration of Carillion's accounting treatment of the EPF Amounts.

1009.5 Section F gives a summary and conclusion.

B. Carillion's use of the EPF

(1) The extent of the use of the EPF from 2012 to 2016

1010. According to an internal Carillion document titled "*2015 Cash Flow Summary*", the total value of invoices on the EPF platform increased substantially in each of the years from 2012 to 2016 as follows:

	2012	2013	2014	2015	2016
EPF Bank B	£35m	£104m	£102m	£103m	£108m
EPF Bank A	-	£40m	£109m	£129m	£205m
EPF Bank C	-	-	£24m	£110m	£159m
Total	£35m	£144m	£235m	£342m	£472m

(2) The operation of the EPF

(a) Descriptions of the EPF in Carillion's annual reports and accounts

1011. There are no descriptions of the EPF in Carillion's annual reports prior to 2014.

1012. The 2014 annual report recorded that payments totalling £977.6 million were made through the EPF. It was also stated that suppliers using the EPF were being paid either on the same terms as before, or in many cases up to 20 days earlier, at no cost to the suppliers, and that they also had the option to take payment even earlier, at minimal cost.

1013. The 2015 annual report stated that the EPF had been extended to cover 60% of Carillion's UK external spending on suppliers, with over 400 suppliers now using the facility.

1014. The 2016 annual report described the EPF as a "*sector leading supply chain finance offering*" which allowed Carillion's suppliers to obtain payment ahead of their contractual terms, thereby reducing their need for working capital and "*helping them grow and sustain local communities*".

(b) *Information provided by Carillion on its website*

1015. Throughout the relevant period, Carillion's website provided information about the operation of the EPF under the heading "*How does our Early Payment Facility work?*" and a link to a leaflet, dated 7 November 2012 and titled "*Carillion Early Payment Facility*" (the "**EPF Leaflet**").[65] These set out the following details of the EPF process:

1015.1 The supplier would raise an invoice, which Carillion would approve for payment.

1015.2 The supplier could opt to receive payment from the Banks either on the supplier's existing payment terms - typically up to 65 days - or sooner.

1015.3 Through a "*second element of the EPF Package*", the Supplier Incentive Scheme ("**SIS**"), Carillion ensured that suppliers could "*receive payments* either in line with their existing terms *or in many cases in advance of their existing terms, at no cost to themselves*".

1015.4 Carillion would then reimburse the Banks for the amounts paid to the suppliers, normally in line with the payment terms formally agreed with the supplier.

[65] A version of this leaflet was obtained by KPMG in the course of the 2012 audit.

1015.5 A "*third element of the EPF package*" was an agreement by the suppliers to change the formally agreed payment terms to provide for payment within 120 days. These extended terms would not in practice determine when the suppliers were paid by the Banks, but rather when Carillion was required to repay the participating bank.

1015.6 Despite the extension of the formally agreed terms, amounts settled under the EPF would, therefore, still comply with the shorter payment terms required under the Prompt Payment Code, Fair Payment Charter and other contractual terms relating to payment terms.

1016. Whilst Carillion stated in other documents that the extension of formally agreed terms to 120 days would apply "*irrespective*" of the suppliers' use of the EPF and that it would apply "*across the board*", its website presented the extension of payment terms as being a part of the "*EPF Package*". Carillion required suppliers using the EPF to agree to the extension but explained that agreement to the change would not impact when the suppliers were in fact paid or necessarily result in any financing charges being paid by the suppliers. In practice, therefore, Carillion used the EPF to obtain an extended period from, typically, 65 days to 120 days, to pay its suppliers, for which Carillion agreed to pay financing charges.

1017. The connection between the EPF and the extension of payment terms was acknowledged by the KPMG audit team in 2014. In an audit working paper titled "PR900.1 Process Activities", KPMG noted as follows (emphasis added):

> *"As of late 2012, Carillion have implemented a Reverse Factoring process in which to pay their suppliers. <u>Under the scheme suppliers allow a 120 day credit period to Carillion</u> but will be paid by the bank […]*
>
> *[…] Suppliers sign up to the Reverse Factoring scheme <u>and in doing so extend their credit terms to 120 days</u>."*

(3) The impact of the EPF on Carillion's borrowing requirements

1018. Carillion recognised the benefit it obtained from the EPF, stating on its website that the EPF gave it "*greater flexibility in terms of managing its own working capital*" and in the EPF Leaflet that the EPF was a "*mutually beneficial arrangement*".[66]

1019. The extent of the benefit to Carillion's working capital, and the consequent impact on reported borrowing, depended on the extent to which the operation of the EPF enabled Carillion to extend the period for it to make payment on its suppliers' invoices.

1020. Internal correspondence and documents within Carillion indicated that its senior management considered that the impact of the EPF on reported net borrowing was substantial, but estimates of the amount varied significantly. For example:

1020.1 On 19 and 20 January 2017, with the value of invoices on the EPF platform at 31 December 2016 standing at approximately £472 million, Carillion Director A wrote in emails to a member of the Audit Committee as follows (emphasis added):

> *"Externally, we've historically said that of £300 drawn under the EPF the benefit to net debt is c£100m. Based on this likes of* [a bank] *will assume that £470m translates into £155m benefit to net debt.* ***Difficult to say what the actual benefit to net debt is as this depends how much you could stretch your creditors in the absence of this facility. The range is obviously nil to £470m so you could say £235m*** *[…]*
>
> *[…] The £100m we quoted as being the favourable impact on debt was really an estimate.* ***Under the EPF we used to pay the banks on 120 days (its now 126 days) and it was assumed that before the EPF came along we on average took 80 days to pay our creditors. Difficult to be categoric about the benefit of EPF for net debt but it would be safe to assume that the actual benefit is around 50% as compared with the 1/3rd quoted externally*** *[…]*
>
> *[…] I'm not wedded to a number on this but the analysis was designed to illustrate that the underlying cash generation has had to be supported by these additional measures which we can't really continue to exploit indefinitely."*

1020.2 Also in January 2017, a Carillion director referred in an email to a Carillion non-executive director to Carillion's "*real underlying debt*" of "*approx. £800mn-£900mn*", stating:

> *"This number is post the positive affects of reverse factoring (+£350m) - extending supply payment terms, which we did in 2012."*

1020.3 In March 2017, Carillion Group management stated in an email to Carillion's Group Corporate Affairs team, that as part of some work performed for Carillion Director A the previous month, they had estimated that:

> *"the EPF facility ha[d] an average facility use of £339m, with an impact to net debt of £210m"*

1020.4 A Carillion presentation, apparently produced in July 2016, put the figure for "*Estimated cash benefit*" at £168 million, whereas a calculation in July 2017 of the estimated impact on cash of "*unwinding*" the payment terms agreed under the EPF put the figure at between £136 million, assuming Carillion would pay all suppliers 95 days after the month end (which it was acknowledged "*may not be possible*"), and £288 million, assuming Carillion would revert to its "*previous terms*".

1021. Carillion management therefore understood that although the impact of the EPF on reported borrowing depended on the extent to which Carillion could "*stretch*" its creditors in the absence of the facility, the impact on reported borrowing, and thus on its overall financial position, was very significant.

C. The appropriate accounting treatment and related disclosures for the EPF Amounts

1022. IFRS contained no guidance that dealt specifically with facilities such as the EPF.

1023. However, IAS 8 paragraph 10 provided as follows:

> *"In the absence of an IFRS that specifically applies to a transaction, other event or condition, management shall use its judgement in developing and applying an accounting policy that results in information that is:*
>
> *(a) relevant to the economic decision-making needs of users; and*
>
> *(b) reliable, in that the financial statements:*
>
> *(i) represent faithfully the financial position, financial performance and cash flows of the entity;*
>
> *(ii) reflect the economic substance of transactions, other events and conditions and not merely the legal form;*
>
> *(iii) are neutral, ie free from bias;*
>
> *(iv) are prudent; and*
>
> *(v) are complete in all material respects."*

1024. The appropriate accounting treatment of the EPF, therefore, depended on (*inter alia*) its economic substance and its impact on Carillion's reported financial performance.

1025. If the substance of the EPF was that:

1025.1 the supplier would receive payment from the Bank by way of an advance, using its receivable as collateral;

1025.2 the supplier would retain a right of action against Carillion;

1025.3 the arrangement did not affect the date on which Carillion had to make payment;

1025.4 the payment by Carillion to the Bank simultaneously discharged its own obligations to the supplier and the supplier's obligations to the Bank; and

1025.5 the Bank's fees and interest charges were borne by the supplier,

then it might have been appropriate to treat the outstanding liabilities of Carillion as "*trade payables*".

1026. On the other hand, if the substance of the arrangement was that:

1026.1 Carillion's obligation to the supplier would be extinguished and replaced by an obligation to the Bank;

1026.2 Carillion obtained a cash flow benefit in that the date on which it settled its obligations was materially later than it would otherwise have been; and

1026.3 Carillion incurred expenses as a result of the arrangement, in the form of bank fees and/or interest charges,

then the arrangement would have had characteristics similar to bank financing and it might have been appropriate to treat the outstanding liabilities of Carillion to the Bank(s) as "*borrowing*".

1027. Determining the appropriate accounting treatment for the EPF Amounts thus required a careful analysis of the features of the EPF and the Terms and their substance and effect on Carillion's reported financial position. Where there were any material changes over time, the analysis would have to be revisited to ensure that the accounting treatment remained appropriate.

1028. The following matters concerning the operation of the EPF from 2012 onwards would have been of particular relevance to that judgement:

1028.1 that, from the date on which the invoice would have been payable in the absence of the EPF until the date on which Carillion was liable to pay the Bank under the EPF (120 days, or later 126 days from the date of the invoice, or from the month end), the EPF conferred a cash flow benefit on Carillion.

1028.2 that Carillion agreed to pay the finance costs for the period between the suppliers' pre-existing payment terms and the extended payment terms determining when Carillion reimbursed the Banks, albeit it apparently did not undertake a legal obligation to do so; and

1028.3 that the use of the EPF, and hence the scale of the cash flow benefit conferred on Carillion, increased substantially from year to year.

1029. Further, IAS 1 required Carillion to disclose in its financial statements:[67]

1029.1 judgements made in applying its accounting policies that had the most significant effect on the amounts recognised in the financial statements; and

1029.2 sub-classifications of line items where appropriate to reflect the amounts, nature, and timing of liabilities.

1030. In view of the significant amounts involved (many times the level of materiality), the significant cash flow benefit apparently derived by Carillion and the level of judgement required in establishing the appropriate accounting policy, Carillion was, therefore, required to disclose sufficient details of the judgements made and sub-classifications showing the amounts involved to enable users of the financial statements to understand the impact of the EPF on Carillion's financial position and performance.

D. Carillion's accounting treatment of the EPF Amounts

1031. Carillion included the EPF Amounts in "*other creditors*" and so treated them neither as "*trade payables*" nor as "*borrowing*". Carillion Director B confirmed this in an interview with the FRC on 18 June 2018, in which they stated:

> *"A creditor if they weren't on the system would be in trade creditors, so show as a trade creditor. If they came on to the system then their liability, they're trade creditor, when it got settled by the bank yes, would move to other creditors, yeah, because that was the payment that Carillion then had to make to the bank; didn't have to make it to the trade creditor because they'd already been paid by the bank so it was shown in other creditors."*

1032. There were no disclosures made in any of the 2014, 2015 and 2016 financial statements concerning either the accounting treatment of the EPF Amounts or the impact of the EPF on Carillion's financial position.

[67] Paragraphs 58, 77, 78 and 122.

E. KPMG's consideration of the accounting treatment of the EPF Amounts

(1) The 2010 Carillion Paper

1033. In 2010, Carillion prepared a paper titled "*Background to Carillion Reverse Factoring Initiative*" (the "**2010 Carillion Paper**") in relation to arrangements similar to the EPF operating before its full introduction in 2012. A copy of the paper was provided to KPMG in the course of the 2010 audit.

1034. According to the 2010 Carillion Paper, Carillion had identified a number of characteristics of the proposed arrangements which determined that Carillion's liabilities under the arrangements should be treated as "*trade payables*" rather than debt or "*borrowing*". In particular, the 2010 Carillion Paper made the following observations:

1034.1 The purpose of the arrangements was not "*at least at this stage*" to improve Carillion's working capital, because Carillion would pay the Bank on the same day (day 65) as it would normally pay the supplier. The intention was "*to assist suppliers in obtaining affordable credit*".

1034.2 Carillion would pay only the face value of the invoice to the Bank. It would receive no commission from the Bank but would negotiate an additional discount from suppliers using the facility. However, this discount would be negotiated "*outside the structure*" and as part of the larger "*supplier step up*" programme.

1034.3 The facility would not affect the timing of Carillion's cash flows in respect of payment, early payment discounts, credit notes or interest. Carillion would continue to pay in full on the existing agreed supplier terms.

1035. Overall, Carillion considered that the correct accounting treatment of the payments covered by the scheme would be "*a continuing classification as trade payables*".

(2) The 2010 Memorandum

1036. KPMG then prepared a memorandum in which it concluded that Carillion's liabilities under the arrangements should be included as "*trade payables*" (the "**2010 Memorandum**"). In reaching this conclusion, KPMG noted that:

1036.1 the suppliers' payment terms were a maximum of 65 days, in line with current supplier payment terms;

1036.2 the payment terms remained consistent for Carillion, in that it was still required to pay the invoices 65 days after they were approved; and

1036.3 Carillion was not required to pay interest to the Banks, which instead charged the supplier for drawing down cash sooner than 65 days after approval of the invoices.

(3) The 2010 DPP Paper

1037. Also in the 2010 audit, KPMG prepared a document titled "*Query to DPP – Accounting & Reporting*" (the "**2010 DPP Paper**"), which recorded a query submitted by the audit team to KPMG's Department of Professional Practice ("**DPP**").

1038. The audit team's analysis, as set out in the 2010 DPP Paper, included the following:

1038.1 the amount to be paid by Carillion remained equivalent to the invoice amount, whether or not the supplier drew down early payment from the Bank;

1038.2 Carillion's supplier payment terms of 65 days continued to apply;

1038.3 Carillion would receive no fees from, and pay no interest to, the Bank, apart from an initial set-up fee; and

1038.4 accordingly, the liabilities should remain classified as "*trade payables*".

1039. The DPP team's response, as set out in the 2010 DPP Paper, was as follows:

> *"We agree that, after taking into account the reverse factoring agreement set out above, that its remains appropriate to classify the amounts payable to the supplier as a trade payment rather than a liability owed to the bank."*

1040. However, the paper also noted as follows:

> *"It is not intended that Carillion will obtain extended credit terms under this arrangement. Any instances where extended credit is obtained would need to be reconsidered given the decision set out below."*

(4) 2010 Summary

1041. In summary, in the 2010 audit, KPMG concluded that liabilities under the proposed arrangements should be classified as "*trade payables*" and not as "*borrowing*" because:

1041.1 Carillion would pay the Banks on the same day (for example, day 65) as it would normally pay the supplier, meaning that the facility would not affect the timing of Carillion's cash flows; and

1041.2 Carillion was not required to pay interest to the Banks, which instead charged the supplier for drawing down cash sooner than the invoice would otherwise be paid (for example, day 65).

1042. However, KPMG noted that this conclusion would have to be reconsidered in the event that, under the arrangement, Carillion obtained extended credit terms.

(5) The 2012 Working Paper

1043. In the 2012 audit, KPMG prepared a working paper titled "*Reverse factoring accounting treatment*" (the "**2012 Working Paper**"), which considered changes made to the arrangements since the analysis performed in 2010. The 2012 Working Paper stated as follows:

> *"Carillion have experienced further pressures on their own working capital. As a result of this, and in line with current industry trends, they have proposed to increase their standard payment terms with all suppliers to 120 days (regardless of whether the reverse factoring facility is used by that supplier)."*
>
> *"The terms of the reverse factoring facility are being extended from 65 days to 120 days in line with Carillion's revised supplier payment policy."*
>
> *"Carillion is no longer to receive a nominal fee from suppliers using the facility (in the form of payment discounts)."*

1044. Thus, KPMG concluded that the EPF Amounts should (in their entirety) continue to be treated as "*trade payables*" because:

1044.1 the timing of Carillion's payments to settle its suppliers' invoices and the payment terms agreed with suppliers were both unaffected by the EPF; and

1044.2 Carillion was neither deriving a financial benefit nor incurring a "*penalty*" from its suppliers' use of the EPF.

1045. However, the 2012 Working Paper did not include or refer to sufficient evidence to show:

1045.1 that the new payment terms of 120 days applied to all suppliers;

1045.2 that the extension of payment terms was consistent with current industry practice; or

1045.3 that Carillion was neither deriving a benefit from, nor paying a cost for, the use of the EPF. The working paper did not refer to the arrangements described on Carillion's website, under which Carillion agreed to pay the financing costs covering the period of the extension.

1046. Further, the 2012 Working Paper did not consider the extent to which the suppliers' agreement to the extension of payment terms, and the consequent cash flow benefit to Carillion, depended on the availability of the EPF, and Carillion's promise that:

> *"suppliers could receive payments either in line with their existing terms or in many cases in advance of their existing terms, at no cost to themselves"*

(6) Other advice to Carillion

1047. In an email dated 23 October 2012 to Carillion Group management, the Carillion Group finance team wrote:

> *"Following my call with KPMG tonight we have confirmed that:*
>
> *- they are happy with treating the factoring as a creditor and not debt as long as we can demonstrate that:*
>
> > *§ we will be moving all suppliers to 120 days*
> >
> > *§ 120 days is a reasonable level of payment terms to have (we need to provide them with evidence – I have asked* [Carillion Group management] *to gather something on this and to get the list that* [a bank] *stated)*
> >
> > *§ they will not be happy if we include anything in the written communications about our potential contribution to costs and therefore we agreed that this will be dealt with through the verbal communication (I have updated* [Carillion's Group Corporate Affairs team]*and* [they are] *sending through the script later).*
>
> *KPMG will not formally sign off until they have sent the evidence on the payment dates, however, I have agreed with* [Carillion Director B] *that we will not hold up the process for this and therefore we can start communications tomorrow."*

1048. The email was then forwarded to Carillion Director B and other Carillion executives. It is not clear what evidence was provided to KPMG thereafter.

1049. Carillion remained aware of the advice regarding its contribution to EPF costs. On 4 April 2017, Carillion's Group Corporate Affairs team emailed Carillion Director A, stating:

> *"The really tricky thing, which I expect you're aware of, is that KPMG insist that we cannot pay the fees that our EPF partner banks charge our suppliers and nor can we even mention in the same sentence that the incentives we pay to suppliers are to reimburse the fees they have paid to the banks, otherwise the EPF will be treated as debt."*

1050. Thus, KPMG had advised that, if Carillion paid a "*contribution*" to the costs of the EPF, or agreed in writing that it would, then it would be necessary for the EPF Amounts to be accounted for as "*borrowing*". This was notwithstanding that, as noted at paragraph 1015.3 above, Carillion's website included details of the SIS from the commencement of the operation of the EPF, stating that suppliers could "*receive payments either in line with their existing terms or in many cases in advance of their existing terms, at no cost to themselves*".

(7) The 2014 audit

1051. The 2010 DPP Paper was included in the 2014 audit file but it is not clear whether the audit team considered its contents during the audit.

1052. In a working paper on the 2014 audit file titled "*4.6.1.G.8.21 Other NewFeb17th*", KPMG noted as follows:

> *"All reverse factoring goes through* [Entity A] *and other entities then have a debtor obligation to* [Entity A]*. Therefore the overall creditor balance lies within* [Entity A] *hence this is the only entity which will include reverse factor credit balances. However the credit is no longer to the supplier but instead the obligation is with the bank. Therefore this is a finance creditor as opposed to a trade creditor.*
>
> *As a result it is appropriate to journal out the reverse factoring finance creditors into other creditors […]*
>
> *The increase is to do with reverse factoring as seen below:*
>
> [EPF Bank B] *Reverse Factoring [£] 102,300,000*
>
> [EPF Bank A] *Reverse Factoring [£] 107,400,000*
>
> [EPF Bank C] *Reverse Factoring [£] 33,000,000*
>
> *Total (agreed to journal) [£] 242,700,000*
>
> *Summary:*
>
> *The journal was initiated by an appropriate individual and recorded in the correct accounting period. Furthermore the journal is consistent with accounting standards and in line with prior year thus in line with KPMG's understanding."*

1053. Accordingly, KPMG knew that, in the financial statements, within "*trade and other payables*", Carillion had included the EPF Amounts in "*other creditors*". This was inconsistent with the conclusion – reached in 2010 and confirmed in 2012 – that the amounts should be accounted for as "*trade creditors*". KPMG provided no support or explanation for its conclusion that the treatment was "*consistent with accounting standards and in line with prior year thus in line with KPMG's understanding*".

1054. There are no other working papers on the 2014 audit file which record any consideration of the correct accounting treatment of the EPF Amounts, nor is there any evidence that the agreements with the Banks or Carillion's suppliers were reviewed in order to determine the correct accounting treatment of those amounts.

(8) The 2015 audit

1055. There are no working papers on the 2015 audit file which record any consideration of the correct accounting treatment of the EPF Amounts, nor is there any evidence that the agreements with the Banks or Carillion's suppliers were reviewed in order to determine the correct accounting treatment of those amounts.

(9) The 2016 audit

(a) Introduction

1056. There are no working papers on the 2016 audit file which record any consideration of the correct accounting treatment of the EPF Amounts, nor is there any evidence that the agreements with the Banks or Carillion's suppliers were reviewed in order to determine the correct accounting treatment of those amounts.

1057. However, as set out below, the 2016 audit file includes working papers that show that:

1057.1 KPMG was in possession of evidence demonstrating that Carillion expected its suppliers' use of the EPF to reduce its reported net borrowing;

1057.2 KPMG knew that Carillion had in fact included (or at least that it was its normal practice to include) the EPF Amounts under "*other creditors*" in the group accounts; and

1057.3 the only substantive audit work undertaken by KPMG on the "*other creditors*" balance was to agree it to the corresponding account in Carillion's consolidation accounting software.

(b) Information provided to Carillion's Board of Directors

1058. A working paper titled "*2.5.1.0010 Oct 2016 Board Minutes*" contains notes of information provided to Carillion's Board of Directors in October 2016, including the following (emphasis added):

> "*Cash Update*
>
> *Average Net Borrowing 2016*
>
> - *Average net borrowing for 2016 is forecast to be (£530.0 million) in Budget.*

- *This potentially deteriorates to (£536.0 million) after including opportunities of £11.6 million in relation to reverse factoring, £9.2 million in relation to the potential* [Outsourcing] *contract extension, £7.0 million in relation to* [a project] *and £1.2 million in relation to* [another project] *less £35.0 million relating principally to unfavourable FX movements […]*

[…] Average Net Borrowing 2017

- *Average net borrowing for 2017 is currently included in the Business Plan at (£510.0 million).*

- *This potentially improves to (£335.0 million) after including opportunities of £50.0 million in relation to additional reverse factoring, £40.0 million in relation to a potential sale of the Health business, £40.0 million in relation to the potential* [Outsourcing] *contract extension, £30.0 million in relation to* [a project] *and £15.0 million in relation to* [another project] *(including the impact of reverse factoring).*"

1059. A working paper titled "*2.5.1.011 Nov 2016 Board Minutes*" contains notes of information provided to Carillion's Board of Directors in November 2016, including the following (emphasis added):

> "*Minutes of the Board Meeting of 5 October 2016*
>
> *[…] Presentation: Cash, operational and strategic impacts*
>
> *The average net debt has increased form £40m to £540m in the last five years (likely to reach £560[m] by year end). Factors relevant to the year-end position include additional reverse factoring …*
>
> *It was noted that the Group liquidity profile in the context of the business plan was not necessarily understood by investors.*"

1060. These working papers show that KPMG knew that:

1060.1 Carillion saw "*opportunities*" arising from the use of the EPF as a means of reducing its reported "*net borrowing*" or "*net debt*";

1060.2 the amounts of these "*opportunities*" were material; and

1060.3 Carillion was aware that its "*liquidity profile*", which necessarily included the effect of the EPF on its cash flows, was "*not necessarily understood by investors*".

(c) <u>*Substantive testing of EPF Amounts*</u>

1061. A working paper titled "*4.6.4.A.2 Act Consol 2016*" shows a credit balance of £497.9 million under "*Other Creditors and Accruals*" for the "[Entity A] *Balance sheet entity*", which, as set out at paragraph 1052, was the entity that included the EPF Amounts.

1062. A working paper titled "*3.3.1.0080 Other Creditors*" documented the testing of "*Other Creditors*" within Carillion Construction. It referred, as follows, to the treatment of two balances under the EPF:

> "*In 2015 the* [EPF Bank C] *reverse factoring balance was discussed with Group Finance as the balance had been mapped to this account instead of Group where it was confirmed that the reverse factoring balances are held within Other Creditors. Therefore there was no adjustment to reclass this balance in the prior year at consolidation level (only for stats). In the current year this has been included correctly at Group level and is therefore no longer present in the Buildings Other Creditors. Furthermore the [Group Audit Team] will audit the reverse factoring, so no further work proposed.*
>
> *[…]*
>
> *The DEBA balance is in relation to pods bought for the Battersea contract. The payments are made through [the EPF] and hence due to system limitations a manual payment has to be made from* [Outsourcer A] *and a journal posted to remove these balances from creditors. However this balance was originally posted in trade creditors, therefore there is a credit balance remaining in the trade creditors account which has not been correctly offset against the payment now made.*"

1063. A working paper titled "*3.3.1 Substantive Procedures for Non-Significant Accounts*" set out details of substantive procedures undertaken for "*non-significant*" accounts, which included "*other payables and accruals*" of £1,104.1 million (representing the total of "*other creditors*" (£760.5 million) and "*accruals and deferred income*" (£340.9 million) as set out in note 18 to the 2016 financial statements). As to the substantive procedures undertaken on the balance of "*other payables and accruals*" (including "*other creditors*"), the working paper:

1063.1 recorded that the "*other payables and accruals*" were "*Agreed to* […] *on the BS as work performed by components*"; and

1063.2 referred to a further working paper titled "*4.6.2.E.N20.1 Carillion Annual Report 2016*", which confirmed that "*other creditors*" of £760.5 million had been agreed to Carillion's financial reporting software.

1064. There are no working papers that document any other substantive testing of the EPF Amounts.

1065. Thus, the only substantive audit work undertaken by KPMG on the "*other creditors*" balance of £760.5 million in the 2016 financial statements was to agree it to the corresponding account in Carillion's consolidation accounting software.

F. Summary and conclusion

(1) KPMG's consideration of the EPF before 2014

1066. In 2010, when Carillion's liabilities under the EPF were payable on the same payment terms (typically up to 65 days) that would have applied in the absence of the EPF, KPMG concluded that the EPF Amounts should be treated as "*trade payables*". KPMG reached this conclusion largely on the basis that the payment terms were not changed, providing no cash flow benefit to Carillion, and that Carillion bore none of the finance charges.

1067. In 2012, Carillion informed KPMG that it proposed an increase in the payment terms agreed with its suppliers to 120 days and that this would be reflected in the Terms of the EPF. KPMG reconsidered the accounting treatment and again concluded that the EPF Amounts should continue to be treated as "*trade payables*". KPMG reached this conclusion on the grounds that the extension of payment terms to 120 days applied to all suppliers, was not linked to the use of the EPF, and was consistent with current industry practice, and that Carillion was consequently deriving no benefit from the use of the EPF.

1068. KPMG did not consider the extent to which the suppliers' agreement to the extension of payment terms, and the consequent cash flow benefit to Carillion, depended on the availability of the EPF.

1069. KPMG had also advised Carillion that, if Carillion either paid or contributed to the fees charged by the Banks to Carillion's suppliers in connection with the EPF, then it would be necessary for the EPF Amounts to be accounted for as "*borrowing*". However, KPMG did not consider or refer to the impact of SIS described on Carillion's website, under which Carillion bore the financing costs covering the period of the extension of payment terms.

(2) KPMG's consideration of the EPF in the 2014, 2015, and 2016 audits

(a) The accounting treatment of the EPF

1070. KPMG gave no further consideration to the correct accounting treatment of the EPF Amounts in the 2014, 2015, or 2016 audits. It performed no audit work:

1070.1 to obtain an accurate understanding of how the EPF operated; or

1070.2 to assess the appropriateness of the accounting treatment of the EPF Amounts adopted by Carillion.

1071. KPMG knew that Carillion had included (or at least that it was its normal practice to include) the EPF Amounts under "*other creditors*" in the group accounts, but did not consider whether this was appropriate. In particular:

1071.1 KPMG did not consider whether (consistent with the 2010 and 2012 audit work) the EPF Amounts should have been accounted for as "*trade payables*"; or

1071.2 whether all or part should have been accounted for as "*borrowing*" instead of "*other creditors*".

1072. KPMG did not review the agreements with the Banks or Carillion's suppliers in order to gain an understanding of:

1072.1 the effect of those agreements on Carillion's payment obligations; or

1072.2 the financing charges payable under those agreements.

KPMG therefore failed to gain an understanding of the economic substance of the arrangements and the impact on Carillion's financial position and performance.

1073. There is no evidence that KPMG, in the course of the audits, considered its conclusions in 2010 and 2012 that the EPF Amounts should be classified as "*trade payables*", or considered whether, in light of the information available to them, the basis for these conclusions continued to be robust.

1074. This was despite the fact that it was clear amongst Carillion management that the EPF enabled Carillion to secure the extension of payment terms to its suppliers, with the consequent benefit to Carillion's working capital and impact on its reported borrowing.

1075. KPMG did not identify these matters, nor that, where the Banks were providing what was in substance a financing arrangement to Carillion, Carillion was likely to be paying some form of interest charges or fees. Even though, in 2012, KPMG had advised Carillion that, if this were the case, the EPF Amounts would have to be accounted for as "*borrowing*", KPMG failed to obtain any evidence to show whether this was the case.

(b) *Disclosures concerning the EPF in the financial statements*

1076. KPMG gave no consideration to what, if any, disclosures concerning the EPF needed to be made in Carillion's financial statements.

1077. KPMG should have recognised the following:

1077.1 The accounting policies, judgements, and disclosures in relation to the EPF were significant matters, because:

1077.1.1 the EPF Amounts were very substantial;

1077.1.2 the appropriate accounting treatment was not straightforward;

1077.1.3 they potentially affected the reported level of Carillion's borrowing, reflecting its liquidity, and so were of significant interest to stakeholders; and

1077.1.4 the accounting treatment of the EPF Amounts, and in particular whether all or part should have been classified as "*borrowing*", had a knock-on effect on a range of other disclosures made in the financial statements.

1077.2 The disclosures in Carillion's annual reports were potentially misleading in that they emphasised that Carillion's suppliers were receiving a cash flow benefit without providing any indication that Carillion was also receiving a significant cash flow benefit.

1077.3 As a result, Carillion's financial statements did not present a true and fair view in that:

1077.3.1 there was no reference in the financial statements to the accounting policies adopted by Carillion in respect of the EPF Amounts;

1077.3.2 there was no reference in the financial statements to any judgements made by management in applying Carillion's accounting policies in respect of the EPF Amounts; and

1077.3.3 the fact and scale of the cash flow benefit to Carillion from the operation of the EPF was not apparent.

(c) *Substantive testing*

1078. Although the EPF Amounts had increased from £35 million in 2012 to £472 million in 2016, including an increase by over £130 million in 2016 alone, KPMG conducted no substantive testing of the EPF Amounts in the 2016 audit other than agreeing the "*other creditors*" balance of £760.5 million in the financial statements to the corresponding account in Carillion's consolidation accounting software. Consequently, KPMG obtained no audit evidence in relation to the audit assertion of valuation.

(3) Conclusion

1079. In light of the matters set out in this chapter, KPMG failed to design and perform adequate audit procedures in respect of the EPF.

1080. There were thus breaches by the Respondents in the **2014, 2015, and 2016 audits** of:

1080.1 **ISA 200 paragraph 15**, in that the Respondents did not approach this area with an adequate degree of professional scepticism, and so did not critically assess evidence, in particular failing to make a critical assessment of whether the Banks were, in effect, providing Carillion with substantial additional financing;

1080.2 **ISA 315 paragraph 11(c)**, in that the Respondents did not perform audit work to enable them to understand or evaluate the appropriateness of Carillion's accounting treatment and disclosure of the EPF Amounts, including in particular (a) whether the conclusion previously reached by the Respondents that the EPF Amounts should be treated as "*trade payables*" had remained valid; or (b) whether Carillion's accounting treatment of the EPF Amounts as "*other creditors*", which was not consistent with the Respondents' previous conclusion, was appropriate; or (c) whether all or part of those amounts should have been treated as "*borrowing*";

1080.3 **ISA 330 paragraph 18**, in that the Respondents failed to design or perform any audit procedures for a material class of transaction, account balance, and/or disclosure;

1080.4 **ISA 500 paragraph 6**, in that the Respondents failed to design and perform appropriate audit procedures to enable them to obtain sufficient appropriate audit evidence to support (a) the correct accounting treatment of the EPF Amounts; or (b) the quantum of the EPF Amounts; and

1080.5 **ISA 700 paragraph 9(b) and 9(c)**, in that the Respondents failed to evaluate (a) whether Carillion's financial statements adequately disclosed its accounting policy in relation to the EPF Amounts; or (b) whether Carillion's accounting policy in relation to the EPF Amounts was consistent with IFRS and appropriate.

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15. THE 2016 OUTSOURCING TRANSACTIONS

At the end of 2016, Carillion entered into a group of contracts with Provider A, its provider of outsourced services. These included provision for payments totalling £40 million by Provider A to Carillion for the purchase of various intellectual property rights, as well as payments by Carillion to Provider A for an expanded range of outsourced services for an extended period. The accounting treatment for the initial payment by Provider A to Carillion increased the profit reported by Carillion in the 2016 financial statements by £34.2 million, and thus materially improved Carillion's position.

KPMG identified a significant risk that the contracts were dependent on each other and that, as a result, the income from the sale of the intellectual property rights should be spread over the life of the outsourcing contract. However, KPMG failed to audit the accounting treatment of the contracts properly, and failed to respond appropriately to evidence that suggested the treatment adopted was inappropriate and that no profit at all should have been recognised. KPMG showed a lack of scepticism and objectivity in relation to judgments made by Carillion's management.

A. Overview

1081. In December 2013, Carillion had entered into an outsourcing agreement with Provider A, by which Provider A provided various business support services to Carillion. The agreement was set out in a Master Services Agreement, within which Carillion and Provider A acknowledged their mutual intention to enter into a further agreement whereby Carillion agreed to license to Provider A various rights relating to Ecopod, a clean energy product. Provider A paid Carillion £27 million for the Ecopod licence and also paid a further £14 million, described as a "contribution" to "exit fees" payable by Carillion to its previous supplier ("**previous supplier**") - a total of £41 million.[68] KPMG's audit work in 2013 in relation to these transactions is the subject of its own separate *Final Settlement Decision Notice*.

[68] The contribution to exit fees payable to the previous supplier related to an earlier outsourcing agreement that Carillion entered into with the previous supplier in 2009. That agreement encompassed essentially the same services as the 2013 agreement, but also provided for the previous supplier, at the commencement of the contract, to pay Carillion £40 million. This sum comprised £30 million described as an "inducement payment" and two payments of £5 million each described as "mobilisation costs" and "discount". The agreement provided for a proportion of this cash to be repaid if the agreement was terminated early, reducing through the term. By 2013, this amount had reduced to £14 million.

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1082. On 5 December 2016, Carillion entered into four new agreements with Provider A as follows:

1082.1 Carillion and Provider A agreed to extend the existing outsourcing agreement (the "**Outsourcing Extension**"). Under the Outsourcing Extension, which was recorded in seven "*Contract Change Notes*":

1082.1.1 Carillion would pay Provider A a total of approximately £166 million over 10 years; but

1082.1.2 Provider A would immediately pay Carillion £10 million (characterised as a contribution to mobilisation costs incurred by Carillion); and

1082.1.3 Carillion would provide Provider A with a letter of credit in the sum of £30 million (as security against the risk of early termination of the Outsourcing Extension).

1082.2 Carillion and Provider A entered into three agreements relating to Carillion's intellectual property (collectively the "**IP Transactions**"), under which Provider A would pay Carillion a total of £30 million. Specifically, the IP Transactions were as follows:

1082.2.1 an assignment and licensing agreement of "*Geneva*", Carillion's computer-aided facilities-management system, under which Provider A would immediately pay Carillion £20 million (the "**Geneva Sale**");

1082.2.2 an assignment and licensing agreement for some of Carillion's "*proprietary processes for facilities management and construction systems*", under which Provider A would immediately pay Carillion £5 million (the "**UK IP Sale**"); and

1082.2.3 an assignment and licensing agreement for some of Carillion Canada's "*proprietary processes used in connection with finance systems*", under which Provider A would immediately pay Carillion £5m (the "**Canada IP Sale**").

1083. Collectively, the Outsourcing Extension and the IP Transactions are referred to as the "**2016 Outsourcing Transactions**".

1084. Carillion determined that the Outsourcing Extension and the IP Transactions were not linked and accounted for them as separate, independent, arm's length transactions. This approach increased Carillion's reported revenue for 2016 by £20 million and its reported profits for 2016 by £34.2 million, thus materially improving Carillion's position as shown in the 2016 financial statements.

1085. KPMG identified a significant risk that the 2016 Outsourcing Transactions were linked and that, as a result, the income from the sale of the intellectual property rights should be spread over the life of the Outsourcing Extension. KPMG should have considered specifically whether any revenue should have been recognised at all, and the risk that, in light of the impact on reported profit, Carillion's adopted treatment was affected by management bias. This risk was apparent in particular from the following matters:

1085.1 the transactions were being negotiated simultaneously and were entered into at or around the same time, and between the same counterparties;

1085.2 Carillion provided no evidence other than representations to support the market value of the intellectual property assigned in the IP Transactions;

1085.3 the transactions were entered into at the end of the financial year and resulted in a significant improvement in Carillion's reported profit for 2016; and

1085.4 KPMG was told that there had been speculation within Carillion that the 2016 Outsourcing Transactions were a *"contrived deal"*, in that Provider A was simply adding the money that it was paying to Carillion under the IP Transactions to the price it was charging Carillion under the Outsourcing Extension.

1086. Further, the 2016 Outsourcing Transactions was the third occasion on which Carillion had awarded an outsourcing contract and at the same time obtained an upfront cash payment from the supplier. In 2009, the payment had been accounted for as a creditor, so Carillion had obtained a cash flow benefit but with no, or minimal, impact on revenue and profit. In 2013, the entire payment of £41 million had been recognised in the income statement, with a corresponding increase in profit, with KPMG having accepted Carillion's treatment of the different elements of the agreements between it and Provider A as not linked.

1087. KPMG had been Carillion's auditor in 2009 and 2013. Peter Meehan had "*shadowed*" the engagement partner in 2013, attending various meetings with Carillion alongside the engagement partner in preparation for becoming the engagement partner on the 2014 audit. He was aware in 2016 of the similarities between the 2013 and 2016 transactions. In addition, KPMG Senior Manager A was a manager on both the 2013 and 2016 audits and was aware of the details of the transactions in both audits. In any event, the similarity between these transactions was obvious and should have caused KPMG to approach the 2016 transactions with heightened scepticism.

