Patisserie Valerie update – analysis in January 2019
Volume 2: Financial Failures & Scandals: From Enron to Carillion
By Krish Bhaskar and others
Online companions volume
Post Publication Comments: Patisserie Valerie case

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Patisserie Valerie breaking news November 2019

It is being reported that KPMG was paid for work on failed chain after quitting administrator role over a link with GT[1]:

> The Big Four accounting firm, whose insolvency partners earned £875 an hour for the work according to its latest disclosure to creditors, will cease to be administrator as it cannot pursue legal claims against Patisserie Valerie's auditor, which is expected to be the next stage in attempting to recoup money for creditors. It is unable to take action against Grant Thornton as it is its own auditor.
> The collapsed business will instead be taken over by restructuring firm FRP Advisory, which will put the company into liquidation.
> FRP was hired by creditors to replace KPMG in July, six months after the cake and coffee chain collapsed following the discovery of a £40m black hole in its accounts. A new administrator was required to pursue legal claims against Grant Thornton, which audited Patisserie Valerie, as KPMG was unable to consider such proceedings as Grant Thornton also vetted its accounts.
> The potential legal claim against Grant Thornton is believed to be the company's biggest asset in administration. FRP will also consider whether to launch legal action against Patisserie Valerie's former directors, officers and advisers.

This case continues to amaze….

[1] Kinder, T., KPMG nets £2.3m for Patisserie Valerie despite conflict of interest, *Financial Times*, 23 October 2019.
Available at:
https://www.ft.com/content/8a89282e-f1cc-11e9-ad1e-4367d8281195
Accessed October 2019.

Patisserie Valerie update – September 2019

Two recent events.

a) The high-profile company failures such as Carillion, and the later discovery of suspected fraud at Patisserie Valerie, have made auditors far less appealing to insurers, which now rate the sector as one of the least attractive for professional indemnity cover.
b) This soaring insurance bill is a setback for the smaller audit firms such as GT, BDO and Mazars in their battle to lure clients away from the Big Four. This was a major remedy advocated by the CMA to improve competition. We were against this proposal. See:
http://www.fin-rep.org/which-book/disruption-to-the-audit-market/
Mainly we think it will take too long in time and we are not sure of the benefit of the joint audit recommendation (price, quality and responsibility).

Matt Scaife is a partner at Causeway Capital which is the Irish turnaround fund that paid £5m up front (from a peak market value of £450m) to save much of Patisserie Valerie. However, press reports[2,3] indicate that the new owners found the business in a desperate state - including a cost-cutting approach so severe that managers stopped using butter in the cake chain's puff pastry. Matt Scaife was also reported as:

> "Things had been going wrong for a considerable time and as soon as we arrived the extent of the under-investment became increasingly apparent. There were ovens that had been broken for several months, and there was a leak in the bakery roof. Suppliers were often left unpaid, while new ones were sought. Overall, it was not a good culture," Scaife said.
>
> Scaife admitted that some of the corner-cutting reached extreme levels, including stripping butter out of key products.
>
> Patisserie Valerie, which at one stage was valued at £450m, plunged into administration in January after it was unable to secure new bank finance. The black hole in its finances that precipitated the crisis has turned out to be at least £94m.[4]
>
> …
>
> When asked about Scaife's claims, first made in an interview with the Sunday Telegraph, Johnson declined to comment further on the basis that a criminal investigation remains ongoing.

Patisserie Valerie update – September 2019/Continued

[2] Brignall, M., Cash-starved Patisserie Valerie 'stopped using butter in puff pastry', The Guardian, 16 June 2019. Available at:
https://www.theguardian.com/business/2019/jun/16/cash-starved-patisserie-valerie-stopped-using-butter-in-puff-pastry
Accessed June 2019

[3] Gill, O., Patisserie Valerie troubles laid bare: unpaid suppliers, broken ovens and butter removed from pastries, The Telegraph, 16 June 2019.
Available at:
https://www.telegraph.co.uk/business/2019/06/16/patisserie-valerie-troubles-laid-bare-unpaid-suppliers-broken/
Accessed June 2019

[4] Op. Cit Gill, *The Guardian*

> Six months on from the buyout the "new" Patisserie Valerie is looking much brighter, Scaife said on Sunday, with plans to replace the outlets' salmon and brown colour scheme and install a smaller menu. Scaife hosted a meeting of 140 key staff last week to thank them for their hard work in helping turn round the business[5].

What is not clear is:

a) Whether these cut-backs were part of the alleged fraud in trying to prevent the $40m black-hole and (we suspect) a large lack of profitability before the scandal surfaced.
b) Or whether it was post- the discovery the hole and the consequent firing of key executives, in order to shore up the lack of profitability.

Our guess is that the key personnel involved had to try to stem the losses, so the cut-backs (our guess [nothing more]) is that the cut-backs started before discovery and then continued and deepened post-discovery of the black-hole and lack of profitability.

Just as a last word by the famous Sunday Times columnist and private equity sponsor, Luke Johnson made some comments that were highly critical of the auditors (GT) in an article by the Times[6]:

> The former chairman of Patisserie Valerie has broken his silence over the collapse of the café chain to criticise the roles of Grant Thornton, its auditor, and the stock market. He said that the chain had appointed Grant Thornton "because having a top-six firm seemed to me a worthwhile investment — even if the fees were higher".
> "One of the most astonishing aspects of the entire episode is the way in which it seems such an eminent firm had the wool pulled very comprehensively over its eyes. They never raised any material issues about the quality of our accounts," he said.
> Mr Johnson, 57, also took issue with Aim, the London Stock Exchange's junior market, where Patisserie Valerie was listed. He said that the "holes in the management team" meant that getting to the bottom of the hole in the company's accounts was a "colossal problem". He said that its troubles were exacerbated by Aim "insisting on almost daily announcements of every painful aspect of the debacle".

