Edited for publication

IN THE MATTER OF

THE EXECUTIVE COUNSEL TO THE FINANCIAL REPORTING COUNCIL

and

(1) KPMG AUDIT PLC

(2) DARREN KEITH TURNER

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.

3 AUGUST 2023

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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 "**2013 audit**" means the audit of the financial statements of Carillion;

   3.3 the "**Respondents**" means:

      3.3.1 KPMG Audit plc ("**KPMG**") which was the *Statutory Audit Firm* for the 2013 audit;

      3.3.2 Mr Darren Keith Turner ("**Mr Turner**"), who was the *Statutory Auditor* of Carillion for the 2013 audit.

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 2013 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 Requirement(s)*, with reasons;

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

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

8. In this *Final Settlement Decision Notice*, the Executive Counsel sets out the *Relevant Requirements* that the Respondents have breached in connection with the 2013 audit.

9. Carillion was required to prepare its 2013 financial statements in accordance with International Financial Reporting Standards ("**IFRS**").

10. In carrying out the 2013 audit the Respondents were required to act in accordance with the International Standards on Auditing (UK and Ireland) ("**ISAs**"). The provisions of the ISAs are 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. On 12 February 2019 the FRC's Conduct Committee referred potential allegations relating to the 2013 audit 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 Audit of the consolidated financial statements of Carillion plc for the year ended 31 December 2013 in relation to transactions entered into between Carillion plc and* [Provider A]*."*

12. The transactions forming the scope of the investigation are referred to in this *Final Settlement Decision Notice* as the "2013 Outsourcing Transactions" and are defined at paragraphs 31 and 32 below.

B. Structure of this *Final Settlement Decision Notice*

13. This *Final Settlement Decision Notice* is divided into the following chapters:

13.1 Chapter 2 sets out background details on Carillion and on KPMG's role as Carillion's auditor.

13.2 Chapter 3 sets out a summary of the breaches.

13.3 Chapter 4 sets out facts relevant to the breaches including:

13.3.1 Explanatory background on Carillion's outsourcing

13.3.2 Explanatory background on a product known as "Ecopod" which formed a part of the 2013 Outsourcing Transactions

13.3.3 KPMG's knowledge regarding the proposed transactions prior to the 2013 audit

13.3.4 Concerns raised by members of the audit team regarding the 2013 Outsourcing Transactions

13.3.5 Details of the 2013 Outsourcing Transactions

13.3.6 Accounting treatment and disclosure of the 2013 Outsourcing Transactions in the Carillion 2013 financial statements

13.4 Chapter 5 sets out an analysis of the audit work relating to the 2013 Outsourcing Transactions and the breaches.

13.5 Chapter 6 sets out the *Sanctions*; and

13.6 Chapter 7 sets out the costs.

C. ISA breaches and liability of the Respondents

(1) ISA breaches

14. 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) KPMG's liability

15. As the Statutory Audit firm responsible for the 2013 audit, 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.

(3) Mr Turner's liability

16. Mr Turner was the engagement partner on the 2013 audit. He was responsible for the overall quality of the audit and the direction, supervision, and performance of the audit in compliance with the professional standards and applicable legal and regulatory requirements. Accordingly, Mr Turner is responsible for any established breaches of ISAs in relation to the audits.

(4) Carillion's conduct

17. 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:

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

    17.2 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

18. Carillion supplied services "*to create and manage buildings and infrastructure, from project finance through design and construction to lifetime maintenance, facilities management and energy efficiency*".

19. Carillion's results for 2013 were as follows:

    19.1 Group revenue £4,081 million.

    19.2 Profit after tax £106 million.

    19.3 Net assets £984 million.

B. KPMG's role on the 2013 audit of Carillion

20. KPMG (or its predecessor firm) was appointed as Carillion's auditor for the year ended 31 December 1999.

21. On 5 March 2014, KPMG signed its 2013 audit report which gave an unmodified audit opinion on Carillion's financial statements for the year ended 31 December 2013.

22. Mr Turner was the engagement partner and signed the audit report as "*Senior Statutory Auditor*".

23. The audit team for the 2013 audit included the following:

    23.1 The Group Senior Manager.

    23.2 The Manager on the Group and Services component audits ("**Group Manager"**).

24. A KPMG partner was the Engagement Quality Control Review partner.

25. Under ISA 320 paragraph 2, information was material if its omission or misstatement could reasonably have been expected to influence economic decisions made on the basis of the financial statements. KPMG set the materiality amount for the 2013 audit at £13 million.

26. KPMG recorded audit work and evidence on its audit files. Documents on the audit files are referred to as "working papers" and other documents, for example those forming attachments to emails, are referred to using their filenames, prefixed "Document".

3. SUMMARY OF BREACHES

27. This chapter sets out a summary of the breaches. Background facts relating to these breaches are provided in Chapter 4 and the breaches are described in detail in Chapter 5.

28. In 2009, Carillion entered into an agreement with a supplier for the provision of various business support services. This agreement included provision for a payment of £40 million from the supplier to Carillion at the outset of the agreement, and for repayment of this sum (or a proportion thereof) in the event the agreement was terminated before the expiry of the contractual term. The cash received appears to have been treated in Carillion's financial statements as creating a creditor and then recognised in the income statement over the life of the contract, reflecting the link between the cash receipt and the outsourcing agreement. In 2013 Carillion terminated the agreement with the supplier and entered into a new agreement for the provision of business support services with a new provider ("**Provider A**"). Carillion was therefore liable to repay a proportion of the £40 million received from the supplier (hereafter referred to as "**the outgoing supplier**") in 2009.

29. By October 2013, before the new agreement was signed, Mr Turner and the Group Senior Manager understood that Carillion was expecting that a significant proportion of its profit recognised in 2013 would be "*in relation to the outsourcing contract*" and that this would most likely arise from the sale of a licence and/or intellectual property to Provider A, the new provider of outsourced services. In other words, Carillion was anticipating receiving money *from* Provider A, while simultaneously agreeing to pay money *to* Provider A over the term of the outsourcing contract.

30. During the latter part of 2013, as the terms of the relevant agreements were negotiated by Carillion, KPMG communicated to Carillion that to recognise cash received from Provider A as profit in its 2013 financial statements, the auditor would need to verify:

    30.1 that the licence sale and outsourcing agreements were 'separable' or independent of each other; and

    30.2 the licence sale was at a market value.

31. On 6 December 2013, a Master Services Agreement ("**MSA**") was concluded between Carillion and Provider A. The MSA provided, among other things, as follows:

31.1 Provider A would provide information technology and business process outsourcing services to Carillion (the "**Outsourcing Transaction**"). The Outsourcing Transaction included provision for the following:

31.1.1 A payment by Provider A to Carillion of £14 million in 2014 "by way of contribution" to "exit fees" payable by Carillion to the outgoing supplier, as the current supplier of those services to Carillion ("**Exit Fee Contribution**").

31.1.2 Amounts payable by Carillion to Provider A relating to outsourcing services to be provided by Provider A, as well as amounts described as "***Other Charges***" which did not appear to relate to any specific services. These Other Charges totalled £40.8 million over the life of the contract.

31.1.3 A termination charge payable by Carillion to Provider A in the event that the Outsourcing Transaction was terminated early ("**Termination Charge**"), initially in the sum of either £39 million or £46 million (depending on the reason for termination) and reducing over the duration of the contract.

31.2 Carillion would assign to Provider A certain intellectual property rights relating to a product known as "Ecopod" (the "**Ecopod Transaction**"). The consideration payable by Provider A to Carillion for these rights was:

31.2.1 £25 million payable on the date of the contract;

31.2.2 £2 million payable on 30 September 2014; and

31.2.3 a 10% royalty in respect of sales arising from exploitation of the intellectual property.

32. The Outsourcing Transaction, including the Exit Fee Contribution, the Termination Charge and Other Charges, together with the Ecopod Transaction, are referred to in this *Final Settlement Decision Notice* as the "**2013 Outsourcing Transactions**".

33. The combined effect of the 2013 Outsourcing Transactions was that:

33.1 Provider A would pay Carillion a total of £41 million (£25 million in late 2013 and an additional £16m in 2014); and

33.2 Carillion would pay Provider A:

33.2.1 charges for specified outsourced services provided by Provider A;

33.2.2 Other Charges, payable while the contract was in operation and which over the life of the contract would total £41 million; and

33.2.3 a Termination Charge, payable only if the contract was terminated early. This was initially between £39-£46 million, depending on the reason for the termination, and then reducing over the life of the contract.

34. In all the circumstances the most likely explanation for the 2013 Outsourcing Transactions being entered into together was that Provider A's agreement to the Ecopod Transaction and the Exit Fee Contribution was a *quid pro quo* for the award of the outsourcing contract, and the £41 million paid by Provider A was in substance either an advance discount on its charges under the Outsourcing Transaction, or a loan that would be recovered by those charges being inflated. In either case the cash receipt would not represent income earned in 2013 and should not result in increased profit.

35. However, the 2013 financial statements included £41 million profit relating to the Ecopod Transaction and the Exit Fee Contribution and did not recognise or disclose Carillion's obligation to pay Provider A at least £39 million by the end of the contract term, whether as an advance discount (which would require the amount to be spread over the life of the contract) or as a loan.

36. The accounting treatment adopted was only possible if the Outsourcing Transaction and the Ecopod Transaction were treated as separate independent transactions with the contractual values for each element being at fair value. KPMG accepted this treatment despite compelling evidence that the transactions were dependent on each other and that the Ecopod Transaction was not at a fair value.

37. KPMG failed to classify the question of linkage regarding the 2013 Outsourcing Transactions as a significant risk, despite their unusual nature, their materiality and the need for a significant level of judgement by Carillion's management.

38. In reaching its conclusions KPMG gave insufficient weight to the following:

38.1 KPMG's identification of increased pressure on Carillion's management to improve revenue and cashflow, and consequently a risk of management bias.

38.2 KPMG's knowledge that Carillion was expecting to derive a significant proportion of its profit recognised in 2013 "*in relation to the outsourcing contract*" and of compelling evidence that the 2013 Outsourcing Transactions were linked.

38.3 KPMG's awareness that Carillion's management wished to recognise the proceeds from the transactions as income immediately and had a "*very strong view*" against disclosing details of the transactions in its financial statements.

38.4 KPMG's awareness that the profit recognised would be *"significant to the overall true, fair and understandable picture of the accounts"*.

38.5 Concerns repeatedly raised by a member of the audit team that:

38.5.1 the 2013 Outsourcing Transactions were linked and the amount paid by Provider A under the Ecopod Transaction was inconsistent with indicators of its fair value; and

38.5.2 the financial statements might be misleading given that the significant level of profit did not reflect underlying trading.

