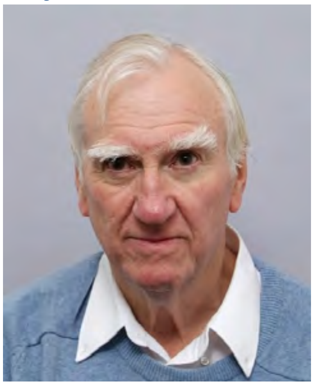
The Carillion disaster – real culprit is the IFRS accounting system

by Malcolm Howard



In January 2018 Carillion plc went into liquidation, with massive liabilities on the company's pension scheme. This disaster resulted in many employees losing their jobs and every employee having to accept a reduced pension. On top of this, sub-contractors working for the company lost money and the banks lost millions of pounds. So who is to blame for this fiasco? Naturally, the directors are being called to account and the auditors might be asked why they signed off the 2016 accounts with a clean bill of health when they knew there were problems with certain large contracts. However, the real culprit is the IFRS accounting system introduced in 2005. Until then accounts were drawn up under UK GAAP (generally accepted accounting practice), which was based on principles that had stood the test of time for hundreds of years.

I explained in my November 2017 article in 'The Private Investor' that under UK GAAP there were three prime safeguards, all of which were abandoned by IFRS.

The most important safeguard that was abandoned was the 'Prudence Concept', that stated that assets must not be overstated and liabilities must not be understated. Historical cost was replaced by 'fair value', which is defined as 'the amount for which as asset could be exchanged between knowledgeable, willing parties in an arm's length transaction'. The problem is that 'fair value' is merely an assessment, unlike historical costs accounts, which were factual. Worse, IFRS accounting standards not merely sanctioned imprudence, but forced accountants and auditors to be imprudent. 'Fair value' had to be applied even where there was no market for a particular asset, and where a company was in trouble and had to sell an asset at a distressed price the accounts had to show the full fair value. Development costs, including branding, could be capitalised and the directors could decide whether or not to amortise. Likewise with goodwill, the directors could decide not to amortise. With historical cost at least you knew what had happened; now it is all about judgement. With the concept of prudence being abandoned, directors could, as was the case with Carillion, have an 'aggressive' accounting policy, the effect of which was to overstate profits.

IFRS has seemed to blur the distinction between capital reserves and revenue reserves. Under UK GAAP if a property was revalued upwards, then the difference between the old value and the new value would be debited to the asset and credited in capital reserves. Under IFRS such an unrealised gain is taken as profit in the Income Statement, which in turn increases revenue reserves. Therefore, you can no longer tell if the figure stated as 'revenue reserve' is distributable or not. This has a legal importance.

Section 830 of the Companies Act 2006 states:

(1) A company may only make a distribution out of profits available for that purpose;
(2) A company's profits available for distribution are its accumulated realised profits, so far as not previously utilised by distribution or capitalisation, less its accumulated realised losses, so far as not previously written off in a reduction or reorganisation of capital duly made.
(source: www.legislation.gov.uk)

Wherever we have aggressive accounting, it is relatively certain that profits will be overstated and what has clearly been happening, regardless of the Companies Act, is that companies have been paying more in dividends that could be justified if the concept of prudence were being applied.

If the concept of prudence were to be applied to IFRS accounting, then:

- Where there was no market for a particular asset, 'fair value' would be equal to historical cost;

- Where it was known that a particular asset would have to be sold at a distressed price, then 'fair value' would be equal to that distressed price;
- Unrealised gains would be credited to 'capital reserves' and not taken as profit;
- Intangible assets would be written off, unless the directors had good reason to believe there was any value. Even here, goodwill should be amortised over time;
- Where large contracts are subject to stage payments, then a 'part sale' should only be taken when the stage payment has been received.

The truth of the matter is that both the Income Statement and the Balance Sheet, put together under IFRS accounting standards, cannot be relied upon when making investment decisions. The plight of Carillion aptly demonstrates that IFRS accounting is fanciful nonsense. Their 2016 accounts showed the company to be solvent (assets exceeded liabilities), but they were in fact insolvent.

The only statement that can be relied upon is the 'Cash Flow Statement', as the majority of the balances shown are 'actual' rather than 'fair value'. It is a fact that in a properly run business cash generated will equal net profit over time. In any one accounting period there will be ups and downs, but if a company shows consistent profits with debt continually going up, we know that there is something wrong.

