Private and Confidential

Rt Hon Frank Field MP and Rachel Reeves MP

The Chairs

The Work and Pensions Committee

The Business, Energy and Industrial Strategy Committee

5 April 2018

Re: Joint Select Committee Hearing – Carillion

Dear Mr Field and Ms Reeves

Thank you for your letter dated 20 March 2018. Please find my responses to your questions below.

1. Emma Mercer notified Adam Green on 15 April 2017 that she was concerned with the accounting treatment on construction contracts, citing the use of negative accruals that whilst allowable under international accounting standards, were forbidden by Carillion as a "golden rule". Can you confirm whether KPMG, or the executive directors on the Board, made you aware of any such issues as part of the 2016 audit?

I first became aware of concerns regarding the use of negative accruals shortly after the May Board Meeting and the Annual General Meeting on 3 May 2017 (I cannot recall specifically whether it was the evening of 3 May or the following morning of 4 May). The Chairman, Philip Green, called me to tell me that Mrs Mercer had raised concerns over the use of negative accruals and that Robin Herzberg (Head of Risk) was looking into that as a matter of urgency over the weekend.

KPMG had previously identified the use of one non-material negative accrual in relation to a UK services contract as part of the audit of the 2016 accounts, and this was referred to in KPMG's year-end audit memorandum presented to the Audit Committee on 23 February 2017. In that case, management stated that this was a one-off administrative error and that it had taken immediate and appropriate steps to reinforce the Group policy. In contrast, Mrs Mercer's concerns were that the use of negative accruals appeared wider in the UK Construction business, affecting several construction projects.

2. The process put in place for reviewing these contract positions was initially set-out as a four-stage process, including an independent accounting review. This independent review was subsequently dropped, meaning that the only people involved in reviewing the contracts were those who had already signed-off on the positions in the 2016 accounts. Why was an independent accounting review not deemed necessary?

A Board Meeting was convened on 9 May (within three working days of the issue being raised) specifically in order to discuss the negative accruals issue. At this meeting the Board decided that a working plan should be produced and circulated later that day for a four-stage review (including an independent review by an external firm).

Later that day, there were further discussions involving Board members regarding the appropriate working plan for the accounting review. Our particular concern was that the investigation should be undertaken as urgently as possible while ensuring the process was robust and independent. We considered that a wholly independent review by an external firm (the fourth stage of the proposed review) would involve significant delay. Further, we felt that an appropriate level of independence and interrogation could already be ensured in a three-stage review by KPMG involving an independent team of auditors who had not been involved in the audit of the balance sheet of the UK Construction business for the 2016 year-end.

All members of the Board subsequently agreed to a working plan based on a three-stage review comprising: (i) the internal review (with Mrs Mercer having a key role), (ii) the KPMG review and (iii) the sub-committee chaired by me. If further issues had arisen, we could still have involved an additional external firm at any

time. The three-stage review thoroughly investigated the relevant issues and came to a prompt and reasoned conclusion.

3. The result of the review confirmed that there had been no misstatement in the 2016 accounts but that there had been an override of a key internal control. Who was, therefore, responsible for not identifying that key override of control?

The use of negative accruals was a breach of Carillion's internal reporting guidelines, even though their use can be acceptable under accounting standards. It is ultimately the responsibility of the finance director in the relevant business division (in this case the UK Construction division) and the Group Finance Director to ensure that internal reporting guidelines are followed, to identify where they are breached and, where necessary, to bring that to the attention of the auditors, the Audit Committee and the Board.

Zafar Khan, the then Group Finance Director (and former Group Financial Controller) confirmed at the 9 May 2017 Board Meeting that he had not been aware of the use of negative accruals until it had been "tabled" by Mrs Mercer. I do not know whether his predecessor, Richard Adam, was aware of the use of negative accruals while he was in his role.

