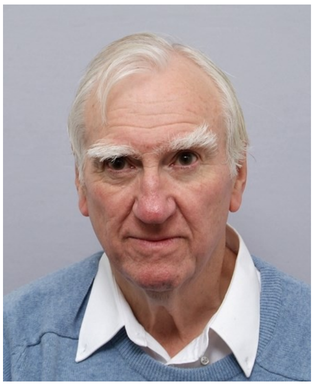
# What do auditors do all day?

*by Malcolm Howard*



On 24 August 2016, Carillion plc announced that their Finance Director, Richard Adam, had decided to retire as he approached his 60th birthday. He would leave the company at the end of the year. Whenever a Finance Director suddenly resigns, it is possible that the resignation is not for the reason given. If the announcement had said that Mr Adam would be 60 before the year end, then it would be more convincing. The real reason *may be* that he was unhappy and was unwilling to sign off the 2016 accounts as things stood. We have no evidence that this is the case and have to accept the reason given, but as investors we must retain the right to be suspicious. At the end of August that year the company's shares were trading at 272p.

On 1 January the company appointed Zafar Khan to be the new Finance Director succeeding Richard Adam. On 1 March 2017 the 2016 accounts were signed off by the new Finance Director, but clearly he cannot be responsible for them. KPMG LLP, the statutory auditor, carried out the audit of the accounts shown in the 2016 Annual Report, charging the company £1.4 million. This was broken down as £300,000 for the audit of the annual accounts, £900,000 for the audit of the company's subsidiaries, £100,000 for the audit of the company's pension scheme and £100,000 for the audit of joint ventures.

In their audit report KPMG stated that their audit accounted for 87% of Group revenue and 89% of Group profit before tax. This suggests that the majority of accounting transactions had been audited, which seems comprehensive. They also said that components subject to specific risk accounted for 8% of Group revenue. By specific risk they can only mean that they were looking at contracts to verify their validity. Their audit report states that for the Group as a whole an error in excess of £8 million would be regarded as material. In other words, if they found (for example) that inventories had been overstated by £5 million, they would not regard this as material given the overall size of the company. The audit report reads, "*For the remaining components (excluding the 8%, as above) we performed analysis at Group level to re-examine our assessment that there were no significant risks of material misstatement within them. Our opinion is that we have not identified material misstatements in those reports.*"

In their report, the directors restated that the Group had a progressive dividend policy which aims to increase the dividend each year broadly in line with the growth in underlying earnings per share. Given in 2016 the EPS was shown as 28.9p, slightly lower than 30.9p in 2015, shareholders could expect roughly an unchanged dividend.

Analysis of the accounts (below) reveals that there could be problems. Cash Inflow from Operating Activities should be higher than earnings because earnings are arrived at after charging non-cash items such as depreciation and amortisation. When the 'prime check' is negative, as in this case, there is a problem with either inventories, debtors, or the company pension scheme, or indeed all three could be a problem.

Revenue was split 52% support services, 6% public private partnership projects, 13% Middle East construction and 29% construction excluding the Middle East. Geographically, 74% of the business was in the UK, 11% was in Canada and 15% was in the Middle East and North Africa.

Analysis of the Cash Flow Statement shows that the company's pension scheme is a major problem, with £47m paid into it in 2016 and 2015. £46m was paid in 2014 and £39m in 2013. In 2016, debtors were up £291m and £35m was lost on foreign exchange contracts.

| | 2016 | 2015 | 2014 | 2013 |
|---|---|---|---|---|
| | £m | £m | £m | £m |
| Revenue | 4,395 | 3,951 | 3,494 | 3,333 |
| Operating profit | 181 | 207 | 190 | 150 |
| Earnings | 130 | 139 | 128 | 106 |
| Cash inflow from operating activities | 73 | 73 | 124 | (78) |
| Prime check | (57) | (66) | (4) | (184) |
| Inventory days | 7 | 7 | 6 | 6 |
| Debtor days | 138 | 117 | 138 | 133 |
| Net debt per share (pence) | 43 | 39 | 47 | 53 |

Any accountant looking at these figures would conclude that given the pension scheme had been audited and the problem therefore understood, the only potential concerns would be debtors and increasing debt. Given this, I would expect the auditor to be more concerned with specific risk, that being ensuring outstanding contracts were on target.

On 30 June 2017, the company announced that Baroness Sally Morgan was appointed a non-executive director with effect from 1 July 2017 to serve on the Audit, Remuneration, Nomination and Sustainability and Business Integrity Committee. Five days later the shares were trading at 189p. However, it wasn't long before she must have wondered what she had signed up to, when on 10 July 2017, just over four months after the 2016 annual accounts were signed off, the company dropped a bombshell. The Board said that it had come to their attention that there were major problems with some contracts with the result that they were making £845m worth of provisions, having carried out an initial review. This provision was over one hundred times greater than the auditor's definition of materiality. The company appointed Keith Cochrane as Interim Chief Executive, presumably believing he could work with the new Finance Director, given that he was previously a Finance Director with the Weir Group. The share price collapsed to 78p.

On 17 July 2017, EY was appointed to carry out a strategic review; on this news the share price fell to 64p.

On 22 August 2017, the company disclosed its interim results, where details of the £845m provision were provided. This provision related to the Middle East, exiting the construction market in Canada and certain construction markets in the UK. The enhanced contracts review had been completed and lessons had been learnt. Fifty per cent of operations in Oman had been sold and more sales were in the pipeline. Because of all this, there would be no dividend in 2017 and the Board would review dividend policy in 2018. Zafah Khan, the Finance Director, said his priorities were to reduce debt and increase financial reporting transparency. The full interim statement would be issued on 29 September 2017. The shares fell to 48p.

Now given that the auditors charged a fee of £1.4m to audit the 2016 accounts, you would have thought they, at least, would have foreseen some of the impending disaster. One has to ask what they do all day.

What has happened is completely unacceptable. Auditors should be held to account. Internal audit papers held by the auditors (not by the company) should be published, so we can find out what had been happening behind the scenes. We are supposed to have a Financial Conduct Authority; maybe shareholders should be advised what this organisation actually does. Now, in case you are wondering if this is personal, you can be assured it is not; I never invest in any company that fails my 'prime test' for three consecutive accounting periods. I don't rely on audit reports, but feel very sorry for shareholders that do. It really is time for shareholders to fight back.