3. The collapse of Carillion plc

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This case examines the collapse of Carillion plc, an outsourcing company. It describes how outsourcing became a common business model in the 1990s, how being the lowest cost provider is not by itself a sustainable long-term business strategy, and how optimistic assumptions about the profitability of long-term contracts can lead to financial failure. Carillion provides a rich source of material for exploring a wide range of management, governance, finance and accounting questions. The issues explored in the case include:

- industry structure – the market for construction and facilities management services, the business of outsourcing, especially with public sector customers;
- Carillion's strategy and business model;
- the upsides and downsides of growth through mergers and acquisitions;
- managerial decision-making – agency theory, groupthink and the winner's curse;
- the difficulties in accounting for long-term contracts;
- the role and responsibilities of auditors;
- corporate governance – why good corporate governance is important for preventing agency problems and poor managerial decision-making, and the 'presenting issue' of high executive pay;

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- the 'financialisation thesis' advanced by Greta Krippner, Gerry Davis and others – the increasing influence of financial considerations in the management of large corporations in the late 20th and early 21st centuries.

Guidance on how to write a case analysis can be found in Chapter 1, 'Business cases: what are they, why do we use them and how should you go about doing a case analysis?'.

A teaching note for this case is available to bona fide educators. To request a copy please email a.a.pepper@lse.ac.uk

Introduction

'There are some failures where the ramifications are so enormous that the industry feels as if it's been felled as well. Losing Carillion was a disaster.'[2]

In July 1999, Carillion plc demerged from Tarmac plc to form a construction company specialising in facilities management and construction services. Through a series of mergers and acquisitions the company grew into a multinational group, operating across the UK, Canada and the Middle East. Carillion made most of its revenue (74 per cent or £3.8 billion in 2016) in the UK and the company eventually rose to become the UK's second largest facilities management and construction services business, with government contracts accounting for 33 per cent of its total revenues and 45 per cent of its UK business. The value of these contracts made Carillion the sixth largest strategic supplier to the UK government in 2017. Contracted services included facilities management, catering, road and rail maintenance, accommodation, consultancy and construction. These services were provided to support the armed forces, prisons, transport, hospitals and schools across the UK. In June 2017, the company reported total annual revenues of £5.2 billion and £146.7 million in profit before tax for the year ended 31 December 2016, before paying its highest dividends ever (£55 million).

Just one month later, Carillion issued a profit warning and reduced the value of several major contracts by £845 million. Shortly after this, an additional £200 million was also written off, cancelling out the previous seven years' profits and leaving Carillion with over £405 million in liabilities. Between 7 and 12 July 2017, the share price plummeted from 197p to 57p per share. In that year, Carillion reported debts of over £900 million as well as a pension fund deficit of £587 million (a figure later thought to be understated by an independent pensions consultant, who speculated that the real pension deficit could be closer to £800 million). On 15 January 2018, Carillion was forced into mandatory liquidation because it had 'no real assets left to sell'; by this time its shares were valued at just 14p. At that time Carillion employed around 45,000 people, and as a trusted strategic government supplier, held around 420 UK public sector contracts.

All companies have a natural life cycle, but Carillion's collapse was not natural. Its rapid decline brought into question whether the entity, so strong on paper, had ever had any real substance. In the words of the joint Department of Work and Pensions and Business, Energy and Industrial Strategy parliamentary committees, 'The mystery is not that [Carillion] collapsed, but how it kept going so long.'[3]

Formation

In 1999, Tarmac plc, a British construction company, demerged its construction contracting and facilities management arms to create Carillion plc. Having previously expanded into facilities management and construction services through mergers, Tarmac was hit hard by the housing recession of the early 1990s. To survive the economic downturn, Tarmac's board decided to downsize and to return the company to its roots in heavy building materials. The firm's construction contracting and professional services businesses officially became Carillion plc in July 1999.

As a construction services business, Carillion had to acquire profitable new contracts in order to build scale. Once a contract had been negotiated and signed, it became Carillion's responsibility to ensure that the work was completed within the agreed terms of the contract. Carillion would do this by hiring multiple suppliers and subcontractors to complete the various parts of the project. Once construction was complete, Carillion might also be obliged to provide ongoing facilities management services for the facility in question. For example, after constructing a school Carillion might be contractually obligated to provide such services as catering for pupils, cleaning the school buildings and maintaining the grounds. Carillion's construction services and facilities management obligations varied, depending on the terms of individual contracts. Because of its inheritance from Tarmac, Carillion was immediately responsible for a number of high-profile public projects, including the renovation of the Royal Opera House and transformation of the derelict Bankside Power Station into the famous Tate Modern art gallery. On paper, its business model looked simple but effective.

Over the years that followed, the business grew larger and more complex until the company careered progressively out of control from beneath the feet of its senior management. To understand why Carillion collapsed, we need to go back to the beginning of its corporate story, to take a closer look at Carillion's early years of rapid growth, ask questions about its corporate governance, and examine exactly how its business model was implemented in practice. The story begins by examining a long list of mergers and acquisitions, arguably the start of Carillion's problems.