4. A lessons-learned session was held following on from this review. The minutes of that session quote you as following:

"he felt it important to identify the underlying issues, which he felt related to a push for cash at period end; a push to win work to grow; inadequate progress reviews on operational contracts, and perhaps also a hold back of bad news, which seemed to be the case on one particular recent contract."

Could you confirm to us which contract you were referring to here and the specifics around that view?

The specific contract I was referring to when I said there was "*perhaps also a hold back of bad news*" was the Royal Liverpool University Hospital contract. There had been a number of significant problems on that project, including an asbestos issue, power supply delays, design issues and a cracked beam. The construction issues on the project then deteriorated further in the second quarter of 2017, in particular, with the discovery of more cracked beams requiring significant remedial work. What I was raising at the meeting was whether the serious consequences of these deteriorations were made clear enough to the Board as soon as they could have been.

With regard to my other comments, these particularly related to the Royal Liverpool University Hospital and Midlands Metropolitan Hospital which by this stage had much more risk than originally forecast.

5. Can you confirm to us what was the trigger for conducting an enhanced contract review across all the Group's key contracts during this period? Was it related to the failings in key controls identified as part of the contract reviews in May?

Around the time of the accounting review relating to the use of negative accruals, a number of the most significant contracts in the business were showing deterioration in revenues, rising costs and delays. Having looked backwards to consider the position on a number of contracts regarding negative accruals for the 2016 financial year, it made sense to undertake a broader, forward-looking review of contract values as well and to extend the audit work required for the half-year results. Management, the Board and the Audit Committee determined that an analysis of the key contracts should therefore be undertaken internally, principally involving Mrs Mercer. This was separate to the usual process of contract monitoring done by management (as described in greater detail in my answer to Q8). While the accounting review relating to the use of negative accruals was not the principal reason for this further review taking place, it was one of the factors feeding into it. This was also something that would be required for the purposes of any potential equity raising, which was starting to be considered in May 2017. As part of that process, the Board asked KPMG to perform certain audit procedures (as described below in my answer to Q6) on management's forward-looking contract review – those combined reviews became what we referred to as the "Enhanced Contract Review".

6. KPMG's report on this review sets out that they conducted, at the Audit Committee's request, "deep dives" on a number of contracts that went "beyond the level of detail that would typically be completed by the audit team". Why did the Audit Committee feel it necessary to extend the level of audit work performed on these contracts?

As stated above, the Audit Committee felt it was important to understand whether judgements applied to major contracts remained appropriate in view of deteriorating revenues and a potential equity raising.

Accordingly, the Audit Committee asked that certain year-end audit procedures be accelerated in relation to those contracts. The most significant and complex contracts were to be subject to an "enhanced" audit beyond what would ordinarily occur in an audit review at the half-year. Fifty-eight contracts (which represented 73% of total group receivables) were therefore subject to review by the audit team on an accelerated basis. The 11 most significant and complex contracts (out of the 58) were subject to a further "enhanced" testing by KPMG major contract specialists who engaged closely with the commercial, operational and contract teams. The major contract specialists also inputted where needed on the other 47 contracts (for example to ensure consistency of approach).

7. The results of the review recommended a provision of £695 million, subsequently increased by management to £845 million. KPMG note that they challenged management to consider whether this presented evidence of a prior period error and that management concluded they were satisfied there was no such error. Were the Audit Committee in agreement with this conclusion?

Yes. Management concluded that each of the changes to the contract positions identified in 2017 related to subsequent events which gave rise to amendments to the judgements and estimates which had been made at the end of 2016, in particular: (i) the Group's decision to withdraw from construction activities in Canada, Qatar and Saudi Arabia was taken subsequent to the publication of the Group's 2016 annual report – as such, any write downs associated with those contracts were triggered by the decision to withdraw; and (ii) certain contracts in the UK construction market had individual challenges which crystallised subsequent to the publication of the Group's 2016 annual report. On that basis, management determined that it did not believe there was a fundamental error in the positions traded in the Group's 2016 accounts.

