House of Commons

Business, Energy and Industrial Strategy and Work and Pensions Committees

Carillion: Responses from Interested Parties to the Tenth Report of the Business, Energy and Industrial Strategy Committee and Twelfth Report of the Work and Pensions Committee

Second Special Joint Report of the Business, Energy and Industrial Strategy and the Work and Pensions Committees of Session 2017–19

Twelfth Special Report of the Business, Energy and Industrial Strategy Committee of Session 2017–19

Eleventh Special Report of the Work and Pensions Committee of Session 2017–19

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Business, Energy and Industrial Strategy Committee

The Business, Energy and Industrial Strategy Committee is appointed by the House of Commons to examine the expenditure, administration, and policy of the Department for Business, Energy and Industrial Strategy.

Current membership

Rachel Reeves MP (*Labour, Leeds West*) (Chair)

Vernon Coaker MP (*Labour, Gedling*)

Drew Hendry MP (*Scottish National Party, Inverness, Nairn, Badenoch and Strathspey*)

Stephen Kerr MP (*Conservative, Stirling*)

Peter Kyle MP (*Labour, Hove*)

Mr Ian Liddell-Grainger MP (*Conservative, Bridgwater and West Somerset*)

Sir Patrick McLoughlin MP (*Conservative, Derbyshire Dales*)

Albert Owen MP (*Labour, Ynys Môn*)

Mark Pawsey MP (*Conservative, Rugby*)

Antoinette Sandbach MP (*Conservative, Eddisbury*)

Anna Turley MP (*Labour (Co-op), Redcar*)

Powers

The Committee is one of the departmental select committees, the powers of which are set out in House of Commons Standing Orders, principally in SO No 152. These are available on the internet via www.parliament.uk.

Publication

Committee reports are published on the Committee's website at www.parliament.uk/beis and in print by Order of the House.

Evidence relating to this report is published on the inquiry publications page of the Committee's website.

Committee staff

The current staff of the Committee are Chris Shaw (Clerk), Ben Sneddon (Second Clerk), Jeanne Delebarre (Assistant Clerk), Ian Cruse, (Committee Specialist), Becky Mawhood (Committee Specialist), James McQuade (Senior Committee Assistant), and Gary Calder (Media Officer).

Contacts

All correspondence should be addressed to the Clerk of the Business, Energy and Industrial Strategy Committee, House of Commons, London SW1A 0AA. The telephone number for general enquiries is 020 7219 5777; the Committee's email address is beiscom@parliament.uk.

Work and Pensions Committee

The Work and Pensions Committee is appointed by the House of Commons to examine the expenditure, administration, and policy of the Department for Work and Pensions and its associated public bodies.

Current membership

Rt Hon Frank Field MP (*Labour, Birkenhead*) (Chair)

Heidi Allen MP (*Conservative, South Cambridgeshire*)

Jack Brereton MP (*Conservative, Stoke-on-Trent South*)

Alex Burghart MP (*Conservative, Brentwood and Ongar*)

Neil Coyle MP (*Labour, Bermondsey and Old Southwark*)

Rosie Duffield MP (*Labour, Canterbury*)

Ruth George MP (*Labour, High Peak*)

Steve McCabe MP (*Labour, Birmingham, Selly Oak*)

Nigel Mills MP (*Conservative, Amber Valley*)

Chris Stephens MP (*Scottish National Party, Glasgow South West*)

Justin Tomlinson MP (*Conservative, North Swindon*)

Powers

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Committee staff

The current staff of the Committee are Anne-Marie Griffiths (Clerk), Katy Stout (Second Clerk), Libby McEnhill (Senior Committee Specialist), Rod McInnes (Committee Specialist), Tom Tyson (Committee Specialist), Jessica Bridges-Palmer (Senior Media and Policy Officer), Esther Goosey (Senior Committee Assistant), and Michelle Garratty (Committee Assistant).

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All correspondence should be addressed to the Clerk of the Work and Pensions Committee, House of Commons, London SW1A 0AA. The telephone number for general enquiries is 020 7219 8976; the Committee's email address is workpencom@parliament.uk.

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Twelfth Special Report of the Business, Energy and Industrial Strategy and Eleventh Special Report of the Work and Pensions Committees

The Work and Pensions and Business, Energy and Industrial Strategy Committees published our joint report into the collapse of Carillion on 16 May 2018. On 22 May, we wrote 27 letters to interested parties in the report, inviting them to comment on the findings and to offer further thoughts on the implications of Carillion's collapse. This special report sets out the responses from all those interested parties who chose to respond to our letters.

Chapter 1 provides the response from the Department for Business, Energy and Industrial Strategy. We also wrote to the Department for Work and Pensions but regretfully they have failed to provide a response to us within the given timescale. We will publish their response separately when it is provided. A full Government response, that is due on 16 July, will also be published separately.

Chapter 2 gives the responses of other Government bodies, with updates from a number of regulators on the status of their investigations into Carillion. It also includes a response from Sir John Kingman, who is chairing the independent review of the Financial Reporting Council.

Chapter 3 offers the responses of the Big Four accountancy firms all of whom worked for Carillion in one form or another over the past decade. It also includes a response from Lord Tyrie confirming his willingness as the new chair of the Competition and Markets Authority to look at remedies for the audit market.

Chapter 4 details the responses of all the Carillion directors that we took oral or written evidence from. In most cases, they have chosen not to comment further on the report whilst investigations remain ongoing, other than to state that they disagree with much of what was written about them.

Chapter 5 gives the responses from other interested parties, with the likes of the Confederation of British Industry and the Institute of Chartered Accountants in England and Wales offering their thoughts on the implications of Carillion's collapse and improvements that will need to be made going forward.

Chapter 1: Government Departments

Department for Business, Energy and Industrial Strategy

Letter from the Chairs to Rt Hon Greg Clark MP

Dear Rachel and Frank

I was very grateful for your letter dated 22 May. You ask for my views on the leadership, role and performance of the FRC, and the rationale for the review. You also asked for up to date figures on the sums paid to PwC in their role as Special Managers in support of the Official Receiver for Carillion. This letter is of course, distinct from the full Government response to the Select Committee's report which is due later this month.

As you know, I have asked Sir John Kingman to conduct a comprehensive independent review of the FRC which will assess the FRC's governance, impact and powers, to ensure it is fit for the future. I believe the FRC's capabilities and culture need to be strengthened and I look forward to receiving and considering Sir John's recommendations at the end of the year.

The review is part of the Government's aim, expressed in the Industrial Strategy to create a business environment that works for everyone, in which independent and effective regulation plays a key role. The UK has a strong reputation as a dependable place to do business, but this needs to be continuously updated, and it is important to ensure that our regulators continue to drive high standards. I am determined to do what is necessary to deliver effective regulation in this important sector of the economy.

The appointment of the Special Manager, as set out in the Insolvency Act 1986, is by the order of the Court, and not as an officer appointed by or accountable to me. The remuneration rates of the Special Manager are also a matter for the Court. Sarah Albon, Chief Executive & Inspector General of the Insolvency Service and David Chapman, the Official Receiver have written to the Committees on this issue in their responses.

I want to thank you again for the Committees' helpful contributions to these important issues and look forward to continuing our dialogue.

The Rt Hon Greg Clark MP
Secretary of State for Business, Energy & Industrial Strategy

Department for Work and Pensions

Letter from the Chairs to Rt Hon Esther McVey

DWP have informed us that they were unable to provide a response in time for inclusion in this report.

Chapter 2: Government Bodies

The Pensions Regulator

Letter from the Chairs to TPR

The Pensions Regulator (TPR) welcomes this opportunity to respond to the Committees' joint report on Carillion.

The collapse of Carillion impacted workers, pension scheme members, suppliers, customers, creditors and shareholders. Carillion's Board of Directors was accountable for running the business and ultimately for the decisions that led to Carillion's collapse. Stakeholders should be able to rely on audited company accounts to provide an accurate picture of a business' finances. Clearly, something was fundamentally wrong with Carillion's corporate governance for it to have gone from a position of apparent strength to insolvency in a matter of months.

Regarding TPR's role in regulating the funding of Carillion's pension schemes, we accept the report's criticisms of TPR's approach in terms of how quickly we sought to use our powers at the point of our engagement with the sponsoring employer and trustee at the 2008 and 2011 valuations. As we said in oral evidence, TPR should have reached a decision more quickly to bring our powers to bear at the 2011 valuation. Too long was spent negotiating the valuation and we should have taken more decisive action to bring the situation to a close.[1]

We have previously written to the committee[2] about the very different climate towards the start of the decade in respect of the public debate on DB pensions. Both the business and pensions lobbies were calling for greater breathing space to help pension schemes and sponsoring employers to cope with the impact of low interest rates and quantitative easing, as businesses sought to recover from the financial crisis. In October 2012, then Chairman of the National Association of Pension Funds Mark Hyde Harrison[3] said: "*The current approach to pricing pension funds risks undermining our faltering economy. Businesses are very worried about channelling cash away from jobs and investment and into pension deficits.*" In the 2012 Autumn Statement, the Government signalled its intention to take action to prevent defined benefit (DB) pensions regulation from acting as a "*brake on investment and growth*".[4] Following a consultation, the Government announced that TPR would be given a new statutory objective to minimise the impact on sustainable growth in relation to the regulation of DB schemes and sponsors (introduced in the Pensions Act 2014). In terms of TPR's approach during this period, the organisation was too reliant on educating and enabling those we regulate to find a solution when much bolder intervention was needed.

1 At Q678 http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/work-and-pensions-committee/carillion/oral/79121.html

2 https://www.parliament.uk/documents/commons-committees/work-and-pensions/Correspondence/Letter-from-Lesley-Titcomb-Chief-Executive-The-Pensions-Regulator-(TPR)-to-the-Chair-regarding-DB-regulation-following-up-22-Feb-evidence-session-13-April-2018.pdf

3 See also https://www.plsa.co.uk/Press-centre/Press-Releases/Article/Pension-funds-need-discount-rate-relief-to-cope-with-QE and http://www.bbc.co.uk/news/business-19967194

4 https://www.gov.uk/government/publications/autumn-statement-2012-documents

However, TPR's culture has been changing since then and is now a very different organisation. While we believe that it was fair for the Committees' report to criticise TPR's approach 4–5 years ago in the Carillion case, we believe it was wrong to extrapolate those criticisms to the culture of the organisation and how it is being led today.

Culturally, TPR is now a more proactive organisation and we are clearer with pension trustees and sponsoring employers about our expectations, quicker to take action to put things right, and tougher on those who do not behave in the best interest of their members. Our bolder approach is getting results and having an impact with our stakeholders and those we regulate. We set out in detail examples of how we are making more frequent use of our powers, including previously unused powers, in our written submission to the Work and Pensions Committee's inquiry into the DB White Paper in May.[5]

We increased our proactive DB casework by more than 90% in 2017/18. We are intervening much more quickly and clearly, so that parties to corporate transactions understand how we expect DB pension schemes to be treated. We are being more front-footed on mergers and acquisitions. We met with representatives of both GKN and Melrose setting out our concerns and our efforts, reinforcing those of the trustees, led to improved protections in the event of the completion of a takeover. We moved quickly to engage with trustees of Asda and Sainsbury's schemes to ensure that members are protected. In cases where we have initiated anti-avoidance action, we have secured recoveries in excess of £1bn, with our largest settlements Coats (£329m) and BHS (£363m) occurring in the past couple of years.

On funding, we are taking swifter action where valuations are not submitted within statutory timescales. Since April 2017, we have issued 9 Warning Notices for late valuations for Improvement Notices, Third Party Notices and fines. Seven of the 9 schemes complied either following the initial Warning Notice or after TPR issued Improvement Notices and Third Party Notices against trustees and employers requiring valuations to be submitted by a specific date, or they would face a fine. In respect of the other two schemes, in June TPR issued its first fine for a late valuation of £25,000 and the other will shortly be referred to the Determinations Panel with the recommendation of a £15,000 fine.

We are using a much broader range of our available powers, including criminal sanctions. Since April 2017 we have successfully prosecuted 19 offenders (individuals and companies) in 8 cases for a range of offences including noncompliance with our information requests, wilful noncompliance with automatic enrolment duties, providing false information to TPR, and offences under the Computer Misuse Act. We are actively pursuing fraud offences in relation to pension scams and expect to issue summonses for criminal offences shortly.

We are taking more action to clamp down on noncompliance with basic governance requirements, which can be an indicator of wider governance failings. Over the past couple of years we have issued 252 financial penalties for noncompliance with Chair's Statement requirements and 146 financial penalties relating to scheme returns.[6]

TPR's spending on levy-funded activity last year, which includes DB regulation, was £44.1m. The budget agreed for this year includes an extra £8.3m spend on levy activity

5 http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/work-and-pensions-committee/defined-benefit-pensions-white-paper/written/83155.html
6 http://www.thepensionsregulator.gov.uk/doc-library/enforcement-bulletins.aspx

in 2018–19, and about £1m on top of that in each of 2019–20 and 2020–21. Average levy-funded headcount is anticipated to increase by 150 people over the next 3 years (40%) to fulfil our broadened responsibilities and to implement our new set of regulatory approaches.

Under our TPR Future programme, we have designed and are implementing a new regulatory model for the organisation. This will further increase our level of proactive contact across all the areas we regulate (DB, defined contribution, master trusts and public service schemes) and we are introducing a much broader range of regulatory tools and approaches in order to influence the behaviours of pension trustees and sponsoring employers. All schemes will experience some form of regulatory oversight, at increasing levels of intensity where required. For example, the most significant DB schemes will be subject to ongoing supervision rather than simply having contact with us every 3 years at the point of valuation.

Since 2015, we have strengthened our relationship with Government and have successfully made the case for additional resources to strengthen our frontline teams and for new powers to authorise and supervise master trusts. We asked the Government to strengthen our powers to regulate DB schemes, including our scheme funding powers, which are poorly defined in legislation. We worked with the Department for Work and Pensions (DWP) to develop the package of proposals in its recent White Paper. While most sponsoring employers and trustees of DB pension schemes do the right thing, we believe these measures will provide a stronger deterrent and improve our ability to intervene more quickly and decisively. We thoroughly welcome the White Paper and are liaising closely with the DWP as it consults with the pensions sector on the detail and develops legislative proposals.

The Pensions Regulator

Financial Reporting Council

Letter from the Chairs to FRC

Dear Ms Reeves and Mr Field

Thank you for your letter of May 22nd, with your additional questions following our evidence to your joint hearings on Carillion.