Mergers and acquisitions

In 2001 Carillion, already specialising in construction contracting, expanded aggressively into facilities management. The board was keen to establish Carillion as a major player in the facilities management industry and therefore implemented an aggressive growth strategy. Carillion's growth was initially achieved through mergers and acquisitions of companies with strategically important areas of specialism in the contracting industry. For example, Carillion added railway maintenance to its portfolio of service offerings by acquiring the remaining 51 per cent share of GT Rail Maintenance it did not already own, creating Carillion Rail in September 2001. This helped the company to bid for large Network Rail contracts. Recognising a connection between its acquisitions and its ability to secure new contracts, Carillion sought to strengthen its service offering and reduce competition by acquiring major rivals. In addition, mergers potentially offered cost savings through scale and synergies.

The first major acquisition was of one of the UK's largest construction and civil engineering companies, Mowlem, which Carillion successfully bought for £350 million in 2006. Acquisitions were typically funded by debt rather than equity, thus increasing the company's gearing. Debt was offset in Carillion's balance sheet by goodwill arising on acquisition. When purchasing a company, the difference between the net value of tangible assets and the actual amount paid is referred to as 'goodwill'. In part, goodwill represents intangible assets, such as brands, know-how and client-contacts. There may also have been a premium for 'strategic fit' between the acquiring and acquired companies. The balance sheet value of goodwill is therefore highly judgemental. The purchase price of Mowlem significantly exceeded the value of its net tangible assets, resulting in a substantial goodwill element of £431 million. Some commentators thought that Carillion had overpaid, but this did not appear to cause much concern to Carillion's management for a number of reasons. First, they regarded the acquisition as a strategic move designed to reduce competition, which it did. Secondly, Carillion's profits that year were not affected. Finally, they were able to persuade the company's financial advisers to capitalise any acquisition premium as goodwill. Given the difficulty in determining how many extra contracts Carillion acquired per year as a direct result of the acquisition, or the exact value of cost savings which it benefited from, it was difficult to say whether the acquisition of Mowlem was a financial success or not.

Emboldened by the increase in revenues and the size of its balance sheet, Carillion continued to make acquisitions. In 2008 it acquired Alfred McAlpine, a major road builder which had constructed over 10 per cent of Britain's motorways, for £565 million. By 2009, Carillion had become one of the UK's largest construction services firms, second only to Balfour Beatty. Next, Carillion set its sights on Eaga, a British supplier of energy efficiency products. Unfortunately, Carillion's purchase of Eaga for £298 million in 2011 resulted in five years of losses worth £260 million, completely wiping out Carillion's cash reserves. Undeterred, in 2014 Carillion sought to become the UK's biggest construction firm by proposing an 'opportunistic' £3 billion merger with Balfour Beatty. Balfour Beatty's board rejected the proposal, suspicious of Carillion's predicted cost savings of at least £175 million a year by 2016. The rejection marked the end of Carillion's strategy of expansion via mergers and acquisitions.

Public finance initiative

Carillion derived a significant proportion of its total revenues from government contracts and, as a company receiving over £100m in revenue per year from public sector contracts, was classified as a 'strategic supplier' to the UK government. In order to understand Carillion's business model, we must first examine the government's position as a major client and provider of contracts to Carillion. The government has a responsibility to provide national infrastructure and public services at the lowest reasonable cost to taxpayers. Since the mid-1980s it has been common for the UK government to achieve this by outsourcing through 'public-private partnership' projects (PPPs). This is known as the Private Finance Initiative (PFI). PPPs are contracts between public sector bodies and construction firms, under which private sector firms take responsibility for the provision of public infrastructure projects and their associated long-term support services, in exchange for a predetermined contract price.

Carillion was able to win a significant number of valuable PPP contracts. It became one of the leading suppliers of rail infrastructure services in the UK, consistently featuring as one of Network Rail's top suppliers. For example, in 2013, Carillion won two contracts worth £122 million for the integration of the new Crossrail service with Network Rail's existing infrastructure. Carillion also won contracts to build some urgently needed and highly specialised public buildings such as the Royal Liverpool and Midland Metropolitan hospitals. They also won contracts with the Ministry of Defence, such as a joint venture contract to support the Army Bases Programme. This involved designing, constructing and providing facilities management services to the Salisbury Plain Training Area and to army bases in Aldershot, work valued at over £1.1 billion. Carillion also managed several local government school meals contracts.

Government contracts are typically awarded through a descending-price or 'Dutch' auction process: contractors bid for projects at the lowest contract price for which they are willing to work, and the company proposing the lowest amount wins the contract, thus guaranteeing the government the best price. Carillion's strategy for securing contracts was to undercut competitors' bids. Though apparently successful, winning Carillion its strategic government supplier status and 450 governmental contracts worth £2 billion, this was not a sound strategy. Government contracts are very price-sensitive, so consistently bidding lower than the next lowest bidder inevitably results in razor thin profit margins. For example, the facilities management services Carillion provided to central government typically had operating margins of around 1 per cent. Though local government contracts were generally more profitable (operating margins of 13–15 per cent), these were offset by several of Carillion's high-profile PPP projects, which incurred significant losses.