38.6 Concerns raised at various points by the technical panel, a technical partner and the Engagement Quality Control Review partner about (a) the "*economics of the arrangement*" and a potential link between the Ecopod Transaction and the Outsourcing Transaction, and (b) the quality of the audit evidence obtained to support the proposition that the 2013 Outsourcing Transactions were not linked.

38.7 The similarities with the agreement with the outgoing supplier in 2009, where Carillion had obtained a significant cash receipt when it awarded the original outsourcing contract, which was recoverable from Carillion on early termination. However, in this earlier case, the cash receipt was treated not as income but as creating a creditor.

39. KPMG failed to approach the 2013 Outsourcing Transactions with an adequate degree of professional scepticism, failed to consider and respond to the risk of fraud, failed to perform audit procedures that would provide sufficient appropriate audit evidence to enable it to conclude on the appropriate accounting treatment of the2013 Outsourcing Transactions and failed to identify and respond to evidence that the accounting treatment and disclosures might be inappropriate and misleading.

4. FACTS

A. Introduction

40. This chapter sets out facts relevant to the breaches set out in this *Final Settlement Decision Notice*, under the following headings:

    40.1 Carillion's 2009 outsourcing agreement

    40.2 Ecopod

    40.3 KPMG's early involvement

    40.4 Concerns raised by the audit team over the 2013 Outsourcing Transactions

    40.5 Details of the 2013 Outsourcing Transactions

    40.6 Accounting treatment and disclosure in the 2013 financial statements

B. Carillion's 2009 outsourcing agreement

41. In 2009, Carillion had entered into an agreement with the outgoing supplier for the outsourcing of various business support services. The agreement included provision for an immediate payment of £40 million from the outgoing supplier to Carillion. The payment, described as "[the outgoing supplier] *investment*", comprised an "*inducement payment*" of £30 million, "*mobilisation costs*" of £5 million and "*deferred charges*" (also described as "*discount*") of £5 million. The agreement further provided that, in the event the agreement was terminated before the expiry of the contractual term, a proportion of the £40 million would have to be repaid, reducing over time. It appears that the cash received was treated in Carillion's financial statements as creating a creditor and subsequently, over the life of the contract, recognised as a credit in the income statement.

42. As set out in further detail below, in 2013 Carillion decided to replace the outgoing supplier with Provider A as provider of the outsourced services. This decision meant that Carillion would have to repay to the outgoing supplier £14 million of the £40 million received in 2009.

C. Ecopod

43. Ecopod was described within Carillion's 2013 annual report as follows:

    > *"a heating system, which combines a range of technologies, including highly efficient cascade boilers with biomass, ground source and gas absorption heat pumps and thermal solar panels to deliver major energy savings."*

44. Ecopod was developed by a third party (the "**Ecopod developer**").

45. Carillion acquired the rights to market, manufacture and install Ecopod through two transactions in 2012 and 2013. Working paper "*KPMG TECHNICAL PAPER*" (ECO.3) sets out the following details of the acquisition:

45.1 Eaga plc, a subsidiary of Carillion, had a relationship with a third party in developing Ecopod.

45.2 In 2012 Carillion paid £3.8 million for a five year worldwide licence for Ecopod.

45.3 In October 2013 Carillion paid £4.5 million for outright worldwide rights for Ecopod. This was shortly before the owner of the rights entered administration.

45.4 The total of around £8.3 million was capitalised as an intangible asset.

D. KPMG's early involvement

(1) Introduction

46. In interview with the FRC, Mr Turner stated that the 2013 audit of Carillion was difficult "*principally … because of the* [outsourcing] *transaction*". He explained further, stating:

> *"Yes, because it ran for such a period of time, you know. You will have seen from the documents, this ran for a number of months, and kept coming back, the client was not clear or did not appear to be clear on how they wanted to structure this transaction. They just wanted to do this transaction. So, on top of everything else, this occupied a very significant amount of time."*

47. Mr Turner went on to describe when he first became aware of the 2013 Outsourcing Transactions:

> *"… somewhere around that summer period it became apparent. I imagine it came up in discussions as part of the second re-forecast that Carillion went through. So, they -- as a group, they would have an initial forecast for the year, that would be revised periodically through the year to look at are they still on track to hit that end of year position? In talking through the constituent parts of that re-forecast, it would probably have come up as one of the significant things that they needed to achieve in the second half..."*

48. From August 2013 there was extensive correspondence both within KPMG and between KPMG and Carillion on the 2013 Outsourcing Transactions. An overview of this correspondence is set out in two parts:

48.1 Initial discussions on the 2013 Outsourcing Transactions between August and October 2013; and

48.2 Drafting the agreements for the 2013 Outsourcing Transactions between October and December 2013.

(2) Initial discussions on the 2013 Outsourcing Transactions

49. On 22 August 2013, the Group Senior Manager emailed Mr Turner following a meeting with Carillion's finance team, stating:

> *"Sorry to interrupt the hols, but I spent the train back from the announcement with* [Carillion's finance team] *and* […] *discussed some further ideas on the contract accounting.*
>
> *…*
>
> *The key points are; …*
>
> *…• Looking into the possibility of selling a licence to the outsourcer so that they can sell ECOPOD's. The companies are apparently very focused on energy efficiency and believe that a licence to advertise and sell this hardware may be something that is of interest. Again separate contract, likely that this will include a condition that if sell over x items then additional payments will be made. Assuming that the hurdle on being able to re-licence something that C only have a licence for themselves, then again this would appear to be a separate contract to purchase a licence. I do not think that you would spread the amount over the sales to the upper limit as this is just a commercial condition to ensure C are not losing out? …*
>
> *…*
>
> *• In addition to the above they also notified me that there will be contract exit costs (likely to be a payment of some £14m) when the contract is exited (despite the fact that this is at a contract break clause). Therefore they want to match the costs (payment) with part of the payment received from the new proposed supplier. We discussed that the matching principal is not always the accounting basis, but if the contract stated that this was compensation / payment to cover the exit costs incurred by Carillion on switching to the supplier, would this suffice or is this again something that should be spread?*
>
> *• This means that overall they are looking at receiving a payment of £34m, £14m to compensate / pay exit costs incurred on switching and then £20m that could be above points (probably split 10/15m in Yr1), with a overall P&L impact of £20m as previously discussed."*

50. Mr Turner responded to the email, providing his thoughts on the options and stating that the sale of a licence or intellectual property *"would meet the definition of "separable contracts""* subject to *"establishing a "fair market value" for these items which could be audited"*.

51. Discussions between KPMG and Carillion's finance team were also reported in an internal Carillion email of 23 August 2013 which stated:

> *"We have had productive discussions with the* [Provider A] *financial team over the £20m early savings and believe if we can identify processes and systems related to the construction and services markets these can be valued and sold to* [Provider A] *as intangible assets. This will give us a cash and profit impact in the year and* [Provider A] *can take this cost to their balance sheet.* [Carillion's finance team] *has had discussions with KPMG and they seem to support this idea so long as it is through a separate agreement and not linked to the outsourcing contract. The processes would be valued by an independent auditor but arguments could be used for use in global and related markets to maximise the value assigned."*

52. On 29 August 2013 the Group Senior Manager emailed Mr Turner with the subject "Carillion outsourcing", stating:

> *"Further discussions and considerations on the points that they previously raised*
>
> □ *Selling the ECOPOD licensing for India and the sub continent seems to progressing as the preferred option. However following my discussion today there are a further few points that I want to check with you.*
>
> *The sale is for the licence and IP and looks like it will be for a 10 year period (I assume that this is not spread as just normal licence sale and putting a timeframe is common in industry?). There will be a condition that this is for 300 units (say - not sure of amount). The risk on selling the 300 units is with the purchaser and part of the initial valuation, as they will also be sourcing and making sales then they have the risk and therefore I do not believe that Carillion would spread and take on each of the sales up to 300 units, but on the initial sale of the licence.*
>
> *The final point is in relation to royalties on sales, they are looking at putting on all sales, but I would assume that this would mean that the first 300 is then in the sale payment and therefore you would have to spread this element. If the royalty is on anything in excess of the limit above then no issue. I assume that if there was no limit and royalty just on all sales then we would say that this revenue is recognised only on sale. In relation to the valuation, if they internally value based on sale price etc of Ecopods, would this impact any of the above?, again if based on say the 300 I think that the risk is purely with the purchaser that they have paid too much for the licence and therefore no impact on Carillion they just recognise the sale and we audit and verify the valuation."*

53. Mr Turner responded by suggesting a call the next day. Apparently following that call, the Group Senior Manager emailed Mr Turner and asked him to review a draft email the Group Senior Manager was proposing to send to Carillion's finance team. The draft set out the criteria that, in KPMG's view, Carillion had to satisfy in order for it to recognise all the proceeds of the sale of the licence in revenue immediately. The draft also stated:

> *"The valuation will need to be done on a M[arket] V[alue] basis and we would need to consider this in comparison to available data on sales / price paid by Carillion for the original licence."*

54. On 8 October 2013 the Group Senior Manager spoke to a Carillion director and later, on 15 October 2013, emailed notes of this call to the Group Manager and another member of the audit team. These notes included the following:

> *"Outsourcing arrangement*
>
> *Revised underlying profit of £185m includes £16 - £20m of income in relation to the outsourcing contract.* [A Carillion director] *noted that this was still being worked through and that Carillion would provide papers to review as soon as possible so that all parties can work through and ensure that everything is in line with previous discussions.*
>
> *Carillion to provide paper and group team to audit"*

55. By October 2013, therefore, Mr Turner and the Group Senior Manager knew that, in order to achieve its forecast profit, Carillion was expecting to recognise profit of £16 - £20 million (in the region of 10% of its overall expected underlying profit for 2013) "*in relation to the outsourcing contract*" and that this would likely involve the sale of a licence and/or intellectual property for Ecopod to the party who would also be providing the outsourced services to Carillion. They had also identified and communicated to Carillion that to recognise profit from such a sale in its financial statements, key considerations would include whether the licence sale and outsourcing agreements were '*separable*' or not linked, and whether the Ecopod licence sale was at a market value, and that these matters would have to be audited.

(3) Drafting the agreements for the 2013 Outsourcing Transactions

56. From October 2013 until 6 December 2013, when the 2013 Outsourcing Transactions were signed, there were further discussions between KPMG and Carillion on the terms of the proposed agreement for the Ecopod Transaction and the impact these would have on its accounting treatment. The precise terms of the agreements and the points raised in the discussions with KPMG appear to have been primarily driven by Carillion's desire:

    56.1 to treat the Ecopod Transaction as a sale of a licence, and consequently recognise the total proceeds in revenue immediately; and

    56.2 not to disclose any details of the agreements and their financial impact in its financial statements.

