The systemic questions Carillion gives rise to

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I have not commented to date on Carillion’s failure. Partly that has been because of a lack of time. And partly it’s because I needed to read enough.

I do not offer specific comment here: there is, very obviously, more to know. But there is now enough known to make some pretty specific observations.

The first is to suggest that there was misreporting by Carillion. The likelihood that markets were misled as to its profitability and balance sheet worth until about a year ago seems very high. It also now seems that some in the City were aware of this risk from 2013 onwards. In that case the questions are obvious. They are:

1) If this was known why didn’t the Financial Reporting Council act sooner, quicker, and more directly?

2) Why was there no whistle blowing? Someone in this company knew how bad things were. Is there appropriate protection in place for them? If not, why not?

3) How come the auditors managed to satisfy themselves for several years that sensitive issues, such as turnover and the value of goodwill, were fairly stated in this company when it now looks very unlikely that this was true? KPMG are on the line, again.

But let's get more systemic about this and extend the questions:

4) The losses that will arise as a result of this failure will be to many classes of stakeholder including customers, suppliers, employees, tax authorities, local communities and others. Despite this company law still maintains the pretence that accounts are only prepared on behalf of the shareholders of the company, and that the auditors have no duty to anyone else but those shareholders. Why do we do that when it is so obvious that the consequences of limited liability extend so far beyond the shareholders, who in so many cases (as in this one) represent a tiny proportion of the claims on the company?

5) Why do we remain so relaxed about the concept of limited liability? I do not dispute that it has had its use in mobilising capital for social gain, but it does also give rise to very clear risk of moral hazard. This is particularly true now that the separation of ownership and control is so stark, and when the rewards to control are so often so high, as in the case of Carillion. Management in this case was exceptionally well rewarded, with the chief executive earning more than £1 million a year, and the chairman earning more than £200,000 for a part-time employment. Non-executives were paid £61,000 the year each, again for a decidedly part-time employment, and the simple fact is that they did not do their jobs appropriately: if they had then this failure would not be so severe.

So is it time to ask whether limited liability should be denied to the directors of limited companies? Shareholders need it: they are given remarkably little information to decide upon with regards to the affairs of the corporation in which they have invested, and so it is appropriate that their risk is limited. This is, however, not true of the directors: they are meant to know what is going on, and in that situation to limit their liability simply encourages recklessness. And it cannot be argued that it would be unfair that they carry such risk. As evidence look at what is happening in Carillion: most of the directors will walk away without a penny of personal loss. Many of their employees, most of their pensioners, many of their small suppliers, and many of those small suppliers own employees, will walk away with considerable personal loss arising as a consequence of the recklessness of the action of this Board of Directors.

The directors of Carillion will no doubt think that they did not have liability to these people: caveat emptor when dealing with a limited liability company, they will say. But I do not agree. The primary duty of the directors of a limited liability company is not, whatever most people think, to the shareholders. That primary duty is, instead, to the creditors: it is the duty of the directors to make sure that everyone who deals with the company can be paid. This has failed in the case of Carillion. From the pensioners onwards the creditors of this company have been treated with contempt: in my opinion the directors should be personally responsible for that, to the limit of their own financial assets.

6) The liability of companies to their pension funds has to be reappraised: the indifference of this company to the deficit that it maintained on its pension fund is indicative of the contempt that they had for their employees, both present and past. If the company was unable to make good this deficit then it, along with all other companies in a similar position, should not have been allowed to do three things. First it should not have been allowed to remunerate its directors at a rate more than ten times median company pay. Second, it should not have been allowed to pay a dividend. Third, it should not have been allowed to continue in business without supervision by a board appointed by the pension trustees, to remain in office until such time until the deficit was cleared. It is no longer acceptable that the ultimate risk in a company should be borne by its pensioners.

7) The form and content of company accounts has to be brought into question because, quite clearly, the accounts of Carillion failed to draw attention to the risks that were inherent within it. This issue requires further elaboration in due course, but one of the primary problems in current accounting is, I think, the failure to report cash flow adequately. A long time ago company accounts included a cash flow statement: this is long been replaced by statement of funds flow, but these things are not the same and the funds flow statement does not, in my opinion, draw adequate attention to the ability of the company to service its debts as they fall due, which is vital if solvency is to be proved. I am well aware that there is a purpose to a funds flow statement, and that there is an argument that for a heavily solvent company this is a much better and more useful document, but there is an important caveat in that statement, and it is that the company is heavily solvent. In precisely the circumstance when a statement on insolvency is required the funds flow statement fails to deliver, and a cash flow statement is necessary. Precisely because a cash flow statement would focus the minds of the directors on their duty to ensure that creditors can be paid it should be included in all financial statements.

That are, of course, other additional statements that are required. There was no country-by-country reporting in these accounts, and that means another important aspect of risk could not be appraised.

But then there is perhaps the most important questions of all:

8) Why is it that the Financial Reporting Council's membership is still dominated by those associated with the Big Four firms of accountants? Shouldn't this be brought to an end?

9) Why is it that the UK does not have a company law regulator who ensures that the requirements of the Companies Acts are enforced, because that is not the job of Companies House? Hasn't Parliament been negligent in ignoring this issue?

10) Why is it that financial ethics training does not highlight these issues, and ask these questions. Indeed, why does it seemingly fall to just Atul Shah to do so in academia?

11) When will the audit market be reformed so that we have genuine separation of auditors from other aspects of financial services, not least so that the Big Four merry-go-round does not profit whatever happens in these situations, as PWC are now doing here?

And, perhaps, most important of all:

12) When will government realise that dumping its obligations into limited companies, who have no capacity to fulfil them, at long-term costs to the employees who provide public services, is no way to run a state?

Until such questions are answered Carillion will leave a very big stain on our economy, and the ethics of finance and accountancy.

I am not hopeful.