

T6.2 Case study

The Fall of Carillion Plc (UK) - Accounting for Long-Term Contracts

Introduction

Carillion Plc was a British multinational facilities management and construction services company. It was involved in a number of high-profile construction projects, including hospitals, roads, and even part of a high-speed rail line. However, Carillion declared insolvency in January 2018, making it one of the UK's largest corporate failures (see UK Parliament report:

<https://researchbriefings.files.parliament.uk/documents/CBP-8206/CBP-8206.pdf>).

Objectives

1. To examine the complications of accounting for long-term contracts.
2. To explore the ethical and regulatory considerations in financial reporting.
3. To understand the impact of accounting irregularities on various stakeholders.

Background

Founded in 1999, Carillion grew rapidly through a series of acquisitions. It was heavily reliant on large, complex, long-term contracts. Many of these projects were subject to cost overruns and delays, which put significant financial stress on the company. Carillion was accused of aggressive accounting practices, including overestimating the profitability of long-term contracts and recognizing revenue prematurely.

Risky Acquisitions

Carillion had a history of acquiring businesses to spur growth, but as covered in the press, these acquisitions were not always well-integrated. For example, the acquisition of Alfred McAlpine in 2008 was viewed as an aggressive expansion strategy, but it also increased the firm's exposure to the construction market, right before the global financial crisis that followed.

Warning Signs

In July 2017, Carillion announced (a profit warning) that its profits would be hit to the tune of £845 million, and as a consequence its CEO resigned, while its shares lost 70% of their value over the two days that followed. On 29 September 2017, Carillion's half-year financial statements revealed a total hit to the company's worth of £1.2 billion – enough to wipe out the profits from the previous eight years put together. Further, the Carillion pension scheme (a defined-benefit pension scheme with 27,000 members) had an estimated deficit of around £800-900 million.

Reportedly, Carillion was left with just £29m in cash when it collapsed; it owed more than £1.3bn to its banks, including a £790m credit facility and £349m in private placement notes. It also had £630m of "bonding facilities" and £350m of invoice finance, taking the total exposure of its 13 banks above £2bn. Carillion would apparently have been left with a cash shortfall of £3.5m, had it kept operating just a few more days without drawing down further debt facilities. This is the main reason for which the company was liquidated instead of being placed under administration. The latter would entail a moratorium to protect the company from legal actions whilst a survival plan or an orderly wind-down of the company's affairs is being attempted.

Surprisingly, even after this red flag, the company was still awarded more public-sector contracts, raising questions about the effectiveness of government oversight in awarding such contracts. On

the other side, following the insolvency of Carillion, the government had to step in and provide funding in order to maintain public sector services, until suitable alternatives were found.

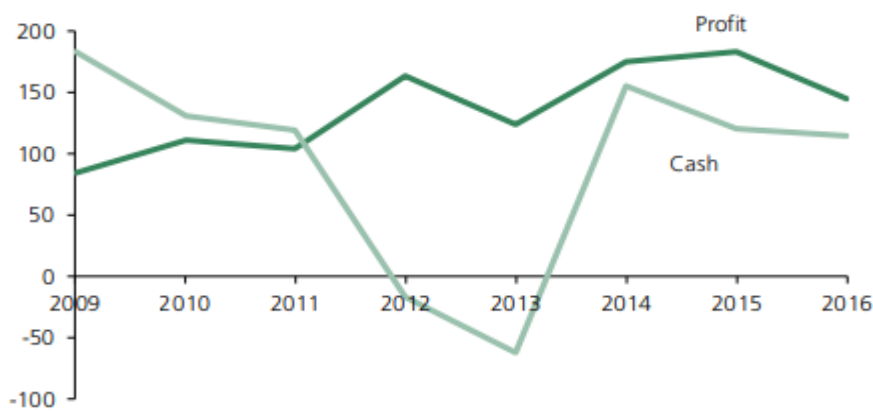
Aggressive bidding and accounting

Carillion has been criticised for its **aggressive bidding and accounting**. 'Aggressive accounting' is the practice of **declaring revenue and profits based on optimistic forecasts** (e.g. about total cost of a long-term project) or recognizing income before the money has actually been made (earned). All is well if the forecasts are correct. But if costs rise and revenues fall (say, because of delays and defects), expected profits turn into actual losses. Because aggressive accounting means declaring profits before receiving the money, it shows up in company accounts as a fall in the actual cash that the company makes compared with the profits it declares. Carillion's accounts are a case in point.

The graph below shows profit and operating cash flows for Carillion, over the period 2009 to 2016.

Declared profit vs cash generated

From operations, £ millions



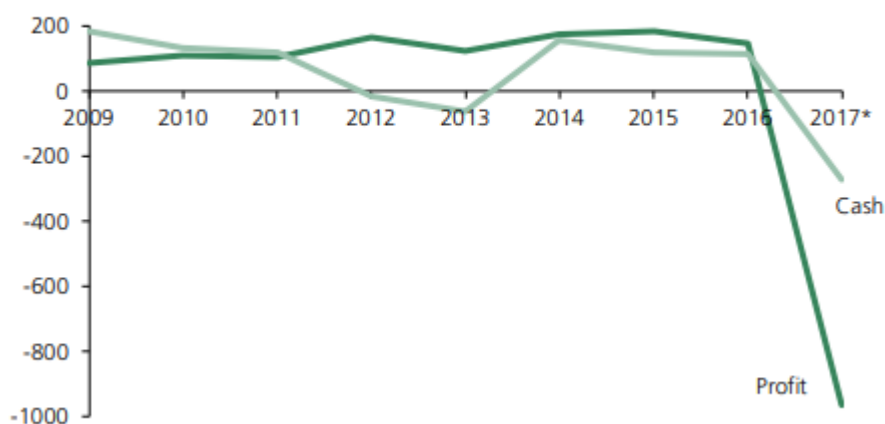
Source: Carillion's annual [financial statements](#)

Note: Profit is group operating profit; Cash is net cash generated from operations

The mismatch between profit and cash flows is aggravated when 2017 is included in the analysis.