57. For example, on 5 November 2013, the Group Senior Manager emailed Mr Turner, with the subject line "Re:URGENT ECO-POD", as follows:

    > *"I am under extreme pressure to provide them with an answer, I have explained that this takes time, but initial review of the document would suggest an intangible asset. They are not happy and they want to know what words / changes they need to make to the contract now in-order for this to be treated as a licence, with no additional disclosures."*

58. On the same day Mr Turner stated in an email to the Engagement Quality Control Reviewer:

    > *"At this stage, the agreement is still draft so of there are things that C could factor in to justifiably achieve the treatment they desire, we can feed those back."*

59. On 20 November 2013 Mr Turner, the Engagement Quality Control Reviewer and a technical partner at KPMG ("**KPMG technical partner**") considered whether a KPMG technical panel would need to be convened to determine the correct accounting treatment for the proposed transaction relating to Ecopod. The KPMG technical partner suggested that the requirement for the technical panel would in itself indicate that the accounting treatment was a significant risk for the audit and would therefore need to be disclosed in the audit report. Mr Turner stated:

    > *"Key point will be how specific that disclosure is on the specific licence / royalty/ revenue recognition point; we have not quantified any other specific matters in the draft Audit opinion, so arguably would not do so here."*

60. KPMG was also aware of the impact the transactions would have on Carillion's reported results. On 5 November 2013 the Group Senior Manager stated in an email to Mr Turner:

> *"at £25m this item is (13%) of underlying and (20%) of PBT and therefore significant to the overall true, fair and understandable picture of the accounts."*

E. Concerns raised by the audit team over the 2013 Outsourcing Transactions

61. During the same period, the Group Manager sent a number of emails setting out concerns over the 2013 Outsourcing Transactions as follows:

    61.1 On 24 October 2013 to the Group Senior Manager and Mr Turner:

    > *"They should get lawyers to review these arrangements because I am genuinely worried they could be misleading the city with this if not disclosed clearly in the accounts – is this buyer genuinely going to be installing ecopods in India because if not it stinks. 25 mil is going to get them to a number which in no way reflects underlying trade, irrespective of ifrs."*

    61.2 On 24 October 2013 to the Group Senior Manager:

    > *"In 2012 [redacted] disposed of a product line and reflected the gain on disposal as an above the line non gaap adjustment.*
    >
    > *Seems like the most sensible place to me for this too but perhaps too transparent for client taste!!"*

    61.3 On 3 December 2013 to the Group Senior Manager and Mr Turner, referring to a confidentiality clause in the Ecopod Transaction:

    > *"Frankly I wouldn't want us commenting on the legal position re: the confidentiality clause in the* [Provider A] *document. We aren't disclosing the purchaser so not sure if that satisfies either way.*
    >
    > *[If it is genuinely confidential – how do we know about it?]*
    >
    > *The reason for that clause was to protect from creditor claw back via* [the Ecopod developer]*. Did Carillion pay* [the Ecopod developer] *a fair price to* [the Ecopod developer]*for the IP (£9m) given they immediately sold a small portion of the IP to India for a vastly increased price (£27m)? Do they want us, as the auditors, investigating this from a legal standpoint? Not sure they do..."*

    61.4 On 4 December 2013 to the Group Senior Manager and Mr Turner, again referring to the confidentiality clause in the Ecopod Transaction:

    > *"This doesn't apply to the assignor (ie. Carillion).*

In fact, all the confidentiality and announcement clauses I can see are binding only to the assignee (ie Buyer) not the assignor.

[Hang on, does this also mean buyer can't even sell Ecopods in the 12 months following?]

Contract is rubbish."

61.5 On 4 December 2013 to the Group Senior Manager and Mr Turner:

"I can't leave this alone I'm afraid.

I think we need to arrange a call with [Carillion's in-house lawyers] *and/or the Group's legal advisors … to confirm the following:*

In regards to the £27 million Ecopod Licensing agreement [dated X] the Board are satisfied that:

1. The sale of the licence to Buyer in no way contravenes the Bribery Act 2010 (or indeed Competition Law) given the following facts:

- *The Buyer is set to be sole provider of the Group's outsourced finance services from [November] 2014*

- *The Buyer is currently unable to release the money from India due to governmental restrictions*

- *The Buyer appears to be restricted from any form of disclosure, including to potential customers for the product, until at least 12 months following the signing date of the contract*

- *The Buyer will therefore not be able to make any sales of the product until at least 12 months following the signing date of the contract*

- *It is the Group's view that Royalties (of 10% per product) will not be material in comparison to the up-front licence sale price*

2. The sale of the licence to the Buyer in no way contravenes UK Company Law in respect of:

- *The purchase price of the Global licence from the* [the Ecopod developer] *(immediately prior to administration) being some 6 times smaller than the sale price of this regional component*

- *The sale of the licence being under negotiation at the time of the purchase of the Global licence from the* [the Ecopod developer]

3. Disclosure of the sale of the licence to the Buyer is allowable in the Group Financial Statements under UK Law on the basis that:

- *Disclosure may be a requirement of IFRS and therefore required by UK Company Law; and*

- *The non-disclosure terms of the contract are applicable to the Buyer only.*

Clearly I'm not a lawyer but these are the questions in my mind and the questions I think a third party looking at this would ask."

62. In response to the last of the Group Manager's emails above, Mr Turner responded:

> *"Thanks for this – probably best if we discuss rather than engage in email exchanges but I understand that things may have moved on such that cash is now being released on deal completion"*

F. Details of the 2013 Outsourcing Transactions

63. On 6 December 2013, Carillion entered into the MSA with Provider A. The MSA set out the terms of the Outsourcing Transaction under which Provider A would provide information technology and business process outsourcing services to Carillion. This included a schedule that set out the payments that would be made under the MSA, including:

63.1 The Exit Fee Contribution, payable by Provider A to Carillion "*by way of contribution*" to "*exit fees*" payable by Carillion to the outgoing supplier. As noted above, the exit fees were repayment of a proportion of a £40 million cash advance paid to Carillion by the outgoing supplier in 2009 on the award of the original outsourcing contract.

63.2 "*Operational Service Charges*", payable by Carillion to Provider A in respect of four areas of services to be provided by Provider A. Schedule 7 of the MSA set out details of these charges, including a summary of the charges over the life of the agreement, analysed between each service area and between the following categories:

63.2.1 "*Service Delivery (SOW) On-Shore Service Delivery*"

63.2.2 "*Service Delivery (SOW) Off-Shore Service Delivery*"

63.2.3 "*Service Delivery (SOW) Non Adjustable Element (Fixed)*" and

63.2.4 "*Other Charges*"

Schedule 4 of the MSA set out the "*Statement of Work*" or "*SOW*" for each "*Service Delivery*" category. No details were provided for the "*Other Charges*".

63.3 The Termination Charge, payable by Carillion to Provider A in the event that the Outsourcing Transaction was terminated early.

64. In addition, within the terms of the MSA Carillion and Provider A acknowledged their mutual intention to enter into:

64.1 the Ecopod Transaction, in which Carillion would assign to Provider A rights to manufacture, market, sell and distribute Ecopod in the Republic of India, Sri Lanka, Bangladesh, Nepal and Bhutan. The consideration for these rights payable by Provider A to Carillion was:

64.1.1 £25 million payable on the date of the contract;

64.1.2 £2 million payable on 30 September 2014; and

64.1.3 a 10% royalty in respect of sales.

64.2 a licence granted by Carillion to Provider A relating to "*certain IT and Business Process Assets*" for £1,000.[1]

65. Confidentiality clauses in the MSA provided that neither Provider A nor Carillion could disclose to any third party any information about the existence of the Ecopod Transaction for twelve months after the signing of the agreement.[2]

66. The Other Charges totalled £40.8 million over the life of agreement.[3] Unlike other terms used in the MSA, and despite the capitalisation of the term, the MSA contained no definition of Other Charges. Nor did the MSA provide any explanation as to what the Other Charges represented, or as to what (if any) services Provider A was required to provide in return.

67. Further, the Other Charges were excluded from a number of provisions throughout the MSA, in particular:

67.1 in the event of a delay to commencement of services provided by Provider A, charges payable by Carillion could similarly be deferred, except the Other Charges which would remain payable;

67.2 unlike some other amounts payable under the Outsourcing Transaction, the Other Charges would not be adjusted for inflation;

67.3 the Other Charges were excluded from the cap on liability; and

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[1] The extracts in the audit file version do not include this.

[2] As referred to above, an email from the Group Manager suggests that this restriction applied to Provider A only in earlier drafts of the agreement.

[3] Other Charges £6.0m + £3.9m + £13.1m + £17.8m = £40.8m.

67.4 the Other Charges were excluded from a calculation of an amount Provider A was required to invest in improvements to services, suggesting that the Other Charges did not relate to matters that might benefit from such investment.

68. The Termination Charge was payable by Carillion to Provider A in the event that the Outsourcing Transaction was terminated. The MSA provided that the amounts payable would reduce over the life of the contract, with the initial amounts payable as follows:

68.1 £39 million in the event that the agreement was terminated in 2014 for (broadly) reasons relating to an inability of Provider A to provide the services or a failure of performance by Provider A, in particular if there was a material or persistent breach by Provider A of its obligations under the MSA.

68.2 £46 million in the event that the agreement was terminated in 2014 for other reasons, including: where the agreement was terminated by Carillion "*for convenience*"; where Carillion was unable to receive the services because it was not permitted by applicable law; where Provider A terminated the agreement on an insolvency or similar event or a material breach by Carillion to pay charges; or where Carillion terminated the agreement following benchmarking.

69. Carillion therefore agreed to pay Provider A a significant amount if the agreement was terminated in 2014, even if the reason for the termination was a breach of the agreement by Provider A (albeit the payment by Carillion would then be slightly lower). These obligations then continued beyond 2014, with the amounts reducing incrementally over time.

70. The MSA also provided that Carillion should provide letters of credit to Provider A ("**Letters of Credit**") which would become payable if Carillion became insolvent and the agreement under the Outsourcing Transaction was terminated but the Termination Charge had not been paid. The Letters of Credit reduced over the life of the agreement, from an initial aggregate amount of £30 million.

71. The various elements of the MSA therefore provided for the following payments:

71.1 Provider A to pay Carillion a total of £41 million in 2013-2014.

71.2 Carillion to pay Provider A "*Operational Service Charges*" under the Outsourcing Transaction over the next ten years, including Other Charges totalling £40.8 million over the life of the agreement, where no services were specified.

71.3 If the agreement was terminated, Carillion was to pay Provider A an amount reducing over the life of the Outsourcing Transaction from an initial amount of either £39 million or £46 million, depending on the reason for termination. These payments were partially guaranteed by the Letters of Credit.

