Thomas Cook Breaking News see page 12 (November 2019)

Thomas Cook (liquidation as of October 2019)
One might say that this was a disaster waiting to happen. The fall and the reasons for it are aptly covered by a range of references shown at the end. Thomas Cook went into liquidation in September 2019 - liquidation not administration. No administrator could fund such a complex business while seeking a buyer.

There is a long history to this firm’s collapse with debts of probably more than £2 billion. Also unpleasant for the 21,000 employees (9,000 of which in the UK) and the 150,000+ customers left stranded on their holidays. And the 3,000 hotels who probably will not be fully paid for most of the summer guests. Plus the more than 500 high street stores which have closed.

Recent history
Thomas Cook, founded in 1841, was one of the world’s largest holiday businesses, with 21,000 employees in 16 countries, including more than 22 million customers every year. Its £2+ billion debt burden had left it vulnerable to factors including last year’s heatwave, Brexit uncertainty and the weak pound, forcing it into a rescue deal led by Fosun, the Chinese owner of Club Med. Though the hole in the group’s finances was revealed (in the High Court as £3.1 billion. And may be more when the dust settles.

In 1992 it was bought by Germany's third largest bank, the Westdeutsche Landesbank after a set of financial roubles. Its next owner in 2001 was another German company, C&N Touristic AG, which quickly rebranded the whole business as Thomas Cook. And in 2007 the company merged with MyTravel - owner of the Airtours and Going Places brands - and was rebranded as the Thomas Cook Group. It is unfortunate that the big push to expand occurred just as the GFC occurred in 2007-2009. Some say this purchase was at an overpaid price. The resulting 1,200 retail outlets was important as the group needed scale to be profitable. But 2011 saw renewed financial problems and a change of the top management.

As the FT claimed:\footnote{Hancock, A., Top trio who oversaw Thomas Cook’s rise and fall, Financial Times, 26 September 2019. Available at: \url{https://www.ft.com/content/1b1abb78-e089-11e9-9743-db5a370481bc} Accessed September 2019.}

Suddenly you put the two strongest together [Tui and First Choice] and put the two bottom of the class together,” said one person with knowledge of the negotiations at the time.

…

The deal turned Thomas Cook from a privately owned catalogue holiday provider to a group with a retail estate, tour operator and airline, giving it the scale to compete with online rivals and low-cost airlines. But when a month later Tui snapped up First Choice, Thomas Cook was upstaged.

\footnote{Hancock, A., Top trio who oversaw Thomas Cook’s rise and fall, Financial Times, 26 September 2019. Available at: \url{https://www.ft.com/content/1b1abb78-e089-11e9-9743-db5a370481bc} Accessed September 2019.}
The chief executive, who two board members of the time said was overpromoted, left in 2011 following three profit warnings. That year net debt stood at £891m, with annual interest charges of £122m. That was the start of a mounting debt pile that ultimately crippled the company.

**The rescue deal**

Thomas Cook had nearly agreed a deal with its investors and banks for a £900m deal of additional funds. But the banks insisted on an additional £200m and raised this to £250m in order to finalise the deal. This additional slice could not be agreed with the Chinese and other partners. “Although a deal had been largely agreed, an additional facility requested in the last few days of negotiations presented a challenge that ultimately proved insurmountable,” he said.

**The CEO’s defence of the group’s actions**

Peter Fankhauser claims:

“We were so close to a deal,” he said. “We didn’t ask for a bridging loan, just a back-up loan, which would be drawn only in the worst-case scenario.”

Reading between the lines, Fankhauser is also frustrated by the banks, which include Barclays, Morgan Stanley, UniCredit, Credit Suisse and Royal Bank of Scotland. They, the bondholders, Thomas Cook and its main equity partner, China’s Fosun — which he described as “all in” — had spent most of the summer trying to thrash out a £900m rescue package for the group, whose debts reached a crippling £1.7bn.

The package had been agreed in principle by last month, but began to founder when the banks asked the company to raise a further £200m to prop up its finances in case winter bookings were disappointing. Fankhauser agreed to raise the cash and insists he succeeded, in part by persuading some Spanish and Turkish hotel groups to stump up. “We had enough money,” he said. “We had solutions.”