KPMG's report to the Audit Committee dated 9 July 2017 agreed with management's assessment. The Audit Committee (in the meeting on 9 July 2017) questioned at length the positions set out by management and KPMG with respect to there being no prior period error and it was satisfied with the conclusion reached.

8. The KPMG report also stated that there was a "lack of consistency and guidance around the Group in when to recognise value on claims". Were the Audit Committee not aware of such issues prior to this review? Would such failings not fundamentally compromise the potential accuracy of revenue recognised in the accounts?

I was not aware (nor, to my knowledge, were the other members of the Audit Committee) that there was a "*lack of consistency and guidance around the Group in when to recognise value on claims*" before KPMG's report highlighted it. This was not something that was apparent from the information provided to the Board by senior executive management or from the Company's auditors (who gave positive feedback about the robustness of the Company's financial processes and procedures).

I believe that KPMG's observation was intended to refer to the guidance given to finance/management functions at a contract and business unit level, rather than being a reference to the approach taken to revenue recognition at division and group level by senior executive management. The Audit Committee and the Board relied on the accuracy of the information provided by senior executive management (and the work of the Company's auditors). The key value judgements on significant contracts were made after interaction of junior management with senior executive management through regular and detailed Performance Review Meetings. Senior executive management evaluated the information deriving from the business's many contracts and applied its own judgements to the Group's contracts to ensure consistency. For that reason, I do not believe that KPMG's observation would compromise the accuracy of the revenue recognised in the accounts.

9. Emma Mercer told us in evidence that the positions taken on contracts were "slightly more aggressive" when she returned to the UK, having spent nearly four years in the Canadian part of the business. The Audit Committee papers from February 2017 would appear to support that suggestion, showing that Carillion were trading over £290m of revenue not certified in December 2016, compared with £233m in June 2014. What was your opinion on the aggressiveness of Carillion's trading positions on contracts and whether they had increased over time?

Until mid-2017, I was not aware that Carillion adopted "*slightly more aggressive*" or overly-optimistic accounting in its traded position on contracts or that there had been a material change over time in how that accounting was done. Following the Enhanced Contract Review (referred to in my answers to Q5 to Q7 above) it was clear that some 2017 traded positions were no longer justified which led, in part, to a provision being made in July 2017.

However, I do not believe that the figures for non-certified revenues the Committees refer to in the question pointed to a change to more optimistic accounting. Indeed, Carillion's year-end figures for non-certified trading revenues in its construction business were relatively stable from 2011 to 2015, ranging between a low of £248 million (in 2011) and a high of £264 million (in 2012). In December 2016 the figure was £294 million, but the impact of foreign currency changes accounted for £37 million of the increase from the previous year-end such that the underlying amount was only marginally higher (£257 million) than the figure for 31 December 2015 (£250 million).

10. Michael Jones, who acted as Carillion's internal auditor, told us that his review of contract Peer Reviews showed that in a number of cases, those peer reviews had taken a more pessimistic view of the performance of the contracts. He has subsequently confirmed to us that:

"Our work in July and August 2017 found that 42% of the Peer Reviews undertaken in the period January 2015 to July 2017, which related to the contracts for which a provision was allocated, recommended a forecast EOL margin that was less than that in the Contract Appraisal (the Contract Appraisal takes into account any management adjustments to the site teams' positions). For more than half of these, the adverse variance exceeded £5 million. The differences arising with regard to the November 2016 Peer Reviews relating to Royal Liverpool University Hospital and Midlands Metropolitan Hospital were £53.9m and £16.9m, respectively... We had discussions in August and September 2017 where we shared our findings with the CFO and the Chairman of the Audit Committee as well as with the interim CEO. They expressed surprise that management's reporting procedures had not previously brought to their attention the differences highlighted by the Peer Review process and were concerned these differences did not appear to have been followed up by management."

Do you believe therefore that management were not presenting you with a complete picture of the trading position on key contracts? In light of these reviews, do you still stand by the conclusion reached by management on the enhanced contracts review that there was no prior period error on key contracts?