One such PPP contract was the Royal Liverpool Hospital, which began haemorrhaging money. The contract, to design and construct the hospital over a five-year period, was signed on 13 December 2013 for a contract price of £235 million. Construction began in February 2014 and the first phase was due to be completed by the end of March 2017. In May 2015, reports of asbestos on the old site led to extensive delays. Nevertheless, a major project status report published in October 2015 estimated a final profit margin of 5.5 per cent, 2 per cent higher than the initial forecast before delays. In November 2016, cracks were discovered in two of the hospital's concrete beams. A further review revealed smaller cracks in six further beams. Richard Howson, Carillion's chief executive, announced that Carillion would fix all the beams at an extra cost to the company of over £20 million, even though he also said that 'those beams would probably never [have failed] in their cracked state'. The director of the hospital company begged to differ, stating five of the eight defective beams could have failed under the load of a fully operational hospital, resulting in an unsafe work environment and potentially causing injury or loss of life. Fixing the problem required three virtually finished floors to be removed to allow new steel beams to be inserted.

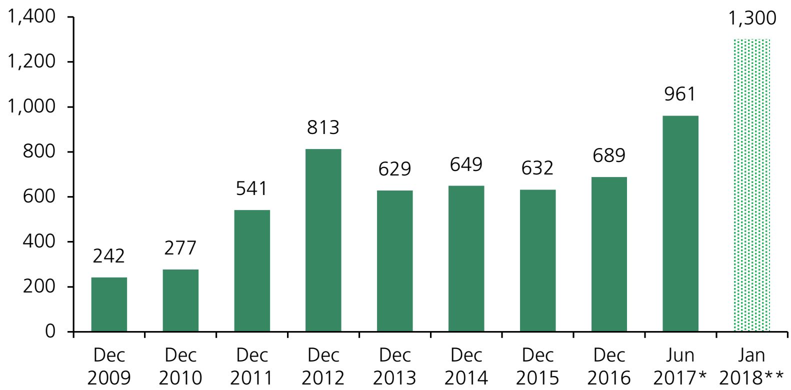
A peer review of the contract in November 2016 concluded that additional costs would result in losses of 12.7 per cent, but Carillion's senior management disagreed and continued to record an expected profit margin of 4.9 per cent. Because of the contract accounting method used by Carillion, this resulted in approximately £53 million in additional revenues being recognised in the 2016 accounts (see further comments below under the heading 'Aggressive accounting'). It is interesting to note that this is the same amount that the company eventually made provision for in its July 2017 profit warning.

The Royal Liverpool Hospital contract's problems did not end with Carillion's eventual insolvency. Further issues were uncovered in the aftermath of Carillion's collapse. A quarter of the hospital's exterior cladding which had been installed by Carillion did not meet fire regulations and had to be replaced. The government had to underwrite all excess costs following the collapse of Carillion. The contract was due to be completed five years late and more than £200 million over budget. Additional costs include over £1 million for essential maintenance of the dilapidated old hospital, which in 2018 suffered eight floods and several related electrical failures.

Rising debt

Over the eight years from December 2009 to January 2018, the total owed by Carillion in loans increased from £242 million to an estimated £1.3 billion – more than five times the value at the beginning of the decade; see Figure 3.1.

Figure 3.1: Carillion's loans: total owed (£ millions) 2009–2018



Source: Mor *et al* (2018) p.15, reproduced under the Open Parliament Licence v3.0.[4] Data from Carillion's annual financial statements; * Interim financial statement for the six months ended 30 June 2017; ** from *Financial Times* (16 Jan 2017)

In December 2015, Standard Life Investments began selling shares in Carillion. In its letter to the Parliamentary Work and Pensions Committee regarding its decision, the investment company cited its concern about the UK's shrinking construction market, Carillion's defective corporate governance, its widening pension deficit, low levels of cash, high dividend pay-outs and even higher levels of debt. In early 2015, UBS claimed that Carillion's total debt levels were higher than the company was stating in its reports, prompting more and more investors to bet against Carillion's shares.