But by then, media reports of the company’s woes meant bookings had “fallen off a cliff” and suppliers, including hotels and the firms that fuelled Thomas Cook’s 105-jet fleet, were asking for payment up front. “We were in meltdown last weekend,” Fankhauser said. That, he claimed, prompted the banks to demand the government guarantee a backstop. “On the Sunday evening, they said: ‘Without the government, we don’t stay at the table.’ ”

If creditors had acted quicker, Fankhauser believes Thomas Cook would still be in business. “The longer the talks dragged on, the more uncertainty grew, increasing the likelihood of a liquidity squeeze.” He accused banks and bondholders of “trading for every point”. The banks and bondholders have lost about £1.8bn in total and Fosun about £200m.

The counter to that is that the actions since 2015, he took over as CEO were inadequate. The failure to close retail outlets and move more significantly into online and the profitable parts of the business (hotels and airlines) was too little too late.

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2 Exclusive interview: We did nothing wrong, says Thomas Cook boss Peter Fankhauser, The Sunday Times, 29 September 2019.
That said\textsuperscript{3} Mr Fankhauser set up a £150m hotel joint venture with the Dutch real estate investment company LMEY and took Thomas Cook to China through a partnership with shareholder Fosun, which ended up putting more than £200m into the business before it failed.

\textsuperscript{3} Op. Cit., Hancock
Our analysis of the annual report
In general the annual report is a fantasy, a fairy tale from the very start of the reorganisation going back to 2007 and the reorganisation at 2011 and the outgoing CEO in 2015. The summary of the financial results are provided in the table below.

EY has been auditor of Thomas Cook for two years since 2017. It took over from PwC, which had audited the business since 2008. EY earned £3m in audit fees and a further £1m in non-audit services (NAS) for year end 2018, although there are no details in the annual report about the type of NAS provided.4

<table>
<thead>
<tr>
<th>Thomas Cook Group plc £m</th>
<th>2015</th>
<th>2016</th>
<th>2017</th>
<th>2018</th>
<th>2018</th>
<th>2019</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Full</td>
<td>Full</td>
<td>Full</td>
<td>Half</td>
<td>Half</td>
<td>Half</td>
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<tr>
<td></td>
<td>year</td>
<td>year</td>
<td>year</td>
<td>year</td>
<td>year</td>
<td>year</td>
</tr>
<tr>
<td></td>
<td>Sept</td>
<td>Sept</td>
<td>Sept</td>
<td>March</td>
<td>March</td>
<td>April</td>
</tr>
<tr>
<td></td>
<td>Restated</td>
<td>Restated</td>
<td>Restated</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Revenue</td>
<td>7,834</td>
<td>7,812</td>
<td>9,006</td>
<td>9,584</td>
<td>3,277</td>
<td>3,277</td>
</tr>
<tr>
<td>Gross profit</td>
<td>1,772</td>
<td>1,822</td>
<td>1,990</td>
<td>1,933</td>
<td>672</td>
<td>672</td>
</tr>
<tr>
<td>Profit after tax</td>
<td>19</td>
<td>9</td>
<td>9</td>
<td>-163</td>
<td>-255</td>
<td>-303</td>
</tr>
<tr>
<td>Intangible assets</td>
<td>2,794</td>
<td>3,077</td>
<td>3,136</td>
<td>3,104</td>
<td>3,104</td>
<td>3,063</td>
</tr>
<tr>
<td>Current liabilities (mainly debtors)</td>
<td>3,702</td>
<td>4,630</td>
<td>4,339</td>
<td>4,222</td>
<td>3,739</td>
<td>4,107</td>
</tr>
<tr>
<td>Borrowings &amp; other liabilities</td>
<td>5,590</td>
<td>1,934</td>
<td>2,010</td>
<td>2,056</td>
<td>2,632</td>
<td>2,073</td>
</tr>
<tr>
<td>Auditor's comments</td>
<td>May be</td>
<td>Yes</td>
<td>Yes</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Intangibles
The issue is that much of the value of the business was written into its brand value and the loyalty of its customers - accounted for in its books as goodwill. This value changed significantly in 2019. The other factor is that the firm had little tangible assets, such as planes or hotels.

