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<u>To Whom it Might Concern</u>

Copies for information: Jon Holt, CEO KPMG-UK; David Price, Construction News

REF: FOR INFORMATION: PROFESSIONAL NEGLIGENCE CLAIM-OFFICIAL RECEIVER CARILLION v KPMG

EXPERT OPINION
24th November 2021

KPMG- Defendant
Carillion Plc- Claimants

I refer to David Price (Construction News) Report on 22 November 2021, Article: “Liquidator set to lodge claim of up to £1bn against KPMG”

I further refer to my E-Mail correspondence (link below) with Frank Field, Head of the Works & Pensions and BEIS Committees joint inquiry into the collapse of Carillion Plc, dated 18/19 February 2018. I believe the Information in the attached Links is pertinent to the case.

Also please note my conclusion as an Independent Analyst at the time:

1. KPMG were unlikely to have been culpable at the time, in my view, either legally due to professional negligence or in breach of a duty of care, given the near impossibility of Auditors to fully assess the value of Work-in-Progress on large contractors' Balance Sheets, without full due-diligence on all potential problem contracts. This is a duty which cannot normally be expected to be performed by an Auditor. Difficulties of checking revenue recognition and estimates of cost assessments are complex and were only finally starting to be addressed at the time by the Accounting Profession with IFRS 15, not implemented until 2018.

2. The culpability lay squarely, in my view, with the senior management who were aware of, or should professionally have been aware of, the company’s financial position on problem contracts, and aware of any management accounts irregularities (in not reporting correctly major loss-making projects) at an earlier date than public announcements. If provable this

was a serious matter of negligence on the part of senior directors, for the Committees to consider.

3. Throughout my professional analysis of Carillion (2016 through 2018), and my prior contact with their senior management (CEO Richard Howson) and, prior to the company's liquidation – in contact with their advisers EY and indirectly Lazards (Michael McCartney) – my advice was that Carillion should have been focused on seeking a large financially strong acquirer to save the company- not the fire sale/disposal of subsidiaries and other capital raising methods to generate short term cash, which ultimately proved a flawed financial strategy. I had identified one such potential investor, the potential interests of whom were apparently ignored by all of Carillion's advisers, at the time (14.12.2017), when their interest was solicited in writing to EY.

Sincerely

Greg Malpass
www.thinkbigpartnership.com

24TH November 2021

LINK:

https://nebula.wsimg.com/abd898f9c603abf99b4fd40cd3269376?accesskeyid=95b6737f98b38e354d56&disposition=0&alloworigin=1

COPY OF E-MAIL:
GREG MALPASS – FRANK FIELDS
(Works & Pensions and BEIS Committees Joint Inquiry)

From: frank.field.mp@parliament.uk
Date: 19/02/2018 - 13:16 (RST)
To: syler.bros@btinternet.com
Subject: RE: Carillion- Opinion

www.parliament.uk

Dear Greg Malpass,

Thanks for your email. Our inquiry has a long way to run; we have much evidence to collect as well as a whole series of questions to follow up about the Carillion operation, and I am grateful for the views and information you have shared.

Best wishes,

Frank Field

PTO (cont'd)

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From: GREG MALPASS [mailto:syler.bros@btinternet.com]
Sent: 18 February 2018 15:31
To: FIELD, Frank <frank.field.mp@parliament.uk>
Subject: Carillion- Opinion

Dear Frank
I am following the Work and Pensions and BEIS Committees joint inquiry into the collapse of Carillion. The Committees will be investigating how a company that was signed off by KPMG as a going concern in Spring 2017 could crash into liquidation.
I am an independent Construction Analyst based in Weston Turville, Aylesbury Berks HP22 5SL; and Malaga Spain 29630, and have been involved in analysing Carillion's woes, and offering advice since late in 2016.
The bottom line of my analysis is:
1) It is very difficult for Auditors to fully assess the value of Work-in-progress on large contractors' Balance Sheets, without full due-diligence on potential problem contracts. Difficulties of checking revenue recognition and estimates of cost assessments are finally starting to be addressed by the Accounting Profession with IFRS 15, only implemented this year.
2) If proven that senior management were aware of the Management Accounts irregularities (in reporting major loss-making projects) at an earlier date than public announcements suggest, then that is a matter for the Committees to consider. However, throughout my analysis of Carillion I have stated to management, and publicly, that Carillion should have been focused on seeking a large financially strong acquirer to save the company- not the fire-sale/disposal of subsidiaries and other capital raising methods to generate short term cash.
For your information, details of my analysis and dialogue with management, its advisors, and the media are given in the links below.
Kind Regards
Greg Malpass
https://www.thinkbigpartnership.com

Copy of Relevant Links:

