

Patisserie Valerie

Patisserie Valerie

LOVINGLY HANDMADE SINCE 1926

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NAME:	AMBIA HAQUE
STUDENT NUMBER:	1700508

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1. EXECUTIVE SUMMARY

Earning management is *“the planning and control of the accounting and reporting system to meet the personal objectives of management”* (PentVars Business Journal, 2017, p.3). When a company is listed on the capital market, there are several incentives and pressures which could encourage managers towards earnings management. With specific reference to Patisserie Valerie the economic incentives and commercial pressures they faced were not evident. Regardless there are two types of earnings management, these are efficient earnings management and opportunistic earnings management. Patisserie Valerie were leaning to opportunistic earnings management compared to efficient earnings management as accounts were inflated compared to informative communication. The UK corporate governance structure constrains accounting practices such as earnings managements however these actions do not reduce earnings management as the UK Auditing Practices Board believe it should as aggressive earnings management is a significant threat.

2. INTRODUCTION

2.1 REPORT REMIT

This report aims to examine the contemporary issue of earnings management in corporate reporting with reference to the case of Patisserie Valerie. In addition to analysing the incentives and pressures which could encourage managers towards earnings management and evaluating the role of the UK Corporate Governance Code in constraining such accounting practices.

2.2 AGGRESSIVE EARNINGS MANAGEMENT

The UK Auditing Practices Board believe aggressive earnings management is a significant threat and actions should be taken to reduce it. It can be defined as: *the planning and control of the accounting and reporting system to meet the personal objectives of management*” (PentVars Business Journal, 2017, p.3). There are two types of earnings management, these are: efficient earnings management and opportunistic earnings management. Efficient earnings management is to improve earnings informativeness in communicating information and opportunistic earnings management is where management reports earnings opportunistically to inflate their accounts (Scott, 2000; Siregar and Utama, 2008). The Auditing Practices Board are particularly concerned because as history shows when the environment surrounding the economy becomes difficult the likelihood of aggressive earnings management and misleading financial reporting increases (Accountancy Age, 2001).

2.3 INCENTIVES AND PRESSURES

Financial reporting in the United Kingdom has been toughened by increasing stronger measurements to accounting standards, auditing standards and corporate governance. However, the improvements to financial reporting may be undermined

by increasing economic incentives and commercial pressures on those responsible for the preparation of financial statements such as managers and directors. This in turn encouraged management towards ambiguous accounting practices such as aggressive earnings management (APB, 2001).

“Earnings management occurs when managers use judgement in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting number” (Healey and Wahlen, 1999, p.368).

The Auditing Practices Board suggest the following examples of incentives and pressures:

- Adverse market reactions to the share price of a listed entity when results failed to meet the market’s expectations, which directors and management may have encouraged. whether or not the expectations were reasonable
- Directors and management’s income being highly geared to results and/or heavily supplemented by stock options and other possibilities for large and capital gains
- The importance of meeting targets to ensure protection of the jobs of directors, management and other employees
- The desire to understate profits to reduce taxation liabilities
- Legal and regulatory requirements to meet specific financial threshold or ratios
- The need to ensure compliance with loan covenants to pacify bankers

These economic incentives and commercial pressures could encourage managers towards earnings management despite there being a threat of action by the Financial Reporting Review Panel for both listed companies and private companies (*ibid.*).

3. PATISSERIE VALERIE

Patisserie Valerie are a chain of cafés on high streets across the United Kingdom. Their stores offer cakes and patisseries alongside continental breakfasts and café favourite foods and drinks. It was first established in Soho London by Belgian born Madame Valerie in 1926 who's mission was to introduce continental patisserie to the English (Patisserie Valerie, 2020;2017).

Currently, Patisserie Valerie has become one of the greatest corporate collapses of recent times. In 2018 the owner of Patisserie Valerie, Patisserie Holdings, revealed the company accounts had been misstated extensively by multimillion of pounds. Amongst the fraudulent activity the chairman of Patisserie Valerie invested £20m to keep the company from going into administration.

In 2019 Patisserie Valerie claim it had found “thousands of false entries into the company’s ledgers” resulting in profits “materially” below the numbers reported than first revealed whilst forensic accountants revealed “very significant manipulation” of the balance sheet and profit and loss accounts (Luke, 2019).

Once Patisserie Holdings had gone into administration after failing to extend borrowing facilities with the bank the company was found to have misstated its accounts by £94m. In addition to this the company was found to have overstated its cash by £30m and failed to disclose overdrafts of almost £10m as well as falsely claimed to have £54m in cash according to KPMG March 2019 auditing report (Butler and Wood, 2019).

KPMG had concluded an agreement for a management buyout funded by Causeway Capital Partners to acquire assets and the company of Patisserie Valerie form administration for a total of £13m (Butler, 2019; Luke, 2019).

With reference to Patisserie Valerie the following economic incentives and commercial pressures could have taken place to encourage management towards aggressive earnings management. It could have occurred because there was a need to meet market expectations or because managements' remuneration was linked to earnings. Also, to an extent to reduce tax liabilities by understating profits or to secure borrowing by increasing profits (Elliot and Elliot, 2015; Ronen and Yaari, 2008).

The type of earnings management Patisserie Valerie utilised is unclear, there is not enough evidence to support whether Patisserie Valerie conducted efficient or opportunistic earnings management. However, it can be assumed bad earnings management took place as the true operating performance was hidden misleading financial statement users compared to good earnings management undertaken in order to manage the company effectively and create value for stakeholders (Hamilton et al, 2018).

4. UK CORPORATE GOVERNANCE CODE

The UK Corporate Governance Code, previously known as the Combined Code, sets out standards of good practice for companies listed on the capital market. It can be defined as: *"the system by which companies are directed and controlled. Boards of directors are responsible for the governance of their companies. The shareholders' role in governance is to appoint the directors and the auditors and to satisfy themselves that an appropriate governance structure is in place"* (FRC, 2018, p.1).

A few ways the UK corporate governance structure constraints accounting practices such as earnings management is by the size of the board, separate management and chairman of the board and auditing committee independency to improve

stakeholder confidence (Juan el at, 2009). Firstly, the size of the board affects the overall efficiency of the board as it reflects the impact of the administrators control. Therefore, a bigger board size means varied opinions leading to better control whereas a small board size can be dominated by the opinion of the manager (Pitol Belin, 1997; Graham et al, 2005). Next, separation between management and the chairman of the board divides leadership simplifying the task of decision making leading for focused performance. Lastly, members of the auditing committee should be independent to members on the board as the composition of the auditing committee is made up of already in the United Kingdom (Atri et al, 2011).

5. CONCLUSION

The Accounting Practices Board call bad earnings management as 'aggressive' however not all earnings management are 'aggressive'. There are two types of earnings management, these are efficient earnings management and opportunistic earnings management.' When a company is listed on the capital market, there are a number of economic incentives and commercial pressure that encourage managers towards earnings management. With specific reference to the case of Patisserie Valerie, it can be concluded they were leaning to opportunistic earnings management as the opportunity was taken to change the accounts for own personal gain. In addition to this, earnings management continues to take place despite the UK corporate governance structure providing constraints to earnings management.

6. RECOMMENDATIONS

The UK Corporate Governance structure could be improved in an effort to constrain such cases as Patisserie Valerie in the future by following companies on the implementation of the constraints earlier on to identify any fraudulent activity.

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