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 March 2018

Re: Carillion: follow-up questions

Dear Mr Field and Ms Reeves

Thank you for your letter that I received on 26 February 2018. Your letter asked some questions in relation to concerns that I raised in April 2017 which were recorded in the minutes of Carillion Board meetings on 9, 15 and 23 May 2017.

Can you please confirm what you found when you returned to the UK that led you to raise concerns?

The concerns that I raised in mid-April 2017 related to an internal reporting issue arising out of the use of "negative accruals" in Carillion's accounts. So that I can explain what negative accruals are, it may be helpful first to explain simply some of the key issues that arise in accounting for construction contracts.

There is a very significant degree of judgement associated with accounting for construction contracts. In accounting for these contracts one has to use an "end of life" forecast – this means that, in order to account accurately for the revenues and costs associated with that contract, one has to assess constantly where the Company will be at the end of the project in relation to revenue, costs and profitability. At Carillion, we assessed contracts continuously using monthly Performance Review Meetings and forecasts. Reviews would include monitoring performance against a number of measures including progress against program, end of life forecasts, level of receivables and client certification amongst other things. Revenue recognition throughout the life of a contract is based on the contract costs at a point in time and the end of life forecast margin. Guidance for how to recognise that revenue is given not only by accounting standards but also by the Company's internal revenue recognition policy. Major, complex, long-term, construction projects of the kind that Carillion was involved in therefore require detailed judgements to be made by the Operational, Commercial and Finance teams, working in conjunction.

Part of the assessment that the Company has to make when preparing its accounts is the claims it might have against customers, contractors or consultants under the project. As those claims represent potential income on the project they need to be recorded in the internal and external accounts and are relevant to the overall profitability of the contract. A lot of judgement is required with those claims as you need to determine the likelihood of the claims being successful and the amount. This assessment was required to be done in accordance with Carillion's revenue recognition policy.

In accounting for these claims Carillion had a policy (which I considered to be the right approach) that any claims were to be recorded as a separate receivable on the balance sheet as an asset. Negative accruals are where these claims are not recorded on the asset side of the balance sheet but rather are set off against the cost of the project on the liability side. It is, in essence, just a different way of accounting for the same item. This might be acceptable under accounting standards in certain circumstances but it was not permitted by the internal policy at Carillion. The reason that

Carillion had a policy against negative accruals and why I also did not agree with them is because there is a risk that their use can mean that some of the measures we monitor such as percentage of costs complete, receivables by project or the level of uncertified revenue by project are less transparent.

The use of negative accruals first came to my attention in late March on the Royal Liverpool Hospital contract. This gave me concern as the internal reporting was inconsistent with Carillion's internal rules and I wanted to understand how this impacted on our internal reporting of this contract and its performance. I also wanted to understand whether it was limited to the Royal Liverpool Hospital contract and, if not, what effect the use of negative accruals had (if any) on reporting of contract performance within the Construction Division.

I deemed the use of negative accruals as lazy accounting as the project team had not fully documented the claims we were trading despite the fact that they were significantly progressed with the claims strategy.

Was this the "aggressive" trading of contracts you referred to in Q264-265 of your oral evidence?

When I referred in my oral evidence (in response to Q264-Q265) to there being "*slightly more aggressive trading of the contracts than I had previously experienced in the UK before I left*", I was not specifically making reference to the negative accruals but commenting instead about the number and size of contracts where significant judgements were being made in relation to the recognition of uncertified revenue in construction contracts. "Certification" of revenue means that the client signs off on work that has been done or that the client is agreeing to be done. Upon certification, the revenues associated with such work can be recognised with near certainty in the accounts. Some revenue generated on construction contracts will not necessarily have been certified but there may still be valid reasons for that work to be recognised in the accounts. For example, where costs have been incurred on behalf of a customer but before the Company has recovered those costs and there is not necessarily formal agreement in place for those costs. Recognising uncertified revenue can, in certain cases, be wholly uncontentious. For example, where there are technical timing differences on a project or where a client has agreed a change to a contract but has not yet given a document to formalise that change, one has near certainty. In other cases judging how revenue should be recognised is more contentious, such as for claims and variations. In those cases, judgements have to be made by the commercial accountants in the business. Some of those judgements are then reviewed centrally in accordance with an agreed review procedure and some will then also be audited in accordance with audit procedures.