1088. However, despite these facts, KPMG accepted Carillion's representations that the 2016 Outsourcing Transactions were not linked:

1088.1 without designing and implementing audit procedures adequate to ascertain the position;

1088.2 without obtaining sufficient appropriate audit evidence as to the fair value of either the Outsourcing Extension or the IP Transactions;

1088.3 despite having obtained audit evidence suggesting that the accounting treatment adopted was inappropriate; and

1088.4 with a lack of professional scepticism and objectivity.

B. Background

(1) IFRS requirements

1089. IAS 18 paragraph 13 provided:

> *"The recognition criteria in this Standard are usually applied separately to each transaction. However, in certain circumstances, it is necessary to apply the recognition criteria to the separately identifiable components of a single transaction in order to reflect the substance of the transaction. For example, when the selling price of a product includes an identifiable amount for subsequent servicing, that amount is deferred and recognised as revenue over the period during which the service is performed. Conversely, the recognition criteria are applied to two or more transactions together when they are linked in such a way that the commercial effect cannot be understood without reference to the series of transactions as a whole. For example, an entity may sell goods and, at the same time, enter into a separate agreement to repurchase the goods at a later date, thus negating the substantive effect of the transaction; in such a case, the two transactions are dealt with together."*

1090. Therefore, where the commercial effect of a transaction could only be understood by reference to one or more other transactions, the criteria for recognising income arising from those transactions should be applied to those transactions together.

(2) Initial information provided to KPMG on the 2016 Outsourcing Transactions

1091. KPMG (Mr Meehan) first became aware of the intended transactions at a meeting with Carillion (Carillion Director B and Carillion Director A) at 14:30 on 29 September 2016.

1092. In advance of the meeting, Carillion Director B prepared briefing documents for KPMG setting out a very brief outline of what Carillion Director B had called "*Transaction 1*" and "*Transaction 2*":

1092.1 Transaction 1 consisted of the IP Transactions. Carillion Director B's document showed a payment of £30 million from Provider A to Carillion in connection with Transaction 1.

1092.2 Transaction 2 was the Outsourcing Extension. Carillion Director B's document showed *"c£160m"* payments from Carillion to Provider A over 10 years in connection with Transaction 2, but with a £10 million payment from Provider A to Carillion immediately as mobilisation costs. Carillion Director B's summary of the Outsourcing Extension included a reference to having the contract's value benchmarked by external consultants.

1093. After the meeting:

1093.1 At 17:04 on 29 September 2016, Mr Meehan emailed KPMG Senior Manager A stating as follows:

"[Outsourcing] *deal was discussion. Inc sale of Geneva system ip to them not linked for £30m profit.!!!!"*

1093.2 At 16:45 and 17:06 on 29 September 2016, Carillion emailed Mr Meehan (among others) details of two meetings to be held on 3 October 2016 as follows:

1093.2.1 "[Outsourcing] *Pre Meeting*" to which Mr Meehan, Carillion Director B, a partner at Solicitor Firm F acting for Carillion on the 2016 Outsourcing Transactions), Carillion Director A and Carillion Senior In-House Lawyer A, were invited; and

1093.2.2 "[Outsourcing] *Meeting - Monday 3rd October*" with an agenda listing Mr Meehan, Carillion Director B, the partner at Solicitor Firm F, a solicitor at Solicitor Firm F, and various others from Carillion as attendees.

1093.3 At 18:06 on 29 September 2016, Mr Meehan forwarded the agenda for the second meeting to KPMG Senior Manager A and KPMG Senior Manager B stating:

> *"FYI. Few of us there - not just me. No probs for us. But note* [Solicitor Firm F] *there so pretty serious they think obviously! Keep to yourself"*

1093.4 On 30 September 2016 at 13:43, Mr Meehan sent an email to KPMG Senior Manager A and KPMG Senior Manager B with the subject "*Chat yesterday*". Attached to the email were two photographs of a document resembling Carillion Director B's internal briefing document, apparently provided to Mr Meehan at the meeting, on which he had made various manuscript notes.

(3) Meetings on 3 October 2016

1094. The meetings to discuss the proposed 2016 Outsourcing Transactions were then held a few days later on 3 October 2016. These comprised, as planned:

1094.1 A "*pre-meeting*" between Carillion Director B, Carillion Senior In-House Lawyer A, Mr Meehan and the partner at Solicitor Firm F, which was scheduled for 14:45.

1094.2 A meeting with a larger group of Carillion employees (including Carillion Director B, a member of Carillion Group management and a member of Carillion Group finance team), Mr Meehan and the partner at Solicitor Firm F, which was scheduled for 15:00.

1095. There is no record that Mr Meehan made a note of either meeting. However, a note made by the partner at Solicitor Firm F, apparently of the second meeting, records as follows:

> "[Carillion Director B] - *purpose of meeting: because speculation that this is a contrived deal, we want to ensure that everyone understands + is comfortable with everything we are trying to do. Carillion would not do anything inappropriate* […]
>
> […]
>
> – [Carillion Director B]*: some people have suggested the transactions are linked +* [Provider A] *will add consideration for transaction 1 to transaction 2 charges. We have no idea how much they will make out of the contract.*
>
> *– To ensure vfm* [value for money] *we need to be sure that we are paying less than it costs us.*
>
> *+ use* [a valuation expert] *to benchmark pricing.*

> *Peter Meehan – benchmarking is key. Could we go to market?*
>
> [Carillion Director B] – *market wouldn't take this seriously ∵* [because] *we are reliant on* [Provider A].
>
> […]
>
> [Partner at Solicitor Firm F] – *No reason to say 1 transaction can't happen without the other.*
>
> [Carillion Director B] – *It's likely that we wouldn't do the IP deal w/o* [without] *the other."*

1096. The note indicates that at the second meeting:

1096.1 Carillion Director B told Mr Meehan that the purpose of calling the meeting was because there had been "*speculation that this is a contrived deal*" and "*we want to ensure that everyone understands + is comfortable with everything we are trying to do. Carillion would not do anything inappropriate*". Specifically, Carillion Director B explained that it had been suggested within Carillion that the monies to be paid under the IP Transactions (which Carillion Director B collectively called "*Transaction 1*") would be added by Provider A to the charges levied for the Outsourcing Extension (which Carillion Director B called "*Transaction 2*").

1096.2 Carillion Director B also stated that Carillion could not 'go to market' for the Outsourcing Extension but it intended to have the price that it was paying under the Outsourcing Extension assessed (or "*benchmark[ed]*") by an independent consultant. Mr Meehan expressed the view that this was "*key*".

1096.3 The partner at Solicitor Firm F stated that there was "*no reason to say*" that one of the transactions couldn't take place without the other.

1096.4 But Carillion Director B indicated that Carillion would be unlikely to proceed with the IP Transactions without also agreeing to the Outsourcing Extension.

(4) Benchmarking exercise in November 2016

1097. The benchmarking exercise proceeded during November 2016. On 29 November 2016, Carillion Group management emailed the valuation expert's final valuation report to KPMG Senior Manager A. It set out a range between £148 million and £186 million.

1098. Shortly afterwards, on 30 November 2016, KPMG Senior Manager A emailed Mr Meehan, stating as follows:

> *"I am minded to get our specialists to review the workings and liaise with these guys – what do you think?*
>
> *They've given a more than £38m range which hardly seems precise and could easily encompass the licence and other bits!!"*

1099. However, no KPMG specialists were asked to review the expert valuation, nor was any work undertaken by KPMG or requested from Carillion to narrow the range provided in the valuation expert's report, despite KPMG Senior Manager A's concern that it "*could easily encompass the licence and other bits*".

1100. KPMG Senior Manager A then discussed the valuation with the valuation expert and Carillion in a telephone call on 6 December 2016 (the day after Carillion had signed the contracts for the 2016 Outsourcing Transactions). The contents of this call are dealt with below.

(5) Audit Committee meeting on 1 December 2016

1101. Carillion's Audit Committee met on 1 December 2016.

1102. In advance of the meeting, KPMG prepared a document titled "*Carillion plc Audit Strategy and Controls Update*". On page 7, under the heading "*Complex accounting judgements*", KPMG stated:

> *"A potential licence sale is being considered with* [Provider A] *and we have been involved in initial discussions with management on both accounting and disclosure.* […] *We will evaluate both matters for significance at the year end and reconsider our risk assessment accordingly, reporting to you on our results."*

1103. Mr Meehan then attended the meeting. The minutes record the following:

> *"Mr Meehan presented his Audit Discussion Memorandum.* […] [Mr Meehan] *described in detail the accounting review of the proposed* [Outsourcing] *transactions, noting the similarities to the 2001*[69] *Ecopod sale. An external valuation of the* [Outsourcing] *work had been obtained from external specialists, and the proposed cost of work stood within the range involved. He noted that he had received representations from management in relation to the structure of the transaction and noted that the software which was proposed to be sold to* [Provider A] *had been the subject of external approaches. He also noted his discussions with* [Solicitor Firm F]*, and indicated that in order to confirm his accounting judgement he would need sight of the contracts, the valuers' engagement letter, the details of the valuation process and benchmarks.*
>
> *Responding to* [a member of the Audit Committee]*, Mr Meehan confirmed that KPMG was comfortable with the proposed transaction in accounting terms; the issue was simply what disclosure would be required.* [Carillion Director B] *summarised the position by saying that in principle* [they] *understood that KPMG was confirming that it was happy with the transactions, and the proposed accounting for them, but needed to do the detailed accounting disclosure work. Mr Meehan confirmed that this was the case."*

1104. These minutes were subsequently supplied to KPMG as part of the pack for the 23 February 2017 Audit Committee meeting and were approved at that meeting, also attended by KPMG.

(6) Finalisation of the 2016 Outsourcing Transactions

1105. The final contractual documents between Carillion and Provider A for the 2016 Outsourcing Transactions were signed on 5 December 2016, but not dated. They were dated on 9 December 2016 after Carillion confirmed receipt of cleared funds to the value of £40m from Provider A.

1106. Copies of the CCNs[70] for the Outsourcing Extension, signed and dated 9 December 2016, were supplied to KPMG on 20 December 2016. No signed or dated versions of the contracts for the IP Transactions were sent to or obtained by KPMG.[71]

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[69] Assumed to be an error and should read 2013.

[70] Contract Change Notes through which the Outsourcing Extension was recorded.

[71] Unsigned and undated copies of the documents relating to the IP Transactions were provided to KPMG: KPMG Senior Manager A commented "*will need signed ones of course*" but KPMG did not obtain them.

(7) The 2016 Year-End Audit Memorandum

1107. KPMG presented the 2016 Year-End Audit Memorandum to the Audit Committee on 23 February 2017. In relation to the 2016 Outsourcing Transactions, the Memorandum stated as follows:

> *"we have reviewed the various contracts for the different transactions and note that they are legally separate, signed on different dates, and do not cross refer; and we have held a meeting with* [the valuation expert] *to understand their methodology for calculating the fair value of the outsourcing package, challenged their assumptions and confirmed our understanding. Further, during our enquiries of the Group's legal advisors (*[Solicitor Firm F]*) they confirmed it was not uncommon for a number of contracts to be entered into simultaneously, but independently with the same counterparty. On balance, the outsourcing extensions appear to be at fair value which imply the licence and IP sales are not linked to these extensions."*

(8) Carillion's accounting for the 2016 Outsourcing Transactions

1108. In its 2016 financial statements, Carillion accounted for the £40 million of cash received from Provider A pursuant to the 2016 Outsourcing Transactions as follows:

1108.1 £20 million from the Geneva Sale as revenue, with a corresponding increase in reported profit;

1108.2 £5 million from the Canada IP Sale as a sale of an intangible asset with a reported value of £1 million. The £4 million surplus on this sale was treated as a reduction to administrative costs, with a corresponding increase in reported profit;

1108.3 £5 million from the UK IP Sale as a reduction to administrative costs, with a corresponding increase to reported profit; and

1108.4 £10 million from what had been characterised as a contribution to mobilisation costs under the Outsourcing Extension, which was split and accounted for as follows:

1108.4.1 £5.2 million as a reduction to administrative costs, with a corresponding increase to reported profit; and

1108.4.2 £4.8 million as a creditor, to be accounted for as a reduction to administrative costs in 2017.

1109. The 2016 Outsourcing Transactions overall resulted in a £40 million increase in reported cash and £34.2 million increase in reported profit in 2016.

C. Audit work

(1) KPMG's principal working paper

1110. KPMG's principal working paper for its audit work on the 2016 Outsourcing Transactions was titled "*AP500.3.1.A0* [Outsourcing] *TRANSACTIONS*". It contained the following seven tabs:

1110.1 one titled "*Professional Judgement*", in which KPMG recorded its reasoning on the evidence it had gathered;

1110.2 one titled "*Disclosure*", in which KPMG recorded its views on the level of disclosure about the 2016 Outsourcing Transactions proposed by Carillion in its 2016 financial statements;

1110.3 four dealing with the IP Transactions (one for each of the Geneva Sale and the UK IP Sale, and two separate tabs (with differing contents) for the Canada IP Sale); and

1110.4 one recording KPMG's conclusions in relation to the £10 million of mobilisation costs paid by Provider A under the Outsourcing Extension.

1111. In the "*Professional Judgement*" tab, KPMG stated that it had "*considered the separability of*" the Geneva Sale (not the other IP Transactions) and the Outsourcing Extension. As to this:

1111.1 KPMG stated that it had considered whether these two transactions "[we]*re linked and therefore whether they ha*[d] *been carried out at fair value when considered as independent contracts and whether the revenue ha*[d] *been recognised correctly"*. KPMG added that this question was "*not dependent on any external factors but instead depend*[ed] *on the substance of both transactions and the related contract spefications and legal outlook*".

1111.2 Under the heading "*Evaluate Information*", KPMG then summarised the audit procedures performed. In summary, these comprised:

1111.2.1 examination of the contracts;

1111.2.2 meeting Carillion's valuation expert; and

1111.2.3 discussions with Carillion's legal advisers.

1111.3 KPMG's ultimate conclusion was, "*The license agreement* [i.e., the Geneva Sale] *could be deemed independent from the extension to the scope of services provided by the Group's outsourcing provider* [i.e., the Outsourcing Extension]".

1112. No clear explanation was provided for how KPMG had reached the conclusion that the Geneva Sale and the Outsourcing Extension were not linked. However, it appears that KPMG relied on the evidence it had obtained as demonstrating that:

1112.1 the Outsourcing Extension was at fair value;

1112.2 in light of the above, the IP Transactions were implicitly at fair value; and

1112.3 the transactions were legally separate.

1113. Audit evidence obtained to support the accounting treatment of the 2016 Outsourcing Transactions is set out below.

(2) Audit evidence relating to the fair value of the Outsourcing Extension

1114. Carillion supplied the final valuation expert report to KPMG on 29 November 2016. It consisted of a page-and-a-half of text, and a four-page attachment (setting out a list of the documents supplied to the valuation expert, the degree to which the valuation expert had reviewed those documents, and some specific comments on them).

1115. The valuation expert report was heavily caveated and contained a number of limitations. In particular:

1115.1 The valuation expert reported that they had been "*asked by Carillion to perform a rapid and high level review*".

1115.2 The review was based on information provided by Carillion. In particular, the valuation expert had "*not reviewed the final versions of the CCNs*", but understood from Carillion that they were "*consistent with the documents in Attachment 1*". In addition, in "Attachment 1" to their report, the valuation expert noted a number of limitations on the information provided.

1115.3 The valuation expert had not reviewed one of the seven elements of the contract relating to Canada, instead including an unspecified amount based on the "*current budget provision*" in their amount for the contract as a whole.

1115.4 The valuation expert had only considered their "*benchmark market price rates*" and not the reasonableness of the estimated quantities to which these rates were being applied in order to arrive at the total amount. The valuation expert stated that it had been instructed by Carillion not to consider the accuracy of those resource estimates. The valuation expert stated:

"Note that the level of the overall charge depends on the accuracy and robustness of the estimated volumes of resources proposed. We understand that these estimates have been made by [Provider A] *in discussion with Carillion and further assume that they will have been driven by factors which would include their assessment of functional and technical complexity, design approaches, allocation of roles and other dependencies, none of which we have reviewed and we can therefore provide no opinion on their accuracy."* [emphasis added]

1115.5 This was reaffirmed where, under the heading "For the avoidance of doubt", the valuation expert had stated:

"We did not address whether the quantity of resource which [Provider A] *proposes to deploy is appropriate. Our approach has been to use the* [Provider A] *resource quantity estimates ('q') and to apply our benchmark market price rates ('p') to arrive at the comparable market charge range ('p' x 'q')."*

1115.6 The valuation expert had also stated that:

"Carillion expressly asked us not to assess the capability of [Provider A] *to deliver the programme, nor to assess whether* [Provider A]*'s overall estimates are based on complete and robust assumptions".*

Consequently, the opinion given in the report was:

"limited to what could reasonably be assessed in the limited timescale and through review of the documentation made available to us".

1116. KPMG should have identified from these passages that very limited reliance could be placed on the valuation expert's report. In particular, the report stated that the quantity estimates had been arrived at on the basis of discussions between Carillion and Provider A, and the valuation expert had stated expressly that it had done no work at all to verify that the resource quantity estimates were accurate or reasonable. This meant that any desired value of the equation 'p' x 'q' could be produced simply by altering the numerical values of 'q' (the quantity estimates), which were being supplied to the valuation expert by Carillion.

1117. Given that KPMG had been told on 3 October 2016 that there had been speculation within Carillion that this was a *"contrived deal"*, KPMG should have been alert to the risk of manipulation of the benchmarking process by management and realised that the valuation expert's ability to provide independent evidence supporting the overall value of the Outsourcing Contract was severely compromised.

1118. The quantity estimates had supposedly been arrived at on the basis of discussions between Carillion and Provider A. The involvement of Provider A provided only limited comfort to KPMG. If the contracts were indeed a *"contrived deal"*, as KPMG had been told some people within Carillion had speculated was the case, then Provider A evidently could not be relied upon by KPMG as an independent source.

1119. The valuation expert commented on document CCN142 as follows: "*Updated scope and scale of the actual CCN with updated volumes. Differed significantly from initial brief and from earlier email clarifications. Used as the final basis for our assessment*". This comment revealed that there had been material changes in the quantity estimates during the audit. There was no explanation for the changes, and this further undermined the sufficiency and reliability of the valuation expert's report as audit evidence.

1120. The fact that the valuation expert had stated that it had simply not reviewed the Canadian component meant that there was no evidence about that component <u>at all</u> in the valuation expert's report, even though it had been given a value of £35 million.

1121. KPMG recorded in the Audit Memorandum that they had:

> *"held a meeting with* [the valuation expert] *to understand their methodology for calculating the fair value of the outsourcing package, challenged their assumptions and confirmed our understanding".*

1122. Evidence of the meeting is contained in a note of a telephone discussion between the valuation expert, KPMG Senior Manager A and Carillion Group management which took place on 6 December 2016. The note recorded:

1122.1 In relation to Provider A's resource quantity estimates, the note stated at paragraph 3.2, "*They then did look at estimates from* [Provider A] *for reasonableness & completeness of volume for the quoted works.* [The valuation expert] *confirmed that they were satisfied with the planning and approach and that the scope looked reasonable – there were no obvious gaps in the extension of services*". However, this was inconsistent with the express statements in the report that the valuation expert had not reviewed and could "*provide no opinion*" on Provider A's resource estimates, but there was no attempt to resolve this inconsistency. There was apparently no discussion on the "*updated volumes*", which the valuation expert had observed "*Differed significantly from initial brief*", and what impact that might have had on the reasonableness of the estimates.

1122.2 In relation to Canada, the note recorded, "*Although not provided in detail,* [the valuation expert] *confirmed that the Canada outsourcing proposals seemed a reasonable estimate.* [The valuation expert] *had seen notes on the proposals and Carillion had committed to place business as part of the BPO/*[outsourcer] *implementation."* This also contradicted the express statement in the valuation expert's report that the valuation expert had not reviewed the "*Canada BPO 10-Year Arrangement*", but had "*simply included the current budget provision made by Carillion within our total estimates*", and again there was no attempt to resolve this inconsistency.

1122.3 The note records no discussion of any of the other express limitations and caveats in the valuation expert's report referred to above.

1122.4 The note records no 'challenge' from KPMG about the "*broad assumptions*" on which the valuation expert had stated its estimates had been based, as recorded in the Audit Memorandum.

1123. KPMG did not consider whether a discussion of the valuation expert's report <u>in the presence of Carillion</u> might inhibit the discussion. Given that KPMG was supposed to be assessing the risk that Carillion was entering into a *"contrived deal"*, it was an elementary precaution to arrange to discuss the valuation expert's report without Carillion.

1124. There is no evidence to show that KPMG considered whether the valuation expert had been examining the correct contractual arrangements for the Outsourcing Extension. The valuation expert's report stated that the valuation expert had not examined the final contract documentation but had relied on representations from Carillion that it was similar to the draft documents provided. KPMG was sent the final CCNs on 20 December 2016 but there is no evidence that KPMG considered checking the final contract documentation for consistency.

1125. KPMG did not consider why the valuation expert had been "*asked by Carillion to perform a rapid and high level review*", when their review was completed in November 2016, in advance of the transactions being finalised by Provider A, and whether the limitations in their report could be addressed before the financial statements were finalised.

1126. Finally, none of the work performed by KPMG addressed the key issue (which KPMG Senior Manager A had identified immediately on receipt of the valuation expert's report) that, as well as providing weak evidence regarding the fair value of the Outsourcing Extension, the size of the range encompassed the entire value of the licence and "other bits", and so provided no evidence at all regarding the fair value of the other elements of the 2016 Outsourcing Transactions.

(3) Audit evidence relating to the fair value of the IP Transactions

1127. The KPMG audit team recognised that direct evidence of whether the Geneva Sale was at fair value would have provided persuasive audit evidence. In particular:

1127.1 On 14 October 2016, KPMG Senior Manager A sent an email to Mr Meehan on the topic of evidencing that the Geneva Sale was separate from the Outsourcing Extension, in which they stated, "*Prefer FV of licence as well as contract to make it less judgemental*".

1127.2 On 17 November 2016, KPMG Senior Manager A sent an email to Carillion to which they attached a document in which they had commented on the proposed disclosure in the 2016 financial statements relating to the 2016 Outsourcing Transactions. In response to a paragraph dealing with the independence of the transactions, KPMG Senior Manager A commented:

> *"This para is good. From an audit perspective I would also much prefer the licence agreement to be fair valued by an external expert."*[72]

1127.3 On 30 November 2016, KPMG Senior Manager A forwarded the newly received valuation expert report on the Outsourcing Extension to Mr Meehan and commented:

> *"Don't find the range particularly helpful. They should have FV the software as I asked".*

1127.4 The "*Professional Judgement*" tab of KPMG's principal working paper titled "*AP500.3.1.A0* [Outsourcing] *TRANSACTIONS"* referred to KPMG considering:

> *"whether <u>the two transaction</u> […] <u>have been carried out at fair value</u> when considered as independent contracts [and] the costs of <u>each of the respective elements</u> and […] the fair value of <u>each element</u>" (emphasis added).*

1128. Despite the above, KPMG obtained no independent audit evidence which directly assessed whether the Geneva Sale or the other IP Transactions had been at fair value.

[72] KPMG Senior Manager A's comments were specifically in response to two sentences which read "*Management concluded that the transactions should be recognised independently and in their own right. This judgement was made after engaging an independent third party to verify that the contracts relating to the extension in scope to the outsourced back-office service provider were at fair market value and were therefore not linked to the licensing agreement.*"

1129. KPMG instead relied on a paper prepared by Carillion in relation to the Geneva Sale and on reasoning to the effect that if the Outsourcing Extension was at fair value, it must follow that all of the IP Transactions were also at fair value.

1130. The paper prepared by Carillion, titled "*Sale of IP Geneva FINAL*", was embedded in KPMG's work paper "*AP500.3.1.A0* [Outsourcing] *TRANSACTIONS*". In the paper, Carillion made various assertions about the demand for such software and stated that "*The £20 million consideration* [was] *clearly supported*" by those assertions. Carillion also claimed to have "*had conversations*" with third parties about buying the Geneva intellectual property, and that "*consideration was proposed*" and "*discussed"* in comparable amounts. No supporting evidence for any of these matters was sought or received by KPMG.

1131. The paper also made clear that Carillion was itself engaged on a significant project to update its own facilities management software, including the Geneva system, creating a new technology platform, but that:

> *"Carillion has no obligation to provide updates, enhancements or share future developments with* [Provider A]*. Furthermore, there is no requirement to provide any other on-going support in respect of the technology."*

1132. This suggested that the Geneva technology might shortly be obsolete, and the cost of upgrading the system would fall on Provider A.

1133. There is no evidence that KPMG gave any detailed consideration to this paper, or any challenge of management's assertions.

1134. KPMG's reasoning regarding the fair value of the Outsourcing Extension depended entirely on evidence from the valuation expert. For the reasons set out above, this provided insufficient evidence that the Outsourcing Extension was at fair value and, in light of the range of values, insufficient evidence that the IP Transactions were at fair value.

(4) Audit evidence relating to discussions with legal advisers

1135. KPMG also relied on discussions with Carillion's legal advisers in relation to whether the 2016 Outsourcing Transactions were linked or not. The tab "*Professional Judgement*" included the following:

1135.1 "*We first considered whether the licensing agreement could be deemed independent from extension to the scope of services provided by the Group's outsourcing provider by examining the terms of the respective contracts and meeting with the Group's legal advisors*";

1135.2 "*we sought to understand the cost of each of the respective elements and consider the fair value of each element, which included meeting with both the Group's third party expert and legal advisors to understand their valuation and benchmarking process for the outsourcing arrangements, the expert's historical experience and challenging the assumptions used*"; and

1135.3 "*Peter Meehan (Audit Partner) met with Carillion lawyers to discuss this transaction, speifiall its seprability,* during *the meeting it was confirmed to contracts are separate and signed on different dates*".

1136. In addition, in the 2016 Year-End Audit Memorandum, KPMG stated, "*during our enquiries of the Group's legal advisors (*[Solicitor Firm F]*) they confirmed it was not uncommon for a number of contracts to be entered into simultaneously, but independently with the same counterparty*".

1137. The only meeting which had taken place between KPMG and Solicitor Firm F was that of 3 October 2016. Despite the reliance placed on the contents of the meeting, KPMG did not prepare a note. Whilst the only available note of the meeting (that of the partner at Solicitor Firm F) records the partner at Solicitor Firm F stating that there was "*No reason to say 1 transaction can't happen without the other",* it also recorded that Carillion Director B, had said "*It's likely that we wouldn't do the IP deal w/o the other*".

1138. Neither the fact that the various transactions were documented in separate contracts, nor the terms of those contracts, established that they were not linked; the very issue for KPMG to determine was whether they were linked <u>in substance</u>. The comment recorded from Carillion Director B suggested that they were linked in substance, and this was consistent with all the other circumstantial evidence.

(5) Audit work in relation to mobilisation costs

1139. A separate tab of KPMG's working paper "*AP500.3.1.A0* [Outsourcing] *TRANSACTIONS*" recorded KPMG's work on the £10 million which Provider A was paying to Carillion as a contribution towards Carillion's mobilisation costs.

1140. KPMG confirmed the obligation on Provider A to make the payment, and receipt of the payment by Carillion. KPMG also received a paper from management explaining the accounting treatment to be adopted, and a schedule of amounts evidencing the costs Carillion had incurred and expected to incur.

1141. The majority of the costs were salaries of Carillion employees. Carillion management had carried out an exercise to calculate the amounts that were referable to mobilisation. KPMG identified three relevant issues arising from this exercise:

- *How the personal used in the calculation were identified*

- *How the wages cost for each individual was obtained*
- *How the percentage of their time allocated to the projects was calculated*

1142. KPMG recorded a brief account of how the exercise had been performed, relying entirely on assertions from management. KPMG performed no audit work to check or verify any part of the exercise or to address the specific issues identified.

1143. Despite the limited nature of this audit work, KPMG concluded:

> *"KPMG believe the costs incurred to date appear rasonable given the work performed in realtion to mobilistaion of the Project Rio and Office Services*[73] *- the governance works spans both areas and therefore is related to both areas in proportion to the total costs incurred on each. Given the Tokyo project*[74] *is set to start in 2017 the majority of the mobilisation work is expected to be completed by year end 2017 so taking 52% of the total costs to date appears reasonable. There is no risk of overstatement, so the completeness of the data is not applicable. KPMG have recalculted the costs per the above breakdown to ensure these have been recorded correctly. There seems to be a reasonable ranbge of job titles inlcuding primarily IT as well as finance, operations, supply chain, project leads and HR."*

1144. KPMG had obtained no audit evidence other than the schedule of mobilisation costs prepared by management (as embedded in the work paper) to support any part of these conclusions. The evidence obtained was insufficient.

1145. Further, KPMG was aware that the £10 million being paid by Provider A to Carillion in mobilisation costs was expressly linked to the c. £166 million being paid by Carillion to Provider A under the Outsourcing Extension. The "*Mobilisation Recovery* [Proivder A]" tab of KPMG's working paper "*AP500.3.1.A0* [Outsourcing] *TRANSACTIONS*" stated:

> *"Carillion has received £10 million excluding VAT as a contribution to mobilisation costs* <u>*associated with*</u> *Project Toyko (the £160m package of opportunities for Outsourcing and Systems Transformation with* [Provider A]*) – in particular Project Rio £7.7 million and Office Services £2.3 million"* (emphasis added).

1146. As a result, the £10 million should have been treated as one element of the cash flows arising from the outsourcing contract and the obvious approach would have been to record the amount as a liability, to be released over the duration of the contract.

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[73] Project Rio and Office Services were elements of the Outsourcing Extension.

[74] "Tokyo" was the codename given by Solicitor Firm F to the 2016 Outsourcing Transactions.

1147. However, the treatment in fact adopted, which recognised the receipt as a credit against costs in 2016 and 2017, appeared to be contrary to the requirements of IAS 1 paragraph 32, which provided:

> *"An entity shall not offset* […] *income and expenses, unless required or permitted by an IFRS".*

1148. KPMG did not identify either of these issues and recorded no consideration of how it concluded that the accounting treatment adopted was appropriate.

(6) Consideration of whether the 2016 Outsourcing Transactions were linked

(a) Scepticism

1149. IAS 18 provided that, where the commercial effect of a transaction could only be understood by reference to one or more other transactions, the criteria for recognising income arising from those transactions should be applied to those transactions together.

1150. In its audit work in relation to the 2016 Outsourcing Transactions, KPMG should have been sceptical of representations from Carillion's management that the transactions were not linked in the light of the following facts:

1150.1 They were with a single counterparty.

1150.2 They were entered into on the same day. The evidence shows that KPMG failed to appreciate this fact, given that it failed to obtain signed copies of the contracts for the IP Transactions[75] and given that it twice referred to the contracts having been signed on different dates.[76] (That was a failure to obtain audit evidence in itself.) However, KPMG did at least appreciate that the contracts were signed at approximately the same time.[77]

1150.3 They were entered into towards the end of Carillion's financial year.

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[75] Unsigned and undated copies of the documents relating to the IP Transactions were provided to KPMG. KPMG Senior Manager A commented "*will need signed ones of course*" but there is no evidence that KPMG ever received signed copies.

[76] "*AP500.3.1.A0 [OUTSOURCING] TRANSACTIONS"* ("*Peter Meehan (Audit Partner) met with Carillion lawyers to discuss this transaction, speifiall its seprability, during the meeting it was confirmed to contracts are separate <u>and signed on different dates</u>*") and the 2016 Year-End Audit Memorandum ("*we have reviewed the various contracts for the different transactions and note that they are legally separate, <u>signed on different dates</u>*").

[77] Note of 6 December 2016 telephone call with the valuation expert ("*Carillion had entered into a various outsourcing extension agreements <u>at a similar time to</u> a number of licence and IP sales*") and the 2016 Audit Report (*"The licensing agreement secured in 2016 was entered into <u>at or around the same time</u> and with the same counterparty to a series of contracts that extended the scope of the services provided by the Group's back-office outsourcing provider*").

1150.4 They had a significant and positive effect on Carillion's financial statements for 2016, in particular by increasing net profit by £34.2 million.

1150.5 KPMG was informed at the meeting on 3 October 2016 of speculation within Carillion about the linked nature of the transactions and their possibly contrived nature. The same concern had also been recorded in the minutes of Carillion's board meeting of 5 October 2016[78] (which were reviewed by KPMG at the time and which, as KPMG Senior Manager A noted, exaggerated the degree to which a previous similar transaction had been approved by KPMG and the FRC).[79]

1150.6 KPMG had seen from the valuation expert's report:

1150.6.1 that Carillion had limited the areas which the valuation expert was to investigate ("*Carillion expressly asked us not to assess the capability of* [Provider A] *to deliver the programme, nor to assess whether* [Provider A]*'s overall estimates are based on complete and robust assumptions*"); and

1150.6.2 that Carillion had changed the valuation expert's instructions during the benchmarking exercise (providing new volume assumptions which "*differed significantly from initial brief and from earlier email clarifications*").

1150.7 There was no evidence other than management assertion to support the value of the intellectual property rights sold.

1150.8 The audit team was aware that this was at least the second time that Carillion had obtained a significant cash payment from an outsourcer at the same time as awarding a lucrative contract, and that on both occasions the supplier of the outsourcing services was Provider A.

[78] The minutes stated "*that the prior transactions had been audited by KPMG in the normal course, but also approved by the KPMG technical team and by the FRC Audit Supervision team which had audited KPMG's audit of the Group's account in the year in question*".

[79] "*what* [Carillion Senior In-House Lawyer A] *has written in those minutes is just not accurate & we shouldn't repeat as fact if poss. AQR did not just sign off the prior transaction by any stretch (neither did our technical dept)*".

1151. Cumulatively, these circumstances clearly indicated that the contracts were linked and called for the application by KPMG of heightened professional scepticism. KPMG was required to obtain sufficient appropriate audit evidence to support Carillion's representations that they were not linked. As set out above, in fact, KPMG ultimately accepted Carillion's representations that they were not linked without sufficient appropriate audit evidence to justify that conclusion.

(7) Conclusion

1152. KPMG correctly identified that whether the 2016 Outsourcing Transactions were linked was a significant risk. The evidence obtained indicated that the contracts were linked, meaning that the accounting treatment would be very different from that adopted by Carillion and would have a significant impact on reported profit for the year.

1153. KPMG also correctly identified that an important factor in determining whether the transactions were linked was establishing whether each element was at fair value. However, the audit work performed was inadequate to address the risk, and provided little or no evidence on the fair value of the individual elements. The evidence obtained was clearly insufficient to support the conclusion that the treatment adopted was appropriate.

1154. KPMG failed:

1154.1 To identify and give proper weight to the circumstances surrounding the transactions (in particular those identified at paragraph 1085 above) and the history of Carillion entering into similar transactions. These matters cumulatively indicated that the transactions were linked.

1154.2 To obtain sufficient evidence that the Outsourcing Extension was at fair value, and in particular to identify the limitations in the evidence of management's expert, and properly evaluate that evidence.

1154.3 To obtain sufficient evidence that the IP Transactions were at fair value, in particular by accepting management's assertions without enquiry or challenge.

1154.4 To perform appropriate audit procedures in relation to mobilisation costs, either as to the appropriate accounting treatment or as to calculations performed by management.

1155. There were thus breaches by **the Respondents** in the **2016 audit** of:

1155.1 **ISA 200 paragraph 15**, in that the Respondents did not approach the audit of each element of the 2016 Outsourcing Transactions, and whether they were linked, with an adequate degree of professional scepticism and so did not critically assess management's judgements and the evidence obtained;

1155.2 **ISA 330 paragraphs 5 and 6,** in that the Respondents did not design or perform adequate audit procedures to respond to the assessed risk of the 2016 Outsourcing Transactions being linked, or whether the IP transactions had been carried out at fair value;

1155.3 **ISA 500 paragraphs 6 and 7**, in that the Respondents failed to design and perform appropriate audit procedures to enable them to obtain sufficient appropriate audit evidence relating to the treatment of each element of the 2016 Outsourcing Transactions, and whether they were linked;

1155.4 **ISA 500 paragraph 8**, in that the Respondents failed to obtain a sufficient understanding of the work of Carillion's expert and its limitations, or to evaluate properly the sufficiency of that work as audit evidence; and

1155.5 **ISA 700 paragraph 9(c)**, in that the Respondents did not adequately evaluate whether Carillion's accounting policy for mobilisation costs was consistent with the applicable financial reporting framework.

1156. Further, Mr Meehan repeatedly failed to challenge management or respond to evidence that the accounting treatment of each element of the transactions was inappropriate, as follows:

1156.1 On 29 September 2016, some months before the contracts were finalised, Mr Meehan attended a meeting with Carillion Director B, during which he was provided with a hard copy of two slides setting out a summary of the proposed 2016 Outsourcing Transactions.

1156.2 No note of this initial meeting was taken or obtained by Mr Meehan. However, after this initial meeting, Mr Meehan emailed members of the audit team stating:

> "[Outsourcing] *deal was discussion. Inc sale of Geneva system ip to them not linked for £30m profit.!!!!"*

1156.3 Also after this initial meeting, Mr Meehan was invited to two further meetings at Carillion the following Monday, 3 October 2016. He forwarded the agenda for the second meeting to KPMG Senior Manager A and KPMG Senior Manager B stating:

> *"FYI. Few of us there - not just me. No probs for us. But note* [Solicitor Firm F] *there so pretty serious they think obviously! Keep to yourself".*

1156.4 Invitees to the "*pre-meeting*" on 3 October 2016 were Carillion Director B, Carillion Director A, Carillion Senior In-House Lawyer A, a partner at Solicitor Firm F and Mr Meehan. No note of this meeting was taken or obtained by Mr Meehan.

1156.5 During the second meeting on 3 October 2016, attended by additional employees of Carillion, Mr Meehan was informed that concerns had been raised within Carillion that the transactions might be linked and contrived. No note of this meeting was taken or obtained by Mr Meehan. However, the evidence available does not suggest that the meetings on 3 October should have provided any comfort to Mr Meehan that the transactions were not linked.

1156.6 On three occasions, KPMG Senior Manager A proposed to Mr Meehan that evidence should be obtained directly addressing the value of the IP Transaction, but this was not done.

1157. Mr Meehan was aware of the significance of the judgement relating to the accounting treatment of the transactions and the impact on Carillion's reported profit, and of the various matters, set out earlier in this chapter, that suggested that they were linked. He was also aware of Carillion Director B's desire to treat the transactions as not linked and of concerns raised within Carillion that this was not appropriate.

1158. However, despite his initial (and warranted) scepticism in his email of 29 September 2016, he thereafter failed to respond adequately to indications that the accounting treatment was inappropriate and, without any explanation, failed to seek further obviously relevant evidence. He had been told of speculation within Carillion but did not record this anywhere, nor take any steps to ensure that they had been properly resolved. He failed to adopt a rigorous and robust approach to management's judgement but accepted the accounting treatment adopted without having properly addressed the risk of misstatement, and thereby acted without objectivity.