Continued

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[5] Ibid.

[6] Ralph, A., and Kinder, T., Patisserie Valerie's boss criticises auditor over its collapse, *The Times*, 10 June 2019.
Available at:
https://www.thetimes.co.uk/article/caf-chain-s-boss-criticises-auditor-over-its-collapse-ns7sxhhs7
Accessed June 2019

Patisserie Valerie update – September 2019/Continued

And his own article in the Sunday Times[7]:

> On October 9 last year (2018), I went to work as usual and found myself walking into what felt like a nightmare parallel universe. That morning, Paul May, chief executive of Patisserie Holdings, the AIM-listed chain of cake shops where I was chairman and biggest shareholder, told me our bank accounts had been frozen. We'd thought we had £28.8m of cash in the bank. In fact, we had almost £10m of debt, with £9.7m drawn down on two secret overdrafts.
>
> It seemed inconceivable. How could the bank balances not be there? What had happened to the money?
> The conversation with Paul left me in a state of profound shock. In business, as in life, there are certain documents and facts you rely on. They might be audited accounts, bank balances, a passport or a qualification. If these are fake, you wonder what is real and what is not. It was apparent that matters had gone awry, and we had to try to fix them — but we were battling against the clock.
> ….
> The following morning we announced to the stock market that we had discovered what appeared to be a serious fraud, and our shares were suspended. Chris Marsh, the finance director, was also suspended. Two days later, he was arrested and by the end of October he had resigned. At our invitation, the Serious Fraud Office opened an investigation. We faced a crisis of frozen bank accounts, a winding-up petition, and huge arrears to creditors — all unearthed in 48 hours.

The rest of the article is a frank admission of mental and physical illness that stemmed from what he calls betrayal[8].

Continued

[7] Johnson, L., Luke Johnson on his very public disaster with Patisserie Valerie, The Sunday Times, 9/10 June 2019.
Available at:
https://www.thetimes.co.uk/article/luke-johnson-on-his-very-public-disaster-with-patisserie-valerie-9p5xbwph8
Accessed June 2019

[8] Ibid.

Patisserie Valerie update – analysis in May/June 2019

The original section on this is shown on page 13 of this document.

The FT in an opinion article had another criticism of the Big Four:[9]

> What's the biggest problem with the Big Four accountants Deloitte, EY, KPMG and PwC? Most critics would say it is that they are too cosy a club. But it is arguable that their real failing is a lack of club rules leading to a wholly inconsistent notion of club ethics. Nowhere is this more evident than in Deloitte's resignation as Ferrexpo's auditor and KPMG's selection as Patisserie Valerie's administrator. It is a tale of two accountants: one, possibly, with the best of motivations; another, seemingly, with the worst.

The piece went on to develop its critique of KPMG[10]:

> …. KPMG was called "shameless" for taking money as administrator to Patisserie Valerie in the face of a clear conflict of interest. Last month KPMG said it would not be "appropriate" for it to pursue legal claims against Pat Val auditor Grant Thornton — possibly the only way shareholders and creditors can get any money back — because KPMG employs Grant Thornton as its own auditor. However, KPMG sought and won the administrator role in January, months after it was known there might be a claim against Grant Thornton. And in spite of Pat Val directors and KPMG partners being aware of this — it was reported in many newspapers — KPMG was given the job and paid fees out of shareholders' and creditors' cash. A second fee-charging administrator must now be appointed to pursue Grant Thornton.
>
> Having been previously shamed over conflicts of interest — notably advising the Grenfell Tower inquiry despite past links to the council and contractors under scrutiny — KPMG appeared to decide it wanted the money more.
> KPMG's appointment came after it told Pat Val's directors a second administrator would be needed to pursue Grant Thornton, but the directors appointed KPMG anyway — and one of them was Luke Johnson, who is also an out-of-pocket shareholder and creditor. Also, when KPMG was appointed, it was not clear Grant Thornton had done anything wrong — and it still isn't. Even so, with the UK's competition watchdog calling for a break up of the Big Four, one might think that on matters of principle the Four would act as One.

Strong words indeed.

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[9] Vincent, M., 2019, Deloitte and KPMG show accountants club rules are inconsistent, Financial Times, 29 April 2019.
Available at:
https://www.ft.com/content/cc77d60e-6a63-11e9-80c7-60ee53e6681d
Accessed May 2019

[10] Ibid

Patisserie Valerie update Continued

At the end of this section is what we reported in the online companion volume to the book. Patisseries Valerie came close to collapse after a black hole of £40m had been discovered. Then the company was rescued by the chairman and a major shareholder Luke Johnson, who loaned £20m of his own cash. At the same time, shareholders backed a discounted share sale. The company’s financial director, Chris Marsh, was suspended and arrested by the SFO before being released. He subsequently left the company. See the next major section if you need a blow-by-blow account of what went wrong.

