ACCA Think Ahead

DUFF & PHELPS

Carillion: More questions than answers?

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ACCA supports its **200,000** members and **486,000** students in **180** countries, helping them to develop successful careers in accounting and business, with the skills required by employers. ACCA works through a network of **101** offices and centres and more than **7,200** Approved Employers worldwide, who provide high standards of employee learning and development. Through its public interest remit, ACCA promotes appropriate regulation of accounting and conducts relevant research to ensure accountancy continues to grow in reputation and influence.

ACCA is currently introducing major innovations to its flagship qualification to ensure its members and future members continue to be the most valued, up to date and sought-after accountancy professionals globally.

Founded in 1904, ACCA has consistently held unique core values: opportunity, diversity, innovation, integrity and accountability.

More information is here: www.accaglobal.com

About Duff & Phelps

Duff & Phelps is a premier independent advisor with expertise in the areas of valuation, corporate finance, disputes and investigations, compliance and regulatory matters, and other governance-related issues.

Our clients include publicly traded and privately held companies, law firms, government entities and investment organisations such as private equity firms and hedge funds. We also advise the world's leading standard setting bodies on valuation issues and best practices. Duff & Phelps' nearly 2,500 professionals are located in over 70 offices in 20 countries around the world.

Our Restructuring Advisory practice includes more than 200 restructuring and insolvency professionals globally with backgrounds in accounting, banking, private equity and within industry. These professionals are experts in providing financial, operational and managerial solutions for distressed businesses to ensure survival and future prosperity. Services we offer include negotiating Time To Pay arrangements with HMRC, IBRs, debt advisory, cost reduction exercises, management assessments, operational process improvement and supply chain management – all to help our clients better manage, maintain and improve their own businesses and client relationships.

For more information, visit www.duffandphelps.co.uk

Introduction

Unprofitable and problematic contracts ultimately led to significant write-offs and cash issues, which resulted in a business that was beyond rescue.

The collapse of Carillion is likely to have a far-reaching impact in the UK and beyond. Clearly great efforts were made in the preceding weeks to rescue the business but these ultimately failed and the directors took the decision to liquidate in the final few hours, rather than follow the expected administration route. This has given the impression that the fine detail of the chosen insolvency process may not have been fully planned.

There is speculation that a failure could have been anticipated following the numerous profit warnings throughout 2017, particularly as the short sellers were taking positions based upon the expectation that the share price would fall. The group had reported significant issues on contracts relating to development projects in Doha, the Aberdeen bypass and both the Royal Liverpool University Hospital and Midland Metropolitan Hospital. These unprofitable and problematic contracts ultimately led to significant write-offs and cash issues, which resulted in a business that was beyond rescue.

It has been reported that the group owed £1.3bn to the banks, £630m of additional bond facilities and £350m in relation to invoice finance facilities, taking the total debt burden to over £2bn. This does not include the pension deficit of around £587m affecting an estimated 28,000 members, which has now been taken into the Pension Protection Fund (PPF) with the future members taking a 10% reduction in future pay-outs. When the business failed it had just £29m in cash and an immediate funding requirement: with no stakeholder willing to provide additional support, options were limited.

It appears that the banks, which included RBS, Lloyds, Santander UK, Barclays and HSBC, would not extend further support and therefore the directors requested the government to intervene to recognise the scale of public sector contracts, and the impact these had on the current financial issues. However, the government by contrast viewed this as a private sector matter where state intervention was not appropriate, and the construction giant was not classed as 'too big to fail'.

With no further funding available, the directors had no option but to look to an insolvency procedure. The directors chose to file for compulsory liquidation on 15 January 2018, with the official receiver appointing partners from PwC as special managers.

The special managers' advice is:

The Official Receiver's priority is to ensure the continuity of public services while securing the best outcome for creditors. Unless told otherwise, all employees, agents and subcontractors are being asked to continue to work as normal and they will be paid for the work they do during the liquidations.

You will get paid for goods and services you supply from the date of the Official Receiver's appointment onwards. Over the coming days we will review supplier contracts and we'll contact you concerning these soon. Goods and services you supply during the liquidation will be paid for. A letter will be sent to suppliers shortly containing further instructions.

For more advice from the special managers from PwC visit **https://www.pwc.co.uk/carillion**

What does the liquidation and appointment of special managers mean?