1159. There was thus a breach by **the Respondents**, (through Mr Meehan) of **ES 1 paragraph 6** in the **2016 audit**.

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D. Carillion's 2016 financial statements

(1) Accounting treatments

1160. In the 2016 financial statements, the various elements of the 2016 Outsourcing Transactions were treated in different ways:

1160.1 The Geneva Sale was treated as revenue and recognised in full in the year, without attributing any costs to it.

1160.2 The UK IP Sale and Canada IP Sale were treated as a reduction in operating costs. An intangible asset (with carrying value of £1 million) was attributed to this "sale" and written off.

1160.3 The Outsourcing Extension was recognised as an expense spread over the contract period of 10 years.

1160.4 The £10 million contribution to mobilisation costs was treated as a reduction in Carillion's overheads to the extent incurred to date (£5.2 million), and as deferred income to the extent that those costs had not yet been incurred.

(2) Disclosures

1161. Disclosures about the 2016 Outsourcing Transactions were contained in Note 31 to the 2016 financial statements and page 39 of Carillion's strategic report.

1162. The disclosures were materially misleading. In particular:

1162.1 The strategic report suggested that only £20 million had been recorded as profit from the 2016 Outsourcing Transactions. In fact, as set out above, the cumulative increase in profit recognised by Carillion as a result of the 2016 Outsourcing Transactions was £34.2 million (being the £20 million referred to in the strategic report, which came from the Geneva Sale; plus £9 million from the UK IP Sale and the Canada IP Sale; plus £5.2 million from the mobilisation costs payment), and so the impact of the transactions on Carillion's reported profit was materially understated.

1162.2 Note 31 stated that licensing income was recorded as revenue. In fact, as noted above, £9 million of licensing revenue from the UK IP Sale and the Canada IP Sale had been recorded as a reduction in operating costs and £1 million had been recorded as a disposal of an intangible asset.

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1163. The "*Disclosure*" tab of KPMG's working paper "*AP500.3.1.A0* [Outsourcing] *TRANSACTIONS*" contained an analysis of a version of the disclosure which was different from that made in the 2016 financial statements and thus appears to have been superseded. There is no evidence that KPMG identified either of the materially misleading points above.

(3) Audit Report

1164. The 2016 Audit Report included the following:

> *"We first considered whether the licensing agreement could be deemed independent from extension to the scope of services provided by the Group's outsourcing provider by examining the terms of the respective contracts and meeting with the Group's legal advisors. Further, we sought to understand the cost of each of the respective elements and consider the fair value of each element, which included meeting with both the Group's third party expert and legal advisors to understand their valuation and benchmarking process for the outsourcing arrangements, the expert's historical experience and challenging the assumptions used."*

1165. This was potentially misleading, in that by stating:

> *"… we sought to understand the cost of* ***each of the respective elements*** *and consider the fair value of* ***each element*** …"

it suggested that KPMG had undertaken audit work addressing directly both the cost and fair value of the Geneva Sale. In fact, as set out above, KPMG's audit evidence of the value of the Geneva Sale consisted only of representations in management's paper and KPMG's reasoning that the fair value of the IP Transactions could be deduced from the fair value of the Outsourcing Extension.

(4) Conclusion

1166. The disclosures in the financial statements, taken together with the Audit Report, did not sufficiently reflect the impact of the 2016 Outsourcing Transactions on Carillion's reported results and the judgments made by both management and the auditor. There was thus a breach by **the Respondents** in the **2016 audit** of **ISA 700 paragraph 9(f)**, in that the Respondents did not adequately evaluate whether the financial statements provided adequate disclosures to enable the intended users to understand the effect of the 2016 Outsourcing Transactions and events on the information conveyed in the financial statements.

16. REVENUE FROM THE PORTSMOUTH CAR PARK

Carillion recognised £16.7 million in revenue in its 2016 financial statements, representing a number of years' future income in relation to the Portsmouth car park, based on a change in the accounting treatment adopted. KPMG did not give proper consideration to whether this change was appropriate and accepted, without sufficient analysis or evidence, that the recognition of this revenue was appropriate.

Carillion also entered into a contract at the end of 2016, whereby it received a cash payment of £9.4 million in return for paying monthly amounts over the subsequent five years, based on the level of the car park income at the time of agreement. Despite indications that this arrangement was a loan, Carillion did not recognise the transaction as borrowing, but instead recognised it as deferred income - a different treatment that meant the amount was not included in Carillion's reported debt. KPMG accepted this treatment despite having received advice from its own technical experts that the balance should be treated as borrowing.

Both transactions involved significant judgements by management and each had a substantial positive impact on Carillion's reported performance. There was, therefore, a heightened risk of management bias and KPMG should have treated these judgements with particular scepticism.

A. Overview

1167. The Portsmouth Contract, considered in detail in Chapters 10 and 12 above, commenced in June 2009 and was due to expire in 2039. The contract provided that Carillion was entitled to income from the Portsmouth car park. In 2016 and previous years, Carillion had treated this income as consideration for the services it provided under the Portsmouth Contract. This meant that the income was recognised as revenue, as the related services were provided under the contract.

1168. In 2016, Carillion considered various ways in which its right to this income over the remaining life of the contract could be exploited to obtain a cash receipt and additional revenue to be recognised in the 2016 financial statements. KPMG was aware of this, describing a proposed sale of this income as one of a number of "*one-offs*" that would have the effect of increasing Carillion's reported revenue and cash for 2016.

1169. The increased revenue and cash were ultimately achieved through two means:

    1169.1 first, a change in the accounting treatment of the income resulting in the recognition of £16.7 million revenue in 2016; and

1169.2 secondly, a transaction with the purchaser resulting in a cash receipt of £9.4 million shortly before the 2016 year end.

1170. With respect to the additional revenue recognised as a result of the change in accounting treatment:

1170.1 In preparing its 2016 financial statements, Carillion decided that the right to the income was not linked to the other services it provided under the Portsmouth Contract and that the right to income should be treated as consideration for construction work that Carillion had completed under a separate contract at Portsmouth hospital between 2006 and 2010. This suggested that the previous treatment had been incorrect.

1170.2 Relying on this change in approach, Carillion recognised £16.7 million as additional revenue in 2016, representing estimated future income from the car park over some 7.5 years until one of the break clauses in the contract in 2024. Despite the significant impact on reported revenue and profit, no details of this accounting treatment, in particular the change from previous years, were disclosed in the financial statements.

1170.3 However:

1170.3.1 KPMG did not obtain sufficient appropriate audit evidence to support the conclusion that income from the Portsmouth car park could be treated as consideration for past construction work.

1170.3.2 KPMG did not consider whether Carillion's change of approach meant that a prior-year adjustment was necessary to correct material errors in the previous financial statements.

1170.3.3 KPMG concluded, without proper consideration or sufficient appropriate audit evidence, that it was appropriate for Carillion to recognise a sum to reflect future car park income in the 2016 financial statements.

1170.3.4 KPMG did not perform adequate audit work on the quantum of car park income, £16.7 million of which Carillion recognised as revenue in the 2016 financial statements.

1170.3.5 KPMG failed to exercise adequate professional scepticism in its audit of this aspect of the 2016 financial statements.

1171. With respect to the cash receipt:

1171.1 On 28 December 2016, Carillion entered into a contract with a purchaser, (the "**Portsmouth transaction**"), whereby Carillion received an immediate cash payment of £9.4 million in exchange for undertaking to repay monthly amounts over the subsequent five years, based on the average monthly income from the Portsmouth car park in the twelve months preceding the agreement.

1171.2 Carillion recorded the cash payment it received under the Portsmouth transaction in the 2016 financial statements as deferred income. KPMG's technical team had considered the terms of the contract and advised that the amount should have been treated as borrowing, which accorded with views expressed by members of the audit team. The evidence obtained during the audit thus suggested that the accounting treatment adopted was not appropriate but KPMG nonetheless accepted it.

B. Background

1172. Carillion built the Portsmouth hospital for the customer under a Private Finance Initiative contract. The construction works were completed in three phases between 2006 and 2010.

1173. The Portsmouth Contract, which had a "*Commencement Date*" of 15 June 2009 and was due to terminate in 2039, was a contract for the provision of facility management services to the customer. Pursuant to the Portsmouth Contract, Carillion was:

1173.1 obliged to provide car parking services; and

1173.2 entitled to retain all income, excluding income from a staff permit scheme, derived from the Portsmouth car park (the "**car park income**").

1174. In 2016, Carillion explored the possibility of exploiting its right to the car park income to obtain a cash payment, and to recognise all or part of this cash as revenue and profit in the 2016 financial statements. It entered into negotiations with a number of potential parties including a potential contractor ("**potential contractor**").

1175. KPMG was aware of Carillion's negotiations with the potential contractor and its intention to exploit its right to the car park income to obtain cash and to increase the revenue and profit to be reported in the 2016 financial statements. In particular:

1175.1 In an email of 12 July 2016 to Mr Meehan, the Carillion Construction finance team summarised, "*The initial offer from* [the potential contractor] *is an upfront*

payment of £18m c23 years left'. Mr Meehan forwarded this email to KPMG Senior Manager C and KPMG Senior Manager A.

1175.2 In an email of 28 November 2016 to members of the audit team, KPMG Senior Manager A set out a "*'one offs' list*", which identified:

1175.2.1 profit one-offs, including "*Sale of Portsmouth Car Park income stream (*[KPMG Senior Manager C] *– FYI) - £25 m (??)*"; and

1175.2.2 "*Cash one-offs* […] *Portsmouth TBC*".

On 30 November 2016, KPMG Senior Manager A forwarded this email to Mr Meehan.

1175.3 On the following day (29 November 2016), KPMG Senior Manager C responded, saying:

"Interesting it was sale of an asset last time for Portsmouth now an income stream. Are they disclosing as exceptional (haha)? It makes the Portsmouth contract loss making by c1m a year. We told them at HY they would need to provide at least some"

1175.4 In an email of 8 December 2016 sent to Mr Meehan and KPMG Senior Manager A, and copied to members of the audit team, KPMG Senior Manager C stated:

"Portsmouth car park – [senior management of the Carillion Construction and Carillion Services finance teams] *are out of loop on this and want to be involved as much as possible. Want a solution on how it could be recognised in profit."*

1176. In light of the above, and the potential impact of any transaction on Carillion's reported profit and financial position, KPMG was, or should have been, aware of the risk of bias in management's judgements as to the appropriate accounting treatment and should have approached the assessment of those judgements with professional scepticism.

C. Recognition of car park income

(1) Introduction

1177. Prior to 2016, Carillion had treated the car park income as consideration for the services it was obliged to provide under the Portsmouth Contract, with the consequence that the car park income was recognised at the point the corresponding service was provided. In 2016, however, Carillion decided that the car park income should be treated instead as part of the consideration for construction work that Carillion had completed under a separate construction contract at Portsmouth hospital between 2006 and 2010. If this treatment was correct, it suggested that the previous treatment had been incorrect.

1178. Carillion justified this change on the basis of:

1178.1 certain wording in the Portsmouth Contract, apparently supporting the view that the right to the car park income had been granted as consideration for its construction; and

1178.2 an assessment designed to demonstrate that the Portsmouth Contract was profitable (and, therefore, at fair value) without the car park income, and thus the two were not linked. This was despite the fact that, without the car park income, the contract would have been loss-making since its inception.

1179. In a phone call on or around 13 December 2016 with KPMG Senior Manager A and Mr Meehan, Carillion discussed the possibility of treating the car park income as consideration for construction work. In an email of 18 December 2016 to Carillion Construction management, Carillion Director B and Carillion Director A (but not to KPMG), Carillion Group finance team summarised their conclusions of this discussion, stating, "*Following our discussions with KPMG, the recognition of the profit is being linked to the construction of the car park*".

1180. The conclusion that the car park income should be treated as consideration for past construction work was relied on to allow Carillion to recognise an amount in revenue and profit to reflect future car park income in the 2016 financial statements.

1181. Carillion estimated that it would earn £52.2 million in car park income between 1 January 2017 and the expiry of the Portsmouth Contract in 2040. Because one of the break clauses in the contract fell in 2024, Carillion decided that only 7.5 years of future car park income, assessed at £16.7 million, should be recognised as revenue in its 2016 financial statements. Future income from 2024 to 2039, estimated by Carillion to amount to £35.5 million, was not recognised in the 2016 financial statements.

1182. In its 2016 working paper, "*AP060.3.00470 PORTSMOUTH CONSTRUCTION PROFIT*", KPMG recorded that it agreed with:

1182.1 Carillion's change of view that the car park income was not linked to the Portsmouth Contract, but was instead to be treated as consideration for construction work that Carillion had completed between 2006 and 2010; and

1182.2 Carillion's assessment that £16.7 million should be recognised immediately as revenue in Carillion's financial statements, representing 7.5 years of future car park income.

1183. The £16.7 million was recorded in Carillion's 2016 financial statements as:[80]

1183.1 an increase in revenue and consequent increase in profit; and

1183.2 an accrued income debtor.

(2) Accounting standards

1184. IFRIC 12 paragraph 2 explained a service concession arrangement as follows:

> *"An arrangement within the scope of this Interpretation typically involves a private sector entity (an operator) constructing the infrastructure used to provide the public service or upgrading it (for example, by increasing its capacity) and operating and maintaining that infrastructure for a specified period of time."*

1185. Carillion's right to the income from the Portsmouth car park derived from what appeared to be, in substance, such a service concession arrangement and was, therefore, subject to the requirements of IFRIC 12.[81]

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[80] "*5.1 Summary of Exceptionals*" records that £16.7 million (described as "*Sale of Portsmouth Car Park income stream*") was included within "*Revenue Related Exceptionals*". It appears that this amount was mistakenly described and represented the future car park income recognised as revenue relating to past construction work. "*4.6.2.E.N17.2. OTHER RECIEVABLES BREAKDOWN*" sets out that £14.9 million for "*Portsmouth car park debtor*" was included within the amounts reported as recoverable after more than one year in Carillion's 2016 financial statements at page 114.

[81] IFRC 12 (along with other IFRICs) was an "*interpretation*" developed by the IFRS Interpretations Committee (formerly the International Financial Reporting Interpretations Committee), and formed part of the accounting framework under IFRS.

1186. IFRIC 12 paragraphs 17 to 18 set out the following principles on accounting for a right to charge users of a public service granted to an operator under a service concession arrangement:

> *"17 The operator shall recognise an intangible asset to the extent that it receives a right (a license) to charge users of the public service. A right to charge users of the public service is not an unconditional right to receive cash because the amounts are contingent on the extent that the public uses the service.*
>
> *18 If the operator is paid for the construction services partly by a financial asset and partly by an intangible asset it is necessary to account separately for each component of the operator's consideration. The consideration received or receivable for both components shall be recognised initially at the fair value of the consideration received or receivable."*

1187. As explained above, in 2016, Carillion determined that its right to the car park income formed part of the consideration for construction services it had provided some years earlier; whereas in previous years, it had treated this income as revenue under a separate facilities management contract. KPMG agreed that the new treatment of the car park income was in principle correct, and should, therefore, have considered whether there were material errors in Carillion's earlier financial statements. The principles on making adjustments to correct prior period errors were contained in IAS 8. In particular, IAS 8 paragraph 42 provided as follows:

> *"Subject to paragraph 43, an entity shall correct material prior period errors retrospectively in the first set of financial statements authorised for issue after their discovery by:*
>
> *(a) restating the comparative amounts for the prior period(s) presented in which the error occurred; or*
>
> *(b) if the error occurred before the earliest prior period presented, restating the opening balances of assets, liabilities and equity for the earliest prior period presented."*

1188. IFRIC 12 also required changes in accounting policy to be accounted for in accordance with IAS 8, i.e. retrospectively.

(3) Audit work on treatment of the car park income as consideration for construction work

1189. In determining whether Carillion's treatment of the car park income was appropriate, KPMG needed to examine carefully the basis for the change in treatment and the appropriateness of the new treatment. However, the audit work was seriously deficient in relation to both matters.

1190. KPMG failed to obtain the evidence necessary to enable it to determine whether treating the car park income as consideration for Carillion's past construction work was appropriate. In "*AP060.3.00310 MANAGEMENT PORTSMOUTH CAR PARK*", which was prepared by Carillion and saved as a working paper on the 2016 audit file, Carillion summarised the circumstances which had resulted in Carillion acquiring the right to the car park income as follows:

> *"Due to affordability issues for the* [customer] *towards the conclusion of the construction phase, primarily in relation to the construction of the hospital where Carillion made a loss of c£20 million, Carillion agreed to build and maintain the car parks on the hospital site in return for the entitlement to the income from the car park".*

1191. The circumstances of Carillion's acquisition of the right to the car park income were clearly central to determining the correct accounting treatment of the car park income and warranted further investigation. In working paper "*AP060.3.00470 PORTSMOUTH CONSTRUCTION PROFIT*", KPMG referred to a paragraph contained in the Portsmouth Contract which provided as follows:[82]

> *"The* [customer] *seeks to maximise the income it receives from car parking but recognises that Project Co.* [i.e., Carillion] *should receive a fair return for the cost of construction of the car parks, the management of them and the risk attached to the receipt of income from them".*

1192. KPMG relied on the above paragraph as evidence in support of the link between the construction work and the car park income, but failed to obtain any evidence to corroborate the matters referred to in Carillion's summary set out above, in particular as to:

1192.1 whether Carillion had recorded a loss of approximately £20 million on the construction of the hospital, and had sought to recover that sum from its customer; or

1192.2 critically, whether "due to affordability issues for the [customer]" or otherwise, Carillion had in fact "agreed to build and maintain the car parks on the hospital site in return for the entitlement to the income from the car park". The extract from the Portsmouth Contract above referred to both the cost of construction and the management of the car parks as well as the risk relating to the level of income that might be received, and thus did not support any clear conclusion on the issue.

[82] The working paper also referred to schedule 17 of the service contract relating to benchmarking and market testing for the services provided under the Portsmouth Contract.

1193. Further, KPMG's reasoning in support of its conclusion that the car park income was not consideration for services performed under the Portsmouth Contract was deficient. In working paper "*AP060.3.00470 PORTSMOUTH CONSTRUCTION PROFIT*", KPMG stated that Carillion's plan to improve the profitability of the Portsmouth Contract in 2017 and the resolution of issues with an energy unit "*further supports the view that the car park income is not linked and does not support the profitability of the facilities management contract* [i.e., the Portsmouth Contract]". However, when considering whether the Portsmouth Contract was profitable and at fair value without the right to the car park income, the appropriate date was when the contract was entered into; and, at that point, the terms would obviously not have taken account of Carillion's future improvements plans, or the energy unit problems, and their possible resolution.

1194. In any event, KPMG also failed to obtain sufficient appropriate audit evidence to support the future profitability of the Portsmouth Contract without the car park income. In particular:

1194.1 KPMG obtained insufficient evidence to enable it to evaluate Carillion's plan to improve the profitability of the Portsmouth Contract and whether it was likely to succeed. Management's paper included "*margin improvement*" forecasts under a range of headings, including "*Reductions in service failure losses and general efficiency improvements*", "*Reduced life cycle costs*" and "*Targeted reductions in overheads*", but the version obtained by KPMG had no detail as to how these would be achieved.[83]

1194.2 The evidence as to the resolution of the energy unit issues was at best unclear, both as to the timetable for resolution and the cost savings that might be achieved. Further, management's forecast made clear that full resolution of the issues would not of itself make the contract profitable and did not provide sufficient evidence that the required improvements in profitability would be made.

1195. There were thus breaches by **the Respondents** in the **2016 audit** of:

1195.1 **ISA 200 paragraph 15**, in that the Respondents did not approach this area of the audit with an adequate degree of professional scepticism, and so did not critically assess the (inadequate) evidence in relation to the car park income; and

[83] This stated "There are detailed plans that are either implemented or with a clear route to implementation" but there is no evidence that KPMG obtained or reviewed these plans.

1195.2 **ISA 500 paragraphs 6, 7 and 11**, in that the Respondents failed to design and perform appropriate audit procedures to enable them to obtain sufficient appropriate audit evidence on the source of the car park income, nor did they consider properly the inconsistency of the new approach with the understanding gained in previous years.

(4) Audit work relating to recognising future car park income as revenue in 2016

1196. Once Carillion had concluded that the car park income was to be treated as consideration for past construction work, KPMG should have considered whether the new treatment provided an appropriate basis for Carillion to recognise revenue representing future car park income in the 2016 financial statements, and also whether Carillion's previous accounting treatment had been incorrect and a prior-year adjustment was, therefore, necessary.

1197. As noted above, IFRIC 12 paragraphs 17 to 18 required "*a right (a licence) to charge users of the public service*" received as consideration for construction services to be recognised as an intangible asset at its initial fair value, to be amortised over the period of the concession. Even if IFRIC 12 did not apply, any appropriate alternative accounting treatment would ordinarily have led to substantially the same outcome.

1198. This suggested that it was not appropriate for Carillion to recognise any amount in revenue in the 2016 financial statements in respect of the future car park income and that the appropriate treatment would require:

1198.1 a prior-year adjustment to correct the material misstatements in Carillion's previous financial statements, in particular to increase reserves as at 1 January 2015 to reflect the fair value of Carillion's right to the car park income when it was acquired, less amortisation to 1 January 2015; and

1198.2 a *reduction* to the amounts of profit reported for 2015 and 2016 to reflect further amortisation of the right to the car park income in each year.

1199. KPMG did not consider whether IFRIC 12 should have applied, and accepted Carillion's decision that revenue representing future car park income should be recognised in the 2016 financial statements.

1200. KPMG considered Carillion's decision not to recognise any future profit from the right to the car park income prior to 2016 to have been justified by "*issues with an installed energy unit, which had an ongoing impact on the profitability of the services contract* [that is, the Portsmouth Contract]". In particular:

1200.1 In the 2016 Year-End Audit Memorandum, KPMG implied that issues with the energy unit had prevented Carillion from recognising future car park income earlier, stating that revenue of £16.7 million had "*been realised following the partial resolution of construction issues in the QAH energy unit*".

1200.2 Similarly, the minutes of a pre-clearance meeting on 16 January 2017 record, "*KPMG have concluded that this treatment* [i.e., recognising revenue of £16.7 million] *is appropriate given the resolution of the legacy issues in the energy unit*".

1200.3 In working paper "*AP060.3.00470 PORTSMOUTH CONSTRUCTION PROFIT*", KPMG set out in its "*Summary of Findings*" its agreement with management's assessment that £16.7 million should be recognised in the 2016 financial statements, "*Due to the rectification of legacy construction issues and historical data supporting the car park income*".

1201. These matters, which arose years after the agreement under which Carillion acquired the right to the car park income, were irrelevant in determining the appropriate accounting treatment:

1201.1 The issues with the energy unit were first identified in 2012 and neither the issues, nor their subsequent resolution, should have affected the correct treatment of the car park income.

1201.2 There was no reason why a sufficiently reliable estimate of the fair value of Carillion's right to the car park income could not have been made when it was acquired, and thus no reason why the availability of "*historical data*" should have led to change in the accounting treatment.

1202. There were thus breaches by **the Respondents** in the **2016 audit** of:

1202.1 **ISA 200 paragraph 15**, in that the Respondents did not approach this area of the audit with an adequate degree of professional scepticism, particularly in light of the risk of management bias, and so did not critically assess whether it was appropriate to recognise revenue representing future car park income in the 2016 financial statements; and

1202.2 **<u>ISA 700 paragraphs 9(b), (c), (d), (e) and (f)</u>**, in that the Respondents did not evaluate whether:

1202.2.1 the 2016 financial statements provided adequate disclosure of Carillion's accounting policies to enable intended users to understand the effect of material events (i.e. Carillion's decision to recognise revenue representing future car park income in 2016) on the information conveyed in the financial statements;

1202.2.2 Carillion's accounting policies relating to the car park income were consistent with the applicable financial reporting framework and were appropriate in the circumstances; or

1202.2.3 the information presented in the 2016 financial statements relating to the car park income was relevant, reliable, comparable, and understandable.

(5) Audit work relating to the quantum of car park income recognised

1203. KPMG should also have considered properly whether the amount of future income recognised was appropriate but the audit work on this issue was deficient.

1204. First, KPMG failed to challenge Carillion's reasoning that the right to the car park income would cease upon the termination of the Portsmouth Contract. In "*AP060.3.00310 MANAGEMENT PORTSMOUTH CAR PARK*", Carillion stated, in the context of assessing the quantum of income to be recognised, as follows:

> *"The next break clause in the facilities management agreement is due in 2019 and then five years later in 2024. Management's view is that at present there are no reasons to suggest that the next break clause in 2019 will be triggered. Therefore, a reasonably prudent view of 7.5 years of income until 2024 has been taken."*

1205. This reasoning was inconsistent with the conclusion that the car park income was *not* attributable to the Portsmouth Contract but had been granted as consideration for past construction work. KPMG should have:

1205.1 identified this inconsistency in Carillion's analysis; and

1205.2 considered whether Carillion's right to the car park income would in fact cease on the triggering of the break clause in the Portsmouth Contract.

1206. KPMG should also have obtained evidence to corroborate management's view that the break clause would not be exercised in 2019. KPMG should have considered management's view with scepticism given that KPMG was, or should have been, aware that:[84]

1206.1 the Portsmouth Contract was in dispute; and

1206.2 the customer was close to terminating the Portsmouth Contract in 2016, without waiting to rely on the 2019 break clause.

1207. There is no evidence that KPMG gave any consideration to these points.

1208. KPMG also failed to assess adequately the discount rate assumption used by Carillion to estimate the present value of 7.5 years of car park income, less running costs, as £16.7 million. Carillion had applied a discount rate of 2.3%, reasoning as follows:

1208.1 *"The incremental cost of borrowing to Carillion of 2.3% (as per the 2017 Budget) has been used as the discount rate.*"

1208.2 "*As the income is effectively backed by the UK Government via the* [customer]*, management view the risk associated with the income to be relatively low and that a risk free rate on UK Government bonds is a reasonable rate to use. The yield on 8 year Government bonds is currently approximately 1.1%. An increase of 1.2% on this rate to 2.3% reflects an allowance for potential demand volatility inherent in the income stream*".

1209. This was in stark contrast to the interest rate of 10% used to calculate the value of five years of future car park income for the purpose of the Portsmouth transaction, discussed below. That was an arm's length transaction concerning the same future cash flows and, therefore, would ordinarily provide strong evidence of an appropriate discount rate. KPMG did not consider this fact or record any explanation as to why it was more appropriate to adopt a 'risk-free' rate.

1210. There were thus breaches by **<u>the Respondents</u>** in the **<u>2016 audit</u>** of:

1210.1 **<u>ISA 200 paragraph 15</u>**, in that the Respondents did not approach this area of the audit with an adequate degree of professional scepticism, and so did not critically assess the (inadequate and conflicting) evidence in relation to the quantum of car park income they considered should be recognised in the 2016 financial statements;

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[84] See Chapter 10 Section E.

1210.2 **ISA 500 paragraphs 6 and 7**, in that the Respondents failed to design and perform appropriate audit procedures to enable them to obtain sufficient appropriate audit evidence to support the quantum of car park income recognised in the 2016 financial statements; and

1210.3 **ISA 500 paragraph 11**, in that the Respondents did not adequately consider or respond to inconsistencies in the audit evidence as to whether:

1210.3.1 Carillion's right to the car park income could be affected by the exercise of a break clause contained in the Portsmouth Contract; or

1210.3.2 the break clause would be exercised in 2019.

D. The Portsmouth transaction

(1) Introduction

1211. On 28 December 2016, Carillion entered into the Portsmouth transaction. The intended purpose of the transaction appeared to be to obtain an immediate cash payment through a 'sale' of the right to future car park income, with the initial expectation that the sum received would be recognised as revenue and profit in the 2016 financial statements.

1212. The Portsmouth transaction involved the following elements:

1212.1 The Purchaser would pay £9.4 million to Carillion on 29 December 2016 (the "**Portsmouth payment**").

1212.2 Carillion Services Limited would pay the Purchaser monthly amounts over the subsequent five years, based on the level of income from the Portsmouth car park at the time of the agreement, less a fee to reflect Carillion's costs of operating the car park.

1212.3 Carillion Services Limited's obligations were guaranteed by Carillion plc.

1213. Under the terms of the Portsmouth transaction, Carillion bore the risk of circumstances occurring that might result in:

1213.1 the termination of Carillion's right to the car park income; or

1213.2 any reduction to the car park income.

1214. In Carillion's 2016 financial statements, the Portsmouth payment was recorded as deferred income. This meant that it was not included within the amount of borrowing reported in Carillion's 2016 financial statements.

(2) Audit work

1215. Prior to entering into the Portsmouth transaction, Carillion sought KPMG's opinion on the impact of the transaction on Carillion's financial statements. In responding to Carillion, KPMG's audit team consulted with KPMG's technical team. By an email of 9 December 2016 to KPMG's technical team, and copied to KPMG Senior Manager A, KPMG Senior Manager C:

1215.1 sent KPMG's technical team (as an attachment) a draft of the Portsmouth transaction document ("*Car Park_DRAFT Sale and Purchase Agreement 541105890_3*"); and

1215.2 requested KPMG's technical team's opinion on the appropriate accounting treatment, writing, "[Carillion] *want*[s] *to recognise the profit on completion of the deal. I am sceptical however, as the hospital is still paying Carillion and the Carillion pay the buyer, is this not just a loan secured on future income?*".

1216. In an email of 9 December 2016 to KPMG Senior Manager C in reply, and copied to KPMG Senior Manager A, KPMG's technical team stated as follows:

> *"Carillion's right to future car parking is dependent on them providing future services to the Hospital. Therefore until those services are provided Carillion do not have an asset to recognise with regard to that car park income as it remain dependant on future performance. In addition no current right has been disposed of rather an agreement has been made to pay an equivalent amount to what has been received in respect of a future service. So there is no basis for de-recognition of any existing right/asset.*
>
> *The agreement indicates that Carillion will pay over the car park income when received (or will pay over an equivalent amount if Carillion are not entitled to the car park income). Therefore it is a contractual obligation to pay over future cash flows which would meet the definition of a financial liability (the fact that the amount can be variable does not mean that it not a financial liability).*
>
> *Therefore the agreement should be considered a financial liability with no effect on the existing arrangement with the hospital".*

1217. Thus, the advice of KPMG's technical team, which was based on a draft of the Portsmouth transaction document and was clearly communicated to KPMG's audit team, was that the Portsmouth transaction created a financial liability. It should, therefore, have been included in borrowing.

1218. KPMG Senior Manager A forwarded the advice of KPMG's technical team to Carillion Group finance team in an email of 9 December 2016, with the comment, "*Still not got the answer you want on* [the] *car park*".

1219. Although KPMG's technical team provided the above advice on the basis of a draft of the Portsmouth transaction document, the final terms of the Portsmouth transaction were not materially different.

1220. Members of KPMG's audit team also considered that the Portsmouth transaction was a loan and so should be recognised as borrowing. In particular:

1220.1 In an email of 8 December 2016 to KPMG's technical team, and copied to Mr Meehan and KPMG Senior Manager A, KPMG Senior Manager C, referring to the draft terms of the Portsmouth transaction, explained as follows:

> *"Carillion think they have sold an income stream for a contract and can recognise it in profit. To me it looks like a debt transaction, they have received an amount a cash and have to pay the other side an amount (albeit variable) over the following 5 years".*

1220.2 Similarly, in the email of 9 December 2016 to KPMG's technical teamKPMG Senior Manager C wrote, "*as the hospital is still paying Carillion and the Carillion pay the buyer, is this not just a loan secured on future income?*".

1220.3 In an email of 18 December 2016 to the Carillion Group finance team, KPMG Senior Manager A, commenting on a draft of the Portsmouth transaction, stated, "*At the most simple interpretation it's a loan*". On 18 December 2016, KPMG Senior Manager A forwarded this email to Mr Meehan, KPMG Senior Manager C and a member of the audit team.

1220.4 In an email of 19 December 2016 to Carillion Director B and Carillion Director A, and copied to the Carillion Group finance team and KPMG Senior Manager A, Mr Meehan commented, "*the* [Portsmouth transaction] […] *may raise cash but the other side may look like a loan which isn't achieving much perhaps. I may be stating the obvious (and may be wrong) but the* [Portsmouth transaction] *monies seem quite expensive now if they aren't driving the profit*".

1221. Despite the advice of KPMG's technical team and views of members of KPMG's audit team, in working paper, "*AP060.3.00300 PORTSMOUTH FORWARD SALE*", KPMG:

1221.1 stated that the Portsmouth payment was "*a cash advance*"; and

1221.2 concluded that the Portsmouth payment had "*correctly been treated as deferred income in the balance sheet and will be released to the P&L over the 5 year period*".

1222. The paper provided no explanation for why the payment was to be treated as a cash advance and recognised as deferred income, and the conclusion was contrary to both the advice of KPMG's technical team (that the Portsmouth transaction should be considered as creating a "*financial liability*") and the views of members of KPMG's audit team referred to above (that the Portsmouth transaction was, in substance, a loan).

1223. In this way, KPMG thus wrongly accepted:

1223.1 that the £9.4 million received under the Portsmouth transaction could properly be treated as deferred income and excluded from borrowing; and

1223.2 the erroneous presentation of the Portsmouth transaction in Carillion's 2016 financial statements.

1224. KPMG's audit team was aware of Carillion's intention to use its right to the car park income to obtain cash and that Carillion wanted to avoid recognising the liability to the parent company of The Purchaser as a loan. There was, therefore, a risk of management bias in management's judgements as to the appropriate accounting treatment of the car park income.

1225. Mr Meehan, KPMG Senior Manager A and KPMG Senior Manager C each expressed the view that the arrangements resembled or constituted a loan. They must have been aware that the accounting treatment of the Portsmouth payment as deferred income was inappropriate.

1226. There were thus breaches by **the Respondents** in the **2016 audit** of:

1226.1 **ISA 200 paragraph 15**, in that the Respondents did not approach management's treatment of the Portsmouth transaction as deferred income with an adequate degree of professional scepticism and so did not critically assess the (conflicting) evidence on whether management was correct to treat the Portsmouth transaction as deferred income; and

1226.2 **ISA 500 paragraph 11**, in that the Respondents failed to consider and respond adequately to audit evidence suggesting that Carillion should not have recognised the Portsmouth payment as deferred income.

1227. Further, there was a breach by **the Respondents**, (through Mr Meehan, KPMG Senior Manager C and KPMG Senior Manager A) of **ES 1 paragraph 6** in the **2016 audit**, in that, by accepting management's treatment of the Portsmouth transaction as deferred income, where they had identified that it was inappropriate, they failed to act rigorously and robustly and thereby failed to act with objectivity.

17. NET BORROWING

Net borrowing at year end featured prominently in Carillion's 2016 annual report. It was presented as "*the most appropriate measure of liquidity*", including all sources of financing, and was described as "*providing further clarity on the Group's underlying performance"*. KPMG understood that borrowing was an important metric for users of the financial statements. However, KPMG had evidence suggesting that the reported net borrowing figure at year end did not provide a fair and accurate picture of the group's actual underlying borrowing requirements.

In this regard, KPMG failed to assess adequately whether the financial statements provided a true and fair view of Carillion's financial position and failed to assess whether the presentation of net borrowing in the annual report was consistent with KPMG's knowledge acquired during the audit.

A. Overview

1228. Carillion's 2016 financial statements reported the group's "*net borrowing*" (also referred to as "*net debt*") as £218.9 million at the year end. It was defined as total borrowing less net cash and cash equivalents.[85]

1229. This amount was highlighted and referred to repeatedly elsewhere in the 2016 annual report, including on the first numbered page (entitled "*2016 At a glance*"), which displayed net borrowing as an "*Alternative Performance Measure*".

1230. Net borrowing was presented as "*the most appropriate measure of liquidity for the Group"* and hence was, amongst other things, an important indicator of Carillion's ability to continue as a going concern. The 2016 annual report stated:

> *"The Directors view net borrowing rather than cash and cash equivalents as the most appropriate measure of liquidity for the Group as this measure includes all sources of financing used to fund the Group's operations."*

1231. However, KPMG was in possession of evidence suggesting that the level of net borrowing at the year end was not representative of the group's underlying level of borrowing, which was hundreds of millions of pounds higher. KPMG should have identified that the year-end figure could only have been achieved by manipulating cash balances using methods that were unlikely to be sustainable, and also did not include "*all sources of financing used to fund the Group's operations*".

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[85] The amount of £219 million is recorded as both "*Net debt*" and "*net borrowing*".

1232. KPMG should, therefore, have considered whether the information relating to net borrowing in the 2016 financial statements was reliable and adequate in presenting a true and fair view of Carillion's financial position and whether the information presented in the 2016 annual report was consistent with KPMG's understanding of Carillion's underlying level of borrowing derived from its audit work. However, despite the importance of net borrowing to users of the financial statements and the very significant amounts involved, KPMG did not identify or consider these issues.

B. Background

1233. As noted above, net borrowing, and in particular the year end figure of £218.9 million, was referred to repeatedly in the 2016 annual report:

1233.1 The first numbered page was titled "*2016 at a glance*", and included the amount for net borrowing at year end as one of ten highlighted metrics, alongside group revenue, profit before tax and earnings per share. It was one of the "*Alternative Performance Measures*" referred to, which were stated to be:

"presented in order to supplement reported results by providing further clarity on the Group's underlying performance and to present additional information that reflects how the Directors monitor and measure the progress of the Group."

1233.2 In relation to net borrowing specifically, the report stated:

"The Directors view net borrowing rather than cash and cash equivalents as the most appropriate measure of liquidity for the Group as this measure includes all sources of financing used to fund the Group's operations."

1233.3 The ratio of net borrowing at year end to EBITDA was presented as a key performance indicator, described as one of the:

"…key metrics we believe will assist our stakeholders in assessing our performance during 2016."

1233.4 Net borrowing was also referred to in the chairman's report, which explained that the increase in net borrowing resulted largely from exchange rate movements and recorded the board's focus on steadily reducing net borrowing over the medium term.

1233.5 The performance and financial review referred to the increase in net borrowing, and again referred to the group's "*plans*" and "*ambition*" to reduce net borrowing.

1233.6 Detailed disclosures about Carillion's net borrowing position were contained in notes 18 and 19 to Carillion's 2016 financial statements.

1234. Average net borrowing over the year (£586.5 million) was also reported but was not highlighted or treated as an Alternative Performance Measure, or as a factor in the Key Performance Indicators.

1235. In interview, Mr Meehan stated, "*Cash is a metric that people focus on*", and that the "*headline everyone's going to report*" was the difference between Carillion's loan facilities and the level of borrowing at the year end.

1236. There was, however, a very significant disparity between the amount of net borrowing at the year end, as reported in the 2016 financial statements, and the amount of net borrowing both in the months immediately before the year end (as reported to Carillion's board during the latter part of 2016) and in the months immediately following (contained in forecasts prepared by management for the early part of 2017).

1237. This was evident to KPMG as follows:

1237.1 KPMG recorded the following from the minutes of the 6 October 2016 board meeting:

> *"Closing September net borrowing of £711.9 million was £121.9 million higher (£82.8 million higher excluding the impact of foreign exchange) than the Budgeted position […]."*

1237.2 KPMG recorded the following from the 9 November 2016 board meeting:

> *"Net debt of £175.0 million for the full year is in line with the budgeted position. Average net debt is now expected to be £575.5 million compared to £538.9 million at the end of 2015 with the increase led by foreign exchange movements."*

1237.3 In its work paper on going concern, KPMG recorded that it had received management's 2017 budget and compared that version to the figures reported to the board. Management's base case predicted net debt of £624 million at the end of January 2017, rising to £706 million at the end of March 2017.[86]

1238. It was, therefore, clear that Carillion expected very large movements in net borrowing around the year end, involving a net cash inflow of nearly £500 million in the final quarter of 2016, followed by an equivalent net cash outflow in the first quarter of 2017.