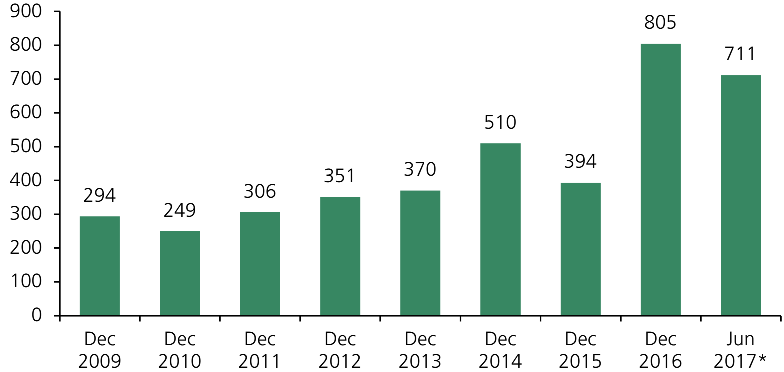
Although Carillion's board acknowledged the company's debt levels were significant, the company's loans seemed to be of little concern to the directors. While giving oral evidence to a parliamentary committee in February 2017, Keith Cochrane, non-executive director from July 2015 and interim chief executive from July 2017, would later reflect that, although the board was aware of shareholders' concerns raised in 2015 regarding the debt position and pension deficit, these were considered as being among the company's 'lesser concerns'. He admitted that it was not until 2016 that the board would rather belatedly recognise the importance of addressing these issues.

Pension schemes

There are two types of occupational pension scheme: defined benefit pension schemes (DBs) and defined contribution schemes (DCs). DB schemes guarantee a certain pay-out at retirement, dependent on the employee's tenure and salary. DC schemes provide a pay-out at retirement based on the amount of money contributed by the employee and the employer, and the success of the investment vehicle used. With a DC pension plan it is the employee's responsibility to ensure they have paid sufficient contributions to purchase an adequate retirement annuity. With a DB scheme it is the employer's responsibility to ensure sufficient funds have been raised to cover pension liabilities owed to their employees on retirement. At any one time, therefore, DB schemes may be in surplus or in deficit, depending on the level of its assets and liabilities. In the UK, private sector occupational pension schemes are typically 'funded', established separately from the sponsor company and held in trust by a body of trustees appointed by the company and pension scheme members.

As well as its own DB pension scheme, which it inherited on the demerger from Tarmac, Carillion also acquired various other pension schemes on its acquisition of Mowlem, Alfred McAlpine and Eaga. All these schemes were in deficit. Under the 'Scheme Specific Funding Regime' introduced in the Pensions Act 2004, trustees must have a statutory funding objective – to ensure there are 'sufficient and appropriate assets to cover their technical provisions' (or liabilities). They must obtain triennial actuarial valuations, and where a scheme is in deficit, they must prepare a recovery plan setting out the steps that will be taken to meet the funding objective, and over what time. A copy of the plan is sent to the Pensions Regulator. The trustees expected the valuation of the various Carillion schemes to have a cumulative deficit of £990 million

Figure 3.2 Carillion's pension deficit (IAS 19) gross of taxation (£ millions)



Source: Mor *et al* (2018) p.22, reproduced under the Open Parliament Licence v3.0.[5]
* Interim financial statement for the six months ended 30 June 2017

as at 31 December 2016. The reason for the increase since 2013 (see Figure 3.2) was the significant reduction in interest rates over those three years. At the end of December 2013, the same schemes were 76 per cent funded. A recovery plan was agreed, under which recovery payments could continue until 2029. The total size of the deficits is shown in Figure 3.2.

In 2007, Richard Adam, Carillion's finance director had refused to invest in the pension schemes, describing them as a waste of money. In April 2009, under Adam's leadership, Carillion closed its DB schemes for future accruals, replacing them with a more cost-effective DC plan. However, it was still required to honour all DB pension entitlements that had accumulated until that date, and the deficits on the various schemes continued to increase as asset values failed to match rising pension liabilities.

Expansion into new markets

Carillion's acquisitions policy had increased the company's debt levels and exhausted its cash reserves. To survive, Carillion desperately needed to increase its profits by securing new contracts. By 2014, the Carillion board had concluded that the company could no longer increase its market share by acquiring further competitors, and that its best option was to expand into new markets. This led to several largely disastrous expansions into Canada, the Caribbean and the Middle East. In the words of Richard Howson, chief executive from January 2012 to July 2017:

> We did not have any money to buy competitors, as we had done in the past. We had to win our work organically. We had to bid and we had to win …[6]

Carillion commenced bidding on a large number of contracts, particularly in the Middle East. Although, according to Carillion's own research, the Dubai market outlook was given a relatively poor rating, in Carillion's 2010 annual report the company stated it would 'target new work selectively' in Dubai and other parts of the United Arab Emirates. Despite a poor understanding of the local property market, Carillion proceeded to aggressively bid for 13 new contracts in Qatar between 2010 and 2014. Although Carillion was largely unsuccessful in winning work in Qatar, the one contract the company was able to secure went on to become notorious as Carillion struggled to adapt to local business practices and to manage the contract profitably. The Msheireb Properties contract involved building hotels, offices and residential buildings in Doha. Although it was due to be completed in 2014, the project remained unfinished in 2018. The directors of Carillion and Msheireb Properties each claimed that the other party owed them £200 million. Carillion's auditors were unable to determine what the reality of the situation was. Even after being sacked as chief executive in July 2017, Richard Howson was retained by the company in a new role devoted solely to negotiating payment for failing contracts in the Middle East. In an interview with the parliamentary committee following Carillion's collapse, Howson expressed relief that Carillion had 'thankfully' only won one construction project in Qatar. In their report, the parliamentary committee concluded that:

