

FRC fines KPMG for the Carillion collapse (Lecture A844 – 10.41 minutes)

On 12 October 2023, the FRC announced that they had issued sanctions against KPMG LLP, KPMG Audit PLC and two former partners. These sanctions were in relation to the audit of Carillion PLC ('Carillion'), a company which collapsed and sent shock waves through the business community.

1.1 Background

Carillion was a multinational construction and facilities management company based in Wolverhampton, in the UK. Over the years the company was very successful, and its logo was often seen hanging at the front of large construction sites. The company was not very old, despite its success, having been founded in 1999, so in total lasted some 18 years before its demise in January 2018.

The company's demise caused significant cost to not only the taxpayer, but also to investors, pension holders and employees. The FRC imposed record fines on KPMG due to significant failings in the audit work carried out on Carillion – a problem that seems to keep cropping up time and time again of late.

KPMG were the auditors of Carillion and its group companies for the financial years 2014, 2015 and 2016. In each of these years, KPMG expressed an unmodified (unqualified) audit opinion on those financial statements stating that the financial statements gave a true and fair view of the state of Carillion's affairs. KPMG's auditor's report for the financial year 2016 was dated 1 March 2017 and in July and September 2017, Carillion announced expected provisions totalling £1.045 billion. These losses primarily arose from expected losses on a number of its construction contracts and there was a goodwill impairment charge of £134 million. This was effectively the start of some colossal problems that would eventually lead to the collapse of the company.

1.2 FRC investigation

The FRC stated that their investigation was '*... exceptionally complex and required the analysis of a very substantial volume of information and documents.*' During the investigation, the FRC noted an '*... unusually large number of breaches of Relevant Requirements.*'

In their investigation, the FRC concluded that the breaches found contributed to Carillion's eventual demise. The company was not subject to rigorous, comprehensive and reliable audits and in the 2016 audit, the work on going concern and Carillion's financial position was deemed to be 'seriously deficient'. Both KPMG and the audit partner, Mr Peter Meehan, failed to respond to numerous indicators that the company's core operations had become loss-making and that it was reliant on short-term and unsustainable measures to support its cash flow.

Other deficiencies in the audit work included:

- A failure to gather sufficient appropriate audit evidence to enable a conclusion to be formed that the financial statements gave a true and fair view.
- A failure to consider (adequately or at all) the implications for the audit evidence suggesting that Carillion's accounting may have been incorrect or unreliable.
- A failure to conduct its audit work with a suitable degree of professional scepticism.
- A failure to challenge management's judgements and estimates, even when those judgements and estimates appeared unreasonable and/or appeared to be inconsistent with accounting standards and might have suggested management bias.
- Other breaches were found in respect of Carillion's reported debt and its status as a going concern in 2016, including consideration of Carillion's use of a supply chain finance facility.
- A number of other discrete areas were found to contain deficiencies, such as in the 2016 pension liability and the testing for goodwill impairment.

During the investigation, it became apparent that Carillion was an important client for both KPMG and key members of the audit engagement team for the years in which the firm carried out the audit. This created an ethical threat to the firm's and the team's independence and objectivity. Such threats can result in the audit engagement team 'turning a blind eye' to transactions or events which may need further challenge or scrutiny. The FRC concluded that in a number of instances, both Mr Meehan and other members of the audit engagement team did not adopt a rigorous and robust approach. They simply accepted the information concerning the financial statements that was presented to them and which suited Carillion's management.

The FRC also found that in the 2016 audit, Mr Meehan and KPMG failed to ensure that the audit engagement was adequately managed and supervised. For example, audit procedures in a number of areas were not completed until more than six weeks **after** (yes, after!) the date the auditor's report had been signed. Records of the preparation and review of working papers were not only deemed to be unreliable, but, in some cases, misleading. This meant that Mr Meehan did not have a suitable basis to be satisfied that the audit opinion provided in the 2016 audit was, in fact, appropriate.

But that was not the end of the story ...

Another audit engagement partner, Darren Turner, was responsible for the audit of Carillion for the financial year ended 2013.

The FRC carried out a review of the audit work performed on the 2013 financial statements, in particular in respect of transactions entered into by Carillion in 2013 that involved changing its provider of outsourced IT services and business process services.

At the same time as finalising the contracts for those services, Carillion finalised other agreements with the same counterparty that involved the assignment of certain intellectual property rights in exchange for a significant sum plus 'exit fees' payable to the former

outsourcing provider. These transactions were treated as being independent of each other in Carillion's financial statements, contributing to a significant increase in Carillion's reported profit for 2013.

The FRC noted that a key failing by KPMG and Mr Turner was that they failed to obtain sufficient appropriate audit evidence concerning the accounting treatment of these transactions (i.e. whether the accounting was correct).

Both KPMG and Mr Turner:

- did not approach the audit of these transactions with a sufficient level of professional scepticism (i.e. challenging management's accounting treatment);
- failed to consider and respond to the risk of fraud;
- failed to obtain sufficient appropriate audit evidence concerning the accounting treatment adopted; and
- failed to identify that the disclosures in the 2013 financial statements about these transactions may be misleading.

It should be noted that the FRC also concluded that the breaches by KPMG Audit PLC and Mr Turner were not deemed to be intentional, dishonest, deliberate or reckless.

1.3 Sanctions

The FRC had two lots of sanctions to arrive at: one in respect of KPMG LLP and Mr Meehan and the second in respect of KPMG Audit PLC and Mr Turner.

Decision 1: KPMG LLP

The FRC imposed the following sanctions on KPMG LLP:

- A financial sanction of £26.5 million. This was reduced by 30% to £18.550 million on the grounds of the firm's co-operation and admissions. The firm also received a severe reprimand.
- A declaration that the auditor's reports signed on behalf of the firm did not satisfy the Relevant Requirements.
- An order requiring KPMG LLP to take remedial action to prevent these breaches reoccurring. This includes evaluating and reporting as to whether the measures taken by the firm since 2017 are sufficient in this respect.

Decision 1: Mr Meehan

The FRC imposed the following sanctions on Mr Meehan:

- A financial sanction of £500,000. This was reduced by 30% to £350,000 to reflect Mr Meehan's co-operation and admissions.

- A severe reprimand.
- Exclusion from membership of the ICAEW for ten years which runs concurrently with the period of exclusion already imposed in other proceedings.

Decision 2: KPMG Audit PLC

The FRC imposed the following sanctions on KPMG Audit PLC:

- A financial sanction of £3.5 million. This was reduced by 20% to £2.450 million on the grounds of the firm's co-operation and admissions.
- A severe reprimand.
- A declaration that the auditor's report signed on behalf of KPMG did not satisfy the Relevant Requirements.

Decision 2: Mr Turner

The FRC imposed the following sanctions on Mr Turner:

- A financial sanction of £100,000. This was reduced by 30% to £70,000 on the grounds of Mr Turner's co-operation and admissions.
- A severe reprimand.

The whole Carillion debacle has had massive repercussions. Not only has a company collapsed, but a significant number of jobs have been lost, professionals have had their careers cut short and the auditing profession is, once again, in the spotlight for all the wrong reasons.

It would seem that a lot of this could have been avoided had the auditors applied suitable levels of professional scepticism and management challenge. Accepting information at face value is a reckless strategy nowadays and can result in decisions being made that are the wrong ones. In addition, the Carillion collapse highlighted an overlap of a self-interest threat which clouded the judgement of the audit team given that Carillion was such an important client to the firm and the team.