4 White, S., Thomas Cook auditor EY will face regulator probe, Accountancy Daily, 25 September 2019. Available at: https://www.accountancydaily.co/thomas-cook-auditor-ey-will-face-regulator-probe
Marginal profitability

As can be seen the profitability of single figures to 8 to 9 billion pounds is essentially break-even. Worse is that there is a suspicion that expenses and provisions were under-reported. So in fact, losses could have been reported for all of the years before the £163m loss in 2018 – accelerating to £1.5 billion for the 2019 half-year. Common sense would indicate, if nothing else, that with a heavily geared firm, that trouble for its survival was brewing fast. Just the PR impact would recued holidays as customers opted for ‘it may go bust’ flight to other holidays. For the underreporting of charges see:

Thomas Cook’s collapse has drawn attention to the way its accounts reported historic exceptional charges that flattered profits, as well as its treatment of goodwill writedowns and heavy debts.

The total borrowing impact

Just a quick look at the summary stats shows the best part of £6 billion of liabilities many of which were borrowing or other short or medium term liabilities that would have to be paid. This, in itself, should have raised not just warning bells but large flashing signs clearly visible to all.

Auditor’s comments

EY in its half-year review of the six-monthly report said this:

Material uncertainty related to going concern

We draw attention to note 1 (page 23) in the financial statements, which indicates that the outcome of the strategic review and the associated conditions in the new financing arrangement is uncertain. As stated in note 1, these events or conditions indicate that a material uncertainty exists. This may cast significant doubt on the company’s ability to continue as a going concern. Our conclusion is not modified in respect of this matter.

… and

Conclusion

Based on our review, nothing has come to our attention that causes us to believe that the condensed consolidated interim financial statements in the interim financial report for the six months ended 31 March 2019 is not prepared, in all material respects, in accordance with International Accounting Standard 34 as adopted by the European Union and the Disclosure Guidance and Transparency Rules of the United Kingdom's Financial Conduct Authority.

For us this is fairly weak in terms of any warnings or qualifications. EY would disagree and he probably has the support of Accountancy Daily.

See our books in https://www.fin-rep.org/ for our views on such auditing practice. It may be acceptable and common practice. But it hardly fits with true and fair, or even the FRC’s revised Fair, Balanced and Understandable tests.

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5 Kinder, T., Accounting regulator looks into Thomas Cook investigation, Financial Times, 24 September 2019
Available at: https://www.ft.com/content/f8454e2e-deda-11e9-9743-db5a370481bc

6 See https://www.fin-rep.org/buy/
Volume 1: Disruption in the Audit Market: The Future of the Big Four, Routledge, April 2019
Defences of the auditors warnings

As we have said, in our opinion, the annual report is little more than a wish-list, a flight of fancy. One can say this with hindsight but even then we think that management were blissfully unaware7 of the impact of Brexit and its increasing debt burden, coupled with the move to online bookings by its customers (who were probably at the lower end of the markets). That said Sara White of Accountancy Age made these points8:

However, EY has flagged a number of significant concerns over the last 18 months, most recently when Thomas Cook issued its half yearly results in May.

At the time EY flagged material uncertainty related to going concern. The auditor warned that ‘the outcome of the strategic review and the associated conditions in the new financing arrangement was uncertain. These events or conditions indicate that a material uncertainty exists. This may cast significant doubt on the company’s ability to continue as a going concern. Our conclusion is not modified in respect of this matter.’

In the annual report for year end April 2018, the auditor also warned Thomas Cook about issues around journal reporting and debt repayment terms.

Our viewpoint is that reading though the auditors report did not seem to cause much alarm though the warnings were there but not made with any degree of force. This is because the auditors probably did not want to create a self-fulfilling prophecy. The fact that between the UK Banks, the Chinese (Fosun) and the Turkish interest, too much time was taken to reach a deal. And a deal that at each stage seems to have been publicly reported which led to a fall-off of customers in a situation which was at best marginal and, if all the write-off had been completed then, at worst, losses throughout the period since at least 2015.