- https://nebula.wsimg.com/3d9a2c4fc82e2100997863fe641e9f9e?AccessKeyId=95B6737F98B38E354D56&disposition=0&alloworigin=1
- https://nebula.wsimg.com/28e78a59a3991aa9e63cc07241d71c07?AccessKeyId=95B6737F98B38E354D56&disposition=0&alloworigin=1
- https://nebula.wsimg.com/55a62a197347d66ad5f6e561ed60c5cc?AccessKeyId=95B6737F98B38E354D56&disposition=0&alloworigin=1
- https://nebula.wsimg.com/f4822725ac6815fed0993a30cf0ca567?AccessKeyId=95B6737F98B38E354D56&disposition=0&alloworigin=1

  KPMG's Report on "The impact on the construction industry of new IFRS revenue standard"

- https://home.kpmg.com/content/dam/kpmg/pdf/2014/10/First-Impressions-O-201409-Impacts-on-the-construction-industry-of-the-new-revenue-standard.pdf

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Disclaimer: "The comments made in this E Mail and comments in attachments made during 2017/2018, are based purely on the opinion of www.thinkbigpartnership.comand are not to be considered statements of fact, nor represent the opinion of others. They should not have any impact on the up-coming Committees' Review procedures"

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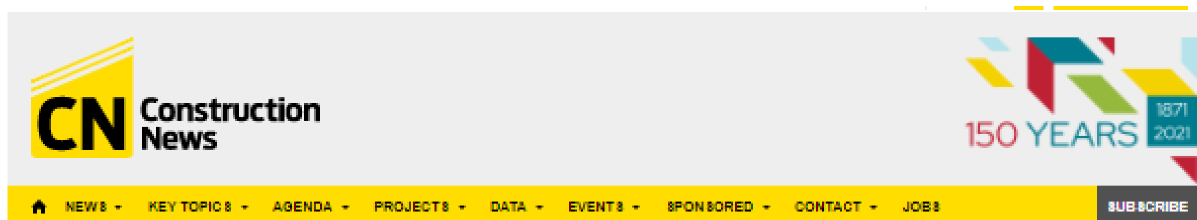
COPY OF CN ARTICLE: LEGAL CLAIM AGAINST CARILLION



Carillion: liquidator set to lodge claim of up to £1bn against KPMG

22 NOV 2021 BY DAVID PRICE

A legal claim against Carillion's auditor KPMG has moved a step closer and could reach £1bn in value.

Legal papers were filed on Friday ahead of a full claim being launched, which is expected to happen in the next few weeks.

A professional negligence claim was filed on behalf of the Official Receiver, which is handling the contracting group's liquidation with the aim of maximising returns for creditors. The filing names Carillion Plc and Carillion Construction Ltd as claimants, and KPMG as the defendant.

The particulars of the claim are stilling being finalised and *Construction News* understands the receiver could pursue KPMG for up to £1bn. Of this, around £250m represents dividends that the contractor paid out in the years before its collapse. If the claim also includes trading losses incurred, then the overall value could reach £1bn.

KPMG declined to comment on the claim, which was first reported by Sky News.

The core of the legal action focuses on dividends, bonuses and advisory fees of around £250m, which it claims would not have been paid between 2014 and 2017 if KPMG had spotted misstatements in the company's accounts.

Separately, the Financial Reporting Council has been investigating KPMG's auditing of Carillion between 2014 and its collapse in early 2018. It was reported in March that the auditor was moving towards a settlement with the FRC, which could reach £25m.

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WEBSITE POSTING
COMMENT- CASH & ACCOUNTING IRREGULARITIES

www.thinkbigpartnership.com
(Based on Report posted December 28, 2017)

UK CONTRACTORS-
PROBLEMS WITH ACCOUNTING FOR WORK-IN-PROGRESS

There are examples given in my On-Line Report- (www.thinkbigpartnership.com "UK Construction Consolidation 2017-2022" Appendix IV- Historic Competitor Analysis- "Work-In-Progress" pages 54-59). – see extracts over page.

https://www.thinkbigpartnership.com/reports.html

These examples highlight the major industry problem for contractors associated with "Audit Risk" in valuing Work-in-Progress and determining the amount of revenue to be recognised in projects. It requires management to make significant judgements and estimates including the costs to complete, and the identification of any other costs that might arise, the impact of any changes in scope of work, the outcome of disputes with the client over valuation, and the recoverability of Work-in-Progress and receivables balances.

Revenue recognition and contract accounting is a significant risk for all contractors. It is an impossible task for external auditors on annual audits to check all project accounts and predict the final cash position on all the yet-to-be completed projects. Management can hide problems leading to false declarations of profits or understate valuations creating the build-up of reserves. The resultant envelope in valuation of working capital for large contractors can run into tens or even hundreds of millions of pounds.

