Annual Reports: Fact or Fiction? Are there governance implications?

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Two recent high-profile announcements of companies going into administration (Palmer & Harvey) and liquidation (Carillion) raise questions about the robustness of statements made in annual reports including the quality and objectivity of audit reporting, and the implications of this on Corporate Governance practice. This discussion coincides with the Financial Reporting Council 'Proposed Revisions to the UK Corporate Governance Code', December 2017.

This paper considers some of the behavioural factors which influence performance and, most likely, performance reporting. It also considers some of the potentially fraudulent activity by firms, and the quality and nature of audit reporting in Annual Reports. Contexts of this paper are Agency Theory and Merger and Acquisition (M&A) activity. The next step in this research will be to increase the sample size and explore the scale of the issues being considered, and then develop recommendations for both corporate reporting narratives in Annual Reports, and the adoption of forensic accounting techniques in audit reporting.

INTRODUCTION

In their last Annual Report Carillion explained their vision 'to be the trusted partner for providing services, delivering infrastructure and creating places that bring lasting benefits to our customers and the communities in which we live and work'. They present their values as: 'We care, We achieve together, We improve, We deliver'. The Chairman stated in his Outlook (2016 Annual Report) 'we have a good platform from which to develop the business in 2017'. They went into liquidation in January 2018 with almost £1 billion of debt, a pension deficit of over £500m, and questions around directors' bonuses and pay. Their auditors were KPMG who stated that 'We have nothing to report on the disclosures of principal risks, and 'We have nothing to report in respect of the matters on which we are required to report by exception'. No problems here!

Palmer & Harvey was the UK's largest delivered wholesaler of grocery products. Their Chairman, in their 2015/16 Annual Report, stated that 'the business now has a clear plan to deliver improvement to the financial results'; 'we have taken important steps to drive forward our strategic objectives'; 'we successfully completed a bank refinancing at the start of the year'. They went into administration in November 2017 with the loss of over 2,500 jobs, an escalating pension deficit, and directors taking dividends despite the firm being heavily indebted. There was virtually no indication in the Company's last published accounts of the likely consequences of the continuing deterioration in the Company's performance on its stakeholders. Their auditors were KPMG, who stated that 'the information given in the strategic report and the Directors' report for the financial period for which the financial statements are prepared is consistent with the financial statements'. No problems here!

AGENCY THEORY

The majority of research in the field of corporate governance is based on the assumption of agency theory. There have been frequent calls to develop behavioural analyses of board behaviour (Pye, 2014). Agency Theory is concerned with the potential for parties to a transaction to have conflicting interests and goals, thereby resulting in actions which produce an outcome which is positive for one party but not the other. Asymmetry in the information available to the different stakeholders tends to exacerbate the potential for conflict of interest.

Jensen and Meckling (1976) claimed that agency problems are widespread in organizations. Eisenhardt (1989) explained that one of the problems in agency relationships is that the principal and the agent may prefer different actions because of the different risk preferences.

The separation of ownership from control of corporations has made the financial statement the primary mechanism for shareholders to monitor the performance of directors. Audit serves a vital economic purpose in this regard within the financial reporting process. It plays a crucial role in reinforcing trust and confidence in the agency relationship that exists between the principal and the agent (shareholders and directors respectively) (ICAEW, 2005).

The line of reasoning of agency theory is from the economic models that argue that people are only motivated by self-interest and self-preservation (McGregor , 1960). In order words, the underlying agency theory is a set of behavioural assumptions about the agent. The assumptions hold that all agents are unconstrained self-interest maximisers who do not act in the best interest of the principal (Albrecht, Albrecht, & Albrecht , 2004).

The conflict of interest in an agency relationship usually occurs because of information asymmetry (Jensen & Meckling, 1976). 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).

In theory, the best mechanism that can be used to align the interests of agents with that of principals, and to allow the principal to measure and control the behaviour of their agent and reinforce trust, is external audit (Awolowo, Garrow, Clark, & Chan, 2018). Audit should serve as a fundamental mechanism in promoting confidence and reinforcing trust between the principal and the agent (ICAEW, 2005).