FRC Investigation

FRC welcomes your comprehensive report into the collapse of Carillion. I can assure you that our own investigation into the audit of the company and the conduct of two of its accountants who fall within the scope of our remit will be very thorough. It will focus on whether audit standards were breached by KPMG, and whether there was misconduct by the two accountants in order to determine if we should to take enforcement action. The work of your joint Committees is very helpful to our consideration.

These investigations are large and complex. They entail obtaining and reviewing a vast set of documents including four years of audit files, KPMG's and Carillion's emails, extensive company documents, as well as interviewing KPMG and Carillion employees. As part of the investigation we will instruct an independent expert witness to consider the key accounting and audit issues and to prepare a detailed report that will be relied on at any subsequent tribunal proceedings.

Once the investigations are complete, the FRC Executive Counsel will determine whether the legal threshold is met to bring disciplinary proceedings. As matters stand it should be expected that if proceedings are commenced, they will be contested. In those circumstances we cannot set a final date for the conclusion of enforcement action, not least because the proceedings take place before an independent tribunal, and it is the tribunal that will set the timetable. However, we are committing resources to complete the investigative work as fast as possible. We have provided a recent update on the progress of the investigations and, in light of the exceptional level of public interest in Carillion, will continue to keep you and others informed of progress.

Disclosure of dividends

Your letter asks whether we provided mixed messages by commenting positively on the quality of Carillion's dividend disclosures in the Financial Reporting Lab report. The views expressed in the report reflected input from investors but nevertheless it would have been better not to reference Carillion. We need to be clearer about what we are endorsing and on what basis.

For clarification, there is no requirement for a company to disclose the level of their distributable reserves, but many investors had said that more information about dividend policies would be helpful. The report suggested best practice on meeting that investor wish. Subsequent implementation studies in 2016 and 2017 found that a significant number of companies had provided more information drawing on the Lab report.

Regulatory reviews of Carillion

Your report makes a number of observations about our review of Carillion's report and accounts for 2015.

We raised a number of questions about disclosures in the 2015 report as part of our Corporate Reporting Review (CRR). We followed up with a review of the 2016 accounts. It is our policy to check that the required improvements have been made in subsequent accounts. These inquiries informed our review of the 2016 audit which we started following the July profits warning. An audit quality review is our most effective tool to ascertain whether any of those losses should have been recognised earlier in the accounts as it gives us access to the auditors' records. The review showed that the case for enforcement action should be considered. At the point the company failed, this consideration was well advanced and we were quickly able to announce our investigation. The points the Committee has raised about the accounting treatment of goodwill, reverse factoring and other matters will form part of the investigation.

Stewardship

We welcome your observations on investor stewardship. These will inform our work on the Stewardship Code which will start after the Corporate Governance Code review is completed shortly. We plan to consult on stewardship later in the year. We intend to look at the effectiveness of the Code but also consider other ways in which effective engagement between companies and investors can be achieved and the role of intermediaries such as proxy agents.

Audit Market Competition

We share many of the concerns expressed by the Committee about concentration in the audit market and, in particular, the dominance of the Big 4. The failure of a firm could have serious implications for confidence in the capital markets. It is also worth noting that at present the loss of an audit contract gives a firm an opportunity to pick up better remunerated consulting work. The market does not therefore fully incentivise high quality performance. We have a responsibility to monitor these risks but do not have powers to intervene. We have therefore raised the issue with the CMA who are considering the matter. Working with the CMA we will consider whether any of the audit regulations could be changed to reduce concentration in tandem with competition measures.

Lessons Learned / Powers

Through our work in reviewing the quality of corporate reports and audits we secure improvement to individual companies' reports and to their audit work. We are committed to identifying and calling out poor performance and have done so in our most recent reports on the major audit firms after finding a reversal in the last year of a previously improving trend.

However, in the light of Carillion we have reviewed whether our supervisory work should be strengthened further and whether we should do more to signal our concerns to investors.

The objective of the powers granted to the FRC in relation to audit is to enhance overall audit quality. We have therefore focused on and published our assessments of the overall performance of the audit firms. It was not envisaged when the regulatory framework was put in place that these powers should or would prevent failure by individual companies. Indeed, because of the confidentiality requirements in the Companies Act, we are not able to publish our views on individual company audits.

We now intend to enhance our focus on the audits of companies which appear to be in danger and should like this to be combined with an ability to call out what we find. Companies will still fail. Not every impending failure can be stopped, especially through the backward-looking lens of audit. However, we do feel it would be valuable to investors if we could do more to signal concerns, if before problems become terminal.

Carillion has also shown the importance of a Board's awareness of its own effectiveness and willingness to enhance its own performance. Statements by companies in the Annual Report about their governance can fail to provide real insight and investors can find them hard to challenge. The FRC has no power to challenge these parts of the Annual Report. We believe this should be addressed by extending the scope of our corporate reporting review powers, combined with a power to undertake or commission a report into the quality of governance akin to the powers of the FCA. The role of investors in governance must not be undermined but we believe they would benefit from regulatory support.

In relation to audit the Statutory Audit and Third Country Audit Regulation 2016 went a long way to strengthening our monitoring regime. However, there are gaps in that regime, such as in relation to the performance of leadership, the suitability of those being appointed to senior audit positions and the strength of the business. The firms have recently agreed to work with us in these areas on a voluntary basis and so far this is working satisfactorily. However, we believe that in view of the systemic importance of the major firms and the variation in audit quality within each firm, a statutory basis for scrutiny and challenge of leadership roles in protecting the sustainability of the business and driving consistency in quality is especially important.

On enforcement, as we informed the BEIS Select Committee in 2016 we have no powers to pursue directors who are not accountants. The Committee supported action to correct this. Such powers are held by the FCA and INSS. Nevertheless we believe it would be more efficient for the FRC to have limited concurrent powers to enable a better, more efficient and holistic regulatory framework.

It is also important to recognise that our enforcement action on Carillion is taking place under two separate procedures. The case against the auditor is pursued under the Audit Enforcement Procedure ("the AEP"). This procedure does not apply to the accountants in business who we investigate under The Accountancy Scheme ("the Scheme"), a contractual arrangement with the profession. The AEP requires us to establish that there has been a breach of relevant requirements. The Scheme test is misconduct. This is a much higher test, which tribunals have defined as poor conduct more serious than negligence. We believe that the Scheme should be replaced with a new statutory regime and its tests should be aligned with and similar to those in the AEP.

We hope this provides sufficient detail in response to your letter. There are other legislative issues, such as our overall statutory basis which we believe Sir John Kingman will consider; the above points are those which we believe of most relevance to learning from Carillion.

We are happy to follow up on any points in further detail should you wish.

Yours sincerely,

Stephen Haddrill
Chief Executive

The Insolvency Service

Letter from the Chairs to the Insolvency Service

Dear Mr. Field and Ms. Reeves,

Thank you for your letter of 22 May 2018. The Insolvency Service is pleased to have assisted the Committees in undertaking this important work and recognises and appreciates the consideration given to the Official Receiver's views when releasing information into the public domain.

I am happy to see the Committees' recognition of the good work so far undertaken to effect an orderly liquidation of the companies in the Carillion group, including the early improvement of payment terms and in preserving many of the jobs.

We will of course take on board the Committees' recommendations when dealing with the liquidation and investigation of Carillion and in the way that we deal with any future events of this nature.

In particular, I note your comments on wrongful trading and director's duties. I can inform you that while the Official Receiver's investigation into the failure of Carillion is still at an early stage, the investigation team is pressing forward and focussed on concluding the investigation as quickly as possible. From the outset it has been clear that the investigation will involve significant challenges in terms of the unprecedented volume of accounting records to be secured and analysed. We have obtained more than 350TB of electronic data from the company. Investigators, using specialist IT services and products, are reviewing key documents such as board papers and emails as well as examining data in the financial accounting system. They have contacted those individuals who were directors of the companies in the three years before liquidation and have begun the process of meeting and interviewing key personnel. The Official Receiver has engaged legal advisers in the form of specialised solicitors, senior and junior counsel to provide legal opinion as and when issues arise within the investigation.

Turning to the specific points and/or recommendations made in your joint report, I would respond as follows and have copied the relevant extracts for ease of reference:

> 161 (and 35 of the Conclusions and Recommendations). We are concerned that the decision by the court not to set any clear remuneration terms for PwC's appointment as Special Managers, and the inability of the appointees to give any indication of the scale of the liquidation, displays a lack of oversight. We have seen no reliable estimates of the full administrative costs of the liquidation, and no evidence that Special Managers, the Official Receiver or the Government have made any attempt to calculate it. We have also seen no measures of success or accountability by which the Special Managers are being judged.
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> 162 (and 36).As advisors to Government and Carillion before its collapse, and as Special Managers after, PwC benefited regardless of the fate of the company. Without measurable targets and transparent costs, PwC are continuing to gain from Carillion, effectively writing their own pay cheque, without adequate scrutiny. When the Official Receiver requires the support

> of Special Managers, these companies must not be given a blank cheque. In the interests of taxpayers and creditors, the Insolvency Service should set and regularly review spending and performance criteria and provide full transparency on costs incurred and expected future expense. (Paragraph 162)

I am aware that the Official Receiver set out in his letter to you of the 29 March 2018 the steps that have been taken to scrutinise the costs of PwC and to monitor their performance in acting as special managers. He referred to the difficulties in setting firm targets given the dependency on third parties and the difficulties in concluding a large and complex liquidation, in particular where litigation is involved. That of course does not mean that the Official Receiver is not closely scrutinising the progress of the liquidation and the performance of the special managers who are assisting him. There are milestones including the completion of sales processes and the transitioning of the majority of company contracts to new suppliers by the end of June 2018. Progress on this and other investigation matters is very closely monitored, including weekly meetings with officials from the Insolvency Service, the Treasury, Cabinet Office, the Official Receiver and a Special Manager.

The Official Receiver mentioned a protocol had been agreed between him and PwC setting out the work that the special managers carry out and the governance that applies. The Official Receiver assesses the work carried out by PwC, including the costs incurred in carrying out this work. The special managers are producing weekly breakdowns of their time costs and regular breakdowns of disbursements, which are in line with procedures set down in the regulations and guidance covering the work of insolvency practitioners.

To ensure control over their activities, PwC are required to provide regular reports covering a range of areas such as financial performance, employees, contract performance and health and safety showing progress on both a daily and weekly basis. These are used by the Official Receiver in evaluating the progress of the liquidation and the performance of the special managers.

There are daily meetings between the Official Receiver and the key individuals at PwC at which the contents of these reports are discussed, updates provided and operational issues resolved.

As the Official Receiver set out in his letter of 29 March, PwC agreed to act as special managers at a discount on their standard rates. The special managers' remuneration must nevertheless be considered and agreed by the court, prior to which the Official Receiver must be satisfied that the application to court is appropriate. During this process the remuneration claimed has been under close scrutiny by the Official Receiver and by court.

On 28 June the court considered a remuneration application from PwC and concluded that a sum of £22.9m (net of VAT) is due for the period from 15 January to 31 March. This sum takes into account the discount negotiated by the Insolvency Service, meaning a saving of £5.7m.

Scrutiny of PwC's costs is also being carried on generally within the Official Receiver's liquidation team for which there is a dedicated resource. Review and challenge occurs across the different work-streams reported in the weekly time cost reports. This has included a review of PwC's time reporting database to determine how time is recorded, categorised and signed-off; scrutiny of time costs per work-stream and division, and monitoring the instructions given to the legal firms within the parameters of their appointment by the different PwC teams.

With regard to transparency on costs, the Official Receiver is providing details of costs to the Cabinet Office, Treasury and more widely with key creditors in the liquidations.

There is a regular report prepared by the special managers estimating income and costs over the course of the liquidation. As set out in the National Audit Office report, the expected net cost of the liquidation is around £148 million. It is expected that PwC's final bill will be in the region of £50m for their work as special managers, representing around 10% of the total gross costs of the liquidation.

The Joint Committees' report acknowledges this is a liquidation of unprecedented scale with many uncertainties and third party dependencies. For this reason, whilst I recognise the Committees' concerns regarding the uncertainty surrounding the final bill for the special managers, I don't think it would have been possible or realistic to have obtained an accurate estimate of costs prior to their appointment. There has been a significant reduction in the resource deployed by the special managers over the short course of the liquidation to date.

Once trading has ceased, the work of the special managers will be narrowed down further, primarily to assist with the remaining asset recoveries. The investigation team will continue to require specialist services currently provided by PwC in relation to the forensic collection and analysis of information and electronic data.

> 159. David Kelly, one of the PwC Special Managers, told us that he believed Carillion's work preparing Government for Carillion's insolvency did not represent a conflict. This is questionable.

It is true that PwC had knowledge of the affairs of Carillion and, as the Official Receiver has said, this was of assistance in putting the firm in a position that it could quickly take on the responsibilities required of the special managers. That knowledge was not however of a level that would constitute a conflict of interest, taking into account the considerations that are to be applied by an insolvency practitioner before taking an appointment. In particular, their prior knowledge of, and involvement with, the company has not affected their ability to assist the Official Receiver in conducting an orderly liquidation and, in fact, was a very important factor in being able to deal with the enormous challenges facing the Official Receiver on 15 January 2018. I understand that you have written to the Official Receiver regarding conflict and he should be providing further details on conflict in that reply.

> 164. Under insolvency law, a director may be guilty of wrongful trading if they knew, or ought to have known, that there was "no realistic prospect" of the company avoiding liquidation or administration. Once an insolvency process becomes inevitable, directors are obliged to seek to minimise the loss to the company's creditors. By January 2018, if not before, it must have been clear to the board that only a bailout from Government could save the company. It is of course up to the courts to determine, following any application from the liquidator, whether any offence was committed, and in respect of what period. Given that, as far as we know, no indications

had been given that a bailout would be forthcoming, and that the board apparently took no steps to minimise the potential loss to creditors, there must at least be a question as to whether individual directors could reasonably be accused of wrongful trading.