Rachel Reeves

MPs will hold an inquiry into the collapse of Thomas Cook focusing on its accounting practices, executive pay, and the role of its auditors as costs from the fallout look set to reach nearly £1bn. The now famous Rachel Reeves and her business, energy and industrial strategy select committee said it would seek to question Thomas Cook’s chief executive, Peter Fankhauser, as well as its chairman, finance director and auditors.

With Carillion and other failures, this select committee has been fast and the most effective as a watchdog and raiser of alarms – in some ways more so than all the official watchdogs.
Rachel Reeves/Continued
Rachel Reeves said of the current management:
“appears to be a sorry tale of corporate greed, raising serious questions about the actions of Thomas Cook’s bosses and their stewardship of the business”.
But previous executives sowed the seeds of its downfall with a debt-fuelled expansion and an inability to deal with disruption from new online rivals.

Remuneration too high?
But we have to put this in perspective:
1) The group went under because successive chief executives failed to reshape the business swiftly and cleverly enough.
2) As Lex of the FT pointed out: the senior executives “pay was high by the standards of a Thomas Cook store worker getting £15,000 a year. It was only a shade more than median pay of about £1.5m for a FTSE 250 CEO over the past five years”.

For example:
Peter Fankhauser, Thomas Cook’s last captain, made £8.4m over four years if you believe the remuneration reports. Don’t. Incentive shares worth £4.1m sank to the sea floor with his ship. Manny Fontenla-Novoa, whose Noughties mis-steps left Thomas Cook badly positioned, did better. He got some £16m over a five-year span, annual reports suggest. He was hit more modestly by share price falls.

These are the details:

<table>
<thead>
<tr>
<th>Name</th>
<th>Title</th>
<th>Pay (since 2007)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Manny Fontenla-Novoa</td>
<td>CEO 2003-2011</td>
<td>£14.5m</td>
</tr>
<tr>
<td>Harriet Green</td>
<td>CEO 2012-2014</td>
<td>£4.5m + 2015 share bonus £5.6m</td>
</tr>
<tr>
<td>Peter Fankhauser</td>
<td>CEO 2015-2019</td>
<td>£8.4m + share bonus worth £4.1m but now worthless</td>
</tr>
</tbody>
</table>

Note: Mr Fontenla-Novoa started in Thomas Cook’s printing department in 1972, and led its £1bn 2007 merger with MyTravel, which brought the company to the public market. Some say also a false step but it gave Thomas Cook sufficient scale.

Now in comparison with some CEO payments (of example a lowered £75m for the outgoing CEO of Persimmon, the Thomas Cook payments were about average, if not a little low. That is not to say all of us support such high payments for a comparative fact. So clawing back any of this would be little more than a pinprick against the size and cost of the total failure.

Other repercussions
Andrea Leadsom, the business secretary (BEIS), has said that she would ask the Insolvency Service to “fast-track” its investigation into the circumstances surrounding Thomas Cook’s collapse into liquidation. Along with The Insolvency the Financial Reporting Council said it was reviewing (urgently) whether to join that probe. And it has announced there will be an investigation\textsuperscript{12}. Any FRC action would put the work of two Big Four audit firms, EY and PwC, under the spotlight once again\textsuperscript{13}.

The transport secretary, Grant Shapps, has suggested that Thomas Cook directors could have some of their bonuses seized or be disqualified from serving as directors after the tour operator’s implosion.

The rational for the regulators actions
Such moves won’t happen. But the FRC investigation is more serious especially the impact on the two Big Four who audited the group – EY and PwC. The Thomas Cook accounts are claimed to have reported historic exceptional charges that flattered profits, as well as its treatment of goodwill writedowns and under-reporting debts. The problem for EY is that in October signed off on the travel group’s 2018 accounts as a going concern, meaning it had judged that the business could survive another 12 months\textsuperscript{14}.

EY may also be criticised because in the half-yearly review of Thomas Cook’s interim results in May 2019, that there was a “material uncertainty related to going concern” linked to a new financing agreement. The company disclosed that month that it had agreed a new £300m lending facility\textsuperscript{15}.

Not only have the FRC now releases (as of October 2019) new godliness for the evaluation of going concern, but they are tightening up other regulations as well.