> …[Carillion's] expansions into overseas markets were driven by optimism rather than any strategic expertise. Carillion's directors blamed a few rogue contracts in alien business environments, such as with Msheireb Properties in Qatar, for the company's demise. But if they had had their way, they would have won 13 contracts in that country.[7]

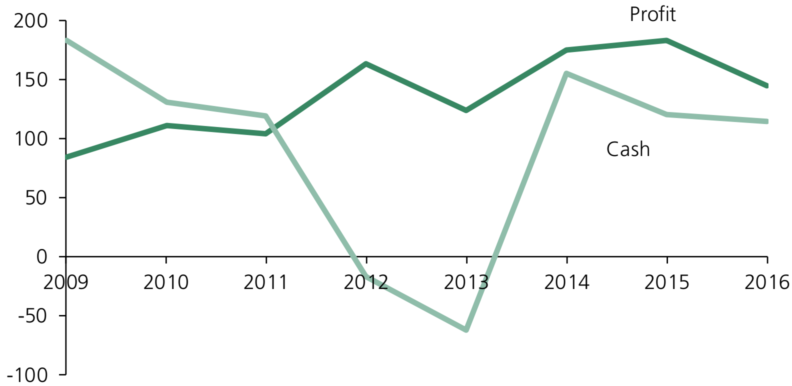
Aggressive accounting

Accounting for construction contracts is inherently difficult as, under the accrual basis of accounting, revenues are accounted for when they are earned rather than received. This means that construction companies are able to account for future revenues on long-term contracts at the start of a project rather than when cash is received and expenditure incurred. To accomplish this, construction companies typically deduct forecast costs from predicted revenues in order to determine profits. However, when a construction project is not due to be completed for many years, the difficulties in assessing how far from completion the project is and what costs will be incurred in future make profit recognition a matter of judgement and often highly subjective. It is also a requirement that losses should be recognised in the accounts when they are first anticipated.

According to board minutes, Andrew Dougal, chair of the audit committee, identified a reluctance on the part of management to acknowledge the losses incurred on the major Royal Liverpool Hospital project. In an August 2017 board meeting, Keith Cochrane also observed that long-serving Carillion staff tended to adopt a rather cavalier attitude towards profit recognition. Andrew Dougal described the finance director, Richard Adam, as 'defensive in relation to some challenges in board meetings', and as someone who 'exercised tight control over the entire finance function, [and] had extensive influence throughout the Group'. Nevertheless, the non-executive directors failed to challenge Carillion's accounting and risk management process.[8]

Carillion was widely criticised for its aggressive accounting. Aggressive accounting is the practice of declaring revenue and profits based on optimistic forecasts, before the money has actually been made. 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 shown in Figure 3.3 are a case in point.

Figure 3.3: Declared profit vs cash generated, from operations (£ millions)



Mor *et al* (2018) p.17, reproduced under the Open Parliament Licence v3.0[9]

Richard Adam's decision to leave the company in 2016, before problems began to emerge in 2017, is perhaps significant. He received a final payment of £1.1 million in December 2016. His decision to immediately offload his shares after leaving is also noteworthy. He sold all his shares on the day the 2016 accounts were published, then cashed in his 2014 long-term performance award on the day that it matured in May 2017. In total, he profited by an amount of £776,000 between March 2017 and May 2017, before the share price fell to 57p in mid-July.

Dividends

Despite Carillion's ever increasing debt levels and pension scheme deficits, dividend payments increased every year from the company's inception in 1999. The board announced that dividend payments were increasing in line with earnings per share. Nevertheless, cash from operations and profits varied significantly between 2011 and 2016. In both 2012 and 2013, operational cash flow was negative as construction volumes decreased. However, despite the net cash outflow, dividends continued to be paid. Carillion's first profit warning was issued in July 2017, yet its highest dividends of over £55 million were paid just one month prior to this on 9 June 2017. In January 2017, Zafar Khan, the new finance director, proposed withholding the June dividend payment in order to reduce debt and conserve cash, but faced strong opposition from other board members, and was eventually over-ruled. Andrew Dougal, chair of the audit committee, and Keith Cochrane, then senior independent non-executive director and later interim chief executive, worried about the message that withholding dividends would send to the market. Some investors, such as BlackRock, made investment decisions on a passive basis, using tracking indices. These indices are reactive to events such as the suspension of dividends and significant falls in share price, which trigger an automatic obligation to sell shares. Withholding or reducing dividends would have been likely to cause a fall in the share price, triggering automatic selling. However, a number of active investors saw high levels of dividend payments as red flags and chose to sell their shares. In their letter to the parliamentary committee which examined the collapse of Carillion, Standard Life Aberdeen cited 'unsustainable dividends' as one of many reasons why they chose to divest from Carillion in December 2015.[10] They believed it was indicative of Carillion's failure to manage its debt levels in favour of paying dividends. The board rejected the idea that dividends were prioritised over other financial obligations. Richard Adam claimed that Carillion's dividends policy 'balanced the needs of many stakeholders', including pensioners, staff and shareholders.[11] Nevertheless, between 2011 and 2016, while Carillion made only £246 million in pension scheme deficit recovery payments, it paid dividends of £441 million. Richard Adam argued that dividends increased by only 12 per cent during this period, while pension payments increased by 50 per cent. However, during his tenure as finance director, deficit recovery payments increased by only 1 per cent, while dividend payments rose substantially.