166 (and 38). In Chapter 1, we argued that the business model was based on generating new business rather than pursuing the long-term strategic interests of the company. We also argued that managers had little regard to the need to foster business relationships with suppliers: late payment practices took advantage of smaller suppliers as a matter of practice. This approach was at odds with any notion of maintaining a reputation for high standards of business conduct. We have also argued that the board failed to look after the interests of their employees and former employees by under-funding their pension schemes in favour of cash elsewhere. In evidence to us, Carillion's board members did not give the impression that they were acutely conscious of the wide range of legal duties they had, nor of the prospect of any penalties arising from failure in this regard. It is difficult to conclude that they adequately took into account the interests of employees, their relationships with suppliers and customers, the need for high standards of conduct, or the long-term sustainability of the company as a whole. Any deterrent effects provided by section 172 of the Companies Act 2006 were in this case insufficient to affect the behaviour of directors when the company had a chance of survival. We recommend that the Insolvency Service, as part of its investigation into the conduct of former directors of Carillion, includes careful consideration of potential breaches of duties under the Companies Act as part of their assessment of whether to take action for those breaches or to recommend to the Secretary of State action for disqualification as a director.

It is clear that Carillion's insolvency has caused public concern about the conduct of the directors of the firm and its auditors in the period prior to the insolvency. The Official Receiver is under a statutory duty to investigate the cause of failure of any company in compulsory liquidation and generally its business, dealings and affairs and has wide-ranging powers to obtain information, material, and explanations.

The Official Receiver also has a duty to report any potential misconduct and will take appropriate action where there is evidence of criminal offences or unfit director conduct, including breaches of company law or the provisions of the Insolvency Act such as those related to wrongful trading. The Official Receiver can apply for a disqualification order which can lead to disqualification for a period of up to 15 years.

A specialised investigation team was set up on the making of the winding-up order and, as discussed above, are expediting, at the request of the Secretary of State, the investigation into the company including analysis of company records, interviews with directors and close liaison with other investigating authorities.

In line with this the Official Receiver is considering recoveries that might be made against company officers and other third parties.

Due to the uncertainty that attaches to any investigation, particularly one of this unprecedented complexity and size, it is not possible at present to make a precise statement regarding the time required to progress matters to a successful conclusion.

I hope that you will find this information useful in the compilation of the Special Report but I am of course happy to provide further information if required.

Yours Sincerely,

Sarah Albon
Chief Executive
The Insolvency Service

Financial Conduct Authority

Letter from the Chairs to the FCA

Dear Frank Field and Rachel Reeves

Re: Carillion plc ("Carillion")

Thank you for your letters of 22 May and 14 June 2018. In your first letter, you ask for an update on our investigation into Carillion and our timeline for reporting on it. In your second letter, you ask more specific questions about a request from Carillion's former Chairman, Philip Green, to protect the company and its lenders from any fines or penalties for action taken by Carillion before July 2017.

We are grateful to the Joint Committees for their report into Carillion, and the evidence sessions it held, all of which we are considering. We do not intend to comment on the report, however, while our investigation remains open in order not to prejudice the outcome of the investigation.

The following is in response to your questions.

"…please update us on the status of your investigation and detail your timetable for reporting on it."

"Could your response please detail what aspects of Carillion's market announcements are being investigated, including whether it will cover any insider trading of shares?"

Scope of our investigation

On 3 January 2018, Carillion announced that we are carrying out an investigation into its announcements to the market.

Our investigation is into the timeliness and content of the firm's announcements. Our primary focus is to determine whether the matters announced in Carillion's trading update on 10 July 2017 were identified and announced at the appropriate time.

We are also considering whether earlier announcements made by Carillion were false or misleading as a result. This includes Carillion's £845 million contract provision as well as Carillion's revised expectations as to revenue, profit and debt levels that were also announced on 10 July. Our investigation currently covers potential breaches of the Market Abuse Regulation, Listing Rules and Listing Principles. We are aware of allegations of insider trading in Carillion's shares prior to its trading update on 10 July 2017 and are looking into them.

Current status

We have made good progress and have conducted interviews and meetings with senior Carillion staff, key advisers and shareholders. This is helping us to build a picture of the circumstances that led to the announcements by the firm, the information available to Carillion's board at the time and how the announcements were viewed by the markets. We have also obtained a significant number of documents.

We also continue to liaise closely with the Insolvency Service, the Financial Reporting Council and the Pensions Regulator on our respective investigations.

Timescales

The specific timing of the investigation is subject to access to the company's records as well as ongoing cooperation with the Insolvency Service, the FRC and the Pension Regulator. However, we aim to complete the investigation as soon as possible.

"Were the FCA made aware by Carillion and/or the Cabinet Office that such a request [to protect Carillion from fines and penalties] had been made?

Were the FCA aware that the request was being made at the behest of Carillion's major financial lenders?

As for your question about a request for us to withhold action or grant immunity, I am not aware of a request from Carillion, or the Cabinet Office, to the FCA of this kind.

Have the FCA ever previously received requests such as this where lenders or investors have asked for immunity from fines or prosecutions as a precondition to lending/investing in companies? If so, what approach does the FCA take to such requests?"

Our policy to setting penalties is set out in our Decision Procedure and Penalties Manual, which is available on our website.[1] Under the policy, it would only be in an exceptional case that we would be prepared to agree to issue a public censure rather than impose a financial penalty if a financial penalty would otherwise be the appropriate sanction. Examples of such exceptional cases could include:

- where the application of our policy on serious financial hardship results in a financial penalty being reduced to zero;
- where there is verifiable evidence that the firm would be unable to meet other regulatory requirements if we imposed a financial penalty at an appropriate level, or
- where there is the likelihood of a severe adverse impact on the firm's shareholders or a consequential impact on market confidence or market stability if a financial penalty was imposed. However, this does not exclude the imposition of a financial penalty even though this may have an impact on a firm's shareholders.

As is to be expected, the occasions on which we have agreed to issue a public censure against a firm rather than impose a financial penalty, where a financial penalty would otherwise be the appropriate sanction, are rare.

In August 2015, we took action against Co-op Bank for breaching the Listing Rules. The failings merited a substantial financial penalty. However, given the impact of the financial penalty we decided to impose a public censure instead. The circumstances were that Co-op Bank was engaged in a turnaround plan aiming to ensure it met its Individual Capital Guidance on a sustainable basis and had adequate capital to withstand a severe stress. It was important the plan was successful and that Co-op Bank's capital resource was directed towards improving its resilience.

I hope that you find this Information helpful.

Yours sincerely

Andrew Bailey
Chief Executive

1 https:/ /www.handbook.fca.org, uk/handbook/DEPP/

The Pension Protection Fund

Letter from the Chairs to the PPF

Dear Mr Field

Carillion

Thank you for your recently received letter following up on the report published jointly by the Work and Pensions and Business Committees' on the insolvency of Carillion plc. We were grateful for the opportunity to provide written submissions to this important inquiry.

As the Committees rightly note, the combined aggregate deficit of the defined benefit (DB) pension schemes associated with Carillion mean, absent significant recoveries, it may constitute the largest claim to date on the PPF. Given the scale of the claim, we have followed the inquiry with close interest and believe it has shed vital light both on the specific circumstances of this case as well as the broader issues facing the defined benefit pension schemes we protect. Where lessons can be learnt, not least to strengthen protections for members and the PPF, they should be. I trust our evidence, both written and oral, to the Committee's current DB pensions White Paper inquiry was helpful in outlining how we think these protections could be strengthened.

The report acknowledges the important role played by the PPF in protecting the c.27,500 members of the Carillion DB pension schemes. At the point of insolvency, the significant funding shortfall in the schemes (c.£800 million on a PPF basis) may, without the PPF, have resulted in many members facing severe reductions comparative to what they had been promised. Thanks to the safety net provided by PPF, Carillion scheme members can be comforted that they will receive at least PPF levels of compensation on their lost pensions. The contribution of our levy payers should not be forgotten in helping us ensure members do not face financial hardship in retirement.

As we detailed in our letter of 3 April 2018, the majority of Carillion's pension schemes have entered PPF assessment and we expect the final scheme to enter in the near future. We have continued to make progress with our assessment tasks to assess whether each of the schemes will in due course transfer to the PPF or, if they can afford to, buy out the same or better than PPF level benefits with a commercial insurer. We are working closely with the scheme trustees and are making good progress.

While the trustees continue to have responsibility for the day-to-day running of the schemes throughout the assessment process (including communicating with and paying members), we have brought in specialist advisors to support the schemes. This includes trustee, administration, legal, audit and actuarial support from our dedicated panel firms who are experts on what needs to be done during a PPF assessment period. This approach of bringing our specialists in swiftly, which we commonly employ when schemes enter PPF assessment, will ensure that the process proceeds as smoothly and efficiently as possible.

It is still relatively early days in the assessment period for the schemes. Our ambition is that 75 per cent of schemes complete assessment within two years although this can take longer for more complex cases, such as the Carillion schemes. We have, however, already agreed indicative completion dates for some of the Carillion schemes for the end of 2019.

We will shortly be publishing our Annual Report and Accounts for 2017/18, which will reflect the Carillion claim. The last financial year saw the largest value of claims on the PPF to date, as well as significant market volatility for our investment operations. You will appreciate I cannot divulge the results before the publication is laid before Parliament. I can though reassure the Committees that despite this challenging backdrop, we expect to be able to provide reassurance, to both you and our members, that our funding position is at the very least undiminished. Anticipating this will be of interest to the Committees, I will write again when we publish these results.

Yours sincerely,

Oliver Morley CBE
Chief Executive

CC: Rachel Reeves MP, Chair of the Business, Energy and Industrial Strategy Select Committee

Sir John Kingman, Chair of the independent review of the FRC

Letter from the Chairs to Sir John Kingman

Dear Frank and Rachel

Many thanks for your letter of 22 May.

I can confirm that the Review will certainly need to consider whether to give a view on the leadership of the FRC – as you say, as part of considering the culture of the regulator, as the Government's terms of reference ask me to do. The Review will shortly publish a call for evidence, which will (amongst many other things) specifically ask for views on the FRC leadership.

I would very much welcome a chance to discuss the issues with you. It goes without saying that your recent joint report on Carillion forms a very important part of the context for the Review.

I am sending a copy of this letter to Greg Clark.

Yours,

John Kingman

cc The Rt Hon Greg Clark MP Secretary of State for Business, Energy and Industrial Strategy

Chapter 3: The Big Four

Deloitte

Letter from the Chairs to Deloitte

Dear Ms Reeves and Mr Field,

Thank you for your letter of 22 May inviting Deloitte LLP to respond to the matters raised in the joint Select Committees' report on Carillion.

Your report has laid out the analysis of the circumstances surrounding, and the issues arising from, the collapse of Carillion and we welcome the opportunity to set out our thinking on the matters considered in your report in relation to the audit profession.

We recognise the distress that the liquidation of Carillion has caused for all Carillion stakeholders, especially employees, pensioners, customers (including government), and suppliers. For the audit profession, other advisors and regulators, it has underscored the need for continuous improvement. As a firm we acknowledge our responsibility to play a significant part in this debate and to make proactive and constructive suggestions on the future shape of the audit market.

Having reflected on the Committees' recommendations and drawing on the engagement we have undertaken with investors, regulators, policymakers and our industry peers, we attach two appendices setting out our immediate reactions in relation to the audit profession: In the first, we consider how external audit must evolve to remain relevant and continue to provide the bedrock of trust and confidence in the capital markets, for investors and broader society; in the second, we consider matters in relation to the role of internal audit.

The ongoing support of the public, policymakers, regulatory bodies, investors and other stakeholders is vital in underpinning confidence in the UK as an attractive capital market and the role that we all hope this market will continue to play in the economy as we prepare to leave the European Union.

We hope that our comments and observations are useful to the Committees. We would welcome the opportunity to discuss our thoughts in greater detail with members of the Committees and other stakeholders.

Yours sincerely

Nick Owen
Chairman, Deloitte LLP

APPENDIX 1: Professional services and the future of audit

The debate around the purpose of audit and the structure of the market is complex and there is no single overarching, simple solution. We appreciate many of the issues raised by the Committees and other commentators and welcome the opportunity to set out how we believe reforms can be made to improve confidence in audit and encourage a more vibrant market for audit services.

A. Concentration and choice

The level of competition in the market for public interest entity (PIE) audit featured prominently in your evidence gathering, final report and the wider debate that has followed.

We recognise that the market for FTSE 350 PIE audits is concentrated. Ideally there would be more firms operating in this market and we would support measures that enable this.

However, competition between the firms in this market is fierce, and increasingly so since the new regulations on audit tendering and rotation came into force. We would also add that, in our wider business, beyond audit, we compete against a range of different players including standalone consultancy firms, boutique tax and financial advisory firms, and global technology firms.

The critical question for the PIE audit market is: how do we get from "four to more"? To achieve this, key structural issues in the marketplace must be addressed to encourage greater market participation. The debate should focus on both the supply and the demand side, looking at what can be done to provide greater incentives for firms to participate in the market and what can be done to encourage audit committee chairs and investors to select auditors who are not amongst the largest firms.

The high reputational risk profile, increasing regulation and the spectre of high financial sanctions, including unlimited liability, are all key factors. As the ICAEW and Grant Thornton (in their decision to withdraw from bidding for new large, PIE audits) have noted, these factors make large company audits unappealing to smaller firms in the UK and have deterred them from competing effectively. More broadly, these aspects will encourage all market participants to be increasingly selective about which companies they wish to audit.

It is interesting to note that, whilst in the USA the four largest firms audit the vast majority of the Fortune 500, their overall share is currently less than 50% of all US-listed companies. This contrasts with the UK and, recognising that sustainable changes which maintain and enhance audit quality will take time, we believe that any potential UK solutions need to look at all of the listed market and not just the FTSE 350.

B. The structure of the largest audit firms

The Committees, and other commentators, have suggested that the break up of the largest professional services firms should be examined as a means of increasing competition and ensuring audit quality. We do not believe that this is a viable solution to either matter and would be concerned that it would damage both audit quality and the UK's position as an attractive capital market.

Larger, more diverse firms are more financially independent and are therefore far better positioned to objectively and robustly challenge the largest companies that they audit and to make the significant investments required in systems and technology. Deloitte itself has invested hundreds of millions globally in audit innovation, training and technology over the past five years, which have both increased the coverage of audit and reduced audit risk.

Firms with a multi-disciplinary model – providing wider services beyond audit – have the best mechanisms to challenge large companies, attract specialist talent and develop the skills, expertise and global consistency needed for good quality audits. Such firms are also better positioned to offer a broad and varied range of career paths that ensure they attract and retain the best talent to the profession.