\textit{/Continued}

\textsuperscript{12} FRC, Investigation in connection with the financial statements of Thomas Cook Group plc, 1 October 2019. Available at: \url{https://www.frc.org.uk/news/october-2019/investigation-in-connection-with-the-financial-(1)}
Accessed October 2019.
\textsuperscript{13} Davies, R., and Topham, G., Thomas Cook directors could have bonuses seized, suggests Shapps, \textit{The Guardian}, 25 September 2019. Available at \url{https://www.theguardian.com/business/2019/sep/25/thomas-cook-directors-could-have-bonuses-seized-suggests-shapps}
\textsuperscript{14} McCormick, M., and Kinder, T., Accounting regulator launches probe into EY audit of Thomas Cook, Financial Times, 1 October 2019. Available at \url{https://www.ft.com/content/41fdd630-e412-11e9-9743-db5a370481bc}
Accessed October 2019.
\textsuperscript{15} Ibid.
The rational for the regulators actions/Continued

This quote provides some idea of the direction the regulators are going in (according Bob Moritz, global chairman of PwC)\(^\text{16}\):

“The expectation of the market [for an audit] is above the regulatory requirement,” said Bob Moritz, global chairman of PwC. “When big failures happen, it is not necessarily an audit failure. The controls might be appropriate, but the continuation of the business, its financial position and long-term sustainability can still be in question.”

The gap between what a company’s shareholders, employees and pensioners expect from an audit and the reality of an auditor’s legal responsibilities is a core part of the government review led by Sir Donald Brydon.

At a minimum, Thomas Cook is an example of what is the relevance of the audit opinion,” said Mr Moritz….

The Final Bill
The final bill for refunded bookings, repatriations and compensating hotels likely to be more than £750m\(^\text{17}\). There is a further sum of around £250m so far unmeasured and unaccounted for. This sum was paid by various people including customers to finalise their return home, to stay additional days where the government scheme was not sufficiently operational, and sometimes to release customers held as prisoners by hotels who were not going to be paid by Thomas Cook, and other similar items of expenditure.

You might add the sums of money lent by the German government to prop up the German part of the airlines business called Condor – at least an initial Euro 380m loan.

Thomas Cook probably owes upwards of £600m to hotels and other groups. Then Banks including Barclays, Morgan Stanley, UniCredit, Credit Suisse and Royal Bank of Scotland are facing writedowns of up to £2 -billion from the failure of Thomas Cook.

“The collapse of Thomas Cook has uncovered what appears to be a sorry tale of corporate greed, raising serious questions about the actions of Thomas Cook’s bosses and their stewardship of the business,” said Rachel Reeves, chair of the committee.

\(^\text{16}\) Kinder, T., Thomas Cook collapse will intensify UK audit debate, PwC says, Financial Times, 1 October 2019. Available at: https://www.ft.com/content/1e3aeabc-e34a-11e9-9743-db5a370481bc

\(^\text{17}\) This sum is our estimate and is higher than that so far quoted (around £600m plus plus).
Should the government have helped?

Krish’s view is that it should have. His reasoning is that the cost of going into liquidation is likely to be in the region of £1 billion plus the social welfare costs that comes for, unemployment. There may be the additional cost of the various reviews.

To Krish’s way of thinking, Germany did the least financially damaging event by saving Condor the airline subsidiary. It is profitable. What needed to happen was to takeover Thomas Cook, keep in place as much of management as possible and then undertake the following actions:

a) Repatriate all the customers from the holidays as normal.

b) Advertise the online package business has government approval and guarantees. This will prevent a complete collapse of the holiday business online.

c) Close the loss making retail outlets – keeping just a few regional centres if necessary.

d) Streamline and slim the online business and make ready for eventual sell-off. Close any streams that cannot maintain sustainable profits including the whole online business if necessary.

e) Split off the profitable hotels and close the unprofitable ones. Make the hotel division autonomous and the profitable hotels available for sell-off.

f) Split off the airline business – combine with Condor and create a separate autonomous business available for sell-off.

Of course, there will be a net loss but it may be significantly less than the current cost and there would be some business divisions that would survive and Condor airline would be invaluable in a post-Brexit world.

