Journal of Modern Accounting and Auditing, July 2018, Vol. 14, No. 7, 390-398
doi: 10.17265/1548-6583/2018.07.004

DAVID PUBLISHING

# Palmer & Harvey: A Case of Governance and Audit Failure

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Palmer & Harvey (P&H) is a recent example of a UK corporate failure which raises questions about current corporate governance practice, the quality and integrity of audit reporting, and the "sugar coating" of Annual Reports. P&H is but one example of UK firms currently struggling to survive, or failing. The paper presents some details about the P&H case, and then considers questions about corporate governance practice, and whether it is designed to truly safeguard the interests of stakeholders; it raises questions about conventional audit reporting, and whether it is too limited in its analysis and reporting. The paper recommends a strengthening of corporate governance guidelines and practice within the terms of the current Financial Reporting Council (FRC) review, and a wider adoption of forensic accounting practice and reporting, in part taking account of the impact of behavioural factors in management practice. A wider study is proposed to take this analysis and discussion further.

*Keywords:* corporate governance, audit failure, corporate failure, agency theory, forensic accounting

## Introduction

The appointment of administrators on November 28, 2017 by Palmer & Harvey (Holdings) Plc, hereafter referred to as Palmer & Harvey (or P&H), highlighted not only the risks associated with mergers and acquisitions (Tuch & O'Sullivan, 2007), particularly highly leveraged acquisitions, but also the potentially serious adverse consequences of conflicts of interest between stakeholders particularly in an acquisition. P&H's entry into administration, and the reporting of performance over time by directors and auditors in their Annual Reports[1], highlights the apparent weakness of existing governance practice and requirements in providing protection for those stakeholders most vulnerable to the impact of decisions taken by minority stakeholders (usually senior executives or directors) and the inability of the current accounting paradigm in guaranteeing the robustness of the going concern statement required from auditors. Palmer & Harvey (Holdings) Plc was the result of a management buyout (MBO) in 2008.

The Financial Reporting Council (FRC) published in December 2017 "Proposed Revisions to the UK Corporate Governance Code"[2]. In their Executive Summary, the FRC stated that "In some high-profile cases the quality of governance has been poor" and they also stated that "Now is the right time to undertake a comprehensive review to ensure that the Code remains fit for purpose and continue to promote improvement in the quality of governance". The Executive Summary also stated that "Successful companies should be open and

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[1] Palmer & Harvey Annual Reports, year ending April: 2008 to 2016.
[2] UK Corporate Governance Code 2016.

accountable to their workforce". The FRC sought responses to the Draft by February 28, 2018; the P&H case provides a number of issues worthy of consideration by the FRC as part of their process.

The last published Palmer & Harvey Annual Report and Accounts (April 2, 2016) provides virtually no indication from the directors of the likely consequences of the continued deterioration in the firm's performance on its stakeholders; the FRC could be asked to consider the format of a risk assessment that could be required in an Annual Report to sustain stakeholder support and provide a more realistic assessment of current performance and future outlook and hence give added reassurance on the "going concern" requirement.

## Palmer & Harvey (P&H) Activities

P&H had been in operation for more than 90 years. The principal activity of P&H and its subsidiaries was the distribution and delivered wholesaling of tobacco, confectionery, soft drinks, crisps and snacks, grocery and household, alcohol, and fresh, chilled and frozen foods. It was the UK's largest delivered wholesaler of grocery products operating from one national distribution centre, 14 regional depots, and 48 local depots across the Great Britain and Northern Ireland, servicing approximately 90,000 retail sites for its customers ranging from the local corner-shop and petrol forecourt to the UK's largest multiple grocers. P&H also owned a 71-strong chain of local grocery shops. Wholesale tobacco accounted for about 70% of P&H revenue. P&H had approximately 4,500 employees.

## Financial Performance

The financial performance of P&H is summarised in Table 1. Across the seven-year period from 2008/9, revenue increased by 4.9% to £4,435m, PBT (profit before tax) fell from £0.5m to a loss of £17.3m, the highest paid director's emoluments increased by 29% to £439k whilst total equity fell steadily over time from £4m in 2008/9 to -£48m in 2015/6. Directors emoluments in total increased by 67% from 2008/9 to £1.4m in 2015/6; average payroll cost per employee (including directors and managers) changed from £23.0k in 2008/9 to £23.4k in 2015/6.