CASH IS KING IN VALUATIONS

In the Report Appendix, extracts copied over the page, the key issues/items to watch were listed as:

- Over focus on top-line growth (and more generally EBITDA) at the expense of cash.
- Need to view profit as secured only once realised in cash
- Working capital stress through the supply chain leading to businesses taking active steps to pass down cash pressure to subcontractors with late payments
- Importance of evaluating and managing working capital profile across contract portfolios and tender pipeline
- Pressure on balance sheets to support bonding requirements, and liquidity levels to cope with lumpy cash flows (upfront costs/deferred receipts)
- Absence of a cash culture
- [Using debt to pay dividends]

In Carillion's specific case, signs of strain were detected by Hedge Fund Managers who were shorting the stock. It's aggressive management of payment terms with suppliers, and increasing amounts of declared receivables despite sales decline, suggested Carillion with substantial and increasing debt was struggling to generate cash flow. The long-term nature of many Carillion contracts also meant revenues and costs were often recorded based on management estimates of when they fall due. The very nature of these costs being 'probable' means there is the real risk of manipulation or, at best, unintentional errors in the estimates. This was highlighted by its auditors at the time, albeit it was recognised as an industry-wide risk. At Carillion there were over 400 live contracts which were impossible to audit in their entirety, and the likely evidence points to management manipulation of the figures on problem contracts, not negligence by the auditors. Nevertheless, the 'writing was on the wall' with growing debt problems, and suspicion of manipulation might have been justifiably warranted, if not verifiable based on the information provided and available.

CONCLUSION

Management of Construction Groups can, and often has knowingly, or unwittingly seriously over-stated profits as a result of inaccurate management accounts associated with on-going projects. Often these errors remain undetected by Annual Audits of accounts, which relies necessarily on management honesty and transparency in information disclosure and reporting.

G J Malpass: www.thinkbigpartnership.com (Based on Report - December 28, 2017)

For more information, please contact:

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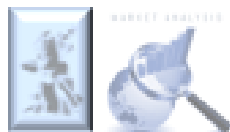
Link: (Think Big History)
https://nebula.wsimg.com/1e1a95b2dca8fba414cebbd73e5de99c?AccessKeyId=95B6737F98B38E354D56&disposition=0&alloworigin=1

Attachment (PTO): Extract from On-Line Report- (www.thinkbigpartnership.com "UK Construction Consolidation 2017-2022" Appendix IV- Historic Competitor Analysis, sub-section, "Work-In-Progress Valuation", pages 54-59).

Extract from On-Line Report-
(www.thinkbigpartnership.com "UK
Construction Consolidation 2017-2022" Appendix IV-
Historic Competitor Analysis, sub-section - "Work-In-
Progress Valuation", pages 54-59).

https://www.thinkbigpartnership.com/reports.htm



APPENDIX IV

HISTORIC COMPETITOR ANALYSIS
THE 2007 CRASH "CASH IS KING"

Source: Analysis by G J Malpass

- The 2007 crash & lessons for M&A
- The Economic Cycles
- Work in Progress Valuation.
- Cash is King
- 2007 Competition Analysis
- 2010 Competitor Analysis
- The Analysis 10 years on (2017)

THE 2007 CRASH & LESSONS FOR M&A

2007 was a pivot year, and worthy of historic analysis, due to three penonema:

- The Global Financial Crisis was about to have a heavy impact on the Global Construction market, and the access to Debt Finance in the market.
- There was a wave of Mergers & Acquisitions going on which was starting to lead to Consolidation in the Industry.
- The Liquidity and Cash reserves of some of the Major Construction companies was weak, and they were vulnerable as a result.

Due to the latter, some companies faltered and some companies divested their business or were acquired (eg. ROK went into liquidation as predicted by analysis over the page; Amec sold its Construction business to Morgan Sindall; Carillion acquired Alfred McAlpine; Taylor Woodrow Homes merged with Wimpey Homes; and Costain had yet another Rights Issue to replenish its cash shortfall).

Some companies currently have low reserves, and these weaknesses are coming to bear. Balfour Beatty is a case in point. Its problems are centred around operating losses in its core UK contracting business. Previously work had been won at wafer thin margins, and profits had been taken on projects before they ought have been.

The problem of accounting for Work-in-Progress is the Contractor's achilles heel. It is also so prevalent in the history of contractors that it is worthy of a Chapter on its own, because many Mergers and Acquisitions, or company liquidations are a result of Management not accounting properly for incomplete projects. Not even external auditors are able to assess true positions on hundreds of projects on a company's books. The way companies account for project cashflow and profits is a dark secret to many outside a company. The difficulty in valuing WIP has been, in the past, a "poison pill" for would-be acquirers of diversified groups with a construction division.

With the difficulties of predicting economic cycles and making sure there are sufficient reserves in the business, makes difficult work for acquirers and their due diligence.

