Carillion plc

MINUTES OF A MEETING OF THE BOARD OF DIRECTORS

Held at 25 Maddox St., London W1 on Tuesday 23 May 2017 at 2pm

Present:
Mr. P.N. Green Chairman
Mr. K.R. Cochrane (by telephone)
Mr. A.J.H. Dougal
Mrs. A.J. Horner (by telephone)
Mr. R.J. Howson
Mr. Z.I. Khan

In attendance:
Mr. R.F. Tapp Secretary
Mr. D. Arch Stifel (by telephone)
Mr. A. Green
Mr. F.R. Herzberg (by telephone)
Mr. D. Holmes
Mr. P. Meehan KPMG
Mrs. E. Mercer
Mr. T. Perry Morgan Stanley (by telephone)
Mr. C.W.Y. Underhill Slaughter and May (by telephone)
Mr A. Wright KPMG (by telephone)

Minute ACTION
No:

2138 Minutes

The Minutes of the meeting held on 15 May were approved.

The Minutes of the meetings of the Accounting Review Sub-Committee held on 18 May and 22 May were noted.

2139 Accounting Review

The Chairman noted that the meeting would receive an updated report of the work of the Working Group led by Mr. Herzberg, and a report of the work carried out by KPMG, which Mr. Meehan would present.

Mr Herzberg’s Paper

At the Chairman's request, Mr. Herzberg spoke to his paper. He noted the background to his report as described in his paper, and summarised the further investigation work which had been undertaken by the Working Group. In particular he noted that it had:
• Interrogated the accounting system to list all negative accruals and then investigated in detail the material items on this list, being those over £2.5m. This criteria had identified four major projects (Liverpool, Battersea, Aberdeen, and Army 2020) and four smaller contracts where negative accruals over £2.5m existed;
• Prepared information packs for KPMG containing for each project (i) the original recovery plan as at 31 December 2016 (ii) a revised recovery plan as at 31 December 2016 (iii) a reconciliation between the original and revised recovery plans (iv) a range of possible outcomes (v) opportunities for further recovery (vi) probabilities of success for each claim and (vii) supporting documentation
• Met with KPMG and discussed the packs prepared for them;
• Arranged for KPMG to have access to the site teams.

He noted that copies of all documentation issued to KPMG were available to any Board member. However, it was very detailed and it was recommended that they be viewed at the offices at Maddox Street should colleagues so require. In the meantime it had been agreed with Mr. Dougal, as Chairman of the Sub-Committee, that a summary of the revised recovery plans was appropriate documentation for discussion at this stage.

As such, a summary of the revised recovery plans was contained in an appendix to his paper. There remained a trading exposure of £3m on one of the smaller contracts, but this was covered by central provisions.

The Working Group had noted that all the claims were contemplated either at or before 31 December 2016. It was clear that some claims, both against customers and suppliers were at the top end of expectations – in particular Liverpool and Battersea – but they still remained credible.

Mr. Herzberg confirmed that the Paper contained further detailed information requested by the Sub-Committee at its meetings on 18 and 22 May.

Mr. Dougal confirmed that the Paper contained the information requested. There were a number of lessons learned but they were for later consideration: in terms of the resolution of the issue before the Sub-Committee and the Board, everything which the Working Group had identified was contained entirely within the Paper.

Mrs. Horner noted that some of the claims had been described as being at the top-end, and asked for clarification as to what would be felt to be realisable – for example 90% or 50%?

Mr. Herzberg noted that on Liverpool the traded claim was 64% of the ask, and some 75% on Battersea. That said, Aberdeen was at 48% and Carillion had a very good record of recovery, albeit that it may take a while. Mr Howson noted there was no rule of thumb as to what was an appropriate percentage: it was largely subjective. Each strand had its own dynamics and probability of success, and the
dispute resolution process could itself be flawed – as with Taunton where an adjudication was lost, but we were advised to commence a new adjudication coupled with an arbitration to recover.

Mr. Dougal noted that the Liverpool traded claim of 69% could be adjusted to 59% if additional possible claims, not in the official route map, were taken into account. Mr. Cochrane noted that it was clear that all the claims had been in the system at the year-end – that was not in doubt.