Table 1
*P&H Financial Performance From 2008 to 2016*

| April, £m | 2008/9 | 2011/12 | 2014/5 | 2015/6 |
|---|---|---|---|---|
| Revenue | 4,227 | 4,228 | 4,466 | 4,435 |
| PBT | 0.5 | 4.9 | -8.5 | -17.3 |
| Pref. dividend | 11.2 | 8.6 | 8.2 | 8.2 |
| Intangible assets | 350 | 325 | 334 | 336 |
| Total assets | 981 | 1,003.2 | 1,240 | 1,094 |
| Total equity | 4 | -17 | -35 | -48 |
| Highest paid director £k | 341 | 391 | 439 | 439 |

*Note*. Source: Palmer & Harvey Annual Reports, year ending April: 2008 to 2016.

## Financial Issues

In the aftermath of the P&H administration, a number of the directors/senior management decisions have come under scrutiny, as follows:

(1) The misalignment of directors' emoluments and firm performance, and its misalignment with average employee payroll changes over time;

(2) Total equity becoming negative in the second year of the MBO, thereby eliminating any potential return to ordinary shareholders (notably employees excepting directors);

(3) The terms of a £3.4m loan to former CEO Chris Etherington, notably interest free and initially repayable on demand; this loan was to enable him to purchase shares in the company. The terms of Etherington's loan were changed in 2011 such that it became repayable "in the event of any sale of all or some of the 'A' ordinary shares and 'B' preference shares held"; unlikely now that P&H is in administration;

(4) Uncertainty exists regarding the company pension fund and its "health"; on December 4, 2017, Frank Field, Chairman of the House of Commons work and pensions committee, wrote to P&H Pension Trustees Ltd. seeking clarification on the current surplus/deficit of the P&H pension scheme, and what is the evidence of the Trustees challenging the company over its dividend policy, and how have the trustees communicated with scheme members to keep them informed?

(5) Shareholders and directors took dividend payments on preference shares they held, despite the continuing losses of P&H and potential issues with the pension fund;

(6) High level of funding dependence on short-term funds, notably increased days payable from suppliers, and trade receivables on an asset-backed financing arrangement. Two of their largest creditors, Imperial Tobacco and Japan Tobacco International, are believed to have instigated processes which led to the administration;

(7) Significant payment of fees for financial restructuring of P&H during and following 2008.

## Mergers and Acquisitions (M&As)

M&As are more likely to be value destroying for acquiring firm shareholders than value enhancing (Tuch & O'Sullivan, 2007), with serious adverse consequences on a range of stakeholders; the "winners" in M&A tend to be the shareholders of the firm being acquired, and the gains for them can be quite significant. This paper is not examining the gain, if any, to shareholders in the Palmer & Harvey Company being acquired by Palmer & Harvey (Holdings) Plc, but examines performance from 2008. It might be argued, in governance terms, that performance following an acquisition (such as the P&H MBO) requires more critical analysis and reporting than "business as usual" reporting.

Behavioural factors are known to materially influence business performance and yet there is no governance requirement for them to be commented or reported on in Annual Reports. Research indicates that hubris (Roll, 1986), narcissism, or animal spirits can be significant factors in management decision-making, and in leading to acquisitions. It is interesting to examine the text of the chief executive's statements in the P&H Annual Reports and to reflect on whether they have a tendency to be over-optimistic and not consistent with the actual financial performance and trend of the P&H business; this paper suggests that the reports do have a tendency for over-optimism, particularly in the 2016 Annual Report and in light of the subsequent administration filing.

The CEO of P&H, Chris Etherington, was appointed in June 2006 from Unipart Automotive. Etherington and P&H Chairman, Christopher Adams, had only about 18 months working together prior to the MBO. Research shows that the shorter the period of time that a Chairman and CEO have worked together at the date of an acquisition, the less successful that acquisition will be (Garrow, 2012). That research indicated that the optimal period of joint tenure at the date of the acquisition for a Chair and CEO is six years, significantly longer than the period that Etherington and Adams were together when the MBO was consummated.

## Annual Reports: Helpful, Responsible, or Misleading?

As mentioned earlier, P&H entered administration in November 2017. In light of that and the financial results during the period from 2008 to 2016, did the 2016 Annual Report and Accounts provide any clues to stakeholders in the Report narratives regarding impending problems which would result in administration, loss of jobs, and creditors taking significant write downs against what they were owed?