Our Opinion

The fifth largest accounting firm (GT is fifth just after the Big Four) missed or failed to spot thousands of entries in Patisserie Valerie’s ledger. Then there was the problem of hidden and secret overdrafts amounting to close to £10m. The Sunday Times reported insiders said that serious forgery had taken place[11]:

> Company insiders told The Sunday Times that "serious forgery" had taken place.

Indeed the same paper led this story by saying:

> The scandal-hit cake chain Patisserie Valerie could go bust tomorrow if emergency talks between leading shareholder Luke Johnson and its banks fail.

Of course it is ironic that Luke Johnson (ex Pizza express) and often categorised as a serial investor, wrote articles on running firms in the Sunday Times business section. That same edition wrote a critique of the principal shareholder (with a 37% stake)[12]:

> In an unpublished column for The Sunday Times in October, Luke Johnson observed that business partners fell out for many reasons. “It might be over strategy, or relative contributions, or whether to sell out,” he wrote.
>
> Had the serial investor and entrepreneur sent his column a few days later, he could have included alleged fraud, an arrest and one of the biggest scandals to rock the AIM market in years.

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[11] Meddings S., Last-ditch battle to save Patisserie Valerie, *Sunday Times*, 20 January 2019
Available at:
https://www.thetimes.co.uk/edition/business/luke-johnson-at-centre-of-last-ditch-battle-to-save-patisserie-valerie-gk7brj8c5
Accessed January 2019

[12] Meddings S., Start-up guru Luke Johnson left holding a crumbling Patisserie Valerie, *Sunday Times*, 20 January 2019
Available at:
https://www.thetimes.co.uk/article/start-up-guru-luke-johnson-left-holding-a-crumbling-patisserie-valerie-r9brrhg7n
Accessed January 2019

Patisserie Valerie update Continued

> The crisis at Patisserie Valerie, the cake-shop chain of which he is executive chairman and the largest investor, has left Johnson's reputation in tatters and prompted fresh questions over the quality of audits done by some of Britain's leading accountancy firms. Grant Thornton failed to spot thousands of false entries in Patisserie Valerie's ledgers.

Patisserie Valerie admits supplier payment issues amidst fraud investigation
Nick Perrin, the interim chief financial officer of Patisserie Valerie, is reported to have said: that there are many creditors with a large backlog of unpaid invoices[13]. The company discovered last October that its cash position had been heavily overstated amid significant "and possibly fraudulent" accounting irregularities[14].
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The personnel exodus
James Horler, a non-executive director, has stepped down from Patisserie Holdings[15]. Chief executive Paul May and Finance Director Chris Marsh have already stepped down. Then the Deputy Chairman, Lee Ginsberg, announced his resignation with immediate effect[16].

The financial scandal looks to worse than first thought
It almost beggars belief as to how the auditors (GT – a mid-tier firm or challenger[17] firm) could overlook what is reported as thousands of false entries in the ledgers, leading to a material misstatement of its accounts and very significant manipulation of the profit and loss account and balance sheet.

Continued

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[13] Skoulding, L., Patisserie Valerie admits supplier payment issues amidst fraud investigation, *Accountancy Age*, 11 January 2019.
Available at:
https://www.accountancyage.com/2019/01/11/patisserie-valerie-admits-supplier-payment-issues-amidst-fraud-investigation/
Accessed January 2019
[14] Ely, J., Patisserie Valerie acknowledges supplier payment problems, *Financial Times*, 10 January 2019,
Available at:
https://www.ft.com/content/091c35a6-14eb-11e9-a581-4ff78404524e
Accessed January 2019
[15] Irvine, J., Patisserie Valerie loses another director, *Economia*, 15 January 2019
Available at:
https://economia.icaew.com/news/january-2019/patisserie-valerie-loses-another-director
Accessed January 2019
[16] Ashworth, L., Patisserie Valerie exodus continues as deputy chairman steps down, City A.M., 17 January 2019.
Available at:
http://www.cityam.com/271772/patisserie-valerie-exodus-continues-deputy-chairman-steps
Accessed January 2019
[17] Coined by the CMA as a challenger to the Big Four.

What does this mean for accountants?

Accountancy Age commented[18]:

> Gavin Pearson, partner and ahead of forensic accounting at business advisory firm Quantuma said: "It is clear from the announcement that the "manipulation" of the Patisserie Valerie accounts was extremely extensive, given that even after forensic accountants have been investigating for around three months, the true position has still not been established.
>
> "In particular, the reference to "thousands of false entries" suggests a long, complex and well-disguised fraud. The fact that the cash flow and profitability is now likely to be below that announced on 12 October suggests that the position is likely to be worse than was anticipated when investors determined to inject new funds into the company following identification of the fraud.
>
> "It is also interesting to note that KPMG has been hired to carry out a "review of all options available", which may suggest that the extent of the fraud may continue to threaten the future viability of the company. This is likely to be of significant concern to stakeholders in the business, who it appears will need to wait some time to find out exactly what has occurred.
>
> "This update on the extent and impact of the fraud may also be of particular interest to those investigating Grant Thornton's historic role as auditor of Patisserie Valerie."
>
> Simon Bittlestone, CEO of Metapraxis, comments on the news that Patisserie Valerie has revealed it significantly manipulated its balance sheets: "This is categoric proof that Patisserie Valerie's management information was simply not good enough.
>
> "Its accounting system had become so complex that it hid any understanding of the underlying business performance. The fact is that if those not implicated in the scandal had effective management information that allowed them to cut through the noise, they would have spotted such colossal mistakes far earlier.

