

## THE CARILLION FAILURE: MISUNDERSTOOD RISKS AND CONSTRAINED AUDITORS

British construction and logistics firm Carillion collapsed in January, a breathtaking business implosion that left tens of thousands unemployed, more than £1 billion in debts unpaid, and an astonished corporate governance community wondering.

How could a failure so mammoth emerge with no apparent warning?

More precisely, how could the emergence of a failure so mammoth go unnoticed for so long today, in 2018? The last 20 years offer a pantheon of business failures — Enron, WorldCom, Lehman Brothers, Satyam, Royal Bank of Scotland, and more — that drove modern corporate governance and demands for a strong assurance function. They were supposed to provide the teachable moments and wisdom to prevent oversight failures like this.

And yet, we are here again, picking through the rubble of another corporate collapse to see what new lessons can be found.

### What Went Wrong

Carillion's final days began in July 2017. The company announced an £845 million writedown on projects that were no longer profitable; and debt had surged in the last several years to more than £600 million at that time. Carillion's CEO, Richard Howson, resigned. The company canceled its dividend.

The following months grew worse. Debt ballooned to more than £900 million. In September, Carillion reported a loss of more than £1 billion for the first six months of 2017. By November, executives were warning that the company would breach its debt covenants, and disclosed that its pension fund was underfunded by nearly £600 million.

The British government, which relied on Carillion for everything from running military bases to delivering



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## The IIA

1035 Greenwood Blvd.  
Suite 401  
Lake Mary, FL 32746 USA

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Michele J. Hooper  
Kenton J. Sicchitano

school lunches, began working on a rescue plan. None could be assembled as the company's financial picture continued to decline. Carillion went into liquidation in January, with £29 million in cash on hand and £1.3 billion in debt.

Beneath those historical facts, however, are larger questions of strategy and oversight.

## Extracting the Right Risk Assurance

The first question is how Carillion's audit committee missed the worsening financial picture. The answer drives toward how a board connects operational performance and risk management to financial results.

For example, in the simplest analysis, Carillion failed because the company racked up debt at the same time it concluded that multiple large contracts were not as profitable as first expected (if they were profitable at all). The money raised through that debt had been used, among other purposes, to keep paying dividends to investors — so when Carillion did need cash in the latter half of 2017, the coffers were empty.

It's easy to fault Carillion's board for allowing management to pursue financial engineering like that. Unhappy members of Parliament have leveled exactly that criticism. The full truth is more complicated.

Raising debt to pay dividends is not unheard of and can be a reasonable piece of financial engineering. The challenge for boards is to ensure a prudent amount of borrowing to pay dividends, rather than an excessive amount. So Carillion's audit committee needed to understand how those financial obligations would be repaid in the future.

In practical terms, the board needed assurance that the company's operational performance — above all, managing costs on current contracts — would generate the cash necessary to repay that debt. It needed to know that risk management practices in operations were sufficiently strong either to (a) support the rosy picture Carillion projected in the years before its collapse; or (b) escalate any concerns that contracts would not be as profitable as forecast, early enough that the board could work with the CEO to make necessary course corrections.



That's a subtle but important point sometimes lost on audit committee members: that part of the duty to assure effective financial reporting is to confirm the operational assumptions behind those numbers. Using the Committee of Sponsoring Organizations of the Treadway Commission (COSO) framework for internal control, we could place that duty in Information and Communication: Principle 13, "The organization obtains or generates and uses relevant, quality information to support the functioning of internal control."

Carillion's board did have a "major projects committee" to approve significant commitments and contracts. Within the business itself, management implemented a system of peer reviews for contract management, and self-assessment of controls by managers.

Clearly those operational risk management practices were insufficient. That led to rising losses on projects that became the company's undoing.

## Missing: The Free-Range Auditor

Many are blaming Carillion's external auditor for not seeing the impending doom. Another reasonable question to ask: Why didn't Carillion's internal audit function raise sufficient alarms in the mid-2010s, before calamity struck in 2017?

Carillion outsourced the internal audit function to a service provider. In Carillion's case, the arc of the outsourced function's audit plan stretched over three years. As the de facto chief audit executive for Carillion told a hearing in Parliament in February:

Typically [we] do that on a three-year basis and then we have a plan for each year. We do that in discussion with the company and ultimately we take that to the audit committee and we set out to the audit committee what we are doing and what we are not doing.

A contracted service provider could hardly have insisted on performing more internal audit coverage than permitted in the contract — and directed by the customer (Carillion's audit committee). However, internal audit needs to focus on risks as they emerge, not those identified at the beginning of the year, or those identified three years earlier.

It's critical that the audit committee lives up to its responsibilities regarding its oversight of internal audit. To ensure a highly effective internal audit function, audit committees must (at a minimum):

- Engage in an open, transparent relationship with the Chief Audit Executive (CAE).
- Empower internal audit to be independent by maintaining a clear functional reporting relationship.

## Start the Conversation

### Where financial risk comes from.

Carillion's fatal flaw came from adopting a financial strategy (high debt, and a balance sheet heavy on intangible assets more than physical ones) that hinged on strong operational performance. When that performance failed, the financial strategy became a millstone around the organization's neck. Some questions to consider include:

- Does your audit committee have a clear understanding of the operational assumptions behind financial engineering?
- How does the audit committee gain assurance over the risk management practices in operations to ensure those assumptions hold true?

### Welcome the free-range auditor.

Carillion's outsourced audit function worked on long-term contracts with an annual review of audit plans. Unfortunately, internal audit did not seem aware of the operational risks growing in Carillion, which led to internal audit being unresponsive to the disaster that unfolded in 2017. Some additional questions to consider:

- How does your audit committee empower the internal audit function to be agile and responsive, especially in outsourced functions where their duties are prescribed by contract language?
- Is your internal audit function truly risk-focused, or merely executing a stale audit plan?
- Is your internal audit function agile in practice? Will the CAE challenge the status quo of the business? How does the audit committee incentivize the CAE to be a challenger?

- Meet regularly with the CAE without the presence of management.
- Ensure the audit plan incorporates input from the audit committee.
- Review the Audit Committee Charter at least annually to ensure it includes sufficient oversight of the internal audit function.

Another pressing question for audit committees is how to mesh their need for an agile, responsive audit function that can escalate risk concerns in a timely fashion, with an outsourced model, or an audit group that believes last year's risks can drive this year's work.

For example, in the most recent IIA North American Pulse of Internal Audit report, 67 percent of respondents said agility will be important in the future. Agility will require flexibility in setting priorities, plus the ability to detect emergent risks early and to triage their potential severity. Working on three-year cycles with annual sign-off from the audit committee won't satisfy that need.

## Conclusion

The fallout from Carillion will continue for quite some time. British lawmakers and regulators have called for investigation of the company itself, and its external auditor; into the auditing profession overall, and whether the Big Four firms need more competition; and even into other regulatory and policy lapses that let such an important provider of services to the British government go bankrupt so quickly.

The corporate governance community, however, can take away several important lessons. Above all, audit committees need to ensure they understand the risk management practices in operations that undergird the financial results they review and approve. They must also establish a progressive internal audit function — one that can pivot quickly along with a swiftly tilting risk landscape.



### Quick Poll Question

What is the most important lesson about the Carillion meltdown?

- Clear understanding of how changing operational risks may affect financial assumptions.
- Importance of an agile internal audit function that can investigate emerging risks and escalate concerns quickly.
- An audit committee that has the time and focus to challenge auditors and management, and to gain the assurances they need.

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