[86] This showed 2017 net borrowing peaking at £726.5 million in May and then reducing to £220 million in June.

1239. In interview, Mr Meehan acknowledged that the year-end amount for net borrowing of £218.9 million and the average net borrowing over the year of £586.5 million suggested a peak level of borrowing during the year of approximately £900 million. Mr Meehan stated that he did not understand how Carillion could have reduced its borrowing by so much at the year end, other than by "*slowing down payments when they could and accelerating receipts when they could*". He said that Carillion Director B:

> *"laboured a lot that, you know, 'we have an awful lot of levers we can play to manage cash in this organisation'."*

1240. As Mr Meehan himself recognised, the large movements in the figures were highly unlikely to have been from normal operational cash flows and strongly suggested manipulation of borrowing at year end - for example, by delaying payments to creditors. KPMG was also aware of a number of transactions (sometimes described by KPMG as "*one offs*") designed to obtain large cash receipts prior to the year end, with no corresponding liability included in borrowing.

1241. Further, as is explained in Chapter 14, Carillion's liability under the EPF had increased significantly to around £471.6 million at the year end, providing Carillion with a significant cash flow benefit and a source of financing which was not included in reported borrowing. There was an obvious question whether at least a part of this liability should have been classified as borrowing, and whether the treatment actually adopted called into question whether the net borrowing figures in fact provided "*the most appropriate measure of liquidity for the Group*".

C. The audit

1242. In light of the prominence given to year-end net borrowing in the annual report and its importance to users, KPMG should have considered carefully whether the presentation was accurate and reliable. It was (or ought to have been) clear to KPMG that Carillion's stated net borrowing, presented as *"the most appropriate measure of liquidity for the Group*", was significantly lower than its actual underlying net borrowing, and that the discrepancy was a result of actions that were not sustainable and largely unrelated to its core operations. There was also an obvious question as to whether net borrowing in fact included "*all sources of financing used to fund the Group's operations*". Consequently, there was a risk that the information on net borrowing in the annual report and financial statements, and the implications as to Carillion's true liquidity and financial position, were misleading and inconsistent with KPMG's knowledge.

1243. For example, as noted above, the ratio of net borrowing at year end to EBITDA was presented as a key performance indicator. The ratio reported was 0.8, accompanied by a "*Target*", described as:

> *"Continue to focus on cash generation in order to minimise our net debt to EBITDA ratio"*

1244. Had the net borrowing figure for September 2016 been used (which was evidently more representative of Carillion's underlying level of borrowing), the ratio would have been 2.6, giving a very different picture of Carillion's cash generation and in turn its ability to repay its borrowing.

1245. In the circumstances, KPMG should have:

1245.1 approached the information concerning net borrowing reported in the financial statements with scepticism, recognising the risk of improper manipulation;

1245.2 sought to understand the reasons for the huge reduction in borrowing apparently achieved over such a short period immediately before the year end, and the subsequent corresponding increase in the months immediately following the year end;

1245.3 in light of its findings on the issues above, considered whether the information concerning net borrowing reflected the true level of Carillion's indebtedness and financing requirements and was representative of its position during the year;

1245.4 given specific consideration to whether the presentation of Carillion's net borrowing in the financial statements was true and fair, and in particular whether additional disclosures were necessary; and

1245.5 assessed whether the presentation of net borrowing as "*the most appropriate measure of liquidity for the Group*" and that it "*includes all sources of financing used to fund the Group's operations*" was consistent with its knowledge of:

1245.5.1 net borrowing at the year end being around a quarter of the level of net borrowing at other times of the year, and less than half the average level of net borrowing; and

1245.5.2 other sources of financing, such as the EPF, which were not included in net borrowing.

1246. There is no evidence that KPMG considered any of these matters.

1247. There were thus breaches by the Respondents in the 2016 audit of:

1247.1 **ISA 700 paragraph 9(f)**, in that the Respondents did not evaluate whether the financial statements contained reliable and sufficient information to enable the intended users to understand the effect of material transactions and events relating to the level of net borrowing; and

1247.2 **ISA 720 paragraphs 6 and 6.1**, in that the Respondents did not identify a material inconsistency between the presentation of net borrowing in the annual report and their knowledge on borrowing obtained in the audit.

18. 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, KPMG 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.

A. Overview

1248. The going concern basis of accounting should be adopted except where management intends to liquidate the entity or to cease trading or has no alternative to liquidation or cessation of operations. When preparing financial statements, management is required to make an assessment of the entity's ability to continue as a going concern to ensure the going concern basis of accounting is appropriate.[87] Any material uncertainty relating to the entity's ability to continue as a going concern should be disclosed in the financial statements.[88]

1249. KPMG was thus required to obtain sufficient appropriate audit evidence to conclude on the appropriateness of the preparation of the financial statements on the going concern basis and whether there was a material uncertainty about Carillion's ability to continue as a going concern. KPMG failed to discharge that responsibility in the 2016 audit. In particular:

1249.1 KPMG failed to evaluate and challenge management's going concern assessment adequately.

1249.2 KPMG failed to identify and/or respond to events or conditions that collectively may have cast significant doubt over Carillion's ability to continue as a going concern. These should have prompted additional audit procedures, but KPMG gave no, or no proper, consideration to these matters.

[87] IAS 1 paragraph 25.

[88] IAS 1 paragraph 25 and ISA 570.

B. Requirements of auditors relating to going concern

1250. ISA 570 sets out specific requirements of the auditor relating to the going concern assumption, falling into two main elements, as follows:

1250.1 Consider management's assessment of the entity's ability to continue as a going concern, specifically:

"evaluate management's assessment of the entity's ability to continue as a going concern" (ISA 570 paragraph 12); and

"consider whether management's assessment includes all relevant information of which the auditor is aware as a result of the audit" (ISA 570 paragraph 14);

1250.2 Identify and respond to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern, specifically:

1250.2.1 As part of risk assessment procedures, to "*consider whether there are events or conditions that may cast significant doubt on the entity's ability to continue as a going concern*" (ISA 570 paragraph 10);

1250.2.2 Throughout the audit to "*remain alert … for audit evidence of events or conditions that may cast significant doubt on the entity's ability to continue as a going concern*" (ISA 570 paragraph 11); and

1250.2.3 And "*If events or conditions have been identified that may cast significant doubt on the entity's ability to continue as a going concern, the auditor shall obtain sufficient appropriate audit evidence to determine whether or not a material uncertainty exists through performing additional audit procedures, including consideration of mitigating factors*" (ISA 570 paragraph 16).

1251. KPMG's failures in respect of these requirements are considered in the remainder of this chapter.

C. Evaluating and challenging management's assessment

(1) Introduction

1252. Management's going concern assessment comprised a paper, "*Full Year 2016 Going Concern and Viability Review*", together with the following nine appendices:

1252.1 Appendix 1, "*Information to support the adoption of the going concern and viability report*"

1252.2 Appendix 2, "*Top Ten Risks Management Plan January 2017*"

1252.3 Appendices 3, 4 and 5, "*Borrowing Facility Adequacy*"

1252.4 Appendix 6, "*Covenant 2016 Full Going Concern and Viability Review*"

1252.5 Appendix 7, "*Bank borrowing facilities as 31 December 2016 and as at 31 January 2019*";

1252.6 Appendix 8, "*Bonds outstanding by Bondsman at 31 December 2016*"

1252.7 Appendix 9, "*Viability statement*"

1253. Management's assessment included a forecast of Carillion's monthly borrowing requirements, based on forecast cashflows, for a three year period subsequent to the year end and concluded that there was sufficient headroom between these requirements and available financing facilities. Based on this assessment, Carillion's management determined that it was appropriate to prepare its 2016 financial statements on the going concern basis. This approach therefore depended on the reliability of Carillion's forecast cashflows and its level of net borrowing. It also depended on the ongoing availability of financing facilities.

1254. KPMG's audit work on going concern is recorded in working paper "3.*3.1.C.GC1 GOING CONCERN 2016*". KPMG considered that there was a "*low risk around going concern*". KPMG concluded that, given the level of headroom available, it had "*significant comfort"* that Carillion was a going concern and, on the basis of its findings, "*no further work* [was] *therefore proposed*".

(2) Verifying forecast borrowing requirements in management's assessment

1255. KPMG's working paper recorded that the budgets in management's going concern paper, which contained the forecast of Carillion's borrowing requirements, had been compared to annual budgets approved by the Board. KPMG did not perform any other audit procedure to evaluate the budgets and ensure they were reliable.

1256. KPMG had planned further procedures but failed to perform them. In particular:

1256.1 In its working paper "2.*5.3 Other Risk Assessment Procedures*", KPMG had recorded:

> *"The Budgeting and forecasting process will be considered in detail in the Going concern review. As with any plc there is pressure from the market to meet expectations and therefore Group management does forecast aggressively and put pressure on Component management".*

This included a cross-reference to KPMG's working paper on going concern "*3.3.1.C.GC1 GOING CONCERN 2016*". This working paper contains no record, however, that KPMG considered the budgeting and forecasting process (whether "*in detail*" as planned or at all). It noted only that the budget had been approved by the Board.

1256.2 In the 2016 Audit Strategy Memorandum, KPMG stated that it planned to:

> *"Evaluate the Board's process for developing, assessing and approving forecasts used in the goodwill impairment review, deferred tax calculation and going concern assessment"*

There is, however, no evidence that KPMG performed its planned procedures in relation to the forecast cash flows used in Carillion's going concern assessment.

1257. KPMG therefore did not evaluate either:

1257.1 the process which management had followed to prepare its budgets and forecasts, or how these were assessed and approved by the Board; or

1257.2 the basis for and the reasonableness of any assumptions underlying the forecast cash flows.

1258. This was despite recognising that Carillion was under "*pressure … to meet expectations*" and that consequently "*Group management does forecast aggressively*", which should have highlighted the risk of management bias in the preparation of their assessment. KPMG should have approached that assessment with heightened professional scepticism.

(3) Reasons to challenge the assessment

1259. In addition to the failures described above, there were a number of areas where KPMG should have challenged management's assessment and/or requested further evidence, as set out below.

1260. **First**, KPMG considered a "*downside scenario*" where none of the £294 million, described as "*Overtrading*" or "*uncertified WIP*" at the year end,[89] would be recovered and identified that for a number of months in the period subsequent to the year end, the forecast headroom between borrowing requirements and borrowing facilities would reduce to just over £100 million. KPMG then concluded:

> *"KPMG have applied the worst case scenario of none being recoverable, even when applying this worst case scenario there is sufficient headroom."*

1261. However, KPMG had no proper basis to conclude that a shortfall of £294 million was the "*worst case scenario*", particularly where in its audit of Carillion's major contracts KPMG had identified risks over the recovery of amounts totalling over £600 million.

1262. There was also no explanation for why headroom of £100 million was deemed "*sufficient*".

1263. KPMG should have recognised that the failure to recover contentious amounts on certain major contracts presented a real risk that Carillion's borrowing requirements might exceed its facilities in the period under review.

1264. **Second**, at the year end, Carillion's net borrowing was £218.9 million. This represented a significant (and unexplained) improvement in net borrowing when compared to:

  1264.1 £711.9 million just three months earlier at 30 September 2016;

  1264.2 £586.5 million average of net borrowing at each month end of 2016; and

  1264.3 forecast net borrowing of £624 million at the end of January 2017, rising to £706 million at the end of March 2017.

1265. KPMG did not investigate how that improvement in net borrowing at the year end had been achieved. It therefore did not obtain an understanding of the true level of Carillion's indebtedness and financing requirements and did not consider the implications of these significant movements in net borrowing for the assessment of going concern.

[89] Understood to be revenue recognised but which had not been certified by Carillion's customer.

1266. **Third**, in relation to management's forecasting of profit:

1266.1 In the prior year, KPMG's working paper "*3.3.1.C.GC2 GOING CONCERN*" recorded that Carillion had set a budget for group underlying operating profit for 2016 of £214.9 million.

1266.2 Carillion's 2016 financial statements recorded that Carillion's group operating profit was £199.6 million, approximately £15 million lower than budget.

1266.3 However, a substantial proportion of the reported group operating profit resulted from "*one-off*" transactions, including £50.9 million from just two transactions - £34.2 million from the 2016 Outsourcing Transactions (Chapter 15) and £16.7 million from Portsmouth car park (Chapter 16). These were unlikely to have been included in the budgeted profit for 2016 and thus the difference between the budget and actual underlying profit was far greater.

1267. This shortfall between management's budgeted and actual underlying results suggested that management's profit forecasts may have been unduly optimistic, corroborating KPMG's observation that forecasting was "*aggressive*".

1268. **Fourth**, management's forecasting of borrowing also appeared to be optimistic. In November 2016, Carillion's forecast net borrowing for the year end was £175 million, but its actual net borrowing (as recorded in the 2016 financial statements) was significantly higher at £218.9 million.[90] Again, this showed a significant difference between management's budget and actual results and suggested that management's forecasts were optimistic.

1269. **Fifth**, there were various further factors that might have had an adverse impact on financing requirements and where KPMG should have challenged management's assessment and/or requested further evidence:

1269.1 KPMG was aware that not all of Carillion's cash was available to discharge Carillion's borrowing. KPMG did not consider whether restrictions on the accessibility of Carillion's cash had been accounted for in the assessment.

[90] "*2.5.1.011 NOV 16 BOARD MINUTES*" under the heading, "*Board meeting – 9 Nov 2016*": "*Net debt of £175.0 million for the full year is in line with the budgeted position*".

1269.2 KPMG had established, through its review of the minutes of Carillion's Board meetings, that the deficit recovery programme in relation to Carillion's pension obligations was *"not on track"*, that funding had *"worsened"* since the last valuation and that an increase in deficit recovery payments had been proposed *"from £39 million p.a. to £57 million until 2022"*. This would have represented an additional adverse cash flow of £18 million per annum. Note 30 to Carillion's 2016 financial statements shows that Carillion was expecting to pay £50.2 million to defined pensions schemes in 2017. KPMG did not consider whether these cash outflows had been accounted for in the assessment.

1269.3 KPMG was aware that the PFI sales had previously been a significant source of cash and profit for Carillion but that they were coming to an end. This represented the loss, or potential loss, of an important source of revenue and profits. KPMG did not consider whether this had been accounted for in the assessment.

1269.4 The EPF was a significant source of financing and its use had grown substantially over the previous years. Carillion's Full Year 2016 Going Concern Viability Review noted that EPF liabilities exceeded the "*prescribed limits*" and that the EPF "*does use up bank credit capacity which may limit opportunities elsewhere*". KPMG did not determine the nature and the limits of those credit facilities or test whether Carillion's forecasts for the use of EPF risked exceeding those limits.

1270. Overall, KPMG did not respond sufficiently either to indications that management's forecasting might be optimistic or to factors that might have had an adverse impact on financing requirements that should have been taken into account in that assessment. In both areas KPMG should have challenged management and obtained further information.

(4) Conclusion

1271. KPMG concluded in its working paper:

> *"Given the level of headroom available, we have significant comfort that the Group is a going concern for the twelve month period following the proposed signing date of the annual report."*

1272. However, the "*level of headroom"* depended on the reliability of management's forecast. As set out in this section, KPMG's evaluation of those forecasts was inadequate, and gave no proper consideration to whether they reflected all relevant information of which KPMG was aware. In particular, KPMG should have recognised that contentious amounts it had identified on certain major contracts presented a real risk that Carillion's borrowing requirements might exceed its facilities in the period under review.

1273. Further, having recognised the "*pressure* [on Carillion] … *to meet expectations*", KPMG should have identified the risk of management bias and approached the going concern assessment with an adequate degree of professional scepticism, but did not.

1274. There were thus breaches by **the Respondents** in the **2016 audit** of:

1274.1 **ISA 200 paragraph 15**, in that the Respondents did not approach management's assessment of Carillion's ability to continue as a going concern with an adequate degree of professional scepticism;

1274.2 **ISA 500 paragraphs 6 and 7**, in that the Respondents failed to design and perform appropriate audit procedures to enable them to obtain sufficient appropriate audit evidence to evaluate management's assessment of Carillion's ability to continue as a going concern; and

1274.3 **ISA 570 paragraphs 12 and 14**, in that the Respondents failed to perform adequate audit procedures in relation to management's assessment, specifically in failing to properly evaluate the assessment and in failing to ensure it included all relevant information.

D. Identifying and/or responding to events or conditions that may have cast significant doubt on Carillion's ability to continue as a going concern

(1) Introduction

1275. As set out above, ISA 570 required KPMG to consider whether there were events or conditions that may have cast significant doubt on Carillion's ability to continue as a going concern. KPMG was required to *"remain alert throughout the audit"* for such events or conditions, and where these were identified, to perform additional audit procedures in order to determine whether a material uncertainty existed.

1276. Carillion's ability to continue as a going concern depended on its ability to meet its financial obligations when they fell due. KPMG therefore needed to remain alert to events or conditions in the following areas:

 1276.1 Carillion's liabilities, and the extent to which it had demonstrated its ability to repay its borrowing;

 1276.2 Carillion's profitability and ability to generate cash and hence the extent to which Carillion would be able to meet its financial obligations in the future; and

 1276.3 Carillion's liquidity, that is, its ability to meet its immediate and short-term financial obligations.

1277. As set out below, there were events or conditions concerning these three areas that, when viewed collectively, may have cast significant doubt over Carillion's ability to continue as a going concern and therefore further audit procedures were required to be performed. KPMG gave no, or no proper, consideration to these matters.

(2) Increases in Carillion's liabilities

1278. Carillion's 2016 financial statements and annual report recorded that net borrowing increased in 2016, specifically:

 1278.1 Carillion's total borrowing (i.e., the total of current and non-current bank overdrafts, bank loans, finance lease obligations and other loans) had increased by £56.7 million to £688.7 million;

 1278.2 year end net borrowing (borrowing less cash and cash equivalents) had increased by £49.1 million (29%) to £218.9 million; and

1278.3 average net borrowing had increased by £47.6 million (9%) to £586.5 million (average net borrowing being "*the average of the net borrowing at the end of the previous financial year and each of the month end net borrowing figures as reported to the Board in the current financial year*").

1279. However, these substantial increases in reported net borrowing did not reflect Carillion's use of all sources of financing, including:

1279.1 An increase in the use of the EPF, which provided Carillion with an improvement in its cash flow and was in substance a form of additional financing (see Chapter 14 Part C).

1279.2 A huge increase in trade and other payables of £301.5 million during 2016. Whilst this included the EPF Amounts, the extent of the increase suggested that Carillion was taking longer to pay significant amounts to suppliers and other short-term creditors outside the EPF at the year end, effectively using them as further short-term financing. This could only have been a short-term measure and was unsustainable.

1280. Carillion's financing requirements by the year end had therefore increased significantly and by far more than the increase in reported net borrowing suggested. This suggested Carillion was not generating sufficient cash to avoid debt levels from rising significantly.

(3) Carillion's ability to generate cash

1281. Carillion's 2016 financial statements recorded net cash inflows from operating activities to be £73.3 million. However, there were indications that Carillion's core business was not in fact generating cash.

1282. **First**, as noted above, a significant proportion of the cash inflow was attributable to a huge increase in trade and other payables of £301.6 million, including the expansion of the EPF. Without this, operating cashflow would have been negative.

1283. **Second**, KPMG was aware that a number of one-off transactions had increased reported cash at the year end.

1284. On 28 November 2016, KPMG Senior Manager A emailed other members of the KPMG audit team, observing, "[t]*he "one-offs" list is creeping ever upward*". KPMG Senior Manager A's running total at that time (i.e., at the planning stage) recorded that £88.2 million in profit and £152.2 million in cash was attributable to these one-offs. As the table below shows, the amounts ultimately included in Carillion's 2016 financial statements were smaller, but still substantial:[91]

	One-offs per KPMG Senior Manager A's email of 28 Nov 2016		**One-offs included in 2016 financial statements**	
	Profit	**Cash**	**Profit**	**Cash**
The Geneva Sale (relating to Outsourcing Transactions)	£20.0m	£20.0m	£20.0m	£20.0m
Sale of IP (relating to Outsourcing Transactions)	£10.0m	£10.0m	£9.0m	£10.0m
Mobilisation on Outsourcing Transaction (relating to Outsourcing Transactions)	£5.0m	£5.0m	£5.2m	£10.0m
Restructuring Caribbean	£20.0m		[Unknown]	
Sale of Portsmouth car park income	£25.0m	£25.0m	£16.7m	£9.4m
A transaction		£74.0m	-	-
Debt factoring		£10.0m		[Unknown]
Total	**£80.0m**	**£144.0m**	**At least £50.9m**	**At least £49.4m**

1285. Carillion's reliance on one-offs to improve profit and cash at the year-end was unsustainable, as KPMG knew, or should have known.

1286. KPMG was also aware that concerns over cash generation had been raised within Carillion:

1286.1 On 25 July 2016, KPMG met with a member of the Audit Committee. KPMG's minutes of that meeting record, "[the member of the Audit Committee's] *main concern was around cash collection*".

1286.2 KPMG's working paper "*2.4.1.0010 GROUP PLANNING ANALYTICS*", which contained KPMG's preliminary analytical review dated 23 November 2016, noted that non-operating outflows (including investments in acquisitions and net capital expenditure) exceeded cash flow from operations and that this "*raised considerable cash pressure throughout the group*". The same

[91] The references to "Sale of Geneva", "Sale of IP", and "Mobilisation on the Outsourcing Transaction" are to the 2016 Outsourcing Transactions (see Chapter 15). The reference to "Sale of Portsmouth car park income" is to revenue from the Portsmouth car park (see Chapter 16).

analytical review also referred to "*margin pressure*", which raised questions on whether profitability may have been falling.

(4) Liquidity

1287. The level of "*Net current assets*", being current assets minus current liabilities, provides insight into the net amount of likely cash receipts and payments due over the subsequent twelve months and so indicates how easily a business can meet its most immediate financial obligations. A very low or negative amount indicates that, whilst a business might be profitable and might have valuable assets, it nonetheless may not be able to meet its obligations and may therefore be in financial difficulty.

1288. Carillion's 2016 financial statements recorded that Carillion's current assets were £2,269.8 million and its current liabilities were £2,217.4 million. Net current assets were therefore just £52.4 million. Further:

1288.1 Note 30 to the 2016 financial statements disclosed that Carillion was expecting to pay £50.2 million in pension deficit contributions over the course of the following year. This was shown within "*non-current liabilities*". Whilst there was no requirement under IFRS to classify this as a current liability, a more representative consideration of cash flows would have included the £50.2 million as being an outflow within the next 12 months.

1288.2 Current assets included £614.5 million for "*Amounts owed by customers on construction contracts*". This had increased significantly from £386.8 million in 2015, and incorporated significant amounts, in particular from claims, over which both the timing and amount of the related receipt was highly uncertain.

1289. A more representative position on net current assets would therefore have been just £2.2 million and even this would have incorporated significant uncertainty. It should therefore have been apparent to KPMG that Carillion had a very low, and quite possibly negative, level of net current assets.

1290. Further, Carillion's 2016 financial statements recorded total assets of £4.433 billion and total liabilities of £3.703 billion, with overall net assets of £729.9 million. The non-current assets included the following:

Intangibles (predominantly goodwill)	£1,669.3 million
Deferred tax assets	£148.4 million
Investments in joint ventures	£174.9 million
Total	£1,992.6 million

1291. These assets could not easily or swiftly be sold or exchanged for cash if required. In contrast, the liabilities reflected in Carillion's 2016 financial statements were generally payable within one to three years.

1292. The positive amount for overall net assets thus did not provide any comfort over Carillion's ability to meet its liabilities as they fell due.

(5) Conclusion

1293. As noted in Section C above, the possibility that Carillion would not recover the very significant contentious amounts that KPMG had identified on certain major contracts presented a risk that Carillion's borrowing requirements might exceed its facilities.

1294. A significant increase in Carillion's liabilities and financing requirements indicated it was not generating sufficient cash to reduce its borrowing. There were other indications that Carillion's core business was not generating cash and that it was instead relying on '*one off*' transactions to generate cash, which was likely to be unsustainable.

1295. Carillion's very low level of net current assets and high level of illiquid assets suggested that, taken together with these concerns about cash generation, it might have difficulties in meeting its short-term financial commitments.

1296. In view of all of these matters, KPMG should have concluded that these were collectively "*events or conditions*" that may have cast significant doubt over Carillion's ability to continue as a going concern and therefore that further audit procedures were required.

1297. KPMG, however, failed to identify any of these matters and failed to properly assess their cumulative effect on the going concern assumption and whether there was any material uncertainty about Carillion's ability to continue as a going concern.

1298. There were thus breaches by **the Respondents** in the **2016 audit** of:

1298.1 **ISA 200 paragraph 15**, in that the Respondents failed to plan and perform the audit with an adequate degree of professional scepticism and did not critically assess the evidence in relation to Carillion's ability to continue as a going concern; and

1298.2 **ISA 570 paragraphs 10 and 11**, in that the Respondents failed to consider adequately or at all whether there were events or conditions that might have cast significant doubt on the ability of Carillion to continue as a going concern.

PART D

19. VALUATION OF PENSION SCHEME LIABILITIES

The 2016 financial statements reported an increase of over £400 million in Carillion's net liability in respect of its employee pension schemes, taking the total to over £800 million. This increase was mainly driven by an increase in the valuation of Carillion's future obligations under the schemes and in particular by changes to a number of financial and actuarial assumptions on which this valuation was based.

However, even with this increase, KPMG's actuaries regarded the assumptions used in the 2016 audit as likely to result in a valuation of liabilities "*at the extreme weak limit*" of acceptability, so minimising the amount reported. KPMG identified that moving some of these assumptions to the centre of its benchmark range would have increased the reported liability by at least a further £200 million. KPMG failed to respond to this and other indications of management bias relating to these assumptions.

In addition, KPMG's actuaries identified a number of elements of Carillion's valuations which required further audit work to ensure the accounting treatment was appropriate. KPMG failed to perform this further audit work adequately or at all.

A. Overview

1299. In 2016, Carillion operated 14 defined-benefit pension schemes, 13 in the UK and one in Canada. In addition, Carillion provided post-retirement benefits under four separate arrangements in Canada.[92]

1300. A defined benefit pension scheme creates an obligation on an employer to provide specific benefits to current and past employees. An employer generally accumulates pension scheme assets to fund this obligation. The net liability (or asset) reported by the employer in its financial statements is the difference between:[93]

    1300.1 the fair value of any pension scheme assets; and

[92] Carillion's 2016 financial statements at page 128.

[93] IAS 19 paragraph 8.

1300.2 the present value of the obligation arising from employee service in the current and prior periods, calculated by:[94]

1300.2.1 estimating the value of the future obligations by making assumptions about financial and actuarial variables such as inflation, future salary increases and mortality; and

1300.2.2 applying a discount rate to these future obligations.

1301. This chapter addresses KPMG's audit work in relation to the valuation of pension scheme liabilities – it does not consider KPMG's audit work relating to the pension scheme assets.

1302. Carillion's 2014, 2015, and 2016 financial statements provided the following amounts and disclosures relating to its defined benefit pension schemes:[95]

	2014	2015	2016
Financial amounts			
Gross pension obligations	£2,830.1m	£2,695.9m	£3,377.5m
Gross pension assets	£2,320.4m	£2,302.4m	£2,572.7m
Net defined benefit liability	£509.7m	£393.5m	£804.8m
Actuarial gain/(loss) arising from changes in financial assumptions	(£278.3m)	£112.4m	(£724.8m)
Main assumptions[96]			
Discount rate	3.70%	3.95%	2.70%
Inflation - RPI	3.05%	3.05%	3.20%
Inflation - CPI	2.00%	2.00%	2.15%
Salary increases	3.55%	3.55%	3.20%

1303. As this table shows, (a) Carillion's net defined benefit liability increased significantly in 2016 from £393.5 million to £804.8 million and (b) this increase was mainly driven by an "*actuarial loss*" arising from changes in financial and actuarial assumptions. These assumptions were determined by management, after receiving recommendations from independent external actuaries appointed by Carillion ("**Carillion's external actuaries**").

[94] IAS 19 paragraph 57.

[95] Carillion's 2014 financial statements at pages 79 and 111 to 114; Carillion's 2015 financial statements at pages 83 and 115 to 119; Carillion's 2016 financial statements at pages 93 and 128 to 131.

[96] These were the assumptions used in valuing liabilities under Carillion's UK pension schemes. Different assumptions were used in respect of Carillion's Canadian scheme.

1304. For the 2016 audit, KPMG identified the valuation of pension scheme obligations as a significant risk, explaining as follows:

> *"In providing the valuation of each of the Group's pension schemes the Group's independent qualified actuaries use certain principal assumptions around discount rate, forecast inflation and mortality. The outcome of this valuation could vary significantly if the assumptions applied differed by only a small percentage."*

1305. KPMG asked its own actuaries to review the actuarial assumptions applied by Carillion's external actuaries and the methods used to prepare the valuations. KPMG's actuaries set out their own assessment in working paper "*AP200.3.P.2 AUDIT ASSIST REPORT*".

1306. In their report, KPMG's actuaries:

1306.1 concluded that *"the assumptions overall are likely to result in liabilities that are within our normally acceptable range, albeit at the extreme weak limit"*;

1306.2 identified that further evidence was required to support the changes made in 2016 to the assumptions on salary increases and mortality, which had the effect of reducing the valuation of Carillion's obligations by £8-9 million and £40 million respectively;

1306.3 raised issues relating to specific elements of the valuation, described in Section C below, which indicated that Carillion's liability might be significantly understated and required consideration by the audit team; and

1306.4 noted that because the Canadian pension schemes constituted only 1% of total liabilities, they had not reviewed assumptions relating to overseas schemes.

1307. KPMG also calculated that the reported liabilities would have been approximately £215 million greater if the assumptions on inflation and discount rates had been moved to "*the centre of KPMGs benchmark range*".

1308. As set out below, the audit work on pension liabilities was deficient in that KPMG:

1308.1 did not obtain sufficient evidence to support either the changes in assumptions relating to salary increases or mortality, or their conclusion that Carillion's chosen inflation and discount rates placed it within the "*median range*" of comparable companies;

1308.2 failed to perform an adequate review of management's judgements more generally, showing a lack of scepticism and failing to respond adequately to the risk of management bias;

1308.3 did not adequately respond to five separate issues identified by its actuaries, highlighting potential misstatements in the 2016 financial statements and suggesting that further work was required;

1308.4 did not perform any, or adequate, audit work on the assumptions used in connection with the Canadian schemes which were outside the scope of KPMG's actuaries' review; and

1308.5 did not perform any work to check the source data relied on by Carillion's actuaries in performing their work.

1309. The rest of this chapter is structured as follows:

1309.1 Section B concerns KPMG's audit work on the actuarial assumptions applied in calculating Carillion's pension obligations.

1309.2 Section C concerns KPMG's audit work relating to specific issues raised by KPMG's actuaries, namely:

1309.2.1 Pension Scheme A;

1309.2.2 Pension Scheme B;

1309.2.3 IFRIC 14 adjustments;

1309.2.4 PPF levy; and

1309.2.5 Canadian pension schemes.

1309.3 Section D concerns KPMG's audit work on source data.

B. Actuarial assumptions

(1) Introduction

1310. As noted above, the valuation of Carillion's pension obligations required management to make assumptions about inflation, future salary increases, mortality rates and an appropriate discount rate.

1311. In relation to these assumptions, IAS 19 provided:

> *"Actuarial assumptions shall be unbiased and mutually compatible.*
>
> *…. Actuarial assumptions are unbiased if they are neither imprudent nor excessively conservative.*
>
> *… Actuarial assumptions are an entity's best estimates of the variables that will determine the ultimate cost of providing post-employment benefits."*

1312. Reported liabilities in relation to pension obligations would decrease with:

1312.1 lower assumptions for inflation and salary increases; and

1312.2 higher assumptions for the mortality and discount rate.

1313. KPMG was aware that the outcome of the valuation of Carillion's pension liabilities:

> *"could vary significantly if the assumptions applied differed by only a small percentage".*

This was not uncommon when calculating pension liabilities, but KPMG was nevertheless required to conclude on whether management's approach was reasonable and ultimately whether the risk of material misstatement had been sufficiently addressed.

1314. In 2016 KPMG's actuaries reported to the group audit team that the overall effect of the assumptions adopted by Carillion was that they were likely to result in reported liabilities "*within our normally acceptable range, albeit at the extreme weak limit*".

1315. In light of this, it was important for KPMG to assess the assumptions adopted by management, both individually and in the round, to identify whether there were risks of management bias. Each of the assumptions is now considered below.

(2) Inflation and discount rate assumptions

1316. The net discount rate (that is, the difference between the discount rate and Retail Price Index ("**RPI**")) was described by KPMG's actuaries as "*"in most cases the key assumption" in valuing pension liabilities"*. As KPMG recognised in working paper "*TOD 3.1 Professional Judgement Paper*":

> *"The gap between the discount and inflation rates is the main driver of the liability and deficit numbers".*

1317. Carillion's external actuaries provided valuations of Carillion's pension liabilities in a report dated 30 January 2017, which was saved on the audit file as working paper "*TOD 4.B.1* [Carillion's external actuaries'] *Report" ("***independent report**").

1318. The independent report stated:

> *"The rationale for the assumptions used for the valuation is described in our draft paper on assumptions dated 5 January 2017. After consideration of our advice, the Company has determined to use the assumptions recommended in that paper with the following changes:*
>
> - *the inflation risk premium was increased from 0.25% p.a. to 0.30% p.a. …".*

1319. The effect of Carillion increasing by 0.05% the inflation risk premium which had been recommended by Carillion's external actuaries was to reduce both inflation measures – RPI and Consumer Price Index ("**CPI**") – by 0.05%. Carillion's assumptions on inflation were therefore less prudent than those recommended by Carillion's external actuaries.

1320. KPMG's actuaries then:

1320.1 determined benchmarks for the inflation measures – RPI and CPI – and discount rate, and an "*acceptable range*" around the benchmark figure; and

1320.2 compared Carillion's assumptions against those benchmarks and ranges.

1321. KPMG's actuaries reported that:

1321.1 Carillion's assumed discount rate of 2.7% was "*higher (less prudent) than our benchmark [*2.55%*], but within the normally acceptable range*";

1321.2 Carillion's assumed RPI of 3.2% was "*lower (less prudent) than our benchmark [*3.45%*], but on the edge of our normally acceptable range*"; and

1321.3 Carillion's assumed CPI of 2.15% was less prudent and "*just outside the normally acceptable range*" of 2.45% +/- 0.25%.

1322. As with any large defined benefit pension scheme, variances in the assumptions within the "*normally acceptable range*" could have a very significant impact on Carillion's reported pension liabilities, of many multiples of audit materiality. In its 2016 Memorandum to the Audit Committee, KPMG stated:

> *"Moving the discount rate and inflation rate assumptions to the centre of KPMG's benchmark range would increase the pension scheme liabilities at 31 December 2016 by approximately £215 million".*

1323. There is no evidence that KPMG considered whether further analysis or evidence was required in light of:

1323.1 Carillion's selection of rates that were consistently less prudent than KPMG's benchmark rates (in one case "*on the edge of*" and in another case "*outside*" the normally acceptable range);

1323.2 the size of the "*normally acceptable range*" compared to materiality set for the audit;[97] or

1323.3 the impact on both the value of the liability and on Carillion's overall reported financial position of adopting KPMG's benchmark rates.

1324. In fact, in contrast to the view of its actuaries, KPMG stated in its 2016 working paper "*4.5.4.5 Pension Valuation*":

> *"Consistent with previous periods, management has adopted assumptions which they believe will place them within the market median range once full market data becomes available".*

1325. This reflected Carillion Director A's report to the Audit Committee, which stated:

> *"We continue to target overall assumptions which fall within the median range for our peer group, taking into account market conditions and benchmarking our pension assumptions against comparative FTSE constituent disclosures."*

1326. KPMG's actuaries compared the assumptions on the RPI and discount rates adopted by Carillion with the "*preliminary*" RPI and discount rates of 67 of KPMG's audit clients (including the preliminary assumptions of Carillion). KPMG's actuaries explained:

> *"as the assumptions are only preliminary they may not be the final audited and accepted assumptions adopted".*

1327. The comparison of the final assumptions adopted by Carillion against the preliminary RPI and discount rates of 67 of KPMG's audit clients indicated that:

1327.1 only 19% of the preliminary net discount rates were equal to or lower (less prudent) than the net discount rate used by Carillion (–0.5%);

1327.2 Carillion's assumptions therefore placed it in the bottom quartile of preliminary net discount rates; and

[97] Given that the effect of moving Carillion's assumptions to the centre of the range was to increase liabilities by £215 million, it seems that the difference between the top and bottom of the range was over £500 million.

1327.3 the comparison identified a single value for a median net discount rate (–0.7%), with the comment "*The Company is therefore more optimistic than the median we are expecting*".

1328. Despite the above, KPMG concluded as follows:

1328.1 "*An assessment of the information available to date indicates that the assumptions chosen by management are within the current median range*"; and

1328.2 "*Although we recognise that a high level of subjectivity remains in the above assumptions, those used by the client (after adjustments made due to KPMG feedback) are within our benchmark ranges and are expected to fall within the median range of comparative companies. As such the risk of material misstatement is considered to be reduced to an acceptable level*".

1329. This conclusion had no basis in the light of the evidence available to KPMG. Nor did it contain any explanation for:

1329.1 the phrase "*median range*",[98] or how it was defined or calculated;

1329.2 how Carillion's assumptions, which on the evidence placed it in the bottom quartile of the relevant group, could nevertheless be within the "*median range*"; or

1329.3 how the data considered could provide a "*market median range*" or whether that group comprised either "*comparable companies*" or Carillion's "*peer group*", including in particular:

1329.3.1 whether the data related to UK pension schemes, overseas schemes or a mixture; or

1329.3.2 the size of the pension schemes to which the data related.

[98] The median is a single value and consequently a "*median range*" does not have any obvious or easily discernible meaning.

1330. In summary:

1330.1 The inflation and discount rate assumptions applied by Carillion were both less prudent than those recommended by Carillion's external actuaries and less prudent than those recommended by KPMG's actuaries. The inflation rates in particular were either "*on the edge of*" or "*just outside*" KPMG's "*normally acceptable range*". The actuaries nonetheless concluded that the "*assumptions overall*" were *within our normally acceptable range, albeit at the extreme weak limit*".

1330.2 Reported pension scheme liabilities would increase by approximately £215 million if the midpoints of the benchmarks determined by KPMG's actuaries for the inflation and discount rate assumptions were adopted.

1330.3 KPMG's conclusion that Carillion's selected rates were "*within the market median range"* had little basis and ignored evidence that the rates were in fact in the bottom quartile of market data considered by KPMG's actuaries.

(3) Future salary increase assumptions

1331. In 2014 and 2015, Carillion had assumed that salary increases would increase at 0.5% above RPI. In 2016, however, Carillion reduced the salary increases assumption so that it was in line with RPI only (see paragraph 1302 above).