Continued

[18] Skoulding, L., Is Patisserie Valerie fraud worse than everyone originally thought? The popular cake chain says it's accounts were 'significantly manipulated' before its near-collapse last year, Accountancy Age, 18 January 2019.
Available at:
https://www.accountancyage.com/2019/01/18/is-patisserie-valerie-fraud-worse-than-everyone-originally-thought/
Accessed January 2019

What does this mean for accountants?/ontinued

As the FT commented[19]:

> Forensic accountants, believed to be PwC, have identified "thousands of false entries into the company's ledgers", parent company Patisserie Holdings said. Their analysis "revealed that the misstatement of its accounts was extensive".

And the Daily Telegraph reported[20] along the same lines:

> Patisserie Holdings said on Wednesday that its advisers had discovered that past misstatement of accounts was "extensive", and "involved thousands of false entries into the company's ledgers". The company warned that profitability would be less than had been predicted when the irregularities in its financial reporting were first discovered on October 10 last year. "It will take some time before a reliable trading outlook can be completed", it said in a statement. Patisserie Holdings has now appointed KPMG to assist "in carrying out a review of all options available to it in order to recover from the devastating effects of the fraud, and to preserve value for its stakeholders going forward".

And

> Patisserie Valerie lurched back towards the brink after hiring KPMG to prepare the business for "all options", including collapsing into an insolvency.

Shareholders concerns

Shareholders in the company are becoming increasingly concerned that Patisserie Valerie the might be sold cheaply or even put into administration after the warnings that its financial and accounting problems ran deeper than initially thought. It is reported[21] that Patisserie Holdings is in urgent talks with its lenders HSBC and Barclays to extend a financing agreement beyond its scheduled expiry date (18 January 2019).

Continued

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[19] Ely, J., Patisserie Valerie warns accounting scandal is worse than thought: 'Thousands of false entries in ledgers', says café chain, *Financial Times*, 16 January 2019.
Available at:
https://www.ft.com/content/f139e9ee-19a7-11e9-9e64-d150b3105d21
Accessed January 2019

[20] Gill, O., and Torrance, J., Patisserie Valerie hires KPMG to prepare for potential collapse, *Daily Telegraph*, 16 January 2019.
Available at:
https://www.telegraph.co.uk/business/2019/01/16/patisserie-valerie-hires-kpmg-prepare-potential-collapse/
Accessed January 2019

[21] Ely, J., Shareholder fears grow over future of Patisserie Valerie: Café chain in urgent talks with lenders to extend financing deal beyond Friday deadline, *Financial Times*, 17 January 2019.
Available at:
https://www.ft.com/content/bb4a0288-1a5b-11e9-9e64-d150b3105d21
Accessed January 2019

Shareholders concerns continued
The Guardian reported and commented[22]:

> Shareholders told the Guardian they were flummoxed as to how a simple cash-based business with less than £10m of debts when it raised £15m from shareholders before Christmas was still struggling to finalise a deal with its banks.
> Luke Johnson, the multimillionaire chairman of the business, was forced to put £20m of his own money into the firm to keep it afloat after the uncovering of potentially fraudulent accounting irregularities left it teetering on the brink. Johnson was paid back £10m after other shareholders later put up £15m in new funds.
> “Things must have got demonstrably worse. They are collecting cash every day and have very little in the way of inventory. [Stock] is going in and out as soon as possible,” one said. He suggested Johnson should be able to keep the business afloat by putting in more cash if necessary.
> Another shareholder expressed shock that a business which had been expected to make profits of close to £30m this year was now likely to make less than £6m. “The discrepancy from where we were to where we are now is massive for such a small company,” he said.
> Shareholders in Patisserie Valerie, which was valued at £450m before its profits “black hole” was uncovered, are braced for considerable losses. Shares were suspended in October and have yet to restart trading.
> The company’s finance director, Chris Marsh, was arrested by Hertfordshire police and bailed in October. He resigned in the same month.
> The Serious Fraud Office has confirmed that it has opened a criminal investigation into an individual but has not given further information.
> The Financial Reporting Council has said it is also investigating Marsh and the accountancy firm Grant Thornton for its role as auditor to Patisserie Valerie.

Continued

[22] Butler, S., Patisserie Valerie locked in talks over banking lifeline: A standstill of the chain’s banking facilities was set to expire on Friday night, *The Guardian*, 18 January 2019.
Available at:
https://www.theguardian.com/business/2019/jan/18/patisserie-valerie-locked-in-talks-over-banking-lifeline
Accessed January 2019

Luke Johnson made at least £20m on Patisserie Valerie over years Entrepreneur may not recover all of £13m loans advanced in wake of accounting scandal[23]

The FT reported:

> Luke Johnson has made at least £20m during the past 12 years from Patisserie Valerie, the bakery chain that went into administration on Tuesday with the loss of more than 900 jobs.
>
> Mr Johnson was executive chairman of Patisserie Holdings, the café chain's parent company and its single biggest shareholder. He owned 38.6m shares, worth £165m when trading in the stock was suspended in October after the discovery of accounting irregularities at the company. Those shares are likely to be worthless now, given that the company is in administration. On Wednesday, administrator KPMG confirmed the closure of 71 of the chain's stores.
>
> Mr Johnson may also not recover the entirety of the £13m of loans he made to the group in the aftermath of the crisis. But the entrepreneur had already extracted significant value since becoming involved in the business more than a decade ago.