Our observation is that other mechanisms such as share options, good remuneration, and pension packages have proven not to be an effective mechanism for aligning the interest of directors with that of shareholders (Garrow & Awolowo, 2018). Our argument is that even in the presence of these mechanisms, the board still commits financial statement frauds, and/or produces misleading information for shareholders. Behavioural factors are suggested as a cause of this, but these factors are typically not addressed in Annual Reports. Hence, there is a need to enhance audit quality in order to reduce accounting scandals and prevent incomplete information or misinformation ('fake news') being circulated in annual reports.

What this suggests is that going forward, in order to be able to reduce accounting scandals, corporate collapses and audit failures, there is a need for more effective external audits, and for directors and auditors to be more accountable for the clarity and correctness of Annual Reports and to be subject to punitive measures in the event that they fail these assessments.

However, the presently constituted audits cannot guarantee the prevention and detection of fraudulent or misleading reporting; neither can it provide early warning signs that a company's going concern in under treat. We propose a forensic accounting approach to financial statement audit. Similarly, there appears to be no mechanism to ensure no 'sugar coating' in Annual Reports.

We view forensic accounting as a high level validation of financial information through an array of skills and knowledge from but not limited to accounting, auditing, information system, economics, finance, psychology, criminology, fraud investigation and an understanding of legal framework which can be used in actual or potential civil or criminal proceedings.

Joshi (2006) emphasizing the relevance of forensic accounting in fraud prevention and detection observed that "auditors should be watchdogs and not be the bloodhounds". This quote alone is enough in making the forensic accounting definition even simpler and helps differentiate a forensic accountant from other accountants and auditors. A forensic accountant is a bloodhound of bookkeeping (Crumbley, 2009).

These bloodhounds sniff out fraud and criminal transactions in banks, corporate entities or from any other organization's financial records. They hound for the conclusive evidence. External auditors are known to find out the deliberate misstatement only, but the forensic accountants find out misstatements deliberately. External auditors look at the numbers but forensic accountants look beyond the numbers (Joshi, 2006). These are some of the attributes that makes forensic accounting skills relevant in the fight against financial deception.

Our argument is that what external audit represents within the agency relationship is an assurance function to the principal that the entity is a going concern and to the agent it is an investigative role that the company's financials or maths book are free from errors, frauds and misrepresentations (Garrow & Awolowo, 2018).

This is because audit is established to be a vital economic and accountability tool. It plays an important role in serving the public interest by strengthening and reinforcing trust and confidence in the financial reporting process and corporate governance (ICAEW, 2005).

As such, the use of a forensic accounting approach and skills might increase the chances of fraud prevention and detection and also has the capacity to provide early warning signs needed to salvage a company's going concern.

Behavioural Factors

Mergers and Acquisitions (M&A) have played an important part in the journey of both Carillion and Palmer & Harvey. A search of the M&A literature provides some insights on the behavioural characteristics such as hubris, of acquiring firm leaders (Roll, 1986; Gregory, 1997; Sharma & Ho, 2002; Chatterjee & Hambrick, 2007), characteristics which one might assume carry over into other decision making, not just in M&A. Measuring hubris is difficult. Sirower (1997) claimed it is not possible to test whether the hubris hypothesis – or the hypothesis that managers simply pursue their own objectives – is the true explanation of M&A performance, consistent with Agency Theory. Tichy (2001) noted that theories around management self-interest cannot easily be checked for their concordance with the driving motive of acquisitions such as Roll's (1986) Hubris Theory.

Leadership style and behaviour is recognized as being an important contributor to firm performance (Bass & Avolio, 1990; Kets de Vries, 1993), especially in situations where significant decisions, such as an acquisition, are being made (Chatterjee & Hambrick, 2007). Some doubt exists as to whether it is hubris which influences CEO behaviour, with its avoidance of managerial irrationality (Sirower, 1997; Bruner, 2004).

Hubris is just one possible contributor to failed acquisitions; alternative explanations are narcissism and hubris syndrome (Higgs, 2009; Campbell, Goodie, & Foster, 2004). This paper proposes that hubris as an explanation of behaviour can be extended to other significant managerial decisions (not just M&A) such as capital projects, restructuring, and portfolio changes. Narcissism has been explored within the context of leadership by Higgs (2009), Kets de Vries (1993) and Chatterjee and Hambrick (2007).