Delivering a quality audit requires input from experts drawn from across our firm, including industry specialists and others with expertise in areas such as valuations, controls, treasury and financial instruments, pensions, leading technology accounting systems such as SAP and Oracle, and of course specialists for the audit of tax, where regulation is itself becoming more complex and is changing at a rapid pace. These teams build expertise through their advisory work for non-audit clients, and we strongly believe that audit-only firms would not be able to attract this talent.

This range of expertise is becoming ever more crucial to quality audits as companies themselves become more technology-focused, automating processes using blockchain and robotics, for example, and as they increase in size, complexity and international reach. Firms such as ours have grown to match this, supporting UK companies with these challenges and supporting them overseas with our international networks. Large and complex companies require large audit firms with the necessary breadth and depth of capabilities. The very largest investors recognise the benefits of the multi-disciplinary model in delivering quality audits and providing the financial strength that the audit firms require for investment and attracting talent and the strength to challenge the world's largest companies.

C. Conflicts of interest

The Committees' report in particular focused on whether there is a 'cosy club' in the market that limits competition and generates conflicts of interest.

We understand the concerns raised by the Committees, and others, about these risks arising in the course of our work. We take the issue extremely seriously, both in how these are defined in regulatory standards but also the perceptions they can create and how they can undermine work that firms such as our own undertake. To safeguard the public interest in our client take-on procedures, we have a committee of partners that meets weekly to consider potential assignments that might be of a higher profile or public interest nature. We frequently decline work which does not meet a public interest test.

The issue of non-audit services provided to audit clients was commented upon in your report, and continues to be referenced by other commentators. We recognise that there is a general perception that firms participate in the audit market to enable the cross-selling of other consultancy work. As you will be aware, the EU audit regulations and the FRC's ethical standards introduced in 2016 now severely restrict both the nature and volume of non-audit services that firms can provide to the entities that they audit. In part due to this legislation the level fees for non-audit services provided to audit clients has declined significantly in the past decade, and continues to do so.

Data from the FRC shows that fees for non-audit services to companies audited by the largest firms was just 11% of the firms' fee income in 2016, down from 35% in 2011. We would note however that it is common market practice for listed companies to ask their auditors to perform a review of half year results. This is classified as a non-audit service, yet no one would suggest that this is not an appropriate service for the company's auditors to perform.

Given the legislation is complex, and to promote confidence, the audit profession and the FRC, would be wise to make available a clear listing of what is permitted and what is not permitted, and to keep this current. We would be very willing to discuss what more could be done in this area.

D. The future of audit: improving the system

The framework for audit must evolve with the times to remain relevant, effective and trusted. Technology is rapidly changing the profile of businesses, increasing both their global reach and complexity. Auditors are adapting to keep up with this, whilst deploying technology themselves to improve audit quality. For example, Deloitte has developed a data analytics technology platform that allows audit teams to look for unusual trends and anomalies within large datasets, giving unprecedented visibility of data trends and increased audit coverage.

The whole ecosystem of corporate governance and reporting needs to be alive to the challenges companies face and the requirements for transparency and accuracy. This will include boards, those within companies charged with risk management and corporate governance, investors, regulators, policymakers and auditors working together.

The immediate observations and recommendations we would make – for regulators, the profession and Audit Committees, include:

For regulators

- There should be a more defined mechanism for management, auditors, regulators and investors in large public interest companies to raise 'red flags.'
- Regulators and government – which have finite resources – should have more robust risk assessment processes to focus on companies most at risk.

For auditors

- Auditors should provide more detailed explanations of the procedures performed in relation to assumptions about the future, inherent in the financial statements.
- Auditors should also explain their procedures in relation to companies' risk management procedures and viability assessments. However, a reporting framework needs to be developed as these are activities and plans owned and executed by management.
- In addition to confirming their independence, auditors could be asked to refer in their audit report to the description of any non-audit services set out in the annual report and confirm specifically that they are permitted by the Ethical Standard and UK law.

For Audit Committees

- Investors tell us that they want to invest in well-controlled companies. Greater clarity should be sought on how companies design, document and test their internal controls over financial reporting. Although difficult perhaps on immediate introduction, the introduction of the Sarbanes-Oxley (SOX) regime in the USA, addressing internal controls over financial reporting, saw a considerable improvement in the control environment of companies, and emphasised the role of the audit committee, and accounting professionals in industry, and their responsibility for internal controls. The SOX regime has had a considerable benefit in enhancing the control environment of companies listed in the USA. These matters should be considered by the various reviews now being undertaken.
- Audit Committees should be asked to explain in the annual report the due diligence they have applied to a company's viability statement, the fundamental assumptions underpinning financial statement judgements, the diligence applied to how high impact risks are being managed, challenging management to ensure that the control environment is robust, and ensuring that the scope and resources of internal audit is sufficient to provide an effective third line of defence.
- Company boards should be required to state in setting their dividend policy how they have taken into account the company's gearing, access to finance and pension funding requirements.

E. Relevance of audit

Clarity around what an audit is and how it should evolve is also, we believe, essential to this debate. The Committees will be familiar with the concept of the 'expectation gap' in audit – the difference between what an audit does and what people think it does, or should do. Whilst steps have been taken by regulators and the audit profession to 'open the black box' and report more about the audit and increase the transparency of what is covered, it is apparent that society and investors are demanding more from both companies and auditors and this is undermining confidence in audit. Clearly, as the debate post-Carillion has demonstrated, we need a new consensus built around the scope and expectations of audit.

To achieve this, we support – and have been engaged in discussions to initiate – the independent review led by the Audit Quality Forum that aims to clarify the roles and responsibilities of auditors, for which a chairman is currently being sought. This review will require input from investors, regulators, standard setters, auditors and the wider public. It needs to be forward looking and consider what could and should be done to meet investor and broader societal expectations as businesses become more complex and technology-driven, and, increasingly as we consider the role of companies in society and the impact of business on our planet. The profession would of course welcome input from members of both Committees, government and the political parties to this review.

APPENDIX 2: The future of internal audit

With regard to internal audit, there are undoubtedly areas to reflect upon following the Carillion experience and the recommendations contained in the Committees' report.

Within the current framework, internal audit in the corporate sector is not a statutory requirement, unlike the annual external audit. The UK Corporate Governance Code ('the Code') requires the Audit Committee to consider the need for an internal audit function, and, where one exists, to monitor and review the effectiveness of its activities. The regime regarding internal audit and the role of risk committees differs considerably in the financial services sector.

To strengthen the future role that internal auditors can play in the corporate sector, we would welcome a debate which brings together views from Audit Committee members, the profession, investors and wider stakeholders as to whether the Code should further clarify the role of internal audit and the reporting obligations of the Audit Committee in annual reports of the very largest companies.

Since the internal audit function is the third line of defense in a company, the Audit Committee could be asked, for example, to include further explanation in the company's annual report of areas such as:

- The scope of internal audit activities across the business;
- Whether the Audit Committee believes the resourcing and skills of the internal audit function to be sufficient, and if not, how appropriate resources are to be obtained;
- The work performed by internal audit on the effectiveness of management's processes to identify, assess and mitigate the principal risks to the Company;
- How the performance of the internal audit function is evaluated, the results of the most recent assessment, and the actions identified as a result of this assessment.

Ernst & Young

Letter from the Chairs to EY

Dear Mr Field and Ms Reeves

Thank you for your letter of 22 May inviting EY's response to your committees' joint report into Carillion.

We viewed your inquiry as an important and timely examination of the issues around the failure of Carillion. Your report highlights a number of ongoing and important discussions and reviews into the adequacy of corporate governance, regulation and the audit market, among other areas, such as pensions reform and the oversight of critical government suppliers. We are committed to playing a constructive role in these matters.

We are currently engaged with Sir John Kingman with regard to his review of the Financial Reporting Council (FRC) and with the Competition and Markets Authority with regard to their considerations of the audit market. We are also committed to supporting the work of the Audit Quality Forum to review the scope of audit to ensure it meets the needs of society and the markets. This is commonly called Project Flora and brings together the Institute of Chartered Accountants in England and Wales, the Department of Business, Energy and Industrial Strategy (DBEIS) and the FRC with the support and encouragement of the Policy and Reputation Group, which represents the large and mid-tier accounting firms and is currently in the process of identifying a chair for its work. It is intended that it will develop a set of proposals for consideration by DBEIS.

In addition, in recent years, we have invested significantly in enhancing audit quality, including investment in digital audit, blockchain, robotics, artificial intelligence and other cutting-edge technologies that further extend our ability to provide high-quality work in a dynamic and changing world. Our multidisciplinary model and related investments provide the structure, breadth and depth of technical skills, and industry expertise necessary to deliver high-quality audits, particularly to large, complex, international businesses.

With these capabilities, our absolute priority is to serve and protect the public interest and to bring confidence to the capital markets. And your report highlights that the services provided by our profession must be delivered not just to a company we may serve, but in the context of the broader public interest. EY is committed to working constructively with all stakeholders to this end.

Your report also identified other areas in which the UK capital markets could be made stronger. For example, we welcomed the opportunity presented at your inquiry for our restructuring partners Alan Bloom, Lee Watson and Andrew Wollaston to talk about the lessons learnt from the Carillion situation and to share our views with regard to insolvency and pre-insolvency measures which might have helped to prevent that situation. Mr Bloom gave two examples which he believed, based on his extensive restructuring experience, might have assisted in delivering a better outcome for Carillion's stakeholders.

1. Lessons could be drawn from the US Chapter 11 process which gives greater protection to companies as they prepare their restructuring plans. In particular, the legal protections

with regard to contracts and the ‘stay’ on creditors’ actions might have avoided a situation where lenders’ support was withdrawn from Carillion before the business plan had been presented or the independent review of that plan (by the bank’s advisers) been undertaken.

2. Drawing from work in the financial services sector post financial crisis, the development of resolution plans for systemically important companies (often called ‘living wills’) including those providing critical services to the Government could provide for service continuity in the event of a company entering difficulties.

EY is not proposing that, alone, these measures would have prevented the Carillion situation, but we believe that there is scope to examine whether the creation of a new pre-insolvency regime in the UK could contribute to the successful restructuring of businesses facing difficulties, minimising the impact on stakeholders.

We believe that without action of this kind, the UK’s position as a location where businesses can successfully restructure and survive is at risk of dropping, in relative terms, as other jurisdictions, including the EU, update their insolvency and pre-insolvency legislation. New legislation could cover, among other things, the company’s ability to get protection through a moratorium and to obtain further debt finance. An updated regime could draw on the best of US Chapter 11 along with aspects of other international legislation. It would need to strike a balance between being rehabilitative and punitive and to address the current convention that a company can only file for protection once it has run out of funds. Removing the stigma of filing for protection would lead company boards to act earlier and, we believe, create an environment where more companies could be returned to health.

There are a small number of points regarding EY in your report which we would wish to clarify and we have done so in the appendix to this letter.

If we can be of any further assistance to you, please do not hesitate to contact us.

Yours sincerely

Steve Varley
Chairman UK

Appendix - Clarifications

We were happy that our restructuring partners Alan Bloom, Lee Watson and Andrew Wollaston had the opportunity to appear before the joint Inquiry in March to talk about EY's work for Carillion, attempting to find a solution which would have allowed the company to continue to operate on a sustainable basis. There are a small number of points regarding EY in the report which we would wish to clarify.

1. Your report describes one of EY's partners as having been 'seconded onto the Carillion Board'. This was not the case. The partner concerned, Lee Watson, was seconded to Carillion as Chief Transformation Officer (CTO), reporting to the Chief Executive, Keith Cochrane. He did attend some Board meetings in his capacity as CTO to provide updates on restructuring activity, however he was not a Director of Carillion nor a member of the company's Board.

2. The report also stated that EY had proposed to Carillion's management that it extend its standard payment terms to 126 days. We have also clarified this point in correspondence with the Federation of Small Businesses subsequent to your report's publication. This suggestion was not made with regard to all of Carillion's suppliers. Rather, it was confined to four larger suppliers who were already registered on Carillion's Supply Chain Finance platform (SCF) on non-standard terms (i.e., 120 days), and in respect of whom we recommended that Carillion consider applying its current standard terms instead (i.e., 126 days). Our understanding of the SCF is that it was set up to allow suppliers to draw down funds in line with their agreed payment terms at no additional cost, or earlier than agreed at an additional cost. Our recommendation did not materially disadvantage the suppliers concerned, as regards the timing of their access to cash.

3. Finally, the report describes EY as having provided 'six months of failed turnaround advice.' We would remind the committee that EY's role at Carillion was to support the company's management in reorganising the business and reducing its costs; to identify ways of improving the company's cash flow; and to assist in preparing a detailed financial model which then used by the company's management to develop a five-year business plan to present to its creditors. We also supported the company's lead advisor in liaising with creditors and other stakeholders. We were very disappointed that, despite all efforts, Carillion was unable to agree a restructuring plan that its creditors were prepared to fund and that would allow the company to continue operating on a sustainable basis. As our restructuring partners said when they appeared before your committees, the Carillion situation was one of the most complex that they had encountered in their long experience and the outcome – a company of this size going directly into liquidation – was virtually unprecedented.

KPMG

Letter from the Chairs to KPMG

Dear Mr Field and Ms Reeves

Carillion Inquiry

Thank you for your letter of 22 May 2018 giving us the opportunity to comment on your joint report.

As we have said previously, KPMG understands the importance of this Inquiry. We recognise the scale and consequences of Carillion's insolvency differentiate it from many other companies which fail. We are very conscious of the human impact and have great sympathy for those employees, suppliers and others who have suffered as a result. The Inquiry's objective of seeking to understand exactly why Carillion failed and to ensure that all relevant lessons are learned is one which KPMG entirely supports.

Our audit work for the 2014, 2015 and 2016 full years, together with our audit work in 2017, is now the subject of an ongoing investigation by the Financial Reporting Council ("FRC"). It would therefore be inappropriate to provide any further comment in relation to our audit work beyond what we said, in our detailed letter to you of 2 February 2018, in response to your earlier questions. We have been providing extensive disclosure of our audit working papers and related material to the FRC, and we will continue to cooperate fully with their investigation.

We do, though, respectfully disagree with your characterisation of our audit work as "complacent" which does not reflect the hard work and commitment of the Carillion audit team.

We understand why the circumstances of Carillion's failure have led to public questioning of KPMG's role, and fully accept that the auditor's work should be subject to appropriate scrutiny. However, as we have said, while a company might fail following issuance of an unqualified audit opinion, this does not automatically mean the auditor did a bad job.