Continued

[23] Eley, J., 2019, Luke Johnson made at least £20m from Patisserie Valerie: Entrepreneur may not recover all of £13m loans advanced in wake of accounting scandal, *Financial Times*, 23 January 2019.
Available at:
https://www.ft.com/content/a56ef226-1f14-11e9-b126-46fc3ad87c65
Accessed January 2019

Patisserie Valerie offers a bitter financial lesson: The collapse of the café chain shows the dangers of over-optimism[24]

This article proclaims:

> Luke Johnson, former chairman of the PizzaExpress chain and Channel Four, is one of the UK's most prominent venture capitalists and his stake in Patisserie Valerie was worth £190m at its height. The company, its auditor Grant Thornton, and its banks now face inquiries from regulators including the Financial Reporting Council into how the debacle occurred.
>
> The manner in which Patisserie Valerie grew its cake, expanding from eight stores in 2006 to more than 200 today, is under scrutiny. Mr Johnson was right about the value of entrepreneurship and how it is often undervalued, but his company's failure also shows that ambition and risk-taking need to be accompanied by strict financial and ethical controls.
>
> When Patisserie Valerie floated on Aim in 2014, it added two non-executive directors to back Mr Johnson and its chief executive and finance director, both of whom resigned following the discovery of the accounting fraud last October. Investors relied heavily on the judgment and expertise of the triumvirate at the top, who had overseen its expansion since 2006.
>
> They also depended on its auditor and banks to spot that it was flattering profits. According to last year's interim accounts, it was a reliable growth machine, with 99 per cent of new cafés profitable within a year of opening. Uncannily smooth and untroubled growth can be a sign of hidden trouble — Patisserie Valerie turned out to have a £40m gap in its finances.

The net result is that[25]:

> The company has been in crisis since October, when a £40m black hole in its finances was blamed on "potentially fraudulent" accounting irregularities. Earlier this week the company said it had been unable to renew its bank facilities as a "direct result of the significant fraud".
>
> In November it secured £15m in new cash from shareholders in a bid to keep trading.
>
> Johnson, who bought Patisserie Valerie in 2006, sold nearly £23m of shares when the company floated in 2014 and nearly £13m a year later and has also collected dividends and a £60,000 a year salary. There is no suggestion that the entrepreneur was involved in any fraudulent activity.

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[24] Editorial Board, Patisserie Valerie offers a bitter financial lesson: The collapse of the café chain shows the dangers of over-optimism, *Financial Times*, 23 January 2019.
Available at:
https://www.ft.com/content/6a8bacc0-1f0b-11e9-b126-46fc3ad87c65
Accessed January 2019

[25] Butler, S., and Wood, Z., 2019 Patisserie Valerie chair cashed out £40m from failed cafe chain: Original outlet in London's Soho among those closed at cost of 920 jobs, *The Guardian*, 23 January 2019.
Available at:
https://www.theguardian.com/business/2019/jan/23/patisserie-valerie-cafes-shut-old-compton-street-london
Accessed January 2019

Grant Thornton faced grilling over failures that led to Patisserie Valerie collapse

This is typical of the articles being written post collapse. For example[26]:

> Grant Thornton faces questions over whether it examined Patisserie Valerie's accounting journals, which could have provided clues about the suspected fraud that brought down the cake-shop chain.
>
> The auditor may have failed to look at journal entries, according to someone familiar with a report commissioned by Patisserie Valerie from the accountant PwC. The journals show the names, dates and amounts of transactions.
>
> Grant Thornton audited the company until the discovery of a £40m black hole in its accounts, caused by "significant, and potentially fraudulent, accounting irregularities", Patisserie Valerie said.
>
> The accusation against Grant Thornton comes after a report that the suspected fraud involved several finance staff and a supplier enlisted to provide fake invoices. According to the Financial Times, the PwC review contains details of how the staff discussed whether they should adjust fake ledgers to take account of roadworks outside shops.

Management pressure the real culprit?

Oliver Shah[27] think this might be the real underlying cause:

> The demise of the cake chain, after the discovery of a £40m hole in its finances last October, appears to be another story of underlings trying to make numbers match the aggressive targets set by their bosses.
>
> There are suggestions that executive chairman Luke Johnson, the serial entrepreneur and Sunday Times columnist, put immense pressure on the business to perform. As at Tesco, there were governance flaws in the board, which had just two non-executives. Yet Johnson has lost more than any other investor — about £170m. It is important that he sets out his side of the story.

Continued

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[26] Meddings, S., and Evans, P., 2019, Auditor Grant Thornton faces grilling over failures that led to Patisserie Valerie collapse, *The Times*, 27 January 2019.
Available at:
https://www.thetimes.co.uk/article/auditor-grant-thornton-faces-grilling-over-failures-that-led-to-patisserie-valerie-collapse-rbcw75x7l
Accessed January 2019

[27] Shah, O., 2019, Oliver Shah: *Sunday Times*, 27 January 2019.
Available at:
https://www.thetimes.co.uk/article/oliver-shah-a-toxic-culture-was-the-real-villain-at-tesco-xqslr22mg
Accessed January 2019

Patisserie Valerie auditor says 'not his role to uncover fraud'

This article starts a dispute as to what is the nature of auditing which continues below by Sir Donald Brydon who is reviewing the whole area of auditing[28].