72. Carillion was therefore committed to pay to Provider A an amount similar to the £41 million received from Provider A in 2013-2014, either through the Other Charges or the Termination Charge. This appeared to be payable independently of payment for any services provided by Provider A.

G. Accounting treatment and disclosure in the 2013 financial statements

(1) IFRS requirements

73. 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*** *[emphasis added]. 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."*

74. The accounting treatment for agreements comprising a number of components therefore depended on whether the commercial effect of each component could be understood in isolation or only by reference to other components.

(2) Accounting treatment

75. Carillion determined that the different elements of the 2013 Outsourcing Transactions were not linked and accounted for them as separate, independent, arm's length transactions. As a result, the 2013 financial statements included the following amounts in relation to the Ecopod Transaction and the Exit Fee Contribution:

		Profit	Net assets
Ecopod Transaction	Revenue Cash or receivable asset	+ £27m	+ £27m
Exit Fee Contribution[4]	Reduction in expenses Receivable asset	+ £14m	+ £14m

76. The cumulative effect of the accounting treatment adopted for the 2013 Outsourcing Transactions on the 2013 financial statements was thus an increase in profit and net assets of £41 million. This treatment was based on the different elements of the transactions being separate, and not commercially linked. However, if the cash received had been treated as linked to the Outsourcing Transaction, then it would not have been recognised as revenue and profit earned in the period, but instead as creating a liability.

(3) Audit report

77. The 2013 audit report included the following narrative as one of the identified "risks of material misstatement":

> *"The risk – The timing of revenue recognition from licence arrangements is dependent on a number of criteria, including the estimated fair value of any future revenue streams. These criteria state that revenue recognition is required to be consistent with the transfer of the risks and rewards to the contract counterparty. The Group's estimate of the fair value of future royalty streams is judgemental and where this is estimated as not significant then the determinable element of the sale income is recognised immediately with contingent future royalty revenue recognised when earned. If the fair value of the future royalty stream is assessed as significant, this indicates that the risks and rewards of ownership have not substantially transferred to the counterparty such that the determinable element of revenue should be spread over an appropriate period. Given that the fair value assessments are based on a range of variables outside of management's control, this represents an area of judgement.*

[4] KPMG understood that the Exit Fee Contribution was accounted for so that it matched the expense arising from the "exit fees" payable to the outgoing supplier.

Our response – In transactions where there is a potential future royalty stream we obtained and assessed the contractual terms of the transaction. We also considered the Group's assessment of the fair value attributed to the future royalty stream and challenged the assumptions applied with reference to prevailing market data, including historical experience in other territories.

We also considered the adequacy of the Group's disclosures for such transactions in respect of the accounting policies adopted, revenue income recognised in the period and the key judgements and estimates made by the Group in arriving at the conclusions."

(4) Disclosure of accounting policies

78. The 2013 financial statements disclosed an accounting policy for licence fee income. This was a newly disclosed accounting policy as there was no equivalent in the 2012 financial statements. It stated:

> *"Revenue from the sale of a licence is recognised immediately where an agreement is, in substance, an outright sale. For an outright sale to have occurred, the Group must have a signed non-cancellable contract, have provided the licensee with the rights to freely exploit its contractual rights, have no significant ongoing delivery obligations to perform and have received a fee which is not expected to be subject to material adjustment based on future activity. Where there is an element of contingent revenue to such an agreement, an assessment of the estimated fair value of this future revenue is considered. If this fair value is minimal then the risks and rewards of the agreement are considered to have been transferred in full and therefore the determinable sale income is recognised as revenue immediately, with any contingent revenue recognised as it is earned. Should the contingent revenue be assessed as significant, the sale income is recognised as revenue over a period consistent with the life of the technology or other appropriate measure."*

(5) Disclosure of significant judgements

79. The 2013 financial statements disclosed the recognition of revenue from licencing sales as a significant accounting judgement, stating:

> *"In respect of licensing revenue a number of judgements are made by management in determining whether the criteria (as stated in the company's accounting policies 'note 1') have been met in order to allow for the full, immediate recognition of the sale income. These judgements may involve the estimation of the fair value of future royalty income receivable, based on which management will assess whether the licence sale revenue should be recognised immediately or spread over a period consistent with the life of the technology or other appropriate measure. The assessment of that future royalty revenue stream relies on forecast data and a number of variables which are outside of Carillion's control, and hence judgemental. The licence revenue recognised in the year (see note 2) related to amounts recognised immediately, given that contingent revenues arising in future periods from these licensing activities were assessed as not significant."*

80. Neither the accounting policy nor the disclosure of significant judgments made reference to the specific transaction, or the circumstances surrounding the receipt of the licensing income – that the income was received under an agreement made at the same time and with the same counterparty as the Outsourcing Transaction but management's conclusion was that the transactions were not linked.

(6) Disclosure of underlying profit

81. The 2013 financial statements provided amounts for underlying profit after adjusting for "*Non-recurring operating items*". The adjustment largely comprised restructuring costs and resulted in an increase in the amount reported as underlying profit of £44.2 million. No adjustment was made for the non-recurring profit of £41 million recognised as a result of the 2013 Outsourcing Transactions.

(7) Other disclosures

82. The "*Performance and financial review*" stated the following:

> *"However, we have had some success with EcoPod sales. Over the period from 2011 to 2013, Carillion acquired the exclusive worldwide rights to sell and licence EcoPod, a heating system, which combines a range of technologies, including highly efficient cascade boilers with biomass, ground source and gas absorption heat pumps and thermal solar panels to deliver major energy savings. EcoPod generated revenue, including licence fees, of some £36 million in 2013 and has delivered an overall return on our investment of over two times, which compares favourably with the returns we expect from other investment decisions."*

83. A footnote to note 2 "*Segmental reporting*" for the revenue and profit for "*Support services*" stated:

> *"Includes licensing revenue of £27 million (2012: Nil)."*

84. There were no disclosures specifically relating to the Outsourcing Transaction. However, note 33 "*Off-balance sheet arrangements*" stated:

> *"In respect of outsourcing contracts, the Group has entered into various arrangements to outsource the provision of certain back-office functions with a third-party provider. These arrangements are on commercial terms and any penalty or termination clauses associated with these arrangements will not have a material impact on the financial position of the Group."*

5. AUDIT WORK AND BREACHES OF *RELEVANT REQUIREMENTS*

A. Introduction

85. This chapter sets out aspects of KPMG's audit work, and the breaches of *Relevant Requirements* arising from that work, under the following headings:

    85.1 Audit planning

    85.2 KPMG's technical panel

    85.3 Identification of significant risk

    85.4 Accounting treatment of the 2013 Outsourcing Transactions:

    85.4.1 The Ecopod Transaction

    85.4.2 The Exit Fee Contribution

    85.4.3 The Outsourcing Transaction

    85.4.4 The components combined

    85.5 Disclosure in the 2013 financial statements and annual report relating to:

    85.5.1 Accounting policies and significant judgements

    85.5.2 Underlying profit

    85.5.3 Other disclosure in the 2013 financial statements

B. Audit planning

86. Working paper "*Group Planning Analytics*" set out analytical procedures that "*might indicate matters that have audit implications*". It included the following:

    86.1 In "*Tab 1 – IS Analytics*", in relation to Group Revenue, the working paper stated:

    > *"Group Revenue A – There has been an overall reduction in revenue against prior year figures as government spending reviews continue shown with local councils recently being informed to make further savings. Budget against revenue is also lower due to volume reductions …*

… Business Group audit teams should be aware that there is management pressure to improve results in all components in order to make up for the above shortfall. These is therefore a heightened risk that local business group managers may be tempted to allow bias in any judgement which may allow for the potential to bridge the above gap in revenue to budget."

86.2 In "Tab 2 – BS Analytics" in respect of "net (borrowing)/cash" position, the working paper stated:

"Net cash F – The net borrowing/cash position has worsened due to reduced cash conversion[5] *due to, in part, the unwind of early* [Carillion client] *receipts in 2012 (£31.0m), the residual working capital outflow in respect of UK Construction rescaling in the first half (£30.0m), support for supply chain (£20.0m) and* [… a] *settlement (£26.0m), partly offset by the sale of PPP equity £60.0m (excess of proceeds over profit).*

It is noted that the above has raised considerable cash pressure throughout the group and the group and component audit teams will consider this, alongisde the margin pressure detailed in Tab 1, when considering judgements made by management in the preparation. It is also noted that whilst cash receipts have been suppressed in the year we expect a number of key cash injections before the year end (ecopod licence sale, PPP disposals, [a project] *and other contract settlements) which will have a significant impact on cash conversion."*

87. As is apparent from the above, KPMG (a) identified, during the planning stage of the audit, increased pressure on Carillion's management to improve revenue and cashflow, and (b) was aware that this created a heightened risk of management bias. Further, KPMG noted that a "key cash injection" was expected from the Ecopod licence sale with a consequent impact on cash conversion.

C. KPMG's technical panel

88. On 7 January 2014 a technical panel was held to consider issues presented to them by the audit team regarding Carillion's accounting treatment for the Ecopod Transaction, specifically whether the immediate recognition in revenue of the total proceeds was appropriate. The panel also considered what disclosures in the financial statements were required.

89. In advance, on 3 January 2014, the technical panel was sent the following papers:

89.1 Document "Carillion MSA extracts";

[5] The 2013 annual report defines cash conversion as "*the underlying cash flow from operations divided by the underlying profit from operations as reported in the annual report*".

89.2 Document "Sale of Ecopod IP - Management Paper";[6] and

89.3 Document "KPMG Technical Paper 20 12 13 clean".

90. Document "KPMG Technical Paper 20 12 13 clean" was prepared by the audit team and reviewed by members of KPMG's technical team. The KPMG technical partner, who had been assisting the audit team on an ongoing basis on the treatment of the Ecopod Transaction since November 2013, corresponded with Mr Turner as follows:

90.1 On 29 December 2013 the KPMG technical partner emailed Mr Turner and another member of the technical panel, attaching a draft of a document entitled *"Technical Panel Paper for the disclosure of sale of Ecopod licence"*: The KPMG technical partner stated that they had *"added a few significant edits which I have flagged with comment boxes"* and drew Mr Turner's attention to one in particular, stating *"Darren you may wish to review the comment boxes for additional questions that may be raised. In particular, this is the first I have heard of the arrangement including business processing services?"*

90.2 The comment box to which the KPMG technical partner had drawn Mr Turner's attention in this covering email had been made in relation to a bullet point in the draft stating that the MSA provided for *"The outsourcing of Carillion's transactional processing …"*. The KPMG technical partner's comment box for this text stated as follows:

"This is the first I've heard of this!

If the sale and the subsequent services receivable are in a single agreement, how have they concluded that the two elements can be separated and how have they allocated consideration. For example do the contractual prices for services mean Carillion is overpaying for the services, compensated by a overstated proceeds for the licence."