1332. The independent report recorded this change in approach as follows:

> *"The rationale for the assumptions used for the valuation is described in our draft paper on assumptions dated 5 January 2017. After consideration of our advice, the Company has determined to use the assumptions recommended in that paper with the following changes:*
>
> *[…]*
>
> - *the rate of compensation increase has been set in line with the assumed increase in RPI inflation, to reflect the Company's view on likely future pay growth".*

1333. In their 2016 report, working paper "*AP200.3.P.2 AUDIT ASSIST REPORT*", KPMG's actuaries commented on this change as follows:

> *"This change is acceptable provided the Directors have reasonable justification for this change and the new assumption reflects the Directors' views of salary increases over the future working lifetime of active Scheme members*
>
> *In isolation, the impact of this change is estimated by KPMG to reduce the actuarial liability, assuming an average term to retirement of 10 years, by between £8m to £9m".*

1334. The impact of the change to the assumptions on future salary increases on the estimate of Carillion's obligations was thus material and required further audit procedures.

1335. Despite this, the group audit team did not identify this assumption as an "*action point/issue*" requiring further work in the 2016 audit and there is no evidence that KPMG performed any further audit procedures. In particular, there is no evidence that KPMG:

1335.1 sought to obtain, or obtained, evidence about the directors':

1335.1.1 justification for the change; or

1335.1.2 views of future salary increases throughout the working lifetime of active scheme members; or

1335.2 compared the new assumption with evidence of actual increases in salaries:

1335.2.1 for all Carillion employees; or

1335.2.2 for those employees who were members of a pension scheme.

(4) Mortality

1336. In 2016, Carillion changed two elements of its approach to its assumption on mortality:

1336.1 adjustments to published tables of mortality data, referred to as "base tables", to reflect the population of each scheme; and

1336.2 the model for projecting mortality improvements in the future.

1337. In their 2016 report, working paper "*AP200.3.P.2 AUDIT ASSIST REPORT*", KPMG's actuaries commented on these changes as follows:

> *"For all UK schemes, the post-retirement base table mortality assumptions have been updated compared with the prior year.*
>
> *For all UK Schemes, the mortality improvement tables have been updated compared to the prior year. No justification for these changes has been included in the information we have been provided.*
>
> *The overall impact of both changes varies by Scheme, but overall across all of the Schemes there is a reduction in life expectancy, decreasing the actuarial liability by around £40m.*
>
> *For most schemes, the resulting life expectancies are within the normally acceptable range. We would need to request further information on the nature of the roles undertaken by members to comment on the appropriateness of the assumption[s] for the Schemes".*

1338. The impact of these changes on the estimate of Carillion's obligations was therefore multiple times audit materiality of £8 million, with no justification provided for the changes.

1339. However, there is no evidence that the group audit team either sought to obtain, or obtained:

1339.1 a justification for the update to Carillion's mortality assumption; or

1339.2 any other evidence in connection with Carillion's mortality assumption.

(5) Overall consideration of management bias in relation to assumptions

1340. As noted above, the valuation of Carillion's pension obligations required management to make assumptions about inflation, future salary increases, mortality rates and an appropriate discount rate. Small differences in these assumptions could lead to large differences in the resulting valuation of pension liabilities. These assumptions were required to be unbiased, mutually compatible and Carillion's "*best estimates of the variables that will determine the ultimate cost of providing post-employment benefits*". They had to be assessed both individually and cumulatively.

1341. In its 2016 working paper "*4.5.1 Management Bias*", KPMG documented its assessment for possible management bias as follows:

> *"We can be comfortable that there is no intentional management bias in regards to the Group's pension assumptions, largely because our testing has involved the use of* [Carillion's external actuaries]*, the experts engaged by management, and KPMG actuarial specialists. The assessment of the work performed by these experts and specialists has been performed in <3.2.AP200, TOD03>. The terms of engagement between Carillion and* [Carillion's external actuaries] *evidences that there is no limitation of scope on their work and our direct contact with them further serves to confirm that independence and inability for management to exert undue influence. However, even though the assumptions are within KPMG benchmark range, therefore comfort gkained, they are very optimistic".*

1342. KPMG's reliance on the involvement of Carillion's external actuaries and KPMG's actuaries as a basis for a conclusion that there was no intentional management bias in respect of the actuarial assumptions was inappropriate given:

1342.1 KPMG was aware, or should have been aware, that in one instance (the increase in inflation risk premium from 0.25% p.a. to 0.30% p.a.) the assumptions used by Carillion's external actuaries to calculate its valuations were determined by Carillion; and

1342.2 KPMG's actuaries considered that the assumptions were likely to result in amounts for liabilities "*at the extreme weak limit*" of a very large range.

1342.3 KPMG characterised the assumptions overall as *"very optimistic"*.

1343. KPMG should have performed further analysis to address in the round the impact of possible management bias on the actuarial assumptions, particularly in view of both the above and of the following facts:

1343.1 The inflation and discount rate assumptions applied by Carillion were less prudent than both those recommended by Carillion's external actuaries and KPMG's actuaries, with the inflation rates either "*on the edge*" or "*just outside*" KPMG's "*normally acceptable range*". The c.£215 million increase in reported pension scheme liabilities, if the inflation and discount rate assumptions were moved to the centre of the benchmark range, was very significant.

1343.2 The change to the assumptions on future salary increases, which had reduced the reported liabilities by a material amount and for which KPMG had obtained no supporting evidence.

1343.3 The change to the assumptions on mortality, which had reduced the reported liabilities by multiple times materiality and for which KPMG had obtained no supporting evidence.

1344. There were thus breaches by **the Respondents** in the **<u>2016 audit</u>** of:

1344.1 **<u>ISA 200 paragraph 15</u>**, in that the Respondents did not approach this area with an adequate degree of professional scepticism and did not respond adequately to an obvious risk of management bias;

1344.2 **<u>ISA 540 paragraphs 12(b) and 21</u>**, in that the Respondents failed to properly determine whether methods for making the accounting estimates were appropriate and consistent, and failed to perform an adequate review of the estimates for indicators of possible management bias; and

1344.3 **<u>ISA 500 paragraph 6</u>**, in that the Respondents failed to design and perform appropriate audit procedures to enable them to obtain sufficient appropriate audit evidence to support their conclusions that:

1344.3.1 Carillion's assumptions on inflation and discount rates were within the "*median range*" of the market and/or comparable companies; and

1344.3.2 Carillion's change in approach to salary increases and mortality assumptions were justified.

C. Specific issues raised by KPMG's actuaries

(1) Pension Scheme A

1345. Pension Scheme A was an industry-wide defined benefit pension scheme, in which various employers in the rail industry, including Carillion, participated.

1346. In their report, working paper "*AP200.3.P.2 AUDIT ASSIST REPORT*", KPMG's actuaries commented on Carillion's accounting treatment of Pension Scheme A as follows (emphasis in original):

> *"Under the rules of* [Penson Scheme A], *the employer has the option of making the member pay 40% of the cost of the Scheme (both for ongoing service and deficit contributions). Accordingly the Company can opt to show only 60% of the P&L cost and deficit related to these sections. It is likely that if the cost being met by the member is too large, they will leave the Scheme and the entire cost will fall to the Company. Alternatively, the Company may decide to meet the cost directly rather than passing it on to members.*
>
> *It is unclear from the information provided and the prior year accounts whether the Company has or intends to take advantage of this, however, the narrative provided by the Actuary suggests this to be the case.*
>
> *It is a judgement call for the audit team as to whether it is reasonable to assume the employees will realistically meet 40% of the cost (e.g. 40% of the deficit in the GTRM section of* [Pension Scheme A] *is c. £41m, which when split between the active members is a deficit of c. £360k per person – equivalent to around 50% of pensionable pay every year up to these members' retirement, in addition to the cost of funding further benefits).*
>
> *An initial action could be to look at the Schedule of Contributions for these sections, and if the Company is already meeting the deficit payments it would be reasonable for the Company to recognise 100% of the cost in the accounts.*
>
> *As a guide, the impact of recognising the full cost compared with a 60% share is to increase the balance sheet deficit by c. £45m as at 31 December 2016 as well as increasing the P&L charge in the year to 31 December 2016.* ***This should be considered further if the amount is material to the audit.****"*

1347. According to KPMG's actuaries therefore, the Pension Scheme A provided that Carillion could require members of the Pension Scheme A to contribute 40% of the cost of the scheme and on this basis, Carillion was recognising only 60% of the obligations. However, KPMG's actuaries raised a question as to whether this was consistent with the current payments into the scheme being made by Carillion, and whether requiring the members to bear 40% of the costs – c £360k per person – was achievable in practice.

1348. The group audit team therefore needed to assess whether the assumption that members would meet 40% of the cost of Pension Scheme A was reasonable. If not, then Carillion would need to reflect this when quantifying its obligation under Pension Scheme A. KPMG's actuaries estimated that if members did not meet any of the costs, then this would increase Carillion's net pension liability by around £45 million.

1349. In relation to whether the assumption that members would meet 40% of the cost of Pension Scheme A was reasonable:

1349.1 KPMG's actuaries were unclear whether and to what extent Carillion had taken or intended to take advantage of this option. However, evidence in the form of the Schedule of Contributions could be expected to be available;

1349.2 KPMG had been informed by Carillion's external actuaries that the current level of contribution of the members to the deficit was "*not currently 60/40*" and so the assumption did not reflect the present level of contribution of its members; and

1349.3 the 40% costs were substantial, at £360,000 per scheme member or around 50% of pensionable pay until retirement, and it was therefore highly likely that, rather than bearing this cost, members would leave the scheme, meaning that the entire cost would fall to Carillion.

1350. KPMG's actuary suggested that:

> *"The "ideal" next step would be to ask the Company to think a bit harder about this, and come to us with a revised proposal, which could be anything from recognition of 100% of the liability through to probably around 80% of the liability (and maybe further if they have strong justification) – albeit we would want some evidence to back up whatever they propose – the obvious one being the proposed split of employer/employee deficit recovery payments."*

1351. Instead, KPMG accepted the assumption that members would contribute 40% of the cost of Pension Scheme A on the basis of representations from Carillion that they expected to win new work and so add enough new employees to Pension Scheme A, such that members would ultimately accept liability for 40% of the deficit.

1352. KPMG should have been sceptical of whether this was achievable, and in particular the suggestion that new employees would have accepted membership of a defined benefit scheme pension which would have required them to contribute towards a very substantial existing deficit.

1353. In addition, KPMG should have identified the inconsistency between:

1353.1 Carillion's representation that new employees would be invited to join Pension Scheme A; and

1353.2 the policy of Carillion, recorded in its 2016 financial statements, that "*defined benefit pensions are not offered to employees except where required under legislation or to meet the requirements of work winning*".[99]

1354. There were thus breaches by **the Respondents** in the **2016 audit** of:

1354.1 **ISA 200 paragraph 15**, in that the Respondents did not approach this area with an adequate degree of professional scepticism, and so did not critically assess a key assumption on which Carillion's accounting treatment of Pension Scheme A was based;

1354.2 **ISA 500 paragraph 6**, in that the Respondents failed to design and perform appropriate audit procedures to enable them to obtain sufficient appropriate audit evidence to support Carillion's accounting treatment of Pension Scheme A; and

1354.3 **ISA 540 paragraphs 18 and 21**, in that the Respondents failed to properly evaluate whether the estimate of 60% was reasonable and failed to perform an adequate review of the estimate for indicators of possible management bias.

(2) Pension Scheme B

1355. Pension Scheme B is an industry-wide pension scheme in which various employers in the electricity supply industry, including Carillion, participated.

[99] Carillion's 2016 financial statements at page 45.

1356. IAS 19 "*Employee Benefits*" outlined the accounting requirements for defined benefit pensions schemes and paragraph 61 provided as follows:

> *"An entity shall account not only for its legal obligation under the formal terms of a defined benefit plan, but also for any constructive obligation that arises from the entity's informal practices. Informal practices give rise to a constructive obligation where the entity has no realistic alternative but to pay employee benefits. An example of a constructive obligation is where a change in the entity's informal practices would cause unacceptable damage to its relationship with employees".*

1357. This required Carillion to include in its pension liabilities the value of any discretionary benefits which it expected to award.

1358. In their 2016 report, KPMG's actuaries identified an issue concerning the application of this provision, commenting as follows (emphasis in original):

> *"We note that the Company retains an element of discretion over the benefits to award in the Carillion Staff Pension Scheme and the Carillion Group of* [Pension Scheme B]. *Specifically, that in any years where RPI inflation exceeds 5% the Company can choose to award pension increases inline with RPI rather than capping them at 5%. …*
>
> *We further note that in* [Pension Scheme B] *the recorded liabilities is not in line with the Actuary's description of the Company's historic practice with regards to this discretion. This is not in line with our understanding of the requirements of IAS19 (where the liability should reflect the current expectation of the future exercise of discretion), and adjusting this would add c.£2.5m to the balance sheet liability.*
>
> ***This should be considered further if the amount is material.****"*

1359. The group audit team was therefore advised that the recorded liabilities for Pension Scheme B reflected an approach that was inconsistent with that previously adopted by Carillion, indicating a risk of misstatement.

1360. Despite the above, there is no evidence that KPMG performed any audit procedures to determine whether the approach taken was appropriate. The group audit team did not identify this as an "*action point/issue*" requiring further work in the 2016 audit and consequently did not obtain any evidence as to whether there was a proper basis for the departure from the "*Company's historic practice*" in calculating the scheme liabilities.

1361. There were thus breaches by **the Respondents** in the **2016 audit** of **ISA 500 paragraph 6**, in that the Respondents failed to design and perform appropriate audit procedures to enable them to obtain sufficient appropriate audit evidence to support Carillion's accounting treatment of Pension Scheme B.

(3) IFRIC 14 adjustments

1362. IFRIC Interpretation 14 ("**IFRIC 14**") provided guidance to ensure that statutory minimum funding requirements for pension schemes were appropriately reflected in reported amounts. Adjustments prescribed by IFRIC 14 to reflect these requirements particularly impacted pension schemes in surplus, that is, whose assets exceeded the obligations.

1363. In their 2016 report, working paper "*AP200.3.P.2 AUDIT ASSIST REPORT*", KPMG's actuaries commented on Carillion's application of IFRIC 14 in relation to Pension Scheme B and another pension scheme ("**Pension Scheme C**") as follows (emphasis in original):

> *"The Company has applied IFRIC14 for one of the Schemes, resulting in a total adjustment of £15.9m. We would need further details of the underlying recovery plans and copies of the legal advice confirming IFRIC14 applies to confirm this figure.*
>
> *We note that the* [Pension Scheme C] *is in surplus but its position on IFRIC is not specified by* [Carillion's external actuaries] *in their report. The impact of restricting this surplus would be an increase of the balance sheet deficit by c. £5.8m at least, and potentially more depending on the Schedule of Contributions. Based on a 'typical' recovery period of 10 years this could be in the region of £20m.* ***The audit team should confirm the IFRIC position if this amount is likely to be material, in particular, whether the Company has an unconditional right to a refund of surplus on wind-up.***
>
> *Disclosure requirements*
>
> *In the FRC's Annual Review of Corporate Recording 2015/16, the FRC have once again explicitly stated that expect entities to disclose any significant accounting judgements made when assessing trustees' rights in determining whether surplus can be recognised.*
>
> *We have not reviewed the disclosure as it is outside the agreed scope, but would be happy to review a draft to check it is consistent with the FRC's expectations."*

1364. In the above passage, KPMG's actuaries informed the group audit team that:

1364.1 it was necessary to obtain further audit evidence to confirm the amount of £15.9 million for the Pension Scheme B increase in liabilities;

1364.2 it was necessary to obtain confirmation and further evidence on the treatment of a surplus in connection with Pension Scheme C, which had an impact estimated as between £5.8 and £20 million;

1364.3 Carillion was required to disclose any significant accounting judgements it had made in determining whether to recognise a surplus on its pension schemes; and

1364.4 KPMG's actuaries had not reviewed Carillion's disclosure.

1365. Despite the above, KPMG did not perform any further audit work in connection with:

1365.1 the £15.9 million adjustment recorded for Pension Scheme B;

1365.2 the application of IFRIC 14 to the Pension Scheme C; or

1365.3 Carillion's disclosure in respect of the application of IFRIC 14.

1366. There were thus breaches by **the Respondents** in the **2016 audit** of:

1366.1 **ISA 500 paragraph 6**, in that the Respondents failed to design and perform appropriate audit procedures to enable them to obtain sufficient appropriate audit evidence to support Carillion's judgements relating to the application of IFRIC 14; and

1366.2 **ISA 700 paragraphs 9(b) and 9(c)**, in that the Respondents did not evaluate whether:

1366.2.1 the 2016 financial statements contained adequate disclosure relating to the application of IFRIC 14; or

1366.2.2 Carillion's policies and accounting treatments were consistent with IFRS.

(4) PPF levy[100]

1367. In their report, working paper "*AP200.3.P.2 AUDIT ASSIST REPORT*", KPMG's actuaries commented as follows (emphasis in original):

> *"With the exception of the GTRM and CENTRAC Sections of* [Pension Scheme A]*, no allowance for the PPF [Pension Protection Fund] levy is made within the disclosure as the PPF levy is paid directly by the Company and charged to profit or loss as a business expense. For the GTRM and CENTRAC Sections of* [Pension Scheme A]*, an allowance for the PPF levy paid during the year is made within the administration expenses item as these are met by the Scheme.* ***The audit team should check that the PPF levies met by the Company are recognised elsewhere in the accounts and that administration expenses paid by the Company are not recorded twice."***

1368. Despite the above, the PPF levy was not included as an "*action point/issue*" requiring further work in the 2016 audit and there is no evidence that the group audit team performed any audit procedures in connection with the PPF levy.

1369. There were thus breaches by **the Respondents** in the **2016 audit** of **ISA 500 paragraph 6**, in that the Respondents failed to design and perform appropriate audit procedures to enable them to obtain sufficient appropriate audit evidence to enable them to check that Carillion had recognised the PPF levies for its pension schemes correctly.

(5) Canadian pension schemes

1370. Carillion operated the following post-employment benefit arrangements in Canada (together, the "**Canadian schemes**"):

1370.1 a defined benefit scheme with an estimated obligation of £16.9 million; and

1370.2 four other arrangements, described as "*unfunded schemes*", under which Carillion provided post-retirement benefits with a reported total liability of £11.7 million.[101]

1371. The Canadian schemes liabilities were therefore material.

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[100] *The Pension Protection Fund (PPF) pays compensation to members of eligible defined benefit pension schemes, when there is a qualifying insolvency event in relation to the employer and where there are insufficient assets in the pension scheme to cover Pension Protection Fund levels of compensation. The PPF is funded in part by a compulsory levy on eligible defined benefit pension schemes to protect their members in the event of a shortfall.*

[101] Carillion's 2016 financial statements at page 128.

1372. The assumptions used to value Carillion's obligations under the Canadian schemes differed from those used in respect of Carillion's UK schemes[102] and in their 2016 report, KPMG's actuaries made clear that they had not reviewed the assumptions used in connection with the Canadian schemes.

1373. Despite this the Canadian schemes were not identified as an "*action point/issue*" requiring further work and KPMG did no work to address the risk of material misstatement of the liabilities of the Canadian schemes.

1374. In light of the above, there were thus breaches by **the Respondents** in the **2016 audit** of:

1374.1 **ISA 500 paragraph 6**, in that the Respondents failed to design and perform appropriate audit procedures to enable them to obtain sufficient appropriate audit evidence to support the amounts of assets and liabilities relating to the Canadian schemes reported in the 2016 financial statements; and

1374.2 **ISA 540 paragraphs 12, 13, 15, and 18**, in that the Respondents performed no audit procedures to assess whether the assumptions used to value Carillion's pension liabilities under the Canadian schemes were reasonable.

D. Source data

1375. In preparing its 2016 report, Carillion's external actuaries relied on the following:

> *"financial data submitted as at the measurement date by the Trustees of the Schemes without further audit";*

and

> *"participant data as described in the reports on the latest statutory funding valuation for each of the Schemes (as supplied by the Trustees) or more up to date participant data where agreed by the Company".*

the majority of this data being dated 31 December 2013.

1376. In their report, working paper "*AP200.3.P.2 AUDIT ASSIST REPORT*", KPMG's actuaries stated that "*Checks on source data*" were outside the scope of their work and had not been covered by their review. In working paper "*TOD_3.3 AUDIT ASSIST REPORT TRACKER*", checks on source data were identified as constituting an "*Action point/issue*" requiring further work by the group audit team.

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[102] Carillion's 2016 financial statements at page 129.

1377. In working paper "*TOD2 PERFORM PROCEDURES TO GAIN COMFORT OVER THE PENSIONS SOURCE DATA AND ASSETS IN LINE WITH THE MANDATORY AUDIT PROGRAM*", KPMG described the procedure as follows:

> *"This procedure follows the mandatory audit program for defined benefit schemes to gain comfort over the source data used in the actuarial report. It therefore aims to establish the reliability of the data, the valuation basis used by the actuary and gain comfort over the data used by Carillion."*

1378. Notwithstanding the planned audit work recorded in the above working paper, there is no evidence that KPMG in fact performed any procedures in relation to the accuracy of the source data.

1379. There was thus a breach by the Respondents in the **2016 audit** of **ISA 500 paragraph 6,** in that the Respondents failed to design and perform appropriate audit procedures to enable them to obtain sufficient appropriate audit evidence to support the source data used by Carillion's actuaries to produce their valuations.

20. GOODWILL

The financial statements for each of the years 2014 to 2016 reported goodwill balances totalling in excess of £1.5 billion. These amounts represented future economic benefits that Carillion expected to arise from acquisitions that it had made.

Carillion was required to assess the value of its goodwill annually by determining whether these economic benefits were likely to be recovered. If not, the financial statements needed to reflect an impairment to the value of goodwill. The process relied on judgements and estimates made by Carillion and the result had the potential to significantly impact reported assets and profits.

KPMG identified goodwill as a significant risk, noting the size of the amounts and the inherent uncertainty involved. However, KPMG's audit work failed to ensure that the 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 cash flows. Despite the risk of management bias, KPMG did not respond to evidence indicating that some of the assumptions were not reasonable, calling into question the reliability of those forecasts.

A. Overview

1380. The value of goodwill reported in Carillion's financial statements was:

2014	£1,519.1m
2015	£1,544.0m
2016	£1,571.0m

1381. This goodwill represented the value of the future economic benefits that were expected to derive from a number of businesses acquired by Carillion, over and above the total value of those businesses' individually identifiable assets.

1382. Goodwill was therefore initially calculated as the excess of the amount paid for the acquired business over the aggregate value of the business's individually identifiable assets.

1383. In each year, Carillion was required to assess whether this goodwill value was recoverable and so whether any impairment should be made to the goodwill balance.

1384. Carillion performed this assessment by:

1384.1 identifying Carillion's cash generating units ("**CGUs**"), being the smallest identifiable parts of its business, which generated cash flows independently of each other;

1384.2 allocating goodwill to the CGUs which incorporated the businesses of the related acquired entities (not all the CGUs would necessarily have goodwill allocated); and

1384.3 comparing:

1384.3.1 the reported value (or "**carrying value**") of each CGU, including its allocated goodwill;

with

1384.3.2 the recoverable amount, being the amount that was expected to be generated by the assets of the CGU through their continued use in the business, known as the CGU's value in use ("**VIU**"). This was generally calculated as the net present value ("**NPV**") of future estimated cash flows resulting from the continued operation of the CGUs.

1385. If the VIU was less than the carrying value, this indicated that the reported value of the CGU was too high and an impairment to the related goodwill (and potentially other assets of the CGU) would be needed. If the VIU was equal to or more than the carrying value (any excess of the VIU over the carrying value of the CGU being known in this context as the "**headroom**"), there would be no need for any impairment.

1386. In all three audits (the 2014, 2015, and 2016 audits), KPMG identified the carrying value of the group's goodwill as a significant risk on account of, in particular:

1386.1 "*the inherent uncertainty involved in forecasting and discounting future cash flows*"; and

1386.2 the possibility that "*relatively small changes in these assumptions could give rise to material changes in the assessment of the carrying value of goodwill*" given the size of the relevant goodwill balances.

1387. KPMG's audit work concerning goodwill, however, was deficient in various respects. In particular KPMG failed:

1387.1 to obtain an understanding of or test how Carillion allocated assets and cash flows to CGUs;

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1387.2 to ensure that the carrying values of CGUs calculated by Carillion included all appropriate assets and liabilities;

1387.3 to understand and test adequately Carillion's estimates of future cash flows;

1387.4 to respond appropriately to evidence suggesting that those estimates might not be reasonable; or

1387.5 approach Carillion's forecast improvements in profitability and other assumptions with sufficient scepticism, despite the risk of management bias.

B. Background

(1) Carillion's impairment review

1388. Carillion allocated its goodwill to four CGUs as follows:[103]

CGU	2014	2015	2016
UK construction	£233.0m	£233.0m	£239.1m
Canada construction	£9.8m	£8.7m	£10.7m
UK services	£1,191.2m	£1,191.2m	[104]£1,191.2m
Canada services	£85.1m	£111.1m	[105]£130.0m
Total goodwill	£1,519.1m	£1,544.0m	£1,571.0m

1389. The carrying values calculated by Carillion for these CGUs, including the amounts for the goodwill above and certain other assets, were as follows:

CGU	2014	2015	2016
UK construction	£246.1m	£233m	£239m
Canada construction	£10.2m	£8.7m	£11m
UK services	£1,242.7m	£1,246.2m	£1,233m
Canada services	£85.1m	£121.5m	£142m
Total carrying values	£1,584.1m	£1,609.3m	£1,625m

[103] Carillion's 2014 financial statements at page 95; Carillion's 2015 financial statements at page 99; and Carillion's 2016 financial statements at page 110.

[104] Working papers "*AP100.3.0010 Goodwill Impairment Review Dec*" and "*AP100.3.1.A Goodwill paper*" give this figure as £1,187 million. The overall total is not affected, because the figure for Canada services according to the papers cited in this footnote is correspondingly higher (see next footnote).

[105] Working papers "*AP100.3.0010 Goodwill Impairment Review Dec*" and "*AP100.3.1.A Goodwill paper*" give this figure as £134 million. The overall total is not affected, because the figure for UK services according to the papers cited in this footnote is correspondingly lower (see previous footnote).

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1390. Carillion calculated the VIU of the CGUs as follows:

1390.1 First, Carillion derived estimates of the CGUs' future underlying cash flows from operations for the three financial years subsequent to that of the assessment by taking its forecasts of underlying operating profit from its budget and business plans and applying a number of adjustments. The purpose of these adjustments is not clear but apparently included addressing instances where profit and the related cash flows might be recognised in different periods and re-allocating cash flows between different parts of the group.

1390.2 Second, Carillion estimated the CGUs' underlying cash flows from operations beyond this three-year period by applying an annual growth rate of 2.5%.

1390.3 Third, Carillion applied a discount rate to its estimates of future underlying cash flows. The discount rate was intended to reflect the time value of money and the risks specific to goodwill for which the future cash flow estimates had not been adjusted.

1390.4 Fourth, Carillion aggregated the discounted future underlying cash flows from all future years in order provide an estimated VIU.

1391. The VIUs calculated by Carillion were as follows:

CGU	**2014**	**2015**	**2016**
UK construction	£406.3m	£552.2m	£581m
Canada construction	£51.1m	£40.5m	£53m
UK services	£1,933.8m	£2,750.4m	£3,482m
Canada services	£670.5	£1,385.6	£982m
Total	£3,061.7m	£4,728.7m	£5,098m

1392. Carillion then compared these VIUs to the following amounts for the carrying values for the CGUs:

CGU	**2014**	**2015**	**2016**
UK construction	£246.1m	£233.0m	£239m
Canada construction	£10.2m	£8.7m	£11m
UK services	£1,242.7m	£1,246.2m	£1,233m
Canada services	£85.1m	£121.5m	£142m
Total	£1,584.1m	£1,609.3m	£1,625m

1393. Given that Carillion's impairment reviews for each of 2014, 2015, and 2016 showed that the VIU of each CGU exceeded its carrying value, Carillion therefore determined that no impairment to the goodwill balances was required in any of 2014, 2015, and 2016.

(2) KPMG's description of its audit work in the 2016 audit

1394. KPMG identified the carrying value of goodwill as a significant risk in all three audit years.

1395. In the 2016 Audit Strategy Memorandum, KPMG stated that, in response to the significant risk associated with the carrying value of goodwill, it would undertake the following audit procedures:

> *"- Evaluate the Board's process for developing, assessing and approving forecasts used in the goodwill impairment review, deferred tax calculation and going concern assessment.*
>
> *- Assess the key assumptions applied by the Group in determining the recoverable amounts of each Cash Generating Unit ('CGU')*
>
> *- Consider the consistency and appropriateness of allocation of business units to CGU.*
>
> *- Compare the sum of the discounted cash flows to the value derived from the group's market capitalisation to assess the reasonableness of those cash flows.*
>
> *- Challenge and recalculate the discount rates, growth rates and adjustments applied to the Group's budgets and forecasts with reference to external data sources.*
>
> *- Consider the risk of management bias by performing our own sensitivity analysis, including reasonably probable reductions in assumed growth rates and cash flows.*
>
> *- Compare the CGU's carrying values to analyst's 'sum of the parts' valuations."*

1396. Similarly, in the audit report for the 2016 audit, KPMG described its response to the significant risk relating to goodwill as follows:

> *"Our procedures included critically assessing the key assumptions applied by the Group in determining the recoverable amounts of each CGU. In particular, we:*
>
> *− considered the consistency and appropriateness of the allocation of businesses and related goodwill balances into CGUs;*

– considered the underlying assumptions in determining the cash flows and growth assumptions applied with reference to historical forecasting accuracy and wider macro environment conditions;

– challenged the assumptions used in the calculation of the discount rates used by the Group, including comparisons with external data sources;

– performed our own sensitivity analysis, including a reasonably possible reduction in assumed growth rates and cash flows to identify areas to focus our procedures on and, sensitised the total discounted cash flows of the Group against the notional enterprise value of the group; and

– also assessed whether the Group's disclosures about the sensitivity of the outcome of the impairment assessment to changes in key assumptions appropriately reflected the risks inherent in the valuation of goodwill."

1397. KPMG identified "*the key assumptions*" applied by Carillion as:

1397.1 forecast cash flows for the next three years;

1397.2 the growth rate; and

1397.3 the discount rate.

1398. The remainder of this chapter is structured as follows:

1398.1 Section C considers KPMG's audit work on Carillion's controls relevant to the impairment review process.

1398.2 Sections D to H set out details of KPMG's audit work on different elements of the impairment review performed by Carillion as follows:

1398.2.1 the allocation of Carillion's business to CGUs (Section D);

1398.2.2 the calculation of the carrying value of the CGUs (Section E);

1398.2.3 the cash flow forecasts used to calculate VIUs (Section F);

1398.2.4 comparison of the estimated VIUs with Carillion's market capitalisation in the 2016 audit (Section G); and

1398.2.5 sensitivity testing of the VIUs in the 2016 audit (Section H).

1398.3 Section I sets out KPMG's assessment of the disclosure relating to the goodwill balances in the 2016 financial statements.

1398.4 Section J identifies specific issues relating to the Canada construction CGU in the 2016 audit.

C. Controls relevant to the impairment review process

1399. KPMG identified goodwill as a significant risk and so was required to identify and obtain an understanding of controls in place at Carillion which were relevant to this risk.[106]

1400. As noted above, Carillion's impairment review required estimates of:

1400.1 the forecast cash flows for each CGU for the next three years;

1400.2 the appropriate growth rate; and

1400.3 the appropriate discount rate.

1401. In all three audits, KPMG correctly identified each of these matters as a "*key assumption*" within Carillion's impairment review model. In its 2016 working paper "*AP100.3.1.A GOODWILL PAPER*", KPMG explained that this was because those assumptions were "*the most judgemental and most sensitive inputs into the model*".

1402. Therefore, KPMG:

1402.1 was aware that these involved a high degree of judgement by management, with a significant risk of misstatement;

1402.2 was, or should have been, aware of the risk of management bias in the making of those assumptions; and

1402.3 should have considered how Carillion addressed these risks through internal controls.

1403. KPMG identified and considered one control, being the preparation of a goodwill impairment review and the review of this by Carillion Director A. There is no evidence, however, that KPMG either evaluated the design of this control or checked its implementation, or considered whether any other controls operated over the making of estimates relating to the VIU calculations.

[106] ISA 315 paragraph 29.

1404. There were thus breaches by **the Respondents** in the **2014, 2015, and 2016 audits** of:

1404.1 **ISA 315 paragraphs 13 and 29**, in that the Respondents did not obtain an understanding of the controls operated by Carillion over the making of estimates used to calculate the Goodwill CGUs' VIUs, including the impact on mitigating the risk of management bias, and did not evaluate the design of those controls or determine whether they had been implemented; and

1404.2 **ISA 500 paragraph 6**, in that the Respondents failed to design and perform appropriate audit procedures to enable them to obtain sufficient appropriate audit evidence to support the controls operated by Carillion over the making of estimates used to calculate the Goodwill CGUs' VIUs.

D. Allocation of Carillion business to CGUs

1405. KPMG informed Carillion's Audit Committee that it planned to:

> *"Consider the consistency and appropriateness of allocation of business units to CGU".*

1406. Similarly, in the audit report for the 2016 audit, KPMG stated that it had:

> *"considered the consistency and appropriateness of the allocation of businesses and related goodwill balances into CGUs".*

1407. In its 2016 working paper "*AP100.3.1.A GOODWILL PAPER*", KPMG set out the following objective:

> *"To verify that the allocation of the component parts of the Carillion Group to cash generating units for the purposes of management's review of impairment is appropriate".*

1408. This allocation would determine the allocation of assets and liabilities, including goodwill, to the CGU to assess the carrying value and the allocation of forecast cash flows to calculate the VIUs.

1409. Having set out this objective, KPMG stated as follows:

> *"Given that KPMG have performed audit procedures over the allocation of Carillion components to CGU's in prior years, the following paper will focus on any movements between or changes to those cash generating units in the current year.*
>
> *Changes in allocation*
>
> *There has been no change in the allocation of businesses to CGU's, and the allocation is in line with 2015. This is as expected given there have been no significant changes in the group and no acquisitions in the year".*

1410. KPMG thereby purported to "*verify*" that the allocation of the component parts of the Carillion Group to the CGUs was appropriate by:

1410.1 referring to audit procedures performed in previous years; and

1410.2 observing that there had been no change in the CGU allocation in 2016.

1411. However:

1411.1 there was no evidence on the 2014 or 2015 audit files of KPMG performing any audit procedures over the allocation of components of Carillion Group to CGUs in either year;

1411.2 there was no record on any of the 2014, 2015, or 2016 audit files of details or conclusions of any audit procedures performed by KPMG prior to 2014 over the allocation of components of Carillion Group to CGUs;

1411.3 KPMG provided no explanation as to why conclusions from any audit procedures performed in previous years would be a sufficient basis to enable it to reach a conclusion on the appropriateness of the allocation of components of Carillion Group to CGUs in 2016; and

1411.4 KPMG referred to no audit evidence obtained in 2016 to support its observation that there had been "*no change in the allocation of business to CGU's*".

1412. In each of 2014, 2015, and 2016, KPMG therefore relied on unspecified work allegedly carried out during an unspecified prior year to conclude that allocation of Carillion components to CGUs was appropriate.

1413. Further, there was evidence that the allocation of elements of Carillion's business to the CGUs was not straightforward, and might have changed over the relevant period.

1414. KPMG's working paper indicated that, for the purpose of assessing goodwill, some contracts that sat within the UK construction component were nevertheless allocated to the UK services CGU. No explanation or verification of this split of the UK construction component and its allocation to CGUs was provided in the audit file. In interview, KPMG Senior Manager A provided the following explanation:

> *"So those contracts that sit in UK Construction Services that management deemed to be services-type contracts are split out …*
>
> *… So then for the purposes of the CGU assessment, Carillion Services and Construction Services-Services, are added together to give you the UK Services CGU, and Construction Services, just construction forms the UK construction CGU."*

1415. Consequently, the exact composition of the UK CGUs depended on judgements by management on whether certain construction contracts were deemed to be "*services-type contracts*". As Carillion's portfolio of contracts changed year on year and, potentially, as contracts that involved both construction and service elements entered different phases, such judgements needed to be reviewed, and as a result the composition of the CGUs might have changed.

1416. This undermined KPMG's conclusion, which was made without reference to any evidence, that there had been "*no change in the allocation of businesses to CGU's*", and also called into question the reliance placed on the approach in prior years. There is no evidence that KPMG considered either of these points.

1417. There is no evidence that KPMG carried out any audit procedures in any of the relevant years to verify that the allocation of the component parts of Carillion – both assets and liabilities to establish carrying value, and the forecast cash flows to establish VIUs – to CGUs was appropriate.

1418. There were thus breaches by **the Respondents** in the **2014, 2015, and 2016 audits** of:

1418.1 **ISA 315 paragraph 9**, in that the Respondents relied on procedures from previous audits without determining whether relevant changes had occurred since those audits that may have affected their relevance to the subsequent audits; and

1418.2 **ISA 500 paragraph 6**, in that the Respondents failed to design and perform appropriate audit procedures to enable them to obtain sufficient appropriate audit evidence to enable them to determine whether the allocation of components of the Carillion Group to the CGUs was appropriate.

E. Carrying value of CGUs

(1) Introduction

1419. The carrying value of each CGU had to be determined on a basis which was consistent with the basis on which the recoverable amount, or VIU, of the CGU was determined. Accordingly, the cash flows used to determine the VIUs needed to derive from the same assets and liabilities which had been used to calculate the carrying values.

1420. In each of the 2014, 2015, and 2016 audits, however, KPMG failed:

1420.1 to identify the assets and liabilities to which the cash flows reflected in the VIU calculations related; or

1420.2 to determine whether those assets and liabilities had been included in the carrying values.

(2) 2014

1421. In its 2014 working paper *"A.100 GOODWILL WORKBOOK FINAL*", KPMG commented on Carillion's impairment test as follows:

> *"It is noted that the net assets noted per management's workpaper are not reflective of actual net assets across the divisions. Net assets on a high level are as follows*
>
> *Services: £57.5 m*
>
> *Construction: (£175.8 m)*
>
> *As net assets are not significant for Services (with headroom still available if taken into account of the sensitivities), and Construction are in a net liabilities position, these have not been considered within the impairment review calculations.*
>
> *This approach is consistent with previous years and appears reasonable."*

1422. KPMG therefore concluded that, because "*net assets*" in the services segment were "*not significant*" and there were "*net liabilities*" in the construction segment, any assets in those segments could be ignored for the purposes of reviewing goodwill for impairment.

1423. KPMG based its assessment on the values of "*net assets*", whereas it should have based its assessment on the values of assets and liabilities separately and ensured that each asset and liability was appropriately allocated to the relevant CGU.

1424. The assessment of "*net assets*" and "*net liabilities*" did not provide sufficient analysis to ensure that the individual assets and liabilities used to calculate the carrying values were the same as those providing the cash flows used to determine the VIUs.

1425. KPMG therefore had no basis for concluding that the insignificant amount of "*net assets*" in the services segment and the existence of "*net liabilities*" in the construction segment could justify management's incorrect approach.