Mr Jones first raised with me the issue of the variance between the views taken by management and the appraisals made in the peer review in September 2017. I do not know whether Mr Howson and Mr Khan/Mr Adam knew this information at the time and, if so, why it was not shared with us. These issues were also not flagged to the Board or Audit Committee by the Company's internal or external auditors (I also do not know if they were aware of this information before the summer of 2017). With the benefit of hindsight, it would have been helpful for the Audit Committee to have this information so it could have factored it into its challenge of management's judgements.

As to the 2016 year-end, management's view (with which KPMG agreed, based on an audited re-examination of the key contracts) was that the write down was connected to matters in the 2017 financial year and there was no fundamental error in the positions traded in the Group's 2016 accounts.

11. Were you happy with the level of challenge and scrutiny that KPMG offered to your Committee? What steps did your Committee take to guard against familiarity risks arising given KPMG's 19-year stint as auditors?

Generally, I was happy with the level of challenge and scrutiny that KPMG offered to the Audit Committee at the time. The Audit Committee undertook an annual evaluation of the performance of the external auditors before deciding whether to reappoint them. The feedback was that the audit was of a very good quality and that KPMG provided appropriate challenge to management assessments. That being said, the Audit Committee was disappointed that the use of negative accruals that formed part of the accounting review in May 2017 had not been identified in the audit and I anticipated that this would form part of the 2018 evaluation of KPMG's performance following completion of the 2017 year-end audit.

As to familiarity risks, I felt that we guarded against this sufficiently through Carillion's policy that the Lead Audit Partner would be in place for no more than five years and that they could not rotate into a different role in the Carillion team within two years of moving out of those positions.

12. Was there ever serious consideration given to replacing KPMG as external auditors at any point?

We considered the question of whether KPMG should be re-appointed as auditors on an annual basis and as part of that process the Audit Committee would consider the effectiveness and independence of KPMG. The Audit Committee was always open to a change of audit firm if it deemed that to be appropriate.

The Audit Committee report in the 2016 year-end accounts confirmed that the timing of another tender would be kept under review but would comply with regulatory requirements, with it being a possibility that a tender process would be conducted in 2019. The principal reason for not conducting a tender in 2017 was that a new Finance Director had very recently been appointed and so it was considered better to retain KPMG for continuity for that year. In late 2017, I came to the view that we should conduct a retender for statutory auditor in 2018 and was in the process of agreeing that with Justin Read (who was replacing me as Chair of the Audit Committee) and other colleagues when the Company went into liquidation.

13. KPMG's audit fees fell from £1.8m in 2008 to £1.4m in 2016. What was the reasoning behind that?

Statutory audit fees were agreed on a global, annual basis by KPMG and the Audit Committee. As set out in KPMG's letter to the Committees dated 2 February 2018, the audit fees charged by KPMG in the period from 2008 to 2016 were as follows:

- £1.8 million in 2008
- £1.3 million in 2009
- £1.5 million in 2010
- £1.4 million in 2011
- £1.5 million in 2012
- £1.5 million in 2013
- £1.3 million in 2014
- £1.4 million in 2015
- £1.4 million in 2016

The average over this period was £1.46 million. The total audit fees in a particular year would depend on the circumstances of the Group in that year and the number of entities being audited. For example, where there is a significant acquisition meaning there is a requirement to audit new Group companies, it is likely that the audit fees charged will increase prior to the full integration of the acquired company. Although I cannot say for certain because I do not have details of the audit undertaken in 2008, the acquisition of Alfred McAlpine by Carillion was completed in 2008 which was likely a significant part of the higher level of audit fees charged in that year.

14. Were you happy with the quality of internal audit work provided by Deloitte?

Generally, I was happy with the quality of internal audit work provided by Deloitte. I believed that Deloitte's internal audit function was undertaken thoroughly and with a high level of professionalism. The Audit Committee undertook an annual evaluation of the performance of the internal auditors before deciding whether to reappoint them and the feedback was positive.