[6] An initial version of this paper was first provided to KPMG on 31 October 2013. The version provided to the technical panel was emailed by Carillion's finance team to KPMG on 22 December 2013. The audit file contains what appears to be an older version of the paper (last modified 25 November 2013) and appears to be identical to a version emailed by a member of Carillion's finance team on 15 November 2013.

90.3 On 30 December 2013 Mr Turner replied to the KPMG technical partner. He said that he could not read the comments on his iPhone but that he was sure that they would be *"entirely sensible and valid"* and he indicated that he would read them in preparation for the meeting with the technical panel. He then stated:

> *"In relation to the BPO agreement, we have been at pains to stress to management that these agreements are entirely separate and each represent fair value for the respective services. Management note that they are satisfied this is the case and highlight that the BPO arrangement was externally tendered and* [Provider A] *price was much lower than the incumbent and marginally lower than the third bid, such that they believe the price for the stand alone BPO agreement is a fair value based on market testing."*

90.4 Mr Turner added in interview:

> "*…we, me, the audit team, have been at pains to stress to management that they need to demonstrate these contracts are entirely separate and that fair value is represented with these services. If that is not the case, then a different treatment may be appropriate.*"

91. Document "*KPMG Technical Paper 20 12 13 clean*" (which was the final version of the paper sent to the technical panel) set out the following questions for the technical panel:

> *"1. Does the Panel agree that it is appropriate to recognise the transaction as a sale in the year?*
>
> *2. Does the Panel agree with the proposed presentation and disclosure of the transaction in annual financial statements for the year ended 31 December 2013?*
>
> *3. If the Panel believes this proposal to be unacceptable then what additional disclosure does it believe are required and does it believe that we would modify our audit opinion if the client declines to meet additional disclosure requirements?*
>
> *4. In considering the significant risks for disclosure in our audit report, does the panel consider that reference should be drawn to this transaction and if so which aspects, e.g. timing and / or disclosure?"*

92. The technical panel met on 7 January 2014. Its views were recorded in working paper "KPMG TECHNICAL PANEL FINDINGS" (ECO.5). Under the heading "Background", this working paper stated:

> *"The team explained their and the client's analysis. Carillion have entered into an agreement with* [Provider A]. *That agreement contains two distinct components/elements: an outsourcing arrangement and the assignment of IP over a product known as EcoPod.*

The team are satisfied (subject to audit) that the amount allocated to the outsourcing arrangement represents an arms' length fee payable (based on comparison with tenders from other bidders) and so the amounts payable per the contractual terms for the IP are considered to be fair values. This point was not debated by the Panel."

93. The working paper later stated:

> *"The Panel questioned the economics of the arrangement, in this case–it was not clear why* [Provider A] *would be prepared to pay a significant upfront sum unless sufficient sales were anticipated to enable them to recoup it …*
>
> *… A Panel member asked what audit evidence was likely to be available to support the argument that the value of the royalties is not expected to be significant; it was thought unlikely that there would or could be anything concrete but the Panel noted that rationale behind the client's view should be explored further."*

94. The audit team referred to and addressed this particular point in working paper "*SUMMARY IMPACT OF MSA"*:

> *"The Panel questioned the economics of the arrangement, in this case – it was not clear why* [Provider A] *would be prepared to pay a significant upfront sum unless sufficient sales were anticipated to enable them to recoup it. An argument could be that* [Provider A] *was offering a higher price for the licence agreement in order to secure the BPO agreement under the MSA.* ***It is therefore important for the client to demonstrate that the amount paid for the new BPO arrangement was at an arm's length and no fair value was attributed to the Ecopod licence****."*

95. On 7 January 2014, after the technical panel had met, a member of KPMG's technical team emailed Mr Turner and the Group Senior Manager stating:

> *"My recollection was that the BPO vs IP split was accepted 'as is' by the panel so nothing more there from them, but think* [the Engagement Quality Control Review partner] *had a query on what was seen as audit evidence so far (contracts vs managements word etc) - but I didn't see that as a panel request so it won't make my note unless* [a member of KPMG's audit team] *feels differently."*

96. The technical panel was not asked to consider the key issue relating to the 2013 Outsourcing Transactions, which was whether the various elements were linked and/or at fair value. Nevertheless, the technical panel queried the "*economics of the arrangement*", in the context of the 10% royalty payments, and both the KPMG technical partner and the Engagement Quality Control Review partner raised questions on whether there was a link between the Ecopod Transaction and the Outsourcing Transaction.

97. In relation to disclosures in the financial statements, the working paper summarised the panel's decision as follows:

> *"The Panel decided that immediate recognition was acceptable of revenue for a 'sale' of a licence to use IP even though the contractual terms meant that additional amounts might become payable but that the degree of judgement required by management in reaching that conclusion meant that significant disclosure would be required in the accounts (to meet the requirements of both IAS 18 and IAS 1) and in the front end."*

D. Identification of significant risk

98. Paragraph 25 of ISA 315 required KPMG to identify and assess the risks of material misstatement at the assertion level for classes of transactions, account balances, and disclosures, to provide a basis for designing and performing further audit procedures.

99. Paragraph 27 required KPMG to determine whether any of the risks identified were significant risks.

100. Paragraph 28 required KPMG, in determining which risks were significant risks, to consider (amongst other factors) the complexity of the transactions, and whether the risk involved significant transactions that were outside the normal course of business for the entity, or that otherwise appeared to be unusual.

101. The 2013 Outsourcing Transactions resulted in Carillion receiving a £41 million payment and recognising an identical sum in profit. Not only was this a material amount in itself, but it had a significant impact on both Carillion's reported level of profit and in fact was being relied on to meet forecasted profit targets. It impacted other performance indicators, including cash conversion and reported net debt, and involved complex and unusual transactions which, entered into in combination, appeared to be outside Carillion's normal course of business.

102. Carillion's recognition of the entire sum as profit depended on the Outsourcing Transaction and the Ecopod Transaction being treated as separate transactions. However, KPMG was aware from before the commencement of the audit that Carillion was relying on the award of the outsourcing contract as a means of achieving its profit targets, and consequently that the sale of intellectual property and award of a new outsourcing contract were connected. Consistent with this, when finalised, they were reflected in a single overarching agreement.

103. Further, in 2009 Carillion had obtained a significant cash receipt when awarding the original outsourcing contract, comprising an 'inducement payment' of £30 million and other payments described as 'mobilisation' and 'discount' payments. These payments were clearly linked to the outsourcing contract, and the accounting treatment adopted reflected that. The similarity with the 2013 Outsourcing Transactions, with a significant cash payment being obtained from a business to whom a valuable outsourcing contract was being awarded, was striking, but in the 2013 financial statements the different elements were being treated as not linked. KPMG and Mr Turner audited the 2009 financial statements and must have been aware of the outgoing supplier transaction but there is no evidence that this similarity was identified or considered during the 2013 audit.

104. In those circumstances KPMG should have identified the question of linkage of the transactions as a significant risk, in particular in light of the risk of management bias already identified. However, these circumstances were not recorded on the audit file and KPMG only classified the timing of revenue recognition of the Ecopod Transaction as a significant risk.

105. Working paper "4.5.4.8 Licence Revenue" records the audit team's response to the significant risk from licence revenue and provides the following description of the risk:

> *"In December 2013 the Group entered into a transaction with* [Provider A] *in India to licence the Ecopod IP for use in that territory. This income has been recognised in revenue, in full, in the year ended 31 December 2013.*
>
> *There is a risk that revenue has been overstated and that some portion of the income needs to be deferred.*
>
> *There is also a risk around the disclosure of the transaction in the annual report"*

106. The 2013 audit report set out details of KPMG's assessment of risks of material misstatement in the 2013 financial statements. It included risks relating to revenue recognition and a specific risk relating to "the timing of revenue recognition from licence arrangements". The Executive Counsel assumes that this related to the Ecopod Transaction, although that was not specified.

107. KPMG's risk assessment therefore did not at any stage identify the issue of linkage as a significant risk, despite (a) KPMG's knowledge of the background to the transactions and the indications that they were linked, and (b) the likely impact on the financial statements should the accounting treatment adopted by Carillion be inappropriate.

108. There were thus breaches by **the Respondents** of **ISA 315 paragraphs 27 and 28** in that the Respondents failed to identify the significant risk arising from the potential linkage of the Ecopod and Outsourcing transactions.

E. Accounting treatment of the 2013 Outsourcing Transactions

(1) Introduction

109. As set out above, IAS 18 provided that the accounting treatment for agreements comprising a number of components depended on whether the commercial effect of each component can be understood in isolation or only by reference to other components.

110. As set out above, Mr Turner and the Group Senior Manager had already identified that whether the contracts were '*separable*' and at market value would be the key areas of focus for the audit.

111. Further, before the transactions were entered into, KPMG understood from Carillion that it was expecting to recognise a significant level of profit "*in relation to the outsourcing contract*", through a sale of intellectual property to the same counterparty with whom Carillion would be contracting as a new supplier of outsourcing services. In due course Carillion entered into the 2013 Outsourcing Transactions, all of which were set out in the MSA, a single, overarching contract. This was direct evidence that the transactions were linked. The most likely explanation for the 2013 Outsourcing Transactions being entered into together was that Provider A's agreement to the Ecopod Transaction and the Exit Fee Contribution was a *quid pro quo* for the award of the outsourcing contract, and the payments were in substance either an advance discount on Provider A's charges under the Outsourcing Transaction, or a loan that would be recovered by those charges being inflated. In either case the cash receipt would not represent income earned in 2013 and would not result in increased profit.

112. As noted at paragraph 90.2 above, this risk had been immediately identified by the KPMG technical partner, a member of KPMG's technical panel, when the KPMG technical partner became aware of the full extent of the transactions.

113. Further, KPMG knew that from the outset Carillion intended to recognise the entire sum received under the Ecopod Transaction in revenue immediately. Where a licence provided for royalties to be paid in the future, all or part of the initial consideration would ordinarily be spread over the duration of the licence, but Carillion justified recognising the entire sum immediately by arguing that sales under the licence and consequently revenue from the royalties would be negligible. However, again as noted by KPMG's own technical panel, it was not clear why Provider A would pay millions of pounds for a licence that in Carillion's view would not lead to substantial levels of sales.

114. In these circumstances, KPMG should have been sceptical about management's chosen accounting treatment and the justification for it. In view of its knowledge of the transactions, KPMG should have approached the audit of the transactions on the basis that all the components needed to be treated as linked unless the evidence they obtained demonstrated clearly that they were separate, independent transactions; that is, the commercial effect of each element could be understood without reference to the other elements.