> David Dunckley, chief executive of Grant Thornton, which was replaced by RSM as the chain’s auditor in mid-January, told MPs on the business, energy and industrial strategy committee that there was an “expectation gap” that “needs to be fixed”.
> “We’re not looking for fraud, we’re not looking at the future, we’re not giving a statement that the accounts are correct,” he said, adding that his firm audits 7,000 companies. “We are saying [the accounts are] reasonable, we are looking in the past and we are not set up to look for fraud.”
> In a heated exchange with Rachel Reeves, the Labour MP and committee chair, Dunckley reiterated: “If people are colluding and there is a sophisticated fraud that may not be caught by normal audit procedures.”
> He said in an ideal world it would be spotted. Reeves replied: “But in a shop that sells tea and cakes, you’d sort of think that might be spotted. It’s not a multinational complex organisation.”

This is in marked contrast to the normal interpretation that if there are material misstatements, an auditor cannot say the accounts are fair, reasonable and balanced.

Continued

[28] Kollewe, J., and Butler, S., 2019, Ex-Patisserie Valerie auditor says 'not his role to uncover fraud': Head of Grant Thornton tussles with select committee over collapse of cafe and cake chain, The Guardian, 30 January 2019.
Available at:
https://www.theguardian.com/business/2019/jan/30/ex-patisserie-valerie-auditor-says-not-his-role-to-uncover
Accessed February 2019

Update on the Brydon audit review with disagreements over GT's statements about fraud and auditors (Feb)

According to the FT[29], the extent to which auditors should be expected to detect fraud will form a crucial part of a government commissioned review of the audit market that is being led by London Stock Exchange (and Sage Group) chair Sir Donald Brydon. This contrasts with the FT's reports of what GT said:

> Sir Donald highlighted a heated House of Commons committee session last week — where Grant Thornton chief executive David Dunckley raised eyebrows after telling MPs that an audit "is not designed to look for fraud" — as a clear indication that this issue requires clarification.
>
> He said: "The evidence was very interesting because it showed the need for greater clarity...There is no doubt that if there is material fraud, that does fall inside the auditor's scope otherwise they can't say the accounts are fair, reasonable and balanced. There is an issue there.

This is also in sharp contrast to the other statements made by Dunckley (GT CEO):

> Mr Dunckley told MPs at last week's hearing: "We are not doing what the market thinks. We are not looking for fraud and we are not looking at the future and we are not giving a statement that the accounts are correct. We are saying they are reasonable, we are looking at the past, and we are not set up to look for fraud."

However, Scott Knight of BDO disagreed:

> Knight said: "You look for material frauds. If they are sizeable and material then I think you do have to look for them. In a large organisation there will be petty frauds and that is not something an audit is designed to wheedle out. But if they are material to the financial statements and of relevance to the shareholders, then you should be expected to find them."

Continued

[29] Marriage, M., 2019, UK audit review will focus on fraud, *Financial Times*, 4 February 2019. Available at:
https://www.ft.com/content/7814183a-28a9-11e9-a5ab-ff8ef2b976c7
Accessed February 2019

The aftermath – closing stores and a possible bid for the residual stores (Feb)

The stores to close have now been identified by the administrators, KPMG. This article explains[30]:

> Administrators of Patisserie Holdings have named the 71 outlets that will close following the firm's collapse.
> KPMG said that 902 jobs will go due to the closure of 27 Patisserie Valerie stores, 19 Druckers and 25 Patisserie Valerie concessions. However, KPMG said it is "business as usual" at the remaining 122 outlets.
> The administrator said it was "pleased" with the level of interest it had received from potential buyers of the surviving parts of the business.

However, despite the black hole, and the now recognised losses rather than profits. Profitability may have been false. The profits being boosted by fake invoices. There is some suggestion that fake Groupon vouchers were also used to inflate sales. They recorded sales in the café’s ledgers when a sale may not have been made at all, according to sources familiar with a report by accounting firm PwC.

That said there seems to be several suitors in the wings trying to takeover the residual stores[31]:

> Over 70 Patisserie Valerie shops around the country have already closed due to the collapse, meaning 920 people have lost their jobs.
> Seeing as 120 Patisserie Valerie shops are remaining open for now, there are potential buyers sniffing around left, right, and centre.

We will update your when more if known.

The next section is the original coverage. Update ends here.

Continued

[30] BBC, 2019, Patisserie Valerie reveals stores to close, *BBC*, 23 January 2019
Available at:
https://www.bbc.co.uk/news/business-46970600
Accessed January 2019

[31] Skoulding, L., Patisserie Valerie receiving multiple bids despite being shrouded in fraud, Accountancy Age, 5 February 2019.
Available at:
https://www.accountancyage.com/2019/02/05/patisserie-valerie-receiving-multiple-bids-despite-being-shrouded-in-fraud/
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Patisserie Valerie – The original coverage

This is an AIM listed company with the charismatic chairman Like Johnson, a 37% shareholder, who write weekly ion the Sunday Time bestowing financial advice. It emerged yesterday that the board, with forensic accountants from PwC, had found that overdrafts of £10 million were run up on two secret facilities with Barclays and HSBC. The company revealed on Friday that, far from having the £28.8 million of cash declared in May 2018, it had net debt of £9.8 million, a deficit of £38.6 million. Accountancy Age[32] reported:

> Trouble started for the cake seller when two "secret" overdrafts with banks HSBC and Barclays were discovered. Almost £10m had already been spent through them.
> The Serious Fraud Office has now opened an investigation into the accounting error and the Financial Reporting Council (FRC) has also promised an investigation.
> Grant Thornton, who audit Patisserie Valerie's accounts, are also facing serious questioning. It has been reported that the cafe chain could take legal action against Grant Thornton.