The CEO in his "Future Prospects" commentary stated that the "new financial year has started well" and that "we expect to make further progress in the year ahead". In his section on "Building on solid foundations" he states that "the last few years have been challenging and to some extent unpredictable… We successfully completed a bank refinancing at the start of the new financial year which provides us with a sound financial platform to deliver our strategy". No storm clouds here.

The governance question which this narrative poses is "what obligation do the directors and the auditors have to accurately reflect the true status of the business, the real risks to stakeholders, and the challenging options which the directors are facing?"

The "Financial Review" written by the Group Finance Director provides detail describing the deteriorating performance of P&H in 2016, with many indications of poor management decision-making. No concern is expressed by the directors on the longer term implications of the issues which are reported on by the Group Finance Director.

In the Directors Report, the following statement is made in the liquidity risk and cashflow risk section: The Group ensures that there is sufficient funding capacity to meet short- and long-term funding requirements through close management by the group treasury function and senior management.

## Potential Red Flags Missed by Auditors of P&H

There were a couple of red flags that suggested that the "going concern" of P&H was under serious threat and this was missed by the auditors of P&H. We are by no means blaming the auditors of P&H for not spotting these red flags and neither are we suggesting that financial statement fraud has taken place. However, investors and other stakeholders rely on audited financial statements to make decisions. We strongly believe that the inability of the auditors of P&H to spot the red flags or at best raise their concerns is down to the weakness of the current accounting paradigm which we classify as reporting and procedural auditing.

In this paper, we utilize agency theory to argue our case that the current accounting paradigm is weak in highlighting red flags that threaten the going concern of business entities, and we propose a paradigm shift to forensic accounting.

Our notion of paradigm follows from the idea of Kuhn. Paradigm, according to Kuhn (1996), "is a universally recognized scientific achievement that for a time provides model problems and solutions to a community of practitioners". To this end, we view an accounting paradigm as a set of principles, concepts, regulations, standards, and conventions that for a time govern how financial information is prepared, presented, reported, and verified by the actors in the business community as well as corporate governance which governs how companies are run.

Potential red flags that were missed or not reported on were as follows:

(1) Complex business structure: P&H had a complex business structure. The company was owned by dozens of private individuals via a complex web of equity and loans. This ought to have been questioned by auditors but this was missed. P&H had unqualified audit reports since the MBO took place. Had the auditor questioned the complex nature of P&H, this might possibly have prevented the company from going into administration;

(2) Merger and acquisition (MBO): The financing of the MBO of P&H raised some serious concerns. When P&H was bought in 2008 by its management team in a deal that was valued at £345m, it was largely funded through debt;

(3) Dividend payment: The directors of P&H (both former and current directors) and other shareholders were paid £70m in dividends over nine years despite the losses that the company made. The rationale behind this should have been questioned by the auditor in the Annual Report, but this was not done. Whilst there is no law to prevent the payment of dividends from losses, the moral ground for doing this is questionable. This is a major weakness in the current accounting, regulatory and governance environment;

(4) Composition of preference shareholding: The composition of the preference shares held by the directors (current and former) is questionable and raised a serious red flag. Christopher Adams (previous Chairman) and Christopher Etherington (previous Chairman and CEO) both held special preference shares "B Preference" that paid out a fixed dividend twice a year. Etherington, who stepped down as chairman in 2017, with his wife were entitled to an estimated £300,000 in dividends in 2016 and Adams £941,000. Half of this payment was deferred under an agreement with shareholders which pledged that it could be repaid if and when the B preference shares were ultimately redeemed. Etherington and his wife had together held the same number of these B shares since the takeover, entitling them to about £2.5m in dividends since 2009. In all of this, one might judge a conflict of interest which could explain why dividends were paid despite the continuous loss making of the company.

## Agency Theory

The separation of ownership from control (which is elsewhere called the Anglo-Saxon Model) has made financial statements the major primary mechanism for monitoring the performance of a company by its shareholders and other stakeholders. Audits which serve a vital economic purpose play a crucial role in monitoring the performance of management in an agency relationship, thereby reinforcing trust and confidence in the financial reporting process (ICAEW, 2005).