The Carillion board clearly took pride in the company's dividend track record and upheld it in spite of the company's erratic financial performance. Many commentators have subsequently argued that this showed scant regard for other stakeholders or the sustainability and long-term future of the company.

Board of directors

According to the UK Corporate Governance Code, the 'underlying principles of good governance [are] accountability, transparency, probity and a focus on the sustainable success of an entity over the longer term'.[12] By this standard Carillion lacked meaningful corporate governance. The chief executive of the Insolvency Service, Sarah Albon, remarked that the company's 'incredibly poor standards' made it difficult to pin down even simple information, such as an up-to-date list of directors.[13] In his presentation to the board on 22 August 2017, Keith Cochrane identified 'continued challenges in quality, accessibility and integrity of data, particularly profitability at contract level'.[14] While conducting a strategic review of Carillion, EY quickly identified a 'lack of accountability … professionalism and expertise', as well as an 'inward looking culture' of 'non-compliance'.[15] It is the responsibility of a company's board to govern the practices which determine its culture. Something appears to have gone wrong.

Before July 2017, the board consisted of seven members, including the chief executive, finance director and five non-executive directors. The executive directors were Richard Howson (chief executive) and Zafar Khan (finance director). Non-executives were Philip Green (chair), Keith Cochrane, Andrew

Dougal, Alison Horner and Baroness Morgan of Huyton. By the time that the company collapsed Richard Howson and Zafar Khan had been replaced by Keith Cochrane and Emma Mercer respectively. With the exception of Emma Mercer and Zafar Khan, none of the board members seemed to grasp the reality of Carillion's financial situation even after it had failed. The non-executive directors, who were responsible for scrutinising executive management's decisions, appeared to do little to challenge the board.

Richard Howson and Philip Green both underestimated the challenges facing Carillion. In one interview, Mr Howson claimed that 'but for a few very challenging contracts, predominantly in the Oman and one in Qatar, … Carillion would have survived.'[16] He further argued that 'the business was in a sustainable position' based on the support it was receiving from banks. Even after being stripped of his role as chief executive, he appeared to remain convinced of his own effectiveness. Philip Green seemed to be equally misguided. Even as the company was collapsing on Wednesday 5 July 2017, just five days before the profit warning on Monday 10 July, in which Carillion announced a write-down of £845 million, the Carillion board minutes recorded:

> In conclusion, the Chairman noted that work continued toward a positive and upbeat announcement for Monday, focusing on the strength of the business as a compelling and attractive proposition … [17]

In the words of the parliamentary committee, 'it is difficult to believe the Chairman was not aware of the seriousness of the situation, but equally difficult to comprehend his [unerringly optimistic] assessment if he was.'[18]

Keith Cochrane was appointed senior independent non-executive director in July 2016. He already had extensive board-level experience, but soon seemed to adapt to the Carillion board's culture of passive optimism. Although aware of shareholder concerns about the pensions deficit and rising debt, the board failed to pursue these issues until the first profit warning. Mr Cochrane claimed that he challenged executives 'in an appropriate manner', and believed there was 'no basis' in 2016 for 'not accepting the view that management put forward'. In an interview post-liquidation, Mr Cochrane asked himself 'should the board have been asking further, more probing questions?', but even with hindsight, could only concede 'perhaps'.[19] After Richard Howson was removed from his role as chief executive in July 2017, Keith Cochrane was asked to take over as interim chief executive until a permanent CEO could be found. During his period of tenure, he gave 'limited and vague' answers to 'fairly fundamental questions', thus reinforcing external shareholders' concerns, and exacerbating the selling of shares. A new CEO was scheduled to join the company in January 2018, but by this time Carillion would already be in liquidation.