On my return to the UK, my impression was that the judgements being made in relation to the more contentious matters had grown in number and value and had a more optimistic tone than I felt there had been in the UK business when I had previously worked there. That does not mean that those judgements were necessarily wrong nor does it mean that I disagreed with them. It also does not mean that the financial statements or reporting made by the Company was wrong. My feeling was simply that some of the judgements (which are complex to make and highly subjective) were being made in a more optimistic way than previously (i.e. when I left the UK business in 2013 to go on maternity leave).

The link between this point and the negative accruals issue is only that, as noted earlier, the impact of the negative accruals had meant that the level of claims traded was less transparent for management.

In your opinion, what caused the issues you identified to arise?

I assume that this question relates to the internal reporting issue referred to in my answer to the first question above.

I was involved in the Carillion Working Group which worked with KPMG and the Sub-Committee of the Board to review and investigate this issue in May 2017. My role within this team was to evaluate the impact of the negative accruals from a balance sheet perspective. Robin Herzberg's role (as the Group Head of Risk) was to interview individuals and assess what lessons could be drawn from the situation.

The background to this issue arising and the conclusions reached with regard to its causes were set out in the Minutes to the Accounting Review Working Group Sub-Committee on 11 May, 18 May and 22 May, the Minutes of the Board Meetings on 9 May, 15 May and 23 May and the KPMG report to the Accounting Sub-Committee presented to the Board on 23 May.

In the end KPMG concluded their investigation finding that it "*remain[ed] satisfied that the profit recognised on construction contracts at 31 December 2016 [was] appropriate*." That meant that there was no need for a restatement of the accounts for 2016 as a result of this issue.

Were you surprised that no-one else, including the Company's auditors, had picked up on the issues you saw just six weeks into your role in the UK? Why do you think this was the case?

I cannot really say from my position why it was not picked up beyond those proposed improvements that were drawn out and I was not involved in the previous year's audit. KPMG's review did though identify some reasons why they had not picked this issue up in their audit. One reason given was that there was no recent history of write-downs arising from negative accruals. The review that was subsequently conducted (by management and KPMG) identified a number of systems improvements in order to ensure that this kind of issue did not happen again. For example, KPMG suggested that there needed to be "*clear communication of the Group's accounting policies distributed to all relevant employees highlighting the risk associated with negative accruals and [the] potential consequences*." Another reason may have been that the amount of negative accruals had grown and therefore they were more material in March than at December.

Did the information you uncovered lead to the decision for a fuller contract review, which ultimately led to the profit warning in July 2017?

From my position as Finance Director of Carillion Construction Services, and as part of my 90 day plan in my new role, I wanted to understand the position on all of the contracts in my business. Given that I was aware of the negative accruals issue, we had reviewed these looking back to December 2016 but I wanted to look at the current position as well. In addition to this, several of the very significant construction contracts were suffering deteriorating revenues, cost overruns and delay (which may therefore have affected their effective end of life). That deterioration required a closer examination of those contracts to assess whether the judgements that applied to them were still appropriate. So we started work in the management team to review those contracts from that perspective as well.

I kept Mr Howson and Mr Khan up to date with the progress of my review. The decision was subsequently taken by management, the Audit Committee and the Board to expand the review to a broader analysis of the main contracts in the business looking forward (rather than back to the previous financial year). This was in part connected to the proposed equity rights issue that the Board was pursuing. That meant that we extended the forward-looking work we had commenced (that I was referring to above).

In addition, we asked KPMG to perform audit procedures on these reviews and this became the "enhanced review" that we undertook, culminating in the 10 July trading announcement (which was also related to our withdrawal from certain markets in the Middle East and Canada).

Why did you approach Mrs Dawson on 3 May after Mr Howson and Mr Khan had already heard your concerns? Did you consider yourself a whistle-blower?

I approached Mrs Dawson on 3 May because I felt that the use of negative accruals was a potentially important issue and I was not seeing as great a response as I would have expected to see from executive management, being Mr Howson and Mr Khan. My approaching Mrs Dawson was a way to escalate the issue with the executive management, which it achieved. I did not consider myself to be a 'whistle-blower' in any formal sense of the phrase. I did not feel the need to go to an independent hotline or through a formal whistle-blowing process. I could have raised it further to the non-executives if I had not received the traction I wanted, but when I escalated the issue it was dealt with swiftly and seriously, by Mr Howson raising it with the Chairman and then the Board.

Please let me know if I can be of any further assistance.

Yours sincerely

Emma Mercer