We believe that a wider debate is needed regarding the role of audit and, in particular, the reasons for any difference between that role as prescribed in relevant professional standards and guidelines on the one hand, and the public expectation of what an audit should be able to achieve on the other.

Your report also makes a number of points about the existing structure of the statutory audit market. We do not share the view that changing the audit market structure is the key to driving up quality but we will, of course, take part in any debate on these complex issues, in whatever forum is most appropriate, with a view to exploring workable solutions. As I hope you would agree, we all need to be confident that changes are made only where this will improve – or certainly not be to the detriment of – audit quality.

We remain fully committed to continuously improving audit quality and consistency, which will include learning any specific lessons there are for us from Carillion.

Thank you again for the opportunity to respond to your report.

Yours sincerely

Bill Michael
Chairman and Senior Partner

PricewaterhouseCoopers

Letter from the Chairs to PwC

Dear Mr Field and Ms Reeves,

Carillion inquiry

Thank you for your letter of 22 May 2018. We welcome the opportunity to respond to the Joint Committee's (Committee) findings on PwC and the wider audit market in its report on the Carillion inquiry. This letter addresses both points.

1. Findings on PwC

1.1 The Carillion liquidation is the largest ever compulsory liquidation process in the UK. The Committee itself has recognised that the liquidation is "*of exceptional size and complexity*" and has also recognised "*the unique scale of work required to both manage the insolvency and maintain services*".[1]

1.2 PwC was appointed as Special Manager in the Carillion liquidation process because we were best qualified to undertake the role. We have a market-leading insolvency practice led by experts with proven skills and the experience to manage a liquidation of this scale. The multi-disciplinary nature of PwC's services gives us the ability to draw on large numbers of skilled staff across our business. We do not believe that PwC was appointed because we were "*the least conflicted of the Four*" or because there was an "*extremely limited pool*". There were other firms which could have been appointed by the Official Receiver but our track record shows we have experience[2] of what is required in the Special Manager role and can be relied on to support the Official Receiver.

1.3 PwC's ability to provide the range of services required, on a large scale and at speed has been vital to the liquidation process and has ensured that a "*disorderly liquidation... which would have meant the termination of all the contracts, including the public services contracts, and redundancy for all the workers on those contracts*"[3] has been avoided. In the first week of the liquidation, PwC was able to deploy 257 people to provide specialist skills at short notice.[4] These included specialists in cyber, technology, health and safety as well as experts in restructuring, pensions and tax. Over time, we have reduced the number of people working on the liquidation whilst continuing to support the supply of essential public services.

1.4 In its report, the Committee finds that "*there are conflicts at every turn*" but it is operating on the basis that PwC's work prior to the liquidation process for Carillion Plc and its subsidiaries (together, Carillion), the trustees of the Carillion pension fund (trustees) and the Government has given rise to a conflict of interest for PwC in the Special Manager

1 https://publications.parliament.uk/pa/cm201719/cmselect/cmworpen/769/769.pdf at p.65
2 In 2015 PwC was appointed as Special Manager in the compulsory liquidation of Sahaviriya Steel Industries UK Limited (SSI). This was the second largest compulsory liquidation (where a Special Manager was required) in the UK and another complex and difficult engagement.
3 Evidence of Rt Hon David Lidington to the Liaison Committee on 7 February 2018: https://www.parliament.uk/documents/commons-committees/liaison/oral-evidence-session-transcript-07-02-2018.pdf
4 Evidence of Rt Hon David Lidington to the Liaison Committee on 7 February 2018: https://www.parliament.uk/documents/commons-committees/liaison/oral-evidence-session-transcript-07-02-2018.pdf

appointment. When PwC was appointed as Special Manager, there was no conflict of interest. This continues to be the case. The Official Receiver has written to the Committee on this point.[5]

1.5 As we have explained in evidence to the Committee[6] including in our most recent letter of 19 June 2018, we considered the services we were asked to provide and our appointment as Special Manager in the context of the regulatory rules with which we are required to comply.[7] The rules are clear that PwC is able to act for different clients in relation to the same situation provided appropriate safeguards are in place. We put safeguards in place and concluded that there was no conflict of interest in our Special Manager appointment. The Official Receiver concurs with our assessment.

1.6 The Committee has also found that PwC is able to "*name its price as Special Manager of the liquidation*" and "*write their own pay cheque, without adequate scrutiny*". This is not the case. The Official Receiver has negotiated a 20% discount on our standard market rates for this type of work which is at odds with the Committee's assertion that PwC is able to "*name its price*".

1.7 We have explained the processes which govern approval and payment of our Special Manager fees in our evidence to the Committee.[8] PwC's fees are subject to review, challenge and approval by the High Court following submission of a fee application by the Official Receiver. Prior to any fee application to the High Court, we are required to prepare a report for the Official Receiver in accordance with the regulatory standard for Insolvency Practitioners.[9] The application is then subject to review by the High Court following the rules which govern such applications in insolvency proceedings.[10] These rules include the guiding principle for the assessment of fees of the office-holder by reference to the value of the services provided, not simply reimbursement of time spent and costs incurred[11] and the principle that fees should be proportionate to the nature, complexity and extent of the work done.[12] Contrary to the conclusion drawn by the Committee, our fees and work are subject to significant scrutiny and it is unrealistic in our view to expect a High Court judge to set parameters for the Special Manager fees at an early stage of such a large and complex liquidation process, particularly when the scale and complexity is unprecedented.

1.8 The Committee asserts that the Special Manager work lacks oversight.[13] It has found that it has "*seen no measures of success or accountability by which the Special Managers are being judged*" but this does not mean that there is no scrutiny of our work or accountability by PwC. Our Special Manager work is monitored by the Official Receiver and his team on an ongoing basis. We provide regular updates on activity and achievements which

5 Letter from David Chapman to the Chairs of the Joint Committee dated 5 February 2018: "In appointing the Special Managers, I took into account the need for a firm that was not conflicted; which had sufficient resources to undertake this complex liquidation; and that had some existing knowledge of the Carillion group."

6 Also evidence of Marissa Thomas to the Committee on 21 March 2018 Q1317 http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/work-and-pensions-committee/carillion/oral/80775.html

7 Code of Ethics of the Institute of Chartered Accountants in England & Wales (ICAEW)

8 Evidence of David Kelly to the Committee on 21 March 2018 at Q1346, letter dated 29 March 2018 from Marissa Thomas to the Chairs of the Committee

9 Statement of Insolvency Practice 9

10 Practice Direction - Insolvency Proceedings, Civil Procedure Rules which can be accessed at https://www.justice.gov.uk/courts/procedure-rules/civil/rules/insolvency_pd

11 Practice Direction - Insolvency Proceedings, Civil Procedure Rules at Part 6 para 21.2 (4)

12 Practice Direction - Insolvency Proceedings, Civil Procedure Rules at Part 6 para 21.2 (7)

13 https://publications.parliament.uk/pa/cm201719/cmselect/cmworpen/769/769.pdf at para 161

have been made in the 15 work streams which are in progress and we provide details of the costs incurred. As we have explained to the Committee, there are no prescribed performance indicators for a compulsory liquidation.[14] The Official Receiver's objectives in the liquidation process have been met by acting in the best interests of creditors and ensuring continuity in the supply of essential public services.

1.9 Our work in supporting the Official Receiver has had a positive impact. This has been acknowledged in a statement to the Public Accounts Committee by Mr John Manzoni, Chief Executive of the Civil Service and Permanent Secretary for the Cabinet Office on 20 June 2018 when he thanked PwC for our work on Carillion.[15] The continuity of public services has also been highlighted by the National Audit Office (NAO) in its recent report[16] which states: "*the Cabinet Office believes that almost all services have continued uninterrupted*",[17] "*services...continued to be delivered to schools, hospitals, military bases and so on, which would otherwise have had to curtail operations or close completely*"[18] and "*construction projects either continued uninterrupted … or stopped where sites were made safe while awaiting a new contractor*".[19]

1.10 In addition, our work has helped to save jobs. As noted in the NAO's report: "*By 29 May 2018 the Official Receiver had found continuing employment for 11,638 (64%) of the pre-liquidation Carillion UK workforce where contracts have been transferred. It has made 2,332 staff redundant without new jobs (13%), and continues to employ around 3,000 on remaining services*".[20] Updates on the employment position are regularly published by the Insolvency Service.[21] We understand concerns about the cost of the liquidation process but without this work, the cost to UK jobs, the economy and the taxpayer would be considerably higher.

1.11 As a firm we are proud of the work which we have done and continue to do, of the continuity of the services we have helped to ensure, of the jobs we have helped to save and of the successful transfer of contracts with which we have been able to assist. We are pleased that the Committee has acknowledged and stated that it welcomes the work undertaken by the Official Receiver and his team since the insolvency and found that "*The Official Receiver agreed to support compulsory liquidation, and sought the appointment of Special Managers, in the best interests of the taxpayer and has sought to achieve the best possible outcome for employees, suppliers and other creditors.*"[22]

14 Letter from Marissa Thomas to the Chairs of the Committee dated 29 March 2018

15 "We have saved more than 75% of the jobs, not a single loss time incident has happened since that break down and not a blip in public service and there are thousands of people both inside the Civil Service, in Carillion, in PwC and in the Official Receiver and I just want to say thank you to them because I think it's important that we do that", statement of Mr John Manzoni to the Public Accounts Committee inquiry on strategic suppliers on 20 June 2018

16 https://www.nao.org.uk/wp-content/uploads/2018/06/Investigation-into-the-governments-handling-of-the-collapse-of-Carillion.pdf

17 https://www.nao.org.uk/wp-content/uploads/2018/06/Investigation-into-the-governments-handling-of-the-collapse-of-Carillion.pdf at para 11

18 https://www.nao.org.uk/wp-content/uploads/2018/06/Investigation-into-the-governments-handling-of-the-collapse-of-Carillion.pdf at part 5, para 5.3

19 https://www.nao.org.uk/wp-content/uploads/2018/06/Investigation-into-the-governments-handling-of-the-collapse-of-Carillion.pdf at part 5, para 5.6

20 https://www.nao.org.uk/wp-content/uploads/2018/06/Investigation-into-the-governments-handling-of-the-collapse-of-Carillion.pdf

21 https://www.gov.uk/government/news/carillion-official-receivers-employment-update--3, dated 18 June 2018.

22 https://publications.parliament.uk/pa/cm201719/cmselect/cmworpen/769/769.pdf at p.158

2. The wider audit market

2.1 The Committee's recommendation is "*that the Government refers the statutory audit market to the Competition and Markets Authority*" and that the terms of reference for that review "*should explicitly include consideration of both breaking up the Big Four in to more audit firms, and detaching audit arms from those providing other professional services.*"[23] It is keen for an "*ambitious and wide-ranging set of reforms that reset our systems of corporate accountability in the long-term public interest.*"[24]

2.2 Whilst there are a number of ongoing investigations in to Carillion and the full facts are not yet known, there are important issues of audit quality and the relevance of audit for which a solution is needed, and one which preserves, rather than damages audit quality.

2.3 Audit is part of a wider reporting and governance system which includes companies, shareholders, non-executives, legislators and regulators. Any consideration of audit must take into account the entire system. One of the issues at the heart of the Carillion situation is the "expectation gap" between what an audit does and what the public want it to do. The Project Flora initiative - which is being promoted by the FRC and the ICAEW and has Government support - is intended to address this. We support Project Flora and would welcome the Committee's support in this important project. It is crucial that this proceeds promptly with a suitable independent and credible Chair and in an identifiable timeline.

2.4 We recognise that it would be better to have increased choice of audit firms and we will welcome any initiatives that realistically lead to that outcome. The EU has adopted rules which require companies to change auditors regularly and limit the other services which a company's auditor can provide. These rules have driven innovation and increased the focus on audit quality but have not increased choice in the large company audit market.[25] The limited options for choice which are currently available reflect the size, scale and expertise required by large organisations in their statutory audit.

2.5 The Committee's recommendation to break up the large firms would not solve the problems of audit effectiveness or the "expectation gap". A break up could also harm audit quality when it is imperative that any solution has this as a priority. The delivery of a high quality audit requires audit teams who are able to access a broad base of specialist knowledge (within the UK and internationally). This would be difficult to maintain in a firm which focused only on audit services.

2.6 High quality audits also require talented people and it's important for audit firms to offer a range of career opportunities if they are to attract and retain high quality staff. PwC is the largest private sector recruiter of graduates and the wide-ranging experiences which we offer to our staff help them with their knowledge of business, of market sectors, of industries and also to develop professional scepticism. In our view, the attraction and retention of the right talent would be more challenging in a firm which focused only on audit services.

2.7 The audit would also be less efficient in terms of time and cost in a firm which focused only on audit services. At PwC, the multi-disciplinary model has enabled us to invest more than $500m globally in new audit technologies, using the specialist skills and technology

23 https://publications.parliament.uk/pa/cm201719/cmselect/cmworpen/769/769.pdf at p.85
24 https://publications.parliament.uk/pa/cm201719/cmselect/cmworpen/769/769.pdf at p.96
25 More than 97% of FTSE 350 companies are audited by the largest four firms

solutions we have in the non-audit part of our business. New technology and approaches are introduced in our audits all the time to better analyse the vast amounts of data in companies and to identify financial reporting risks.

2.8 Large complex audits need specialist skills beyond accountancy, often at short notice. For example, we can easily access valuation experts to provide audit support services, business recovery specialists to advise on going concern issues and tax specialists to consider whether companies have assessed their tax liabilities. Similarly, we draw on specialist skills in our audit business to support our non-audit engagements, such as in the administration of Lehman Brothers International (Europe). If we had to hire outside specialists for audit engagements, this would lead to increased costs and complexity for companies.

2.9 It is clear that a break up of the large firms has implications for audit quality and so it is important that solutions are found to help other firms overcome the inevitable barriers to entry in this complex market. These barriers include increased auditor liability, greater regulatory scrutiny and the need for significant investment. The solutions identified will need to work for the UK economy and internationally given the global nature of business and capital markets.

We are ready to engage in constructive discussion and debate on these issues. If you have any further questions or if we may be of any further assistance, please do get in touch.