(3) 2015

1426. There is no note on the 2015 audit file similar to that described above from the 2014 audit. In the 2015 audit, KPMG did not identify (still less challenge) management's failure to identify properly the assets and liabilities to be included in the carrying values of the CGUs.

(4) 2016

1427. In its 2016 working paper, "*AP100.3.1.A GOODWILL PAPER*", KPMG identified a number of deficiencies in Carillion's impairment test, including the following:

> *"the NPV is compared against the recoverable amount (i.e. Goodwill) and not the other non current assets such as PPE and investments in joint ventures within the CGU."*

1428. KPMG was wrong to identify only non-current assets as assets to be included in the carrying values. Current assets and liabilities should have been included if they generated cash flows used in calculating the VIU. In any event, there is no evidence on the 2016 audit file that KPMG considered which assets and liabilities were to be allocated to each Goodwill CGU in order to produce a carrying value consistent with its VIU.

1429. Therefore, in all three audits, KPMG took insufficient steps to ensure that the calculation of the carrying values used by Carillion to test goodwill for impairment included all appropriate assets and liabilities and was consistent with the approach to calculating the VIUs.

1430. There were thus breaches by **the Respondents** in the **2014, 2015, and 2016 audits** of **ISA 315 paragraph 11(c) and ISA 700 paragraph 9**, in that the Respondents did not adequately evaluate whether Carillion's process for calculating the carrying values was consistent with the applicable accounting standards.

F. Carillion's cash flow forecasts used to calculate VIUs in the 2016 audit

(1) Introduction

1431. KPMG informed Carillion's Audit Committee that it planned to:

> *"Assess the key assumptions applied by the Group in determining the recoverable amounts of each Cash Generating Unit …*
>
> *… Challenge and recalculate the discount rates, growth rates and adjustments applied to the Group's budgets and forecasts with reference to external data sources".*

1432. Similarly, in the audit report for the 2016 audit, KPMG stated that it had:

> *"considered the underlying assumptions in determining the cash flows and growth assumptions applied with reference to historical forecasting accuracy and wider macro environment conditions".*

1433. This section sets out KPMG's failings in connection with the various stages of Carillion's preparation of these cash flow forecasts and the related estimates and assumptions as follows:

1433.1 the profit forecasts for 2017, 2018 and 2019;

1433.2 the adjustments made to these profit forecasts to derive cash flow forecasts for 2017, 2018 and 2019;

1433.3 consideration of further cash flows attributable to the continued operations of the CGUs; and

1433.4 the long term growth rate applied to cash flows forecasts to derive forecasts for after the period covered by Carillion's budget and business plan.

(2) Profit forecasts

1434. Carillion's impairment review calculated VIUs using cash flow forecasts based on profit forecasts in Carillion's 2017 budget and 2018 and 2019 business plans.

1435. In its 2016 working paper "*AP100.3.1.A GOODWILL PAPER*" (in tab "*2. Management Assessment*"), KPMG recorded that it had performed the following work in connection with these profit forecasts:

> *"KPMG considered the historical accuracy of such forecasts through retrospective analysis in the <Retrospective Review> tab and reviewed the reasonableness of these in the <Budget Review> tab. The figures used in management's models (PBC folder) were also reconciled to those approved by the plc Board. Given our skepticism over the accuracy of such forecasts, in addition (as set out on the <Professional Judgement> tab), KPMG included growth forecasts in the <Sensitivity> tab to assess the impact changes in these figures on the impairment review."*

1436. Thus, KPMG stated that it had performed three procedures on the profit forecasts:

1436.1 considered the accuracy of forecasts prepared in prior years in a tab entitled "*Retrospective Review*";

1436.2 reviewed the reasonableness of Carillion's cash flow forecasts for 2017-2019 and recorded its work in a tab titled "*Budget Review*" in working paper "*AP100.3.1.A GOODWILL PAPER*"; and

1436.3 reconciled the figures produced by management (and set out in "*AP100.3.0010 GOODWILL IMPAIRMENT REVIEW DEC*") with those approved by Carillion's board. No document reference for this work was given.

1437. In respect of the first procedure, KPMG compared actual profit achieved in the current year with the forecast made in the prior year. This analysis showed that Carillion had over-budgeted in 2015 (by £5 million) and 2016 (by £3.5 million). KPMG then concluded:

> *"The above retrospective analysis demonstrates that, as is expected given the nature of budgets and forecasts, unforeseen events have caused significant variances from management forecasts.*
>
> *It is noted from KPMG's cumulative audit knowledge and experience however that the causes of those variances have historically been due to unforeseen one off events, and as such do not point to a significant management bias…"*

1438. There was no proper basis for dismissing the variances they had identified in this way. The primary issue was not whether the forecasts were affected by bias but whether they were sufficiently reliable to be used for the assessment of goodwill.

1439. More importantly, KPMG were aware that in 2016 there were a number of "*one off*" transactions that had had a substantial and positive effect on the actual results, such as the sale of the Group's "*Geneva*" facilities management system and the transaction relating to Portsmouth car park (see Chapters 15 and 16). Such "*one off*" transactions were, by their nature, unlikely to have been included within the forecast made in the previous year, meaning that the underlying variance between forecast and actual results would likely be significantly larger.

1440. In respect of the second procedure, in contrast to the equivalent working papers for 2014 and 2015, working paper "*AP100.3.1.A GOODWILL PAPER*" contained no "*Budget Review*" tab. There is no other reference to work undertaken on the "*reasonableness*" of the profit forecasts and no evidence of any such work.

1441. In respect of the third procedure, whilst the working paper records that the amounts in the impairment review were reconciled to the Board's approved budgets and forecasts, there are no further details or evidence of the process by which these were approved.

1442. There is thus no evidence that KPMG performed any audit work on Carillion's process for producing the forecasts for the budgets and business plans.

1443. Further, the profit forecasts for 2017, 2018 and 2019 incorporated significant growth compared to the actual amounts achieved in the preceding and current years:

		Increase on previous year	% Increase
Actual			
2014	£191.8m	£4.0m	2.1%
2015	£208.4m	£16.6m	8.7%
2016	£199.6m	- £8.8m	- 4.2%
Forecast			
2017	£226.8m	£27.2m	13.6%
2018	£244.0m	£17.2m	7.6%
2019	£262.5m	£18.5m	7.6%

1444. KPMG should have been sceptical about Carillion's forecast of consistent increases in profit over these three years and sought supporting evidence of the underlying assumptions, particularly in the light of the individually positive one-off transactions' impact on the 2016 results, without which the fall in underlying profits would have been significantly greater.

1445. Additionally, to derive forecasts for subsequent years, a long term growth rate of 2.5% was applied to the forecast for 2019, which, due to the significant growth forecast for 2017, 2018 and 2019, was more than 30% higher than the actual profit figure for 2016, and thus these increases also impacted forecasts for later periods. The size of the forecast for growth in profit in these three years was also especially striking given the long-term growth rate of just 2.5% used for later years.

1446. The increases in forecast profits for the UK and Canada construction and services operating segments, which broadly corresponded to the CGUs, were especially significant, and thus should have been approached with even greater scepticism.

1447. However, despite claiming to have reviewed the reasonableness of Carillion's cash flow forecasts for 2017-2019, KPMG did not consider the significant increases in profit incorporated into the budgets and forecasts; or obtain any evidence to support such predicted growth.

(3) Adjustments made to profit forecasts to derive operating cash flow forecasts

1448. Carillion applied various adjustments to the profit forecasts in its budget and business plan to derive operating cash flow forecasts for 2017, 2018 and 2019. The adjustments were described as:

1448.1 "*Depreciation and other non-cash items*";

1448.2 "*Working capital*";

1448.3 "*Dividends received from Joint Ventures*";

1448.4 "*Divisional Adjustment*";

1448.5 "*Group Services Allocation*"; and

1448.6 "*Bonus Accrual Allocation*".

(the "**Adjustments**").

1449. The Adjustments resulted in cash flow forecasts which were significantly higher than profit forecasts for each of 2017, 2018 and 2019:

	Profit forecast	Adjustment	Cashflow forecast
2017	£226.7m	£85.6m	£312.3m
2018	£244.0m	£66.3m	£310.3m
2019	£263.5m	£68.6m	£332.1m

1450. These Adjustments therefore reflected an expectation that underlying operating cash flows would be substantially greater than profits over each of the three years.

1451. Whilst some timing differences might be expected between the recognition of certain elements of costs and revenue and the occurrence of the related cash flow, there was no explanation or analysis to support the expectation that operating cash flows would substantially exceed profits over three years.

1452. It was unlikely that Carillion's underlying operating cash flows would be consistently greater than profits at these levels and over a three-year period. The effects of the Adjustments were thus significant and in the absence of a clear explanation warranted the exercise of professional scepticism and (at least) further investigation.

1453. Given the significance of the amounts and their impact on the calculation of VIUs as a whole, KPMG should have:

1453.1 obtained an understanding of:

1453.1.1 the reasons for the Adjustments;

1453.1.2 how the Adjustments had been made; and

1453.1.3 the data on which the Adjustments were based;

1453.2 sought and obtained evidence corroborating the reasonableness of the fact and amount of the Adjustments; and

1453.3 considered whether the Adjustments were complete, that is, whether there were further items in the profit forecasts which would not represent an immediate cash flow, for example revenue recognised from claims and variations recorded in future years but not settled until subsequent periods, and accordingly required cash flows to be adjusted downwards compared to profit.

1454. However, KPMG did not perform any audit procedures on any of the Adjustments.

1455. In particular, KPMG failed to identify and challenge:

1455.1 first, that it was unlikely that cash flows would be greater than profits by such a significant amount over a three year period; and

1455.2 secondly, that the resulting cash flow forecasts were used as a basis for calculating cash flow forecasts in perpetuity, meaning that, in effect, the excess of cash flow over profits was also assumed to apply in perpetuity. This was implausible, if not impossible. Whilst some discrepancy between profit and cash flow might be expected in specific years, cash flows could not be consistently greater than profits in perpetuity.

(4) Consideration of further cash flows attributable to the continued operation of the CGUs

1456. In its 2016 working paper "*TOD04 Assessment of Underlying Cashflows*" KPMG stated that it would "*Review cash flows to determine that all cash flows directly attributable to the continued use of the CGU are included*."

1457. The only type of cash flow considered in Carillion's VIU calculation was "*Underlying Cash Flow from Operations*". There is no evidence that KPMG considered whether this represented all cash flows directly attributable to the continued use or operation of the CGU.

1458. The use of *"Underlying Cash Flow from Operations"* excluded other types of cash flow, such as cash outflows associated with capital expenditure and pension fund obligations. Cash outflows of this kind were likely to be significant. In particular:

1458.1 Carillion's 2016 financial statements reported a depreciation expense of £25.0 million. Ordinarily, non-cash flow items relating to depreciation would be likely to be comparable with cash outflows relating to capital expenditure.

1458.2 Carillion's 2016 financial statements in fact reported expenditure on property, plant and equipment of £20.2 million. It was likely that:

1458.2.1 at least some of this expenditure would have related to the CGUs; and

1458.2.2 further capital expenditure of a comparable amount would be incurred by the CGUs in future periods.

1458.3 Carillion's 2016 financial statements disclosed that it expected to make payments totalling £50.2 million to defined benefit schemes during the next financial year. Again, at least some of this was likely to have related to the continued operation of the CGUs.

1459. In addition, Carillion's forecasts of underlying cash flows from operations did include cash outflows but which were not allocated to the CGUs. These were significant:

1459.1 £19.4 million in 2017;

1459.2 £39.4 million in 2018; and

1459.3 £51.8 million in 2019.

1460. The following features of these unallocated cash flows were striking:

1460.1 the amounts were substantial and were increasing substantially from year to year; and

1460.2 the impact of excluding these cash outflows would, in effect, have continued to increase in perpetuity with Carillion's assumed growth rate of 2.5% applied.

1461. These unallocated cash flows warranted further investigation, in particular as to whether Carillion was correct to treat them as not relating to any of the CGUs to which goodwill had been allocated. If any of the unallocated cash flows were properly attributable to one or more of the CGUs KPMG were considering, then Carillion's VIUs for those CGUs would have been overstated.

1462. KPMG identified that pension scheme contributions should have been incorporated[107] but otherwise did not consider whether there were either further non-operating cash flows, or operating cash flows not allocated to CGUs, which related to any of the CGUs to which goodwill had been allocated and so needed to be incorporated in the VIUs. In both cases the amounts involved could have been significant.

[107] See paragraphs 1502-1504 below.

(5) Growth rate

1463. Future cash flows are generally forecast on the assumption that the performance and profitability of a CGU will improve. A growth rate is applied to reflect this assumption. A higher growth rate for a cash generating business will generally result in higher future cash flow forecasts. Small adjustments in the assumed growth rate can have significant effects on the VIU.

1464. The applicable accounting standard provided that the growth rate used in calculating the VIU could not exceed:[108]

> *"the long-term average growth rate for the products, industries, or country or countries in which the entity operates, or for the market in which the asset is used, unless a higher rate [could] be justified".*

1465. In each of its impairment reviews for 2014, 2015, and 2016, Carillion used a growth rate of 2.5% to calculate cash flow forecasts beyond the three-year period covered by its budget and business plan.

1466. In the 2014, 2015, and 2016 audits, KPMG compared Carillion's chosen rate to growth rates from the following two external sources:

1466.1 reports compiled by the HM Treasury Economic Assessment Team titled "*Forecasts for the UK economy: a comparison of independent forecasts*" which collated forecasts of economic indicators made by independent forecasters and produced averages of those forecasts (the "**HM Treasury Reports**"); and

1466.2 the latest available accounts of Carillion's industry competitors.

1467. The comparators from these sources used by KPMG to assess Carillion's growth rate were deficient in the following ways:

1467.1 In 2014, 2015 and 2016 audits, KPMG considered rates in the HM Treasury Reports for the year subsequent to the impairment assessment (i.e., 2015, 2016 and 2017 respectively). Given that the growth rate was being applied to extrapolate cash flow projections beyond the three-year period covered by Carillion's budget and business plans, KPMG should instead have used rates applicable to periods after this three year period.

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[108] IAS 36, paragraph 33c.

1467.2 In 2016, KPMG considered the rates disclosed by its industry competitors in 2015, i.e., prior to the result of the Brexit referendum. There was therefore an obvious question as to whether those rates continued to be appropriate comparators, which KPMG failed to consider. This is especially notable given that:

1467.2.1 Carillion's 2016 financial statements had stated: "*Future uncertainty relating to Brexit* […] *could impact future volumes*"; and

1467.2.2 KPMG had itself recognised that Brexit would increase uncertainty in forecasting growth rates.

1467.3 The evidence obtained by KPMG in connection with growth rates related only to forecasts of the UK growth rate. The same growth rate was applied to the Canadian CGUs but KPMG failed to obtain any evidence on Canadian growth rates.

1468. The comparison showed that Carillion's growth rate of 2.5% was consistently higher than all the indicative growth rates from these external sources, that is:

1468.1 the rates from the HM Treasury Reports referred to in KPMG's working papers:

1468.1.1 2.4% forecast for 2015, referred to in the 2014 working paper;

1468.1.2 2.3% forecast for 2016, referred to in the 2015 working paper; and

1468.1.3 1.4% forecast for 2017, referred to in the 2016 working paper;

1468.2 the rates in the HM Treasury Reports which actually related to the periods to which the growth rate was to be applied, that is, beyond the three-year period:

1468.2.1 2.2% forecast for 2019 in the HM Treasury Report of November 2015;

1468.2.2 1.9% forecast for 2020 in the HM Treasury Report of February 2017; and

1468.2.3 2.0% forecast for 2021 in the HM Treasury Report of February 2017; and

1468.3 the rates used by Carillion's industry competitors for 2013, 2014, and 2015 of 2.2%, 2.3%, and 2.2% respectively.

1469. Although the differences were small in percentage terms, they were capable of having a significant impact on the VIU calculation, as KPMG had recognised. There was no explanation why Carillion could reasonably expect to experience consistently higher growth rates than these comparators.

1470. Despite the above:

1470.1 in the 2014, 2015 and 2016 annual reports, Carillion stated that the growth rate used did "*not exceed the long-term industry average*"; and

1470.2 in each year, KPMG concluded that the growth rate used by Carillion was acceptable on the basis that the rate:

> *"was broadly in line with those chosen by it's associated competitors and as such comfort is gained that the growth rate historically chosen by management does not indicate managment bias".*

1471. KPMG failed to obtain sufficient appropriate audit evidence:

1471.1 to conclude that the growth rate being used by Carillion was reasonable;

1471.2 to support the accuracy of the above statement made in Carillion's 2014, 2015, and 2016 financial statements; or

1471.3 to support its conclusion that the growth rate as historically chosen by management did not indicate management bias.

(6) Summary

1472. Carillion's impairment review calculated VIUs using forecast cash flows based on profit forecasts in Carillion's 2017 budget and 2018 and 2019 business plans.

1473. KPMG did not perform any audit work to assess Carillion's process for preparing these profit forecasts or to verify their reasonableness. There is no evidence that KPMG considered the appropriateness of the significant growth incorporated into these forecasts or properly considered indications that Carillion's forecasting may not be reliable.

1474. Further, KPMG performed no audit work on Adjustments to these profit forecasts to arrive at cash flow forecasts. These Adjustments resulted in cash inflows exceeding profit by between £66.3 million and £85.6 million each year, which was unlikely. This excess of cash inflows over profit was then assumed to continue in perpetuity, which was implausible, if not impossible.

1475. In addition, KPMG did not consider whether any other cash flows were attributable to the continued operations of the CGU and should therefore be included in the calculation of VIUs, for example, capital expenditure, and cash flows described as "Group eliminations and unallocated items", all of which were substantial.

1476. Having arrived at cash flows for the CGUs for 2017, 2018 and 2019, Carillion assumed that this cash flow would grow by 2.5% annually. KPMG's conclusion that the rate was in line with estimates of economic growth generally and with long term industry averages was flawed and failed to properly consider the possibility for management bias.

1477. These cash flow amounts had a very large impact on the assessment of whether goodwill should be impaired. Each of these failures in KPMG's assessment were significant given the amounts involved and the risk of management bias on the judgement and estimates made.

1478. There were thus breaches by **the Respondents** in the **2016 audit** of:

1478.1 **ISA 200 paragraph 15**, in that the Respondents did not consider Carillion's chosen growth rate with an adequate degree of professional scepticism, despite that rate being higher than all the comparators considered;

1478.2 **ISA 330 paragraphs 5 and 6**, in that, in response to the risks it had identified (which included the carrying value of goodwill), the Respondents did not adequately design or perform audit procedures to assess the reasonableness of the profit forecasts contained in Carillion's budgets and business plans and the Adjustments made to these forecasts;

1478.3 **ISA 500 paragraphs 6 and 9**, in that the Respondents failed to design and perform appropriate audit procedures to enable them to obtain sufficient appropriate and reliable audit evidence to support the profit forecasts contained in Carillion's budgets and business plans and the Adjustments made to these forecasts and, further, in that the Respondents did not adequately consider or respond to inconsistencies or indications of unreliability in the audit evidence that they gathered relating to the profit forecasts and growth rate used by Carillion in calculating VIUs; and

1478.4 **ISA 540 paragraph 8(c), 12, 13, 15 and 18**, in that the Respondents did not adequately understand or assess the method for deriving the estimates used in forecasting cash flows or assess whether the resulting estimates were appropriate and reasonable.

1479. There were also breaches by **the Respondents** in the **2014 and 2015 audits** of:

1479.1 **ISA 200 paragraph 15**, in that the Respondents did not consider Carillion's chosen growth rate with an adequate degree of professional scepticism, despite that rate being higher than all the comparators considered;

1479.2 **ISA 315 paragraph 11(c) and ISA 700 paragraph 9**, in that the Respondents did not adequately evaluate whether the growth rate used by Carillion to calculate VIUs was consistent with IAS 36;

1479.3 **ISA 500 paragraphs 6 and 7**, in that the Respondents failed to design and perform appropriate audit procedures to enable them to obtain sufficient appropriate audit evidence to support the growth rate and the conclusion that there were no risks of management bias in the growth rate as historically chosen by Carillion; and

1479.4 **ISA 540 paragraph 8(c) 12, 13, 15, and 18**, in that the Respondents failed to obtain an understanding of how the estimates and assumptions relating to Carillion's growth rate had been made and of the data on which they were based. Further, the Respondents did not adequately assess whether the estimates and assumptions, and processes for deriving those estimates and assumptions, were appropriate and reasonable.

G. Consideration of Carillion's market capitalisation

(1) Introduction

1480. KPMG informed Carillion's Audit Committee that it planned to:

> *"Compare the sum of the discounted cash flows to the value derived from the group's market capitalisation to assess the reasonableness of those cash flows".*

(2) KPMG corporate finance's findings

1481. By email on 1 February 2017, the KPMG group audit team sought the assistance of KPMG corporate finance in relation to goodwill impairment. KPMG corporate finance responded by email of 9 February 2017 to Mr Meehan, and copied to a member of the audit team. In the email, KPMG corporate finance stated:

> "*We note that you should pay particular attention to the key findings highlighted in red below as part of your overall impairment review assessment.*"

1482. The key findings, communicated to the group audit team, in bold type and highlighted in red stated:

> *"Key findings*
>
> *We note that the EV [Enterprise Value] for the Group of £5.1 billion, based on the recoverable amounts of individual CGUs, is considerably higher than the reported EV of £1.3 billion, based on reported market capitalisation of £1,015.6 million, net debt of £290.6 million and minority interests of £30 million (as at 31 December 2016, source: Capital IQ)."*

1483. Accordingly, the group audit team was aware that the discrepancy between Carillion's market capitalisation and the sum of the VIUs was very substantial and would require particular consideration in the 2016 audit.

(3) Market capitalisation calculations

1484. In its working paper "*TOD06 Reasonableness Test Market cap vs Recoverable Amount*", the group audit team stated that it would perform the following work as part of its assessment of Carillion's VIU calculations:

> *"We will perform a high-level comparison between market capitalisation, adjusted for the average net debt and the pensions deficit. A secondary market capitalisation reconciliation will also be undertaken to include the brokers target share price which takes into account construction segment volatility (eg* [competitors'] *profit warnings) and that Carillion is one of the most popular share for hedge funds to sell short".*

1485. In its working paper "*AP100.3.1.A GOODWILL PAPER*" (tab "*8. Market Capitalisation*"), the group audit team performed the two market capitalisation calculations just described. These calculations differed from those of KPMG corporate finance and produced higher values for Carillion's Enterprise Value. In particular:

1485.1 The first calculation produced a market value for Carillion of £2.3 billion. This calculation differed from that of KPMG corporate finance in that it:

1485.1.1 omitted £30 million for the market value of minority interests, as most recently reported at 30 June 2016;

1485.1.2 added £0.8 billion for the value of Carillion's pension deficit; and

1485.1.3 included £0.5 billion for debt, representing the average value over the year, based on Carillion's internal accounting records rather than using the market value of £290.6 million as reported for 30 June 2016.

1485.2 The second calculation differed in the same ways as the first calculation but, additionally, used a broker's target share price of 350 pence instead of the actual share price. This further change produced an Enterprise Value for Carillion of £2.8 billion.

1486. No explanation was recorded for why the group audit team substituted Carillion's average value for debt rather than a market value, which would generally be more appropriate.

1487. However, both approaches (KPMG corporate finance's and the group audit team's) compared Carillion's market capitalisation with total VIUs (as calculated by Carillion) of £5.1 billion, but that amount only included the values of CGUs to which goodwill had been allocated. There were other CGUs reported as profitable (namely, the public-private partnerships CGU and the Middle East construction CGU), which if taken into account would have increased the value of total VIUs still further. Consequently, both approaches were likely to have understated Carillion's enterprise value based on its estimated cash flows, and therefore understated the difference between this value and its market capitalisation.

1488. In any event, even the group audit team's more optimistic calculations identified variances of £2.8 billion (£2.3 billion – £5.1 billion) and £2.3 billion (£2.8 billion – £5.1 billion) between the market values for the business and Carillion's total VIUs.

1489. KPMG responded to this by:

1489.1 allocating the variances *pro rata* across the Goodwill CGUs;

1489.2 deducting the variances allocated to each Goodwill CGU from the VIU attributed to that CGU to produce a reduced VIU; and

1489.3 calculating the headroom between the carrying value of each Goodwill CGU and its reduced VIU.

1490. Applying the greater variance of £2.8 billion, the results of this procedure were as follows:

1. CGU	2. VIU	3. Variance (pro rata)	4. Reduced VIU (2 + 3)	5. Carrying value	6. Headroom (4 – 5)
UK construction	£581m	(£323m)	£258m	£239m	£19m
Canada construction	£53m	(£29m)	£23m	£11m	£13m
UK services	£3,482m	(£1,934m)	£1,548m	£1,234m	£314m
Canada services	£982m	(£545m)	£437m	£142m	£295m
Totals	£5,097m	(£2,831m)	£2,266m	£1,626m	£641m

1491. KPMG commented on these results as follows: "*Given that this approach still indicates headroom in the impairment testing, the team was satisfied*".

1492. However, there was no proper basis for this conclusion. There was no sensible rationale for pro-rating the variance across these CGUs and none was included in KPMG's work paper. In any event, the stated purpose of carrying out the comparison between Carillion's value (calculated by reference to the forecast cash flows) and its market capitalisation was in order to "*assess the reasonableness of those cash flows*". The fact that there was sufficient headroom to absorb the difference between the total VIUs calculated by Carillion and Carillion's market capitalisation did not support the reasonableness of Carillion's forecast cash flows.

1493. In fact, the size of the variance between those values indicated that management's forecasts were *not* reasonable. In an email of 15 February 2017 to Carillion Director A, which was copied to the Carillion Group finance team and Mr Meehan, KPMG Senior Manager A commented on the fact that management's NPV was "*nearly 100% more than the Enterprise value*", and wrote, "*This implies to me that the Group's NPV calculation is highly optimistic.*"

1494. Having identified the significant variance between Carillion's market capitalisation and the VIUs of the Goodwill CGUs, KPMG should have:

1494.1 appreciated that the explanation for this variance was either:

1494.1.1 that Carillion's process for calculating the VIUs was not reliable; or

1494.1.2 that Carillion's shares had been very significantly undervalued by the market (which, in the absence of a credible explanation as to how that might have occurred, was unlikely); and

1494.2 obtained sufficient appropriate audit evidence to enable the auditor to decide which of the above was the more probable explanation.

1495. By contrast, without referring to any supporting evidence, KPMG concluded as follows:

> *"Given the market does not have access to perfect information and there are inherently estimates in the group cash flows, the variance between market value and NPV is due to the Carillion share price being considerably undervalued given market uncertainty in the sector, profit warnings and Carillion becoming the most popular share for hedge funds to sell short as analysts questions the support services groups lack of growth. Other tests have been performed in order to challenge the conclusions reached in our detailed testing of goodwill for impairment on each of the CGUs (see Tab 9. Revised Base Case)."*

1496. This did not amount to a credible explanation for the variance and the evidence did not support the conclusion. Further, KPMG's conclusion did not explain the variance of £2.3 billion produced on its second market capitalisation calculation which, by using the brokers' target share price, had already taken into account *"construction segment volatility (eg* [competitors'] *profit warnings) and that Carillion is one of the most popular share for hedge funds to sell short*".

1497. There were thus breaches by **the Respondents** in the **2016 audit** of:

1497.1 **ISA 200 paragraph 15**, in that the Respondents did not approach this area with an adequate degree of professional scepticism concerning Carillion VIU calculations, and so did not critically assess the evidence from the market in relation to Carillion's cash flow forecasts;

1497.2 **ISA 330 paragraphs 5, 6 and 26**, in that the Respondents did not adequately perform planned audit procedures and did not adequately consider relevant evidence from the market to determine the reasonableness of Carillion's cash flows forecasts; and

1497.3 **ISA 500 paragraphs 6 and 11**, in that the Respondents failed to design and perform appropriate audit procedures to enable them to obtain sufficient appropriate audit evidence to support Carillion's cash flow forecasts and in particular did not adequately consider or respond to indications in the audit evidence that they gathered that Carillion's process for estimating future cash flows was not reliable.

H. Sensitivity testing in the 2016 audit

(1) Introduction

1498. Sensitivity testing is the process of performing recalculations to analyse the effect of changes in assumptions and identify the range of reasonably possible outcomes.

1499. KPMG informed Carillion's Audit Committee that it planned to "*Consider the risk of management bias by performing our own sensitivity analysis, including reasonably probable reductions in assumed growth rates and cash flows*".

1500. Similarly, in the audit report for the 2016 audit, KPMG stated that it had:

> *"performed our own sensitivity analysis, including a reasonably possible reduction in assumed growth rates and cash flows to identify areas to focus our procedures on and, sensitised the total discounted cash flows of the Group against the notional enterprise value of the group".*

(2) Audit work

1501. KPMG set out sensitivity testing on tab "*6. Sensitivity*" of its working paper "*AP100.3.1.A GOODWILL PAPER*". This testing identified the "*key assumptions*" applied in Carillion's assessment "*to which the valuation of future cash flows is most sensitive*". These "*key assumptions*" were the discount rate, the growth rate and the forecast profit from the 2017 budget and 2018 and 2019 business plans. The working paper then set out amounts for the NPVs that would result from certain changes to these assumptions and in each case determined that none of the changes considered would result in an indication of an impairment to goodwill.

1502. However, KPMG identified that Carillion's assessment included various errors, stating:

> *"Management's base case scenario for the NPV calculation included working capital from year 2 to perpetuity and did not include the pension deficit contributions across the CGUs. Furthermore, the NPV calculated was only compared to goodwill and not the other non current assets such as PPE and investments in joint ventures."*

1503. The initial sensitivity testing, described on tab "*6. Sensitivity*", replicated these errors.

1504. KPMG then prepared a "*revised"* version of the *"base case*" used by Carillion in its impairment review by making the following adjustments:

    1504.1 reducing the VIU by:

        1504.1.1 removing cash flows from working capital 'improvements' from year 2 onwards; and

1504.1.2 including pension contributions; and

1504.2 increasing the carrying value by including:

1504.2.1 property, plant and equipment;

1504.2.2 intangible assets; and

1504.2.3 investments in joint ventures.

1505. KPMG performed two sensitivity tests on this revised base case:

1505.1 The first sensitivity test involved assessing the effect of:

1505.1.1 a 20% reduction in Carillion's forecast cash flows;

1505.1.2 a pre-tax discount rate at the top of KPMG's benchmark range (9.9% for the construction CGUs and 9.3% for the services CGUs); and

1505.1.3 a more modest growth rate of 1.5%.

These assumptions resulted in an impairment to the UK construction CGU of £65.7 million and headroom of only £0.3 million in the Canada construction CGU.

1505.2 The second sensitivity test involved assessing the effect of a 15% reduction in Carillion's forecast cash flows and the same pre-tax discount rate and growth rate as applied in the first sensitivity test. These assumptions resulted in an impairment to the UK construction CGU of £52.7 million and no headroom in the Canada construction CGU.

1506. In both sensitivity tests, the impairment to the UK construction CGU was material.

1507. In light of these results, it was evident that even a sensitivity test involving a smaller reduction in Carillion's forecast cash flows would indicate the need for a material impairment to goodwill. KPMG should therefore have either challenged management as to whether an impairment might be required or performed further sensitivity tests.

1508. In fact, KPMG performed no further sensitivity testing but concluded as follows:

> *"Applying a 20%/15% reduction in 2017-2019 future cash flows whilst using a pre tax discount rate at the top of KPMG's range implies impairment in UK Construction and minimal headroom in Canada Construction.*

As documented in Tab 6.a, the results of the retrospective review showed that that management's budgets were in line with actual results with the actual result differing from budget by only -1%. Therefore, a 20%/15% reduction in future cash flows can be deemed as excessive given management's previous history of detailed forecasting. As shown in the the first table above, no change to future cash flows leaves headroom in both UK Construction and Canada Construction.

Revising the growth rate into perpetuity down to 1.5% could also be regarded as too much. Given that management used a growth rate of 2.5% then a more modest 2% into perpetuity could also have been used rather than 1.5%. As this is being taken into perpetuity, it is likely to have a considerable effect on the headrooms.

When reviewing management's working capital benefits in year 1, due to the nature of the Construction business model, there is scope for increasing this further than the numbers used by management (16.3m for UK Construction and 18m for Canada Construction). Once again, increasing both of these figures would result in an increase in the NPV.

Goodwill is a judgemental balance and relatively small changes in assumptions could give rise to material changes in the assessment of the carrying value of goodwill. This revised base case calculated by KPMG shows headroom in all four CGUs before applying further sensitivities. Robust sensitivity has already been performed in Tab 5 using management's base case scenario and no impairment was found and therefore even when using this scenario, KPMG do not propose impairing goodwill. However, the goodwill in the construction CGUs will be monitored closely going forwards."

1509. In this passage, KPMG effectively stated that:

1509.1 a reduction in future cash flows of 15% or more was not reasonably possible;

1509.2 a growth rate of only 1.5% was not reasonable;

1509.3 there was potential for working capital benefits to be increased, which would result in increased cash flows; and

1509.4 the results of sensitivity tests performed on Carillion's (original) base case provided sufficient assurance that no impairment was necessary at this time.

1510. However, these conclusions were unsupported by or inconsistent with the evidence obtained by KPMG.

1511. First, there was no basis for concluding that a variance of 15% or more in Carillion's cash flow forecasts was not reasonably possible. Indeed, the evidence available to KPMG indicated the opposite. In particular:

1511.1 KPMG referred to "*the actual result differing from budget by only -1%*" but this -1% variance was an aggregate budget variance, including elements of Carillion's business that had not been considered in the goodwill impairment testing. Significant negative variances had occurred in respect of individual segments, and KPMG had observed a substantial negative aggregate variance in reviewing Carillion's budgets in the 2015 audit. In particular:

1511.1.1 The working paper recorded that there had been negative segment variances in 2016 as significant as –40% and –35%.

1511.1.2 The working paper recorded that there had been negative segment variances in 2015 as significant as –32%.

1511.1.3 The previous year's equivalent working paper had recorded that there had been negative segment variances in 2014 as significant as –66%.

1511.1.4 The previous year's equivalent working paper had also recorded that the 2013 aggregate variance was –27%, with negative segment variances as significant as –85%.

In light of the above, the evidence did not demonstrate that Carillion's management had established a sufficiently reliable budgeting process to allow KPMG to conclude that variances of 15% or more from the budget were not reasonably possible.

1511.2 Further, KPMG was or should have been aware that the aggregate variance of –1% had been achieved because of three significant one-off credits to operating profits in 2016, namely:

1511.2.1 a £20 million gain on the sale of the "*Geneva FM Platform*";

1511.2.2 a £16.7 million gain from recognising revenue from the "*Portsmouth Car Park*"; and

1511.2.3 a £10.4 million gain from the sale of "*IP from UK* [Provider A] *and Mobilisation recovery from* [Provider A]",

without which the aggregate variance would have been approximately –20%. As noted above, it was unlikely that these "*one-off*" transactions had been included in Carillion's business plans, and this further undermined the conclusion that Carillion's 'detailed forecasting' was reliable.

1512. Second, KPMG's statement that "*Revising the growth rate into perpetuity down to 1.5% could also be regarded as too much*" was inconsistent with its own explanation for using that rate for the sensitivity test, as follows:

> *"KPMG obtained UK economy forecasts from HM Treasury […] and this estimates average growth of 1.4% therefore KPMG rounded this to 1.5%."*

1513. Third, KPMG referred to no evidence in connection with its statement that there was "*scope for increasing* [working capital benefits in year 1] *further*" and this was improbable given that the assumed working capital benefits were already very significant.

1514. Fourth, KPMG referred to "*Robust sensitivity*" testing performed on Carillion's base case to support its conclusion that no impairment was necessary. However, KPMG had identified that this base case was incorrect, in that it included working capital benefits to perpetuity in the VIUs and did not include assets other than the goodwill balances and intangible assets in the carrying values. The sensitivity analysis performed on this base case could not therefore provide support for this conclusion.

1515. In summary, KPMG's sensitivity testing did not provide sufficient appropriate audit evidence that no impairment of goodwill was required. In fact, it suggested the opposite, and therefore, at the very least, further investigation was necessary.

1516. There were thus breaches by **the Respondents** in the **2016 audit** of:

1516.1 **ISA 200 paragraph 15**, in that the Respondents did not approach its sensitivity testing with an adequate degree of professional scepticism, and so did not critically assess the (inadequate and conflicting) evidence in relation to whether an impairment to goodwill was necessary;

1516.2 **ISA 330 paragraphs 5, 6 and 26**, in that the Respondents did not perform adequate audit procedures to assess whether the impact of changes in key assumptions indicated that an impairment might be necessary, and did not adequately consider all audit evidence; and

1516.3 **ISA 500 paragraphs 6, and 11**, in that the Respondents failed to design and perform appropriate audit procedures to enable them to obtain sufficient appropriate audit evidence to enable them to conclude that no impairment to goodwill was necessary and did not adequately consider or respond to inconsistencies.

(3) Communications with the Audit Committee

1517. In the 2016 Year-End Audit Memorandum, KPMG did not refer to the results of the sensitivity tests it had performed on the revised base case. KPMG referred only to the results of sensitivity tests it had performed on Carillion's original, flawed base case, stating as follows:

> *"Our cash flow sensitivity applies a 20% reduction to the UK Services forecast cash flows for 2017 to 2019, coupled with a growth rate of 1.0% into perpetuity (rather than 2.5% assumed by management) and a discount rate of 9.3% (upper end of KPMG range). As shown in the above table, this combined sensitivity still does not trigger an impairment."*

1518. Given that:

1518.1 KPMG had revised Carillion's base case because it considered Carillion's approach contained errors (in particular, in its calculation of carrying values and treatment of working capital benefits); and

1518.2 sensitivity tests performed on the revised base case had indicated an impairment to the goodwill balance of UK Construction,

KPMG's report was incomplete and should have communicated to the Audit Committee the results of the sensitivity tests performed on the revised base case.

1519. Further, in the 2016 Year-End Audit Memorandum, KPMG stated, "*We note that the vast majority of the Group's goodwill is held in UK Services, and we have therefore focused our impairment review and sensitivities on this CGU*".

1520. However, the sensitivity testing of the revised base case had indicated an impairment to the goodwill balance of UK construction and minimal headroom in Canada construction. In these circumstances, KPMG was, or alternatively should have been, aware that the goodwill balances of the construction CGUs were most at risk and should have been the focus for their testing.

1521. There were thus breaches by **the Respondents** in the **2016 audit** of **ISA 260 paragraph 16**, in that the Respondents did not adequately communicate with the Audit Committee on the results of the sensitivity testing performed by the Respondents.

I. Disclosure relating to the goodwill balances in the 2016 financial statements

1522. Carillion's 2016 financial statements included the following disclosure:

> *"Management has also concluded that there was no reasonably possible change in any of the key assumptions used in testing goodwill for impairment that would have caused an impairment to be recognised."*

1523. KPMG's 2016 Year-End Audit Memorandum expressly confirmed that KPMG had assessed Carillion's disclosure on goodwill impairment, stating as follows:

> *"we also assessed whether the Group's disclosures about the sensitivity of the outcome of the impairment assessment to changes in key assumptions appropriately reflected the risks inherent in the valuation of goodwill."*

1524. However:

1524.1 KPMG had itself performed sensitivity tests (described above) on the basis of certain alternative assumptions; and

1524.2 KPMG had established that these alternative assumptions would have led to an impairment in the goodwill balance of the UK construction CGU.