115. Each element of the 2013 Outsourcing Transactions is considered below.

(2) The Ecopod Transaction

(a) *Introduction*

116. The Ecopod Transaction was an assignment of rights relating to Ecopod for the following consideration:

116.1 £25 million payable at the date of the contract;

116.2 £2 million payable on 30 September 2014; and

116.3 10% royalty in respect of sales.

117. This was accounted for in the 2013 financial statements as £27 million revenue and a corresponding increase in net assets. The accounting treatment which recognised £27 million in revenue immediately depended on the following conclusions:

117.1 That the Ecopod Transaction was not linked to the Outsourcing Transaction;

117.2 That the £27 million represented a fair market value for the rights acquired; and

117.3 That the expected revenue from royalties would be negligible, since otherwise (as KPMG appreciated) the total of the initial payments and subsequent royalties would need to be spread over the duration of the agreement.

118. KPMG recorded its audit work and evidence on the accounting treatment of the Ecopod Transaction in the following working papers:

118.1 Working paper "*Summary Impact of MSA*" (ECO.1, headed "*MSA with* [Provider A] *–Ecopod Licence and BPO agreement*") which set out an overview of the 2013 Outsourcing Transactions, and referred to a number of further working papers.

118.2 Working paper "*Management Ecopod Paper*" (ECO.2) was a document prepared by Carillion which set out Carillion's rationale behind the accounting treatment and disclosure of the Ecopod Transaction. (This document is significantly different from a later version of the same paper which was submitted to the technical panel.)

118.3 Working paper "*KPMG Technical Paper*" (ECO.3) set out an assessment by KPMG of Carillion's proposed accounting treatment and disclosure of the Ecopod Transaction, and various questions for the technical panel.

118.4 Working paper "*KPMG Technical Panel Findings*" (ECO.5) recorded the minutes of the meeting of the technical panel on 7 January 2014 and its findings.

118.5 Working paper "*Ecopod IP Legal Opinion*" (ECO.6) was a memorandum prepared by Carillion's external lawyers on instruction from Carillion and in response to a request from KPMG, to address a question from the technical panel on whether the Ecopod Transaction allowed Carillion to market other applications for the intellectual property in the territory.

119. These working papers and other information obtained by KPMG provided information relevant to both the question of linkage and the fair value of the Ecopod Transaction, broadly comprising information relating to:

119.1 The amount paid by Carillion for Ecopod;

119.2 Sales and profits on Ecopod made by Carillion;[7] and

119.3 Carillion's view on the sales Outsourcer A were likely to make.

120. Each of these are considered below.

(b) *<u>The amount paid by Carillion for Ecopod</u>*

121. Carillion acquired the worldwide rights to Ecopod for £8.3 million and recorded an intangible asset for this amount. KPMG obtained evidence that demonstrated clearly that the rights transferred to Outsourcer A under the Ecopod Transaction were substantially more limited than the entirety of the rights acquired by Carillion, stating:

[7] KPMG had identified at an early stage that the first two matters would necessarily have to be the subject of audit procedures, stating in an email to Carillion "*The valuation will need to be done on a M[arket] V[alue] basis and we would need to consider this in comparison to available data on sales / price paid by Carillion for the original licence.*"

> *"Carillion retains IP rights which it has the right to exploit in the Territory notwithstanding the* [Provider A] *Assignment."*

122. Carillion's acquisition of the rights was concluded very shortly before the assignment of a subset of those rights to Outsourcer A for £27 million. It was unlikely that the value of the rights had increased significantly during that period, and there was no explanation or evidence that suggested it had.

(c) *Sales and profits on Ecopod made by Carillion*

123. Working paper "*KPMG Technical Paper*" (ECO.3) stated:

> *"After several years of development, the Group has begun installing Ecopod units in the UK during 2013 following the commencement of the Green Deal and ECO arrangements announced by the UK government. The average revenue per installation is c. £800,000 and in 2013 the Group completed 11 installations across a number of public sector contracts; the instalments to date have generated a loss for the Group."*

124. Therefore, despite several years of development, Carillion had achieved sales in 2013 of around £9 million from installing Ecopods but these had been loss-making. There was no information as to why losses had been made, or whether the level of future sales was likely to increase, or whether future sales might generate any profits. The "*data from sales*" thus suggested that the value of a licence to install Ecopods would be negligible, unless there was an obvious reason why the purchaser would achieve greater success from installing the product than Carillion had experienced.

(d) *Carillion's view on the sales Provider A were likely to make*

125. Document "*Sale of Ecopod IP - Management Paper*", prepared by Carillion (in the version provided to the technical panel) provided the following information on Provider A's likely sales from Ecopod:

> *"Whilst the market is large (whether growth is achieved or not), we believe that there is significant risk associated with the ability of* [Provider A] *to exploit both the technology and the market in order to generate sales in the immediate future.*
>
> *From our experience in the UK, this product takes time to get to market. We know* [Provider A] *have the same concern and this has been reflected in the 12 month confidentiality agreement. We do not have any expectation that* [Provider A] *will make significant sales in the short to medium term …*
>
> *… A 10% royalty fee will be paid to Carillion on each future sale of EcoPod system by* [Provider A]. *Carillion do not consider that this revenue stream will be material …*

… Carillion believe that the on-going revenue stream from royalty income will not be material, as whilst the agreement is into perpetuity we believe that technological developments will reduce the useful economic life of the EcoPod royalty revenue stream …

… Carillion believes that the future royalty income is negligible …

… we believe that the fixed fee of £27 million is a full value for the intellectual property and includes a premium paid by [Provider A] *in order to strengthen* [Provider A]*'s position in the market place, support development of* [Provider A]*'s energy management business, as well as support wider go to market opportunities in order to drive further value".*

126. In summary, therefore, Carillion asserted that:

126.1 it was not anticipated that Provider A would generate significant revenue from exploiting the rights in the short to medium term;

126.2 a 10% royalty on all future sales by Provider A would be "*negligible*";

126.3 technological developments would reduce Ecopod's useful economic life; but even so

126.4 the £27 million fee was "*full value*", apparently on the basis that other benefits to Provider A's business might result from acquiring the rights.

127. There was an obvious contradiction between Carillion's claim that Provider A would not be able to achieve significant sales and the assertion that the £27 million paid for the licence was fair value. The explanation as to why Provider A would be willing to pay a '*premium*' was vague and superficial and was evidently insufficient to support the assertion that the transaction was at a market value.

(e) *KPMG's consideration*

128. Working paper "*KPMG Technical Paper*" (ECO.3) set out an assessment of the proposed accounting treatment for the Ecopod Transaction. It did not consider at all the question of linkage, and, whilst it recognised that "*in order to justify the upfront £27m, the present value of the 10% royalties appears to be in excess of £15m*", it did not go on to consider the obvious inference, that the £27 million was not a fair value. Instead the paper focused on more limited issues:

128.1 whether the transaction should be treated as revenue and recognised entirely in 2013 or as the sale of an asset; and

128.2 the related necessary presentation and disclosure.

129. The paper contained no analysis or explanation of how the fair value of the rights transferred could reasonably be £27 million in the light of the following factors:

129.1 Carillion had paid £8.3 million for much wider rights relating to Ecopod than those transferred to Provider A;

129.2 after several years' development Carillion had achieved sales of around £9 million in the UK in 2013, resulting in a loss;

129.3 Provider A was not anticipated to generate significant revenue in the short to medium term;

129.4 a 10% royalty on all future sales was anticipated to be "negligible";

129.5 technological developments were expected to reduce the useful economic life of the Ecopod technology; and

129.6 the claimed benefits to Provider A's business that might support the value were vague and unsupported by evidence.

(f) *Conclusion*

130. As part of its assessment of whether the 2013 Outsourcing Transactions were linked, KPMG should have considered whether the Ecopod Transaction made commercial sense in isolation. Appropriate audit evidence for these purposes would have been evidence that the fair value of the rights acquired broadly corresponded to the consideration payable. KPMG in fact obtained compelling evidence suggesting that the amount paid by Provider A in the Ecopod Transaction far exceeded the fair value of the rights it obtained.

131. There is no evidence that the impact of this evidence on the accounting treatment of the Ecopod Transaction was identified or considered. In particular, there is no evidence that modifications or additions to audit procedures were considered.

132. KPMG did not approach Carillion's explanation for the commercial rationale of the transaction with an adequate degree of professional scepticism. In particular, the contradiction identified above, between the very substantial amount paid for the rights and the minimal amount that was expected to be earned from their exploitation, remained unresolved.

133. The evidence obtained by KPMG strongly suggested that the Ecopod Transaction was not at fair value or on commercial terms, and consequently could only be properly understood if linked to other components of the MSA.

(3) The Exit Fee Contribution

134. The MSA provided that Provider A was required to pay Carillion £14 million, apparently to meet the cost to Carillion of terminating its existing outsourcing contract with the outgoing supplier.[8] This was described by the audit team as follows:

> *"We note that the signing of this agreement requires termination of the current arrangements with* [the outgoing supplier]*, which will expire in September 2014.*
>
> *As such an exit fee of £14.0 million is payable to* [the outgoing supplier] *in September 2014.*
>
> *Carillion has agreed with* [Provider A] *that, as the new provider,* [Provider A] *will pay the exit fee. These costs, i.e. £14.0 million, have been included in the BPO part of the MSA (ECO.10), payable in instalments.*
>
> ***We are therefore satisfied that both a liability and equivalent asset exist at 6 December 2013 reflecting these arrangements****."*

135. It was therefore explicitly recognised that the Exit Fee Contribution was linked to the Outsourcing Transaction. Further, there was no reason for Provider A to agree to make the payment unless the £14 million was in substance part of the overall pricing for the outsourced services. By contrast, the liability to the outgoing supplier arose from the 2009 transaction, and not from the agreement with Provider A, and the fact that the payment was described in the agreement as a contribution to the amount to be paid to the outgoing supplier did not change its substance. This suggested that the amount should have been treated as a creditor, to be released over the term of the agreement.

136. The inclusion of the Exit Fee Contribution in the MSA could only be understood by reference to the Outsourcing Transaction, which further supported the conclusion that all of the components should have been treated as linked.

137. KPMG should have been sceptical about management's proposed treatment of the Exit Fee Contribution, particularly in light of the substantial impact on reported profit and the obvious link to the Outsourcing Transaction. KPMG should have considered carefully the most appropriate accounting treatment, specifically whether the payment was simply one element of the overall cashflows relating to the Outsourcing Transaction and that consequently there was no basis for Carillion to recognise an asset or a credit to the income statement. There is no evidence that KPMG considered these matters at all.

[8] The extracts in the audit file version do not include this.