The special managers act as agents for the official receiver, whose stated priority is to ensure the continuity of public services while securing the best outcome for creditors. The liquidation will also present an event that will result in the current contracts terminating and the ability to reissue and provide continuity.

Initially the message was that the government would continue to fund the public sector contracts, and it was separately reported that there would be 48 hours of support for private sector contracts. It now appears that the situation might have changed after an announcement by the Insolvency Service on 17 January 2018, stating that private sector contracts might now also be funded.

INSOLVENCY SERVICE ANNOUNCEMENT:

'Over 90% of these customers (private sector) have indicated that they want Carillion to continue providing services in the interim until new suppliers can be found and will provide funding which enables the Official Receiver to retain the employees working on those contracts.'

It remains ambiguous as to whether the government, as with the public sector contracts, is underwriting this funding, and ultimately if this could be construed as a quasi-government bailout.

Public vs. private

The private sector construction projects will be challenging to extract value from and will likely be handed back to developers, banks and other stakeholders.

While awaiting confirmation of the government's funding position of the private sector contracts, there did appear to be two distinct classes of creditors following the failure; those relating to the public sector and those relating to the private sector.

The public sector services and construction contracts are continuing to operate as normal and are being funded through the official receiver by the government, effectively 'business as usual' and we understand that on-going debts to creditors will be paid. However, if the old debts are not going to be settled the special managers may find that suppliers refuse to cooperate.

The scenario faced by the private sector was said to be different, whereby the liquidation will mean that the contracts terminate and work will grind to a halt on numerous building sites across the country. This will result in bad debts for the trade suppliers which will have an immediate and significant knock-on effect upon the wider supply chain.

Whilst the support services divisions of Carillion (which include schools, the NHS, and the Ministry of Defence) are likely to be traded and sold to competitors in the market or taken in-house, the private sector construction projects will be challenging to extract value from and will likely be handed back to developers, banks and other stakeholders.

Construction project issues

If the development has an agreed contractual future sale price, the question must be asked is the project still worth completing?

If there is no long-term prospect of the official receiver continuing to fund developments indefinitely, it is likely that the sites will become deserted causing immediate issues for developers. Site security, equipment hire, and insurance will all need to be covered in the short-term while a new plan is adopted for the site.

The existing suppliers and subcontractors will be concerned about the potential for bad debt, and they will require clarity with regards to payment of current and on-going liabilities. This could result in ransom positions relating to items such as hire of equipment required on site and on-going services and warranties.

One area that is critical to the current and on-going position of developments is the significant time lag before a new main contractor can be appointed. There may not be an appetite to progress a part-completed construction project, and there are further issues with warranties that will be key in any on-going sale contract. As part of any new main contractor assessing the work required to complete a particular development, there will be significant professional fees and holding costs that need to be covered in the interim by the developer / government.

To compound matters further, there will be issues in relation to the revised profit margins and the escalating costs. Once again, the developer will find themselves in a position whereby the new costs to complete will increase due to the perceived risk and remedial works, and therefore the underlying viability of developments may be called into question.

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In addition to the above, there will be also be ramifications to the joint venture partners who are now left to complete the developments without the support of Carillion. Many of the developments will be subject to Performance Bonds, and these will need to be taken into consideration in any work-out strategy.

Support

It is very important that a plan of action is drawn up and that banks are contacted immediately when loan repayments cannot be made or overdraft facilities are going to be exceeded.

Many ACCA members act for, or are employed by, businesses that supply Carillion and which are now left potentially out of pocket with resultant cash flow difficulties of their own. Set out below are points to consider on what action to take and where to get further help.

BANKS AND FUNDERS

Lenders are contacting customers and, where appropriate, putting in place emergency measures including overdraft extensions, payment holidays and fee waivers to ensure those facing short-term issues can be supported while a plan is formulated. Monies have been provided by banks to support small business customers who are struggling after the failure of Carillion. Lloyds is creating a £50m fund, while RBS is offering £75m worth of assistance and HSBC £100m.

It is very important that a plan of action is drawn up and that banks are contacted immediately when loan repayments cannot be made or overdraft facilities are going to be exceeded. They will want as much information as possible in order to formulate an action plan. Most banks will try and work with their customers but unfortunately there is always the ultimate sanction of 'pulling the plug' and withdrawing certain facilities. This may also include invoking any personal guarantees that the funder holds, so the clear message is to contact them as soon as a cash flow problem is recognised.

It is also very helpful if the business knows exactly what the terms and conditions of its funding are and what the agreements state about a breach of covenant.