1525. Therefore, KPMG could not have agreed with the disclosure above unless it considered that the alternative assumptions that it had itself applied in its sensitivity tests were not reasonably possible. In order to be satisfied that the disclosure was appropriate, KPMG should have considered what assumptions were reasonably possible and designed and performed sensitivity tests based upon those assumptions.

1526. There was thus a breach by **the Respondents** in the **2016 audit** of **ISA 700 paragraph 9(f)**, in that the Respondents did not evaluate whether Carillion's disclosure (to the effect that no reasonably possible change in assumptions would have caused an impairment to be recognised) would adequately enable the intended users of Carillion's financial statements to understand the effect of material transactions and events on the information conveyed.

J. Consideration of the potential closure of the Canada Construction CGU

1527. Working paper "*INTCACC.B1 C.06 APPENDIX 1*", which was completed by KPMG Canada and emailed to KPMG UK on 10 February 2017, advised as follows:

> *"Carillion has significant reduce scale of its general contracting business within CCI due to poor historic performance. No formal closure decision has yet been announced and there is an intention to continue working on PPP projects where the control over the design of the projects is in Carillion's view much better controlled. This is important because there is an element of historic construction goodwill related to the construction business which is considered to be recoverable from future cash flows locked up in WIP and claims. Carillion have locked in a number of key personnel to assist with the process of agreeing claims through mediation, arbitration or litigation process.*
>
> *The calendar year has seen a significant further reduction in turnover and by the end of the year the overall construction portfolio is now substantially complete. Both* [Canada Contract A] and [another Canadian contract] *where construction work continues are also significantly more advanced than the prior year so construction risk delays have been reduced for the future. The reduction in construction also means that traded margin on new work is modest and the financial result is materially impacted by changes in historic traded claims positions.*
>
> *The principal audit risk lays within the claims for additional costs not approved by clients in the form of agreed change orders or delays caused by poor subcontractor no performance. The arguments being made by Carillion are that poor design led to additional costs staff and materials being incurred or material non-performance by sub-contractors. The potential client's rebuttal is that Carillion failed to appropriately mitigate these delays as the general contractor and thus should remain liable for a proportion of the costs.*
>
> *Carillion seeks to pass through sub-contractor claims to the client and make sub-contractor accept any shortfall in the overall negotiated position which generally works in the Canadian market. One factor which may weigh on Carillion's success in negotiations with subcontractors is that with the winding down of the business which means that they can't offer new projects in exchange for comprises on future projects."*

1528. In this working paper, KPMG Canada made clear that the business of the Canada construction CGU was "*significant[ly] reduce[d]*", with the contract portfolio "*now substantially complete*".

1529. In working paper "*AP100.3.1.A GOODWILL PAPER*", KPMG stated the following in connection with the risk relating to the Canada construction CGU:

> *"The Canada Construction goodwill balance of £10.7m at year end is in relation to the legacy construction business …. There are now two elements of construction business in Carillion namely the PPP related business which will continue and the legacy construction business which is likely to be closed in 2017. The GAT [i.e. the group audit team] also received reporting from KPMG Canada as seen in <5.1.INTCACC.b1> which concluded positively about the level of local goodwill to lower materiality therefore providing greater comfort than when assessing from a Group level. In the overall context of the total goodwill balance, the amount held in Canada Construction is regarded as immaterial."*

1530. In this passage, KPMG drew attention to the likelihood that the "*legacy construction business* [was] *likely to be closed in 2017*" and was thus obviously aware of the possible impact on the future cash flows that would be generated by the Canada construction CGU.

1531. In the circumstances, KPMG should have considered whether:

 1531.1 the likely closure of this element of the business had been reflected appropriately in the VIU calculation, and whether any cash inflows would be generated beyond 2017 (or possibly shortly thereafter, depending on how timely Carillion's customers were likely to be in making their final payments); and

 1531.2 as a result, whether an impairment to the goodwill balance of the Canada construction CGU should be made.

1532. KPMG did not consider these points at all. As shown in "*AP100.3.0010 GOODWILL IMPAIRMENT REVIEW DEC*", Carillion had assumed not only that the Canada construction CGU would continue to generate cash flow from operations until 2040, but also that the amount would grow each year. This was at odds with what KPMG knew about Carillion's plans for the Canada construction business.

1533. Further, having set materiality for the financial statements at £8 million, KPMG inappropriately concluded that the £10.7 million goodwill balance in the Canada Construction CGU could be "*regarded as immaterial*".

1534. There were thus breaches by **the Respondents** in the **2016 audit** of:

 1534.1 **ISA 200 paragraph 15**, in that the Respondents did not approach this issue with an adequate degree of professional scepticism, and so did not critically assess the (inadequate and conflicting) evidence in relation to whether an impairment to the goodwill balance of the Canada construction CGU should be made; and

1534.2 **ISA 500 paragraph 11**, in that the Respondents did not adequately consider or respond to the inconsistency between the treatment of the Canada CGU in management's VIU calculations and the other information they received suggesting that the major part of relevant component would shortly close.

21. OVERSEAS COMPONENTS

One of Carillion's overseas components, Qatar, included the Msheireb Contract, which was estimated to have a final value of over £600 million. In 2016 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.

However, KPMG did not identify the Qatar component as significant and planned to perform only "*limited desktop review procedures*" for the component. Despite evidence of significant risks relating to the contract, KPMG did not revisit its approach throughout the 2016 audit. The limited procedures planned were poorly executed and overall KPMG's audit work provided insufficient evidence to support the very large amounts recognised.

Additionally, in its 2016 audit of the Canada component, KPMG failed to evaluate information provided by the component auditor adequately and failed to respond appropriately to indications of possible management bias and risks that revenue in relation to claims had been recognised inappropriately.

A. Overview

1535. Carillion had a number of overseas components. KPMG was required to identify which of these were significant, that is, whether each component either:

    1535.1 had financial significance to the group; or

    1535.2 was likely to include significant risks of material misstatement of the group financial statements.

1536. The classification (as significant or not significant) affected the audit procedures to be performed in relation to that component.

1537. One of Carillion's overseas components was located in Qatar. This included the Msheireb Contract, which was estimated to have a final value of over £600 million and had experienced significant delays, and with uncertainty over the recovery of over £100 million of revenue.

1538. KPMG failed in the audit of this component in that:

1538.1 KPMG determined that the Qatar component was not significant and failed to revisit this decision during the 2016 audit, despite having obtained clear evidence that the Msheireb Contract was likely to include significant risks of material misstatement; and

1538.2 the limited audit procedures that were in fact planned and performed on the Qatar component were poorly designed and executed.

1539. As a result, KPMG did not subject the Qatar component and the Msheireb Contract to an appropriate level of scrutiny and obtained little evidence to support the amounts recognised.

1540. Another of Carillion's components was in Canada. This was described in working papers as being a "*full scope*" component and was audited by KPMG Canada in Toronto, upon whose work the group audit team relied. However, the group audit team did not properly evaluate or respond to information provided by KPMG Canada, including:

1540.1 an uncorrected misstatement of $4.5 million relating to Canada Contract C;

1540.2 indications that claims included in revenue might not meet the criteria set by accounting standards; and

1540.3 indications of possible management bias in relation to claims in general and the Canada Contract D in particular.

1541. This chapter is structured as follows:

1541.1 Section B concerns the identification of the significance of the Qatar component.

1541.2 Section C concerns the performance of limited audit procedures in relation to the Qatar component.

1541.3 Section D concerns the assessment of information provided by KPMG Canada in relation to the Canada component.

B. Identification of the significance of the Qatar component

(1) Introduction

1542. Carillion had a number of overseas components. In order to ensure sufficient audit work was performed to address the risks of material misstatement, KPMG was required to identify which of these were significant.

1543. ISA 600 paragraph 9(a) defined a "*component*" as:

> *"An entity or business activity for which group or component management prepares financial information that should be included in the group financial statements".*

1544. ISA 600 paragraph 9(m) defined a "*significant component*" as a:

> *"component identified by the group engagement team (i) that is of individual financial significance to the group, or (ii) that, due to its specific nature or circumstances, is likely to include significant risks of material misstatement of the group financial statements".*

1545. ISA 600 paragraphs 12 and 18 provided:

> *"the group engagement team shall obtain an understanding of the group, its components, and their environments that is sufficient to identify components that are likely to be significant components*
>
> *[…]*
>
> *The group engagement team shall obtain an understanding that is sufficient to:*
>
> *(a) Confirm or revise its initial identification of components that are likely to be significant; and*
>
> *(b) Assess the risks of material misstatement of the group financial statements, whether due to fraud or error."*

1546. The group audit team was therefore required to identify components which were significant, that is, whether each component either:

1546.1 had financial significance to the group; or

1546.2 was likely to include significant risks of material misstatement of the group financial statements.

1547. ISA 600 paragraphs 26 to 29 required auditors to perform different procedures in relation to components depending on whether or not they were identified as significant.

(2) KPMG's assessment of whether the Qatar component was significant

1548. KPMG's 2016 working paper "*2.8.1.4.0020 SCOPING CRITERIA*" is recorded as having been prepared on 24 November 2016, and described KPMG's approach to deciding whether or not components were significant as follows:

> *"The group audit team then scoped these components based on its:*
>
> *a) Consideration of the size of component*
>
> *b) Consideration of the historical background and risks associated with the component and overall audit approach."*

1549. The working paper then listed each of Carillion's components along with certain details including:

1549.1 management's forecast operating profit, both in monetary terms and as a percentage of the total amount for the group; and

1549.2 the proposed audit approach and a description of the rationale for that approach.

1550. The approach for the Qatar component was described as "*Limited scope*" and the rationale given for this was:

> *"Qatar & Saudi- Components are not financially significant. We will perform limited desktop review procedures".*

1551. There was no other evidence or analysis referred to supporting this conclusion. In particular, there was no reference to any consideration of the "*historical background and risks*" described in KPMG's working paper above.

1552. The working paper then concluded:

> *"76.4% of gross Group operating profit is subject to full scope audit, with a further 13.6% specific reporting (in the case of PFI). 90.0% coverage from this level of testing will enable a Group Audit Opinion to be formed. Note the remaining 10.0% will not be ignored instead will be exposed to reviews".*

1553. There is no other information on the audit file on the assessment of significant components.

1554. KPMG recorded that "*MENA*" (which included Qatar as well as components in Oman and Saudi Arabia) had an operating profit of £11.8 million or 4.6% of Carillion's group operating profit, and decided as a result that Qatar was not a significant component. However, the Qatar business incorporated the Msheireb Contract which had an "*overall value*" of over £600 million and required recovery of over £100 million from variations and claims which had yet to be agreed. Therefore, despite having a relatively low operating profit, this contract and the Qatar component were highly likely to include significant risks of material misstatement of the group financial statements. They were thus of "*financial significance*".

1555. KPMG's analysis was inadequate for two reasons:

1555.1 First, forecast operating profit alone was evidently an inadequate criterion by which to assess whether a component was significant, because operating profit could be very low even where the "*financial significance*" of the component was very high, as was the case of the Qatar business.

1555.2 Second, KPMG's analysis took no account of part (ii) of the definition of "significant component" (which related to "*significant risks of material misstatement*").

Thus, KPMG did not have a proper basis to conclude that the Qatar component was not financially significant.

1556. Further, the working paper was dated 24 November 2016 and used data from before the year-end, meaning that the data was not representative of the year-end position. There is no evidence that KPMG re-assessed the significance of the components using year-end data, as it should have done.

(3) Further evidence available to KPMG that was relevant to the consideration of the significance of Qatar

1557. In the same working paper, in relation to the audit approach adopted for the Qatar component, KPMG recorded:

> *"Site visits by the UK team are not expected to be performed in 2016 based on our understanding of the operations and the relative stage of completion of the contracts in these locations.* ***We will monitor these contracts throughout 2016 and update our strategy accordingly if required."*** [emphasis added]

1558. Both prior to and during the 2016 audit, KPMG obtained information on the Msheireb Contract from a number of sources which was relevant to whether the Qatar component was "*likely to include significant risks of material misstatement of the group financial statements*". These included:

1558.1 notes prepared by Mr Meehan on a site visit to Carillion's MENA business in June 2015;

1558.2 position papers prepared by Carillion on Msheireb as at May 2016 and October 2016;

1558.3 a draft report dated 1 August 2016, apparently intended to be discussed at an Audit Committee meeting on 18 August 2016;

1558.4 a "*reconciliation for Msheireb*" sent by Finance Director of the MENA component of Carillion to Mr Meehan on 15 August 2016;

1558.5 handwritten notes prepared by Mr Meehan and KPMG Senior Manager B of a call in February 2017; and

1558.6 the Director A's report for the Audit Committee meeting on 23 February 2017.

1559. Those sources disclosed the following information:[109]

1559.1 Carillion's share of the value of the Msheireb Contract was around £670 million.

1559.2 Following his site visit, Mr Meehan had recorded that the contract was "*extremely large, and challenging*" and faced "*very obvious challenges*", though "*there was plenty of evidence to support the position traded by Carillion*".

1559.3 The contract had been expected to be completed in 130 weeks when the tender was submitted, but by May 2016 this had doubled to 260 weeks. By February 2017 the completion date had been put back a further four months.

1559.4 The total contract value had increased by more than 50% from when the contract was awarded and included significant amounts for claims and variations.

1559.5 There was considerable uncertainty over the recoverability of the claims and variations. In August 2016 Carillion's share of claims and variations which the client had not paid or agreed totalled £98.6 million and by February 2017 had increased to £106.2 million.

1560. There were also significant anomalies in the position papers and information provided by Carillion that called for further investigation. For example:

1560.1 between October 2016 and February 2017, the completion date had been put back by four months but the reported "*overall value*" and margin on the contract were unchanged;

1560.2 there were significant variations that were stated to have had no impact on forecast costs; and

1560.3 amounts for revenue recognised to date on the contract together with amounts stated to be recovered were inconsistent with the end-of-life forecasts.

[109] Amounts provided on Msheireb contract in this paragraph are Carillion's 80% share and are translated using the 2016 average exchange rate of 0.2035.

1561. There were also indications that significant amounts relating to claims were included in revenue that might not meet the requirements of the applicable accounting standards (which, inter alia, required negotiations to have reached "*an advanced stage such that it is probable that the customer will accept the claim*").

1562. All of these matters clearly indicated that the Msheireb Contract was "*likely to include significant risks of material misstatement of the group financial statements*".

1563. KPMG acknowledged many of these issues in their reporting to the Audit Committee. KPMG included the Msheireb Contract as one of a number of contracts which contained the "*highest degree of judgement, estimate and challenge*", stating:

> *"The total contract value in Qatari Riyal on the Msheireb project has not increased significantly from 30 June 2016 with an expectation that works will be substantially complete by April 2017. EoT[110] 3b was presented to the client on 26 August 2016, and together with EoT 3a Carillion need to settle the submitted claims of £82.2 million for £44.4 million. In addition, to achieve the traded margin of 3.2%, Carillion need to recover £61.8 million in variations (£11.6 million incurred to date), which management are confident in obtaining as they have already recovered other significant variations to date."*

(4) Conclusion

1564. KPMG recorded that it assessed the significance of Carillion's components according to their size and their "*historical background and risks*".

1565. KPMG calculated that forecast operating profit of the MENA business, of which the Qatar component was a part, represented 4.6% of the total forecast operating profit for the group. Relying on that calculation, KPMG concluded that the Qatar component was "*not financially significant*" and as a result, planned to perform "*limited desktop review procedures*". However, KPMG recorded no other evidence or analysis supporting this conclusion and in particular made no reference to any "*historical background and risks*" relating to the Qatar component.

1566. KPMG obtained evidence, both prior to and during the 2016 audit, that the Msheireb Contract was "*extremely large, and challenging*" and faced significant delays, and that there was uncertainty over the recoverability of claims and variations totalling over £100 million. This clearly indicated that the Qatar component was "*likely to include significant risks of material misstatement of the group financial statements*".

[110] Understood to be an "*extension of time*" for the contract to be completed.

1567. Although it highlighted these points to the Audit Committee, KPMG failed to consider the obvious risk relating to the recovery of this amount both in its initial assessment of the significance of the Qatar component, and throughout the audit.

1568. There were thus breaches by **the Respondents** in the **2016 audit** of:

1568.1 **ISA 315 paragraph 31**, in that the Respondents failed to respond to evidence concerning the Msheireb Contract that ought to have caused them to change their assessment of the risks associated with the Qatar component; and

1568.2 **ISA 600 paragraph 18**, in that the Respondents failed to classify the Qatar component as significant (or to revise its initial classification) based on their understanding of the risks of material misstatement of the group financial statements.

C. Performance of limited audit procedures in relation to Qatar

(1) Introduction

1569. In its working paper "*TOD 2 Non-significant component reviews*", KPMG described the procedures it had undertaken in relation to non-significant components, including Qatar, as follows:

> *"Review the 2016 results based on 2015 figures, for any variances in excess of >1/2 PM[111] investigate reasons for variance through enquiry with management/local audit teams"*

1570. The approach was then explained in KPMG's working paper "*TOD 2.0040 component analytics*" as follows:

> *"1/2 PM has been determined to be an appropriate threshold for testing because of the following factor:*
>
> *• Identifying balances with variances greater than 1/2 PM against prior year has mitigated the risk that individually significant balances are materially misstated.*
>
> *KPMG are comparing current year against prior year because it is in with our understanding of the business that no significant changes have occurred in the non-significant components."*

[111] Understood to refer to performance materiality.

1571. The suggestion that "*no significant changes ha[d] occurred in the non-significant components*" had no obvious basis. In view of the substantial changes to both the value and duration of the Msheireb Contract during its lifetime, in relation to Qatar this was unlikely.

1572. Working paper "*TOD 2.0040 component analytics*" also recorded the performance of these procedures addressing both amounts in the profit and loss account and amounts in the balance sheet (each of which is considered below).

1573. However, a schedule called "*ReviewNoteSummary*" was emailed between the audit team on 2 March 2017, the day after the date of the 2016 audit report. This set out notes of the audit team's review of working papers and instructions for further work which needed to be completed. It included the following comment in relation to working paper "*TOD 2 Non-significant component reviews*":

> *"Complete Group Services, Saudi and Qatar component analytics"*

1574. This suggested that this work had not yet been completed at the date of the 2016 audit report. It is therefore not clear whether the work described below was in fact completed before the date of the audit report and so could support the audit opinion. This is discussed in Chapter 22 Part E below.

(2) Profit and loss account

1575. In relation to the profit and loss account for Qatar, KPMG identified variances of over £3 million (half of performance materiality) in revenue, costs of sales, gross profit, operating profit, profit before tax, and profit after tax.

1576. As to revenue and costs of sales, KPMG wrote:

> *"Revenues are up due to the mix of projects and also specificallty due to the Msheireb project in downtown Doha, which is bringing in additional revenues beyond those origianllly forecast with the value now forecast at some £665.0 million against the original contract award of £440.2 million. Volumes in Qatar also continue to increase supported by Expo 2020 and the 2022 World Cup. The cost of sales is also up in line with this increased revenue."*

1577. This explanation indicated that KPMG's "*understanding […] that no significant changes ha[d] occurred in the non-significant components*", i.e. the expectation underpinning the procedure, was wrong. Further, the statement "*The cost of sales is also up in line with this increased revenue*" was incorrect: cost of sales had increased by 7.9%, but revenue had increased by 13.6%. This was not identified or addressed.

1578. KPMG provided no further explanation for the increase in gross profit, operating profit, profit before tax, and profit after tax even though profit was negative in 2015 but positive in 2016, and the variance was over £10 million.

1579. In light of these deficiencies, the procedure provided no assurance over the reliability of the 2016 reported amounts.

(3) Balance sheet

1580. In relation to the Qatar balance sheet, KPMG identified and commented on variances of over £3 million in trade/other receivables and prepayments, cash, trade and other payables and retained earnings.

1581. As regards trade/other receivables and prepayments, KPMG wrote:

> *"Receivables have increase in line with the increased revenues".*

1582. This was incorrect: receivables had increased by 35.2%, but revenue had increased by only 13.6%. The actual increase in receivables of £30.3 million was also greater than the increase in revenue of £24.8 million, which should have led to further inquiries.

1583. As regards trade and other payables, KPMG wrote:

> *"Payables have increase in line with the increased revenues".*

1584. This was also incorrect: payables had increased by 37.9%, but revenue had increased by 13.6%. Further, there was no explanation why payables would have been expected to increase in line with revenue rather than costs.

(4) Overall assessment

1585. As explained above, in relation to both profit and loss and balance sheet amounts, KPMG failed to properly investigate the variances identified, and the reasons recorded for the variances were inadequate. The outcome of the test suggested that the initial expectation was simply wrong, and that no evidence of value had been obtained. At the end of the working paper "*TOD 2 Non-significant component reviews*", KPMG nevertheless confirmed that it had obtained the audit evidence that had been expected from the procedure and that no misstatements been identified as a result.

(5) Conclusion

1586. Based on its categorisation of Qatar as a non-significant component, KPMG performed certain limited analytical review procedures in relation to Qatar. However, the procedures in question – which amounted to the identification and investigation of variances between 2015 and 2016 amounts – were deficient, as was KPMG's performance of them. In particular:

1586.1 It was unclear why the procedures would provide sufficient or appropriate evidence. In fact, the expectation that these amounts had not changed significantly was unlikely and unsupported by the evidence.

1586.2 The explanations provided for the variances were flawed and inadequate.

1587. As noted above, KPMG received other information concerning the Qatar component and the Msheireb Contract during the audit, including a position paper. However, KPMG did not subject the information received to any proper analysis or challenge, and consequently obtained no assurance over the evident risk of misstatement.

1588. There were thus breaches by **the Respondents** in the **2016 audit** of:

1588.1 **ISA 500 paragraphs 6 and 7**, in that, based on the entirety of their audit work, the Respondents failed to design and perform appropriate audit procedures to enable them to obtain sufficient appropriate audit evidence in relation to the Qatar component; and

1588.2 **ISA 600 paragraph 17**, in that the Respondents failed to adequately assess the risks of material misstatement relating to the Qatar component.

D. Assessment of information provided by KPMG Canada in relation to the Canada component

(1) Introduction

1589. KPMG's 2016 working paper "*2.8.1.4.0020 SCOPING CRITERIA*" recorded that Carillion's Canada component was a "*full scope*" component and that it would be audited by KPMG in Toronto, with a site visit by the group audit team.

1590. The group audit team therefore relied on audit evidence obtained by KPMG Canada for the group audit.

1591. ISA 600 paragraphs 41 and 42 provided as follows:

> *"The group engagement team shall request the component auditor to communicate matters relevant to the group engagement team's conclusion with regard to the group audit […]*
>
> *[…]*
>
> *The group engagement team shall evaluate the component auditor's communication […]. The group engagement team shall:*
>
> *(a) Discuss significant matters arising from that evaluation with the component auditor, component management or group management, as appropriate; and*
>
> *(b) Determine whether it is necessary to review other relevant parts of the component auditor's audit documentation."*

1592. ISA 600 paragraph 44 provided as follows:

> *"The auditor is required to obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion. The group engagement team shall evaluate whether sufficient appropriate audit evidence has been obtained from the audit procedures performed on the consolidation process and the work performed by the group engagement team and the component auditors on the financial information of the components, on which to base the group audit opinion."*

1593. The group audit team was therefore required to obtain and evaluate the communication from KPMG Canada, discuss significant matters and, if necessary, review the component auditor's audit documentation, in order to determine whether sufficient appropriate audit evidence had been obtained.

1594. The remainder of this section considers:

1594.1 uncorrected misstatements;

1594.2 claims; and

1594.3 Canada Contract D.

(2) Uncorrected misstatements

1595. ISA 450 paragraph 12 provided as follows:

> *"The auditor shall communicate with those charged with governance uncorrected misstatements and the effect that they, individually or in aggregate, may have on the opinion in the auditor's report, unless prohibited by law or regulation. The auditor's communication shall identify material uncorrected misstatements individually. The auditor shall request that uncorrected misstatements be corrected."*

1596. ISA 450 paragraph 15 provided as follows:

> *"The auditor shall include in the audit documentation: […]*
>
> *(b) All misstatements accumulated during the audit and whether they have been corrected*
>
> *(c) The auditor's conclusion as to whether uncorrected misstatements are material, individually or in aggregate, and the basis for that conclusion."*

1597. In working paper "*INTCACC.B C.06 HIGHLIGHTS COMPLETION MEM*", prepared by KPMG Canada, it was reported that:

> *"Canada Contract C claims relate to additional revenue claimed by Canada on services provided, on top of the contract revenue for these services. As such, this WIP balance should be assessed as contingent asset under IAS 37."*

1598. Working paper "*INTCACC.D C.08 SUMMARY OF MISSTATEMENTS*", also prepared by KPMG Canada, set out a "*Summary of Group Misstatements - Uncorrected*" which included $4.5 million relating to the Canada Contract C claims. KPMG Canada considered that this amount should be transferred from debtors to expenses, but reported an explanation from Carillion, which referred to "*excess provisions*" that Carillion was "*treating as an offset relating to this issues*".

1599. In its working paper "*TOD 1.1 GROUP REPORTING TRACKER*", the group audit team referred to the "*Canada Contract C SAM*" and stated:

> *"The UK team have considered provisions across the Group and have determined the level of provisioning to be appropriate."*

1600. No further consideration or evidence relating to this amount was recorded on the audit file.

1601. However, in interview, KPMG Senior Manager A recalled that the Group audit team had considered the issue, and concluded that Carillion's treatment of the claim was appropriate and disagreed with the view of KPMG Canada:

> *"they concluded, or they were concluding, that you couldn't have a claim on the balance sheet for an IAS 18 accounted contract. I don't know why … Which -- I didn't agree with;* [KPMG Senior Manager C] *didn't agree with; on that basis, of our experience in the UK. …*
>
> *… the Group Team, you know, and myself, took a position which was, "Well, I understand that you've included this audit difference in your reporting, for KPMG Toronto; but based on my understanding, and what you've said to me, I don't agree that we have an Audit difference here". So, we didn't take this Audit difference any further."*

1602. Before reaching a conclusion on this issue, KPMG should have discussed it with the component audit team and, in light of that, considered whether, in respect of the correct treatment of the amount, the work performed by the Canada audit team could be relied on and whether sufficient appropriate audit evidence had been obtained. KPMG did neither.

(3) Claims

1603. Working paper "*INTCACC.B2 C.06 APPENDIX 2 CLAIMS ANALYS*" set out the following details of two contracts (called "*Canada Contract A*" and "*Canada Contract B*") in Carillion's Canada component:

	CAD		**GPB**[112]	
	Canada Contract A	**Canada Contract B**	**Canada Contract A**	**Canada Contract B**
"*B/S exposure + WIP*"	$71.1m	$37.2m	£42.9m	£22.4m
"*original contract*"	$175.1m	$296.0m	£105.6m	£178.5m
"*agreed variations*"	$14.6m	$114.2m	£8.8m	£68.9m
"*variations to be agreed*"	$2.4m	$6.4m	£1.4m	£3.9m
"*cost reduction*"	-	– $37.4m	£0.0m	– £22.6m
"*claims*"	$85.9m	$87.5m	£51.8m	£52.8m
"*Total EOF Revenue*"	$278.0m	$466.6m	£167.6m	£281.4m
"*% Complete*"	95%	91%	95%	91%

[112] Converted using an exchange rate of 1.6585 as at 31 December 2016.

1604. Thus, the carrying value of the balance sheet assets and revenue recognised in the 2016 financial statements in relation to these two contracts depended on highly material estimates in relation to claims and cost reduction.

1605. In working paper "*INTCACC.B C.06 HIGHLIGHTS COMPLETION MEM*", and its appendix, working paper "*INTCACC.B1 C.06 APPENDIX 1*", KPMG Canada described these claims further. The descriptions made clear that significant amounts were disputed and that negotiations in some cases appeared to be at a very early stage. In relation to the Canada Contract B claims, KPMG Canada stated:

> *"In terms of resolving the disputed additional costs this will be a slower moving exercise. The client still hasn't formally acknowledge an extension of terms. In the period Carillion submitted their interim statement of claim to* [the party to Canada Contract B]*on 28 September 2016. Management continue to work hard with* [the party to Canda Contract B]*and getting better access to the real decision makers".*

1606. Mr Meehan visited Canada in November 2016 and recorded the following in his note of that visit:

> "[Canada]
>
> *[…]*
>
> [Canada Contract B] *will probably end up going legal was now the view. This legacy contract is now complete, and has some C$60m of claims etc traded.*
>
> *[…]*
>
> [Canada Contract A]
>
> *This legacy contract had an initial tender value of C$175m but is now traded to C$278m, it is 30 months late having started in early 2011 and now due to finish early 2017. Claims have been submitted for C$148m, of which C$83m is traded, of which C$10m has been paid. The remainder has been subject of debate, mediation and is now heading towards legal."*

1607. The description in Mr Meehan's notes that these claims were "*going legal*" and "*heading towards legal*", taken together with the comments made by KPMG Canada, suggested that neither met the requirement of being "*probable that the customer w*[ould] *accept the claim*" and therefore that the requirements of IAS 11 for the amounts to recognise as revenue were not met.

1608. In working paper "INTCACC.B1 C.06 APPENDIX 1", in respect of "*Heavy civil engineering and road construction claims*", KPMG Canada stated:

> *"Whilst there is evidence to support Carillion traded claims in terms of reports and filings the past track record would suggest that management are the optimistic end of an acceptable range in terms of potential outcomes."*

1609. Further, in working paper "*INTCACC.B1 C.06 APPENDIX 1*", KPMG Canada indicated that, of $13.3 million of "*Heavy civil engineering and road construction claims*" included in revenue over the previous three years, only $8.7 million (that is, 66%) had been recovered. This suggested that Carillion had recognised significantly more in respect of these claims than it had recovered over the three years considered, and corroborated KPMG Canada's observation that Carillion's "*track record*" in respect of claims of this type was optimistic.

1610. In light of this, to properly evaluate whether sufficient audit evidence had been obtained by KPMG Canada, the group audit team should have considered:

1610.1 whether the overestimate of the recovery rate on the "*Heavy civil engineering and road construction claims*" was an isolated issue or systemic; and

1610.2 whether, in light of the fact that litigation appeared likely, the revenue being recognised from claims on Canada Contract A and Canada Contract B met the requirements of IAS 11, and whether additional evidence was needed.

1611. KPMG should also have considered the possibility that Carillion Canada's recognition of revenue from claims was affected by management bias.

1612. However, there is no evidence that KPMG gave proper consideration to any of these issues.

(4) Canada Contract D

1613. In its working paper "*INTCACC.B1 C.06 APPENDIX 1*", KPMG Canada wrote under the heading "[Canada Contract D] *Claims and Fines*":

> *"Since Carillion has cumulatively recognized margin significantly in excess of actual financial performance. Accordingly, Carillion had built up a debtor in respect of the* [Canada Contract D] *portfolio of $47m as at December 31, 2015.*
>
> *[…]*
>
> *The 2016 result is revenue of $134.5M, and actual cost of sales of $135.5M, resulting in a negative margin of ($1M). This resulted in an increase to WIP balance of $21M with an ending WIP balance on* [Canada Contract D] *of $68M as at December 31, 2106*
>
> *[…]*

KPMG Toronto considered the overall reasonability of the revised end of life forecast. The final outcome will depend on both the final outcome of MTO negotiations (where management have selected estimates near the middle of range of likely outcomes), costs savings realized from efficiency plan and also inevitably over the remaining contract period the severity of weather returning to more normal trends (the last few winters have seen significantly greater snow)."

1614. The words "*Carillion has cumulatively recognized margin significantly in excess of actual financial performance*" was another indication of possible management bias in Carillion's estimation process.

1615. The working paper also indicated that KPMG Canada had "*considered the overall reasonability of the revised end of life forecast*" and that this depended on the outcomes of negotiations with the client, cost savings and the weather.

1616. In light of the history of these contracts, in order to properly evaluate the communication from KPMG Canada, the group audit team should have sought further assurance that the "*revised end of life forecast*" (which relied on both reducing costs and increasing revenue sufficient to produce an overall End of Life "**EOL**" profit) had been considered with appropriate scepticism and that sufficient audit evidence had been obtained. However, there is no evidence that the group audit team adequately considered or responded to this point.

(5) Conclusion

1617. There were thus breaches by **the Respondents** in the **2016 audit** of:

1617.1 **ISA 500 paragraphs 6, 7 and 11**, in that the Respondents failed to design and perform appropriate audit procedures to enable them to obtain sufficient appropriate audit evidence in relation to the Canada component and did not respond appropriately to evidence suggesting that in some cases the requirements of accounting standards for recognising revenue for claims had not been met; and

1617.2 **ISA 600 paragraphs 42 and 44**, in that the Respondents failed to evaluate whether sufficient appropriate audit evidence had been obtained from the work performed by KPMG Canada on the Canada component.

PART E

22. MANAGEMENT, SUPERVISION AND REVIEW

In the 2016 audit Mr Meehan and KPMG failed in their duties to ensure that the audit engagement was properly managed and supervised, and that a reliable means of ensuring that audit work was correctly recorded and properly reviewed, was in place.

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. Audit procedures in a range of areas of the 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. The final audit file does not provide a reliable record of the evidence that in fact formed the basis for the audit report.

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.

In 2015 audit procedures were also performed after the date of the audit report but nonetheless recorded on the audit file as if they had been performed before that date. Additionally, in both 2014 and 2016 the audit files were not finalised until long after the date mandated by KPMG's audit manual or recommended in auditing standards.

A. Overview

1618. The 2016 audit report was dated 1 March 2017, with the audit opinion confirmed to Carillion late on 28 February 2017 and announced to the public early on 1 March 2017.

1619. Before signing the 2016 audit report Mr Meehan needed to be satisfied that sufficient appropriate audit evidence had been obtained to support the conclusions reached and that the audit report was appropriate in the circumstances. He thus needed to be satisfied that over a thousand working papers setting out details of audit procedures, and many hundreds more working papers supporting these procedures, had been properly prepared and reviewed, either by himself or by a suitably experienced member of the audit team.

1620. However, Mr Meehan did not ensure that a reliable process had been implemented to track the preparation and review of these working papers and to record accurately the audit work performed. The 2016 audit file in fact provided an unreliable and, in some cases, misleading record of when and whether working papers had been prepared and reviewed, and by whom. The audit file recorded reviews by at least one senior manager regardless of whether any substantive review had been performed. In at least one case, the audit file recorded that a working paper had been prepared and reviewed when in fact it was blank.

1621. In the absence of any reliable process being implemented, Mr Meehan was heavily reliant on the senior managers performing proper reviews and on his expectation that they would raise any concerns in their respective areas. This in turn relied on the senior managers having a clear understanding of their responsibilities in each area of the audit. There was, however, a lack of clarity as to who was responsible for certain areas of the audit.

1622. For many of the areas considered in earlier chapters of this *Final Settlement Decision Notice*, the records of preparation and review, coupled with the accounts of their completion given by Mr Meehan and members of the audit team, provide a confused and inconsistent picture of how responsibility for audit work was allocated between members of the audit team.

1623. In fact, the audit was incomplete at the date of the 2016 audit report, as demonstrated by the facts that:

1623.1 on or after 1 March 2017, the audit team recorded hundreds of "*review notes*", identifying where further work was required to be performed and recorded on the 2016 audit file; and

1623.2 further audit procedures and conclusions were still being performed and recorded in the audit file, purporting to provide support for the audit opinion, more than six weeks after the date of the audit report.

1624. The failure by the audit team to complete and review a substantial part of the audit work by the date of the 2016 audit report was not addressed, and possibly not even identified, by Mr Meehan, before he signed the report or thereafter.

1625. In all the circumstances, Mr Meehan did not have a proper basis to be satisfied that sufficient appropriate audit evidence had been obtained to support conclusions reached at the date of the 2016 audit report and thus that the audit report was appropriate. The audit file should provide a record of the basis of the audit report. However, as a result of matters above, the 2016 audit file provided an unreliable and sometimes misleading record of the audit evidence, audit procedures and analysis underpinning the 2016 audit report. The extent of the evidence that was actually available to support the 2016 audit report remains unclear.

1626. In addition, in both 2014 and 2016 the audit files were not finalised until long after the date mandated by KPMG's audit manual or the period recommended in auditing standards.

B. Background

(1) Auditing standards

1627. ISA 220, on quality control in relation to audits, required the "*engagement partner*" to ensure that the audit was properly managed and that work was properly reviewed. Specifically:

1627.1 Paragraph 15 provided:

> *"The engagement partner shall take responsibility for:*
>
> *(a) The direction, supervision and performance of the audit engagement in compliance with professional standards and applicable legal and regulatory requirements; and*
>
> *(b) The auditor's report being appropriate in the circumstances."*

1627.2 Paragraph 16 provided:

> *"The engagement partner shall take responsibility for reviews being performed in accordance with the firm's review policies and procedures."*

1627.3 Paragraph A16, providing guidance on this provision, refers to ISQC 1 paragraph 33 which states:

> *"the firm's review responsibility policies and procedures are determined on the basis that work of less experienced team members is reviewed by more experienced team members."*

1627.4 Paragraph 17 provided:

"On or before the date of the auditor's report, the engagement partner shall, through a review of the audit documentation and discussion with the engagement team, be satisfied that sufficient appropriate audit evidence has been obtained to support the conclusions reached and for the auditor's report to be issued."

1627.5 Paragraph A18, providing guidance on this provision, stated:

Timely reviews of the following by the engagement partner at appropriate stages during the engagement allow significant matters to be resolved on a timely basis to the engagement partner's satisfaction on or before the date of the auditor's report:

- *Critical areas of judgment, especially those relating to difficult or contentious matters identified during the course of the engagement;*
- *Significant risks; and*
- *Other areas the engagement partner considers important.*

The engagement partner need not review all audit documentation, but may do so. However, as required by ISA (UK and Ireland) 230, the partner documents the extent and timing of the reviews."

1628. ISA 230 on "*Audit documentation*" stated:

"The objective of the auditor is to prepare documentation that provides:

(a) A sufficient and appropriate record of the basis for the auditor's report; and

(b) Evidence that the audit was planned and performed in accordance with ISAs (UK and Ireland) and applicable legal and regulatory requirements."

1629. ISA 230 goes on to set out various requirements for documentation of audit work as follows:

1629.1 Paragraph 8 provided:

"The auditor shall prepare audit documentation that is sufficient to enable an experienced auditor, having no previous connection with the audit, to understand: […]

(a) The nature, timing and extent of the audit procedures performed to comply with the ISAs (UK) and applicable legal and regulatory requirements;"

1629.2 Paragraph 9 provided:

"In documenting the nature, timing and extent of audit procedures performed, the auditor shall record:

(a) The identifying characteristics of the specific items or matters tested; […]

(b) Who performed the audit work and the date such work was completed; and

(c) Who reviewed the audit work performed and the date and extent of such review."