Declared profit vs cash generated

From operations, £ millions



Note:

The graph, the pictorial representation of the data, is shown to be very sensitive to scaling. When the scale of the vertical axis increases, the image of the drop of cash for 2012 and 2013 is clearly

reduced in the second graph to accommodate, to keep the proportion right with, the huge drop that followed in 2017.

Dividends paid out

Carillion's aggressive accounting also drove up its borrowing. Dividends illustrate this well.

Dividends are a distribution of profits and there are great pressures on companies to, at the very least, maintain dividend payments. While declared profits can be based on expectations, dividends are paid out in hard cash. When dividends are paid on the basis of expected profits, the company is effectively borrowing money to pay its shareholders.

Dividends vs cash, £ millions

For the year	Cash from operations	Dividends paid	Cash left
2009	184	53.4	130
2010	131	59.1	72
2011	120	64.6	55
2012	-16	70.4	-87
2013	-62	74.6	-137
2014	156	75.7	80
2015	120	76.8	44
2016	116	78.9	37
2016	116	24.5	91
2017 H1*	-270	54.4	-325
Total 2009-2016	748	554	194
Total 2012-2016	313	376	-63
Total 2012-2017*	43	376	-333

Whistleblower Accounts

Interviews with whistleblowers and former employees revealed that the company's precarious financial situation was known internally well before it became public knowledge. Issues such as delayed payments to subcontractors were overlooked, as the company focused on meeting short-term financial objectives.

The Role of Auditors (KPMG)

The audit firm responsible for reviewing Carillion's books came under heavy scrutiny post-collapse for failing to signal the risky accounting tactics and financial instability of the company. The auditors were accused of not performing due diligence, thus putting investors and stakeholders at risk. In September 2023 it was reported in Sky News that KPMG was in advanced talks with regulators about a record fine running into tens of millions of pounds, for failings in its auditing of Carillion. One month later, on October 12, 2023, BBC reported that FRC (the UK audit oversight authority) handed KPMG a record fine of £21m over **"exceptional" failures** in its accounting work for Carillion (<https://www.bbc.com/news/uk-67087757>).

Political Implications

The collapse led to an inquiry at the parliamentary level in the UK, which examined the appropriateness of government procedures in awarding public contracts to private entities. The case led to discussions about whether a reconsideration of this model is needed, given the considerable risks if a large contractor fails.

Accounting Irregularities

Carillion's collapse is often attributed to aggressive accounting methods, particularly in relation to revenue and contract recognition. One major issue was that the company recognized revenue from long-term contracts before the outcomes of these contracts were certain. This approach, known as "overstated revenue," inflated both revenue and profits, and hence equity, misleading investors and other stakeholders about the company's actual financial health. The aggressive accounting methods essentially masked the underlying financial troubles until it was too late. Prematurely recognizing revenue inflates the top-line figure on the income statement, which in turn can hugely inflate profitability metrics. Carillion reportedly engaged in this practice, particularly concerning its construction contracts.

Carillion reportedly used an aggressive form of this accounting technique, often referred to as "percentage-of-completion" accounting. In this approach, revenue is recognized based on the estimated percentage of the contract that has been completed. This becomes problematic if the company overestimates the percentage of completion or the total contract value, leading to inflated revenue figures.

In a hypothetical example below conceived for the purpose of illustrating the case of Carillion:

- Net income is reduced by 1.500.000, restated to 3.500.000, as a result of lower revenue recognized under the percentage of completion method. This also reduces assets (accounts receivable) by the same amount. This reduces net income to a loss of 600.000 from a profit of 900.000 (difference of 1.500.000).
- Unrecognized liabilities (e.g. from underreported contract costs) in the amount of 2.000.000 help turn equity negative.

All this information is depicted in the financial statements below.

Income Statement

Account Item	20X0 Overstated	20X0 Restated
Sales Revenue	5.000.000	3.500.000
Cost of Goods Sold	3.000.000	3.000.000
Gross Profit	2.000.000	500.000
Operating Expenses	1.100.000	1.100.000
Net Income	900.000	-600.000

Balance sheet

Account Item	Dec 31, 20X0 Overstated	Dec 31, 20X0 Restated
Assets	7.000.000	5.500.000
Liabilities	6.000.000	7.000.000
Shareholders' Equity	1.000.000	-1.500.000

Ratios	2017 (Overstated)	2017 (Restated)
Net Profit Margin	18,0%	-17,1%
Return on Assets	12,9%	-10,9%
Return on Equity	90,0%	40,0%

Implications:

1. Net Income: The restated financials show a net loss, contrasting sharply with the net profit in the overstated financials.
2. Shareholders' Equity: The restatement reveals negative equity, because net loss for the year and unrecognized liabilities, signaling insolvency issues.
3. Key Ratios: Profitability ratios turn negative, indicating financial distress.
4. Note that ROE on restated financial statement is positive 40% only because of negative signs for income and equity.

Carillion's collapse serves as a cautionary tale about the importance of ethical accounting practices and transparent financial reporting. Its aggressive accounting practices led to significant financial misrepresentation, with dire consequences for stakeholders and the broader economy.

The case also illustrates the importance of effective audits as well as of effective oversight over audits by pertinent authorities (see Levitt speech).