(4) The Outsourcing Transaction

138. The Outsourcing Transaction was an agreement for provision of information technology and business process outsourcing services to Carillion by Provider A. As explained above, it provided for the following payments by Carillion to Provider A:

138.1 "*Operational Service Charges*", relating to services provided by Provider A;

138.2 Other Charges, which were included in "*Operational Service Charges*" but with no services specified;

138.3 the Exit Fee Contribution, considered above; and.

138.4 the Termination Charge.

139. In respect of the Operational Service Charges, the outsourcing service from Provider A had not started by 31 December 2013 and so no expense for the services was recognised in the 2013 financial statements.

140. The Other Charges, totalling almost £41 million over the life of the outsourcing contract, were payable while the contract remained in place.

141. The Termination Charge was a charge which reduced over the life of the contract. A Termination Charge of either £39 million or £46 million, was payable if the outsourcing contract was terminated in 2014. This was partially supported by the Letters of Credit, which reduced in value over the life of the agreement, from an initial aggregate amount of £30 million.

142. The 2009 agreement with the outgoing supplier had similarly provided for payment of a substantial termination charge, which reduced over the life of the contract and included repayment of a "*sales incentive*" of £40 million paid by the outgoing supplier. This "*sales incentive*" of £40 million had been treated as linked to the agreement to provide the outsourced services.

143. The audit team had been alerted by the KPMG technical partner, a member of the KPMG technical panel, to the key question they needed to consider:

> *"If the sale and the subsequent services receivable are in a single agreement, how have they concluded that the two elements can be separated and how have they allocated consideration. For example do the contractual prices for services mean Carillion is overpaying for the services, compensated by a overstated proceeds for the licence."*

144. KPMG should have been sceptical as to whether the terms of the Outsourcing Transaction were wholly commercial and recognised that they might include a mechanism to enable Provider A to recover all or part of the upfront cash. KPMG should therefore have ensured that they had a proper understanding of the charges due under the Outsourcing Transaction and the cashflows that would result from both the Outsourcing Transaction and the other components of the MSA, to determine whether the elements were linked, and thus whether the accounting treatment adopted was appropriate.

145. Evidence of KPMG's work on the MSA itself is recorded in two working papers:

145.1 Working paper "*Summary Impact of MSA*" (ECO.1), headed "*MSA with* [Provider A] *–Ecopod Licence and BPO agreement*", set out an overview of the 2013 Outsourcing Transactions and related audit work performed. The section concerning the Outsourcing Transaction records that KPMG assessed "*the remainder of the MSA*" i.e. those elements not relating to the Ecopod Transaction, but comments only on the Exit Fee Contribution.

145.2 Working paper "*Carillion MSA Extracts*" (ECO.4) comprised the contents pages for the MSA and the unsigned agreement for the Ecopod Transaction as included in the MSA. The working paper is annotated:

> *"This is an extract from the full MSA attached in the permanent file. In particular, the Ecopod Licence assignment of the "strategic partnership" section. This documented has been assessed in the context of the revenue recognition and disclosure requirements and our findings are set out in the technical panel document <ECO.3>"*

146. There is no record of any other review of the MSA.

147. A review of the MSA to understand the charges to be paid and the cashflows that would result from the Outsourcing Transaction would have necessarily considered:

147.1 the Other Charges, which were substantial, and which did not obviously relate to the services to be provided; and

147.2 the Termination Charge, which at the outset of the contract represented over two years' contractual payments for all the services to be provided, and thus appeared to be disproportionate to any set up costs that Provider A might incur and reasonably seek to recover.

148. Both matters would have warranted further investigation as both suggested that elements of the agreement were not on commercial terms. They raised a question as to whether the Outsourcing Transaction created obligations separately from the ordinary requirement to pay Provider A for services as they were provided, and consequently whether the different elements of the MSA were linked. There is no evidence that KPMG considered these matters at all and was therefore not in a position to reach a conclusion on the commercial effect of the MSA in practice.

149. Instead of seeking to understand the charges that would be payable, KPMG set out to establish that the Outsourcing Transaction was at fair value by considering the tendering process for the award of the contract. To the query raised by the KPMG technical partner, Mr Turner responded, stating:

> *"the BPO arrangement was externally tendered and* [Provider A] *price was much lower than the incumbent and marginally lower than the third bid, such that they believe the price for the stand alone BPO agreement is a fair value based on market testing."*

150. To corroborate this KPMG obtained the following documents:

150.1 A presentation to Carillion's Major Projects Committee dated 11 November 2013. This included a 'pricing comparison' setting out costs for the provision of the outsourced services between three bidders: the outgoing supplier, Provider A, and another bidder.

150.2 An email from Carillion of 6 January 2014 (which was not included on the 2013 audit file) providing a high-level comparison between some of the contractual amounts payable to Provider A and those payable by other bidders as follows:

	Provider A	Another bidder	The outgoing supplier	
	£m	£m	£m	
Per MPC	174m	173m	232m	Provider A & another bidder included Retained Organisation (RO) costs from 1/1/14 The outgoing supplier excluded RO costs as declined to tender, therefore we have included Provider A RO cost for comparability
Carillion costs	(9)m	(9)m	(9)m	
Remove RO (Jan & Feb 14)	(2)m	(2)m	(2)m	
Provider A Final Contract	163m	162m	221m	

150.3 A document prepared by Carillion and annotated by KPMG, included on the audit file as working paper "*MPC TO CONTRACT RECONCILIATION*" ECO.8. This purported to provide a bridge from the costs as presented in the Major Projects Committee presentation to the costs as specified in the MSA.

151. These documents were relied on to demonstrate that the pricing for the outsourcing services offered by Provider A was comparable to other providers. However, there is no evidence that KPMG:

151.1 corroborated any of the amounts in any of the documents, either to the original tender documents or to any other third party evidence;

151.2 established whether the services offered by the respective tenders were comparable;

151.3 established whether the Exit Fee Contribution was also offered by other bidders on similar terms and how this was accounted for in the comparison;

151.4 considered the impact of the Termination Charges, and equivalent charges from the other bidders;

151.5 established whether other substantive terms and elements of the contracts proposed by the respective bidders were comparable;

151.6 obtained an explanation for the adjustments for the "*Retained Organisation*" costs; or

151.7 obtained clear explanations for, and verification of, the various reconciling items between the amounts in the Major Projects Committee presentation and those in the MSA.

152. The evidence therefore consisted of comparing amounts in internal Carillion documents and then seeking to reconcile those amounts to the MSA, which relied on a series of adjustments, the basis for which remained opaque. As a result, the evidence was plainly insufficient to establish that the Outsourcing Transaction was at fair value. Despite this, KPMG relied on this evidence not only to establish that the Outsourcing Transaction was at fair value but also the Ecopod Transaction. KPMG then further relied on this evidence to conclude that they were therefore not linked, as follows:

> *"this document* [the MPC presentation] *demonstrates that, when taken together, the cost of the BPO and ITO are comparable for* [Provider A] *and* [another bidder]*. As such, we have assessed that the outsourcing agreement was at an arm's length basis, and not unduly reflective of the simultaneous licensing agreement"*

(5) The components combined

153. The combined effect of the components was as follows:

    153.1 Carillion was to obtain outsourcing services from Provider A for which it was to pay certain fixed and variable amounts over ten years depending on service delivery.

    153.2 Carillion transferred certain rights relating to Ecopod, of highly uncertain value, to Provider A.

    153.3 Provider A was to pay Carillion a total of £41 million in late 2013 and 2014.

    153.4 Separately from and in addition to the payments for services described above, through the mechanisms of the Other Charges and the Termination Charge, Carillion was to pay Provider A between £39-46 million over the life of the agreement, the exact sum depending upon whether it continued to term or was terminated early.

154. With a clear understanding of the cashflows under the various components, the commercial substance of them all taken together was straightforward. Provider A would provide services to Carillion for which it would be paid, and would also, as part of an overarching agreement, provide a cash advance to Carillion that would be repaid, either over the lifetime of the contract or on termination, or a combination of both. The substance therefore appeared very similar to the circumstances in 2009; whilst the core outsourcing agreement appeared to be a genuine commercial arrangement, the cash payments made to Carillion did not have a commercial effect that could be understood independently of the outsourcing agreement. The correct accounting treatment would have reflected that reality, such that no revenue should have been recognised and with little or no impact on profit.

155. The circumstances leading up to the conclusion of the MSA and the identity of the counterparty, the obvious questions about the fair value of the Ecopod licence, and the questionable commercial rationale for the Exit Fee Contribution, Termination Charges and Other Charges, amounted together to compelling evidence that the various components of the MSA were linked. The limited procedures performed by KPMG, described above, even if carried out rigorously, would not have supported a conclusion that the components were not linked.

156. KPMG did not perform sufficient audit procedures to assess whether the 2013 Outsourcing Transactions were linked, ultimately relying primarily on uncorroborated representations from management. As a result, KPMG did not obtain sufficient appropriate audit evidence to support their conclusions.

157. There were thus breaches by **the Respondents** of:

157.1 **ISA 200 paragraph 15**, in that the Respondents failed to approach the valuation of the Ecopod Transaction and the commercial substance of all the components of the 2013 Outsourcing Transactions with an adequate degree of professional scepticism;

157.2 **ISA 330 paragraph 5 and 6**, in that the Respondents failed to design and implement audit procedures responsive to the assessed risk of the 2013 Outsourcing Transactions being linked or to assess whether the Ecopod Transaction had been carried out at fair value; and

157.3 **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 treatment of each element of the 2013 Outsourcing Transactions, and whether they were linked.

F. Disclosure in the 2013 financial statements and annual report

(1) Accounting policies and significant judgements

158. The 2013 financial statements disclosed an accounting policy for licence fee income. It stated:

> *"Revenue from the sale of a licence is recognised immediately where an agreement is, in substance, an outright sale. For an outright sale to have occurred, the Group must have a signed non-cancellable contract, have provided the licensee with the rights to freely exploit its contractual rights, have no significant ongoing delivery obligations to perform and have received a fee which is not expected to be subject to material adjustment based on future activity. Where there is an element of contingent revenue to such an agreement, an assessment of the estimated fair value of this future revenue is considered. If this fair value is minimal then the risks and rewards of the agreement are considered to have been transferred in full and therefore the determinable sale income is recognised as revenue immediately, with any contingent revenue recognised as it is earned. Should the contingent revenue be assessed as significant, the sale income is recognised as revenue over a period consistent with the life of the technology or other appropriate measure."*

159. The 2013 financial statements also disclosed the recognition of revenue from licensing sales as a significant accounting judgement, stating:

> *"In respect of licensing revenue a number of judgements are made by management in determining whether the criteria (as stated in the company's accounting policies 'note 1') have been met in order to allow for the full, immediate recognition of the sale income. These judgements may involve the estimation of the fair value of future royalty income receivable, based on which management will assess whether the licence sale revenue should be recognised immediately or spread over a period consistent with the life of the technology or other appropriate measure. The assessment of that future royalty revenue stream relies on forecast data and a number of variables which are outside of Carillion's control, and hence judgemental. The licence revenue recognised in the year (see note 2) related to amounts recognised immediately, given that contingent revenues arising in future periods from these licensing activities were assessed as not significant."*

160. The MSA was a complex, material and unusual transaction for Carillion. The accounting treatment adopted for the various components of the MSA resulted in an increase in reported profit of £41 million and was therefore highly relevant to an understanding of Carillion's 2013 financial statements. Further, the most important judgement made in relation to the recognition of the revenue from the Ecopod licence (which gave rise to the entirety of the licensing revenue in 2013) was determining that the 2013 Outsourcing Transactions were not linked. However, the disclosure focused on whether all the purported profit from the Ecopod Transaction should be recognised immediately or spread over the period of the royalties.