/Continued
Derivatives though small were not helpful

Just a note. Thomas Cook’s collapse shows perils of debt derivatives\textsuperscript{18} which shows a small amount of funds can hold up a much larger financial problem\textsuperscript{19}:

CDS are derivatives that behave like insurance contracts, protecting holders against the risk that a company does not repay its debts. But such is the complexity of the contracts, it was initially unclear whether the rescue plan Thomas Cook had been pursuing would trigger payouts on the swaps.

Last weekend’s insolvency filing removed all uncertainty: holders of $250m of CDS will be paid. But it seems that CDS experts’ earlier doubts were justified.

The panel of industry lawyers whose decisions govern the market made a bizarre ruling this week. They decided that the company’s filing for protection from creditors in the US, days before it tipped into full insolvency, would trigger payouts on older contracts but not on a newer set that was much more widely used. That is because of a one-word difference in a single clause.

The lack of clarity on whether the company’s proposed restructuring would trigger payouts on the CDS led a group of bondholders to threaten to block the deal. The fact that the situation unravelled so quickly means that nobody got to see that unseemly outcome: where hedge funds vetoed a rescue deal to ensure they got paid on their swaps.

But attempts to rescue Thomas Cook were also complicated by the fact that one key bondholder had the opposite trade on: it had sold the CDS.

The collapse of Thomas Cook shows reform is needed. The UK urgently needs a tax on disappointments. This is the only answer to public anger over the demise of a 178-year-old business that has left holidaymakers stranded. Chief executives who received pay typical to their station turned out to be a bit useless. They should be made to suffer.

Available at 
https://www.ft.com/content/d64bd980-e058-11e9-b112-9624ec9edc59

Available at 
https://www.ft.com/content/d64bd980-e058-11e9-b112-9624ec9edc59
Breaking news November 2019

The one sure event is that further revelations will now doubt be revealed as the various reviews report going forward. The FRC may handover to ARGA and may not report until 2020 or 2021 – though the future of ARGA is in doubt with the current government.

Criticism has been launched about Thomas Cook’s payments of fees worth tens of millions of pounds to more than 30 advisers in its dying days as it struggled to secure a rescue deal, with the vast payouts adding to an already severe cash burn at the collapsed travel group:

Thomas Cook was seeking to put together a £900m rescue deal by splitting its business between its largest shareholder, Fosun, and its lenders and bondholders. It collapsed in the early hours of September 23 after more than eight hours of talks to find an additional £200m needed to secure a deal fell apart. The company paid out more than £20m in fees to advisers during its restructuring negotiations despite most working on behalf of other parties involved in the talks, said a person close to the negotiations. The bill would have been much higher if these groups had been paid in full for their work in September.

The FT Lombard gave an opinion that the auditors comments were properly made and that the market understood what the auditors were saying:

But, arguably, an FRC probe should find the auditor did no wrong. A “going concern” is one that can survive another 12 months which, in November 2018, Thomas Cook quite possibly was (and nearly remained). Even then, EY flagged that debt levels were only sustainable if the company’s own tests were realistic, and scrutinised: “Covenants in the last two quarters of FY19 remain tight, but pass under management’s severe but plausible scenarios . . . We have increased the amount of audit partner involvement.” And EY warned that Thomas Cook could not go on disclosing costs as separate exceptionals: “We had strongly recommended to management that they strengthen the process over the identification and approval of separately disclosed items.” In fact, it was the auditor’s insistence on booking these in the p&l that led to £28m of charges and a profit warning.

Then, at its very next opportunity — the May 2019 half-year results — EY identified “material uncertainty” and cast “significant doubt on the company’s ability to continue as a going concern.”

/Continued

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20 Hancock, A., and Thomas, D., Thomas Cook handed over millions to 30 advisers in dying days, Financial Times. 4 October 2019. Available at https://www.ft.com/content/e6a27a4e-e6c7-11e9-9743-db5a370481bc Accessed October 2019.