There was analysis in the Appendix to the Paper explaining the position at the year-end, which was really important: it was very clear that only the position at the year-end could be accepted, not any subsequent apparent improvement. That posed a different question – the need to be very careful about using facts subsequent to the year-end.

Mr. Cochrane asked for an assurance that the Board was looking at the position only from a year-end lens. In response Mr. Khan noted that all the items were discussed and noted – the Liverpool claims against Crown House, Hoare Lea and Lucien, for example. Mr. Howson noted that things did also develop – in Liverpool, the possible car park had more than doubled in scale to 2000+ spaces.

In reply to the Chairman, Mr. Cochrane confirmed that he was content with the position, noting it was a key position from an audit perspective, and the Chairman noted that management had clearly indicated that the assurance sought by Mr. Cochrane was given.

KPMG Report

Mr. Meehan spoke to the detail of his Paper, which had been circulated. He noted the overall position in the Executive Summary, stressing that the review was performed by different members of the Audit team, who, whilst familiar with Carillion, had not performed the CCS audit under review.

In conclusion, KPMG agreed with management that there were only some £3m of negative accruals without a route to recovery, which was not material in accounting terms. All of the claims had been identified prior to the year-end.

KPMG Response

KPMG concurred with the output of management’s review, and remained satisfied that the profit recognised on construction contracts at 31 December 2016 was appropriate. There was no impact on the 2016 Accounts. However, KPMG would evolve its audit procedures for future periods to respond to the identified override of control.

Mr. Meehan then detailed the work performed, the discussions held with management, including David Holmes, Emma Mercer and the local contract teams, as well as Rob Wardle and Alan Haywood. He noted also the substantive work, in each case as set out in his
Paper, and the documentary evidence proven. He noted that in some cases, where work continued, claims had not been notified to subcontractors in order to avoid difficulties with completing the job, which was understandable.

In the case of Liverpool, he noted that in June the contract papers had identified the claim, and it had been established through discussion that it was going up. He did not know why it had dropped off the papers at the year-end. Mr. Wardle had indicated that the Finance teams had tended to produce a paper sufficient to justify the required number and then stop, rather than including all possible claims.

Finally, he confirmed that KPMG had looked elsewhere in the Group to ensure there was no evidence of the relevant practices beyond construction. In terms of findings, he confirmed that KPMG remained satisfied that the revised contractual positions remained recoverable, albeit challenging, in the context of the associated route maps.

**Review of 2016 Audit Files**

Mr. Meehan then turned to KPMG’s review of the 2016 audit files, noting that KPMG had:

- Revisited the interim site visit minutes to corroborate existing claims;
- Re-reviewed minutes of BURs, MPC and audit completion meetings to consider whether any residual risk in the positions were overlooked;
- Re-reviewed the contractual work performed by the KPMG CCS audit team; and
- Re-reviewed the ledgers for the residual balance sheet captions.

He reiterated that none of the claims in the route maps were new — the vast majority had some form of documentation in KPMG’s files.

He also noted the other audit work KPMG had carried out, noting the £6m balance sheet reclassification in CCS, and that discussions with Karen Booth had identified that in the NGEC signed accounts for 2016, audited by Deloitte, included a £17m (Carillion share £8.5m) negative accruals balance. This provided further context to the negative accruals debate — they are totally permissible from an Accounting Standards perspective. The Carillion golden rule prohibits them to provide consistency and transparency, not because they are erroneous from an accounting perspective.

In conclusion, he summarised KPMG’s finding that they were satisfied that the majority of claims and variations outlined in the revised route maps were considered either as part of existing claims or as part of the contractual end-of-life positions in KPMG’s year-end file. However, it was fair to say that they did not form part of the final position papers as prepared by management and audited by KPMG.
Consideration of control risk

Mr. Meehan then turned to a consideration of control risk. He noted the interviews which had taken place, and discussed his findings, that KPMG was satisfied that the rationale for the postings to negative accruals were to maintain end of life margin on each contract, which is appropriate under IAS11, Construction Contracts. This was predicated on the recovery of the claims, variations and cost savings identified. However, KPMG believed that these claims, variations and cost savings were not clearly communicated to senior management and the audit team. This was reflected in position papers which were not properly updated in the period from October to December 2016.