Yours sincerely,

Margaret Cole
General Counsel

Lord Tyrie, Chairman of the Competition and Markets Authority

Letter from the Chairs to Andrew Tyrie

Dear Frank and Rachel,

RE: The Big Four

Thank you very much for your letter of 22 May about audit. The Committees' joint report raises important points and I understand that the CMA is already considering a number of these issues.

You should be aware that I do not expect to take up my post for a month. When I arrive, I will certainly bear in mind your advice, not least about brooms.

Yours sincerely,

Andrew Tyrie

Chapter 4: Former Carillion Directors

Richard Adam, former Finance Director

Letter from the Chairs to Richard Adam

Dear Mr Field and Ms Reeves

Carillion

Thank you for your 22 May 2018 letter inviting me to comment on your 16 May 2018 report on Carillion, in addition to the comments that I gave you on 15 May 2018 in relation to the embargoed version of that report which you published on 17 May 2018.

Your report and subsequent media appearances put the blame on me and others for Carillion's collapse. The reasons for Carillion's collapse are clearly complex, however, I do not believe that all the evidence you heard and read justifies your conclusions and I believe the assumptions you have made in order to arrive at your conclusions are unwarranted in respect of my role at the company prior to my retirement in 2016.

I am participating in ongoing regulatory investigations, which I hope will be fair and involve due process.

Yours sincerely

Richard Adam

Keith Cochrane, former Interim Chief Executive

Letter from the Chairs to Keith Cochrane

Dear Mr Field and Ms Reeves

Carillion – Joint Select Committee Hearing Evidence

I refer to your letter of 22 May 2018 inviting comments on the report published on 16 May 2018.

While I am concerned that, in reaching its conclusions, there are a number of instances where the Committee appears to have taken the evidence I provided to them out of context, and note generally that I do not accept many of the conclusions reached in the report, in view of the ongoing investigations into the insolvency of Carillion, I do not consider that it would be right for me to comment in detail at this time.

Yours sincerely

Keith Cochrane

Andrew Dougal, former Chair of the Audit Committee

Letter from the Chairs to Andrew Dougal

Dear Mr Field and Ms Reeves

Carillion – Joint Select Committee Hearing Evidence

Thank you for your letter dated 22 May 2018 inviting me to comment on your report published on 16 May 2018.

Whilst I disagree with many of the report's conclusions, in light of the ongoing investigations into the insolvency of Carillion I do not consider that it would be right for me to comment in detail on the report at this time.

Yours sincerely

Andrew Dougal

Philip Green, former Non-Executive Chairman

Letter from the Chairs to Philip Green

Dear Mr Field and Ms Reeves

Carillion – Joint Select Committee Hearing Evidence

Thank you for your letter dated 22 May 2018 inviting me to comment on your report published on 16 May 2018.

As you are aware, the insolvency of Carillion and the circumstances around it are currently the subject of investigations by the Insolvency Service, assisted by PwC as Special Manager, the Financial Conduct Authority and the Financial Reporting Council. Whilst I have a significant number of comments on your report and disagree with many of its conclusions, I do not believe that it would be appropriate for me to comment at this time whilst those investigations are ongoing.

I have been and will continue to cooperate fully with such investigations and look forward to their outcomes.

Yours sincerely

Philip Green

Alison Horner, former Chair of the Remuneration Committee

Letter from the Chairs to Alison Horner

Dear Mr Field and Ms Reeves

Carillion – Joint Select Committee Hearing Evidence

Thank you for your letter dated 22 May 2018 inviting me to comment on your report published on 16 May 2018.

While I am concerned that there are a number of instances where the report misquotes or misrepresents the evidence that I gave to the Joint Committee, given the ongoing investigations into the insolvency of Carillion, I do not consider that it would be right for me to comment generally on the report at this time.

Yours sincerely

Alison Horner

Richard Howson, former Chief Executive

Letter from the Chairs to Richard Howson

Dear Mr Field and Ms Reeves

Joint Report by the Work and Pensions and Business, Energy and Industrial Strategy Committees into Carillion

I refer to your letter dated 22 May 2018 inviting me to comment on your second joint Report into Carillion. The stated aim of your work was to inquire into and investigate how Carillion went into liquidation.

The Report has not considered all of the issues which are key to understanding the reasons why Carillion went into liquidation. In dealing with the issues which have been covered, the Report has omitted or ignored some of the more significant evidence submitted. The Report fails both to analyse all of the evidence received and to explain the Joint Select Committee's interpretation of that evidence in a clear and balanced way. In some cases the Report also fails to understand the complexity of the contracts or markets that Carillion was party to and describes the evidence in a misleading fashion. I have therefore restricted my comments to a few key observations; however, failure to deal with any point should not be taken as acceptance of those points:

1. The reasons for Carillion's demise are mixed and varied (and are yet, I believe, to be fully understood). Yes, debt was too high but for my part I was absolutely committed to working through to conclusion our challenging contracts and reducing it. As a board we relied on cash flow forecasts, working capital projections and on our customers acting in accordance with the contracts and administering fair and timely cash flows. However, any examination of the causes of the liquidation has to look closely at the events immediately preceding the liquidation. Without such an investigation, any findings are flawed and incomplete. No review was conducted of those last few crucial months and the actions taken or more importantly not taken leading up to the liquidation both by the company and by Government.

Given the size of the contracts and the contractual claims Carillion had against its customers for additional and variable works and suppliers for significant non performance, cash collection was a key part of the senior and executive management team's role (see my evidence Q426). It is not clear to what extent effort was expended in this regard in the last few months immediately preceding the liquidation, when 4 out of the 5 existing experienced Divisional Managing Directors were removed from their roles. I have had numerous concerns raised with me, from those there to the end, that amounts owed were not pursued by senior and executive management, and that they appeared to ignore the fact that those on the other side of the negotiating table expected executive management (given the seriousness of the situation) to be present to lead the collection of cash or conclusion of accounts.

2. Crucial to a thorough and proper investigation was for the Joint Select Committee to obtain an understanding of the amounts owed to Carillion by various Government Departments and agencies. In investigating the causes of the failure, the Committee should have asked Carillion's Government and public sector customers how much was properly due to Carillion under the contract. Emma Mercer referred to the cash flow issues

when she gave evidence (Q338). In my letter dated 10 April 2018 I suggested that details of the sums could be obtained from Emma Mercer but I see no reference to this in your report. In my letter of 10 April I referred to the NOMS (National Offender Management Service) contract to provide facilities management services to the prisons in the South of England. Despite the fact that Government had completely underestimated in their tender documents the size of the estate (which turned out to be some 60% bigger by number of assets than Government had estimated), Carillion was obliged contractually to maintain and administer this bigger estate and rely on change mechanisms within the contract to make it and its suppliers whole and to undertake substantial variable works (for example, following prison riots). Carillion did this and bore the significant additional costs as a result. Despite the fact that Carillion was not being paid for this additional work, it continued to deliver the daily services and pay its own suppliers as it should.

Carillion in my time was constantly chasing up its Government and public sector customers to agree such additional amounts, despite the fact that such amounts had arisen because those customers had failed to adequately understand the size of their estate and had failed to administer the contract between the customer and Carillion in a fair and timely manner. Therefore, these amounts should never have been disputed because they flowed from the pricing structure in the contracts and the terms and conditions within the contract relating to change management. At the time of my departure substantial amounts were properly due to Carillion under the contract from Government, or from Government-owned or majority-owned entities on a range of contracts (for example, MoD on NGEC, Highways England, Transport for Scotland, NOMS, Network Rail). I understand from concerns raised with me by senior members of the Carillion team present at the point of the liquidation that similar large amounts were still outstanding.

3. Whilst I am aware of the work of the PAC/PACAC Joint Select Committee looking at government and public sector outsourcing, any analysis as to the causes of the failure of Carillion is not complete without looking at the way in which Government and the wider public sector procured services from Carillion and failed to administer payments. Government and the wider public sector failed to provide adequate data and threatened to strike out the company as a contender for future work if Carillion had pursued its claims against the Government by the threat of litigation.

Carillion is one of a number of companies that have commented on such treatment. Rupert Soames, CEO of Serco, has recently talked of the need for four principles in government contracting, with transparency and fairness on both sides being key. Construction and facilities management contracts are not static: the approach required to ensure that contracts are successful and deliver the customer's objectives must be based on partnership between the customer, the contractor and suppliers to support service delivery excellence and honest and fair cash flows. This must not be solely based on timing, but, just as importantly, on quantum.

I note that the Federation of Small Businesses states in its letter of 27 February 2018 that "As you know, the general problem small businesses across the economy face with poor payment is much wider than simply payment terms- it is just as much about issues such as spurious invoice disputes, barriers and delays before issuing a purchase order, unfounded quibbles with work carried out". In my letter to you dated 10 April (which was not referred to in the Report and was not disclosed by the Committee), I discussed Carillion's Early Payment Facility (EPF) and I described the challenges that contractors face in collecting all of the amounts due to them. The Government quite rightly mandates contractors to pay suppliers on 30 day terms; however, in order to achieve this, Government should be prepared (in all senses of the word) to administer monthly payment applications holistically to enable all parties in the supply chain to be paid fairly for all of the work undertaken within a given period. Hiding behind spurious disputes around scope, changed or varied works, eligibility for legitimate additional costs or punitive levying of performance penalties, and therefore effectively using its supply chain as a bank, is not acceptable. In this regard, the Federation of Small Businesses is quite right, but be under no illusion that this problem starts at the top.

4. The Joint Select Committee asked for and invited evidence from a number of sources. Any report into the collapse of Carillion, for it to have weight and be credible, has to both analyse all the evidence received and explain its interpretation clearly and in a balanced way. In many instances, the Report arrives at conclusions but no evidence is given in support. In its approach, the Committee chose to publish the evidence it received selectively, ignored some of the more significant evidence submitted to it and quoted information in a misleading fashion.

First, my letters of 21 February 2018 (second letter), 10 April 2018 and 9 May 2018 (pointing out an inaccuracy in the Committee's first report and commenting on EPF and Msheireb Properties and other issues) were never published, despite the Committee agreeing with my evidence (and also set out in my letter of 21 February) and changing their first report as a result. I also note that a large number of letters (13 in total) were not published until the Committee published its second report on 16 May 2018, despite being received much earlier (between February and April), meaning that interested parties had no opportunity to provide further evidence prior to publication of the second report. For example, Emma Mercer's letter to the Committee dated 5 March 2018 was only published on 16 May 2018 and the letter from Gavin Vaughan dated 30 March was published on 16 May 2018. I am also aware that various other correspondence has never been published by the Committee.

Second, in my letter of 10 April 2018 I provided significant detail in respect of the project in Qatar for Msheireb Properties, which the Committee has not published and which appears not to have been considered in the Report. In my letter I referred to the fact that the issue which Carillion faced in terms of payment by Msheireb Properties was also confirmed by the experience of other contractors; "clearly demonstrate that Carillion's experience with Msheireb Properties (owned by the Qatar Foundation) has been and is being experienced by a number of other contractors and sub-contractors in Qatar" .

Third, in dealing with the EPF issue, I do not consider that the way in which Carillion structured its EPF has been communicated accurately within the Report. Both Emma Mercer and myself dealt with this at Q352–355 and Q545 and in my letter dated 10 April 2018. The Report states that "Carillion was a signatory of the Government's Prompt Payment Code, but its standard payment terms were an extraordinary 120 days. Suppliers could be paid in 45 days, but had to take a cut for the privilege." This is just not correct. As I said in my letter of 10 April (which the Committee has chosen not to publish and not to refer to) I explained that the EPF "allowed suppliers to choose when they took payments on approved invoices, which they could do at no cost to themselves on 30 days on government contracts and on 45 days on non-government contracts." The bank would deduct the interest for this but Carillion would make the supplier whole, so it is simply not correct to say that the supplier had to take a cut for the privilege. Whilst the 120 days was provided for in the contract, this (as I said in my letter) “effectively set the time period with which Carillion paid its EPF partner banks, not the time period it took to pay its suppliers.”

You will appreciate that in preparing this letter I have not necessarily had the opportunity to refer to the information I would have had at the time.

Yours sincerely

Richard Howson

Zafar Khan, former Finance Director

Letter from the Chairs to Zafar Khan

Dear Mr Field and Ms Reeves,

Carillion

Thank you for your letter of 22 May 2018 and for your invitation to comment on the Committees' Joint Report.

I do not agree with the views set out in the Joint Report insofar as my own position is concerned. As you will be aware, other regulators are undertaking detailed investigations in relation to Carillion and I consider it would be more appropriate for me to provide any further explanations of my position in the course of those investigations.

Yours sincerely,

Zafar Khan

Emma Mercer, former Finance Director

Letter from the Chairs to Emma Mercer

Dear Mr Field and Ms Reeves

Carillion – Joint Select Committee Hearing Evidence

Thank you for your letter dated 22 May 2018.

While I disagree with much of the commentary in the Committee's report, in view of the ongoing investigations into the insolvency of Carillion, I do not intend to provide comments at this time.

Yours sincerely

Emma Mercer

Chapter 5: Industry Bodies

Confederation of British Industry

Letter from the Chairs to CBI

CBI response to the Work and Pensions and BEIS Committees joint report into the collapse of Carillion

Carillion acted irresponsibly, and their actions serve as a stark lesson in the dangers of short-termism.

Carillon's business model prioritised winning contracts at the expense of the company's overall sustainability and the health of its supply chain. This was wrong, and deeply irresponsible.

The severe impact of Carillion's failure includes the 2,354 jobs lost so far, and the almost £7bn owed to creditors including pension schemes and suppliers. From the taxpayers' perspective, the government has had to spend around £150m keeping essential services running.

Given the extent of these failings and their consequences for customers, suppliers and staff, working together government and business must do everything possible to avoid another Carillion. This means learning lessons and putting them into practice whenever necessary across the economy.

Responsible firms give due regard to their long-term performance and social impact, and targeted action by business and government can encourage this approach across the economy.

Companies that have, and act on, a long-term vision for their social and economic impact are more likely to deliver sustainable growth and behave responsibly in the interests of staff, customers and supply chains. This behaviour can also focus investment in drivers of prosperity that will be key to their success and that of the UK overall, such as the skills and technologies needed as the world of work changes.

In short, doing good is good business, and when the public see companies operating in this way it builds people's confidence in the value of business to the UK. This is especially important for companies in receipt of public money and delivering vital services and infrastructure – they rightly have even higher expectations placed upon them in terms of their business practices.