Breaking news November 2019/Continued

However, taking just the last sentence is this quote, it ignores the totality of the meaning:

Material uncertainty related to going concern
We draw attention to note 1 (page 23) in the financial statements, which indicates that the outcome of the strategic review and the associated conditions in the new financing arrangement is uncertain. As stated in note 1, these events or conditions indicate that a material uncertainty exists. This may cast significant doubt on the company’s ability to continue as a going concern. Our conclusion is not modified in respect of this matter22.

But the pinnacle of their conclusion was:

Our conclusion is not modified in respect of this matter

and

Based on our review, nothing has come to our attention that causes us to believe that the condensed consolidated interim financial statements in…

Taken in context anyone reading this would believe that the auditors had given this a positive response. Of course, that is the fault of the audit process. There is the pass or a qualification which could cause many subsequent ripples.

Select Committee criticisms of PwC and EY

The committee chaired by the now famous Rachel Reeves yielded this report 23:

MPs criticised the auditors for repeatedly signing off the company’s accounts with a clean bill of health despite admitting they had raised significant risks to its financial stability with its board and had concerns over some of its accounting practices.

Rachel Reeves, who chairs the committee, said PwC should have more aggressively challenged management on its allocation of large exceptional items. She also said EY had displayed “no learning” on the appropriate accounting treatment of large amounts of goodwill from the failure of Thomas Cook.

Ms Reeves said the failure of the travel group showed legislation was needed to force a separation of the Big Four accountants, which also include Deloitte and KPMG.

“How many more company failures, how many more egregious examples of accounting do we need before your industry opens its eyes and recognises you’re complicit in this and that you need to reform?” Ms Reeves said.

PwC was also challenged by MPs over a conflict of interest for advising bosses on their pay and bonuses while it was the company’s auditor.

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22 See Thomas Cook TCG+H1+2019+Presentation+vFINAL.pdf
Where it is obvious there is no public inkling of near failure despite on-going survival talks.
Available at https://www.thomascookgroup.com/investors/insight_external_assets/TCG+H1+2019+Presentation+vFINAL.pdf

23 Kinder, T., PwC and EY accused of complicity in Thomas Cook collapse, Financial Times, 22 October 2019.
Available at: https://www.ft.com/content/3bba8a46-f4ce-11e9-b018-3ef8794b17c6
Accessed October 2019.
Breaking news November 2019/Continued
Select Committee criticisms of PwC and EY/Continued

The committee also had criticisms of Thomas Cook’s accounting practices:
Thomas Cook’s collapse has drawn attention to the way it reported historic one-off charges, as well as its treatment of goodwill and its heavy debts. Its accounts have been scrutinised for stripping out “exceptional items” totalling £1.8bn over eight years, which flattered its headline financial results.
Millions of pounds in bonuses paid to executives are also under the spotlight, as they were calculated in part from the underlying operating profit figure once exceptional items were removed.
Thomas Cook has also been questioned for taking more than a decade to write down £1.1bn of goodwill from the acquisition of MyTravel in 2007.

The committee went on to criticise PwC joint role and conflict of interest in PwC consulting and audit work for Thomas Cook:
Rachel Reeves, the Labour MP who chairs the business, enterprise and industrial strategy committee, said there had been “a clear conflict of interest” for PwC, which earned £4m over five years advising Thomas Cook while also acting as its auditor.
“Whilst we acknowledge that PwC eventually terminated their non-audit work for Thomas Cook, we are disappointed that this only came about as a reaction to a change in the law,” Ms Reeves said in a summary of the committee’s conclusions and recommendations published on Monday.
MPs on the committee also criticised auditors’ failure to challenge goodwill assumptions made by Thomas Cook’s directors, saying it would be “cause for grave concern” if goodwill were being treated in this way across the FTSE 350.
“It presents a picture of audit automatons that are incapable of drawing the most basic of conclusions from a balance sheet, questioning what they add to the corporate reporting process.”

However, before the EU audit directive, the combining of consulting work with audit work was widespread even if morally and ethically indefensible. The BHS case discussed in these references.

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Another note on the failure to protect investors

Another report calls for reform of audit and reporting sector that has not acknowledged complicity in 'string of failures\(^{26}\). This is repeated in full as it is so revealing:

Here is a modern financial mystery that involves the now-bankrupt travel group Thomas Cook. It involves dividends of nearly £100m, which were paid eight years ago despite the company lacking the apparent wherewithal to pay a cent.