HMRC SUPPORT

Many businesses with HMRC liabilities in relation to PAYE, CIS and VAT will be unable to make these payments due to cash flow issues or bad debts. While the government was not prepared to support a tax payer bailout of Carillion, it remains to be seen if it is willing to provide support for SMEs in relation to time to pay arrangements, enabling the liabilities to be paid over a number of months.

As part of its ongoing commitment to delivering support for businesses, HMRC states that it will provide practical advice and guidance to those affected through its Business Payment Support Service (BPSS), which has been a critical lifeline to many businesses facing cash issues in the past. Whether or not it will have the resources to be able to cope with the demand remains to be seen and therefore contacting professional advisers familiar with the process might be helpful.

HMRC should be contacted as soon as possible so that the situation can be discussed and a payment plan put into place. Although the Carillion situation is very uncertain, it is easier to convince HMRC to delay payment where an estimate can be given of when the debts can be paid. HMRC's details are:

- Business Payment Support Service
- Telephone: 0300 200 3835;
  Monday to Friday, 8am to 8pm;
  Saturday, 8am to 4pm
- Follow this link for more details of the HMRC time to pay service

Sole traders and partnerships not experiencing financial difficulty may wish to consider reducing their payment on account, due on 31 January 2018, because of the bad debt that they may experience. The reduction would apply where you know your tax bill is going to be lower than last year. You can ask HMRC to reduce your payments on account. Either:

- log in to your online account and click 'Reduce payments on account'
- send form SA303 to your tax office.

Support

Creditors will normally be far more helpful if their customers contact them before the situation becomes impossible to turn around.

WHAT CAN THE SUPPLIERS DO?

As always, professional advice and support is essential to understand the options available as more information is provided over the next few days from the special managers.

There will be an immediate need to conserve cash in the short-term while work is undertaken to understand the medium and long-term prospects in a world without Carillion, and one where the government may step in to provide support.

When experiencing cash flow difficulties, a business will need to consider the options available. It is very important that key creditors are contacted as soon as possible and the situation explained. Creditors will normally be far more helpful if their customers contact them before the situation becomes impossible to turn around.

Key creditors might include:

- suppliers of key goods where an alternative is not possible to source or is uneconomical
- IT suppliers (who regularly maintain your IT system) are often high up the list, as trying out a new supplier can be a risk in itself
- your landlord may have the right to evict you for non-payment and would also have the right to seize goods within your premises, without going to court
- utilities providers can cut off vital supplies of electricity, gas, water, etc
- suppliers of commodity items, which you can buy elsewhere, are bottom of the list.

A slowdown in cash-flow will automatically affect the ability to pay your own employees. A staff meeting is essential as soon as possible to set out where the company is and what the problems are. Simply avoiding employees and not paying them will only lead to further problems.

Laying off staff and short time working may be an immediate option especially where there is doubt about future contracts. A lay-off is where employees are not provided with work by their employer and the situation is expected to be temporary. Short time working occurs when employees are laid off for a number of contractual days each week, or for a number of hours during a working day.

The Advisory, Conciliation and Arbitration Service (ACAS) has produced guidance to help with the layoff/short time process.

It is important that businesses establish their financial position. If there are cash flow difficulties there is no option to simply do nothing. Directors who allow their limited company to continue trading with no reasonable prospect of avoiding insolvent liquidation may be personally liable. They also run the risk of 'creating preferences'. For example, if you pay back a director's loan in preference to paying a trade creditor, this would probably be a preference – in which case the money would have to be repaid.

Whilst there will be businesses which have strong cash reserves and the ability to trade through the crisis, there will equally be many that will have to consider other options. We would anticipate the use of company voluntary arrangements (CVA's), and cannot rule out the potential of further administrations and liquidations that will flow down the supply chain. Where the financial difficulties are so severe that creditors cannot be paid, businesses should contact an insolvency practitioner as soon as possible.

Support

FURTHER ADVICE

The demise of Carillion is the first significant failure in 2018 and ACCA in collaboration with Duff & Phelps will keep members posted as events unfold and the picture becomes clearer. Duff & Phelps are happy to provide advice and support to members and their clients that might need assistance in dealing with the issues and problems caused by the Carillion failure. Contact David Fleming FCCA at Duff & Phelps via *David.Fleming@duffandphelps.com* or the ACCA Technical Advisory Team at *advisory@accaglobal.com*

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