161. The presentation was therefore obviously incomplete and, by omitting reference to the key judgement made, was potentially misleading.

(2) Underlying profit

162. The 2013 financial statements provided amounts for underlying profit after adjusting for "*Non-recurring operating items*". The adjustment largely comprised restructuring costs and resulted in an increase in the amount reported as underlying profit of £44.2 million. No adjustment was made for the non-recurring profit of £41 million recognised as a result of the 2013 Outsourcing Transactions.

163. In working paper "*KPMG Technical Paper*" (ECO.3), KPMG set out the following justification for including the Ecopod Transaction within operating profits and, by implication, not requiring any separate disclosure or adjustment to arrive at underlying profit:

> *"Exploiting this IP forms part of the Group's ordinary business activities (evidenced by inclusion in budgeted results since 2012 and significant on-going negotiation in other territories at the time of writing) and therefore as the recognition criteria have been achieved for the EcoPod agreement this should be recognised as revenue with no separate disclosure.*
>
> *…*
>
> *Management stress that the Group as a whole comprises a large number of individual contracts which have significant gains and losses in both the current and previous periods. They also note, correctly, that items of this scale have historically been included within operating profit with no separate disclosure of the amounts arising from any given contract, nor the contribution of any given line of business, within a segment.*
>
> *In discussions management emphasised that they plan to exploit this IP through additional licence sales in other territories, therefore believe that the accounting to be adopted should mirror that in the software and media sectors, whereby the intangible asset is amortised down over a period of time, rather than "disposing" of an element of that IP with each licence sale. Consequently they do not believe that this transaction should be recognised as a sale of an intangible asset."*

164. However, the Ecopod Transaction was not similar to long term contracts that were the major part of Carillion's "*ordinary business*" and which, by their nature, might show "*significant gains and losses*" in different accounting periods. This comparison did not provide any support for the inclusion of the Ecopod amounts within operating profits, or for not making any specific disclosure.

165. Further, there was no evidence other than management assertion that exploiting the Ecopod intellectual property could reasonably be described as "*part of the Group's ordinary business activities*":

    165.1 there was no evidence of any similar previous transactions, or evidence to support any expectation of similar transactions in the future other than unsupported management representations (as to which KPMG should have exercised an adequate degree of professional scepticism);

165.2 the evidence did not suggest that further exploitation was likely to be significant:

165.2.1 Ecopod had generated operating losses (rather than profits) for Carillion;

165.2.2 Carillion did not anticipate that Provider A would be able to make significant sales in the short or medium term; and

165.2.3 Carillion anticipated that Ecopod would be overtaken by other technology; and

165.3 the only transaction actually concluded was as part of an overarching agreement made with Carillion's provider of outsourced services, who did not appear to have any experience in the relevant sector.

166. Additionally, the amount was much higher than materiality with no costs attributed to it, meaning that it accounted for a very high proportion of profit for the year. This point was noted:

166.1 By the Group Manager in an email dated 24 October 2013 to the Group Senior Manager and Mr Turner:

> *"They should get lawyers to review these arrangements because I am genuinely worried they could be misleading the city with this if not disclosed clearly in the accounts – is this buyer genuinely going to be installing ecopods in India because if not it stinks.* ***25 mil is going to get them to a number which in no way reflects underlying trade, irrespective of ifrs.****" (emphasis added)*

166.2 By the Group Senior Manager in an email of 5 November 2013 to Mr Turner in which the Group Senor Manager stated:

> *"at £25m this item is (13%) of underlying and (20%) of PBT and therefore significant to the overall true, fair and understandable picture of the accounts".*

167. The evidence indicated that the £41 million profit arising from the 2013 Outsourcing Transactions was not representative of underlying performance or likely to be recurring. It was therefore misleading to present it as being part of "*underlying profit*".

(3) Other disclosure in the 2013 financial statements and annual report

168. As noted at paragraphs 82 and 83 above, the 2013 financial statements included certain disclosures related to Ecopod and the Ecopod Transaction.

169. The "*Performance and financial review*" reported the following:

> *"… we have had some success with EcoPod sales. Over the period from 2011 to 2013, Carillion acquired the exclusive worldwide rights to sell and licence EcoPod, a heating system, which combines a range of technologies, including highly efficient cascade boilers with biomass, ground source and gas absorption heat pumps and thermal solar panels to deliver major energy savings. EcoPod generated revenue, including licence fees, of some £36 million in 2013 and has delivered an overall return on our investment of over two times, which compares favourably with the returns we expect from other investment decisions."*

170. Note 2 "*Segmental reporting*" included a footnote to the revenue and profit for "*Support services*" which states:

> *"Includes licensing revenue of £27 million (2012: Nil)."*

171. These disclosures omitted or obscured a number of matters that would have been highly relevant to a reader, as follows:

171.1 that only £9 million of the £36 million revenue from Ecopod arose from installation of the product, with the balance, £27 million, coming from licensing fees;

171.2 that Carillion's installations of the product had resulted in losses, and thus the entirety of the return on Carillion's investment was derived from licence fees;

171.3 that the £27 million licence fee was in turn derived from a single transaction, entered into with Carillion's third-party provider of outsourced back-office functions, at the same point in time, and under the same contract, as the agreement relating to those back-office functions; and

171.4 that the entirety of the £27 million of licensing revenue for Support Services related to Ecopod.

(4) Summary

172. The 2013 financial statements:

172.1 did not disclose any accounting policy on linkage between transactions;

172.2 did not disclose the significant judgement that the 2013 Outsourcing Transactions were not linked;

172.3 contained incomplete and misleading disclosures on underlying profit; and

172.4 contained incomplete and misleading disclosures on the Ecopod Transaction.

173. KPMG did not consider these matters, properly or at all.

174. There were thus breaches by **the Respondents** of **ISA 700 paragraphs 9(b) and 9(f)** in that, in respect of the 2013 Outsourcing Transactions, the Respondents failed to properly evaluate whether Carillion's 2013 financial statements adequately disclosed both the significant accounting policies applied and other information necessary to enable users to understand the effect of the transactions, including the impact of the transactions on Carillion's reported profit.

6. *Sanctions*

A. *Sanctions*

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

175.1 **<u>KPMG</u>**:

175.1.1 A financial sanction of £3,500,000 (taking into account aggravating and mitigating factors) and reduced by 30% for admissions and early disposal, so that the financial sanction payable is £2,450,000.

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

175.1.3 A declaration that the 2013 Statutory Audit Report did not satisfy the *Relevant Requirements*.

175.2 **<u>Mr Turner</u>**:

175.2.1 A financial sanction of £100,000 (taking into account aggravating and mitigating factors) and reduced by 30% for admissions and early disposal, so that the financial sanction payable is £70,000.

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

B. Reasoning

(1) Introduction

176. Paragraph 10 of the FRC's Sanctions Policy (Audit Enforcement Procedure) effective January 2022 (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:

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

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

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

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

177. 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 the wider public interest. Accordingly, *Sanctions* will normally be intended to:

177.1 improve the behaviour or performance of the auditors concerned;

177.2 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;

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

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

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

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

178.1 the full circumstances of the case;

178.2 the seriousness of the breaches;

178.3 proportionality;

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

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

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

(2) Approach

(a) <u>Overview</u>

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

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

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

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

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

179.5 considered discounts for admissions and early disposal.

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

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

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

181.1 The breaches of *Relevant Requirements* in this case relate to a single material group of transactions in one audit year.

181.2 The *Relevant Requirements* breached were ISAs 200, 315, 330, 500, and 700. These are important ISAs designed to ensure the quality and effectiveness of an audit. Several involve basic requirements fundamental to the work of an auditor.

181.3 The most serious breach by the Respondents in this case related to the failure to approach the valuation of the Ecopod Transaction and the commercial substance of all the components of the 2013 Outsourcing Transactions with an adequate degree of professional scepticism. The audit team therefore did not obtain sufficient, appropriate audit evidence to satisfy themselves that management's assessment that the transactions were not linked was appropriate. Further, Mr Turner did not take sufficient steps to challenge management on the most appropriate accounting treatment to ensure a fair presentation in the financial statements.

181.4 In respect of KPMG (but not Mr Turner), the breaches are likely to recur and, indeed, have recurred. The Executive Counsel has found breaches of *Relevant Requirements* against KPMG for their 2016 audit of Carillion including in relation to very similar issues, again, involving Provider A contracts.

181.5 The breaches found in this *Final Settlement Decision Notice* in relation to audit work were not intentional, dishonest, deliberate or reckless.

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

181.7 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.

181.8 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.

181.8.1 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*.

181.8.2 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.

181.8.3 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.

181.8.4 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 Requirement*s.

181.8.5 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 Requirement*s.

181.8.6 In December 2021, a financial sanction of £4.3 million (reduced to £3,110,000 on settlement) and a severe reprimand were agreed for breaches of *Relevant Requirements*.

181.8.7 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.

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

181.8.9 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*.

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

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

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

(c) *Identification of Sanctions*

182. Having assessed the nature, seriousness, gravity and duration of the breaches, Executive Counsel has identified the following combination of *Sanctions* set out at paragraph 175 above as appropriate.

183. 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*

184. The disciplinary record of KPMG has been considered above in determining the seriousness of the breaches. There are no other aggravating factors.

185. There are no applicable aggravating factors in the case of Mr Turner.

186. 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.

187. 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 Turner.

(e) *Adjustments for deterrence*

188. 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*

189. 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 £2,450,000 and that for Mr Turner is reduced to £70,000.

7. Costs

190. The Respondents have agreed to pay Executive Counsel's costs in full in this matter. Such costs shall be paid no later than 28 days after the date of this *Final Settlement Decision Notice*.

Signed:

[Redacted]

JAMIE SYMINGTON
DEPUTY EXECUTIVE COUNSEL

Date: 3 AUGUST 2023