Let’s set the scene. It’s 2011, four somewhat barren years after Thomas Cook merged with MyTravel, a rival operator, to create a giant travel group.

A sharp downturn in the business has left Thomas Cook nursing a net loss of £520m, which rules out the possibility of paying dividends from current earnings. What about the past surpluses it has made and stashed away for a rainy day? No dice there either. Because of that year’s losses, the company has impaired the value of its subsidiaries by a thumping £1.5bn.

That’s not only wiped out the £199m of retained profits on the parent company balance sheet that they need to pay an uncovered dividend; it has left Thomas Cook nursing a deficit of £1.3bn.

So how did the directors pay out dividends without raising all sorts of embarrassing questions? Easy: they just shuffled some accounting numbers.

First off, let’s take that pesky £1.5bn impairment. This may reflect a permanent diminution in the earnings capacity of those MyTravel assets, and hence a real loss to Thomas Cook’s investors who paid a premium over their net asset value to buy them.

But no matter. Because Thomas Cook forked out for MyTravel in its own stock, it can write off most of that loss not against its retained profits but a curious accounting artefact: the so-called “merger reserve”.

This is no more than the difference between the nominal value of the shares it issued to buy MyTravel in 2007 and the “fair value” it computed at the time for those assets it purchased. The merger reserve has no real value whatever. And the idea that it is some form of loss-absorbing capital is the opposite of prudent.

The second thing Thomas Cook does is even more mysterious. According to its accounts, the company lends almost £400m of cash to its subsidiaries, and receives a dividend from them of roughly similar value. This is treated as profit and added to Thomas Cook’s distributable reserves.

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Despite the apparent circularity, this is also entirely kosher — at least so long as any dividend payment made from them does not jeopardise the subsidiaries’ financial health. That is ultimately a judgment for the company, those subsidiaries and their auditors.

Now it is worth stepping back and looking at where all these manoeuvres lead us. So, despite the thumping losses, they mean that Thomas Cook’s distributable reserves in the parent company balance sheet do not drop from their 2010 level of £199m. In fact, they more than double to £447m. This gives the impression that the company’s solvency — and ability to pay a dividend — has actually improved.

And that’s after paying out those near £100m of dividends — a sum roughly equal in value to Thomas Cook’s entire equity market capitalisation at the end of 2011.

Now, neither of these intricate tactics appears to breach any accounting rules. But what each did in this case was to bathe the company’s finances in a misleadingly positive glow. And this raises a big question: which is whether, without all this accounting jiggery-pokery, Thomas Cook’s directors would have been forced to take action much earlier to shore up the group’s balance sheet, rather than pursuing what followed — namely a leisurely path to September’s collapse, during which time the shareholders received further dividends and the executive directors banked almost £1m a year in bonuses.

Of course, concerns about parent company balance sheet dependability go much wider than Thomas Cook. The UK accounting watchdog, the Financial Reporting Council, recently expressed concern at the tendency of listed companies to place values on subsidiaries that far exceed their total stock market capitalisation, and whether this meant they could be overstating their distributable reserves.

Take Barclays, for instance. Following a revaluation last year, the banking group increased the carrying value of its subsidiaries on the parent balance sheet from £39bn to £57bn. Yet the stock market values the whole group at just £29bn.

Parent balance sheets may seem obscure, and are often buried at the back of listed company accounts. But they matter. Distributable reserves are supposed to be the irreducible core of a company’s value — something owners and creditors can cling to. If the rules permit them to be inflated, that makes it more likely that companies will over-distribute — whether in dividends or bonuses paid out to bosses — and creditors’ interests will be impaired.

It is precisely to stop this abuse of limited liability that audit was made compulsory in the first place — in the 1900 Companies Act. Reflecting on Thomas Cook’s manoeuvres, one might ask whether these protections are working as they should.
Breaking news November 2019/Continued
Another note on the failure to protect investors/Continued

That comment is very revealing and raises some important questions and failures in the financial reporting and auditing system in the past and in today’s current set of regulations and environment.
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