1629.3 Paragraph 13 provided:

"If, in exceptional circumstances, the auditor performs new or additional audit procedures or draws new conclusions after the date of the auditor's report, the auditor shall document: …

(a) The circumstances encountered;

(b) The new or additional audit procedures performed, audit evidence obtained, and conclusions reached, and their effect on the auditor's report; and

(c) When and by whom the resulting changes to audit documentation were made and reviewed."

1629.4 Guidance at paragraph A20 on this requirement gave the following example of such "*exceptional circumstances*":

"facts which become known to the auditor after the date of the auditor's report but which existed at that date and which, if known at that date, might have caused the financial statements to be amended or the auditor to modify the opinion in the auditor's report"

1629.5 Paragraph 14 provided:

"The auditor shall assemble the audit documentation in an audit file and complete the administrative process of assembling the final audit file on a timely basis after the date of the auditor's report"

1629.6 Guidance at paragraphs A21 and A22 on this requirement stated:

"an appropriate time limit within which to complete the assembly of the final audit file is ordinarily not more than 60 days after the date of the auditor's report."; and

"The completion of the assembly of the final audit file after the date of the auditor's report is an administrative process that does not involve the performance of new audit procedures or the drawing of new conclusions"

(2) KPMG audit files

1630. KPMG's audit files included the following documents (referred to throughout this *Final Settlement Decision Notice* as working papers):

1630.1 Documents prepared by the audit team, recording details of audit procedures performed, falling into two categories:

1630.1.1 "*subactivity*" – a document generated and completed within KPMG's audit file software; and

1630.1.2 "*attachment*" – a document added to the audit file in a native format.

1630.2 Other documents which had been obtained from Carillion and other sources for the audit.

1631. The audit file also included a purported record of the dates the "*subactivity*" and "*attachment*" working papers were prepared and reviewed, and the individuals responsible. For "*subactivity*" working papers this was recorded within the document and for "*attachment*" working papers this was recorded in a separate document. In some cases, working papers were recorded as having been prepared or reviewed on more than one date, suggesting that their initial preparation or review was revisited during the audit.

1632. Versions of the complete audit file could be saved and retained, providing a snapshot of the audit procedures recorded on the audit file at an earlier moment in time, before the file had been finalised and archived.

1633. KPMG's audit software enabled the audit team to record "*review notes*" when reviewing working papers during the audit. These review notes were not intended to record audit work and did not form part of the audit file. However, they frequently included instructions for additional work which the audit team had identified needed to be performed and so provide an indication of the extent to which audit procedures had been completed at a particular point in time, before the file was finalised and archived.

1634. KPMG's audit software was also designed to reflect the requirements of ISA 230, in particular that records of the preparation and review of working papers were completed. These requirements were also reflected in KPMG's audit manual.

C. Direction, supervision and review of the 2016 audit

1635. The 2016 audit file contained a total of 3,050 working papers, including a total of 1,280 "*subactivity*" and "*attachment*" documents, recording details of audit procedures performed (or in some cases purportedly performed), and many hundreds of further supporting documents obtained from Carillion and other sources.

1636. Mr Meehan needed to ensure that the evidence recorded in these working papers supported the conclusions reached at the date of the audit report. He therefore needed a reliable process in place to ensure that the working papers were reviewed, either by himself or by a suitably senior and experienced member of the audit team before that date.

1637. The records on the audit file of who reviewed which working papers and when suggest, on their face, that a significant number of working papers were both prepared and reviewed shortly before, or on the actual date of, the audit report. They also suggest that further audit work was performed, and many working papers reviewed after the date of the audit report. In particular:

1637.1 On 21 February 2017, two days before the Audit Committee meeting, they record that Mr Meehan reviewed 59 working papers.

1637.2 On 28 February 2017, the day before the date of the 2016 audit report, they record that Mr Meehan reviewed 32 working papers.

1637.3 On 1 March 2017, the date of the 2016 audit report and the date Carillion's results were announced, the audit file records that 184 working papers were first prepared and 320 working papers were first reviewed. Mr Meehan is recorded as having reviewed a further 18 working papers.

1637.4 On the evening of 1 March 2017, at 21:46, KPMG Senior Manager A wrote to KPMG Senior Manager B and a member of the audit team as follows:

> *"So I ran the not reviewed report and there were quite a few screens (7 pages) - mostly seemed to be construction?* [KPMG Senior Manager B] *are you tackling these tonight or what's the plan?"*

1637.5 After the date of the 2016 audit report, 224 working papers were recorded as first reviewed and of these, KPMG Senior Manager B was recorded as having reviewed 221.

1638. However, members of the audit team explained in interview that the dates contained in these records are not a reliable indicator either of when the work underlying the working papers was performed, or of when the working paper was reviewed.

1639. Further, as set out below, it is clear that these records are not a reliable record either of the individual responsible for the review, or of whether a substantive review had been performed at all.

1640. KPMG Senior Manager B was recorded as reviewing 513 of the 1,280 working papers setting out audit procedures, of which 417, over a third, were not reviewed by anyone else. However, they (i.e., KPMG Senior Manager B) described their approach to recording their review as follows:

1640.1 When asked about their recorded review of an actuary's report relating to pensions, they responded:

> *"There's several occasions during the audit we had reviewed sessions either with Peter or* [the EQCR]*,*[113] *the screens have to be signed off before they came through to it. Certain screens it was just an administrative process. In regards to the overall pensions I would not have reviewed this in detail or the pensions main one."*

1640.2 When asked about their recorded review of a working paper described as "*the main going concern working paper*", they responded:

> *"I've clicked it as the manager available on that day to enable the reviews to take place."*

1640.3 When asked about their recorded review of a working paper on contracts provisions, they responded:

> *"*[KPMG Senior Manager A] *was uncontactable to click 'Review', therefore, from an admin perspective, that was myself then that clicked it, to enable* [the EQCR] *to go through the process."*

Later, they confirmed that as far as they could recall they had not performed *"a more substantive review"* of the document".

1640.4 When asked about their recorded review dated 2 March 2017 of working paper "*TOD 1.1 GROUP REPORTING TRACKER*", they responded:

> *"Well, at that point in time the report would've been run to identify any workpapers that hadn't been signed off, and that would've been picked up, the team would've come to me to go through: even at this stage, the audit opinion in the ARA went out on 1 March, so it's already gone, therefore it was just an admin task just to go through to enable the file to be closed down. …*

[113] Understood to be Peter Meehan and the Engagement Quality Control Reviewer for the 2016 audit.

… that is an admin process; I've reviewed it there the day after the group opinion has gone out. Obviously, comfort has been gained: from an admin perspective, the decision was made by myself to then click "Review" at that point in time."

They were asked how they knew "*comfort had been gained*" and they responded:

"that would be Peter signed the audit opinion; Peter has obviously got comfort himself."

They later stated:

"when it came to the group side, and there was planning screens that had still not been signed off by January, with [the EQCR] *coming up, then, yes, as an admin point of view, at that time I would have clicked it to enable the review to go the next level."*

1640.5 When asked about their recorded review of working papers covering areas that were not "*within [their] purview*", they responded:

"An example of that would be the provisions workpaper, an example where it's got the stage where all of the audit committee work has been done, I know the work has been done or discussions were being had to get it there; I'm the only one available. It should've been somebody else, the time-pressure, if it comes to it --"

1641. Mr Meehan's approach to reviews demonstrates that the records of his review of audit working papers were not reliable:

1641.1 A few days before the date of the 2016 audit report, Mr Meehan instructed the audit team to access his laptop and to use it to record a number of working papers as reviewed by him. Mr Meehan did not specify which documents he had in fact reviewed and when he had reviewed them; nor did he specify which documents were to be marked as reviewed. Specifically:

1641.1.1 On 27 February 2017, a member of the audit team wrote to Mr Meehan:

"The team are just going through the remaining eaudit screens and some of these require your sign off. Are you around tomorrow in the office for us to get your laptop for an hour?".

1641.1.2 Five minutes later, Mr Meehan replied:

"I'm not in til thurs [i.e., 2 March 2017, the day after the date of the 2016 audit report]*. Laptop in desk".*

1641.1.3 The member of the audit team then wrote:

> *"Thanks, we'll get* [Mr Meehan's secretary or assistant at the time] *to help us with the laptop tomorrow."*

1641.2 The above correspondence also indicates Mr Meehan did not have access to his laptop on 28 February 2017 and 1 March 2017, suggesting that the record on the audit file of Mr Meehan's review of 36 working papers on 28 February 2017 and a further 18 working papers on 1 March 2017 was not made by Mr Meehan and provides no assurance that he had in fact reviewed them. This included working paper "*4.7.3.0050 PETER MEEHAN - REVIEW 16*" describing Mr Meehan's review as follows:

> *"I am satisfied that sufficient audit evidence has been obtained to support the conclusions reached and to allow me to provide an unmodified audit opinion on the Group financial statements of Carillion plc. I have been able to come to this conclusion through a review of the audit documentation, discussion with the engagement team and client and through the completion of the review process set out above.*
>
> *I am satisfied that whilst certain audit information may still need to be put on the Group and component audit files after the date of signing the Group accounts (for example, specific topic meeting minutes), that this is an administrative and compilation process only and that all audit evidence required to give the audit opinion has been obtained, reviewed, discussed and communicated as required"*

This was recorded as prepared by a member of the audit team on 28 February 2017 and as reviewed by KPMG Senior Manager B and Mr Meehan, both on 28 February 2017.

1641.3 A similar pattern of behaviour can be seen during the 2015 and 2016 reviews of Carillion's half year reporting, during which Mr Meehan similarly instructed the audit team to access his laptop and to use it to record a number of working papers as reviewed by him. Again, Mr Meehan did not specify which documents he had in fact reviewed or which documents were to be marked as reviewed.

1642. Comparison of different versions of the audit file provides further evidence that the records of preparation and review of working papers were not reliable. For example, in a version of the 2016 audit file, last modified in April 2017, working paper "*TOD 4.A.2 RLUH SITE VISIT*" was blank and only later replaced with the version seen on the final version of the audit file. Despite this it was recorded as prepared by a member of the audit team on 1 March 2017 and as reviewed by KPMG Senior Manager B on 2 March 2017.

1643. Of the 835 working papers categorised as "*attachment*", the metadata indicates that 308 were modified after the date of the last recorded review. Whilst the modification was not necessarily substantive in all cases, this indicates that nearly half of the "*attachment*" working papers recording audit procedures were subject to at least some action by the audit team after the date of their recorded review.

1644. The 2016 audit file therefore provided an unreliable and sometimes misleading record of when and whether working papers had been prepared and reviewed, and by whom. In summary:

1644.1 many working papers were recorded as having been reviewed by KPMG Senior Manager B when they had not, or not properly, reviewed them, in some cases on the basis that Mr Meehan had signed the audit opinion and so had "*obviously got comfort himself*";

1644.2 Mr Meehan instructed others to record on the audit file that he had reviewed working papers without specifying which documents he had in fact reviewed or which documents were to be marked as reviewed; and

1644.3 many working papers were modified after the date of their last recorded review, and after the date of the audit report, indicating at least some action by the audit team. In one case the working paper was entirely blank at the time of the last recorded review.

1645. Mr Meehan needed to ensure that the audit work and evidence recorded in working papers supported the conclusions reached and the audit report. He was asked in interview whether, other than on the audit file, there was any record of the review of audit work and confirmed that there was not. He was also asked how he ensured that each area of the audit work had been satisfactorily completed and reviewed before he signed the audit report. He responded:

> *"Well, I don't go through the whole audit file checking who's signed what or get a printout as at the date. I trust the managers, I suppose is the ... simplest answer to that. …*
>
> *… And they're – but they're savvy individuals and they're senior managers and they're senior individuals; I think they should be able to work that out between themselves. I'm not sure I can go around checking …*
>
> *… There's a requirement that certain screens are signed off before the opinion's signed, clearly, there is, but -- and that's important. But the important thing is has it -- you know, people, hopefully, sign off when they've properly reviewed it. …*

… I can't check the --without reviewing the whole file, ... Of course I must rely on the senior managers to be happy with their respective areas"

1646. When asked how he ensured the senior managers were "*happy*" he responded:

"it's sort of implicit that they shout if there's anything wrong"

1647. In the absence of any reliable record that audit work, and audit evidence obtained, had been reviewed, Mr Meehan was reliant on the senior managers performing sufficient reviews of the audit work performed and evidence obtained in their respective areas, and on the "*implicit*" expectation that they would raise any concerns. This in turn relied on the senior managers having a clear understanding of their responsibilities in each area of the audit.

1648. This was particularly important in the 2016 audit because the senior manager normally responsible for audit work relating to "*group*" areas was absent during January 2017, nearly two weeks of which was unexpected. However there is no record of where responsibility for these "*group*" areas lay and in interview, Mr Meehan and the senior managers were not able to provide a clear and consistent explanation of what, in these circumstances, "*their respective areas*" were. For many of the "*group*" areas which feature in this *Final Settlement Decision Notice*, including contract provisions, going concern, pensions and overseas components, the records of preparation and review, and the accounts provided by Mr Meehan and the senior managers in interview, reveal confusion and inconsistency as to who was responsible for these areas of the audit.

1649. There were thus breaches by **the Respondents** in the **2016 audit** of **ISA 230 paragraphs 8 and 9**, in that the audit file was inaccurate, unreliable and/or misleading in its records of what documents had been prepared and reviewed, when and by whom.

1650. There were also breaches by **the Respondents** in the **2016 audit** of **ISA 220 paragraphs 15(a) and 16**, in that Mr Meehan failed:

1650.1 to take responsibility for the direction, supervision and performance of the audit; and

1650.2 to take responsibility for reviews being performed in accordance with KPMG's policies and procedures.

1651. There was also a breach by **the Respondents** in the **2016 audit** of **ES 1 paragraph 6**, in that Mr Meehan failed to act with integrity in causing a record of his review of working papers to be made while either knowing this review had not been performed, or being reckless as to the truth of that record.

D. Audit procedures performed after the date of the audit report

(1) The 2015 audit

1652. The 2015 audit report was dated 3 March 2016, and the 2015 audit file was finalised on 17 April 2016.

1653. On 4 April 2016, the KPMG reviewer sent KPMG Senior Manager A and KPMG Senior Manager B their "*post signing review of Carillion*". This review was to:

> *"identify any learning points and to make suggestions for improvement of the documentation of your team's work prior to the finalisation of the audits".*

1654. In a document recording the post-signing review, the KPMG reviewer set out issues in a table in a column headed "*Comment/query*". The next column of the table was titled "*Disposition*", for the audit team to record its responses to the issues raised. The review was after the date of the audit report and the audit team should not have performed additional audit procedures or drawn new conclusions as a part of that process.

1655. On 20 May 2016, a further version of this document was produced which included the following entries in the "*Disposition*" column:

    1655.1 In response to a "*Comment/query*" about a large "*discrepancy*" between Carillion's "*enterprise value*" as indicated by the "*market value comparison*" and Carillion's "*VIU calculation*", the audit team recorded that the working paper was updated to include further analysis demonstrating a smaller discrepancy.

    1655.2 In response to a "*Comment/query*" about the audit team's decision that no provision was necessary in relation to an HMRC inquiry, and in particular about the audit team's reliance on IAS 37, the audit team recorded that the working paper had been amended to refer to IAS 12 instead.

    1655.3 In response to a "*Comment/query*" suggesting that the audit team's final analytical review ought to have included work on the cash flow statement, the audit team recorded that "final analytics" had been incorporated into the relevant working paper.

    1655.4 In response to a "*Comment/query*" querying whether the treatment of a claim on the Nottingham Contract should be assessed under criteria set out in IAS 37, the audit team recorded that the working paper had been amended to refer to IAS 18 not IAS 37.

1655.5 In response to a "*Comment/query*" raising a number of issues on the calculation of the projected loss calculation for the Nottingham Contract, the audit team recorded that an additional working paper had been added providing further calculations.

1656. In each of these instances, the audit team's comments demonstrated that they had, after the date of the 2015 audit report, performed new audit procedures and/or drawn new conclusions, and added records or evidence of those procedures and conclusions to the audit file. The audit file does not include any reference to any "*exceptional circumstances*" which might explain why audit procedures were performed after the date of the audit report, nor is there any evidence to suggest that any such circumstances existed. The records of when the relevant working papers had been prepared and reviewed did not reflect the dates when the additional audit work had actually been performed and were thus misleading.

1657. There were thus breaches by **the Respondents** in the **2015 audit** of **ISA 230 paragraphs 8 and 9**, in that the audit file did not provide a reliable record as to the nature, timing and extent of the audit procedures performed, and the date such work was completed.

(2) The 2016 audit

(a) Introduction

1658. The 2016 audit report was dated 1 March 2017, with the audit opinion confirmed to Carillion late on 28 February 2017. Early on 1 March 2017 Carillion announced its results and included in the announcement:

> *"The statutory accounts for the year ended 31 December 2016 will be delivered to the Registrar of Companies following the Company's Annual General Meeting. The auditors have reported on those accounts; their report was unqualified, did not include references to any matter which the auditors drew attention by way of emphasis without qualifying their report and did not contain statements under section 498(2) or (3) of the Companies Act 2006"*

1659. By 1 March 2017 KPMG had thus represented to Carillion that the 2016 financial statements had been audited and that their audit report would be unqualified.

1660. However, further audit procedures were performed after the date of the audit report. Of the 835 working papers categorised as "*attachment*", the metadata indicates that 260 were modified after the date of the audit report. Whilst some of these modifications may have been administrative (and therefore permissible), a comparison between the final audit file and a draft version of the audit file saved on 15 April 2017,[114] indicates that substantial modifications were made to at least 16 working papers after 15 April 2017, more than six weeks after the date of the audit report.

1661. It is not now possible to determine how many working papers in the final audit file accurately reflect the procedures performed and evidence obtained at the date of the audit report. However, an analysis of the following evidence has revealed a large number of occasions when either audit procedures were performed or conclusions were reached after the date of the audit report:

1661.1 Review notes, which recorded the audit team's internal instructions for additional audit work.

1661.2 Audit evidence recorded on the audit file which was not obtained until after the date of the audit report.

1661.3 A comparison between a draft version of the audit file saved on 15 April 2017 and the final version saved on 3 July 2017.

1662. The audit file does not include any reference to any "*exceptional circumstances*" which might explain why audit procedures were performed after the date of the audit report; nor is there any evidence to suggest that any such circumstances existed. The records of when the relevant working papers had been prepared and reviewed did not reflect the dates when the additional audit work had actually been performed and were thus misleading.

(b) *Review notes*

1663. As set out above, KPMG's audit software enabled the audit team to record "*review notes*" when reviewing working papers during the audit. These review notes were not intended to record audit work, but they provide an indication of the extent to which audit procedures had been completed at a particular point in time.

[114] This was 45 days after the date of the audit report, that is, the date by which KPMG's procedures required the audit file to be closed.

1664. Spreadsheets of review notes extracted from the 2016 audit file after the date of the audit report, but before the file was finalised, show that 253[115] review notes were created on or after 1 March 2017 and 121 review notes had not been "*closed*" or addressed by 13 April 2017, 44 days after the date of the audit report.

1665. Many of the review notes contained requests for further evidence to be obtained and further analysis to be performed on evidence obtained. However, although many of the review notes were either opened on or after the date of the audit report, or unaddressed at the date of the audit report in many cases, work performed in response to these review notes was incorporated into the relevant working paper on the final audit file. The review notes thus evidence audit procedures and the reviews of these procedures being completed and recorded, and audit conclusions being reached, after the date of the 2016 audit report. For example:

1665.1 A review note created on 1 March 2017 in relation to working paper "*AP100.3.1.A Goodwill Paper*" stated:

> *"I think we should criticise management's assessment on the management assessment tab:*
>
> *1) NPV is compared to "recoverable amount" - what is this? Should be gorss assets*
>
> *2) The model - excludes TAB*
>
> *3) cashflows include working capital benefit every year"*

1665.2 A review note created on 1 March 2017 also in relation to working paper "*AP100.3.1.A Goodwill Paper*" stated:

> *"Tab 2 - How did we determine that those factors are the key assumptions? Just need to think about why - these are the most judgemental perhaps? Or the most sensitive? In the audit report I'm pretty sure it says we use sensitivity to determine which are the most sensitive"*

1665.3 A review note created on 1 March 2017 in relation to working paper "*4.6.1.G.8.17 Reclass - MENA retentions*" setting out details of a journal relating to the classification of an amount of £141 million, stated:

> *"Waiting on discussions as to how to explain this journal"*

[115] 193 created on 1 March 2017 and 60 created 2 March 2017 and after.

1665.4 A review note created on 1 March 2017 in relation to working paper "*4.6.2.C.03.A.0010 2016 Sustainability ARA*" stated:

> *"Need to create a workpaper that shows we have reviewed the KPIs in the meeting with the client plus volunteeting."*

1665.5 A review note created on 1 March 2017 in relation to working paper "*2.6.9.B Legal Letters List 2016*" stated:

> *"I have been through the summary tab and highlighted the lawyers where we have requested legal letters. Need to explain why we have not requested the others. Please change the question marks. Also need to state the amounts in the legal letter to see if they are different from the dispute register. Also we need to sit down and go through this paper"*

1665.6 A review note created on 1 March 2017 in relation to working paper "*AP100.3.2.A Intangible Assets Amortisation*" stated:

> *"On what basis do we concur that the useful lives are still appropriate? Probably need more here."*

1665.7 A review note created on 1 March 2017 in relation to working paper "*4.6.2.D.5.2 Cash Flow Workings*" stated:

> *"1. Opening and closing no of creditors do not agree with the latest version of ARA? Is the difference on account of capital accruals?*
>
> *2. Finance income received amount £ 2.5 mn matches with P&L –is there no finance income receivable as at 31 Dec 2016 or 31 Dec 2015 which needs to be updated?*
>
> *3. PPE additions – are there any advances given for capital assets to be adjusted?"*

1665.8 A review note created on 2 March 2017 in relation to working paper "*AP050.3.2CCS Unders and Overs*" stated:

> *"ensure ties into group schedule and then cross ref to the work"*

1665.9 A review note open at 1 March 2017 in relation to working paper "*2.6.9 Litigation, claims and assessments*" stated:

> *"As discussed please add a work paper that details the legal costs through the P&L and ensures any material bills from a lawyer we have requested a legal"*

1665.10 A review note open at 1 March 2017 also in relation to working paper "*2.6.9 Litigation, claims and assessments*" stated:

> *"re-review all legal letters"*

1665.11 A review note open at 1 March 2017 in relation to working paper "*2.5.3.IA.1 Internal Audit 2016*" stated:

> *"Update impact on audit for Needs Improvement reports and address the report rated Inadequate"*

1665.12 A review note open at 1 March 2017 in relation to working paper "*TOD 2.0040 Component Analytics*" stated:

> *"Complete Group Services, Saudi and Qatar component analytics"*

1665.13 A review note open at 1 March 2017 in relation to working paper "*4.6.4.A.2 ACT consol 2016*" stated:

> *"Look into Canada reporting numbers differences"*

(c) <u>Audit evidence obtained after the date of the 2016 audit report</u>

(1) February 2017 legal disputes register

1666. Working paper "*2.6.9.C MATERIAL DISPUTES FEB 2017*" was a version of Carillion's legal disputes register. This version of the document listed disputes in which Carillion was involved as at 28 February 2017.

1667. At the top of the working paper, KPMG added the following annotation:

> *"KPMG have reviewed the material disputes register as at Feb 2017 to ensure there were no further disputes which have not been requested in the original legal letters sent in January. No further material disputes were identified, therefore no additional confirmations have been requested".*

1668. Save for this annotation, there does not appear to be any difference between this working paper and the copy or copies of the legal disputes register held by Carillion.

1669. However, the document was not received and the audit procedure not performed until after the date of the audit report:

1669.1 A member of the audit team requested the "*latest legal disputes register (February 2017)*" from Carillion at 22:44 on 27 February 2017.

1669.2 The member of the audit team received Carillion's February 2017 legal disputes register on 20 March 2017.

1669.3 Metadata shows that the member of the audit team added or modified the annotation described above on 29 March 2017.

1670. Despite the above, the audit file records that the working paper was prepared by the member of the audit team on 1 March 2017 (the date of the 2016 audit report) and reviewed by KPMG Senior Manager B the same day.

(2) Interest rate swaps

1671. KPMG performed audit procedures to verify that the requirements of IAS 39 for interest rate swaps were met.[116]

1672. Working paper "*3.3.1.HE.10 HEDGING EFFECTIVENESS*" set out this work and in tab "*CPF Cash Flow Hedges*", KPMG stated:

> *"In order to get comfort over whether Carillion can hedge account for the PPP cash flow hedges (interest rate swaps) against interest rate risk, KPMG will perform the following procedures".*

1673. The working paper then contained links to four separate working papers (the "**Swap Inception Papers**"):

1673.1 Inception Paper A;

1673.2 "*LIVERPOOL SWAP INCEPTION*";

1673.3 Inception Paper C; and

1673.4 "*ABERDEEN SWAP INCEPTION*".

1674. The Swap Inception Papers record the audit procedures performed by KPMG and the audit evidence obtained. Text boxes added to the documents contain KPMG's reasoning.

1675. However, the documents were not received, and the audit procedure not performed, until after the date of the audit report:

1675.1 Since 27 February 2017, a member of the audit team had been requesting documents from Carillion.

1675.2 In an email sent on 31 March 2017, the member of the audit team explained as follows:

> *"Apologies for chasing but I wondered if you might have the inception documents for the below hedges:*
>
> [Subject of Inception Paper A] *(Commenced: 11 Dec 2015)*

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[116] IAS 39 set out criteria for allowing the interest swaps and related amounts on the balance sheet to be accounted for using an approach referred to as "*hedge accounting*".

Liverpool Hospital (Commenced: 31 Aug 2016)

[Subject of Inception Paper C] *(Commenced: 21 July 2016)*

[The Aberdeen JV] *(Commenced: 12 Dec 2014 and 30 Apr 2015)*

We could do with these to support our file and for reference next year if you are able to provide them?"

1675.3 The member of the audit team chased Carillion for these documents again on 10 April 2017:

"I was hoping to get the below documents before our file is closed on Thursday".

1675.4 The member of the audit team then chased Carillion for these documents once again at 09:21 on 13 April 2017:

"Would it be possible to get the documents hedging today? Our file deadline is Saturday so it would be much appreciated."

1675.5 The reference to "*our file deadline*" is understood to be the requirement in KPMG's audit manual to finalise or "*close*" the audit file within 45 days from the date of the audit report. Since the 2016 audit report was signed on 1 March 2017, this deadline was therefore Saturday 15 April 2017.

1675.6 At 16:21 on 13 April 2017, Carillion emailed 12 documents to the member of the audit team in response to their request.

1675.7 Metadata shows that, later in the afternoon of 13 April 2017, the member of the audit team modified the Swap Inception Papers.

1676. Despite the above, the audit file records that working paper "*3.3.1.HE.10 HEDGING EFFECTIVENESS*" and the four Swap Inception Papers were each prepared by the member of the audit team on 1 March 2017 and reviewed by KPMG Senior Manager B on 2 March 2017.

(3) Post-balance-sheet events

1677. Working paper "*4.6.3.A SERVICES PDSES WP*" sets out confirmation of seven matters relating to events after the date of balance sheet, stating that these were:

"Per discussions held with[senior management of the Carillion Services finance team]*"*

1678. However, KPMG did not obtain confirmation of these matters until after the date of the audit report:

1678.1 On 27 February 2017, a member of the audit team emailed the senior management of the Carillion Services finance team (copying KPMG Senior Manager C) explaining that they were "*currently looking at subsequent events*". The member of the audit team requested a copy of the PRM for January 2017 and asked eight questions relating to whether there were any relevant post-balance-sheet events. These questions were broadly in line with the seven matters indicated as confirmed in the working paper.

1678.2 On 13 March 2017, nearly two weeks after the date of the audit report, senior management of the Carillion Services finance team replied to the email, copying KPMG Senior Manager C and providing answers to the eight questions.

1678.3 The working paper's metadata reveals that it was last modified on 24 March 2017.

1679. Despite the above, the audit file records that this working paper was prepared by the member of the audit team on 27 February 2017 and reviewed by KPMG Senior Manager C on 28 February 2017.

(d) <u>Changes to working papers made during or after April 2017</u>

(1) Introduction

1680. A comparison of a draft version of the audit file, from 15 April 2017, six weeks after the date of the audit report, and the final version of the audit file when it was finalised on 3 July 2017, indicates that at least 26 working papers were modified after 15 April 2017, and that 16 of these working papers were modified substantially. The modifications included those set out below.

(2) The Liverpool Contract

1681. Working paper "*AP050.3.1 DEC 2016 BUILDINGS*" sets out audit procedures performed on buildings contracts selected for detailed testing.

1682. The final version of the working paper shows an additional explanation, not provided in the April 2017 version of the working paper, in tab "*RLUH*" relating to claims and in particular reference to evidence obtained in prior years.

1683. Despite this, the audit file records that this working paper was prepared on 20 February 2017 and reviewed on 21 February 2017 by KPMG Senior Manager B, Mr Meehan and the EQCR.

(3) The Battersea Contract

1684. A comparison between the April 2017 version of working paper "*AP050.3.1 DEC 2016 BUILDINGS*" and the final version also shows that a number of changes were made to tab "Battersea" including:

1684.1 The April 2017 version working paper included the following analysis headed "*Summary*":

Summary		
Total agreed contract sum:	*486,713,743*	*(See Cert)*
Unagreed claims:	*28,590,980*	
	515,304,723	
Add margin of 1.8%:	*524,580,208*	*(See final Dec 16 EoL value below)*

1684.2 The amount £524.6 million, referenced "*final Dec 16 EoL value*", was equal to the total forecast end of life revenue used in the working paper to calculate the revenue recognised on the contract in 2016. The working paper indicates that this amount was calculated by increasing the total of the "*Total agreed contract sum*" and "*Unagreed claims*" by 1.8%, or £9.3 million. There is no explanation for why a "*margin*", or any amount, would be added to the agreed contract sum and unagreed claims, to arrive at the amount for total forecast end of life revenue.

1684.3 The final version of this working paper showed an amended version of this analysis:

Summary of revenue		
Total agreed contract sum	*486,713,743*	*(See Cert)*
Unagreed variations	*9,084,245*	
Unagreed claims:	*28,590,980*	
	524,388,968	

1684.4 The description for over £9 million of forecast revenue on the contract changed from being an unexplained "*margin*" in the April 2017 version to "*Unagreed variations*" in the final version.

1684.5 The working paper included a description of variations, which changed between the two versions as follows:

1684.5.1 The April 2017 draft version stated:

"All variations are included in the claim to be recovered"

1684.5.2 The final version stated:

"KPMG reviewed the change register during the site visit with no issues to note in Carillion being able to support the requests made. Note to the end of 2016 Carillion had successful increased the value of the contract to £488m per agreement from the client, see CERT. Aside from the claim mentioned below, Carillion need to obtain a further £9m in variations from £19m, which is within the percentage normally achieved by Carillion. Carillion have recovered a significant number of variations with the challenge made by KPMG is that easier items were agreed first leaving more difficult to the end, however from a review of the change register it appears in the round that changes have been dealt with in chronological order therefore most recent ones to settle now."

Agreed contract value	*487*
Contract value requested with variations	*505*
Ask	*18*
Traded	*9*
Percentage	*50%*

1684.6 The working paper also included a description of claims which differed in the two versions as follows:

1684.6.1 The April 2017 draft version included the following information:

Claims traded	*£28,590,980*
Claims submitted to client	*£20,000,000*
Difference %	*143%*
Traded	*9*
Percentage	*50%*

The claims value unagreed at year end 2015 was £11,500,000, this has increased by £17,090,980 in the period. KPMG requested draft heads of terms explaining claims figure of £28m.

However the heads of terms at the point of this paper do not include values - it only itemises the areas which give rise to an increased value"

1684.6.2 The final version did not provide the above information instead stating:

"KPMG requested submitted claim, bit were informed only draft heads of terms has been created to date, itemises the areas which give rise to an increased value"

1685. In summary:

1685.1 The 15 April 2017 draft version identified £9.3 million in the forecast end of life revenue which had no supporting explanation or evidence and stated that all variations were already accounted for in the claims. The final version, however, included an additional amount for variations of £9.1 million with the statement "*Carillion need to obtain a further £9m in variations from £19m*" suggesting £19 million of other variations which had not previously been included. No evidence is included for these variations.

1685.2 The 15 April 2017 draft version identified that the claims traded of £28.6 million exceeded the claims actually submitted of £20 million and indicated that none of this was agreed. The final version excluded this analysis.

1686. Despite this, the audit file records that this working paper was prepared on 20 February 2017 and reviewed on 21 February 2017 by KPMG Senior Manager B, Mr Meehan and the EQCR.

(4) Verification of total amounts included in the 2016 financial statements for construction contracts

1687. Working paper "*TOD 5.A.2 CAV TO* [Carillion's financial report software] *MAPPING*" sets out a verification between:

1687.1 totals on Carillion's "*CAV*" reports, which set out assets, liabilities, income and costs for each contract and were used by KPMG as a basis for audit work on contracts; and

1687.2 aggregated amounts in Carillion's financial reporting software, determining the amounts reported in the 2016 financial statements for contracts.

1688. The 15 April 2017 draft version of this working paper and the final version of this working paper include different amounts for both the CAV reports and the aggregated amounts in Carillion's financial report software, and changes to some of the explanatory commentary.

1689. Despite this, the audit file records that this working paper was prepared on 1 March 2017 and reviewed on 2 March 2017 by KPMG Senior Manager B.

(5) Site visits for construction contracts

1690. Working paper "*TOD 4.1 CCS SITE VISIT SUMMARY*" records audit procedures performed on site visits for construction contracts.

1691. The differences between the 15 April 2017 draft version of the working paper and the final version of the working paper include the following additions:

1691.1 worksheet setting the basis for selecting the contract for a site visit; and

1691.2 reference to an additional contract, as one of the contracts visited on the "*Summary*" tab.

1692. Despite this, the audit file records that this working paper was prepared on 1 March 2017 and reviewed on 2 March 2017 by KPMG Senior Manager B.

(6) Work in progress for a Carillion Joint Venture

1693. Working paper "*AP050.3.10.4 WIP*" sets out audit procedures performed for work in progress amount on the Carillion joint venture.

1694. A comparison of the 15 April 2017 draft version and the final version of this working paper shows that an additional tab "*Claim*" was added to the final version, which set out amounts of claims and descriptions of audit procedures performed on these amounts.

1695. Despite this, the audit file records that this working paper was prepared on 20 February 2017 and reviewed on 21 February 2017 by KPMG Senior Manager B, Mr Meehan and the EQCR.

(7) BURs

1696. Working paper "*HLC.1.0040 CCS BUR YE*" sets out details of construction BURs.

1697. The final version of this working paper included the following four additional comments, attributed to Carillion Construction management which were not present in the 15 April 2017 draft version of this working paper:

> "[Carillion Construction management] *requested detailed report on timeline post crack beam"*
>
> "[Carillion Construction management] *challenged whether CCS could operate in South if required"*
>
> "[Carillion Construction management] *questioned whether the team were still hopefully and should be included in pipeline as did not win pre-works"*
>
> "[Carillion Construction management] *challenged the team to whether they would actually make the same margins as previous contract"*

1698. Despite this, the audit file records that this working paper was prepared on 1 March 2017 and reviewed on 2 March 2017 by KPMG Senior Manager B.

(8) Developments

1699. Working paper "*TOD 2.0020 DEVELOPMENTS - PROJECTS*" sets out audit procedures performed on a number of projects within the Developments components.

1700. The final version of this working paper includes the following changes from the 15 April 2017 draft version of this working paper:

1700.1 A comment in tab "*P&L*" relating to the sale of a site has been amended to include "*agreed to cash received*".

1700.2 An embedded revaluation document for that site has been removed from tab "*P&L*".

1700.3 A comment in tab "*P&L*" relating to a project has been amended to include "*reviewed by KPMG with clear evidence they were signed before 31 December 2016.*"

1700.4 The conclusion on another tab relating to a different project has been amended from "*High Risk due to recoverability of remaining land value*" to "*No issues to flag*".

1700.5 The conclusion on another tab relating to a different project has been amended from "*Low Risk, one to watch*" to "*Low Risk*".

1701. Despite this, the audit file records that this working paper was prepared on 1 March 2017 and reviewed on 2 March 2017 by KPMG Senior Manager B.

(e) Conclusion

1702. In the absence of exceptional circumstances, new audit procedures should not have been performed and further conclusions should not have been reached after the date of the audit report. At the date of the audit report the file should have contained all the evidence required to enable the engagement partner to be satisfied that an appropriate opinion could be given. It was Mr Meehan's responsibility to ensure that these requirements were met.

1703. In fact, the process of performing audit procedures, obtaining and documenting audit evidence and performing reviews carried on for weeks after the date of the audit report. This was not expressly documented and the records of the preparation and review of the relevant working papers were misleading.

1704. There were thus breaches by **the Respondents** in the **2016 audit** of **ISA 230 paragraphs 8 and 9**, in that the audit file did not provide a reliable record as to the nature, timing and extent of the audit procedures performed, who performed the audit work and the date such work was completed; and who reviewed the audit work performed and the date and extent of such review.

1705. There were also breaches by **the Respondents** in the **2016 audit** of **ISA 220 paragraphs 15 and 16** in that Mr Meehan failed to take responsibility for the direction, supervision and performance of the audit to ensure that the requirements of ISA 230 above were complied with.

E. Engagement partner review of the 2016 audit

1706. Before the audit report could be issued, Mr Meehan had to be satisfied that sufficient appropriate audit evidence had been obtained to support the conclusions reached.

1707. However, as set out in Section C above, Mr Meehan had no reliable means of ensuring that audit procedures had been properly performed and reviewed.

1708. Further, as set out in Section D, audit work was performed after the audit report. This demonstrates that, at the time of the audit report, audit work was incomplete in substantial areas. Mr Meehan did not identify that the audit was incomplete, or if he did, he failed to address this issue.

1709. There was thus a breach by **the Respondents** in the **2016 audit** of **ISA 220 paragraph 17** in that Mr Meehan had no proper basis to be satisfied that sufficient appropriate audit evidence had been obtained to support the conclusions reached and for the auditor's report to be issued.

F. Late closure of the 2014 and 2016 audit files

1710. KPMG's internal audit manual required that the audit file be finalised within 45 days of the date of the audit report. The timescale in guidance in ISA 230 was that appropriate time limit within which to complete the assembly of the final audit file was not more than 60 days.

1711. However, in both 2014 and 2016 the audit files were not finalised until substantially later than each of these periods:

1711.1 In 2014, the audit opinion was signed on 4 March 2015; the 45-day period ended on 19 April 2015, and the audit file was closed-out on 13 July 2015. The final audit file was thus not completed until 131 days from the date of the 2014 audit report.

1711.2 In 2016, the audit opinion was signed on 1 March 2017; the 45-day period ended on 15 April 2017, and the audit file was closed-out on 3 July 2017. The final audit file was thus not completed until 124 days from the date of the 2016 audit report.

1712. There was thus a breach by **the Respondents** in the **2014 and 2016 audits** of **ISA 230 paragraph 14**, in that the Respondents failed to close audit files "*on a timely basis*".

Signed:

[Redacted.]

ELIZABETH BARRETT
EXECUTIVE COUNSEL

Date: 3 August 2023