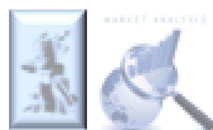
THE ECONOMIC CYCLES

With respect to Balfour Beatty's recent dilema and losses, an Analyst commented. "Construction can be the exact opposite to other industries and business models. New building projects are sensitive to changes in the economy which makes the workflow lumpy and difficult to predict. Contracts also tend to operate on wafer-thin profit margins at the best of times. A mistake on budgeting for building costs can blow a big hole in a company's profits. There is also considerable scope for aggressive accounting - particularly in terms of when profits are recognised. This makes them hard to understand which has led many investors to be wary of construction companies over the years."

During down-turns contractors call upon reserves to survive. A fall in Revenues can be hurtful in loss of staff, and a further cash outflow as a result. That is why companies sometimes bid so lowly to maintain turnover in recession. While interest rates were so high in th early 1990's playing the cash game was more important than operating profits.

The full analysis over the pages, draws a picture of an industry on the move in 2006 with another year of growth before a serious 2007 crash, just when some companies were low on cash, and quite simply some were cheating on the numbers then too.

The chickens came home to roost for a few. ROK went bankrupt, and was always a boom bubble about to burst, as all acquisitions were based on raiding Working Capital of acquired businesses to move onto the next- a flawed Acquisition Strategy. Costain did complete a Rights Issue and again diluted its Strategic Sharholders positions as they got tired of stumping up more cash. McAlpine got acquired by Carillion, and the industry rumbled on without any large company mergers at the top.



Accounting for reserves does not always provide the buffer. ACS of Spain declared a €2bn loss in 2012, due to losses in its contracting business and Iberdrola subsidiary. Had it not been a company of such scale it could have faltered. But it too, has been accused recently of accounting discrepencies in declaring profits, as well as corruption related accusations concerning government clients. It seems the industry always has more than its fair share of bad news.

Work in Progress Valuation.

Cash does not lie. Profits are an accounting term for dealing with cash flows to derive Profit which is subject to taxation, after relief for interest and depreciation.

The tell-tale signs for problems in a cash model must be understood, before embarking on an acquisition of a contractor. At due diligence stage they include:

- Comparing Operating Profits with operating Cash Flow. (Any large discrepencies need explaining).
- Monitoring (in the Notes to the Accounts) what the "Net Amounts due on Long Term Contracts" are.

The value of WIP and Working Capital is where the reserves are held, or where less conservative management have taken early profits. In some exaggerated cases, like Costain in the early 2000's even large outstanding Claims were taken to value on incomplete projects. In the case of Costain it precipitated a subsequent £75m declared loss when all was revealed in 2005.

Conservatism is always the prudent route to survival. Gross margins should not be recognised on newer projects, as businesses begin to be more conservative and robust, and not recognising margin until sufficiently through the life of the project is the hallmark of a wisely accountable contractor. What usually happens is a CEO will over-trade the project portfolio's profit position, then his (or her) successor will take write-downs and make provisions, so that positions are looked upon favourably when profitablity returns, and some provisions written back also to the P&L account. It's not an honest game, and often goes on below the radar in the industry.

Costain was by no means alone. Many contractors have been caught or come under suspicion. Amey's demise in the 1990s was due to large over-declared profits; interserve was investigated over accounting irregulaities, ACS of Spain, as mentioned was also reported. Balfour Beatty clearly has had to deal with either loss making projects, or projects where profits were taken too early. Amec's Construction business, after declaring record profits, swung quickly into free fall, as its CEO left, and the business sold off to Morgan Sindall. The list goes on.

The Audit risk in valuing WIP is also one of determining the amount of revenue to be recognised on projects. It requires management to make significant judgements and estimates including the cost to complete, and the identification of, any other costs that might arise, the impact of any changes in scope of work and the recoverability of work-in-progress and receivables balances.

Revenue recognition and contract accounting is a significant risk for all contractors. Interserve Risk Register (see below) rates this the highest risk in terms of impact and probability.

Balfour Beatty has implemented new Management Accounting procedures during a project's life span (see above) as did Costain under its new CEO in the mid 1990s

The systems differ, but are the same in their aim- to predict the final cash position on yet to be completed projects. Project Managers will tend to hide problems, and understate valuations when there are reserves. The envelope in valuing a large contractors' working capital and specifically its WIP can run into tens of millions of pounds.

Cash is King

Some of the key issues/ items to watch:

- Over focus on top-line growth (and more generally EBITDA) at the expense of cash; which has led to lack of gearing
- need to view profit as secured once realised in cash
- Working capital stress through the supply chain is leading to businesses taking active steps to resit and/or pass down cash pressure to subcontractors
- Importance of evaluating and managing working capital profile across contract portfolios and tender pipeline
- Pressure on balance sheets to support bonding requirements, and liquidity levels to cope with lumpy cash flows (upfront costs/deferred receipts)
- Absence of a cash culture reflecting the historic lack of gearing