The core issue appeared to be that the company produced position papers in October in CCS, which were then updated to December rather than produced afresh. In 2016, there were many moving parts.

He did not believe that there was an intent to deceive, but rather was due to incompetence, negligence or sloppy accounting. Responding to Mrs. Horner, he confirmed that this was his view, and that in relation to past years, he had discussed with his two predecessors as KPMG Audit Partners. They had suggested that the so-called golden rule had been introduced as a result of negative accruals in 2008/9. Mr. Howson confirmed that he had not been aware of that: in his experience it had always been a golden rule.

Mrs. Horner said that it seemed weird that it had happened in both CS and CCS. Mr. Khan noted that he had come across other instances but with much smaller numbers and had told people not to do it. Mr. Dougal noted it was important to note that the costs the Position Paper referred to are included in the more detailed Contract Papers: one would have thought that if there were an intention to do something wholly improper, those Contract Papers would have been adjusted too.

Mr. Cochrane noted that Mr. Meehan had not spoken to certain individuals. He found that surprising, noting that in his view KPMG should have spoken to everyone needed and the company should have made arrangements. Mr. Meehan clarified that he had personally spoken to all relevant individuals save for Simon Webb, which had simply not been possible in the time.

Mr. Cochrane reiterated that one of the issues was that in the course of the audit KPMG had spoken only to the accountants, and that they needed to have spoken to the contract leads on all the key contracts.

Mr. Meehan noted again that he had spoken to all save one of the contract leads and would do so as soon as possible.

[Post-meeting note: Mr Meehan was able to speak to Mr Webb later in the day, who confirmed that:
  • he was very much aware of the MEP issues as at 31.12.16 and]
prior
- In October the focus had been more about asbestos and power from the client. By December the power / MEP issue had moved more downstream i.e. recovery from the suppliers
- Whilst he cannot specifically remember Position Papers vs Contract Papers he was very confident that there was no intention to hide any issues
- He is very confident on the recovery route map for MEP, car park, and other items and confirmed all existed at the quantum in the current papers, as at year end.]

Audit approach

Next, Mr. Meehan turned to a consideration of the audit approach, noting that the focus on the end of life margin – a proper focus for the business – meant a focus on profitability rather than the balance sheet. KPMG had seen significant movement between the October and December positions, but which were not properly reflected in the position papers at contract level. They had identified several material debit balances which were centrally reclassified in the balance sheet.

He acknowledged that KPMG’s audit approach should evolve to detect such instances of override of controls in future period, noting the specific responses proposed to deal with the position, which were described in full in his Paper.

Recommendations

Finally, Mr. Meehan drew attention to a number of key recommendations or suggestions going forwards which were set out in full in his paper. These were, of course, a matter for management but the key point was that “one version of the truth” (i.e. detailed contact papers to be in line with the year-end position papers).

There were nine key suggestions, which he described in full. He also noted and explained the Appendix to his Paper.

The Chairman noted that the 7 June Board would consider lessons learnt from the exercise, as well as current year trading.

Conclusions

The focus of the current exercise was to provide comfort as to the year-end position. Mr. Dougal, as Chairman of the Sub-Committee, confirmed that in his view, the conclusions reached by the Working Group and KPMG did give that comfort, subject to the need to speak to Mr. Webb.

Mr. Cochrane indicated that in his view the recommendations or suggestions from KPMG were critical; however, in response to the question of whether we would have been comfortable with this level of recovery at the year-end, he felt that it had been demonstrated that that was the case, and he could also get himself comfortable with that position.
Mrs. Horner confirmed that she had no further questions.

The Chairman asked all colleagues, executives and non-executives, if they had any points to make or questions to ask – none were forthcoming.

As such, the Chairman confirmed that the Board was content that the year-end position was supported by the work which had been carried out and that it noted and agreed KPMG's position that no restatement of the 2016 accounts was needed.

**Next steps**

The Agenda for the meetings of 7 and 8 June were to be finalised.

The Chairman thanked colleagues and advisers.