The company employed around 3,000 people. See Table 1 and that £39m hole is significant for the Balance Sheet. With total assets of close to 100%, that hole represents close to 40% of the balance sheet vale. It has 206 stores with a further 20 slated to open in 2018.

Luke Johnson tok Patisserie Valerie into an expansion ptah cahsign in on the casual dining experience. Which is worth around £9 billion in the UK. Define as the market where people spend between £10 to £20 per head, this segment of the market has grown fast.

Continued

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[32] Skoulding, L., 2018, "Was lack of visibility to blame for Patisserie Valerie fraud? With nearly 3,000 jobs at stake, Accountancy Age speaks to Mario Spanicciati, chief strategy officer at BlackLine about what was to blame for the fraud's success", *Accountancy Age*, 19 October 2018.
Available at:
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Accessed October 2018.

Table 1 Financials of Patisserie Valerie

Comprehensive Income in £m			
		2017	**2016**
Revenue		**£114.2**	**£104.1**
Gross profit		£89.3	£81.3
Operating profit		£20.1	£17.2
Profit before tax		£20.2	£17.2
Net profit		**£16.4**	**£13.7**
Balance Sheet in £m			
		2017	**2016**
Assets		**£98.9**	**£85.3**
Non-current assets		£57.4	£54.4
	Intangibles	£17.7	£17.9
	Property, plant and equipment	£39.7	£36.5
Current assets		£41.5	£31.0
	Receivables	£12.2	£11.0
	Tax	£1.7	£1.9
	Inventories	£6.0	£4.9
	Cash and near-cash	£21.5	£13.3
Liabilities		**£98.9**	**£85.3**
Equity		£92.3	£78.2
	Share capital	£1.0	£1.0
	Share premium	£34.1	£33.7
	Other reserves	£0.7	£0.4
	Retained earnings	£56.5	£43.1
Non-current liabilities	Deferred tax	£1.4	£2.1
Current liabilities	Payables	£5.2	£5.1

Patisserie Valerie – The original coverage/Continued

On 10 October 2018, the company announced the discovery of “significant, and possibly fraudulent” accounting irregularities and a winding-up petition from tax authorities, the board of Patisserie Holdings said it had reached the conclusion there was a “material shortfall” between its reported financial position and the actual state of the business. “Without an immediate injection of capital, the directors are of the view that there is no scope for the business to continue trading in its current form,” the company said in the early afternoon[33].

Some salient points

- Patisserie Valerie was a stock-market darling worth £450m[34].
- Finance director Chris Marsh had been arrested and bailed[35].
- Luke Johnson agreed to lend £10m for three years to owners Patisserie Holdings plc, which the company said would provide "immediate liquidity". He has also provided a further bridging loan facility of up to £10m[36].
- The firm said raised another £15m by issuing new shares at large discount. This allowed the company to repay of some of the money lent as an emergency by Luke Johnson, the Chairman.
- This emergency raising of the money from the market has created some problems:

  The Telegraph[37]. reported:

  Patisserie Valerie’s management snubbed a £30m deal that would have protected small investors, it has been revealed, as furious shareholders rounded on the company last night. Investment fund Crystal Amber was plotting a convertible debt deal to rescue the firm which would have meant investors would not have seen their stakes diluted by the emergency fund raise that offered up new shares at a huge discount.

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[33] See: Pooley, C., R., and Eley, J., 2018, “Patisserie Valerie on the brink amid cash shortfall”, *Financial Times*, 11 October 2018.
Available at:
https://www.ft.com/content/ac0cf454-cd50-11e8-9fe5-24ad351828ab
Accessed October 2018.

[34] Wood, Z., 2018, “It survived a Nazi air raid, but now Patisserie Valerie is in a deep hole: Brexiter Luke Johnson is forced to bail out the Soho cafe he turned into a national chain after it suffers financial catastrophe”, *The Guardian*, 13 October 2018.Available at:
https://www.theguardian.com/uk-news/2018/oct/13/patisserie-valerie-financial-catastrophe-luke-johnson
Accessed October 2018.

[35] Buck, K., 2018, “Patisserie Valerie finance boss arrested on suspicion of fraud”, *Metro,* 12 October 2018.
Available at:
https://metro.co.uk/2018/10/12/patisserie-valerie-finance-boss-arrested-on-suspicion-of-fraud-8033687/
Accessed October 2018.

[36] Eley, J., 2018, “Patisserie Valerie secures lifeline from chairman”, *Financial Times*, 12 October 2018.
Available at:
https://www.ft.com/content/3ab490d8-cdf4-11e8-b276-b9069bde0956Accessed October 2018.
Accessed October 2018.

[37] Rees, T., and Torramce, J., 2018, “£30m rescue deal ignored by Patisserie Valerie bosses”,
Daily Telegraph, 13 October 2018.
Available at:
https://www.telegraph.co.uk/business/2018/10/13/30m-rescue-deal-ignored-patisserie-valerie-bosses/
Accessed October 2018.

Patisserie Valerie – The original coverage/Continued

The FRC, FCA and SFO are all likely to take an interest and run their own investigations. But as time marches on, new revelations seem to mire the company into further issues.