Agency theory provides a formal framework for studying principal/agent relationships and has been recognised as a powerful research paradigm in describing and explaining the contractual relationship that exist between the principal and the agent (Chi, 1989).

Within the purview of the agency theory, an organisation is viewed as the locus or intersection point for many contractual type relationships that exist among management, owners, creditors, and other actors (Chariri, 2008).

Agency theory describes the principal agent relationship that exists between stakeholders and management, with top management acting as agent whose personal interest does not naturally align with company and shareholders interest (Jensen & Meckling, 1976).

The agency theory is premised on the economic perspective which assumes that the relationship between the principal and the agent is characterised by a conflict of interest (W. S. Albrecht, C. C. Albrecht, & C. O. Albrecht, 2004; ICAEW, 2005; Choo & Kim, 2007; Chariri, 2008).

Consequently, managers are perceived as individuals who solely act in their own interests, which may conflict with the organisation's best interest. In this case, P&H management acted, it might be argued, in their own interest and not in the interest of all the company's stakeholders.

This conflict of interest usually occurs as a result of information asymmetry (De Lange & Arnold, 2004). Information within an organisation is very critical to decision-making and management working at the coal face of the operations of the company are privy to essential information that can be manipulated to maximise their own interest at the expense of the principal (ICAEW, 2005). This might be argued was the case with the chairman statements that gave no indication that the business was in serious financial difficulty.

As a result of this, management (agents) have a competitive advantage of information within the company over that of the owners (principal) and other stakeholders, such as pensioners. This results in the inability of the principal, and other stakeholders, to control the desired action of the agent (De Lange & Arnold, 2004).

This conflict of interest is called "agency problem" (Albrecht et al., 2004). Because of information asymmetries and self-interest, principals lack reasons to trust their agent and will seek to resolve these concerns by putting in place mechanisms to align the interest of agents with that of the principal and to reduce the scope for information asymmetries and opportunistic behavior (Albrecht et al., 2004; ICAEW, 2005).

In the same context, other stakeholders suffer from having inadequate information, thereby preventing them from making informed decisions. Provision for such information to be made available to these stakeholders (along with unbiased, informed, opinions) is an important governance question.

There are several mechanisms that can be used to align the interest of the agent with that of the principal and to allow the principal to measure and control the behaviour of their agent and reinforce trust in the agent. Brigham and Houston (2007) suggested several measures that can motivate managers to act in shareholders' and other stakeholders, best interest: managerial compensation, direct intervention by shareholders, firing and threat of takeover (Brigham & Houston, 2007). Lasher (2010) suggested that the effective management of the agency problem includes monitoring of the agent's work.

One of the mechanisms for effective management of agent work should be the external audit. While some other mechanisms (such as a good compensation plan, internal audit, and corporate governance practices) are internal in nature and can be overridden by management to suit their own very purpose. External audits serve as a fundamental mechanism in promoting confidence and reinforcing trust between the principal and the agent (ICAEW, 2005).

However, the external audit and its reporting in the Annual Report in the case of P&H might be argued to have failed to protect the interest of the shareholders and other stakeholders, particularly those 2,500 workers who lost their jobs. The FRC review of the UK Corporate Governance Code is a timely process to address such issues.

According to agency theory, the very purpose of an external audit is to serve as an instrument for ensuring that financial reports have been subjected to an independent scrutiny by a competent external auditor (Wolk & Tearney, 1997). What the independent audit represents in this regard is a bastion of safeguards implemented by the principal in the agency relationship to monitor the agent (De Lange & Arnold, 2004).

Within the agency relationship, we argue that external audit serves a dual role. External audit is that unique link between the principals and the agent. It serves an investigative role to the agent (management), and an attestation role to the principal (stakeholders).

The investigative role involves checking the accounts prepared by management for errors and frauds and making sure that the accounts reflect a true and fair view of the entity affairs by identifying any red flags that threaten the going concern of the entity in order to safeguard the investment of the principal. While the attestation role entails giving assurance to the principals (stakeholders) that the enterprise is a going concern and will yield a good return on investment.