The other non-executive directors claimed that they were effective in their roles. 'We challenged; we probed; we asked', said Philip Green, citing the company's level of debt in 2016 and 2017 as an example. 'The board consistently challenged management on debt, and management then developed a so-called self-help plan to reduce debt.'[20] However, the debt actually rose from £689 million to £961 million over the same period. Mr Green also referenced the non-executive directors' challenges regarding contract mismanagement, although he later named large contract mismanagement as a 'very significant factor' in Carillion's collapse. Former Carillion shareholder Murdo Murchison of Kiltearn Partners questioned whether the non-executive directors exercised 'any effective check on the executive management team'. Non-executive directors are vital in challenging a company's risk management and strategy, but as Mr Murchison suggested 'it appears that they were hoodwinked as much as anybody else'.[21]

Remuneration committee

Carillion's remuneration committee (RemCo) was responsible for determining senior executive salaries, bonuses and share awards. RemCos typically investigate the remuneration for particular jobs within an industry, then set their own remuneration levels for equivalent jobs in the company. According to the chair of Carillion's RemCo, Alison Horner, the company's executive remuneration policy was to pay the industry median. Carillion commissioned Deloitte to carry out a pay benchmarking analysis for this purpose in 2015. Their research suggested that Carillion's chief executive's remuneration package was lower than average. To correct this apparent inconsistency, the RemCo agreed to raise Richard Howson's salary by 8 per cent in 2015 and 9 per cent in 2016. As such, Richard Howson's basic salary increased from some £1.1million up to £1.5million by 2016. Other board members also received pay rises based on the benchmarking exercise. For example, Philip Green, chair of the board, received a 10 per cent increase in the amount of his remuneration from £193,000 to £215,000. At the same time Carillion's workforce received only a 2 per cent pay increase in 2016.

In a meeting in March 2015, some executives expressed concerns that their bonuses might be clawed back because of declining profits and said that any such decision should not include 'retrospective judgements on views taken on contracts in good faith'. Nevertheless, the RemCo went ahead to approve potential bonuses for senior executives of up to 100 per cent of basic pay. For example, Richard Howson was awarded a bonus of £245,000 (37 per cent of his salary) in 2016 despite meeting none of his financial performance targets.

The RemCo failed to reclaim bonuses as Carillion's situation deteriorated. Clawback terms had been introduced in 2015, but the terms were defined in such a way that the RemCo was not able to recoup bonuses even at the time of the £845 million write-down in July 2017. In September 2017, the RemCo briefly considered asking directors to return their bonuses, but failed to make the case for the return of bonuses even as the company collapsed.

External auditors

One of the noteworthy features of the Carillion case is that all of the Big 4 auditing and accounting firms were involved with the company in some way. KPMG were Carillion's external auditors. Deloitte had a contract to provide internal audit services. EY were Carillion's external financial advisers for the six-month period prior to the company's failure. PricewaterhouseCoopers were appointed as special managers in the company's liquidation.

Although it is the directors of a company who are responsible for producing its annual financial statements, it is the external auditor's responsibility to confirm the validity of these documents and flag up any evidence of misinformation. KPMG served as the Carillion's external auditors from the company's formation in 1999 until it was forced into liquidation in 2018. Some commentators argue that such long relationships between companies and auditors cast doubt over the auditor's impartiality and objectivity. KPMG eventually accepted that in Carillion's case that the length of the relationship was too long to be impartial.

The subsequent review of Carillion's accounts revealed that the external auditors could have raised concerns for any number of reasons. For example, at no stage was there an impairment charge in respect of goodwill carried in Carillion's accounts. This seems hard to justify in the case of the Eaga acquisition, which resulted in the creation of goodwill of £330 million, but was followed by five consecutive years of losses.

Internal auditors

Carillion outsourced its internal auditing services to Deloitte. Carillion used two internal processes to verify margins on projects: first, through monthly project review meetings (PRMs), at which management appraised contracts and made reasonable adjustments; second, by peer reviews, whereby an external party conducted a similar assessment. Between July and August 2017, Deloitte reviewed the peer reviews for contracts from January 2015 to July 2017. They found that internal PRM appraisals generally reported higher profit margins than peer reviews. While peer reviews did sometimes recommend higher margins than the PRM appraisals (14 per cent of cases), management recommended higher margins than peer reviews on three times as many occasions (42 per cent of cases). The impact on the accounts was significant, as the PRM values were included in annual reports. In the case of the Royal Liverpool University Hospital contract, Carillion's 2016 report and accounts recognised an additional £53 million in profits compared with the peer review, which proposed losses of 12.7 per cent rather than a profit margin of 4.9 per cent. Carillion's July 2017 profit warning would later include a provision of £53 million against the same contract. Andrew Dougal, chair of Carillion's audit committee, expressed concern about these variances when they were first revealed to him, but this happened too late for the audit committee to avert the crisis.

Collapse

The retirement in December 2016 of Richard Adam, the 'architect of Carillion's aggressive accounting policies' according to the parliamentary committee, marked the beginning of the end for Carillion. The company issued its first profit warning on 10 July 2017, announcing it would reduce the value of several major contracts by £845 million. The announcement was unexpected, given Carillion had paid its highest ever dividends just one month before. An additional £200 million was subsequently written off, cancelling out profits for the last seven years and leaving Carillion with £405 million in liabilities. Borrowing rose to £961 million, goodwill on Carillion's balance sheet was reduced by £134 million, and its level of working capital fell to a dangerously low level. Between 7 July and 12 July 2017, the share price plummeted from 197p to 57p. By 15 January 2018, when Carillion was forced into liquidation, its shares were valued at only 14p.