Some companies involved in the Private Finance Initiative (and others) have expanded fast by acquisition, often paying too much for a business, giving rise to a high level of goodwill. Sometimes the acquisition has not led to the expected increase in profitability, so a key question is: does goodwill have any value? The truth is that neither goodwill nor other intangible assets have any real value. If a company has to sell assets to stay afloat, it cannot sell much (if any) of its intangible assets, as any sale will be at a distressed price. So if we are judging whether a company is technically solvent or not, the advice is to ignore intangible assets. If by doing so the Balance Sheet goes negative (liabilities exceed assets), then the company is technically insolvent. Given the lack of understanding of IFRS accounting, it is not surprising to find a number of companies with a high valuation based on their share price that are actually technically insolvent. A number of these companies are shown below (all figures are taken from their latest published accounts, being the full year in 2016 or half year in 2017):

	Shareholder's Funds £ million	Intangible Assets £ million	Net Value £ million	per share pence	Net debt £ million	per share pence
AA	(1,871)	(1,291)	(3,162)	(518)	(2,618)	(429)
Babcock	2,410	3,263	(853)	(169)	(1,313)	(260)
Balfour Beatty	757	1,162	(405)	(59)	(32)	(5)
Capita	408	2,754	(2,346)	(353)	(1,923)	(289)
Centrica	2,666	4,383	(1,717)	(31)	(3,980)	(72)
Interserve	347	504	(157)	(107)	(391)	(268)
Kier Group	508	803	(295)	(302)	(128)	(131)
Serco	397	662	(265)	(24)	(132)	(12)

What is interesting is comparing the current share price with the net asset value per share excluding goodwill, as this amounts to the 'goodwill' built into the share price. What puts companies at risk of becoming another Carillion is a combination of being technically insolvent and having a high level of debt. The end only comes when the company needs more money and the banks are not prepared to lend anymore, but in the current climate there is evidence that banks are beginning to get nervous. We are already seeing that the threat of a hard Brexit is badly affecting consumer confidence. Many restaurant chains are in trouble and the retail environment is deteriorating. Maplin and Toys R Us recently fell into administration and Carpetright announced it was struggling and negotiating with its bankers. Retail stocks where the company has a high level of debt must be considered high risk along with others who have a negative balance sheet.

It is always 'events' that push companies over the edge. We are being told by the Bank of England that interest rates will increase in the near future. This would be one such event.

The share price quoted was the closing price on 28 February 2018.

	Net Value £ million	per share pence	Share price pence	Goodwill per share pence
AA	(3,162)	(518)	80	598
Babcock	(853)	(169)	652	821
Balfour Beatty	(405)	(59)	265	324
Capita	(2,346)	(353)	176	529
Centrica	(1,717)	(31)	143	174
Interserve	(157)	(107)	55	162
Kier Group	(295)	(302)	1,037	1,339
Serco	(265)	(24)	91	115

Some shareholders buy into companies involved in the Private Finance Initiative because of their high yield. What they don't seem to realize is that if the dividend increases net debt, they are paying themselves with their own money. Carillion paid high dividends, but in doing so they reduced the company's capital; unfortunately to such an extent that they fell over the cliff.

The concept of IFRS is illogical. For example, under IFRS proposed dividends do not appear in the income statement because they have yet to be authorized by the shareholders. Nevertheless, this is a liability in the same way that a deficit on the company's earnings-related pension scheme is. Both liabilities might not happen, but both liabilities should be shown in the balance sheet. IFRS goes to great lengths to take unrealized profits. A paid for ante-post bet should be shown as a cash advance, but it is defined as a 'financial instrument', so forecast profit must be taken.

If the Prudence Concept were to be reintroduced and only realized profits could be taken in the income statement, then 'Carillion' type disasters would be avoided as corrective action could be taken long before the company arrived at the cliff edge.

Editor's note: Readers inspired by this article and wishing to know more are recommended to read Warren Buffett's 1984 essay on the distinction between economic and accounting goodwill at the end of his 1983 letter to shareholders, which can be found at http://www.berkshirehathaway.com/letters/1983.html

The long view – from John Hunter

I'm reading a book called 'The Wisdom of Finance', which is much more interesting than its title, and from this I pinch a quote from *Confusión de Confusiones*, written in 1688 by José de la Vega (me neither) about the new financial markets (trading just one stock – Dutch East India Company) and including a parable in which a 'shareholder' describes the market to a friend:

"I really must say that you are an ignorant person, friend Greybeard, if you know nothing of this enigmatic business which is at once the fairest and most deceitful in Europe, the noblest and the most infamous in the world, the finest and most vulgar on earth. It is a quintessence of academic learning and a paragon of fraudulence; it is a touchstone for the intelligent and a tombstone for the audacious, a treasury of usefulness and a source of disaster, and finally a counterpart of Sisyphus who never rests as also Ixion who is chained to a wheel that turns perpetually."