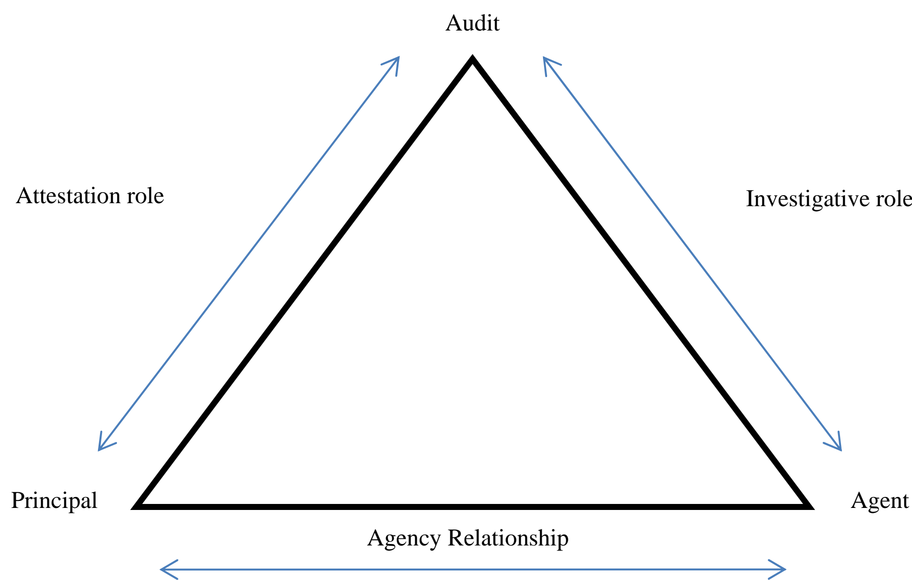


*Figure 1*. The agency triangle.

Looking at P&H, the investigative and assurance role that audit was meant to play in the agency relationship seemed to be lacking in the current audit environment as those red flags were not identified which led to the company going into administration.

## Forensic Accounting Paradigm

We argue that if all audits are approached from a forensic accounting standpoint, most of the corporate collapses and fraudulent financial reporting that we have witnessed in recent times would have been avoided including P&H.

This is because forensic accounting involves the application of investigative and analytical skills for resolving financial issues in a manner that meets standards required by the court of law (Hopwood, Leiner, & Young, 2012).

Our concern with the current accounting paradigm is that it only looks at numbers and compliance, while forensic accounting not only looks at numbers but also looks behind those numbers. The forensic accounting factor includes the human behaviour element, as discussed earlier, which is what the current accounting and auditing reporting environment lacks.

A questioning mind set and an understanding of what motivates fraudulent conduct are what make forensic accounting stand out in the crusade against financial deception. The forensic accountant is a bloodhound of bookkeeping (Smith & Crumbley, 2009). These bloodhounds sniff out fraud and criminal transactions in banks, corporate entities or from any other organization's financial records. They search for the conclusive evidence.

External auditors are known to find the deliberate misstatement only, but the forensic accountant finds out when misstatements are made deliberately. External auditors look at the numbers but forensic accountants look beyond the numbers (Joshi, 2006). These are some of the attributes that make forensic accounting relevant in the fight against financial deception, and incomplete analysis and reporting.

## Conclusion

In conclusion, one might argue that the P&H MBO was doomed from the start in light of its selection of leadership and the change of leadership team over time compared with the pre-MBO team. Acquisitions are always challenging, high risk, undertakings. P&H was no different in that regard, and the debt structuring may have added to that risk.

What is the evidence in the P&H story for good and/or bad governance? Would an improved Code rectify this? Would a forensic accounting paradigm have avoided many of the issues emerging from the P&H review?

Frank Field's question to trustees referred to earlier could be broadened as follows: what is the evidence of the Board challenging the management over its policies and strategies? What protection did employees, pensioners, creditors have, and what should they have had, and should rightfully expect to have? All good questions for corporate governance.

Annual Reports may "sugar coat" performance reporting, and agency theory is a possible explanation for this. Behavioural factors influence performance and most probably determine what is written about the firm in the Annual Report. In extreme cases, fraudulent practices may exist, and traditional auditing methods and reporting are not sufficient, hence the proposal to adopt more of a forensic approach to auditing and audit reporting in Annual Reports. If the integrity of the Annual Report is in question, then new governance practices need to be adopted to restore stakeholder confidence. The impact that deleterious performance and its reporting has on stakeholders, especially employees and pension holders, is significant, as experienced in the case of P&H.

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