At the time of its collapse, Carillion was responsible for providing essential public services to the UK's NHS, national defence, education, energy and prison sectors, all of which were left vulnerable given the speed of Carillion's demise. In particular, two urgently needed hospitals, the Midland Metropolitan Hospital and the Royal Liverpool, had to be rescued by the government. Carillion's supply chain included hundreds of small companies, many of which were placed in a perilous financial position because of extended credit terms imposed by Carillion and the non-payment of debts. The eventual liquidation of the construction group raised big questions about outsourcing, bank lending, governance and auditing. MPs singled out a number of parties who played a role in the demise of the outsourcing firm.

The politicians – from the joint inquiry by the Business, Energy and Industrial Strategy Committee, and Work and Pensions Committee – said the collapse of Carillion was a 'story of recklessness, hubris and greed', and pulled no punches in their findings as to what led to the firm's failure, which put 20,000 jobs at risk. Carillion's board of directors bore the brunt of the responsibility, the report of the joint parliamentary committee found, but many others were involved in the behaviour that ultimately pushed the company over the edge.

Preparing the case

In preparing the case analysis you might like to consider three specific questions in particular:

1. *Business model.* Explain Carillion's business model in the light of transaction cost economics, Porter's generic business strategies and the resource-based view of the firm. You should focus primarily on Carillion's facilities management (support services) and public-private partnership projects businesses.

2. *Managerial decision-making*. What insights can be gained from the literature on organisational decision-making on the activities of Carillion's board of directors, senior management team and auditors? You should base your analysis primarily on evidence contained in the case documentation, rather than speculating about what may or may not have taken place.
3. *Case analysis*. To what extent is the formation, growth and eventual collapse of Carillion explainable in terms of the 'financialisation thesis'?[22]

Further reading

Barney, J. (1991) 'Firm resources and sustained competitive advantage'. *Journal of Management,* vol. 17, no. 1, pp. 99–120. https://doi.org/10.1177/014920639101700108

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Janis, I. L. (1982) *Groupthink*. 2nd ed. Boston, MA: Houghton Mifflin.

Thaler, R. H. (1992) *The Winner's Curse: Paradoxes and Anomalies of Economic Life*. New York: The Free Press.

References

1 The case was written by Lauren Oddoye under the supervision of Professor Alexander Pepper.

2 Rogers, D. (2018) 'Carillion analysis: the fall of the titan'. Building. https://perma.cc/42GJ-HCNB

3 House of Commons (2018) 'Second Joint report from Business, Energy and Industrial Strategy and Work and Pensions Committees', HC 769, p.16, paragraph 14. https://publications.parliament.uk/pa/cm201719/cmselect/cmworpen/769/769.pdf

4 Mor, Federico; Conway, Lorraine; Thurley, Djuna and Booth, Lorna (2018) 'The Collapse of Carillion', House of Commons Library Briefing Paper, Number 8206,14 March, p.15. https://researchbriefings.files.parliament.uk/documents/CBP-8206/CBP-8206.pdf. Figure reproduced under the Open Parliament Licence v3.0. https://www.parliament.uk/site-information/copyright-parliament/open-parliament-licence/

5 Mor *et al* (2018), p.22. See Note 4 licence information.

[6] House of Commons (2018) HC 769 p.15. paragraph 10.

[7] House of Commons (2018) HC 769, p.16, paragraph 14.

[8] House of Commons (2018) HC 769, p.46, paragraph 103.

[9] Mor *et al* (2018), p.17. See Note 4 for licence information.

[10] House of Commons (2018) HC 769, p.18, paragraph 19.

[11] House of Commons (2018) HC 769, p.18, paragraph 18.

[12] House of Commons (2018) HC 769. p.26, paragraph 44.

[13] House of Commons (2018) HC 769. p.27, paragraph 47.

[14] House of Commons (2018) HC 769. p.27, paragraph 46.

[15] House of Commons (2018) HC 769. p.27, paragraph 45.

[16] House of Commons (2018) HC 769. p.28, paragraph 51.

[17] House of Commons (2018) HC 769. p.31, paragraph 62.

[18] House of Commons (2018) HC 769. p.31, paragraph 62.

[19] House of Commons (2018) HC 769. p.29, paragraph 54.

[20] House of Commons (2018) HC 769. p.30, paragraph 58.

[21] House of Commons (2018) HC 769. p.30, paragraph 58.

[22] See Krippner, G. R. (2005) 'The Financialization of the American Economy.' *Socio-Economic Review*, vol. 3, no. 2, pp. 173–208; and Davis, G.F. (2009) *Managed by Markets: How Finance Re-Shaped America*. Oxford: Oxford University Press.