

Let's audit KPMG over Carillion

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I prepared this guest post from Professor Atul K. Shah that asks questions about the audit of Carillion last night. I have just heard that the Financial Reporting Council has just announced that it will be reviewing this audit. The issues any such review will raise will drive to the heart of the fitness of the UK audit and reporting system:

A company with rising dividends suddenly goes bust six months after their audit. KPMG had given it a clean bill of health on 1st March 2017, with no qualifications, and stated that the financial statements gave a 'true and fair view'. They confirmed that those accounts had been prepared in accordance with the law. They said they had nothing to report on the disclosures of principal risks. They agreed with the assumption that Carillion was a going concern.

But they were wrong: it wasn't.

The role of the audit is to verify the accuracy of the disclosures a company makes in its financial statements and the reliability of reported financial data and notes to the accounts. In the case of construction companies, there are two commonly known high-risk issues: liquidity, which requires a critical assessment of cash flows, and the timeliness of the recognition of income. Any auditor of companies in this sector should know that these issues have to be the principal focus of the audit, and that they must be verified microscopically for to determine the presence, or not, of material risks.

In the case of Carillion what we learned in June 2017 was that there were an additional £1bn of previously unanticipated contract losses. As a result a profits warning was issued three months after the completion of the audit. Within another six months, Carillion was bankrupt. The obvious question that gives rise to was whether the audit to which KPMG lent its name was properly undertaken.

These are just some questions that common sense suggests it would be appropriate for KPMG to answer with regard to what they knew on 1st March 2017 when signing off Carillion's financial statements with a clean bill of health:

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What was known about the risks of those big construction contracts at the time of signing the audit opinion? The trade receivables figure of £1.7bn should have raised huge queries, given that this is ten times the Operating Profit of the business, and if unrecovered, even partially, could cause serious problems;

- * Current liabilities in the financial statements were £2bn and were higher than trade receivables. This was, surely, a danger sign? In this situation where it seemed more money was due by the company than it could reasonably expect to recover in the short term what checks were made of creditors and how did this impact on the assessment of likely cash flows?

- * Intangible assets were stated to have a worth of £1.7bn on the last financial statements. These have now proved to be worthless, but when the accounts were signed off they represented 70% of total assets. Why was no warning given on such a large figure on the balance sheet, given the business problems that were already apparent to many, including the hedge funds that were already shorting the shares of the company?

- * Profit margins were wafer thin over years (less than 5%) but this is not like food retail where such margins can be tolerated because that is a safe, dependable, business. It is, instead, a high risk construction business. How did KPMG verify the business' sustainability at such low margins?

- * The recognition and timing of contract income is a hugely risky area for audit, and requires a very careful review of contracts, repayments and assumptions. What evidence do the audit files contain to support the decisions taken?

- * The dividend was increased by 1% in spite of the huge problems the company appeared to be facing, and despite a very tight cash flow. What questions were raised about this with the Board of Directors? Given the huge pension deficit of £440mn, giving a comprehensive loss of £205mn in 2016, why was this dividend paid at all, given that distributable reserves need to take account of all losses, realised and unrealised? What calculations were undertaken to prove that it was legal? Auditors have a specific duty to check this issue.

- * To what extent were loan covenants breached, and how was this audited?

- * Post-balance sheet events need to be audited to ensure any new information does not affect the basis for the audit opinion. What work was done on this? What changed between March 1 and the date of the profit warning? Why couldn't the change of circumstance have been anticipated when the audit was underway?

- * To what extent did KPMG's consulting work on the multi-billion pound High Speed Rail project (HS2) influence the audit opinion? How were conflicts of interest created by this project addressed in the course of the audit?

Sometime, someone is going to have to answer these questions. And for the sake of all involved the sooner the better might be a reasonable request.

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