Carillion fell far short of this vision, and the CBI believes there are several areas where action can be taken by business and government to help minimise the likelihood of this happening again. We set out in detail in this response our views on a number of these, including prompt payment, corporate governance and public procurement. In addition, the audit market is also under scrutiny. The CBI will input in more detail to this, but our early thinking is that any review will want to consider the scope and expectations of audit, how to increase choice and competition, and whether more could be done to further reduce potential conflicts of interest.

1. Increasing transparency to drive improvements in payment performance

Carillion's payment practices, which included extending terms of up to 120 days and charging a fee for early payment, were indefensible. They enabled Carillion to hold on to cash for longer, but transferred the financial risk to its supply chain, putting smaller firms under pressure.

That Carillion was a signatory of the Prompt Payment Code shows that there is much more that payment guidelines need to do to drive improved payment practices. The overwhelming majority of firms recognise that paying on time is a cornerstone of good business and already act accordingly. Yet with small and medium size businesses' late payment debt sitting at £14.2bn,[1] there is no doubt that payment practices can and must improve.

This requires action by business – not just because of the social and economic impact of late payment, but more importantly because paying promptly is the right thing to do. Government can help make these necessary changes in behaviour happen by driving greater transparency of payment performance, inspiring businesses to raise their game.

Greater use of data in measuring a company's payment performance would create the transparency needed to allow businesses to benchmark, monitor and improve their performance. Companies would be assessed against their peers, by their clients and by their customers, and which would in turn drive businesses to improve their payment performance or explain how they intend to do so over time.

By making best use of existing measures such as the 'Duty to Report' to underpin performance and the Prompt Payment Code as guiding principles of good practice, government has the framework available to use data as a force for positive change. Where there are firms who need to show a marked improvement in payment practices, they should be supported in addressing issues on their journey towards best practice – a journey in which each company should be an active participant.

A further lever which the CBI supports is the consideration by government of a company's payment performance in tendering processes for public contracts. Government can use its purchasing power to drive improvements in behaviours, ensuring payment performance is considered when assessing potential suppliers to government, and that transparent publication of payment data is available to drive improvements.

As one of the biggest clients across the UK economy, government also has an opportunity to lead by example in displaying the behaviours of a 'responsible client'. By ensuring government suppliers receive payment in a timely and transparent manner, those businesses can in turn deliver payment through the supply chain faster.

2. Reforming corporate governance requirements to enhance scrutiny and hold leaders to account

Focusing on a company's behaviour by increasing accountability for corporate governance practices is a vital step in ensuring all stakeholders, from shareholders and investors to employees and suppliers, are appropriately engaged in the direction of a business. Carillion could and should have been subject to greater scrutiny earlier. It is clear that

1 BACS, 'Late payments costing smaller UK businesses more than £2bn a year', 11 July 2017

despite the legal duties placed upon both directors and non-executive directors, those on Carillion's board were unable, or unwilling, to provide the levels of challenge that might have compelled the company to shift its focus onto fixing problems it was facing before it collapsed.

Responsible leaders have a duty to run their business with a view to its long-term success. Action is already underway to make such behaviour more widespread. The new Companies (Miscellaneous Reporting) Regulations will build on the existing Section 172 duties for directors as set out in the Companies Act 2006. Listed companies will also be guided by a revised Corporate Governance Code from July, which emphasises obligations towards stakeholders and requires large privately-owned firms to disclose corporate governance arrangements.

Company directors will be obligated to review the appropriateness of their existing corporate governance standards in a meaningful way, and it's anticipated that improvements will be made as directors identify and remedy any poor practices that exist. These reforms benefit from an added degree of flexibility for firms to apply the new rules in a way which best suits their business. This is welcome because businesses collectively employ a vast number of management and operational structures, and a 'one size fits all' approach would be impractical.

These latest reforms will come into effect at the beginning of 2019, and many firms are already considering how to make changes to reflect these new requirements. If this improvement is found not to have been as effective as hoped, government should work with business to establish additional standards to shine a spotlight on areas of unsatisfactory business practice.

Independent challenge and the benefits of diverse and wide-ranging experience cannot be underestimated as a critical component of decision-making at board level. Shareholders also play a critical role, for example, and efforts to align the revised UK Code and the Stewardship Code could help ensure shareholders and company directors share the same vision of effective corporate governance. Companies that get this right will be motivated to monitor, benchmark and improve performance.

3. Focusing public contracts on long-term value and the outcomes that matter to the public.

Government is a significant client in many sectors and has substantial purchasing power. Carillion was a key player in this marketplace, consistently winning large contracts. Yet losses on key schemes, for example, defective beams at the contractor's Royal Liverpool University Hospital scheme and delays to a bypass in Aberdeen, were associated with the company's collapse.

Carillion was particularly exposed to such issues because it relied heavily on bidding at low prices in order win work and generate revenue. It too readily accepted the financial risk that this could pose further down the line should delays, disputes or unforeseen problems arise.

Suppliers to the public sector need to bid responsibly for contracts, be prepared to challenge bad deals, and walk away from opportunities that wouldn't yield long-term value. They also need to be clear about what constitutes their core business, and disciplined in bidding for opportunities that are a good fit. Carillion, by contrast, was short-sighted in its pursuit of unsustainable growth.

Government, for its part, should encourage companies to bid on the strength of the overall value they can provide for taxpayers, including their social and environmental impact, commitment to local supply chain engagement, and spend on R&D – not just on price.

There have been positive developments. David Lidington MP recently spoke of the need to 'repair and rebuild' trust between the public and private sector – and in doing so, increase the public's trust in government and business working together.

Yet the CBI's recent survey on public procurement practices found that there is more to do: 60 per cent of companies believe government awards work primarily on a basis of lowest cost. Rarely would this present the 'best mix of quality and value for the outlay' as Crown Commercial Service guidelines call for. Similarly, 37 per cent said government's handling of risk has deteriorated since 2015.

Changing bidding behaviours requires giving business the confidence that wider factors will have a meaningful impact on their opportunity to win contracts, and for government itself to more rigorously identify quality and value in its contracts. Driving adoption of commercial guidance across the wider public sector would help. Crown Commercial Service guidance on standard terms and conditions for smaller contracts is frequently ignored, despite the efficiencies that bidders and procurement teams would benefit from. Other guidance says risk should not be inappropriately transferred to suppliers.

If it fails to change the signals its sending to suppliers, government runs the risk of responsible firms exiting the market, reducing the level of competition for major contracts and diminishing the value for money taxpayers ultimately receive. The need for action is illustrated by Spend Network evidence showing a 476 per cent[2] rise in single-bidder tenders between 2012 and 2017.

In seeking to learn the right lessons from Carillion's collapse, it's important to maintain a sense of perspective – the vast majority of businesses do act responsibly

Carillion acted irresponsibly and provided a harsh lesson for business in the dangers of short-termism. Yet as the Committee has acknowledged, it's crucial to maintain a sense of perspective on the value of business to the UK.

Business is a major force for good in the UK. The CBI's Everyone's Business research revealed that the public recognises the important role that business plays. The survey found that 65 per cent thought the reputation of UK business was good or very good, with the top reason being a perception of the high quality of UK services and products. The research also highlighted an improvement in positive views of business among 18–34 year olds, suggesting younger people are strongly engaged in the role business plays in shaping the UK's economic future.

2 http://www.telles.eu/blog/2018/2/26/the-risks-arising-from-single-bidder-tenders-in-the-uk

When it comes to public contracts, more than 200,000 organisations supply the public sector, and these businesses bring investment and innovation to the public services and infrastructure that communities rely on across the UK's regions and nations. For each one that makes headlines for the wrong reasons, there are many more that are working well.

But this is undermined by a clear disconnect between what most businesses do and what people believe. Business must engage with and respond to the public's concerns – only action focused on what the public really cares about will enhance public trust in business as a force for good.

However, that Carillion was exceptional should in no way diminish the commitment in business and government to learn the right lessons and do everything possible to prevent this happening again.

For its part, the CBI is committed to championing progressive action on related issues. We have recently set up a new Public Sector Partners Council, which brings together suppliers from across the spectrum of industry to establish how government and business build better partnerships. In addition, the CBI's Construction Council is exploring underlying issues affecting the ability of the UK's construction industry to operate sustainable business models and invest in the UK's future needs.

CBI

Federation of Small Businesses

Letter from the Chairs to the FSB

Dear Rachel and Frank

I was glad to see the publication of your joint report into Carillion published in May, and I appreciate your invitation to make further comments.

It was heartening to see senior politicians calling out a corporate culture which too often means big government suppliers squeeze small suppliers. Government procurement practices should encourage a better corporate culture, and at FSB we are grateful for your work.

You are right to identify that the prompt payment code was clearly ineffective in the case of Carillion. As far as small business is concerned, there is an 'open and shut case' against large firms who survive on the back of small businesses who they owe money to.

I am grateful for the focus your work will bring on tackling the issues highlighted by this failure of Carillion – addressing the UK's poor payment culture would bring huge benefits to UK small businesses, to the UK economy, and to workers and consumers.

If we are to make progress on these issues, there are a number of necessary measures needed – I urge you to bring the characteristic tenacity of your committees to bear on these matters. In particular, on public procurement, we believe that splitting up more Government contracts would be in the interests of both taxpayers and small businesses.

Currently, the aggregation of contracts has two main negative effects: first, it encourages the formation of 'too big to fail, too big to succeed' conglomerates, with all of the associated taxpayer risk which the Carillion debacle highlighted; second it reduces the level of competition for government work, denying the public sector, and the taxpayer, access to small businesses with innovative practices who would often be cheaper for Government to use.

In addition to disaggregation, there are a range of measures which we believe would help Government improve procurement and prevent the conditions that led to the calamitous situation with Carillion. These range from increasing the use of Dynamic Purchasing Systems instead of Framework Agreements, and ensuring proper and widespread use of Project Bank Accounts through, for instance, the simple step of requiring a Ministerial Statement to Parliament when these are not used on construction projects.

The report was right to pick up that there should be a review of the crown representatives. The Government should take the lessons from the review to see how it can improve how it operates with strategic suppliers, including to reduce risk to the taxpayer. There is also a role for the Small Business Champion Ministers in every department to review the practices in their departments, with the aim of opening up public procurement to small suppliers.

On late payment, while we are positive about some recent steps taken by the Government, such as recent consultations launched on enforcing better payment practices through government supply chains, it is clear there is a huge amount that still needs to be done.

As part of the Government's corporate governance reforms, we believe there should be a requirement for large companies to appoint a non-executive director with a specific duty to report on behalf of the company suppliers. This director should present to the executive board and, subsequently, their findings should be included in the Annual Report.

We have recently carried out further research on supply chains, including government public sector supply chains. The report is thorough and wide ranging, but one particular aspect I wanted to draw your attention to is the finding that 25% of firms responding, who work on public sector infrastructure projects amongst other work, report being paid late more than half of the time.

I have enclosed a copy of this report with this letter, as I hope it will be useful as your respective committees. Despite your excellent work in Parliament, I do fear that without a long-term commitment to a comprehensive range of actions from Government, we will face a similar situation again.

I look forward to working together to try to secure the changes needed in government policy and practice to prevent that. Those changes are sorely needed.
Yours sincerely,

Mike Cherry OBE AIMMM FRSA
FSB National Chairman

Institute of Chartered Accountants in England and Wales

Letter from the Chairs to ICAEW

Carillion Joint Inquiry Report

Thank you for your letter of 22 May, inviting ICAEW to respond to your joint report on Carillion.

Public Trust

The publication of your report represents a watershed moment for audit and auditors. We are committed to ensuring that we learn and apply the lessons from Carillion in ways that will help sustain public trust in audit and confidence in business. If we do not, we will not have a profession worthy of the name in the UK in twenty years' time.

Trust is at risk because of perceived conflicts of interest, a lack of transparency and an expectation gap relating to the purpose and value of audit. Consistent with its commitment to the public interest, ICAEW will participate fully in the various reviews of regulation and the market which have both predated and followed your Inquiry.

Sir John Kingman Review

The Secretary of State announced a review of the Financial Reporting Council (FRC) on 21 March, to be led by Sir John Kingman. The FRC is this profession's oversight regulator and is the competent authority for audit. We therefore share the Government's goal to 'see the FRC's standing as a beacon for the best in governance, transparency, and independence'. Not only are we supporting the Kingman Review through participation in its consultation programme and by the submission of written evidence, we are encouraging ICAEW members and member firms from all parts of the market to engage with it.

ICAEW's own evidence to the Review will make two points directly referenced by your report. You state, 'the FRC can pursue some directors, not others' and 'it is the professional regulator of accountants and actuaries, but also responsible for the voluntary codes that guide the behaviour of directors and investors'. We strongly agree that the FRC's powers should be strengthened to apply to all directors of large public interest companies and not only those who are accountants. The current arrangement creates a perverse incentive for directors to remove themselves from their professional bodies, with a consequent loss of personal development and ethical oversight.

We note with approval your report's observation of 'four different regulators engaged, potentially pursuing action against different directors for related failings in discharging their duties'. We will therefore also be recommending to the Review that the FRC's remit and powers should be more focussed: confusion is created when they stray into areas of other regulators' jurisdiction.

Competition in the audit market

Responding to the current concentration in the audit market, your report recommends that 'the Government refers the statutory audit market to the Competition and Markets Authority, and that the terms of reference of that review should explicitly include consideration of breaking up the Big Four into more audit firms'. You also quote the new Chair of the CMA, the Rt Hon Andrew Tyrie, as saying 'something needs to be done about the audit market'.

ICAEW has long supported increased competition in audit and we consider the best way to do this is to make the market more attractive to new entrants. We have consistently made the point that high quality audit is not the preserve of the largest four firms - ICAEW itself licenses around 3,000 audit firms across the UK. While many smaller firms have no interest in either the main listed market or AIM audits, there is growing recognition that under the right circumstances more 'challengers' could emerge to compete at that level.

While we agree that robust measures are needed in the aftermath of Carillion and other corporate failures, we are not convinced that breaking up the Big Four firms is the answer. It could be an issue if audit-only practices did not retain access to the global networks and capabilities which the current multi-disciplinary firms enjoy: although not impossible to address, it would require international coordination and could increase costs for clients. Additionally the focus on audit quality should not be forgotten. Choice needs to progress in lockstep with quality. As much as the dominance of the Big Four, smaller audit firms have also cited the cost of regulation, the long time frame for reviewing audits and unlimited liability as some of the reasons they are reluctant to enter the market.