Narcissism[1] is defined as emotional self-investment. When normal, it leads to self-regard and mature aspirations. When pathological, it is accompanied by inordinate demands upon oneself, excessive dependence upon acclaim from others and deteriorated capacity for interpersonal relations.

The measures of narcissistic tendencies adopted by Chatterjee and Hambrick (2007) included an examination of the incidence of CEO photographs in annual reports, CEO prominence in company reports. They concluded that CEO narcissism is positively related to 'strategic grandiosity', as indicated by the number and size of acquisitions, and that these results supported the view that narcissism is a personality dimension rather than a pathological category. This means that narcissists are very confident about their abilities in task domains, to the point of being objectively overconfident, rating themselves very highly on competence and leadership (Chatterjee & Hambrick, 2007).

Misleading Annual Report

Many companies have experienced financial distress since the global financial crisis in 2008, with serious adverse consequences for a range of stakeholders, most notably employees, pensioners and creditors. A high profile example of this is Carillion in the UK, potentially a good case study of financial distress and the failure in reporting to shareholders to highlight the drivers of performance.

Carillion went from a construction management company with 2016 sales of £ 4.4 billion and an early 2017 market capitalization of £1 billion to liquidation and no equity value by January 15, 2018. Comments and analysis by management and the auditor in the 2016 annual report issued March 1, 2017 did not foreshadow the fall of the company less than a year later. In that annual report the chairman wrote "Given the size and quality of our order book in the pipeline of contract opportunities, our customer-focused culture and integrated business model, we have a good platform from which to develop the business in 2017" (Carillion, 2017).

The chief executive's strategic overview focused on winning high-quality contracts, high-level deliverance on the contracts, and developing and retaining excellent employees. The auditor's report opined that the financial statements contained in the report gave a full and fair view of Carillion's affairs. The adequacy of disclosure related to the recognition of contract revenue using the state of completion basis and the large carrying value of goodwill at £ 1,571m was considered and apparently did not alter the full and fair view opinion. No mention was made in the body of these reports of circumstances that might give context to the reader for the disintegration of the company in under one year.

An analysis of Carillion's 2016 annual report using widely applied accounting ratios and empirically validated metrics provides a basis for concern with the company's position at the end of 2016. Profitability ratios were weak. Net operating profit margin was 3.2%. Return on assets was only 4.1%. The interest coverage ratio was 3.42, indicating little leeway in meeting interest expenses.

The firm's days accounts payable outstanding of 171 days suggested that suppliers were being paid very slowly. The Altman Z score (Altman, 1968) came in at 1.32 where a score below 1.81 indicates a significant risk of bankruptcy. The Beneish model for detecting accounting manipulation (Beneish M. , 1999) stood at -2.10 where values greater than -2.22 are taken as raising the possibility of manipulation. Even in companies with no finding of manipulation such scores on this measure are linked with poor subsequent returns (Beneish, Lee, & Nichols, 2012). Thus, problematic trends found in an analysis of the accounts are not reflected in the discussions by management or the auditor.

Corporate Governance and Agency Problems

It is required of a board of directors to adopt corporate governance practices which in part meet the challenge of agent-principal conflict. The Audit Committee, for example, focuses on issues relevant to the integrity of the company's financial reporting.

In regard to Palmer & Harvey uncertainty existed 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 asked 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? Frank Field's question to Trustees 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, as we challenge Board processes at a time of corporate collapses.

'Now is the right time to undertake a comprehensive review that the Code remains fit for purpose and continue to promote improvement in the quality of governance. The findings of our Culture Report demonstrated the importance of aligning company purpose, strategy and values in order to achieve long-term success. Successful companies should be open and accountable to their workforce' (Financial Reporting Council, 2017). As such, there is a need for improvement in annual reports and accounts of companies.

CONCLUSION

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. Nevertheless measuring behavioural factors is not easy, let alone commenting on them objectively in an 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 cases of Carillion, and Palmer & Harvey.

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