This is Money[38] commented:

> With the company's shares hitting new peaks in February as investors' confidence in the numbers ballooned, chief executive Paul May, finance director Chris Marsh and a non-executive director James Horler, whose job it was to keep an eye on the management, cashed in a swathe of shares worth almost £5.9 million.

FRC

One worrying concern was that The Times found that the FRC approved the quality of GT's audit of the company without spotting the "potentially fraudulent accounting irregularities" which were then discovered later[39]. That said the Kingman report on the FRC[40] has already recommended the replacement of the FRC with a new body and with new enacted powers with a much broader coverage and deep reach.

Continued

[38] Craven, N., 2018, "After Patisserie Valerie bosses sell £13m shares months before scandal, why didn't ANYONE in charge see their cakes were sinking?
Available at:
https://www.thisismoney.co.uk/money/markets/article-6298703/Why-didnt-charge-Patisserie-Valerie-sinking.html
Accessed October 2018.

[39] Fino, J., 2019, FRC saw Patisserie audit before fraud detected: The Financial Reporting Council (FRC) monitored the audit of Patisserie Valerie six months before the cake chain discovered a £40m black hole in its accounts, *Economia*, 14 January 2019.
Available at:
https://economia.icaew.com/news/january-2019/frc-saw-patisserie-audit-before-fraud-detected
Accessed January 2019.

[40] Kingman Report: Independent Review of the Financial Reporting Council, December 2018
Available at:
https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/767387/frc-independent-review-final-report.pdf

Other Patisserie Valerie issues

The FT reported that Paul May (CEO) and Chris Marsh (the Finance Director now on bail) appeared to have sold their bonus shares twice[41]. Subsequently it has been claimed that these bonus share awards were not disclosed to the shareholders. The FT reported[42]:

> Troubled UK café chain Patisserie Valerie on Wednesday revealed it had awarded millions of pounds of share bonuses to its two top executives without notifying shareholders. Half of the undisclosed awards were exercised by Paul May, chief executive, and Chris Marsh, finance director, just three months before the fast-growing group suspended its shares after uncovering "significant, and potentially fraudulent" accounting irregularities. The two made £1.7m in profits on the sale of those options, exercised on July 20.

Events such as these do not add credibility to the Board. And now there are more unanswered questions. Included in these is what knowledge Luke Johnson had of such manoeuvres – despite his statements that he knew nothing of the scandals.

There is also some criticism over their investigation itself. This, so it is claimed, should not be handled by Luke Johnson, but handed over to an independent law firm or some other body[43].

Some have criticised Luke Johnson the Chairman from for spreading himself too thinly, contributing to his ignorance of the black hole that precipitated the arrest of Chris Marsh, the chief financial officer, and the launch of an investigation into his activities by the Serious Fraud Office[44].

No doubt there will be adverse comment. An example of which is from Catering Today[45]:

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[41] Vincent, M., 2018, "Patisserie Valerie share options — so good they sold them twice? Chief and CFO had second helpings of shares despite no explanation from chain", *Financial Times*, 22 October 2018.
Available at:
https://www.ft.com/content/3ee81e82-d5f5-11e8-ab8e-6be0dcf18713
Accessed October 2018.

[42] Cocco, F., 2018,"Patisserie Valerie admits to undisclosed share awards: Company cannot explain why shareholders not notified of grants to CEO and CFO", *Financial Times*, 24 October 2018.
Available at:
https://www.ft.com/content/074ad1d6-d771-11e8-ab8e-6be0dcf18713
Accessed October 2018.

[43] Kinder, T., 2018, "Pressure on Patisserie Valerie over inquiry into 'fraud': Investors demand independent firm takes over", *The Times*, 23 October 2018.
Available at:
https://www.thetimes.co.uk/article/pressure-on-patisserie-valerie-over-inquiry-into-fraud-dl787hqmc
Accessed October 2018.

[44] Walsh, D., 2018, "Patisserie could sue auditor Grant Thornton over £40m hole", *The Times*,
Available at:
https://www.thetimes.co.uk/article/cafe-chain-could-sue-auditor-over-40m-hole-87hmvcmlj
Accessed October 2018.

[45] Ennals, E., 2018, "Forget Luke Johnson: the biggest loser in the Patisserie Valerie fallout is the brand itself: How will the bakery chain restore its reputation?", Catering Today, 23 October 2018.
Available at:
https://www.cateringtoday.co.uk/comment/analysis/forget-luke-johnson-the-biggest-loser-in-the-patisserie-valerie-fallout-is-the-brand-itself/
Accessed October 2018.

Other Patisserie Valerie issues Continued

> The cake shop has a monumental hole to climb out of and, with shareholders now threatening legal action against the chain, the crisis looks set to worsen in the coming weeks. Any damage to the reputation of the brand is going to be all the more painful given the current state of the casual-dining market: Patisserie Valerie must now fight hard to keep its head above water.

and

> To an extent, the media focus on Luke Johnson has taken the heat off Patisserie Valerie – but for how long? After all, it wasn't Johnson himself who created the financial arrears, nor did he take out the 'secret overdrafts', which have left them with a £20m, blackhole. The blame here lies squarely with the Patisserie Valerie finance team, who remain oddly silent.

All in all we suspect that Patisserie Valerie will survive and prosper. The negative PR effect will dwindle. Luke Johnson may pay more attention to the company. This will just be another scandal because it is relatively small in relation to Carillion, Steinhoff or GE, noone is going to remember this greatly. But proportionately it is more significant. And this is not the only AIM scandal.