During the course of 2017, various issues had come to light regarding management and financial controls (as discussed at the 7 June 2017 "lessons learned" session). I have no reason to believe that Deloitte was aware of those issues, but if Deloitte had been I would have expected them to have raised those issues with the Audit Committee.

One area where we decided to add to the scope of Deloitte's work was in mid-2017, when I proposed that the scope of the Internal Audit should be changed to include the identification of negative accruals and the use and reporting of information from peer reviews relevant for contract judgements. The February 2018

Audit Committee was intended to discuss further changes to the Internal Audit scope of work but that meeting did not occur because of the Company's liquidation.

15. How would you describe the culture of Carillion and its Board? Did it alter over time?

The culture of the Board in my view was engaged, honest and collaborative. I felt that the independent Non-Executive Directors operated in an environment where they were able to challenge and support management through constructive debate. I felt that this culture was consistent over time.

In relation to the broader culture of Carillion, the people whom I came across within the Carillion organisation from construction sites to senior management were hard-working and focussed on delivering the best results for the customer. As a Company and Board, we were proud of the values the Company upheld and its commitment to business integrity and sustainability.

There were a number of weaknesses at management and operational level that were identified in June 2017 at the Board's "lessons learned" session. When that became apparent to the Board, we acted swiftly and transparently to identify those issues, their causes and how they could be resolved. Steps were being taken to implement those changes during Mr Cochrane's time as Interim CEO.

16. How would you categorise Richard Adam's approach as Finance Director? How did that compare to Zafar Khan?

My impression of Mr Adam as Finance Director was that he was authoritative and very close to the detail. He exercised tight control over the entire finance function, had extensive influence through the Group and worked closely with Mr Howson as CEO. At times I felt that Mr Adam was defensive in relation to some challenges in Board meetings and I had previously raised my concerns with him to that effect. I believe that he had taken this on board and had made adjustments to his style in response to those criticisms.

Mr Khan was only in his role as Finance Director for a short period of time (around nine months) so he had less time to stamp his style on that position. However, in his time in the job, I felt that Mr Khan was committed to ensuring increased transparency and to doing what he could to bring net debt levels down. Nevertheless, by September 2017 and following discussions with Mr Cochrane, it became clear that Mr Khan was not the right man to take the Company through the restructuring (in particular in the context of needing to engage effectively with financial and other stakeholders).

17. Was there sufficient challenge from the non-executive directors on the Board?

Yes, I believe that there was. The Non-Executive Directors were fully committed to their responsibility of challenging and overseeing the Executive Directors and senior management. Our role was to provide constructive challenge and independent advice in relation to the Group's strategy, performance, risk management, reporting and governance procedures and to hold the Executive Directors to account. I believe firmly that we fulfilled that role to the best of our ability.

18. Could you offer your own thoughts on why Carillion failed, what responsibility you accept for its failure and the decisions you most regret and why?

First, I would like to say that I am deeply saddened by and sorry for the failure of Carillion and the impact that it has had on individuals, employees, customers, suppliers and pensioners. I accept responsibility for the failure of Carillion as one of the Non-Executive Directors on the Board, which was ultimately the body with responsibility for the Company's performance.

I believe that ultimately Carillion failed because the business was unable to secure the short-term funding that it needed so that it could complete its well-advanced plan to restructure. In my view, there was a viable business plan and a good underlying profitable business (based on core UK services) that Carillion could have continued as the legacy of the construction contracts which had caused so much difficulty in 2017 reduced but, unfortunately, management and the Board were unable to secure the support that was needed for that restructure to succeed.

In hindsight, I regret the Company's entry into the contracts which caused so much difficulty in 2017 and I regret that the Company did not manage to reduce net debt sooner.

Please let me know if I can assist any further.

Yours sincerely

Andrew Dougal