Conclusion

ICAEW strongly supports a full and proper scrutiny of the role of audit in effective governance and the wider economy. For us, this includes working closely with your Committees, contributing to the Kingman Review and maintaining a constructive dialogue with the CMA.

ICAEW also supports the Independent Review of Audit, convened by the Audit Quality Forum. With increasing demands from business and the public, and the increasing impact of technology, this is the right time to secure the changes needed to equip the UK's and the international audit profession for the future.
Yours sincerely

Michael D M Izza
Chief Executive

Institute of Directors

Letter from the Chairs to IoD

Thank you for giving the Institute of Directors (IoD) the opportunity to respond to the Business, Energy and Industrial Strategy Committee & Work and Pensions Committee's joint report into Carillion.

About the IoD

The IoD was founded in 1903 and obtained a Royal Charter in 1906. It is an independent, non-party political organisation of approximately 33,000 individual members. Its aim is to serve, support, represent and set standards for directors to enable them to fulfil their leadership responsibilities in creating wealth for the benefit of business and society as a whole. The membership is drawn from right across the business spectrum. 49% of FTSE 100 companies and 45% of FTSE 350 companies have IoD members on their boards, but the majority of members, some 70%, comprise directors of small and medium-sized enterprises (SMEs), ranging from long-established businesses to start-up companies. IoD members' organisations are entrepreneurial and growth-orientated, and more than half (61%) export goods and services internationally.

The IoD has long been an advocate of high standards of corporate governance. According to our Royal Charter, one of the IoD's key objectives is "to promote the study, research and development of the law and practice of corporate governance, and to share findings." We strongly believe that an effective system of corporate governance is a key underpinning of UK economic performance and business legitimacy.

Summary of our view

The collapse of Carillion was a sorry episode in the annals of UK business. The joint report that the two committees have published sets out the plausible case that the collapse of Carillion was avoidable. It ultimately occurred due to weaknesses in several key aspects of Carillion's governance framework. One of these was the flawed oversight capability of Carillion's board, although the report rightly indicates that the inadequate roles played by other actors - such as auditors, shareholders, regulators and government - also contributed to Carillion's downfall.

We have submitted in this response several proposals which the IoD has been developing in response to collapse of Carillion, and which we believe can potentially enhance the overall UK framework of corporate governance.

Summary of key proposals:

1) The Public Service Corporation

-We propose the establishment of a newly-defined corporate form – the Public Service Corporation – through which the outsourcing of public services and related activities could be delivered.

2) A Professional Framework of Conduct and Competency for directors of significant corporate entities

- We propose the establishment of a business-run Framework of Professional Conduct and Competency for board members of significant corporate entities.

We also provide some additional perspectives relation to executive pay weaknesses and late payments which have emerged from the Carillion collapse.

Specific proposals – an improved board focus on stakeholders

The report rightly highlights that the collapse had a significant and negative impact on a wide ranging number of Carillion's stakeholders, beyond shareholders. What's more, while many shareholders were able to divest and reduce their exposure to the fallout from failure, this option was not as readily available to employees, suppliers or pension scheme members whose fate was tied to that of the company. This makes the apparent lack of regard towards these groups in the director's decision making process all the more unfortunate.

As stated in Section 172 of the Companies Act 2006, directors of UK companies have a statutory duty to take into account the likely impact of their decisions on a wide group of stakeholders, not just shareholders. The degree to which this duty was fulfilled in the case of Carillion is open to doubt, and indeed the practise of late payments to suppliers, disregard to mounting debt and pension scheme deficits is highly suggestive of insufficient regard to these groups. We have two concrete proposals to address the governance concerns:

Proposal 1: The Public Service Corporation

For major public sector contractors like Carillion, we believe that a structured legal framework - through which to ensure a better balance between the interests of shareholders and other stakeholders - could be made available. We have proposed the establishment of a newly-defined corporate form - the Public Service Corporation - through which the outsourcing of public services and related activities could be delivered.

Like a private company, such a vehicle would have shareholders and operate on a commercial basis. However, its underlying legal framework would require a balance to be maintained between the interests and obligations relating to its various stakeholders, including its shareholders, employees, pensioners, creditors and public sector clients. For example, it would not be possible within such a legal entity to make significant dividend or bonus payments if there was a substantial pension fund deficit or if defined levels of corporate indebtedness were exceeded. This duty to maintain balance between the interests of stakeholders would be defined in the law relating to the general legal duties of the board of directors at such Public Service Corporations.

The composition of the board could also reflect a more pluralistic approach. In particular, the appointment or dismissal of directors could not only be a matter for shareholders – as is currently the case according to UK company law - but for other key stakeholder groups as well.

We are not advocating that such a corporate form be imposed on outsourcing firms or public contractors on a mandatory basis. However, it could be encouraged through government procurement decisions on the basis that such entities would embody a good balance between commercial know-how, prudent governance and social legitimacy.

This proposal was included in the IoD's response to the Department for Business, Energy and Industrial Strategy consultation on Insolvency and Corporate Governance.[1]

Proposal 2: A Professional Framework of Conduct and Competency for directors of significant corporate entities

In the light of the failings of Carillion's board, there is an understandable demand for board members to be held more accountable for failures of corporate oversight and direction.

In such circumstances, one possible response from policy makers might be to further increase the weight of regulatory oversight and legal sanction that is applied to directors.

However, the experience of the United States and other countries has demonstrated that a more litigious or punitive legal regime for directors does not necessarily lead to better corporate behaviour. Indeed such a regime may in many instances impose significant costs on business and encourage a box-ticking approach to corporate decision-making.

Nonetheless, the IoD recognises that more needs to be done to regain public confidence in directors. Consequently, we propose the establishment of a business-run Framework of Professional Conduct and Competency for board members of significant corporate entities.

Such a framework would provide a mechanism through which the board member community would itself define acceptable norms of behaviour relating to the practice of company directorship (through a Code of Conduct for directors), and hold its peers accountable against these norms. Directors that behaved badly would be subject to public censure and reproach.

For example, a Professional Standards Board for Directors could be established, either as a stand-alone body or within an existing professional body. Oversight and management of such a body would be business-led and business-financed.

Such a body would define a Code of Conduct applying to boards and board members of significant corporate entities, i.e. companies exceeding a certain size threshold or level of importance for stakeholders and the wider UK economy.

All persons joining the board of directors of a significant corporate entity would be required to sign-up to the Code of Conduct.

In cases where the conduct of an individual director (or board of directors) failed to live up to the standards prescribed in the Code of Conduct, the case would be reviewed by a panel of experienced business practitioners.

Based on the findings of the review, a public statement of censure or reproach could be issued in relation to the conduct of the director or the board. The possibility of such a reproach would serve to increase board-level responsibility and accountability due to its implications for the reputation and standing of affected persons.

1 Insolvency and corporate governance – IoD response : https://www.iod.com/Portals/0/PDFs/Campaigns%20and%20Reports/Corporate%20Governance/Insolvency-Corporate-Governance-consultation.pdf?ver=2018-06-07-203901-573

In the most significant cases, the panel could recommend to BEIS that a director should no longer be permitted to serve as a board member of a significant corporate entity or that legal proceedings should commence which might lead to that person being disqualified as a director. In effect, the consequence of the bad behaviour would be that a person is "struck off" from serving in a similar role in the future.

In addition, directors that signed-up to such a professional framework would also be required to undertake a targeted programme of continuing professional development (CPD). We believe that this could exert a positive impact on the capacity of boards to make better decisions and enable them to better internalise the requirements of an increasingly complex business and regulatory environment.

Overall, we believe that such a professional framework of Conduct and Competency for directors could play a significant role in increasing the responsibility and accountability of boards of directors, both to their peers and society as a whole.

Furthermore, the new framework would represent significant progress in shifting the role of director (particularly that of non-executive director) away from that of "gifted amateur", and more in the direction of competent professional with a practical understanding of fiduciary duties and responsibilities.

Additional perspectives relating to executive remuneration and dividend payments

The current edition of the UK Corporate Governance Code states that 'Executive Directors' remuneration should be designed to promote the long-term success of the company. Performance-related elements should be transparent, stretching and rigorously applied.'[2] The committees report highlights that in Carillion's case this central principle was not adhered to and indeed the attempt to increase bonuses shortly before the firm publically admitted its financial difficulties is a striking example of this.

The fact that investors halted this displays the important role which shareholders play in holding the board to account on the issue of remuneration. This role can only be effectively fulfilled if shareholders are able to get a clear picture of remuneration packages. It is for this reason that the IoD has been encouraging companies to move away from often opaque Long Term Incentive Plans and towards a simpler model. We highlighted this to the Business, Energy and Industrial Strategy Committee in our response to their call for evidence on the issue of executive pay.[3] Where companies choose to use LTIP's, and it is our belief that ultimately it is for companies to choose how they remunerate and reward performance, we advocated that remuneration committees should seek to model the potential highs and lows of a proposed package clearly so that shareholders are aware of what they are voting for.

Another issue which the collapse of Carillion highlighted was that of 'clawback' clauses in relation to executive bonuses. The IoD was quick to highlight the change in wording between Annual Reports at Carillion which gave the impression of loosening the conditions under which the company could 'clawback' bonuses. In our submission to the FRC in relation to the proposed changes to the UK Corporate Governance Code we argued that the Code should be more explicit about the circumstances in which claw back of executive

2 The UK Corporate Governance Code 2016 : https://www.frc.org.uk/getattachment/ca7e94c4-b9a9-49e2-a824-ad76a322873c/UK-Corporate-Governance-Code-April-2016.pdf

3 Call for evidence: Executive Pay IoD Response: https://www.iod.com/Portals/0/PDFs/Campaigns%20and%20Reports/Corporate%20Governance/Executive-Pay-IoD-Response.pdf?ver=2018-05-10-102228-763

bonuses should occur. As a minimum, claw back should be required in cases of gross misconduct, material accounting restatements and corporate insolvency. Furthermore, boards should ensure that any wording in relation to the claw back of bonuses in their remuneration report is in line with that found in director's service contracts.

Additional perspectives on late payments

The report rightly shines a light on the impact that Carillion's bad payment practices had on suppliers. Concerns were notably raised about the fact that the company had signed the Government's Prompt Payment Code, but did not follow the commitment to pay 95% of invoices within 60 days and to aim towards the 30 day payment terms.

Carillion's practices should serve as a prime example of why the Prompt Payment Code - and indeed wider measures to clamp down on late payments – should be scrutinised further to ensure they are able to address the issues at the heart of poor payment practices.

Late payments have obvious and damaging financial repercussions for businesses, but they also often severely impact the wellbeing of the people that run them. A recent study by the Prompt Payment Directory (PPD) has revealed that there has been a rise in SME leaders suffering from mental health problems as a result of the financial difficulties that their company has been put into by late payment practices.[4] In addition, the effects on the economy are also striking – it is estimated that SMEs in the UK are losing £26 billion in cash flow as a result of late payment practices.[5] BEIS is therefore right to be putting this issue higher up their agenda.

As many as 49% of IoD members have experienced issues with late payments over the past 12 months, with 47% of the total being small businesses. The main cited reasons for difficulties in obtaining payments included the company being invoiced having excessively bureaucratic payments system (31%) and 'grossly unfair' terms or practices used by larger firms in their supply chains (23%). Only 5% said it was related to a dispute between their company and the company being invoiced. When asked to comment further on the issue, members also noted that the company being invoiced was itself experiencing cash flow problems.

These figures suggest that current measures to protect small businesses against systematic late payment practices may not go far enough. The Government's decision to launch the Payment Practices and Performance Reporting (PPPR), asking large UK companies that exceed £36m turnover or have more than 250 employees to disclose the average time they take to pay invoices, was a step in the right direction. However, up to now only a very small number of companies have submitted reports on their payment practices.

Although there are ways for companies to get the money they are owed, the reality is more complex. Only a very small number of IoD members have said they would approach the Small Business Commissioner (SBC) if they were experiencing issues with late payments. In fact, a significant proportion of directors have expressed they were not aware of its existence. Low awareness is to be expected considering the SBC has only been in operation for a few months – the Government should look at promoting it using the channels already in place for accessing businesses, such as communications from HMRC and Companies House that contact individual companies on a regular basis.

4 http://www.smeweb.com/2018/05/09/half-sme-business-owners-knife-edge-due-late-payments/
5 https://www.gov.uk/government/speeches/small-firms-deserve-to-be-paid-on-time

However, a much bigger issue is the leverage that big businesses have over smaller suppliers. Evidence from many IoD members indicates that they would not report a customer that pays late to a mediating authority for fear of compromising an important commercial relationship. Dealing with this stigma has long been a problem with no obvious solution in the debate on tackling late payments, and there is a sense that the measures currently in place to deal with the poor payment practices do not adequately address it either.

Over the coming months, policy makers should monitor carefully the impact of the new reporting requirements, as well as awareness and use of the Small Business Commissioner as both a signposting body and mediation service. Government should also assess ways in which the Prompt Payment Code can be strengthened so that signatories are better held to their commitments.

The issue of late payments is hardly a new one, but there is a real feeling within the SME community that unless the latest bout of measures lead to a demonstrable shift in corporate culture around payment practices, more significant action will need to be considered.

Additional perspectives on access to public procurement opportunities

As indicated in the report, the collapse of Carillion has also shone a light on wider procurement practices and the need for greater transparency within the supply chains.

Of IoD members who have not tendered for public sector contracts in the UK in the past 12 months, a third said that the process of bidding is excessively costly/time consuming. When asked what steps should central government and local authorities take to make direct public procurement more accessible to SMEs, 60% of directors said further simplifying the tendering process was the main way to do so. Other suggestions included better promotion of tendering opportunities (40%). A third of members also said that making tendering rules across different local authorities more similar would help.

There is clearly space for improvements to make public procurement more accessible to SMEs. The Government should do more to ensure that the current target of 33% of public sector contracts dedicated for SMEs is actually met.

The target is currently not exclusively based on the direct contracts that the Government offers SMEs, but on the total overall benefit to these firms. While the target was set to encourage more SMEs to apply for government contracts, on its own it is not enough. The processes need to be simplified and guidance improved in order to attract more small businesses to tendering opportunities.

I hope you have found our comments helpful. If you require further information about our views, please do get in touch.

Kind regards,

Dr. Roger Barker
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Institute of Directors

James Jarvis
Corporate Governance Analyst
Institute of Directors